

# **MICROFINANCE IN ETHIOPIA**

## **Elixir or Poison?**

A thesis submitted by

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# List of Acronyms

ACSI	Amhara Credit and Savings Institution, Share Company
ADB	Asian Development bank
ADLI	Agricultural Development-Led Industrialization Strategy
AEMFI	Association of Ethiopian Microfinance Institutions
ANRS-	Amhara National Regional State
BancoSol	Banko Solidario
BKK	Bank Rakyat Indonesia
CAMEL	Capital, Asset quality, Management, Earnings, Liquidity and Social Impact
CBB	Construction and Business Bank of Ethiopia
CBE	Commercial Bank of Ethiopia
CBO(s)	Community Based Organization(s)
CGAP	Consultative Group for the Poorest
CSA	Central Statistical Authority, Ethiopia
DBE	Development Bank of Ethiopia
DECSI	Dedebit Credit and Savings Institution, Share Company
DFC(s)	Development Finance Company (ies)
DFI(s)	Development Finance Institution(s)
DOI	Depth of Outreach Index
ETB	Ethiopian Birr (Ethiopian currency ETB1 is about USD 0.115)
EU	European Union
FDRE	Federal Democratic Republic of Ethiopia
FeMSEDA	Federal Micro and Small Enterprise Development Agency
GB	Grameen Bank (Bangladesh)
GBCS	Green Bell Consultancy Service
GMFSC	Gasha Microfinance Share Company
GTZ	Gesellschaft fuer Technische Zusammenarbeit (German Technical Cooperation)
IFAD	International Fund for Agricultural Development
IFPRI	International Food Policy Research Institute
IPRSP	Interim Poverty Reduction Strategy Paper (Government of Ethiopia)

MEDAC	Ministry of Economic Development and Cooperation (Ethiopia)
MFI(s)	Microfinance Institution(s)
MIS	Management Information Systems
MoFED	Ministry of Finance and Economic Development, Ethiopia
MOTI	Ministry of Trade and Industry, Ethiopia
NBE	National Bank of Ethiopia
NGO	Non-Governmental-Organizations
OCSSCO	Oromia Credit and Savings Institution, Share Company
OMFI	Omo Microfinance Institution, Share Company
ONRS	Oromia National Regional State
PEACE	Poverty Eradication & Community Empowerment Microfinance Institution, Share Company
ReMSEDA	Regional Micro and Small Enterprise Development Agency
ROSCAs	Rotating Savings and Credit Associations
RUFIP	Rural Financial Intermediation Programme
SDPRP	Sustainable Development and Poverty Reduction Programme (Ethiopia)
SDI	Subsidy Dependence Index
SFPI	Specialized Financial and Promotional Institution, Share Company
SMFI	Sidama Microfinance Institution, Share Company
TNRS	Tigray National Regional State
WMFI	Wisdom Microfinance Institution, Share Company

# Abstract

This study examines microfinance in Ethiopia. The introductory chapter formulates the issues to be examined and the research questions. The second chapter reviews the relevant literature and presents the theoretical framework. On that basis, the methodology used to collect and analyse data is presented. The third chapter introduces the background of the study (country situation) to provide a brief overview of Ethiopia's macroeconomic condition and financial sector development as relevant to microfinance in the country.

Chapter 4 introduces the general profile of the selected microfinance institutions with respect to formation, source of capital, policy for financial service provision, products, operational locations in the country and, to some extent, internal organization. Chapters 5 to 7 are the main chapters, presenting the findings of the empirical research. Chapter 5 analyses the financial performance of the institutions studied. The chapter shows progress made by the microfinance institutions (MFIs) towards self-sufficiency, comparing them based on operational and financial self-sufficiency. A more rigorous analysis of financial performance is done using the subsidy dependence index. An in-depth analysis of one of the MFIs follows, regarding the relationship between volume parameters and output parameters including some variables related to infrastructure. Some 170 retail outlets (sub-branches) of ACSI, one of the two largest MFIs in the country, are analysed for this purpose.

Chapter 6 examines the outreach of microfinance in both scale and depth, together with the profile of clients and non-clients by exploring features of the client population. Institutional sustainability is discussed in chapter 7. The chapter analyses the ownership, the governance structure and the impact of the regulatory framework on ownership and governance, including aspects of the regulatory framework that have implications for the sustainable operation of the MFIs. The final chapter presents the major findings of the research and draws some conclusions.



# Samenvatting

Het eerste hoofdstuk beschrijft het onderwerp van deze studie en de onderzoeksvragen en in het tweede hoofdstuk volgt een overzicht van de relevante literatuur, het theoretisch kader en de in het onderzoek gebruikte methoden en technieken. Het derde hoofdstuk schetst de achtergrond van het onderzoek en geeft een beknopt overzicht van de macro-economische toestand in Ethiopië en van de ontwikkeling van de financiële sector voor zover die relevant is voor de verstrekking van microkredieten in het land.

Het vierde hoofdstuk beschrijft de onderzochte organisaties die microkredieten verstrekken (Microfinance Institutions of MFI's). Daarbij komen de volgende aspecten aan de orde: de oprichting, waar het kapitaal vandaan komt, het beleid voor financiële dienstverlening, de producten, de gebieden waar deze organisaties actief zijn en tot op zekere hoogte hun interne organisatie.

De onderzoeksresultaten worden gepresenteerd in hoofdstuk vijf, zes en zeven. Hoofdstuk vijf bevat een analyse van de financiële prestaties van de bestudeerde organisaties. Om te laten zien in hoeverre deze verstrekkers van microkredieten (MFI's) vooruitgang hebben geboekt op de weg naar onafhankelijkheid, worden ze vergeleken op basis van hun operationele en financiële onafhankelijkheid. Voor een nauwkeurigere analyse van de financiële prestaties is een subsidie-afhankelijkheidsindex gebruikt. Verder is er bij een van de MFI's een gedetailleerd onderzoek gedaan naar het verband tussen omvang en resultaten, waarbij onder meer gekeken werd naar factoren die met de infrastructuur te maken hebben. Hiervoor zijn honderdzeventig filialen van ACSI (Amhara Credit and Saving Institution) geanalyseerd. Dit is een van de twee grootste MFI's van het land.

In hoofdstuk zes wordt de reikwijdte van de verstrekking van microkredieten geanalyseerd, zowel in kwantitatief als in kwalitatief opzicht. Daarbij wordt gekeken naar enkele kenmerken van de cliëntenpopulatie. De institutionele duurzaamheid wordt besproken in hoofdstuk zeven. Daarin worden de eigendoms- en bestuursstructuur en de invloed van regelgeving op het eigendom en het bestuur geanalyseerd. Daarbij komen ook de aspecten van regelgeving die van invloed zijn

op het duurzaam functioneren van MFI's aan de orde. Het laatste hoofdstuk geeft een overzicht van de belangrijkste onderzoeksresultaten en bevat de conclusies van het onderzoek.

# 1

## Introduction

### 1.1 Microfinance and international development

Microfinance has evolved as an approach to economic development intended to benefit low-income women and men. It expanded enormously in the 1990s (Ledgerwood, 1999). Policymakers, donors, practitioners and academics underline the role of microfinance as a powerful tool for poverty alleviation and economic development. Few economic agendas are as popular these days as microfinance, rural finance and microcredit. A wide body of literature has been produced on the subject through the World Bank-based Consultative Group to Assist the Poor (CGAP), a consortium of international donors and other agencies like the Women's World Banking (WWB), ACCION International and academic institutions on microfinance theory and practice.

In academics too microfinance has moved to the centre of development research. Research results have brought about a revolution in microfinance practice, which now is gaining popularity worldwide (Robinson, 2001). Research has also led to formulation of theoretical frameworks and connection of microfinance practice to the theory of various academic disciplines, particularly finance and economics. Beyond research, many universities in both the developed and developing countries have adopted microfinance subjects in their curricula and introduced specialization in the area at the graduate level (Moll, 2005). The first wave of publications that emerged from Ohio State University-based research (Adams et al., 1984) exposed the failure of subsidized and targeted rural credit programmes. At the same time, the success of experimental programmes, such as the Grameen Bank, in introducing innovative approaches stimulated further research in the field.

Microfinance as a poverty alleviation tool and development pathway, as it is perceived by many, especially in developing countries, is associated with gender issues as well. In this regard it is seen as having potential and, more often, as a panacea for the empowerment of women. This has contributed to promote microfinance not only within the domain of economics but also in the fields of anthropology and gender studies.

Since the fall of subsidized targeted credit, microfinance is said to have undergone a revolution (Robinson, 2001), with the financial systems approach and institutional microfinance introduced to render wider financial services instead of only supplying credit. Institutionalization of microfinance has also advanced the frontier of research on the subject. These days, microfinance is not only a matter of providing loans to the poor, but also of building a viable institutional framework that will cater to the needs of the poor, today as well as tomorrow (Schreiner, 1997). Thus, issues of organization, corporate governance and financial regulation have become matters of concern. In this respect, theories of institutional economics and regulatory economics are as important as finance and development theory. Organizational issues require reference to the management literature.

In the millennium development goal campaign, microfinance is being promoted as a main strategy. Littlefield et al. (2003) put in perspective the benefits of microfinance beyond supporting businesses that benefit the poor to encompass investments in health, education and alleviation of household emergencies. They claim that microfinance is unique among development interventions in that it can deliver social benefits on a permanent basis on a large scale. The Microcredit Summit campaigns aim to reach billions of poor households through credit (after nearly meeting the previous target of reaching 100 million poor by 2005). Many developing countries' governments have embraced microfinance due to its perceived development potential; and microfinance is also high on the UN agenda as a development intervention strategy for achievement of the millennium development goals.

Not surprisingly, the future of microfinance is a subject of debate among academics, since current practice contributes to determine microfinance's future course. The debate on whether to subsidize microfinance is not only about helping the poor now (Schreiner, 2002), but also about ensuring the future of microfinance as a long-term develop-

ment intervention. Few microfinance institutions have difficulties expanding their business as far as demand is concerned, but they commonly face shortages of funds, that is, permanent access to equity and loans to fund their portfolio. International donors and governments and even regional development banks have other priorities to fulfil. The Microcredit Summit (2005), among others, complained that the world's leading development financier, the World Bank, has avoided funding microfinance. According to the Summit, less than 1% of the Bank's total loan portfolio went into microfinance funding and increased to only less than 2% recently after many appeals. It is generally believed that the future of microfinance depends on access to funds to meet the poor's ever-increasing demand for loans.

Recently global commercial banks have developed a keen interest in microfinance. Major European banks are moving into wholesale lending to microfinance. These banks see not necessarily immediate profit but aim to "push forward the financial frontier" now, for there are billions of clients of tomorrow. If the involvement of global banks is supported by technology and skill transfer to gain efficiency in service provision, reduce transaction costs in rendering services and enable expansion of outreach, it is believed that many will come out of poverty and be integrated into the financial market. It is also perhaps to be called the "third revolution", fulfilling the dream of many sustainability camp writers who claim "[Of] donors and governments, both notably prone to fads[,]...only the private sector has plenty of resources and will stick with moneymaking activity even if it is not in fashion" (Rhyne, 1998: 8).

## 1.2 Microfinance institutions in Ethiopia

In Ethiopia microfinance services were introduced after the demise of the Derg<sup>1</sup> regime following the policy of economic liberalization. Microfinance is taken as a shift from government- and NGO-subsidized credit programmes to financial services run by specialized financial institutions. With this shift some NGO and government microcredit programmes were transformed to microfinance institutions. A regulatory framework was put in place to license and supervise the institutions (Proclamation No. 40/1996) under the country's central bank. The regulatory framework was put in place as part of government's effort to liberalize the

financial sector and lay down an alternative institutional framework to provide financial services mainly to the rural poor to boost agricultural production, enable food self-sufficiency and reduce rural poverty. Most importantly experts observing the unsound financial practices of NGOs and government agencies recommended the regulatory framework to promote more systematic financial service provision and bring microfinance in the country within the existing financial system.

Currently 22 licensed microfinance institutions (MFIs) are operating in Ethiopia. All are registered as share companies to comply with the requirements of the proclamation which transformed them from NGO credit programmes into microfinance institutions. These institutions, on one hand, face several challenges related to their products, resources, organizational structure, governance, and lack of proper information systems to guide management decision making and external challenges as a result of the unregulated credit system of the past. They struggle to become viable institutions that provide appropriate financial services as demanded by clients. The demand for financial services in the country is also high (IFAD, 2001) and the prospect to meet the demand largely depends on the success and sustainability of these institutions. There is a general consensus that governmental agencies and regional governments should relinquish their role in supplying credit for farmers to the MFIs (IPRSP, 2000). It is, therefore, imperative to design and operate microfinance services that serve the poor in a sustainable manner, which requires the building of viable institutions.

The problem of MFIs in Ethiopia is how to build sustainable institutions to meet the financial needs of the poor. Different methods are employed by researchers and donor communities (especially within the framework of the CGAP) to evaluate sustainability of MFIs. Most of the methods or approaches used however concentrate on what interest rate charged by MFIs would generate sufficient revenue to cover costs. The current study takes this discussion a step further to examine the relationship between the volume of operations and financial sustainability as the basis for achieving wider outreach.

### 1.3 Statement of the problem

Studies indicate that 5.5 million Ethiopian households with an annual credit demand of about ETB 4.4 billion (USD 514.8 million) needed microfinance credit services by 2001 (GBCS, 2000). By 2005 this demand was expected to reach 6.2 million people, who needed about ETB 4.9 billion (USD 602.4 million) in loans (GBCS, 2000). Chao-Beroff et al. (2000) calculated outreach of the MFIs by the end of the year 2000 was about 9% of the demand, or about one-quarter of a million client households, while in monetary terms only 6.3% of the credit demand was satisfied. Regional distribution varied from none in the Afar, Benishangul-Gumuz, Gambella and Somali regions to as high as 72% of needy households reached in Tigray National Regional State (TNRs). A study sponsored by IFAD and the World Bank (IFAD, 2001) reports similar results, that is, the current supply is less than 10% of potential credit demand. Given the current institutional and financial capacity, this demand will likely remain unmet unless MFIs' capacity is vigorously raised.

Further outreach, however, seems challenged by a number of problems, as those involved in the operations and studies have expressed several concerns about the MFIs. Shortage of resources, organizational problems and overall governance issues are blamed as hindrances to further development (GBCS, 2000; Tassew, 2001; Getaneh, 2000). Other problems mentioned are institutional viability, lack of operational flexibility, and problems of reaching the needy poor (limited outreach capacity) and also lack of promotional activities to create awareness (Tassew, 2001; Getaneh, 2001). Non-development of management information systems (MIS) to implement strict financial control, absence of loan portfolio tracking systems to enhance risk management and inability to generate timely reports to inform the decision makers are also among weaknesses mentioned (IFAD, 2001).

There are also clear challenges to the MFIs in their potential market. Beyond the high level of poverty, which may affect the repayment capacity of potential clients, financial products that MFIs provide have suffered damages in the past due to unregulated interventions by government and NGO programmes (GBCS, 2000). Financial interventions by line ministries and NGOs were not based on solid norms and standards. Loan repayments were not strictly enforced; NGOs especially were reluctant to collect loans

(Worku, 2000). The long history of drought that resulted in the free supply of relief food and at times other assets in kind or cash also distorted people's expectations and attitude towards credit repayment (Tassew, 2001).

Despite all these potential problems and challenges, studies suggest that, in light of the general underdevelopment of the financial sector (downgrading of commercial banks for instance), the sector is unable to create alternative institutional arrangements to reach the poor and the large number of population that need financial services. Hence strengthening microfinance services should be part of the development strategy in Ethiopia (Addison and Alemayehu, 2002). The Ethiopian government's Interim Poverty Reduction Strategy Paper (IPRSP, 2000) and other policy documents in the medium term place microfinance institutions in position to assume the responsibilities currently undertaken by the regional governments to supply loans for the purchase of agricultural inputs to rural farmers. However, while Addison and Alemayehu refer to the need to expand financial services to the poor through microfinance, the implication is to use microfinance institutions as instruments or intermediaries to implement government development policies. Moreover, policy documents (MOI, 1994a; MOI, 1994b) refer exclusively to rural finance, while microfinance is broader in scope, including financial services for the poor. In the literature, the poor are not only rural residents who need credit for agricultural inputs, but cover a diverse group of vulnerable people, both rural and urban, with complex livelihoods who have no access to traditional banking services.

Despite the fact that microfinance is recommended, still most MFIs in Ethiopia are donor funded or government subsidized institutions. Donor funds and government subsidies, however, are not expected to continue indefinitely. Government strategy papers (e.g. the IPRSP and SDPRP; FDRE, 2002) indicate that MFIs should run their business according to commercial principles.

Thus, the problem in Ethiopia is how to build viable and vibrant microfinance institutions with sustainable programmes and outreach, given the conditions mentioned. These institutions must contribute towards the poverty alleviation and economic development efforts of the country. Most MFIs have not yet attained the operational and financial self-sufficiency to continue their operations as viable institutions. Several factors could contribute to problems in gaining financial sustainability.

Some local studies have partly blamed lack of sustainability on the low interest rates charged by the MFIs (Gebeyehu, 2001). This could be partly true. But charging market (cost-based) interest rates is only one factor towards sustainability, and the evidence indicates factors other than interest rates to explain the limited progress towards sustainability. Cost-based interest rates can be misleading; because if costs are unreasonably high, interest will be pushed up to cover it, forcing the MFIs to fail in their very objective. In Ethiopia, there are no market-determined interest rates, as competition among microfinance operators is not yet in place and in fact the country has no as such competitive financial market. Data on the performance of MFIs in the country show that those that report better levels of coverage of both operating costs and financing expenses are not necessarily the ones that charge high interest rates.

While the problem of sustainability (operational and financial self-sufficiency) could be attributed to the overall institutional design and arrangements, sufficiency of interest and fees income to cover costs, overall service delivery mechanisms, diversity and efficiency of services provided and transaction costs incurred in all phases of the operation finally affect profitability. Thus, factors that influence the transaction costs need be carefully considered. The small size of individual loans, underdeveloped infrastructure, and low population density (in rural areas) contribute to raise the cost of lending in Ethiopia. Many of the costs are fixed, as MFIs need to build capacity to execute their programmes and attain their stated objective. The very essence of having institutional intermediation is based on the belief of the institutional economist that an institution is better placed to gather market information, using its institutional structure and resources to detect potential clients and markets on a mass scale to reduce transaction costs of contracts, which make it cheaper than individual dealings. Therefore, coverage of costs requires a minimum level of volume of operations. Thus, in order to be sustainable the programme must operate at a level where all costs of lending can be covered from the revenues generated from the operation.

The problem is, therefore, what volume of operation should be attained at all levels, starting from the smallest unit of operation to the level of the institution as a whole, to cover the costs of lending? This research will thus focus on the viability of the MFIs in Ethiopia with the emphasis on volume of operation.

## 1.4 Objectives of the study

The main objective of this study is to assess the sustainability of microfinance institutions with a focus on cost and performance of financial services in relation to volume (scale) of operation.

The specific objectives of the study are four:

1. assessing operational and financial sustainability of MFIs and volume of operation in relation to major performance parameters;
2. analysing the scale and depth of the programme outreach of MFIs so far and their relations with clients;
3. evaluating institutional viability of MFIs, with respect to ownership, governance structure, institutional design and resources, and management of financial information systems;
4. assessing the impact of the regulatory and other financial policies of the government on the MFIs.

## 1.5 Institutional sustainability: Position in the literature

Microfinance institutions are the main vehicles through which financial services reach the needy poor. Efficient and sustainable institutions build client confidence, increase positive impacts on clients' lives, and justify donor and development aid investments (Krahnert and Schmidt, 1994). On the contrary, unsustainable institutions may foster an unhealthy attitude towards the programme since clients may lose trust and default (*ibid.*). Sustainable institutions enable continuity of service with wider outreach to many poor, which is the main objective of microfinance services (Rhyne, 1998). Study of institutional sustainability is in a way the measurement of the impact of the microfinance programme on the clients, since direct measurement of impact among clients is fraught with methodological problems (Yaron and Pepriker, 1997). It is in this spirit that the current study calculates operational and financial self-sufficiency of the MFIs and other profitability indicators, such as return on assets, return on equity and other profitability ratios, to evaluate institutional achievement. Yaron (1992) developed a sustainability dependence index (SDI) to measure the extent to which an institution depends on financial subsidies to cover its operational and financial costs of lending, including the implicit cost of capital. The

SDI then is used to guide the interest rate to be charged by an institution to free itself from subsidy. The SDI shows the way ahead to reach sustainability by indicating the extent to which interest and fees should be raised to cover the costs incurred at the current level of operations. It can be calculated for any organization, small or large. Thus it assumes the cost structure and the level of operation as given. It is calculated on the basis of historical costs and accounting profit or loss adjusted for inflation and cost of funds. It does not take into account the possibility of changing the volume of operations and its effect on the cost per unit of product or service.

Low population density in rural areas, underdeveloped infrastructure, and low earnings due to the small size of loans and limited financial services per client raise the cost of financial service provision. It is thus important to approach the analysis and evaluation of the MFIs from the perspective of what cost and volume of services justifies the operation. Some authors note the importance of the cost of lending and transaction costs, both to the borrower and the lender, and the ability to manage costs in order to attain a level of self-sufficiency (Cuevas and Graham, 1984; Ladman, 1984). Charging an on-lending interest rate that covers the cost of operations and funds has been taken as a leading recommendation for sustainability in much of the literature. Thus, the procedures used by the CGAP to analyse sustainability of microfinance concentrate on what interest rate should be charged by the institutions, given the costs of financial services, in order to break even (Hulme and Mosley, 1996; Khandker, 1998) and by what percentage the interest rate has to be raised in order for the MFIs to be free from subsidy (Yaron, 1992, 1994). Some writers warn about the efficiency of operations when using the results of the SDI model (Schreiner, 1997). But this model and the breakeven interest rate formula (Hulme and Mosley, 1996) explicitly express cost elements as independent and the interest rate as a dependent variable. At a point, it must be recognized that there is a limit to the amount that interest rates can be raised. We should also note that MFIs face competition and cannot raise their interest rates beyond those charged by other institutions in the market.

Efficiency and cost aspects should both be considered to improve the cost per unit of financial services provided at the retail end, to enable institutions to charge an affordable but yet sustainable price. Cuevas and Graham (1984) in their study of two banks that provide agricultural credit in Honduras showed how the organizational structure, source of funding and

approaches in offering financial services affect the cost structure and the cost per unit of financial service provided. Their analysis, above all, indicated that the bank that incurred a higher fixed cost for screening and loan collection at branch and operating unit levels ultimately had the lowest average cost per loan unit and lower loan losses. Careful and intensive screening enabled the bank to increase volume of operations while maintaining high client quality to ensure repayment. The screening also included choice of the area of operations and justifications for opening branches and operating units on the basis of the expected volume of business.

Navajas, Conning and Gonzalez-Vega (2002) emphasized the role of economies of scale in ability to cover fixed costs in their analysis of competition among MFIs in Bolivia. They stressed that MFIs have high fixed costs that require a certain minimum scale of operation and that financial intermediaries should attempt to minimize the average cost per loan unit through maintaining a certain loan size and volume. In this respect, it should be noted that increasing the individual loan size might have limitations since emphasis on larger loan size may lead to the exclusion of small borrowers. Increase in the overall loan volume, also implying an expansion of outreach, could result in lower cost per loan unit as well.

A different approach is followed by Moll (1989; 1994). He uses the expanded cost of lending formula that helps us to calculate the average cost of financial services per period at different levels of operation and the feasible interest rate at different levels. The formula helps the institutions to find the level of operation that would minimize the cost per loan unit within a relevant range of fixed cost and also the minimum level that should be attained to cover costs. This approach helps MFIs to plan operations in a sustainable manner instead of trying to adjust the interest rate to cover costs, which will no longer be sustainable beyond some points. This aspect is missing in most of the literature, especially in the evaluation techniques adopted so far.

Our effort here is to fill this gap by showing the importance of the volume of loans and overall financial services in providing the services in most economical way to reach financial self-sufficiency. The importance of this approach is also evident in cost management and evaluation of institutional viability since it considers administrative and financial costs. The scale or volume of levels of operations is also related to the choice of the

most appropriate and innovative methodology, simple but enforceable loan contracts and services tailored to the needs of the client.

Discussion of volume have practical relevance to Ethiopia and developing countries like Ethiopia since this approach calls for efficient utilization of existing material and human resources (capacity). It similarly encourages expansion of outreach and charging of reasonable interest rates on loans within the capacity of the borrower which also contribute to increase demand for financial services.

In addition the results can contribute to information on and evaluation of funding agencies in the NGO sector, international development organizations and the government to identify areas of practical intervention in building capacity and regulation of the MFIs. Potential investors, private for-profit and social investors as well, may benefit from applying the results of the research.

## 1.6 Research questions

This study focuses on the supply side of microfinance and thus our units of analysis are the institutions that supply financial services. The research questions therefore concern the internal strength of the institutions in terms of financial and operational self-sufficiency and impact within the framework in which the MFIs operate. The study questions centre on institutional sustainability, financial and operational sustainability, and evaluation of financial performance in relation to the volume of financial services provided, and also explore outreach of and client relations to the MFIs. Finally, the issue of institutional arrangements is addressed by referring to both the organizational and the legal framework within which the MFIs operate. Research questions are formulated in three areas:

### 1. Scale and sustainability

- Are the institutions operationally and financially self-sufficient, or are they progressing towards self-sufficiency to ensure sustainable financial services?
- To what extent do the institutions rely on subsidies and concessional loans from the government and donor organizations, and to what extent do they attempt to mobilize local resources through savings, equity investment by private persons and commercial borrowing?

- To what extent does the volume of operations influence the performance parameters of the MFIs (particularly at the branch and sub-branch level) to gain financial self sufficiency?
2. Outreach and client relations
- What proportion of people eligible for a loan or financial services is reached, and what is the overall profile (the characteristics or type) of clients reached?
  - What is the profile of potential clients not reached by the MFIs within their operational vicinity, and what factors contribute to their inclusion or exclusion?
  - What is the client response in terms of repayment and the demand for subsequent loans, and how do clients perceive the service in general?
3. Institutional viability
- What is the impact of the current regulatory framework and other government policies in enhancing or inhibiting the success of the MFI programmes?
  - To what extent do the current ownership and governance structures affect the efficiency and effectiveness of the institutions in their effort to gain sustainability?
  - Do the existing management information systems, accounting and internal control systems including internal policies and procedures of the institutions enable them generate the information necessary to guide decisions in their overall operations, including their relations to clients and the regulatory body?
  - Do the institutions have the required level of human and material resources to enable them to efficiently and effectively manage their activities, and are there well-designed programmes to upgrade and develop these resources so as to accommodate future growth?

## 1.7 Hypotheses

The hypotheses are based on the research questions and objectives.

1. The volume/scale of operations attained has significant impact on the ability of the institution to cover its costs and attain financial sustainability.
2. The current governance and ownership structure of the MFIs has influenced the freedom of the institutions in their formulation of business programmes, decisions on operational network (opening of branches and choice of client site) and decisions on interest rates.
3. Management information systems (MIS) are not currently fully applied to enable MFIs to manage portfolios and generate the necessary financial and operational reports.

## 1.8 Structure of the study

The second chapter of the study presents a review of the literature and describes the research methodology, on which the study's theoretical framework is based. This serves as the foundation for the data collection and analyses methodology. The third chapter introduces the background of the study (country situation), giving a brief overview of Ethiopia's macro-economic conditions and financial sector development, particularly with relevance to microfinance in the country. The fourth chapter introduces the general profile of the selected MFIs with respect to their formation, source of capital, policy for financial services, products, operational locations in the country and to some extent internal organization. Chapters 5 to 8 are the main empirical chapters. Chapter 5 deals with the analysis of financial performance of the institutions studied. The chapter shows progress made by the MFIs towards self-sufficiency, comparing them on the basis of operational and financial self-sufficiency. A more rigorous analysis of financial performance is shown with a subsidy dependence index, while in-depth analysis of one of the MFIs is conducted based on the relationship between volume parameters and output parameters including some variables related to infrastructure. Some 170 retail outlets (sub-branches) of ACSI, one of the two largest MFIs in the country, are analysed for this purpose.

Chapter 6 analyses the outreach of microfinance in terms of both scale and depth, together with the profile of clients and non-clients, by exploring some features of the client population. Institutional sustainability is discussed in chapter 7. The chapter analyses the ownership, governance structure and impact of the regulatory framework on ownership and the resulting impact on governance including aspects of the regulatory framework that have implications for the sustainable operation of the MFIs. The final chapter discusses the major findings of the research and its conclusions.

## Notes

<sup>1</sup> The term *Derg* is an equivalent to a committee in Amharic language referring to group of junior military officers that took over political power in 1974 as a committee/ *Derg*/ for the coordination of the ground, air, naval and the police forces which was later renamed Provisional Military Administrative Council (PMAC), but remained popularly known as the *Derg*.

## 2

# Theoretical Framework and Methodology

This chapter reviews the literature. The first section presents a general overview of microfinance services, their origin and historical development. The second section deals with debate between two camps, the welfarists and the institutionists, on the role of and approaches to microfinance. The third section deals with financial sustainability, outreach and institutional sustainability issues, as well as the importance and place of microfinance regulation.

## 2.1 Microfinance: Concept and evolution

### 2.1.1 Microcredit and microfinance

Microfinance has been variously defined in the literature. No single definition exists, but variations are mostly a matter of emphasis. Narrower definitions equate microfinance with microcredit, following early practice of NGO credit schemes. Microcredit is the provision of small loans to poor households and small business operators with or without guarantee. Ledgerwood (1999) defines microfinance in short as “the provision of financial services to low-income clients, including the self-employed”. Robinson (2001) defines microfinance more elaborately, with reference to its clients or potential clients and the main financial service provided:

Microfinance refers to small-scale financial services – primarily credit and savings – provided to people who farm, fish or herd; who operate small enterprise or micro enterprise where goods are produced, recycled or sold; who provide service; who work for wages or commissions who gain income from renting out small amounts of land, vehicles, draft animals, or machinery and tools; and to other individuals and groups at the local levels of developing countries, both rural and urban (Robinson, 2001: 9).

The above definitions indicate the target or potential users of microfinancial services as low-income people, which often means the poor section of society, while the first definition is general and does not specify what financial services means. The second definition is more specific on the potential beneficiaries and the type of financial services. However, the main aspect that makes microfinance different from conventional financial services is not the financial services provided and not even in only servicing the poor, but in how the service is rendered. The methodology applied in the delivery of the service and the institutional arrangement used in the provision of the service makes it different from conventional banking services provided to mainstream commercial bank clients.<sup>1</sup> Microfinance services are characterized by innovative design and methodology, constituting small repetitive loans and savings services with character references largely substituting for asset collateral and simple organizations closer to clients than commercial entities (Schreiner, 2003; Christen 1997). Robinson's definition of microfinance as "small-scale financial services" should be understood as referring to loan size rather than overall operation, as microfinance institutions have attained a large scale of operation in many countries.

Microfinance institutions are organizations that provide microfinance services to low-income groups as their principal objective. Microfinance is provided by "formal institutions, such as rural banks and cooperatives; semiformal institutions, such as nongovernmental organizations; and informal sources such as money lenders and shopkeepers" (ADB, 2000: 2). Formal microfinance institutions are banks and non-bank financial institutions that take into account special design and methodology for the delivery of financial services. The next section considers why specialized institutions and designs were needed to provide microfinance service.

### 2.1.2 The evolution of microfinance practice and institutions

Microfinance services were popularized in the 1980s (Ledgerwood, 1999). However, microfinance as a concept and in practice goes far back in the history of financial services. As indicated above, both informal and formal institutions provide microfinance. Christen (1997) attributes the innovations of modern microfinance to centuries old private moneylenders' practices. He claims that modern microfinance stems directly from private loans to the poor and that "successful micro lending programmes have

taken a page out of the informal moneylenders' book, developing character-based technologies that rely more on the borrowers' demonstrated willingness to repay than on the quality of their guarantees" (Christen, 1997: 16). In earlier work, he criticized micro-enterprise credit programmes that adopted methodologies from formal banking, which are too expensive to implement in that situation, while "informal moneylenders financed small business since the beginning of commerce" (Christen, 1992).

The history of informal financial institutions, especially private money lending, can be traced to ancient Egypt and the Middle East. The Old Testament documents restrictions on lending for interest among the Jews and describes morality issues related to collateral from the poor (e.g. in the books of Deuteronomy, 23:20; 24:10-13, and Ezekiel, 18:8, 12, 13, 18). Referring to the Jewish usury lenders in Europe during the medieval ages, despite restrictions on usury by Christian religious authorities, Steinwand (2001) cites the verse in the book of Deuteronomy 23:20 which the Jews might have used as justification to lend for interest to Christian Europe. The same book, 24:6, 10-13, prohibits the taking of pledges or collateral from the poor or a widow of vital goods such as a milling stone or a persons' cloak that they need for their daily lives.<sup>2</sup> Thus, money lending to the poor with or without collateral must have been widely practiced, not only for commerce, but also for private consumption, since the provisions in these books of laws at the time were attempts to regulate the practice along religious and moral values, rather than to prohibit them.

Steinwand (2001) attributes the early birth of microfinance in Europe to the periods of transformation of the economy from agriculture to industry and rapid demographic growth after the end of the great European war (1618-48), which led to an increase in poverty. He accounts for the establishment of pro-poor self-help groups, savings banks, and cooperatives in the 18<sup>th</sup> and 19<sup>th</sup> centuries with the aim to fight poverty and "to release the poor from the grasp of moneylenders" (Steinwand 2001: 51). He described further, the establishment of Irish loan funds in the 1720s; establishment of 18<sup>th</sup> century savings banks in Germany and various parts of western Europe; establishment of cooperatives in Germany in 1850 (the most famous of which was Raiffeisen's cooperative) and the starting of microfinance practice in the Netherlands in 1784, which later served as the basis for establishment of rural banks in 1895. This led to the present Bank

Perkreditan Rakyat (BPR) established in 1978 in the then Dutch colony of Indonesia to protect the local population from “the grasp” of Chinese and Arab moneylenders.

The literature often conveys microfinance as a recent concept introduced in the 1980s. Taking the above points as background and the source of the current innovations in microfinance product design and methodology, which many attribute to informal finance, we may conclude that microfinance is the rediscovery or renaissance of existing practice. It has become more institutional and formal, of course, benefiting from innovative approaches and findings of modern research in some areas.

There seems to have been a disconnection in the development strategy or approach between what the Europeans used and the approach followed for developing countries after the Second World War, when the European style of microfinance was replaced with the provision of capital or transfer of capital as a development strategy to the developing countries from the industrialized countries to bridge the alleged gap or shortage of capital for investments (Krahn and Schmidt, 1994). Krahn and Schmidt (*ibid.*) classify the views of finance in economic development in developing countries from the 1950s to 1990s, into four, based on the conceptualization and policies pursued by development planners. The first view was based on the understanding of the role of finance as a critical input factor for economic growth which the developing countries lack due to low levels of savings, thus providing the capital from foreign savings to help acquire modern technology to be used in the economy (the financial aid reaching the countries in the form of imported machinery or other technologies). The second view targets finance to help free people from the grasp of poverty. Specialized government-owned development finance institutions were formed to undertake the task of distributing credit to the target group, to bring about credit-induced development. The third view is based on the financial systems approach with emphasis on financial intermediation rather than targeted credit, and on the need to liberalize the financial system to allow the financial market to properly operate. Finally, the fourth view is based on the new institutionist approach and the economics of information. The failure of the second view of finance (the targeted credit approach) (Krahn and Schmidt, 1994) led to a shift to this alternative view, which looked back to private moneylending as an efficient practice

(Hulme and Mosley, 1996). It also adopted practices of the European savings banks and cooperatives.

Coming back to why microfinance was popularized from the 1980s and has now become a buzzword as a tool for poverty alleviation and economic development, we encounter the history of governments' intervention in economic development and attempts to reduce poverty through credit provision (Matin, Hulme and Rutherford, 1999; Robinson, 2001; Hulme and Mosley, 1996).

From the 1970s governments and international donors subsidized credit delivery to small farmers in the rural areas of many developing countries to respond to the financial needs of the poor and thereby foster economic development (Hulme and Mosley, 1996). The need for financial services for the poor emerged from the belief that lack of savings and capital made it difficult for many poor people to become self-employed and undertake productive income-generating activities (Khandker, 1998). Provision of credit could help generate self-employment and income. However, the poor lack physical collateral, which formal financial institutions require to access institutional credit. Lending to the poor also involves high risk of default and high transaction costs (Hulme and Mosley, 1996) due to the cost of processing small size repetitive loans to serve the poor. Informal moneylenders and traditional community-based institutions, which could be taken as better alternatives in dealing with the poor, lack capacity to reach the poor. Moreover, the poor cannot afford to rely on informal moneylenders due to high interest rates they charge, while the capacity of traditional institutions is constrained (Khandker, 1998).

Microcredit thus emerged as an antipoverty instrument in many developing countries, targeting the poor, especially women, with financial services to help them become self-employed. Much of the credit service was directed to the rural poor to improve agricultural productivity and thereby bring about economic development (Moll, 1998). In response to the financial needs of the poor governments and international donors introduced subsidized delivery of credit to small farmers in rural areas of many countries (Yaron et al., 1997). Specialized financial institutions were established as government programmes to extend farm credit to rural producers (Von Pischke, 1981).

Specialized financial institutions were established on the basis of a number of "almost universal assumptions" regarding farm households

and finance (Siebel, 1989; Yaron et al., 1997; Moll, 1998). The assumptions were as follows:

- Farm and rural household are too poor to save.
- Rural micro-entrepreneurs are unable to organize themselves.
- They need cheap credit for income-generating activities.
- Supply of credit is essential for agricultural development.
- Existing institutions are unable or unacceptable to perform the role of supplying credit.
- Government should promote rural welfare, and credit is an instrument to do so.

According to Robinson (2001), government intervention in rural credit was advocated by stressing the responsibility of government for economic development and emphasis on supply-led finance theories. The assumption was that economic growth in rural areas could be induced through finance by giving rural farmers incentive through subsidized credit to enable them use modern technologies to increase production. It is also assumed that farmers could not save and pay the commercial cost of credit. This assumption led to providing loans in advance of demand, while saving was disregarded, which the critics call the “forgotten half of rural finance” (Vogel, 1984).

The practice resulted in subsidized “cheap” credit, which soon fell under severe criticism as the specialized institutions accumulated large loan loss balances which made it difficult for them to achieve the desired objective (Ledgerwood, 1999). The failure of supply-driven cheap credit through specialized government institutions was mainly criticized in the popular study subsidized by the US Agency for International Development (USAID) in 1973, popularly known as the Spring Review (Robinson, 2001), and the new views expressed in the works of Adams, Bauman, Gonzalez-Vega, Von Pischke and others who were based at Ohio State University and thus referred to as the “Ohio group” (Hulme and Mosley, 1996; Robinson, 2001). The approach was criticized for its almost exclusive emphasis on credit, ignoring the perhaps more crucial benefit of savings, inability to cover costs and operating at a loss which resulted in continued dependence on funds from the initiator (Moll, 1998). According to Yaron et al. (1997), while interventions had some positive effects, the objectives of income expansion and poverty reduction were not met. Subsidized credit became perceived as a

government disbursement window, rather than financial intermediation. “The sole, disproportionate emphasis of rural financial institutions on disbursing agricultural credit led to general neglect of portfolio quality, non-farm rural development, savings mobilization, and efficient rural financial intermediation” (Yaron et al., 1997).

Microcredit and cooperative programmes were developed to fill the gap. Their purpose is to help the poor become self-employed and thus escape poverty (Khandker, 1998). According to Chao-Beroff (1999), one assumption behind the development of the microfinance sector is that poor populations possess the capacity to implement income-generating economic activities, and the main limitation on their initiative is lack of access to capital. This argument is in line with several other contributors in the field reaching conclusions that “market failure” or failure on the part of financial market to reach the poor (and also government failure, see Hulme and Mosley, 1996) necessitated the introduction of more flexible institutions (see also Zeller and Sharma 1998).

As stated by Johnson and Rogaley (1997), the dependence on fluctuating government and donor funds together with poor investment decisions and low repayment rates made many of the development finance institutions unable to sustain their lending programmes. While exclusion of the poor from financial services due to their presumed unbankability (on the basis of risk and cost factors) resulted in a “market failure”, the inability of the specialized government banks, on the other hand, resulted in “government failure”, in the words of Hulme and Mosley (1996). Thus the search for alternatives brought about innovative uses of microfinance. According to Ledgerwood (1999), microfinance arose in the 1980s in response to the doubts and research findings about the delivery of subsidized credit to the poor farmers through government-owned specialized banks. The abolition of subsidized lending schemes in favour of non-directed financial services at cost-covering terms through viable financial institutions is also considered a “shift of paradigm” (Robinson, 2001).

Meanwhile the success of experimental credit programmes by the Grameen Bank of Bangladesh and others (Robinson, 2001), partly applying lessons from private moneylending (refer to Christen above), impressed donors and development practitioners. This major innovation resulted in group guarantee and other lending methods drawing more on social capital than the traditional capital (Karlan, 2002).

Steinwand (2001) attributed the success and popularity of microfinance in developing countries to three factors. The first factor is the emergence of a new class of entrepreneurs as the result of structural changes in Third World economies at a specific stage of economic development that released people from rural farms. Economic transformation and urbanization created a new class who had to undertake micro and small enterprise, resulting in new demand for finance. The implication is that microfinance is in essence micro-enterprise finance. The second factor is the development of the financial systems approach, emphasizing the role of finance and financial markets as an important tool for economic development and recognizing microfinance institutions as financial institutions rather than disbursement windows. The third factor is the application of the New Institutional Economics. As Steinwand himself put it, it is difficult to accept the first factor, since it implies that development in all Third World countries is at an equal stage or that microfinance would not succeed in countries where the new entrepreneur class had not yet emerged. It is also difficult to assume that financial services are not in demand for on-farm activities and in the rural areas, as witnessed by much research on the demand for rural finance.

As a result of changes in approaches several successful microfinance institutions emerged. Some changes also occurred in the formal financial sector, which started rural banking using the microfinance approach (Ledgerwood, 1999; Khandker, 1998). Yet if previous experiences failed in dealing with the poor how could microfinance succeed in its transactions with this segment? Christen (1997), answering this question, states that the problem of lending to the poor is in selection and enforcement of timely repayment of loans. The informal nature of the businesses of the poor and the character of their assets makes it difficult for traditional lending techniques to be applied. It was through this innovation that the group guarantee and other lending methods were developed capitalizing more on the social capital than traditional collateral (Karlán, 2002).

Ledgerwood (1999: 2) summarised the evolution of microfinance as follows:

Microfinance arose in the 1980s as a response to doubts and research findings about the delivery of subsidized credit to poor farmers. In the 1970s government agencies were the predominant method of providing productive credit to those with no previous access to credit facilities. Governments and interna-

tional donors assumed that the poor required cheap credit and saw this as a way of promoting agricultural production. In addition, donors set up credit unions inspired by the Raiffeisen model developed in Germany in 1886. The focus of these cooperative financial institutions was mostly on savings mobilization in rural areas in an attempt to teach poor farmers how to save.

Beginning in the mid 1980s, the subsidized, targeted credit model supported by many donors was the object of criticism... because most programmes accumulated large loan losses and required frequent re-capitalization. ...This led to a new approach that considered microfinance as an integral part of the overall financial system (see also Chao-Beroff, 1999; Yaron and Rogaley, 1997).

As pointed out at the end of the above quotation, targeted credit lasted up to the 1980s. According to Robinson (2001), agricultural credit was transformed to subsidized microcredit (micro-enterprise credit) by donors, which had been unable to achieve wide outreach in both savings and lending. In the 1980s it became clear that microfinance could provide both large-scale outreach and profitability. In the 1990s there occurred a “shift of paradigm” to the financial system approach and microfinance developed as an industry.

The microfinance sector moved to the institutional financial systems approach, which called for sustainable financially and operationally self-sufficient microfinance institutions (Rhyne and Otero, 1994). The subsidized system was rejected and a move to market-based microfinance system was recommended, because the subsidized system kept borrowers dependent, which resulted in non-achievement of the desired development objectives. Experience showed that several MFIs sponsored by the state and international donors had fallen short of their stated goals, while continued subsidization drained public funds, depriving other sectors of chances. Innovations in the operational mechanisms of the MFIs through provision of social collateral, enforcement of regular repayment schemes and mobilization of savings were considered a substitute for loan repayment guarantees and enforcement mechanisms (Johnson and Rogaley, 1999).

Unlike Krahn and Schmidt (1994), above, Matin, Hulme and Rutherford (1999) classify the evolution of approaches in financial service provision into three eras demarcated by time. They consider each of the shifts in approach as based on the conceptualization of poor and poverty leading to policy design (see also Moll, 2005).

Debates about finance and poverty-reduction have been shaped by the changing conceptualizations [of who] the poor are and [what is] the nature of poverty. During the subsidized agricultural credit Era (1950s to 1970s), the poor were seen as **small or marginal farmers**, usually male, whose poverty could be overcome by credit-induced increases in productivity. From 1980 to 1995 they were seen as mostly female **micro-entrepreneurs** with no assets to pledge (but the world to conquer with microcredit financed investment that would raise their incomes). Recently they have become diverse group of **vulnerable households with complex livelihoods** and varied needs. From such a perspective, microfinance is a mechanism that can reduce vulnerability (i.e. sudden drop in income, consumption or assets) and/or reduce income poverty. We are now entering the '**micro financial service era**' (Matin, Hulme and Rutherford, 1999: 4).

Thus the three stages microfinance underwent are summarized as follows: government-subsidized agricultural credit provided through the intermediary of specialized development financial institutions (1950s to 1970s), donor-sponsored (some government sponsored) targeted microcredit (1980 to 1995), and finally adoption of the financial systems approach through institutional microfinance provision services. Robinson (2001) indicates that despite the evidence in favour of commercial financial services, in some countries subsidized microcredit by donors and governments still persists. Krahnen and Schmidt (1994) describe the latest development in the microfinance revolution as the "institution-building approach".

The transition from subsidized to commercial microfinance, or the financial systems approach, divided development economists and practitioners into two camps and kindled sharp debate in the 1990s, which the following section briefly examines.

## 2.2 Sustainability versus outreach for poverty alleviation

"Microfinance in the 1990s was marked by the major debate between the leading views the financial systems approach and the poverty lending approach" (Robinson, 2001: 22).

The debate demarcates an "ideological rift" (Burrell, 2000) between the proponents of subsidized microcredit services identified as welfarist, in other words as supporting the poverty alleviation approach to microfinance services, and those supporting the market approach for the

provision of microfinance services on a sustainable basis. The latter are also known as the “institutionist” financial systems camp, the financial systems approach or the sustainability camp (Rice, 2000). Moll (2005) refers to these two camps as the “targeted credit camp” and the “financial frontier camp”, as the welfarists still prefer targeting the poorest while the institutionists support expansion of financial services or financial deepening beyond the current outreach of the formal banking sector. The poverty lending approach argues for poverty reduction through credit together with other non-financial services. Credit is to be supplied to the poor mainly targeting the poorest of the poor at below-market interest rates. The financial systems approach emphasizes large-scale outreach to the economically active poor who can repay loans and interest from their earnings, and thereby become self-sufficient (Robinson, 2001). While the welfarists refer to the other camp as “institutionists” (Woller, Dunford and Woodworth, 1999), Robinson (2001) refers to this camp the “financial systems approach or camp”. Morduch (1998) calls the debate between the two camps the “microfinance schism”.

Both camps have a lot in common, including the core belief in poverty reduction as the ultimate objective. The difference between the two camps starts with the definition of the poor as indicated in the quotation from Matin et al. (1999) above. While the institutionists take the poor as the economically active poor (Robinson, 2001) or the diverse group of vulnerable households (Matin et al., 1999), the welfarists understand the poor as those who struggle on the margins of survival (Woller et al., 1999), the poorest of the poor, in other words, those at or below the 50<sup>th</sup> percentile of the national poverty line of a country. This guides the approach or strategy the welfarists support in terms of design and institutional structure.

### **2.3 The sustainability or financial self-sufficiency (institutionist) approach**

The institutionists focus on creating sustainable financial institutions to serve clients who are not served or are under-served by the formal financial system. Their main emphasis is on achieving financial self-sufficiency, and the breadth or scale of outreach, this latter meaning the number of clients reached instead of depth of outreach or level of poverty reached. Central attention is on institution building through financial self-sufficiency

(Woller et al., 1999). The literature on microfinance from CGAP, the World Bank, USAID and leading research institutes like the Ohio State University represent the views of this camp. Views of the institutionists are promoted in various microfinance literature. Robinson (2001) and Rhyne (1998) directly address the debate, arguing for the institutional or financial systems approach. According to Rhyne (1998: 6), “[the] split continues between those in the poverty camp and those in the sustainability camp”, but everyone wants to reach the poor and everyone believes that sustainability is important. She claims that one fundamental difference is whether service can be delivered to the client at a cost the client can afford, which is ultimately about whether to subsidize interest rates. She maintains that research shows institutions that charge cost-covering interest rates to have better financial self-sufficiency and better outreach. Rosenberg (1996) asserts that the demand for credit is still high for programmes that charge high interest rates contrary to the expectation of those who claim high interest rates prohibit the poor from accessing services.

Several points can be presented that the sustainability (or institutionist) camp supports but which are contended by the welfarist/poverty camp:

1. The long-term viability (sustainability) of the programme matters because institutions that continue to exist have a long-term impact on the lives of the poor. Sustainable institutions serve the poor not only today but also in the future (Schreiner, 1997; Krahn and Schmidt, 1994).
2. Economies of scale matter. The sustainability camp believes that successful poverty reduction requires massive intervention in the face of the wide distribution of poverty in the world. The volume of credit disbursed and interest earned on the high volume improve MFIs’ earnings and expand their operational frontier (Christen et al., 1995).
3. Financially viable MFIs are better able to mobilize savings and other financial resources from private investors in the form of loans and equity.

[The] sustainability camp views the private investors as the future home of microfinance while those in [the] poverty camp seem wary of allowing that future to be dominated by commercial for profit operators. They foresee donor and government involvement... for an extended period of

time... in contrast [the] sustainability group argues that... dependence on donors and government is a future in which few microfinance clients will be served. Governments and donors, both notably prone to fads, are unlikely to continue microfinance indefinitely and are not generous enough to do [so] on [a] major scale (Rhyne, 1998: 7).

4. Subsidized credit often ends up in the hands of the non-poor, which has the unintended result of depriving the poor of the chance to get access to financial services. The poor demand access to financial services, not just “cheap credit” (Rice, 2000, Morduch, 1998).
5. Sustainability is the means to expand outreach, not an end in itself (Rhyne, 1998):

Working toward institutional financial self-sufficiency (IFS) is essential for microfinance institutions to reach and benefit significant number of the poorest households — those living in the bottom 50% of poverty group — with financial services for poverty-reduction. IFS reflects an MFI’s “ability to operate at a level of profitability that allows sustained service delivery with minimum or no dependence on donor inputs” (Christen et al., 1995).

The institutionists advocate non-intervention (or minimal intervention): the role of government or donors is that of underwriter to help in entry and exit (Schreiner, 1997; Christen, 1997), scale of outreach should be increased to include as many poor as possible, and demand-driven financial services should be provided instead of subsidized cheap credit.

Ledgerwood (1999) summarizes the beliefs that characterize the financial system or sustainability approach in another but similar way.

- Subsidized credit undermines development.
- Poor people can pay an interest rate high enough to cover transaction costs and the consequences of the imperfect information markets in which lenders operate.
- The goal of sustainability (cost recovery and eventually profit) is key not only to institutional permanence in lending, but also to making the lending institution more focused and efficient.
- Because the loan size to poor people tends to be small, MFIs must achieve sufficient scale if they are to become sustainable.

- Measurable enterprise growth, as well as impact on poverty, is not easily demonstrated; outreach and repayment rates can be proxies for impact.

Another line of argument by the institutionists relates to the problems of subsidized services. Subsidy results in high government involvement and corruption. “Loans often ended up subsidizing well-off, politically-connected entrepreneurs rather than the poor households” (Morduch, 1998). Moreover, there is a belief that subsidy is not a financial intermediation but a transfer of resources from one sector to another, which means a zero-sum game at the macro-economic level, even if it goes well with the poor.

### 2.3.1 Depth of outreach or poverty lending (welfarist) approach

Welfarists declare their core values clearly, as in the writings of Woller et al. (1999), while Morduch’s article on the “microfinance schism” focuses more on the critique of the institutionist literature and promotion of “best practice”.

Welfarists are quite explicit in their focus on immediately improving the well-being of participants. They are less interested in banking per se than using financial services as a means to alleviate directly the worst effect of deep poverty among the participants and communities, even if some of these services require subsidies. Their objective tend to be self employment of the poorer of the economically active poor, especially women, whose control of modest increase of income and savings is assumed to empower them to improve the conditions of life for themselves, and their children. The centre of attention is the family (Woller et al., 1999: 31).

Practical justification from the welfarist point of view comes from the success of subsidized microfinance models – the Grameen Bank of Bangladesh and its replicates elsewhere, FINCA-style village banking in Latin America and others in Africa and Asia (ibid.).

Concerns of the welfarists can be summarized as follows:

1. Value-based commitment to serve the very poor (the bottom 50% of the population below the national poverty line.) Woller et al. (1999: 35) declare:

Welfarists distinguish themselves from the institutionist primarily by their value-based commitment to serve the very poor. While they acknowledge the benefits and necessity of scale in attacking world poverty, their inclination is to place greater weight on depth of outreach than breadth. They do not differentiate themselves by any lesser degree of commitment to sound operational and management practices or to institutional efficiency or effectiveness but whereas they believe that increasing financial self-sufficiency is generally desirable, they are unwilling to take the next step — to accept that financial self-sufficiency is necessary to fulfil their institutional mission.

