

**ADDIS ABABA UNIVERSITY  
SCHOOL OF GRADUATE STUDIES  
REGIONAL AND LOCAL DEVELOPMENT STUDIES**

**SUSTANABILITY OF ETHIOPIAN  
MICROFINANCE INSTITUIONS**

**THE CASE OF OMO MICRO FINANCE INSTITATION ,  
(OMFI) SIDAMA MICROFINANCE INSTITUTION, (SMFI) AND  
ADDIS CREDIT AND SAVING INSTITUTION (AdCSI)**

**MUBAREK SANI HUSSIEN**

June, 2006

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(OMFI) SIDAMA MICROFINANCE INSTITUTION, (SMFI) AND  
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**BY  
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## Abbreviation

ACSI:	Amhara Credit and Saving Institutions.
AfDB:	African Development Bank
AdCSI:	Addis Credit and Saving Institution
AEMFI:	Association of Ethiopian Microfinance Institutions
BAAC:	Bank for Agricultural and Agricultural Cooperatives, Thailand
BKK:	Badan Kredit Kecamatan
BRI	Bank Rakyat Indonesid
CGAP	Consultant Group to Assist the poor
CSU:	Credit and Saving Union
FI:	Financial Institution
GAAP:	Generally Accepted Accounting Principles
GB:	Grameen Bank
IFAD:	International Finance for Agricultural Development
MBB:	Micro Bank Bulletin
MFI:	Micro Finance Institution
NBE:	National Bank of Ethiopia
NGO:	Non Governmental Organization
OMFI:	Omo Microfinance Institution
RoSCA:	Rotating Saving and Credit Association

PEACE	Poverty Eradication and Community Empowerment
RUFIP:	Rural Financial Intermediation Programme
SDI:	Subsidy Dependency Index
SDPRP:	Sustainable Development and Poverty Reduction Programme
SEEP	Small Enterprise Education and Promotion Network
SFPI:	Specialized Financial and Promotional Institution
SMFI:	Sidama Micro Finance Institution

## ***Abstract***

*In recent years the growth and expansion of microfinance programs and increasing attention to microfinance as a poverty reduction strategy has given rise to a number of questions. What is the interrelationship between scaling up outreach and financial sustainability of MFIs? Are outreach and financial sustainability positively related or is there direct trade off between the two? What are the factors that are necessary for strong outreach and financial viability? To observe the responses to those questions, the case of three institutions namely, OMFI and SMFI operating in the Southern Regions and AdCSI, in Addis Ababa were used. The main objective of the study is to assess the relationship between outreach and financial sustainability and draws conclusions and make recommendations for improving the financial sustainability of the MFIs.*

*The study used both quantitative and qualitative methods to obtain information on outreach and financial performance of the three sample MFIs. Primary data were collected through semi-structured questionnaires. Focus group discussions were held with the clients of the sample MFIs. Detailed discussions were held with employees and executives of MFIs. Secondary data were mainly collected from audited financial statements. Finally, adjustments to financial data were made and the performances of the MFI were measured by taking selected indicators.*

*The results of the study revealed that the three sample MFIs have achieved extensive outreach. The volume of saving as well as the gross loan portfolio has grown significantly. The participation of women in three sample MFIs was also encouraging. All sample MFIs under study have not achieving the level of financial self-sustainability. However, the trends of their financial performance demonstrate that there is a good and steady progress towards reaching operational self-sufficiency in the three MFIs. Both AdCSI and OMFI already achieved operational self-Sufficiency. The results of operation demonstrate that with the increase of outreach, operational self-Sufficiency has increased. Institutional capacity was identified as the driving force to attain outreach and sustainability in the sample MFIs. Over all, the outreach and financial sustainability of the sample MFIs has grown significantly. However all sample MFIs did not achieve financial self-sufficiency.*

*The main constraints in improving outreach and financial sustainability of MFIs in Ethiopia are: - Lack of experienced and competent board of directors, lack of customer responsive lending mechanism and service design, shortage of commercial loanable fund for future expansion, Lack of trained manpower and efficient legal system to enforce contracts and low interest rate. In order to improve the outreach and financial sustainability of microfinance industry, the importance of designing client centered financial service provision, the need to have competent board of directors and management body is emphasized. Furthermore, the importance of having human resource development strategy, presence of reliable management information system, putting in place an efficient legal system to enforce contracts and adjustment to lending interest rate has been recommended. Financially viable MFI only delivers flexible financial services to the poor that have significantly contributed to poverty reduction. Moreover, all development stakeholders should work together with the microfinance programs to tackle the development challenges of Ethiopia.*

## **CHAPTER ONE**

### ***Introduction***

#### ***1.1 Background of the problem***

Microfinance is nothing new in Africa. Communities worldwide have developed their own financial system since many decades ago. For example Rotating Saving and Credit Association (ROSCAS), where group members pay a certain sum into a common pot every week and a different member take the money each week are common in most African countries. Informal credit markets-where rich individuals lend to others at very high rates, but without collateral, are similarly wide spread in Africa.

The traditional and informal credit markets have been characterized as exploitative because of their high interest rates. Following this accusation, governments of developing countries initiated subsidized credit programmes, which aimed at assisting small farmers to increase their productivity and income and reduce their dependence on moneylenders. The impact of these policies has been limited (Robinson, 2001). Institutionalized and specialized microfinance has largely developed in reaction to the failure of this policy in reaching significant number of poor people through sustainable financial services. Microfinance is an activity that involves the delivery of loan products, saving products and insurance products.

Credit is necessary for the poor as it is one of the means of enhancing the income of the poor. MFIs help the poor to increase their income through providing loans for income generation activities and availing saving facilities. Since the demand for financial services is huge, there is high need for financial institutions, which can provide financial services to the poor in sustainable manner especially in low-income countries such as Ethiopia. Sustainability however, for microfinance institution that caters for the poor is not an easy task. Attaining the objective of financial sustainability and the objective of poverty alleviation successfully is the real challenge of microfinance institutions.

## ***1.2 Problem statement***

Two objectives are paramount for MFIs to be successful: financial self-sustainability and substantial outreach to target population (Yaron: 1994). Providing poor people with effective financial services can help them to deal with vulnerability and thereby to reduce poverty, but MFIs have two challenges. The first challenge is to become a viable institution that built a firm foundation of efficient operation. Only an institution operating efficiently (operationally and effectively) can be an instrument in sustainable poverty alleviation efforts. The second challenge is how to increase outreach so that a significant number of poor have access to financial services. Without significant growth of microfinance institutions, microfinance will not be able to play a leading role in poverty reduction.

Only a financially viable MFI that provides competitive financial services to the poor offers a long-term solution to poverty. Several MFIs opting for outreach before achieving viability find themselves paralyzed down the road and neither goal, viability nor outreach is achieved (Healy, 1998). The key to rapid growth, of services is the ability to maintain financial viability i.e. controlling loan loss, reducing administrative costs to manageable level, and developing a rapidly growing base of financial resources.

Both these challenges are very essential for the successes of MFIs. Therefore, this study is initiated to contribute some information to the existing knowledge on institutional sustainability, financial sustainability and outreach by considering the case of three MFIs namely, OMF1, SMF1, and AdCSI.

## ***1.3 Objectives of the study***

This study examines the institutional sustainability, financial sustainability and outreach of microfinances based on case study of Omo Microfinance Institution (OMFI), Sidama Microfinance Institution (SMFI) and Addis Credit and saving and Institution (AdCSI). The study has the following specific objectives.

1. To assess the outreach, the ability to reach large number of poor people, especially poor women, with quality financial services, by the MFIs (mainly OMFI, SMFI, AdCSI).

2. To assess financial sustainability, the ability of the institutions to cover all (OMFI, SMFI and AdCSI) annual operating cost through revenue generated by the MFIs with minimum or no dependence on donor support.
3. To assess institutional sustainability.
4. To assess client sustainability.
5. To assess how outreach and financial sustainability are inter related.
6. To propose actions to improve the policy environment and practices of donors, policy makers and practitioners in order to improve outreach, financial sustainability and institutional sustainability of MFIs.

#### ***1.4 Research Questions:***

*The following are some of the questions that this research try to answer.*

- ❖ What is the interrelationship between scalingup outreach and moving towards institutional and financial sustainability?
- ❖ Does serving the poor preclude achieving financial sustainability, or can institutions achieve both?
- ❖ What factors are necessary for strong outreach and financial sustainability?
- ❖ What are the problems in achieving financial sustainability of MFIs?

#### ***1.5 Significance of the Study***

Some likely users of the research findings are donors, policy makers, academicians and practitioners. The research finding may help the stakeholders:-

- ◆ To improve the financial viability of OMFI, SMFI, AdCSI and other micro finance institutions

- ◆ To design a means and ways for reducing existing risks and problems both within the programme and client
- ◆ To suggest policy alternatives to improve the performance of MFIs.

### ***1.6 Limitations of the study***

1. Limited coverage of the study, i.e. the study covers only three of the twenty six MFIs operating in the country.
2. The study doesn't directly address the impact of MFIs on the clients themselves.
3. Limited data sources of the microfinance industry of Ethiopia and lack of adequate reports and statements from the institutions engaging in the microfinance activity.
4. The limited time and financial constraint.
5. Limited data size, i.e the study took only 2 years data of sample microfinances.

## CHAPTER 2

### *Review of Literature*

#### *2.1. Review of Literature*

##### *2.1.1. Revolution in Microfinance.*

Poor people in less developed countries have a problem of accessing credit both for their short term working capital requirements and meeting their consumption gaps. For instance, it was estimated that only 5% of the farmers in Africa; about 15% in Asia and Latin America had access to formal credit; and of which only 5% of the borrowers have received 80% of the credit (Sarah, 1976). This is because; formal financial market fails to provide service to poor people as, the poor can not have collateral and therefore perceived as risky (Hulme and Mosley, 1996).

It is also indicated that the poor are reluctant to borrow from formal banks because the administrative and costly formalities of obtaining credit from them are so problematic (Levitsky, 1998). As a result, poor people are usually forced to seek credit either from the money lender at high interest rate, or to mortgage their land, labor or product at low price (Bakhoum, et. al. 1989).

To minimize the problems, governments of most developing countries and development partners have been providing capital (at a subsidized interest rate) to banks to lend a minimum amount of their capital to poor borrowers. These banks were forced to give a low interest rate credit service to the poor, with the assumption that short term costs are appropriate for long-term benefit of the mass of the poor (Rogaly, 1996). However, these banks were not able to continue providing the services as intended because:

*The cheap credit was attractive to borrowers outside the target group, and was diverted away from its intended purposes [like a means of having vote by waiving outstanding and overdue loans at election time]; and loans were often not repaid. This combination of cheap credit and wide spread default resulted in the rapid erosion of loan funds (Jonson and Rogaly, 1997: p52).*

In response to doubts and research findings about state delivery of subsidized credit to poor farmers, microfinance, in the 1980s, was considered as the viable instrument to address sustainability. Since the beginning of the mid 1980s the subsidized targeted model supported by many donors was the object of a steady criticism, mainly because most programs accumulated large amount of loan losses and as a result required frequent recapitalization to continue operating (Ledgerwood 1999; Hulme 1996; Robinson 2001). This phenomenon inevitably led to a new approach that considered microfinance as an integral part of overall financial system instead of a separate development tool. Thus, emphasis shifted from the rapid disbursement of the subsidized loans to target populations towards the building up of local sustainable institutions to serve the poor.

Since the 1970s there has been an evolution in the approach (paradigm) employed to microfinance in the context of poverty alleviations. Strong criticism was made against the prevailing “mode of intervention” in microfinance institutions. It was proven that the traditional, supply-driven approach was neither effective nor efficient. Credit subsidies, which are capital constrained, provide triple threat to the development of viable financial institutions with wide out reach. They often:

1. Finance at high, cost influential local elites who capture the subsidies
2. Severely limit the volume of institutional micro credit available to the poor.
3. Depress both savings mobilization and institutional sustainability because the interest rates on loans are too low to cover the operating costs required for effective combined operation of saving and credit programs (Robinson, 2001, P.139).

As a result, the emerging new alternative paradigm emphasized the role of private banks and NGOs and acknowledged the importance of broader financial services (including saving as well as credit).

In the 1970s the emphasis was on the aspects of outreach and particularly on disbursements, where as in the new approach, especially since the 1990s, there has been serious concern with sustainability, is in turn the possibility of important trade off between those different aspects. The focus of the old approach on disbursement has been taken as a result of pressure generated

not only by donors but also by government officials, who showed the number of loans dispersed to obtain medium and small farmers as indicator of their social and economic development and to obtain political support. Targeting was pursued as political economy operation, to indicate the social group to which loans were directed (Feinstien 2000).

Recently some innovative microfinance institutions such as Bank Rakyat Indonesia (BRI) and Bancosol in Bolivia have shown that it is possible to deliver credit to large number of poor people without the financial institution being at risk.

### ***2.1.2 Poverty in Ethiopia***

Poverty is the main challenge and a fundamental issue of economic development in Ethiopia. According to World Bank study (1992), about 60% of the population in Ethiopia is reported to live below poverty line and about 13 million people living in rural areas are classified as chronic poor.

To understand determinants of poverty in Ethiopia, it is important to think in terms of people's assets, and the volatility of returns or income. These assets can be divided into; human assets, such as the capacity for basic labor, skills and good health; natural assets, such as land; physical assets, such as access to infrastructure, financial assets, such as savings and access to credit; and social assets, such as networks, contacts and reciprocal obligations that can be called on in time of need, and political influence over resources (Wolday, 2003).

The incidence of poverty in Ethiopia is very high. According to 1999/2000 household income, consumption and expenditure and welfare monitoring survey conducted by central statistical Authority (CSA), about 42 percent of the population cannot afford to spend enough to buy the minimum food requirements. About 45.5 percent of the rural and 37 percent of the urban population are below the nationally defined poverty line. On the overage, the income of the rural poor is 12.1 percent far from the poverty line, while it is 10.1 percent for the urban poor (Tassew, 2004).

The prevalence of malnutrition continues, a large proportion of the population is facing chronic food insecurity and vulnerable livelihoods. In 1991/2000, the daily per capital calorie intake for the entire country was 2212. The daily per capita calorie intake was relatively higher in rural areas compared with urban areas. World Bank report (1998) indicates that a nutritional deficiency in Ethiopia directly accounts for 7.8 percent of all deaths and that an estimated 52 percent of the population is food insecure.

The World Bank report (1999) indicated that 43.3 percent of the total population has life expectancy of less than age 40. People without access to safe water, health services, and sanitation accounts for 64%, 75% and 85% of the total population respectively. Wolday (2003) indicated that poverty in Ethiopia is a manifestation of complex factors such as high population growth, environmental degradation, high unemployment, draught, low level of literacy, limited access to resources, health and education services, etc. Poverty, in Ethiopia, is also a multi-dimensional problem owing to poverty's large scope and multiplicity of actors, there is no single guaranteed approach to its eradication. The solutions to poverty are as multifaceted as its causes.

In Ethiopia, among other things, lack of finance is one of the bottlenecks impeding production, productivity and income of households. The deliveries of financial services have been viewed as one of antipoverty tool of the national sustainable development and poverty redaction program (SDPRP).

### ***2.1.3. Microfinance and poverty alleviation.***

Most studies suggest that microfinance can play an important role in helping clients increase their income. For example, Hulme and Mosley's study of microfinance in seven countries concluded that the more effective microfinance have helped many poor households to cross official poverty line. Marcus, et. al (1999) indicated that for the very poor household even small increases in income can mean, for example that a family can eat twice, rather than once a day in the hungry season.

However, it is widely indicated that not all participants benefit from the programme. The better off people benefit from microfinance more than the poorer people. Marcus, et. al (1999) indicated the following reasons for the low benefit microfinance for the poorest.

- a. Better-off people usually have more resource, both financial and interims of knowledge and skill which they can use to develop or improve their business.
- b. Inflexible repayment schedule and short grace periods before repayment, though good for the MFI profitability and sustainability, can also push people into activities such as trading, which are rapid but may not have good return.
- c. The issue of social exclusion is also there with regard to the poorest people in the community. Various studies such as Goetz, et. al (1996); Hulme (1995) claim that group members did not really welcome the poorer member of the village, as members select each other based on the individual's capacity to pay the loan.

Based on the risky nature of credit service, some question whether credit service for the poorest people is appropriate. Hulme (1995) views credit as only one element of a micro-level poverty alleviation strategy and maintains that for the poorest house-holds, the opportunities for credit financed self employment are very limited and the risks unreasonably high. Brnnet et. al. (1996) adds to the debate by stressing that the very poor, the destitute and the disabled should not be put in a position which creates an additional liability for them but that a demarcation should be made between those with an ability to pay and those who can not.

*“Placing in debt those who are too poor to use credit effectively helps neither borrowers nor lenders. Food deficit borrowers without opportunities to use credit or to market their output may have no choice but to eat their loan. This can in turn, lead to humiliation and the diminishing of an already low level of self-confidence. Lenders to extremely poor also face difficulties because low payment rates caused by borrowers who can not repay prevent the development of sustainable microfinance” (Robinson, 2001, P.20)*

Thus, while credit is heralded as improving the lives of poor people, it appears that the heterogeneous nature of the poor has not always been recognized and that credit has not always benefited the core poor. The appropriateness of credit as a single strategy of poverty alleviation is questioned by various researchers.

#### ***2.1.4. Impact Assessment in Microfinance***

Impact assessment is a controversial issue in microfinance. There has been strong argument that the success of microfinance institution should be evaluated through whether they have met their goal of expanding income and reducing poverty (Harper, et. al., 1998). The reason behind this argument is that, this financial institution came into being as a means of making a significant difference in the lives of a specified target groups normally the urban or rural poor. Consequently it is believed that the impact they have on the lives of these people should continue to be evaluated. As a result many researches have tried to assess the immediate impact of microfinance on the participants' income, the impact on their income generation activity, on their consumption and savings which are mostly anecdotal (Rogaly, 1996). The rigorous evidence of the long-term impact is limited.

The process of impact assessment is criticized for its high cost compared to the reliability of data and potential findings (Rhyne, 1994). The findings may become less reliable because, measuring impact based on household and individual income can have some methodological problem, such as:

- ◆ Indicators of change in income are various in types: financial, non-financial asset, level of consumption, individual expenditure, expenditure patterns and so on. Therefore, it may become complex to analyze and indicate a realistic change on the income of an individual that the microfinance service has brought about.
- ◆ Second, conducting income assessment at household level may miss the reality that all the family members have no equal access to incomes and expenditures. This means that, even though change in income is registered at household level, that change may not improve the lives of some members of the family.

Yaron (1992) introduced a new criterion for measuring the success of microfinance institutions, which is 'sustainability and outreach'. Yaron argues that if financial institution are able to

provide a *wide range of financial services in efficient manner*, they are likely to contribute to income expansion and poverty reduction. Therefore, measuring the performance of MFIs based on the criteria of ‘sustainability’ and ‘outreach’ can serve as a means of assessing the development impact the service brought while reducing the methodological problem (Yaron, 1997).

### 2.1.5. Level of Financial Self-Sufficiency

The new microfinance agenda increasingly emphasize on the need to achieve sustainability of microfinance institution. Sustainability is defined “The Ability of the programme to continuously carry out activities and services in pursuit of its objective” (Shanidur, 1995, P.36).

