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Strengthening Regulation and Supervision of Microfinance Sector for
Development in Ethiopia

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Abstract

This paper analyses regulatory and supervisory issues in the Ethiopian microfinance sector, which caters to the needs of those who have been excluded from the formal financial sector. Microfinance has received increased importance in development because of its grand goal to give credits to the poor to raise their economic and social wellbeing and improve the quality of lives. The microfinance at present has been moving towards a credit-plus period through covering savings and insurance functions. It thus helps in reducing the rate of financial exclusion and social segregation, alleviating poverty and, consequently, stimulating development. The Ethiopian microfinance policy has been generally positive and developmental but major regulatory and supervisory limitations such as the absolute prohibition of NGOs to participate in microcredit functions, higher risks for depositors of microfinance institutions, lack of credit information services with research and development, the unmet demand, and risks of market failures due to over-regulation are disappointing. So, to remove the limited reach and high degree of problems typical in the informal means of financial intermediation plus to deal with the failure of formal banks to provide basic financial services to a significant portion of the country's population, more needs to be done on microfinance. Certain key regulatory and supervisory revisions hence need to be taken to strengthen the Ethiopian microfinance sector so that it can practically provide majority poor access to a range of high quality financial services that help them work their way out of poverty and the incapacity it imposes.

Keywords

Microfinance, microfinance regulation and supervision, microfinance institutions, financial access, social segregation, poverty alleviation, development, and Ethiopia.

Abbreviations

ACSI: Amhara Credit and Savings Institutions

AEMFI: The Association of Ethiopian Micro Finance Institutions

DCs: Developing Countries

DECSI: Dedit Credit and Savings Institutions

ETB: Ethiopian Birr

FDRE: Federal Democratic Republic of Ethiopia

GDP: Gross Domestic Product

GTP: Growth and Transformation Plan

ICT: Information and Communication Technology

MDGs: Millennium Development Goals

MFIs: Microfinance Institutions

MIS: Management Information Systems

NBE: National Bank of Ethiopia

NGOs: Non Governmental Organizations

OCSSCO: Oromia Credit and Savings Institutions

PASDEP: Plan for Accelerated and Sustainable Development Programme

PRSP: Poverty Reduction Strategy Paper

R&D: Research and Development

SMEs: Small and Micro Enterprises

1. Introduction

1.1. Microfinance and Development: From Directed Credit towards Inclusive Finance

‘Indeed, microfinance is rapidly shifting from a niche product to a globally recognised form of finance. Yet as microfinance offerings become more sophisticated and diverse, regulatory and market gaps keep the industry from operating as well as it should. This increases the need for a systematic way of tracking and evaluating conditions for microfinance’.¹

Many policy interventions, including better nourishment to enhance levels of productivity and wages; control of population growth to free resources for human capital investment; education for women to fight inequalities and bring empowerment; and stronger property rights to direct markets have been suggested to deal with deep-rooted development problems, or at least to perceptibly alleviate poverty.² To create a sustainable development structure against the background of increasing globalisation, there is presently, on the whole, a proposition for critical globalism and/or interdisciplinarity which refers to theorising the entire field of forces in a way that takes into account not just market forces but also interstate relations, international agencies and civil society in its domestic as well as transnational manifestations.³ In particular, considering that the state has been internationalised in the framework of globalisation thinking, there is a credible argument of a better and a changed responsibility of the state concerning development.⁴ There is accordingly a range of policy reactions to the situation.

Whilst much optimism has recently been placed on the effectiveness of expanding access to financial services, commercial banks hitherto have had observable difficulty providing such access helpfully. The unbanked and/or under-banked tend to be deprived and regularly not have worthy assets to submit as pledge for credits that can, in principle, bring gains in both efficiency and equity.⁵ Besides, many of the unbanked have the incentive to make transactions at too small a size to be a focus for profit-seeking institutions.⁶ The microfinance has thus had to argue from the context of these motivation problems along with more usual challenges imposed by transactions costs. Also, an extensive list of other issues related with poverty including low education levels, poor health, discrimination, and weak labour markets are more critical.⁷

At the outset, much of the interest on financial access centred on programs for microcredit delivery. With the start of experimental programs aimed to provide very small credits to groups of poor people, particularly women, to engage in self-employment projects and transform economic and social structures, the model microcredit was invented in Bangladesh.⁸ The best known campaigner has been Muhammad Yunus, the co-winner of the 2006 Nobel Peace Prize together with Grameen Bank founded to serve the poor of Bangladesh.⁹ Over the years however, caused mainly by urban-biased credit allocation, higher transaction costs, interest rate restrictions, high default rates and corrupt practices, government rural credit programs to reach low-income households are collapsed overall.¹⁰ Since the 1980 thus, as a substitute to the observed failures of capital transfer and government-directed credit¹¹ as well as to the formal financial system to supply financial services to poor, the emphasis in development policy has shifted towards expanded expression microfinance selected to be inclusive of other financial services for the poor, including savings and insurance.¹²

Today, microfinance is entering an innovative and more dynamic stage. Microfinance sector primarily plays a significant role in the fight against poverty by allowing poor households to raise their income and assets.¹³ Microfinance delivers expanded financial services such as deposits, loans, payment services, money transfers and insurance to the poorer and low income segments of the population and their micro-projects.¹⁴ Provided that they do not borrow excessively, such basic financial services contribute to the potency of domestic economic life of the many poor and under-served people of the developing countries (DCs) through increasing capitals and helping production, exchange and consumption.¹⁵ Microfinance hence is a system that potentially serves the poor with comprehensive financial services in a most supportive and dynamic way primarily.