2. Welfarists fear that overemphasis or exclusive emphasis on financial self-sufficiency would bring about mission drift from poverty alleviation among the poor to a profit motive, displacing the social mission (Rice, 2000).
3. Emphasis on institutional performance rather than the impact of the programme on the poor with the threat to withdraw support from unsuccessful programmes will have a negative impact on the “industry itself and the on those whom it serves” (Woller et al., 1999: 36). Impact on the client is often assumed rather than measured by the institutionist.
4. Welfarists claim that the institutionists’ core argument, which refers to “best practice”, will ultimately result in the replication of the so-called “best practice” to the detriment of innovation (Woller et al., 1999; Morduch, 1998). Woller et al. (1999) argued that all path-breaking innovations come from a subsidized mission-driven model of microfinance, namely the solidarity group from the Grameen bank, and the village banking system from ACCION and FICA which were operating under subsidy at the time. They claim that donors are more willing to invest in experimental projects aiming for innovation than would a “selfish” for-profit investor.
5. Welfarists are unconvinced of the institutionist argument that poor households can pay the high cost of commercial interest rates, which for this group of clients is often higher than that typically charged by the conventional banks (Morduch, 1998).

Welfarists also oppose the methodologies and tools used by the institutionists to measure financial success and institutional viability, such

as the subsidy dependence index and profitability measurements. Welfarists argue that charging high interest rates excludes the majority of the poor, depriving them of the chance to access financial services, as they cannot afford expensive loans or are screened out as non-creditworthy. According to this group, the main criterion for evaluation of microfinance institutions should be depth — the extent to which the poorest section of the population is reached instead of scale or cost coverage (Rice, 2000; Burrell, 2000; Woller, Dunford and Woodworth, 1999).

While some writers on microfinance and microcredit agree with the sustainability camp, others fall in-between the two camps, seeming to maintain a balance between the sustainability and outreach camps.

## 2.4 Sustainability and outreach

### 2.4.1 Sustainability indicators

Sustainability is a complex and popular term frequently used in relation to various fields of study. It is popularly applied in environmental studies, development economics, agriculture and many other areas (Bell and Morse, 1999). A clear definition of sustainability has proved elusive due to the variety of contexts in which it is applied (Bell and Morse, 1999). Environmentalists define it their own way, as do development economists. Definitions of sustainability are given in the fields of philosophy and ethics, geography, urban studies, and environmental studies (Mingshun, 2002). A general definition of sustainability is given as: “The capacity of a system to maintain output at a level approximately equal to or greater than its historical average with the approximation determined by the historical level of variability” (Lynam and Herdt, 1998: quoted in Bell and Morse, 1999).

It is difficult to take this definition as universal. Output at some historical average has never been a good benchmark, for example, in a competitive business environment, since stagnant operations are never sustainable. In our context, a microfinance institution might have been operating at a modest profit that barely covers costs or at loss. But does this constitute sustainability?

Sustainability of an institution refers to the long-term availability of the means required for the long-term achievement of goals (Bell and Morse, 1999). It is thus defined in relation to the resources of the institution and its capacity to meet goals. Bell and Morse (1999) refer to the works of

prominent writers on microfinance institutional sustainability (Adams and Von Pischke, 1992; Otero and Rhyne, 1994; Hulme and Mosley, 1996), where emphasis on institutional sustainability is particularly noticeable in the provision of financial services to the urban and rural poor.

No wonder writers in many fields find the definition of sustainability in the microfinance literature more meaningful than in other areas. Sustainability in microfinance has become a hot subject in relation to microfinance as a tool for poverty alleviation and for economic development. In microfinance, the issue of sustainability is important from the viewpoint of both the clients and donors or financial suppliers.

Sustainability is important for the poor themselves since an unsustainable institution will soon cease to exist, interrupting the service without bringing meaningful impact to the lives of the poor (Schneider, 2002). Neither are donors motivated to fund institutions that are not viable:

from the standpoint of development aid, it does not make much sense to work with institutions which are unstable, unprofessional and inefficient. Even if they are able to operate in a decidedly target-group manner for a short while, their overall development impact will almost invariably be negative: The unit cost of their services will prove to be extremely high, not only for the donor countries but also, if measured in terms of opportunity cost, for developing countries (Krahn and Schmidt, 1994: 95).

Navajas et al. (1998: 5) defined sustainability as “to reach goals in the short term without harming your ability to reach goals in the long term”. Edgcomb and Cowley (1994: 77) define it as “ability of an organization to sustain flow of valued benefit and services, to its members or clients over time”. Common to both definitions is the possibility of maintaining capital (in a microfinance context) to continue to meet current objectives while assuring continuity. This means financial self-sustainability. Without financial self-sustainability there can be no maintenance of capital; if capital is not maintained, future objectives are compromised, and services and benefits cannot continue as before. Welfarists object to this concept. They offer an alternative definition as “the ability of a programme to produce outputs that are valued sufficiently by beneficiaries and other stakeholders, that the programme receives enough resources and inputs to continue production” (Woller et al., 1998: 42). This was an effort to adjust the definition of sustainability to the view of the poverty camp, which does not want finan-

cial self-sufficiency to be set as a requirement. The programme survives as long as it continues to “receive enough resources and inputs” from donors.

Schreiner (1997) differentiates sustainability in general from self-sustainability on the basis of the source of funding. He gives the simple definition, “sustainability is meeting goals now and in the long term” (Schreiner, 1997: 63), while “self-sustainability is meeting goals now and in the long-term with subsidized funds replaced with market funds” (ibid.: 66). This boldly specifies self-sustainability as profitability, but he warns that sustainability is not the same as subsidy independence, since there are several subsidy-free private institutions, which are not sustainable in the market. Self-sustainable microfinance institutions are those that keep their mission going from their own resources.

Von Pischke, Schneider and Zander (1996) defined the MFI from a financial sustainability perspective. To them financial sustainability is “positive net present value of an investment or institution”. The definition emphasizes the ability of an institution to cover its costs of investment or capital maintenance. Yaron (1994) defines a sustainable institution as one that “achieves the level where the return on equity, net of any subsidy equals or exceeds the opportunity cost of funds”. The key factor here for an institution to be sustainable is its financial self-sufficiency through its own earnings. Von Pischke, Schneider and Zander (1996) elaborate that institutional sustainability should be viewed in the dimensions of cost coverage, management of risk and the complex of governance, investment and socioeconomic issues. Box 2-1 presents the basic elements of their elaboration. According to their explanations, sustainability of an institution should be viewed from the totality of its institutional viability including appropriate governance structure, financial and economic self-sufficiency through value-added investment and efficient management of its loan portfolio and wide outreach to the poor.

Sustainability in this definition is institutional sustainability, which encompasses financial self-sufficiency to be free from subsidy, well-defined capital structure with optimal leverage, and an appropriate and efficient governance system to fulfil its mission. Appropriate governance systems, including a system of management, greatly contribute to the sustainability of operations.

Subsidy reduction is possible when the institution can earn sufficient revenues from its lending activities through positive lending-on interest

**Box 2-1**  
*Components of the definition of sustainability*

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Sustainability comprises various components:

Subsidy reduction (elimination) through

- cost coverage (including cost of inflation)
- setting appropriate lending rates and fees
- high percentage of loan collection
- attracting deposits through attractive interest rates
- control of costs of operation (promotion of efficiency)

Financial (risk) management in

- lending
- funding
- administration activities

Governance structures to enhance

- viability of organizational structure and strategy
- corporate governance
- local participation
- financial and operational controls (MIS, accounting, and internal controls)

Investments that lead to

- incremental value augmentation

Socioeconomic consideration of

- broad access of the poor
  - innovation
  - voluntary participation
  - appropriate structure
- 

Source: Schneider (1996).

rates and fees, while at the same time minimizing loan losses through effective portfolio management, efficiently controlling costs of operations, and raising funds for additional loans through savings mobilization, which is a cheaper source of funds. Broader outreach to the poor with innovative methodologies and encouraging local participation also contribute to minimize transaction costs to the beneficiaries as well as to the institution.

The issue here is how sustainability of microfinance programmes is measured. Several financial and operational ratios and indices are used in evaluating the adequacy of service and self-sufficiency in operations and finance. Here, we shall only present the more comprehensive models (indicators) used to measure sustainability, namely, the breakeven interest rate,

the Subsidy Dependence Index (SDI), the Depth of Outreach Index (DOI) and the lending cost formula. We will finally look into the cost of lending approach related to the ability of MFIs to decide on their volume of operation.

Khandker (1998) alongside the above explanations, discussed sustainability under four interrelated headings: financial viability, economic viability, institutional viability and borrowers (client) viability. According to his definition, financial viability and economic viability are measured differently. The institution is financially viable if it can meet the cost per unit of the principal lent with the price it charges. His measure of financial viability is the same as that employed by Hulme and Mosley (1996) to measure the financial breakeven point. The breakeven point is where the interest charged on the principal lent equals the cost of raising the funds and of rendering other services plus the expected loan losses. Thus, financial viability is reached when

$$r \geq \frac{i + \alpha + p}{1 - p}$$

where

$r$  is the interest rate charged per unit of principal lent,

$i$  is the cost of obtaining loanable resources per unit of principal,

$\alpha$  is cost of administering and supervising loans per unit of principal lent,

$p$  is the expected financial loss per unit of principal lent (principal and interest lost due to default) (Khandker, 1998; Hulme and Mosley, 1996).

For Khandker, economic viability is reached when the interest and other revenues earned by the MFI meet the economic cost of funds including the opportunity cost of the funds used for credit and other operations.

Economic viability, in his case, is similar to what others refer to (above) as the “level of sustainability”. It is measured by Yarn’s subsidy dependence index. Client viability is measured by the extent of benefits that clients get out of the service. The transaction and cash costs of funds to the client must be equal to or less than the income they derive from the business financed by the loan. This involves measurement of impact on clients when taken at the larger scale.

Sustainability of MFIs is more clearly measurable (Bell and Morse, 1999), since the indicators can be identified in financial terms. For MFIs,

Yaron's subsidy dependence index (SDI) is widely used as a sustainability indicator (Yaron, 1994; Bell and Morse, 1999). The model uses data from the financial records of the institution to measure the extent to which an MFI depends on subsidy. The SDI was developed to evaluate development finance institutions (Yaron, 1992, 1994), primarily the extent to which these institutions could meet their costs from their internal resources. The index has been praised as good indicator of sustainability and as user friendly since it employs data available within the institution (Bell and Morse, 1990; Yaron, 1994).

Yaron (1994) lists the strengths of the index as follows:

- It quantifies the impact of subsidy that affects the financial performance of the institutions making it clear that the cost of subsidy is not recorded in the conventional income statement.
- It measures the overall subsidy in relation to the primary source of income of the institution.
- It imputes the cost of capital of the MFI equity (the "cost less equity").
- It enables meaningful comparison of different MFIs with various equity-to-asset ratios.
- It applies the economic shadow price to calculate the economic return (taking the market rate estimate).
- It shows the progress made towards phasing out subsidy.

SDI is also used to measure the social cost of subsidy to development finance institutions, including the MFIs. SDI is not, however, an absolute indicator of sustainability, since other factors affecting performance of the institution are taken for granted. Drawing conclusions from SDI alone may lead to a concentration on interest and fees without considering the effect of internal efficiency and other capacities of the institution. When referring to the outcome of the SDI, positive outcome is taken as an indication of the extent to which interest rates should be raised to be free from subsidy, while negative values are interpreted as the amount of economic profit after covering all costs (Yaron, 1992). Its interpretation, therefore, requires closer examination of causes of positive or negative values for the SDI. Efficiency of operations reduces cost and improves the chance of being free from subsidy dependence (Bell and Morse, 1999). This suggests

**Box 2-2**  
*Subsidy dependence index*

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$$\text{SDI} = \frac{\text{subsidy received}}{\text{outstanding loans} \times \text{interest rate}}$$

$$\text{SDI} = \frac{A(m - c) + [(E * m) - P] + K}{LP * n}$$

The numerator is annual subsidy received by the institution

A= concessional borrowing funds (annual average)

m= interest rate that the institution is supposed to pay in the market

c= average annual concessional rate actually paid by the institution on outstanding (A)

E= average annual equity

P= reported annual profit (adjusted for inflation)

K= sum of all other subsidies received

LP= average annual portfolio of the institution

n= average lending interest rate

SDI= 0, sustainability achieved

SDI= >0, sustainability is not achieved (subsidy required)

SDI= <0, surplus (making economic profit)

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Source: Yaron (1992).

that other tools should be used to supplement the results of the computed SDI. The other limitation is that the figures used in the computation of the SDI are drawn from the accounting records of the institution.

This may limit accuracy unless the accounting records are adjusted for inflation and loan losses (Christen, 1997). Therefore, additional conventional indicators such as profitability ratios, leverage and gap analysis for interest rates paid and received, operational efficiency ratios, and cross sectional analysis of trends must supplement institutional evaluation. Rhyne (1994), Christen (1997), Ledgerwood (1999) and the various technical tools developed for the CGAP give us a menu to choose various indicators. Sustainability of the MFIs also depends on effective and institutionalized procedures for ensuring administration and management succession, optimal allocation of resources and staff development (Khandker, 1998). Client viability involves impact assessment by direct or indirect methods. Direct impact assessment is expensive and requires controlling for other factors that contribute to the improvement or deteriora-

tion of the life of the client. Thus, outreach is used as a proxy to measure impact (Ledgerwood, 1999).

### 2.4.2 Outreach

Outreach is part of the MFI programme objective (Christen, 1997). Outreach and sustainability are considered the two overarching goals of MFIs (Matin, Hulme and Rutherford, 2000; Christen, 1997). Programme outreach is measured along two dimensions: breadth of outreach (the number of clients served) and depth of outreach, which indicates the poverty level of clients served. The relationship between the breadth of outreach and financial self-sufficiency is direct. More outreach implies a reduction in the cost of services and increases in revenue, ultimately leading to sustainability (Christen, 1997; Hulme and Mosley, 1996; Matin, Hulme and Rutherford, 2000). The scale or breadth of outreach is also included in the evaluation of sustainability (Rhyne, 1994). Rhyne (1998) argues that the ultimate objective of any MFI is to increase outreach, while sustainability or financial self-sufficiency is only a means to ensure lasting outreach, rather than being considered a selfish motive on the part of the institution.

The relationship between depth of outreach and financial self-sufficiency on the other hand is complicated (Christen, 1997). Financial self-sufficiency or profitability has been argued as possible to achieve only at the expense of abandoning the poor clients (Rice, 2000). Microfinance institutions that grant smaller loans to poor clients incur high transaction costs. Therefore, there is an implicit trade-off between depth of outreach and financial sustainability (Paxton, 2002).

Measurement of depth of outreach poses another problem. Socio-economic and income measures must be applied to measure the poverty level of the clients. However, this is expensive for MFIs since they may not keep such records (Paxton, 2002). Loan size is usually taken as a proxy to measure depth of outreach. Smaller loan sizes are associated with the poor (Christen, 1997; Matin, Hulme, Rutherford, 2000). Use of loan size as a proxy is criticized since it has little relation to the poverty level and degree of exclusion from access to formal financial services (Paxton, 2002). A relatively easy and more effective indicator is the Depth of Outreach Index (DOI) developed by Paxton and Cuevas (1998). The DOI includes demographic variables in the income level to measure the depth of outreach to the excluded (Paxton, 2002). DOI is represented as follows:

$$DOI = \sum (e_{in} - e_{cn})$$

$$DOI = (rur_i - rur_c) + (inc_i - inc_c) + (fem_i - fem_c) + (ilt_i - ilt_c)$$

where

$i$  = institutional outreach,

$n$  = categories of people excluded from formal finance,

$c$  = country average,

$rur$  = rural,

$fem$  = female,

$ilt$  = illiterate,

$inc$  = represents poor people with income below average per capita GDP.

A positive DOI outcome shows that the institution serves more of the rural, female and illiterate population. The index also provides a useful tool when its result is compared to the SDI to measure the extent of correlation between sustainability and depth of outreach. DOI computations also require compilation of data on the income of clients and other additional information which is not ordinarily recorded on the institution's books due to the extra effort and cost required. The DOI is not an indicator of financial and operational sustainability as such. It simply indicates how far some target groups are reached and thus serves the social objective. The scale of outreach is measured in most cases by referring to quantitative indicators such as number of clients served, total amount of loans, loans per credit (field) agent, etc. The problem is determining what scale of outreach is optimal for an institution, its branches and other segments. Obviously the institution should have capacity to attain a certain level of outreach. Capacity of the institution on the other hand is represented as the fixed costs which need to be covered at some minimum level of operation. Minimum cost per financial product would be attained when the institution operates at maximum capacity. This is a cost-volume relationship. It is, therefore, necessary to introduce the analysis of costs in relation to the volume of operation, which will guide the decision on what volume of operation the institution should attain to minimize the cost of service that at an acceptable market price could yield the required return to make the programme sustainable.

Outreach could be measured by accommodating more of the social contribution of MFIs to the well-being of clients, as well as the cost effectiveness and sustainability of the outreach according to Schreiner's (2002)

six aspect of outreach: (1) worth of outreach to clients, (2) cost of outreach to clients, (3) depth of outreach, (4) breadth of outreach, (5) length of outreach and (6) scope of outreach. Schreiner brought together outreach indicators that would accommodate both the welfarist and the institutionist approach. Some of these indicators may be difficult to measure since they require data that may not be readily available.

The lending cost model (Moll, 1994) introduces the above perspective and attempts to measure performance from the cost perspective rather than from the price perspective. So far, we observed that the methods related to the breakeven interest rate and SDI are geared towards finding the positive on-lending interest rate that should be charged if the institution is to cover its costs. The cost of lending approach, in contrast, identifies the minimum cost level per period to provide financial services in relation to the volume of operations. It thereby guides the pricing of the financial service. The model ultimately relates cost to volume of service to determine an average cost of providing the service. The formula is stated as follows (Moll, 1994):

$$L_{ct} = (L_{ct} * \frac{c}{u}) + (L_{at} * d) + (L_{nt} * A_{vt}) + \frac{(A_f + A_{ot})}{(L_u * 1 - d)}$$

where

$L_{ct}$  = lending cost in year  $t$ ,

$L_{vt}$  = weighted volume of loan (in currency unit period),

$C$  = cost of raising funds,

$U$  = proportion of fund utilization,

$d$  = default rate,

$L_{at}$  = amount of loan issued in year  $t$ ,

$L_{nt}$  = number of loans issued per period,

$A_{vt}$  = variable administrative cost of providing service,

$A_{ft}$  = fixed administrative cost,

$A_{ot}$  = allocated head office overhead costs (in case of branches).

The importance of the formula is that  $L_c$  could be calculated for different volumes of operation within the relevant range (within the range that the fixed cost of the institution remains the same) to evaluate the performance of the institution as well as to identify the minimum level of operations that should be attained to cover costs. The classification of costs into variable and fixed elements, maintaining records on the active loan portfolio, and

strict monitoring and provision for loan losses also requires good management information systems. The formula indirectly imposes requirements on institutional viability, in terms of administrative efficiency, efficient product design and customer selection, efficient information systems and strict cost control. This method has practical relevance for the evaluation of programmes in countries where experience is lacking and inefficiency in resource utilization is likely to affect the financial viability most.

From the above points we gather that sustainability of MFIs involves building a viable institutional structure, financial sustainability and client sustainability, which is also affected by the regulatory framework. Before concluding this section, the role of the management information systems (MIS) will be introduced as an essential component of the institutional viability and also as an important interface between management and regulatory agencies and between the entire MFI operation and its clients.

### 2.4.3 Institutional viability

Institutions are variously defined. North (1991: 97) defines institutions as “humanly devised constraints that structure political economic and social interactions. They consist of both informal constraints (sanctions, taboos, customs, traditions, and codes of conduct) and formal rules (constitutions laws, property rights).” This definition may not appear directly relevant to the (organization of) microfinance institutions. For this we must look into the functions or roles of institutions in the economics literature. The definition is better understood at the macro level than at the micro or firm level. But firms too are structures that facilitate interaction between economic actors. Institutions could include “organizations, markets, contracts, and cultural rules” (Steinwand, 2001: 29). Krahn and Schmidt (1994) explain the meaning of institutions with respect to microfinance as follows.

The generic term “institutions” is used in broad sense. It includes markets as [a] special type of institution, with firms and governments also being regarded as basic types of institutions. The financial system is an institution, and its main elements such as specific financial markets and “banks” or financial intermediaries (financial institutions in common terms) are also institutions (Krahn and Schmidt, 1994: 22).

This definition includes microfinance institutions as a basic type of institution, such as firms or organizations. Schreiner (1997) uses the term “organization” instead of the term “institutions” in referring to microfinance

institutions. He argues that the institution is the financial system as a whole, while microfinance organizations are only part of the financial system, but not institutions in themselves. It is important to refer to the role of institutions when used in the context of an organization, as to which institutional theory is applicable. Microfinance institutions as financial institutions are part of the financial system. Institutions trade with financial instruments in the financial markets (Krahn and Schmidt, 1994). Financial markets are imperfect due to asymmetrically distributed information. It is costly to obtain information in the selection of potentially good clients and also to enforce the contract. Financial contracts raise incentive problems thus leading to moral hazard and adverse selection (problems of agency).

Agency theory deals with incentives and control mechanisms to minimize the effects of moral hazard and adverse selection (Steinwand, 2001). Good institutions can reduce transaction costs of obtaining information and increase efficiency in financial intermediation through the right incentive and control mechanisms (Krahn and Schmidt, 1994; Steinwand, 2001).

Perceiving banks both as principal (towards its credit clients) as well as an agent (towards its deposit clients) the governance mechanism of agency theory can be applied to the design of financial institutions. Many of [today's] MFI principles and techniques like strict and timely loan enforcement, incentive [for] timely repayment, spatial and social closeness to clients in order to reduce information costs, peer group pressure and monitoring devices etc, address problems raised by agency theory (Steinwand, 2001: 31).

Krahn and Schmidt (1994) argue that development finance in the 1960s and 1970s paid little attention to institutional viability (of banks) but now development finance is concerned more with institution building, since financial services are only as good as the institutions that provide them. They identify four possible approaches to institution formation for the provision of microfinance services to the poor:

- upgrading informal institutions and semiformal institutions,
- downgrading banks or formal traditional institutions,
- linking formal and informal institutions,
- forming new institutions.

Upgrading informal institutions assumes there are informal and formal institutions such as Rotating Savings and Credit Associations (ROSCAS) or cooperatives which could be further nurtured and converted to institu-

tions that formally provide financial services to the poor, while downgrading presupposes the existence of formal banks that could be used to enter microfinance services, either by opening a window for microfinance or by totally converting to provision of microfinance services. Institutional economists suggest that institutions evolve in response to technological and economic progress, but there is no clear indication as to how far the evolutionary theory is applicable to the establishment of MFIs (Steinwand, 2001). Many microfinance institutions have been established as a result of either NGO initiatives or government interventions rather than as an evolutionary transformation of existing formal or informal institutions in response to economic and social developments.

Subsidized non-viable institutions cannot be good institutions to operate in the financial markets. Institutional viability comes not only from profitable operations or financial self-sufficiency, but also from good institutional design. To operate in the financial market and be a good intermediary between lender and borrower, governance mechanisms of the institution should work towards the above principles to minimize the transaction cost of contracts.

To put the proper incentive and control mechanisms in place, a good governance system should be adopted. In corporate management, the agency theory is applied in the relationship between owners as the principal and the management of the firm as agent to the owners. Members of the board of directors as representatives of the shareholders, or in most cases they themselves being shareholders, are the ones who should ultimately put in place proper incentive mechanisms, organizational designs and systems of information gathering, so that the management and employees act in the best interest of owners. If management of MFIs act in the best interest of owners, that is, taking due care in client screening, loan monitoring, timely collection of loans, control of administrative costs and loan losses, then profitable operation will not only reward the owners but also assure the depositors the safety of and return on their investment. The board is responsible for overseeing that this happens. The governance issue is thus crucial.

Although corporate governance can be defined in a variety of ways, “generally it involves the mechanisms by which a business enterprise, organized in a limited liability corporate form, is directed and controlled” (Gregory, 2002). It is concerned with monitoring management in their conduct of business and strategic decisions concerning the entity. Respon-

sibility for corporate governance lies with the board of directors, which is elected from and by shareholders. According to Rock et al. (1999), the board of directors traditionally either consists of owners or represents the interests of owners; aligning the interests of individual directors with the interests of the institution is key to effective governance. Board members must have a stake in the institution to commit themselves to the role, which entails not only legal responsibility but also professional and ethical obligations. In a corporate form of governance the role of board members should be clear in that their commitment is assured. Board members representing NGOs may not act in the best interest of the institutions unless appropriate incentives are in place. Von Pischke, Schneider and Zander (1996) argue that successful business persons in their private lives seem to lose a sense of rigor when they enter the NGO boardroom, thus control of costs and inefficiencies may be insufficiently exercised. The issue of ownership is evident here. Board members have duties of care, loyalty and obedience to the institutional objective (Rock et al., 1999). The basic responsibility of board is to develop strategic plans, institutional policy and procedures and set institutional goals to guide the management of the institution and oversee that management properly implements plans, policies and procedures. Beyond monitoring the management team, board members should also draw up codes of conduct and procedural manuals to define the responsibilities of individual board members related to governance responsibilities (Rock et al., 1999).

Organizations are created by their owners to help reduce the transaction cost of contracts (North, 1990), and microfinance institutions are organizations created by NGOs, governments or private investors with either social missions or social plus profit motives. Organizations can reduce the transaction cost of contracts when they have an effective system of collecting and processing relevant information about the contracts in a better way than an individual or group of unorganized individuals could do. Basically the strength of an institution lies in its systems and resources. MIS are the primary tool with which MFI managers collect relevant information on financial contracts. It is the map of the activities of the MFI used for monitoring and coordination of operations (Ledgerwood, 1999). MIS is a greater concern for MFIs due the nature of the services they provide and their need for accurate information (Waterfield and Ramsing, 1998). MIS also deserves special attention regarding MFIs because of their inter-

est in controlling costs, which much depends on the strength of information about individual cost elements. MFIs require three basic MIS components. First is the accounting system, including the chart of accounts and general ledger system. The second is the portfolio tracking system. The third (not commonly available) is the customer impact tracking system (Ledgerwood, 1999; Waterfield and Ramsing, 1998). The MIS is also related to the other components of the organization such as the personnel system and payroll.

MIS can be manual or computerized. A manual system, while the easiest to understand and process using basic skills, is nonetheless inefficient with respect to data storage and retrieval. It is also susceptible to manipulation and possibly corruption and fraud since there is no in-built security system (Berhanu and Thomas, 2000). In a large organization or fast-growing organizations a computerized database is a requirement. Effective management of MFIs depends on the establishment of an efficient and computerized MIS. This need is especially felt at the sustainability stage, when thousands of transactions are to be processed due to a large number of small clients (Edgcomb and Cawley, 1994).

MFI transactions are relatively frequent, involving repeated collections, payments and multiple reporting requirements. In most cases MFIs have branches scattered over large geographic areas and lend to large numbers of clients with frequent loan disbursements, loan collections, savings collections and payments resulting in a high volume of transactions. With manual systems, MFIs cannot process and produce the necessary reports to track loan status. Use of modern information technology to process data and report on activities is thus not a matter of choice but necessity for MFIs (Christen, 1997). As stated above, the two basic components of the MIS are the accounting and portfolio tracking systems. There are several accounting packages, such as “Peachtree”, “DacEasy” and “ACCPAC”, on the market and in use by many organizations that can be adapted to MFIs with little customization (Berhanu and Thomas, 2000). But much of this software is industry specific with an integrated loan portfolio tracing system and accounting system. Customization of conventional accounting software to microfinance is not always optimal. Even software produced exclusively for MFIs cannot be implemented universally due to differences in microfinance practices, namely (Ledgerwood, 1999; Waterfield and Ramsing, 1998):

- variations in lending methodology (individual lending, group lending, village banking, rotating funds) among institutions;
- variations among institutions in the calculations of interest rates, penalties and links between loans and savings;
- centralized and decentralized operations;
- size of the organizations;
- reporting requirements by the central banks, donors and the board.

The larger portfolio management systems used by commercial banks could be available, but these are expensive and need adjustment for MFIs (Christen, 1997). At present there are a few guidelines worked out under the CGAP to standardize approaches to MIS. An MIS handbook by Waterfield and Ramsing (1998), the *Handbook of Operational Planning and Financial Modelling* by Lunde (1998, 2001) and other technical tools for external audit, accounting and financial analysis are part of the CGAP efforts. However, MIS standardization is difficult due to the variations in approaches and organizational design of MFIs in different countries.

Another difficulty faced by the MFIs in implementing MIS is the cost of acquiring and maintaining the system, as they cannot afford the high price of software and the technology, including the cost of staff to operate and maintain the system (Ledgerwood, 1999). MFIs can nonetheless benefit from the use of computerized MIS in the long run, due to the substantial reductions these systems bring in the cost of processing information and the resulting improved decision making if the system is carefully designed and implemented. Waterfield and Ramsing (1998) give the fundamental principles to be followed in designing and implementation of the MIS for microfinance institutions. They also indicate the kind of information that could be processed for a typical MFI, several types of indicators to be calculated, and the minimum reports to be produced. The strength and benefit of an MIS largely depends on the underlying organization. Procedures, manuals, flow and the system of authorization for the transactions must be clearly defined, the information needs of management clearly articulated and the system documented. Furthermore, the communication between the systems staff and users of the information should be clear and mutual to gain maximum benefit (Christen 1997; Ledgerwood, 1999).

Strong MIS help institutions to (Ledgerwood, 1999, Water and Ramsing, 1998):

- promote the quality of accounting records and reports;
- report and follow up in a timely manner on loan portfolios, savings accounts and delinquency;
- introduce stronger internal control systems;
- adhere to supervisory body reporting requirements;
- introduce a self-monitoring system by reporting on relevant variables and indicators;
- monitor impact on clients;
- maintain information and asset security.

An MIS programme must be flexible to accommodate changes and future expansions of the business and products. Study of institutional sustainability should include analysis of the MIS since it is the basic explanatory factor for institutional viability. An in-depth analysis of MIS may require a systems study where the information needs of the institution in relation to management planning and control decisions are identified and the capacity of the system to provide the relevant information on a timely basis is evaluated. The current research conducts an evaluation of MIS on the basis of discussions with staff, management of the institutions and observation of the system during field visits.

## 2.5 Regulatory framework for microfinance

The need for regulation of economic activities has gained substantial attention and is often justified as a policy instrument to minimize the effects of market failures (Armstrong, Cowan and Vickers, 1994; Majone, 1996). In broad terms, regulation refers to a set of enforceable rules that restrict or direct the actions of participants and as a result alter their outcomes (Chaves and Gonzalez-Vega, 1994). Financial regulation is also defined as the “rules that govern commercial behaviour in the financial system” (Carmichael and Pomerleano, 2002). This implies the relations between the actors within the market who may have conflicting interests, which the regulatory framework would reconcile by providing standards of behaviour. Regulation in the financial sector is primarily about ensuring systemic stability and protecting depositors (Arun, 2000).

Chaves and Gonzalez-Vega (1994) indicate that their definition does not necessarily imply that the government alone imposes regulation. Rather, market forces can sanction and regulate as well. The idea is that players who play within the rules of the market will succeed, while those who do not adhere to the rules of the game risk bankruptcy. These authors, however, indicate that the market is not necessarily perfect. Proponents of efficient markets assert that financial markets are sufficiently efficient to accomplish the role of self-regulation (Carmichael and Pomerleano, 2002). Stiglitz (1994) dismisses this claim as “ideological commitment to idealized conception of markets that is grounded neither in fact nor in economic theory”. He identified seven market failures that justify government intervention in financial markets. The major ones are externalities of variables and the nature of information as a public good. According to Carmichael and Porleano (2002), the four causes of market failure are anticompetitive behaviour, market misconduct, information asymmetry and systemic instability in the financial market. Regulation is aimed at reducing the adverse effects of these factors on financial institutions.

Financial regulation is still under discussion in economic theory. The need for some degree of regulation seems to have been accepted by many, though debate remains on how and to what extent the financial markets should be regulated. The importance attached to financial market regulation is primarily related to the importance of the financial system to the entire economic system of countries. Stiglitz (1994) refers to financial systems as the “brain” of the entire economic system, as they are the central locus of decision making. Their failure to perform would thus impair the entire economic system.

Recent literature in development finance recognizes microfinance as part of the financial system (Robinson, 2001; Krahnert and Schmidt, 1994). Thus, microfinance institutions need to be regulated like any other financial institution.

### **2.5.1 Rationale and nature of regulation in microfinance**

The issue of regulation and supervision has attracted growing interest in the microfinance sector, as in the formal financial sector. Regulation in the formal financial sector aims at maintaining a balance between shareholder and debtor/depositor interests that may arise from information asymme-

tries due to the peculiar nature of the assets of the banking firm (Stiglitz, 1994; Chaves and Gonzalez-Vega, 1994).

Appropriate regulation of financial markets depends very much on country-specific characteristics, such as level of development and institutional capacities, but there is general agreement that regulation may not be necessary for all types of MFIs, and if needed the regulation should take into account the special characteristics of MFIs that distinguish them from other financial institutions, as blanket regulation may repress MFIs (Greuning, Gallardo and Randhawa, 1998).

Deposit-taking financial intermediaries are characterized by three factors (Chaves and Gonzales-Vega, 1994) that call for regulatory intervention. These are the fixed value of deposits or liabilities that are not matched by the owner's equity, the amount of unsecured assets represented by personal and institutional loans, and contracts with depositors. Deposits are claims against the assets of the institution, the bulk of which, in the case of MFIs, is represented by investment in the risky loan portfolio. On the other hand, the contract between the institution and the depositor is based on trust on the part of the saving public. There is an asymmetry of information between the depositor and the bank. There is also an asymmetry of information between the borrower and the lending institute. Ultimately the saving public remains unprotected as they bear the risk of losing their money if lending contracts between the bank and its borrowers are not based on appropriate consideration of risks. Thus there could be a market failure due to possible moral hazard on part of the bank to undertake excessive risk.

There are concerns as to whether regulation is really needed in the microfinance sector, and if needed, what are the different options, rather than emulating the practices from the formal sector. Greuning, Gallardo and Randhawa (1998), in their work on the framework for regulation of microfinance institutions, ask four questions about the regulation of MFIs: whether there is a need for regulation of MFIs; and if so, what aspects should be regulated, who should regulate, and what are the fundamental issues in the regulation of MFIs.

There are arguments in favour of not regulating microfinance at all, based on cost and benefit. Because microfinance institutions have small-size operations, the cost of developing and implementing a regulatory system will likely exceed any benefits accrued from the regulation. Microfinance regulation nonetheless becomes important when the institu-

tions start raising deposits from the public to finance their loan products and to build financial sustainability (Christen and Rosenberg, 2000). Protection of customers' deposits necessitates appropriate regulations (Vogel, Gomez and Fitzgerald, 2002; Hannig and Braun, 2000).

The need for regulation is also attributed to governance of MFIs, which depends on the commitment of the managing boards. Since most microfinance institutions are funded by donated resources, the "board members do not have a serious amount of their own money at risk. So they tend not to watch management so closely" (Christen and Rosenberg, 2000). Microfinance institutions themselves view appropriate regulation as a means to improve organizational integrity, legitimacy, independence and responsible market growth (Meagher and Wilkinson, 2000). A study of 12 regulated microfinance institutions in Latin America reported that the benefits of regulation exceeded the cost (Theodore and Loubiere, 2002), and these benefits include greater access to commercial sources of funds for equity and debt, ability to provide diversified products, higher standards of control and reporting and enhanced legitimacy in the operations

Christen and Rosenberg (2000) recommend that regulation of microfinance be limited to deposit-taking MFIs, and that credit-only MFIs not be regulated. They do not believe in self-regulation through microfinance-controlled federations. Vogel, Gomez and Fitzgerald (2002) share concern about the limitations of microfinance self-regulation and further point out that some microfinance institutions take deposits from their loan clients, which does not qualify them as "deposit taking" since their deposits are against the loan and the depositors are net debtors to the institution. They also criticize current practice and support for regulation as providing space for those who disfavour commercial microfinance and restricting flexibility of operations by imposing limits on interest rate ceilings.

Most literature underlines the need for regulation, while suggesting carefully designed regulatory frameworks tailored to specific country conditions with sufficient supervisory oversight to enforce them (Hannig and Braun, 2000; Christen and Rosenberg, 2000). According to Christen and Rosenberg (*ibid.*), "regulation without supervision is worse than no regulation". Chaves and Gonzalez-Vega (1994) underline that "prudential provision, as the process of enforcing the regulations, should show a high degree of flexibility and neutrality towards character arrangements and the market segment of

particular intermediaries". With this, they recommend that the business of microfinance that is not collateralized by marketable assets be regulated differently from the regular banks. Microfinance regulation, therefore, should take into account the specific risk character of the institution.

Meahger (2002: 3) relates the special characteristics of microfinance that need to be addressed in the regulatory framework as follows:

- its attempt to deepen financial markets to serve micro-enterprises and poor households;
- its high unit costs of lending;
- its approach of physically taking banking services to clients who have few other options to receive financial services;
- the relatively undiversified and sometimes volatile nature of MFI credit portfolios;
- the fact that most MFIs began as unregulated credit NGOs, with a focus on social goals rather than financial accountability and sustainability;
- the difference in institutional orientation, with some MFIs clearly profit oriented while others are committed to providing services to the poorer segments of the population on a non-profit basis, creating very different cost structures and fund sources;
- the fact that MFIs deal with savings and credit transactions with relatively low value in relation to the system as a whole. As a result they are unlikely to have problems that cause broad systemic instability (Johnson, 1997);
- the market risk posed within the microfinance sector itself when MFIs (especially large ones) are improperly managed and monitored.

### 2.5.2 The role of governments in regulation

Mostly, microfinance institutions are registered as NGOs, which are not generally included under the financial regulations applied by the central banks. Neither do NGOs have a legal charter to engage in financial intermediation. In many countries, deposit taking from the public is an activity restricted to licensed financial institutions (Al-Bagdadi and Bruentrup, 2002). Most microfinance institutions are dependent on subsidies and unable to operate profitably enough to pay a commercial cost for a large por-

tion of their funds (Christen and Rosenberg, 2000). This restricted status prohibits most of the microfinance institutions from accessing deposits from the public or engaging in any type of banking operations such as providing savings services for the poor, which is a means to obtain long-term capital at a reduced cost. Under such circumstances, adequate regulation may help these institutions to attract deposits from the public, which may lead them to grow in a sustainable way (Meagher, 2002).

Some governments are concerned enough about the level of interest rates to intervene in MFI operations. According to Christen and Rosenberg (2000), Latin American experience shows that non-involvement by the government has helped the microfinance institutions immensely in their early stages. Most countries in Latin America had legally permissible lower levels of interest rates, which were insufficient for sustainable operations by microfinance institutions and which compel them to operate as NGOs. Over the years, the government has seen increased demand for high interest rate loans, and this became a non-issue in the licensing of microfinance institutions later on because there was no shortage of demand. Even when interest rates were high, the governments did not consider fixing of interest rate ceilings for microfinance. Governments are also keen to regulate these institutions to protect depositors' interests, particularly in the case of microfinance institutions that are already taking deposits. This is justified by the government's attempts to protect poor depositors from possible moral hazards. In many countries poor people have lost their savings due to the incompetence or fraud of unregulated and little known institutions (Wright, 2000).

Most governments have not as yet intervened in the operation of microfinance institutions, though this has recently been changing (Meagher, 2002). Meagher points out that governments are considering regulation as an opportunity to control microfinance institutions, mainly due to the potential contributions of these institutions to politics. Since the governments have the legal power to influence economic agents to conform to regulations, the role of government in regulation is significant.

Lack of regulation may also lead to ambiguities in legal and policy frameworks in the operational environment of microfinance institutions (Meagher, 2002). This would encourage governments to apply existing laws that may have severe effects on the operation of microfinance institutions.

Both donors and governments expect regulation to speed the emergence of sustainable microfinance institutions. Christen and Rosenberg (2000) suggest that the process of integrating microfinance institutions into a licensed environment should be properly timed and gradually phased, due to the inexperience of the regulatory process in the microfinance sector. Because of the variety in types of microfinance institutions, it has been suggested that institutions be fitted into a tiered structure which clearly defines what types of institutions are to be regulated and by whom (Meagher, 2002). The advantages of a tiered approach are that it would provide opportunities and incentives for microfinance institutions to graduate between tiers while creating appropriate regulatory requirements for the different types of institutions.

The approach to regulation of microfinance institutions is country specific in nature. Though there is no single prototype that can be applied universally, the role of government should be restricted to facilitation rather than suppression.

## 2.6 Methodology

This research focuses on the evaluation of the sustainability and outreach of microfinance institutions in Ethiopia. For the purpose of analysing financial and operational sustainability, five-year financial and operational data was gathered from each institution (1999-2003) where available. At the same time primary data was collected by conducting interviews and group discussions with clients of the selected MFIs to explore client relations with the institutions, client profile and to some extent the outreach to clients. To measure institutional viability, interviews and discussions were conducted with the management, employees and also members of the board of directors. Legal and policy documents, procedural manuals and reports were collected and studied to evaluate the institutions' systems resources and impact of the regulatory framework on the institutions. Written documents related to regulations and policies were collected from the National Bank of Ethiopia and the Association of Ethiopian Microfinance Institutions.

Data related to sustainability was analysed using the subsidy dependence index to show the extent of progress achieved by the institutions toward self-sufficiency, comparing the same with operational and financial

sustainability ratios. Regression analysis of major volume and performance parameters were conducted for 170 sub-branches of one of the MFIs selected (for which full data was available) to show the relationship between the volume of operation and performance. In addition, the Statistical Programme for Social Science (SPSS) was used to process and analyse the responses of clients' and the questionnaire used to interview employees was also analysed using SPSS. Descriptive statistics were used to analyse the background data and financial and operational data, and simple statistical comparisons among the MFIs were made. The scale of outreach was measured on the basis of number of clients reached (growth in number of clients over years), geographic areas covered, number of service outlets (branch or sub-branches opened), range of financial services provided and amount of gross portfolio (with growth of portfolio over years).

Depth of outreach was shown by gender (with preference to women), location (rural population preferred), level of education (illiterate preferred), household (female-headed household preferred), loan size (smaller indicates depth) and loan term (shorter term loan indicates poorer clients).

Institutional viability was analysed with respect to effective governance resources and ability to generate appropriate information that enables the organizations to appropriately manage their programmes. The regulatory framework and its impact on the institutions were analysed from the perspective of institution building and the implication of the legally imposed ownership structure and governance structure.

Sample institutions were systematically selected using criteria appropriate to capture the different characteristics of the microfinance institutions. Thus, for the purpose of data collection, MFIs were selected on the basis of their age, size, ownership and the regions in which they operate. The cut-off point used for age was establishment in or before the year 2000 to ensure that operational and financial data are available for a minimum of four years. As to the size, MFIs that had a minimum of 5,000 clients at the end of 2001 were selected, and in as much as possible all areas (regions) in which MFIs were operational in 2002 were included (Table 2-1). Accordingly nine institutions were selected for the study. Branch and sub-branches visited were selected on the basis of age and also proportionate to the size of the institutions. Thus, four sub-branches each were visited for large two institutions, two for medium sized and one each for small institutions.

**Table 2-1**

*Selection of MFIs for the survey, based on 2002 data (those selected are shaded)*

Institution	Founded	No. of clients	Retail outlet	Clients per outlet	Ownership (predominant)	Region or area served
1. Addis Credit and Savings Institution (AdCSI)	2000	15,895	6	2,649	Regional Government	AA
2. Amhara Credit and Savings Institution (ACSI)	1995	262,880	163	1,612	Regional Government	ANRS
3. Africa Villages financial Service (AV FS)	1998	1,535	2	768	NGO	AA+ ONRS
4. Asseer Microfinance Share Company (AMSC)	1999	4,234	4	1,059	NGO	AA+ SNNPR
5. Benishangul-Gumuz Microfinance Institution (B-GMFI)	2001	3,660	2	1,830	Regional Government	BGRS
6. Buusaa Gonofaa Microfinance Institution (BUGMFI)	1999	4,405	4	1,102	Local NGO	ONRS
7. Dedebit Microfinance institution (DECSI)	1994	154,417	96	1,609	Regional Government	TNRS
8. Esthet Microfinance Institution (E MFI)	2000	3,444	3	1,148	NGO	ONRS
9. Gasha Microfinance Share Company (GMFSC)	1998	6,224	4	1,561	NGO	AA+ONRS
10. Meket Microfinance Institution (MKMFI)	1999	2,298	1	2,298	NGO	ANRS/Wollo North
11. Meklit Microfinance Institution (MKLMFI)	2000	2,500	2	1,250	NGO	AA+ ONRS+ SPNNRS
12. Metemaman Microfinance Institution (MTMFI)	2002	800	6	133	Local NGO+	ONRS
13. Omo Microfinance Institution (OMFI)	1997	62,805	9	6,978	Regional Government	SPNNRS
14. Oromia Credit and Savings S. c. (OCSSCO)	1997	50,000	70	714	Regional Government	ONRS
15. Poverty Eradication and Community Empowerment (PEACE)	1999	9,064	7	1,295	NGO	ONRS, ANRS, SPNNRS
16. Specialized Financial and Promotional Institution (SFPI)	1998	7,159	4	1,780	NGO	AA+ONRS
17. Shashemane Idir Yelimat Agar Microfinance Institution (SIYAMFI)	2001	1,628	1	1,628	NGO	ONRS
18. Sidama Microfinance Institution (SMFI)	1998	12,318	9	1,369	Zonal Government	SPNNRS
19. Wsaasaa Microfinance Institution (WAMFI)	2000	2,624	2	1,312	NGO	ONRS
20. Wisdom Microfinance institution MFI (WMFI)	1998 <sup>1</sup>	12,000	15	800	NGO	ONRS+ANRS+S PNNRS

Note: 1. Wisdom Microfinance is one of the oldest. It started its credit programme in the 1980s.

### 2.6.1 Choice of analytical model

As indicated in the objective of this research, our purpose is to evaluate institutional viability with the focus on outreach and financial sustainability. Thus, the models chosen here are taken on the basis of the ability to express the relationship between the variables used to evaluate the institutions.

To evaluate the performance of MFIs for the purpose of donor evolution and other routine monitoring purposes, various ratios were developed within the framework of the CGAP, SEEP, Women's World Banking (WWB) and several other institutions. Thus, financial ratios such as profit-

ability, asset management and capital adequacy ratios, and other operational indicators related to loan portfolio quality and repayment rate fall within this group. Profitability ratios among others are used in this study to analyse the basic data, but with full recognition of the pitfalls in the use of ratios to draw conclusions, and only to the extent that it can help to form judgments about the MFIs, as an indicator of outreach and sustainability. Ratios must be interpreted with care when used as the basis for judging operations and financial performance. Our analysis involves the comparison of different sets of instruments, which could function as cross checks to one another. Ratios reflect the relationship between two figures used in the computation but no more facts about the variables in the computation. A high ratio of liquid assets to total deposits may be taken as a positive indication to guarantee the solvency of an MFI in the short run from the savers' perspective. The same outcome could be taken as an indicator of inefficient utilization of funds to generate revenue, especially when excessive funds are kept idle or invested in alternatives that earn lower returns than could be garnered with an increase in loan portfolio. Relating the outcome of different measurement techniques may provide a better interpretation of the indicators. Ratios nonetheless can provide insight into short-term performance, though they are less useful as long-term indicators. The analytical models used here are not only those that evaluate the historical performance, as in the case of traditional financial statement analysis for operational control, but also those that enable us to evaluate the chance for the institutions to remain viable, and alternatives to the operation to improve performance.

The subsidy dependence index developed by Yaron (1992), in line with the financial sustainability objective, measures the financial viability of institutions at two levels: operational self-sufficiency and financial self-sufficiency. This model is chosen here for two reasons. First, it supports our analysis of the level of the financial self-sufficiency attained by the institutions, which is traditionally indicated by a ratio of costs to total revenue (including the opportunity cost of capital). Second, the SDI indicates the level of subsidy dependence of the institution and the percentage increase in earnings required to reach self-sufficiency. Thus, the findings of the financial self-sufficiency ratios, such as the return on equity (with a reciprocal relation to the subsidy dependence index), and the SDI are compared to show the extent of profitability and viability. The importance of the sub-

sidy dependence index primarily lies in its inclusion of the implicit cost of equity capital which is not included in most accounting ratios.

The subsidy dependence index, however, gives the impression that the institution has to increase the on-lending interest rate by the percentage indicated in the index (when the result is positive) to reach sustainability. This implies that the operation is efficient enough at the level it is operating, on which assumption it is based, but this is rarely true, as MFIs because of various factors do not operate at optimal efficiency. The SDI can be calculated for small MFIs with limited outreach and larger MFIs with wider outreach alike, but the scale of the outreach, which has a significant impact on fixed transaction costs of operation, is paid insufficient attention. Outreach, which is the ultimate objective of MFIs, can at the same time be a good indicator of financial self-sufficiency as financial self-sufficiency assures sustainable outreach to the wider clientele.

## Notes

<sup>1</sup> The founder and managing director of Grameen Bank, Muhammad Yunus, was quoted saying, "...If banks lent to the rich, I lent to the poor. If banks lent to men, I lent to women. If banks made large loans, I made small ones. If banks required collateral, my loans were collateral free. If banks required a lot of paperwork, my loans were illiterate friendly. If you had to go to the bank, my bank went to the village. Yes, that was my strategy. Whatever banks did, I did the opposite" (Daley-Harris, 2006).

<sup>2</sup> Steinwand refers to the book of Deuteronomy 23:20 "unto foreigner thou may lend upon interest but unto thy brother thou shall not lend"; in the new international version (NIV) translation the verse reads "You may charge a foreigner interest but not a brother Israelite, so that the Lord your God may bless you in everything you put your hand to in the land you are entering to possess"

# 3

## Country Background

### 3.1 Introduction

In this chapter, the broader context of the country is described. A general overview of the country is presented followed by a few indicators of macroeconomic performance and past and present policy regimes that have implications for financial system development. The poverty profile and welfare indicators are briefly presented to show possible impact on microfinance development. Finally, financial sector development in the country is shown referring to both the formal and informal sector. This will help us to understand the place and importance of microfinance in the country.

### 3.2 The country profile

Ethiopia is a land of contrasts. It is the third most populous country in sub-Saharan Africa, home of diverse cultures and reasonably good resource potential for development, yet faced with complex poverty, which is broad, deep and structural (MoFED, 2002). The country is physically located between 33<sup>o</sup> and 48<sup>o</sup> east, and 9<sup>o</sup> and 14.7<sup>o</sup> north, with a surface area of 113 million ha (1.14 million square km).

Of the total land mass, 45% is estimated to be arable land. It is also estimated that 27.9 ha or 25% of the total land mass is currently under intensive or moderate cultivation. Peasant farmers till most of the cultivated land, and agriculture is rain fed. Irrigated land accounts for less than 5% of the area under cultivation (EEA, 2000).

The climate differs depending on the altitude from cold in the extremely high mountains, temperate on the high plateaus, to hot in the peripheral lowlands of the eastern and western coasts. Altitude ranges from a high of 4,620 m above sea level at the peak of the highest mountain to as low as 100 m below sea level in the Dalol Depression along the north-

eastern coast. The extreme difference in altitudes and the rugged and mountainous nature of the land make transportation difficult.

Ethiopia's population was estimated at 69.1 million in June 2003 (1995 Ethiopian Calendar) with a population density of 60.6 persons per square km (NBE, 2004). By 2005, the national population was projected to reach 73.1 million, according to the Central Statistical Authority (CSA) based on the 1994 census (EEA, 2000). According to the NBE, on 30 June 2003 (NBE, 2004) the working population (ages 15-59) constituted 37.04 million or 53.6% of the total population, resulting in an age dependency ratio of 86.5%.

By all standards, Ethiopia is one of the poorest countries of the world. The per capita GDP was estimated at US\$ 93 in the recent NBE report, while the World Development Report 1999/2000 ranked the country last out of 210 countries in terms of per capita GNP and 208<sup>th</sup> in terms of per capita GNP purchasing power parity (EEA, 2000).

In terms of standard of living and poverty profile, about 44% of the country's population is currently believed to live below the absolute poverty line (MoFED, 2002). Poverty is more severe for the rural population, and some estimates still report the percentage at as much as 50% of the population (EEA, 1999/2000). According to the latter, infant mortality and child mortality is 12 per 100 and 8 per 100, respectively, and the average life expectancy is below 50 years, while 66% of the population have life expectancy of only 60.

School enrolment rate is less than one-third of the school age population, while progress to higher levels of education shows an enormous wastage, with only about 19% of the enrolled continuing on to the secondary level. Those who go on to the tertiary level are less than one per cent of the cohort.

Only 28.4% of the population (19.9% in the case of rural) has access to safe drinking water and 4.0% has access to electric power (NBE, 2004b). Road infrastructure is underdeveloped, with in 2002 a road density of 29 km/1,000 km<sup>2</sup>, and 0.48 km/1,000 population (MoFED, 2002). The rural population on average must travel 8 km to reach the nearest health post, 11.5 km to reach an all-weather road, and 18 km to reach a telephone station (Mulat et al., 2003).

The economy is still dominated by agriculture, which accounts for 48.2% of the GDP and is dominated by subsistence peasant production.

Commercial and modern farms owned privately and by the government account for less than 5% of total farm products (*ibid.*, 2003). The share of government in production declined after the collapse and abandonment of the state farms operated under the military/socialist regime.

