

**Outreach and Financial Performance
Analysis of Microfinance Institutions in
Ethiopia**

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Abstract

Ethiopia is one of the least developed countries. The per capita income of the country, though it showed improvement in recent years, is only USD 180 as at end of 2005/06¹. Most of the poor, which mainly argued to be constrained by absences of credit access, participant in some kind of informal sector ranging from small petty trading to medium scale enterprises.

Several micro finance institutions (MFIs) have established² and have been operating towards resolving the credit access problem of the poor. In light of this, this paper attempted to look at MFIs performance in the country from outreach and financial sustainability angles using data obtained from primary and secondary sources.

The study finds that the industry's outreach rise in the period from 2003 to 2007 on average by 22.9 percent. It identified that while MFIs reach the very poor, their reach to the disadvantages particularly to women is limited (38.4 Percent). From financial sustainability angle, it finds that MFIs are operational sustainable measured by return on asset and return on equity and the industry's profit performance is improving over time. Similarly, using dependency ratio and Non-performing Loan (NPLs) to loan outstanding ratio proxies the study also finds that MFIs are financial sustainable. Finally, it finds no evidence of trade-off between outreach and financial sustainability.

¹ Source: National Bank of Ethiopia database.

² The MFIs have been receiving licenses and supervised by NBE under the proclamation number of 40/1996.

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Chapter 1- Introduction

Ethiopia is one of the least developed countries. The per capita income of the country, though it showed improvement in recent years, is only USD 180 as at end of 2005/06³. This is very little money to cover daily meal, let alone health, education and other emergency expenses, which make the poor vulnerable to unforeseen illness expenses and others. There is also high level of unemployment even with the skilled labor force. For instance, according to 2004 World Development Indicators, out of the total unemployment of the active labor force 26.9, 61.3 and 8.3 percent have complete primary, secondary, and tertiary education, respectively. And, this unemployed population is increasing from time to time as the population of the country is increasing.

It is also the experience in the country that the poor households are the main participants in some kind of informal sector ranging from small petty trading to medium scale enterprises (Jean-Luc 2006). And due to the fact that this sector uses intensive labor force and as well since it is the livelihood of most of the poor, developing this sector argued to be a weapon to resolve the problem of unemployment and poverty of a household (Lakew 1998 and Jean-Luc 2006).

Several studies noted different causes for poverty in a country. Some argued that the cause of poverty in developing economies among other things is that the poor does not have access to credit for the purpose of working capital as well as investment for its small business (Jean-Luc 2006).

To this end many developing economies have developed and have been providing credit to the poor through microfinance schemes. The experience of several Asian, African as well as Latin American countries could be a typical example for this (Meyer 2002).

³ Source: National Bank of Ethiopia database.

In Ethiopia, several micro finance institutions (MFIs) have established⁴ and have been operating towards resolving the credit access problem of the poor particularly to those participates in the petty business.

In light of this, this paper attempts to look at MFIs performance in the country. It aims to assess the performance of micro finance institutions in Ethiopia from different angles. Specifically it will attempt:

- γ To look at The MFIs outreach to the poor and their financial sustainability;
- γ To identify challenges faced by MFIs not to operate efficiently; and
- γ Finally, to deliver policy recommendations towards efficient operation of MFIs.

Mostly argued that MFIs could not sustain for long with out the back funding of donors, federal government, regional government or others. So, we raise the question does they really not sustain if the support is gone. To this end, assessment of MFIs performance particularly answering if they are financially sustainable would be significant. Therefore, What ever the study finds out could be an input for policy making for improved operation of MFIs so as to promote sustainable poverty reduction as most target provision of credit to the poor.

The data types used in the study are both secondary and primary data. The secondary data were obtained from the Association of Micro Finance Institutions (AMFI) and National Bank of Ethiopia (NBE). To obtain the primary information a representative sample of microfinance institutions were selected based on different criterions: convenience to reach; outreach deviation and diversion in major objective.

One-fourth of MFIs operate in the country were selected hoping to be representative sample size. The decision to include some MFIs in a sample mainly is based on the fact the MFIs have an office in Addis Ababa. Some are included to take account of the

⁴ The MFIs have been receiving licenses and supervised by NBE under the proclamation number of 40/1996.

boundaries based on the outreach (i.e., taking in to account those that have high outreach as well as low outreach). Of course, I also attempt to include a microfinance institution because it has different feature from the other (like Specialized Financial and Promotional Institution).

Then, to acquire the primary data a questionnaire was prepared and ready to be distributed to a sample of seven Microfinance institutions hoping that they would be representative. Unfortunately, two of the Microfinance institutions were not accessible to receive the questionnaire. And the other two did not return the questionnaires. Therefore, I was forced to use only the information obtained from three MFIs in the analysis process.

Simple correlation econometric analysis technique and descriptive analysis technique were employed in the analysis process. For the data obtained from the questionnaire, as it is kind of open ended and has qualitative in nature, the analysis of the obtained information is presented in the same fashion.

The major limitation of the study was time and money. When I start working on this paper my plan was to get direct information from client of MFIs through interviewing as well as focus group discussion so as to assess how MFIs are impacting their clients' lives. However, due to the limitation of time and money I was forced to shorten my hands to assess MFIs performance only from outreach and financial sustainability angles and disregard their impact on poverty reduction for future study.

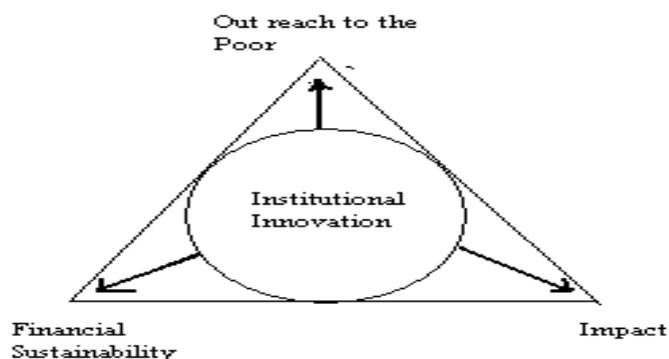
The paper is organized in five chapters. This introduction section is chapter one. In the following chapter the paper will review literatures that deal about how we examine the performance of MFIs. Then, the paper presents the findings of the study in the third chapter. And finally, it raps up by delivering conclusions and policy implications of the study.