According to Otero and Rehyne (1994) and Havers (1996), there are various level of self sufficiency in microfinance institutions based on the degree to which the institutions depend on grants and soft loans to cover their various cost items. The levels of self sufficiency can be summarized as follows:-

**Table 1. Level of self sufficiency in credit programme.**

	<i>Amount of Subsidy</i>	<i>Source and types of funds for on-lending</i>	<i>State of revolving fund</i>	<i>Operating expense paid by</i>
level 1 Traditional highly subsidized programme	High	Grants or soft loans from donor agencies	Values erodes rapidly through delinquency and inflation	Continuing grants
Level 2 As level 1 but better managed	Some	Borrowed at concessional but near market rate from donor agencies	Slow erosion of funds	Partly by interest income, partly by grants
Level 3 Approaching sustainability	Approaching Zero	Borrowed at concessional but near market rate from donor agencies	Fund stable in real terms	Interest income
Level 4 True sustainability	Zero	Raised at commercial rates from formal financial institutions and client saving	Fund stable in real terms	interest income

*Source: (Havers 1996, p 145)*

The most commonly used methods of measuring financial sustainability are:

- a. Sustainability index, which is expressed as a percent of total cost covered by income in a given period, and
- b. Subsidy dependency index:, which focuses on the degree to which the programme relies on external support for its operation (Havers, 1996).

The sustainability index focuses on the amount of cost covered by revenue, and doesn't show how much the programme is dependent on external fund, whereas subsidy dependence index shows the extent of self sufficiency or dependency of the programme (Yaron,1994 P.57).

According to Yaron, financial self-sustainability is achieved when return on equity, net of any subsidy received equals or exceeds the opportunity cost of the equity fund. Subsidy dependency is the inverse of self-sustainability.

#### ***2.1.6. Best practice and innovations in achieving sustainability***

In the past decades, a number of initiatives to provide saving and credit to the poor have been evolving. Microfinance institutions like the Grameen Bank of Bangladesh, BRI-Unit Desa, and BKK of Indonesia are some of the successful microfinance institutions in reaching large number of poor people (Yaron, 1994). These institutions have made use of innovative financial policy and delivery mechanism, which helped them to overcome the problems of rural financial market. The success stories of these MFIs have attracted the attentions of governments, international communities and funding agencies and therefore, large amount of development funds are directed towards the establishment and strengthening of MFIs. This section deals with the level of achievements by some of well known MFIs in terms of sustainability and outreach.

##### ***2.1.6.1. Institutional Sustainability.***

According to Yaron (1997), institutional sustainability is necessary to attain a high level of financial sustainability and outreach. Institutional sustainability is possible where there is:

- a. A responsive organizational structure which encourage participation;

- b. A system and a procedure, which are client focused, efficient flow of information, and sufficient transparency;
- c. A management team capable of translating the organization's objective into action;
- d. A system to secure appropriate human, financial and technical resources
- e. Motivated and skilled staff with the ability to efficiently execute and continuously refine and improve the operational methodology to better meet the organizational need (Yaron, 1997).

The success of most innovative microfinance institutions is mainly the result of their strong organizational culture and management system. Staff motivation and development is one of the most common characteristics of these institutions. Best performing staffs in assessing, extending and collecting loans are rewarded (Yaron, 1994). In the case of successful microfinance institution such as in Indonesia, the managers of the institutions have made the co-owners of their corresponding unit in the form of quisy-equity contribution in the form of efficiency earnings (Chaves, 1996). Furthermore, employees are selected on competitive basis and have to undergo extensive three month training followed by a year management and communication programme in the case of Bancosol of Bolivia and other similar programmes (Chingoli, 1998).

#### **2.1.6.2. Outreach**

Outreach is "a hybrid measure that assesses the extent to which a Rural Financial Institution (RFI) has succeeded in reaching its target clients and the degree to which the RFI has met the clients demand for financial services" (Yaron, 1997, p:91). The indicators of outreach are: the depth (types of clients reached and level of poverty) and breadth of outreach (number of clients served) (Yaron, 1997).

Most innovative microfinance institutions are successful in reaching large number of poor clients. Grameen Bank (GB) for instance, covers 56 out of 64 districts making it the largest credit programme in the country with annual growth rate of 34% (Sarah, 1997). It gives service to more than 2 million people, of which 98% are women. However, it is indicated that the poorest of these women have been excluded from getting the services through the process of group formation. This is because: group members select each other on the basis of the potential

of each member for making timely repayment and savings (Rogaly, 1996). If a woman is very poor and has no asset that indicates her potential to pay the loan, she is likely to be excluded (Johnson, 1997).

Growth or outreach has some positive implications for financial institutions. First, growth enables the organization to reach large number of clients; Second, growth reduces average operating cost for the institutions. Third, growth helps institutions to satisfy their client's need through various services. Fourth, growth gives better image of the institutions to attract loanable funds from banks for further expansion and it increases the borrower's willingness to repay (Schreiner, 1997). However, unless it is well organized and planned, rapid growth may have some disadvantages, such as:

- ◆ **Increase in loan arrears:** Loan arrears may increase for two reasons. First, rapid growth means increasing new borrowers. New borrowers are more risky than well-established borrowers. Second, expansion makes monitoring difficult.
- ◆ **Problem of organizational capacity:** The organizational capacity, the skill available may not be consistent to the rapid expansion of the MFIs.
- ◆ **Problem to deepen the outreach:** The objective of reaching the poorest and increasing number of clients may not be compatible. The scattered settlement of the rural poor; the problem of access for communication; have negative effect on growth. With this regard, institutions may focus on highly populated communities of urban areas where they can find large number of clients with a very minimum effort and cost.

### ***2.1.6.3. Financial Sustainability.***

According to Johnson and Rogaly (1997), most of the well-known programmes have been operating in subsidies especially at the beginning of their operation. The following table shows the subsidy dependence index of BKK (The Bdan Credit Kecamatan, Indonesia); BUD (the Bank Rakyat Indonesia Unit Desa); BAAC (Bank for Agriculture Co-operatives, Thailand); GB (Grameen Bank, Bangladesh).

**Table 2. The Subsidy Dependence Index.**

<i>Indicator</i>	<i>BKK</i>		<i>BRI UnitDesa</i>		<i>BAAC</i>		<i>GB</i>	
	<i>1987</i>	<i>1989</i>	<i>1987</i>	<i>1989</i>	<i>1987</i>	<i>1989</i>	<i>1987</i>	<i>1989</i>
Index reading <sup>a</sup>	24	20	3	-8	28	26	180	130
Effective annual lending rate	35.8	33.8	41.9	40.1	12.3	11.9	13.3	12.0
Effective lending rate required to eliminate all subsidies <sup>b</sup>	44.4	40.5	40.3	37.1	15.7	15.0	17.2	27.6

*Source (Yaron, 1994:59)*

Table 2 indicates that, most institutions are dependent on external funds at the early stage. The dependence on external fund decreased through time. BKK and BRI UnitDesa have attained higher level of sustainability through high interest rate. These institutions are also indicated to be financially profitable. For instance, Chaves (1993) indicated that, in 1989, BKK had a profit of 1,700 (million Rupiah) with an average equity capital of 13,022 (million Rupiah) and similarly BRI UnitDesa had a net profit of 37,000 (million Rupiah) with an average equity capital of 97,000 (million Rupiah).

Grameen-Bank however, shows still higher level of dependence on subsidies. Effective lending interest rate of the institution, which is equal to the commercial interest rate (Sarah, 1997), is still quite low to cover the subsidy. The institution has to increase the lending interest rate more than double to have a true financial self-sufficiency. In general, studies show that it is possible to be financially self-sufficient, if institutions are able to charge a high interest rate (usually more than the market interest rate). When determining the interest rate, several factors must be considered. A balance between what clients can afford and what the lending organization needs to earn to cover full cost must be considered when fixing interest rate (Ledgerwood, 1999, p 138-139). "Full cost interest rates are a pre-condition not only for sustainability but for exponential growth."

According to Bob Christen, (1995) successful Latin American MFIs, who were able to pay high interest loans, was because they were generating extremely high rates of return from extra

<sup>a</sup> . The degree to which the programe relies on external support for its operation

b.  $[(1 + \text{effective interest rate}) / (1 + \text{inflation rate}) - 1]$

liquidity represented by loan (Johnoson and Rogaly, 1999, p.44). Therefore, to reach financial sustainability, MFIs have to charge on effective interest rate that covers all costs incurred in providing financial services to the poor. Both saving outreach and the quality of volume of lending can benefit from positive real on lending rate that covers the true risk and full administrative costs associated with lending to target group. A positive interest rate will enable an MFI to pay competitive interest rates on deposits. Paying competitive interest rates can simultaneously stimulate both savings mobilization and the volume of lending; since additional deposits can be extended to credit (Yaron, Benjamin 1997, p.109). Charging such a high interest rate to poor borrowers may not be easy and also may not be acceptable to all people. It needs appropriate policy environment and staff commitment.

Financial self-sufficiency in microfinance is possible through many factors such as, high rate of loan collection combined with increased loan size and, the encouragement of voluntary saving (saving mobilization), and the decrease in administrative costs (Yaron, 1994:59).

#### ***Reducing transaction (administrative) cost***

Innovative microfinance institutions have been able to reduce their transaction costs to some extent. This has been possible by bringing about rapid approval and disbursement. In most cases, information required for loan approval is reduced and group (in Group based micro-finance) or local agents are delegated to make client selection (Otero and Rehyne, 1994).

MFIs shall be able to reduce their transaction costs to a level that keeps their sustainability. Presently administrative cost without including costs incurred for training and consultancy can rarely be brought to less than 10% of the loan dispersed, where average loan size is \$300 or less (Levitsky, 1998). This is because: costs per lending are very high as the average loan size is very low in most MFIs. It may become possible to minimize the administrative cost significantly, if financial institutions (FIs) can relay on NGOs or SHOs (self help organizations) as an intermediaries between the FIs and the groups or members (Levitisky, 1998).

### ***Loan recovery rate***

Loan repayment delinquency is recognized as the major threat to maintain the value of fund. A high rate of non-repayment erodes the value of the loan portfolio and reduces income, which undermines the hope of achieving sustainability (Levistky, 1998). Most successful microfinance institutions have a good record of repayment rate. Grameen Bank for instance has loan recovery rate of 98% in 1994 (Sarah, 1997). Similarly in most best managed MFIs the loss amount 2-3% of the value of the portfolio. It is indicated that, for viable MFI losses shall not be more than 5% of the value of loan portfolio (Levitsky, 1998).

High repayment rate in some microfinance institutions has been associated with group formation, close monitoring and follow-up. Groups have largely been considered as a means of minimizing the risk of failure through peer pressure. The practical role of group in enhancing repayment however has not yet been clear. Jain, (1996) indicated that in many cases group members are not responsible for the repayment of unpaid loans in the group. Rather the purpose of group is more to do with the development of credit-responsive organizational culture by enabling routine repetition of identical behavior by all members. During the weekly meeting, members have the obligation to do the same kind of pledge, which is meant to keep their commitment for timely repayment.

Further to the group formation, higher repayment has been possible through client centered system of credit operation. The high repayment rate in some institution shows that poor people are credit worthy and capable of paying their debt if the credits are based on their need and if the system of operation considers their business type. The time and patterns of repayment, time and seasons for loan disbursement; should consider the client's situation and business. For instance, if the client needs the loan for animal rearing, the repayment schedule should not be designed to be in a weekly basis.

### ***Saving***

Studies indicate that savings were the "forgotten half" of rural finances (Robinson, 2001 p. 224). Policy makers and bankers in many parts of developing world have been taught to believe that the poor don't save, can not save, and do not trust financial institutions, and prefer non-financial

forms of savings (Robinson 1994). In the earlier period, micro finance programmes were not effective in mobilizing saving deposits and showed little interest in this regard. Ledger wood, (1999) mentioned two major reasons for these. The first one is the mistaken belief that the poor can not save, and the second one is due to regulatory constraint of license to mobilize deposits. Recent microfinance experience shows that even poor households would deposit their surplus in MFIs provided, that they get attractive interest rate, convenience /location (priority and accessibility), security (the safety of the saving option), and ease of withdrawal (Jones than Morduck, 1999, 1606-07). Since the 1990, there is a shift from credit (lending) and obligatory saving products to a financial systems approach that recognizes the importance of savings for the poor, for the fact that the MFIs mobilizing savings have recorded better governance structure than credit only MFIs. Vogel, (1994) referred MFIs that neglect savings as “incomplete institutions”. Because more clients can be reached through savings than credit operation alone and this improves the clients outreach.

Saving is important as it contributes to the sustainability by providing financial security through revolving funds independently from outside resources. Besides, it is believed that, saving improves discipline and loan recovery while motivating the clients to manage their money more efficiently (Kidder, 1997).

The experience of the successful MFIs shows that there is high need for deposit services in rural areas. Grameen bank had a total loan of 10,000 (million of Taka) in 1994 with a total deposit of 2,000 (million of Taka) (Yaron, 1997). Similarly, in BRI-Unitdesa, customers of deposit service were higher in number than loan service customers (about two-and-a-half time) and the aggregate deposit balance (\$1.4 billion) were large than loans outstanding (\$ 1 billion) (Chaves, 1996). This indicates that MFIs can mobilize a significant amount of their capital from the savings of the poor. There are five main preconditions to succeed in mobilizing the savings of the poor.

1. An enabling macro economy and political stability
2. An appropriate regulatory environment
3. For the protection of their customers, especially savers, microfinance institutions that mobilize voluntary savings need to be publicly supervised.

4. Accountable ownership, effective governance, and consistently good management of its funds.
5. Allocation of high-level management resources to the institution's microfinance efforts. (Robinson, 2001, p. 258-59).

MFIs should have the capacity (organizational, skilled manpower), appropriate culture (trust and openness) to administer both the saving and credit service appropriately and satisfy the clients with the quality of their services.

“The success of microfinance institutions saving mobilization is not dependent solely on their design but also on the pricing and marketing process and on understanding of the market. For saving products to thrive in the market place, the MFI must have a sound Management structure and an appropriate MIS to ensure that client deposits are not at risk” (Bass and Henderson, 2000 p.3). A viable and sustainable MFI has to cover the cost of saving mobilization and other costs from the revenue it generates; therefore to be viable and sustainable, the loan interest rate must be sufficient enough to cover all incurred costs (Yaron, 1997 p34). For institutions that collect savings, prudent regulation is crucial (Christen and Rosenberg, 2000, p 40).

### ***Size of the loan***

Average size of loan per lending also influences the effort towards sustainability. If the average loan size is small, the average administrative cost per lending becomes high. In most well known financial programmes the average loan size was very low, about \$200 or less and had a loan limit of about \$500 (Levitsky, 1998). Similarly Grameen Bank has an average size of loan \$141 in 1995 (Yaron, 1997).

The intention of giving smaller loan could be that, the financial assistance is given to the real poor and needy people. With low loan size, a limited financial resource can go farther and helps more people where as larger loans would considerably limit the number of loan beneficiaries (Yaron, 1997). Similarly, if average loan size is high, it would attract the better off people and therefore, the poorest may be excluded from getting the access.

However, there is a belief that there shall be no ceiling for the loan amount to have better development impact on borrowers. For instance, Levitsky (1998) argues that, the strongest incentive to repay a loan is the anticipation that this will lead to being granted another larger loan. When loan ceilings are low, only multiple loans of the same size can be expected. Accordingly, the economic growth and impact resulting from the lending programme is limited (Levitsky, 1998). Considering this situation, some programmes have raised their loan ceiling. For instance, BRI-unit Desa is now lending up to \$13,500, when several loans of increasing size have been repaid.

#### ***2.1.6. Policy Environment***

Inappropriate policy environment has often undermined efforts to strengthen financial sectors. Conducive policy environment is believed to be important for MFIs to achieve substantial outreach and financial viability.

As Yaron and Bernjamen (1994) put it, the main attributes of a favorable policy environment for rural financial intermediate are:-

- a. Maintaining macro economic stability: - Both internal and external factors may generate macro economic instability. Internal factors include volatile fiscal and monetary policies as well as political risks. The goals of prudent fiscal and monetary polices should be price stability and sound, well-aligned exchange rates which foster macro economic stability.
- b. Removing urban biased policies:- polices that favor industry over agriculture and urban over rural sector reduce the profitability of agriculture and non-farm rural enterprises and inhibit the development of rural financial markets
- c. Promoting integrated and resilient financial markets: - Government can promote financial market by strengthening the supervision and prudential regulation of financial intermediation and introducing measures supporting financial liberalization including deregulating interest rates reducing high reserve requirement, and relaxing credit controls.

Four aspects of policy environment, which mainly affect MFIs performances according to christen (1995, P 20-21)

- i. Successful government policies reflected in high rates of economic growth, and ultimately in high levels of GDP per capital may affect the ability of MFI to achieve substantial outreach and affect financial viability.
- ii. MFI will have greater difficulty achieving financial viability and wide spread client base if it has to cope with risks and uncertainties of macro-financial stabilities
- iii. The extent of government control over interest rates. Interest rate restriction usually undermines an institution's ability to operate efficiently and competitively and to achieve substantial outreach and to attain viability.
- iv. The regulatory environment can affect the success of MFIs. A key element of success in the ability of an MFI to develop techniques appropriate to their particular policy environment.

### ***2.1.7 Over View of Micro Finance in Ethiopia***

#### ***2.1.7.1 Saving and Credit Needs in Ethiopia***

Need for credit is very high among the poor in Ethiopia. Renee Chao Beroff et.al, (2000) indicated that, economically active poor people in Ethiopia who can potentially access financial services are about 5.2 million.

In the case of rural area, the poor requires credit basically for four reasons. First, innovations in farming like improved seed and fertilizers increases the capital requirements of the farmer. Secondly most farmers remain at subsistence level and therefore, there is no surplus that can be used for the future and hence farmers need credit to bridge the gap of food shortage. Thirdly, women and small businessmen in urban and rural area need short-term credit for their petty trading or other income generating activities. Lastly, People also

need credit to meet their social obligation like weeding, holidays, social gathering like 'Mahabr' (Dejene, 1993).

Similarly the need for saving is high despite the wide spread belief that the poor cannot save. One can observe that a lot of saving is taking place in different forms in rural and urban areas that are susceptible to risks. People save for various purposes: to manage their daily house hold finance, as insurance for unexpected crisis, to meet social obligations and to accumulate for future needs. People save outside the financial system in many forms, including Jewellery, animal, grain, etc. They also exhibit certain strategies for savings. Examples of such strategies are when they are confronted with shortage of grain, they sell their older animal and buy young animals at lower prices and allocate the difference for consumption. With this strategy, the poor people try to maintain their stock and cope with problems of food shortage confronting them. The forms of saving that people are using in rural areas in the form of grain, animal, etc. are very risky as they are subjected to pests, disease, theft, drought and loss. As a result, there is good ground to say that people will take the opportunity of saving in financial terms when available in trusted microfinance institutions.

#### ***2.1.7.2 Institutional arrangements for rural credit in Ethiopia.***

Interventions through the delivery of credit service have been considered as one of the policy instruments of the government and non-government organizations (NGO) to enable rural and urban poor increase output and attain food security. Although, the establishment of formal microfinance institutions is a recent phenomenon in Ethiopia, saving and credit services have been provided to the rural people in various forms through Government, bilateral institutions, NGOs and community based and traditional organizations.

***Government.*** A number of credit services have been provided by government. In the past, Agricultural and Industrial Development Bank and Commercial Bank of Ethiopia provided credit mainly for fertilizer, improved seed, pesticides and agricultural tools. These funds were channeled through service cooperatives. Since the declaration of the Mixed Economy Policy in March 1989, the cooperative's ability to provide financial

services have significantly reduced. Recently the Bureaus of Agriculture and Cooperative bureaus in various regions have been acting as an intermediary to implement various credit programmes to promote national extension package. Under this programme agricultural input, livestock and small ruminants are provided in kind on credit. These have proved to be inefficient and unsustainable.

### ***Non-Governmental organizations (NGOs).***

The activities of NGOs are very diversified which include, among others, water development, environmental rehabilitation, health, education and integrated rural development as well as promoting income generating activities. Most of NGO activities had the saving and credit as a component of their major activities. They were involved in micro-credit scheme either as an implementer, founders or as providers of technical assistance.

