Regulating Microfinance in Ethiopia: Making it more Effective

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FORMAL MICROFINANCE in Ethiopia started in 1994/5. In particular, the Licensing and Supervision of Microfinance Institution Proclamation of the government encouraged the spread of Microfinance Institutions (MFIs) in both rural and urban areas as it authorized them among other things, to legally accept deposits from the general public (hence diversify sources of funds), to draw and accept drafts, and to manage funds for the micro financing business. Currently, there are 23 licensed MFIs reaching about 905,000 credit clients and some saving clients. Considering the potential demand, particularly in rural areas, this only satisfies an insignificant proportion.

The Amhara Credit and Saving Institution (ACSI) was established in the Amhara region, and aims to fill the gap of formal institutions by meeting the needs of small scale borrowers in income generation schemes. It was initiated by the Organization for the Rehabilitation and Development in Amhara (ORDA), an indigenous NGO engaged in development activities in the Amhara region. In a move to depart from the more usual direct provision of relief, the NGO created a department to supply small credit to rural people on a pilot basis. That department grew into a separate institution, and ACSI was licensed as a microfinance share company in April 1997, with the primary mission of improving the economic situation of low income, productive poor people in the Amhara region through increased access to lending and saving services.

ACSI currently delivers four types of financial products: Credit, Savings, Pension Fund Management and Money Transfer. Through its 10 branches and 174 sub-branch field offices, it has reached all Woredas (districts) in the region, and operates in over 2221 Kebeles or Peasant Associations (over 75% of the total). As of February 2005, ACSI had an outreach of over 345,000 active credit clients (with over US$ 35 million outstanding loan balance), 35% of them being poor women. With an estimated potential market of about 2.9 million people in the region, ACSI and other smaller MFIs and Saving and Credit Cooperatives (SACCOs) in the region only manage to reach between 10 and 12% of the demand.

ACSI operates under the regulatory framework laid-out by the National Bank of Ethiopia. Obviously, since the microfinance institutions in Ethiopia are depository MFIs, the Government needs to oversee the financial soundness of the MFIs. Thus, there are different government policies, laws and directives in Ethiopia which affect directly or indirectly the development of the microfinance industry. These mainly include: Proclamation No. 83/1994, Proclamation No. 84/1994, Proclamation No. 40/1996. In particular, Proclamation No. 84/1994 regarding the licensing and supervision of banking business provides that only incorporated institutions may conduct banking business, and only if they are licensed by the National Bank of Ethiopia to do so. The proclamation allowed, for the first time, the

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2. The Kebele (Peasant Association) is the lowest Government administrative unit, and covers on average 5,000 people (1000 households). The higher level Woreda (District) covers about 100,000 people.

3. Demand estimates calculated in ACSI’s 2001-2005 Strategic Plan.
establishment of private financial institutions, thus breaking the state monopoly in banking sector. (See Amha 2004).

Proclamation No. 40/1996, titled “A proclamation to provide for the licensing and supervision of the business of microfinance institution”, and the 17 directives issued by the National Bank of Ethiopia, constitute the major legal and regulatory framework which is used to regulate and supervise the microfinance industry. In the proclamation, microfinance business is defined as “an activity of extending credit, in cash or in kind, to peasant farmers or urban small entrepreneurs.” The NBE is empowered to license, supervise and regulate the delivery of financial services to the rural and urban poor through microfinance institutions.

In as much as the regulations have created an enabling environment for the healthy operation of the microfinance industry, there still is room for improvement that needs to be taken into consideration. The following paragraphs try to highlight these areas, as they affect the operations of MFIs like ACSI.

**Foreign ownership of MFIs**

Currently most types of non-financial foreign direct investment are encouraged by the Ethiopian government, while financial foreign investment, including the banking business in whatever form, is prohibited. Specifically, Proclamation No. 84/1994 precludes a foreign national from undertaking banking business in Ethiopia, and no person is permitted to own more than 20% of a banking company's shares. Accordingly, MFIs in Ethiopia should be established as share companies, the capital thereof owned fully by Ethiopian Nationals and/or organizations wholly owned and registered under the laws with a head office in Ethiopia.

The challenges or problems that constrain the government from permitting foreign banks’ entry include many interrelated factors. Perhaps most importantly, foreign bank competition with infant domestic banks may be detrimental to the domestic banks rather than making them efficient. Moreover, foreign banks will focus on private returns rather than social (i.e., serving the poor), and given their easy access to funds in the international financial market, they may not be interested in mobilizing domestic savings. There is also the possibility of a sudden outflow of capital in response to changes in investor sentiment which would bring instability in the domestic banking system. Finally, given the current capacity within the NBE, there will not be any mechanism to effectively supervise and monitor that these foreign banks are operating within the law.