Additionally, the microfinance movement, through its constructive social impact, such as female empowerment and education, noticeably has assisted to ease gender concerns. Country specific researches where microfinance services are prevalent prove the realisation of higher literacy rates, higher levels of contraceptive use, and lower fertility rates for women.¹⁶ Critics conversely reject this assertion such as even if a woman gets a credit, she submits it to her husband for his personal dealing thus simply manipulated let alone to be empowered.¹⁷ While this may actually be the case, the microfinance sector has provided an unprecedented employment chances for women with limited skills in customary life.¹⁸ This

among others gives women an income, which allows them the opportunity of supporting themselves and their families. The conclusion of 20 years of analysis on microfinance in Bangladesh confirms that, overall, the relevant outcomes have been positive in this regard.¹⁹

Microfinance finally has praised for enhancing equity in the global financial structure. It sensibly has assisted in ‘democratising global financial markets through new contacts, organisations and technology’.²⁰ In Kenya for instance, people by now get cheap cash transfer service through a message-based technology called M-PESA which allow them to transfer cash electronically to other mobile users.²¹ Additional examples can be the ever-increasing participation of commercial banks²² and the improved foreign investment, both debt and equity, which has quadrupled to reach USD13 billion during the 2007-11 period, into the sector.²³

In general, a single sector or technological innovation cannot indeed address poverty and other development concerns. Complex and multidimensional reasons contribute to financial exclusion also and hence require an all-inclusive variety of providers, products, and technologies that work in and are a manifestation of the socio-economic, political, cultural, and geographic conditions of each country. So, countries are in the best position to appraise their domestic institutional, socio-economic, financial and political circumstances and practise the approach that best fits to them. As there is no distinct prearranged models for improving financial access, DCs are thus focusing on a set of solutions best appropriate to their national environments.²⁴ For example, El Salvador is investigating how publicly owned banks can play a more important role; Jordan is using macroeconomic measures and the promotion of the inter-bank and bond markets; Brazil and Egypt are focused on supporting channels for delivering new products; and others like Peru and Indonesia concentrate their efforts on empowering people so they can make improved use of already existing services.²⁵

Absolutely therefore, microfinance is not a panacea. But, generally, as it enables expanded financial access for those ordinarily ignored by formal banks because of their lack of collateral and credit scores, there is an unequivocal contributory links between ensuring accesses to microfinance services, solving the poverty problem and, accordingly, stimulating development.²⁶ Countries hence need to maintain the sector’s competent operation. In DCs particularly, capacitating poor people to access basic financial services and combating poverty sustainably imply the necessity to take the microfinance field into consideration.

Precisely put, the respective governments of such nations should efficiently regulate and supervise the microfinance sector as a tool for expanding financial access to the nearly ninety percent of population who are excluded from the commercial banking sector.²⁷ The paper on this ground emphasises the same notion and, then, asserts that microfinance sector involves an effective and adaptable potential for development.

1.2. The Overview of Regulatory Requirements for Successful Microfinance

Microfinance involves a wide range of organisations known as microfinance institutions (MFIs) which initially has been established in DCs with the narrow purpose of credit delivery and limited concept such as group lending contracts, character based lending, short-term repeat loans and incentives for loan repayments.²⁸ Today however, there are considerable rising in the scope of financial intermediations (including deposit taking) provided by these institutions as well as in the number of the institutions and their customers. These new trends have contributed to an ever-increasing credit and financial and operating risks that concern the microfinance sector.²⁹ So, revising regulation to control these perils becomes essential.

Given the above phenomenon in the microfinance field, regulation indeed is indispensable. However, compared to the formal financial intermediaries (banks primarily), there are certain specificities as to MFIs institutions' risks³⁰ that makes them vulnerable to high risk of evasion, problems of information irregularity in measuring customers risk profile and a high discrepancy in expected returns.³¹ Such peculiarities in MFIs mainly include client base, the total asset base, the lending methodologies, the structure and governance, the portfolios, and the deposits.³² Therefore, because of certain differences and with the goal of allowing MFIs to find modern resolutions for their overall efforts, regulation for microfinance sector has to be adopted avoiding certain commercial principles used in the regulation of formal financial system.³³

1.3. Aim of the Paper

This paper examines microfinance regulation and supervision matters in Ethiopia. Despite the above underlined key potential of microfinance for expanding financial access, many countries have been regrettably relaxed in efficiently regulating and supervising this sector. Specifically, the microfinance field regulation in most DCs is very weak and impedes the improvement of competent approaches for the provision of the valuable micro financial

services and the associated constructive social and development benefits.³⁴ Similar to many other DCs, the Ethiopian microfinance sector also faces different regulatory and supervisory limitations that require change.³⁵ The main aim of this study is thus, by thoroughly reviewing the literature concerning the rationale behind, the determinants for, and the common aspects of an effective microfinance regulation and supervision approach, to critically evaluate and classify such limitations. It shall also give some recommendations for strengthening microfinance sector regulation and supervision in Ethiopia to improve financial access and social inclusion for the significant portion of the country's population that lives without access to basic, affordable and sustainable financial services hitherto³⁶ and, consequently, contribute to the country's development endeavour.

1.4. Structure of the Paper

The rest of the paper is organised as follows. The second part thoroughly reviews the literature about the debates in and the determinants for microfinance regulation and supervision. The common aspects of an effective microfinance regulation and supervision approach are also identified. This then serves as a theoretical framework for the paper's ultimate evaluation. The third part deals with the country background of the study. It presents an overview of the Ethiopia's financial sector and financial access. It in addition introduces the existing microfinance regulation and supervision framework in Ethiopia. Part four is the critical one. It deals with the evaluation of the remaining limitations in the microfinance regulation and supervision framework of Ethiopia in light of the theoretical frame set up in chapter two. The final part then presents the conclusion of the dissertation and, so, provides certain important recommendations that help to strengthen regulation and supervision of microfinance sector for expanding financial access and, consequently, alleviating poverty and spurring development in Ethiopia.