Most NGO based credit programmes had a social objective. They were not designed to be self-sustaining. The NGOs tend to provide credit services at a very low interest rate (below market interest rate) focusing on the poorest of the poor (based on humanitarian reasons). They lack sound lending and loan collection policies and most of the schemes had bad loan portfolio arising from insufficient analysis of the borrower repayment capacity. In recognition of these problems, the government of Ethiopia issued the a legal framework in 1996 (Proclamation No. 40/1996) under which micro-finance institutions can be registered and supervised by the National Bank of Ethiopia. As results NGOs are prohibited, by law, from delivering financial services in Ethiopia.

### ***Informal finances.***

In Ethiopia, like all other developing counties, informal finance is available from various traditional institutions. The informal sources of credit at present are moneylenders, friends and relatives, rich farmers, traders, Eqqub and Edir (Dejene, 2001). The significance of each of these sources varies from area to area. However, the traditional mutual self help schemes (Iquib, Idir, Meredaja-mahber) play an important role in rural and urban micro-financial service delivery in Ethiopia. Of these the Equib is used as a Rotating Saving and

Credit Association. A study on the establishment of rural credit in Ethiopia estimates that the volume of money revolving within the Equib is in the range of 8-10% of the GDP of the country (UNDP, 1997).

Kejela, et.al (2005) assessed the role of informal finance sector in Ethiopia. The study was conducted in four regions of the country, namely, Oromia, Amhara, Southern nations, Nationalities and Peoples and Tigray. The results of the study indicated that, informal finance has immense importance in providing credit to rural and urban communities. In the study area, the share of informal finance interims of borrowers and loan size is estimated to reach 69 percent and 61 percent, respectively, showing significant contribution of the informal finance in the financial service delivery.

Credit and Saving Unions (CSU) serve most likely to salary and wage earners operating in urban areas, thereby excluding the bulk of the population (Dejene 2001). Also Wolday (2001) indicated that although there is a continuous increase in the number of credit and saving Cooperatives and members in the country, they have entirely exclude the rural areas. About 98 percent of the saving and credit cooperative members are employees and urban based. Of the total registered saving and credit cooperatives about 53 percent are located in Addis Ababa.

### ***2.1.7.3 Financial policies of the government of Ethiopia.***

A number of policies have been designed to govern the financial sector and reflect the overall banking policies of the government and regulate the way banks and other financial institutions operate in Ethiopia. Proclamation No.40/1996 is directly related to the microfinance promotion policy. The proclamation provides that micro financial institutions should be established as share companies, the capital of which is owned fully by Ethiopian national and/or organization registered under the commercial code of 1960. As a result NGOs are apparently excluded from directly engaging in microfinancing business. However, NGOs of domestic origin registered under the civil code, can be shareholders of micro-finance institutions.

The minimum capital required to establish a micro finance institution is birr two hundred thousand (about 24,000 US Dollar) unlike birr 75 million (10 million US Dollar) for formal banks.

There has been a gradual move from long time fixed rate of interest to market rate. The directives that issued by NBE in may 2002 has removed partly the birr 5000 single borrower limit to MFIs which mobilized 1,000000 birr of savings and also raised the loan repayment period from one year to two years for all MFIs. The minimum interest rate that shall be paid per annum by MFIs on savings and time deposits has been reduced to 3 percent.

#### ***2.1.7.4 The development of Micro-finance Institutions in Ethiopia.***

The development of microfinance institutions that recognizes and accommodates the shortcomings of the past saving and credit services is a recent phenomenon. As of December 2005, 23 microfinance institutions are providing services with a combined outreach of 1,277,939 loan clients. They had outstanding loan balance of Birr 1,622,107,210.00 and mobilized about birr 600689,122.00 of saving (Table 3).

Table 3 indicates that number of clients and their saving amount and the outstanding loan portfolio of MFIs were increased significantly.

MFIS	Number of loan Client					Outstanding loan portfolio					Client Saving Balance					
	Dec,2001	Dec,2003	Dec, 2004	Dec, 2005	Dec, 2001	Dec, 2003	Dec, 2004	Dec, 2005	Dec, 2001	Dec, 2003	Dec, 2004	Dec,2005	Dec, 2001	Dec, 2003	Dec, 2004	Dec,2005
ACSI	152,601	288,681	347,981	434,814	93,159,799	210,355,000	312,823,000	446,971,000	84,874,800	128,649,000	172,798,000	239411000	84,874,800	128,649,000	172,798,000	239411000
ADCSI	6,906	22,500	44,000	61,300	7,774,861	26,792,000	61,412,000	117,681,000	994,620	3,940,000	12,643,000	39219000	994,620	3,940,000	12,643,000	39219000
Aggar	-	-	1,153	1,459	-	-	2,646,216	2,989,447	-	-	1,186,693	1744682	-	-	1,186,693	1744682
Asser	311	654	938	-	754,484	672,891	635,488	-	90,070	127,500	198,704	-	90,070	127,500	198,704	-
AVFS	606	2,866	4,867	5,948	654,304	2,233,602	3,274,012	6,482,799	194,104	611,992	1,012,384	1704490	194,104	611,992	1,012,384	1704490
Benshangul	1,319	2,968	9,172	12,730	441,743	2,116,087	4,607,921	9,989,939	162,163	547,146	1,768,067	3261617	162,163	547,146	1,768,067	3261617
Bussa Gono	3,030	5,999	5,571	9,952	908,912	2,150,122	2,129,246	7,817,235	82,986	477,584	773,636	1206652	82,986	477,584	773,636	1206652
DECSI	158,689	225,996	336,733	423,573	111,169,239	204,345,291	399,790,899	681,673,090	121,997,984	131,346,540	147,429,324	183340918	121,997,984	131,346,540	147,429,324	183340918
Dire MFI	-	-	-	-	-	-	1,960,313	-	-	-	1,024,854	-	-	-	1,024,854	-
Eshet	2,337	6,540	9,728	12,432	748,473	3,829,215	7,346,132	11,636,830	100,794	456,595	850,800	1649616	100,794	456,595	850,800	1649616
Gasha	4,381	6,423	8,556	10,157	2,446,939	3,425,646	6,892,131	14,123,591	1,187,993	2,108,831	3,300,993	5275874	1,187,993	2,108,831	3,300,993	5275874
Harbu	-	-	-	NA	-	-	-	845,558	-	-	-	423898	-	-	-	423898
Meket	2,484	1,964	2,291	2,610	224,525	580,059	1,355,948	1,463,182	116,273	198,079	165,480	373544	116,273	198,079	165,480	373544
Meklit	1,952	3,577	3,667	6,215	899,530	2,458,345	2,739,670	7,045,883	293,357	995,440	1,845,180	2321859	293,357	995,440	1,845,180	2321859
Metemamen	385	1,501	3,286	4,610	78,563	478,300	916,300	1,484,400	-	202,600	246,800	427020	-	202,600	246,800	427020
Ocssco	38,186	70,753	83,188	125,782	28,225,379	65,954,270	94,940,712	153,489,150	15,539,030	21,693,765	36,805,101	60948960	15,539,030	21,693,765	36,805,101	60948960
Omo	58,058	70,590	78,836	82,400	38,867,168	29,487,833	36,321,356	73,917,267	10,287,455	20,912,337	25,944,098	34624761	10,287,455	20,912,337	25,944,098	34624761
PEACE	3,367	5,428	7,766	13,728	2,114,868	5,192,837	7,697,556	15,729,075	436,416	1,185,308	1,921,456	3472323	436,416	1,185,308	1,921,456	3472323
SFPI	6,526	9,552	11,430	14,345	3,925,422	7,047,200	9,893,560	13,841,714	1,824,221	3,744,009	4,515,117	5777665	1,824,221	3,744,009	4,515,117	5777665
Shashimene	1,081	1,850	1,531	1,365	823,341	1,610,212	1,361,742	1,912,420	155,155	449,668	480,348	465333	155,155	449,668	480,348	465333
Sidama	7,891	11,346	12,010	12,700	5,748,224	11,347,876	12,906,200	14,521,465	1,407,828	2,703,778	3,269,857	4115551	1,407,828	2,703,778	3,269,857	4115551
Wassasa	1,457	3,728	8,949	12,151	731,514	2,275,726	5,523,196	7,542,844	189,195	637,380	1,574,570	2504901	189,195	637,380	1,574,570	2504901
Wisdom	9,759	12,157	19,912	29,668	8,890,302	11,626,351	18,708,012	30,949,321	3,356,387	4,041,118	5,629,932	8419458	3,356,387	4,041,118	5,629,932	8419458
Total	461,326	755,073	1,001,565	1,277,939	308,587,590	593,978,863	995,881,610	1,622,107,210	243,290,831	325,028,670	425,384,394	600689122	243,290,831	325,028,670	425,384,394	600689122

Source: Association of Ethiopian Microfinance Institution (AEMFI)

The ownership of MFIs includes regional government, CBOs, NGOs and individuals. Although MFIs in Ethiopia are established as private share companies, the dividends are not dispersed to share holders. The entire resources (dividends) are to be utilized for the benefit of the target group (the poor). With the exception of one MFI, shareholders of Ethiopian micro finances are not investors. Individual shareholders are predominantly trustees of donated funds rather than investors with profit motives. Recently, there is also privately owned MFI in Ethiopia, having profit maximization objective, i.e. Agar micro finances. It can also distribute the dividend to its shareholders.

In a broad classification MFIs in Ethiopia could be divided into three groups: Those targeted to specific region and have relatively strong support from regional government, those operating nation wide and are mainly supported by international NGO and those with profit motive, e.g. Agar.

#### ***2.1.8. Studies on performance of microfinance in Ethiopia***

Despite the growing importance of provision of microfinance to the productive poor people, there are few studies made in the area. Although many of the studies conducted dealt with the impact assessment (focusing on household impact), assessment of the performance of microfinance institutions are very limited. But some researchers have attempted to study the performance of microfinance institutions in Ethiopia . For instance wolday (2000), studied microfinance industry in Ethiopia. His results showed that the MFIs in Ethiopia in 2000 reached 471,966 clients; the loan portfolio amounted about Birr 526 million, outstanding loan was about Birr 273 million and saving mobilization reached about birr 129 million. The gross saving as percentage of loan outstanding was about 47 percent. This is an indication that the performance of MFIs is promising. Moreover, Wolday indicated that the repayment rate of the MFIs varied from 94 to 100 percent which is relatively a good performance. The majority of clients served are the rural poor. Out of the total clients, the number of females reached only 44%, which is very low compared with the Grameen Bank's women client which is over 94 percent.

Renee chao-Beroff et .al (2000) assessed the overall performance of six MFIs in Ethiopia namely SMFI, OMFI, ACSI, WMFI, OCCSCO and Bussa Gonfa MFI operating in southern, Amhara, and Oromia regions. The study comes with the findings that, the majority of the MFIs in the sample were efficient but due to low lending interest rate, they were not profitable. After adjustment for inflation, all MFIs showed adjusted operating loss. Taking financial self-sufficiency, the least institute, which was said to be new, was 25% while the best one was 87%. The lending interest rates of MFIs in Ethiopia were relatively low. Their subsequent findings were that the majority of Ethiopian MFIs are deficient in their accounting and management information system and the information system is not integrated with to accounting system. All MFIs did not have business plans that combine strategic planning and financial projection.

Haile Selassie (2001) assessed the financial viability and outreach of two MFIs in Ethiopia, namely SFPI and PEACE operating in urban and rural area respectively. According to his study, the sample MFIs increased outreach and mobilized significant amount of savings. The number of savers as well as the value of saving has increased.

He also indicated that the repayment rate is very high (98% for SFPI and 99.6% for PEACE). With respect to financial viability, he found out, both institutions as subsidy dependent. The lending interest income and fees they generate did not cover the administrative expense. However, the trend of their financial performance demonstrates that there was encouraging and steady progress towards reaching operating self-sufficiency.

Wolday (2002) also studied the challenges and prospects of new product development in the microfinance industry in Ethiopia. He indicated that products of microfinance, institutions were not designed based on market analysis to meet the need and the preference of the clients, while keeping the financial institutions profitable. This has consequently affected dropout rates, outreach and long term objectives.

Tsegaye (2005) conducted a study on the performance of Ethiopian microfinance institution. His results showed that the MFIs in Ethiopia have shown a tremendous growth in geographical and client outreach in short period of time. He indicated that as of December 2003, there were

twenty two MFIs with a combined outreach of 755073 loan clients accessing both credit and saving products amounting to birr 594 million and birr 425 million respectively. He also indicated that among the 14 institutions analyzed in his study, six have already achieved operational self-sufficiency.

Generally most of the studies with the exception of Haile Selassie and Tsegaye, have followed similar approaches. That is, they mainly focused on the overall performance of the MFIs. The relationship between outreach and financial sustainability were not specifically addressed in these studies.

## CHAPTER 3 METHDOLOGY

### *3.1. Description of the Study area*

The three institutions used as case studies are the OMO micro finance Institution (OMFI), the Sidama micro finance Institution (SMFI) in the southern regions of Ethiopia and Addis Credit and Saving Institution (AdCSI), which is operating in Addis Ababa. One of criteria of selecting the above three MFIs is to capture the activities of MFIs which work in both rural and urban areas. Moreover, the three sample MFIs are categorized in the same peer group (as medium level MFIs) by AEMFI based on criteria such as program size interims of number of borrowers, gross loan outstanding etc. Choosing the sample from the same peer group allows the researcher to make observations about the trends of performance within a group sharing a single or a set of characteristics.

The Omo microfinance institution was established in 1997, as part of the national food security programme by the regional government. Based on a broad federal food security objective of poverty alleviation through intensification of economic growth, the development of financial markets is one of the strategic interventions that the government has put in place. With this background, the Omo Microfinance Institution was established to promote access to finance in the region particularly in rural areas. The shareholders of the institutions are the regional government, (owning 80% of the share); local NGOs (19.5% of the share) and individuals (0.5% of the share). Currently, the Omo Microfinance Institution is operates at 9 branches bank offices and 52 sub branches of southern nations, nationalist and peoples regional state.

The Sidama MFI is also working within the same region. However it only operates in Sidama Zone. SMFI is the continuation of the Saving and Credit Program of Sidama Development program, was established in 1994 with the support of Irish Aid. The bilateral agreement between the Ethiopian and Irish governments restricts the Irish Aid from being the direct implementer of the whole sector projects, including the saving and credit activities. Thus, the bureau of Agriculture (BOA) of Sidama has been mandated to implement the scheme. The saving and credit programme used the group lending methodology, very similar to the Grameen Bank approach.

Following the 1996 microfinance Proclamation, it became necessary to fulfill the legal requirements and transform itself into proper microfinance institution. Therefore, the Sidama microfinance Institution was established in 1998. 74.5% of the shares are owned by six Agricultural cooperatives, whereas the NGO and a private organization own shares of 12.5% each.

Addis Credit and Saving Institution (AdCSI) evolved from “Small Scale Job Opportunity Creation Project” which was established 1995 to provide credit facilities for small-scale projects in region of Addis Ababa. Following the proclamation of 1996, it was registered as a microfinance institution on January 2000, with a paid up capital of Birr 517,000. The shareholders include Addis Ababa City Administration, Addis Ababa Youth and Women association, Addis Ababa Teachers Association and Karaola Farmers Associations. AdSCI operates its activities in 10 branches offices and 88 service posts.

### ***3.2. Methods of Data Collection***

The study has used both quantitative and qualitative method to obtain information on outreach and financial performance of the three sample MFIs. For outreach indicators, the data were collected on number of clients, value of loan on arrears, loan size, loan term, saving mobilization, percentage of growth of saving, rate of dropouts and percentage of women clients. Data for financial performance were mainly collected from to the audited financial statement.

Primary data were collected through semi structured questioners and observation of the researcher. Focus groups discussions were held with the clients of the sample MFIs. Detailed discussions were held with employees and executive officers of the MFIs at branch and head office level. The lending, repayment and saving practices were captured by reviewing the various manuals and procedures of the MFIs

Secondary data was mainly collected from an audited financial reports, annual reports, and business plan and policy documents. Other data relevant to the study were gathered from

different sources such as the Association of Ethiopian microfinance Institutions, (AEMFI), National Bank of Ethiopia etc...

### ***3.3. Methods of Analysis***

After the gathering of the primary and secondary data, the following methodologies were employed: - first adjustment to financial data was made and secondly the performances of the MFIs were measured by taking selected indicators.

Measuring the performance of MFIs based on the criteria of sustainability and outreach can serve as a means of assessing the development impact, of MFIs, while reducing the methodological problem (Yaron, 1997). One of the best measures of financial performance of MFIs is profitability of MFIs. However, as yaron described it, the profit presented in conventional accounting report can not be used as an indicator of self sustainability for an institution receiving subsidies. i.e, without an adjustment, an MFI that receives subsidy may appear more profitable than the better performing subsidy free institution. Thus, profitability figures provide partial information with respect of financial self sustainability. Christen also argues that, MFIs must apply financial analysis that considers real (inflation adjusted) unsubsidized profits. There are two approaches regarding the assessment of the financial performance of MFIs. The first approach is subsidy dependence index (SDI), which was addressed by Yaron. SDI takes into account the subsidies received by an MFI and provide a more appropriate measure for the assessment of performance. In the second approach adjustment is made in the conventional financial statements so as to exclude the effects of subsidy and inflation and then financial ratio analysis is carried out.

Christen et.al (2000) explained that, the two approaches are entirely compatible. Both approaches compensate the short comings of the conventional financial statements. But the second approach is more popular and is applied by many researchers; therefore, this study also used the latter one.

### ***3.3.1. Adjustment of the financial information***

Analytical adjustments are different from periodic accounting adjustment in that the former are not part of the formal accounting records of an MFI. Without analytical adjustments, the full costs of an MFI can not be determined and its long-term sustainability can not be assessed as there will be some hidden costs that will not be captured by the internal accounting recording and reporting processes. Adjustments are made to add the hidden costs to the actual expenses reported by the management of an MFI and assess the long term viability of the institution. Adjustments are usually made for two purposes:-

1. To reflect the true performance of MFIs (or their ability to maintain their level of operation over the long term); and
2. To enable bench marking across a wide range of institutions. (SEEP, 2005,P 40-41)

The common accounting problems which affect the financial statements of MFIs may be grouped into two categories. Those that occur by wide variety of accounting practices or by neglecting the Generally Accepted Accounting Principles (GAAP) and those that are not treated by the conventional accounting reporting. To solve the above problems two types of adjustments are required (Ledger Wood, 1999, P. 187). The first type of adjustment addresses those MFIs that fail to comply with GAAP. These adjustments include accounting for loan loss and loan loss provisions, accounting for depreciation of fixed assets, and accounting for accrued interest expense. Accordingly adjustments were done for loan loss provision in the financial statements of the three sample MFIs. The second type of adjustment treats the effects of inflation and subsidy. Moreover, adjustments were made to the financial data to make them more compatible and to remove the influence of subsidies from key indicators of profitability. Inflation is a general rise in prices and volume of money, which results in a decline in the purchasing power of money. Since the conventional financial statements are prepared in at monetary unit adjustment is required to compensate for the effects of inflation.

In this study, the financial statements of the three MFIs are adjusted to ensure comparability, taking into account the effect of subsidy, inflation levels and difference in loan loss provisioning. Subsidies are adjusted to the cost of fund. Additional cost are added for any liabilities bearing interest rates, which are substantially lower than the market price. In kind-subsidies such as

donated vehicles or computers, free rent, or direct payment of staff member's salaries by a third party adjusted to the expense account and the net income is adjusted accordingly.

Adjustment has been taken on cost of funds on income statement for three MFIs to take into account the effect of inflation on institutions equity overtime. This adjustment takes the form of a net expense account on the income statement, reducing reported net income.

To standardize loan loss provision and write off policies, the provision are 50% of the outstanding balance of loans that are past-due more than 90 days but less than 180 days or are rescheduled, and 100% of the balance of over due loans over 180 days. Any loans outstanding more than 365 days fully written off.