Chapter 2- Literature review

2.1 Theoretical framework

Poverty is the major problem in most developing economies. In these economies, it is argued that among others absence of access to credit is presumed to be the cause for the failure of the poor to come out of poverty. Meeting the gap between demand and supply of credit in the formal financial institutions frontier has been challenging (Von Pischke 1991). In fact, the gap is not aroused merely because of shortage of loan-able fund to the poor rather it arise because it is costly for the formal financial institutions to lend to the poor. Lending to the poor involves high transaction cost and risks associated with information asymmetries and moral hazards (Stiglitz and Weiss 1981). Nevertheless, in several developing economies governments have intervened, through introduction of microfinance institutions to minimize the gap then allow the poor access credits.

There are different arguments concerning how to evaluate the performance of micro-finance institutions. Meyer (2002), Citing from Zeller and Mayer (2002), indicated that there is what is called "Critical Micro-finance Triangle" that we need to look at to evaluate Micro-finance institutions based on their objective. The triangle can be depicted as (Mayer 2002; 3):



Here, the corners of the triangle represent *outreach to the poor*, *financial sustainability* and *welfare impact*. And " Performance criteria are required for each objective and all three must be measured thoroughly to evaluate micro-finance performance," noted Meyer (2002). Further he indicated, "The inner circle in the figure represents MFI innovations in technology, policies, organization, and management that affect how well each objective is met. The outer circle represents the environment within which micro finance operates that also affects performance. This environment broadly includes the human and social capital possessed by the poor, the economic policies of the country, and the quality of the financial infrastructure that supports financial transactions. Improvements in the environment make it easier for MFIs to reach the three objectives." Meyer (2002; 2).

Let's review in detail how we measure the micro-finance institutions are meeting the objective of outreach to the poor, financial sustainability and improve welfare of the poor.

a) Measuring outreach to the poor

Outreach at glance means the number of clients served. But, Meyer (2002) noted that outreach is multidimensional concept. In order to measure outreach we need to look in to different dimensions.

"The first is simply the number of persons now served that were previously denied access to formal financial services. Usually these persons will be the poor because they can not provide the collateral required for accessing formal loans, are perceived as being too risky to serve, and impose high transaction costs on financial institutions because of the small size of their financial activities and transactions. Women often face greater problems than men in accessing financial services so number of women served is often measured as another criterion.... Although difficult to measure, depth of poverty is a concern because the poorest of the poor face the greatest access problem. Some measure of depth of outreach is

needed to evaluate how well MFIs reach the very poor. Finally, the variety of financial services provided is the criterion because it has been shown that the poor demand and their welfare will be improved if efficient and secure savings, insurance, remittance transfer and other services are provided in addition to the loans that are the predominant concern of policy makers."

Navajas et al. (2000), similarly, indicated that there are six aspects of measuring outreach: *depth, worth of users, cost to users, breadth, length and scope*. Where, depth of outreach refers to "the value the society attaches to the net gain from the use of the micro credit by a given borrower," (Navajas et al. 2000:335). This measure is to identify the poor clients. Because, the poor are the one who fail to get access to get credit from formal financial institutions since they fail to signal that they can repay their loan (Conning, 1997). And, worth of outreach to users refers to "how much a borrower is willing to pay for a loan,"(Navajas et al. 2000:335). Similarly, cost of outreach to user refers to "cost of a loan to a borrower," (Navajas et al. 2000:335). These costs to users might consists of prices like interest rates and various payments that they have to pay, which could be revenue to the lender, and other loan related transaction costs like expenses on documents, transport, food, taxes, etc. (Navajas et al. 2000:336). Finally, "breadth of outreach is the number of users...length of outreach is the time frame in which a microfinance organization produces loans," and "Scope of outreach is the number of type of financial contracts offered by a microfinance organization," (Navajas et al. 2000:336).

It is argued that length of a loan matter, because if the microfinance institutions support the poor only in the short run it will hamper the social welfare of the society in the long run. In the case that when the client of the microfinance institution knows that he/she will not receive additional loan in the future they would have no incentive to borrowers to repay their loan (Navajas et al., 2000.)

b) Financial sustainability

The other indicator of performance of a micro finance institution is its financial sustainability. Different literatures noted that financial sustainability is one of the areas that we need to look at to assess the performance of micro finance institutions. Meyer (2002) noted that the poor needed to have access to financial service on long-term basis rather than just a one time financial support. Short-term loan would worsen the welfare of the poor (Navajas et al., 2000). Meyer (2002) also stated that the financial unsustainability in the MFI arises due to low repayment rate or un-materialization of funds promised by donors or governments. According to Meyer (2002), there are two kind of sustainability that we could observe in assessing MFIs performance: Operational self-sustainability and financial self-sustainability.

Operational self-sustainability is when the operating income is sufficient enough to cover operational costs like salaries, supplies, loan losses, and other administrative costs. And financial self-sustainability (which he referred as high standard measure) is when MFIs can also cover the costs of funds and other forms of subsidies received when they are valued at market prices.

Meyer (2002:4) indicated, "Measuring financial sustainability requires that MFIs maintain good financial accounts and follow recognized accounting practices that provide full transparency for income, expenses, loan recovery, and potential losses."

There also are some dispute on the link between financial sustainability and outreach to the poor. According to some (Christen et al. 1995; Otero and Rhyne 1994), cited in Meyer (2002), outreach and financial sustainability are complimentary this is because as the number of clients increase MFIs enjoys economies of scale and hence reduce costs which help them to financial sustainable. On the other hand, Hulme and Mosely (1996) argued that there is inverse relation ship between outreach and financial sustainability. Here the argument is higher outreach means higher transaction cost in order to get information about creditworthiness of clients and hence make MFI financially unsustainable.

Including credit in the production function can be used to assess impact of MFIs. But, Scholars like Adam (1988) critic that it is wrong because this kind of assessment involves complications; probably it could be difficult to sort out loan effects from technical assistance.

Regarding indicator of financial sustainability, Khandker et, al. (1995) pointed out that loan repayment (measured by default rate) could be another indicator for financial sustainability of MFIs; because, low default rate would help to realize future lending.

c) Welfare Impact

Welfare impacts of the services of MFIs are also argued to be another indicator to evaluate the performance of the institutions. As indicated at the beginning of this paper, one way or another, the objective of MFIs is reducing poverty. Hence, which imply that we need to access the impact of the microfinance programs on reducing poverty to evaluate their performance.

