

MicroNed

**ETHIOPIA
MICROFINANCE COUNTRY SCAN**



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PREFACE

The Ethiopia country scan presents an overview of the current state of the Ethiopian microfinance sector and will serve as the basis for shaping the future microfinance investment strategy in Ethiopia under the auspices of MicroNed.

One of the key challenges encountered during this country scan development is the lack of adequate basic data. This could be attributed to the youthful nature of the formal microfinance industry in Ethiopia coupled by very recent enactment of the relevant regulatory laws in Ethiopia, particularly savings and credit co-operatives. Further studies and regular updates of this scan in the future are therefore necessary.

The content, structure and format of the original version of this country scan was slightly altered by MicroNed's Ethiopia country group team with permission from the author. The section on the savings and co-operatives sector is attributed to an additional research that was undertaken by ICCO/Terrafina.

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INTRODUCTION

In June 2005, the directors of four major Dutch development finance organizations (DFOs) decided to cooperate on a structural basis with respect to the establishment of a specialized sector approach for microfinance. This cooperation aims at supporting emerging microfinance institutions (MFIs). The four agencies, ICCO, Cordaid, Hivos and Oxfam-Novib, formalized the new facility under the name of MicroNed.

In recognition of the fact that capacity building at the bottom side is a blind spot, which is currently grossly underserved, MicroNed intends to position the DFOs as lead players for that segment within the *Dutch Offer*¹ for microfinance; to organize the microfinance support of Dutch DFOs in such a way that it can meet the challenges in a result oriented way; and to improve the efficiency of service delivery to MFIs.

MicroNed intends to support its members to create a coherent support package targeted at capacity building and institutional reinforcement of emerging MFIs. Given the nature of its support package, the focus of MicroNed is primarily on grants. Its members will complement these instruments with loans, guarantees or equity participations where this is possible and appropriate.

A first step towards enhancing cooperation and formulating support packages is the production of country microfinance scans with a view of identifying investment opportunities relevant for filling gaps between supply and demand in the realm of capacity building. This Ethiopia scan is the first in a series that will extend to all countries targeted by MicroNed.

This scan was prepared by Blue Rhino Consult BV and the Association of Ethiopian Microfinance Institutions (AEMFI). It was commissioned by MicroNed and funded by Oxfam-Novib.

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¹ The so-called *Dutch Offer* is the collective investment package of all Dutch institutions active in supporting microfinance. Apart from the four DFOs, these include banks, investment funds, the Netherlands government and various other institutions. Together they operate under the name of Netherlands Platform for Microfinance (NPM; www.micro-finance.nl)

TABLE OF CONTENTS

PREFACE	2
INTRODUCTION	3
TABLE OF CONTENTS	4
1. GENERAL INFORMATION	5
1.1 Historical Background	5
1.2 Dimensions of Poverty	5
1.3 Poverty Alleviation Strategies	7
1.4 Role of Microfinance	8
2. THE FINANCIAL SECTOR	9
2.1 Introduction	9
2.2 Banking Sector	9
2.2.1 Formal Banks	10
2.3 The Microfinance Sector	10
2.3.1 The Era of regulation.	10
2.3.2 The Rules of the Game	11
2.3.3 Supervision	13
2.4 The Co-operatives Sector	13
2.5 Non-Governmental Organisations (NGOs)	14
2.6 Informal Financial Sector	15
3. THE MICROFINANCE SERVICES	16
3.1 General Characteristics of the MFI Sector	16
3.1.1 Appreciation	16
3.1.2 Loan Capital	16
3.1.3 Investment Capital	17
3.1.4 Ownership, Profit and Expansion	18
3.1.5 Governance	20
3.1.6 Product Range	20
3.1.7 Human Resource Development	21
3.1.9 Regulation and Supervision	22
3.2 Microfinance Service Providers.	22
3.2.1 Overview	22
3.2.2 Financial Performance	23
3.2.3 Social Performance	24
3.2.4 Profitability and Cost Levels	26
3.2.5 Efficiency and Productivity	26
3.2.6 Risk and Liquidity	27
3.2.7 Economic Performance	28
3.3 Savings and credit co-operatives Providers	28
3.3.1 Overview	28
3.3.2 Financial Performance	30
3.3.3 Protection	31
3.3.4 Effective Financial Structure	31
3.3.5 Rates of Return and Costs	31
3.4. Support and Funding Needs	32
3.4.1 Capital Funding Needs.	32
3.4.2 Management Information Systems (MIS) and Information Communication Technology (ICT)	32
3.4.3 Research & Development (R&D) and Training Facility.	33
3.5 Donors and Investors.	34
3.5.1 Overview	34
3.5.2 The Current State of Affairs.	35
4. ACTORS ON SECTOR LEVEL - The Association of Ethiopian Microfinance Institutions (AEMFI)	37
5. CONCLUSION AND RECOMMENDATIONS	38
5.1 Strategic Considerations	38
5.2 A New leverage Mechanism.	39
6. REFERENCES	41

1. GENERAL INFORMATION

1.1 Historical Background

Ethiopia is one of the oldest nation states in the world, Amharic is the African language with the longest written history, and throughout its thousands years of history the country has maintained its independence with only brief spells of foreign dominance and colonialism. Ancient Abyssinia was home to the legendary Queen of Sheba in the 10th Century BC and another royal, Ras Tafari, was arguably the most famous African monarch since he assumed the throne in 1928 as Emperor Haile Selassie until he was deposed in 1974.

Apart from being the oldest African nation state and one of the largest, Ethiopia is also one of the poorest. Essentially feudal and archaic in character, the monarchy failed to transform the country into a modern state and after the famine of 1973 the problems in the country became numerous. The army took over in 1974 and started a radical reform process which only increased the chaos in the country. After the suppression of an Eritrean rebellion in 1975, a country absorbed by Ethiopia after the defeat of Italian forces in World War II, a hardliner military dictatorship under Mengistu Haile Mariam took over in 1977. In 1991 a force of combined regional liberation movements toppled this Derg regime. The new constitution of 1994 federalized the country and allowed for secession of regional states. Eritrea seceded after a referendum in 1993, but border disputes evolved in a full-fledged war between 1998 and 2000.

The erstwhile liberation movements that drove out the Derg still dominate political life through their coalition party. Their landslide electoral victory in 2000 was followed by a much thinner one in 2005 which led to political tensions, particularly in urban centres. The ruling party holds on to a socialist development perspective but with piecemeal liberalization of key economic sectors. Dramatic decisions of the Derg regime, such as collectivization of land and nationalization of the banking sector, have not been revoked to date and agricultural production was long expected to drive economic development under the slogan *agricultural led industrialization*.

Whereas in other developing countries the international donor community typically demands rigorous public sector reforms and full liberalization of the economy as a precondition for substantial aid packages, the Ethiopian government has well managed to escape taking this standard recipe. This can only be explained by pointing to its strong commitment to poverty alleviation which has resulted in a robust leverage mechanism to continue its otherwise seemingly outdated state driven economic planning process.

1.2 Dimensions of Poverty

Though this may run entirely against currently popular economic theory, the government at face value has good reasons to massively direct public resources to poverty alleviation: larger parts of the country are strikingly under-developed. Poverty is perpetuate and dynastic: whereas in developing countries parents may hope and work for a better future for their children, in non-developing countries such as Ethiopia they have to fear that their children will actually be worse off. The reason for that is the interaction of a number of persistent poverty traps.

TABLE 1: POVERTY STATISTICS PEOPLE	2002	2003	2004
Total Population	64.3m	68.6m	70.0m
Annual Population Growth	2.4%	2.1%	1.9%
Poverty Ratio National Poverty Line	44.2%	Na	Na
Life Expectancy At Birth (Years)	42.3	32.3	42.5
Fertility Rate (Birth Per Women)	5.7	5.5	5.4
Mortality Rate Infants (Per 1000 Births)	116.0	Na	110.4
Mortality Rate Under 5 (Per 1000)	176.0	Na	166.4
Births Attended By Skilled Health Staff	5.6%	Na	Na
Malnutrition Prevalence, Weight For Age (Children Under 5)	47.2%	Na	Na
Immunization Measles (Children 12-23 Months)	52.0%	59.0%	71.0%
Prevalence HIV (Population 15-49)	Na	4.4%	Na
Primary Completion (Relevant Age Group)	36.7%	49.6%	50.6%
School Enrolment, Primary	63.4%	72.8%	77.0%
School Enrolment, Secondary	17.5%	25.4%	27.8%
School Enrolment, Tertiary	1.1%	2.2%	2.5%
Ratio Of Girls To Boys In Primary And Secondary Education	65.1%	69.4%	72.8%
Literacy Rate Adults (15 Years And Above)	Na	Na	Na

The first is the interaction of poverty and population pressure with the productive resource base. Unprecedented population pressure has turned average agricultural plot sizes from 0.50 ha in the 1960s to 0.11 ha at the turn of the millennium. This has rendered traditional farm techniques largely inadequate to sustain rural families and led to progressive deterioration of assets. And whereas in the past this process could be partially remedied by movement of families to less populated areas, today the limits of useable land have been reached, forcing farmers to move further onto less productive and more fragile lands.

TABLE 2: POVERTY STATISTICS ENVIRONMENT	2002	2003	2004
Surface area (sq. km)	1.1M	1.1M	1.1M
Forest area (sq. km)	137.1K	NA	NA
Agricultural land	30.7%	31.8%	NA
CO2 emissions (metric tons per capita)	0.1	NA	NA
Improved water source (% of population with access)	NA	NA	NA
Improved sanitation facilities, urban	NA	NA	NA
Energy use (kg of oil equivalent per capita)	291.1	298.9	NA
Energy imports, net (% of energy use)	6.1%	7.89%	NA
Electric power consumption (kWh per capita)	23.4	30.1	NA

A second perpetuating poverty trap is the link between poverty and low investment in human capital. Most families can not invest in the education of their children; not only because the direct costs are prohibitive, but also because all family members are required to contribute to the family income by way of low-margin economic activities such as fetching water and firewood. Low-margin economic productivity does not allow for asset accumulation and, hence, education.

TABLE 3: POVERTY STATISTICS <i>ECONOMY</i>	2002	2003	2004
Gross National Income (GNI, Atlas method), USD	6.8B	6.3B	7.6B
GNI per capita, USD	110.0	90.0	110.0
Gross Domestic Product (GDP), USD	6.5B	6.5B	8.0B
GDP Growth	6.0%	-3.9%	12.1%
Inflation (GDP deflator)	2.9%	12.5%	9.5%
Agriculture (value added, % of GDP)	47.6%	43.0%	46.9%
Industry (value added)	9.4%	10.2%	9.5%
Services (value added)	42.9%	46.8%	43.6%
Exports of goods and services (% of GDP)	15.1%	17.6%	18.7%
Imports of goods and services	30.0%	36.1%	39.6%
Gross capital formation (% of GDP)	15.9%	21.0%	21.2%
Revenue, excluding grants (% of GDP)	NA	NA	NA
Cash surplus/deficits (% of GDP)	NA	NA	NA

Third, low levels of rural infrastructure lead to underdeveloped markets, high transaction costs and low returns. Even if agricultural production is high, farmers can not bring it to the market for lack of transportation or sheer absence of functioning markets, and not get a fair price because of lack of storage and processing facilities. Lack of functioning markets and transportation systems also prevent the private sector to invest in agriculture as initial investment levels are too high. Related to this is the low-risk, low-return trap. Farmers can not invest in crop diversification or production enhancement facilities as they have insufficient cash, lack extension services and face unpredictable outcomes. As a result, they get stuck in subsistence farming and cannot engage in more lucrative cash crop farming.