Finally, local macro economic factors such as local commercial deposits rate (3%) and the inflation rate (9%) (National Bank of Ethiopia Bulletin Volume 19, No 4 of June 2004) were used in this study in the adjustment process.

### ***3.3.2. Performance measurement***

There are several performance indicators that could be used to analyze the over all performance of MFIs. In this study, the most widely applied performance indicators which were developed by Small Enterprise Education and Promotion Network (the SEEP Network), the Consultants Group to Assist the Poor (CGAP) and the Micro rate Africa, are used to measure the performance. It is possible to evaluate the performance of an MFI using one of the above approaches; the researcher selected a combination of the three approaches to supplement indicators that the other approach has not covered.

The financial performance indicators are usually ratios calculated from the financial reports (balance sheet, income statement and portfolio report). For the purpose of this research, the performance indicators are organized into six areas namely growth and outreach ratios sustainability/profitability ratios, revenue and cost ratio, efficiency and productivity ratio, portfolio quality ratio and financing structure ratio.

### 3.3.2.1. Growth and outreach indicators

Growth and outreach indicators cover both voluntary saving and lending operations, the important indicators are:-

1. Value of ending saving= Gross saving at end of period.

Value of ending Saving:- The value of saving at the end of each period is important indicator of a program outreach.

2. Percentage growth in saving deposits= 
$$\frac{\text{Amount of deposits at end of Period (-)} - \text{amount of deposit at beginning of period}}{\text{Amount of deposit at beginning of period}}$$

Percentage growth in saving deposits: - The growth in savings mobilization is another gauge of how quickly the institution is increasing outreach in its saving operation.

3. Total saving as percentage of out standing loan:- 
$$\frac{\text{Total saving}}{\text{Outstanding loan}}$$

Total saving as percentage of outstanding loan: - This ratio indicates the proportion of saving to outstanding loan.

4. Value of ending portfolio= Gross portfolio at end of period.

Value of ending portfolio:- The value of portfolio at end of each period is an important gauge of program outreach.

5. Growth in number of active borrowers = 
$$\frac{\text{number of active borrowers end of period} - \text{number of borrowers at beg. of peri}}{\text{Number of active Borrowers at beginning of period}}$$

Growth in number of active borrowers:- This ratio measures the percent growth of in number of loan clients as one measure of outreach expansion efforts. This ratio supplements outstanding number of active loans at period end. The higher this ratio, the better it indicates the efforts of an MFI.

6. Growth in portfolio= 
$$\frac{\text{Gross portfolio at end of period} - \text{gross portfolio at Beginning of period}}{\text{Gross portfolio at beginning of period}}$$

Growth in portfolio:- The percentage growth rate, adjusted for changes the institution is implementing, to increase operating efficiency, provides a good basis for comparison.

7. Percent of active women borrowers =  $\frac{\text{number of active women borrowers at end of period}}{\text{Total number of active borrowers at end of period}}$

Total number of active borrowers at end of period

Percent of active women loan clients:- This ratio indicates the accessibility of the loan Provision services of an MFI by women.

8. Borrowers dropout rate= Number of active borrowers who left

Borrowers dropout rate: - This ratio measures the degree to which the MFI is trying to retain its existing unsecured loan clients through progressive loan cycles.

### **3.3.2.2. Sustainability/profitability indicators**

Sustainability and profitability reflects the MFIs ability to continue operating and grow in the future. The following ratios are used to measure sustainability of MFIs.

1. Operating sustainability ratio=  $\frac{\text{financial revenue}}{\text{Total expense}}$

Total expense

This ratio shows the ability of the MFI to cover its total expenses from revenues excluding grants. Operating revenue include financial revenue and other operating income. Both revenues and expenses are unadjusted. An operating sustainability ratio exceeding 100% is indicative of MFIs sustainability in the short run.

2. Financial sustainability ratio =  $\frac{\text{Adjusted financial revenue}}{\text{Adjusted total expense}}$

Adjusted total expense

This ratio shows the ability of the MFI to cover its adjusted expenses from adjusted revenues excluding grants. Financial sustainability indicates whether or not enough revenue is earned to cover all the operating, financial and loan loss expenses as well as to maintain the value of the equity and quasi-equity in the organization in relation to inflation. A higher ratio (more than 100%) is indicative of a long-term financial sustainability.

### 3.3.2.3 Revenue and expense structure

#### 3.3.2.3.1. Revenue

$$1. \text{ Financial revenue ratio} = \frac{\text{Adjusted financial revenue}}{\text{Adjusted average total assets}}$$

This ratio measures the percentage revenue from financial activities to total average assets

$$2. \text{ Yield on gross portfolio} = \frac{\text{Adjusted financial revenue from loan portfolio}}{\text{Adjusted average gross loan portfolio}}$$

This ratio indicates the degree to which the largest assets of an MFI, the gross loan portfolio, generates interest and fee income

$$3. \text{ Profit margin} = \frac{\text{Adjusted net operating income}}{\text{Adjusted financial revenue}}$$

#### 3.3.2.3.2. Expense

$$1. \text{ Total expense ratio} =$$

$$\frac{\text{Adjusted (financial expense + Net loss provision expense + operating expense)}}{\text{Adjusted average total assets}}$$

$$2. \text{ Financial expense ratio} = \frac{\text{Adjusted financial expense}}{\text{Adjusted average total assets}}$$

$$3. \text{ Loan Loss provision expense ratio} = \frac{\text{Adjusted loan loss provision expense}}{\text{Adjusted average total assets}}$$

$$4. \text{ Adjusted operating expense ratio} = \frac{\text{Adjusted operating expense}}{\text{Adjusted average total assets}}$$

$$5. \text{ Administrative expense ratio} = \frac{\text{Adjusted administrative expense}}{\text{Adjusted average total assets}}$$

$$6. \text{ Personnel expense ratio} = \frac{\text{adjusted personnel expense}}{\text{Adjusted average total assets}}$$

$$7. \text{ Adjustment expense ratio} = \frac{\text{Adjusted net operating income} - \text{unadjusted net operating income}}{\text{Adjusted average total assets}}$$

#### ***3.3.2.4. Efficiency and productivity indicators***

Efficiency and productivity indicators are performance measures that show how well the institution is streamlining its operation. Productivity indicators reflect the amount of output per unit of input, while efficiency indicators also take into account the cost of the inputs and or the price of outputs. The key efficiency and productivity indicators are as follows

$$1. \text{ Loan officer productivity} = \frac{\text{Adjusted number of active clients}}{\text{Total number of loan officers}}$$

This ratio indicates the average number of active loans handled by loan officer at a given point in time. This ratio is a common one and a good indicator of loan officer productivity. The loan officer productivity ratio says a fair amount about how well the MFI has adapted its process and procedures to its business purpose of lending money.

$$2. \text{ Total personnel productivity} = \frac{\text{Adjusted number of active clients}}{\text{Total number of personnel}}$$

This measures the overall productivity of the MFI staff in managing borrowers, voluntary savers and other clients

$$3. \text{ Operating expense ratio} = \frac{\text{Adjusted operating expense}}{\text{Adjusted average gross loan portfolio}}$$

This ratio provides an indicator of the overall efficiency of a lending institution and it is also commonly referred to as the efficiency ratio. It measures the institutional cost of delivering loan services. It is regularly assumed that the lower operating expense ratio, the higher the efficiency of an institution.

$$4. \text{ Personnel expense} = \text{Adjusted personnel expense} / \text{adjusted average loan portfolio}$$

$$5. \text{ Personnel Allocation ratio} = \text{number of loan officers} / \text{number of personnel}$$

This ratio indicates the proportion of the most productive employees of an MFI, the loan officers, relative to the total number of employees. The higher the ratio the more focused the MFI is on its core loan provision activity.

6. Cost per client= Adjusted operating expenses

Adjusted average number of active clients

This ratio provides a meaningful measure of efficiency by showing the average cost of maintaining an active client. It informs the MFI how much it must earn from each client to be profitable.

### 3.3.2.5. *Loan portfolio quality indicators*

The largest source of risk for any financial institution resides in its loan portfolio. The quality of loan portfolio determines the institutions over all financial health. For microfinance institutions, whose loan are typically not backed by bankable collateral, the quality of the portfolio is absolutely crucial. If an institution is on- lending the savings of its clients, it needs to ensure that there savings are invested responsibly. If the portfolio is not sound, the institution may not survive. The loan portfolio is normally by far largest assets of an MFI and its primary source of earned income. The risk that some of the loans will not be paid back must be anticipated. Management of this risk is very important to sustainability of MFIs. The following indicators are used to analyze portfolio quality.

$$1. \text{ Portfolio at risk } > 30 \text{ days} = \frac{\text{Total loan portfolio with arrears} > 30 \text{ days}}{\text{Adjust Gross loan portfolio}}$$

This rate measures the percentage of the outstanding gross loan portfolio that could be lost uncollected unless collection efforts are improved. This ratio is the most accepted indicator of portfolio quality. When referring to the PAR rate, an MFI should always specify the number of days used for cut- off days such as 30 or 90 days. Best practice uses the 30- days cut-off.

$$2. \text{ Adjusted Loan loss provision expense ratio} = \frac{\text{Adjusted loan loss provision expense}}{\text{Adjusted average gross loan portfolio}}$$

This ratio measures the percentage of the adjusted outstanding unsecured loan portfolio that could be lost unless collection efforts are improved. Although a lower ratio is an indicator of good portfolio quality, MFIs must make adequate provisions because their loans to a larger extent are not collateralized.

$$3. \text{ Portfolio risk coverage ratio} = \frac{\text{Adjusted Loan loss allowance}}{\text{Portfolio at risk for loan portfolio} > 30 \text{ days}}$$

This ratio tests the adequacy of the loan loss reserve in covering the portfolio at risk. The higher the ratio the better the protection of the loan portfolio and voluntary deposits.

$$4. \text{ Adjusted Loan write-off ratio} = \frac{\text{Adjusted value of gross loans written off}}{\text{Adjusted average out standing loan portfolio}}$$

This ratio measures the actual loan loss the MFI is suffering from its loan provision service. The repayment rate and portfolio at risk ratio might indicate that the MFI has quality portfolio but this ratio would reveal any window-dressing through excessive write-offs. The ratio could be used to estimate the loan loss provision amount and there by the appropriateness of the various reserve rates that apply to the aged portfolio. Also this rate, among other variables, could be used to set the sustainable interest rate the MFI should charge given that it has exerted at most efforts to collect written-off loans and it has controlled its other expense categories.

### 3.3.2.6. *Financing Structure*

$$1. \text{ Adjusted capital to assets ratio} = \frac{\text{Adjusted total equity}}{\text{Adjusted total assets}}$$

This ratio measures the degree to which MFI has financed its total assets from equity. The higher the equity proportion, the more the capacity of the MFI to absorb losses before the assets become inadequate to satisfy debt holders claims.

$$2. \text{ Adjusted commercial funding ratio} = \frac{\text{All liabilities with market price}}{\text{Gross loan portfolio}}$$

This ratio measures the degree to which the MFI has been financing its loan portfolio from commercial loans and voluntary deposits

$$3. \text{ Debt to equity ratio} = \frac{\text{Adjusted total liabilities}}{\text{Adjusted total equity}}$$

This ratio measures the safety cushion the institution has to absorb losses before creditors are at risk.

$$4. \text{ Voluntary deposit to gross loan portfolio} = \frac{\text{voluntary saving}}{\text{gross loan portfolio}}$$

This ratio measures the degree to which the MFI depends on voluntary saving to finance its loan portfolio

5. Voluntary deposits to total assets ratio= voluntary saving/total assets

This ratio indicates the proportion of voluntary saving to total assets employed by the MFI.

6. Portfolio to total assets= gross loan portfolio/total assets

This ratio measures the weight of the investment in total loan portfolio relative to total assets. The higher the ratio the better the management of loan portfolio in particular and total assets in general.

### ***3.4. Conceptual Framework***

Development finance has traditionally been based on assumed gap between the demand for credit and saving services by specific population groups. Small farmers were the primary concern in the 1960s and 1970s; the poor emerged as the focus of financial institutions in the 1980s and 1990s. Matching access to or supply of financial services with demand has been a consistent challenge for financial intuitions attempting to serve clientele groups outside the frontier of formal finance (Von pischke: 1991)

The policy makers have sought to narrow the gap between the supply and demand for financial services through various interventions during the past four decades, albeit, with mixed success. These interventions, and rationale for them, have changed over time. In the 1960s and 1970s, the state was at the center of action on the ground, and parastatal development banks and agricultural credit projects predominated (ZELLER and MEYER: 2002).

The new paradigm began to emerge in the second half of the 1980s because of the wide spread failures of development banks and the encouraging results of some microfinance innovations to serve the poor. The period was marked by a major debate between the financial system approach and poverty lending approach. The financial system approach, focus on large scale outreach to the economically active poor both to borrowers who can repay micro loans from households and enterprise income streams and to savers. It also emphasizes on institutional self sufficiency (Robinson 2001). The poverty lending approach concentrates on reducing poverty through credit, often provided together with complementary services such as skills training. Under this approach donor and government funded credit is provided to poor borrowers, typically at below market

interest rates. The goal is to reach the poor, especially the extremely poor the poorest of the poor-with credit to help overcome poverty and gain empowerment. Except for mandatory saving required as a condition of receiving loan, the mobilization of local savings is normally not significant part of the poverty lending approach to micro finance (Robinson: 2001)

The new microfinance agenda increasingly emphasize the need to achieve sustainability of microfinance institution. Sustainability is “the ability of a programme to continuously carry out activities and services in pursuit of its objective” (Shahidur, 1995, P.36).

**“A sustainable MFI is permanent, but it is not constant; its organization and its structure of incentives must be flexible so the managers can adapt and adjust to keep performing well in a shifting environment. Sustainable MFIs meet their goals now without harming their ability to meet their goals later” (Schreiner, 1997, P.1).**

For sustainability, institutions shall be financially and institutionally self-sufficient. Havers (1996) indicated that in order to get financial self-sufficiency, institutions should be able to cover the following costs from the income they receive;

- ◆ Its cost of funds: that is, the interest, which the programme has to pay to the provider of its fund.
- ◆ Its operating costs: including staff, offices and equipment;
- ◆ Its loan write-off; the losses incurred as a result of some borrowers failing to repay their loans;
- ◆ Inflation; which should be reflected in a true cost of funds (Havers, 1996)

The ‘poverty lending’ approach emphasizes the need for the integration of various support programmes with the financial service, like training and awareness raising programmers. It also believes that, financial institutions, which cater to the poorest, may never be sustainable in

financial terms as their capacity in revenue generation is weak (Kidder, 1997; Havers, 1996). Supporting this idea Brown (1997) argues that

**“To equate sustainability with financial self-sufficiency and to concentrate efforts on revenue generation is in fact a mistake... (Financial) sustainability and development objective conflict, and the institution is pulled in different directions. Since the pressure for sustainability are often more intense (and more difficult to resist) than the development goal, institutions can easily losses sight of the latter as sustainability itself becomes the main goal (Brown, 1997:187).”**

On the other hand, the “financial approach’ aims at insuring the financial viability of the financing institution by covering all the costs of services from its revenue and providing credit at market related interest rate (Kidder, 1997). Rhyne and Otero (1994), Johnson and Rogaly (1997) argued that the availability of credit is most constraining factor than the cost of credit to poor people and therefore, it is viable to transfer all costs to the small-scale borrowers and so charge realistic interest rate. This approach discourages the involvement of financial institutions (FIS) in non-financial support activities. Because, these supplementary activities share the institutions’ limited resource in terms of material, human, and financial and therefore, they may become burden for an institution striving to sustain. (Kidder, 1997; Havers, 1996).

Achieving financial sustainability is an important goal for MFIs. It is critical since self-sustaining programmes can operate without subsidies, enabling them to reach more people permanently. Financial sustainability is also said to be a pre requisite of attracting commercial funding, and thus of large-scale expansion. Whilst financial sustainability is an important goal; it depends on low overhead and high repayment rate. This means that MFIs should provide their service in areas which are easy and cheap to reach and to people they can be sure to repay. This automatically may exclude the poorest people and the remote rural areas where infrastructure is underdeveloped. Therefore it seems that there is a trade-off between the objective of financial sustainability and the objective of poverty alleviation for MFIs. Most MFIs consider both financial sustainability and poverty alleviation as their core objectives.

Hulme and Mosely (1996) argue that there appears to be a trade-off between improving outreach, in particular reaching the poorest and achieving financial sustainability. This trade-off stems from the fact that MFIs transaction costs are high for obtaining information about the credit worthiness of poor clients. Transaction costs have a large fixed cost component, so unit costs for smaller savings deposits or smaller loans are high compared with those for larger financial transactions. Decreasing unit transaction costs with increasing transaction size generates the trade-off between improved outreach to the poor and financial sustainability irrespective of the lending technology used.

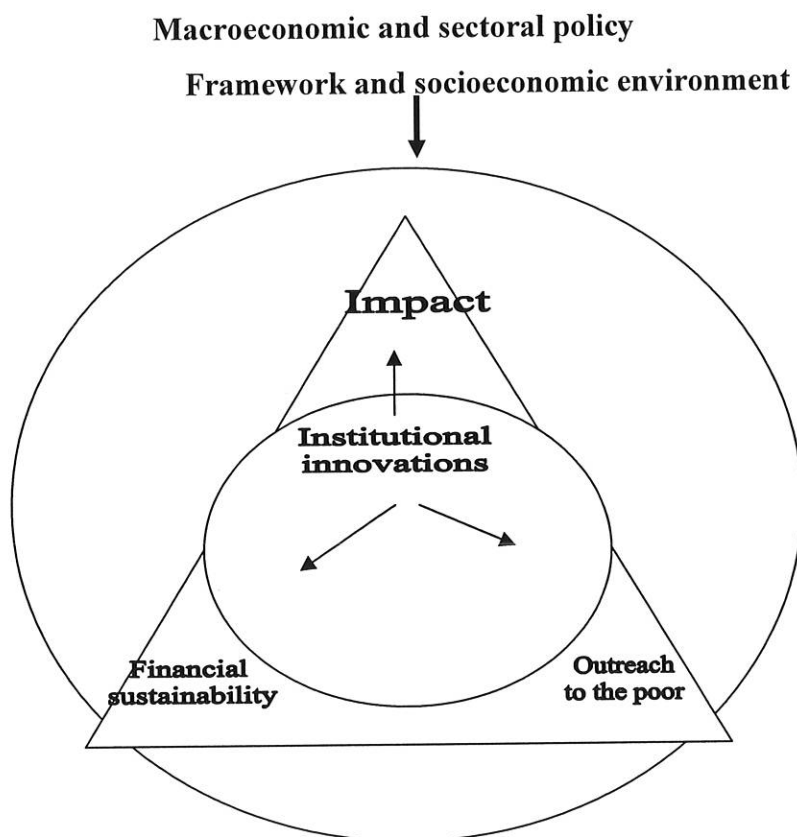
Since, financial sustainability of MFIs and outreach to the poor are only two of the policy objectives characterizing recent development in the field of microfinance when policy intervention and direct support for institution building enquire public investments, the question arises as to the pay-off or impact. Such public investments are justified from public policy perspective only if the discounted social benefits of public investment in MFIs are expected to outweigh the social costs. This consideration raises the third objective of finance, improving the well fare impact (Zeller and Meyer: 2002). The potential trade-offs may also exist between impact and financial sustainability. As Sharma and Buchenrieder suggested, the impact of finance can be enhanced through complementary services such as business or marketing service or training of borrowers that raise the profitability of loan-financed projects. Complementary services are some times offered by MFIs, but supplying them increases operating costs, thereby jeopardizing financial sustainability, if the additional costs are not covered by borrowers or public transfers.