As defined in World Bank (2000/01) report poverty is viewed as lack of money, lack of adequate food, shelter, education and health and the poor are vulnerable to ill health, economic dislocation and natural disaster. According to Meyer (2002) this perspectives of poverty can be used to access the impact of the MFIs on those who receives the services. Meyer (2002) also noted that assessment of impact of the MFIs on their clients is a very difficult and controversial way of evaluating the institutions performance. This is:

"Because of the methodological difficulties and high costs involved in conducting robust studies, it has been argued that the most important evidence of impact should be whether or not MFI clients continue to use the services. If they do, they must value the benefits received more than the costs of obtaining them. Impact analysis, therefore, should focus on understanding the impact on MFIs of programs offering

services to the poor rather than impacts on the clients of such services. A counter argument is that most of the industry requires substantial amounts of public funds at least in the form of start-up costs if not in the form of long-term subsidization. These funds have opportunity cost (they have alternative uses for society) so policy makers need evidence as to whether or not clients are receiving direct measurable benefits from microfinance. If not, the fund should be allocated to other means to fight poverty, "(Meyer, 2002; 5).

Given the prevailing challenges, however, in the impact assessment process, several impact indicators are noted in literatures. Mostly, the impact indicators can be categorized as economic and non-economic benefits.

2.2 Empirical literature review

The micro finance institutions participation in several developing economies is escalating from time to time. Various studies on different countries on the performance of the MFIs confirm this (Adongo and Stork 2005, Zeller and Meyer 2002, Meyer 2002, Robert cull et al. 2007). For example, in Bangladesh a microfinance institution called Grameen Bank at the end of 2000 reported 2.4 million members, where 95 percent of them are women, with \$225 million outstanding loan. In addition, Thailand also has reported impressive outreach⁵ through agricultural lending by the Bank for Agriculture and Agricultural Cooperative (Meyer 2002). In general, a lot number of microfinance institutions have registered impressive outreach in several developing economies including India, Cambodia, and others (Meyer 2002).

⁵ About 70 to 80 percent of the farm household receives credit in a year either directly or indirectly from Bank for Agriculture and Agricultural Cooperatives (Meyer, 2002)

A survey by Robert Cull and others on the performance of leading MFIs in 49 countries finds interesting results. It founds over half of surveyed MFIs are profitable after making adjustment of subsidies. It also identified no evidence of trade off between being profitable and reaching the poor.

For the Ethiopian case, there are few studies undertaken in relation to MFIs. But, the objectives addressed in these previous studies are different, insuring the value added of this study.

Lakew (1998) examines POCSSBO's⁶ micro financing program contribution to poverty reduction. He found that after the credit program employment opportunity for the beneficiaries have been created. He also noted that the credit program of POCSSBO had positive effect on income and saving of the clients. In addition, He stated that medical, education and nutrition access of the clients had been improved.

Similarly, Aklilu (2002) reviews the importance of micro finance institutions in developing economies based on countries' experiences. In the review she suggested for promotion of the existing well developed institution 'iddir" to facilitate growth of formal MFIs.

Borchgrevink and et. al (2005), studies marginalized groups, credit and empowerment for the case of Dedit Credit and Saving Institution (DECSI) of Tigray. The study finds that female household heads are extremely marginalized groups; and also, young households', rural landless households and urban house-renting households are the other marginalized groups. Trough two-phase assessment, the study found that the DECSI's program has had a positive impact on the livelihood of and as well enhanced the social and political position of many clients. Concerning the constraints for economic development, the study noted poor rainfall, small farm size, and shortage of labor during peak agricultural seasons as the main constraints. Similarly, the main constraints in non-farm business

⁶ POCSSBO stands for Project Office for Creation of Small Scale Business Opportunities and the office was established in 1995.

ventures are low return and lack of demand. However, credit is not the main constraining factor for expanding economic activity, except that in urban areas. The study further noted, DECSI's heavy involvement in credit delivery in the region has more or less satisfied to most of the people with some exceptions in the urban areas.

Chapter 3- Empirical Analysis of MFIs

As indicate above, the findings stated below are from the questionnaire on representative samples and the secondary sources. In this section the paper presents findings of the study on outreach and financial sustainability of MFIs in the country. But, first let's view structure of MFIs in brief.

3.1 Structure of MFIs

Microfinance in Ethiopia is in its infant stage. Based on data of 2006, the industry's outstanding loan to GDP was 1.7 percent and its share to loan and advances of lending banks and MFIs was 1.6 percent. Mobilize client savings by MFIs had reached 3.6 percent of gross national savings⁷.

As at the end of June 2007, twenty-seven Microfinance institutions operate in the country, obtaining license from National Bank of Ethiopia⁸. Most of the MFIs operate both in the rural and urban areas mainly centering their head office in Addis Ababa. Dedebit Credit and Saving Institution (DECSI) and Amhara Credit and Saving Institutions (ACSI) take more than 65% share in serving clients served in the market. Similarly, in outstanding loan provision also these institutions take the lion share (62 percent) in the market (See Figure 3.1 and 3.2 below for details).

⁷ Authors computation based on National Bank of Ethiopia database

⁸ Under proclamation number 40/1996 National Bank of Ethiopia holds the mandate to license and supervise MFIs operate in the country.

Figure 3.1 : Market Share by Number of Clients

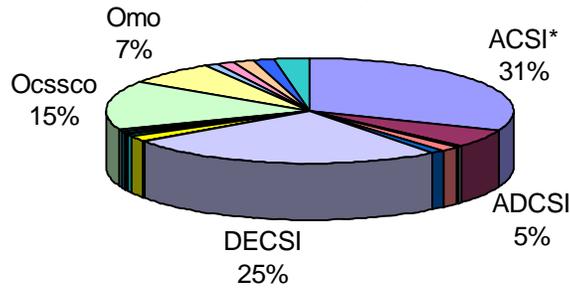
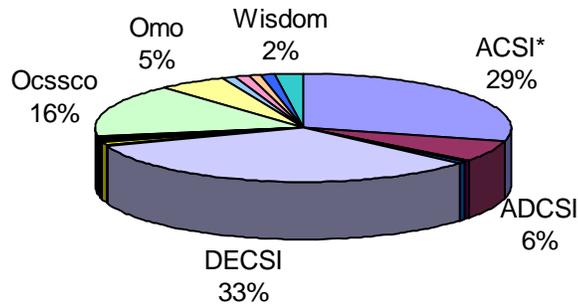


