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MICRO-FINANCE INSTITUTIONS IN ETHIOPIA: ISSUES OF PORTFOLIO RISK, INSTITUTIONAL ARRANGEMENTS AND GOVERNANCE*

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ABSTRACT

The paper looks at the portfolio risk and resource allocation implications of the region-based nature of MFIs; implications of some regulatory restrictions in place on the expansion and viability of MFIs, and on availability of small enterprise finance, and some governance issues. While there are good reasons for establishing regional MFIs, the regional nature limits their ability to reduce credit and liquidity risks by diversifying away idiosyncratic risks in connection with their loan portfolio and sources of finance. There is unduly high dependence on interest income; MFIs need to diversify to non-lending services. Although MFIs were hoped to fill the financing gap to micro and small borrowers, the regulatory limits on loan size and term to maturity and MFI's preference for small, short-term loans tend to pre-empt this. The system of governance in place in most MFIs is weak. Individual commitment and dedication aside, neither shareholders nor board members nor management seem to have appropriate incentives. The composition (qualification mix, business experience, etc.) of MFI boards also needs to be reconsidered.

1. INTRODUCTION

Poverty alleviation efforts involve enabling measures that increase the capacity of the active poor to engage in gainful activities (farming, petty trade, micro and small enterprises, etc.) so as to enhance their earnings and/or reduce variability of earnings (i.e. smoothing). Given their locational flexibility, low requirements of capital, training and technology, and labour intensive nature, micro and small enterprises (MSEs) are increasingly recognised as *effective instruments* not only of *poverty alleviation*, *broad-based development* and *job creation* (hence more equitable income distribution) but

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* The opinions expressed here are those of the author and do not necessarily reflect the views of the Ethiopian Development Research Institute (EDRI). I am grateful for comments by anonymous referees. Any remaining errors are mine.

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also of rapid economic growth and structural transformation. Some also view them as "incubators of indigenous entrepreneurship"[1]

Equally recognised is that the poor are hindered from being engaged in such activities by, *inter alia*, finance constraints, from the formal financial sector in particular. So are micro and small business operators[2]. The main reasons cited in the literature are high transactions cost of small loans, information problems (hence *adverse selection* and *moral hazard* effects), lack of appropriate collateral, and the informal nature of their businesses. The problem is more pronounced in rural areas due to limited presence of formal lending institutions and the problem of covariant risk. The absence of formal financial institutions in rural Ethiopia also means that a substantial section of the population lacks access to alternative financial assets and financial services in general, and that mobilisation of rural savings is, at best, weak. Hence, the need for financial institutions that specialise in the provision of small loans (micro finance[3]) and mobilise small savings.

Cognisant of these, governments, NGOs as well as bilateral and multilateral donors have given high emphasis to Micro Finance Institutions (MFIs). (The Economist (November 1999) remarked: "Micro-finance is one of the trendiest areas of international development"[4]). Ethiopia is no exception. This is evidenced by the introduction of micro finance programs (e.g. at the Development Bank of Ethiopia (DBE)) and the proliferation of both NGO-based and government-supported MFIs in recent years[5].

It was found necessary that micro finance services be business-like (rather than aid) and bring these activities "within Ethiopia's monetary and financial polices", hence the enactment of the Licensing and Supervision of Micro Financing Institutions Proclamation No. 40/1996 which requires MFIs to be established as share companies. The proclamation enhanced the status of MFIs as it allowed them to, among other things, legally accept deposits from the general public, draw and accept drafts, and manage funds for micro financing business (Article 3 (2a, b, i)). However, their engagement in such functions also makes it necessary that their activities be brought under the purview of the financial regulatory framework[6]. The emergence of a number of MFIs since then is encouraging. However, the width and depth of poverty in the country requires provision of financial services to the poor on *sustainable* basis. For an institution in a deposit taking-lending business such as MFIs to do this, it has to be financially *viable* as it cannot count on cheap subsidised funds.

The limited previous studies on MFIs focused on assessment of their impact, and/or loan recovery rates and their implication on sustainability. This paper looks at the viability issue by examining aspects of their current organisational structure, the legislation and National Bank of Ethiopia (NBE) directives that govern them and their governance. It is based on data obtained from MFIs, extensive discussion held with

their managers and examination of relevant documents. The rest of the paper is organised as follows. Section 2 gives brief history of MFIs. Section 3 examines the implication of the structure of MFIs on their portfolio structure and the potential risks therein. Section 4 deals with some regulatory restrictions in place and their implications on the expansion and viability of MFIs, and on availability of small enterprise finance. The issue of MFI governance is discussed in section 5. Section 6 concludes with a summary.

2. BRIEF MFI HISTORY

Microfinance evolved in the 1980s as a development approach that intends to benefit the (active) poor largely as response to the failure of targeted subsidised cheap credit programmes. In such programmes, benefits mainly went to those with connections and influence rather than the target beneficiaries; large loan losses accumulated, and frequent re-capitalisation were required to continue operating, suggesting the need for a new approach. The new approach considers microfinance as an integral part of the financial system, emphasises *sustainable institutions* operating on market principles to serve the poor (as opposed to *subsidised* loans to target populations), and recognises the importance of both credit and savings services (Ledgerwood 1999). On the other hand, a pilot project led by professor Yunus in the late 1970s had demonstrated that the poor can be bankable and that high loan recovery rate can be achieved under non-collateral lending, leading to the establishment of the Grameen Bank (in 1983). Grameen Bank became a highly publicised success story.