TABLE 4: POVERTY STATISTICS <i>STATES AND MARKETS</i>	2002	2003	2004
Time required to start a business (days)	NA	44.0	32.0
Military expenditure (% of GDP)	9.5%	5.4%	4.3%
Fixed line and mobile phone subscribers (per 1000 people)	3.9	7.8	NA
Internet users (per 1000 people)	0.2	1.1	1.6
Roads, paved (% of total roads)	12.0%	12.9%	NA
High technology exports (% of manufactured exports)	0.1%	0.2%	NA

A last trap is the early childhood nutrition problem. Widespread malnutrition in early life affects mental and physical development and limits lifetime potential and productivity, which in turn creates low-income, low-consumption households, not able to improve nutrition for the next generation.

TABLE 5: POVERTY STATISTICS <i>GLOBAL LINKS</i>	2002	2003	2004
Merchandise trade (% of GDP)	26.8%	40.8%	46.5%
Net barter terms of trade (2000 = 100)	100.0	88.5	90.8
Foreign direct investment, net inflows, USD	134.6M	465.0M	545.1M
Long terms debt, USD	5.3B	6.9B	6.4B
Present value of debt (% of GNI)	NA	NA	30.4%
Total debt service (% of exports, services and income)	13.0%	7.0%	5.3%
ODA, USD	693.0M	1.6B	1.8B
Remittances, USD	53.0M	46.5M	133.4M

Source Tables 105: *World Development Indicators*, April 2006

1.3 Poverty Alleviation Strategies

In line with World Bank procedures for developing countries aspiring to access comprehensive international aid packages, Ethiopia also produces so-called Poverty Reduction Strategy Papers (PRSPs). These basically define the national

development agenda and set priorities and targets. The first one covered the period 2001-2004 and was named Sustainable Development and Poverty Reduction Program (SDPRP). Last year a new one was formulated for the years 2005-2010 under the title Plan for Accelerated and Sustained Development to End Poverty (PASDEP).

Although PASDEP is presented as a logical sequel from SDPRP, at crucial junctures it departs from some rigidity included in the latter. Whereas Ethiopia averaged 5.0% economic growth during the last years, a substantial part thereof was absorbed by population growth of 2.9% per annum. The resulting 2.1% net economic growth is insufficient to accelerate economic development. Moreover, economic growth was largely achieved in urban sectors of the economy; farmers, representing 85% of the population and 90% of the country's poor, hardly saw their income or resource base improve. Between 6 and 13 million face the risk of starvation every year.

Consequently economic growth has to be considerably accelerated. This is only possible by giving more prominence to the private sector as well as by stimulating further growth of the higher yielding economic sectors such as mining, cash crops and tourism. A new priority therefore is to improve the conditions for private sector investments. For rural areas this translates into stimulating a shift to higher-valued crops, export oriented crop diversification, creation of off-farm employment, infrastructure works to link producers with markets, area irrigation through multi-purpose dams and measures to improve land tenure systems and introduction of large-scale commercial farming.

Whilst allowing and stimulating private sector based commercial farming and off-farm development, the government continues to improve subsistence farming aimed at substantial increase of grain production to create food security. This is expected to be achieved through upgrade of extension services, demonstration centres, low-level veterinary services, small-scale irrigation and better use of ground water.

1.4 Role of Microfinance

Ethiopia is one of only few countries that have prominently included microfinance in their PRSPs. Already in the old SDPRP the provision of micro-loans was considered crucial for rural development, particularly to support subsistence farmers accessing farm inputs such as seeds, fertilizer and production tools. It expected Microfinance Institutions (MFIs) to focus on that, and in fact, a regulatory framework was already designed in 1996 to ensure the microfinance industry's allegiance to this national objective.

Since approximately three years, and parallel to preparing the new PASDEP, MFIs were stimulated to diversify service delivery and also include loan delivery to rural micro and small businesses. This is thought to stimulate value addition to agricultural production and, ultimately, to increase farmers' income.

2. THE FINANCIAL SECTOR

2.1 Introduction

The origins of Ethiopia's financial sector date back to 1905 when the first commercial bank was established, followed by a development bank, the first branch office of an international bank and the first insurance company in 1922. During the Italian occupation only Italian banks were allowed to operate, only to disappear again after independence was regained. In 1943 the State Bank of Ethiopia (SBE) was founded which combined commercial with central banking functions. Two years later the Agricultural Bank of Ethiopia was established and in 1951 the Investment Bank was founded. Between 1943 and 1963 all banking activity was nationalized and dominated by the SBE. Lack of competition characterized this period.

As of 1963 the banking was liberalized. A specialized central bank emerged from the SBE, the Commercial Bank of Ethiopia (CBE) was founded, foreign banks were allowed to set up joint ventures with local banks, private banking was allowed, a stock market emerged and various insurance and mortgage companies came into being. This liberalization process ended abruptly in 1974. All banks and finance companies were nationalized once more, along with nearly all larger private companies, state-owned CBE came to dominate the market and the central bank, the National Bank of Ethiopia (NBE) became the 'fiscal arm' of the new military government.

As of 1991 the pendulum started moving back again, albeit at low speed. In fact, fifteen years later the banking sector is still in the midst of a reform process though progress has been made. Private banks are allowed again, and have been established in the meantime, state-owned banks are increasingly independently managed, foreign exchange controls are being relaxed, interest rates have been gradually liberalized and the NBE has become a genuine central bank once more. The slow speed of reform is generally associated with the government's objective to expand the delivery of financial services to the rural areas, a task it cannot yet entrust to the private sector to take up. A fair characteristic of the reform process, therefore, is gradual and careful liberalization.

While this protective policy may be in line with overall national objectives, the results are clearly visible: the banking sector shows many inefficiencies, interest rates of public banks are well below commercially viable levels, provision of financial services to rural areas is still largely inadequate and the relationship between the NBE and the government is ambiguous.

2.2 Banking Sector

The banking sector is still dominated by state-owned banks: the Commercial Bank of Ethiopia (CBE), the Development Bank of Ethiopia (DBE) and the Construction and Business Bank (CBB). Together these three banks control roughly 90% of all assets in the banking industry, although this percentage is slowly decreasing with the entrants of private banks. CBE is the real giant with control of well over two-thirds of all assets. The world giant is deceptive though; as per June 2005 total capitalization of the banking sector stood at EBR 3.3 billion or roughly EUR 330 million whereas the overall asset base was only EUR 4 billion, of which only 50% was outstanding. Banks take in substantial more savings than they need for credit delivery, at EUR 3.3 and 2.0 billion respectively, indicating a rather excessive liquidity build-up.

In comparison, the microfinance sector is relatively large. Its collective loan balance is rapidly approaching 10% of the volume of the formal banking sector. Its major problem is that savings intake only covers just over one-third of the loan capital.

TABLE 6: NATIONAL VOLUME SAVINGS AND LOANS

Indicator	Formal banks		Microfinance Institutions	
	06/2005		12/2005	
Currency	EBR	EUR	EBR	EUR
Total loan balance	20,308,900,000	1,846,264,000	1,622,107,210	147,464,000
Total savings balance	33,793,320,000	3,072,120,000	600,689,122	54,608,000

Next to formal banks and microfinance institutions, other service providers are active in the country. These are savings and credit as well as multipurpose cooperatives, informal or semi-formal financial systems, and individual service providers such as moneylenders, traders, friends and relatives. On top of that both government and international development programs occasionally include credit facilities.

2.2.1 Formal Banks

Ethiopia now counts ten formal banks: six private banks (Awash, Dashen, Wegagen, Abyssinia, United and NIB), three government banks (CBE, DBE and CBB) and one cooperative bank (Oromia Cooperative Bank).

Although excessively liquid, most formal banks to date have not become involved in microfinancial services. Direct involvement, retail service delivery, is not considered opportune due to the limited rural distribution capacity in place. All state-owned banks together have little more than 200 branches and private banks have less than 100 outlets. The vast majority of all branches are located in urban centers. Moreover, both public and private banks consider microfinance to be costly and risky. This also prevents them to become involved indirectly by way of providing wholesale loans to established MFIs. Despite government pressure and sympathy for the microfinance cause, and although losing money on their current liquidity positions, formal banks find it hard to structure deals with MFIs. Typically they would ask up to 100% security in the form of collateral or guarantees, which condition MFIs are not able or willing to meet.

This reluctance to become involved is directly connected with increased supervision by the National Bank of Ethiopia. To enhance performance levels of government banks, fairly independent management has been installed and banks are required to demand full collateral for their outstanding loans, including those to MFIs.

2.3 The Microfinance Sector

2.3.1 The Era of regulation.

Since 1996 Ethiopian microfinance is regulated on the basis of Proclamation Nr 40/1996 for Licensing and Supervision of Microfinance Institutions. The National Bank of Ethiopia (NBE) is authorized to license, regulate and supervise MFIs, which are required to be incorporated under Section 304 of the Commercial Code of the country as for-profit share companies, wholly owned by Ethiopian nationals or organizations owned by Ethiopian nationals.

Regulation followed a major survey ACIDI/CEE of microfinance activities in 1995; at that time largely provided by development NGOs. The study revealed various

shortcomings; the ones more commonly associated with NGO credit delivery: lack of sustainability perspective, too low interest and repayment rates, undercutting of a healthy credit culture and inappropriate products and services. Thus study as well as other ones conducted at the same time advised the government to formulate performance standards for all credit providers.

Building sustainable financial institutions was accordingly considered by the government as a first priority for the microfinance industry. A next one was to build a genuine national microfinance industry. And, equally important, the old instrument of directed credit delivery was included in the regulation package. The government wanted MFIs to serve the rural subsistence farmers, as they represented the vast majority of the country's poor; microfinance had to play an important role in the national poverty reduction agenda.

Existing service providers were required to cease all activities and apply for a license under the new format. That regulation was clearly intended to create a new class of players may follow from the fact that the first four newly licensed MFIs were all regional government related, two of which were established well before new regulation became effective, and that it took erstwhile credit NGOs some time to transform into MFIs. The first three MFIs were established using a similar shareholding structure: the regional governments of Tigray, Amhara and Oromia took a 25% share in DECSI, ACSI and OCSSCO respectively, whereas the remaining shares were distributed over government related development NGOs, youth and women associations and, in the case of OCSSCO, some individuals. The fourth government related institution was Omo MFI where regional government took up 80% of all shares. In 2000 and 2001 three other of such entities were established in Addis, Dire and Benishangul with local government involvement of 96, 97 and 40% respectively.

SFPI and Gasha were the first converted NGO based MFIs, later followed by Sidama, Asser, Buussa Gonofa, PEACE, Meklit, ESHET and Wassasa. In all these cases the mother NGO is a main shareholder. Alternatively, NGO capital was brought in through individuals acting by proxy on behalf of these NGO, such as Wisdom, Africa Village and Mekket.

2.3.2 The Rules of the Game

Capitalization levels for new MFIs are modest at EBR 200,000 or just over EUR 18,000. This facilitates market entry of new MFIs. Right from the start MFIs are allowed to collect savings from the general public to boost portfolio growth. However, if savings intake passes the EBR 1 million mark, MFIs have to re-register with the NBE. This process involves further scrutiny of liquidity and capital adequacy ratios and more demanding reporting requirements, but exempts MFIs from maximum loan sizes and amortization terms.