Financial sustainability may be perceived by potential clients as a crucial indicator of MFI permanence and will influence their decision about whether it is worth while in the longrun to become clients. Thus, greater financial sustainability can positively influence outreach. This synergy may be even more important for savers. Who must have faith in the permanence of the institution to which they entrust their savings. No one will save with an institution that is thought to be only temporary. On the other hand striving for financial sustainability forces MFIs to be sensitive to client demand and induces them to improve products, operations, and outreach.

Better financial products, intern, generates greater economic benefits for clients, and thus greater impact.

Zeller and Meyer (2002) argued that the over all performance of MFIs is also improved by internal institutional innovations that contribute toward improvement of financial sustainability, outreach and impact. According to Yaron (1997), institutional sustainability is necessary to obtain a high level of financial sustainability and outreach. Favorable socio-economic as well as macro economic environment could also facilitate the development of microfinance institutions.

**Figure 1. The critical triangle in achieving economic sustainability of microfinance**



**Source:-** Manfred Zeller & Richard L.Meyer (2002), The triangle of microfinance

The inner circle in figure1 represents the many types of institutional innovations that contribute to improving:-

- Financial sustainability (such as employment of cost-reducing information system);
- Impact (such as designing demand-oriented services for the poor and more effective training of clients); and
- Outreach to the poor (such as more effective targeting mechanisms or introducing lending technologies that attract a particular group of clients);

The outer circle represents the external socio economic environments as well as macro economic and sectoral policies that directly or indirectly affect the performance of financial institutions. Innovation at institutional level (the inner circle) and improvement in the policy environment (the outer circle) contribute to improving the over all performance of financial institutions.

## CHAPTER 4

### Results and discussion

This chapter is organized in to three parts. Part one reviews the institutional sustainability of MFIs, in the study. Part two examines outreach, in terms of saving mobilization and lending. Part three analyzes the performance in terms of financial sustainability. Outreach and financial sustainability are measured using several indicators which are indicated in chapter 3.

#### ***4.1. Institutional sustainability***

##### ***4.1.1. Governance and ownership structure***

###### ***4.1.1.1. Ownership***

AdCSI evolved from small Scale Job Opportunity Creation Project which was established in 1995 to provide credit facilities for small scale projects in the region of Addis Ababa. AdCSI is Owned by Six share holders namely, Addis Ababa city administration, Addis Ababa City Women's Association, Addis Ababa Youth Association, Addis Ababa City Teachers Association, Karalo area Peasant Association and one natural person, Mr.Tesfmariam G/medhin.

Omo micro finance Institution was established as Share Company as per the requirements of Proclamation number 40/1996, which provides for the licensing and supervision of the micro finance business and in line with the commercial code of Ethiopia. Accordingly, its ownership is divided into Share and owned by five share holders namely, the Southern Nations, Nationalities and People's Regional State, Southern Nations, Nationalities and People's Development Association, Wondo Trading Company and two natural Persons, Mr. Mattewos Mantamo and Mr. Meskel Ayele.

SMFI is the Continuation of the saving and Credit Program of Sidama Development Program which was established in 1994 with the support of Irish Aid. SMFI is owned by eight share holders.

A close look into the ownership structure of the three sample MFIs reveals that the ownership is mainly a mixture of NGOs, government, associations and private individuals.

**Table 4. Ownership structure of Sample MFIs**

MFI	Paid up Capital (in million)	NGO	Private Organization	Regional Gov.	Associations Cooperatives	Individuals
AdCSI	0.517			98%	1.7%	>.01
OMFI	0.5		9.5%	80%	10%	0.5%
SMFI	0.2	12.5%	12.5%		74.5%	

**Source:- Respective MFIs.**

Table 4 indicates that the regional government owns 98% of the shares of AdCSI while in OMFI, the regional government's share is 80%. OMFI and AdCSI have one individual each as shareholders. In SMFI, six agricultural Cooperatives together own 74.5% of the shares while the NGO and private organization own 12.5% each.

The profit generated from the operations of the three Sample MFIs would not be distributed among the share holders as dividend. It would rather be ploughed back into the operations of MFIs.

In AdCSI and OMFI the respective regional governments own 98% and 80% of the Shares and there is no provision in their document of incorporation to transfer these shares to clients or to private investors. Under normal circumstances, government ownership sometimes may facilitate resource flow but it has some negative implication on loan recovery incase of say, political unrest. This has been observed in some of the areas of operation of OMFI. There is also risk of lack of diversification in ownership of these MFIs. Shareholders in the sample MFIs were mobilized mainly to fulfill the requirements of the proclamation and the guide lines of the national Bank of Ethiopia. Therefore, the shareholders are just nominal owners. Moreover, when programs that were operated by Ngos or other subsidized government programs are converted into financial institutions, it is obvious that people deployed to in the new system either as board

members or chief executive, always come with dual mission. It is difficult for them to easily discard the welfare orientation and lead the MFIs as purely profit oriented financial institutions. These issues have their own implications in the effectiveness of the governance of the MFIs.

In MFI such as AdCSI and OMFI, where the regional government has the majority shares, gradual relinquish of shares to clients of these MFIs, private organizations like banks, universities and foundations would help to diversify the ownership of these MFIs.

#### **4.1.1.2 Governance**

Governance according to rock, et. al. (1998) is a process by which a board of directors, through management, guides an institution fulfilling its corporate mission and protects the institutions assets. Experience has shown that MFIs have yielded important successes when board members have identified strongly with institutional mission and been able to guide the MFI strategically and hold management accountable to performance. Institutions have to question whether their board members in a position to provide proper guidance to management regarding strategic direction for the institution and oversees management efforts to move in this direction.

As the commercial code of Ethiopia states, next to the general assembly of shareholders, the highest and decisive governing body of a share company is the board of directors. The board is expected to protect or safe guard the shareholders business interest by providing policy guidance and decisions for the management of the company. The highest governing body in three sample MFIs is the general assembly of the shareholders. The board members in three sample MFIs were drawn from among the shareholders. Nonetheless, SMFI and AdCSI have involved non-shareholders such as the Commercial Bank of Ethiopia and Association of Ethiopian Microfinance Institution (AEMFI) respectively in the Board to bring expertise, even though the Commercial Code of Ethiopia states that its members can only manage a company. The number of board members in each sample MFIs is seven. The general assembly elects the board of directors. The chair person of the board of directors is elected from among the representatives of highest share holding organization in sample MFIs.

**Table 5. Qualification and experience of the Board Members**

<b>MFI</b>	<b>Number</b>	<b>2<sup>nd</sup> degree</b>	<b>1<sup>st</sup> degree</b>	<b>Diploma</b>
AdCSI	7	3	2	2
OMFI	7	3	3	1
SMFI	7	5	2	-
	21	11	7	3

Soutce- Respective MFIs

Table 5 indicates that, board members in three sample MFIs are qualified people. 52 Percent and 33 Percent of the board members are trained for masters’ degree and bachelor degree respectively. However, they have limited experience in microfinance management. Most of the Board members in the three sample MFIs are high ranking government officials. The major problem of the sample MFIs in which high ranking officials are board members is the irregularity in attending board meetings because of the engagement of the officials in priority government duties and responsibilities and unexpected absence for official travels. In three sample MFIs, board members are paid nominal fees when they attend the meetings. The payment made can not be considered as incentives for attending board meetings, as they are very small and nominal.

The Practice of the board of directors evaluating themselves is not common in sample MFIs. In AdCSI , however, a brief evaluation was carried out at one point and the major issue identified was that board members did not come to meetings prepared or by reading the reports or other materials prepared and submitted to them prior to board meetings.

Although Boards of Directors of sample MFIs fulfill the requirements of the National Bank of Ethiopia, they lack awareness and are generally less exposed to the microfinance industry. An appropriate training and exposure visits to best practice MFIs in Asia, Latin America and Africa should be given to board members. In order to increase sense of responsibility and accountability it is necessary to develop code of conduct for board members regarding attendance in meetings

and mechanisms of self-evaluation and individual contribution. Providing the necessary incentives to Board members could maximize the benefits by involving them in strategic issues.

#### ***4.1.2. Organizational Structure***

OMFI has three-tier organization structure, head office, branch and sub-branch. It consists of branches and 52 sub-branches. Sub branches are the lowest operational units in OMFI organization structure and are responsible for approval, disbursement and collection of loans and saving deposits. Branch offices are generally found between the head office and the sub-branch offices and also perform as liaison office between head office and sub-branches. Branches do not actually make operational decisions such as loan disbursements and collections.

The head office on the other hand is responsible for the implementation of credit and saving, human resources and other policies, monitoring and evaluation of the credit and saving operations, and running the day –to-day management of the institution.

AdCSI adapts the same type of organizational structure as OMFI. It has a head office, 9 branch offices and 88 service delivery posts. Service delivery posts in kebele are staffed by branch manager, Accountant, Cashier and Loan officer. Service delivery posts are authorized to loan up to 20,000 birr. Loans between 20,000 and 100,000 birr are authorized at branch level.

SMFI currently operates in 9 branch offices of the 10 districts of the Sidama Zone. The branch office in districts is staffed by branch manager, Banker, Accountant and cashier. The branch office is responsible to authorize loans between Birr 300 and Birr 3,000. Loan above Birr 3,000 and below Birr 15,000 to individual borrower is approved by the head office.

#### ***4.1.3. System and procedures***

OMFI, SMFI and ADCSI follow the solidarity group lending methodology. The methodology is such that, the clients are required to organize themselves in groups, and the federation of such groups, makes a center.

Each of the three MFIs has different group and center size. In OMFI groups consist of about 5 to 7 persons and a federation of 7-10 such groups make a center. In SMFI clients are required to

organize themselves in a group of about 5. 3 to 4 of these groups will then form as center made up of members between 15 and 20. In AdCSI groups consists of about 5 persons, out of which 4 to 6 of make a center that is made up of about 20 members.

Members in particular group are considered to be poor people who are capable of doing productive activities. Key informants in this study indicated that, the extreme poor are excluded from being eligible to the service through the process of group formation in three sample MFIs. This is because group members select each other on the bases of the potential of each member for timely repayment and savings. It is believed by the three sample MFIs that the extreme poor and the destitute who are not capable to engage in productive activities shall not get the credit as these people may have very urgent need such as basic needs (food and shelter) than credit for income generation. The poorest in OMFI and SMFI are specified as people who have no land or any asset. This trend of classifying eligibility based on assets may miss the reality that there are people who don't have any assets or land but have the capacity to do business and pay back the debt. In Ethiopian condition, especially in the southern region, where OMFI and SMFI are operating, women rarely own land, as they don't inherit asset from their family regardless of the legal right they have in the constitution. The chance to own land for unmarried or separated women is very minimal. If eligibility is going to be measured on the basis of their asset level, these women will automatically be excluded from getting credit.

Both OMFI and SMFI offer two types of loan products:- Agricultural (term) loan and micro business (installment) loan. Whereas, AdCSI provides four types of loan products:-Urban Agricultural loan, micro business loan, micro lease and housing loan.

The average loan size in SMFI is well below Birr 1000. The floor and ceiling of the micro lending loan is between Birr 300 and Birr 5,000. Its size will increase by a maximum of Birr 1,000 for subsequent loans. The floor and ceiling of the small business loan is between Birr 5,000 and Birr 1, 5000, its size will increase by maximum of birr 2500 for subsequent loan. The business of the customer and economic activity of the area are main determinant for loan size. The Loan terms in SMFI ranges between 6 month and 24 months.

The average loan size for OMFI is also well below Birr 1000. The Loan size for agricultural and micro business loans ranges between Birr 200 and Birr 15000. The loan size for first loan cycle do not exceed birr 1000. Loan size for small business loan on the other hand starts with a minimum of Birr 5000. Its size for first cycle not exceeds an average of Birr 10,000. Loan term for all agricultural and micro business loan ranges between three months and two years depending on the types of activities financed.

AdCSI also provides loan to Joint ventures, Cooperatives and Edris. Its loan size ranges between Birr 500 and Birr 100,000. The amount is determined by the nature of business and financing requirement. Loan ceiling for individual business and joint venture is Birr 30,000.00 and Birr 40,000 respectively, for existing clients. Whereas, the loan ceiling for Cooperative is Birr 100,000. The loan size for Edris determined by agreement between the two institutions. Loan term in AdCSI ranges between 12 months and 48 months depending on loan type and size the of loan.

**Table 6. Loan size in Birr**

Loan size	AdCSI	OMFI	SMFI
Minimum loan	500	200	300
Average loan	1032	391	592
Maximum loan	100000	10,000	15,000

Source: - Respective MFIs

Table 6 indicates that average loan size for both OMFI and SMFI is well below Birr 1,000 and for AdCSI about Birr 1,000. Smaller loan size of OMFI and SMFI shows that the financial assistance is given to the real poor and needy people. With low loan size, limited financial resources can go further and helps more people. Its size also did not attracts well-off people.

Loans are tied to compulsory savings in all three institutions. Savings are used as indirect collateral to loans. In case of loan defaults, member's saving in the individual account will be used to cover losses. To facilitate this process, a pledge of funds is obtained from the group before the loans is disbursed to members.

SMFI requires borrowers to have 4 percent of the required loan amount in saving before accessing loan and they must continue to save a minimum of Birr 10 bi weekly or Birr 20 monthly for the term of the loan. Moreover, all borrowers are required to contribute 1 percent of the loan amount for the purpose of death insurance.

OMFI also requires each client to deposit initial saving up to 5% of the requested and approved loan prior to loan disbursement and on going savings an amount of fixed Birr equal to Birr 4 monthly with their loan repayment.

In AdCSI, 10%-20% of the loan approved deduct from each client and deposited into saving account. To write off the loan, in case of death of a client, the client is required to pay 1% up front as insurance premium of the loan for the year, and 1% of the outstanding balance for the coming year, if any.

Consumption loans and loans for emergencies are not included in the sample MFIs, as the risks are believed to be very high for lending institutions. None of the MFIs have made assessments that show the purposes and the incidences to which clients take credit from the money lenders or other sources. However, the interviewed staffs of MFIs explained that people take credit from moneylenders, relatives or other sources not only for productive activities but also for emergencies during drought, illness and food shortage.

Ruther Ford (2000) argued that the function of financial services should be seen from the point of view of the users to help manage money. According to him, the belief that financial institutions should aim to increase productivity and alleviate poverty is in fact a misunderstanding. This is because it over looks the reality that borrowers have many other money management needs besides financing the business. Disasters and ordinary life cycle events (like schooling, marriage, home making ...etc.) require expenditure that can only be financed out of their own saving or by borrowing from other sources. Therefore, the role of MFIs should be simply help the poor to reallocate expenditure across time, so that people would able to pay now for things they need in the future, and to pay in the future for things they need now.

The range of product mainly offered by both OMFI and SMFI are very much limited. Clients have few options to choose from. It is, hence extremely important to design and redesign products to provide a magnitude of options to clients and become client need responsive. A through market survey should be done, the results of which should be the basis for new product. Most of key informants indicated that, group lending methodology contributed to the repayment problems as well as conflict and distrust among group members. They also revealed that the loan provided by both OMFI and SMFI are small in the urban area. Therefore sample MFIs should redesign the products to take care of the loan size, loan term and methodology.

#### ***4.1.4. Human Resource Development***

The three institutions are providing training to their staff at various levels. Various short terms training were offered to branch level staffs. SMFI trains branch managers at diploma level and key staffs at the head office are also trained for bachelor degree. Staffs participated in various exposure visits, locally and abroad (such as Bangladesh and Latin America). The Association of the Ethiopian Microfinance Institutions (AEMFI) is playing a major role in training and facilitating a forum to learn from each other's experience. The Association also have the objective of promoting and supporting net working activities among MFIs, initiate and support policy dialogue, providing up-to-date information on the status of MFIs in Ethiopia.

In spite of the above efforts, most of branch and sub branch staff of the Institution lacks the necessary qualification and knowledge of microfinance, particularly in the areas of accounting, and financial management. Furthermore, the staff lacks experience of Management, supervision, monitoring and follow up of the microfinance operation. AdCSI has developed an incentive system to credit officers based on their performance or output such as portfolio quality, number of active clients, and level of saving collected. However, OMFI and SMFI did not have any incentive system yet. Regarding salary payment, 4 out of 6 credit officers in AdCSI, 3 out of 4 credit officers in OMFI and 2 out of 3 accountant in SMFI responded that compared with the work load the salary paid by the MFIs is low.

One important aspect of effective human resource management is the attractive pay scheme, which would enable an institution to reduce staff turnover and frequent recruitment expense and eventual enhances staff effectiveness, efficiency and productivity.

The three sample MFIs did not have clear human resource Development strategy. Lack of staff development primarily affects staff motivation and then the performance of institution itself. It might end up in high staff turnover leading MFIs to lose the most experienced employee. Hence, the three sample MFIs should develop and put in place clear staff development strategy including but not limited to carrier structure, staff training policy performance related incentive system and packages of benefits like life and medical insurance based on their financial capability. Moreover, it is important to work closely with the regional government to get scholarship and sponsorship for best performing staff. Once staff training policy is developed and approved by board of directors project document could be developed and submitted to those donors in capacity building. In addition, policy could be adopted to allocate certain percentage of personnel cost for staff development each year to be built in annual plan.

#### ***4.1.5. Management information system***

Presence of reliable information flow system shall be more and more indispensable as the financial products and outreach of an MFI increases. Reliable managerial information system (MIS) is vital for prudent management of an institution. The MIS, as essential as it is, should have the capacity to track loans and help record, update, analyze and produce reports of operational and financial activities timely.

AdCSI uses software, namely Total Microfinance Solution (TMS) software at branch level. Service delivery posts at kebele use manual system, currently they are attempting to computerize the service delivery posts.

OMFI utilizes manual management information system. The system doesn't produce the portfolio quality, which is an important report for the analysis of the portfolio. OMFI has MIS in the area of operation, finance, internal audit and human resources, which it tracks manually. However, the systems (operation, accounting and audit) lack completeness. SMFI process its financial data using Peachtree accounting and track loan portfolio and client saving using Total Microfinance Solution (TMS) software. A manual ledger is maintained at branch office level.

The branch level financial data is transferred to head office together with supporting documents and summery report. Accounts are processed at head office.

Manual information tracking associated with limited accounting knowledge of branch and sub branch staff makes difficult to ensure faster and timely information. Therefore, it is necessary for OMFI to develop or acquire appropriate accounting software. SMFI also should computerize its branch offices.

#### ***4.2. Policy environment***

All sample MFIs agreed that there is conducive policy environment for the growth of viable microfinance institution in the country. Government in its policies and strategies such as poverty reduction strategy, rural developments strategy and industrial policy has clearly indicated its commitments to support and promote microfinance.

Proclamation No 40/1996 and 17 directives issued by the National Bank of Ethiopia have created an enabling environment for the industry. The lending interest rate ceiling has been waived and MFIs are free to set their own interest rate. The interest rate is one of the main factors that affect outreach and sustainability of MFIs. The low minimal paid up capital requirement for registration is a positive policy initiative from the part of the government.

The minimum capital required to establish a micro finance institution is birr two hundred thousand Birr (about 25,000 us Dollar) unlike birr 75 million (10 million US Dollar) for formal banks. This is done to encourage investments in medium and small banks that cater the financial needs of the rural and urban poor.

International fund for Agricultural Development (IFAD), African Development Bank (ADB) and the Ethiopian government has jointly launched a Rural Financial Intermediation program (RUFIP) with the overall goal of contributing towards rural poverty alleviation in Ethiopia. The Specific objectives are:- a) to enhance outreach of microfinance institutions through institutional development and provision of equity and credit funds; b ) to promote linkage between the rural financial network and the main banking system; and (c) to improve the regulation and

supervision of MFIs including self regulation. Rural financial intermediation programme (RUFIP) expected to increase outreach and improve efficiency of MFIs. It has started by providing loan fund to MFIs in 2003.