### 3.3 Overview of policy regimes and macroeconomic performance

#### 3.3.1 A brief review of past and present economic policies

Comparing the economic policies of the past and present regimes of Ethiopia brings into focus the making of the country's current economic structure. The early years of the imperial era (up to 1935) were characterized by the introduction of trade and businesses owned mostly by foreigners (Greeks, Armenians, Arabs and Indians). Business activities were mainly small scale and cottage industries and general trade. This helped the Ethiopians to gain experience with wider organizational alternatives to the traditional household-based economic activity, by participating in partnership with the foreigners and also by the introduction of modern education (Tilahun, 2002). This beginning was interrupted during 1935-41 due to the Italian invasion and the Second World War. After restoration of the imperial regime in 1942, several measures were taken to modernize the economy, including issuance of systematic regulations and incentives to stimulate private investment. Ethiopia was also among the first countries to be granted a development loan in 1951 by the World Bank, which led to the establishment of the Development Bank of Ethiopia (World Bank, 1976).

Systematic economic strategy was introduced with the government's first five-year development plan in 1957 (Taffera, 1973). Three such plans were implemented until 1974, when the monarchy was finally deposed and a military government took power. During the plan period important legislation issued by the regime, including the Commercial Code of Ethiopia of 1960, which remained partly in force during the military/socialist regime and is still in force, helped modern business to flourish.

Foreign direct investment and joint ventures were relatively high during this period due to the liberal economic policies and incentives for investors (Box 3-1). Financial institutions were organized on the basis of market principles, despite the government ownership of main financial institutions and some restriction of capital ceilings on foreign capital participa-

**Box 3-1***Ethiopian government's investment policy prior to 1974*

The Second Five-Year Plan states that the government will provide facilities to encourage prospective foreign investors since it recognizes that foreign private capital is needed and welcome in Ethiopia. Official policy recognizes no discrimination between the public and private sectors, and there is no limitation on the private sector as to the kind of business it may undertake or the size of the enterprise it may promote.

The Investment Decree of 1963, issued in the *Negarit Gazeta* of 16 September 1963, was enacted in the words of the preamble “for the express purpose of stimulating and encouraging future private capital investment” which is considered “vital to the accelerated growth and development of the economy”. The Decree was amended and replaced by Proclamation No. 242 issued on 7 November 1966. This comprehensive investment law extends various benefits, privileges and exemptions to certain existing and new-to-establish agricultural, industrial, mining, transport and touristic enterprises with a view to encouraging and stimulating potential and existing private foreign and domestic investors in such activities. The relief consists of exemption from import duties for investment goods, tax relief from business profits, export duty relief for manufactured goods destined for export and a facility for remittance of foreign exchange.

Two main changes were brought about by the 1966 amendment of the 1963 Investment Law.

1. The Investment Committee was transformed from a temporary, advisory body into a permanent committee with executive power to decide on enterprises' applications for privileges under the proclamation.
2. The Investment Committee was mandated to determine what specific activities would be considered eligible as “industrial enterprises” and thus to enjoy the facilities and tax exemptions and it was further asked to determine the amounts of investment to be used in obtaining tax concessions from the Ministry of Finance:
  - for a period of 5 years from the date of commencement of operations for a newly established enterprise which invests in Ethiopia an amount over Eth \$200,000;
  - for expansion of productive facilities for an enterprise that invests in Ethiopia not less than Eth \$200,000;

Among investments not eligible for tax exemption are industries engaged in the manufacture of alcoholic beverages or liquors or enterprises which commenced operation prior to the coming into force of the Investment Proclamation.

Source: Taffera (1973: 24).

tion in banking. Ethiopia was also favoured by foreign investors as the only safe country in which to invest at that time due to the threat of nationalization in other countries following the liberation of several African nations,

including neighbouring Sudan (Taffera, 1973). “Ethiopia had the major prerequisite to attract foreign investment due to rich economic potential, currency and government which is stable, and liberal economic regulation governing repatriation of profit” (ibid.: 23).

The Investment Law of 1963 as amended in 1966 outlined the incentives to be given for private investors (foreign and domestic alike) and also provided for procedures for issuance of licenses (Box 3-1). Incentives included relief from import duties, tax exemptions and right to profit repatriation for those undertaking industrial activities with the exception of production of alcoholic beverages and liquor.

Despite the liberal economic policy, the educated strata of the time were uncomfortable with the state of the economy, especially with the political unwillingness of the monarchy to introduce any reform and the neglect of the rural population, who were left to languish under the repressive feudal system of tenancy (EEA, 2000; Tilahun 2002). This led to the 1974 uprising (“the revolution”) that ultimately brought about the transfer of political power to a group of middle and lower rank military officers, who established the provisional military government.

The military government followed a centrally planned economic system adopting socialist principles. In this line, the regime implemented a series of economic measures, among others, nationalization of banks, insurance companies and industrial and commercial firms, and land reform which brought rural and urban land under the control of the state. As a result the entire institutional set-up was changed to reflect the new economic policy.

The ceiling on private investment was legally set at ETB 250,000 for a domestic investor and US\$ 500,000 for a foreign investor. Financial sector policy was overhauled with a new proclamation in 1976. The proclamation enhanced the power of the National Bank of Ethiopia (NBE) to implement monetary and credit policy, exercise exchange controls, allocate foreign exchange and administratively determine interest rates. Banks lent to state-owned enterprises according to the central plan allocation of credit facilities (EEA, 2000).

There was virtually no private investment after 1977 until the fall of the system since the environment was no longer conducive, even for the limited investment allowed within the permissible capital limit, as the economic principles and policies were derived from anti-market and anti-private sector ideology (Mulat et al., 2003). In the rural areas, produc-

tion of the mono-export product, coffee, drastically decreased due to the government's monopoly of directly buying coffee from the peasant farmers at a dictated price for export. Peasant farmers had no incentive to produce coffee as the price was too low, and prices did not increase even when international prices were high. Above all the financial system and institutions degenerated as the result of the institutional transformation to serve the planned economy.

The regime ultimately presided over an economy that was progressively collapsing as a result of poor macroeconomic policies, mismanagement, and war with Somalia, protracted civil war, internal instability and recurrent drought. Clinging to the Soviet bloc socialist system for armaments and self-alienation from international economic relations denied the country economic opportunities. These, coupled with a population growth rate of around 2.9% per annum, led to a decline in the welfare of the society at large. The crisis of the 1980s called for substantial economic, political and institutional reform to reverse the retrogression (Mulat et al., 2003). Despite its recognition of the need for economic reform (partly due to the collapse of the Soviet bloc and lost faith in socialism) and its introduction of a mixed economic policy, in 1991 the regime crumbled amidst an economic and social crisis whereby a coalition of one of the insurgent rebel groups took over political power and formed a transitional government.

The Transitional Government of Ethiopia (TGE) adopted the Stabilization and Structural Adjustment Programme (SAP), which called for significant policy reforms. Stabilization policies emphasized the reduction of government budget deficit, credit control and the like while structural adjustment policies focused on removing constraints on the supply side and paid close attention to the production of export crops through depreciation of the real exchange rate and other incentives. A number of reform measures were introduced in the 1990s as part of the SAP. These included, among others (Mulat et al., 2003):

- devaluation of the domestic currency against the dollar and determination of the exchange rate through auctions;
- abolition of interest rate ceilings;
- removal of subsidies;
- tax reform (lowering the marginal tax rates and broadening the tax base);

- reduction of tariffs and removal of non-tariff barriers;
- simplifying licensing procedures;
- reorganizing the customs authority;
- deregulation of prices;
- privatization of (some) public enterprises.

Besides this several other sectoral policies and strategies were formulated for the development of the economy. Central to all of the economic policy of the country was Agriculture-Led Industrialization (ADLI), enacted in the belief that the agricultural sector could serve as the driving force for the rest of the economy. The policy aimed at exploiting the county's labour force and land with modernization of the agricultural sector, thereby increasing agricultural productivity. It was believed that surplus agricultural products would provide industry a cheap source of raw materials, while the demand for industrial goods would increase for agricultural inputs and consumption. Government intervention and direct involvement was called for where market failure was expected (in the area of public goods in particular). State intervention was also foreseen in the development of infrastructure for towns and cities to create conducive investment conditions for private-sector development and achieving balanced regional economic development through deliberate budgetary allocation and incentives in favour of the least developed regions (EEA, 1999/2000). ADLI and food security, the justice system and civil service reform, improved governance and capacity building were stated as the building blocks of development. Rural and agricultural development, food security, pastoral development, road infrastructure, water resources, health and education were identified as key sectors under the poverty reduction effort (MoFED, 2002). Among others, the food security strategy and rural redevelopment strategies envisaged the expansion and sustainable provision of rural finance, including strengthening the microfinance sector.

The private-sector development strategy of the government envisaged, besides macroeconomic stability, the improvement of investment finance by strengthening the financial sector including the financing small and micro-enterprises (SME).

## 3.4 Economic performance

### 3.4.1 Economic structure and trends in growth<sup>1</sup>

Available evidence indicates that the pace of economic growth was unsatisfactory over the past three decades. Regardless of the policy regimes, real GDP, agricultural GDP, industrial GDP and service sector GDP grew on average by 3.0%, 2.1%, 2.1% and 4.4% per annum, respectively, during 1980/81-2000/01. However, population grew on average by 2.9% during the same period, implying a 0.1% annual growth rate in per capita income (Mulat et al., 2003).

Economic performance improved in the 1990s, compared to the situation during the last ten years of the previous regime. Real GDP growth, on average, increased from 2.3% in 1980/81-1991/92 to 4.6% in 1992/93-2000/01. The growth rates of agriculture, industry and services were 1.4%; 0.02% and 2.8%, respectively, during the 1980s, compared to 2.5%, 5.3% and 7.5% in the 1990s (Table 3-1). But the improvements failed to be sustained as the economy continued to suffer from fluctuations in weather conditions. Figure 2-1 shows that annual growth rates of GDP, agricultural GDP (AGDP), industry GDP (IGDP) and service GDP (SGDP) were subject to substantial fluctuations due to war, drought, mismanagement and policy failures. With regard to the sectoral mix of the economy, agriculture continued to take the lion's share of the economy, followed by the services and industrial sectors.

The share of agriculture decreased slightly from 52.9% in the 1980s to 48.2% in the 1990s. The share of industry declined from 11.9% to 10.8% over the same period, while the share of services increased from 35.2% to 44.0% (Table 3-2). In the last two years the share of agriculture declined further to 39.4% in 2002/03, which is the result of the decline in agricultural production due to drought rather than improvement in the structure of the economy. This is also witnessed by the overall decline of GDP during the same periods.

It appears that the structure of the economy essentially remained the same, with dominance of the subsistence agrarian sector showing no sign of decline. Commercial or modern farms belonging to the state or private investors are few and account for less than 5% of agricultural output.

The share of the service sector, which includes trade, hotels and restaurants, banking and insurance, transport and communication, and public ad-

**Table 3-1**  
*Growth in GDP, 1980/81-2000/01 averages,  
 and the last two years (%)*

Sector/Year	1980/81- 1991/92	1992/93- 2000/01	2001/02	2002/03
GDP at constant factor cost	2.3	4.6	1.22	-3.77
Agriculture	1.4	2.5	-3.13	-12.17
Industry	0.02	5.3	5.78	4.93
Services	2.8	7.5	4.58	2.05

Source: MoFED (2002), Mulat et al. (2003) and NBE (2004).

**Table 3-2**  
*Sectoral shares of GDP (percentages)*

Sector/Year	1980/81- 1991/92	1992/93- 2000/01	2001/02	2002/03
Agriculture	52.9	48.2	43.18	39.42
Industry	11.9	10.8	10.95	11.94
Services	35.2	44.0	45.87	48.64

Source: MoFED (2002), Mulat et al. (2003) and NBE (2004).

ministration, has been expanding. The service sector also includes very small and informal businesses, which have been growing rapidly as a result of limited employment opportunities in the formal sector. The industrial sector consists of state-owned large and medium scale manufacturing that relies on outdated technology and inefficient management. Most of these companies have found it difficult to compete in a liberalized market environment. Similarly, small-scale manufacturing and handicraft activities lack the capacity to compete with cheap and superior products imported from abroad.

### 3.4.2 Other macroeconomic indicators

In terms of price development, evidence suggests that inflation has never been out of control in Ethiopia. It has been checked within single digits, usually below 5% except in 1994/95 (MoFED, 2002). However, price movements in the country are highly correlated with agricultural production (especially food production). For instance, inflation was 0.3% in 1995/96 while it was 6.2% in 1999/2000. The former period was characterized by favourable weather conditions and a good harvest, implying low

food prices, which are the major element driving the general price level. The period 1999/2000 was marked by drought and low agricultural production and relatively higher food prices. The national inflation rate was below zero (-5.2% and -7.2%) in fiscal years 2000/01 and 2001/02 due to good weather and better performance of the food sub-sector. In fact this period was marked by a grain boom that resulted in the drastic fall of grain prices in which many farmers and traders were reported losing on their investments. Many rural farmers who produced a surplus by using fertilizers and improved seeds were drastically affected when grain prices fell even below the pre-Derg period. Drought and food shortage characterized 2002/03, following the year of abundance. The impact of the previous period contributed to that year's crisis (Table 3-3)

The employment figures of the country are alarming in the face of the slow growth of the real economy. As mentioned in Mulat et al. (2003), based on the 1999 Labour Force Survey, the unemployment rate using the current status approach for the total country was found to be 8.0% in 1999. But urban unemployment was 26.4%, about five times higher than that in the rural areas (5.1%). The incidence of unemployment also varied by sex. In urban areas, unemployment among women was 34%, compared to 18.3% among men. The same pattern holds for rural areas, where 8.6% of women and 2.4% of men were reported unemployed.

The country is also characterized by a very high rate of population growth. The total population more than doubled during the past three decades, increasing from 29.1 million in 1972 to 67.2 million in 2002 (NOP, 2000). The sharp increase in the annual growth rate of population from 0.2% at the beginning of the century to 3% in the 1980s was mainly due to an increase in fertility and a decline in mortality (Mulat et al., 2003). This perhaps has led to growing unemployment and a decline in overall welfare. The gender-biased employment condition in the urban and rural areas also relates to poverty status.

### 3.5 Poverty profile in Ethiopia

Poverty reduction is a major agenda item in many developing countries. In Ethiopia, poverty reduction is the priority of development policy, and the Interim Poverty Reduction Strategy Paper (IPRSP) was prepared first in 1999. The Ministry of Finance and Economic Development (MoFED)

**Table 3-3**  
Trends in inflation (%)

	1996/97	1997/98	1998/99	1999/00	2000/01	2001/02	2002/03
General	0.3	3.9	4.8	6.2	-5.2	-7.2	15.1
Food	N.A.	N.A.	9.0	8.6	-10.4	-12.9	24.8
Nonfood (core)	N.A.	N.A.	-1.3	2.4	1.9	0.9	0.5

Note: N.A.=not available.  
Source: NBE (2004).

published the final paper in July 2002 under the title *Sustainable Development and Poverty Reduction Programme* (SDPRP). The paper presented the poverty profile of the country based on the CSA's (Central Statistical Authority) 1995/96 and 1999/2000 surveys of household income, consumption and expenditure (the HICE surveys). The 1995/96 HICE survey covered 11,441 households from eleven regions, eleven major urban centres and reports for other urban areas, while the 1999/2000 covered 17,332 households from eleven rural areas, fifteen major urban centres and eleven other urban areas. Hence, there is a difference in coverage and quality of HICE surveys conducted in the two periods. The data were compiled and analysed in the report *Ethiopia: Sustainable Development and Poverty Reduction Programme*.

Other data are from the household survey of the Department of Economics of Addis Ababa University. The sample size for rural households consists of 1,576 households at 18 sites. These sites are located in different regions and agro-ecological zones. A sample of 1,500 urban households was drawn from seven major urban centres. These urban centres included Addis Ababa (capital city), Awassa, Bahir Dar, Dessie, Dire Dawa, Jimma and Mekelle (Mulat et al., 2003). At this point it should be noted that the data available might not necessarily be accurate due to limited coverage of the population and lack of cross-sectional data.

### 3.5.1 Poverty indices

Poverty indices have been estimated based on the minimum calorie requirement for subsistence at 2,200 kcal per adult per day. The expenditure necessary for a basket of the required calories adjusted for basic nonfood expenditure is estimated at ETB 1,075 per annum per person (MoFED, 2002). Notwithstanding other social indicators, which we shall see below

in brief, the poverty line was established on the basis of consumption and consumption expenditure. Table 3-4 presents the proportion of people living below the poverty line in 1995/96 and 1999/2000, according to MoFED (2002). Poverty incidence scarcely declined between 1995/96 and 1999/2000. The MoFED's analysis indicated that poverty was more severe in rural Ethiopia than in the urban centres. Since the majority of the population lives in the rural areas, the overall countrywide poverty rate approximates the rural poverty incidence.

The regional distribution of poverty shows uneven distribution of people living below the absolute poverty line. In some regions poverty increased over the two observation periods, except in Amhara, Southern Nations, the Nationalities and People's Region (SNNP) and Harari. The slight decline in the national poverty level in 1999/2000 is attributed to the significant decline in two regions, namely Amhara and SNNP. The data for most part correspond with the starting of institutionalized microfinance interventions; however, it is difficult to generalize conclusions about the impact of microfinance on the regional population overall. Nonetheless, the national poverty line is used to estimate demand for microfinance.

Harari had the lowest incidence of poverty in both periods. Other city-states, such as Addis Ababa and Dire Dawa, also had lower levels of poverty than the other regions. The incidence of poverty is the highest in regions such as Tigray and Amhara, where drought is a recurrent problem and land degradation is a major constraint to agricultural production. Poverty is also rampant in SNNP, the region with the highest population density. Oromia, the most populous region in the country, has relatively more favourable natural resources and thus relatively less poverty in recent years, but the poverty situation worsened rather than improved in 1999/2000.

According to the MoFED, aggregate poverty among male-headed households, measured by the head count index, decreased from 0.461 in 1995/96 to 0.444 in 1999/2000. On the other hand, the head count poverty index among female-headed families increased (from 0.425 to 0.434) over the same period.

Surprisingly, the evidence indicates that the head count poverty index is slightly higher for male-headed than female-headed households in rural areas in both periods. It has been documented that customary laws and practices are patriarchal and have significantly constrained women's access to resources both within and outside the home. For instance, land is managed

**Table 3-4**  
*Trends in poverty*

Description	1995/96			1999/2000		
	Rural	Urban	National	Rural	Urban	National
Head count index (P <sub>0</sub> )	0.475	0.332	0.455	0.454	0.369	0.442
Poverty gap index (P <sub>1</sub> )	0.134	0.099	0.129	0.122	0.101	0.119
Squared poverty gap (P <sub>2</sub> )	0.053	0.041	0.051	0.046	0.039	0.045

Source: MoFED (2002).

**Table 3-5**  
*Regional profile of poverty levels*

Regions	1995/96			1999/00			Percent change		
	Rural	Urban	Total	Rural	Urban	Total	Rural	Urban	Total
Tigray	--	58	46	56	62	61	61	6	33
Afar	52	--	33	68	27	56	31	--	69
Amhara	57	37	54	43	31	42	-24	-17	-23
Oromia	35	28	34	40	36	40	16	30	17
Somali	35	.02	31	44	26	38	27	1531	23
Benishan gul	48	34	40	56	29	54	17	-16	15
SNNP	57	46	56	52	40	51	-9	-12	-9
Gambella	42	24	34	55	38	51	31	57	47
Harari	13	29	22	15	35	256	12	20	17
AA	40	33	30	27	36	36	-33	21	20
DireD	37	25	29	33	33	33	-9	35	12
Total	48	33	46	45	37	44	-4	11	-3

Source: MoFED (2002).

and administered at the village level by local officials who operate with a traditional gender bias. The problem is compounded by the absence of women's grassroots groups, due to both past experience under the former regime and cultural factors.

Comparing poverty by occupation, the MoFED reported that poverty is higher in households headed by farmers than non-farmers. About 48% and 45% of the farming households lived below the poverty line in 1995/96 and in 1999/00, respectively. The corresponding proportion was 35% and 41% among non-farming households.

**Table 3-6**  
*The gender dimensions of poverty*

	1995/96			1999/2000		
	Rural	Urban	National	Rural	Urban	National
<i>Head count index (<math>P_0</math>)</i>						
Male headed	0.477	0.329	0.461	0.455	0.339	0.444
Female headed	0.460	0.337	0.425	0.447	0.492	0.434
<i>Poverty gap index (<math>P_1</math>)</i>						
Male headed	0.135	0.090	0.131	0.123	0.086	0.120
Female headed	0.129	0.106	0.123	0.118	0.134	0.115
<i>Squared poverty index (<math>P_2</math>)</i>						
Male headed	0.053	0.039	0.051	0.046	0.030	0.045
Female headed	0.051	0.046	0.049	0.044	0.051	0.043

Source: MoFED (2002).

### 3.5.2 Other basic welfare indicators

Apart from income or consumption, other important components of welfare are education, access to clean water and sanitation, mortality and fertility rates and life expectancy. It is widely accepted that human capital accumulation is the engine of socioeconomic transformation or development in any country (Mulat et al., 2003). It is, therefore, necessary to incorporate some of these indicators here for Ethiopia. In Ethiopia, the literacy rate is one of the determinants of poverty. That is, poverty indices are 45% higher for illiterates than literates in rural areas and 85% higher for illiterates in urban areas (MoFED, 2002).

Ethiopia has one of the highest adult and youth illiteracy rates in not only sub-Saharan Africa, but also in the world (Table 3-7). Adult illiteracy for men and women was 57% and 68% in 1999/2000, respectively, while youth illiteracy for men and women was 46% and 48%, respectively. By contrast, the sub-Saharan adult illiteracy rates for men and women were 31% and 47%, respectively, while youth illiteracy rates for men and women were 18% and 27%, respectively, in 1999. According to the MoFED (2002), the literacy rate among the rural population was 21.8%, compared to 70.4% in urban areas.

Gross primary, secondary and tertiary enrolment rates in Ethiopia are also among the lowest in the world. The situation changed little even after post-reform efforts to expand enrolment, according to the EEA (2000). Both gross enrolment and net enrolment rates were lower for rural areas

**Table 3-7**  
*International comparisons in education, 1999 (%)*

	Adult illiteracy rate (age 15 and above)		Youth illiteracy rate (ages 15-24)	
	Male	Female	Male	Female
Ethiopia	57	68	46	48
Kenya	12	25	4	6
Tanzania	16	34	7	12
Uganda	23	45	15	29
Sub-Saharan Africa	31	47	18	27

Source: World Development Indicators (2000), cited in Mulat et al. (2003).

(52.4% for gross enrolment and 28.0% for net enrolment rates in 1999/2000) than their urban counterparts (105.4% for gross enrolment and 74.5% for net enrolment rates). Similarly, women have lower enrolment rates than men in both rural and urban Ethiopia. The government has set itself the goal achieving universal primary education by the year 2015 (MEDaC, 1999)

However, while a recent country assessment by the World Bank reported a sharp increase in overall school enrolment, a decline in pedagogy was also found due to reduced per capita expenditure on education materials, increased student-teacher ratios and increased student-section ratios. The World Bank indicates the student-to-teacher ratio, in some instances, is more than double the average of the preceding periods. The same was reported for student-sections ratios. The increase in enrolment therefore can be attributed more to population growth than to investment in education (World Bank, 2005).

Health service coverage in Ethiopia is among the lowest in the world. The potential health service coverage (PHSC), for instance, was limited to 51.2% of the population in 2000/01. There were only four physicians per 100,000 population in 2000. The average infant mortality rate per thousand was 106.1 and the total fertility rate was 6.8 (OECD, 2001). One in every six children dies before age five, with 58% of these deaths occurring during the first year of life (EEA, 2000).

The majority of the population lacks access to adequate health facilities. The average distance from a household to the nearest health centre was 7 km in 1999/2000. About 50% of the population in the country resides more than 6 km from a health centre (Mulat et al., 2003).

**Table 3-8**  
*Access to other economic infrastructure (average distance in km),  
 1999/2000*

Type of infrastructure	All-country	Rural	Urban
Food market	5.19	5.88	1.04
Post office	18.81	21.20	4.64
All-weather road	9.77	11.35	0.30
Telephoe booth	18.44	20.95	3.62
Milling house	3.74	4.31	0.32
Cooking fuel	1.49	1.66	0.43

Source: MoFED (2002).

Average life expectancy at birth for Ethiopians was 52 years in 1984, and 51 years in 1994. Life expectancy declined further in recent years because of the AIDS pandemic, especially among the working age group. According to the World Bank (World Development Report, 2003), life expectancy at birth was only 42 years in 2000. HIV/AIDS is now the major development challenge facing the country. Access to economic infrastructure is key for the welfare of the population. A person living in a rural area, on average, must travel 5.9 km to reach a food market.

Determinates of poverty in Ethiopia vary between rural and urban population. But type of employment, gender, age, ownership of assets, level of education, and household size and composition are found to be common. Female-headed households have more chance to fall into poverty. Thus, beyond the massive poverty, human capital development is as yet weak in Ethiopia, which has direct relevance to our topic.

## 3.6 Financial sector development in Ethiopia

### 3.6.1 The formal sector

The banking sector emerged in Ethiopia with the establishment of the Bank of Abyssinia in 1905 in partnership with the National Bank of Egypt under an imperial concession for a fifty-year franchise as a sole operator in the country (Addison, Alemayehu, 2002; Taffera, 1973). The bank opened its first branches in Dire Dawa, Gore and Dessie and agencies in Harar and Gambella (Taffera, 1973). Foreign companies wanting to operate in the country challenged the monopoly position of the bank. The Bank of Egypt relinquished its monopoly in 1931 and its assets were purchased by order

of the emperor and replaced by the Bank of Ethiopia (Banque Nationale Ethiopienne) with the principal aim of reorganizing the banking and currency of the country under national auspices (Taffera, 1973). The bank took over the premises of the Bank of Abyssinia with authorized capital of £ 750,000 divided into 30,000 shares of £25 and with a paid capital of £235,962.

The Bank of Ethiopia was abolished during the Italian occupation and replaced by Italian bank branches. During the Italian occupation (1935-41) foreign bank branches other than Italian ones were banned and replaced by Italian banks only. "During the period of occupation branches of Banca d'Italia, Banco di Roma, Banco di Napoli and Banca Nazionale del Lavoro were established with several branch offices in the main towns in the interior" (Taffera, 1973). In 1941 Barclays Bank (then Dominion, Colonial & Overseas) came to Ethiopia with the British troops and organized banking services in Addis Ababa, until its withdrawal in 1943, when the State Bank of Ethiopia was established.

The State Bank of Ethiopia was originally created as a commercial bank by a proclamation issued in August 1942. But a year later, in addition to its commercial banking functions, the bank was entrusted with the three basic duties of a central bank: controlling the issue of currency, holding the foreign reserves of the country and acting as the fiscal agent of the government. Up to December 1963, when the State Bank disappeared with the banking reorganization, it combined these official and private functions acting at the same time as a central bank of issue and the only important deposit bank operating in the country.

The first specialized bank, the Agricultural Bank was established in 1945, and was succeeded by the Development Bank of Ethiopia in 1951. The other specialized institutions were Imperial Savings and Home Ownership Public Association (ISHOPA) established in 1962 and the Ethiopian Investment Corporation in 1963. The Development Bank of Ethiopia and the Ethiopian Investment Corporation were later merged to form the Agricultural and Industrial Development Bank (AIDB) in 1970, which was government's principal instrument to extend investment credit in agriculture, industry and other investment activities (Taffera, 1971; Tilahun, 2002).

The Commercial Bank of Ethiopia was established after the July 1963 banking proclamation (Monetary and Banking Law) as a result of which the State Bank of Ethiopia was abolished and replaced by the National Bank

of Ethiopia (NBE), and the Commercial Bank of Ethiopia (CBE), with the role of central bank and commercial bank separated for the first time. Three private banks were licensed as a result of 1963 Monetary and Banking Law (Taffera, 1971), the Addis Ababa Bank (1964) established under private initiative with a minority foreign share and two branches of foreign banks - Banco di Roma (Ethiopia) and Banco di Napoli (Ethiopia). There were some thirteen insurance companies most of which were under private ownership. According to Taffera, (1973), nine insurance companies were registered between 1963 and 1967. In addition to the domestically registered ones, companies registered in Great Britain, Japan, France, India, Italy, New Zealand and the United States also operated in the country. Thus, despite the interruptions during WWII, there was fair development in the financial sector up to the 1974 revolution.

A stock market was also established in 1964 where equity shares of leading privately owned companies were traded in the capital. Ethiopian government treasury bonds were offered to a wider market, public and private alike, when they were issued.

After 1974, the first wave of nationalization started with the nationalization of banking and insurance businesses (Proclamation No. 26/1975). The three private banks were merged to form a new bank under the Addis Bank (Proclamation No. 69/1975), and later the Addis Bank was merged with the Commercial Bank of Ethiopia (1980) consolidating the commercial banking service in the country under the monopoly of one state-controlled bank. The Imperial Savings and Home Ownership Public Association and the Ethiopian Investment Corporation were abolished and merged to form the Housing and Savings Bank of Ethiopia (currently renamed the Construction and Business Bank (CBB)). The role of the National Bank was redefined to fit the central planning and “socialist” objectives. Shares exchange and sales of debt instruments, which was just starting to form the basis for the security market were abandoned, and financial sector development arrested.

After the fall of the socialist regime in 1991, the banking sector remained closed to the private sector until 1994, when Proclamation No. 84/1994 was issued for the licensing and supervision of the banking business. As a result, the banking and insurance sectors were deregulated and opened to the private sector. The currency (ETB) was devalued and foreign currency and interest rate regulations relaxed. Regulatory frameworks

were also put in place. The first private bank Awash International Bank (AIB) was licensed in 1995. In the subsequent years (1995-98) six private banks and eight private insurance companies were established. Operations of government-owned banks and the insurance company were reoriented and restructured according to the new economic policy.

The Ethiopian financial sector is, however, still fairly undeveloped. Only some one per cent of the rural households maintain a bank account (Al-Bagdadi and Bruentrup, 2002) and commercial bank branches are available in only 21% of the woredas (districts) of the country (Mulat et al., 1998). The number of banks per capita and population per bank branch are the lowest in sub-Saharan Africa (Lakew, 2000). The government-owned Commercial Bank of Ethiopia still dominates the market and commercial banking activities in the country. It is the single largest bank in terms of branch network (it had over 60% of branches in the country by 1999 and still 51% in 2003, Table 3-9), total assets, market share in loans and savings mobilization capacity. Table 3-9 shows a simple comparison of loan and deposit balances at different times between 1998 and 2003. Six private banks contributed 7%, 13% and 28% for years 1998, 2000 and 2003, respectively, in total bank loans outstanding. The share of the CBE alone was 72%, 67%, and 54% during the same years. Total loans outstanding for the banking sector increased by 26% from June 1998 to June 2003, while total deposits and savings increased by about 69% over the same period. The new banks did not push their shares on the savings and deposit front as they did with loans in the period, despite larger growth in total deposits mobilized over the years, the share of private banks reached only 19% in the total deposits mobilized by 2003.

The opening of new banks did not expand the outreach of the financial institutions into new territories or markets, since all new banks opened their head offices in Addis Ababa with a few branches outside the capital in the same towns where there were branches of the government banks, thus sharing the existing already served market with no significant increase in the overall service. The size and capacity of the private banks is small compared to the CBE, the giant government-owned bank. The other specialized government banks share a relatively small proportion of the market, comparable to the shares of the private banks, but do not necessarily share the same markets as they serve specialized investment and long-term loan clients, most which are not served by the commercial banks.

**Table 3-9**  
*Comparison of banks' market shares of loans and deposits, Ethiopia*

Banks	Share of total loans and deposits (%)					
	Loans			Deposits		
	1998	2000	2003	1998	2000	2003
Commercial Bank of Ethiopia (CBE)	72	67	54	86	83	76
Development Bank of Ethiopia (DBE)	14	15	14	4	4	3
Construction and Business Bank (CBB)	7	5	4	4	2	2
<b>Total government</b>	<b>93</b>	<b>87</b>	<b>72</b>	<b>94</b>	<b>89</b>	<b>81</b>
Awash International Bank S.C. (AIB)	3	3	5	2	3	4
Dashen Bank S.C. (DB)	2	4	8	2	3	6
Bank of Abyssinia S.C. (BA)	1	3	5	1	2	4
Wegagen Bank S.C. (WB)	1	2	4	1	2	2
United Bank S.C. (UB)	0	1	2	0	0.5	1
Nib International Bank S.C. (NIB)	0	0	4	0	0.5	2
<b>Total private</b>	<b>7</b>	<b>13</b>	<b>28</b>	<b>6</b>	<b>11</b>	<b>19</b>
<b>Total</b>	<b>100</b>	<b>100</b>	<b>100</b>	<b>100</b>	<b>100</b>	<b>100</b>

Source: Constructed by author from NBE data.

Thus despite the 300% increase in the number of banks from the level of 1995 the increase in total loans and savings was not of the same proportion. Still, branches of commercial banks remained concentrated in major towns where there were already financial services. The majority of the rural and, in fact, the residents of many smaller towns including several district capitals still lack access to banking services.

The formal financial institutions, in addition to their limited coverage in terms of geographic area, could not reach the majority of the population within the area they serve due to their requirements for high collateral pledges in physical assets. Thus, the rural poor and small and medium enterprises remain excluded from the service, since the banks do not serve them due to reasons common to formal banks elsewhere, that is, the lack of sufficient information about the poor, high transaction costs related to screening and processing small repeated loans, and the high risk of default including the difficulty of enforcing loan repayment contracts (Wolday, 2003).

In the absence of formal banks and any alternative arrangement not only the poor but also many relatively better-off individuals who could have or already had business ideas were not served.

**Table 3-10**  
**Capital and branch outreach of the formal banks in Ethiopia**  
**(capital in million ETB)**

Banks	Number of branches						Capital			
	2001/02		2002/03				2001/02		2002/03	
	Total	%	Regions	A.A.	Total	%	Total	%	Total	%
<b>Government</b>										
CBE	171	53.4	137	35	172	50.7	1498	59.2	1277	47.7
CBB	20	6.3	15	5	20	5.9	79	3.1	75	2.8
DBE	32	10	31	1	32	9.4	417	16.5	643	24
<b>Total government</b>	<b>223</b>	<b>69.7</b>	<b>183</b>	<b>41</b>	<b>224</b>	<b>66.1</b>	<b>1994</b>	<b>78.8</b>	<b>1995</b>	<b>74.6</b>
<b>Private</b>										
AIB	24	7.5	13	13	26	7.7	111	4.4	132	4.9
DB	23	7.2	14	14	28	8.3	88	3.5	122	4.6
BA	13	4.1	7	7	14	4.1	138	5.5	141	5.3
WB	20	6.3	15	8	23	6.8	56	2.2	83	3.1
UB	9	2.8	2	11	13	3.8	72	2.8	91	3.4
NIB	9	2.5	1	10	11	3.2	70	2.8	111	4.2
<b>Total private</b>	<b>97</b>	<b>30.3</b>	<b>52</b>	<b>63</b>	<b>115</b>	<b>33.9</b>	<b>535</b>	<b>21.2</b>	<b>680</b>	<b>25.4</b>
<b>All banks</b>	<b>320</b>	<b>100</b>	<b>235</b>	<b>104</b>	<b>339</b>	<b>100</b>	<b>2529</b>	<b>100</b>	<b>2675</b>	<b>100</b>

Source: NBE Annual Report (2003).

### 3.6.2 The informal financial institutions

Informal lending and borrowing takes several forms in Ethiopia. The most common and popular are the community based and more organized ones, *Iddir* and *Iqub*, which are common in both rural and urban areas. Private moneylenders exist throughout the country, and friends and relatives lend money free of interest.

Ethiopia has a strong tradition of informal, community-based financial institutions (Al-Bagdadi and Bruentrup, 2002), which are known as *Iddir*, and *Iqub*. *Iddir* is an indigenous institution in which members regularly contribute to a common pool — in cash or in-kind — with a view to supporting a needy member based on varying criteria for membership. *Iqub* is a

ROSCAS, in which members contribute to a common pool on a regular basis and collect the money by ballot among them or some other arrangement as agreed upon (Dejene, 2003). EEA (2000) traces the origin of *Iqub* to the period of Italian occupation of the country (1936-41) quoting accounts of historians like Pankhurst, but in fact the origins of *Iqub* seem much earlier, as *Iqub* is not the result of modernization but of social ties. Membership to *Iqub* is based on pre-established relations among the individual members. Normally they are made up of neighbours or peer groups of a certain age, occupation or persons that share something in common. It is a temporary association, for the purpose of raising funds, but there are also cases where the *Iqub* is permanently continued as money goes round.

*Iddir* serves in most cases the social objective of supporting the members in the event of a funeral, wedding or other social need that requires mutual assistance (including one or a combination of contributions of labour, food and drink, consolation of family during mourning, money from the common pool) as may be defined in the by-laws of the *Iddir*. Taffera (1971) referred to *Iddir* as a mutual aid association. Dejene (1993) identified four types of *Iddir*:

- community *Iddir* (formed by families residing in the same area),
- workplace or occupational *Iddir*,
- friends' *Iddir* (such as former schoolmates, close friends),
- family *Iddir* (people sharing a common ancestral tree or kinship).

EEA (2000) rightly adds one to the above list, that is, an *Iddir* based on ethnic background in major towns. In addition to mutual assistance, *Iddir* members are involved in development efforts such as road construction and other social affairs that require collective participation based on the strength and financial capacity of the *Iddir*.

An *Iqub* is an important means of converting small savings to a lump sum amount, organized in most cases with a purely financial objective. In rural areas an *Iqub* is less permanent than an *Iddir*, since the former may be terminated after one or more rounds, while the latter has an indefinite life, especially when it is a community *Iddir* based on residential area. According to Dejene (cited above), the participation rate of the rural communities and annual mean contribution to the two indigenous institutions vary significantly. The participation in an *Iddir* is higher (76%) and the annual mean contribution is small (ETB 55 per year per member), while for the *Iqub* the

participation rate is low (17%), and contributions are high (ETB 317 per member per year). The importance of these institutions is immense where there are no formal financial institutions. A number of works by Dejene Arado explore their significance (Dejene, 1993; Dejene and Kibre, 1995; Dejene, 2003a; Dejene, 2003b). However, there has been little effort to link these institutions with the formal sector except in the case of a few microfinance institutions.

The need to consolidate the experiences and financial operations of these traditional institutions was recognized as early as 1971. In his address to the conference Mobilization of Savings in African Countries in Milan (1971), the then general manager of the Commercial Bank of Ethiopia, Taffera Degueffe, underlined the importance of *Iddir* and *Iqub* as means of saving mobilization which could be used “effectively if ...better coordinated [and] managed and their funds... channelled through banks or financial institutions”. He suggested linkage of the informal sector to the formal sector to effectively finance productive activities, since in their current state they were not channelling funds to the productive sector. However, while the resources pooled by these institutions are important to smooth consumption and meet social needs (Dejene, 1993), they may be insufficient for investment in productive undertakings. Neither are such community-based organizations always reliable sources due to shortages of resource and the fact that members are equally affected by the same risks in adverse conditions (Khandker, 1998).

In a more informal way, it is part of the culture in Ethiopia that friends and relatives lend money to one another to provide mutual support in forms beyond the more institutionalized *Iddir* and *Iqub*. These loans are generally free of interest and used for consumption, though there are cases where family assist their younger members with loans to help them establish a means of earning income. Some such loans are not collected, but rather pardoned, depending on the prosperity of the lending member and the degree of affinity of lender to borrower. During the fieldwork for this study, some rural young men indicated a loan practice based on profit sharing. Profit sharing differs from loans in the degree of risk involved to the creditor. Profit sharing in some instances is like a partnership in a business among friends, while in other cases it is purely a financial provision, when for example the provider of money is guaranteed the principal at anytime and fully participates in sharing the profits of the financed venture. The

only risk in this regard is loss of profit in case of business failure. According to Dejene (1993), the share of friends and relatives in an informal money market constitutes 66%, while for private moneylenders the share constitutes only 15%.

A study by Gebrehiwot and Wolday (2004) found that relatives and friends funded micro and small businesses, but trade credit also played an important role. The 2003 informal sector survey by CSA showed that friends and relatives contributed more than microfinance institutions. In both cases, private moneylenders contributed the least in financing micro and small business enterprise finance.

In Ethiopia, private moneylenders are unwelcome by both tradition and the law of the country. During the imperial era the civil and penal code declared usury illegal and punishable by law. But moneylenders have persisted under the guise of “interest-free lending”, in which the contract between the borrower and lender states only the amount due from the borrower at a specified future date. Rural landlords and urban-based merchants have been prominent players in this market and have had opportunities to circumvent the law. Money continues to be lent for the next harvest, where agreements between farmer and lender fix the price in advance (a typical sales at discount with implicit interest rate). Moneylenders also provide shorter term loans collectible in cash.

During the military government private moneylenders were virtually unable to operate until near the end of the regime due to hostile attitudes towards the rich, who were considered exploiters if they were found lending for interest. Many private moneylenders lost their outstanding portfolio when rural land and other “means of production” were nationalized, since there was no possibility of enforcing lending contracts. Most landlords and merchants went bankrupt due to nationalization of land, their main source of income. But in urban areas moneylending persisted during the military regime among the participants of the dynamic black market, locally called “*ayer bayer*” trade, which involved explicit or implicit high interest rates. Moneylenders revived in the rural areas with the decline in the authority of the military regime with a new class of traders and some richer farmers entering the market.

Interest rates charged by private moneylenders are still high, even though the introduction of microfinance is reported to have contributed to reduce the rates in some regions (Tassew et al., 2003). Poor households borrow

from private moneylenders mostly for consumption or when there are problems of meeting social or financial obligations. The interest rates charged by moneylenders are exorbitant (up to 240%); it is thus difficult for the poor to use the loans for investment in productive activities (Teressa and Heidues, 2000). Apart from being expensive the resources available from moneylenders are limited, since few people are in a position to lend money.

According to a recent survey sponsored by AEMFI, informal finance contributes significantly to fulfilling urban and rural poor demand for financial services (Emana et al., 2005). Adding to the informal sector there are arrangements in the rural areas by which farmers who lack oxen may lease the services of an ox or pair of oxen for the rainy season only with the agreement either to pay in cash or in kind from their agricultural produce. The oxen might be placed with the user or the owner depending on the proximity of the lessee. In western Oromia, this practice is common among those who have spare oxen. It is called *gateetti gurguru* meaning “lease of the shoulder”.

There is a variety of such practices in the rural areas that have not yet been studied or their contribution identified. In pastoral regions, where wealth is measured in number of cattle and the economy is not yet monetized, borrowing and lending are done in the form of cattle. The Borana Oromo pastoralists have an insurance scheme which parallels the *Iddir* of the sedentary farmers and urban areas. They are bound by customary law to contribute cattle to restore a person their wealth of cattle in case of death of animals by natural causes as well as if cattle are looted by foes from a rival clan. The practice is called *buusa gonofaa*, which approximately means “contribution against devastation”. One of the MFIs in Ethiopia has adopted this name, Buusa Gonofaa.

Another traditional financial arrangement is “*meskel aksion*” (Emana et al., 2005), a year-long fund savings programme in which members of a community residing in the same locality save money by contributing to a common pool for the purpose of purchasing fattened ox at the *meskel* festival (the day of the finding of the true cross celebrated each September 26-27). In Sodo and Damot Weyde in the Walayita zone, clients informed this researcher that almost all residents of the rural areas and low-income groups in towns have such an association. Members may also borrow money from the fund during the year at an interest rate decided by the association leaders. The main purpose of this fund is to smooth the burden of

**Box 3-2**  
*Ethiopian anti-usury law, Ethiopian civil code*

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Civil code of 1960 Article 2479

1. Parties may not stipulate a rate of interest exceeding twelve per cent per annum.
2. Where it has been agreed that a loan will bear interest but no higher rate has been fixed in writing, the borrower shall owe interest at the rate of nine per cent.
3. The borrower shall also owe interest at the rate of nine per cent per annum where a rate of exceeding twelve per cent per annum has been agreed in writing.

Penal code 1957 Art 667

1. Whosoever, by exploiting a person's reduced circumstances or depending on material difficulties or carelessness, inexperience, weak character or mind;
  - (a) Lends him money at a rate exceeding the official rate; or
  - (b) Obtains a promise or assignment of benefit in property in exchange for pecuniary or other considerations, which is in evident disproportion, is punishable with simple imprisonment or according to the gravity of the case, rigorous imprisonment not exceeding five years and fine.
2. Whosoever, by simple intent acquires a usurious claim and sets it up against or assigns it to another is liable to the same punishment.

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Source: Emana et al. (2005).

festival expenditure by spreading it over a year and to supply meat, the major food cost for the festival, at production cost by buying live animals for slaughter instead of each member buying meat from a butcher at retail price. Lending from the fund was introduced recently as means of solving financial problems faced by some members and also to enable the fund to earn instead of keeping it idle. Their interest rate is less than moneylender rates but far greater than MFI rates in the area. Our informants told us the charge is up to 5% per month. *Meskel aksion* associations keep the money with the treasurer of the group, who manages the money at home; few deposit it in a bank. There were none who deposited the money with an MFI.

Besides the above-mentioned practices are various financial service arrangements such as money keeping on behalf of savers and leasing arrangements. Some of these constitute areas of opportunity for microfinance to expand their financial services. They can also use the local associations such as *meskel aksion* as a vehicle to mobilize savings and to ex-

pand the scope of savings to include that for other basic expenditures, such as housing, for which MFIs could lend after a member has saved some amount. The group could also be used for village banking, depending on the strength of the association, which could eventually reduce the transaction costs of lending. However, there has been little effort on the part of MFIs in Ethiopia to link their operations with traditional institutions. AEMFI's recent attempt to study the informal sector is a step towards the industry's learning the nature and operational mechanisms of the informal operators and to design new products that improve or link with these institutions.

### 3.6.3 Formal microfinance institutions

Microcredit started in 1980s by some NGO groups in Ethiopia as part of the relief and rehabilitation programme especially after the 1984/85 droughts. The origins of formal microfinance in Ethiopia counts on efforts made by international and local NGOs. NGOs and their activities in the country grew in the wake of the drought and famine that has repeatedly struck the country in the past two decades. NGOs introduced credit and savings schemes to help the victims develop self-employment opportunities and bring about stability and improvement in the lives of drought victims (EEA, 2000). NGOs also encouraged and sponsored studies to establish microcredit programmes. Later, studies were conducted on the effectiveness and sustainability of the NGO projects to develop them into microfinance programmes.

The microfinance sector in Ethiopia is relatively young compared to other developing countries. Federal Government Proclamation No. 40/1996 provides the legal framework for establishment of microfinance institutions (see also chapter 7). There are 22 licensed microfinance institutions operating in the country. Most of the now-licensed MFIs have evolved either from the credit component of the government programmes or from NGO credit schemes. Still regional governments or "mother NGOs" are the major contributors of the ownership equity of the MFIs. The microfinance institutions now play a major role in providing financial services to the poor, especially in rural areas and outside the major metropolises where formal banks either do not operate or do not serve the market as a matter of policy.

Cooperatives are governed under separate regulations, with a regional cooperatives bureau having the authority to monitor their acuties. NGO sponsored schemes provided background information on microfinance institutions in Ethiopia. Important lessons have been learned from the schemes in terms of targeting, selection, performance and sustainability. Most of the schemes have common features, using Grameen Bank type of credit delivery and repayment enforcement (i.e. through group pressure), emphasis on women's empowerment, community participation and above all proving that the poor are bankable if the programme is handled appropriately. It is safe to assume that the involvement of the regional government in microfinance operations has been inspired by the experience of the NGOs and governments "being fond" of rural populations, thus, extending the opportunity to take advantage of credit on cheaper terms.

In addition to the MFIs, multipurpose savings and credit cooperatives (SASCOS) serve members only. Currently there are 716 such cooperatives with 157,000 members in the country. These have mobilized more than ETB 180 million in savings (about US\$ 20.8 million) and have loans outstanding of ETB 167 million (about US\$ 19 million). SASCOS extend credit to members, the majority of whom are employees in urban areas (98%), and about 53% of the cooperatives were registered in Addis Ababa only (IFAD, 2001; Wolday, 2003).

### 3.6.4 Financial sector regulation

Financial sector regulation in Ethiopia dates back to the imperial era. The most complete monetary and banking proclamation was promulgated in 1963 (Befekadu, 1995). That proclamation allowed foreign equity participation (minority) in the banking and insurance sector. The Derg era was a period of financial repression under socialist policies which not only reversed the provisions of the previous law but also greatly undermined the financial system. After 1991, new regulations were legislated. The two main proclamations were Proclamation No. 83/1994 (the Monetary and Banking Proclamation) and Proclamation No. 84/1994 (for licensing and supervision of banking and insurance business). The latter proclamation allowed private ownership of banks and insurance companies, but limited this to Ethiopian nationals only. The proclamation required that businesses be formed as share companies with diversified ownership of at least five shareholders.

However, government still owned the dominant banks in the country as public enterprises.

The National Bank of Ethiopia was given the authority to license and supervise the banking and insurance industry in the country. The bank had the authority to issue directives and other secondary legislation for effective implementation of financial policy and the provisions mandated in the primary law.

Microfinance institutions remain regulated under a separate law. Federal Proclamation No. 40/1996, on the licensing and supervision of the business of microfinancing institutions, established the regulatory framework for MFIs in Ethiopia, while cooperative societies, including savings and credit associations, were regulated under another separate provision.

### 3.6.5 Conclusions

The country background reviewed in this chapter points to a weak macroeconomic structure with a predominance of agriculture in the GDP. Massive poverty, with more severity in rural areas and among the female population, has implications for demand for microfinance as well as presenting challenges. Limited access to basic facilities, such as health centres, and underdeveloped road and communications infrastructure, add to the challenge of reaching people with modern services. Human capital development has a long way to go, with the school enrolment rate poor, illiteracy high and health facilities generally lacking. Frequent policy change (drastic rather than gradual), as a result of regime changes, has interrupted economic directions. The financial sector, both formal and informal, has been particularly affected by the socialist ideology such that now the sector is underdeveloped.

Ethiopia is one of the most under-banked countries in sub-Saharan Africa. Microfinance was introduced fairly recently compared to other countries, but has now been in business for almost ten years. From this country background, especially the poverty situation in the rural areas and the poor infrastructure, we anticipate many challenges to microfinance performance.

## Notes

<sup>1</sup> The information and sources for this section are largely from the EEA report of 1999/2000, Mulat et al. (2003), MoFED reports and NBE reports.

# 4

## The Selected Microfinance Institutions

### 4.1 Introduction

The institutions included in the sample study were selected based on the set of criteria adopted under the methodology section. This section describes some features of the institutions selected in the sample study. A list of the selected MFIs and the regions in which they operate, retail outlets and visits, and the location of the retail ends is given in Table 4-1. Number of kebeles (urban dwellers' associations) visited and number of clients and non-client respondents interviewed during the survey is also included. The profile of the MFIs here aims to cover their basic features that are important in the following chapters. Thus, the origins and formation as MFIs, ownership structure, size, institutional design, governance structure, objectives, products and polices are shortly described.

### 4.2 Genesis and ownership

Many studies conducted on MFIs in Ethiopia attribute the starting of microfinance to Proclamation No. 40/1996, which laid the formal basis for the institutionalization of microfinance practice. The proclamation, rather, helped the consolidation and institutionalization of the MFIs as regulated financial institutions as we shall see later in chapter seven. Efforts were already being made to establish savings and credit cooperatives in the 1960s during the imperial era while informal and traditional community-based institutions (*Iqub* and *Iddir*) were used by the Ethiopian communities to pool savings and finance their needs (Taferra, 1971). However, most modern microfinance institutions evolved out of the NGO credit and savings schemes that started their programmes in Ethiopia in the mid-1980s

**Table 4-1**  
*The selected MFIs, sample areas, distributions of the MFIs, and branch, sub-branch and kebeles coverage*

Institution	Region (state)	Retail ends visited/ location ( <i>woreda</i> )	Kebeles (respondents)
Amhara Credit and Savings Institution S.C. (ACSI)	Amhara National Regional State (ANRS)	Merawi/Merawi	2 (15)
		Tisabbay/Bahrdar Zuria	2 (15)
		Woldia/Gubba Lafto	2 (15)
		Qobbo/Qobbo	2 (15)
Dedebit Credit and Savings Institution S.C. (DECSI)	Tigray National Regional state (TNRS)	Kuha/Inderta	2 (15)
		Mekele North/Mekele	2 (15)
		Wuqiro/Wuqiro	2 (15)
		Agulae/Wuqiro	2 (15)
Gasha Microfinance S.C. (GMFSC)	Addis Ababa (AA)	Gulale/Gulalle sub-city	2 (20)
Oromia Credit and Savings Share Company (OCSSCO)	Oromia National Regional State (ONRS)	Dandi/Dandi	2 (15)
		Adaa/Adaa	2 (20)
Omo Microfinance Institution S.C. (OMFI)	South Nations, Nationalities and Peoples Regional State (SNNPR)	Sodo/Sodo Zuria	2 (20)
		Damot Weyde/Damot Weyde	2 (20)
Poverty Eradication and Community Empowerment (PEACE)	ANRS, ONRS	Molale/Mama Midir-lalo	2 (20)
Specialized Financial and Promotional Institution (SFPI)	AA	Shola/Arada sub-city	2 (20)
Sidama Microfinance Institution S.C. (SMFI)	SNNPR	Awassa Zuria/Awassa	2 (10)
		Shebedino/Shebedino	2 (11)
Wisdom Microfinance Institution (WMFI)	ONRS	Adama/Adama	2 (20)
<b>Total coverage</b>	<b>5 regions</b>	<b>18 retail outlets/ 18 <i>woredas</i></b>	<b>36 (296)</b>

Note: See also the areas map for sample *woreda* in the annexes.

and early 1990s. The NGO programmes, however, took a project approach, which could not serve the communities on a permanent basis. After 1991 the ruling party organs of the regional political organizations started to establish a type of NGOs to rehabilitate the regions they claimed to represent. After coming to power these EPRDF organs organized development associations, which would intervene in regional development efforts with the participation of the residents of the regions and supporters of the party. These development efforts included provision of credit as part of development projects of the relief organizations following the example of NGOs. Some of today's regional government supported MFIs emerged from this effort. The rest are results of NGO initiatives either al-

ready involved in microcredit before the proclamation or established after the proclamation with NGO backing.