Governments, donors, NGOs, etc. found both the new approach to finance and MFIs appealing. This led to efforts to establish Grameen-Bank-type institutions, resulting in the proliferation of MFIs. Generally, MFIs focus on the active poor, give emphasis to women, provide group-based lending, and use compulsory savings, joint liability and social sanctions.

MFIs in Ethiopia are rather new. The early formal microfinance activity is the DBE Pilot Credit Scheme, initiated in 1990 under the Market Towns Development Project*, implemented in 1994. While many NGOs had credit schemes for years, NGO programmes that emphasises both *credit and savings* began in early 1990s. For example, the REST Credit Scheme of Tigray (RCST) (now Dedebit Credit and Savings Institution, DECSI) was launched in 1993, Sidama Saving and Credit scheme (now Sidama Microfinance Institution) was established in 1994, Oromia Credit and Saving Scheme (now Oromia Credit and Saving S. C.) started in 1996. Currently, there are more than 18 MFIs, registered and operating in accordance with Proclamation No. 40/1996.

3. INSTITUTIONAL/ORGANISATIONAL ARRANGEMENT, PORTFOLIO STRUCTURE AND RISK

Financial viability (also called financial self-sufficiency) refers to the ability to cover both *direct* costs (i.e. financing costs, loan loss provisions, operating expenses) and *indirect* costs (i.e. adjusted cost of capital) with operating revenue (i.e. revenue from credit and savings operations and investment)[8]. Financial viability is essential for MFIs to expand outreach and provide services on sustainable basis. An important determinant of financial viability is *risk* as it affects both the cost and the revenue side. The major types of risks deposit taking-lending institutions such as MFIs face are credit risk, liquidity risk, reputational risk, operational risk, market risk, interest rate risk, and legal risk. In this paper, we look at aspects of portfolio structure, institutional arrangement and governance of MFIs that have implications on the first four types of risks and their likely consequences.

Portfolio structure and risk:

Some of the existing MFIs are region based[9] both in terms of their lending activities and sources of funds (while others depend on donor funds[10]); of the 18 registered MFIs that are currently operational, 7 are regional. There is also an almost complete dependence on the lending business, hence interest income is the only source of income.

For a deposit taking-lending institution such as MFIs financial viability is crucial for at least two reasons: (a) Outreach expansion and provision of services on sustained basis is possible only if they are viable. (b) Failure of such an institution has significant negative externalities (more on this latter).

Although regional MFIs are established for a good reason, this, in my view, has two negative consequences with implications on their financial viability. First, it segments the rural credit market in ways not based on *risk capacity* and *transaction cost* considerations. Second, it effectively limits the scope for diversification of their loan portfolios as well as sources of loanable funds, exposing them to risks that are *idiosyncratic* to their respective area/region[11], hence are diversifiable. If, for instance, some natural disaster such as severe drought occurs in an area/region, (a) their loan portfolio could be wiped out due to widespread default (i.e. credit risk), and (b) source of loanable funds (i.e. savings to be mobilised in the area/region) could dry up. Such a squeeze from both directions impairs liquidity[12], which in turn affects ability to obtain sufficient funds - through deposit taking or converting assets promptly - at reasonable cost, hence profitability. The risk is real, particularly for MFIs with large operations in rural areas and in drought-prone regions. Neither group/centre guarantee nor social sanction nor physical collateral will be of much help since such events simultaneously affect many groups and erode the value of asset collateral.

Failure involves costs, other than the loss of owners' capital and jobs, each of which has serious consequences. These include disruption of credit services; loss of deposits; erosion of public confidence, and loss of information 'capital' of the MFI.

Disruption of credit services of failing MFIs affects the activities of their clients since getting alternative lenders to switch to may not be easy (or, at least, will be costly[13]). The problem will be more pronounced if the failed MFI was the only one in the area/region (which is the case in many regions), hence an argument for having more than one MFI operate in a given area. Given the agro-climatic diversity of Ethiopia, this risk is diversifiable. Moreover, intangible assets such as the information capital the failed institution possessed about its clients, borrowers in particular, are lost as they are not easily transferable.

Bad reputation is particularly damaging for a deposit taking-lending institution since it erodes *confidence* of depositors, creditors and the general market place. The major sources of reputational risk are operational failures and failure to comply with relevant laws and regulations. Failure of a deposit-taking MFI affects depositors which, while probably negligible at the aggregate, may be huge locally as well as for individual depositors. Its depositors, likely to be mostly low-income individuals and micro-enterprises, lose hard-earned savings; savings which may constitute a significant proportion of their wealth. (That the potential losers are poor and less informed about the risks involved argue for introducing some protection against such losses such as deposit insurance, which can be justified on both economic and moral grounds). It also imposes negative externality effect on other MFIs, and deposit-taking institutions in general, by eroding confidence among the affected groups and the public at large.

These argue for (a) giving due emphasis to the issue of MFI financial viability early on through, *inter alia*, diversification; (b) proper regulation and supervision of MFIs; (c) putting good MFI governance in place; and (d) having some insurance mechanism to partially compensate *small* depositors in the event of failure.

Diversification of both sources of funds and loan portfolios is one important consideration. There are several (not necessarily mutually exclusive) potential alternatives: allowing MFIs operate cross-regionally; linking MFIs; and linking MFIs with banks.