2. Regulation, Supervision and Microfinance

Regulation, as to the financial system, refers to a set of enforceable rules created to direct the structure and the functions of financial markets' intermediaries and accordingly correct the effect of their action. Directly connected to regulation, the concept of supervision is defined as the prompt ensuring of the execution of such norms incorporated in the regulation.³⁷ The ground for regulation and, consequently, supervision, of the formal financial system

principally derives from the necessity to control the possibility of a market failure.³⁸ It is definite that banks, as it is the case for other business firms, will fail and the possibility of this danger is higher when risks in a particular banking concern are not supervised properly, bubbles in certain markets collapse or financial markets are very weak due to either domestic or foreign causes.³⁹ Thus, regulation and supervision for banks conventionally is necessary to promote competitiveness and consumer interests.⁴⁰ However, financial regulation nowadays is additionally understood more regularly as a tool needed to promote developmental objectives.⁴¹

2.1. The Debate for and against Microfinance Regulation and Supervision

There is debate as to whether regulation and supervision is really needed in the microfinance sector in light of, as it is the case for the formal financial system, the necessity to promote stability, efficiency and competitiveness in the sector and MFIs and the necessity to promote development objectives.⁴² Based on the argument that MFIs have not yet achieved the saturation to pose any systemic risk on the financial system as a whole⁴³ and the assumption that it is expensive to regulate small financial institutions,⁴⁴ critics argue for no regulation and, consequently, supervision in microfinance.

However, a growing portion of literature on this concern confirms that there are solid reasons for regulating the microfinance industry. The level of risks to which customers are exposed to, for example, new measures and high operating costs, requires regulation.⁴⁵ The prudential regulation for any financial institution originates from the need to protect the depositors from the loss of their savings and to protect the public confidence and strengthen the financial system.⁴⁶ Traditionally, MFIs have depended on donor funds and subsidies.⁴⁷ Today however, there are considerable rising in the scope of financial activities (including deposit taking) provided by these institutions as well as in the number of the institutions and their customers.⁴⁸ By the early twenty-first century, for instance, tens of millions of people in more than 100 countries were accessing wide-ranging financial services from formal and semi formal MFIs.⁴⁹ These new trends have contributed to an ever-increasing credit and financial and operating risks that concern the microfinance sector.⁵⁰

Microfinance (sub-heading 1.1) is a system that potentially serves the poor with broad financial services in a most helpful and dynamic way consequently reducing the rate of

financial exclusion and helping the welfare of society. Such change yet could not be considered reasonable if it must cause a higher weakness in the system itself and higher risks for those who deposit their savings in MFIs.⁵¹ It is noted that public confidence has a central role in sustaining any financial system stability.⁵² Above all therefore, regulation and supervision is needed in microfinance to protect the interest of the small depositors, increase liquidity management, and expand operational and financial sustainability and to defend against moral hazards.⁵³

Additionally, the uncertainties in the microfinance sector could have a serious effect of causing the possibility of systematic risk to the financial system as a whole.⁵⁴ For instance, it can distress the commercial banks that provide loans to MFIs. Hence, akin to the formal financial system, to put proper regulation in place for the microfinance business to control systematic is justified.⁵⁵ Furthermore, though the costs of regulating and supervising MFIs may indeed be large particularly during the opening years,⁵⁶ researches prove that the benefits outweigh the costs provided that an effective approach is followed. The benefits included better access to commercial sources of funds for equity and debt, increased ability to supply diversified products and services, higher standards of control and reporting, and the enhanced legitimacy of the operations.⁵⁷ Consequently, this paper supports the belief that microfinance requires a regulation and supervision by respective national governments.

2.2. The Determinants for Microfinance Regulation and Supervision

Regulating microfinance is certainly necessary given the above phenomenon in the sector or concisely as MFIs move to operate on a commercial basis. There is but issue whether it should follow the same regulation principles used for other typologies of formal financial intermediaries (commercial banks primarily) or if it needs a specific regulating and supervising framework.⁵⁸ The answer to this question is significantly influenced by the differences between MFIs and commercial banks and, therefore, it is necessary to consider the features that determine the regulation and supervision of MFIs.

A most important characteristic of MFIs is that they have a large number of clients but their total asset base is very small compared to commercial banks.⁵⁹ The client base of MFIs also differs as their lending is to the poor people who have little, if any, collateral and often little formal business experience. The major customers of these institutions are those who face rigorous difficulties preventing them from accessing financial services from that of formal

financial institutions. Briefly, MFIs have emphasised the incapability of the poor people to engage in income generating activities due to scarce provision of savings, credit and insurance services.⁶⁰ In addition to these apparent risks, MFIs are exposed to several of the risks that apply to conventional financial intermediaries, though with unlike character. For instance, the credit-only institutions that operate in a narrow geographical area predictably result having a small diversification of their loans portfolio. Consequently, the prudential requirements of banks that operate on notions of loans portfolio diversification that MFIs do not have are not similar with the managements of many microfinance institutions.⁶¹ Accordingly, MFIs are susceptible to high risk of default, information asymmetry problems in assessing their borrowers' risk profile and a high variance in expected returns.⁶² All these determinants underline the distinctiveness of the sector and, therefore, supports independent regulatory and supervisory framework for microfinance sector for its effective application.⁶³

2.3. Common Aspects of an Effective Microfinance Regulation and Supervision Approach

A model regulatory and supervisory framework for microfinance must, in view of this paper's principal aim, encourage the wider goal of expanding financial access and, accordingly, contributing to the pursuit of development or at least solving the persistent problem of poverty in DCs. Hence, the evaluation of the most efficient regulation and supervision approach to be implemented for microfinance sector should be made considering the following aspects.

2.3.1. Expansion of Financial Services

Originally, MFIs in DCs had focused their operations only on small loans service.⁶⁴ These institutions are predominantly registered as NGOs and do not have a legal authorization to undertake an all-encompassing financial services such as taking deposits from the public or providing savings and insurance services for the poor.⁶⁵

But, more fundamentally, the conceptual frame centred on providing small credits is very restraining and, thus, changed to providing a variety of services eventually.⁶⁶ There is currently an increasing growth in the number of MFIs' target beneficiaries given the change of microfinance policy focus on not only 'poorest of the poor' but also some groups of disadvantaged and marginalized entrepreneurs.⁶⁷ This phenomenon has brought about not

only an increased demand for microcredit services to be met but also needs for expanded types of financial services.⁶⁸ Poor people, for example, want savings accounts as shown by 1.3 billion ‘accessible’ savings accounts worldwide that mean low average balance, and low costs.⁶⁹ Empirical evidence demonstrates that access to comprehensive financial services such as savings, payments, and credit can make a substantial positive difference in poor people’s lives. For firms like small and medium enterprises (SMEs), lack of access to range of finance is regularly the main barrier to growth.⁷⁰