Figure 3.2: Market Share in Outstanding loan by MFIs



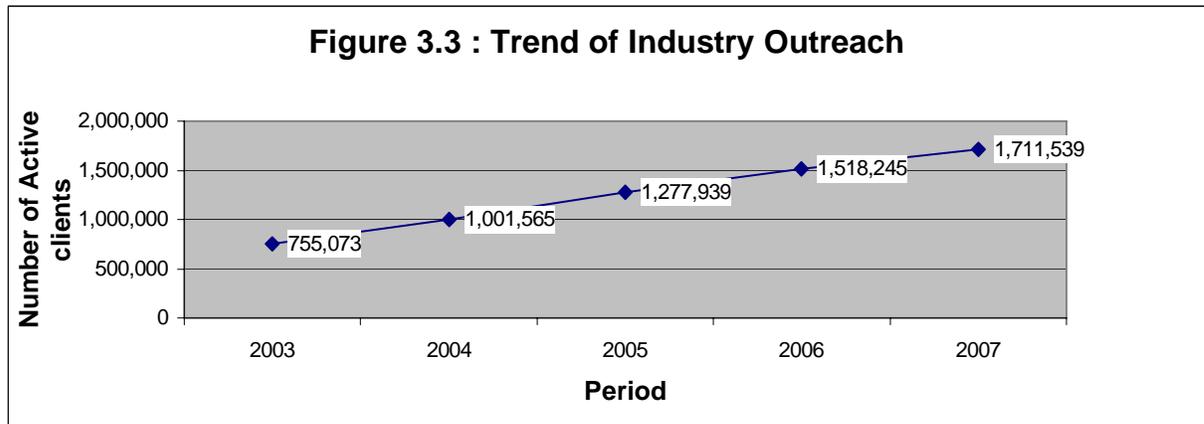
Source: Association of Ethiopian Microfinance Institutions (AEMFI). Please note (*) indicate data is as at March 2007.

3.2 Performance of MFIs

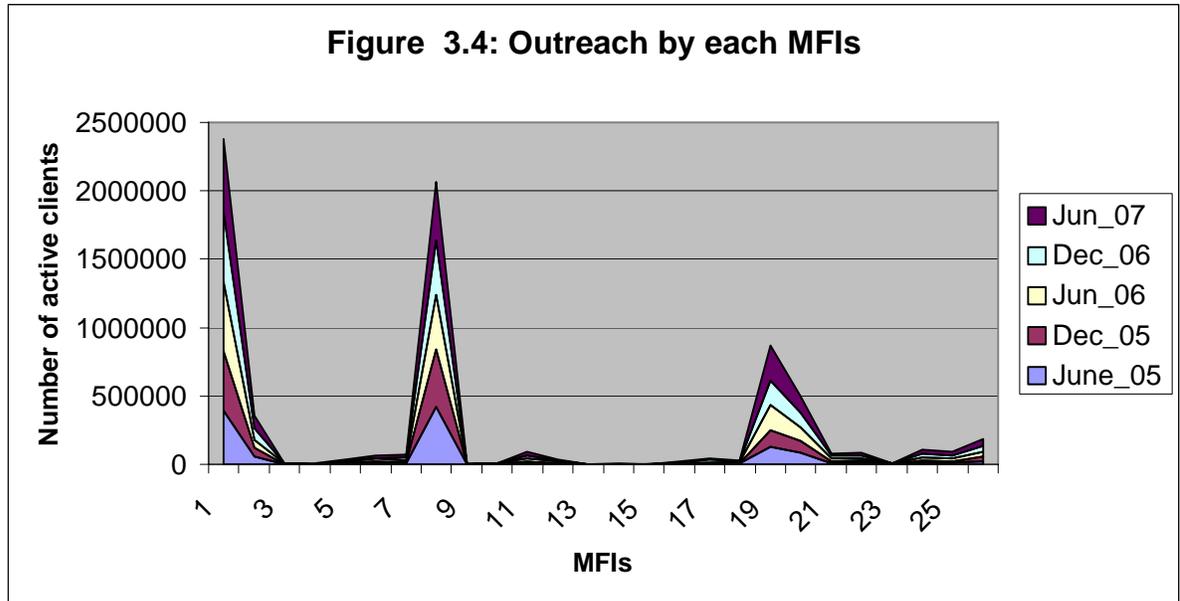
After having the brief on the structure of MFIs, let's examine as presented in the following paragraphs, the findings of the study on outreach and financial sustainability. Please note that the discussion onwards concerns only the 26 MFIs, as data is not available for the 27th MFI.

3.2.1 Outreach

Assessing the number of clients being served by a MFIs has been noted in literatures as core performance indicator for a given MFIs. To this end, the study's finding to Ethiopian case is hopeful. Number of active clients of the individual MFIs and at the industry level is surging as can be observed from figure 3.3 and 3.4 below. Individual MFI's outreach has shown increment over the period of the study with different rates of growth, leading the industry's outreach to rise in the period from 2003 to 2007 on average by 22.9 percent.



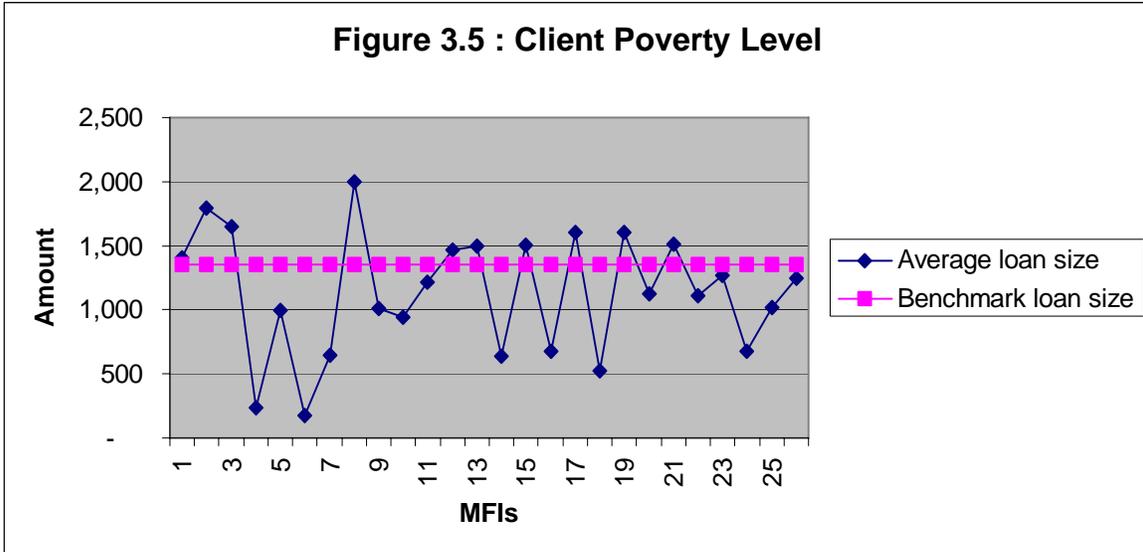
Source: National Bank of Ethiopia



Source: Association of Ethiopian Microfinance Institutions (AEMFI)