Allowing MFIs to mobilise savings from and undertake lending activities in both rural and urban areas without restriction. This has the additional advantages of eliminating the monopoly and market segmentation problems, as well as inducing efficiency improvement in MFIs by introducing competition between them. One major limitation of this is that it will be costly for individual MFIs to establish a large network of branches covering various regions (hence not feasible even in the medium term). Moreover, it may be argued that, being the "first mover" in the rural areas of their

respective regions. MFIs have little or no prior information about the profitability of their "catchment areas"; they need to explore, hence incur exploration costs. Exposing them to competition too early (i.e. before they recoup these costs through abnormal profits) may make sustainability difficult, unless subsidies in the form of technical assistance and other institutional development support are provided. In the absence of support, granting them temporary exclusive rights (i.e. an opportunity to enjoy abnormal profits) as 'compensation' for the exploration costs may be socially beneficial (Hellman et al. 1996). But, one also needs to ensure that they have incentives to improve their efficiency. The length of the exclusive right can be used as an instrument to achieve this; it can be fixed in such a way that it induces efficient entry.

The other alternative is to link the MFIs so that funds flow from surplus to deficit MFIs and/or introduce an inter-MFI fund market[14] where those with surplus funds can lend to those facing shortage. Most of the MFIs are facing shortage of loanable funds despite the fact that they extend only short-term (with maximum maturity of 1-year) small loans, while some apparently have excess funds. There are at least three main reasons to link MFIs: to improve their liquidity, share information, and improve resource allocation efficiency and increase investment both at regional and national levels.

Not restricting the lending and savings mobilisation activities of the regional MFIs to their respective regions and creating links are important not only from the point of view of risk spreading but also diversification of sources of funds and flow of funds. Such a flow allows (a) investment to be undertaken in areas/regions, which otherwise would have been postponed due to lack of sufficient funds within, and (b) better utilisation of resources which otherwise would have either remained idle or been invested in low quality local projects. Of course, in the event that a certain MFI is in trouble, due to *idiosyncratic* risk or otherwise, existing depositors will rush to withdraw their money while savers will be reluctant to hold deposits with it, especially if there are alternative deposit taking institutions. (To some extent other financial institutions may also suffer through contagion effects and erosion of confidence.)

The other reason for networking MFIs (and creating a link with banks) is to facilitate information exchange[15]. Unlike other transactions, credit transaction involves a promise by the borrower to pay in the future, hence there is *uncertainty* as to whether it will be delivered; it depends on borrower's ability and unwillingness to pay. Ability to pay is influenced by, among other things, the borrower's level of indebtedness (i.e. accumulated debt). Information on whether a loan applicant has unpaid past loans from other lenders is thus useful. More so when one considers the fact that, according to the 1960 Commercial Code of Ethiopia, repayment claims on new loans are "junior" relative to prior commitments. While secured creditors have *preferred* rights over unsecured ones, between secured creditors[16] rights "rank in accordance with the date

on which such rights have been registered" while mortgages registered on the same day rank concurrently (Negarit Gazeta, 1960, art. 192). Although MFIs do not normally secure their loans against borrowers' assets, they will still be affected because the availability of assets to be realised affects a borrower's general ability to pay. The old loan may have been secured against the borrower's assets. In fact, that MFIs do not secure their loans against assets and have it registered means that their claims will be *junior* even compared to *new* loans which are secured as the law gives preferred right to secured creditors.

One potential problem with this alternative, however, is that areas with relatively low profitable investment opportunities due to, say, poor infrastructure, may face credit starvation as the MFIs will now consider lending opportunities at a national level. This downside should thus be weighted against the benefits.

A third alternative is to link MFIs with formal banks. However, in this case one needs to ensure that MFIs do not simply become mechanisms for siphoning out rural savings for use in urban areas or for channelling bank funds to rural borrowers. One option is to require MFIs undertake active savings mobilisation and to plough back part of the funds so mobilised to rural areas/localities. The latter, to some extent, conflicts with the objective of allocating funds to their most efficient uses at a national level. On the other hand, not allowing MFIs to make their excess funds available for use by others will be costly both to them and to society since it results in *under-utilisation* or inefficient utilisation of funds and may encourage MFIs to lend to less creditworthy borrowers. So, one needs to strike a balance.

It should also be noted that the benefits of reduced asset portfolio and liquidity risks resulting from diversification of loan portfolios and source of funds across regions come at a price in that the *advantage* of being local (i.e. more information, and relatively easy *monitoring* and state *verification)* is lost.

Another area of concern is the concentration of MFIs on the lending business, having interest as their only income source. They need to diversify their income sources by widening the range of their services[17] to include, among others, transfers, safe-keeping, rural insurance, etc. Regarding agricultural (or rural) insurance, the insurance premium involved may be too high for most rural agents given the high natural risk and covariance of risks in rain-fed agriculture making expansion of coverage difficult. Small membership in turn limits the risk-spreading (sharing) benefits of insurance. Besides, it may be risky for regional MFIs to get into the agricultural (or rural) insurance business, in the drought-prone areas/regions in particular, due to limited scope for diversification. The occurrence of an insured-against-event on a large scale will squeeze their liquidity (rising non-performing loans and drying-up of deposits, and a rise in payout of insurance claims and decline in issue of new insurance policies resulting from reduced ability to pay premiums on the

part of those affected). There are also the issues of adverse selection, unless coverage is fully *comprehensive* (i.e. covers all rather than specific risks–e.g. all crops–and buying insurance is *compulsory*), and moral hazard.