In this circumstance it is necessary, in the modern microfinance sector, to put in place a regulatory and supervisory framework that allows MFIs to engage in other type of banking operation in addition to credit.⁷¹ There are no other possible means for the MFIs to raise resources and sustainably meet the increasing demand for microcredit as well as needs for a diversity of new financial services. For that reason, an efficient microfinance regulation and supervision approach should, predominantly, allow these institutions to attract deposits from the public or to engage in providing savings services for the poor.⁷²

2.3.2. Expansion of Financial Service Providers

To expand access to sustainable and safe financial services which contributes directly to rising income and reducing vulnerability for the poor, the best microfinance regulatory and supervisory framework must additionally facilitate the entry of new service providers in the sector.⁷³ Most of the laws in the formal sector hence need to be restructured in the perspective of MFIs for their helpful use. For instance, MFIs have to be regulated by a relaxed legislation which should fix separate flexible capital requirements and organizational structure than the formal financial institutions.⁷⁴ The experiences of Indonesia and Philippines, for example, prove that the availability of financial licences with lesser capital requirements has fostered private rural banks into the microfinance business.⁷⁵ Generally stating, though MFIs must still be required to show that they have sufficient capital and reserves to face any reasonable and startling losses, minimum capital requirements and other regulations can be improperly high for organizations serving a low income market and are a barrier to entry to the microfinance sector. Another possibility is in the form of the government creating new types of legal instruments that permit affiliation between MFIs and commercial banks to help them to reduce fees while extending service outreach.⁷⁶

2.3.3. A Tiered Approach to Regulation

It is understood that regulation will accelerate the realisation of sustainable MFIs.⁷⁷ Yet, in consideration of sector specific determinants (sub-heading 2.2.) and given the diversity in their nature, the process of integrating MFIs in a prudential regulation must be a gradual one.⁷⁸ It has thus been frequently suggested that MFIs be fitted into a tiered structure which clearly defines how the types of institutions are regulated and by whom.⁷⁹ Because systemic risk is low and the costs of supervision would not be compensated by the viable benefits, there is a consensus in the literature regarding the impropriety of prudential regulation for the MFIs operating in the market as NGOs or offer small credit.⁸⁰ Even so, the institutions must be registered with the supervision authority of the financial system and a planned report of the granted micro-credits must be required. This is required to supervise the sector's general performance and to control potential problems that may jeopardise the stability of the financial system.⁸¹

But, once MFIs start to offer a wider scope of services, gather public deposits and manage significant volumes of financial resources, stringent regulation needs to be implemented.⁸² This step to raise their funds on a commercial basis represents a considerable systematic risks and necessities a precise regulation that provides the organizational minimum requirements, risk control units inside the MFIs, the minimum capital requirements (provided that it is lower than the banks) and the capital adequacy coefficients.⁸³

2.3.4. Availability of Depositors' Insurance

The rules of microfinance, with the purpose of supporting the progress of the sector and fight financial exclusion, must respect the safety of those who deposit their savings in MFIs. Depositors should hence be given the same guarantees that the depositors of commercial banks receive on the return of their deposits, or of part of them, in case the MFIs struggles to repay.⁸⁴ Because most of the depositors of MFIs are poor and unorganised, this protects many poor people from losing their savings due to the incompetence or deception of *laissez faire* and lax institutions.

2.3.5. Presence of Credit Information Services

So as to reduce the information asymmetries which physiologically belong to microfinance sector, there must be the offer of credit information services and/or an attempt to formalise MFIs into a mainstream in this respect. This will inter alia include collection of, to be most successful in fostering financial inclusion, information on marginal and unregistered clients.⁸⁵ While such an organized task can certainly be performed by local associations of MFIs, governmental intervention nevertheless is indispensable in its initial stages to define the criteria of the collection and the advantageous of such facts.⁸⁶

2.3.6. No Interest Rate Cap

Finally, in the direction of supporting microfinance, there is the need to bear in mind the interest rate ceilings, if any. With the intention of achieving sustainability through time and intelligibility in the financial system, MFIs often supply loan services at higher interest rates than the formal market rates.⁸⁷ This element must therefore be effectively measured when conceiving a regulation for microfinance, with a possible exemption of MFIs from these caps if they come out to be too severe, or requiring MFIs to reveal the technique of calculation of the interest rates they fix.⁸⁸ Although some governments are concerned about the high interest rates, the Latin American practice shows that leniency by government has helped the MFIs greatly in their premature stages.⁸⁹ Most of the countries in Latin America had officially allowed lower levels of interest rates, which were not sufficient for sustainable MFI operation and which forced them to operate as NGOs. Over the years, governments have understood the enhanced demand for high interest rate loans and this becomes a non-questionable in the licensing of MFIs afterwards.⁹⁰ Nevertheless, to reduce the risk of MFI's abusing their special position and/or to ensure better conduct of business in the sector the high interest rate should be compared with the existing rates in the mainstream market or the informal market.

Furthermore, the arrangement of regulation and supervision instruments for microfinance has to consider the shortage of economic and human resources that can be used for such activities in many DCs, which are incapacitated by poverty and limitation in the public control systems and in the judicial system.⁹¹ It is likewise crucial that the MFIs should not present significant weaknesses in the performance of internal organization systems and should not have governance that disregards the principles of sustainability.