The association of Ethiopian micro finance (AEMFI) is a net work of micro finance institutions in Ethiopia. It has been bringing Ethiopian MFIs together through forums, workshops and produced various publications to promote the industry. It is also expected to address the problem facing the industry through research, and advocacy to improve the national policy and regulatory environment. There would contribute to improvement in the performance of MFIs.

### ***4.3. Outreach***

#### **4.3.1. Savings**

There are two major types saving products, (compulsory and voluntary saving) in the microfinance industry. According to Marcus et.al (1999), compulsory and voluntary saving are based on different assumptions. Compulsory savings assumes that the poor must be thought to save, and that they need to learn financial discipline. Voluntary savings assumes that the working poor already save and that what is needed is institution and services appropriate to them. It is also believed that compulsory saving can reduce risk of providing loan as it may demonstrate the ability of the client to manage debt and repay loans.

Apparently all the three institutions Addis Credit and Saving Intuition (AdCSI), Omo microfinance Institution (OMFI) and Sidama micro finance Institution (SMFI) have both compulsory and voluntary saving products. As it is indicated in table 7 the value of saving has grown significantly. In OMFI, the saving as a percentage of gross loan portfolio reached 87 percent in the year 2003, but it declined by 3 percent in the year 2004. This implies that about 87 percent of the loans are financed from client savings, which is higher than the national average, 41 percent. Out of the total savings, voluntary saving accounts for 13 percent. In AdCSI, the savings mobilized amount increase by 108 percent in the year 2004. Total saving reached 15 percent of the gross loan portfolio. In SMFI, total saving as a percentage of gross portfolios increased from 29 percent in the year 2003 to 32 percent in the year 2004. However, their ability to raise funds from voluntary saving is very low, which is below average for Ethiopian and

African MFIs. Voluntary saving to gross loan portfolio almost zero for both AdCSI and SMFI and about 10 percent for OMFI.

**Table 7. Saving Outreach Indicators**

INDICATORS	AdCSI		OMFI		SMFI		AVERAGE FOR ETHIOPIA (AEMFI) Performance indicators report	AVERAGE FOR AFRICA Micro Bank Bulletin (MBB)
	YEAR		YEAR		YEAR			
	2003	2004	2003	2004	2003	2004		
Voluntary saving balance	9872	264364	2670576	3113562	41234	1767	14343685	2677610
compulsory saving	2972522	5950797	18211943	22856111	2407349	2904673	7055440	NA
Total saving balance	2982394	6215161	20882519	25969673	2448583	2906440	21399125	NA
Percentage growth of saving		108%		24%		19%		
Total saving as percentage of gross loan portfolio	34%	15%	87%	84%	29%	32%	41%	NA
Voluntary saving to gross loan portfolio	0%	1%	11%	10%	0%	0%	17%	20.7%

From table 7 we can conclude that, the value of saving has grown in all three sample MFIs. However, there are significant variations among sample MFIs in value of saving mobilized. This is partly the result of difference in outreach among sample MFIs. OMFI is serving more client than both AdCSI and SMFI. About 87 percent of its loan is financed from client saving. This implies that as outreach increases, MFIs could mobilize significant amount of finance from client saving. This intern, contribute for further outreach.

**Figure 2.**

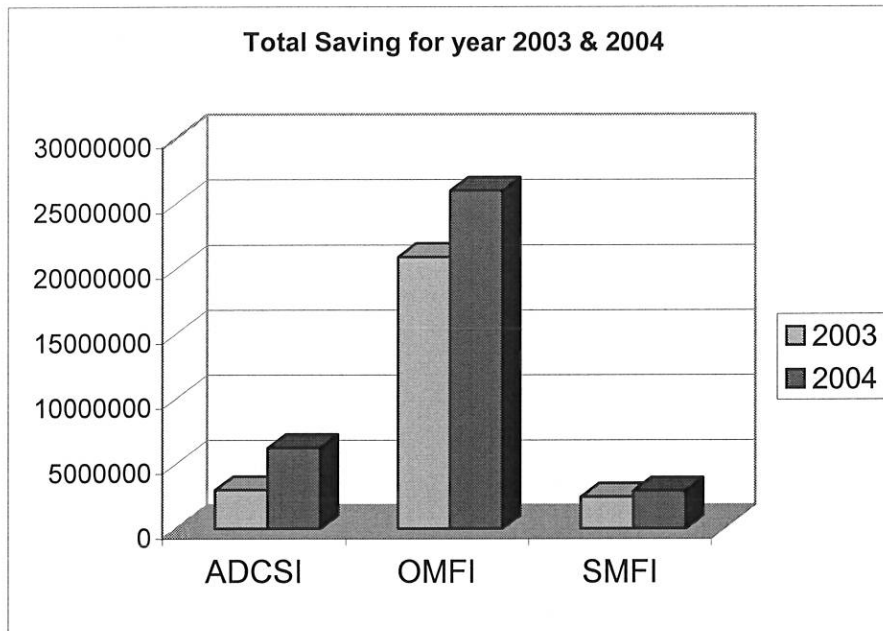


Figure 2 indicates that saving for all three sample MFIs has been improved. But, at different rate. OMFI was mobilized more saving than both AdCSI and SMFI.

#### **4.3.2. Lending**

The number of borrowers served as well as the loan of portfolio has increased in all the three MFIs (Table 8). Sample MFIs has served between 11346 and 78836 borrowers which is an average greater than the average for African MFIs 9196. Average loan for individual borrower varies between 360-1032 which shows that MFIs in Ethiopia focus on relatively low income clients. The loan size doesn't attract well-off people. With low loan size, a limited financial resource can go farther and helps more people. The level of outreach in each MFI is significant. The growth in portfolio and growth in number of borrowers in AdCSI was 362 and 174 percent, respectively in year 2004. OMFI and SMFI also showed a promising growth rate in year 2004. The growth in portfolio and growth in number of borrowers in OMFI was 29 percent and 18 percent, respectively. SMFI also achieved 10 percent growth in number of borrowers and 37 percent growth in loan portfolio.

The client drop out rate was low in all sample MFIs. The dropout rate was 1 percent in SMFI, 4 percent in OMFI and 10.7 percent in AdCSI in the year 2003.

In AdCSI, the participation of women reached 71 percent in the year 2003, but it declined by 4 percent in the year 2004. Women cliental in OMFI and SMFI accounted for 36 and 38 percent, respectively in the year 2003. This is above the average for Ethiopian MFIs of 30 percent and below the average of African MFIs, 65.3 percent.

In a male-dominated culture, the efforts of MFIs to deliver financial services to women clients should not be undermined.

**Table 8. Lending Outreach**

INDICATORS	AdCSI		OMFI		SMFI		AVERAGE FOR ETHIOP (AEMFI ) performance Indicators report	AVERAGE FOR AFRICA Micro Bank Bulletin (MBB)
	YEAR		YEAR		YEAR			
	2003	2004	2003	2004	2003	2004		
Number of active borrowers	14271	39087	66571	78836	11346	15558	47051	9196
Percentage of women borrowers	71%	68%	36%	35%	38%	30%	30%	65.3%
Total Gross loan portfolio	8734856	40350579	23940625	30807793	8375810	9216374	36606606	11471961
Total average loan balance per borrower	612	1032	360	391	738	592	704	1273
Number of client dropout	1706	7240	2867	6970	139	175		
Rate of dropout	10.2%	15.6%	4.0%	8%	1%	1%		
Percentage growth in borrowers		174%		18%		37%		
Percentage growth in loan portfolio		362%		29%		10%		

Figure 3

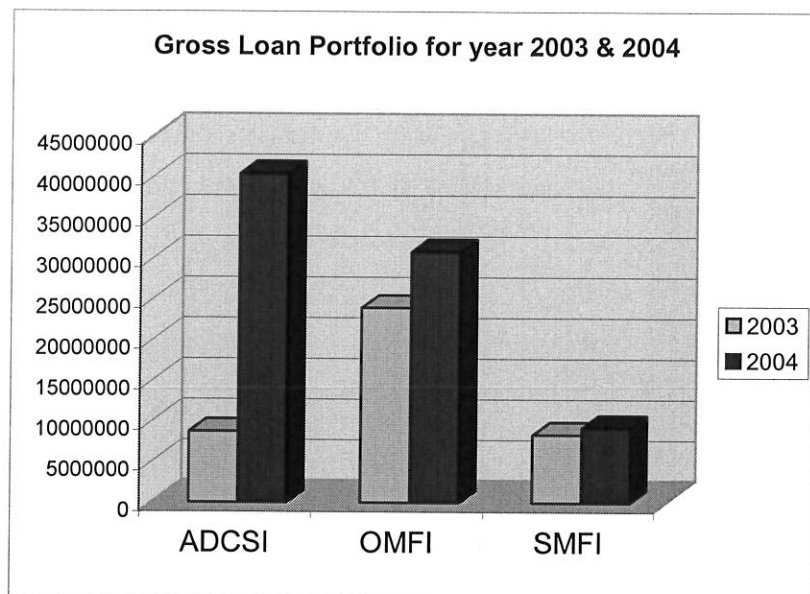


Figure 3 indicates that, the gross loan portfolio for three MFIs was increased. AdCSI was showed significant increase in loan portfolio in year 2004, followed by OMFI.

#### 4.4. Financial sustainability

##### 4.3.1. Profitability

Both AdCSI and OMFI achieved operational sustainability of 103 percent and 106 percent in the year 2004 respectively, which is almost equal to average for Ethiopian MFIs, 104 percent and below average for African MFIs, 111.1 percent. The revenue they generated from operations fully covers their operating costs. However, all sample MFIs under study are not achieving the level of financial sustainability.

**Table 9. Sustainability (Profitability)**

INDICATORS	ADDIS CREDIT AND SAVING INSTITUTION		OMO MICRO.FINANCE S.CO		SIDAMA MICRO-FINANCE S.CO		AVERAGE FOR ETHIOPIA (AEMFI) performance Indicators report	AVERAGE FOR AFRICA Micro Bank Bulletin (MBB)
	YEAR		YEAR		YEAR			
	2003	2004	2003	2004	2003	2004		
Operational self sufficiency	85%	103%	89%	106%	56%	83%	104%	111.1%
Financial self sufficiency	60%	70%	49%	62%	37%	51%	77%	93.7%

Figure 4.

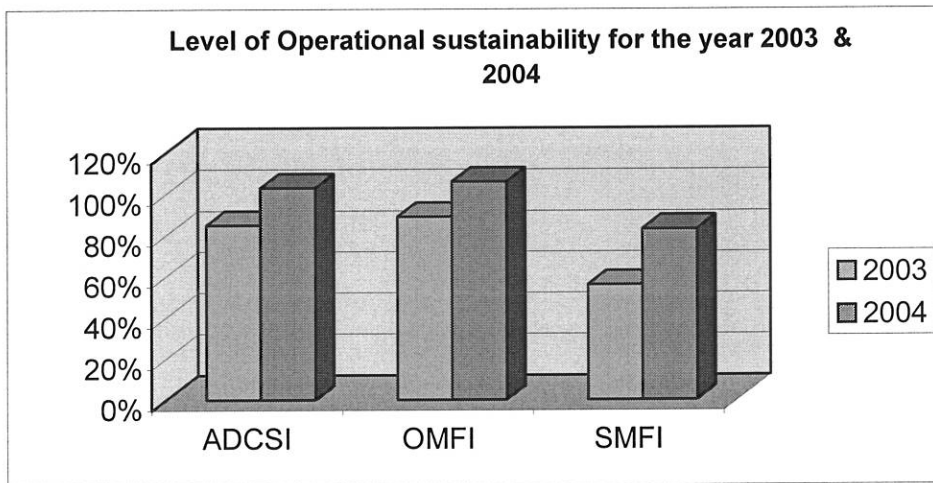


Figure 4 shows that, all the three sample MFIs have improved there level of operational sustainability. Both AdCSI and OMFI already achieved operational sustainability in the year 2004.

### 4.3.2. Revenue and expense structures

#### 4.3.2.1. Revenues

The source of revenue for sample MFIs is interest from loan portfolio, fees and commissions and other incomes. Interest income is the most important variable for higher return and sustainability.

MFI's must charge a rate of lending interest that covers all costs (the cost of fund, loan reserve, operating costs), including inflation in order to enable the loan fund to cover the costs.

Both SMFI and OMFI charge an interest rate of 15% on loans on flat basis. AdCSI charges interest rates ranging from 10% and 15%, based on type of loans.

Financial revenue to average total asset for the three sample MFI's is 12 percent in AdCSI, 10 percent in OMFI and 6 percent in SMFI in the year 2003, which is below average of Ethiopian and African MFI's, 16% and 22.9% respectively. The ratio shows declining trend for all sample MFI's in the year 2004 compared to 2003 (Table.10).

The portfolio yield is the initial indicator of institution's ability to generate revenue with to cover its financial and operating expenses. Portfolio yield shows how much, on average an MFI really receives in interest payments on its loans. The average portfolio yield for AdCSI is 18 percent, OMFI is 16 percent and SMFI is 13 percent which is below average of Ethiopian and African peers, 23 percent and 31.6 percent respectively. This is explained by the relatively lower lending interest rates of MFI's compared to African MFI's. The profit margin is negative for three sample MFI's. Financial sustainability not yet achieved by all sample MFI's.

**Table 10. Revenue**

INDICATORS	AdCSI		OMFI		SMFI		AVERAGE FOR ETHIOPIA (AEMFI) performance Indicators report	AVERAGE FOR AFRICA Micro Bank Bulletin (MBB)
	year		year		year			
	2003	2004	2003	2004	2003	2004		
Adjusted Financial revenue ratio	12%	7%	11%	10%	6%	7%	16%	22.9%
Adjusted profit margin	-66%	-42%	-104%	-60%	-174%	-98%	-45%	-6.8%
Yield on gross portfolio (nominal)	18%	11%	16%	19%	12%	13%	23%	31.6%

Figure 5

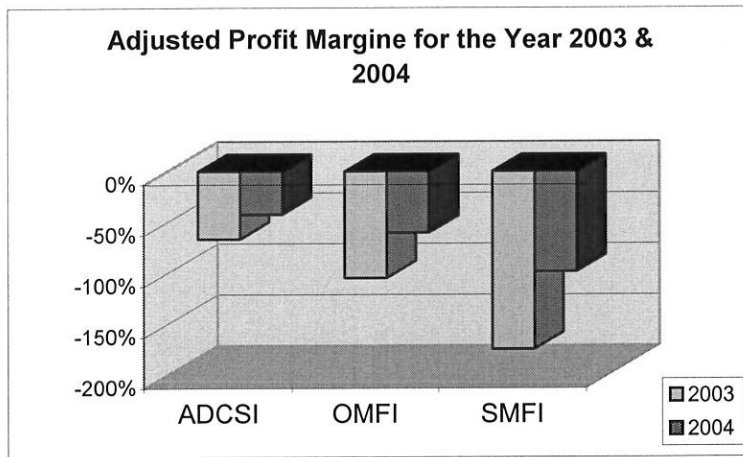


Figure 5 indicates that adjusted profit margin for three sample MFIs are negative. This implies that the revenue generated by each MFI didn't cover its operating costs. SMFI was registered higher operating loss than both AdCSI and OMFI.

#### 4.3.2.2. Expenses

The Expenses are interest on deposits of clients, provision for loan loss provision, operating expense and adjustment expense. Operating expense includes salary and benefits, rent and utilities, Transportation, offices supplies and other administrative costs.

Total expense to adjusted average total assets for three MFIs is declining from year 2003 to year 2004. Total expense ratio was declined from, 20 percent to 10 percent in AdCSI, 22 percent to 16 percent in OMFI and 17 percent to 15 percent in SMFI (Table 11). Sample MFIs achieved total expense ratio below average of Ethiopian and African MFIs, 21 percent and 26 percent respectively, in the year 2004. The financial expense for AdCSI and SMFI is slightly above the average of Ethiopian and African MFIs in year 2003. However, SMFI registered financial expense that is lower than the average. Loan provision expense ratio shows a declining trend for all sample MFIs in year 2004. OMFI has provided loan Provision of 10 and 5 percent in the year 2003 and 2004 respectively, which is above the average.

The lion's share of the total cost of the MFIs is operating cost. The operating expense comprises about 50 percent of the total cost of the MFIs. Salary dominates the operating cost of MFIs. It consists above 50 percent of the operating costs. Generally the operating expense of sample

MFIs declined in year 2004. Their ratio is below average of Ethiopian and African MFIs. The declining trend in total expense ratio in sample MFIs demonstrate that the institutions are improving their efficiency and moving towards sustainability

**Table 11. Expense**

INDICATORS	AdCSI		OMFI		SMFI		AVERAGE FOR ETHIOPIA (AEMFI) performance Indicators report	AVERAGE FOR AFRICA Micro Bank Bulletin (MBB)
	YEAR		YEAR		YEAR			
	2003	2004	2003	2004	2003	2004		
Total expense ratio	20%	10%	22%	16%	17%	15%	21%	26%
Financial Expense ratio	7%	4%	3%	3%	7%	6%	6%	6%
A loan loss provision expense ratio	4%	1%	10%	5%	1%	0%	3%	2%
Operating expense ratio	9%	5%	9%	8%	9%	8%	12%	14%
Personnel expense ratio	6%	3%	5%	5%	5%	4%	7%	7%
Administrative expense ratio	3%	2%	4%	3%	4%	4%	5%	7%
Adjustment expense ratio	6%	3%	2%	2%	8%	7%	5%	4%

**Figure 6**

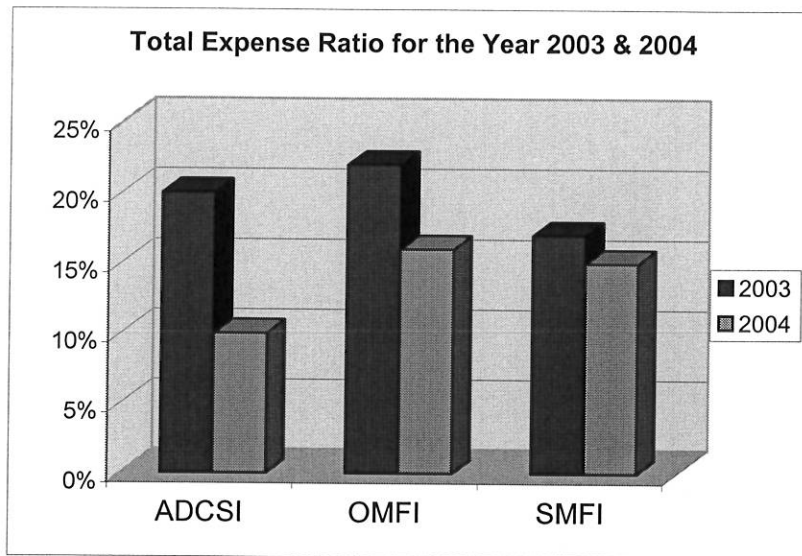


Figure 6 demonstrates that total expense ratio for three sample MFIs, was declined. This implies that the institutions are improving their efficiency.

#### **4.3.3. Operational efficiency and productivity**

Efficiency and productivity indicators indicate how well the institution is undertaking its operations. Since these indicators are not easily manipulated, they are more readily comparable across institutions than, say, profitability indicators such as return on equity and assets.

Microfinance institutions have lower rates of efficiency than commercial banks because the administration cost of small loans are very high. A hundred dollar loan requires about as much effort as loan of a thousand times its size. MFIs administrative costs may be Birr 15, 20 or even 30 for each 100 birr in the loan portfolio resulting in an efficiency ratio of 15, 20 or 30 percent. Commercial Banks commonly report efficiency ratio of 2, 3 or 4 percent (micro rate, 2003).