The effect on depositors of failure of an MFI and that bail out is unlikely indicate the need for introducing some insurance mechanism. Partly because failure of an MFI is unlikely to have *systemic* effect and partly due to the moral hazard problems depositor-compensation and bail out create among depositors and MFIs respectively, bail out may be unlikely. In addition to the implications on government expenditure, it is difficult to justify the use of tax-payers' money in cases of failures unlikely to have *systemic* effects.

Institutional/organisational arrangements

Many of the MFIs require Group/Centre[18] formation and prior savings with them by potential borrowers (up to 2.5% of the amount to be borrowed), which is supposed to continue, even after borrowing, in parallel with the loan repayment, as a *precondition* for membership and access to credit. They disburse loans to group members either simultaneously or in turns. They also require regular *weekly* repayments of loans during group meetings.

Group/centre formation requirement

The rationale behind the group (and centre) formation requirement is their *screening* role *ex-ante* and *monitoring*, *enforcement* and *guarantor* roles *ex-post*. Applicants with unsettled repayment obligations or perceived as dishonest or lacking the ability to make good use of funds, hence less likely to repay, will be screened out in the process of self-selection-based group/centre formation. The assumptions are first, since group members know each other well, they are likely to know if an applicant has prior commitments or is dishonest or lacks the ability to put borrowed funds into good use. Second, given that group members are jointly and severally liable for the repayment in the event of default and that the entire *group* will be excluded from future loans if it fails to repay, would-be members have an incentive to reveal the information. It provides a monitoring and enforcement mechanism as group/centre members put pressure on borrowing members to repay, and have incentives (in the form of repayment obligations of unpaid loans and loss of future access to the credit facility) to do so. In the event that a member defaults, the group/centre pays the loan on behalf of a defaulting member[19]. Termination (actual or treat) of credit in areas of high default (if made *public* and *credible*) may provide an enforcement mechanism by creating incentives for the local community in general to put pressure on borrowers to repay (assuming that continuation of the service is in the interest of the community).

However, the screening out of indebted potential borrowers may not work if most or all members of a group have prior commitments as they may agree not to reveal it, say, on reciprocity considerations (not an impossible outcome). More importantly, although making credit access *conditional* on settling previous loan obligations creates incentive to repay, automatic exclusion of those indebted may not be consistent with the poverty alleviation objective of MFIs - it may well be that they are indebted precisely because they are poor. Forming centres which requires several groups agreeing, among other things, to share risk (i.e. undertake to repay a loan by a defaulting group member(s)) is likely to create access problem. There is some evidence that the 'poorest of the poor' find it difficult to form a group (hence tend to get excluded) because others do not want them in their group. Theoretically, the poor can form a group among themselves (NB: MFIs do not accept a group composed of close relatives). Still, they may face a problem since others are reluctant to have such a group as a member (several groups are supposed to form a Centre). Moreover, given that failure to repay results in loss of future access to credit, these groups are the more likely victims due to their low ability to repay[20]. This defeats the noble (and, in view of the participatory approach to development, economically sensible) objective of reaching the poor, with implications on their capacity to participate in the development effort. Besides, excluding an entire group from future loans (irrespective of their record as individual borrowers) for the default of one member does not seem fully consistent with the long-term interest of MFIs. It erodes their potential borrower base by making more and more of individually good borrowers ineligible for credit (Von Pischke et al. 1996).

MFIs are expected to use a social sanction mechanism to enforce repayment (i.e. social collateral). The question then is, in the event that a borrower has two loans, a bank loan, which is secured (hence accorded priority by the law), and a loan from an MFI (backed by social collateral) but lacks resources to repay both, which loan would the lender give priority to. In other words, which of the two enforcement mechanisms (social sanction or legal) is likely to prevail? Even banks cannot always count on the priority of claims accorded to secured loans either as all their loans are not likely to be secured. It should, thus, be in the best interest of both MFIs and banks to exchange information regarding borrowers on timely basis (hence to create a mechanism to handle this). A lender cannot afford to make lending decisions under the assumption that it is the first lender.

Prior saving requirement

The main reason given for the prior saving requirement is that it helps to "inculcate the habit of saving and impose financial discipline" among their target populations. While the intention is good, it is not clear whether this is the best way to go about it. To some extent, it may also conflict with their stated objective of providing credit services to the poor, as it excludes those unable to meet this requirement (e.g. the poorest

section of society). Besides, some MFIs (e.g. SFPI) do not allow withdrawal from the compulsory savings until the group (or centre) has fully repaid its loans since they use the amount saved as partial collateral. Its collateral function thus provides another (unstated) rationale for requiring savings prior to borrowing (a fact not fully consistent with the common claim that MFIs provide non-collateral based loans). Moreover, such savings are essentially 'blocked accounts', hence involve significant loss of liquidity to the deposit holders – yet they are regarded as savings (rather than time) deposits for the purpose of interest rates. Besides, such prior saving requirements are most likely to exclude the 'bottom poor' who are most likely to fail to meet the requirement. Emphasis should be given to provision of savings services on terms that promote *voluntary* savings (e.g. open-access, individual accounts). DECSI and ACSI[21] are the exceptions in this respect; as of March 2000, they had mobilised *voluntary* savings of Br 76 million and 41.2 million from 202,000 and 151,942 deposit holders respectively. These amount to 52% and 61% of their respective outstanding loans (Wolday 2000).