3. The Existing Microfinance Regulation and Supervision Framework in Ethiopia

3.1. The Overview of Financial Sector in Ethiopia

In Ethiopia, the establishment of an efficient financial system together with a proper regulation remains a challenging task.⁹² Since the fall of the socialist government in 1991, as a part of transition from a planned to a market economy, the country's financial system has passed through major reform process. There have been major financial measures which included the liberalisation of the financial sector, a relaxing of foreign exchange controls, the removal of the previous interest rate regime, and the creation of a new regulatory structure for banks, insurance companies, cooperatives and MFIs.⁹³ In general, Ethiopia's financial sector comprises of commercial banks, insurance companies, MFIs, saving and credit associations, multipurpose cooperatives and money lenders. As well, to tackle poverty in its all phase and to realise the basic needs of the population, the government has implemented a series of economic reforms, which mainly includes the promotion of policies that will encourage savings, private investment, increasing income generating opportunities and promotion of small scale industries in the informal sector.⁹⁴ Major policy documents such as the Government's Rural Development Strategy, the Poverty Reduction Strategy Paper (PRSP), Plan for Accelerated and Sustainable Development Programme (PASDEP) and the most recent one, Growth and Transformation Plan (GTP 2011-2015) underline, among other things, the reduction of poverty and meeting the United Nation's Millennium Development Goals (MDGs).⁹⁵

3.2. The Overview of Financial Access in Ethiopia

Financial inclusion creates policy challenges on a magnitude and with an exigency that is exceptional for DCs, which accommodate nearly 90% of the world's unbanked population.⁹⁶ Similarly, sustainable financial access, which the poor needs to rise out of poverty, is very limited in Ethiopia.⁹⁷ Main reason is that there is a perception by commercial banks of the unattractive risk-return attitude of serving the low income urban and rural population.⁹⁸ A large section of Ethiopia's population consequently lives without access to essential, reasonable and sustainable financial services placing the country in the least banked states in the world.⁹⁹ As the information from the National Bank of Ethiopia (NBE) implies, the country has a share of total population per bank branch of 112 thousand.¹⁰⁰

As a result of the above, more than two third of the population of Ethiopia has resorted to traditional, informal and costly financial services such as unregistered customary institutions such as Iqub and Idir, money lenders, keeping cash at home etc.¹⁰¹ In fact, the natural option to get financial services for those who are excluded by the formal financial sector are informal money lenders and loan sharks. However, such systems take advantage of the difficulty of the poor and charge unaffordable interest rates that are on average five to twenty times higher than most microfinance organizations.¹⁰² Then, while the above mentioned means may prove helpful to the financial requirements of poor families in Ethiopia, they involves significant problems such as high possibility of failure, lack of sustainability, legal challenge and the difficulty of building enduring reliance among stakeholders.¹⁰³

3.3. Microfinance as the Entry Point: the Existing Microfinance Regulation and Supervision Framework in Ethiopia

Microfinance was first seen in Ethiopia in the late 1980s mostly offered by NGOs and development programs.¹⁰⁴ In view of the key potential of microfinance to the expansion of the country's inclusive finance and poverty reduction, the Ethiopian government has paved a way to establish group of prudentially regulated MFIs. The Banking Business Proclamation No. 592/2008 empowered the NBE to license, supervise and regulate financial institutions such as banks, insurance companies, MFIs and savings and credit cooperatives.¹⁰⁵ The year 1996 then saw the formalisation of the microfinance sector as a prudential regulatory framework governing the microfinance sector was issued by the government. This was a distinct legal framework for regulation and supervision of the sector, known as proclamation No. 40/1996 for licensing and supervision of Microfinance Institutions.¹⁰⁶ The objective of the regulation is to protect small depositors, ensure the integrity and stability of the microfinance sector, and to promote efficient performance of the MFIs.¹⁰⁷ This law officially brought MFIs under Ethiopia's monetary and financial system and enabled all MFIs to accept deposits and stressed the need for strict commercial standards in the sector.¹⁰⁸

A revised version was also released in 2009. This is proclamation No. 626/2009 which defines microfinance business as the provision by authorised institutions of financial services such as accepting savings, extending credit, drawing and accepting drafts payable, providing money transfer services and others.¹⁰⁹ Remarkably, this scope does not limit microfinance to loan services and hence it is the providing of an extensive range of financial services, including savings, insurance, transfer facilities etc. Besides, the government of Federal

Democratic Republic of Ethiopia (FDRE) and the NBE have been gradually refining the microfinance regulatory and supervisory framework over time, issuing a series of amending directives.¹¹⁰

As a result, the regulations have brought many positive effects allowing the Ethiopian microfinance sector to be one of the world's fastest growing microfinance sectors.¹¹¹ The microfinance sector is relatively large, with its combined credit balance nearly ten percent of the volume of the banking sector.¹¹² As of September 2010, the sector had mobilised Ethiopia Birr (ETB) two point eight billion, increasing from earlier period although with much lower growth than the banking sector.¹¹³ Fast growth, an aggressive drive to achieve scale, a broad geographic coverage, and dominance of government supported MFIs, a stress on rural households, the encouragement of both credit and savings services, an emphasis on sustainability, and the restriction of foreign ownership are the main features of the Ethiopian microfinance sector.¹¹⁴ MFIs have mobilised a significant amount of savings, thereby improving financial and operational sustainability and thus sector outreach is remarkable and the financial performance good. Moreover, relative to other African countries the sector is transparent.¹¹⁵

The Ethiopian microfinance market is dominated by a few large regional government owned institutions. The three biggest MFIs, Amhara Credit and Savings Institution (ACSI), Dedebit Credit and Savings Institution (DECSI) and Oromia Credit and Savings Institution (OCSSCO), account for sixty five percent of the market share in terms of borrowers, and seventy four percent by gross loan portfolios.¹¹⁶ Unlike many other African countries, MFIs in Ethiopia reach relatively large numbers of beneficiaries, with ACSI only reaching over 650,000 populations.¹¹⁷ Most institutions have over 20,000 customers. The average loan per borrower for the eleven Ethiopian MFIs reporting to the Mix Market as of June 2010 stood at 140 USD, below half of the country's GDP per capita.¹¹⁸

Ethiopia further has one of the strongest microfinance associations in Africa. Since its foundation in 1999, the Association of Ethiopian Microfinance Institutions (AEMFI) has been the network of all licensed MFIs in the country whose membership has increased from four in 1999 to 31 MFIs in 2011.¹¹⁹ AEMFI inter alia aims to provide a means by which MFIs can get information, improve competence through giving training and funding negotiations, and to support the sector through research and development (R&D). AEMFI has

close links to the government and is playing an important function in the growth of the sector and in shaping the regulatory and supervisory framework.¹²⁰

4. Remaining Limitations in the Existing Microfinance Regulation and Supervision Framework in Ethiopia

Although it is well-supported, the Ethiopian microfinance sector still is criticised on its regulatory and supervisory side.¹²¹ In light of the recent common aspects of microfinance regulation and supervision approach that are examined in chapter two, some of the remaining limitations in the Ethiopian framework are evaluated as follows.