On the other hand, however, if foreign banks penetrated the Ethiopian financial system (through subsidiaries, branches, joint ventures, etc...) and brought “packages” of services with them, the domestic financial system may benefit in terms of: higher levels of efficiency in service provision due to increased
competition, more advanced technologies in the provision of financial services; higher quality and quantity of services; better training in financial management; and proper risk assessment and evaluation, leading to improved loan portfolio quality; enhanced access to international capital, either directly or indirectly through parent banks; and potentially increased lobbying for a proper regulatory regime for the entire banking sector, etc.

Obviously, restricting foreign ownership could restrict the growth of the financial sector in general. On the other hand, given the limited experience, capacity and infant stage of the newly established banks, foreign banks could tend to destroy the ability of the young private banks owned by Ethiopian nationals, and given that some of the costs and risks of allowing foreign banks is often unavoidable, they could affect the whole economy negatively. Thus, before allowing the foreign banks to invest in Ethiopia, clearly enough time (with a definite time table) should be given to strengthen the local private banks, including MFIs. But this should not continue permanently. Specifically, the supervision department of the NBE should be given definite time to build its capacity in supervising foreign banks.

On the other hand, whereas foreign ownership of MFIs is “officially” restricted, lack of transparency in capital ownership poses a real threat to the health of the industry. It is clear that in some MFIs equity structures are sponsored by foreign donors who have contributed the initial capital required for registration. In these cases, the real owners are not listed as shareholders. "Nominal" shareholders act as "fronts" for the real owners. These shareholders are precluded from selling or transferring their shares and "voluntarily forsake" their claim on dividends, if any, declared by the MFI. Such shareholders do not have a real stake in the organization and would be unlikely to lend it support at a time of financial crisis. The NBE needs to design effective mechanisms to verify how each MFI is operating.

**Ceiling on interest**

Interest rate ceilings on loans charged by MFIs were lifted by Directive No. MFI/11/98, which reads, “the interest rate to be charged on loans and advances extended by a microfinancing institution shall be determined by the Board of Directors of each microfinancing institution.” This has helped many to set a lending interest rate high enough to cover their operating costs. On the other hand, a minimum is set for the interest that can be paid to depositors. The relevant directive in this regard (Directive No. MFI/13/2002) reads: “The minimum interest rate that shall be paid per annum by microfinancing institutions on saving and time deposits shall be 3%”.

This discourages saving mobilization in remote, difficult to reach areas. The administrative cost associated with mobilizing small deposits in poor areas such as the Amhara Region in Ethiopia is so high because of the high ratio of transactions to deposited amount; and small savings are indeed no less expensive than
bank loans. On the other hand, there is enough evidence that, as in the case of credit, the poor are more interested in “access” to safe saving services rather than the income from it, and there is increasing evidence in many poor areas where the poor actually “pay” (directly or indirectly) for efficient saving services. Indeed, we do the poor a great disservice if we remove modern saving options, and let the poor continue to use riskier saving options, because cash kept in the house can be stolen, livestock can die of disease or be un-salable when cash is needed, and so on. Thus, in as much as MFIs are allowed to charge appropriate interest rates on credit to the poor so as to cover their operation costs, it would be also logical to allow them to fix the level of interest they pay to depositors that would be enough to attract enough money for their operations while also recognizing the high transaction costs in attracting this money.

Each MFI is also required to re-register every time it mobilizes an additional one million Birr saving (approx. US$115,500). Currently, however, some big MFIs like ACSI are mobilizing this amount every week. If the monitoring mechanism was enforced, this would imply that they have to re-register every week. It seems appropriate to design a different time schedule for such tasks based on the size and capacity of each MFI.

**Income and Sales Tax**

MFIs are currently exempted from Income and Sales tax, with a provision in the proclamation that the “Ministry of Finance and Economic Development is responsible for handling and management of such issues”. The exemption is quite appropriate, particularly at the initial stage, to protect the “infant industry”, and to help it develop with the profit made from operations utilized for capacity development purposes. Commercial banks, however, are subject to these taxes but there is still no clear road map regarding at what stage of development such tax mechanism would be operational for MFIs, leaving MFIs confused as to how to plan their long-term cash flows properly. The authorities still have no clear line of communication with the MFIs or any monitoring system to understand each MFI’s development, use of profits, etc. that would help them determine an appropriate timeline for this.