Uniform repayment and timeliness of disbursement

While the regular weekly repayment requirement may have advantages, its rigid application under all circumstances may be inappropriate since ability to pay may not be uniform overtime. For example, for borrowers earning a large proportion of their income from agriculture, repayment capacity typically varies across seasons, suggesting the need for flexibility.

There may be security arguments for extending loans to members of a group *in turns* in that making repayment performance of those borrowing first and maintenance of group discipline conditions for access by the remaining group members ensures good behaviour. The practice, however, negatively affects economic activity in at least two ways. First, that one has to wait until group members have repaid in full involves missed opportunity (i.e. one cannot exploit profitable opportunities as and when they arise). Second, lack of continual access to credit for working capital by a member affects existing activities. It should be noted that timeliness of loan disbursement is important.

4. REGULATORY ISSUES

Currently, MFIs in Ethiopia are subjected to restrictions on the size and term of their loans to Birr 5,000 and 1 year respectively (Directive No. MFI/05/96). A single borrower limit is a standard regulatory measure to guard against imprudent behaviour by lending financial institutions in general to ensure some degree of diversification in their loan portfolio. It is meant to limit excessive risk taking through excessive exposure to limited number of borrowers (asset portfolio concentration). Micro finance schemes also use small loan size (together with frequent regular *compulsory*

meetings for savings and repayment[22]) as means to induce the better-off to exclude themselves (i.e. encourage *self-selection* by non-target individuals), who, otherwise, may compete for funds with the poor, especially if the interest rate is low. According to one survey, the average loan size ranged between Br 223 and 2650 (see, Wolday 2000).

There are at least three reasons to raise this limit. First, there exists a financing gap for micro and small enterprises as banks find them unattractive. Second, prudent lending requires maintaining good client base by retaining borrowers with good track record. Third, providing larger loans to good borrowers has singalling advantage.

The National Micro and Small Enterprises Development Strategy (which uses a capital-based definition of size[23] rather than employment size and use of automation (Ministry of Trade and Industry 1997) envisages MFIs to be the source of finance. However, under such loan size limits, MFIs are unlikely to fully cater for the financial requirements of Micro and Small Enterprises as the loan requirements of many small enterprises are likely to exceed this limit. Some of the MFIs are of the opinion that, given their poverty alleviation objective, the Br 5000 limit is reasonable as those requiring a larger amount are not 'poor', hence outside their target population[24]. They are reluctant to expand to Small Enterprise (SE) financing the reason being that, in trying to address the credit needs of SEs, they risk losing their focus on poverty reduction.

This view, however, fails to look at the issue from a *dynamic* perspective. The Br 5,000 limit is restrictive and rigid (constrains economic activity) for at least two reasons. First, since project costs generally increase over time, the number of business activities the 'poor' can potentially engage in with such low capital declines. Second, as the formerly 'poor' clients of MFIs grow, partly thanks to the credit services, their credit needs in terms of size and terms of loan changes (i.e. require loans of larger magnitude and longer maturity) but *still remain too small for banks to lend to*. In other words, a financing gap will be created with implications on growth; those requiring more than Br 5,000 will be regarded by the MFIs as 'graduates', but are not yet attractive to banks. If the objective of MFIs is not only poverty alleviation but also promotion of small enterprises development, then it is necessary that MFIs see their clients through until they grow to a size where they become of business interest to banks. One solution, some suggest, is to introduce a credit guarantee scheme to enable borrowers "graduating" from MFI loans get access to bank loans. However, care should be exercised since credit guarantee schemes are notoriously famous for breeding moral hazard among lenders, especially if coverage is full and free (moral hazard will be lower if the guarantee is only partial by ensuring that the lender shares the loss). Besides, the reluctance of banks to serve small borrowers emanates not only from their riskiness but also from the high transaction costs of

extending small loans (and mobilising small deposits). Credit guarantee schemes may reduce the first problem but not necessarily the second.

It makes good business and economic sense for MFIs to provide larger loans to clients that proved themselves reliable borrowers (i.e. with good repayment record). It allows MFIs to retain a client base of good quality. Maintaining good client base is consistent with their poverty alleviation effort since it contributes to their viability, thereby allowing them to provide credit services on sustainable basis. Not doing this leads to adverse selection in the sense that those who are good as borrowers and successful in their business 'graduate' from MFIs while others remain behind.

Removing the limit (or raising it to a level beyond which banks can take over) has an incentive element in that it *credibly signals* that good repayment performance is rewarded through access to larger future loans. This may reduce the probability of default.

The 1-year term limit (imposed by Article 4 of Directive No. MFI/05/96) on MFI loans ensures the absence of medium- and long-term credit market in the areas and for the borrowers supposed to be served by MFIs. For example, among the common purposes of borrowing by farmers are purchase of ox and cattle (for breeding). In this case, the 1-year term limit becomes too restrictive since, given the amount involved, it may be difficult to pay back fully in a year. In fact, according to information from some MFIs, borrowers are being forced to resell the ox bought with the loan (sometimes at prices lower than the amount borrowed[25]) in order to repay, which defeats the purpose (poverty alleviation) as there is no asset building. Worse, they may have to take other loans (from other sources) in order to repay previous loans (i.e. engage in *Ponzi* finance).