Proclamation 40/1996 states that loans are delivered to clients based on group guarantees with no property collateral. MFIs are nonetheless allowed to pioneer new lending methodologies such as individual lending based on real collateral, as long as it remains of limited proportion. Such proportion is arranged for in NBE Directive MFI/05/1996 by way of capping maximum loan size at EBR 5000. A later directive, MFI/17/2002, removed this cap partly: MFIs that have passed the 1 million savings mark are free to set loan sizes, but loans over EBR 5000 should not exceed more than 20% of total disbursements. Any individual client can not access loans larger than 0.5% of the MFI's total capital. Directive MFI/05/1996 also included a clause prohibiting amortization period over twelve months. The later directive extended this period to 24 months for loans up to EBR 5000 and 60 months for loans above that amount.

NBE Directive MFI/09/1995 capped interest rates at maximally 2.5% above rates charged by formal banks; likewise a minimum savings interest rate was established at no less than 1% higher than what banks offered their clients. Interest calculation methodology, flat or declining balance, was not specified in the directive. In June 1998 the NBE removed the interest rate ceiling. In the same year the minimum interest over savings was reduced to 6% and in 2002, per Directive MFI/13/2002, to 3% per annum for MFIs and banks alike.

Proclamation 40/1996 allows MFIs to deliver credit, take savings as well as time and demand deposits and engage in other activities customarily undertaken by MFIs, without specifying those. In practice MFIs limit their operations to credit and savings, although some have pioneered money transfer, insurance and remittance activities.

Regulation calls for quarterly reporting to the NBE, directive MFI/07/1996. In practice few MFIs do so for a variety of reasons: sheer size and volume of activities covering entire regional states, limited functionality and capacity of management information systems, often compounded by absence of adequate communication and transportation facilities at branch level and also because regular on-site supervisory trips by the NBE are not as regular as they were supposed to be. It would appear that the NBE does not act on this non-compliance as long as the industry at large reports on an annual basis through AEMFI and MFIs send their externally audited annual statements in time; that is within six months of closure of the fiscal year. Nearly all MFIs comply with this rule.

All MFIs can open as many branches as they like and wherever they like, provided they inform the NBE in writing. Closure of branches, however, requires formal approval of the central bank, at least three months before actual closure.

Taxation is a grey area in the industry. Declaration 40 hands all responsibility to the Ministry of Finance to declare the tax status of MFIs. As few MFIs filed profits, none has ever paid company taxes or, in fact, any form of tax at all. Their argument is that they work for poverty reduction which should automatically be subject to tax exemption. It would appear that the Ministry does not subscribe to this view as it recently requested some MFIs to pay taxes over income on savings and profits. Currently the issue is subject of discussion between AEMFI and the Ministry.

The NBE issued a directive on provisioning in 2002, No. MFI/17/2002, calling for 25% provisioning for past due 91-180 days (sub-standard), 50% for past due 180-365 days (doubtful) and 100% over past due over 365 days (loss). The same directive requires re-registered MFIs, those collecting more than EBR 1 million in savings, to deduct any deposit held as security against the balance of non-performing loans.

The capital adequacy ratio for MFIs, re-registered MFIs only that is, was set at 12% by Directive MFI/16/2002, measured in the risk-weighted assets to total capital ratio, against 8% for formal banks. Directive MFI/15/2002 requires re-registered MFIs to maintain at all times at least 20% of their total savings in liquid assets. Formal banks have to keep 15% in liquidity, but with the NBE in the form of treasury bills, deposits and other short term assets that can be quickly liquidated.

Lastly, Declaration 40/1996 mentioned a penalty system for non-compliance with regulatory directives and in Directive 14/2002 the NBE announced that a MFI

could be charged with penalty fees in case of non-compliance, that the central bank could remove the chief executive director or, ultimately, revoke a MFI's license.

2.3.3 Supervision

In general, supervision of MFIs by the NBE has not been very efficient and effective. In fact, it can be argued that the industry is predominantly self-regulated through AEMFI as well as by MFI board members representing demanding shareholders.

The problems faced by the NBE in exercising effective supervision were manifold: lack of a coherent and appropriate supervisory vision against which to formulate its directives, poor organization of microfinance supervision within the central bank, inadequately qualified staff and inadequate resources to pay on-site visits to NGOs. In the context of Ethiopia it faced another obstacle in the form of the complicated balancing act between social and financial objectives that characterize the market. Some MFI shareholders can exercise considerable political leverage which is rarely applied in practice but possibly inspires the NBE to move with great caution.

Two developments appear to result in stronger and appropriate supervision. First, AEMFI is widely considered to speak on behalf of the microfinance sector at large and it is engaged in formalized discussions with the NBE to upgrade supervision. AEMFI's position is not to move towards relaxation of directives, but in fact towards stronger supervision albeit based on the objective of building strong financial institutions. The network is in favour of installing stronger risk management policies and internal controls to more effectively implement prudential regulation in the industry. Though most MFIs perform fairly well if not excellent, not all do and the network has developed little tolerance for sub-standard performance among its member organizations.

Second, under the terms of the Rural Financial Intermediation Program (RUFIP), which will be discussed below in more detail), the NBE is entitled to receive a comprehensive resource package to strengthen its own supervisory capacity.

2.4 The Co-operatives Sector

Ethiopia has a relatively short history of cooperatives in the country. The first legal framework for cooperatives was enacted in 1960 through the Farm Workers Cooperative Decree which was followed by a more comprehensive legal framework for the development of cooperative societies in 1966. By the end of 1973, 83 cooperatives were established.

In 1974, massive collectivization took place under the military government, resulting in a vast growth of state controlled urban and rural based cooperatives of different types. By the end of this era several thousands of such cooperatives were established. Agricultural production and marketing was undertaken by government established cooperatives.

Since 1991 the organization of cooperatives again changed in the sense that existing organizations were restructured to operate in accordance with principles of cooperation such as voluntary formation, business orientation and self regulation. Promotion of new cooperatives, especially multipurpose cooperatives also took place as a strategy for socio-economic development particularly in the rural areas. Currently the total number of cooperatives is 19,000 with a

membership of 4.5 million people. Female participation in cooperatives is low with about 10% of the members being women.

Following the regime change in 1991 a cooperative desk was established in the Office of the Prime Minister together with cooperatives bureaus at regional level and in major cities. The desk at the Prime Minister's office was transformed into a federal Cooperative Commission in 2002. Two years later the Commission was transferred to the newly created Ministry of Agriculture and Rural Development.

Type	Number	Membership	Average member size
Overall	20.406	4.642.034	227
Savings and credit	5.437	381.312	70
Rural SACCO's	1.166	64.655	

The number of savings and credit cooperatives has doubled since 2004. The number of Rusacco's is still much smaller and with much lower membership of only 65.000 in the whole of Ethiopia, however the growth in membership of Rusacco's over the last 2 years has been almost 300% (membership in 2004 was 16.500). Regional distribution of Rusacco's varies a lot with most of the Rusacco's concentrated in Addis Ababa and Oromya.

Currently RUSACCOs, but also other Community Based Organizations (CBOs), are considered as potentially interesting outlets for microfinance services. Their self-governed and self-managed character allows for lower transaction costs, and they are progressively seen as a useful extension mechanism for MFIs in more remote rural areas. There are efforts under way to create a special form of regulation for SACCOs and some established MFIs are indeed exploring working relations with SACCOs, who, under the terms of such arrangements, would act as agents for these MFIs. It should be noted that Rusacco's are mostly savings rather than credit driven and in this respect they differ from MFI's.

2.5 Non-Governmental Organisations (NGOs)

Although financial service delivery in Ethiopia by non-regulated institutions is legally prohibited, there is a persistent tradition of NGOs, notably International NGOs, to include credit schemes in their broader aimed development programs. Consecutive studies have observed that such NGO credit delivery generally does not follow sound, sustainable and responsible practices and negatively affects the work of established MFIs, not only by unfair competition but more so by undercutting a healthy credit culture.

In fact, overall dismal performance of NGO credit was the major reason for the government to overhaul the entire microfinance landscape by introducing regulation in 1996. Whereas all national NGOs were forced to end their credit programs and apply for a formal MFI license, international NGOs such as CARE and Women Development Fund (funded through World Bank) just continued their operations undisturbed.

This is a sensitive issue in Ethiopian microfinance for two reasons. Apart from having to deal with an unlevelled playing field, regulated MFIs take offense in seeing international NGOs willingly ignore the laws of the country that hosts them. At political level this practice is frowned upon as well, but little remedial action has been taken as yet; most likely to not jeopardize international funding levels, 6.5% of GDP in fiscal 2005-2006, but also because total outreach of NGO

is quite limited and just a fraction of overall outreach, although, typically perhaps, formal NGO outreach figures are not available.

To deal with criticism that occasionally hits them, NGOs now present their credit programs as authentic community based operations. A closer look at any of these CBOs, however, will usually show that there is little authenticity about them.

The emergence of MFI's established by local indigenous mother NGO's is a relatively recent phenomena (since 5 years). After initial establishment problems these MFI's begin to grow into medium size MFI's with good track record and performance on financial as well as social aspects. Notably they can operate quite independent from government interference.

2.6 Informal Financial Sector

Ethiopia counts three larger home-grown informal systems: *Iddir* (*Mode* or *Kire* in Oromian) provide financial assistance in time of mourning, *Iqqub* are essentially cash or kind savings organizations and the *Meskel Aksiyon* are neighbourhood groups mobilizing cash to purchase meat for the religious *Meskel* festival. A larger household survey conducted in 2004-2005 in four regional states concluded that in the informal market, 35% of clients borrow from friends or relatives, 48% from individual money lenders, 15% from *Iddir* and 2% from *Iqqub*; approximately 10% of clients borrow from multiple informal resources.

The outreach of the informal financial sector is high; more than two-thirds of all Ethiopians have access to some sort of informal service provider. The price of informal credit fluctuates greatly from 10.5% per month at average from money lenders and traders to 0% from relatives and friends. Other loan conditions are generally flexible though money lenders usually require guarantors to co-sign a loan agreement. Average loan sizes are small at EBR 470 or EUR 43 and generally considered inadequate by borrowers. Major reasons identified include the demand of high collateral, fear or repayment capacity of borrowers, low fungibility of the lenders and lender's capping of loans.

The popularity of informal finance is due to three main reasons. First, it is more often than not is the only form of service delivery available. Second, loan processing is quick and not too many questions are being asked about the application of the borrowed sum. Third, in the case of *Iddir* and *Iqqub*, loans are provided in the context of social intermediation and self-organization. The capacity of these traditional systems, however, is limited. Their deep social outreach makes them nonetheless potential partners for MFIs wishing to extend service delivery beyond their respective operational areas.

3. THE MICROFINANCE SERVICES

3.1 General Characteristics of the MFI Sector

3.1.1 Appreciation

Further below follows a list of issues and challenges that was compiled from an inventory among all MFIs by AEMFI in 2005. Before going into these, however, it may be opportune to point to a more overriding issue.

When regulation became effective in 1996 it was received with a good deal of scepticism, both domestically and internationally: focus on the rural poor, capped interest rates and loan sizes, involvement of regional governments and affiliated NGOs, explicit prohibition of foreign ownership: it was all seriously frowned upon.