The Amhara Credit and Savings Institution Share Company (ACSI) was established in 1995 by the Organization for Rehabilitation and Development in Amhara (ORDA). ORDA is a relief and development organization founded and registered in the regional state of Amhara by the ruling party (EPRDF) chapter of the Amhara region (Amhara Nation Democratic Movement - ANDM) with the establishment of the regional state. ACSI started its pilot operation in 1996 prior to the issuance of the proclamation for the licensing of microfinance institutions, which was later in the same year (November 1996). In April 1997, ACSI was licensed under the requirements of the proclamation. Pursuant to the requirements of the proclamation, ACSI was organized as a share company with ownership distributed among five entities (the regional state 25%, ORDA 35%, Amhara Development Association (ADA) 20%, Amhara Women for Development Association (AWDA) 10%, and Endeavour (a regional government-based party business conglomerate) 10%.

Dedebit Credit and Savings Institution Share Company (DECSI), was the outcome of the Credit and Savings Scheme of the Relief Society of Tigray. The Relief Society of Tigray (REST) has been involved in development programmes mainly in environmental rehabilitation and agricultural development, relief and social development, rural water supply and credit and savings services. These programmes aim at helping the people of Tigray attain self-reliance based on the genuine participation of the people, by tackling and overcoming the root causes and effects of poverty through promoting sustainable rural development. In 1994, REST implemented a rural credit scheme in Tigray, after studying other countries' experiences, with the aim to serve poor areas with credit supply. The scheme's operational coverage and client outreach soon increased with the implementation of the Grameen model lending methodology, which made it one of the pioneers in the country. The rural credit scheme was thus required to be registered under the National Bank of Ethiopia and allowed by law to form a microfinancing institution when the new proclamation was issued in 1996. Accordingly, the rural credit scheme was changed into a new institutional form under the name Dedebit Credit and Savings Institution Share Company (DECSI) in March 1997. DECSI was licensed to operate in the region of Tigray, and it is now considered an important agent of develop-

ment that caters microfinancing (credit and saving) services for the rural and urban poor in TNRS.

DECSI's shareholders are the regional government, the Relief Society of Tigray (REST), the Women's Association of Tigray (WAT), the Farmers Association of Tigray (FAT), and the Youth Association of Tigray (YAT) with the regional government holding a share of 25%.

Gasha Microfinance Share Company (GMFCS) is the outcome of Pro-pride (a local NGO) engaged in social promotion and prevention of HIV/AIDS. Gasha was licensed in May 1998 and registered at the Addis Ababa trade and industry bureau as a share company as required by the proclamation and relevant laws. Its start-up capital was provided by donor funds accorded to the NGO. The NGO retained a 30% share, the rest being distributed among 732 client shareholders (70%). Of ETB 800,000 subscribed capital, only ETB 200,000 (the minimum required capital for licensing) was paid up. The GMFCS head office is near the Pro-pride office in the densely populated Addis Ketema, near the main market hub of the city continently located to access the poor. Most clients of the institute are poor clients engaged in service businesses, like production and sale of food and drink. They also have a branch in Entoto (Gulale sub-city) where most clients are engaged in production of hand woven traditional cotton clothes.

GMFCS clients are beneficiaries of Pro-pride social programmes. In addition, GMFCS collaborates with several local projects and NGOs to access clients via them. These are the Women Fuel Wood Carrier Project, the Berhan Integrated Community Development Organization, the Bole-Baptist Community Development Programme, RATSON, Mesereta Kirstos church, Pact Ethiopia, the German Development Service (DED), and the Ethiopian Federation of Persons for the Disabled.

Oromia Credit and Savings Share Company (OCSSCO) is a transformation of Oromia Rural Credit Scheme Development Project, which was formed under Oromo Self Help Organization (OSHO), an NGO organized with the support of regional government and/or the ruling party function of the region. It assumed company status in August 1997 with license from the NBE under the provisions of Proclamation No. 40/1996. The company was registered at ONRS trade and industry bureau to operate throughout the region.

The Oromia regional state owns 25% of shares of OCSSCO while the remaining are owned by the Oromo Self Help Association (OSHO) 25%,

Dinsho Private Limited Company 25%, Oromia Development Association (ODA) 20%, and an individual 5%. OCSSCO was established with an authorized capital of ETB 60 million, and subscribed capital of ETB 20 million of which only ETB 5.2 million was paid up at the time of establishment. By 2003 the total paid up capital of the company had reached ETB 38.02 million, which was mainly contributed by the regional state (ETB 35 million). A strange situation with OCSSCO is that the effective owners of the company are only three of the five, the individual and OSHO could not pay the capital they subscribed. While other MFIs have allocated the capital contributed among the nominal shareholders, OCSSCO's records reveal no such camouflage. There was no reaction to this from the supervisory authority while this is violation of the country's company law.

Omo Microfinance Share Company (OMFI) was established in July 1997 by the initiative of the regional government. OMFI was to provide financial services, in the words of the introduction to the five-year business plan (2004-08), "based on the regional state's development strategy which is rural based and agricultural led [Agricultural Development-Led Industrialization (ADLI)]. It was the belief of the regional government that the implementation of this development strategy has to be complemented by the establishment and provisions of effective rural financing scheme" (OMFI, 2003: 4). Thus, the SNNP region launched pilot operations mid-1997 in four districts.

OMFI was licensed and registered at the National Bank of Ethiopia in October 1997 as a share company in compliance with the provisions of Proclamation No. 40/1996 with subscribed capital of ETB 2 million, (about US\$ 231,214) and paid up capital of ETB 0.5 million (about US\$ 57,803). Each shareholder had paid up only one-quarter of the subscribed capital until end December 2004. OMFI, which was effectively launched solely by the initiative of the regional state government and owned by the same, followed the path of others by registering an association and a trading company under the regional government as shareholders and two individuals to fulfil the minimum number of shareholders required by law. The ownership concentration remained largely under the regional state, holding 80% of the subscribed and paid up capital of the institution. SNNP Development Association (SNNPDA), holds 10%, Wondo Trading Company (a business owned by the regional state ruling chapter of the EPRDF) 9.5%, and two individuals hold 0.5% of the shares.

The establishment of the Poverty Eradication and Community Empowerment (PEACE) MFI was initiated by Agri-service Ethiopia, which is an indigenous NGO and which itself used to deliver savings and credit services prior to the new MFI policy. PEACE was formally established in November 1999 with the objective of providing credit and savings services to the active poor. PEACE was licensed to operate at the federal level. It thus has branches in three regions of the country despite its yet very small size when compared especially with the government-supported MFIs.

The Specialized Financial and Promotional Institution (SFPI) was established as a result of a feasibility study undertaken by a group of consultants sponsored by Redd Barna. Save the Children Norway (Redd Barna), USAID, UNDP, Concern, World Vision, the Ethiopian Women's Affairs Office of the Prime Minister's Office, and several line ministries were also involved in the idea. After the study and a day-long workshop on the recommendations, agreement was reached to establish the institution under the ownership of the concerned stakeholders serving as members of a general assembly that would elect a board of directors. The board in turn would nominate the management of the institution. However, events took another course. Proclamation No. 40/1996 was issued before the institution commenced operations in the manner recommended by the consultants. Pursuant to the provisions of the new proclamation some members of the initiative, many of them international NGOs, could not be licensed as owners of the new financial institution. Organizers of SFPI filed an application to the Office of the Prime Minister under the provision that authorizes the council of ministers to exempt institutions from some or part of the requirements of the proclamation on special grounds, but the Office of the Prime Minister turned down the request. As a result SFPI had to be reoriented according to the proclamation and thus was formed with ownership shares distributed among Agri-service (a local NGO), the Ethiopian National Association for the Blind, the National Women's Association for Development, the Ethiopian Women Entrepreneurs Associations, the Commercial Bank of Ethiopia, Dashaen Bank and Mr Hailu Wondafrash, as the founding shareholders.

SFPI was licensed and registered in 1997 to operate at the federal level, and it commenced operations in mid-1998. It currently operates in Addis Ababa and surrounding woredas in Oromia regional state.

**Table 4-2**  
*Ownership structures of the 9 MFIs and their origins*

MFIs	Genesis and operation prior to licensing	License (year)	Ownership structure (% of shares held)			
			Regional gov.	Associations, co-ops, trading companies	NGOs	Individuals
ACSI	Part of ORDA, 1995	1997	25	40	35	--
DECSI	Part of REST, 1994	1997	25	30	40	5
GMFSC	Part of Pro-Pride (NGO)	1998	--	--	30	70
OMFI	Initiated by reg. gov., 1997	1997	80	19.5	--	0.5
OCSSCO	Part of OSHO, 1996	1997	25	45	25	5
PEACE	Part of Agri-Service (NGO)	1999	--	--	16	84
SFPI	Initiated by Redd Barna	1997	--	80	--	20
SMFI	Part of SDA, 1995	1998	--	87	12.5	0.5
WMFI	Part of World Vision (NGO), 1980s	1998	--	--	--	100

Source: Reports of the respective institutions.

Sidama Microfinance Institution (SMFI) evolved from the Sidama Rural Women Credit and Savings Scheme, which started in 1994 as a pilot programme in Bensa woredas of the Sidama zone. The scheme organized some 60 women groups and gave them credit with the requirement to save as well. Irish aid assisted this programme.

SMFI was licensed in 1998 to operate a microfinancing business in the Sidama zonal administration of the SNNRPS. Its shares were initially registered in the name of Sidama Development Association (SDA) and four individuals. Later, the shares were transferred to the farmers cooperatives in the region for the main part.

Wisdom Microfinancing Institution Share Company (WMFI) started operations in 1998 as a spin-off of World Vision. The institution was registered as a limited company, with the majority of shares owned by World Vision employees. WMFI is historically a village banking operation, but

recently introduced individual loans. World Vision and USAID fund the institution. In order to meet growth targets, however, WMFI plans to further intermediate clients' savings and access funds channelled from the African Development Bank. The institution operates through its 7 branches and 20 sub-branches in Addis Ababa, ONRS, ANRS and SNNP.

The other shareholders are in essence organizations that work closely with regional government in the development of the region, and most actions are coordinated along the policies of the regional government. Sidama Microfinance Institution (AMFI) is the transformation of Sidama Development Association's credit and saving scheme. The scheme was supported by a fund from Irish Aid. Irish Aid later helped establish SMFI before relinquishing its activity with the scheme (EEA, 1999/2000). When the MFI was licensed the equity capital so obtained through aid was assigned as a share to individuals and with the participation of Sidama Development Corporation. Four individuals and the corporation were registered as founders. The subscribed capital was 200 shares, Birr 1,000 par value (meaning  $200 \times 1,000 =$  total of Birr 200,000 subscribed capital). Par means par value fully paid. The individuals were truly nominal in that they had to surrender their shares three years after the establishment of the company. The shares registered in the name of the individuals were transferred to cooperatives. In terms of procedure, what was done in the NGO-backed MFIs is the same. Where the MFI was attached to an international NGO (World Vision for example) the capital was registered in the name of the employees of the NGO since the law prohibited foreign nationals from owning shares in financial institutions. Local NGOs held the shares but to fulfil the requirements of the proclamation a minimum of five persons with one natural person had to register as shareholders, thus requiring individuals to lend their names.

### 4.3 Governance structure

The governance structure of Ethiopian microfinance institutions is almost structurally uniform since it is legally prescribed. All of the MFIs follow the structure provided for in the Commercial Code of Ethiopia regardless of size and ownership. MFIs must have a board of directors whose names and CVs are deposited at the National Bank of Ethiopia for registration. Members of the board must have completed twelve grades or high school and have busi-

ness experience, while the chief executive officer (CEO) is expected to have at least a first degree in one of the social science fields. People from natural sciences fields are not accepted by the National Bank unless there is exceptional experience in the field of banking and microfinance. In the upper structure of the microfinance governance are the general assembly, board of directors and the chief executive officer's offices as provided in the law. Chapter seven discusses the governance of the MFIs further.

#### 4.4 Mission and vision of the institutions

The vision and mission statements of the institutions are summarized in Table 4-3. Most of the MFIs presented here have a vision of poverty alleviation or eradication. Empowerment of women and the resource poor and institution building were also among the expressed visions. Another part of the institutions' missions is to provide financial services to the poor who lack access to conventional banks. The mission statements, as such, show that most of the Ethiopian MFIs are minimalist in their programmes. Credit and savings services are explicitly mentioned in a few of the mission statements. While DECSI and OCSSCO have provisions for financial services, in general others make it explicit that credit and savings is in their mission. Whether the intention is to limit them to credit and savings service only is unclear. On the other hand, the two NGO-based MFIs, SFPI and Wisdom, state their mission as provision of financial and non-financial services. Strategic documents of the institutions list objectives, values and operational principles for some of the institutions. Short and long-term goals are also defined in some.

In the vision and mission statements, the regional government-backed institutions define their commitment to the welfare of their respective regions, while the smaller NGO-based MFIs promulgate a vision for the entire rural and urban Ethiopia (Table 4-3). A further look at the objectives and strategies reveals that the regional-based MFIs have plans and commitment to work closely with their regional governments to implement or assist in the implementation of regional development programmes. We observed some variations in the wording, and even at times in the content of the mission statements in different reports and documents produced by the institutions. A review of the mission statements, objectives and strategies of the institutions shows that the Ethiopian MFIs pursue both the ob-

**Table 4-3**  
*Summary of mission and vision of the MFIs*

MFIs	Vision	Mission
ACSI	To contribute a society in which people are free from abject poverty with power to determine their future in their hands	Improve economic situation of low income, productive poor in Amhara region through increased access to lending and savings services
DECSI	To eradicate poverty in Tigray Region	Provide sustainable financial services to the poor people
GMFSC	To contribute to a society where people are able to work towards realizing their dreams and potential for the future	Create an attitude of self-reliance and confidence of the low rural and urban micro entrepreneurs by assisting them increase their income through participation in savings and credit programmes
OMFI	To contribute to an economically strong region where people are free from abject poverty and build a well developed institution to provide services in a sustainable manner	Take part and play an important role in combating poverty to bring about sustainable economic development
OCSSCO	To see enhanced livelihoods of resource poor households of Oromia and become a model microfinance institution in Africa	Alleviate poverty through provision of financial services to the poor
PEACE	To see women empowered and poverty eradicated	Provide credit in cash and in kind
SFPI	To provide poor people, especially women, full access to institutional credit for self-employment. Poverty eradicated both in rural and urban Ethiopia; emergence of self-reliant and business-minded generation	Work toward the socioeconomic empowerment of the active poor both in urban and rural Ethiopia by assisting them create and run viable business through provision of financial and non-financial services
SMFI	To alleviate poverty and empower both the rural and urban poor	Provide financial services to the economically active poor, both urban and rural, who have no access to the conventional banks
WMFI	To improve the economic and social well-being of the productive poor in rural and urban Ethiopia	Promote development and expansion of economically viable and sustainable micro enterprise through quality financial and non-financial services

Source: Compiled from strategic plan documents of the institutions.

jective of poverty alleviation and financial sustainability of their institutions, at least in principle.

Concerning institutional sustainability, some of the institutions did not mention this at all in their mission statement. But in strategic documents all

mention the need for sustainable operations and institutional sustainability/self-sufficiency.

## 4.5 Organizational structure and size

The upper structure of the MFIs is prescribed by law, while lower strata organizational decisions are mostly made by the CEO and board. Smaller MFIs have two basic departments: an operations department and finance and administration. Gasha, PEACE and SFPI are in this group. Indicative of the larger MFIs, ACSI's structure has three organizational layers: the head office, the branch and the sub-branch. Branch managers are directly accountable to the general manager. In ACSI, seven offices plus eleven branch offices are accountable to the general manager, providing for a very wide span of control. ACSI is in fact more of a bank and some of the smaller banks in the country have a less extensive branch network. ACSI and DECSI have a similar structure. The organizational charts of ACSI and Gasha are shown in the annex as representatives of the large and small MFIs in Ethiopia. A number of size parameters are stated in Table 4-4.

PEACE is the smallest of the group in terms of staff members, while ACSI is the largest employer. ACSI accounts for 44% of the total employees of the nine selected MFIs, while PEACE accounts for 1.2%. The differences in the other size parameters, branches, assets and active clients follow a general pattern: ACSI and DECSI are the largest, OCSSCO and OMFI follow at some distance, and the remaining five are much smaller. The MFIs selected cover over 90% of the MFIs in Ethiopia, which means that the remaining 13 MFIs cover less than 10% of the sector, whatever size parameter is used.

The geographical distribution of the MFIs with their branch network does not follow the logic of size, proximity and market or potentials of the clients served. Regional governments or NGO social programmes determine the locations served. ACSI operates in Amhara National Regional State only, but its branches are scattered throughout the region, which is sometimes difficult to access from ACSI's main office. For ACSI it could be easier to serve clients in some near states than to aim for the region's residents who are located far away from its head offices from a cost consideration point of view. Places such as North Showa and South Wollo could better be served by MFIs located in Addis Ababa and Oromia. The dis-

**Table 4-4**  
*Selected MFIs with size parameters as of end of 2003*

MFI	Staff (number)	Branches (number)	Assets (million ETB)	Active clients (number)
ACSI	1,443	170	249.5	20,228
DECSI	718	96	313.8	84,567
GMFSC	80	6	8.3	5,504
OCSSCO	412	70	80.8	50,471
OMFI	338	53	44.1	66,488
PEACE	39	8	6.3	4,381
SFPI	56	4	9.2	10,267
SMFI	112	14	16.4	--
WMFI	82	15	18.0	10,270
<b>Total</b>	<b>3,280</b>	<b>437</b>	<b>746.5</b>	<b>559,792</b>
<b>Of all Ethiopian MFIs (%)</b>	<b>91</b>	<b>93</b>	<b>94</b>	<b>94</b>

Source: Compiled from operational reports of MFIs.

tance from the ACSI head office to some of its sub-branches is 700 km. For Oromia, the situation is similar: the western tip and eastern end of Oromia from Addis is well over 600 km. Smaller MFIs share the distance problem. PEACE operates a branch in Bale (Oromia region) 690 km south of Addis, one 550 km to the north-west in Gojam, one over 600 km away in the south, and one 350 km north of Addis, but it has no branch office in Addis Ababa near its headquarters. Wisdom also operates very scattered branches in Amhara, Oromia and SNNP and in Addis. Gasha and SFPI operate in Addis Ababa, with one branch in Bishoftu. OMFI and SMFI are confined to the SNNP. SMFI has a relative advantage since it operates in the Sidama Zone only. Its operational area is compact, and Sidama is one of the country's most densely populated zones. If its clients were not shared by OMFI, which operates throughout the southern nations, SMFI could easily exploit the opportunity to sustain its operations.

## 4.6 Client targeting

The policies of the MFIs with respect to client targeting, screening and selection, and product mix are stated in Table 4-5. The table reflects the terminology used by MFIs to indicate their target group and their eligibility criteria. Though the phrasing is different, the general focus is on economi-

cally active, low-income households. Among the smaller MFIs, Gasha Microfinance (GMFSC) and Specialized Financial and Promotional Institution (SFPI) focus their operations on the urban poor, particularly in Addis Ababa. Their clients are among the very poor residents of localities much known for their congested settlements occupied by very poor dwellers engaged in a variety of businesses. Businesses undertaken by the people in these areas include processing and sale of food and drinks (injera, tella), retail trade in traditional cotton garments, second-hand clothes and small retail shops, petty trade including street vending and small handicrafts such as weaving of traditional products. These two smaller MFIs recently opened branches around Bishoftu (Debrezeit) and are expanding to small villages around Addis Ababa to engage in agricultural loans in order to diversify their products and improve their performance.

The loan products of the MFIs too are largely similar. The larger MFIs, which are also government supported, are mainly rural focused, and their main area of concern is to serve the rural population in line with regional government policies. Some of the smaller MFIs operate predominately in rural areas (Wisdom, PEACE), mainly financing agricultural businesses, with a relatively high proportion of women clients compared to the large and medium-sized government-owned MFIs. The loan portfolio of three MFIs is shown as an example in Table 4-6.

The differences shown in the table among the portfolios of the three institutions are based on the local economies served and hardly on specific lending priorities. Classification according to loan utilization or sector is difficult, however, and not possible at all for many group loans.

Provision of both credit and savings products is common, whereby compulsory savings is considered not a separate product, but rather a part of the loan agreement, namely as a guarantee. Similarly, insurance cannot be taken as a separate product because the insurance covers the risk of indebtedness of families or loan groups in case of the death of a borrower with an outstanding loan. In this respect, the insurance beneficiaries can be said to be both the institution and the loan group since it relieves the institution from the effort and additional cost of pursuing repayment of the loan, and the spouse and the family of the deceased from the pressure to repay. OCSSCO offers two types of insurance, one with the compensation limited to the outstanding loan, and the other covering the outstanding loan plus an additional payment to the family of the deceased. Additional

Table 4-5 Target clients, eligibility criteria and products

Target (General)	Major eligibility/screening criteria among the target group	Loan products and activities financed	Other financial products and non-financial services
<ul style="list-style-type: none"> <li>· Poor rural and urban households</li> <li>· Female-headed households preferred</li> <li>· Women (preferred)</li> <li>· Active poor (mostly rural*)</li> <li>· Associations</li> <li>· Individuals</li> <li>· Institutions</li> <li>· Rural households (organized into groups)</li> <li>· Rural peasants</li> <li>· Off-farm activity operators</li> <li>* Micro and small enterprise operators and small farmers</li> </ul>	<ul style="list-style-type: none"> <li>· 18-60 years of age (productive age*)</li> <li>· Poorest of the poor (wealth ranking according to one ox or equivalent of property**)</li> <li>· Have a viable business plan #</li> <li>· Willing to join groups and to abide by group laws</li> <li>· No access to formal financial institutions</li> <li>· Willing to accept the group lending methodology</li> <li>· Creditworthy, good reputation among community members</li> <li>· Participate in local development activities***</li> <li>· Working poor with business experience and sound start-up business</li> <li>· Permanent residence in operational area</li> <li>· Willing to accept the operational modalities of the institution</li> <li>· Free from indebtedness to other institutions</li> <li>· Physically and mentally fit to undertake the specified business, viewed as hardworking</li> <li>· Active with good work habits and honesty</li> <li>· Have business and production assets such as land</li> <li>· Productive poor, not fulltime employee of government, private or other institution</li> <li>· Member of formally established association</li> <li>· Willingness to regularly save</li> <li>· Be accepted by other members of the group</li> <li>· Not close relative (immediate family member of) of group members</li> <li>· Availability of market for the product/service proposed by potential client</li> </ul>	<ul style="list-style-type: none"> <li>Regular (with group guarantee methodology)</li> <li>· Agricultural and related</li> <li>· Trade</li> <li>· Manufacturing and handicrafts</li> <li>· Service-type business;</li> <li>Individual guarantee</li> <li>· Asset development (acquisition)</li> <li>Special loan support<sup>®</sup></li> <li>· Package loans (government)</li> <li>· Agricultural inputs (government)</li> <li>· Food security (government)</li> <li>· Loans for specifically targeted (donor specifications)</li> </ul>	<ul style="list-style-type: none"> <li>Mandatory savings (individual, groups, and centre)</li> <li>Voluntary savings</li> <li>· Individual loan clients</li> <li>· Individual non-client</li> <li>· Institutions and Associations</li> <li>Micro insurance</li> <li>Other services</li> <li>Money transfer service</li> <li>Pension payment service</li> <li>Non-financial services (rarely)</li> <li>(Basic business skill training, leadership training, Start your business, and business development training given only by two of the institutions)</li> </ul>

Note: \* There are variations (20-60, 18-59) in some cases. \*\* ACSI and OMF1 and OCSSCO, # OCSSCO \*\*\* DECSI @ ACSI and DECSI

Source: Compiled from various reports of the institutions, operational policy manuals and discussions with officials.

**Table 4-6**  
*Loan portfolio per sector of three MFIs (%)*

Sector	SMFI, 2002	OCSSCO, 2000	ACSI, 2001
Agriculture	16	76	58
Processing and handicrafts	4	--	6
Trade	56	24	35
Service-type activities	24	--	1
<b>Total</b>	<b>100</b>	<b>100</b>	<b>100</b>

Source: Compiled from MFI reports.

insurance products are not provided by the MFIs, leaving insurance for events such as funerals and weddings, health care and loss of property to *Iddirs* (chapter 3).

## 4.7 Credit products and operational procedures

Policies related to loan size and loan term show general similarity (Table 4-7). In all institutions loan size tends to increase for subsequent loans as clients have proven their creditworthiness. This, however, does not mean that all clients get the amount they request. Group members assess financial ability of the applicant member and may reduce the requested loan size based on repayment considerations. Loans are also often rationed due to shortage of loan funds allotted to MFI branches by the head office. When this is the case, a branch reduces the amount granted to a group, and the groups in turn ration the loans to members. MFI branches sometimes simply inform each group of the loan amount available and ask the group leader to deal with the allocation to individuals. In this process some individuals may be bypassed and have to wait until the next disbursement. This rationing has resulted in some areas to overstatement of loan requests to ensure that the actual amount requested is obtained.

The methodology employed for loan delivery is also uniform throughout with minor differences between the institutions. The major structure of loan delivery is to organize the clients in a three-tier structure for the purpose of loan security and creation of social pressure on individual borrowers (Figure 4-1).

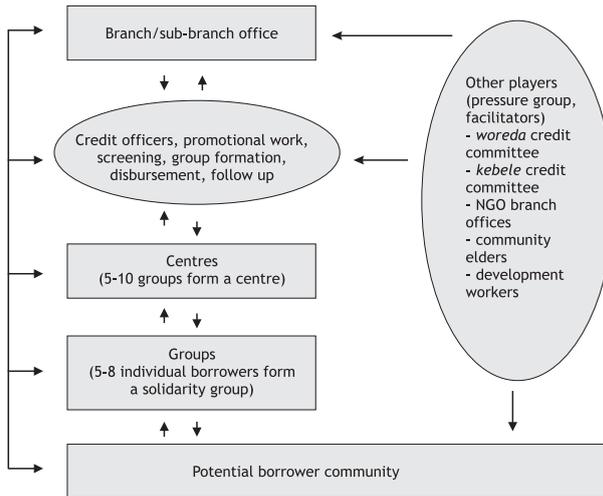
The credit officers have access to the centre, the group and to individual clients without any formal procedure. At the same time, there is a formal

Table 4.7 Loans, terms and conditions

MFI	Loan size	Loan term	Annual interest rates		Other fees and charges
			Loans	Savings	
ACSI	Maximum first loan up to ETB 1,000; increase for each subsequent loan to maximum of ETB 5,000; individual asset loan legal limit ETB 15,000	1. Minimum 3 months, maximum 12 months 2. Maximum 5 years for asset loan	Instalment 15%; End term 18%; government loans 12.5%	Pass book 6%; time deposit 6-7%	None on loans 2.5 birr per person for pension service payment
DECSI	Maximum ETB 5,000, but 3,500 for agricultural inputs	Input loan maximum of 8 months and 12 for all others	Instalment 15%; end term 18%	3% on all savings	None on loans, 2.5 birr on pension payments
GMFSC	First loan size ETB 200-700; increase for subsequent loans up to ETB 5,000 after 4th repeat	Seasonal loans up to 4 months and maximum 12 months; Non-seasonal loan maximum 6 months	13% straight on all loans	3% on savings	3% service charge on disbursements
OCSSCO	First average loan size up to ETB 1,000, increased by instalments, ETB 5,000 after the 6 <sup>th</sup> loan	Farm oxen 1 year; petty trade instalments within one year; agricultural inputs 8 months; fattening 6 months	11.5% flat rate	4% for individuals and 3% for institutions	3% service charge on loans; 10 birr registration fee; 1-1.5% insurance premium
OMFI	First loan ETB 1,000; increase for subsequent loans to a maximum of ETB 5,000 after 6 <sup>th</sup> loan	Agriculture 8 months; handicrafts 6-8 months (instalment); service 12 months (instalment)	15% flat rate	3% on all	None for loans 2.5 birr per person for pension
PEACE	Agriculture first loan ETB 1,000; increased up to ETB 5,000 on 5 <sup>th</sup> loan; non-agriculture first loan ETB 800 and the rest as above	Minimum 3 months, maximum 12 months	15% for business, 18% agriculture	3% up to 2004, and 5% after	2% on loans advanced
SFPI	First loan up to ETB 1,500, increased on subsequent loans up to ETB 5,000 on 5 <sup>th</sup> loan	Minimum 3 months, maximum 12 months	6% flat rate	4% on all	-
SMFI	First loan ETB 1,000-1,200, increased on subsequent loans to maximum ETB 5,000 on 5 <sup>th</sup> loan	Maximum 12 months	15% flat	4%	10 birr for pass book; 20 birr for loan registration
WMFI	Maximum up to legal limit (details unavailable)	Maximum loan term 12 months, minimum NA	12.5% average of various rates	3% on all	2% service charge on all loans upon disbursement

Source: Compiled by the author from the strategic documents of the MFIs.

**Figure 4-1**  
*Relationships between branch/sub-branch staff and the borrowers*



Source: Author.

relationship between the individual in the group, the group and the centre, as well as with the credit officer and branch or sub-branch staff. The other actors facilitate the information exchange and are also able to intervene when loan repayment problems occur. The interventions are loose in some places and stronger in some others.

There are also additional structures external to the loan groups and centres that may exert pressure. These include the kebele and woreda credit committees in the case of ACSI, DECSI and OMFI where such arrangements are made with local administration. Involvement of these administrative units has advantages and disadvantages. In the first place some of the responsibility for client screening is transferred to the kebele authorities. Second, the problem of information about individual clients is resolved if credit committee members use their local knowledge and act responsibly. Participation of the grassroots administration at kebele level in the screening process may save an MFI significant screening costs and help in the enforcement of collection later on. There may also be disadvantages, however. First, the kebele administration may be inclined towards the ruling party and tend to recruit those favoured by the party, excluding residents with no party affiliation, thus compromising the quality of clients. Second, involvement of kebeles may create a feeling among the clients that

the money belongs to the government or is aid money, and thereby create a disincentive for repayment. Additionally people might shy away altogether in fear of “government money”, which they think may involve them in a dispute with local authorities.

While the involvement of local authorities helps in loan repayment enforcement, and to win the confidence of some, it may also negatively impact loans due to past experiences. Some of the smaller MFIs receive information from their respective supporting NGOs in their dealings with clients. Their financial services follow other development and humanitarian activities of their NGOs, and credit clients are selected from among the NGO target groups. Thus, defaults may lead to exclusion from other benefits, or clients make take into consideration that their relation with the NGOs will be endangered if they default.

With respect to loan delivery methodology the two NGO-supported MFIs, WMFI and PEACE, have slightly different types of group formation. WMFI has the village banking type, the cooperative type and the individual loan type. Individuals are required a guarantor with a salary or property level acceptable to the institution as collateral for the loan amount. PEACE uses the association type, in which there are up to 30 borrowers, and the solidarity group, with a flexible number of members. There is no requirement of centre formation for PEACE clients.

Policies regarding fees, charges and additional conditions differ substantially among the MFIs:

- Registration fees vary among MFIs. As shown in Table 4-5. OCSSCO, GMFISC, SMFI, PEACE and WMFI charge additional fees and pass book fees in addition to interest payment.
- There are variations in the amounts withheld as security savings. Those MFIs that do not require savings prior to borrowing withhold a percentage from the loan as part of loan security, which forms the compulsory savings part for the client. The withholding varies from 5% to 15%. MFI employees are often unclear in articulating the effect of the initial withholding for clients (increasing as it does the effective interest in relation to the net borrowing), and most clients expressed dissatisfaction with the amount withheld. Farmers, when asked how much they borrowed responded, for example, “I signed for 1,000 birr, but actually I only borrowed 900 birr.” This means that the borrowers do not consider the amount deducted as part of

the debt since it was not given to the client, despite the fact that the amount is in a savings account and even earning interest.

- Grace periods vary. Some MFIs do not give any grace period since repayment patterns are determined from the very beginning based on the anticipated cash flow of the client's business.
- Gasha and SFPI require clients to start saving for a minimum of four weeks prior to borrowing.

It is remarkable that there are no financial incentive policies for clients in terms of interest reduction for good conduct. The only incentive is the increase in subsequent loan size if funds are available. Penalties are imposed on late payment, and an entire group could be penalized if one member fails to pay on time.

## 4.8 Conclusions

The profiles of the sample microfinance institutions show three categories: large, medium and small. Size is related to ownership: large and medium-sized MFIs are those in which the regional governments have ownership interest. They operate in a specific region within the Ethiopian federal arrangement of government. These MFIs dominate the industry in terms of size, assets, capital, outreach and other aspects.

The difference between the government-owned and NGO-backed MFIs is that the NGO-backed institutions are far smaller. Only two government institutions represent 72% of the total assets of all 22 MFIs in the country, while four of them represent 88% of total assets and 85% of total capital. The dominance of government-owned institutions is then clearly shown.

The mission and vision of the MFIs does not clearly articulate the need for sustainability, perhaps due to the origins of the MFIs either as an NGO or government project. But strategic plans emphasize the need for self-sufficiency, showing that the MFIs are being directed or oriented towards self-sufficiency.



# 5

## The Financial Performance of the Selected MFIs

### 5.1 Introduction

This chapter deals with the financial performance of the selected microfinance institutions. As financial performance of any financial institution depends on the ability to maintain a healthy portfolio, our analysis starts with a review of the portfolio quality of each institution over the five fiscal years between 1999 and 2003. The second part of the chapter analyses the operational and financial sustainability (self-sufficiency) of the institutions to show the extent to which the MFIs have covered their costs from operations (revenues). Extent of self-sufficiency is further analysed using the subsidy dependence index. Finally, the relationship between volume of operations and efficiency of the institutions is examined.

### 5.2 Portfolio quality

Portfolio quality forms the basis of a detailed analysis of the annual accounts to determine the financial viability. Basic indicators of portfolio quality are the portfolio at risk, recovery rate and proportion of delinquent clients (Ledgerwood, 1999). The nine MFIs reviewed have different degrees of emphasis in reporting portfolio-related information and they follow varied ways of referring to issues of portfolio quality. Few follow the supervisory authority's requirement of reports on asset quality and provisions for bad debt (more on this in chapter 7). Many apply their own way of classifying loans in arrears. ACSI, WMFI and PEACE report details of portfolios in arrears from one day past due to over one year. Provisions for bad debt are made according to class with a progressive rate. The rate applied varies from institution to institution. There is no explanation of why an MFI applies or chooses

to apply a specific rate for the determination of provisions. The percentage applied is supposed to be based on the probability of loss, but that had not been established based on analysis of past exposure.

Though the MFIs try to track the portfolios in arrears and at risk, all had very lax policies on write-offs of loans overdue, perhaps for fear of reducing their assets. Loans overdue are thus carried in the accounts for several years. This complicates analysis of effective rate of collections, since collections from the arrears are not separately recorded from the collections from the current loans. Interest rates earned are sometimes accrued on doubtful loans resulting in an overstatement of interest income. Financial positions of the institutions are also overstated. The various portfolio quality indicators are presented in Table 5-1.

Overdue loans are encountered in almost all of the institutions, but few of these result in a complete loss, as group members must somehow settle these loans. ACSI, Wisdom and PEACE, have the highest repayment rate of over 98% for the period of the study. These institutions also have the most transparent recording of loans in arrears, starting from the day after the due date. Provisions for loan losses are made based on these aging accounts, although the estimated amount of the loan loss is different per overdue period from institution to institution. The national bank requires provisions for loan losses be based on a fixed percentage for each class of overdue loan, starting from active loans to those up to one year overdue; loans over one year (360 days) overdue are to be provided for at 100%.

OCSSCO reports a loan recovery rate of 96.5% for six years with disclosure of the total collections and disbursements. The year 2002/03 is the lowest, when repayment fell to 94%, below the 95% that is commonly agreed as the limit for good performance. GMFSC and SMFI are in an alarming position with portfolios in arrears and at risk ranging from 10% to 30%. SMFI's loan recovery rate is the worst among the institutions. For OMFIs records show no information about the portfolio in arrears, while there are clear indications of huge amounts of past due loans.

### 5.3 Operational and financial sustainability

The operational sustainability, that is, the ability to cover operational costs with the interest and possibly other recurrent revenues, is stated in Table

**Table 5-1**  
*Portfolio quality indicators, 1999-2003 (%)*

	1999	2000	2001	2002	2003
<b>ACSI</b>					
Repayment rate	97	99	98	98	99
Portfolio at risk >30 days	5	3	na	2	3
Loan loss provision ratio	na	na	2	3	3
Risk coverage ratio				126	82
Loan write-off ratio	0	0	0	0	0
<b>DECSI</b>					
Repayment rate	na	na	na	na	na
Portfolio at risk >30 days				na	14.6
Loan loss provision ratio				16	11
Risk coverage ratio				na	75.6
Loan write-off ratio	0	0	0	0	0
<b>GMFSC</b>					
Portfolio in arrears	23	10	21	27	28
Portfolio at risk	42	22	55	35	43
Loan loss reserve ratio	0	8	15	17	19
<b>OCSSCO</b>					
Repayment rate	99	98	99	97	94
Portfolio at risk >30 days	na	na	na	na	na
Loan loss provision ratio	1	5	5	7	5
Risk coverage ratio	na	na	na	na	na
Loan write-off ratio	0	0	0	0	0
<b>OMFI</b>					
<b>PEACE</b>					
Repayment rate			99		100
At risk			0.43	0.00	0.38
Risk coverage ratio					
Loan write-off ratio	0	0	0	0	0
<b>SFPI</b>					
Repayment rate					98.0
Arrears to outstanding balance	0	2	2	3	2.6
At risk	3	10	4	3	6.3
Loan loss ratio	17	1	0	0	
Risk coverage ratio	na	na	na	na	na
Loan write-offs	0	0	0	0	0

Note: na = not available

Source: Survey by author.

**Table 5-1**  
*Continued*

	1999	2000	2001	2002	2003
<b>SMFI</b>					
Repayment rate	69	63	60	71	71
Risk coverage ratio	na	na	na	na	na
Loan write-off ratio	0	0	0	0	0
<b>WMFI</b>					
Annual repayment rate	98	96	97	98	98
Portfolio at risk >30 days	3	4	6	2	5
Loan loss provision expense ratio	5	3	4	2	2
Risk coverage		69	40	46	35
Loan write-off		na	14	7	5

Note: na = not available

Source: Survey by author.

5-2. Five of the nine MFIs have attained operational sustainability or operational self-sufficiency (OSS).

All MFIs, except GMFSC and OCSSCO, show an upward trend in operational sustainability, with ACSI and DECSI stably well above the 100% and the others moving towards the OSS of 100%. Both GMFSC and OCSSCO show a decline in the last years stated, with GMFSC stably below and OCSSCO stably above the 100%. OMFI fell significantly below 100% in 2003. OSS normally does not consider the cost of capital in the calculation of operating costs.

The more comprehensive indicator, financial sustainability, was computed with an opportunity cost of capital at a conservative rate of 3%, the interest rate on savings in the country (Table 5-3). In the computation of financial self-sufficiency (FSS), 3% is taken as an implicit cost of capital on the rationale that the next best alternative to which MFIs have access to fund their portfolio is by raising savings from clients. MFIs have already proven that savings mobilization is possible, including in rural areas. There is a cost implied in mobilizing and managing small savings with frequent withdrawals and smaller collections. However, concessional loans, lobbies for donations and applications for government allocated funds are not less costly considering the loss of opportunity while the institutes wait for approval and disbursements. Loans are also rationed among clients and client groups when there is a shortage of funds, during which time more affluent clients with proven repayment history desiring larger loans are denied.

**Table 5-2**  
*Operational sustainability, 1999-2003 (%)*

	1999	2000	2001	2002	2003
ACSI	87	110	106	151	209
DECSI	196	217	164	246	275
GMFSC	34	88	56	71	61
OCSSCO	105	143	152	140	129
OMFI	119	116	113	113	71
SFPI	25	54	55	71	106
SMFI	37	68	49	47	57
PEACE	na	19	50	60	80
WMFI	22	63	88	72	114

Source: Survey by author.

**Table 5-3**  
*Financial sustainability, 1999-2003 (%)*

	1999	2000	2001	2002	2003
ACSI	75	94	94	134	169
DECSI	165	153	130	184	101
GMFSC	31	79	51	54	46
OCSSCO	89	71	84	81	100
OMFI	94	96	93	92	63
SFPI	23	49	50	63	94
SMFI	31	57	39	39	47
PEACE	na	15	44	53	70
WMFI	19	53	74	63	99

Source: Various reports of the MFIs.

The data on financial sustainability show a varied picture. ACSI improved in the period recorded to well above the 100% line, but DECSI declined in 2003, but remained above the 100%. OCSSCO scored just 100%, while GMFSC and SMFI remained stable at around the 50% mark. OMFI was close to 100% except for in the last year. Of the remaining institutions, SFPI, PEACE and WMFI showed significant improvement towards financial self-sufficiency but had not yet achieved 100%.

The financial self-sufficiency ratio is an indirect indication of return on equity (ROE) since the cost of capital is applied to the equity of the institutions. Thus, financial self-sufficiency is affected by the degree of leverage

and how productively the institution has employed capital. The aim here is to measure what the institutions have achieved in freeing themselves from depending on subsidy in the years observed. To be sustainable, the institutions must earn a return that covers their costs, net of inflation. A better indicator of this is the subsidy dependence index presented in the following section.

## 5.4 Subsidy dependence index

The analysis of the institutes' annual accounts through the subsidy dependence index goes beyond the analyses previously conducted, because all explicit and implicit subsidies are taken into account to arrive at the rate that indicates the increase in interest rate required to break even, if all subsidies were obtained at market interest rates. The analysis below uses annual average inter-bank interest rates. This rate was 11% in 1998/99 and 8% for the following years. This rate was chosen instead of the deposit or interest rates that banks charged their clients since MFIs, as financial institutions, could borrow from banks and the inter-bank rate better reflects the financial market in which the MFIs could obtain funds. These rates were well above the inflation rates and thus offer acceptable standards for the computations of the subsidy dependence index (Table 5-4). The subsidy dependence index formula and assumptions underlying it were discussed in chapter 2.

The subsidy dependence indexes show that only ACSI had reached the stage of being able to operate without subsidies. All other MFIs required subsidies or needed to raise interest rates by 92% (WMFI) to as much as 818% (PEACE), according to the 2003 data. WMFI is the second best, with lowest index of 0.92, but it nonetheless must earn almost double its current return (2003) to be subsidy free. Interest increases required in this range point to serious shortcomings among the MFIs. Taking other aspects as they are, PEACE would need to raise its effective interest rate about nine-fold from its 2003 level to operate without subsidy.

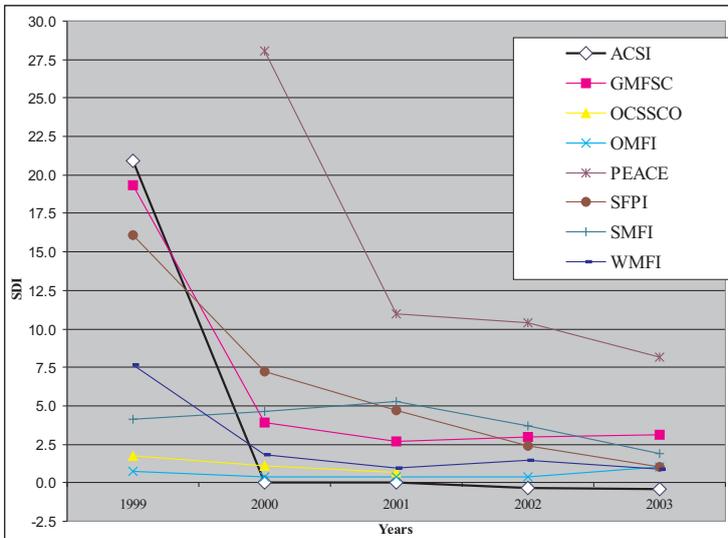
The subsidy dependence indexes also show the relatively weak position of the MFIs in profitability. Ethiopian MFIs charge low interest rates compared to other countries (Wolday, 2003), but interest rate is not the only factor affecting profitability. The subsidy dependence index also shows improvements in the operations, since a decline is measured from the initial years to 2003. Figure 5-1 indicates that all of the institutions initially had a very high level of dependency with rapid declines in subsequent years but

**Table 5-4**  
*Subsidy dependence indexes, 1999-2003 (proportions)*

	1999	2000	2001	2002	2003
ACSI	20.92	0.03	0.03	-0.32	-0.42
GMFSC	19.32	3.88	2.68	2.98	3.13
OCSSCO	1.76	1.10	0.65	n.a.	n.a.
OMFI	0.75	0.37	0.40	0.41	1.06
PEACE		28.08	11.00	10.40	8.18
SFPI	16.06	7.22	4.68	2.43	1.03
SMFI	4.14	4.66	5.27	3.73	1.87
WMFI	7.65	1.83	0.98	1.46	0.92

Source: Survey by author.

**Figure 5-1**  
*Development trend in SDI over the five-year period*

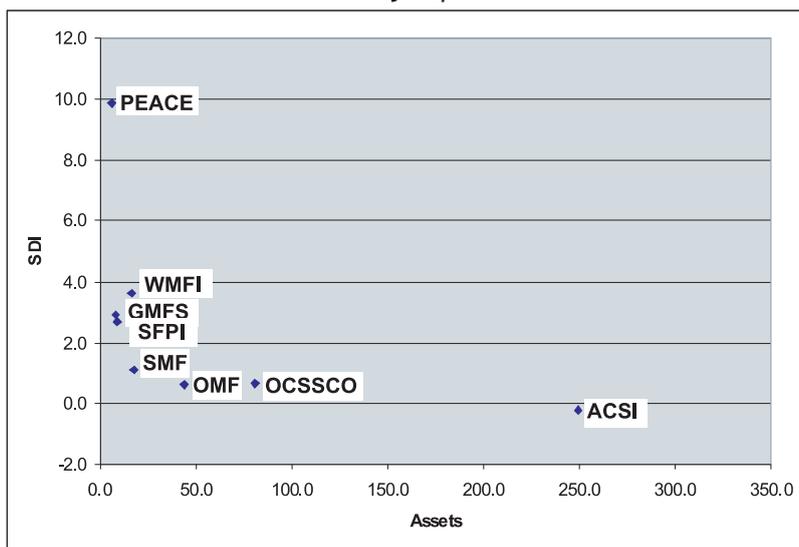


Source: Survey by author.

slowing from 2001 onwards. The relative stagnation of the index after 2001 raises serious questions, since most MFIs, large and small alike, have ceased to improve. Even ACSI, which had a negative index, was moving slowly and the index in 2003 showed a surplus of about 42% of the interest charged.

Another interesting observation is made when the subsidy dependence index is shown in relation to total assets employed by the institutions. This relationship is shown in Figure 5-2. The figure shows a relationship between

**Figure 5-2**  
Assets and subsidy dependence index



Source: Survey by author.

the size of the MFI, as measured by assets, and the subsidy dependence index. A lower index value, or reduced subsidy dependence, is associated with larger size in terms of total assets. ACSI, the largest MFI, has a negative subsidy dependence index, while OMF, OCSSCO and WMFI, which are considered medium sized, have a lower subsidy dependence index than the smaller MFIs. However, the relationship is only indicative because of the few observations possible. Moreover, variation in performance is substantial among the smaller MFIs. Figures 5-1 and 5-2 lead us to consider financial performance in relation to size, volume of operation, and effect of the scale of operation on performance. The following section analyses the relationship between volume of operation and financial performance of the MFIs.

## 5.5 Volume of operations and efficiency

The differences in ownership, governance, operational structure and size, and financial performance among the selected microfinance institutions preclude a meaningful analysis of the relationship between size and financial performance. Therefore, the relationship between the volume of operations and efficiency is studied within one of the largest MFIs, ACSI, with

data from 170 branches (operational units). The fact that ACSI is able to operate without subsidies makes an internal analysis through the comparison of branches all the more interesting.

The dataset covers parameters for volume of operations, costs, revenues, length of operation, and location-specific factors such as distance to main office, means of communication and power connection. The main parameters from the 170 branches are stated in Table 5-5.

The relative variation indicated by the variation coefficients and the ranges for 95% of the branches show that the branches do differ substantially in volume of operations, thus enabling a meaningful analysis. The parameter “loan portfolio end of year” has a smaller variation coefficient than other potential parameters for the volume of operations: “total assets”; “amount of loans disbursed” and “number of loans disbursed”. Therefore, “loan portfolio end of year” is selected for the analysis of the relationship between volume of operations and revenues and expenses.

The relationship between volume of operations and “interest and fees revenues” and two cost parameters are stated in Table 5-6 for all branches and for 95% of the branches, removing the eight branches with the most extreme values from the analysis. The ACSI sub-branch structure is more or less standardized throughout. Each sub-branch has eight employees unless there is a temporary vacancy due to staff leaving the institution. Office facilities used in each sub-branch are minimal. Sub-branches have no computers or high valued equipment and office furniture. There was wide variation in terms of employees, the loan portfolio managed and savings mobilized (Table 5-5). The range for 95% of the sub-branches after eliminating outliers shows wide gaps in those figures, including those for total assets and loan portfolio.

Table 5-6 states the relationship between volume of operations and “interest and fees revenues” and two costs parameters for all branches and for 95% of the branches (omitting the outliers).

The substantial differences between the correlation coefficients for all branches and the selected 95% of the branches show the impact of the eight branches with widely divergent values for the analysed parameters. On the income side there is a reasonably firm relationship with the volume of operations as measured by the loan portfolio: 65% and 90%, respectively, of the variation is explained by the direct relationship. The relationship between volume and the two cost parameters is less firm: from 5% to 49%. Further

**Table 5-5**  
*The branches of ACSI: main parameters, 2003 (ETB)*

Parameters	Mean	Variation coefficient *	95 % of branches range of values	
			Low limit	High limit
Total assets	1,527,225	0.86	314,218	2,961,485
Loan portfolio end of year	1,256,314	0.59	225,044	2,662,116
Amount of loans disbursed	1,681,132	3.11	59,251	5,572,648
Number of loans disbursed	1,792	3.58	71	3,631
Interest and fees revenues	195,375	0.56	9,118	432,297
Personnel expenses	45,127	0.18	12,550	56,545
Total expenses	81,789	0.72	20,432	132,774
Net income/(loss)	129,146	0.76	-11,514	349,837
Voluntary savings	864,412	4.15	21,736	2,048,283
Compulsory savings	243,479	1.11	10,965	836,237
Age (years)	6.5	0.46	1	8
Distance from branch office (km)	101	0.77	0	272
Telephone (automatic = 3 to no connection = 0)	2.0	n.a.	0	3
Light and power (national grid = 2 to no connection = 0)	1.1	n.a.	0	2

Note: \* Variation coefficient is standard deviation/mean.

Source: Survey result by author.

analysis of the costs with location-specific parameters did not produce significant results as no relationships could be detected between costs and distance of a branch from the main office, presence or absence of telephone connection and access to power. Analysis of a possible relationship between length of operation of the branch and performance parameters further gave no indication of a learning effect, a reasonable expectation as continued operation in a location should be accompanied by increased insight on the part of both the borrowers and the enterprises. The absence of a relationship between volume of operations and cost parameters raises serious questions regarding the efficiency of staff deployed and expenditures.

## 5.6 Conclusions

The different and not strictly formulated and applied policies on loan write-offs by the MFIs lead to caution with regard to the financial data

**Table 5-6**  
*Relationships between volume of operation, costs and returns in branches, correlation coefficients, adjusted R square*

	Loan portfolio end of year, all branches	Loan portfolio end of year, 95% of branches
Revenues	0.65 **	0.90 *
Personnel expenses	0.18 **	0.27 **
Total expenses	0.05 **	0.49 **

Note. \* significant at 0.05; \*\* significant at 0.01.

Source: Computed from author's survey.

made available, and the analysis of the financial performance is thus made within these limitations.

The first step in the analysis deals with the actual income statements of the MFIs. Operational sustainability improved over the period analysed. Five MFIs were able to cover their operational costs with their revenues in 2003. Financial sustainability shows a similar upward trend, but only three MFIs had reached the 100% level by 2003. Both indexes are computed with the subsidies included in one way or another in the income statements. The rationale for taking the saving rate is based on the assumption that the widely available alternative for the MFIs to raise loan funds is mobilization of local funds.

The subsidy dependence index provides for a more rigorous analysis, as all subsidies are removed. The results give clear insight into financial performance: only one MFI is in principle able to operate at a cost-covering level without subsidies. Relating the subsidy dependence index of the selected MFIs to their total assets suggests, but certainly does not prove, increasing financial performance with size.

Analysis of the relationship between volume of operations and financial performance at the branch level within the largest MFI shows, in the first place, very wide divergence of the values of the performance parameters among the branches. Secondly, a positive and reasonably firm relationship was found between volume of operations and revenues. The expected relationship between volume of operations and cost parameters could not be established. The result of comparative analysis of branches points to an operation of branches according to standard model without a direct relationship with volume of the actual lending and savings products provided. Additionally, the absence of a relationship between branch performance

and length of operation raises questions about the role of information management regarding clients by the institution. Application of standard procedures in loan provision, irrespective of the loan history of clients, is a possible explanation that warrants additional research.

# 6

## Outreach and Client Profile

### 6.1 Introduction

This chapter analyses the extent of outreach attained by each institution in the sample. The first section explores the scale of outreach attained by institutions. The second presents the results of a client survey covering household characteristics, business financial relations to other institutions, and property ownership. The third section shows the extent of depth of outreach obtained by the institutions on the basis of client profile and some indicators. The conclusion then follows after discussion of some other aspects of outreach.