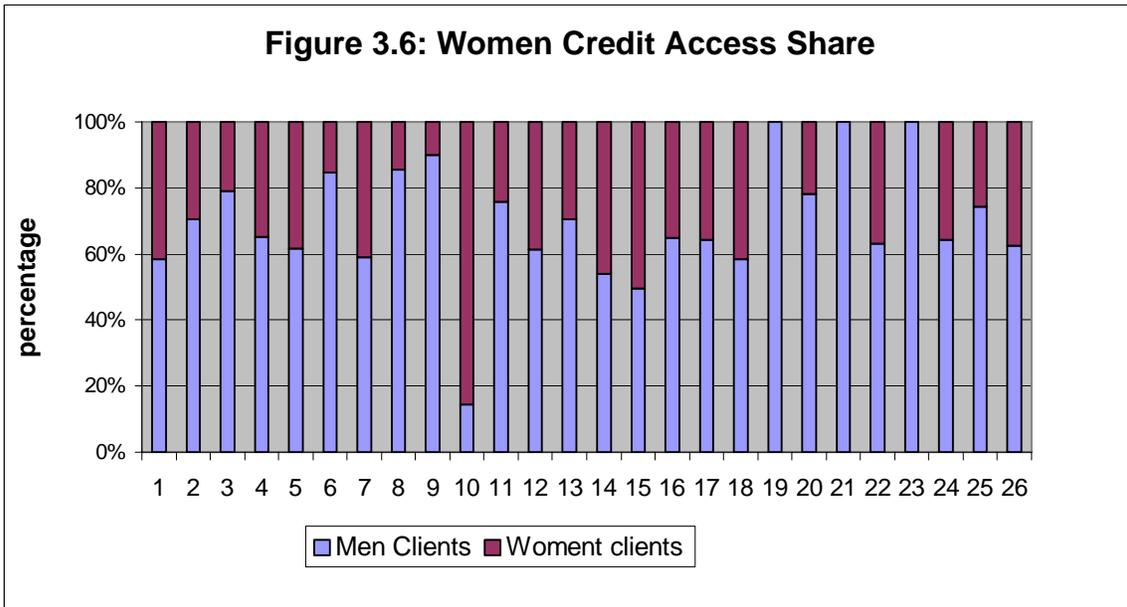
The number of client is a mere indicator for how MFI is reaching the poor. Various techniques, some expensive and some simpler, are noted in literatures to measure client poverty level. Though it is not precise, loan size is one of the simpler indicators that small loans represent poor clientele (Robert Cull et al., 2007). The logic is that better off clients are not interested in smaller loans. In this regard, the study found that MFIs in the country are pro poor, using loan amount below \$150 (Birr 1352) as rough benchmark for calling the client poor⁹ (See Figure 3.5 below).

⁹ The benchmark is obtained from core performance indicator for microfinance manual of United Nations Capital Development Fund (UNCDF). URL: www.uncdf.org/english/evaluation/pdf/core%20indicators--undp%20version.pdf.



Source: Association of Ethiopian Microfinance Institutions (AEMFI)

One of the disadvantaged from economic empowerment's point of view are women. The study found that credit access to women is still limited. At the industry level women credit access share is only 38.4 percent as at June 2007. On individual MFIs level the share of women participation to credit access is different but below 50 percent except for very few of them (See Figure 3.6 below).

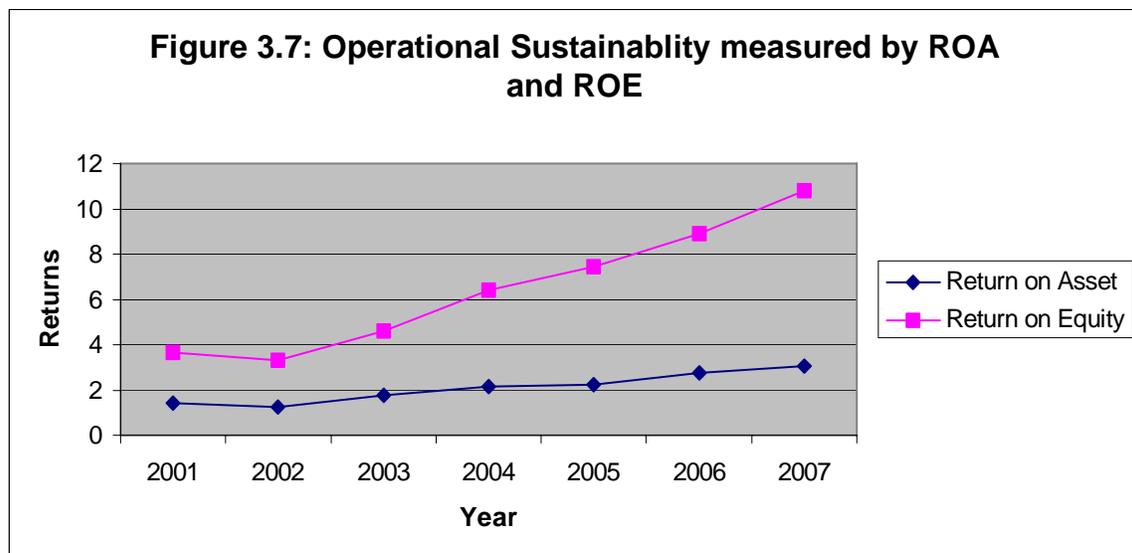


Source: Association of Ethiopian Microfinance Institutions (AEMFI). Please note that those MFIs with no data on women clients are shown above as MFIs with no women clients.

3.2.2 Financial Sustainability

It is difficult to measure financial sustainability of MFIs, as almost all MFIs are subsidized, where some subsidies are in kind form. Nevertheless, alternative measures were used to assess financial sustainability of MFIs in this study.

Operational sustainability examination, as component of financial sustainability measurement, revealed that MFIs as industry are operational sustainable measured by return on asset and return on equity. It is identified also that the industry's profit performance is also improving over time (See Figure 3.7 below).



Source: National Bank of Ethiopia

The reduction in dependency ratio over the years in the MFI industry is also another indication that MFIs can be self-sustainable, profitable, and meet their social missions. Figure 3.8 below illustrates that as dependency ratio measured by the ratio of donated equity to total capital decline, ratio of retained earning to total capital is raising letting the industry to be financial self-sufficient. While dependency ratio reduce from 63 percent in 2001 to 31 percent in 2007, retained earning to total capital ratio went up to 16.3 percent in 2007 from -2.5 percent in 2001. Similarly, financing loan through donated capital has also shown reduction over the years from 42.5 percent in 2001 to 11.1 percent in 2007.