**The Revised Regulatory Framework**

**THE REGULATORY FRAMEWORK** has been quite relaxed on the maximum loan size that MFIs can lend to an individual borrower, with a view to accommodate clients who can manage a loan size beyond the ceiling of Birr 5000 (roughly US$ 575). Specifically, the latest regulation states that MFIs can lend to an individual borrower a loan size equal to 0.5% of their capital, with a precondition that the total sum of money to this kind of lending not exceed some 20% of the preceding year’s
disbursement. This has greatly helped MFIs to accommodate the demands of successful clients who need higher loan sizes.

But, the absence of a well functioning and efficient legal system to enforce contracts and denying the foreclosure law to MFIs affects the implementation of prudential regulation and the MFIs’ ability to utilize collateral effectively, especially for larger loan sizes. Prolonged delays in obtaining legal redress from the courts encourage unscrupulous borrowers to default with impunity. Clear property rights are critical to utilizing collateral and implementing asset-based lending. Although there are some improvements, the legal system in Ethiopia is still very weak in enforcing contracts and facilitating microfinance activities.

In addition, revising the loan size should be handled more cautiously. As explained above, in the revised NBE directive, MFIs are allowed to extend a loan amount to a single borrower up to 0.5% of their total capital. But if, as Proclamation No. 40/1996 (Art. 11) states, MFIs can “… obtain a line of concessional credit or any assistance from foreign sources for the purpose of on-lending or capitalization”, and if a substantial portion of the MFI capital is obtained from such sources, some relatively new MFIs may find themselves in a position to be able to lend at very large loan sizes before they actually get the experience and maturity to handle or manage them. Such MFIs, if they cannot manage their portfolio quality, would tend to damage the microfinance industry at large. Thus, it may be important to set separate rates based on the composition of capital.

**Creating a competitive, healthier and more inclusive microfinance sector?**

The minimum paid-up capital requirement was set at the relatively low amount of Br. 200,000 (about 23,000 US Dollars) with the intention of attracting institutions into the industry; however, the number of MFIs has grown at a very slow pace. Thus, though the number of credit clients is more than 900,000 so far, there are only 23 MFIs licensed under the NBE. The average MFI serves approximately 40,000 clients, with a handful of large MFIs contributing the highest client share. Moreover, since most of the MFIs operate in urban and semi-urban areas, competition for clients in rural areas remains very weak, and the rural poor still have few choices for financial service providers.

Thus, clients are dependent on these few MFIs for financial services, whatever their quality and flexibility. In fact, if donors had invested substantial sums in only one or two MFIs, many businesses and households would be at risk if the MFI eventually failed. On the other hand, if a number of MFIs operate, they not only compete against one another, but the failure of any one does not leave the poor without services. Furthermore, MFIs can be innovative in their techniques to select borrowers and ensure repayment, and in stimulating savings. The assumption that the very low minimum capital requirement might overburden the National Bank’s supervisory capacity by permitting too many
licenses seems not to be a realistic one. Indeed, if the NBE is to enhance the provision of efficient financial services in rural areas by attracting more and competitive MFIs, it has to explore mechanisms other than lowering the minimum capital requirement.

On the other hand, there are a number of NGOs involved in micro-finance delivery without a license. Often, their system of lending involves such practices as subsidized interest rates, mixing business with charity, and not following strict business discipline in the treatment of delinquency etc, which make clients dependent on such operations and potentially endangers the healthy operation of the whole micro finance industry. If such NGOs do not follow strict business discipline and price their services properly, the "subsidized" funds pumped into the industry will affect the economy as a whole. For example, a producer that has access to subsidized credit can price his product lower than the one who borrowed at market interest rate, and thus the latter will be placed at a disadvantage. The cumulative effect of this and similar distortions will have a disastrous effect on the entire free market system and relevant government organizations should take action to correct this. Currently, there is no effective mechanism in place to control this and MFIs are losing loyal clients, a potential danger to the microfinance industry.