### 6.2 Outreach of MFIs

#### 6.2.1 Scale of outreach

At the end of 2003 the total outreach of all MFIs, as indicated in the background chapter, was about 714,000 clients (households). Table 6-1 shows the main outreach parameters: number of active clients; amount of loans outstanding; voluntary savers and amount of savings; and number of retail outlets countrywide (operational branches of the MFIs).

The MFIs included in the sample comprise the larger and medium-sized institutions such that the total outreach in terms of number of clients, loans outstanding and other indicators of outreach nearly equals the number for the entire microfinance industry in the country. The nine sample MFIs represented, as of 30 June 2003, 95% of the client and loan portfolio balance, 95% of all savers, 99% of total savings balance and 93% of total branches/sub-branches of the MFIs in the country.

The nine MFIs had 678,101 active clients of the 713,707 total of all microfinance clients in the country as of 30 June 2003. Of the 465 retail

**Table 6-1**  
*Scale of outreach attained in loan disbursement, number of clients and number of outlets by the nine MFI, 2003*

	No. of loan clients	Loan Balance (million ETB)	Voluntary savers	Savings (million ETB)	No. of Retail Outlets	Clients per Retail outlet	Loans per Outlet (million ETB)
ACSI	267,081	184.563	96,450	82.556	168	1,590	1.099
DECSI	238,908	184.408	181,109	100.535	96	2,489	1.920
GMFSC	5,537	3.023	1,491	0.282	6	923	0.503
OCSSCO	65,812	64.053	1,418	4.323	70	940	0.915
OMFI	66,571	31.175	7,717	13.041	53	1,256	0.588
PEACE	4,937	4.376	447	0.486	8	617	0.547
SFPI	8,263	6.100	2,066	0.584	4	2,066	1.525
SMFI	9,876	8.379	4	0.003	14	705	0.598
WMFI	11,116	10.894	11,026	2.207	15	741	0.726
Total	678,101	496.971	301,728	204.017	434	1,562	1.145
Industry	713,707	521.796	317,768	205.465	465	1,535	1.122
Rest of MFIs	35,606	24.824	16,040	1.448	31	1,149	0.801
As % of industry	95	95	95	99	93		

Source: Computed from MFI financial and operational reports.

outlets in the country (branch and sub-branch networks), the nine MFIs had 434 (93%).

As Ethiopian MFIs target households, almost all of the clients (men and women) are married and heads of household. The effect of outreach on the population is thus more than just the reported number of clients. First, as mentioned above, most clients are heads of household, where households use family labour and there is an interdependence among family members. The average (mean) household size nationally is five persons (CSA, 2003), while our sample showed an average of about six per household. It is policy of the microfinance institutions not to lend to more than one member of a family at a time.

Usually a head of household borrows funds to serve the needs of the household. Taking the national average size of the household, we can assume that microfinance had already affected the lives of over 3.5 million people by mid-2003 (Wolday, 2003) in view of the extended family lifestyle. Discussions with some clients during the survey give the impression that loans serve the interests of households more than a husband or wife as an individual or that the money was used for common goals with mutual un-

derstanding between husband and wife, though this cannot necessarily be taken for granted in every family.

In geographic location and spatial distribution, the nine MFIs operate in different regions of the country (chapter four), covering the whole of the central highlands and plateaus representing the most densely populated areas of the country. The regions of Somali, Afar and Gambella have no MFI operating in their areas so far, while one was opened relatively recently by the regional government in Benishangul-Gumuz. A study was under way to establish an MFI in Gambella regional state by 2003. A new MFI had started operations in the city of Dire Dhawa in the east. The regions of Afar and Somali are known for the pastoralist way of life, which might have made it difficult to initiate microfinance by the regional governments and NGOs. The government of each national regional state has its microfinance institution within its regional boundaries; while NGO-backed MFIs mostly operate without regional boundaries but target the NGO's operational areas.

DECSI, one of the two largest MFIs in the country, covered by 2003 the whole of Tigray National Regional State (TNRS), which has a population of about 4.1 million (CSA, 2003). Taking the population, estimated number of households and those expected to be potential candidates for microfinance, it can be safely concluded that the demand in the region is nearly satisfied by the single supply of DECSI with its current number of clients. DECSI is also the sole operator in TNRS with strong regional government and regional ruling party backing, as it was founded and mainly funded by a party "endowment" fund. The regional state is the third smallest (after Gambella and Benishangul-Gumuz) in terms of land area, but the population exceeds that of Somali, the third largest region in terms of land area. DECSI has the advantage of not being overstretched like the others, due to smaller size of the region and relatively higher population density (third highest population density following SNNP and ANRS according to the CSA, 2003).

ACSI, which is under the Amhara regional state, is the largest MFI in the country in all respects. It has the most clients, the largest outstanding loan balance and the most branch networks. Amhara national state (ANRS) is the second largest region in the country, after Oromia. Its population is 18 million and population density about 112 persons per km<sup>2</sup> (CSA, 2003). ACSI covers all of the woredas (districts) in the region having

opened at least one sub-branch in each, despite the challenges presented by the lack of infrastructure and remoteness. The region is physically characterized by difficult terrain and a lack of transport infrastructure. Many districts have only rural and dry weather roads, making access during the rainy season difficult. Despite having a comparable number of clients to DECSI, similar operational modalities in terms of branch and sub-branch networks, ACSI with its 170 branches has fewer clients on average per branch (about 1,500) while DECSI has about 2,500 clients per branch in its 96 branches. ACSI's relatively lower client density per operational unit (retail outlet) is mainly due to its extensive sub-branch network throughout the vast regional state. Both ACSI and DECSI are engaged in the distribution of agricultural input loans, food security loans and other donor-specific funds, such as the CIDA women-targeted funds and Packard Foundation funds for family planning, in addition to regular loans. These institutions are supposed to serve the entire population of their region since they were organized for that purpose. Thus, for ACSI, it may not be possible to resist sub-branch expansion in favour of more volume of business per sub-branch. It is a matter of a right for people in other woredas to have access to the same services, since the MFI operates with the resources of the regional state. This obligation may override the financial or self-sufficiency objectives. Cross-subsidization of sub-branches obviously exists.

It should also be noted that Ethiopian MFIs target rural clients, thus only a small portion of the urban population is covered so far. In the case of DECSI, since the region is small, only 96 sub-branches cover the entire regional state, and any further expansion is in terms of increasing the volume of services per sub-branch through more intensive outreach.

On the savings front, ACSI is behind DECSI while DECSI leads by far in number of account holders. DECSI's average loan per retail outlet (about ETB 2 million) was also by far the largest in 2003 among all MFIs. This can be explained by the size of the MFI, population density and DECSI's service to urban micro-enterprise owners who take larger loans than rural borrowers. Most of DECSI's clients are repeat loan-takers, and loan sizes tend to increase from one loan to the next as the client stays with the MFI. Next to DECSI, SFPI, which so far exclusively operates in Addis Ababa with recent attempts to expand into rural Oromia, has about 2,000 clients and ETB 1.5 million per retail outlet. PEACE has the fewest clients per branch, at 612 clients, while GMFSC has the lowest loan balance per

branch. OMFI has a reasonable number of clients (compared to the others), but its average loans outstanding per retail outlet is one of the lowest, reflecting small loan size per client.

OCSSCO, which operates in the largest national state, Oromia, had 70 operational branches in 70 woredas of the region. The region is vast with varied geographic characteristics and altitudes. The population density varies with altitude and climatic conditions. The largest part of the region, the south and southeast, is inhabited by fewer people while the western part and central highlands are inhabited by the large majority of the population. OCSSCO follows the administrative structure of the regional state in opening branches, as is common with regional government-owned MFIs. Its client population per branch is 940, which is low compared to large and medium-sized MFIs. As branch managers told us during the survey, OCSSCO targets 1,500 clients per branch, but the average client population per branch in 2003 was far short of that number. Oromia is sparsely populated in general, while OCSSCO mainly operates in the rural areas, which makes it difficult for the MFI to handle many clients where settlements are located far from one another. The MFI has to open branches in areas the regional government considers a priority instead of exhausting the potential borrowers within the most accessible localities. The branches' remoteness from the home office and the difficulty of outreach in the rural environment with its poorly developed communication infrastructure threatens the sustainability of operations, not only of OCSSCO, but also ACSI, which operates in the second vastest region. Small MFIs, such as PEACE, WMFI and others that operate sub-branch offices several hundred kilometres distant from one another face a similar problem. While government MFIs are obliged to operate remote branches due to administrative arrangements and their accountability to the regional government, NGO-backed ones follow the NGO's operational areas.

Tables 6-2, 6-3 and 6-4 present the growth trends in number of clients from 1999 to 2003, loan portfolios and savings of clients. The scale of outreach of these institutions could be judged as encouraging considering the capacity and experience of the industry. However, there is no benchmark against which we can compare outreach. The scale of outreach by the institutions has been growing over time.

Generally, the number of active clients increased from year to year (Table 6-2) except the decline in ACSI between 2001 and 2003, which was

**Table 6-2**  
*Number of active clients*

MFI	1999	2000	2001	2002	2003
ACSI	107,143	131,330	226,934	215,970	278,444
GMFSC	1,928	3,291	481	4,193	5,290
OCSSCO*	22,995	29,450	38,186	42,120	62,188
OMFI	39,469	48,000	58,058	65,448	68,780
PEACE	0	608	3,367	4,192	5,428
SFPI	1,794	4,027	6,346	7,728	9,552
SMFI	4,492	6,529	8,528	11,265	10,767
WMFI	3,821	7,768	9,721	10,508	12,157

Note: \* OCSSCO's fiscal year ends on 30 June based on the fiscal year of the Ethiopian Government.

Source: Compiled by author from MFI operational reports.

followed by a sharper increase from 2002 to 2003. Despite its small size, SFPI has shown a constantly increasing number of clients, increasing at a rate of more than 100% from 1999 to 2003. In terms of outreach, ACSI takes the largest share in absolute numbers, since even a smaller percentage increase means tens of thousands of clients. In 2003, ACSI had 62,000 more clients than in 2002, with a growth rate of only 22%, while OCSSCO, which showed 48% growth, reached only 20,000 additional clients. SFPI showed 24% growth between 2002 and 2003, but the additional number of clients reached was only 1,800.

Outreach in terms of portfolio growth (Table 6-3) and savings mobilization (Table 6-4) indicates growth, despite the variations between institutions and fluctuating trends. The total portfolio grew from about 274 million in 1999 to 523 million at the end of 2003. On the savings front, these MFIs raised voluntary savings of ETB 204,017,000 from 301,728 clients, which gives an average savings balance of ETB 617 per individual saver. The total savings raised by these MFIs represents 99% of the total savings raised by the microfinance industry in the country.

The declining growth rate of the larger MFIs is naturally expected, as even slight percentage increases result in a significant push of the financial frontier.

In general, regarding the scale of outreach, substantial work has been done, as observed from the operational data of the MFIs. ACSI and DECSI are considered the leading MFIs in number of clients in sub-Saharan Africa. Especially the regional government-sponsored MFIs have

**Table 6-3**  
*Loans outstanding balance end of period of the nine MFIs (million ETB)*

MFI	1999	2000	2001	2002	2003
ACSI	78.080	104.904	121.097	159.483	210.355
DECSI*	153.911	119.313	125.138	115.349	184.408
GMFSC	0.806	1.911	2.447	2.597	0.740
OCSSCO	18.623	27.044	36.778	42.029	63.404
OMFI	17.995	22.860	28.225	29.820	31.175
PEACE		0.622	2.115	3.374	5.193
SFPI	0.759	1.985	3.828	5.451	7.480
SMFI	2.019	3.441	5.724	7.486	8.378
WMFI	2.549	6.452	8.889	10.474	11.626
<b>Total</b>	<b>274.741</b>	<b>288.534</b>	<b>334.241</b>	<b>376.062</b>	<b>522.760</b>

Source: Compiled from audited financial statements of the MFIs for the periods covered (except for DECSI for which figures were obtained from quarterly reports at the NBE).

**Table 6-4**  
*Savings and deposit balance, end of period 1999-2003 (ETB '000)*

MFI	1999	2000	2001	2002	2003
ACSI	33,884.1	55,790.1	84,874.8	99,045.7	128,649.1
DECSI	74,100.0	95,810.0	121,998.4	124,420.0	131,345.3
GMFSC	384.2	746.0	1,188.0	1,283.9	288.1
OCSSCO	3,690.4	6,942.6	10,584.4	14,608.2	21,995.4
OMFI	20.8	104.0	570.4	496.0	607.5
PEACE	0.0	92.7	436.4	771.3	1,185.3
SFPI	442.6	991.9	1,897.7	2,936.1	3,868.5
SMFI	848.3	1,054.7	1,401.9	1,923.7	2,410.4
WMFI	882.6	2,454.2	3,516.2	3,974.3	4,043.5
<b>Total</b>	<b>114,252.9</b>	<b>163,986.2</b>	<b>226,468.0</b>	<b>249,459.2</b>	<b>294,393.2</b>

Source: Compiled from MFI financial statements.

expanded their operations over wide geographical areas covering almost all districts within their regions. OCSSCO is the only exception. It covered 71 of the regional state's 171 woredas by the end of the period. In fact there are many smaller MFIs operating in Oromia region together with OCSSCO, but clustered in the central highlands surrounding Addis Ababa. Some of the woredas in Oromia are also pastoralist areas where microfinance in its present state cannot successfully operate. In the SNNP region, OMFI has 62 branches, each in its own district. Other MFIs, including WMFI, PEACE and SMFI have branches in SNNP in addition to

OMFI, PEACE and WMFI also operate in ONRS and ANRS. We could question whether this geographic distribution or coverage means that the MFIs reach all the people in need. Wider distribution of the branches and sub-branches may sometimes serve to reach only a few in each district, while in some places advantage of scale could be exploited.

At this point, we may ask what proportion of the needy or potential clients are reached beyond the number of clients of each institution. To answer this question, we need to roughly estimate the potential demand for microfinance services. Potential demand in the country has so far been estimated based on the simple assumption that microfinance services are demanded by the active population (those of productive age) below the poverty line.

The estimation of Chao Beroff et al. (2000) is frequently quoted regarding potential demand for microfinance services in the country. They based their forecast on the assumption that 50% of the households are poor, and 80% of these fall within the productive age category. Though there is no perfect system of estimation, as even a survey of attitudes and entrepreneurial desires of potential clients might not provide accurate numbers, the above assumption is oversimplified. It fails to take into account several characteristics that may affect potential demand. Only age is taken as a factor to classify the poor. Many productive age poor in drought-prone areas, who recently benefited from relief programmes, pastoralists and even many very destitute people in cities may not be potential candidates for microfinance. To determine this we must define who are the potential candidates for MFI loans and savings services.

Those who believe microfinance services to be for the poorest of the poor including the destitute may count the number of people below the poverty line, while those who see microfinance services as for the enterprising poor would count the poor who could potentially use the money to engage in profitable business, repay a loan and save money (Robinson, 2001). We may say outright that people below the poverty line, but not all people below the national poverty line, qualify for microfinance services. Robinson (2001) applied stratification of the poor into three categories based on the national poverty line. Her stratification is based on the argument that the poorest of the poor (the destitute poor), cannot be candidates for microfinance services, but those economically active poor below the poverty line and some above the poverty line but who are prone to fall-

ing into poverty with exposure to exogenous shocks are the core candidates for microfinance services. In fact, she includes those at the bottom of the formal sector, who are above the poverty line and could qualify for standard commercial bank services but somehow are excluded.

According to Robinson (2001), those economically active poor (the upper segment of those below the poverty line and the lower segment of those above the poverty line) and part of the lower middle-income group are potential candidates for micro-loans on commercial terms. While the entire economically active poor, including the upper 50% of those below the poverty line and the lower middle-income groups are candidates for small interest bearing savings. The savings programme embraces those economically active but below the poverty line and the lower middle-income group. From the institutional sustainability viewpoint this make a great deal of sense, but many may disagree as the extreme poor and part of the so-called “economically active poor” are dubbed here as unfit for savings and credit services. Non-financial poverty alleviation tools are said to be appropriate for those below the poverty line and extremely poor people at the bottom of the poverty ladder.

If we take this view as a standard and estimate the demand for microfinance loans and savings in Ethiopia, we must first categorize the income groups into high, middle (higher middle, medium middle and lower middle) and poor (upper poor, lower poor and extreme poor). The poverty line is expected to separate the upper and lower poor. The lowest strata, the bottom 50% of the poor according to the national poverty line, are to be referred to as the extreme poor. Then we must decide how many people constitute each stratum and what proportions are possible candidates for microfinance services. That gives us a total population of about 28.7 million (70 million Ethiopians times 0.41).

Taking the national average household size of five persons and assuming that the head of a household is the one being considered for microfinance services (especially credit), the estimated households in this category are 5.74 million. If we now assume that 50% of these households are extremely poor with zero demand for financial services, 2.87 million households of those below the poverty line could be considered candidates. The remaining potential candidates for micro loan services are the upper level of the poor, those above the national poverty line but below lower middle income as indicated above. Assuming a pyramidal relation, that is, as we go up the income

ladder the population of the categories decreases, instead of an equal number of demand from this upper level, if we assume about half of the number above, the total demand could be estimated at about 4.31 million households. This is a highly conservative estimate.

In estimating the effective demand, we must take into account other possible sources available to the households, business opportunities in the area of residence, entrepreneurial capacity and additional factors that may affect the demand for financial services. In some remote parts of Ethiopia not only is poverty alleviation a basic priority, but also integration of residents into the mainstream lifestyle through concerted social programmes by providing road and communication connections. This is absolutely necessary, especially in minority-dominated regions where people live on the periphery in relatively worse conditions, though poverty is common throughout the country.

For our purpose we chose a conservative estimate, but one that still indicates outreach lagging behind demand in terms of total households reached. The current total outreach of a little over 700,000 households is far short of the potential demand of 4.3 million households nationwide. Extending this estimation to each region on the basis of 2003 population statistics, we can show the rough distribution of potential demand and households reached by MFIs in the regional states where these institutions are currently active.

Less than 20% of the projected overall demand is satisfied (Table 6-5). In Addis Ababa and Tigray, the level of outreach is far better, because of their relatively low populations compared to the other three regions. But in the case of Addis Ababa, our estimation could not capture the difference in opportunities for the lower poor who could engage in petty trade as opposed to the rural poorest who have few such options. In Tigray even though DECSI is the only MFI operating in the region, the level of outreach is as high as 78% of the potential. In Amhara, despite the size of ACSI, only 25% of the potential clients are served. In Oromia and SNNP, the level of outreach is lowest, at 5% and 7%, respectively.

Taking the data in Table 6-5 in relation to the data in Table 6-2 (client per institution and retail outlet), we can conclude that there is still high unmet demand for microfinance services. DECSI's 2003 semi-annual reports show high profits compared to the other MFIs, perhaps due to its advantage of high outreach within a limited operational area. ACSI has a compa-

**Table 6-5**  
*Outreach to potential clients in regional states*

Region	Estimated HHs	Below poverty	Total estimated demand	Reached by 2003	Estimated not reached by 2003	% not reached
A.A.	560,000	0.36	151,200	86,842	64,358	43%
ANRS	3,620,000	0.418	1,134,870	278,444	856,426	75%
ONRS	5,019,601	0.399	1,502,116	72,188	1,429,928	95%
SNNP	2,837,001	0.509	1,083,025	79,547	1,003,478	93%
TNRS	822,600	0.614	378,807	296,400	82,407	22%
<b>Total</b>			<b>4,250,018</b>	<b>813,421</b>	<b>3,436,597</b>	<b>81%</b>

Source: Author's projections.

erable number of clients though almost twice the number of sub-branches. DECSI's operations cover a region more than twice the size of Tigray. ACSI's client population per outlet is lower than that of DECSI, as is ACSI's profitability. OCSSCO's outreach is among the lowest relative to its size, demand in its region of operations and also to its peers.

The level of total outreach in terms of clients, the vastness of the operational area and the number of clients per branch or sub-branch has implications for the profitability of the MFIs (see also chapter five's profitability analyses). Institutions such as OCSSCO, ACSI, OMFI, and the other smaller MFIs that operate in various regions covering a vast area with branch offices risk not only outreach but also sustainability due to high transportation and communication costs.

MFIs with limited outreach have further been shown to have low profitability, in conformity with our hypotheses and as can be concluded by comparing Tables 6-2 and 6-4 above with Figures 5-2 and 5-4, and Tables 5-4 and 5-6 in the preceding chapter.

## 6.2.2 Depth of outreach

Depth of outreach is measured by direct indicators like the extent of gender composition (more women equals deeper outreach), the urban-rural composition of clients (the more rural, the deeper the outreach), and household characteristics (female-headed, large household size, high dependency ratio and older population represent vulnerable groups which if reached indicate deeper outreach), educational status (illiteracy and low level of education indicate vulnerability) (Schreiner, 2002; Paxton, 2001).

In Ethiopia, research on the profile of poverty based on panel data collected by the Department of Economics and the CSA welfare monitoring survey of 1999/2000 indicate various determinates of poverty for both rural and urban areas (MoFED, 2002):

- People in rural areas are generally poorer than urban residents (area of residence).
- Households in food shortage areas fall into poverty more easily than those in other areas.
- Households that easily fall into poverty tend to have
  - larger family size and high dependency ratio,
  - low level of literacy,
  - older heads of family.

Using the same set of data, Mekonnen et al. (2001) concluded that in addition to the above points, in rural areas the types of crops that farmers grow and the type of employment in urban areas are directly related to proneness to poverty. Farmers growing cash crops and cereals tend to be better off than farmers growing food crops such as *enset*,<sup>1</sup> and in urban areas privately employed individuals have less chance of falling into poverty than casual labourers. Dercon (1999) concludes that access to infrastructure, education and ownership (possession) of farmland help the poor rise out of poverty. The same author (2000) found female-headed households to be more prone to poverty than male-headed households. Enrolment in elementary school was also indicated as having positive impact on reduction of poverty. Tassew and Tekie (2002) reached similar conclusions in their study of the poverty profile of Ethiopia. Ownership of minimal household property, quality of residential house and having farm animals and cattle are stressed as poverty indicators.

Our survey data indicate a high depth of outreach with regard to poverty profile of Ethiopia and based on overall understanding of the vulnerable group to economic shocks and social deprivation. As indicated, MFI clients are more rural, living on crop farming, most with no large farm animals or only one ox.

The household size of our respondents is quite higher than the national average, with a high ratio of illiterate individuals. Housing conditions of the group is poor. Most lack basic items, such as a bed and table and chairs. Most live on a mud floor; the majority of rural clients surveyed did not

have farmland. It is not surprising that Ethiopian MFIs reach the poor in significant numbers, since these institutions' promulgate policies more on the side of addressing poverty than achieving profitability. Some Ethiopian MFIs (ACSI, OMFI) used the wealth ranking approach as a criteria to reach the poorest. Wealth ranking is done simply, taking rural farmers who own only one ox (farmers need two oxen to till) or the equivalent wealth. Equivalence is usually established by the judgments of a local committee (ACSI, OMFI) or elders (OCSSCO).

In rural areas the poor are identified by judgments of the screening committee using the combination of criteria established by MFIs. Non-ownership of conspicuous household items such as a television or refrigerator is used by some of the MFIs in serving urban areas.

Another way of indicating depth of outreach is to look at proxies, such as the size of loans. The size of loans granted by Ethiopian MFIs is very small, perhaps five times less than the world average and two times less than the sub-Saharan Africa average (Wolday, 2003). However, when per capita GNP is considered, loan sizes seem high compared to other countries (Wolday, 2003).

The average loan size of the institutions varies. The lowest is found at ACSI, ETB 766.37 (equivalent of US\$ 89), and the highest at SMFI, ETB 2,056.88 (equivalent of US\$ 238). In actual practice, an initial loan can be as low as ETB 50.00, equivalent to US\$ 5.78. The relationship between the GNP and loan size is used as proxy to measure depth of outreach (Table 6-7). The smaller the depth (the ratio of the loan size to GNP), the poorer the client.

The MFIs' client group screening practices, eliminating potential clients on the basis of property ownership or character references, counterbalance their emphasis on the poor. In general, while the MFIs prefer the poorer, peers seem to insist on a level of loan quality to prevent indebtedness of the group if a member defaults.

Finally, the survey data collected for this study allows us to conclude that the profile of the clients reached by MFIs so far, for the most part, is the population vulnerable to economic shocks and as a result within the poverty group according to the indicators cited earlier. Most respondents did not have farm oxen, many had no land to till (those in rural areas) and those in urban areas did not even have basic household property. Their housing conditions were also poor. Many of those who had a house, had a

**Table 6-6**  
**Loan statistics**

MFI	Loans disbursed 2003	Number of loans 2003	Average loan size	Average loan size to per capita GNP (%)*
ACSI	80,072,000	104,482	766.37	98
DECSI	140,420,880	108,414	1295.23	166
GMFSC	1,402,336	1,611	870.48	112
OCSSCO	28,213,214	29,015	972.37	125
OMFI	6,737,840	4,630	1,455.26	187
PEACE	6,635,530	6,435	1,031.16	132
SFPI	3,051,100	2,198	1,388.13	178
SMFI	7,960,140	3,870	2,056.88	264
WMFI	3,606,000	3,222	1,119.18	144
Group total	278,099,041	263,877	1,053.90	135
Industry	287,417,821	273,733	1,049.99	135

Note: \*USD 90 per capita GNP for 2003, based on World Bank Report, at an average exchange rate of ETB 8.65 to 1 USD which comes to ETB 778.5. CSA report of 2003 gives ETB 774.3 for 2001/2002 fiscal years, which is almost the same in USD at the exchange rate of the time.

traditional thatched grass roof, mud floor and no table or chairs in the house. Thus, we can safely conclude that the depth of outreach of the MFIs is reasonable. This finding is strengthened by measures such as the size of the loans, and household characteristics such as literacy rate, household size and composition.

### 6.3 Client data analysis

An explorative survey of clients was conducted to determine the profile of those served by the MFIs as well as of the population that was not a client within the operational areas of the branches and sub-branches visited. The survey was based on a pre-designed questionnaire and aimed at indicating household characteristics such as age, sex of the head of household, size of the household (family size), educational status of the respondent, main source of income on which the household depends, and whether the household has a secondary and/or more alternative sources of income.

Part one of the survey gathered information on respondents by region, institution, and district (woreda) and kebele, including whether respondents were rural or urban residents. Distance of the residence from the MFI service delivery centre (branch or sub-branch or collection and dis-

bursement centres) at which basic services were provided was also asked at this stage.

This part of the survey targeted both clients and non-clients while other questions, regarding the financial services provided by the MFI and relations with the institution, were for clients only. Further common questions related to the use of non-microfinance source financial services and ownership of property.

The second part of the survey asked questions on respondents' sex, family status, level of education, religion, ethnic group and family size. Part three of the survey asked clients to identify the types of services they were getting from the MFIs, their sources of income, the business financed by the MFI and the overall relations of the client to the MFI and its services, procedures and methodology, including procedures with possible cost implications for the client. Part four was mainly devoted to whether the client had any relations or experience with other financial institutions in the past, and whether the individuals were still using other formal or informal institutions for savings and credit. Part five was devoted to non-clients, asking them why they did not or could not access MFI services. The final part asked respondents whether they possessed basic household assets, farm animals and other property. This served to indicate the wealth status of the clients and non-clients for comparison.

During the survey a total of 296 respondents were interviewed, of whom 219 are active clients of the MFI and 77 non-clients (Table 6-7). The only difficulty was the way the two groups could be accessed for interview. Most clients were interviewed at MFI meeting places and during the collection and disbursement of loans. Some of the clients were also interviewed at their residence and workplaces (at open markets, shops or farms), while for non-clients the only possibility was to go to their workplace.

Despite attempts to balance the number of clients and non-clients, once one started with the kebele (the smallest administrative organ or neighbourhood) covered by the MFI it became difficult to find a non-client within the same neighbourhood. Moreover, non-clients were not readily willing to respond to questions related to finance and credit, as they did not want to comment on programmes in which they were not involved. The large difference in the number of clients and non-clients reached with the survey may make it difficult to test the significance of some of the variables. But as the survey was only an explorative one to supplement our as-

assessment of sustainability and outreach, the picture it reveals is informative.

Comparing the property ownership of the clients and non-clients no baseline data for before the introduction of MFI services is available. Still our objective here is not to measure impact but to learn whether there is a material difference in the ownership of basic property. In the rural areas, possession of farmland may be good indicator. Since land is not for sale in Ethiopia, it would not be affected by microfinance services, but it nonetheless plays a significant role in whether one is a client.

As shown later (Table 6-8) the sample survey taken from each institution was aimed to be proportionate to the size of the institutions. Thus, from the largest two institutions ACSI and DECSI, 60 respondents and, respectively, 21 and 18 non-clients were taken. The next highest respondent numbers were in the OCSSCO and OMFI operational areas. Here we aimed for 40 respondents each, but in the case of OCSSCO only 35 responses were obtained because of problems in meeting non-clients in the Dandi area, despite repeated attempts. For the smaller MFIs, 20 respondents were taken for each, except for SMFI, for which 21 were interviewed by chance. The smaller MFIs were viewed as more or less equal in size.

Basic data, such as respondents' sex, age, status in the household (who is the head of household), marital status, family and household size and level of education are taken here to indicate the profile of the clients and non-client respondents covered in the survey. In addition, the main and secondary source of income (occupation of respondents), business or purpose for which loans were used and property ownership served to characterize the respondents. The data indicate whether the respondent is among those considered poor and also serves as a proxy to judge the depth of outreach.

As indicated above, client and non-client respondents were drawn from each selected institution as well as from all branches and sub-branches. They were also drawn equally from urban and rural areas. Whether a place of residence is considered urban was based on the classification of the Ethiopian Central Statistical Authority (CSA). The CSA has no clear-cut criteria to separate urban areas from rural areas; rather all settlements clustered to form a town were considered urban. One may challenge this grouping if some of the small villages used as marketplaces still qualified as urban. Nonetheless, according to this criterion, 62.2% of our respondents

**Table 6-7**  
*Are you currently an active client of an MFI?*

Clientship	Frequency	Per cent	Valid per cent	Cumulative per cent
a. No	77	26.0	26.0	26.0
b. Yes	219	74.0	74.0	100.0
<b>Total</b>	<b>296</b>	<b>100.0</b>	<b>100.0</b>	

Source: Survey by author.

**Table 6-8**  
*Number of respondents by institution*

Institution	Regional state	Respondents		Total	% non-clients to total	% non-clients to clients
		Non-clients	Clients			
ACSI	ANRS	21	39	60	35.0	53.9
DECSI	TNRS	18	42	60	30.0	42.9
OCSSCO	ONRS	8	27	35	22.9	29.6
SMFI	SNNP	7	14	21	33.3	50.0
OMFI	SNNP	7	33	40	17.5	21.2
SFPI	A.A.	6	14	20	30.0	42.9
PEACE	ANRS	3	17	20	15.0	17.7
GMFSC	A.A.	4	16	20	20.0	25.0
WMFI	ONRS	3	17	20	15.0	17.7
<b>Total</b>		<b>77</b>	<b>219</b>	<b>296</b>	<b>26.0</b>	<b>35.2</b>

Source: Survey by author.

were from rural areas and 37.8% were from urban (including semi-urban' areas (Table 6-9). The relatively high proportion of urban respondents in the sample is the result of two samples in Addis Ababa city. Generally, Ethiopian MFIs do predominantly operate in rural areas. The effect of being rural or urban between clients and non-clients is not significant in the statistical test.

We asked the respondents about the distance they travel from their place of residence to the service delivery centre. Though our question asked the distance in walking minutes, kilometres and cost of travel, most respondents could convey the distance only in terms of walking minutes. This question was important as it indicates the additional costs to the client in accessing services. Table 6-10 summarizes the responses. In terms of distance from the service centre, about 80% of the clients are within

**Table 6-9**  
*Residential location of respondents*

Currently an Active Client?		Location		Total
		Rural	Urban	
No	Count	44	33	77
	% within location	23.9	29.5	26.0
	% of total	14.9	11.1	26.0
Yes	Count	140	79	219
	% within location	76.1	70.5	74.0
	% of total	47.3	26.7	74.0
Total	Count	184	112	296
	% within location	100	100	100
	% of total	62.2	37.8	100

Source: Survey by author.

one-hour walking distance, while 71% of the non-clients are within one-hour walking distance. About 30% of the non-clients interviewed lived within a five-minute walking distance from the service centre, while about 27% of the clients live within the same distance group.

There was no significant difference in distance between the clients and non-clients. However, the number of non-clients increased with farther distance away from the service delivery centre. Thus around 29% of the non-clients had to walk more than one hour to reach the service centre, while only 20% of the clients had to walk more than an hour to reach the service centre. This suggests that distance from the service centre may be a factor to be a non-client, but not necessarily a decisive factor, as some individuals are within a five-minute walking distance but are not yet MFI clients.

The distribution of clients and non-clients by the distance in walking minutes from the MFI service centre is almost equally distributed statically and did not show any test of significance. Despite some differences in numbers, the chi test of the difference is 0.48, which is not significant at  $P < 0.05$ .

### 6.3.1 Household and other characteristics of respondents

Women constitute 47.7% of the clients interviewed and 36.0% of the non-clients which is higher than the national average for microfinance outreach to women (Table 6-11). The gender distribution of our sample is nonetheless close to the national average in outreach, which was calculated at 42%

**Table 6-10**  
*Distance in walking minutes from MFI service centre*

Respondents	Distance group in walking minutes	N	Per cent	Cumulative per cent
Non-clients	< = 5 minutes	23	29.9	29.9
	6 - 15 minutes	18	23.4	53.2
	16 - 30 minutes	8	10.4	63.6
	31 - 60 minutes	6	7.8	71.4
	> 60 minutes	22	28.6	100.0
	<b>Total</b>	<b>77</b>	<b>100.0</b>	
Clients	< = 5 minutes	59	26.9	26.9
	6 - 15 minutes	67	30.6	57.5
	16 - 30 minutes	33	15.1	72.6
	31 - 60 minutes	16	7.3	79.9
	> 60 minutes	44	20.1	100.0
	<b>Total</b>	<b>219</b>	<b>100.0</b>	

Source: Survey by author.

and 43% for 2001 and 2002, respectively (Wolday, 2001; Itana et al., 2003). We could not, however, obtain full information on gender composition of the clientele of the selected MFIs since some did not report on the number of female clients. The female client distributions vary among institutions and between urban and rural areas. In urban areas the number of women clients may exceed the number of male clients, while in the countryside women are fewer in number than male clients. Despite the fact that all MFIs state in their mission or strategic plans their aim to include more women, the proportion clients who are women is behind that of men. The national population distribution of the men and women in the country for the year 2003 is 49.9% women with slightly more women in the urban areas (50.2%). Female outreach of the smaller, NGO-supported MFIs is higher than for the government-supported MFIs. Sex made no significant difference, though women comprise only 36% of the non-clients interviewed and about 48% of the clients, perhaps affected by the disproportional numbers of clients and non-clients surveyed.

The figures on outreach to men and women should be interpreted with care, since some clients used the borrowed money for common spousal goals. Two such cases encountered during the interviews are presented in Box 6-1. While there may be some basis for the fear that men use money

**Table 6-11**  
*Percentage of loan clients who are women*

MFI	1999	2000	2001	2002	2003
ACSI	49	46	43	38	34
DECSI	NA	NA	NA	NA	25
GMFSC	44	56	71	53	54
OCSSCO	11.0	12.0	12	14	14
OMFI	27.9	30.6	32.5	34.3	37.5
PEACE		62.6	90.0	77.2	65.3
SFPI	80.5	73.3	72.3	67.1	66.5
SMFI	58.2	49.3	39.1	28.3	22.8
WMFI	14.0	24.1	30	29	35

Source: Data gathered by author from MFIs.

borrowed by their wife, our survey encountered many instances of a husband and wife using loans towards mutual goals or to support one another.

Regarding the age composition of clients and non-clients, the non-clients represent more the younger and working age populations (Table 6-12). Only 23.7% of the client population falls within the 18-28 age bracket, while 33% of the non-clients fall within this group. While 19.5% of the non-client population is age 46 or older, 26.0% of the client population is 46 and older. With the national life expectancy being less than age 50 (47 years), the 26% of clients older than age 46 represents a high proportion of clients in the older age group. The overall mean age of respondents is 38 years. Nationally, 17% of the total population is older than age 39 (CSA, 2003). Thus, compared to the nationwide figures, the client group has a greater proportion of the older population. Our statistical test of significance for the age difference between clients and non-clients showed  $P=0.32$ , which is not significant at  $p<0.05$ . But still this is problematic due to the difference in the number of clients and non-clients surveyed. Respondents gave more information during the discussions than just answers to the survey questions. In the OCSSCO operational area of Adaa Woreda, young recently married men and single respondents claimed that they were not clients of the MFI because they had no land. In fact, the young are not readily welcome in the groups.

Most MFIs targeted clients of active age or working age, and some specify the group between ages 18 and 59. Some fix an upper limit of 65. During the survey persons older than 70 were also encountered. At the in-

**Box 6-1**  
*Households and loans*

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In Amhara regional state at the Tiss Abbay marketplace, a husband and wife were selling potatoes, tomatoes, onions and other vegetables at an open market (November 2003). We were told that the husband was initially a borrower but left it to the wife since she is better known to the MFI employees for her business. They were interviewed at the marketplace selling their goods side by side. The couple answered our questions together and when asked who the borrower was; their answer was, "What does it matter? We borrow to improve our family life and use it for our business and we repay it." They further told us that they borrow in order to raise their children and improve their lives. They complained about the loan size limit and the prohibition of couples from borrowing at the same time. They said it would be better to increase the loan size for couples like them, instead of separately considering applications. Asked why they do the same job, the husband answered, "We are not considered the same in this market. Sometimes people look at my product and buy from her, other times they take some pieces from me and others from her." They were maximizing their share of the market by offering a larger quantity of products simultaneously to the same buyers.

In Adaa Woreda (Oromia regional State), a wife borrowed from the OCSSCO branch after her neighbours refused to admit her poor husband to a group. She claimed that her husband was denied group membership only because they are poor, but that they had no character problem. She also claimed the motive of some for denying him group membership was to exploit the condition and take over their farmland by lease since they had no oxen to plough their field. After obtaining their first loan they bought an ox, which they used for farm work and sold after fattening it at the end of the season. While the husband worked on the field and was responsible for feeding the ox, she engaged in producing and selling *araki* (local liquor). They also sold firewood, cow dung and grass to repay the loan, helping one another to pay the monthly contributions.

At the end of the farming season they sold the ox, repaid their debt and were left with some money in hand. After obtaining a second loan, they bought an ox and a cow which gave birth to a calf, and the second ox was fattened and sold to settle the loan after the farming season. Now they have a cow and a calf, an ox from a third loan and some money, which she said they will use to pay land taxes and to buy seed to plant their field. She said, "My husband takes care of the cow and the calf by bringing in feed and looking after them in the field." In addition to his farming duties, the husband grows grass on the field for sale, while the wife produces local drink to pay the monthly savings contribution in addition to taking care of the home.

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Source: Survey by author, 2003.

stitutional level, client age distribution shows wide variation. Among the MFIs that serve predominantly rural populations, OCSSCO serves a relatively older population, while GMFSC, which serves an urban population, has by far the oldest clientele with a mean age of about 45 years. GMFSC

**Table 6-12**  
*Average age of respondents by institution*

Institution	Mean	N	Std. Deviation
ACSI	39.50	60	10.91
DECSI	39.83	60	13.49
OCSSCO	42.26	35	12.91
SMFI	33.43	21	5.34
OMFI	34.85	40	11.33
SFPI	35.85	20	13.42
PEACE	33.60	20	13.82
GMFSC	44.60	20	15.34
WMFI	30.75	20	10.06
Overall	37.94	296	12.58

Source: Survey by author.

also has a widely dispersed age distribution, with a standard deviation of 15.34; that is, assuming a normal distribution, about 68% of the clients fall within age 29 to 55 years. Thus, less than 15% of the clients are younger than 29 years while 85% are over 29. It is important to note the difference in ages between the client and the non-client groups. In the rural areas many unmarried young people and even those married have no farmland. Thus, it is difficult for them to find groups to join to borrow money. In urban areas unemployed youth are similarly not readily welcome in credit groups, as those with a family and established life cannot risk trusting unproven young people in terms of character and discipline. The issue of permanent residence also counts, as many young people lack a permanent address, especially young people living in towns. The kebele administration may also be unwilling to issue them the paper required to register at an MFI. Furthermore, NGO-organized MFIs tend to emphasize poor households and women more than unemployed youths. Lending to unemployed youths also may require additional efforts to organize them into groups and get them working permits and to arrange for means to monitor loans. These activities are currently undertaken by the Regional Micro and Small Enterprise Development Agencies (ReMSEDAs), who first give young people business development training and then link them to microfinance institutions for loans. Such opportunities may be lacking in rural areas. As most Ethiopian MFIs are minimalists, they do not tend to provide training to clients and potential clients.

**Table 6-13**  
*Educational level of respondents*

Group	Educational level	Frequency	Per cent	Cumulative per cent
Non-clients	Illiterate	22	28.6	28.6
	Literate-literacy programme	12	15.6	44.2
	Traditional religious schools	1	1.3	45.5
	Primary school	13	16.9	62.3
	Junior secondary school & above	29	37.7	100.0
<b>Total - non-clients</b>		<b>77</b>	<b>100.0</b>	
Active clients	Illiterate	30	13.7	13.7
	Literate-literacy programme	46	21.0	34.7
	Traditional religious schools	6	2.7	37.4
	Primary school	49	22.4	59.8
	Junior secondary school & above	88	40.2	100.0
<b>Total - active clients</b>		<b>219</b>	<b>100.0</b>	

Source: Survey by author.

With regard to marital and household status and level of education (Table 6-13), compared to clients, non-clients are more likely to be single and less educated, and have fewer female heads of household. Indications here support the age distribution argument that many single residents are not eligible for loans, because they have no land, no permanent residence and therefore involve greater risks in trust. Moreover, the client group has a higher educational level than the non-clients.

On the statistical test, the variables marital status and household status (head of family) shows significance between clients and non-clients, with  $p=0.002$  and  $p=0.01$ , respectively. Educational status also shows a statistically significant difference between clients and non-clients, at 0.05 with  $p=0.03$ .

Religious and ethnic background do not differ between the client and non-client population. Nor was any statistical difference measured, since both the client and non-client group are part of the dominant ethnic and religious group in the area. Both distributions simply reflect the composition of areas in which surveys were conducted rather than the effect of being a client or not. In areas where the Muslim religion is dominant, almost

**Table 6-14**  
**Family sizes**

Respondents	Class	Frequency	Per cent	Cumulative per cent
Non-clients	1 - 3	22	28.6	28.6
	4 - 6	37	48.1	76.6
	7 - 9	14	18.2	94.8
	>= 10	4	5.2	100.0
	<b>Total</b>	<b>77</b>	<b>100.0</b>	
Clients	1 - 3	39	17.8	17.8
	4 - 6	102	46.6	64.4
	7 - 9	61	27.9	92.2
	>= 10	17	7.8	100.0
	<b>Total</b>	<b>219</b>	<b>100.0</b>	

Source: Survey by author.

**Table 6-15**  
**Mean family size**

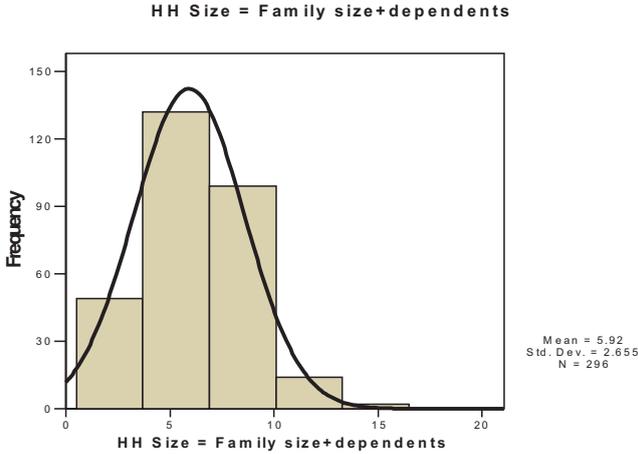
Respondents	Mean family size	Number	Std. deviation
Non-clients	4.87	77	2.457
Clients	5.71	219	2.480
<b>Total</b>	<b>5.49</b>	<b>296</b>	<b>2.497</b>

Source: Survey by author.

all borrowers are Muslim. In the Hara-Siblka kebele of the Woldia sub-branch of ACSI, clients were 100% Muslim.

Family and household size of respondents are given in Tables 6-14 and 6-15 and Figure 6-1. The mean for family size is 4-6 for both groups except that clients have a larger proportion near the upper limits. Over 35% of the client respondents had a family size greater than 7 people. Some 4% of the non-client respondents had more than 7 family members; similarly 7.8% of the clients had more than 10 family members. The national average for family size is 5 members; while here the mean family size of 5.71 is for the clients interviewed. The non-clients have fewer family members, with a mean number of 4.87. The difference in family size of the clients and non-clients was found to be statistically not significant when tested on the basis of frequency distribution in Table 6-14 with  $p=0.07$ . But the result is significant when mean family sizes are compared (Table 6-15) with a  $p$  value of 0.004, slightly below 0.005.

**Figure 6-1**  
*Mean household size of respondents in survey*



The total household size of all respondents (including children, parents and dependents) shows a mean of almost six persons. Still clients have a larger number of dependents per household.

In summary, the data shows that clients have a bigger family size than the national average of about five (CSA, 2003). Also, a large proportion of clients are women, and there are many clients among the older working age population. Clients have a large family and household size and are relatively better educated than non-clients. There are also many female-headed households in the client group. Non-clients were relatively younger, with a smaller family size and lower level of literacy.

### 6.3.2 Client business and financial services of the MFI

Clients and non-clients were asked to name their permanent source of income or the activity on what they mostly depended to earn their livelihoods (Table 6-16). Most responded that crop farming was their primary permanent source of income (32.5% for non-clients, 38.8% for clients), followed by retail trade (23.4% for non-clients, 19.2% for clients). Earnings from casual labour ranked third among the non-clients (20.8%). In fact, this number increases to 24.2% if ex-clients are excluded, while among the clients sale of food and drinks ranked third, with 9.6% of them being engaged in this activity. Wages from labour and animal husbandry fol-

**Table 6-16**  
*Permanent source of income*

	Non-clients		Clients		Total	
	N	%	N	%	N	%
Crop farming	22	35.5	84	38.9	106	38.1
Retail trade	16	25.8	42	19.4	58	20.9
Food and drink sales	1	1.6	21	9.7	22	7.9
Labour	15	24.2	15	6.9	30	10.8
Horticulture	4	6.5	16	7.4	20	7.2
Mixed	3	4.8	19	8.8	22	7.9
Other	1	1.6	19	8.8	20	7.2
<b>Total</b>	<b>62</b>	<b>100</b>	<b>216</b>	<b>100</b>	<b>278</b>	<b>100</b>

chi=22.84; p=0.001

Source: Survey by author.

lowed in the ranking. Most rural households use mixed agriculture, having some animals on their farm and cropping as a matter of tradition. Both clients and non-clients were engaged in multiple activities as their permanent means of income. Some 80.5% of the non-clients had no secondary activity to earn income, while 60.3% of the clients had no secondary engagement; 94.8% and 87.3% of the non-clients and clients, respectively, did not have a third activity. Thus, for both groups, sources of income show little diversification. In the rural areas, crop farming dominates, followed by animal husbandry, cattle fattening or trade in cereals, all of which are closely related to farm activities.

The interrelation of the businesses of clients in the rural areas shows a typical non-diversified rural economy which is problematic for the provision of microfinance on terms of covariant risk on loan portfolio. Most urban clients and non-clients depend on retail trade and sale of food and drinks. The survey also found many clients engaged in casual labour to supplement their primary source of income, which shows the insufficiency of their primary source of income for their livelihood. Clients were supposed to create self-employment at the minimum.

Despite the similarity in engagement in crop farming, there is a significant difference between the clients and non-clients in that the non-clients are more engaged in casual labour.

The purpose, for which loans are used differs little from the permanent sources of income. Trade (in live animals and cereals) ranked first, followed

**Table 6-17**  
*Length of time respondents had been MFI clients*

Respondents	Client duration (years)	N	Per cent	Cumulative per cent
Non-clients	0	77	100.0	100.0
Clients	1	13	5.9	5.9
	2	52	23.7	29.7
	3	45	20.5	50.2
	4	43	19.6	69.9
	5	30	13.7	83.6
	6	36	16.4	100.0
Total		219	100.0	

Source: Survey by author.

by retail trade (small shops), purchase of oxen and cattle fattening in order of importance. The borrowers did not necessarily use the money they had borrowed for one purpose only. Some used it for a combination of activities, as well as for consumption or other purposes not reported to the MFIs. There were cases in which informants reported having used the money to buy corrugated iron sheets for their house construction and repaid the loan by selling cattle. They also used the money to pay taxes, purchase fertilizers and pay off other debt. MFI officers visit client businesses and from time to time to supervise whether the money is being used for productive undertakings, yet there is always room for clients to divert funds.

Among the clients interviewed, 23.7% had been using the service for two years, 20.5% for three years, 19.6% for four years, 13.7% for five years and 16.4% for 6 years or longer (Table 6-17). The majority, 83.6% of clients, had been using the service for less than 6 years. This is reasonable in view of the age of the institutions, since most MFIs have been in business for the last five years only. But the progressively declining percentage of senior clients indicates a high client withdrawal after a few years of membership. Normally when one chooses to visit a branch or sub-branch the groups of clients met are the same since MFI credit agents organize groups early on and mostly continue with that group. New groups are rarely organized in established areas, but rather upon expansion into new areas.

The financial services provided by most MFIs are limited to the traditional credit and savings services (Table 6-18). Only 44.7% of the clients

**Table 6-18**  
*Types of financial services used by clients and non-clients*

Currently an active client of an MFI?		Type of financial service used	Frequency	Per cent	Cumulative per cent
No	Valid	b. Voluntary savings	2	2.6	100.0
	Missing		75	97.4	
	<b>Total</b>		<b>77</b>	<b>100.0</b>	
Yes	Valid	a. Loan with compulsory savings	88	40.2	40.2
		b. Voluntary savings	3	1.4	41.6
		c. Insurance	2	.9	42.5
		d. a & b	98	44.7	87.2
		e. a & c	14	6.4	93.6
		f. a, b & c	14	6.4	100.0
<b>Total</b>		<b>219</b>	<b>100.0</b>		

Source: Survey by author.

surveyed could use voluntary saving services and 12.4% had access to insurance services. These findings compare with those on utilization of other means of savings, in which over 68% of the MFI clients still go to other institutions for savings, mainly traditional institutions such as *Iqub* and money-keepers, though a few also use a formal bank. Forty per cent of the clients use credit with compulsory savings only. Among the non-clients, two individuals using voluntary savings were encountered. This was an isolated case of two young people in the town of Sodo. They were happy to keep their money with the MFI since they could start saving part of their small earnings from time to time. Perhaps this could be taken as an indication that the MFIs could push voluntary savings more, even among non-credit clients who want to save some of their small earnings. Commercial banks in Ethiopia require at least an ETB 50 (about US \$6.00) initial amount to open a savings account, though poor people may need several months to save that amount. Thus, MFIs accepting savings starting as low as ETB 5.00 (less than a dollar) and deposits from ETB 1.00 onwards is perhaps a good incentive for savers. Yet few are aware of the availability of this facility, clients and non-clients.

With the exception of DECSI, most MFIs had low-level voluntary savings mobilization. Insurance was at times available but with limited application to cover loan repayment in the event of death of the borrower. No

other form of insurance had been introduced. Iddir, a mainly not-for-profit informal institution, covers a variety of risks including funeral expenses, health care costs, wedding costs and expenses related to natural calamities affecting individual households. MFIs could learn from these institutions or link their insurance to these institutions, but little effort has been made in this respect. Along with the type of financial services provided it might be important to consider the line of business financed, the variety of loan methodologies, the diversity of businesses financed and the diversity of the target group. In general, while the scale of outreach of Ethiopian MFIs could be appreciated given the age of most MFIs, the scope of outreach remains very much limited.

As to the promotional work done by MFI personnel among potential clients, most respondents say that they heard about the MFI service from friends (41%), and from the kebele administration (35%). Only about 11% learned about the services from MFI personnel coming to their villages. Government-owned MFIs have closer relations with grassroot political administrations and MFIs promoting their programmes may use these venues. Some NGO-backed MFIs use kebele meetings and offices to initially promote their programmes, since cooperation or permission of the administration is required to conduct a meeting with members of the public.

To be a member, 43% of the clients went to the MFI office and filled in the form for membership, while 40% reported that they were recruited by the kebele administration. This shows that administrative organs of the government have some involvement in screening clients of microfinance institutions. After filling in the application form (applying for a loan) clients have to wait until the loans are approved and orientation is given to the candidates. Only 15% responded that this process had been completed in less than a week, and 20% reported one week. Thirty-eight per cent (38%) said it was completed in two to four weeks. For 26.6%, the process took more than a month.

As to loan methodology, 97% of the clients responded that they used group guarantee. Individual guarantees exist, but only 1.4% of the clientele currently use them. Groups are voluntarily formed by clients. In 75.5% of the cases, clients encountered no problem with their groups. The main cause of problems among the remaining 24.5% is default by a member (56.3%), family problems encountered by a group member, such as divorce, ill health or death of a spouse (33.3%) and violation of group disci-

pline (e.g. absenteeism from meetings) (6.3%). In 36% of the cases the problems had not yet been resolved, while about 40% of the cases had been resolved by dissolving the group and forming another, dismissing the defaulting member and by availing legal means to recover the loan. Legal means, according to some informants, can be sluggish and frustrating. To resolve a dispute in some instances the kebele tribunal court either drags the matter out or fails to make a fair decision at all (see Box 6-2). This, however, is not always the case. In many instances kebele administration cooperated to seize property of the defaulter on the request of the group members. But assistance from MFI officers is necessary to attract attention to such difficulties. Unfortunately, when asked whether credit officers keep record of problems encountered in groups, none was available. Employees remember incidents in relation to delayed loan repayments or as remarks on status reports on loan repayment. Many clients have indicated that they would prefer individual lending rather than joining groups. Some stated they had lost opportunities because of the group, since members must wait until all have fulfilled their obligations for the next round of loans to commence. Most of those who do not want group guarantee do not want to bear the risk of others.