Figure 3.8: Trend of Dependency Ratio and Retained Earning to Capital Ratio

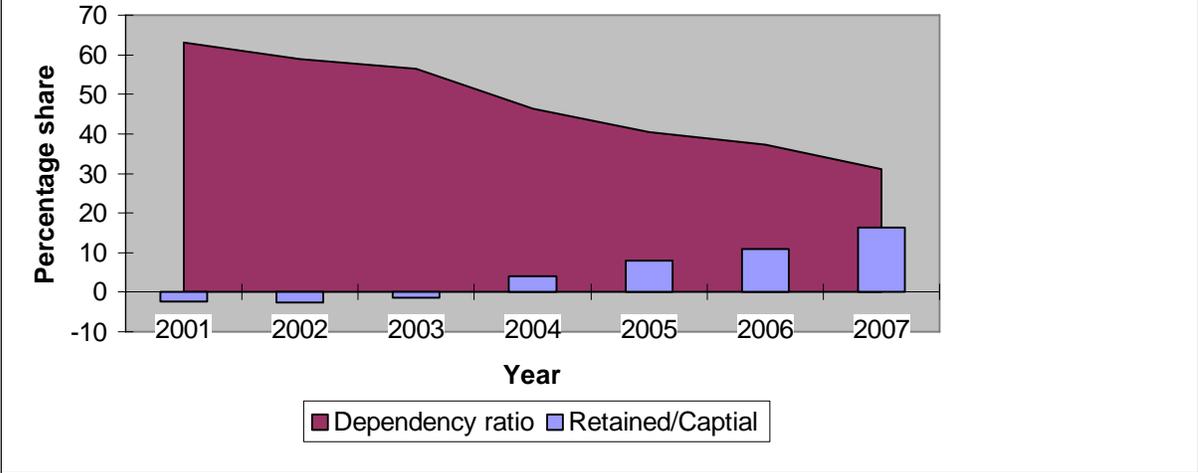
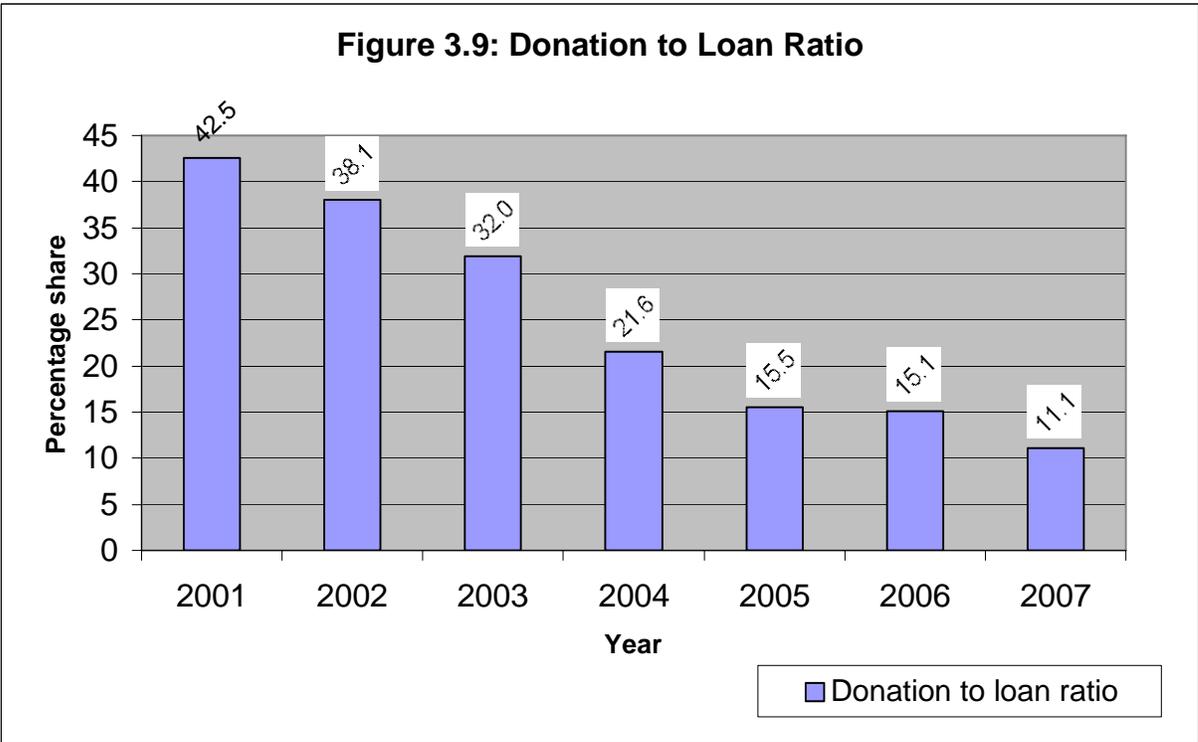


Figure 3.9: Donation to Loan Ratio



Source: National Bank of Ethiopia

Non-performing loan (NPLs) to loan outstanding ratio can also be an alternative indicator for measuring profit quality, which has an effect on financial sustainability of a MFIs. Using this indicator the study found out that MFI financial sustainability is in a comfort zone with average NPLs ratio of 3.2 percent from 2005 to 2007 (See table 3.1 below).

Table 3.1: Non-Performing Loans (NPLs) to Loan Outstanding Ratio

	Jun-05	Dec-05	Jun-06	Dec-06	Jun-07
NPLs*	54,320.68	58,169.93	49,353.7	67,682.4	91,321.2
Gross Loan O/s	1,482,153.88	1,623,510.53	1,959,721	2,168,284	2,735,660.4
NPLs Ratio (%)	3.7	3.6	2.5	3.1	3.3

Note: This NPLs refers to outstanding balance of loans that are past due at least 90 days*

Amount in '000

Source: National Bank of Ethiopia

Similarly, it is well articulated in literatures that less default rate is critical for financial sustainability. Concerning this matter, the study finds from the representative sample MFIs that the default rate is very low for most but it is showing steady growth. For instance, in one microfinance in period 2001 and 2002 it was 0% but in 2003, 2004 and 2005 it steadily grow to 6.9%, 3.2% and 7.6% respectively. Similarly, in another Microfinance the default rate has increase on average from 2001(default rate of 2%) to 2005(default rate of 5%) by 39%. For now, this low default rate is encouraging to support the financial sustainability of the institutions. Yet, the growth trend of the default rate might endanger their financial sustainability.