AdCSI, OMFI and SMFI demonstrated lower percentage of total operating expense to loan portfolio. The sample MFIs shows higher efficiency than the average Ethiopian and African MFIs, with operating expense ratio of 20 and 36 percent respectively (Table 12). AdCSI showed an improvement in efficiency in year 2004. Its operating expense to loan portfolio ratio declined

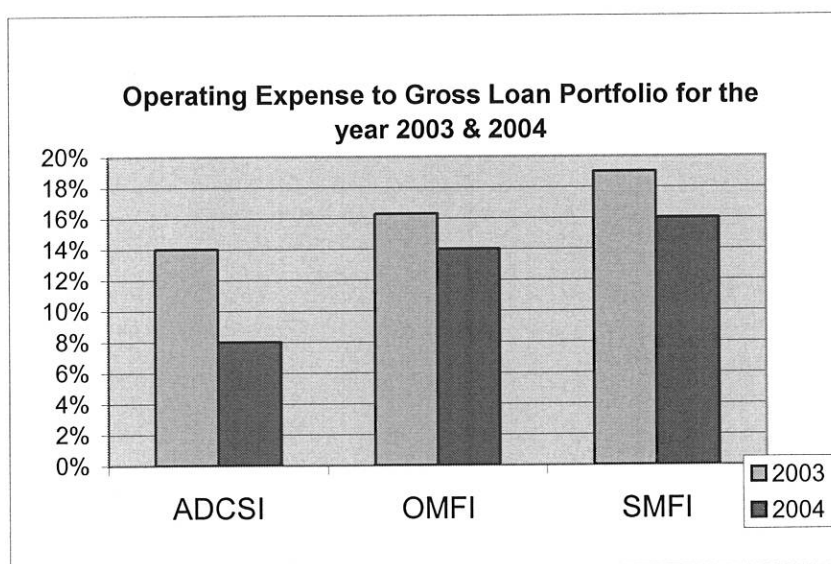
from 14 percent in the year 2003 to 8 percent in the year 2004. Both OMFI and SMFI demonstrate 2 percent and 3 percent decline in operating expense to gross loan portfolio ratio respectively in the year 2004. The decline in operating expense to gross loan portfolio in AdCSI was partly the result of an increase in portfolio size from 8.7 million in year 2003 to 40.3 million in years 2004. Its average loan size also increased from Birr 612 to Birr 1032. The operating expenses of urban MFIs are obviously much lower than MFIs, operating in rural area, since their clients are less widely dispersed. In addition to their low operating expenses to loan portfolio, the urban based MFIs reach more clients at lower costs as shown in their low average cost per borrower. Both AdCSI and OMFI achieved lower cost per borrower ratio than the average Ethiopian and African MFIs, with cost per borrower of birr 129 and Birr 499 respectively. However, SMFI demonstrated cost per borrower ratio which is below the Ethiopian average. Cost per borrower ratio of AdCSI declined from birr 95 in 2003 to Birr 51 in 2004. It is slightly lower than Both OMFI and SMFI. Their productivity in terms of loan officer slightly above the African MFIs.

Personnel allocation ratio indicates the proportion of the most productive employees of an MFI that directly involved on their core loan provision activities. OMFI committed on average 89 percent and 83 percent of its employees to credit activity in year 2003 and 2004 respectively. Only 34 percent of SMFIs employee allocated to credit operation in year 2003, where as its personnel allocation ratio was reached to 78 percent in year 2004. The percentage of employees directly involved with the clients in AdCSI is 54 percent and 64 in the year 2003 and 2004 respectively. In year 2004, all sample MFIs achieved personnel allocation ratio above average for Ethiopian and African MFIs 46 percent and 56 percent respectively.

**Table 12. Efficiency and Productivity**

INDICATORS	AdCSI		OMFI		SMFI		AVERAGE FOR ETHIOPIA (AEMFI) performance Indicators report	AVERAGE FOR AFRICA Micro Bank Bulletin (MBB)
	YEAR		YEAR		YEAR			
	2003	2004	2003	2004	2003	2004		
Borrower per loan officer	259	429	248	265	291	132	383	253
Borrower per staff member	140	273	197	220	98	103	152	132
Operating expense to Gross loan portfolio (GLP)	14%	8%	16%	14%	19%	16%	20%	36%
Cost per borrower	95	51	58	57	141	93	129	499
Staff personnel expense to GLP	9%	5%	8%	10%	10%	7%	11%	15%
Staff personnel allocation ratio	54%	64%	89%	83%	34%	78%	46%	56%

**Figure 7**



In figure 7, the three sample MFIs demonstrate a decline in operating expense to gross loan portfolio. This indicates that, institutions are improving their efficiency.

#### 4.3.4. PORTFOLIO QUALITY

Since the largest source of risk for any financial institution exists in its loan portfolio, the quality of portfolio is crucial for MFIs. In case of microfinance institutions, whose loans are typically not backed by property collateral, the quality of portfolio is absolutely crucial. The most widely used measure of portfolio quality in the microfinance industry is portfolio at risk (PAR), which measures the portion of the loan portfolio 'contaminated' by arrears as a percentage of the total portfolio. This rule is much stricter than what is practiced among commercial banks, but it is justified, given the lack of bankable collateral. Any portfolio at risk (PAR 30) exceeding 10% should be cause of serious concern, because unlike all performances measures, portfolio at risk can be manipulated. The most common form of doing this is to write off delinquent loans. Portfolio at risk must therefore always be analyzed together with the write off ratio.

As indicated in table 13 both AdCSI and OMFI achieved relatively better portfolio quality as shown by low portfolio at risk rate which is above average for Ethiopian and African MFIs ,6 percent and 5.3 percent respectively.

The portfolio at risk rate of AdCSI improved from 8% in the year 2003 to 2% in the year 2004. The portfolio at risk rate for OMFI was 2 percent and 1 percent respectively in the year 2003 and 2004 respectively. OMFI registered low rate of portfolio at risk in the year 2004.

The risk coverage ratio gives the indication of how the institution is prepared for the worst case scenario. For microfinance institutions, loan loss reserves usually range between 80% and 120% of portfolio at risk (the Average for Ethiopian was 160%). OMFI, provide higher provision, almost three times greater than an average for Ethiopian MFIs.

The write-off ratio measures the actual loan loss the MFI is suffering from loan provision service. The writing off of a loan is accounting transaction to prevent asset from being unrealistically inflated by loan that may not be recovered. The write-off ratios for AdCSI were 6% and 3% in the year 2003 and year 2004 respectively. It is below the average for African MFIs. OMFI registered write-off ratio of 30% and 23% in the year 2003 and year 2004

respectively. Which is higher than the average rate for Ethiopian and African MFIs, 5 percent and 8 percent respectively. The higher write off contribute for low portfolio at risk of OMFI.

**Table 13. Loan Portfolio Quality**

INDICATORS	AdCSI		OMFI		SMFI		AVERAGE FOR ETHIOPIA (AEMFI) performance Indicators report	AVERAGE FOR AFRICA Micro Bank Bulletin (MBB)
	year		year		year			
	2003	2004	2003	2004	2003	2004		
Adjusted portfolio at risk 30 days	8%	2%	2%	1%	NA	NA	6%	5.3%
Adjusted write off ratio	6%	3%	30%	23%	NA	NA	5%	8%
Adjusted loan loss rate	6%	3%	30%	23%	NA	NA	5%	8%
Adjusted risk coverage	143%	65%	42%	343%	NA	NA	160%	63.9%

Figure 8

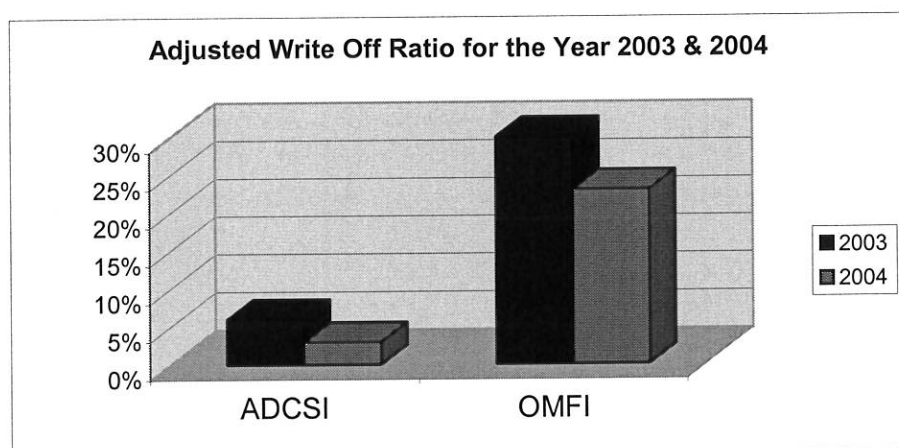


Figure 8 indicates that OMFI demonstrates higher write-off ratio as a result of the deterioration of portfolio quality.

#### ***4.3.5. Financing Structure***

Both AdCSI and SMFI acquire a good mix of financial resources compared to the industry level. The capital asset ratio for AdCSI reached to 82 percent in year 2003. It registered 7 percent increase in preceding year. The capital asset ratio for SMFI has grown to 81 percent in the year 2003 and decline by 12 percent in the year 2004. However, OMFI achieved low capital asset ratio of 17 percent and 14 percent in year 2003 and 2004 respectively (Table 14).

AdCSI and OMFI had a capital to asset ratio above the average for Ethiopian and African MFIs. Very low capital assets ratio of OMFI indicates the inability of the institution's capital to absorb future loses that may occur without endangering debtors claim. Both AdCSI and SMFI had low level of debt equity ratio compared to the Ethiopian average of 81 percent. The ratio shows declining trend for AdCSI where as, increasing trend for SMFI. OMFI demonstrated extremely higher debt equity ratio of 484 percent and 600 percent and saving to gross loan portfolio of 87 percent and 84 percent in year 2003 and 2004 respectively. High debt equity ratio of OMFI indicates that the institution is approaching its borrowing limits, which intern will force it to curtail growth unless additional equity is injected into it.

All sample MFIs have very limited access to commercial funding. OMFI and SMFI had access only 10 percent and 24 percent to commercial funding respectively. Their ability to raise funds from voluntary saving is also very low. It is almost zero for both AdCSI and SMFI and about 10 percent for OMFI. One of the factors contributing for low level of commercial funding for sample MFIs is the collateral based lending system of commercial banks and subsidy received from various sources. Local commercial banks are hesitant to lend to MFIs, as they do not have adequate physical assets to be used for collateral. Hence, the majority of Ethiopian MFIs do not yet access borrowed funds. The regulation in the country also prohibits accessing commercial funding from international banks or sources.

**Table 14. Financing Structure**

INDICATORS	AdCSI		OMFS		SMFS		AVERAGE FOR ETHIOPIA (AEMFI) performance Indicators report	AVERAGE FOR AFRICA Micro Bank Bulletin (MBB)
	YEAR		YEAR		YEAR			
	2003	2004	2003	2004	2003	2004		
Adj capital to asset ratio	82%	89%	17%	14%	81%	69%	59%	39.1%
Adj commercial funding ratio	0%	1%	11%	10%	0%	24%	17%	46.4%
Debt to equity ratio	22%	13%	484%	600%	23%	45%	81%	1.5%
Adj voluntary deposit to Gross loan portfolio	0%	1%	11%	10%	0%	0%	17%	20.7%
Adj deposits to total Assets	0%	0%	6%	5%	0%	0%	11%	11.9%
Adj gross loan portfolio total assets	51%	66%	53%	50%	50%	48%	62%	65.8%
Total saving to GLP	34%	15%	87%	84%	29%	32%	41%	NA
Total saving to Assets	17%	10%	46%	42%	15%	15%	25%	NA

Figure 9

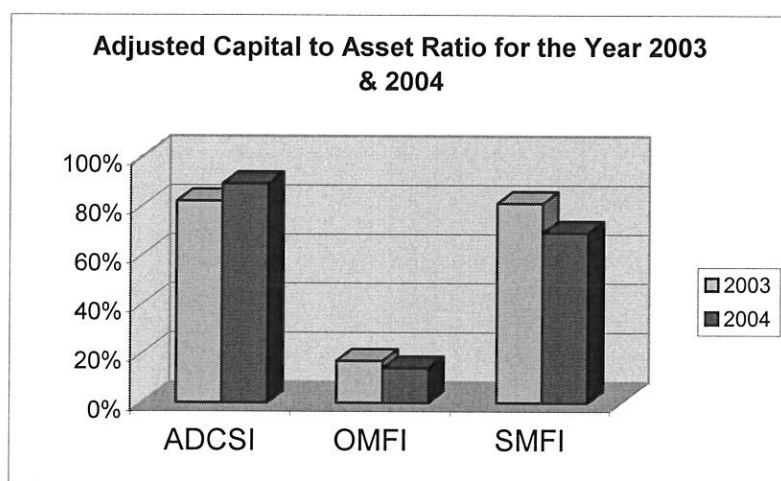


Figure 9 indicates that adjusted capital to asset ratio for both OMFI and SMFI was declined. The ratio was improved in AdCSI.

Based on the above analysis, this study sought to answer the relationship between scaling up outreach and financial sustainability. In this regard all the three institutions in the sample are improving their outreach. The financial operations of three sample MFIs is showing growing trend. Two of the three sample MFIs in the study already achieved operational sustainability. The MFIs are not expected to generate sufficient revenue in the early years of their operation, to cover all their costs from revenue generated from portfolio. Hence, from the above assessment we can assert that as MFI grow and their outreach increases, the costs will spread and return on assets and sustainability increase. Further outreach would also increases operational self sufficiency. Operational self sufficiency intern would contribute to increase outreach.

The assessment also attempted to determine whether serving the poor preclude achieving financial self-sufficiency, or can institutions achieve both. Sample MFIs under study are serving the poor in urban and rural area. Their performance indicates that the value and percentage growth of the portfolio is promising. The number of active clients and their saving is continuously increasing. Therefore, serving the poor has not precluded sample MFIs from achieving outreach and improving their financial sustainability, provided that, the institutions would continue on building institutional innovations.

The Factors that are necessary for strong outreach and financial viability assessed in this study. Institutional building is essential for attaining outreach and financial self-sustainability. The factors include, effective service delivery methodology, competent and efficient management team, organizational structure that support organizational objective, information system that allow the institution to move data as quickly as possible and produce timely reports for decision making and motivated and skilled staff. In order to achieve outreach and financial sustainability, Institutional sustainability is a prerequisite. The profitability of an institution is determined by its efficiency, and efficiency is the result of strong and will-organized institution.

The study tried to identify the problems in achieving financial sustainability in sample MFIs. To identify the problems, it would appropriate to discuss the key factors for sustainability and then discover if, these factors have been fulfilled by sample MFIs.

The major factor that MFIs relied on for financial sustainability is appropriate lending interest rate. To attain financial sustainability, MFIs have to charge an effective interest rate that covers all cost incurred in providing financial service to the poor. Moreover, the MFIs should not transfer their inefficiency on the clients.

High loan recovery rate is very essential for financial sustainability of MFIs. Because high rate of non-repayment erodes the value of the loan portfolio. As a result interest revenue could be postponed or lost, and this could reduce the profitability of the institution.

Reducing transaction (administrative) cost is very important for financial sustainability of MFIs. MFIs must reduce their transaction costs to a level that keeps their sustainability.

Conducive policy environment in a given country is believed to be important for MFIs to achieve financial viability. Liberalizing the interested rate, maintaining inflation at low rate, and legal framework are among the variables for successful performance.

To answer the question, the financial performance of AdCSI, OMFI and SMFI reviewed in line to the above mentioned variables. As it is indicated on table 10, the margin between the nominal rate charged on loans and interest paid on saving is 14 percent in AdCSI, 12 percent in OMFI and 6 percent in SMFI in the year 2003. These rates are not sufficient to cover the current costs. Operating expense to Gross portfolio is 14 percent in AdCSI, 16 percent in OMFI and 19 percent in SMFI in the year 2003 (Table 12). The gap between the yield and the cost is very significant, particularly in SMFI.

The Loan return on equity -63 percent in 2003 and -37 percent in 2004 registered by OMFI is partly due to the deterioration of portfolio quality and result in subsequent increase in loan provision expense and decrease in net income.

The policy environment seems also favorable for MFI operation. The institutions are free to set their own interest rate, the capital required to establish MFI is very low. The launching of Rural Financial Intermediation Program (RUFIP) indicates government commitment to support and promote microfinance industry in the country.

From the above findings, the problems in achieving financial Sustainability in the three sample MFIs, is explained by the relatively lower lending interest rates of these MFIs. In addition to this, deterioration of portfolio quality in OMFI identified as one of the factor constrained for achieving financial sustainability. In SMFI, High operating cost contributed for low level of financial sustainability.

#### **4.5. ISSUES WHICH NEED TO BE ADDRESSED TO IMPROVE OUTREACH AND SUSTAINABILITY**

Internal and external factors to the MFI affect the outreach and sustainability of MFI. Based on the focus group discussions, with clients, employees and officials of the institutions, the following issues were identified to improve outreach and sustainability of MFIs, in Ethiopia.

##### **1. Lack of customer responsive lending mechanism and service design.**

- ❖ Most of the key informants indicated that, group lending methodology contributed to the repayment problems as well as conflicts and distrust among group members. For example, if one of the group members fails to pay his/her loan, MFIs don't collect the amount due from the rest of the group members, even if they have the capacity to pay their obligation. In other words, the policy of the MFIs contributed to the increase in arrears. Besides, this created financial problems for the group, since they are not allowed to get the next loan unless the whole group settles their loans.
  
- ❖ Higher group size to access loans is the other problem reported during the focus group discussions. The current group size required to access loan is five or above. Since clients need the loan very quickly to use it for the intended purpose, they are forced to form a group with non-creditworthy members to meet the group size requirement. As a result, the credits worthy clients are forced to pay for the defaulters (non credit worthy group members). Consequently, conflict and loss of trust may be aggravated among the group members which increases dropout rate.

- ❖ The key informants also revealed that the loans provided by both OMFI and SMFI are small in the urban areas. During the focus group discussion, some of the urban clients indicated that even though they have the capacity to borrow larger loan amount the institutions do not allow them to borrow larger loan amount. Again, this implies that the institutions should design a loan product that meets the demand of its clients using different mechanisms to ensure a higher repayment performance. Present physical collateral for large loan amount or through designing a tight evaluation system to evaluate the creditworthiness of the applicants.
- ❖ Lack of flexibility in the repayment period is identified in focus group discussing in a rural area, as main problem in both OMFI and SMFI. Most of the rural clients suggested that, during poor agricultural production, the institution should extend or reschedule the repayment period until the next harvest period.

## **2. Governance**

In sample MFIs most of the Board members are composed of highly influential individuals, mainly government officials who have limited knowledge and experience in microfinance. Although the involvement of these individuals is advantageous to influence policy at national level and increase the institutions access to source of funds, the fact that they have limited knowledge and experience in microfinance reduces their ability in fulfilling their major role. The Board should address the following issue:-

- ❖ Establishing clear goals for the management or other implementing body and closely monitoring their performance, and confronting weaknesses when they surface.
- ❖ Providing strategic direction to the MFI. The board must work closely with management in carrying out this role to ensure congruence between the institution's strategic thinking and its operations.

## **2 Problem of loan able fund for future expansion**

One of the challenges for growing microfinance institutions (MFIs) in Ethiopia is lack of sufficient capital to fund to expand outreach and loan portfolio. As microfinance matures, there is an increasing expectation that this MFI move away from donor funding and fund their growth by accessing private capital, either by borrowing from commercial banks or by mobilizing deposits. But the sample MFIs has problems in accessing commercial bank funding. There are various reasons for banks to deny these MFIs from accessing loans. The main reason is that microfinance does not have physical collateral and most of their assets are tied up in their loan portfolio. If an MFI goes bankrupt, the loans, which are in the hands of the poor, have no value for commercial banks. Similarly, commercial banks may not understand the methodology of MFIs. They perceive MFIs as risky because MFIs lend to small businesses and the rural poor without any property collateral.