Group meetings are held weekly, fortnightly and monthly on the day payments are made. Unless there are matters to discuss of which they are told in advance, personal attendance of clients is not mandatory. Payments can be sent by delegation. Thus, there is a relaxed attendance of meetings. The Grameen type discussion of social issues or weekly chanting of rules is not practiced. In many of the established groups meetings are called when there is a matter to discuss, while members can send their payments to the group leader or by proxy. When meetings are called they may stay in session for over three hours. Payments are made mainly at MFI retail offices, the branch or the sub-branch as it may be called. Sometimes arrangements are made such that the clients and collectors meet halfway. However, as observed during the survey many rural clients must walk more than two hours to reach the collection place. In fact it is impossible for the credit officers to go door to door for collection, especially in the rural areas. Urban clients come to the MFI branch offices or collection centres, usually kebele offices.

Thirteen per cent of the respondents reported problems repaying their loans on time in the past. The main reasons were lack of a market for their

**Box 6-2***A case of enforcement problems*

Respondent No. 198, who was a client of Omo MFI Soddo Sub-branch and a centre chairperson, spoke of her disappointment at the kebele judiciary tribunal. She claimed the tribunal had deliberately sided with a malicious defaulter who had abused his position in the kebele to borrow in his name and his wives' names in contravention of the MFI policy that only one member of a family may borrow from the MFI at any one time. She was ill but volunteered to answer our questions from her bed. We sat by her bedside while she spoke to us, her head resting on a pillow.

She said "this person was recommended by the kebele for the loan, his wife as well, in the name of his wife he took ETB 500, in his own name ETB 700 and did not repay. Our centre [a centre consists of up to five groups] was denied a next round loan disbursement until we pay his debt. We had to pay his loan plus interest ...and after a delay of 5 months our next loan was disbursed. We sued this person at the kebele judiciary tribunal [also called the justice committee], but the litigation was one of trickery. He denied taking any money from us, which is known. He collected the money from the MFI but we signed that we are all liable severally, collectively and individually for any outstanding debt of group.

"When we asked the MFI branch office representative to intervene with a copy of our agreement, the committee prevented him from intervening; telling him that he cannot intervene since the MFI is no longer claiming anything outstanding. So the issue just drags on endlessly. What can we do when those who ought to help us are against us?"

Source: Survey by author.

product (32.1%), market price fluctuation (17.8%), war (14%) and various other causes.

Despite problems, 94% of the client respondents believe that the income they derive from their business is sufficient to repay their loans and monthly contributions. Six per cent believe it is insufficient, and they thus need to sell live animals or repay the loan from other earnings.

Thirty-eight per cent of the clients complained that the loan size was insufficient to enable them to do what they wanted to do with the money. Those complaining about loan size appear to be the most affluent in business, as such comments come mostly from shop owners and traders. Some were already successful in business but kept the relation with the MFI to access cash to supplement their business earnings, but feel that the amounts available are not enough. For 61.8% of respondents, the loan size was sufficient, but some of these said it was enough because they might no longer be able to repay the debt if they took more money. For 89.5% loan

approval and other procedures were simple and understandable, and they appeared reasonable to 7.8%.

In general from this section of the questionnaire, we gathered that clients could use the loan funds for purposes other than the stated objective, that meetings are not always mandatory and that there are some problems related to group lending and loan size. The number of repeat clients is evenly distributed over the years. This is partly due to the age of the sub-branches visited. Nonetheless, a high proportion of the clients encountered were for repeated loans, 94% for a second loan or higher, and 70% for third loan or higher. About 17% had been a client for six years or more.

### 6.3.3 Financial relations with other institutions

In this section of the questionnaire an attempt was made to obtain information as to whether the clients and non-clients make use of other institutions for financial services or obtain services from sources other than MFIs. Accordingly, 42.9% of non-clients and 49.4% of clients responded that they were using financial services from other sources. Friends and relatives are the main source, mentioned by 32.4% of non-clients and 47.8% of clients. Some 30% of clients borrowed from moneylenders, while 13.5% of non-clients used moneylenders. Some 27% of non-clients have or had access to other NGO and government loans, such as a food security loan, a micro-enterprise loan or other concessional loan.

Thirty per cent (30%) of non-clients and 36.8% of clients who used other sources said these services were interest free, while 30.8% and 44.2% of non-client and clients, respectively, responded that the interest rates charged by other lenders was more than bank and MFI rates. Some non-clients (12.8%) responded that they had a subsidized interest rate below bank and MFI rates. Perhaps here some of the respondents indicating a loan was interest free did not fully understand the amount of implicit interest they were paying. There is also the possibility of relatives giving interest-free loans, with the benefit to the lender being a social or future reciprocal relationship or benefits in kind (free labour of the borrower or simply bondage). Some non-clients reporting that they had used a loan from a moneylender explained that they paid up to 240% interest on the money borrowed. Thus, if they borrowed ETB 100, at the beginning of a month they would be obliged to repay a total of ETB 120 at the end of the month.

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**Box 6-3**  
**Money-keeping**

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Respondent No. 222, client of SFPI in Addis Ababa (Kebele 15 Arada sub-city), is a retired army member. He started trading in sheep to earn a livelihood. One day he met a friend called Woldie, who was going to the kebele. When asked why he was going, after some hesitation, Woldie said that there was a loan to be given to poor people by SFPI. Our respondent said he followed Woldie to kebele office and asked the SFPI people to register him.

They did, and gave him appointment for orientation. After orientation he had to find a group to join and start compulsory saving. He has now increased the number of sheep he occasionally fattens and sells from one to five. He can't keep more since he is in the middle of a crowded city. But he still remains with his shopkeeper friend to save his money. The shopkeeper gives him a passbook of sorts, handwritten; signs for each deposit and withdrawal on the passbook, and charges ETB 3 for each ETB 100 kept for a maximum of six months.

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Source: Interview by the author.

On the savings side, 61.4% of the non-clients and 68.5% of clients use means other than MFIs to save. Contributions to the *Iqub* is the most common means by both groups. Some clients have a bank account for savings for lack of trust in the MFIs. At the Shola branch of SFPI in Addis Ababa, a client carried his pass book issued by a shop owner who acts as a money-keeper. The pass book is a simple handwritten document with columns for date, amount received or paid, balance and signature. Each time the cash is deposited, the amount is recorded and the balance calculated. The shopkeeper then signs in the column following the balance. When the saver wants to withdraw, the date and amount is interred and the new balance calculated by subtracting amount collected. There is no additional covenant or provision for trusteeship. The agreement is oral. The money-keeper charges a commission on a monthly basis (Box 6-3). Other means of saving used by clients of MFIs include buying cereals to speculate on price and investing by lending surplus cash to others. Some also reported keeping money at home in a safe. Here a clear potential was observed for increasing voluntary saving if sufficient incentive is given to savers by way of attractive interest rates and trust-building promotional work.

Responses to this part of the survey indicate that microfinance institutions are not doing enough to mobilize savings from their clients. With the exception of ACSI, savings mobilization is low in most of the MFIs vis-

ited, and many clients are unaware that they can voluntarily save and withdraw money. Perhaps this is explained by looking at the respective MFIs' balance sheet and their sources for financing their portfolios. Neglect of savings services is contrary to the common belief that poor clients benefit more from savings and insurance than from credit. The fact that poor clients deposit savings at other institutions or use other means shows the importance of savings to the clients.

### 6.3.4 Former clients and non-clients

Thirteen ex-clients (dropouts) were among the non-client group interviewed. Six of them (46.2%) had been clients of the MFIs for two years, and four (30.8%) were members for over two years. Five (38.5%) had dropped out because they no longer needed credit, two (15.4%) were unhappy with terms and conditions of the loan, and three (23%) had personal problems preventing continuation with the programme.

Among those who were not members at any time, some had applied for loan in the past but their applications were rejected for various reasons, including non-fulfilment of criteria, inability to find a group or other reasons they did not know. The majority of this group (88.1%) had not tried to apply for a loan. The reasons included mainly fear of indebtedness, no need for credit, problems finding a group, did not think they would fulfil the criteria, loan conditions and lack of information about the benefits of microfinancial services.

During the discussion with these groups, some initially refused to even be interviewed, thinking that we were about to ask them to join the MFI service. One woman interviewed in Marawi (ACSI sub-branch in east Gojam, November 2003), first tried to run away and finally when we persuaded her to talk to us she told us that her husband is a risk-taker. He may join the loan scheme, she said, although he does not know the business and the only result would be to finally push her into a debt that would cost her live animals. She then told us to leave her alone. There were people who told us that the MFI programme brings only debt or asked why they should pay interest. This question partly comes from the expectation that government (aid) money should be free. We may not as such suggest that all poor households be they rural or urban should join MFI. But there are clear indications that there is room for expansion, to bring in many additional clients in areas where the MFIs are currently operating.

Obviously there are also campaigns against MFI services, such as from moneylenders, whose market is being flooded by MFIs. Other possible detractors are people with political motives, since they believe the ruling party is trying to corner the rural and urban population with MFI loans and a monopoly on fertilizer supply. Some claim that MFI money is like AIDS in that nobody will be cured once infected (Tassew and Valle, 2003). Some say it is “666 money”, which will lead to a curse. Others claim that MFI personnel give the money using their left hand so that it brings “bad luck” (Box 6-4). During the survey, clients and non-clients informed us about these tales and discouragements.

The rumours are spread based on the traditions and religious orientation of the residents. In the northern part (ANRS) where the population is predominantly orthodox Christian and yet traditional taboos are observed, the story told appeals to “luck”, while in the south, where the population predominantly follows protestant religion and traditional taboos are mostly overridden by religious taboos they connect their claims against the MFIs to biblical warnings.

### 6.3.5 Household and farm property ownership

The last part of our survey included questions related to basic household and farm property ownership. The main purpose here was to relate findings to the indirect wealth ranking procedure the MFIs use to screen their clients. The same measure was used to compare the clients and non-clients on property ownership and relate it to household and other characteristics.

Many of the clients, especially those in rural areas, have their own house (Table 6-19). To assess wealth, the quality of the house, its size and inventory and ownership of assets such as a television and radio and personal property such as a wristwatch were included in the questions. Such assets tend to be owned by relatively better off, enlightened and literate people. In rural areas, televisions are not used due to lack of infrastructure. Here the relatively better off tend to own radios, tape players, irons or modern wooden beds, and tables and chairs.

Most MFIs use proxies for wealth ranking in screening and targeting. OMFI, OCSSCO and ACSI target persons with one ox or none or the property equivalent in rural areas. SFPI defines poor people in the urban areas as those with low or no permanent income, and those who own no conspicuous household property and appliances, such as television sets, re-

**Box 6-4**  
*The “left hand” and “666 money” myth*

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**The left hand**

In Kuyi, east Gojam, ANRS, clients of PEACE told us the story of the “left hand”. Some groups for unknown motives try to keep people away from the microfinance service. They do this by exploiting traditional beliefs of the people. They tell people that cashiers of the MFIs pay cash to the borrower with the left hand, so that the client (borrower) does not gain from the money and remains in a vicious circle of borrowing. Giving something to someone with the left hand is considered bad luck or wishing the recipient bad luck. One client told us that she was watching the cashier when she first collected the money as to which hand he is using. She was lucky to collect the money from his right hand; the money was also fruitful for her. “Now”, she said, “when I recall of that first encounter with my mindset, I wonder what I could have done if the cashier had used his left hand by chance.”

**“666 money”**

Another story was told in SNNPRS. At the Damot Wyede sub-branch of OMFI, the sub-branch manager told us that as they started promoting the MFI business, gossip was spread telling people (especially those of the Christian faith) that the MFIs’ money comes from those who sponsor evil. A young man and a woman confirmed that there was such a tale. They told us that people said, “it is 666 money” supplied by Satan. The story refers to the monstrous beast described in the last verse of the Book of Revelations chapter 13.

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Source: Survey by author.

frigerators, video cassette recorders or similar items which show one is better off at the household level.

Our survey results indicate that 53.3% of the non-clients own their residential houses, 25.9% live in rented houses and the rest either live as dependents or have no permanent residence. We must relate these figures to those in Table 6-9, which shows 57.1% of the non-client respondents as rural residents and 63.9% of the client respondents as rural. Most rural respondents have their own house, though quality varies. Thus, house ownership may partly reflect the difference between rural and urban life. Still the client group is better off in housing than the non-client group, as 73.9% of the clients have their own residence, 16.4% live in a rented house, 2.7% live as dependents with family or relatives and 6.9% have no permanent residence. The percentage of non-clients having no permanent residence is almost double.

If the level of poverty or wealth status is considered for the clients and non-clients, it is not only the housing stock but also the quality of the

**Table 6-19**  
*Home ownership among clients and non-clients*

Ownership status	Non-clients	% among non-clients	Clients	% among clients	Total	% of total
Not stated and without permanent residence	9	11.7	15	6.9	24	8.1
Live as dependent with family or relatives	7	9.1	6	2.7	13	4.4
Rented	20	26.0	36	16.4	56	18.9
Owned	41	53.3	162	74.0	203	68.6
<b>Total</b>	<b>77</b>	<b>100.0</b>	<b>219</b>	<b>100.0</b>	<b>296</b>	<b>100.0</b>

Source: Survey by author.

house (type of roof and floor) and size that is important. Also, availability of infrastructure such as tap water, electricity and road access may indicate the extent to which clients or potential clients are vulnerable to poverty (Schreiner, 2002). The survey showed that more clients own their home than non-clients, with the statistically significant value of  $p=0.007$ .

As to house quality, our survey indicated that only 52% of non-clients and 67% of clients who own their home have a corrugated sheet-iron roof (Table 6-20). The rest have a traditional grass thatched or hidimo roof (a traditional roof in northern Ethiopia, particularly Tigray, made of a wood overlay spread with mud). The floor is mud for 66% of non-clients and 65.8% of the clients. Obviously concrete floors are rarely available in the rural areas and many of the residential houses in small towns also have a mud floor. The quality of roof type favours the client population. The non-client group has poorer quality housing in terms of roof type. The difference between the clients and non-clients is again statically significant ( $p=0.03$ ) at  $p<0.05$ . The variable floor type was not statistically significant.

We looked at this relationship by segregating the clients into those who had taken loans relatively recently and those who had been using loans for a longer time (1-2 times, 3-4 times and 5-6 times). The results were similar in that home ownership remained dominated by clients, but roof type was statistically insignificant between the clients and non-clients.

As indicated in Table 6-21, 63.6% of the non-clients and 53.9% of the client population have no oxen, sill bearing in mind the urban rural difference. Some 75.3% and 73.5% of the non-clients and clients, respectively, has one ox or no oxen. Just 5.3% of the non-clients and 7.4% of clients

**Table 6-20**  
*Floor type of client and non-client houses*

Currently an active client of an MFI?	Floor Type	Frequency	Per cent	Cumulative per cent
No	Not stated	12	15.6	15.6
	Mud	51	66.2	81.8
	Concrete	14	18.2	100.0
	<b>Total</b>	<b>77</b>	<b>100.0</b>	
Yes	Not stated	16	7.3	7.3
	Mud	144	65.8	73.1
	Concrete	59	26.9	100.0
	<b>Total</b>	<b>219</b>	<b>100.0</b>	

Source: Survey by author.

have more than two oxen. Residents of smaller towns also own oxen, as they are engaged in farming as either a primary or secondary activity (see table in annex on the business of respondents).

Tables 6-22 and 6-23 show the ownership of televisions and radios. Some 86% of the clients and 85% of the non-clients surveyed did not own a television. Some microfinance institutions clearly consider television ownership as an indication of better wealth status and thus put such households outside of their target group (see also chapter 5). Table 6-23 shows that 39% of the non-clients do not own a radio of any sort, while 35% of clients do not have one. Some 65% of the clients own radios, compared to 61% of the non-clients. Ownership of radios is an indicator, especially among the rural population, of better economic status rather than a necessity, but individuals also consider radios a means to access information.

We can compare ownership of many property items and quality of life indicators of clients and non-clients against the national average (Tables 6-24, 6-25 and 6-26). In many respects both groups surveyed are below the national average. For instance, housing and land ownership are less than the national average. Household size is greater than the national average. This indicates that the groups surveyed are among the poorer segments of the society, even without controlling for the effect of microfinance intervention.

**Table 6-21**  
*Ownership of oxen by clients and non-clients*

Currently an active client of an MFI?	Number of oxen	Location (%)		Total
		Rural	Urban	
No	0	20.8	42.9	63.6
	1	11.7		11.7
	2	19.5		19.5
	3	2.6		2.6
	4	1.3		1.3
	8	1.3		1.3
Total		57.1	42.9	100.0
Yes	0	20.1	33.8	53.9
	1	19.6		19.6
	2	17.8	1.4	19.2
	3	2.7	0.5	3.2
	4	3.7		3.7
	5		0.5	0.5
Total		63.9	36.1	100.0

Source: Survey by author.

**Table 6-22**  
*Households with television set*

Currently an active client of an MFI?	Television ownership	Frequency	Per cent	Cumulative per cent
No	No	66	85.7	85.7
	Yes	11	14.3	100.0
Total		77	100.0	
Yes	No	186	84.9	84.9
	Yes	33	15.1	100.0
Total		219	100.0	

Source: Survey by author.

## 6.4 Other aspects of outreach

### 6.4.1 Worth of outreach to clients

Loan size, term to maturity and size of instalments and repayments are indicators of worth to clients. Repayment rate of the MFIs in most cases is above 95%, which is taken as the cut-off point as suggested in the micro-bank bulletin. Only a few smaller MFIs have problems in collection, per-

**Table 6-23**  
*Households owning a radio or radio/tape player*

Currently an active client of an MFI?	Ownership of radio or radio/tape player	Frequency	Per cent	Cumulative per cent
No	No	30	39.0	39.0
	Radio	27	35.1	74.0
	Tape Radio	20	26.0	100.0
<b>Total</b>		<b>77</b>	<b>100.0</b>	
Yes	No	76	34.7	34.7
	Radio	88	40.2	74.9
	Tape Radio	55	25.1	100.0
<b>Total</b>		<b>219</b>	<b>100.0</b>	

Source: Survey by author.

**Table 6-24**  
*Households owning beds*

Currently an active client of an MFI?	Beds owned	Frequency	Per cent	Cumulative per cent
No	0	26	33.8	33.8
	1	33	42.9	76.6
	2	14	18.2	94.8
	3	1	1.3	96.1
	4	2	2.6	98.7
	5	1	1.3	100.0
<b>Total</b>		<b>77</b>	<b>100.0</b>	
Yes	0	39	17.8	17.8
	1	88	40.2	58.0
	2	63	28.8	86.8
	3	20	9.1	95.9
	4	8	3.7	99.5
	5	1	0.5	100.0
<b>Total</b>		<b>219</b>	<b>100.0</b>	

Source: Survey by author.

haps due to weak follow-up. During the survey few complained about the terms and conditions of loans. As a rule, because repayment is high, we can say that the worth of the services to clients is high. GMFSC clients complained about the terms of maturity, specifically the weekly and fortnightly

**Table 6-25**  
*Size of landholdings, 2002*

Landholding in hectares	Survey respondents as a proportion of total agricultural households (%)
<0.10	6.9
0.01-0.5	28.5
0.51-1.0	25.1
1.01-2.0	25.1
2.01-5.0	12.6
5.01-10.0	1.0
10.01<	0.1

Source: CSA (2003).

payments. Some clients complained that loan sizes were too small to support meaningful business. The majority said the loan size is sufficient and they would not be able to repay if it were more. Many would like a longer repayment period than that now given.

#### 6.4.2 Cost of outreach

Cost of outreach is the sum of the transaction cost and price cost to the customer (Schreiner, 2002). Few clients complained about the interest they pay. Clients complained about interest rate only comparing two types of loans, regular loans and agricultural package loans, which have different interest rates but are offered by the same institutions, ACSI and DECSI. ACSI and DECSI extend agricultural package loans at 12.5% while charging 18% interest on regular loans to rural farmers. Thus, the complaint is based more on the difference than the overall cost. Interest rates in Ethiopia are said to be low, even by sub-Saharan African standards (Wolday, 2003). Some institutions charge service charges in addition to interest. The compulsory amount to be retained at the MFI (5%-10%) reduces the effective amount disbursed to clients. In effect, it increases the effective interest rate on loans.

Other costs, especially costs to clients in transport, waiting time and meetings, varied from institution to institution. ACSI clients must walk long distances to settle their monthly payments. Some clients claimed that they have to travel for five hours. Those who have access to roads paid transport costs of ETB 2-3 to reach the collection centre. Overall average distance from the centre as indicated in the survey result is more than one

**Table 6-26**  
*Respondents' household landholdings by location of residence*

Respondents	Farmland (ha)	% Holders by location		Total
		Rural	Urban	
Non-clients	0.00	18.2	42.9	61.0
	0.01	1.3		1.3
	0.25	2.6		2.6
	0.50	5.2		5.2
	1.00	3.9		3.9
	1.25	1.3		1.3
	1.50	7.8		7.8
	2.00	7.8		7.8
	2.50	2.6		2.6
	3.00	1.3		1.3
	4.00	2.6		2.6
	5.00	1.3		1.3
	6.00	1.3		1.3
<b>Total</b>		<b>57.1</b>	<b>42.9</b>	<b>100.0</b>
Clients of MFIs	0.00	18.7	32.9	51.6
	0.08	0.5		0.5
	0.10		0.5	0.5
	0.25	1.8		1.8
	0.50	7.3	1.8	9.1
	0.75	0.9		0.9
	1.00	11.9		11.9
	1.25	0.5		0.5
	1.50	6.8		6.8
	2.00	6.4		6.4
	2.50	2.3	0.5	2.7
	3.00	3.2		3.2
	4.00	2.7		2.7
	5.00	0.5		0.5
5.50	0.5		0.5	
1,000			0.5	
<b>Total</b>		<b>63.9</b>	<b>36.1</b>	<b>100.0</b>

Source: Survey by author.

hour walking. This represents a cost to clients. Unlike other countries, MFIs in Ethiopia do not always conduct meetings. At the end of each month clients come and repay their loans. Meetings are held only if there is

a matter to discuss. Walking to the collection centre, however, does cost rural clients a lot in terms of both time and money.

Cost of outreach to clients can be estimated only by taking into account all direct cash costs and indirect transaction costs incurred by the client. Clients may not understand the full consequences of costs, but they express their feelings by referring to inconveniences or they quit the service when they find it unworthy. Thus, it is important for the MFIs to better estimate the costs to the clients, in their effort to make their services more efficient and competitive.

### 6.4.3 Breadth of outreach

The larger MFIs have reached extraordinarily large numbers of people. ACSI and DECSI have the highest outreach, impressive even by sub-Saharan Africa standards. The rest, like OCSSCO, OMFI and WMFI, are catching up. Smaller MFIs have an outreach of slightly over 5,000 to 12,000 clients while ACSI had reached 480,000 clients with loans and had 443,365 savings accounts by December 2003 (ACSI, 2004). Survey results indicate that many clients live on crop farming, with this undiversified client profile mainly due to emphasis of Ethiopian MFI policy on rural population. But with the recent expansion of the government-owned MFIs into urban areas the client mix should become more varied.

### 6.4.4 Length of outreach

To continue to serve clients, MFI programmes must be sustainable. MFIs enjoy good collection rates, but many have not yet reached financial sustainability, judged as a permanent (ongoing) ability to offer services. Longer term services, or sustainable services, will bring about changes in the lives of clients. But many Ethiopian MFIs are less than 10 years old and progressing towards sustainability, albeit, slowly.

## 6.5 Conclusions

The judgment on scale of outreach for each of the MFIs in our sample is necessarily institution specific. Yet some general conclusions can be drawn on the basis of trends in the growth of client numbers, expansion of retail end posts and overall growth of the MFI services. Ethiopian MFIs reached a total of about 450,000 clients by 2001. By the middle of 2003 they had

713,000 clients. At the end of 2005, the client population was expected to exceed 1 million. The number of branch networks significantly increased over these years as well. Each institution showed an increase in number of clients from year to year, though not all MFIs showed equal growth.

The two largest MFIs also lead in number of clients in sub-Saharan Africa, even surpassing institutions established long before microfinance started in Ethiopia. In general, government-supported MFIs, though they operate within the limited boundary of regional states, have by far surpassed NGO-supported MFIs, which are licensed to operate countrywide. They also show better coverage of the potential client areas than the NGO-supported institutions. This indicates the unique position of the Ethiopian microfinance industry.

In terms of the extent of potential clients covered in their respective areas of operation, DECSI satisfied 78% of potential demand in the Tigray region and ACSI 25% of demand in Amhara region, while OCSSCO covered only 5% of demand in Oromia regional state and Omo and SMFI covered 7% of SNNP demand. The overall coverage of the microfinance institutions for the four regional states and the city of Addis Ababa is 95% of the potential demand according to estimations made here. This did not include other regional states (Benshabgul-Gumuz, Gambella, Somali, Afar and the city states of Harar and Dire Dawa) where microfinance is either nonexistent or just beginning. Our estimations here resulted in a somewhat higher outreach than usually reported, since we took a conservative approach to estimate demand.

Loan portfolios also showed a significant increase over time. Savings as a percentage of the loan portfolios, on the other hand, showed no significant improvement, especially among the smaller MFIs, while some did show an increase. The two regional government-supported large MFIs had a high percentage of savings to loan portfolio. The smaller NGO-supported MFIs have low savings to loan portfolios, which shows their dependence on donor funds for on-lending. But the relationship shows fluctuation in general. The key contributing factors in the increase in the scale of outreach are perhaps regional government cooperation and involvement of the administrative units of the local governments in screening and loan collection enforcement, though some abuse was reported. The impact of the government-owned (and supported) MFIs on the overall industry is enormous. But the rapid branch expansion and outreach to some areas

may be unsustainable. Economic appraisal of the contribution of and cost of running branches and sub-branches may be necessary to avoid any financial haemorrhage caused by the unprofitable outlets.

Two things characterize the significant achievement registered in outreach by Ethiopian MFIs. First, the institutions with the most remarkable outreach are effectively owned and controlled by regional governments, and ownership is affiliated with the ruling party, which makes the Ethiopian situation unique. Second, the achievement in outreach is specific to two regional governments, as in the other regions distribution of microfinance services is uneven due not to market or development potential but rather to political orientation and the ability of the regional government to support MFIs.

The client profile shows that Ethiopian MFIs serve relatively aged individuals (despite the high proportion of younger people in the national population pyramid), with low educational level and large family size. This is not surprising since the MFIs target households and rural populations. The data here showed younger population to be less represented in the client profile. Some 85% of the client population is older than age 29, and 26% is older than age 46. Despite the claim in many MFI mission statements that they place special emphasis on women, women clients constitute only 47.5% of our sample and 42% for the industry as a whole. The exclusion of younger segments of the population may be cited as a shortcoming, since this deprives the active population with potential entrepreneurial capacity the chance to prevail.

The profile of non-clients is not materially different from that of the client population, but the survey showed that non-clients are relatively younger, less educated, more often single and more engaged in casual labour to earn their livelihood, though more similar to the clients in other respects. The conclusions here must be interpreted in light of the problem of unequal representation of the two groups.

Regarding the relationship with clients, it seems that due to problems related to infrastructure and the sparsely populated rural areas in which MFIs render their services, there are high transaction costs for the clients in terms of both time and cash costs. Significant numbers of clients must travel more than an hour to reach the service centre. As such, no difference was found between the clients and non-clients in the distance variable. Clients want to continue using the services and most are satisfied with the

MFI procedures and policies, since the majority responded that the procedures are clear and understandable. But 36% of the clients complained that the loan size available was too low. Additional comments were made by many clients in favour of individual loans rather than group loans and longer loan terms.

The business of clients (occupation) or main means of earning income, for which they also borrow in most cases, is hardly diversified. The non-diversification of activities reflects upon MFI products and their exposure to covariant risk. MFI financial services are also limited in scope. Loans are dominant with compulsory savings provided as a security for the loan. Savings (voluntary) are not yet viewed as necessary and as a core of the financial service offerings. Thus, MFI clients still use informal institutions, even including money-keepers to accumulate funds for future lump-sum expenditures and as a cushion against income shocks. This shows some lack of awareness among MFI directors or perhaps a lack of initiative by employees to raise savings to fund the loan portfolio.

The depth of outreach, as indicated by clients' level of wealth (ownership of basic household property) and other characteristics, could be judged as commendable. The loan size is among the lowest in sub-Saharan Africa. Because of the high level of poverty in the country, the depth of outreach and loans ending up in the hands of the well-off are not problems in Ethiopia, but groups frequently screen out those without property as risky borrowers, which may negatively impact those segments of the population. This has definitely had a negative impact on individuals who are potentially resourceful but do not own property, unless this is recognized by group members on the basis of character.

## Notes

<sup>1</sup> *Enset* is a fibrous plant looking like a false banana grown mainly in southern Ethiopia, popular among the Sidama, Walayita and Gurage of Ethiopia.

# 7

## Institutional Viability

### 7.1 The regulatory and policy framework

#### 7.1.1 The regulatory framework

The institutional framework of the microfinance industry in Ethiopia was founded on the basis of the legal framework for the financial sector in general and, for the microfinance sector in particular, Proclamation No. 40/1996 (Proclamation to Provide for the Licensing and Supervision of Microfinancial Business). Proclamation No. 83/1994 provided for the overall monetary and financial policy of the country, while Proclamation No. 84/1994 provided for the licensing and supervision of the banking and insurance sector in the country. Provisions for regulation of banking in this last did not include guidelines for the operation of specialized microfinancial services. The bulk of both urban and rural livelihoods are provided by small, urban and informal enterprises and rural farm and off-farm activities, for which the formal financial sector does not cater. The need for microfinance services was recognized to reach these small operators so as to improve their standard of living. Thus, the government of Ethiopia promulgated Proclamation No. 40/1996 within the framework of the provisions of Proclamation No. 83/1994 to guide the licensing and supervision of microfinance services in the country. Issuance of the proclamation established microfinance institutions as a separate sub-sector within the financial system, parallel to the conventional banks and insurance industry. Unlike the experiences of many countries, Ethiopia introduced a more comprehensive regulatory framework right from the beginning, and the microfinance institutions were licensed to operate within the framework of the law.

This chapter reviews the institutional viability of the microfinance institutions established and partly affected by the provisions of this legal framework.

### 7.1.2 Rationale for the regulatory framework in Ethiopia

Ethiopia is one of the few countries that have comprehensive, though on some points restrictive, legal provisions for the microfinance industry (Al-Bagdadi and Bruentrup, 2002). The major government concern regarding financial services was to guarantee the rural poor access to financial services. International donors, NGOs and government supported rural credit schemes from the 1970s to the mid-1990s (Shiferaw and Wolday, 2001). The government then intervened to facilitate financial services through the intermediary of the government-owned Agricultural and Industrial Development Bank (AIDB). AIDB services were aimed at providing credit for a single purpose: agricultural inputs for rural poor farmers to increase their productivity and enable food self-sufficiency. AIDB used the farmers' producer cooperatives as a vehicle for the disbursement of loans in the 1980s. The bank suffered a financial debacle due to non-performing loans, an experience similar to that of development banks in other parts of the world during the 1970s (Hulme and Mosley, 1996) including the African countries Tanzania and Zambia (GTZ, 2003). The bank's misfortune was blamed on crop failure, unwillingness of the farmers to repay the loans and absence of collateral. The main reason, however, was inappropriate institutional arrangements and lack of experience and appropriate methodologies on the part of the bank to serve these clients. Employees of the state-owned bank were concerned only with disbursement without bothering about future collection, though collection mechanisms and delivery systems were not in place (Bekele and Wolday, 2001).

In 1989 the military government declared a mixed economic policy in a last minute attempt to rescue the regime, amidst political confusion resulting from opposition lobbying, a mounting guerrilla insurgency and internal discontent, aggravated by failing international support due to the collapse of the Soviet bloc. In a matter of a few days members dissolved hundreds of the rural agricultural producers' cooperatives. Common property of the cooperatives was looted or abandoned by the farmers. The reason was discontent due to forced collectivizations that denied farmers private ownership of their produce, forced villagization that uprooted many farmers

from their long cherished residential plot to live in congested neighbourhoods without the necessary infrastructure, and the forced surrender of produce at controlled and cheap prices to the state-owned Agricultural Marketing Corporation (AMC). These policies reduced the farmers to mere captives of the system. As a result, millions of ETB disbursed through the cooperatives went uncollected. By 1991 when the government collapsed and the TPLF/EPRDF insurgents took over, the AIDB arrears rate had reached 98% of the outstanding portfolio (Table 7-1).

When the transitional government tried to reinstate the credit programmes in 1992 and 1993 in an effort to normalize the situation and resume normal development efforts, the collection rate deteriorated further, dropping to as low as 11% of loans disbursed. The bank was reformed in 1995 and renamed Development Bank of Ethiopia (DBE) abandoning rural credit in favour of medium and long-term loans to industry and development projects. The Commercial Bank of Ethiopia (CBE), which has a wider branch network in major urban areas of the country, assumed responsibility for agricultural input loans in 1995, in collaboration with DBE and regional governments. But by 1997 the CBE had accumulated arrears of ETB 40.7 million on the loans extended to the rural farmers alone (Getahun, 2000).

Besides the DBE and CBE, some 30 NGOs had been active in credit programmes as part of their projects mainly in urban areas since the mid-1980s. NGO programmes were mostly project oriented and related to welfare programmes. They thus tended to lack strict financial discipline.

After 1991 regional governments, on the initiative of the regional EPRDF, started establishing development associations and projects to boost agricultural production by introducing a rural credit scheme. Yet the way credit was managed by NGOs and regional government projects, along with the problems observed with the formal banks, prompted advice from experts on how best to go about providing rural credit and micro and small enterprise loans.

USAID (ACDI/CEE, 1995) sponsored one of the first assessments of financial practices in the country by NGOs and other parties. It identified a number of weaknesses and recommended solutions towards standardization of practices to guide the sector toward sustainability. A long list of weaknesses and shortcomings identified by the USAID-sponsored study was summarized in Bekele and Wolday (2001) (Box 7-1). The study con-

**Table 7-1**  
*AIDB portfolio performance with rural credit, mid-1986 to 1993*

Year	Repayment rate (%)	Loan portfolio ('000 ETB)		Arrears as % of outstanding loans
		Outstanding	Arrears	
1985/6	36	85,000	11,000	13
1987	55	81,000	29,000	36
1988	68	98,000	41,000	42
1989	63	144,800	46,300	40
1990	31	126,000	67,300	53
1991	47	123,263	120,762	98
1992	15	151,558	121,116	80
1993	11	198,711	176,900	89

Source: Tilahun (1995) in Bekele and Wolday (2001).

cluded its findings by recommending adoption of a national standard to avoid distortion of financial markets in the country.

Von Pischke et al. (1996) also recommended adoption of national standards. Shiferaw and Wolday (2001) identify two additional weaknesses of pre-1996 financial practices by both NGOs and government programmes: (i) exclusive focus on credit provision contrary to the principle of micro-lending to link lending with savings and (ii) full reliance on donor funds to source loan funds. The low interest rate combined with the weak repayment enforcement mechanism and absence of a savings requirement encouraged NGO dependence on donor funds while failing to promote a culture of thriftiness and savings among clients. Shiferaw and Wolday (2001) suggest that loan delivery by the government and NGOs prior to the 1996 proclamation was in fact not financial intermediation but rather a means of distributing donor and government funds to target groups with the alleged aim of increasing productive capacity and income of the group.

The regulatory framework was the result of the above findings and recommendations. The national bank in 1995 conducted its own survey on the practices of NGOs and government with respect to microcredit. Introduction of the regulatory framework provided for the creation of specialized non-bank financial institutions to undertake microfinance. The new legal framework was introduced with four aims:

- promoting microfinance practice in the country on the basis of sound financial procedures to help the poverty alleviation effort;

**Box 7-1***Major shortcomings of NGO credit schemes in Ethiopia prior to 1996*

- 
- Real effective interest rates and fees did not cover the true cost of capital and programme operations, the inflation rate, a realistic loan loss reserve and at least a modest return on assets.
  - Sound lending and collection policies and procedures were not developed or inconsistently applied.
  - Sufficient systems were not in place to verify borrower integrity and business acumen.
  - Lending was based on NGO staff perceptions of borrower needs rather than sound credit analysis.
  - Loan terms did not reflect borrower repayment capacity, i.e. production sale cycles and cash flow.
  - Loans were provided without serious expectation of repayment and a realistic system for collecting delinquent amounts.
  - Loan decisions were based on inaccurate market or source of supply information.
  - Risk in loan portfolios was insufficiently diversified by location, type of business activity, number of borrowers and age of loans.
  - Loan security or collateral was either not required or if required, not exercised upon default.
  - Loan size was inappropriate for the borrower's income-producing opportunity.
  - In some cases, loans were granted to personal friends and relatives of the loan officers or influential community leaders. As a result staff was reluctant to press for collection.
- 

Source: Shiferaw and Wolday (2001: 26-27).

- protecting depositors;
- bringing microfinance practice under the country's financial system with stronger financial discipline;
- promoting a more commercial approach to financial services than a mix of charity to abet the distortion of the financial market and people's expectation about financial services.

According to Wolday (2001) and Itana (2000) the legal frameworks are based on several implicit assumptions:

- MFIs must move towards adherence to performance that builds institutional capacity and wider client outreach.
- MFIs that meet prudential standards should be encouraged to raise savings from the public/clients to reduce dependence on subsidy.

- Innovative approaches should be introduced that are different from traditional formal financial procedures for loan processing, disbursement, collection and requirements for collateral, which will encourage poor people to access the service.
- MFIs should link with formal banks to gain lines of credits for retail and micro-enterprises.
- MFIs should be able to issue equity and debt instruments as a means to mobilize funds for lending or capitalization.
- External grants or concessional credit could provide MFI funds for lending.
- MFIs should charge special interest rates, different from conventional banks.

These assumptions seem to have been derived from the purpose outlined in the preamble of the proclamation. We can safely add that those who drafted the law were convinced, beyond the need for microfinance services, that the conventional banks in the country could not provide the service, even if given the role, in view of their structure, experience and methodologies. They further felt that no reorientation or any attempt at special arrangements could overcome this. Indeed, it would be very difficult to extend the arms of the commercial banks to undertake microfinance. The financial sector is generally so underdeveloped that the conventional banks have little to offer in terms of technology and experience to the microfinance sector. The intention of the legislation is better understood by looking at the basic features of the regulatory framework.

### 7.1.3 Definition and scope of the business of microfinance

Proclamation No. 40/1996, article 2(3) defines microfinance business as “the activity of extending credit in cash or in kind to the peasant farmers or urban small entrepreneurs, the loan size of which shall be determined by the [National] Bank”. At a glance it seems that microfinance was understood as provision of credit under this proclamation, while microfinance institutions are defined in article 2(4) as “a company licensed to engage in micro financing business in rural and urban areas” which is more general. Article 3(2) extends the scope of the business of microfinance beyond credit to include wider financial and social intermediation, which includes among others the following activities:

- accepting savings, demand and time deposits;
- drawing and accepting drafts payable (i.e. transfers) within Ethiopia;
- borrowing money for business purposes against the security of its assets;
- investing in treasury bills and other financial instruments to generate income;
- managing funds for the purposes of on-lending them to peasant farmers and micro entrepreneurs;
- engaging in other activities customarily undertaken by micro-financing institutions.

MFIs are allowed to mobilize deposits, invest in government securities and deal in money transfer and payment services except for transactions in foreign currencies. MFIs can also borrow funds in their corporate name from local sources; they are allowed to obtain lines of credit or concessional loans from foreign sources for on-lending or capitalization (article 11(2)).

However, any credit, assistance or loan from a foreign source must have prior approval of the Ministry of Finance (article 11(3)). This restriction is a shortcoming of the legislation. For obvious reasons concessional loans and free financial assistance can rarely be obtained from local sources. Thus, every time foreign loans and assistance are to be obtained, even when it is to the net advantage of the MFI, an application for permission must be submitted to the finance ministry.

The proclamation bestows on the MFIs the right to own and dispose of property as a legal entity as well as to provide counselling and training to clients. However, Ethiopian MFIs are so far minimalists, and few engage in client training in business skill managerial capacity building, marketing or other areas. This activity is mainly undertaken in the urban areas by the offices of ReMSEDA in each regional state and the city of Addis Ababa.

#### **7.1.4 Main features of the regulatory frameworks**

Microfinance regulations are in a separate law providing for the licensing and operation of micro-financial businesses as financial institutions. The authority to license and supervise financial institutions of all types is with the National Bank of Ethiopia (NBE) by Proclamation No. 83/1994. Proclamation No. 84/1996 provides for the licensing of banking businesses and Proclamation No. 40/1996 provides for the licensing and su-

pervision of microfinance businesses. This latter legislation was issued pursuant to the provisions of Proclamation No. 83/1994. Provisions of proclamation No. 84/1994 apply to microfinance “mutatis mutandis” regarding matters not covered under Proclamation No. 40/1996 (article 24). Thus, microfinance law, while being separate regulations, are yet part of the regulations for the financial sector and to the applicable part of the banking law of the country. Application of the banking law provisions are mostly subject to interpretation by the NBE. Despite the applicability of some of the provisions of the banking law, the proclamation to license MFIs envisaged a new non-bank institution specializing in microfinance.

Taken broadly, there were microfinance services in the country prior to the proclamation. These were provided by informal and traditional institutions such as *Iqub* and *Iddir*, and there were savings and credit associations and cooperatives in the county even before NGOs introduced credit schemes. When alternatives were sought for the development bank’s failings, no possibility for linking these traditional institutions to modern banking and microfinance was provided for in the legislation.

The legislation seems a combined effort to establish institutions funded by private equity and/or owned by members (clients) as shareholders. This is indicated in the proclamation in article 2(5), which defines members as “shareholders”, and article 15 reads “micro-financing institutions may extend loans to members as well as to non-members”. The latter article continues, providing that “such credit schemes as operating under group guarantee shall exert themselves to bring borrowers into membership of their institutions”. Here we understand that the legislators expected that MFIs would register with the capital from NGOs and donor sources but gradually transfer their ownership to borrowers or issue shares to borrowers to enable them to take ownership of the institutions or that borrowers would gradually contribute money from their own resources to buy shares. However, the possibility of private or social investors was also allowed. Article 12.3(d) provides that “the bank [NBE] shall have the responsibility to promote investment in micro-financing business, especially in rural Ethiopia pursuant to powers vested in it”.

As various studies indicate, the regulatory framework for microfinance institutions in Ethiopia differs from those of other countries (GTZ, 2003; Shiferaw and Wolday, 2001; Gallarado et al., 2005). GTZ’s (2003) comparative study of 11 countries looks at a stage of development of microfinance

practices at which regulations are introduced. It notes cases in which regulations selectively apply to different categories of institutions and those where different legislation applies to the different categories. There are also cases where regulations for mainstream banking are applied with some alterations (Meages, 2003). NGO MFIs providing microcredit to clients must secure authorization to operate in Benin, while they are not subject to any regulations in Ghana and Tanzania (Gallardo et al., 2005). Credit and savings cooperatives are required to register but are not subject to any prudential regulation. In many of the countries included in the various studies, no blanket regulation applies to all types of institutions involved in microfinance services. Most countries introduced regulation after the microfinance institutions had reached a certain stage at which prudential regulation was required to safeguard savings or the health of the financial system. In 2001, Zambia had not yet issued regulations regarding microfinance practices, while microfinance practices were under way there even earlier than in Ethiopia.

Thus, Ethiopia is unique for issuing a comprehensive proclamation very early in the development of microfinance and for limiting the form of organization to that of a non-bank financial institution. The proclamation left no room for unlicensed microcredit or for NGOs to operate in the country. Transitory provisions of the proclamation allowed organizations that were undertaking microfinance practice prior to the issuance the regulation to continue operation only until reorganization as per the new requirements (article 26).

The NBE was given the authority to issue conditions and limit the time for reorganization, but by 1998 the bank had already closed the window for reorganization, prohibiting any unlicensed institution from engaging in financial operations (Legal Notice No. 2/1998).

Second-tier institutions were introduced indirectly by the proclamation's requirement to reregister when savings equalled or exceeded ETB 1 million (about US\$ 125,000). Additional prudential requirements were set for the MFIs in this category (Table 7-2). Accordingly, the capital adequacy ratio (CAR) of 12% of risk-weighted assets and a liquidity ratio of 20% of deposits were required for reregistered microfinance institutions.

Proclamation No. 40/1996 is the primary regulation, constituting a separate law providing for the licensing and supervision of microfinance institutions. Several directives issued by the NBE for the implementation of

**Table 7-2**  
*Some key provisions of regulations and level of applicability*

Provision	Requirement and applicability	Applicable to microfinance and related laws
Type and form of organization	- Non-bank financial institution, share company (corporate form)	Proc. 40/1996 and Commercial code 1960
Ownership	- 100% Ethiopian national	Proc. 40/1996; Proc. No. 37/1997; Proc. No. 84/1994
Registration and licensing	- All required	Proc. No. 40/1996; Public Notice No. 2/1998
Minimum capital (MCR)	- ETB 200,000 (US \$24,000)	NBE directive MFI/01/96
Documents for registration	- Names, qualification and experiences of CEO and directors - Memorandum and article of association; business plan	NBE directive MFI/03/96
Investment in other entities	- 10% of equity and 3% of net worth only	Directive MFI/06/1996
Reporting requirement	- Quarterly interim report, audited annual reports	Directive MFI/08/96
Interest rates on deposit and loans	- Initially restricted, interest on loans at the discretion of the board since 2002	Directives MFI/09/96; MFI/13/2002
Branch opening, closure or restructuring	- Closure and restructuring with prior approval	NBE directive MFI/07/96
Sanctions for enforcement of regulations	- ETB 3,000 penalty to removal of CEO for failure to provide regular reports and violation of requirements	Proc. 40/1996 and NBE directive MFI/14/2002
Liquidity requirement	- 20% of deposits for reregistered MFIs	NBE directive MFI/15/2002
Capital adequacy ratio (CAR)	- 12% of risk weighted assets for reregistered only	NBE directive MFI/16/2002
Single loan limit ceiling and loan term	- ETB 5,000 (US \$578), max. 24 months - ETB 15,000 (US \$1,700), max. 5 years (reregistered only)	Directive MFI/05/96; MFI/17/2002
Provisions for loans (asset quality)	- 25% for 90 to 180 days past due - 50% for 181 to 360 days past due - 100% for over 360 days	Directive MFI/17/2002
Ownership concentration	- 20% of total share for single owner	Proc. No. 84/1994
Reserve requirements	- None	None

Source: Constructed by author.

Proclamation No. 40/1996 provide guidance to the MFIs. They make up the secondary regulation. Up to now the NBE has issued 17 directives on procedures and requirements to license and operate MFIs. Directives No. 9 through 13 deal with gradual liberalization and subsequent deregulation of interest rates, while others deal with different requirements and guidelines from the bank. Basically, thus, the framework has separate regulations establishing and founding the institutional basis of the industry and allows no room for differential treatment as such, except the difference between reregistered and small MFIs in the application of prudential provisions.

The provisions of the proclamation that prohibits foreign ownership and deals with foreign transactions could be viewed as restrictive, denying the MFIs a chance for exposure to wider capital sources and experiences. Savings and credit associations and cooperatives, which are indeed involved in microfinance, are excluded from the provisions. They are not subject to any financial regulations but are registered under the cooperative law with the cooperative offices of the regional governments.

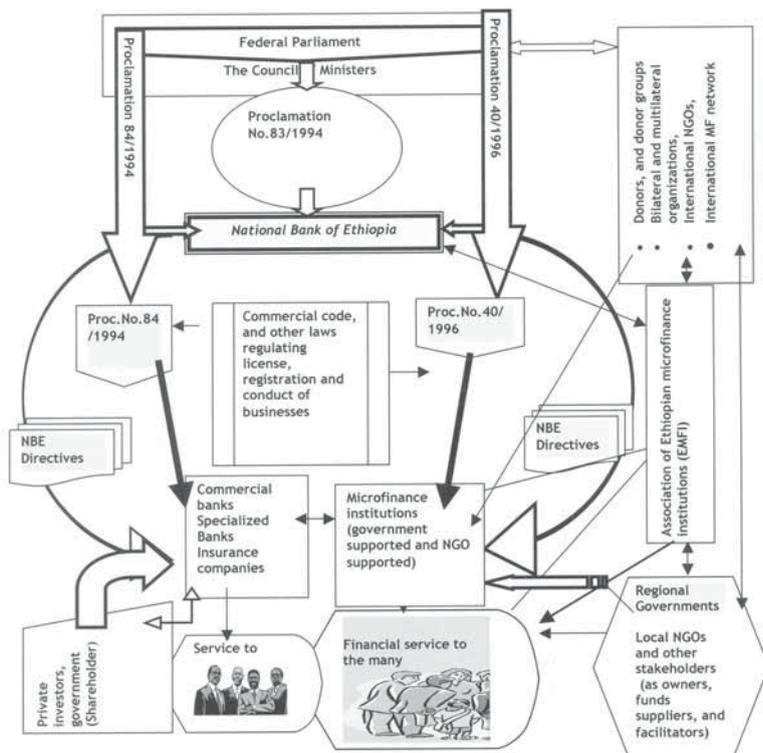
The regulatory framework created an institutional framework for MFIs interactively with other regulations, laws and government polices. Yet, in addition to the relations with the supervisory authority empowered with oversight and issuance of directives by which to implement the provisions of the proclamation, regional governments and NGOs as owners, facilitators and sources of funds still play a vital role in the institutional framework, as do international NGOs, donors and multilateral and bilateral organizations as fund providers and supporters (Figure 7-1). The contract between the MFIs and savings, public and loan clients is monitored the by supervisory authority of the national bank.

## 7.2 The supervisory authority

In Ethiopia the national bank is vested with the power to license and supervise the business of financial institutions. It is the body that sets the prudential standards for the conduct of banking and insurance business.

Thus, the bank issues various directives from time to time, to guide the banking and insurance sector. When microfinance institutions were put within the financial system, the national bank was given the authority to oversee the implementation of the relevant proclamation as well. The national bank is responsible not only for introducing a prudential standard for

**Figure 7-1**  
*Institutional frameworks of the financial sector and microfinance*



Source: Constructed by author.

operations, but also for overseeing governance of the financial institutions, involving the approval or otherwise of appointments of the members of boards of directors and CEOs and monitoring MFI activities. Initially, microfinance supervision was put under banking supervision as a unit. This was revised in the subsequent reform and restructuring of the NBE.

Now there are three departments under the directorate for supervision, namely bank supervision (conventional banks), insurance supervision and the supervision of microfinance.

As shown in Figure 7-1, the NBE supervises implementation of two separate financial laws for which it issues directives. In the case of MFIs, Proclamation No. 40/1996 is the connector for the institutional set-up.

The fact that MFIs are under the supervision of a department of the national bank shows the intention to view the microfinance industry as an integral part of the financial system.

### 7.3 The microfinance network (AEMFI)

The Association of Ethiopian Microfinance Institutions (AEMFI) is the network of licensed microfinance institutions. AEMFI is managed by a board of directors elected from the general managers or board chairpersons of any seven member institutions. Its daily activities are run by an executive director.

The association mainly plays the role of advocacy and lobbying and provides a forum for discussion of common issues. It also conducts a wide range of activities in service to the member institutions, such as coordination of training; studies of system improvement; conducting research; organizing workshops and conferences; organizing experience-sharing visits; maintaining resource centres; and administration of fund raising.

It arranges and sponsors training for personnel and seminars and symposiums on microfinance problems and practices. Its forum enables microfinance operators to discuss and evaluate legal provisions and policy issues that adversely affect their operations and to present petitions for improvement. AEMFI is also a forum through which collective interests of the MFIs are pursued in relation to NGOs, international donor groups (e.g. the CGAP group), the supervisory authority and local NGOs. AEMFI's board of directors is carefully balanced to represent government-supported and NGO-backed MFIs, despite the apparent stronger position of the government-supported institutions. AEMFI is also a member of the African Microfinance Associations, which brings international experience to the MFIs. As indicated in Figure 7-1, AEMFI is the liaison between several actors within and outside of the financial system and the individual microfinance institutions. It is therefore, an important organ within the institutional set-up of the microfinance industry in the country.

The regional governments and local NGOs interact with microfinance institutions and AEMFI as owners and facilitators of the microfinance institutions' relations with clients. International donors, multilateral organizations and international NGOs assist the MFI in several respects. They may maintain relations with individual MFIs or intervene through the in-

**Box 7-2*****Regional government and party-related organizations holding MFI shares***

---

Amhara National Regional State (ANRS) ACSI shareholders:

- ANRS
- ORDA (Organization for the Rehabilitation and Development of Amhara)
- ENDEUVER (TIRET) (a conglomerate comprising several enterprises organized by APDM, an EPRDF member coalition of the Amhara region)
- ADA (Amhara Development Association)

Tigray National Regional State (TNRS) DECSI shareholders:

- TNRS
- REST (Relief and Rehabilitation of Tigray)

Oromia National Regional State (ONRS) OCSSCO shareholders

- ONRS
- OSHO (Oromo self-help organization)
- ODA (Oromo Development Association)
- Dinsho trading company (OPDO run multi-sector trading company)

South Nation Nationalities and Peoples Regional State (SNNP) OMFI shareholders

- SNNP
- Wando Trading Company (regional party (EPRDF) wing owned)
- South Nations, Nationalities and Peoples Development Association (SNNPDA)

SIDAMA Zone (SNNP) SMFI shareholders

- SDA (Sidama Development Association, related to the Sidama zonal council)
- SDC (Sidama Development Corporation, a trading company owned and run by the Sidama Zonal council)

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Source: Survey by author.

termediary of AEMFI. CGAP, for instance, provides technical assistance in the form of training of trainers and direct training of MFI employees. International NGOs have their own local counterpart or directly assist specific MFIs.