The absence of medium- and long-term micro-enterprise credit facilities and the Br 5000 limit together may also have other undesirable economic effects. (a) Borrowers in a given area are restricted to consider only business opportunities that are *small and have short gestation periods*[26], resulting in engagement in similar activities which in turn leads to quick saturation of the market (with implications on their viability and repayment ability). Opportunities are already limited even without such restrictions. (b) Profitable opportunities with larger capital requirements and/or longer maturity remain unexploited.

While extending the 1-year limit may seem to be the obvious solution, it has other implications. First, there will be a jump in the loanable funds needs of the MFIs. Extending loans of longer maturity would mean that funds will be tied-up for a long time, thereby, aggravating their fund problems. More so when one considers the areas yet to receive credit services and the need for continued access to credit by those already covered. This, however, is not an argument for not extending the term

of loans but rather for raising their lending capacity through aggressive savings mobilisation and other means.

Second, it increases credit risk. In fact, a number of MFIs, not surprisingly, find the 1-year limit acceptable. This is quite consistent with the preference for short maturity, which is typical of lenders, due to safety considerations; i.e. the shorter the term to maturity the less the risk. Third, it changes the maturity structure of their loan portfolio probably creating a *mismatch* between liabilities and assets. Of course, a mismatch *per se* will not be a problem so long as MFIs attract increasing deposits[28].

It is desirable to relax the restrictive loan size (Br 5,000) and term to maturity (1-year) limits on MFI loans at least to clients with *proven repayment records* whose financing needs (both for investment and working capital) has increased due to growth of their businesses. It should also be recognised that with experience in lending, monitoring, collection of loans, etc. MFI's ability to handle larger and longer maturing loans increases. If this cannot be done, an alternative mechanism of closing the financing gap identified above should be sought. Promoting some of the MFIs to special/rural banks whose objective is not only poverty alleviation but also promotion of small enterprise development may be one option.

The legislation governing MFIs has no provisions regarding prudential liquidity requirements and access to last resort lending facility of the NBE. It is not clear whether not subjecting them to liquidity requirements from the start is deliberate (i.e. due to consideration of the costs involved). As deposit taking-lending institutions, MFIs need to keep liquid assets enough to meet normal withdrawal requirements of depositors. Like any deposit taking-lending institution, they are likely, from time to time, to face temporary short-term liquidity constraints, hence need to be provided access to the last resort credit facility of the central bank. Although the NBE has recently introduced a discount/rediscount window facility, that MFIs do not, currently, buy T-bills and government bonds means that they cannot access the facility unless some other arrangements are made.

5. GOVERNANCE

Governance, according to the World Bank (1994), refers to "the manner in which power is exercised in the management of a country's economic and social resources". Breakdown in corporate governance[29] is an important element of operational risk. Such breakdown can cause losses to the institution through fraud or *failure to perform* in a timely manner or cause its interest to be compromised by its dealers, or its staff conducting business in an unethical or risky manner. Issues like whether MFIs have appropriate governance structure including an effective independent board, whether board members and management have the appropriate mix of professional

qualification and relevant experience, and face appropriate incentives are thus important. It is often argued that those in the boards and management of MFIs have commitment. However, commitment, while undoubtedly important, cannot be a substitute for qualification or experience.

The 'individual' shareholders (mostly by virtue of being employees of the respective 'mother' NGOs[30]) are *nominal* shareholders. The legislative requirement that MFIs should be registered private share companies[31] (Proc. No. 40/1996) and the prohibition of unlicensed MFIs (Public Notice No. 2/1998) restricts NGOs from directly engaging themselves in microfinance activities. Our discussion with some of the NGO-based MFIs revealed that they had to establish MFIs using nominal shareholders while they provided the required capital. That the shareholders do not really <u>own</u> the shares, hence have *no personal stakes*, raises the issue of whether they have sufficient incentives to *monitor* both the board and management. The absence of remuneration to board members in some MFIs complicates the governance problem. To the extent that serving in a board is free contribution, even if shareholders have effective monitoring, there is not much that could be done to poorly performing board members other than changing them, which does not solve the basic *incentive* problem. While non-profit organisations such as charities may have non-remunerated boards, MFIs are businesses, not charities. It may also be difficult to hold them legally responsible for damage caused by their failure to properly discharge their duties. The Commercial Code of Ethiopia states that directors "shall be jointly and severally liable to the company for damage caused by failure to carry out their duties" (Art. 364(2)) and "when they fail to take all steps within their power to prevent or to mitigate acts prejudicial to the company which are within their knowledge" (Art. 364(4)). However, it is not clear whether the provisions apply to non-remunerated boards. One may hope that the desire on the part of board members and managers to protect their *reputation* (or commitment to establish one) to provide the incentive to perform. This may, however, work only if the market for managers and directors is competitive, *reputation* is important and information flows well, which is not the case in Ethiopia.

Although we have no detailed information on the composition of board members, there is some evidence that many are from parent NGOs or have NGO background. This raises the question whether a board dominated by people of *NGO mentality* is the appropriate body to set strategies and guidelines for the MFIs which are private share companies supposed to be run like businesses with focus on the poor. Although MFIs have *hybrid objectives* in that they combine *social mission* with *profitability* (and it is not clear to what extent the two are consistent), being profitable (hence sustainable) appears to be a necessary condition for the fulfilment of their social mission, hence the need to run them like businesses.