Microfinance generally targets women. A basic premise is that economic participation is a foundation for other dimensions of empowerment. The recent Microcredit Summit report indicates that women constitute over 79% of clients in the industry globally. However, only 35% of ACSI clients are women, and this also seems to be more or less the case with other MFIs in Ethiopia. As employment and traditional livelihood strategies for men disappear, poor women in increasing numbers have had to make their ways into the informal sector, primarily in low paying and often menial work -- piece work, vending, petty trading, agricultural labour, collecting garbage, cleaning toilets, and factory employment. In fact, it is now believed that about 40% of the households in Ethiopia are headed (de jure and de-facto) by women (IFAD 2001). Clearly MFIs’ vision is poverty alleviation, and this can never be attained without reaching women who suffer all kinds of poverty and deprivation. The NBE may consider setting a certain limit for the proportion of women attained by MFIs, as well as appropriate capacity building mechanisms for MFIs aiming at this objective.

There are also those clients who require loan sizes as low as Br. 50 (about US$ 6) for activities such as spinning required for the production of the local gabi (a widely used traditional Ethiopian cloth). These poor people do not necessarily lack business skills and are not looking for charity hand-outs, as is often assumed. They are not passive recipients of money transferred from other segments of the economy in a top-down approach. Rather, they need to be empowered (through credit, business support, etc...) to create their own jobs and enhance private income. They have the requisite skills for this specific
task, and there is a market for their products. They can fully repay loans given to them and, in fact, they are too proud to look for charity.

Yet such loan sizes imply that a portfolio of just Br. 5000 (the maximum loan size allowed to MFIs until recently) would require 100 clients. Smaller loans mean the need for more credit officers to attend clients, creating very high additional costs, when instead bigger loans could be disposed to one single big borrower. As a result, clients with such a very low loan size are not being treated. If the target set by the Millennium Development Goals (MDG) are to be met, a special incentive system (like the one by CGAP/IFAD’s “Pro-poor Challenge” scheme) needs to be designed for microfinance service providers to reach these very poor people, the majority of whom are women, young and old.

Given the geography of the region where ACSI is operating in, and the poor physical infrastructure (particularly the road network, of which up to 80% is inaccessible during the rainy season), operations in the region as a whole, and predominantly in rural areas, have proved to be a very problematic task. Microfinancing activities undertaken by institutions like ACSI are such that not only does one need to identify and disburse loans to the right client in isolated remote areas, but one also needs to ensure full repayment through daily monitoring and follow up of each client, with very low loan sizes. Very small savings have to be encouraged and mobilized from these same poor people. Live cash has to be transported from one location to the other. And such activities often involve a door-to-door service. If microfinance is to spread in such remote areas, attention needs to be paid to such infrastructural issues.

While it may not normally be the case for a central bank to regulate on these general business practices (such as target clientele, serving women clients, operating in difficult geographies), there are several ways the NBE may get involved. First, by promoting a more competitive market, MFIs and other financial institutions will be driven by free market competition to serve these areas. Second, because one cannot be sure that MFIs would even serve these markets even if there are additional incentives applied, the NBE, as a regulatory body may be the appropriate organizations to work with other relevant government agencies working on poverty alleviation to take action and somehow promote the provision of financial services to these under-served populations.

Education about microfinance also needs to be enhanced. Policy makers, experts in the government sector, NGOs, donors, researchers, and the public – in Ethiopia and elsewhere – have limited knowledge of the regulation of microfinance. For example, other departments of the federal government also working in poverty alleviation projects hardly understand the role and objectives of MFIs in Ethiopia. As such, increased education about microfinance in Ethiopia would help other policymakers understand its role in a comprehensive poverty
alleviation strategy, thus garnering their collaboration and support for these initiatives.

Concluding Remarks

The fact that the Ethiopian government has established the regulatory framework early-on in the development of the microfinance industry has helped to lay out the roadmap for the development of the sector. In particular, the provision allowing MFIs to mobilize small savings from the public has enabled them to finance a substantial portion of their portfolio from internally generated sources. Subsequent improvements in the regulatory framework include the revision of the loan size ceiling for individual borrowers, the revision of repayment periods on loans from one year to two years, and removal of the interest rate ceiling on credit. This removes some of the key regulatory problems faced by the industry. But more needs to be done. The Ethiopian MFIs still have no way of learning new insights from foreign banks, yet indirect foreign ownership cannot be fully controlled, and not enough Ethiopian-owned MFIs are forthcoming. The poor still do not have enough microfinance service providers from which to choose. While the interest rate ceiling on credit has been removed, a minimum on interest to be paid for savings persists, hampering savings mobilization in remote rural areas. Existing microfinance institutions, while targeting to reach the poor, are serving mainly men. Thus, the regulatory framework not only needs to find ways and means of helping the industry become more competitive and efficient in delivering flexible financial services to the majority poor, the regulatory mechanism also needs to be better equipped to supervise and monitor the industry.
References