A decade later, however, the situation has dramatically changed: financial performance is excellent though operational margins and profitability are low; outreach is impressive and growth rates even more so; the social and developmental drive has been maintained though social impact is not easy to measure; and the original objective of regulation, building a sustainable national microfinance industry, has been achieved already although many feel that its overall size and capacity is still too limited.

Despite these achievements over the last decade, international appreciation is still largely to be forthcoming. The private donor agencies that have been involved throughout the last decade are generally impressed by the industry's achievements and continue to be supportive. Most of the larger bilateral and multilateral agencies and specialized investment funds, however, tend to either ignore what has been built or use the capacity in place to pursue the related but distinctly different agenda of small and medium enterprise development (SME). Either way, they find it difficult to appreciate Ethiopian microfinance for what it is: a massive and effective socio-politically motivated effort to contribute to poverty reduction in rural areas, which would merit more international support under its own terms.

3.1.2 Loan Capital

A most urgent need faced by many Ethiopian MFIs is to access affordable capital to finance growth. Loan portfolios grow faster than the volume of savings, donor agencies active in wholesale lending to MFIs are reaching the ceilings of their investment capacity and many MFIs borrowing from these facilities have reached the end of grace periods and have to start repaying borrowed funds.

The RUFIP facility will provide some relief but not in the long run. Funds for wholesale lending under this facility are approximately one-third of the volume of the industry's outstanding portfolio at EUR 147 million as per year-end 2005. Demand for service delivery is, however, explosively growing. Nearly all MFIs have the capacity in place to double or even triple outreach and portfolios in limited periods of time, if they only could access more capital. To triple outreach figures in the coming years, approximately EUR 300 million would have to be poured into the industry in the form of loan capital.

Specialized microfinance investment funds have that type of capital available but their return-on-investment expectations will keep them out of the country. Some of the larger MFIs will be able to source additional capital from their shareholders,

particularly regional state governments; this, however, will only increase the already formidable disparity between large and mid-size MFIs.

Non-affiliated MFIs have only two options available to access more capital in the domestic market: increase of savings mobilization and the high level of liquidity in the formal banking sector. As to the latter, the formal banking sector as per mid 2005 reported access liquidity levels of approximately EBR 13 billion or EUR 1.4 billion. Since, this amount has only increased. The largest financial institution of the country, state-owned Commercial Bank of Ethiopia (CBE), currently is reported to have double digit billions of Birr in access liquidity by itself.

Obviously, MFIs talk to the banks but to date without much success. Despite formal banking interest, partly inspired by public pressure to support the microfinance industry and partly by the current negative return on their access liquidity of 3% per annum, banks find it hard to come aboard. Increased regulation of the formal banking sector comes with tough collateral or guarantee demands; initially 100% security is looked after but occasionally this figure drops to 75-80%. MFIs usually can not meet these demands.

Moreover, substantial borrowing may lead to high capital adequacy ratios and raise questions from the NBE, the microfinance supervisor. A related problem in this area is that most MFIs have been capitalized at the minimum level of EBR 200,000, just over EUR 18,000. This does not carry far in providing securities over borrowings. Many have additional and more substantial capital available in the form of past donor capital grants, but it is not always clear how these should appear on their balance sheets and if they can be put up as security or be taken into account when calculating capital adequacy ratios.

As to savings mobilization, most MFIs limit saving operations to borrowing clients only, in the form of compulsory or voluntary savings; few are collecting savings from the public at large. Improving savings collection from this second source, the public at large, would be a preferred option in terms of low costs of capital, but would also be quite demanding in terms of liquidity and risk management. Most MFIs today are technically under-equipped in this area.

Savings and credit cooperatives are usually better equipped to capture savings from their members as they are more savings then credit driven. However in the remote rural areas savings levels are usually very low while the cry for loan funds is noticed also in these areas. Savings and credit cooperatives would need to go through a heavy professionalisation process first before they could even manage more loans in their portfolios. Options of linking savings and credit cooperatives to MFI's are under explorations.

3.1.3 Investment Capital

Existing profit margins hardly allow for major investments in MFIs' systems. This is compounded by the fact that their social drive urges MFIs to put nearly all their resources into their loan portfolios. As a result most MFIs are poorly equipped as regards management information and accounting software as well as the hardware needed to run it smoothly. At the same time, rapid growth of operations increasingly exposes deficiencies and vulnerabilities of the MIS applied. It is not an uncommon feature to see MFIs struggling with impressive backlogs in data processing or breaking their minds reconciling Accounts and MIS data. This, again, can lead to major delays in filing quarterly performance reports and externally audited annual reports with the NBE, which, in turn, affects their status as professional service providers. Moreover, if accurate data are not timely

provided to CEO and board, the MFI may run into a series of internal managerial and governance problems. As a result of this all, risk exposure increases.

A good management information system costs money, not only in terms of purchase of the software, but also for training, installation, licensing, hardware and specialized staff to run it, communication systems to link with branches, back-up facilities to save information and after-sales service provision to immediately attend to problems when they occur. Doing it on the cheap, as most MFIs have preferred for long, only leads to amalgamation of problems in a later stage.

Donors have long been supportive in this area, but the results of their assistance are questionable; they may also prefer to do it on the cheap, more often than not have little understanding of the technical complexities of sophisticated data processing systems, may promote systems of dubious reputation developed or used by some other MFI partner they may have, and have limited means available to cover the wide investment area described above. Most importantly, however, they usually provide support to a single MFI only with the result that although nearly all MFIs apply similar lending operations, they all run different data processing systems which make industry-wide support difficult and also do not facilitate comparison of performance data.

MFIs have identified their problems in this field in terms of lack of quality standard software at affordable prices, lack of skilled labour force in the market and lack of infrastructure to support MIS networks in rural areas.

Investments into proper administrative and monitoring systems of savings and credit cooperatives is even much lower as almost all investment have to come from membership shares and contributions. This makes it very difficult to build long term sustainable cooperative structures.

3.1.4 Ownership, Profit and Expansion

Though Proclamation 40/1996 requires MFIs to be shareholding companies most are actually structured as not-for-profit hybrids. Shareholders are almost exclusively non-profit public or civil society institutions, and rarely act as genuine shareholders do. This has created a wide-spread image of regulation standing in the way of applying a profit motive in microfinance.

This image is inaccurate. MFIs are legally allowed to make profit and declare dividends to their shareholders, albeit declaration of dividend is only possible after filing audited yearly statements with the NBE. With the removal of interest caps and some of the maximum loan size limitations, there are no legal obstacles for private sector actors to become involved in Ethiopian microfinance as long as they are of Ethiopian legal status. In fact, one MFI was recently established on this basis.

The non-profit image is not the result of regulation but of self-imposed restrictions by MFIs. When applying for regulation they have to submit a Memorandum of Association and in this document the MFI can restrain the profit motive, for instance by stating that no cash dividend will be declared and that all profit should be retained in the company in the form of stock dividend or reserves. Quite a few MFIs have such restrictions included in their founding documents and this may shy off domestic private sector equity participation in these MFIs.

When shareholders are not interested in making a profit out of their company ownership, they are looking for non-financial returns on their investment. By and large this takes the form of accelerated service delivery to preferred clients, usually the rural poor. This has turned Ethiopian microfinance into something of a numbers game. Board members, representing public and civil society institutions, continuously urge management to open more branches and service ever more clients. This interest frequently overrides institutional company interests such as the occasional need of consolidation, full compliance with NBE directives, the financial viability of opening new offices in more remote areas, investments in systems, equipment and human resources development to sustain growth, and so on and so forth.

Moreover, the same interest may override genuine client interests. The numbers game works in favour of standardizing products and services and keeping capital provision to individual clients low. MFIs often take greater pride in servicing many clients than servicing clients well. The numbers game is also inspired by an interesting pattern of competition between the largest MFIs. The oldest thereof, DECSI, has managed to achieve a remarkable coverage rate in Tigray. From the onset its target was to provide a loan to each Tigrean family. With 500,000 households in the state, the current outreach figures of 425,000 borrowing clients bring that objective within very close range. This undoubtedly inspires ACSI in neighbouring Amhara state to keep growing at a fast rate as well. Though its outreach is similar to DECSI's, ACSI has considerably more households to service, so it will keep up the pace of growth. This, again, has inspired the shareholders of OCSSCO to demand even faster growth rates in Oromia state. However, Oromia is by far the largest and most populous state in the federation, and OCSSCO would have to service many millions of clients to keep up with its peers in Tigray and Amhara. And that is exactly what the owners expect management to achieve.

The risk in all this is that these MFIs will become largely driven by quantitative target setting. And whereas in Tigray the quantitative target is in sight, allowing DECSI to fully focus on product diversification and innovation before long, in Oromia such a quantitative approach appears to be over-ambitious. The underlying risk is that the numbers game will drive MFIs governed by a quantitative over-drive, ultimately might fall back in the mode of directed public sector credit delivery of old times. If that would happen, the major objective behind Ethiopian regulation, building sustainable financial institutions, would have over-shot.

MFIs without public sector affiliation have other problems to deal with. Conceptually the common idea was that the MFI would serve clients in locations where the NGO owners were operational already with other developmental interventions such as agricultural extension work or health and sanitation; that way good synergies could be pursued in the best interest of clients. The intricacies of NGO work, however, sometimes come to undercut this synergy approach. NGOs need operational licenses and these are usually granted in connection with regional development plans. Regional governments aim to prevent over-concentration of NGO work in a limited number of geographical locations, and also expect NGOs to be complementary to their own interventions; they also have adopted the concept of synergy.

As a result it may happen that NGOs occasionally have to cease operations in a particular location and are requested to open shop elsewhere. In such cases, it requests the subsidiary MFI to move with it. As the NGO is usually incapable of pouring more capital into the MFIs to become operational in the new location as well, the tendency is to expect the MFI to cease operations in the old location as well. MFI managers obviously object to such movements as they work on the

basis of permanent service delivery to their clients. If they win the battle, the synergy concept falls apart: the MFI stays behind in the old area whereas the NGO moves to a new location. If they lose, they have to face massive involuntary client drop-out rates and start from scratch in a new location.

3.1.5 Governance

The common practice of shareholding companies owned by public and civil society actors has consequences for the quality of governance. Whereas the NBE requires MFI managers to be well-qualified, in fact to the point that some MFIs have difficulties recruiting managers of such status, there are no formal qualifications for board membership. Owners usually appoint board members from their own respective institutions which may be unqualified to govern a financial institution, may act exclusively in the best interest of the owner, which interest is often not in the area of financial performance, may have no time to attend board meetings regularly, may directly intervene in daily management, and so on and so forth. All this happens occasionally, though in general most MFIs have managed to develop workable relationships between management and board.

In all MFIs the highest decision making body is the annual meeting of shareholders, usually consisting of five entities, as per legal requirements. In practice this may imply that the meeting appoints itself *in toto* onto the board of directors of the MFIs, thereby reducing the meeting of shareholders to a mere formality and making redundant a useful mechanism for creating checks and balances in the company.

In Ethiopia the positions of CEO and Chairman of the Board can usually not be combined. The CEO habitually is a non-voting *ex officio* member of the board. Given the legally required banking skills of the executive manager, he or she often dominates decision making. This creates a particular pattern of interaction between board and management. Whereas the former is usually driven by non-profit motives that are not necessarily in line with the best institutional interests of the company, the latter is often sufficiently capable to keep these institutional on the agenda and contain over-ambitious or unrealistic expectations at board level. Nonetheless, in many MFIs management is a delicate and tiresome balancing act between different sets of priorities.