Some MFIs are fully or largely 'owned' by individual *nominal* shareholders, some of which are *insiders* to the MFIs. The Commercial Code of 1960 requires a share company to be formed by *public memorandum* which shall contain, among other things, "the manner of distributing profits" (Article 313). Accordingly, many MFIs have included, in their memorandum or articles of association, articles which prohibit distribution of dividends or '... irrevocably and unconditionally waiver[d] any claim to the shares and proceeds thereof or their right to transfer same to third parties' (discussion with MFIs). However, there is nothing that prevents them from removing these restrictions by exercising their right to amend the articles in accordance with the Commercial Code[32], although it can be argued that the amounts involved are not large enough to create strong incentives to tempt many into such actions.

Table 1. Ownership Structure of MFIs (% of Equity)

MFI	% of Equity Owned			
	Regional gov't	Assoc/NGOs	Individuals	Total
ACSI S. C	25	75	0	100
DECSI S. C	25	75	0	100
Oromia Credit & Savings S. C	25	75	0	100
Omo Microfinance Inst. S. C.	80	19.5	0.5	100
Specialised Financial & Promotional Inst. S.C.	0	80	20	100
Gasha Microfinancing Inst. S. C	0	61.9	38.1	100
Wisdom Microfinancing Inst. S. C.	0	0	100	100
Sidama Microfinancing Ins. S. C.	0	70	30	100
Asser Microfinancing S. C.	0	97	3	100
Africa Village Financial Services S. C	0	0	100	100
Buussa Gonfa Micro-finance S. C.	0	19.6	80.4	100
Meket Micro-finance Inst. S. C.	0	0	100	100
PEACE Micro-financing Institution	0	16	84	100
Addis Credit & Savings Institution	96.7	3.3	0	100
Mekiit Micro-Financing Institution	0	91	9	100
Eshet Micro-financing Institution	0	20	80	100
Shashemene Idirs Yelimat Agar Micro-financing	0	0	100	100
Benishangul-Gumuz Micro-financing S. C.	20	50	20	100
WASSASA Micro-finance Institution S. C	0	20	80	100

Source: Wolday (2000), and other unpublished documents.

6. CONCLUSION

MFIs are characterised by geographic concentration of their portfolio. For some, this is the result of limited financial capacity to diversify while, for the region-based MFIs the problem is more than that. That they are regional institutions puts an inherent limit on their ability to diversify geographically both their loan portfolio and source of funds, hence are exposed to idiosyncratic risks (risks which can be diversified away). There is also high concentration in terms of their source of income (almost exclusively

depending on interest income). These need to be resolved as they have negative implications on their financial viability, hence sustainability of their services.

Currently, MFIs exclusively focus on short-term loans. The expressed preference on the part of MFIs for short-term loans, and the implication of providing longer term loans on their loanable fund needs and risk means that removal of the 1-year term regulatory limit by itself may not bring material change in this respect. Currently, borrowers 'graduate' from the credit services of MFIs *prematurely* (i.e. before their businesses can attract bank financing) while sustainability (and, arguably, poverty alleviation) requires continued access to finance. It also makes good business and economic sense for MFIs to retain clients with proven record of good repayment by responding to their growing credit requirements until they become attractive to banks. Moreover, the National Micro and Small Enterprises Development Strategy envisages MFIs to serve the financial requirements of Small and Micro Enterprises. But, MFIs themselves are reluctant to move to small enterprise finance arguing that it diverts their focus on poverty alleviation. The strategy, thus, has to be revisited to address the financing gap. MFIs should recognise that retaining a good client base contributes to their financial viability, thereby allowing them to provide sustainable services.

The group/centre formation requirement to access MFI credit creates a built-in tendency to exclude 'the poorest' members of the society as they find it difficult to form a group/centre. There may also be *self-selection* by the poorest section, convinced that others are unlikely to accept them in their group/centre.

MFIs are supposed to be run like businesses. Yet, for most MFIs, the composition of the boards as well as management does not reflect this in terms of their background, qualification mix and business experience. Most have NGO background. Too much weight appears to have been given to commitment and dedication, which, while important, is no substitute for qualification or experience. In the case of MFIs 'owned' by *nominal* shareholders there is also the problem of lack of incentives to monitor the board and management.

NOTES

[1] By providing opportunities for entrepreneurs to utilise their talents and skills in developing and running business. MSE are thought to be better suited to exploit niche markets, enhance economy-wide productivity, and bring about rapid technical change (see, IFC, 1998).

[2] See, Survey on Urban Informal Sector Activity Operators and Small Scale Manufacturing Industries (CSA May 1997), Ageba (1998).

[3] Microfinance refers to the process of lending small amounts of money, without collateral, to help poor people to become entrepreneurs.

[4] Modern technologies such as the Internet are being used to promote microfinance. According to the Economist (November 1999), the number of microfinance institutions (MFIs) worldwide has reached about 10,000.

[5] There are more than 18 MFIs that have registered and are operating in accordance with Proclamation No. 40/1996.

[6] Although many NGOs that had microfinance schemes complained that the proclamation contained aspects that are not consistent with their objectives as NGOs. For example, the legislation requires that an institution should register as a *private share company* and be wholly owned by Ethiopians. Some feel that the establishment of an MFI as an independent private share company that operates on profitability criteria together with the restriction on foreign ownership, makes it difficult for foreign NGOs to continue their credit services to their target population or to support the MFIs themselves.

[7] The Market Towns Development Project is an IDA-financed national level project aiming to develop infrastructure in 16 towns identified as market and service centres and to alleviate poverty through job creation and income enhancement.