4.1. Limitation on Expansion of Services and Service Providers

So that they can raise resources and be sustainable, MFIs in Ethiopia are authorised to attract deposits from the public. The currently operational regulation noticeably provides that ‘the main purpose of micro-financing institutions shall be to collect deposits and extend credit to rural and urban farmers and people engaged in other similar activities as well as micro and small scale rural and urban entrepreneurs.’¹²² It is hence legitimate for the MFIs to accept both voluntary and compulsory savings.¹²³ While agricultural sector is the main focus, micro financial services for SMEs and housing, consumption and equipment are also legitimate.¹²⁴ Other services such as insurance and local money transfer are additionally allowed to be provided by the MFIs.¹²⁵

Pertaining to the lending methodology used by the MFIs, the 1996 proclamation was restricted only to group loan methodology without the prerequisite for property collateral.¹²⁶ The 2009 version considerably repealed this and allows loans to both groups and individuals and without collateral, secured by collateral or secured by group or individual guarantees as suitable and at the judgment of the institution.¹²⁷ Consequently, though the group lending methodology customarily prevailed in the Ethiopian microfinance industry, nowadays there is a growing focus on individual lending style which has helped MFIs in expanding their service supply.¹²⁸

Besides allowing existing MFIs to expand the financial services they offer, the Ethiopian microfinance rules also facilitate the expansion of service providers in the sector. Capital

requirement for MFIs is set at a low and reasonable level of ETB 200,000, which is approximate to \$11111.111.¹²⁹ Besides, easier organisational structures than banks are required from MFIs. For example, the number of branches MFI may open is unrestricted while closure is more carefully supervised, requiring formal approval from the NBE and at least three months notice.¹³⁰ Non-compliance with the regulatory directives incurs penalty fees, the potential removal of the chief executive and the withdrawal of an institution's license.¹³¹ Furthermore, commercial banks licensed under the appropriate law are allowed to engage in microfinance services without having a separate license.¹³²

Irrespective of the above efforts by the government regarding the expansion of microfinance services and service providers, it is yet demonstrated that there is a continued limitation of unmet demand and/or limited outreach in the Ethiopian microfinance sector.¹³³ At present, there are 31 MFIs registered with the NBE providing micro financial services through 433 branches and 598 sub-branches.¹³⁴ It is calculated that this figure serves barely ten to twenty five percent of the total microfinance demand in the country.¹³⁵ Moreover, there is a regulatory limitation on the loan extended by MFIs to individual and group in that it should not exceed one percent and four percent of total capital respectively. Whilst this lending limit may assist to guarantee that MFI remain focused on their specific social responsibility that is the performance of the social function of financial intermediaries, which, in the case of DCs, consists mainly of contributing to economic growth and solving the problem of poverty, it is criticised as extremely strict.

There also exists a particular problem of limited financial products thus the poor still do not have enough microfinance services from which to choose, uneven coverage over parts of the country, and women segregation that resulted from supervision weakness.¹³⁶ Though commercial banks since 2009 are not required to have a separate license to offer microfinance service, currently most do not supply the service.¹³⁷ The inadequate rural branch distribution of the banking sector has prevented direct service delivery to rural and low income clients, and the risk perceptions towards the same group have in addition limited indirect association through credits to MFIs. Government policies require formal banks to demand full guarantee for their loans, a condition with MFIs are often incapable to provide.¹³⁸

4.2. Limitation on a Tiered Approach to Regulation

The other limitation in the microfinance regulation and supervision framework of Ethiopia relates to the observance and execution of a principle of a tiered approach to regulation. Whilst there is a consensus in the literature that the process of integrating MFIs in a regulated environment must be a gradual one, the Ethiopian microfinance law ruled that the sole source of funding for MFIs in Ethiopia is savings mobilization.¹³⁹ According to the law hundred percent of Ethiopian MFIs must be shareholder companies. This shareholder led model perhaps gives the industry a more sustainable platform, provided that it is not abused and/or the regulator has put in place good checks and balances. Nevertheless, given the international pragmatic findings and also the self-perception of NGO-MFIs, the importance given by the Ethiopian regulation to shareholder MFIs alone is unsatisfactory. Based on performance facts, no ownership type is clearly better to the others and, therefore, NGO owned MFIs constitute a useful complement to regulated MFIs particularly in an economic environment like Ethiopia where there is high excess demand for microfinance and/or where outreach is low and demand for microcredit cannot be satisfied. Therefore, based on the international practice it should be considered to allow NGOs to run microcredit operations together with shareholder prudentially regulated MFIs.

The regulation advocates MFIs to instantaneously move themselves away from dependence on donor subsidised funds or NGOs towards commercial sources of funds only; though the degree to which this has practiced is not certain.¹⁴⁰ It is understood that a tiered approach to regulation is helpful as it provides opportunities and incentives for MFIs to graduate between tiers and, subsequently, creates proper regulatory requirements for diverse types of institutions.¹⁴¹ In Ghana for instance, the tiered approach has led to the development of different types of MFIs simultaneously.¹⁴² Conversely, failing to describe the tiers accurately and/or to gradually regulate MFIs could cause regulatory arbitrage, overlap and vagueness and allows the easy entry of institutions with fragile management and internal governance.¹⁴³ This is thus another setback experienced in Ethiopia's microfinance policy and has resulted in, among other things, lack by MFIs of access to foreign capital and donor funding and, consequently, deficiency in expansion of service through making some services undeveloped and deterring MFIs from investing in their own growth.¹⁴⁴

4.3. Limitation on Depositor's Insurance

To generally deal with concerns of consumer protection in all industry, trade practice law of Ethiopia was amended in 2010 by essentially proposing the establishment of the trade practice and consumer protection agency in the country.¹⁴⁵ This new regulation planned for observance of the universal rights of consumers such as to get satisfaction, accurate information on the type of goods and services offered, and compensation for damages suffered due to deceptive dealings.¹⁴⁶ Besides, AEMFI has becoming effective in protection of rights of clients in the microfinance sector by working with several initiatives like the Smart Campaign, the Social Performance Task Force and *MFTransparency*.¹⁴⁷