Ownership and governance structures in Savings and credit cooperatives are quite different from those in microfinance organizations. The organizational structure of a typical savings and credit cooperative society in Ethiopia consists of a General Assembly which is the supreme decision making body and supervises the management committees and control committees. The organization and management of Sacco's essentially follow the democratic member control principle of cooperatives which allow for all management functions to be delegated to an elected management committee and to hired management while the source of power remains with the general assembly. While officially cooperatives are autonomous bodies, in the case of Ethiopia government control and interference is quite common, although less so for RUSACCO structures which are relatively young and emerged from local self help groups.

3.1.6 Product Range

Regulatory requirements to primarily rely on group lending methodologies and keep average loan sizes in check, by definition pose a limitation to product development. As a result, and also because of the effects of the numbers game

discussed above, the average Ethiopian MFIs for a long time has been a one trick pony.

Lately this pattern is changing. Realization that agricultural development is about addressing hick-ups in value chains as much as it is about increase of production, many MFIs have started individual lending to micro and small entrepreneurs, facilitated by more flexible directives from the NBE.

They also have come to realize that their financial resources are very thinly spread over large numbers of clients with the risk that average quality and size of loan products may be insufficient to address client needs and demands. The challenge here is to design and offer a broader range of products to core clients, the rural poor, whilst maintaining current operational and personnel cost ratios and keeping risk exposure in check and, for those involved, keeping the numbers game going. MFIs are increasingly looking for ways to work with self-governed and self-managed community based organizations to realize this objective. These could be financial service associations (FSAs), rural savings and credit cooperatives (RUSACCOs), informal savings and credit systems (*Iddir* and *Iqub* mainly) and others.

Another fairly recent feature is the realization that the larger MFIs have built distribution systems that could be well used as the backbone for other forms of financial service delivery, usually beyond the range of the MFIs proper. This concerns money orders for third parties, channelling pension fund payments to remote areas, or remittances from overseas workers or relatives or the provision of micro insurance policies as agents for specialized insurance firms. In fact, service provision on behalf of third parties by utilizing distribution capacity in place already, can create a quite profitable new revenue stream as much as it caters to the needs of the rural population.

3.1.7 Human Resource Development

Staff retention rates at MFIs are low, sometimes alarmingly low, due to a variety of reasons, some of a more structural nature. Young, freshly recruited staff often are sent to remote branches where both living and working conditions are poor; so are remuneration packages. Essentially, at this level, staff is driven more by social than by career considerations. After a while, usually two years, the end of this line is reached. Staff will then expect career advancement and higher compensation or leave the MFI. Whereas MFIs can influence working conditions at field level to a certain extent, they are not able to address living conditions. That is why staff turn-over rates will remain high in remote areas.

At headquarter level, or more generally in urban settings, MFIs increasingly feel competition from the rapidly expanding private sector. This is particularly pulling professionals out of MFIs: bookkeepers and accountants, systems specialists, human resource managers, liquidity managers, etc. Particularly in times of expansion, this brain drain from MFIs poses serious capacity risks. To date, most MFIs are reluctant to follow the major way out of this dilemma: substantial increase of remuneration packages, either because the MFI find it impossible to foot the bill for this, it rather would decrease interest rates if profit margins would allow, or because it may find comprehensive salary raises socially undesirable as MFI salaries might get higher than those of the shareholding institutions. Either way, the problem is not being solved and vulnerability will increase.

Some MFIs are thinking of others ways to increase staff loyalty levels, for instance by issuing shares to staff members. This could work as a longer term incentive indeed but only if such shares bring in a real return in monetary terms;

that means through cash dividends or by selling of shares in an open market. Both opportunities to date are virtually non-existent as the country has no stock exchange and MFIs' founding documents may prevent cash dividend payments.

3.1.9 Regulation and Supervision

Although regulatory requirements have been liberalized during the last decade, there appears to be room for further flexibility, particularly as regards individual lending, the remaining loan size considerations and partial foreign ownership. MFIs have great interest in stepping up their involvement in micro and small enterprise lending as it is seen as a pre-condition for achieving higher impact levels on their core activities. In fact, they could rightfully argue that the regulator should not worry too much about mission drift in the sector; MFIs themselves profoundly do so already with all the public and civil society sector players in crucial industry ownership positions.

Rather would they like to see the regulator to remove the last obstacles towards building healthy financial institutions and the supervisor to more pro-actively guard and demand regulatory compliance?

3.2 Microfinance Service Providers.

3.2.1 Overview

The Ethiopian microfinance sector is one of the fastest growing in the world today. As per end-of-year 2005, the then 23 operational MFIs serviced 1,277,939 borrowing clients with an aggregated portfolio of EBR 1,622 billion or EUR 177 million. In terms of outreach these figures represent a nearly 300% increase from end-of-year 2001.

TABLE 8: KEY OUTREACH DATA ETHIOPIAN MFIS

Indicator	December 2001	December 2003	December 2005
Number of borrowing clients	461,326	755,073	1,277,939
Outstanding loan portfolio, EBR	308,587,589	593,978,863	1,622,107,210
Savings balance, EBR	243,290,831	325,028,670	600,689,122

A second characteristic is that outreach and turnover are unevenly spread over the 23 MFIs. The two largest service providers, DECSI and ACSI, service the bulk of the clients at 424,000 and 435,000 respectively and there is only one other MFI that had managed the 100,000 client mark by late 2005.

TABLE 9: DISAGGREGATED OUTREACH DATA PER DECEMBER 2005

MFI	Number of clients	Outstanding portfolio, EBR	Savings balance, EBR
1. ACSI	434,815	446,971,000	239,411,000
2. DECSI	423,573	681,673,090	183,340,918
3. OCSSCO	125,782	153,489,150	60,948,960
4. OMO	82,400	73,917,267	34,624,761
5. ADSCI	61,300	117,681,000	39,219,000
6. Wisdom	29,668	30,949,321	8,419,458
7. SFPI	14,345	13,841,714	5,777,665
8. PEACE	13,728	15,729,075	3,472,323
9. Benshangul	12,730	9,989,939	3,261,617
10. Sidama	12,700	14,521,465	4,115,551
11. Eshet	12,432	11,636,830	1,649,616
12. Wassasa	12,151	7,542,844	2,504,901

13. Gasha	10,157	14,123,591	5,275,874
14. Bussa Gono	9,952	7,817,235	1,206,652
15. Meklit	6,215	7,045,883	2,321,859
16. AVFS	5,948	6,482,799	3,261,617
17. Metemame	4,610	1,484,400	427,020
18. Meket	2,610	1,463,182	373,544
19. Aggar	1,459	2,989,447	1,744,682
20. Shashamene	1,365	1,610,212	465,333
21. Harbu	NA	845,558	423,898
22. Asser	NA	NA	NA
23. Dire MF	NA	NA	NA

A third characteristic is differentiation of background and ownership. The largest services providers are closely linked to their respective regional governments: ACSI in Amhara State, DECSI in Tigray State and OCSSCO in Oromia State. This close association takes the form of the regional state, or some political subsidiary thereof in the form of women's or youth associations or development NGOs, being the largest shareholders of these MFIs and, on that account, driving their MFIs into massive regional outreach. In return, they provide the capital in the form of equity, donations, guarantees or debt finance required to finance portfolio growth.

The mid-size NGOs are predominantly related to NGOs that are genuine civil society organizations. Typically, the mother NGOs ended its credit operations after the introduction of regulation in 1996 and then pooled its resources into new MFIs of which they became the majority owners. As regulation prohibits foreign ownership of MFIs, the respective funding agencies often donated capital grants to the NGOs to allow for capitalization of their shares in their related MFIs. After formal licensing, these NGOs continued to rely on funding agencies to finance their loan portfolios in the form of donations and concessional loans. This practice still continues although savings intake has become a major compliment to donor funding.

A third and small category is represented by MFIs such as Aggar that could not avail of NGO or donor support and exclusively relied on domestic capital markets to get started and finance their loan portfolios. These are new entrants in the microfinance market.

3.2.2 Financial Performance

Most MFIs are doing remarkably well in terms of financial performance given their relatively short track record. The largest have passed the threshold of financial self-sufficiency (FSS) and the vast majority has moved beyond the operational self-sufficiency (OSS) mark.

This follows from annual industry analyses by the Association of Ethiopian Microfinance Institutions (AEMFI), based on commonly agreed industry adjustment standards. Following the methodology introduced by the Micro banking Bulletin (MBB) and now also applied by the Microfinance Information Exchange (The MIX Market), Ethiopian MFIs are classified in three peer categories: small, medium and large. Audited annual reports are adjusted to allow for comparison and benchmarking. The latest analysis was finished in June 2006, covers the year 2004 and is based on performance data of 15 MFIs, including all large and medium ones.

TABLE 10: KEY FINANCIAL PERFORMANCE INDICATORS 2004

Indicator	Small Ethiopian MFIs	Medium Ethiopian MFIs	Large Ethiopian MFIs	Average Ethiopian MFIs	Average African MFIs
Adjusted ROA	-7%	-3%	2%	-3%	-3%
Adjusted ROE	-18%	-7%	6%	-8%	4.2%
OSS	100%	117%	200%	128%	117%
FSS	75%	82%	125%	89%	101%

Across the board OSS jumped from 104% in 2003 to 128% in 2004. When adjusted for inflation, loan loss provisioning and costs of funding, this results in FSS of 89% in 2004, which is below African average, but still good progress in comparison with 2003 when FSS stood at 77%.

Two additional observations may be relevant in the context of self-sufficiency. First, methodologies to calculate averaged are biased to number of institutions rather than overall outreach. A *weighted* average calculation would show that whereas most MFIs have not reached the FSS mark of 100%, the vast majority of microfinance clients are nonetheless served by fully self-sufficient MFIs. Second, whereas Ethiopian MFIs peers score higher than their African peers on OSS, they score lower on FSS. This indicates substantial adjustments, notably in the realm of applying costs of capital over past donated capital grants

This large Ethiopian variance between OSS and FSS also indicates that sustainability in Ethiopia is slightly atypical in nature. Whereas in most microfinance markets this is achieved by pursuing high portfolio yield in combination with scale of operations, in Ethiopia sustainability is mostly achieved through the combination of large scale against low yield and low costs. Operational costs are low, but so is portfolio yield due to the generally low level of interest rates. As a consequence, margins are small and only sustainable because of low costs of capital: 3% over savings intake, 5-10% over local currency debt finance and zero percent over investment capital as nearly all MFIs do not declare cash dividends and retain earnings.

3.2.3 Social Performance

Average loan size, a frequently used indicator for depth of outreach, in Ethiopia is considerably below African average; are in fact just 25% of African average. This surely indicates the deep social outreach that is associated with the fact that subsistence farmers are the preferred clients of Ethiopian MFIs. The figure of 25% is slightly inflated, though, because Ethiopian MFIs only recently started servicing micro and small enterprises, which will drive average loans sizes up. Moreover, the cost of living is lower in Ethiopia than in most other African countries, which may imply that purchasing power per dollar lent is higher in the country: clients can do more with a USD 100 loan in Ethiopia than elsewhere in the continent.