According to the representative sample MFIs the main causes of the default of the clients are:

- ◆ Improper selection;
- ◆ Ineffective repayment enforcement mechanism;
- ◆ Absence of effective group pressure or collateral;
- ◆ Negligence of clients;
- ◆ Crop failure in rural areas;

- ◆ Sickness of the borrower or family member; and
- ◆ Bankruptcy in the business of clients, etc.

3.2.3 financial sustainability vis-à-vis outreach

After investigating outreach and financial sustainability of MFIs lets see how they interact with each other. There have been arguments that there is a trade-off between reaching the poor and becoming profitable rationalizing that high number of clients with small loans will lead to high cost of lending thereby lead to profit loss. In this regard, finding of this study, however, is encouraging. As can be observed from Figure 3.10 and 3.11 below, simple correlation test between number of active client (NAC) and profit performance (PR) of a microfinance has shown strong positive correlation between them.

Figure 3.10: Correlation Result between Number of Active Clients (NAC) and Profit Performance (PR) of MFIs on 2007 data

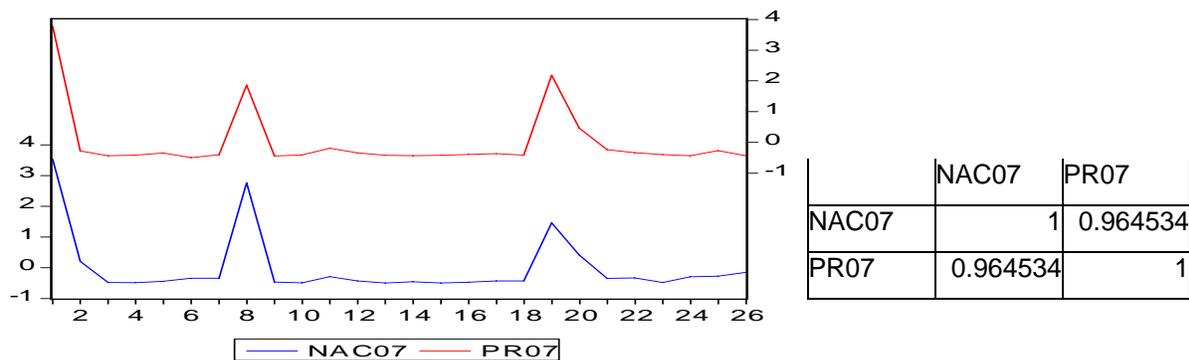
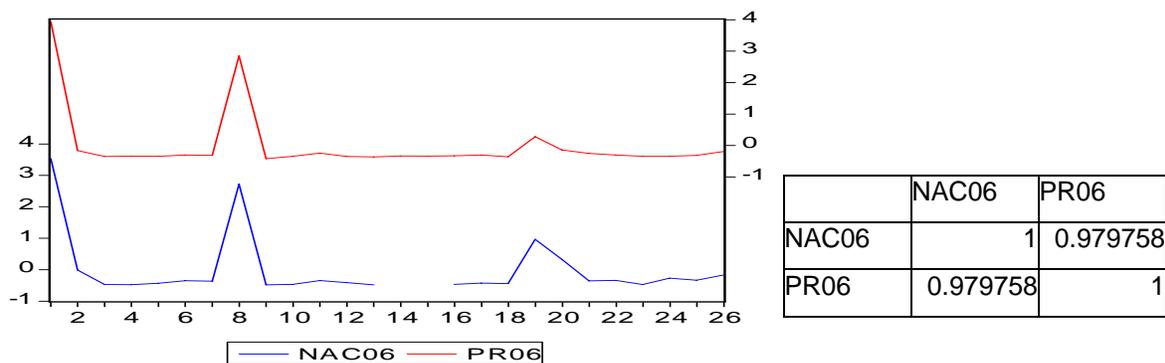
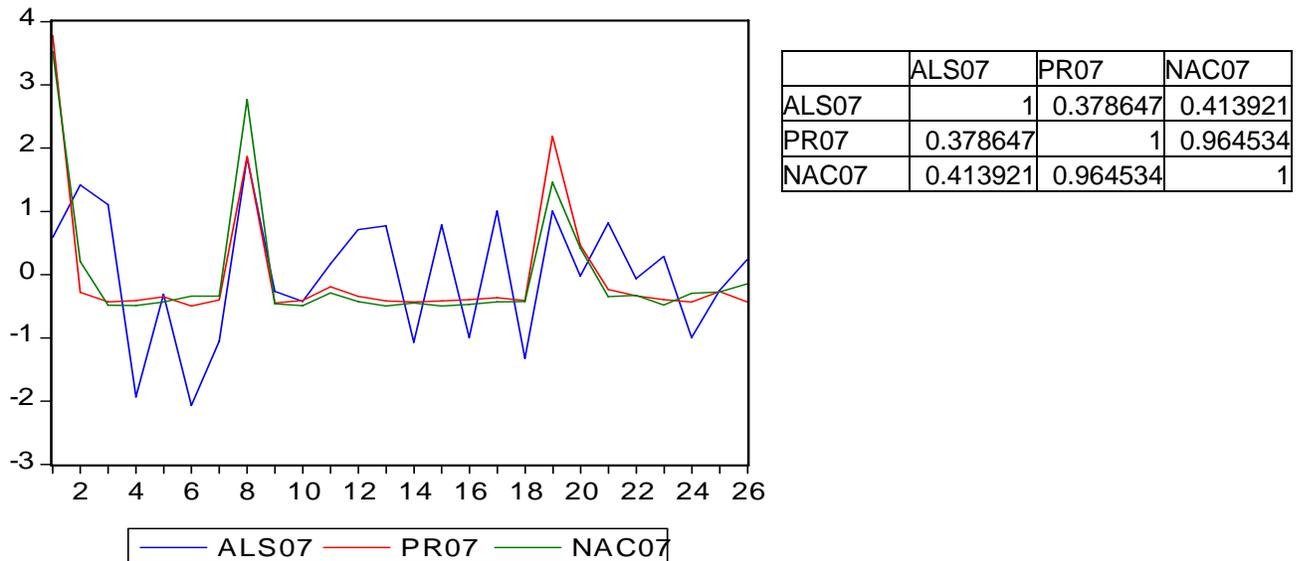


Figure 3.11: Correlation Result between Number of Active Clients (NAC) and Profit Performance (PR) on 2007 data



Nevertheless, when we attempt to investigate the correlation among number of active clients, profit performance and average loan size the result is a bit different. MFIs with low loan size (which was taken as proxy for poverty level) tend to have low profit performance and vies versa (See Figure 3.12 below). Yet, as the correlation is not strong, it does not imply that MFIs should concentrate on high loan size to realize profit.