Nevertheless, there remains an executive problem such as the absence of an efficient and a well-functioning legal and administrative court structure (that by-pass the mainstream court system) to help protect and ensure the safety of those who deposit their savings in MFIs in the Ethiopian and facilitating microfinance activities.¹⁴⁸ For that reason, contracts cannot be sufficiently enforced and there is no a legal procedure by which MFIs transfer a mortgage when there is failure by clientele to make payments. Although enforced property rights are critical to utilizing collateral and implementing asset-based lending, the legal system in Ethiopia is still very weak in this respect thus procrastination in getting legal remedy from the mainstream courts caused fraudulent borrowers to evade payment without punishment.¹⁴⁹

4.4. Limitation on Credit Information Services

The working Ethiopian microfinance law states that one of the activities to be performed by MFIs is rendering managerial, marketing, technical and administrative advice to customers and assisting them to obtain services in such areas.¹⁵⁰ But, there persists a practical challenge of poor management information systems (MIS), the lack of technical competence within the MFIs, and chiefly the problem of human resources.¹⁵¹ Because of their social responsibility to allocate the majority of their resources into their loan portfolios, MFIs are weakly equipped with MIS.¹⁵² There are as well limitations on the NBE's capacity to supervise and provide technical support, lack of expertise consulting firms, a domestic rating agency, and a microfinance training institute that would be able to give education and social and business performance assistance.¹⁵³ Since 2009, the sector has been supervised under a directorate rank which assesses MFIs through both off-site observation through investigation of the quarterly reporting and on-site inspection. Even so, the directorate has a limited capacity to makes on-site visits to MFIs as those institutions entry in the market are overly expanding

without appropriate increase in the number of supervisory staffs and its inspection teams have encountered inconvenience attributable to lack of appropriate MIS in MFIs.¹⁵⁴ This therefore calls for, inter alia, a continuing capacity building of the NBE and/or the directorate.

4.5. Limitation on Interest Rate Cap

The regulation created for microfinance sector in Ethiopia professionally exempts MFIs from the ceiling of the lending interest rate set for formal financial intermediaries. The law distinctly stated that the board of directors of each MFI can set its own lending interest rate.¹⁵⁵ Pragmatically however, owing to the source of funds for MFIs arising mainly from regional governments, interest rate charged on credits usually remains low resulting in low portfolio results and low rates of return for the institutions.¹⁵⁶ Finally, there are governmental problems arising from the risk of market distortion by regional government ownership of microfinance business, over-regulation, the possible politicising of the sector, and the growing challenge of inflation on the sustainability of MFIs.¹⁵⁷

5. Conclusion and Recommendations

5.1. Conclusion

World's smaller and less mature economies accommodate nearly ninety percent of the world's unbanked population.¹⁵⁸ While there is broad availability of technology-focused solutions and interests for financial access, DCs primary choice to cope with the problem of financial exclusion is frequently focused on microfinance.¹⁵⁹ From its early days as credit only programs, the sector of microfinance has changed to being about building inclusive financial systems for all poor and underserved people. Recent microfinance options are being developed that allow wide-ranging financial services to be provided to those low-income populations who have so far had no access to such services.¹⁶⁰ By providing financial services to the poor and non-bankable population, the MFIs serve in helping the poor to continue daily living, create income making opportunities, afford for education for their children and care for the sick and elderly. Therefore, efficient MFIs help the poor to sustain livelihood and to get better quality of life of not only individual households and businesses, but that of the general public as whole. Accordingly, establishing sound regulation and supervision in the microfinance sector can be seen as a set of required governmental responsibilities to tackle exposure, threat and deficiency.

The higher the supply of the microfinance, the more and more households and SMEs benefit from it. MFIs performance and outreach has to improve, which depends on whether sensible regulation and supervision for microfinance is established. As the industry has developed and became powerful, it has in particular required the improvement of regulations and supervisions both to support expanded financial access and to deal with non-bank financial actors that have started to raise deposits from the general public or else intermediate funds.¹⁶¹ To allow microfinance field reach its full prospective, many of its service suppliers hence should gradually be included in the categories of prudentially regulated financial intermediaries.¹⁶²

Many of developing and transition country governments have accordingly put in place a national microfinance policy, though are now at immature stages of addressing an overall goal of expanding financial access. They are using a variety of regulatory techniques to encourage the change and commercialisation of MFIs, institutionally support MFIs, allow charity or non-profit MFIs to function without difficulty, oversee the conduct of micro lenders and give funding facilities for MFIs, and allow commercial banks to downmarket their operations to engage in microfinance activities, either by establishing specialised departments, subsidiaries, or wholesale lending to MFIs.¹⁶³

The all in all conclusion of the study thus is that expanding access to financial services to poor and low-income households embraces the potential to help alleviate poverty and stimulate development and, so, the necessity to regulate and supervise microfinance in Ethiopia should be considered from the background of a large portion of the country's society who lives with no access to essential, reasonable and sustainable financial services. Better put, to remove the limited reach and high degree of problems identified in the informal means of financial intermediation plus to cope with the failure of formal banks to provide financial access to more than two third of the country's population, microfinance can better be used in Ethiopia as an entry point for issues of expanding access to finance and the allied social and developmental merits.

The establishment of microfinance policy framework early in Ethiopia has helped to open the means for the growth of the industry. Subsequent improvements in the form of decrees also solve some of the major regulatory and supervisory difficulties faced by the sector. Yet,

major limitations such as the prohibition of NGOs to participate in microcredit functions alongside the prudentially regulated shareholder model MFIs, higher risks for depositors of MFIs, lack of credit information services with R&D, the unmet demand, and risks of market failures due to over-regulation have persisted within the Ethiopian microfinance field. Therefore, more efforts are still required in the microfinance sector, which holds latest prospects and innovations that are improving the quantity and quality of financial access to poor and low-income households. This could also be viewed against the background of the present Ethiopia's policy push for a rapid transformation of the economy in order to meet the increasing demand by the country's citizens for better living standards in the environment of intensifying globalisation. The government of Ethiopia has outlined its development targets for the next five years in its GTP 2011-2015. According to this strategy document, the country inter alia aims to sustain social development strategy to expand access and improve quality of basic services and meet the MDG targets.¹⁶⁴ This impressive development goal cannot however be in reality pursued without adequate attention being given to the microfinance sector which covers important part of the economy including SMEs in the form of poor farmers, artisans and rural/urban entrepreneurs operating in informal surroundings and lives in poverty and the incapacity it entails. These groups ordinarily do not have the much-needed finances (to empower them) and (deprived the opportunity) to exercise their potentials necessary to rise out of poverty.