TABLE 11: KEY SOCIAL PERFORMANCE INDICATORS 2004 (EBR)

Indicator	Small Ethiopia n MFIs	Medium Ethiopian MFIs	Large Ethiopian MFIs	Average Ethiopian MFIs	Average African MFIs
Nr. of active borrowers	6,289	23,927	258,298	64,922	36,224
% of women borrowers	59%	48%	23%	47%	60%
Gross loan portfolio	3,743,036	17,8143,16	258,214,12	61,203,31	94,524,33
Loan balance per client	588	6	7	5	7
Voluntary savings balance	503,294	883	1,004	809	3,758
Compulsory savings balance	1,177,127	2,977,430	79,146,500	17,386,53	70,074,98
Total savings balance	1,680,310	3,848,487	39,204,116	2	4
Nr. of voluntary savers	2,574	6,270	102,155	10,029,12	NA
				3	
				5	
				6	
				5	
				6	

Also inflated is the Ethiopian average of female participation in credit delivery. The average of 47% is lower than the African average of 60%, but if weighted towards number of clients rather than number of MFIs, it would dramatically drop because most Ethiopian clients are served by large MFIs that only show a female participation rate of 23%.

Though the number of Ethiopian MFIs is steadily growing, overall growth of outreach is almost exclusively realized by the larger MFIs, as shown in Table 3. An enigmatic feature of the Ethiopian industry is that the largest service providers also charge the lowest interest rates at 12-15% per annum over declining balance, which is rock bottom level global microfinance. Low interest rates also are an indicator of social performance as they increase affordability of credit delivery.

When regulation started in 1996, government installed an interest cap at 10% per annum, which required MFIs to access low-cost funds and donations as well as to keep operational costs at bare minimum levels to break even, the more so since MFIs were obliged to pay 6% per annum over savings. The thin spread of 4% prevented substantial growth of the non-politically affiliated MFIs as they had difficulties accessing cheap funds in larger quantities. In the meantime the interest cap over loans has been revoked and minimum charges over savings have dropped to 3%. Smaller MFIs increased interest rates up to 24% per annum flat, allowing for higher costs of capital and, thus, substantial portfolio growth, whereas the larger MFIs only slowly increased interest rates. Competition in the market has driven maximum interest rates down again to 20% flat and this trend will likely continue.

Most Ethiopian MFIs make serious work of poverty targeting. Usually, local village committees or NGOs are deeply involved in identification of potential clients and quite frequently MFIs feel compelled to extend operations to areas that generally are not conducive to maximize profit margins: poor transportation and communication infrastructure, complete lack of formally banking infrastructure putting serious strain on liquidity management, and focus on subsistence farmers as priority clients.

These pro-poor achievements, however, are set off against lower levels of social impact and efficiency. The drive for scale, often politically inspired, has led to rigidities creeping into the system. Massive outreach is not generally matched

with product diversification and demand based product development and women are under-represented in service delivery; the one-size-fits-all approach that comes with the drive for scale and sustainability is not necessarily in the best interest of clients. Ethiopian MFIs, whilst boosting impressive outreach and self-sufficiency data, find it hard to prove that their interventions have directly contributed to poverty eradication.

3.2.4 Profitability and Cost Levels

Low interest rates translate into low portfolio yield and low rates of return.

TABLE 12: KEY REVENUE INDICATORS 2004

Indicator	Small Ethiopian MFIs	Medium Ethiopian MFIs	Large Ethiopian MFIs	Average Ethiopian MFIs	Average African MFIs
Adjusted financial revenue ratio	18%	14%	12%	15%	28%
Adjusted profit margin	-47%	-35%	17%	-29%	-9%
Adjusted nominal yield	30%	21%	16%	23%	39%
Adjusted real yield	19%	11%	6%	13%	30%

Clearly, both small and mid-size Ethiopian MFIs work at negative profit margins, resulting in low yield rates, considerably below African averaged. The large MFIs file small profits at lower yield rates. This indicates that low interest rates only allow for profitability at exceptional scale of outreach and high levels of efficiency. Small and mid-size MFIs have little margin to further decrease interest rate levels without further jeopardizing the meagre profitability of their institutions.

TABLE 13: KEY EXPENDITURE INDICATORS 2004

Indicator	Small Ethiopian MFIs	Medium Ethiopian MFIs	Large Ethiopian MFIs	Average Ethiopian MFIs	Average African MFIs
Adjusted total expense ratio	24%	17%	10%	18%	31%
Adjusted financial expense ratio	6%	5%	5%	6%	6%
Adjusted LLP expense ratio*	6%	2%	0%	3%	3%
Adjusted operating expense ratio	13%	10%	5%	10%	23%
Adjusted personnel expense ratio	8%	5%	3%	6%	12%
Adjusted admin expense ratio	5%	4%	2%	4%	11%
Adjustment expense ratio	6%	5%	4%	5%	3%

* LLP: Loan loss provision

Ethiopian MFIs manage to keep operational costs down; the largest among them could face competition with the industry's expense icon ASA from Bangladesh head-on. Overall operating costs at 10% of assets are amongst the lowest in the industry.

3.2.5 Efficiency and Productivity

Ethiopian MFIs are very efficient and productive service providers. The largest MFIs equal formal bank efficiency levels with single digit efficiency rates whereas the industry at large performs much better in this area than their African peers. In the meantime, operating cost ratios show a continuous downward trend.

DECSI and ACSI spent EBR 39 and 50 per single client, or EUR 3.55 and 4.55 respectively, which must approach world record level. The industry average of EBR 113 or EUR 10.27 is 7.5 times lower than African average.

TABLE 14: KEY EFFICIENCY AND PRODUCTIVITY INDICATORS 2004 (EBR)

Indicator		Small Ethiopia n MFIs	Medium Ethiopia n MFIs	Large Ethiopia n MFIs	Average Ethiopia n MFIs	Average African MFIs
Adjusted expense/GLP*	operating	24%	16%	6%	16%	36%
Adjusted expense/GLP*	personnel	14%	9%	4%	9%	19%
Cost per borrower		128	125	60	113	842
Adjusted borrowers per staff		138	163	261	174	177
Adjusted borrowers per loan officer		285	339	1128	479	368
Personnel allocation ratio		50%	51%	33%	47%	54%

* GLP: Gross loan portfolio

The drive towards low-cost service delivery to the rural poor does, however, lead to a deceptive concept of efficiency. Low formal efficiency and productivity ratios conceal severe problems. Most MFIs have staff retention issues to deal with and many have to work with unreliable or altogether inadequate management information and accounting systems. The software they use, as well as the hardware to work with it, is often of unreliable or inaccurate quality relative to the size and volume of business operations.

3.2.6 Risk and Liquidity

TABLE 15: KEY RISK AND LIQUIDITY INDICATORS 2004

Indicator		Small Ethiopia n MFIs	Medium Ethiopia n MFIs	Large Ethiopia n MFIs	Average Ethiopia n MFIs	Average African MFIs
Adjusted PAR > 30 days		6%	8%	3%	6%	5%
Adjusted PAR > 90 days		5%	2%	2%	3%	2%
Adjusted write-off ratio		11%	6%	3%	7%	4%
Adjusted loan loss rate		11%	5%	3%	7%	3%
Adjusted risk coverage		58%	37%	34%	43%	120%
Adjusted non-earning assets	liquid	38%	24%	17%	27%	16%

Portfolio at risk is a preferred indicator of portfolio quality. Ethiopian levels are slightly above African averages, but heavily influenced by alarmingly high PAR30 rates of one small (Meklit) and two mid-size MFIs (ADSCI and SMFI). Two MFIs report zero PAR30 levels (Wasasa and PEACE), two other report 1% (ACSI and ESHET) whereas three report 2% only (AVFS, SFPI and DECSI).

Another crucial indicator is the write-off ration. Four MFIs must have felt quite uneasy with write-off rations over 10% (Meklit, AVFS, Gasha and OMO) whereas four others report a perfect 0% score (ESHET, PEACE, SMFI and OCSSCO). Looking at the figures in the column of large MFIs, it is safe to suggest that the vast majority of Ethiopian microfinance clients are serviced by MFIs with outstanding portfolio quality.

3.2.7 Economic Performance

Particularly amongst the largest MFIs, the need to increase outreach and include ever more poor in service delivery has turned microfinance into something of a numbers game. Shareholders, state governments or their subsidiary NGOs that is, frequently focus exclusively on quantitative targets. Rarely is the wisdom appreciated that the poor cannot borrow their way out of poverty just like that. If markets are ill-functioning or non-existent, there is little use in urging clients to increase production and borrow money for that purpose.

Acquired political wisdom is slowly catching up with this basic lesson. The same shareholders now direct their MFIs to also focus on the value chain in agricultural production and start service delivery to the not-so-poor: rural micro and small entrepreneurs. And, by the power of political leverage, the same shareholders will be able to facilitate the process by working towards removing non-financial barriers to accelerate it all.

3.3 Savings and credit co-operatives Providers

3.3.1 Overview

Saving and Credit Cooperative societies in Ethiopia operate under the provisions of Proclamation No. 147/98. A saving and credit cooperative is registered as limited liability company to perform the much needed function of financial intermediation - mobilize savings from members and return those to members in the form of loans. Unlike other formal financial institutions (banks and micro finance institutions), however, saving and credit cooperatives are owned, controlled and capitalized by their members. This implies that the savings and credit cooperatives are not subjected to supervision and regulation of the National bank of Ethiopia.

Savings and credit cooperatives in Ethiopia are not permitted to taking deposits from non-members. Many Rusacco's provide loan services for agricultural inputs, animal fattening and in some cases for off farm activities. Loan disbursement policies are prudent, only those with sufficient savings and collateral can lend. The majority of loans are provided for a period of one year or less. Usually interest on loans is higher than charged by commercial banks but often lower than that of MFI's and definitely lower than the moneylenders rate.

While performance of Microfinance organizations in Ethiopia is systematically followed and supervised by the central bank as well as by AEMFI, monitoring of performance and efficiency/profitability of Sacco's is hardly done. Basic ratios and benchmarks for the sector are hardly available. AEMFI as a network would like to take this as a next challenge for the sector in Ethiopia.

The Rusaccos' are marked by poor administrative and financial procedures: outstanding loan amounts and numbers are for example not always well recorded and portfolio at risk not well known. A recent study² noted high levels of illiteracy especially in Rusacco's even among the leaders of these organizations. This puts a challenge to any training program. Also most Rusacco's were lacking any basic physical facilities. Furthermore, insufficient loanable fund and members' limited borrowing capacity also add to limitations of the Rusacco's. Female membership in savings and credit cooperatives is higher in the rusacco's with 47%.

² AEMFI, januari 2007

TABLE 16: NUMBER OF SAVINGS AND CREDIT CO-OPERATIVES (AS PER JUNE 2006)

Type	Number	Membership	Average member size
Overall	20.406	4.642.034	227
Savings and credit	5.437	381.312	70
Rural SACCO's	1.166	64.655	

The number of savings and credit cooperatives has doubled since 2004. The number of Rusacco's is still much smaller and with much lower membership of only 65.000 in the whole of Ethiopia, however the growth in membership of Rusacco's over the last 2 years has been almost 300% (membership in 2004 was 16.500). Regional distribution of Rusacco's varies a lot with most of the Rusacco's concentrated in Addis Ababa and Oromya.