Figure 3.12: Correlation Result among Number of Active Clients (NAC), Profit Performance (PR) and Average Loan Size (ALS) on 2007 data



3.2.4 Related Performance Indicators

Provision of different kind of product by MFIs is also noted on literatures as performance indicator. The study find that though all MFIs in the country focus on loan provision and saving product, few also provide micro insurance, leasing, pension, money transfer and consultancy. The study also found that the MFIs provide credit to all kind of business on both individual and group loans basis.

And, concerning whether the institutions use screening mechanisms to identify credit worthiness of the borrowers, the study finds that the institutions use various mechanisms to select their clients. Some of this mechanisms are: client self selection mechanism, type

of business, income of the client during the last three years, gender, credibility in the community, age (active age group), permanent residence, character assessment, etc.

Regarding the presence of criteria for selecting the specific group for credit access, the representative sample MFIs indicated that they have several criteria to select the potential clients, which include:

- ◆ Willingness to join credit group of self selected members;
- ◆ Willingness to co-guarantee the loan of fellow group members;
- ◆ Prior experience of saving and loan repayment;
- ◆ Willingness to save;
- ◆ Support letter from PA/ Keble;
- ◆ Being above age of 18 and below 60 old; and
- ◆ The client should have the capacity to engage in viable income generating activity, etc.

Looking at the credit term of MFIs, it was found that they are totally concentrated on short-term loan ranging from 6 months to 24 months. This definitely would have a negative impact on the selection of investment projects by the clients. The clients will tend to only participate on trade related activities rather than production activities, which will have high returns in the long run.

The study also found that most MFIs charge different interest rate ranging from 14% to 24%, but some charge flat interest rate. To the majority (whom charge varied interest rate), the rationales for the variations of the interest rate are:

- ◆ Variations in human power and material cost involved in processing and follow up of the credit facility;
- ◆ Variations in risk involved in the type of the business; and
- ◆ Vulnerability to draught or extreme poverty.

The study finds an increase in trend of the interest rate, even when the outstanding lending of the institutions is escalating, which implies that probably the beneficiaries are

price insensitive in association with their desperate demand for the credit. This may in turn imply exploitation of the profit of the poor client given their disparate need for the money.

The representative sample micro finance institutions noted as they provide alternative suggestions towards utilizations of credit. The suggestions are various incomes generating use of the credit which include fattening, cattle rearing, crop and cattle trading and small shops in rural areas; and wood work, metal work and trading in urban areas. Similarly, it was also learnt that the clients some times use the credit for consumption purposes like construction and improvement of housing and furnishing, education, etc.

The MFIs have also clam that the saving habit of their clients is improving. The MFIs have this feature that they force their clients to save. For instance, in one MFIs clients save some fixed amount of money used as mandatory at the beginning of the loan term. And they will be able to withdraw 50% of this saving when they request for the next cycles loan amount and the remaining 50% of the mandatory saving will be retained until they leave the program. As a result of this at the industry level, MFIs client saving mobilization has surged on average by 30.8 percent in the period from 2001 to 2007.

3.3 Challenges of MFIs

Even if the above improvements have been observed, the study also found the presence several challenges that constrain the MFIs operation not to be efficient. Some of the challenges according to the representative sample MFIs are:

- ◆ Many donors are not keen about MFIs and reluctant to fund;
- ◆ Less saving habits;
- ◆ Limited loan products;
- ◆ Absence of legal title of assets in rural areas; and
- ◆ Easy dissemination of bad mouthing (some clients are not visionary; they opt for immediate benefits in illegal way).
- ◆ Less willingness from commercial banks to lend to MFIs without collateral;
- ◆ The legal environment is not conducive enough in enforcing the loan contract;

- ◆ Shortage of experienced human resources; and
- ◆ Shortage of Logistics in rural areas such as road, telephone, etc.

Particularly, the screening process of clients has also noted as challenging area. Lack of adequate information about the client's financial management and absence of recorded evidence is the main challenge. This makes the MFIs to rely on fellow group member's oral information. Additionally, problem of certifying the real ownership of business, problem of clients to target on profitable business, and sometimes lack of understanding of clients about the operation of the institutions, are the challenges.

Hence, to minimize the above stated challenges, the representative sample MFIs have given various possible solutions:

- ◆ Policy makers have to design effective rules and regulations of contract enforcement and the implementation should be followed strictly;
- ◆ Loan products has to be diversified;
- ◆ The National Bank of Ethiopia or any government concerned authority should nurture small MFIs by building their capacity, may be by establishing a fund raising unit for loan able capital; and
- ◆ Appropriate screening mechanism should be sought, strict follow up and capacity building of both clients and credit officers should be organized.

Chapter 4- Conclusion and Policy Implications

The paper examines the performance of MFIs in relation to outreach and financial sustainability. It reviews literatures on core performance indicators of MFIs. The literatures noted that MFIs could be examined through three main polar: outreach to the poor, financial sustainability and welfare impact. The welfare impact assessment is not covered in this paper due to time and money limitations.

Both secondary and primary data (obtained from questionnaire distributed to representative sample MFIs) has been employed in the study. In the analysis process, the study has adopted simple correlation and descriptive analysis techniques.

From the outreach angle, it is found that individual MFI's outreach has shown increment over the period of the study with different rates of growth, leading the industry's outreach to rise in the period from 2003 to 2007 on average by 22. 9 percent. It is also identified that while MFIs reach the very poor, their reach to the disadvantages particularly to women is limited (38.4 Percent).

From financial sustainability angle, it is found that MFIs in Ethiopia are hopeful. They are operational sustainable measured by return on asset and return on equity and the industry's profit performance is also improving over time. While, dependency ratio measured by the ratio of donated equity to total capital decline, ratio of retained earning to total capital is raising letting the industry to be financial self-sufficient. Using Non performing Loan (NPLs) to loan outstanding ratio indicator the study found out that MFI financial sustainability is in a comfort zone with average NPLs ratio of 3.2 percent for the period from 2005 to 2007. The study also found low but increasing default rate.

The study also identified no evidence of trade-off between outreach and financial sustainability for Ethiopian case, rather positive correlation was observed between them. Yet, correlation test among loan size (which measure poverty level), outreach and profit performance, revealed imprecise result.

In general, the study has also identified various challenges that constrain MFIs from efficient operations. And, different policy implication could be drawn from the findings of this study. To mention few:

- ◆ As women access is still limited, women's access to credit has to be strengthened;
- ◆ Positive correlation between outreach and financial sustainability implies that we could reach more client to attain social mission and as well we could be profitable; and finally
- ◆ MFIs in Ethiopia are profitable.

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