'Development consists of the removal of various types of unfreedoms that leave people with little choice and little opportunity of exercising their reasoned agency.'¹⁶⁵

5.2. Recommendations

If right regulatory measures are taken in the right direction, there is a great potential contribution to be made from microfinance. Whereas there is no standard model for rapid imitation globally, it can be concluded that there is huge potential to promote domestic solutions based on available common best practices. So, based on the analysis and findings made above, this dissertation has come about with the following recommendations that helps for strengthening regulation and supervision of microfinance sector to expand financial access to the poor and, so, alleviate poverty and spur development in Ethiopia.

Broadening sector policy objective

It is necessary that the Ethiopian microfinance policy framework must observe an explicit and broad objective of expanding access to sustainable and secure financial services that contribute directly to increasing income and reducing vulnerability for the poor population in the country.

Developing sector harmonised regulation

Adopting country-specific, harmonised policies at the national level that respond to both demand- and supply-side limitations will be most useful in developing financial access. However, the scattered laws operating for the microfinance in Ethiopia has caused the rough growth of the sector, where only few specialised MFIs have evolved to dominate the industry. For that reason, the country shall, with the goal of facilitating the entrance of private-sector capital that expands the sector's scale of operations, creating a level playing field for all MFIs, ensuring basic observance to internationally accepted principles of regulation and supervision, and strengthening the reliability of strongly performing MFIs, adopt a cohesive and comprehensive microfinance regulatory and supervisory statute that concurrently and adequately addresses the following key issues:

- Clear procedure for registration and licensing of MFIs such as interest rate requirement, application of auditing and accounting standards and basic reporting requirements;
- Flexible capital and organisational structure requirement that promote expansion of new forms of service delivery;
- Proper tier approach and/or categorisation of MFIs that considers diversity among institutional specialisations and the basic natures of the sector, such as management capacities, the nature of clients and transaction volume;
- Easy path for transformation from one institutional categorisation to another through technical assistance that focus on governance, managerial, technical, and financial skills strengthening, including strategic and business planning, asset, risk and liquidity management, internal controls, capital mobilisation strategies as well as social performance measures and client protection policies.
- that deal with the treatment of publically funded assets; the future ownership interests of the transforming entity; valuation standards to be used;
- Stringent conformity rules and punishments in the case of non-compliance.

Arranging sector self-regulatory regime

Given its distinctiveness from that of the formal financial market, there is a need to implement a self-regulatory regime in the Ethiopian microfinance system. For example, authorising the national microfinance association, AEMFI, as the self-regulatory body for sector is necessary in order to tackle the concrete threats associated with over-regulation and the possible politicising of microfinance sector in the country.

Promoting sector supportive infrastructure

Providing MFIs supports that will help them improve their institutional and social performance and promote a self-sustaining and responsible sector is important. Therefore, resources need to be allocated by the government to help build AEMFI's and member institutions' capacity to help move forwards the sector along the latest innovations in the sector through:

- Developing sector wide code of ethics and practices that ensure adherence to principles of consumer protection such as prevention of over-indebtedness, transparent pricing, appropriate collections practices, ethical staff behaviour, mechanisms for redress of complaint, and privacy of client data;
- Ensuring consumers have the skills, knowledge and understanding to manage their borrowing and investment plans;
- Giving financial education to poor and low-income clients to ensure that they benefit from access to microfinance, understand how and where to save, avoid over-indebtedness, properly manage investments, strengthen bargaining position, and know how banks work;
- Developing a credit information service under the NBE that facilitates information exchange among MFIs and promotion of sector standards and developments;
- Providing R&D for promoting more consumer-responsive and cost effective services, including the use and adaptation of new technologies such as mobile banking;
- Promoting social performance monitoring through the use of the latest tools like social ratings, audits, assessments, poverty scorecards, and wealth ranking tools among MFIs to assess their progress towards achieving their social and poverty alleviation objectives.

Encouraging service expansion and innovation matters

So as to enlarge the limited reach and meet the demand for other microfinance services beyond credit, MFIs in Ethiopia should strive to pragmatically offer a full range of financial services that the law already ordered to be provided to rural farmers and people engaged in other similar activities as well as micro and small-scale rural and urban entrepreneurs. This requires an uninterrupted market research as regards quantitative and qualitative potential demand for new product development in diverse areas and R&D to increase efficiency of operations in MFIs drawing from international experiences and lessons learned.

Exploring new service providers

Last, but not least, in the direction of increasing efficiency and promoting expansion of microfinance service in Ethiopia, there shall be a mission of innovation by the government to search for a variety of service distribution channels. As it has already alleged, the problem of financial exclusion in Ethiopia is mostly attributable to a supply problem such as the business forms used by the MFIs in action are poor and incompetent, since they are incapable to beneficially serve the low-income sectors. To solve this supply problem, it is crucial to develop business models for the delivery of efficient, low-cost micro financial services that can profitably serve low-income population segments and SMEs. The argument of the paper is therefore substitute models exist and can be applied to Ethiopia. Alternative microfinance service supply channels such as permitting affiliation between MFIs and commercial banks, ensuring the efficient and responsible growth of the sector as a division of the formal financial sector, and the use of information and communication technology (ICT) should be pursued to increase access to until now underserved areas of Ethiopia and allow the expansion of the offer of financial services to customers that, to date, were not bankable, consequently reducing the rate of financial exclusion and social segregation and, as a result, alleviate poverty and spur development of the country.

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