TABLE 17: TRENDS IN GROWTH OF SAVING AND CREDIT COOPERATIVES IN ETHIOPIA

Year	No. of SACCOs	Members	Contribution and Savings (Birr)	
			Total	Per member
1974	35	8,332	1,999,680	240
1975	44	10,136	2,648,987	261
1980	160	19,337	3,954,204	204
1985	218	38,166	12,970,879	340
1990	484	118,037	68,959,446	584
1995	522	116,619	111,173,060	953
1996	578	129,216	124,441,325	963
1997	620	147,302	159,865,849	1,085
1998	670	150,468	167,059,812	1,110
1999	716	156,938	174,577,503	1,110
2004	2,146	155,120	504,334,084	3,251
Mid 2006	5,437	381,212	994,960,169	2,610

Source: Wolday Amha (2003) *Micro Finance in Ethiopia: Performance, Challenges and Role in Poverty Reduction*, Occasional Paper No. 7, AEMFI, and Federal Cooperatives Agency.

Currently the government's agricultural and rural development strategy points towards the strengthening of rural financial institutions, including rusacco's to foster rural economic development. Elements of this strategy are:

- a) replace the provision of large rural loans so far provided via the intermediary of the regional governments by sustainable institutions;
- b) strengthen the rural financial system by forging a strong working relationship between the formal banks and the rural financial institutions;
- c) promote rural banks and expand their operational scope; and
- d) directly extend credit to cooperatives with strong institutional and managerial capacity via forging a strong link between rural banks and cooperatives.

The government wants to streamline the cooperative sector and also savings and credit cooperatives in Union and federation structures. At the moment emerging union structures are still very weak and need support. While government influence on the structures is still very strong, overall the enabling environment

to create stronger savings and credit structures is conducive. However, the current weak organizational structure makes it almost impossible to set common standards for administration and supervision of savings and credit cooperatives. Yet it is commonly recognized that a standard chart of accounts, indicators of condition and performance should be developed in order to improve performance of the sector.

Some recent figures on the sector show the positive growth trend but also the unequal distribution of Savings and Credit cooperatives throughout the country.

TABLE 18. GROWTH OF RUSACCOS, 2004/05-2005/06

Growth Indicators	2004/05	2005/06	% Change
Number	292	1,166	299
Membership	16,579	64,413	289
Capital, million Birr	1.8	8.7	383
Assets, million Birr	1.8	8.7	383
Assets, million Birr	6.8	14.6	115
Saving, million Birr	1.7	8.6	406
Outstanding Loan, million Birr	1.9	5.7	200

Source: Survey Results

TABLE 19. DISTRIBUTION OF URBAN AND RURAL SACCOS BY REGION (MID 2006)

Region	SACCOS		Members	
	Total	% Rural	Total	% Rural
Addis Ababa	2,852	-	254,468	-
Afar	8	100.0	308	100.0
Amhara	231	72.3	20,374	45.6
Benishangul Gumuz	50	94.0	888	86.7
Dire Dawa	78	-	2,815	-
Gambella	16	100.0	2,410	100.0
Harari	12	-	941	-
Oromiya	1,494	35.6	54,060	51.9
SNNP	486	45.1	35,237	43.8
Somali	13	100.0	730	100.0
Tigray	197	83.2	9,081	83.9
Total	5,437	21.4	381,312	17.0

Source: Federal Cooperative Agency

3.3.2 Financial Performance

In an attempt to get some insights into the financial performance of SACCO's the PEARLS Performance Monitoring System developed by WOCCU is used on figures for RUSACCO's in Ethiopia.

Each letter of the name PERLAS³ looked at a different but critical aspect of the credit union. 'P' stands for 'Protection' and looks into the adequacy of the institution's provision for loan losses; 'E' stands for 'Effective Financial Structure' and looks at the composition and changes of the balance sheet; 'A' stands for 'Asset Quality' which refers to delinquency, loan write-offs and recoveries, and non-productive assets; 'R' for 'Rates of Return and Costs', the average income

³ More information about on PEARLS Performance Monitoring System is found at www.woccu.org

yield for each of the assets, the average cost yield for each of the liability and capital accounts; 'L' for 'Liquidity', the ability of the institution to meet deposits withdrawal requests and liquidity reserve requirements; and 'S' for 'Signs of Growth', growth of balance sheet accounts and membership.

As RUSACCOs are not required to have standardized procedures and reporting, they have different accounting systems. Also, their financial statements were either incomplete or lack the required details to compute indicators of performance and financial position. For this reason, only a limited range of indicators have been computed and compared with international standards of excellence. These are summarized in Table 20. The results also show that the RUSACCOs for most part have yet to meet the standards of excellence in the PEARLS financial performance and monitoring system.

3.3.3 Protection

Protection is about making allowances for loan losses. It requires 100 percent coverage for loans delinquent for periods greater than 12 months and 35 percent for 1-12 months. This important financial discipline was not practiced by any of the RUSACCOs.

3.3.4 Effective Financial Structure

A number of ratios have been calculated for the sample RUSACCOs. These include the ratio of net loans to total assets, saving deposits as proportion of total assets, member share capital to total assets and institutional capital as a percent of total assets. The saving amount in relation to the total assets for the sample RUSACCOs was found 77 percent. This favourably compares with the standards for excellence of 70-80 percent. On the other hand, the members share to total assets was 8.5 percent against the goal of 10-20 percent. This reveals the fact that RUSACCOs are under-capitalized by their members.

3.3.5 Rates of Return and Costs

The operating expenses of the sample RUSACCOs was about 4.86 percent of total assets. This compares favourably with standard for excellence of 5 percent. On the other hand the net income to assets was 2.28 percent against the goal of 5 percent. Overall therefore the RUSACCOs' assets are not generating the expected yield on their assets members. This could in part be due to the low level of business transactions.

TABLE 20. PEARLS RATIOS OF SAMPLE RUSACCOs

PEARLS Ratios	Standard Excellence	of Sample RUSACCOs
E Effective Financial Structure		
Net Loans / Total Assets	Between 70 - 80%	77.09%
Non-Financial Investments / Total Assets	0%	0.00%
External Credit / Total Assets	Max 5 %	0.00%
Member Share Capital / Total Assets	Between 10 - 20 %	8.50%
Institutional Capital / Total Assets	Minimum 10%	3.11%
R=Rates of Return and Costs		
Operating Expenses / Average Assets	5%	4.86%

Net Income / Average Assets	Minimum 10%	2.28%
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Source: Survey Results

It can be concluded that RUSACCO's need a lot of capacity strengthening, improved supervision and standard setting in order to become a serious player in the Micro- financial landscape in Ethiopia.

3.4. Support and Funding Needs

Due to the low return on investments, all international specialized microfinance investment funds are inactive in Ethiopia. Their standard debt finance product is priced at 8-13% per annum over foreign currency, which is considerably out of bounds of domestic capital market rates. Whereas this misfit is occasionally interpreted in terms of Ethiopian MFIs being unfit to meet 'international standards' on costs of capital or by pointing to inflated FSS calculation methodologies, the core of the matter is that these funds offer products that are uncompetitive in the real local market and therefore unattractive to Ethiopian MFIs.

Lack of interest in Ethiopia is no exclusive feature though. According to recent calculations by CGAP and published in its new Pink Book, of the aggregated overall investment capital of specialized investment funds to the tune of USD 1.254 billion, only 6% is outstanding in both Africa and Asia whereas Eastern Europe/Central Asia and Latin America/Caribbean take 46% and 41% respectively or 87% combined, even though these latter regions only represent 3.5% of all microfinance clients in the world.

3.4.1 Capital Funding Needs.

Domestic capital market rates vary between 3% (interest over savings) and 6% (RUFIP), which is the general reference rate for MFIs and the departure point for discussing wholesale bank loans to MFIs. There is no demand for debt finance offered at much higher interest rates or in foreign currencies. Monetary controls prohibit repatriation of foreign currency loans on top of that.

Effectively this means that only MicroNed members will be able to directly invest in MFIs in terms of debt finance as they have the opportunity to provide concessional loans; concessional to their own reference rate that is. Likely they will continue to do so. But they will also experience that MFI clients face a double problem: they need considerably higher loan amounts to finance growth and at the same time they have to repay older loans. Even at the best of their capacities, MicroNed members will have great difficulty meeting this demand to the fullest.

At the same time MFIs are quickly developing a need for fresh equity injections to boost capital adequacy ratios but also to bring in a new class of shareholders that can help bring the industry further forwards. Under the present terms of regulation, however, MicroNed members are prohibited to directly place equity with MFIs or assume board membership. All they can do in this field is to go for proxy or puppet constructions which may address the first reason for fresh equity but not the second.

3.4.2 Management Information Systems (MIS) and Information Communication Technology (ICT)

There is considerable demand to introduce a high calibre, high capacity and reliable management information system, preferably one that integrates loan

tracking and accounting software and can be used by a range of MFIs. Scale of introduction facilitates establishing robust after-sales back-up service delivery and can reduce costs of purchase, installation and training.

Now that many MFIs will approach the 20,000 client mark before long, and expectedly will quickly jump to the 50,000 mark, they need reliable and accurate software to work with. Overtime, investment and running costs will be balanced with higher levels of productivity.

It would be helpful if MicroNed members could put together an initial investment budget to pre-pay investment costs of *all* interested MFIs with a client base of at least 5000, and have MFIs repay the investments costs in annual trenches as the new MIS pays off in terms of efficiency gains. Crucial is to invest sufficient time, money and expertise in selecting the most appropriate software package in the market today. There would be opportunity to involve other Platform members in the process, particularly the commercial banks.

As regards application of ICT, innovations in this sector are breathtaking, often originate from Africa (South Africa mostly) and potentially can address a number of recurring problems MFIs have to deal with. Internally these are mainly in the area of linking headquarters with branches and sub-branches. The technology is in place to achieve this even in the remotest rural areas without telephone and electricity facilities. Even from there uploading and downloading of data to and from headquarters is technically viable as there is ample satellite transponder capacity available in the market that could cover nearly all of Ethiopia. At the same time, innovations become available to handle cash flow management far from headquarters, by linking cash points with electronic banking facilities using magnetic cards and finger print or iris identification.

Again, state-of-the-art technology is expensive, but overtime pays off through major efficiency gains in the form of reduction of personnel costs and higher transaction speed. Moreover, collective purchase of technology and satellite capacity offers opportunities for sponsorship by major ICT companies or one of the rapidly giant endowment facilities by high net worth individuals such as the Gates family (Microsoft), Pierre Omidyar (E-Bay) and Mohamed Ibrahim (Celtel Africa).

As in the case of MIS, it helps to purchase ICT applications in bulk. The organization of massive demand could be left to AEMFI, but it would take the support of for instance MicroNed to find the best possible deals in the market and help shoulder the purchase thereof or help broker affordable prizes.

3.4.3 Research & Development (R&D) and Training Facility.

The size of the microfinance market in Ethiopia warrants the establishment of a high quality research and development facility that caters to the need of all MFIs, most prominently in the field of product development. As MFIs slowly move into the MSE sector they need to familiarize with the complexities thereof. At the same time they intend to diversify service delivery to their core clients. This also needs to be well-prepared and tested for which a R&D facility can be most useful.

Moreover, Ethiopian MFIs will face succession challenges before long. Most of the current MFI CEO's have been in that position since the inception of their institutions. For some the time will come to look for other employment that is less demanding and better paid. This poses two major challenges. First, it will not be easy to find capable replacements, particularly not in view of the demanding regulatory qualifications for CEOs. The R&D facility could develop training courses

in conjunction with institutes of higher learning tailored to meeting these qualifications. Second, it would be a loss in terms of human capital if retiring CEOs and other senior executives would be lost for the industry and would move over to the private sector. Creating employment in an emerging national support industry would prevent that possible loss of human capital. The R&D facility could be part of this infrastructure.