AEMFI publishes occasional papers based study of various subjects related to MFIs and industry practice. The network is an important vehicle to update industry practice with international experience, as well as to help MFIs strive for independent financial operations.

## 7.4 Ownership, institutional design and governance

### 7.4.1 Ownership and form of business

The ownership structure of Ethiopian microfinance institutions is the direct effect of regulatory provisions. First microfinance institutions as financial institutions or as part of the financial system are affected by government policies applicable to the financial sector. Investment Proclamation No. 37/1996 legislated that banking and insurance activities (investment in financial institutions) are reserved for Ethiopian nationals (Box 7-2). Proclamations No. 84/1994 and No. 40/1996 stipulate that institutions must be fully owned by Ethiopian nationals and registered under Ethiopian laws with their head office in Ethiopia. This provision precludes international NGOs from owning or partly owning microfinance institutions. The second effect of the regulation is the stipulation of the form of the business organization, which also relates to ownership. Article 2(2) describes a company as a share company, as defined in the commercial code of 1960 (article 304). The commercial code defines a company as a business organization whose ownership capital is divided into shares. The number of owners of a share company may not fall below five persons, at least one whom must be a natural person (article 311).

This regulation of ownership structure had far-reaching implications, since NGOs and regional government development initiatives were already undertaking microfinance activities prior the proclamation. Regional governments registered their credit programmes as licensed microfinance activities by distributing shares among entities affiliated with the regional government development partner organizations, civic organizations established by regional party organs and an individual from the ranks of regional government officials. This created nominal ownership compliant with the law. NGOs followed suit, registering their key employees as shareholders until the minimum number was reached. Few MFIs tried to register their employees as shareholders. This has become a subject of discussion with respect to Ethiopian microfinance. Several studies indicate problems of the nominal ownership for the future of microfinance (IFAD, 2001; Itana et al., 2003; Hebrehiot, 2003).

Before looking into the possible problems of the current ownership structure, it is important to briefly review the ownership of each institution (see chapter 4 for the percentage distribution of ownership shares in each

institution). First, regional government-supported MFIs have regional governments as shareholders, one or more development or relief organization established by the regional party organ, and a trading company owned by the regional ruling party organ. Other partners are women's associations and youth associations organized by the regional government to promote the social policies of the ruling party as well as to derive political support from the public. There are of course variations in ownership from region to region. ACSI and DECSI have civic organizations as shareholders, while OCSSCO and OMFI do not. In SMFI, zonal government is not assigned shares, while farmers' cooperatives were given shares previously held in the name of individuals (Box 7-3).

In the case of NGO-supported MFIs, employees or clients were assigned shares even though the funds for the registration were in fact from the mother NGO or the donor that funded the NGO (local or international).

Owners are ultimately stakeholders in a corporate organization in which the goal of the firm is subordinate to the goal of its creators. Owners are final decision makers in the structure of a corporate organization. Corporate management normally considers additional owners' equity as an alternative source of financing whenever financing decisions are taken. Regulatory authorities look at the owners' ability to meet capital calls if the financial institution proves insolvent due to problems of loan collection or other risks threatening the claims of public savings (Christen and Rosenberg, 2000). Finally, owners constitute the top governance structure of the MFI, being elected to the board of directors. The question is, "Can nominal shareholders or even representatives of the entities that are registered as shareholders play the stated roles to represent best interest of true owners?"

This study reviewed memoranda of association and articles of association for some of the selected MFIs. The memoranda of association contain clauses in which the nominal owners express a disclaimer on the right to collect a dividend from the institution at any time or an agreement stating the same. Thus, the nominal owners have no stake in the institution. Many of these nominal owners are employees of the regional government, party development associations, trading organizations or NGOs. They cannot raise additional equity to expand, or meet strategic financing decisions of the institutions as normally expected from shareholders. Chapter 4 indicated that two of the purported shareholders of OCSSCO did not

**Box 7-3**  
*Restructured ownership of SMFI*

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Sidama MFI was initially incorporated with 200 shares of ETB 1,000 par value, distributed among three individuals and Sidama Development Corporation. Each individual was assigned 15 shares while Sidama Development Corporation was assigned 140 shares. The ETB 200,000 minimum capital required was paid by the Sidama Development Corporation, which is owned by the Sidama zone of SNNP. The four individuals are nominal shareholders, as they did not pay for the shares. (Sidama Development Corporation is an institution established under the zonal council to undertake trading activities in the zone, as regional governments in Ethiopia are charged to ensure control of some key traded items and to promote development within the localities.)

Two years later the shares were reapportioned among new shareholders by decision of the board which revamped the ownership structure. The share of the Sidama Development Corporation was reduced to 25 while another zonal government-affiliated institution, the Sidama Development Association, was assigned 25 shares. The four individuals had to relinquish their shares. A new individual was assigned one share nominally, and five farmers' cooperative societies in the zone were assigned 25 shares each while one farmers' cooperative was assigned 24 shares, making a total of 200 shares. None of the new shareholders paid for the shares. The individual is one of the development activists of the zone and is a member of the board. None of the cooperatives are represented on the board. The zonal council appoints board members. There has never been a formal shareholders meeting, as shareholders have nothing to do with the institution.

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Source: SMFI Strategic Plan 2002.

pay for the capital subscribed in their names. These were an "NGO" and an individual registered as founders of the company. Even if the individuals in whose name the shares are held are represented on the board and personnel believe in the capitalization or additional capital injection, the decision to pay the money must be taken by their organization, which follows its own procedure or depends on the availability of the funds. Owners such as the regional governments cannot be in a position to invest additional capital unless the regional council grants budgetary appropriations for that purpose. A similar situation holds for the NGOs, since NGO resources come from donors, and are project specific each time and also require a decision by the donor.

Under adverse conditions, the MFI may face a shortage of cash to the point that the supervisory authority finds the liquidity position falling below the level designated as prudential. The supervisory authority may then call the owners to subscribe for additional shares or halt disbursement of

loans (Christen and Rosenberg, 2000). That last would effectively ban the MFI from continuing operations since its effects would be far-reaching. It is believed that clients normally pay their debt on time and that group members pressure one another to meet their obligations in the next-round disbursement. If they were to learn that the MFI would no longer lend or would not immediately disburse the next round, there would be no more incentive for them to pay their loans. Savers could react by withdrawing their savings. Under such conditions, borrowing from banks at a commercial rate may also become difficult, as banks would be unwilling to lend to a troubled company even with reasonable collateral. This fear remains even when NGOs own the MFIs, clients are made members or the MFI is linked to informal institutions.

In relation to the regional government-supported MFIs, the problem of ownership goes beyond nominal ownership. The MFIs, in effect, are the property of regional ruling party organs. The party now ruling established either during the guerrilla war or after taking power all of the regional development associations, relief and self-help associations, and party trading companies. This reflects a unique dimension of Ethiopian microfinance institutions. The ruling party defines the current development policy and microfinance is enjoying support of the government for the same purpose. What would happen to the MFIs if the current party were to lose in elections, as almost happened in May 2005. The fate of the MFIs, as well as of the institutions that invested in the MFIs, would be unknown. Is the party allowed to continue to control these institutions? Or would it have to relinquish control to the new party? Even public organizations like women's associations and youth associations are affiliated with the party. In short those entities that own shares are themselves unsustainable or an ongoing concern, as any business. This puts the sustainability of the institutions at risk.

Concerning party enterprises, certain circles of the business community are already feeling uncomfortable about these enterprises because of their presumably privileged positions in the market, with most of their board members and managing individuals being high-ranking government and party officials holding positions that allow them access to privileged information, which helps them to out-compete others. Many in the ruling party and government circles believe that such enterprises detract from free market development and provide an excuse for party officials to abuse their

position to the benefit of the enterprises. Therefore, MFI ownership by such an institution would encourage the opposition or public at large to categorize the MFIs as part of the party organizations and as benefiting from the weaker status of the rural and urban poor. If this perception were to result in rumours, it could have irreversible impact on the MFIs.

Where clients are registered as owners problems remain, since poor and illiterate clients have little understanding of the operations of financial institutions. They may therefore find it difficult to participate in management. Many MFIs are not yet profitable, and for the clients registered as owners to commit money from their already meagre resources would dissuade them from even remaining associated with the MFI, particularly if they notice that they are losing part of their investment due to negative returns. Client shareholders are most common in small, NGO-backed MFIs that are not yet profitable. At present, the money for the shares owned by the clients is paid by NGOs, so that clients are unlikely to think that the MFI belongs to them. This is no better than nominal ownership.

When nominal owners leave the institution they work for or terminate their association with the NGO, shares are assigned to another person. In a typical example, SMFI restructured its ownership twice and finally assigned the majority share to cooperatives in the zone.

When Irish Aid had to withdraw because of the ownership restriction and due to phasing out of its project (EEA, 2000), SMFI was founded with the zonal government taking over effective control. Sidama Development Corporation, which was organized by the zonal government, was put in charge and four individuals together with the corporation were assigned the shares upon incorporation of the MFI (Box 7-3). It appears the zonal council was uncomfortable with continuing with individuals holding shares of the MFI at a certain point. In April 2000, the board of SMFI changed ownership of the institution's shares by reassigning them to new shareholders. The new ownership was to make it more community based by distributing shares among the farmers' cooperatives operating in the zone. There is no indication that the officials of the farmers' cooperative societies and the local farmers clearly understood what that implies. Farmers' cooperatives were not represented on the board. Board members are rather appointed by the zonal council to whom they are accountable. In effect, the MFI is a public enterprise administered by the zonal council. Practically it would be more feasible to simply register the zonal council as owner than several nominal

owners with no stake. This provides an example of problems in defining ownership by those who run the MFIs.

The ownership structure of microfinance institutions in Ethiopia actually are dominated by regional governments with a strong financial and political stake by the ruling party. This has helped the MFIs to gain full support of the regional governments and to expand outreach. NGO-supported MFIs are financed by donor funds, but represented by nominal owners. In all cases nominal ownership is prevalent. The problem of ownership emanates from the requirements of the regulatory framework that prescribe a shared corporation form of organization and restrict ownership to Ethiopian nationals.

Despite the hitherto stable situation of the MFIs the current ownership structure will lead to problem of institutional viability in the long run. Ability to raise additional equity funds to finance expansions or to meet adverse situations is the main problem due to the ownership structure, while the ownership structure has yet to have any impact on governance of the MFIs. The future of government- and party-owned MFIs is another matter of concern, as a change of policy and political landscape in the country may endanger their sustainability. Potential governance problems caused by the current ownership structure are discussed below.

#### 7.4.2 Governance

“Governance is the process through which a board of directors guides an institution in fulfilling its corporate mission and protects the institution’s assets over time” (Rock et al., 1998: 1). It involves checks and balances between owners and other stakeholders under the leadership of a board of directors (Microfinance Network Occasional Paper No 3., 1999). As a system of checks and balances between owners and other stakeholders, good governance of microfinance depends on ownership structure, an appropriately defined organizational framework, well-designed policies and procedures relating to financial, operational and other aspects of the institution including an effective control and incentive system. Sound governance is fundamental for developing and maintaining efficient and sustainable microfinance institutions. Good governance encompasses transparency, accountability, board member qualifications and experience. Dedication to the institutional mission, the policies and procedures followed by the board and vision and skill in leadership are crucial for the suc-

cess of the institution (Rock et al., 1999). In MFIs, board members are the ultimate decision makers and stewards of the shareholders' investment, with fiduciary responsibility as well as the duty to balance the social mission and the financial objectives of the MFIs. Board members are also legally accountable for their acts, under corporate law, to the shareholders and other stakeholders who may be affected by their decisions (cf. Commercial Code of Ethiopia, 1960, articles 362 and 364).

In principle the board of directors is appointed by and accountable to the general assembly of shareholders. Effective governance is expected where some shareholders are personally elected to the board and an appropriate incentive system and procedures are in place with a deliberately selected, broad mix of experience and disciplinary background.

Structurally, governance of the Ethiopian MFIs is based on the standard of corporate governance that the meeting of shareholders should elect the board of directors. The board appoints the CEO and presents the CEO for approval to the National Bank of Ethiopia (NBE), which is the supervisory body vested with power and authority to monitor the background, qualifications and integrity of the candidate as per the required directives. The CEO is then accountable to the board through the chairperson of the directors. While there is no innate problem with this procedure and structure, the nature of the process results in loose accountability in the governance process.

The commercial code of Ethiopia stipulates that only a member of a company may manage the company and the number of directors managing the company shall be no less than three and no more than twelve at any time (article 347). Therefore, any corporate organization formed under Ethiopian law will have between three and twelve board members representing the shareholders. It is unclear whether the provision of the code that stipulates that only a member shall manage a company (article 311) should be strictly interpreted to mean that none of the shareholders may be a member of the board of directors. Currently there are board members appointed by the "shareholders" or appointed but have no ownership interest in their names. Others, who have shares, are predominantly nominal shareholders. If the article is to be applied strictly to mean that directors must be elected from among the shareholders only, nominal shareholders, who are known to the bank, are only tolerated by the bank for the sake of transitionally allowing the MFIs to be formed as share companies in the

hope of perfection in the future. Another problem with the provision for the future will be the difficulty for the MFIs, or any commercial corporate firm for that matter, to find the right professional mix and expertise from among their shareholders for professional governance of the company. The code further provides for the role of meetings of shareholders, directors and the legal responsibility of directors to the shareholders and related matters of corporate governance.

With respect to ownership, we have gathered from the preceding section that shareholders of the MFIs were primarily mobilized to comply with the requirements of the legislation and the guidelines of the supervisory authority. The nominal shareholders were, moreover, delegated to lead the institutions as board members. Besides being nominal owners, those delegated to lead the MFIs come from backgrounds and experience different from leadership of financial institutions.

The National Bank of Ethiopia directive related to governance defines the qualifications and experience required for officers (Directive No. MFI/03/96). The directive specifies that the CEO of an MFI should be a graduate with a degree in a social science field with relevant experience and age 30 years or older. Board members should at least have completed high school and have 25 years or more of relevant experience. The NBE microfinance supervision department evaluates relevance of experience and eligibility according to the directive, both at the licensing stage and during any subsequent change of CEO and board members. Thus, the NBE should approve appointments and replacements of board members and the CEO of the MFI before they assume office.

At this point, it may not be necessary to point to the qualification and experience of CEOs or to their profile (Table 7-3). The NBE strictly verifies the qualification and experience and all should fulfil the minimum requirements of the bank before taking office. The academic profile and backgrounds of board members, however, exhibit wide variation. Qualifications range from the highest university level to completion of high school. Occupationally they include rural farmers as well as high government officials, including federal government cabinet members, high-ranking regional government officials, NGO officials and representatives of civic organizations. In a few cases, individuals engaged in private business and officers of the formal banks with some relation to either NGOs or the MFI have been appointed to the board. In terms of academic quali-

**Table 7-3**  
*Number and profile of the board members*

MFI	Number	2nd degree	1 <sup>st</sup> degree	College diploma	High school completed
ACSI	7	3	1	1	2
DECSI	9	8	1	-	-
GMFSC	5		1	1	3
OCSSCO	5	2	1		2
OMFI	7	3	3	-	1
PEACE	5	4	1	-	-
SFPI	5	1	4	-	-
SMFI	7	5	2	-	-
WMFI	9	3	6	-	-

Source: Compiled by author from reports of the respective MFIs.

fications, NGO-supported MFIs have a higher profile among their board members, except in the case of GMFSC, which is owned by its members and has a minimum qualification of a first degree. The education and experience of board members also represent diverse fields. Those in NGOs have experience in development work with education mostly in social sciences fields. Government officials have experience mostly in administration, legal and related matters. Only one board member represented the Commercial Bank of Ethiopia (having a career in a financial institution) from among the board members contacted during the survey. There is a general lack of experience in banking and related areas among the board members (see also IFAD, 2001), but some have by now worked in microfinance for such a long time that they have accumulated ample experience, though this partly depends on the diligence of individual board members.

In government-owned MFIs, board members are assigned from among high-ranking regional government officials and other federal offices representing government interests. These individuals lend relative advantage to the MFI in that they can solicit cooperation from other institutions within and outside the government. However, these individuals typically lack the time to pay due attention to MFI issues, as well as to inform themselves about current development in the field. They also tend to lack experience and focus on the MFIs' use as a government instrument to implement policies rather than the MFIs' role as a financial intermediary. Box 7-4 de-

scribes several weaknesses in relation to board governance of government-supported MFIs. Lack of a real stake affects all types of MFIs, but the government officials are political appointees who could be removed or replaced at any time, whereby they would also relinquish their board membership. Representatives of mass organizations such as youth and women's groups and cooperatives cannot contribute much to board membership as they have little or no experience in the field.

Senior officers represent NGOs on the MFI board. When it comes to corporate governance, there is a general fear that the MFI may be overtaken by the social objective of the NGO rather than the business objective of the financial institution (Itana et al., 2003). But any such conclusion requires a closer study of the decisions taken, without generalizing that all NGO employees are welfare-oriented and lack business acumen. After all, qualified businesspersons work for NGOs, and commercial microfinance banks such as BancoSol of Bolivia evolved from the NGO microfinance programme of PRODEM.

In the MFIs where clients were promoted to ownership status (GMFSC) the problem is basically qualifications and understanding of the operation. Even if these people have the necessary qualifications, client board members are not recommended for good governance due to potential conflicts of interest.<sup>1</sup>

A survey conducted under the sponsorship of AEMFI found a number of problems associated with ownership of Ethiopian MFIs. The survey provided first-hand information, since AEMFI deals with the MFIs on a daily basis. Its conclusions are furthermore in line with our observations during the survey. Some of the findings, however, are based on judgments and expectations rather than empirical findings. For instance, the claim that NGO officers are inclined to emphasize welfare goals is not proven with evidence in the report. Some of the evidence indicates situations of contravening principles rather than conflict of interest. With these caveats, conclusions reached in that survey are indeed problems encountered by the MFIs in the governance process.

Several other studies conducted on Ethiopian MFIs have raised concern about governance problems within Ethiopian MFIs. Getahun (1999) fears that nominal shareholders of MFIs may not have vested interest to impose controls on management, since they have no stake in the institutions. The executive director of AEMFI shares the attitude that the current ownership

**Box 7-4***Governance problems and three types of ownership*

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## Regional government-backed MFIs

- Board members are high government officials and have difficulty making themselves available as needed by the MFIs.
- Directors lack exposure in the sector and therefore depend on the CEO.
- Most lack the time to come prepared to meetings so as to make a meaningful contribution.
- Sometimes there are unexpected changes in the directors due to political or other reasons.
- Governance system suffers from loose accountability.
- Representatives of associations (of women, youths and farmers) lack expertise to lead the MFIs.
- Directors lack a real stake in the MFIs.

## NGO-backed MFIs

- In most of the cases the directors are senior executives of NGOs, making it difficult for them to attend to the MFI's needs.
- The dual mission of reaching the poor and profitability makes it difficult for directors to lead the MFIs as financial institutions.
- Lack of real ownership affects the contributions of directors.
- Lack of exposure in the financial sector hampers management in some key decisions.
- Some directors are employees of the MFI's lead NGO partner and are influenced more by the NGO's objectives than by the need to run the MFI as a regulated financial institution.
- Conflicts of interest arise for those who are simultaneously shareholders/directors and managers.

## Other types

- In MFIs where clients are shareholders/directors, there is a lack of leadership skill.
- The board fully depends on the CEO to handle MFI affairs.
- The board may neither be in a position to confront institutional and management weaknesses nor be ready to address them.

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Source: Itana et al. (2003: 55).

structure poses problems of governance, not only in terms of loose accountability but also by inviting NGO influence on decisions, but this director somehow refrains from claiming government political influence on MFI operations in cases of regional government-supported MFIs (Wolday, 2003).

In our survey the major weaknesses observed regarding the board composition and procedure were as follows:

- Board meetings are not conducted regularly and there are times when meetings take place only once in a year.
- There are individuals who are members of two MFI boards.
- All board members surveyed responded that there is no standard board manual adopted, except the memorandum of association and article of association to which references are made. Even rules of procedures for meetings are not adopted but conventional rules applied.
- There are no board committees to handle specialized functions such as auditing, financial administration and legal matters.
- Board members have no system of collective self-appraisal to encourage the participation and contribution of each member to the desired level.
- Some members seem unaware of the role and responsibility of a board member and they seem to have had little exposure to reading or training on their role as board members.<sup>2</sup>
- Board members (including CEOs) said that remuneration for board membership is unattractive. In some cases there is no payment for board membership.

While the problems listed in Box 7-4 relate to ownership structure, the weaknesses we identified in terms of procedures and standard board practices may bear on lack of experience, lack of time and little stake to devote time. The commercial code of Ethiopia defines responsibility of board members, including liability that may arise from their actions. But none of the board members seems to take seriously the legal liabilities arising from their decisions.

The fact that ownership is nominal, and shareholders have no stake in the success of the business, directly impacts the governance of microfinance. Directors have no stake and little incentive to devote their time to the management of MFIs. Another incentive-related factor that cannot be overlooked is that the microfinance industry is not yet as popular as banking or other more traditional, high profile businesses, where board members would consider it an honour to serve for future career recognition.

### 7.4.3 Organizational aspects such as internal systems and resources

#### *Organizational structure*

The only structure for MFIs in Ethiopia is that prescribed by law. Thus, the higher level institutional design must take a corporate form, where the general assembly of shareholders forms the highest decision-making level (in principle), followed by the board of directors, which is elected by the general assembly.

The lower structure differs from institution to institution, depending on the organization's size. Larger MFIs, like ACSI, DECSI, OCSSCO and OMFI, have a relatively well-developed organizational structure with segregated duties and departmental responsibilities. ACSI has several functions separated into specialized departments at the head office level.

In general, MFIs follow three approaches to extend their network to reach clients. The two-tier organization is the simplest, with small institutions with a head office and branches that are directly accountable to the head office regardless of their distance or location. Larger MFIs have three tiers, with a head office in charge of overall coordination and branches coordinating the activities of the real service outlets, the sub-branches. Between these two types is the structure that operates with a regional coordinating office between branches and head office. This structure is followed by OCSSCO, which has fewer activities at the coordinating office level. That office is staffed with minimal personnel, as few as one person. At ACSI, branches are important hubs connecting the head office with the operational units. Practical supervision of sub-branch operations, including internal audits, is the responsibility of the head office. Branches collect monthly operational and financial reports from sub-branches and compile and forward them to the head office for consolidation.

Sub-branch personnel normally maintain accounting and operational records and forward them to the branch. The basic sub-branch records are the ledger kept by the accounting clerk (including cash book for collections and payments) and operational data on loans and savings.

Decision-making levels (the extent of centralization and decentralization) differ among the institutions. Expectedly, the smaller MFIs have centralized decision making for loans approval and other financial and administrative matters. In the large and medium-sized MFIs, except be-

yond certain limits and on new issues, the branches or sub-branches decide within their jurisdiction.

The basic functions of the head office are general manager or CEO, finance manager (or head of accounts as it is sometimes called) and operations manager (separated into credit and savings departments in larger MFIs). In smaller MFIs such departments as planning and programming and personnel administration are not separated, but personally coordinated by the CEO. At branch level, where there are sub-branches the basic functions are branch head, finance head, internal auditor, operations manager and secretary. Sub-branches are staffed with basic operations personnel. In charge of sub-branch operations are the sub-branch head, a credit officer, a savings officer, an accountant, a ledger clerk, a cashier and two security guards.

At all of the MFIs, the employees at the retail end are engaged in client mobilization, attending meetings with clients and collecting loans in the field when assigned by the sub-branch head, except the person in charge of the subsidiary ledger. Security guards, in addition to patrolling the office, also escort with arms the cashier or credit agent to the field when cash is carried either to or from the field during disbursements and collections.

While the organizational structure is simple and clear, there nonetheless appears to be difficulty in choosing sites and operational areas. No distance or infrastructure issues are seriously considered when branches and sub-branches are opened. Rather regional administrative structures are followed.

Following the political administrative structure offers some advantages. Offices are safeguarded since they are located on government compounds and the space is free (with the concomitant dependence problem). Cooperation from the grassroots administration is enhanced through such relations and by sharing infrastructure that may be difficult to otherwise obtain in rural areas. A disadvantage of such relations may be the geographic scattering of the branch expansions, which causes administrative problems in relation to supervision and transmission of information. In deciding whether to open a branch no purely economic analysis is conducted. Rather, political and equity issues prevail, as MFIs are assumed to be collectively owned by the people of the regional state. NGO-based MFIs are no better in the above respects, as they depend decisions made by the mother NGO in selection of geographic locations in which they operate.

The organizational structure of the MFIs is not perceived as a weakness and in fact appears to have been copied from one another. Internal auditing is accountable to the CEO, which these days is a debatable set-up since the internal audit should have maximum autonomy to report to the board chair.

#### *Internal policies and procedures*

Most of the MFIs have complete internal policies and procedures. With variation in the level of articulation and detail, the accounting (financial) manual, operations manual (loan and savings operations manuals) are available. Some of the manuals are old and require revision. Two MFIs lacked internal audit manuals. In addition to the basic operations and finance manuals, larger MFIs have administrative (personnel administration) manuals.

Planning documents serve as a guide to operations. Most MFIs prepare strategic business plans with the involvement of consultants. Training had been given to most MFI employees on the use of the CGAP-developed Microfin3 to prepare their strategic plans. None had so far developed a strategic plan without a consultant.

#### *Human resources*

The employee profile of MFIs represents a range of qualifications, from a university degree to under high school completion. Government-backed MFIs are the largest employers of the group (Table 7-4), with the group selected here representing about 95% of workers in the industry. In terms of qualification mix, NGO-supported MFIs employed relatively better qualified personnel. In ACSI and DECSI, the number of those who had not yet completed high school was large, comprising a significant proportion of the staff. Occupationally, those who had not completed high school are mostly employed as security guards at the sub-branch, branch and head offices. In the case of DECSI, the number is large because that institution downgraded its staff profile by upgrading ex-militiamen of the TPLF who used to work as guards to the position of field workers in the rural areas. According to some employees, DECSI took this measure in response to high demand from staff holding a diploma or degree for higher salaried transfers to towns, with some leaving the institution in search of better employment after gaining some experience. But this has also helped DECSI

**Table 7-4**  
*Employee profile of the MFIs*

MFI	Total no. of staff	Credit officer	Degree*	Diploma	12 <sup>th</sup> grade	Below 12 <sup>th</sup> grade
ACSI	1,443	916	13	76	730	216
DECSI	846	516	10	23	514	256
GMFSC	80	38	3	11	45	3
OCSSCO	412	48	10	na	na	na
OMFI	277	68	5	39	233	-
PEACE	39	7	3	13	20	-
SFPI	56	23	3	Na	Na	na
SMFI	122	42	4	18	90	10
WMFI	56	18	5	10	40	8

Note: \* Comprises first degree and higher.

Source: Data collected from respective MFIs.

to hire staff who better understand the peasant farmers and can easily communicate with them.

Most credit officers at other institutions have a college diploma or at least 12-plus certificates from special training. Some field workers have experience from agricultural extension programmes, which the MFIs prefer due the implied exposure and experience in dealing with the peasant population.

Despite the failure to obtain full records on employees from the head office, we found that many OCSSCO branch heads had a diploma in accounting, agriculture or a related field. Many of the accountants in branches and sub-branches had a diploma in accounting. Internal auditors at the head office or branches had at minimum an accounting diploma.

Perhaps owing to the relative age of the institutions almost all of the employees in the field, except the security guards, are young people. Most enjoy their work and are willing to travel one to three hours by foot where there are no transport facilities. They also work regularly during the weekends, both at the office and on-site, where collections are made.

The problem with the younger workers is that many leave the institution in search of higher pay and to pursue higher education in larger towns where there are such opportunities. This leads to the problem of high turnover whereby experienced staff are often replaced with less experienced ones. In order to assess the level of motivation and overall attitude of the employees towards their organization, a short structured questionnaire was designed and conducted among employees of different positions, educa-

**Table 7-5**  
*Is what you earn satisfactory for your qualifications and position?*

		Frequency	Per cent	Valid per cent	Cumulative per cent
Valid	Yes, satisfactory	7	25.0	25.0	25.0
	Fair	6	21.4	21.4	46.4
	Unsatisfactory	15	53.6	53.6	100.0
Total		28	100.0	100.0	

Source: Survey by author.

tional level and background mostly at the branch and sub-branch level. For an unknown reason the response level was low. Almost 30% of the questionnaires were not returned even after the strictest follow-up. Twenty-eight questionnaires were returned out of 40. Nonetheless, the majority of those who returned the questionnaire were also willing to participate in discussions about their institution. Frequency tables from these questionnaires are presented in the appendixes (Tables A1-A13).

The results show that many of the employees had prior experience in other MFIs or at institutions like the agricultural extension unit of the regional bureau of agriculture. This could be taken as an indicator of relatively better pay at the MFIs for positions as compared to other government institutions. But the majority of the employees responded to the question of pay as unsatisfactory (53.6%) in light of their position and qualifications (Table 7-5). Only a quarter responded that they were satisfied with the pay. MFIs have different policies in revising salary scales and career structures, and in adjusting salaries from time to time. Workers refer to benefits obtained by peers at other institutions. Employees of NGO-backed institutions indicated that their benefits and chance of higher earnings declines as NGOs move out of the business, that is, earning under pure NGO employment is better.

Asked whether they had experience at other institutions prior to current employment (A4), 64% responded yes. While 36% did not have such experience prior to joining the MFI. As to the relevance their previous experience to their current job (A5), 55.6% of those with past experience claimed relevance of the experience while 44.4% claimed no relation to current job. Relevant jobs are those at other MFIs, in previous credit schemes of NGOs or government projects, in development extension work among the rural population or similar activities in the case of finance and administrative per-

sonnel. Some 60.7% have taken skill-upgrading training since joining the MFI, and only 30% of those who had taken the training found it very helpful, while for 60% it was only fairly helpful. Some 10% said it had no relevance to their job. For 82%, the mission and objective of the institution is sufficiently clear while it is fairly clear for 14%. About 4% responded that the mission and objective of the organization is unclear to them.

On the issue of working environment, most employees (68%) responded that the organizational structure is clear to them, defining their accountability, responsibilities and the line of command. Some 93% responded that there is a clear policies and procedures manual in their area of responsibility guiding their activities. The respondents strongly felt a need to improve the organizational structure, policies and service to the poor (89%). Regarding the areas requiring improvement, opinions varied from the institutional arrangement to service delivery. Some indicated a need for more capacity building to reach more poor. Decentralized decision making and more empowerment of the branches, strict follow-up and control from the head office were viewed as necessary prior to mishaps rather than taking harsh action after fact. Further designing loan products according to the needs of clients was among the recommendations.

Observations during the survey and from various MFI reports revealed high employee turnover, including of CEOs. Between the preliminary survey conducted for this research and the final survey some six months later, there was a change of CEO at three of the institutions, of the operations manager in one and of several branch heads. Top management personnel leave for better pay, as do the line employees. Employee turnover is more severe in the less stable MFIs. The salary structure and desire to pursue higher education were the main reasons claimed for leaving. Employees of some institutions complained that the career structure and job position classifications were not clear enough to fix salary and remuneration on the basis of job title. Thus, the head office employs individuals working in the same position but for different salaries, by referring to their academic qualifications only. Such a case typically arises when a position demands a definite academic qualification but employees of lower qualification are temporally assigned to do the job. As such, those without a college education are working at the same level as others with the qualification but earning a different salary.

*Material resources*

Material resources, including offices, are of different qualities among the institutions. Larger institutions are housed in modern buildings of their own or in rented offices. ACSI's head office is a modern building with a quality equal to any bank in the country. DECSI has a comparable head office building, while OCSSCO and OMFI have modest buildings. SMFI is housed in a building constructed by the Sidama Development Corporation in Awassa town, while it has its own building at its Shebeddino branch in Morocho. Among the NGO-backed MFIs, PEACE is housed in the compound of Agri Service, the mother NGO. WMFI has moved out of the World Vision compound to a rented building, while SFPI and GMFSC were located in rental houses from the start. Most of the field offices are rented, while a few regional government-backed MFIs use local government (kebele) offices (e.g. ACSI at the Tisabbay sub-branch, OCSSCO at the Ginchi-Dandi branch). At the field level, NGO-backed institutions use rental houses.

The facilities used in offices range from fully furnished modern offices with local networked computers (ACSI) to simple offices with wooden chairs and working tables at the field offices (Table 7-6). Computer facilities are available at the branch level at ACSI and DECSI. Sub-branches process data manually. Vehicles are kept centrally at the head office, while branches and sub-branches are equipped with motorcycles and bicycles. The motorcycle and bicycle supply is limited (often obtained by donations), and the equipment is used by field workers to do their rounds or by the head of the unit. Telephones are connected wherever lines are available. In the largest institutions, like ACSI and DECSI, field-level offices face transportation problems, due to the large number of outlets. The smaller and NGO-backed MFIs appear to have better facilities than the government-backed ones. As outlets expand, facilities supply declines due to budget constraints. Such facilities as motorcycles, which are vital for the field-level operation, are obtained more via donations than through direct purchase from MFI resources. Thus, there is a risk that huge financial outlays will be required to maintain and replace them in the face of expanding operations, especially for the larger and middle-sized MFIs.

Branch and sub-branch employees feel that the facilities used at the sub-branch level are far from sufficient. Some 70.4% of employees felt the facilities were insufficient to accomplish their duties. As we go to the bot-

**Table 7-6**  
*Are the facilities used sufficient to discharge your responsibilities?*

		Frequency	Per cent	Valid per cent
Valid	Yes	8	28.6	29.6
	No	19	67.9	70.4
	Total	27	96.4	100.0
Missing	System	1	3.6	
Total		28		100.0

Source: Survey by author.

tom of the organizational structure, availability of facilities declines. Communication facilities, office provisions and transport are among the facilities that are lacking.

#### *Management information systems*

Perhaps the most crucial and yet least developed area is management information systems in Ethiopian MFIs. Accounting and operational manuals are available at all of the MFIs. During the survey, accounting and operational manuals were reviewed regarding content and flow of information, information transition and reporting systems between the head offices and the branches (operating level units). Sample copies were collected and comparison made where possible.

Significant variations were found in the level of development among the institutions in the quality of MIS. Moreover, the manuals varied in content and details, clarity of information and quality. None of the MFIs had a fully automated MIS. At the head office level, all use computers and different applications to generate data. ACSI and DECSI branches use computers to consolidate the reports that come from the sub-branches. At the other institutions, computers are used only at the head office level, and data forwarded from the branches is entered at the head office.

ACSI effectively applies the spreadsheet programs DacEasy and Excel to produce the financial statements and other operational reports (Table 7-7). It has attempted to introduce comprehensive, locally developed software and networking for the offices, but the program failed to function properly. At the head office level, the computers are locally networked, while there is plan to introduce a wide area network with a dial-up system. DacEasy is applied for the other phases of financial accounting.

**Table 7-7**  
*Systems used to process data by MFIs, survey results*

MFI	Head office level	Operational level
ACSI	DacEasy and Excel	Manual
DECSI	Excel, recently TMS <sup>1</sup>	Manual
GMFSC	TMS	Manual
OCSSCO	TMS	Manual
OMFI	Peachtree	Manual
PEACE	TMS	Manual
SFPI	TMS	Manual
SMFI	Windows NT Excel-Peachtree <sup>2</sup>	Manual
WMFI	TMS	Manual

Note: 1. TMS (Total Microfinance Solutions) is software locally produced at World Vision by a local expert with cooperation of World Vision microfinance staff. 2. New software, Microfits (integrated accounting and loan tracking system) was purchased but not yet operational.

ACSI appears in a better position to use computers to generate financial and operational reports. Operational reports and financial reports are gathered at the sub-branch level. The problems arise because they are not sufficiently standardized to allow immediate encoding of the data. A good MIS requires not only gathering of data but also specific design and systematization. The data collected must be purposeful and relevant to the requirements of management since the information obtained from the data is used for decision-making purposes.

Many of the MFIs have purchased Total Microfinance Solutions (TMS) due its availability and ease of installation by the person who produced it. Many features of this software make it attractive to potential buyers, yet none of those who have purchased the system claim to be applying it fully. WMFI and PEACE make better use of the system, generating integrated portfolio and accounting information. Even these institutions are not using the software to its claimed full capacity. There are a lot of rather ambitious details in the output reports list, without actual data being fed to the system. This software was developed in the country when microfinance was just starting. Thus experience and background of both the programmer and those who participated in defining the information needs was too limited to produce a perfect and complete software package.

OCSSCO, GMFSC and SFPI used the software but to a limited extent. Users complain about the robustness of the system and its user-friendliness while the patent holder attributes the problem to the lack of awareness and diligence of the users to apply the facilities of the program.<sup>3</sup> Whichever way, the problems explain why the system is not being fully utilized and producing the necessary results. As a result, integration of the portfolio and accounting functions is not possible and reports are often delayed.

#### *Reporting qualities and problems*

ACSI is relatively better off compared to others in the number of reports produced, quality of reports and availability of reports, despite the distance from head offices to sub-branches and the rugged terrain that characterizes most of the regional state. ASCSI has established a discipline of deadlines to deliver reports. The sub-branches submit to the branch office handwritten monthly operational and financial reports within 10 days of the end of the month (giving time allowance for travel and transmission of reports), while branches take another 10 days to consolidate and submit the reports to the head office. The respective departments at the head office take the remaining 10 days to consolidate the reports and submit an end of the month report to the general manager. At each level the overhead incurred and transactions accomplished but which were not included in the reports of the lower bodies are added.

A number of reports originate at the sub-branch level (all handwritten):

- portfolio report (number of active clients, portfolio in arrears, that past due, new client mobilization, client dropout);
- savings report (compulsory centre savings (group tax), group savings, individual savings, voluntary savings);
- financial reports (cash collections, disbursements, expenses and other transactions);
- consumption of stationery and other non-cash items;
- other activities accomplished by branch personnel (number of visits made to clients, public awareness addresses, new client recruitment efforts, savings mobilized);
- schedule of collections and disbursements for the coming month to project cash flows.

Beyond these regular reports there are a number of correspondences between the head office, branch and sub-branches and special reports on specific issues, resulting in a high volume of paperwork.

At all other MFIs the details of monthly reports vary from a three-page summary of portfolio and cash movements to the volume of ACSI. Some do not follow a standard format from month to month. In one case the credit officers (branch heads) expand the report by including details of activities, while others do not. One factor that has resulted in a wide difference in reporting standards appears to have been the lack of uniform reporting requirement by the regulatory agency and the association. The national bank requires that MFIs submit quarterly reports showing liquidity, capital adequacy and portfolio status. Audited financial statements are to be submitted to the NBE within three months after the end of the fiscal year.

Some MFIs complain that submission of the quarterly report is impractical due to the time required to collect the data from the remote branches and sub-branches to consolidate and submit it to the NBE within one month after the end of the quarter. The required report, even then, is short and limited in scope to the most important aspects of the operation. Portfolio and savings operational activities are not covered in the reports to the national bank. One observes a wide difference between the reports submitted to the NBE and the figures finally presented in the financial statements. The representational faithfulness of the reports is questionable. This is partly because the NBE imposes a penalty for late submission or failure to submit, but there is no system to verify the accuracy of the reports. The short form of reporting required by the national bank has also given incentive to some of the MFIs to produce their final financial reports in that abbreviated form omitting relevant information. Details of the annual audited financial statements, including disclosure of significant items, differ across the institutions. Still ACSI leads on that front by showing the detailed information and operating results of branches and sub-branches attached to the consolidated statements. Yet due to a lack of local standards and specific requirements by the supervising authority on the standard to be followed, their company standard or decision of some details beyond the basic accounting information guides auditors. The CGAP disclosure requirements are not fulfilled, in terms of disclosing some phases of operation that have significant value for external decisions.

An MIS is aimed to produce the information needed in making decisions. The lack of such information may have the effect of delaying the decision-making process, both at the institutional level and by external parties concerning the institution. Among the reasons for the MFIs' weakness in management information are the following:

- lack of or difficulty in defining information requirements at each decision level (including external reports to shareholders, the regulatory agency, the donor agency and the public at large) and lack of a systematically designed overall system for data collection and reporting;
- lack of qualified personnel at the operating unit level to systematically compile and report the information;
- lack of facilities (computers) at the basic operations unit to record and report data in a timely manner;
- lack of infrastructure (telephone lines and roads) to report in a timely manner the information to head offices;
- scattered retail outlets over wide geographic areas;
- lack of customized user-friendly software, which could be easily understood by operators;
- overall lack of standard requirements by the industry for reporting and performance monitoring.

Beyond these common reporting weaknesses, two other problems are worth mentioning. The annual and periodic reports prepared do not show a sufficiently clear picture of sub-branch operations to enable segment evaluation. For example, head office overhead costs are not allocated to operating units; some revenue items are recorded at the head office level while the earning process is completed at the sub-branch or branch level. These are then not shown on the income statement of the sub-branches (operating units). Inter-branch transfers are similarly not properly accounted for. For instance, some sub-branches raise more money in savings than they disburse in loans, but the funds are transferred other sub-branches for loaning, yet the branch or sub-branch that raised the savings pays the interest on the savings account. This reduces income or profitability of the unit. If performance is judged at each operating unit, the results would be misleading in such situations since cross-subsidization would hurt the stronger. The weakness here is in the accounting process.

The other important factor that affects quality of the reports is the external audit. There is no local accounting standard or standard-setting body (professional association or statutes) in Ethiopia. Thus the audit standard applied to MFIs depends on individual firm decisions of what to disclose and what not to disclose. Thus, audit reports are often abbreviated and too short. Even CGAP disclosure requirements go unobserved. The National Bank of Ethiopia could make it a requirement to get better reports from the auditors.

## 7.5 Prudential requirements and supervision

### 7.5.1 Prudential requirements

Microfinance institutions are allowed to open branches or sub-branches within the operational area they are licensed for without informing the National Bank of Ethiopia. But they are expected to report the opening of a new operational outlet within 15 days of the date of starting operation (article 14 (1)). Closing branches, mergers with other microfinance institutions or other banks requires prior written approval.

Article 17 of the proclamation prohibits disposal of part of or whole businesses by amalgamation or otherwise, transfers of property, reduction of capital and amendment of memoranda of association or changing of names without prior approval of the NBE. Persons who have been declared bankrupt or made special arrangements with creditors, convicted of offences or breach of trust may not be allowed to manage MFIs unless approval is obtained from the NBE.

Specific quantitative requirements set by the NBE are aimed at addressing different aspects of prudential requirements applicable mainly to deposit-mobilizing institutions. The requirements centre on limiting risk exposure by way of loan ceilings and single loan limits and boundaries on ownership concentration, liquidity position, capital adequacy ratio (CAR), asset quality and concentration of MFI investments in other entities (diversification of investment portfolio).

The loan limit and single loan exposure issue was discussed above in relation to operational modality. The loan limit provision also serves the purpose of deliberately keeping the loan size low, to enable access by the poorer households. Irregardless, the loan size limit of ETB 5,000 (about US\$ 578) is criticized as too low for a reasonable-sized micro or small enterprise. Offi-

cials at the national bank defend the position, stating that the initial fixing of the loan limit at a low ceiling is appropriate to avoid excessive risk, since no collateral is provided for the loan. Officials also argue that many MFIs still do not lend the maximum amount, even after several repeat loans. Reregistered institutions are required to adhere to a number of quantitative prudential norms, such as improved but defined loan size limits, loan term, minimum loan loss provisions and other requirements. MFIs that have mobilized total deposits of more than ETB 1 million (about US\$ 116,000) must apply for reregistration. Directive No. MFI/15/2002 requires such MFIs to maintain a liquidity position of 20% of total deposits at any time, which should be available in the form of liquid assets. Total deposits is defined as the aggregate of voluntary and mandatory savings of clients and non-clients. The required liquidity position may be considered high in that it leaves so much of the institution's cash idle, implying high opportunity cost, especially when there is no secured alternative short-term investment to loans. Ethiopian MFIs have few options for investing their cash other than government treasury bills and savings accounts at banks. Yet, they are not required to maintain reserves at the national bank other than the liquidity position for the security of depositors.

In addition to liquidity, Directive No. MFI/16/2002 requires a capital adequacy ratio of 12% of risk-weighted assets with guidelines for calculation of the weights. This is also applicable to reregistered institutions. The CAR requirement seems in line with the formal bank standard requirement of 8% as per the Basel Committee (1988) recommendation with a margin of safety for the nature of microfinance. The percentages required by microfinance institutions in different countries vary based on the extent to which the institution raises deposits from the public (Staschen, 2003). Christen, Lyman and Rosenberg (2003) argue for introducing a higher CAR requirement for microfinance institutions compared to formal banks including more volatility of loan portfolios of MFIs leading to faster recapitalization in case of defaults. An argument against a high CAR requirement is the effect on return on equity arising from low leverage, making the MFI an unattractive venture for commercial investors. Christen, Lyman and Rosenberg (2003) suggest that the provision for CAR partly depends on the experience of management and supervisory authority's judgments of microfinance risks.

Regarding quality of assets, requirements for loan loss provisions seem somewhat relaxed, since no suggestion is made as to provision for current loans and loans past due less than 90 days. Directive No. MFI/17/2002 states loss provisions of 25%, 50% and 100%, respectively, for loans overdue 91 days to 180 days, 181 days to 365 days and for balances past due longer than 365 days after deducting any savings balance of such clients at the institution. The regulation does not prohibit stricter and more conservative provisions based on a study of relative risk profile of each group of loans or other method. For example, what provision is to be attached to loans past due for 60 days? Here, the discretion is implicitly left to the management of the institution to assign a provision of between zero and 25%. Many institutions, either due to lack of capacity to assess risk or a deliberate intention to minimize the amounts of losses reported, tend to report loan loss provisions to the minimum extent required by law in their financial statements, which may not reflect the realities. Some of gap between the ranges suggested and the percentage of allowances assigned is wide, while it is also necessary to provide for past-due loans from those one day past due. Moreover, there is no point in assuming that the current loan balance (not yet overdue) is risk free, since any amount can fall into delinquency and finally end up as a loss. Thus, it may be necessary to estimate the risk probability and make some allowance for the current loan balance.

Investment in “allied activities” (financial institutions, agricultural input distribution and transportation of agricultural products) by an MFI is limited to 10% of the net equity capital, and investment in any single enterprise at any time is limited to 3% of the MFI’s net worth (Directive No. MFI/06/96).

### 7.5.2 Reporting requirements and supervision

The National Bank of Ethiopia is the licensing and supervisory authority for all financial institutions in Ethiopia. The national bank supervises microfinance institutions, albeit with capacity constraints, off-site and on-site. Off-site supervision is conducted via periodic reports. The NBE has issued standard formats and guidelines for quarterly and annual reports. Quarterly reports are required from each institution within one month of the end of the quarter. Annual audited reports are to be presented within six months of the date of balance sheet.

The NBE initially opened a small unit for supervision of microfinance within the supervision department for the formal bank and insurance industry. But the unit was soon overwhelmed by rapid expansion of the MFIs, which far outstripped the formal bank network in terms of branch network and difficulty of access. Thus, the NBE soon recognized that a separate MFI supervision department with enhanced status would be better suited to cope with the challenges. By 2003, the NBE had only seven staff in this department, of whom only five could make field visits as experts. By then there were 21 licensed MFIs with over 430 branches and sub-branches spread through large sections of the country.

MFIs are expected to submit interim quarterly reports, which comprise specific financial and operational indicators, and annual reports. Audited financial statements must be deposited at the NBE within three months of completion of the fiscal year. NBE imposes penalties on those who fail to report on time.

Licensed professional accountants conduct external financial audits based on “generally accepted auditing standards” to verify fairness of the statements presented to them by the management of the institutions. But review of the audited financial statements of the different MFIs reveals wide differences in the extent of information disclosure in the reports. Microfinance is a new industry in the country, whilst most of the audit firms have no experience in financial institutions, as the government-owned audit firm is used to audit publicly owned banks. For its part, the NBE, also lacking experience, issued no guidelines as to what items should be included in the reports.

Ethiopia is a country without a strong accounting professional body to define and enforce accounting and auditing standards. Foreign firms, mainly based in the United Kingdom, certify licensed professional accountants. It is assumed that Ethiopian professionals follow international accounting standards and auditing principles, but there is no agency or body to monitor such compliance. In the absence of such a strong foundation, the bank should perhaps have defined a minimum standard for financial institutions in general, if not for microfinance in particular. CGAP (1998) suggests a disclosure requirement by external auditors for microfinance and possibly specifying the scope of coverage of the tests and verifications in the engagement contract with the boards of directors. As chapter 6 indicated, MFIs do not have the practice of board committee follow-up to spe-

cific professional issues, such as responsibility for internal control and internal and external auditing. Such a committee could help draft a professional and industry-specific engagement contract. It would also be difficult for the supervisory authority to evaluate either findings of the audit or identify defects in the auditing procedure without knowing the necessary scope of the audit and without specific requirements imposed.

Despite strict regulations compared to other African countries (Staschen, 2003; Gallardo et al., 2005) supervision is relatively lenient and many regulatory provisions are in fact violated both by the MFIs and by others outside the MFIs. To cite a few examples, ownership concentration, which is limited by Proclamation No. 84/94 to 20% of the shares, is not observed by some institutions. Regional governments own over a 90% share of capital of the Omo and Addis microfinance institutions. Several of the microfinance institutions that mobilized savings of over ETB 1 million had not yet applied for re-registration. NGOs and government agencies are still engaged in extending loans, in disregard for the provisions of the proclamation that prohibit unlicensed persons from engaging in financial transactions, for which the bank issued Public Notice No. 2/1998. ACSI and DECSI took responsibility for distributing agricultural “package loans” and “food security loans” within their operational areas at a lending rate different from their regular loans. Surprisingly, there are situations in which persons borrow from the MFI at a regular loan rate of 18% while others obtain a government loan at a rate as low as 12%. This has a clear distorting effect. In the OCSSCO operational areas, the MFI is not involved in agricultural input loans. There, regional governments, through agricultural extension offices, directly administer loans for such packages. NBE officials claim that some irregularities are tolerated since the sector is new and at times there may be the advantage of contributing to financial deepening. The office also understands that agricultural input loans are distributed through cooperatives or regional governments mostly in kind, which does not fall under the bank’s jurisdiction, and the food security programmes are not meant for clients of microfinance, but for more destitute people in need of special arrangements. In practice, the loans are supplied to the same people who borrow from the MFI. Another difficulty with supervision is that the MFIs that operate exclusively in one regional state have the right to adopt their region’s working language, while the department does not have the matching mix of staff for the different re-

gional languages. All MFIs use English for reporting to the bank, but home records are maintained in the local language. This is a practical problem, since the management of the MFIs based in one region can exercise their constitutional rights and the national bank may not be able to issue any instruction against the practice. DECSI for example, uses the local language exclusively at its sub-branch, branch and head office levels, including reports to the board, board minutes and all correspondence. It is therefore difficult for the NBE to conduct any on-site supervision without having someone who understands the local language. Formal banks pose no such problems, as they use English as their working language, at least for record-keeping, with most local correspondence in Amharic.

The supervision department on top of all of the problems mentioned is poorly equipped with technology to analyse the data coming from the MFIs each quarter, and the annual audit reports obtained from MFIs are filed as hard copies. Few MFI officials and employees remember any question or comment arising from the national bank's supervision on their reports. On-site supervision is supposed to be conducted by employees of the bank of all deposit-taking MFIs, but due to human resource constraints their visits are selective, and carried out on a first-priority basis, especially when the NBE feels an MFI may be facing problems.

The NBE's MFI supervision department can be characterized as a unit under establishment, but being overtaken by events in the face of the slow pace of capacity building within the department and the faster growing microfinance industry in the country. The department had yet to develop systematic programmes and procedures for MFI supervision and monitoring other than requiring the MFIs to report regularly on their activities. It has pressed the institutions to get their financial statements audited by external auditors, which most of the MFIs have done, especially in recent years. Enforcement of the regulatory requirement in this regard is a positive development since periodic reports and annual audits serve as a psychological deterrent to potential malpractices. The interim reports and annual audit reports are supposed to serve as the basis for off-site supervision. The formats provided by the NBE for reporting quarterly operations include some operational information on portfolio status and financial statements. In a few of the samples inspected in this study, microfinance institutions had left some of the required data blank, whereupon the bank had not taken any action. The problem seems to arise from the fact that the

required data may not be kept by the individual MFI in the form required by the bank.

Many MFIs find it difficult to assemble the financial data within one month and to produce the quarterly reports for the NBE. Therefore, the reports may be far from accurate. Weakness in the overall management information system, the fact that the branches and sub-branches are scattered over vast areas and problems of communication and physical infrastructure hinder the consolidation and submission of information within a short period. For instance, the largest MFIs (ACSI and DECSI) require reports from the sub-branches to reach the coordinating branches and those branches consolidate the reports and include transactions at the branch level (mostly costs and inter-sub-branch transaction adjustments when available). They then forward the reports to the head office. The head office then includes transactions kept at the centre, including central cost and revenue items, to finally produce the required reports. The branches have a month to forward the reports to the head office and the head office produces the consolidated reports in the month thereafter, which means a total of two months is required to have the reports ready. Thus, it would be difficult for them to meet the reporting deadline of the bank.