[8] The adjusted cost of capital is the cost of *maintaining* the value of the equity relative to inflation (market rate of equity) and the cost of *accessing commercial rate liabilities* rather than concessional loans. (Ledgerwood 1999).

[9] Some of them have registered as national MFIs and are trying to expand by opening branches (e.g. the Specialised Financial and Promotional Institution S.C.).

[10] Most of the MFIs that have their origins in the credit activities of foreign NGOs are heavily dependent on funds donated from their "mother" NGOs rather than deposit mobilisation. This constrains expansion of their outreach since donors are reluctant to continue injecting money into them partly due to the private company status of MFIs. Experience shows that credit schemes that heavily depend on external funds (rather than savings mobilisation of domestic savings) are unlikely to succeed.

[11] An anonymous referee pointed out that this may not be a serious problem since the regions are very large, some of them bigger than some African countries. What matters, however, is not the *physical size* of a region *per se* but the opportunity for diversification (i.e. diversity of potential activities, geo-climatic condition, etc.). There is no necessary correlation between the two. Besides, the small countries cited are constrained by national, as opposed to regional, boundaries.

[12] Liquidity risk arises from inability to meet liability obligations or additional loan requests.

[13] Unlike in the goods market, in the credit market switching is difficult or costly both to the lender and the borrower because of the information-intensive nature of the market. In this market sellers (i.e. lenders) consider not only the price/interest rate the borrower is willing to pay but also his/her quality (i.e. the probability that s/he will repay).

[14] The inter-bank money market is also a potential source of loanable funds for MFIs for their short-term lending in particular. Still another source is foreign borrowing. While this may allow rapid expansion of outreach of lending services, it has several potential problems: it is unreliable, may create a disincentive on MFIs to mobilise domestic savings (more so if it is a grant or involves low interest cost), and involves foreign exchange risk.

[15] The MFIs themselves have emphasised experience sharing and other rationale on the basis of which the Association of Ethiopian Micro-finance Institutions (AEMFI) was established.

[16] All unsecured creditors are required by law to enter the universality of creditors to share the remaining proceeds after secured creditors *fully* recovered their claims.

[17] ACSI and DECSI have made a good start in this respect in that they are acting as agents for the Social Security Authority (SSA) in paying pension benefits to pensioners.

[18] A Centre is formed by a number of Groups.

[19] Although MFIs seem to draw much comfort from the presence of '*group guarantee*', it should be noted that *group guarantee* does not help in the event that a risk affecting the group/centre as a whole occurs which is very likely, for example, in rural areas.

[20] A group composed of *homogenous* members has the advantage of reduced information problem (due to easier access to the information and interpreting its implications for persons who are similar), facilitating screening and peer monitoring. But, it also involves a disadvantage in that the similarity in preferences and

covariance in income flows (sources and levels) of members, hence the risk of delinquency/default by the group as a whole, tends to be high.

[21] DECSI = Dedebit Credit and Savings Institution; ACSI = Amhara Credit and Savings Institution.

[22] Repayment is made in public in the presence of the Group members with consequent *loss of face* if repayment is not made – the assumption is that the *humiliation such disclosure of wrong doing brings will restrain default*. As Goodhart (1997) noted, rogues (scamp, cheat, outlaw) may not be humiliated by disclosure. However, in the case of group lending, it can be argued that *rogues must have been excluded* in the self-selection-based Group/Centre formation process.

[23] The strategy defines Micro Enterprises as those with paid-up capital of up to Birr 20,000, and Small Enterprises as those with paid-up capital of Birr 20,000 - 500,000.

[24] In fact, most of them do not (and do not want to) give loans in excess of Birr 2000 (source: author's discussion with MFI managers).

[25] In determining whether a borrower forced into such a situation actually incurs a loss, one should take into account not only the selling price relative to the purchase price of the ox (or asset in general) bought with the borrowed funds but also the *service it rendered* before the sale.

[26] The short-term nature of MFI finance creates a bias towards activities with short gestation period, typically trade, and against productive activities.

[27] An empirical study in Tigray (Fiona Meehan 1999) has found that while DECSI's credit had significant positive impact on income, "the positive impact ... was dependent on continued access to credit, on a regular basis, and where this was interrupted, the improvement in household income rapidly decreased" (pp. 13-14). This has implications on the loanable fund needs of DECSI.

[28] It should be noted that one of the key economic functions of financial intermediaries is maturity transformation. They accept deposits from a large number of savers on short- to medium-term maturity basis and provide loans on long-term basis, without becoming illiquid since, under normal circumstances, the probability that all depositors would want to withdraw their deposits at the same time is low.

[29] The other elements are breakdown in internal control, failure of information technology systems, events like fires or other disasters.

[30] Nominal shareholders who are employees of the respective mother NGOs 'own' up to 97.5% of the shares.

[31] A share company, according to The Commercial Code of 1960, is "a company whose capital is fixed in advance and divided into shares and whose liabilities are met only by the assets of the company" and where members are liable only to the extent of their share holding (Article 304). A share company could be formed either between founders or by public subscription. Almost all of the MFIs have been formed between founders which are regional governments and NGOs (or individuals) (see, Table 1).

[32] The Code (Articles 423, 425, and 462) stipulates that shareholders can amend their memorandum or articles of association in an *extraordinary* meeting with *two-thirds* majority attendance (excluding abstentions and blank ballots) and with, *at least, half* of the shareholders having voting rights represented (1/3rd and 1/4th in case of a second and third extraordinary meetings).

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