There is demand for establishing a training institution to be used by MFIs unable to set up such a facility for their own institution. Given expected continued growth of operations, many more staff need to be trained and introduced to the specific methodologies applied by individual MFIs. A good quality training centre and guesthouse can meet that demand. Moreover, if managed well, such a facility can easily become a profit centre by catering to meeting and conference needs of private and public sector players as well.

Most donor agencies active Ethiopia have regularly contributed to one or more of the issues discussed above; but the impacts thereof have been limited because support was often of an incidental project based nature, directed to one or few MFIs only or biased to donor agendas and not necessarily in line with priorities defined by the industry. Collective pooling of resources, among funding agencies and practitioners alike, creates opportunities to work at economies of scale, involve all, and carry the industry further.

3.5 Donors and Investors.

3.5.1 Overview

Donor agencies, in particular private or independent agencies, have been very instrumental in supporting MFIs getting started as of 1996. Most donor agencies focused their attention and support on their older NGO partners that decided to establish a new MFI. This largely concerns the current mid-size MFIs though not exclusively as some of the larger MFIs also worked with donor agencies before transformation.

Support usually followed a typical pattern. A first grant to help the NGO orientate itself and prepare for setting up a MFI was usually followed by a small capital grant to contribute in the capitalization of the MFI and a much larger one to provide the initial loan capital. During the early years of existence this was commonly augmented with grants to cover initial operational deficits or purchase equipment and a management information system. After reaching break-even point, amongst others through savings mobilization, donors gradually reduced the application of the grant instrument in favour of provision of concessional debt finance, either directly or through affiliated institutions.

That is where most of these donors stand today: an incidental grant for a particular purpose such as upgrade of systems, network activities, product development or social impact surveys, and ample provision of low to medium priced loans. As far as that latter instrument goes, most donor agencies now face the limits of their support capacity due to the explosive growth of need for capital by many MFIs.

Bilateral and multilateral donor agencies have remained remarkably absent in the formative process of the modern microfinance industry, but appear to be catching up quickly:

Swedish SIDA has provided support for MIS upgrades to various MFIs as well as considerable funds for on-lending to few;

- USAID has also supported MIS development and now works to establishing RUSACCOs through ACDI/VOCA as well as building a guarantee facility to help MFIs accessing local capital markets;
- KfW has also moved towards building a guarantee facility and aims to support MFIs in building capacity to service the small and medium enterprise market;
- German Development Service (DED) is building a number of regional business development centres;
- French AFD is also in the process of appraising a guarantee facility;
- Dutch SNV plans to establish a financial intermediation fund for innovative products directed at value chain financing;
- Irish Aid provided technical support to AEMFI and also took the lead, until recently, in coordination all resident donor involvement;
- The EU support programme for small enterprise financing supported some of the larger MFIs for SME lending but 'the program was closed after its pilot phase ended';
- GTZ is involved in an effort to establish a national microfinance strategy as it concluded that 'the microfinance sector in Ethiopia lacks a clear policy and strategy for its development'.

Quite different is the case of RUFIP, a major initiative supported by IFAD, AfDB and World Bank. The Rural Financial Intermediation Program is a USD 80 million initiative based on three lines of support: capacity building for MFIs, low-cost capital provision to MFIs and capacity building for the NBE. Particularly the second part is well under way now; that is to say that eligibility criteria have been formulated and that the first batch of loans to MFIs are now indeed outstanding. The other two lines of activities are still under preparation. The program is housed and managed by the National Investment Bank (NIB) and supervised by the World Bank.

RUFIP is generally perceived as a most welcome and timely support program, also because microfinance practitioners have been consulted and involved in programme design and, through AEMFI, have had some say in program execution and supervision.

3.5.2 The Current State of Affairs.

In 2005 only three out of the four MicroNed members were active in Ethiopia. Together they provided Euro 780,375 in grants to various MFIs whereas they had loans outstanding with three MFIs to the equivalent of Euro 848,830.

TABLE 21: ACTIVITIES MICRONED MEMBERS IN ETHIOPIA IN 2005/2006

Name MFI	Type of Support	Cordaid	ICCO/Terrafina	Oxfam-Novib	Total
ACORD	Sum of Grants 2005			32,000	32,000
AEMFI	Sum of Grants 2005		40,000	-	40,000
AVFS	Sum of Grants 2005		100,000		100,000
BG	Sum of Grants 2005		124,900		124,900
CIDR	Sum of Grants 2005		60,000		60,000
ESHET	Sum of Grants 2005		100,000	50,000	150,000
	Portfolio outstanding 31/12/05			- 487,258	487,258
KEMBATTA	Sum of Grants 2005				10,000

			10,000	
PEACE	Portfolio outstanding			
	31/12/05		215,141	215,141
Harbu	Sum of grants	50.000		50.000
SHDI for				
Rusacco's	Sum of grants	100.000		100.000
SFPI	Sum of Grants 2005	100,000		100,000
Various				
MFIs	Sum of Grants 2005	13,475		13,475
	Portfolio outstanding			
WASASA	31/12/05	146,431		146,431
Total Grants			688,375	92,000
Total Portfolio outstanding			146,431	702,399
				848,830

Original data kindly provided by the Netherlands Platform for Microfinance with minor adjustments from the respective donors.

4. ACTORS ON SECTOR LEVEL - The Association of Ethiopian Microfinance Institutions (AEMFI)

The Association of Ethiopian Microfinance Institutions (AEMFI) network is the only organisation that is currently best placed to service the industry at large. AEMFI is the network of all registered microfinance Institutions (MFIs) in Ethiopia. AEMFI's has three main objectives. *First and foremost* is to provide a forum and structure through which MFIs can share their experiences and exchange information. *Secondly*, it strives to enhance the capacity of the member MFIs through offering training and negotiation for alternative funding resources from both local and international sources. *Finally*, it seeks to strengthen the entire MFI sector development through undertaking research, advocacy, promotion of the industry, engage dialogue with the government and other relevant international institutions with to view to positively influence MFI policy and practises.

Since its inception in 1999, the organisation's memberships has grown from the initial four to the current 27 (as at December 2006) that provide microfinance services in 8 out of the 11 regional states/administrative organs of the Federal Democratic Republic of Ethiopia (FDRE) namely: Tigray, Amhara, Oromia, Benishangul-Gumuz, SNNP, Dire Dawa, Harari and Addis-Ababa. The three regions that are currently not covered are Afar, Gambella and Somali region. AEMFI is in the process of facilitating the creation and provision of microfinance services in the latter regions. This initiative is co-financed by Oxfam Novib and ICCO/Terrafina

5. CONCLUSION AND RECOMMENDATIONS

The Ethiopian microfinance industry is rapidly coming to maturity, albeit largely on its own terms. This leads to the need to develop an Ethiopian support structure in the form of training centres, research and development capacity, credit rating agencies, professional consulting firms, specialized service providers in the area of systems development, academic support, particularly in the field of social performance, business development support (BDS) capacity, capital leverage vehicles, and so on and so forth.

To date, few of such facilities are in place, and even less so with the specific objective of servicing the industry at large. Donor agencies have a good track record of providing the funds for such forms of service delivery, but their efforts are piecemeal and often made available to a single MFI only. On the one hand a tailored approach of donors is recommended to fit the organizational needs, on the other hand a broader services provision including several MFI's could be more effective for the sector in the long run.

For a country with a considerable and rapidly growing microfinance industry, the local support sector is quite small: there is no local rating agency, no specialized consulting firm although there is no lack of high qualified consultants, no training institution and only recently some academic facilities focusing on microfinance have emerged.

At the same time, the national practitioner network AEMFI is among the strongest national networks on the continent, widely appreciated as a representative voice of all practitioners and for its high quality and timely reporting on industry performance.

In the recent past, private consultants and BDS providers have started to familiarize themselves with the sector and began to provide services to Microfinance organizations and savings and credit cooperatives.

The AEMFI network is the only facility in place to service the industry at large, but its means and capabilities are too limited to play a commanding role in all areas mentioned above. It does, however, have the capacity to pioneer the creation of such support facilities, if properly resourced, and the authority to do so in a way that would be beneficial for all MFIs, large and small.

5.1 Strategic Considerations

The Netherlands is home to one of the most active microfinance support industries in the world. It counts funding agencies, investment funds, commercial banks, a public-private development bank and other institutions all active in microfinance in the South with grant, loan, equity, and guarantee products. Together they have founded the Netherlands Microfinance Platform, which likes to picture its collective involvement in microfinance as the Dutch Offer.

Unfortunately, most of all these actors are inactive in Ethiopia microfinance. In fact, only three platform members, all funding agencies, can show a substantial involvement in the industry: ICCO through its Terrafina program, Cordaid and Oxfam-Novib. They, together with Hivos, a fourth funding agency, have recently established a new platform named MicroNed, which is to enhance cooperation and coordination among themselves. It is MicroNed that commissioned this Ethiopian country scan and solicits suggestions for coordination and cooperation to consider.

Since the MicroNed members are part of the broader composition of the Netherlands Microfinance Platform, and since all other Platform members are largely inactive in Ethiopia, a first strategic consideration is to use MicroNed involvement as a lever to create higher levels of involvement of other Platform members.

A second strategic consideration is to think of opportunities to support the Ethiopian industry at large to deal with some of the issues and challenges mentioned in the previous section of this paper. That would mirror the collective action aimed for at the side of MicroNed.

5.2 A New leverage Mechanism.

A possible way to overcome this prohibition and to facilitate MFIs in capturing domestic capital markets is to establish an equity and capital leverage institution in Ethiopia. Initial discussions with senior MFI managers lead to the following contours of such a facility.

- Formal establishment of an investment shareholding company under Ethiopian law.
- Unlike MFIs, regular shareholding companies generally can accept foreign capital intake in the form of equity.
- MicroNed members and possibly other Platform members can place equity and investment capital in the company.
- The company's capital can be directly invested in MFI equity; the company therefore becomes co-owner of the MFIs it invests in and can assume board membership.
- Conditional to assuming equity positions in a MFI is that its Memorandum of Association will remove any obstacle towards declaring cash dividend and that the MFI, if need be, re-registers itself with the NBE.
- As equity positions will not require considerable amounts of capital given low current capitalization levels, the remainder of the company's capital can be used for issuing partial guarantees to Ethiopian banks for issuing loans to MFIs.
- The combination of equity positions, professional investment supervision and guarantee provision will most likely open the market for comprehensive domestic borrowing by MFI from banks.
- The company would likely be able to offer larger guarantees than its own capital base would allow for, by including banking partners in the Platform in structuring guarantee deals. By virtue of the reputation of these banks, such guarantee back-ups do not have to be placed in deposit with the banks issuing loans to MFIs.

After some initial experience it could be expected that the Ethiopian banks will reduce guarantee requirements, increasing leverage potential, and could be convinced to move away from mid-term debt, 3-5 years, to longer term loan provision or even issue subordinate debt, helping MFIs to improve liquidity management as the borrowed fund will stay longer with them.

The leverage facility would be particularly useful for MFIs owned by capital-poor NGOs. They can little contribute to strengthening their own MFIs' capital base and their NGO status as well as limited supervisory capacity is a potential obstacle for these MFIs in accessing domestic debt finance.

If this suggestion is of any interest to MicroNed members, the network is recommended to commission a study into the feasibility of such a leverage facility. Apart from looking into real MFI demand and bank interest, the study

would need to collect first response from regulators and other relevant government institutions. In case of minor legal obstacles, there appears to be room for negotiating special charter status for the facility.

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