On the supervision issue, the NBE does not yet have a manual for on-site supervision. When on-site visits are made, the bank staff employee physically inspects the records, applying in the evaluation the CAMELS approach used for the formal banks. The supervisory authority lacked both organizational and human resources in terms of both experience and numbers. But during the recent visits, according to the department head and a senior expert, the department underwent a major change in capacity building. It hired new staff (15 in October 2005) and planned to take on additional personnel. The bank obtained a capacity-building fund from the Rural Financial Intermediation Programme (RUFIP) of IFAD and the European Union to upgrade the department. Some staff were sent abroad for training, some specialized in microfinance for their second degree. At the time of this study, computer facilities had been procured and were awaiting installation; transport facilities had also been purchased. A supervision manual was also prepared by a consultant and was under review for implementation.

## 7.6 Conclusions

Ethiopia's regulatory framework places the microfinance industry within the financial system. It has shaped the institutional framework within which MFIs operate. One achievement of the regulatory proclamation was the institutionalization of the industry. Microfinance practice is recognized by many in the field as a serious professional financial service rather than as an NGO charity project or temporary activity, as this impression had been imparted under previous NGO practices.

As a result of regulation, the distortion of financial markets drastically declined, though it has not been totally eliminated. The regulatory framework of Ethiopian MFIs seems unique in that it required establishment of specialized financial institutions to undertake microfinance services and it prohibits any other institution from extending such services in the country. Despite the many positive contributions, the legal framework has some negative implications for the growth of the sector.

First its impact on the ownership structure has resulted in an unsustainable structure that needs future reconsideration. The ownership structure has also impacted the governance structure in that nominal owners and delegates with no stake in microfinance lead the MFIs without sufficient incentives. Such governance cannot produce an institutional structure with the necessary incentives and sanctions to minimize agency problems and to strive to achieve institutional goals.

Microfinance institutions in Ethiopia have not followed natural institutional development resulting from socioeconomic changes, as in other countries. Their creation, rather, was induced by a federal proclamation that laid the institutional basis of the MFIs. The formation of the organizations was guided by legislation, rather than based on theoretically recommended approaches. Since formal financial institutions are not widely distributed throughout the country, downgrading formal banks would not have produced the wider coverage that the MFIs have reached by now.

Cooperatives, self-help organizations and other informal institutions were left as they were. A separate cooperative law was enacted providing for the coordination and guidance of the credit unions and cooperatives under regional administration, instead of bringing them under the financial system. Linkages between formal banks and MFIs are not observed. Recently, there was an attempt to create an apex organization within the De-

velopment Bank of Ethiopia with a linkage to provide loan funds obtained under the RUFIP project.

Requirements for licensing MFIs imposed a form of organization with involvement of government and party institutions as owners. This ownership structure has negatively affected the governance process, currently remaining a source of weakness in governance of the MFIs. This undermines the viability of the institutions. Thus, MFIs are exposed to the risk of being considered part of the ruling party or a government institution rather than being viewed as independent financial institutions.

The MFI ownership structure is a major area of concern. Nominal shareholders have no stake in the business. Government institutions and civic organizations themselves sometimes suffer stake or agency problems. As chapter 2 showed, the purpose of having an institution is to facilitate financial intermediation through efficient information gathering using an institutional design and structure closely monitored to minimize transaction costs. It is unlikely that public enterprises can attain such a position. Under the current style of ownership, the MFIs will soon reach a level at which they are incapable of running the business without restructuring.

Currently the profile of MFI board members can be judged as commendable from the point of view of members' academic qualifications and experience in their respective backgrounds. But experience in micro-finance is generally lacking. Neither is the mix of board members based on deliberate selection to obtain the desired qualifications and experience for the purpose of promoting the MFIs. Due either to lack of experience or workload at their official workplaces, board members were not yet implementing working procedures, by-laws and self-appraisal. Neither is accountability of board members to shareholders in evidence. Thus, it could be concluded that the current ownership structure negatively affects governance, leaving institutional viability at risk.

MFIs' organizational structure and design are more or less copied from one another. Branch openings and selection of operational areas depends mostly on external considerations, such as need for support from the local government administration or NGO development project areas instead of being based on market research and assessment of client needs. This renders the design of the institutions more oriented towards social factors than to financial service considerations, reducing the likelihood for transaction costs to be sustainable.

Internal control is not a high concern for the smaller MFIs, since the operations are simple and the volume of transactions is low. In medium-sized and larger institutions with several thousand clients over a scattered geographic area, stronger systems of internal control are decisive. Many of these institutions have internal audit departments at branch offices and daily collections, and occasional disbursements take place at the sub-branch level. In such a situation remote supervision may not be enough.

MFIs enjoy effective implementation of their plans and maintain relatively good performance at the branch and sub-branch level, thanks to energetic and enthusiastic young employees who diligently undertake their duties, despite the unattractive incentive system. Yet employee turnover is high. Current trends indicate that unless the incentive systems are revised, MFIs may soon face problems in recruiting the human resources they need.

Management information systems are generally weak, but with uneven levels of development across institutions. It is difficult to provide timely and accurate information on operations and financial matters with the current state of the MIS in use. Further growth and expansion of MFIs is incompatible with the MIS situation at the time of this study. Mismanagement of resources is a possible result of lack of progress in this area.

The overall conclusion for institutional viability is that ownership and governance issues are matters of concern, as is the non-development of appropriate management information systems. Ownership and governance issues could perhaps be resolved if the current restrictions on foreign ownership are abrogated, since there would then be a possibility of wider access to financial technology and better management.

## Notes

<sup>1</sup> Microfinance Network Occasional Paper no 3. (1999).

<sup>2</sup> AEMFI had conducted a training workshop in 2004 on governance after this survey.

<sup>3</sup> A discussion was held with the software producer who claimed that the system is perfect, except that people do not like to use the facilities diligently and carefully.

# 8

## Discussion and Conclusions

### 8.1 Introduction

Institutional sustainability of microfinance in Ethiopia is the main theme of this study. Institutional sustainability was analysed from a number of perspectives based on the study objectives and research questions formulated in sections 1.5 and 1.6. Institutional sustainability is influenced by several factors. The nature of financial services and the type of client served by these institutions requires special and challenging institutional arrangements and modes of operation. One challenge to microfinance institutions is sustaining operations to meet the stated objective of reaching the poor. Despite the popularity and wide experience of microfinance worldwide, differences between countries in economic development and other aspects make it difficult to apply uniform principles or to replicate experiences.

This chapter discusses the issue of institutional sustainability of microfinance institutions in Ethiopia. It is divided into four sections. The first three sections discuss the findings of the current study in line with the research questions. The last section sets out the conclusions and policy issues for the future of microfinance industry in Ethiopia.

### 8.2 Sustainability and scale of operation

#### 8.2.1 Operational and financial sustainability

Chapter 5 evaluated the financial performance of the microfinance institutions in Ethiopia. Before discussing the findings, it is important to note the wide variation between the institutions studied in terms of size, ownership and experience. In addition, the motivation towards profit or self-sustainability largely depends on the objectives actually pursued by the

MFI, rather than the objectives stated on paper, as it seems that all institutions do not pursue their stated objectives equally. Owners or resource providers of microfinance deliberately — or for lack of experience — contribute to a relaxed attitude to profit reporting. At the same time, however, those who introduced strict reporting requirements without appropriate mechanisms in place to ensure compliance also contribute to the inaccuracy of the reports submitted. Lack of standard reporting requirements for microfinance has led to a wide variation in content and adequacy of the information reported. With respect to financial performance, wide variation is observed among the MFIs in the area of portfolio performance. Some microfinance institutions deliberately avoid reporting, for instance, the amount and percentage of the portfolio at risk in relation to the gross portfolio they hold. While the bulk of their assets could be contaminated they nonetheless concentrate on the total repayment rate, which includes collections from the portfolio in arrears. Neither had management made sufficient provisions for possible bad debt. This shows that there is a fear of showing negative aspects of performance in the reports. The reason may be fear of losing support from financiers. For the most part, lack of experience and lack of effective systems has contributed to the inferior quality of reports, which also undermines the effective evaluation of performance. In government-supported MFIs, where repayments are strictly enforced by the involvement of administrative organs, MFI management has less fear of a few days of delay in collections, and they did not increase provisions to reflect the arrears rate. While recovery of the cash is certainly possible, any contamination of loan portfolio indicates a motive to default or difficulty on part of the client, which in the long run may affect the institution. Without correct information on portfolio quality and appropriate provisions for bad debt and inclusion of the bad debt expense in calculations of profits or losses, financial performance cannot be accurately evaluated. Unsophisticated readers of the financial statements may be temporarily satisfied with the reports, without knowing the implications in the long run. Portfolio quality is a precondition for good financial performance.

The analysis of operational and financial self-sufficiency showed that only five of the nine institutions studied had reached operational self-sufficiency, that is, they could cover accounting operating costs from the revenues generated from operations. Only two of the institutions had reached financial self-sufficiency by end 2003. Accounting profit is by no

means a measure to be used for evaluation of financial performance. Accounting profit fails to recognize several aspects of financial considerations, including the time value of money and the cost of capital. Thus, when firms had not yet covered the accounting costs, it was obvious that they were losing part of their capital, even in nominal measurements.

Financial self-sufficiency is the better indicator of self-sustainability of the institutions. This goes further than operational self-sufficiency by imputing the cost of equity and making adjustments for inflation. Our analysis used a conservative estimate of cost of capital by taking a savings interest rate assuming that the next alternative available for MFIs to raise capital would be from savings collected from the public. Estimation of the cost of capital suffered two shortcomings. First was the difficulty of finding a basis for estimating the cost of equity, since MFIs are not that profitable in the country. The opportunity cost of capital or expected return on equity, therefore, could not be estimated. Second was the lack of a standard or expected level of mix of debt (from savings and commercial loans) and equity financing or capital structure to allow a basis for estimating the marginal cost of capital, except the legally required minimum of 12% capital adequacy ratio (CAR). Most MFIs are currently financed predominantly by soft loans and donated equity. Despite the shortcomings, the deposit interest rate is the only objectively available cost of capital as the future aim should be to raise sufficient deposits from public savings to finance on-lending activity.

While the commonly held view is that MFIs should attain financial self-sufficiency after five years of operation (or three to eight years, though these are not always achieved elsewhere), most Ethiopian MFIs had not yet attained financial self-sufficiency. The five-year data showed improvement over time towards covering costs for most. A few showed fluctuations between years. The question, however, not only relates to improvements over time but also how long will it take for them to attain sustainability and who will finance the operation until they attain self-sufficiency. Perhaps this concern is crucial in Ethiopia, since capital is critically scarce and must be allocated among competing development programmes. This is true whether the funds come from international donors, the national treasury or any other source. The worry, thus, is whether the MFIs can be sustainable (continue to supply services for longer periods). The answer may be yes for the time being, in as far as NGOs and government are willing to

give additional funds to satisfy the needs of the poor in line with government economic policies. This cannot be equally true for all MFIs. Self-sufficiency, not just sustainability, is the best assurance for the MFIs to remain banks for the poor, and also for continuity of enabling the poor to access financial services.

Schreiner (1998) distinguished sustainability (ability of the institution to pursue its objective for a long period) from self-sufficiency (the ability of institutions to continue from their own resources without depending on external resources). Also, as pointed out in chapter 2, institutional sustainability in terms of financial self-sufficiency is crucial for microfinance institutions to reach the desired number of poor people (Rhyne, 1998).

Our primary research question here was whether the institutions are already financially self-sufficient or are progressing towards the attainment of self-sufficiency to ensure sustainable services to the poor. Only two of the nine MFIs had reached financial self-sufficiency, and we can conclude that these are the only self-sufficient institutions in the industry, as the rest are either new or smaller than those in the sample. Progress towards self-sufficiency was observed, but can this ensure a bright future for these institutions? We do not know whether the progress is satisfactory since no benchmark exists to indicate the rate of progress that could be judged as satisfactory or good. To conclude that the progress will lead to attainment of self-sufficiency, we must also know whether the growth or improvement in cost coverage capacity is due to internal operational strength or to additional funds granted for expansion. In many of the cases observed, MFIs improved in financial performance in the early years, but the rate of improvement declined thereafter in a manner that suggests they are reaching the limits of their capacity. The decline in growth rate can be partly explained as due to shortages of loan funds to further expand outreach and also to organizational capacity.

When we say institutions are not self-sufficient it means there is either direct or indirect subsidy to keep the operation going. To what extent do institutions rely on such subsidies? The next section addresses this issue.

### 8.2.2 Dependence on subsidy and concessional funds

This sub-question was partly answered in chapters 4 and 6, while the subsidy dependence index was calculated in chapter 5 as part of measuring financial performance. A look at the balance sheet of the MFIs shows their

dependence on funds from donors, NGO financing and government-allocated initial capital rather than funds generated from savings mobilization and internally retained earnings. While the country's savings potential is encouraging, still many MFIs (except DECSI and ACSI) have a very low proportion of their loan portfolios financed from savings mobilization. The balance sheet of some institutions showed an increase in capital (owners' equity) over time, due to capitalization of donated funds and a large amount of deferred credit, which constitutes the largest part of financing for the loan portfolios. The extent to which the MFIs depended on these concessional loans or donations is better measured by the subsidy dependence index.

The subsidy dependence index showed only ACSI as subsidy-free at the end of 2003 (DECSI was excluded due to lack of data). Other MFIs were subsidy dependent, showing a dependence index ranging from 92% (WMFI) to 818% (PEACE). Thus, not only is there a wide gap between the MFIs in terms of capacity and the potential for self-sustainability, but there is also a lot to do for many of them to reach self-sufficiency. Those with the smallest subsidy dependence index (92%) would have to increase interest on loans by about 100% at present capacity to cover their costs and be free from subsidy. The MFI with the highest SDI (818%) would need to increase interest on loans by about nine times. This is not practical. The implications relate not only to interest rate but also to the capacity and efficiency of institutions to extend financial services. Larger MFIs did not show the much-exaggerated subsidy dependence index of the smallest MFIs.

Ethiopian MFIs were classified into three categories in terms of size as large, medium and small. Based on the size of the loan portfolio we tried to relate the subsidy dependence index to the size of assets, which indicated a reasonable relationship between institutional size (measured in assets) and the subsidy dependence index. These findings, however, cannot be taken as conclusive. A clear case was observed of one institution, classified so far as medium and another, classified as small in asset size, where the smaller institution showed a lower dependence index. The medium-sized institution was financed predominantly by owners' equity while the capital of the smaller was dominated by donations and concessional loans. The implications here relate to the difference in interest rates charged by the two institutions and their efficiency in cost management. Another observation is that smaller MFIs, despite the higher interest rates they charge on loans,

still have higher dependence ratios compared to the larger MFIs, which charge relatively lower interest rates.

The results of the subsidy dependence index and financial self-sufficiency measures indicate that those with better financial self-sufficiency ratios also have lower subsidy dependence ratios. The two measures have a similar goal of assessing the extent to which an institution can depend on its own resources (Aghion and Morduch, 2005). The subsidy dependence index is meant to show the amount by which revenues (interest income) have to be raised to cover the costs of operation if all concessional funds are eliminated (Yaron, 1992). The subsidy dependence also indicates the opportunity cost to society in that it measures the extent to which MFI programmes are taking resources from alternative programmes. If MFIs are self-sufficient, the funds used to subsidize them could be applied to other development efforts. The subsidy dependence index, by comparing revenues from loans to subsidies received, shows the amount of subsidy awarded to microfinance institutions by society for interest paid by borrowers (Schreiner and Yaron, 2001). Thus, when we discuss subsidy dependence, we are somehow indicating that MFIs are taking resources away from other development programmes. Governments, NGOs and other stakeholders may continue to subsidize MFIs if the opportunity cost of alternatives do not exceed the benefits from the MFI programmes.

Other aspects of the operations are not explained by the subsidy dependence index and financial self-sufficiency ratio. Both of these measures indicate the extent to which self-sufficiency is achieved, but neither points to the reason or underlying cause. As outlined in chapter 2 (section 2.3.1 and Box 2-1), subsidy dependence itself cannot be eliminated by raising interest rates only, as other aspects of the operation, such as efficient utilization of resources and improvements in methodology and marketing capabilities contribute to profitability. Looking for alternative sources of funds (mobilization of savings) that are cheaper than commercial loans and better management of costs and efficiency may also influence the subsidy dependence index and financial self-sufficiency ratio. We analysed efficiency by relating operational parameters to volume or scale parameters.

### 8.2.3 Volume of operation and efficiency

As noted in the preceding section, profitability and self-sufficiency are dependent on the volume of operations. This is a common understanding, as we expect some costs to be fixed while others are variable. However, organizations may have different proportions of fixed to variable costs, even within the same industry.

Our finding in analysing 170 sub-branches of ACSI (the only institution with complete reports available and the only financially self-sufficient MFI) regarding the impact of volume of operations and efficiency of performance resulted in an interesting finding. Contrary to the common belief that as volume of operations increase fixed costs are absorbed resulting in lower unit cost, findings here suggest that there is no significant relationship between cost elements and the volume of operations as represented by the loan portfolio. The result of correlation analysis showed a significant relationship between revenue (performance) and loan portfolio size (volume), while the relationship between total costs and personnel costs (performance) and loan portfolio was not significant. Other factors, such as distance of the sub-branches from the main branch, availability of infrastructure (electricity, telephones) and the age of the branches similarly showed no relation to volume of operations.

A significant portion of the sub-branch expenses are personnel costs (salary and employee benefits). In this respect, there should have been a difference between the sub-branches with a high loan volume and those with low loan volumes. ACSI and the rest of the MFIs (especially government-owned ones) have a fixed or standard salary structure and human resource allocations at the head office and branch and sub-branch levels. For instance, ACSI has eight employees at each sub-branch with the same job titles but possibly differing in seniority resulting in minor differences in remuneration. Due to the need to control for fraud, the number of personnel may not be less than a minimum desired level. MFIs have no system of classifying branches and sub-branches into grades to distinguish numbers of employees and levels of qualification (which commercial banks do have) to determine the personnel requirements of each outlet. This could lead to under-utilization of personnel and inefficiency in the smaller outlets while possibly overburdening those working at larger outlets. This may in turn cause incentive problems on the part of employees that feel overburdened.

In conclusion, the hypothesis we formulated that volume of operations impacts the performance of the MFIs, based on a logical outcome of the cost-volume relationship, tested negative in the case of Ethiopian microfinance institutions, which is perhaps unusual.

## 8.3 Outreach and client relations

### 8.3.1 Level of outreach and client profile

Chapter 6 examined the outreach of the MFIs. The eight MFIs in the sample showed an average client growth of 150% in 2003 compared to 1999, with wide variation of growth among institutions. The highest had 432% growth over the five years and the lowest was 74%. In general, all of the MFIs had increased the number of clients reached. The largest two MFIs (ACSI and DECSI) had impressive outreach, each having over 290,000 active clients and outstanding loans of ETB 210.4 million and 184.4 million, respectively. These two MFIs are among the largest in sub-Saharan Africa in terms of number of clients and among the top 20 in terms of loan portfolio.

While the actual demand for MFI services could be more accurately determined by conducting a country-wide survey or at least a representative sample from all regions, we estimated the potential demand based on conventional approaches recommended in the literature for calculating the satisfied and unsatisfied demand. These estimates found the potential demand for MFI services to be about 4.3 million households. The current supply (outreach) of 714,000 is about 20% of this total potential demand. Region-wise, TNRS has 75% of the demand satisfied (with a single supplier, DECSI), ANRS has 25% satisfied (ACSI supplying over 90% of the services in the region), ONRS has 5% satisfied (OCSSCO being by far the largest in addition to several small suppliers) and in SNNP 7% of demand is satisfied (OMFI has the lion's share).

The tremendous achievement in client outreach is attributed to a couple of regional government-supported MFIs, while small NGO-supported MFIs have remained largely stagnant or slow moving. Regional government-supported (owned) MFIs have grown faster in terms of outreach in number of clients, geographic areas covered and balance of outstanding loans. The four regional government-supported MFIs accounted for 89.4% and 88.9% of clients and total loan portfolio, respectively, of the 20 MFIs in the country by mid-2003. The 16 NGO-supported MFIs con-

tributed only 11% in both respects, confirming the claim that Ethiopian microfinance services are mostly supplied by government-owned or supported institutions.

To support our findings on sustainability, we tried to characterize the profile of clients by exploring the characteristics of non-clients in the vicinity of the clients. This was analysed based on several variables included in the survey questionnaire. Findings showed that the client population is older compared to the working age population in the national population pyramid and has a slightly larger family size than the national average. Compared to the non-client group, the client group showed no statistically significant differences in most variables except in educational status. Non-clients were slightly younger than the clients, which could be attributed to exclusion of young people from the client group due to their lack of property. This indication, though not conclusive due to our sample size and the numbers of non-client observations included, suggests that group lending, which was meant to replace the collateral requirement for the poor, indirectly imposes a property ownership requirement, as the haves exclude the poor in fear of greater default risk and difficulty of enforcing repayment. There was sufficient indication during the interviews and group discussions, especially in rural areas, that group members prefer members to have property, a settled life and a mature age. Whether group loan methodology is the best for reaching the poor with the objective of poverty alleviation in the Ethiopian context, especially in view of the way the groups are organized, based on voluntary association of individuals for the purpose of obtaining a loan as mutual guarantors, is a subject for further study. As they are involved in financial transactions, farmers become more conscious about risks and act on that. Not only risk but also market conditions, potential competition for jobs, and perhaps social cliques may contribute to the criteria for selection. During the interviews, a few clients complained about the requirement to borrow in groups. These were especially those who thought they could do better on their own.

Another interesting finding in relation to MFI clients is that many use other sources of financial services, while being MFI clients. As indicated in chapter 6, 68% of the MFI clients interviewed use other institutions, such as *Iqub*, money-keepers, banks and other means to save. Many of these clients have forced (mandatory savings) with the MFI but they do not have voluntary savings. Factors in this are lack of promotional work and flexibil-

ity in handling customer deposits on the part of the microfinance institutions and lack of trust and convenience on the part of the clients. Clients must have trust and unlimited access to their (voluntary) deposits to keep funds with an MFI.

Regarding clients' opinions on the services delivered, we found that most clients have repeated loans, unless the outlet visited is new. Most clients have stayed with the institutions for as many years as the age of the outlet.

## 8.4 Institutional viability

### 8.4.1 Impact of current regulatory framework

The microfinance proclamation of Ethiopia was a landmark in the institutionalization of microfinance services. Institutional economists have formulated a range of theories on formation and changes of institutions, including the evolutionary development of institutions. Steinwand (2001) examined the different groups of institutional theories as part of a study on the evolution of the Indonesian Peoples Credit Bank (BPR). He found that the evolutionary theory did not apply to the creation and development of the BPR system. He also indicated that microfinance institutions in many countries result from policy thrusts rather than developing in an evolutionary manner from existing practices. The historical background of the Ethiopian microfinance industry is not different from that in other countries in that NGOs took the lead in introducing the credit programmes. The Ethiopian government, however, took what could be perceived as "pre-emptive action" rather than waiting for the rather scattered NGO programmes to mature into licensed institutions.

The pro-rural policy of EPRDF led to involvement of party organs to participate in rural finance and other development projects. The government issued a proclamation to organize MFIs on the basis of other countries' experiences. Thus, the regulatory framework has so far played the role of institution building. It created a structure for the provision and supervision of microfinance.

While on the one hand the regulatory framework could be praised for its contribution to consolidating microfinance practice in the country, it has also several observed shortcomings. These are inhibiting the further development of the industry in the country.

Some provisions of the MFI proclamation have clear impact on the development of the industry. Among the major ones is the restriction on foreign ownership and foreign borrowing. The microfinance proclamation extended part of the regulation applying to formal banks to microfinance institutions in prohibiting foreign ownership. The purpose of restricting entry into ownership of microfinance is difficult to understand, as many of the MFIs were established by foreign funds. Microfinance in Ethiopia is not yet attractive to foreign investors seeking profit. Ethiopian investment law reserves business in the financial sector for Ethiopian nationals alone. This is to protect the nascent financial industry from foreign competition and prevent dividend repatriation. Yet foreign involvement in microfinance could bring in better technology and management from which local staff could greatly benefit.

Finance is the other bottleneck for the development of microfinance in Ethiopia which foreign involvement could greatly improve. Ethiopia could have benefited more from foreign ownership if it had been allowed from the very beginning, as it could reduce the cost of information in the conduct of business. Now it would be rather to the advantage of the foreign company in terms of the cost of information after the market is developed. Still, local companies could benefit from better capacity, technology and management if partnerships or co-ownerships were allowed.

International banks are increasingly interested in microfinance due to the prospects of the industry. Borrowing from these banks at a low interest rate could help the MFIs free themselves from capital rationing, to expand their outreach, increase loan size and reach poorer clients. Yet such borrowing is also restricted by law.

Another impact of the proclamation is that even international donors and organizations that give funds for the welfare of the poor are uncomfortable working with private for-profit companies, and Ethiopian MFIs may register as commercial enterprises only. This is a disadvantage for the MFIs since international NGOs and donors prefer maintaining direct control of their funds and refrain from advancing money to companies legally organized as commercial enterprises with registered owners, albeit nominal ones.

#### **8.4.2 Ownership and governance**

Ethiopian MFIs are dominated by two ownership types which are unique partly as a result of the regulatory constraints and partly due to the political

orientation of the ruling party. Nominal ownership and government ownership are both anomalous to the provision of the regulation which requires MFIs to be established as regulated share companies. This is an interesting aspect of Ethiopian microfinance industry. Due to the nominal nature of ownership, shareholders have no personal stake in microfinance. Most of the registered shareholders are not true owners and thus are not expected to contribute additional capital when it is needed to finance the company. Their representation of the company in the board of directors, and other affairs cannot go beyond free will. Government ownership imposes no fewer problems, as MFIs are led by government employees with many responsibilities and busy work schedules. Though there are professional managers, board members could contribute much more in strategic decisions. Our findings concerning board procedures, dedication and attendance at meetings indicate that governance of MFIs suffers from lack of appropriate accountability and defined interest representation. Board members attached to NGO-backed and government-owned institutions due to the positions they hold by appointment and employment often leave when their employment is terminated. Moreover, some organizations that are registered as shareholders can be dissolved since they are voluntary associations (e.g. a women's association or development association).

MFIs are required to be organized as a licensed share company. This drove NGO-based MFIs to become nominally represented by their employees. In the case of regional government-supported MFIs, other companies that are organized by the regional government with nominal shareholders are registered as shareholders. Amorphous institutions like youth and women's associations and regional development associations are registered as owners (shareholders). Regional government-supported (owned) MFIs are not only government owned but also party owned, as they are part of the party's economic policy implementation programmes. A significant share of such MFIs are owned by EPRDF-affiliated regional party-owned trade organizations. Thus, ownership is fragile unless the ruling party remains in power, since others, if they win the election, may not be willing to implement development programmes in line with EPRDF party ideology. We do anticipate that any new party coming to power could not afford to close the regional government-supported MFIs with their entire institutional infrastructure, public savings (which are certainly significant from individual poor households' perspectives), employees and funds

from international bilateral organizations already disbursed. However, party-owned business organizations and NGOs have a significant stake in these MFIs. Would the EPRDF be willing to work with another party, relinquishing its significant influence on the decisions of the MFIs? Would the party-owned business enterprises continue to operate if EPRDF were to lose power? If they were forced to dissolve what would be the fate of the MFIs that are considered subsidiary companies from both a business and a legal point of view? All these fears may seem far away. The last election, however, delivered a great shock to the EPRDF government. If the opposition had won country-wide, as in Addis Ababa, and the EPRDF were to accept the result, perhaps we would be discussing another version of the problem even in this thesis.

Living with the fear of the future and focusing on what is on the ground now, the impact of the current ownership and governance structure on the management of the MFIs could be challenged from practical and theoretical perspectives. Practically we observe that due to the nominal ownership, supervision of management by board members is insufficient. Meetings are not regularly held; board members have little time to attend meetings; and there is a lack of experience in the industry. A practical conclusion is that the current arrangement, which relies on the strength of the CEO and staff rather than supervision from the representatives of the owner (or the owners as board members), cannot continue if business is to expand and competition among the MFIs is implemented. If NGO and government patronage is reduced and market and business principles are followed the challenges will be obvious.

The other practical problem is the role of government in directing the operation and management of business. The Ethiopian government has not been known to pardon loans during political competition. Perhaps the environment in Ethiopia is different from that in other countries in that the EPRDF has a little to fear from political competition in rural areas. The Ethiopian government, through board members and local officials, rather systematically uses the MFIs by forcing them to extend loans including agricultural loans to areas that are not served, regardless of whether such loans are profitable. For example, in Addis Ababa and its regions, unemployed youth were targeted after unfavourable election results due to the lack of support from the urban youth. EPRDF was criticized by the opposition for deliberately indebting rural farmers and stringently enforcing

collections as a means of obtaining obedience to the party. The opposition frequently made this accusation as part of the political campaign, while the government media loudly praised the disbursement of loans to farmers and other needy groups. Government/party ownership obviously impacts MFI decisions on where they operate and which specific segment of the population to target. MFI meetings are also used as a forum for the EPRDF to disseminate party programmes, including election campaign materials. MFI activities and disbursement of loans to particular areas are sometimes given wide media coverage for political gain.

We cannot rule out the possibility of MFI funds being used for political or election purposes if there were sufficient challenges from the political parties. Currently indirect impact is sufficient, that is, in the form of increased loan disbursements rather than cancellation of debt. This is a challenge to the MFI management which they could not discuss during the interviews.

Theoretically, we could challenge the current practice of appointing board members who have little stake in the MFIs and little interest in their operations. Profit-seeking businesses should aim to maximize the value of the firm (or maximize the wealth of shareholders). Board members may not act in the best interest of the owners, whom they nominally represent. There are possible moral hazards due to an undefined principal-agent relationship. There is also a possible conflict of interest when board members are borrowers and representatives of owners, as is the case in some of the institutions. There are also currently board members who are members of several MFIs. The supervisory authorities tolerate this due to the absence of competition between the MFIs at present.

The principle of the political party owning trading business enterprises is controversial and many, especially, in the private sector oppose the practice since it may lead to corruption. Top party officials serve on the boards of the party enterprises while occupying the highest seat in government offices with privileged access to information. Thus, if there is any success in the way they lead the enterprises it is due to the information advantage as the result of their position rather than professional qualifications. On the other hand, others in the market may have to pay for that since they are not competing on the same terms. If the party were to lose in elections, which was almost the case in 2005, the continuation of party-owned business organizations could not be guaranteed. One may consider these as property

of the regional governments, which could be run by any government in power, but they effectively belong to the party now.

Management information systems are weak in general. Most MFIs process their data manually; reports are often delayed. Accounting records, including posting of interest to the ledger of the client may not always be up to date. Reporting formats from the branch to head office, on which operational and financial data are summarized, are not standardized and prepared to allow uniformity between branches. Specific monitoring mechanisms are not in place. Transparency of the reports has improved over time, and all of the MFIs were having their accounts audited by the end of the study period.

Human and material resource capacity varies among the institutions. Except for computing and transport facilities, MFI employees at the branch level do not complain about other facilities, but they do speak of low incentives and remuneration. There is a high turnover of both managerial and line workers due to deficiencies in incentives which in the long run may impair institutional viability.

## 8.5 Conclusions and policy issues

The overall conclusion is that many Ethiopian MFIs are not yet operationally and financially self-sufficient and are unable to ensure institutional sustainability. Better performance in progress towards financial self-sufficiency and outreach to clients is found for the government-owned institutions. Uniquely, these institutions have a better collection rate of loans and good portfolio quality as opposed to the commonly held view that government ownership would result in bad debts due to government political intervention by releasing debtors from loans for election purposes. The Ethiopian government's grassroot political organs are involved in the enforcement of loan repayment, except in a few cases where cliques abuse the situations. Most NGO-supported MFIs are very small and have limited outreach, with scattered operational areas following the NGO development project areas. This weakens their financial position due to the high costs involved in transport and communications.

The microfinance industry in Ethiopia is reaching a crossroad. The industry is approaching maturity in terms of age, yet most MFIs are still subsidy dependent. It has now become the policy of donors to expect MFIs to

be self-sufficient after some years of operation. If Ethiopian MFIs consider themselves permanent institutions, aiming at sustained service delivery, striving for self-sufficiency should be their priority. Financial self-sufficiency is not itself a guarantee of sustainability. MFIs require sustainable governance as well as a viable organizational and ownership structure.

In line with the above and the research findings, a number of issues could be put forward. Primarily, the regulatory framework could be made more flexible. Microfinance could benefit from the involvement of international commercial banks which bring exposure in both financial and experience terms. The industry should be allowed to freely borrow and to raise equity capital by selling equity shares. Involvement of international NGOs and international financial institutions would bring better skills in risk management, better technology and better capacity to expand outreach.

The number of MFIs operating in the country had reached 27 at the time of this study, and still more are expected. Judging from the large unmet demand estimated in this study, it should be possible to accommodate more MFIs. But observation of the existing MFIs suggests that proliferation of the institutions would add little value. This is true in view of the limited contribution of many NGO-supported MFIs. Their contribution to the outreach remained marginal, and profitability could not be achieved. It may be, therefore, advisable to strengthen existing institutions by building their capacity or merging some of the small MFIs, especially the NGO-supported ones, to gain from scale economies. This may be challenging, since NGOs may not be willing to relinquish exclusive control over their affiliated MFI. But if the NGOs aim to help the country build its institutional capacity and their common goal is to bring the country out of poverty, it should not be difficult to jointly operate an MFI.

Another option to strengthen the capacity of MFIs is the sale of additional equity to raise capital for further expansion of outreach. This may be challenged by the fact that MFIs are not yet profitable and therefore are not attractive to profit-seeking investors. Even socially motivated investors are loath to support losing institutions, as they need to see their money adds value to the welfare of the society they support.

Improvement in governance and institutional efficiency may be required to foster collaboration with international NGOs and donor agencies to build local capacity.

As to the government-owned MFIs, the will to transfer ownership rests with the ruling party. However, it is time to consider alternative ways of handling the institutions. It is important to study experiences in other countries in transferring ownership of microfinance institutions to either the public (with clients as owners), to privatize them, or to hand them over to regional governments by transferring party shares to regional governments. A thorough assessment of alternatives is required before taking action so as not to endanger the savings of the public and in the interest of providing sustained financial services to Ethiopia's poor.



# Annexes

## A-1

### *Permanent source of income for the respondents*

Respondents	First Permanent Source of Income	No.	Valid Per Cent
Non- clients	Not stated/no per. income source	2	2.6
	Crop farming	25	32.5
	Retail trade	18	23.4
	Food and drinks sales	2	2.6
	Micro and small enterprise	4	5.2
	Wage employment, labourer	16	20.8
	Horticulture	6	7.8
	Mixed	4	5.2
	<b>Total</b>	<b>77</b>	<b>100.0</b>
Clients	Not stated/no per. income source	2	.9
	Crop farming	85	38.8
	Animal husbandry	3	1.4
	Retail trade	42	19.2
	Food and drinks sales	21	9.6
	Micro and small enterprise	8	3.7
	Wage employment, labourer	15	6.8
	Horticulture	16	7.3
	Mixed	19	8.7
	Animal trade/fattening	4	1.8
	Rental income	1	.5
	Pension	3	1.4
	<b>Total</b>	<b>219</b>	<b>100.0</b>

Source: Survey data.

## A-2

*Purpose 1 for which loan funds are used*

Respondents			No.	Per Cent	Cumulative Per Cent			
a. No	Valid	a. Agricultural Inputs	8	10.4	33.3			
		c. Cattle fattening	3	3.9	45.8			
		d. Purchase of oxen	4	5.2	62.5			
		f. Trade	1	1.3	66.7			
		g. Retail trade (small scale retail s	4	5.2	83.3			
		i. Food and drinks	1	1.3	87.5			
		j. Small Scale production and handicrafts	3	3.9	100.0			
		Total			24	31.2	100.0	
		Missing System			53	68.8		
		Total			77	100.0		
b. Yes	Valid	a. Agricultural Inputs	43	19.6	22.5	22.5		
		c. Cattle fattening	36	16.4	18.8	41.4		
		d. Purchase of Fattening	16	7.3	8.4	49.7		
		e. Purchase of transport or Pack animals	5	2.3	2.6	52.4		
		f. Trade	34	15.5	17.8	70.2		
		g. Retail trade (small scale retail s	14	6.4	7.3	77.5		
		h. Petty trade	4	1.8	2.1	79.6		
		i. Food and drinks	19	8.7	9.9	89.5		
		j. Small Scale production and handicrafts	16	7.3	8.4	97.9		
		l. House construction and maintenance	1	0.5	0.5	98.4		
		n. Other purposes	3	1.4	1.6	100.0		
Total			191	87.2	100.0			
Missing System			28	12.8				
Total			219	100.0				

A-3  
Purpose 2 for which loan funds are used

Are you currently an active client of MFI?			Frequency	Per Cent	Valid Per Cent	Cumulative Per Cent
a. No	Valid	c. Cattle fattening	1	1.3	11.1	11.1
		d. Purchase for Fattening	4	5.2	44.4	55.6
		f. Trade	3	3.9	33.3	88.9
		Consumption	1	1.3	11.1	100.0
		Total	9	11.7	100.0	
		Missing System	68	88.3		
		Total	77	100.0		
b. Yes	Valid	a. Agricultural Inputs	1	0.5	2.9	2.9
		b. Horticulture	1	0.5	2.9	5.9
		c. Cattle fattening	5	2.3	14.7	20.6
		d. Purchase of oxen	7	3.2	20.6	41.2
		f. Trade	8	3.7	23.5	64.7
		g. Retail trade (small scale retail s	5	2.3	14.7	79.4
		j. Small Scale production and handicrafts	1	0.5	2.9	82.4
		l. House construction and maintenance	1	0.5	2.9	85.3
		n. Other purposes	1	0.5	2.9	88.2
		Asset loan	2	0.9	5.9	94.1
		Consumption	2	0.9	5.9	100.0
		Total	34	15.5	100.0	
		Missing System	185	84.5		
Total	219	100.0				

**A-4**  
*Number of respondents to interviews from each MFI*

		Frequency	Per Cent	Valid Per Cent	Cumulative Per Cent
Valid	ACSI	4	14.3	14.3	14.3
	DECSI	3	10.7	10.7	25.0
	GMFSC	2	7.1	7.1	32.1
	OCSSCO	4	14.3	14.3	46.4
	OMFI	4	14.3	14.3	60.7
	Peace	3	10.7	10.7	71.4
	SFPI	3	10.7	10.7	82.1
	SMFI	2	7.1	7.1	89.3
	WMFI	3	10.7	10.7	100.0
Total		28	100.0	100.0	

**A-5**  
*Status or unit in which the employee works*

		Frequency	Per Cent	Valid Per Cent	Cumulative Per Cent
Valid	Management	9	32.1	33.3	33.3
	Administrative/sup port	7	25.0	25.9	59.3
	Line staff	11	39.3	40.7	100.0
	Total	27	96.4	100.0	
Missing	System	1	3.6		
Total		28	100.0		

**A-6**  
*Educational status of the employees interviewed*

Educational status	Frequency	Per Cent	Valid Per Cent	Cumulative Per Cent
High school complete *	10	35.7	35.7	35.7
HS+ Vocational	3	10.7	10.7	46.4
Junior college/ Diploma	9	32.1	32.1	78.6
Degree (BA/BSc)	2	7.1	7.1	85.7
Above BA/Bsc	3	10.7	10.7	96.4
Special Training	1	3.6	3.6	100.0
Total	28	100.0	100.0	

**A-7***Employees with experience in other organization prior to coming to MFI*

Previous experience	Frequency	Per Cent	Valid Per Cent	Cumulative Per Cent
Yes	18	64.3	64.3	64.3
No	10	35.7	35.7	100.0
Total	28	100.0	100.0	

**A-8***Relevance of previous experience in other organization to current position*

Relevance		Frequency	Per Cent	Valid Per Cent	Cumulative Per Cent
Valid	Relevant	10	35.7	55.6	55.6
	Irrelevant	8	28.6	44.4	100.0
	Total	18	64.3	100.0	
Missing	System	10	35.7		
Total		28	100.0		

**A-9***Current responsibility in line with qualification and experience*

		Frequency	Per Cent	Valid Per Cent	Cumulative Per Cent
Valid	Yes	22	78.6	78.6	78.6
	No	6	21.4	21.4	100.0
	Total	28	100.0	100.0	

**A-10***Number that received skill upgrading training since joining the MFI*

		Frequency	Per Cent	Valid Per Cent	Cumulative Per Cent
Valid	Yes	17	60.7	60.7	60.7
	No	11	39.3	39.3	100.0
	Total	28	100.0	100.0	

**A-11***How far did training help in discharging responsibility?*

Helped		Frequency	Per Cent	Valid Per Cent	Cumulative Per Cent
Valid	very much	6	21.4	30.0	30.0
	Fairly	12	42.9	60.0	90.0
	had no relevance to my job	2	7.1	10.0	100.0
	Total	20	71.4	100.0	
Missing	System	8	28.6		
Total		28	100.0		

**A-12***Is mission and objective of your organization clear to you?*

		Frequency	Per Cent	Valid Per Cent	Cumulative Per Cent
Valid	yes sufficiently clear	23	82.1	82.1	82.1
	fairly clear	4	14.3	14.3	96.4
	not clear	1	3.6	3.6	100.0
	Total	28	100.0	100.0	

**A-13***Do you take part in meetings with management of the institution?*

		Frequency	Per Cent	Valid Per Cent	Cumulative Per Cent
Valid	Yes some times	15	53.6	53.6	53.6
	Yes regularly	9	32.1	32.1	85.7
	never	4	14.3	14.3	100.0
	Total	28	100.0	100.0	

**A-14***Is there clear policy and procedure manual in your area of responsibility?*

		Frequency	Per Cent	Valid Per Cent	Cumulative Per Cent
Valid	Yes	26	92.9	92.9	92.9
	No	2	7.1	7.1	100.0
	Total	28	100.0	100.0	

**A-15**

*Are the facilities used sufficient to discharge your responsibilities?*

Sufficient		Frequency	Per Cent	Valid Per Cent	Cumulative Per Cent
Valid	Yes	8	28.6	29.6	29.6
	No	19	67.9	70.4	100.0
	Total	27	96.4	100.0	
Missing	System	1	3.6		
Total		28	100.0		

**A-16**

*Is the organizational structure sufficiently clear defining your responsibility, accountability, and line of command?*

Clear?		Frequency	Per Cent	Valid Per Cent	Cumulative Per Cent
Valid	Yes	17	60.7	68.0	68.0
	No	8	28.6	32.0	100.0
	Total	25	89.3	100.0	
Missing	System	3	10.7		
Total		28	100.0		

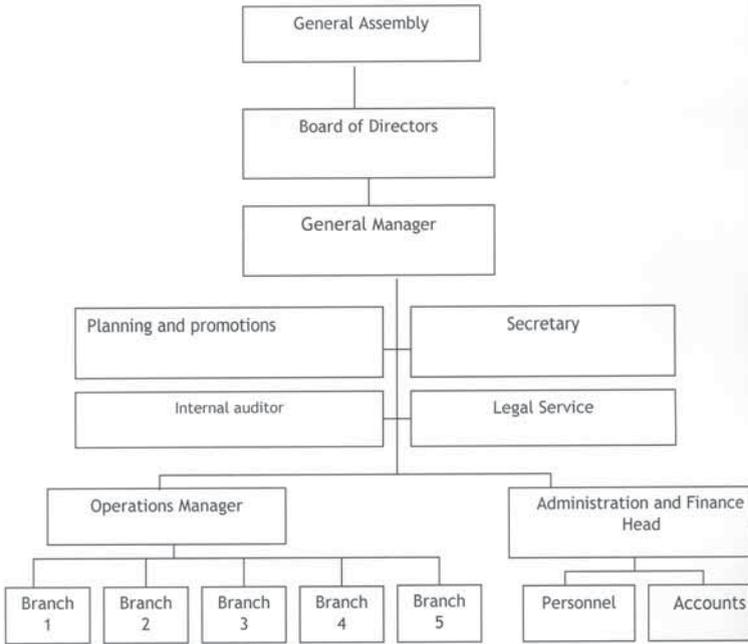
**A-17**

*Do you think there is a need to improve organizational structure, policy, and service to clients?*

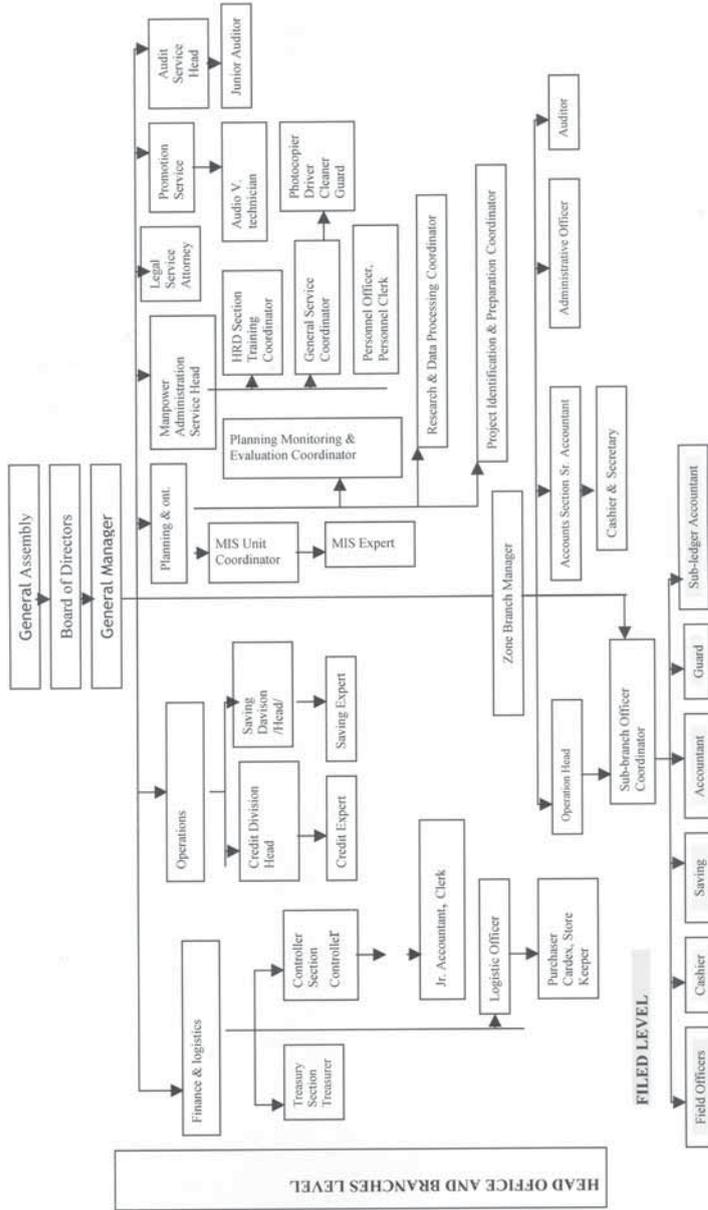
Need improvement		Frequency	Per Cent	Valid Per Cent	Cumulative Per Cent
Valid	Yes	24	85.7	88.9	88.9
	No	3	10.7	11.1	100.0
	Total	27	96.4	100.0	
Missing	System	1	3.6		
Total		28	100.0		

**A-18**

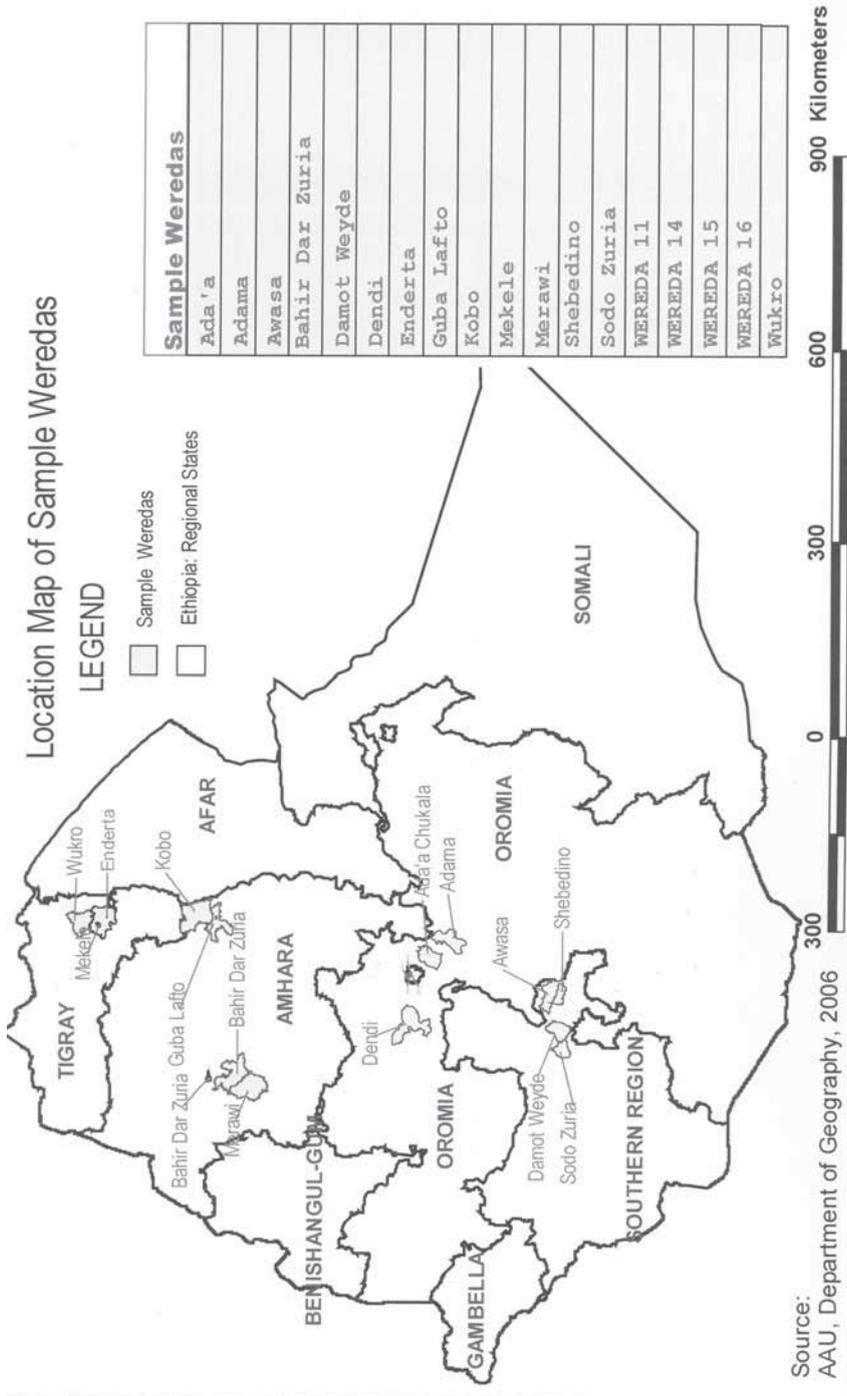
*Typical organizational structure of small sized MFI: Gasha Microfinance Share Company (one of the smallest MFIs), 2003*



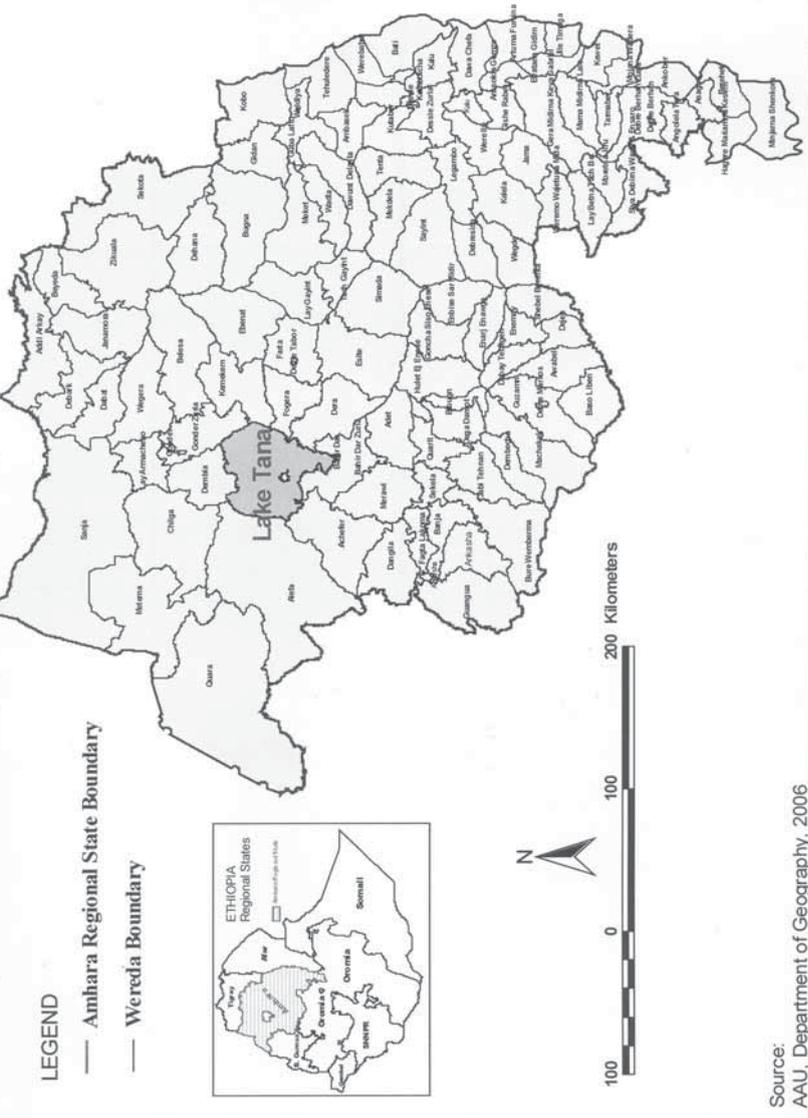
A-19: Organizational Structure of ACSI (largest MFI in branch net work and client population), 2003



Map A-1: Location of sample weredas



Map A-2  
Amhara Regional State Wereda Map (ACSI Service Area), 2006





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