## **3 Lack of trained manpower**

Lack of adequate trained manpower to follow-up and supervise the activities of the institution at branch level, lack of training to the employees of the institution, lack of adequate training and orientations to the clients about loan use, and financial managements.

## **4 Weak MIS**

Managerial Information system (MIS) is weak in sample MFIs. The manual system adopted failed to produce accurate and timely information leaving decision makers with only option of uninformed/haphazard decision-making process.

## **5 Lack of efficient legal system to enforce contracts**

Lack of efficient and realistic legal system for the microfinance institutions to use asset collateral system to provide large amount of loan like the conventional commercial banks.

## CHAPTER 5

### *SUMMARY, CONCLUSION AND RECOMMENDATION*

#### *5.1 Summary*

Microfinance programs and institutions are increasingly important in development strategies to reduce poverty. Microfinance, has the potential of addressing poverty both directly, by improving income growth and economic security, and indirectly, through the impact of greater economic security on social relation at community level and with in the household.

Two objectives are Paramount for MFIs to be successful: financial self sustainability and Substantial outreach. In achieving these objectives, MFIs have two challenges. The first challenge is to become viable institution that built a firm foundation of efficient operation. The second challenge is how to increase outreach so that a significant number of poor have access to financial services. Without significant growth of microfinance institutions, microfinance will not be able to play a leading role in poverty reduction. Given this state of affairs the assessment of microfinance programs remains an important field for researchers, policy makers and development practitioners. This paper is designed to assess financial self sustainability and outreach of the microfinances based on the case study of three institutions namely, AdCSI, OMFI and SMFI. The study has used both quantitative and qualitative method to obtain information on outreach and financial performance of the three sample MFIs. After the gathering of the primary and secondary date, adjustment to financial data was made and then the performances of the MFIs were measured by using financial ratio analysis.

This study tried to examine the interrelationship between outreach, financial sustainability and institutional sustainability and to determine whether outreach, financial and institutional sustainability are positively related or is there direct trade off between them. The specific objective of the study was to explore the interrelationship between outreach, financial and institutional sustainability and to draw conclusions and make recommendations for improving the outreach and financial and institutional sustainability of the MFIs.

The finding of the study indicated that both outreach and financial self-sustainability are positively interrelated. Institutional sustainability is a key element in achieving outreach and financial sustainability. Institutionally sustainable MFI can serve the poor and become financially sustainable as well.

## **5.2 Conclusions**

OMFI and SMFI are microfinance institutions operating with both urban and rural areas where as AdCSI operating with only urban area. The study reviewed the performance of the three institutions in terms of outreach and financial sustainability. The overall performance has been significant.

**Outreach:** - The study indicated that, the three sample micro finance institutions have achieved extensive outreach. They provide financial services to the urban and rural poor. The value of saving has grown significantly. Saving as of a percentage of gross loan portfolios in OMFI was reached 87 percent. Similarly the number of borrowers served as well as the loan portfolio has increased in the three sample MFIs.

The participation of women in three sample MFIs is encouraging. In AdCSI the participation of women reached 71 percent. The client dropout rate was low for all three sample MFIs.

### **Financial sustainability:-**

The lending interests and fees generated by sample MFIs not cover the total expenses. All sample MFIs under study are not achieving the level of financial sustainability. However, the trend of their financial performance demonstrates that there is a good and steady progress towards reaching operational sustainability. Both AdCSI and OMFI already achieved operational sustainability. The productivity and efficiency indicators such as, cost per borrower has decreased. The number of borrowers per credit office has increased for both AdCSI and OMFI.

The major cost for the institutions is operating expense. Operating expense ratio for sample MFIs is very high. Salary dominates the operating cost of the MFIs. However, the declining

trends in total expense ratio in sample MFIs indicate that the institutions are improving their efficiency.

The result of operations illustrates that with the increase of outreach, operational sustainability has improved, though not at equal rates. Total expense ratio has reduced. The financial ratio analysis shows that financial sustainability help to scale up outreach and outreach in turn helps to improve financial sustainability. In other words, there is positive interrelationship between outreach and financial sustainability.

The major reason for the slow growth of the operational sustainability in sample MFIs is mainly low lending interest rate. Deterioration of portfolio quality in OMFI and high operating expense to gross loan portfolio in SMFI contributed for slow growth rate.

Institutional Sustainability:- The ownership structure of the three sample MFIs reveals that the ownership is mainly a mixture of Ngos, government, associations and private individuals. In AdCSI and OMFI the respective regional governments own 98 percent and 80 percent of the shares of MFIs, respectively. The share holders in sample MFIs are nominal owners that were mobilized to fulfill the requirements of the proclamation. Board members in sample MFIs are qualified people except limited experience in micro finance management. Most of them are high government officials that are busy to attend the board meeting regularly. The study identified that the practice of Board of directors evaluating them selves is not common in sample MFIs.

The three sample MFIs follow the group lending methodology. The clients are required to organize themselves in groups. These groups are instruments to maintain social and financial discipline. However, most of the key informants indicated that, group leading methodology contributed to the repayment problems as well as conflict and mistrust among group members. The average loan size of both OMFI and SMFI is small, indicating that the institutions are focusing on the real poor. However the average administrative cost per lending becomes high.

The three institutions are providing training to their staff at various levels. In spite of the above efforts, most of branch and sub-branch staff of the institution lacks the necessary qualification and knowledge of microfinance.

AdCSI has developed an incentive system to credit officers based on their performance. However, OMFI and SMFI didn't have any incentive system yet.

The study identified that; compared to the work load, the salary paid by sample MFIs is low. AdCSI uses soft ware namely, Total Micro Finance Solution (TMS) at branch level. Service delivery post at Keble uses manual systems, currently they are attempting to computerize the service delivery posts. OMFI utilizes manual management information system. SMFI process its financial data using Peachtree accounting and track loan portfolio and client saving using Total Microfinance Solution (TMS) software. However, a manual ledger is maintained in branch level.

### **5.3 Recommendations**

Based on the findings of the study, the following recommendations and further research areas are identified;

#### **1. Governance and ownership structure:-**

Ownership structure of the three sample MFIs reveals that the ownership is mainly a mixture of Ngos, governments, association and private individuals. On the face vale, it looks appropriate; nonetheless, there are risks involved mainly because of the nominal nature of shareholding and lack of diversification in ownership. This inherent flaw in the ownership structure of these MFIs may create a problem as the MFIs grow and in some cases, it may be bottleneck for growth. There fore, the ownership and governance MFIs has to be revisited as follows:-

- Although Board of Directors of sample MFIs are qualified people, they lack awareness and are generally less exposed to the microfinance industry. The appropriate training and exposure visits to the best practice MFIs in Asia, Latin America and Africa should be given to Board members.

- In order to increase sense of responsibility and accountability it is necessary to develop code of conduct for Board members regarding attendance in meeting and mechanism of self evaluation and individual contribution.
- Proving the necessary incentives to Board members could maximize the benefits by involving them in strategic issues.
- In AdCSI and OMFI where regional government own the majority shares, diversification in MFIs should be done by gradual relinquish of shares to clients of MFIs, private organizations like bank, universities and foundations.

## **2. Group lending Methodology**

Most of the key informants indicated that, group lending methodology contributed to the repayment problems as well as conflict and distrust among group members. The majority of respondents most dislike about the three sample MFIs were taking the responsibility for others. Taking responsibilities for others is of course, the core of the group lending methodology and what reduces the risk of lending with out collateral. Nonetheless the three sample MFIs might need to reassess the way this group responsibility is enforced to see if some of the dissatisfactions of their clients can be addressed. In particular it might need to reassess the group credit collection system, which affects the performance of good borrowers, because of the performance of the weakest borrowers, and allow a grace period for the center to sort out the problem of a member in arrears before imposing penalties. Another possibility is to establish mutual insurance or risk fund, in to which all center members must pay token amounts so long as one member has arrears. This would safeguard personal saving and allow individual credit ratings so that the good client could forge ahead, and take bigger loan in the next loan cycle.

## **3. Human resource Development**

Lack of staff development primarily affects staff motivation and then the performance of institution itself. Secondly, it might end up in high staff turnover that force MFIs to lose the most experienced employee. Hence, sample MFIs should develop and put in place clear staff development strategy such as, carrier structure with attractive pay scheme and staff training policy. AdCSI and OMFI should consider introducing performance related incentive system

and packages of benefits based on their financial capability. Moreover, it is important for sample MFIs to work closely with the regional government to get scholarship and sponsorship for best performing staff. Once staff training policy is developed, the project document developed and submitted to those donors in capacity building. In addition, policy could be adopted to allocate certain percentage of personnel cost for staff development each year to be built in annual plan.

#### **4. Management information system.**

Presence of reliable management information system becomes more and more indispensable as the financial products and outreach of an MFI increases. Therefore, appropriate management information system (MIS) is vital for prudent management of an institution. Manual information tracking associated with limited accounting knowledge of branch and sub branch staff makes difficult to OMFI to ensure faster and timely information. Therefore, OMFI should develop or acquire appropriate software. SMFI also should computerize its branch offices

#### **5. Interest rate**

The lending interest rate should be adjusted to cover all costs. The current rate charged by sample MFIs didn't cover their total costs, despite the fact that, institutions are free to set their own interest rates. When determining the interest rate, a balance between what clients can afford and what the lending institutions need to earn to cover full costs must be considered. The institutions should reduce their operating costs by using different innovations so that cost of inefficiency would not be transferred to the clients in the form of high lending interest rates.

#### **6. Saving mobilization**

As microfinance matures, there is an increasing expectation that the MFI move a way from donor funding and fund their growth by accessing private capital, either by borrowing from Commercial banks or by mobilizing deposits. But, the sample MFIs has problems in accessing Commercial bank funding. Therefore, increasing voluntary saving mobilization should be considered as a basis for long term financial sustainability and improved client outreach.

## **7. Policy environment**

Policy makers and experts in the government sector should understand the role of micro finance intervention in poverty alleviation and they should formulate well functioning and realistic elastic legal system in order to enhance the contribution of the industry towards poverty alleviation. Furthermore, though currently the government has permitted the microfinance institutions to use other lending methodologies other than the group collateral system, the legal provision is not a sufficient condition for the microfinance institutions to use the alternative lending methods. For instance, to implement asset based collateral system, microfinance should also get equal legal provision with the conventional banks to sell or possess the collateral of loan defaulters with out court order. This legal provision could help MFI to provide larger loan size in order to meet the demand of its clients as well as to decrease its transaction cost, as a result they can improve the profitability.

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## Appendix 1

### Addis Credit & Savings Institution Adjusted Financial Statements

Financial year 2003					
Currency Ethiopian Birr					
Balance sheet	Unadjusted accounts	Adjusted Accounts	Income statement	Unadjusted accounts	Adjusted Accounts
Cash and due from banks	7,023,888	7,023,888	Financial Revenue	1,771,790	1,771,790
Reserves from Central Bank	0	0	Financial Revenue from Loan portfolio	1,727,306	1,727,306
Short term financial Assets	0	0	Interest on loan portfolio	1,509,341	1,509,341
Net loan portfolio	7,730,596	7,730,596	Fees and commissions on loan portfolio	217,965	217,965
Gross loan portfolio	9,289,912	8,734,856	Financial Revenue from other financial assets	0	0
(Loan loss Reserve)	1,559,316	1,004,260	Other Revenue related to financial services	44,484	44,484
Interest Receivable	1,647,796	1,647,796	Financial Expense	111,504	957,683
Accounts Receivable and other Assets	105,952	105,952	Financial expense on liabilities	111,504	111,504
Long term financial Assets	0	0	Interest and fess expense on deposits	111,504	111,504
Net Fixed Assets	651,969	720,856	Interest and fee expense on Borrowings	0	0
Total Assets	17,160,201	17,229,088	Net inflation adjustment expense	0	846,179
Demand Deposits	2,982,394	2,982,394	Inflation adjustment expense	0	915,066
Voluntary Savings	9,872	9,872	Inflation Adjustment revenue	0	68,887
Compulsory Savings	2,972,522	2,972,522	Subsidized cost-of-funds adjustment expense	0	0
Time Deposits	0	0	Other financial expenses	0	0
Borrowings	0	0	Net financial income	1,660,286	814,107
Borrowings at concessional interest rates	0	0	Net loan loss provision expense	620,672	620,672
Borrowings at commercial interest rates	0	0	Loan loss provision expense	620,672	620,672
Interest payable	0	0	Recovery on loans written-off	0	0
Accounts payable and other liabilities	72,256	72,256	operating expense	1,353,680	1,353,680
Total Liabilities	3,054,650	3,054,650	Personnel expense	841,195	841,195
Paid-in-capital	517,000	517,000	Administrative expense	512,485	512,485
Donated equity	14,775,872	14,775,872	Rent and utilities	29,627	29,627
Prior years	10,523,654	10,523,654	Transportation	0	0
Current year	4,252,218	4,252,218	Office supplies	118,132	118,132
Retained Earnings	-1,187,321	-2,033,500	Depreciation and amortization	214,962	214,962
Prior years	-873,255	-873,255	Other administrative expenses	149,764	149,764
Current years	-314,066	-1,160,245	Net operating income	-314,066	-1,160,245
Adjustments	0	915,066	Net non-Operating income	0	0
Inflation Adjustment	0	915,066	Non-Operating revenue	0	0
Subsidized costs of Funds Adjustment	0	0	Non-Operating expense	0	0
In-kind subsidy Adjustment	0	0	Net income (Before taxes and donations)	-314,066	-1,160,245
Reserves	0	0	Taxes	0	0
Other Equity Accounts	0	0	Net income (after taxes and before donations)	-314,066	-1,160,245
Total Equity	14,105,551	14,174,438	Donations to subsidize financial services)	4,252,218	4,252,218
Total liabilities and Equity	17,160,201	17,229,088	Net income(after taxes and donations)	3,938,152	3,091,973

## Appendic 2

### Addis Credit & Savings Institution Adjusted Financial Statements

Financial year	2004				
Currency	Ethiopian Birr				
Balance sheet	Unadjusted accounts	Adjusted Accounts	Income statement	Unadjusted accounts	Adjusted Accounts
Cash and due from banks	19033156	19033156	Financial Revenue	2695681	2695681
Reserves from Central Bank	0	0	Financial Revenue from Loan portfolio	2576650	2576650
Short term financial Assets	0	0	Interest on loan portfolio	2216308	2216308
Net loan portfolio	39853368	39853368	Fees and commissions on loan portfolio	360342	360342
Gross loan portfolio	41499579	40350579	Financial Revenue from other financial assets	0	0
(Loan loss Reserve)	1646211	497211	Other Revenue related to financial services	119031	119031
Interest Receivable	1717629	1717629	Financial Expense	194867	1405690
Accounts Receivable and other Assets	225703	225703	Financial expense on liabilities	194867	194867
Long term financial Assets	0	0	Interest and fess expense on deposits	194867	194867
Net Fixed Assets	643787	702464	Interest and fee expense on Borrowings	0	0
Total Assets	61473643	61532320	Net inflation adjustment expense	0	1210823
Demand Deposits	6215161	6215161	Inflation adjustment expense	0	1269500
Voluntary Savings	26434	26434	Inflation Adjustment revenue	0	58677
Compulsory Savings	5950797	5950797	Subsidized cost-of-funds adjustment expense	0	0
Time Deposits	0	0	Other financial expenses	0	0
Borrowings	0	0	Net financial income	2500814	1289991
Borrowings at concessional interest rates	0	0	Net loan loss provision expense	437580	437580
Borrowings at commercial interest rates	0	0	Loan loss provision expense	437580	437580
Interest payable	0	0	Recovery on loans written-off	0	0
Accounts payable and other liabilities	682889	682889	operating expense	1985433	1985433
Total Liabilities	6898050	6898050	Personnel expense	1298308	1298308
Paid-in-capital	517000	517000	Administrative expense	687125	687125
Donated equity	54294858	54294858	Rent and utilities	44908	44908
Prior years	13902618	13902618	Transportation	0	0
Current year	40392240	40392240	Office supplies	220713	220713
Retained Earnings	-236265	-1447088	Depreciation and amortization	198877	198877
Prior years	-314066	-314066	Other administrative expenses	222627	222627
Current years	77801	-1133022	Net operating income	77801	-1133022
Adjustments	0	1269500	Net non-Operating income	0	0
Inflation Adjustment	0	1269500	Non-Operating revenue	0	0
Subsidized costs of Funds Adjustment	0	0	Non-Operating expense	0	0
In-kind subsidy Adjustment	0	0	Net income (Before taxes and donations)	77801	-1133022
Reserves	0	0	Taxes	0	0
Other Equity Accounts	0	0	Net income (after taxes and before donations)	77801	-1133022
Total Equity	54575593	54634270	Donations to subsidize financial services)	40392240	40392240
Total liabilities and Equity	61473643	61532320	Net income(after taxes and donations)	40470041	39259218

### Appendic 3

#### OMO Microfinance Institution Adjusted financial Statements

Financial year 2003					
Currency Ethiopian Birr					
Balance sheet	Unadjusted accounts	Adjusted Accounts	Income statement	Unadjusted accounts	Adjusted Accounts
Cash and due from banks	13606246.29	13606246.29	Financial Revenue	4746959.45	4746959.45
Reserves from Central Bank	0	0	Financial Revenue from Loan portfolio	4513096.54	4513096.54
Short term financial Assets	0	0	Interest on loan portfolio	3829058.37	3829058.37
Net loan portfolio	25319879.73	21991161.13	Fees and commissions on loan portfolio	684038.17	684038.17
Gross loan portfolio	31156361.13	23940625.13	Financial Revenue from other financial assets	5767.41	5767.41
(Loan loss Reserve)	5836481.40	1949464	Other Revenue related to financial services	228095.50	228095.50
Interest Receivable	3255817.60	3255817.60	Financial Expense	507249.94	1494422.94
Accounts Receivable and other Assets	5522988.44	5522988.44	Financial expense on liabilities	507249.94	1494422.94
Long term financial Assets	0	0	Interest and fess expense on deposits	507249.94	507249.94
Net Fixed Assets	837813.61	897443.61	Interest and fee expense on Borrowings	0	0
Total Assets	48542745.67	45273657.07	Net inflation adjustment expense	0	987173
Demand Deposits	20882518.41	20882518.41	Inflation adjustment expense	0	1046803
Voluntary Savings	2670575.51	2670575.51	Inflation Adjustment revenue	0	59630
Compulsory Savings	18211942.90	18211942.90	Subsidized cost-of-funds adjustment expense	0	0
Time Deposits	0	0	Other financial expenses	0	0
Borrowings	0	0	Net financial income	4239709.51	3252536.51
Borrowings at confessional interest rates	0	0	Net loan loss provision expense	994153.36	4322871.96
Borrowings at commercial interest rates	0	0	Loan loss provision expense	994153.36	4322871.96
Interest payable	0	0	Recovery on loans written-off	0	0
Accounts payable and other liabilities	16640942.97	16640942.97	operating expense	3849079.14	3849079.14
Total Liabilities	37523461.38	37523461.38	Personnel expense	2259242.61	2259242.61
Paid-in-capital	500.000	500.000	Administrative expense	1589836.53	1589836.53
Donated equity	14386759.31	14386759.31	Rent and utilities	36317.94	36317.94
Prior years	14310665.47	14310665.47	Transportation	0	0
Current year	76093.84	76093.84	Office supplies	168433.97	168433.97
Retained Earnings	-3867475.02	-8183366.62	Depreciation and amortization	134926.77	134926.77
Prior years	-3263952.03	-3263952.03	Other administrative expenses	1250157.85	1250157.85
Current years	-603522.99	-4919414.59	Net operating income	-603522.99	-4919414.59
Adjustments	0	1046803	Net non-Operating income	0	0
Inflation Adjustment	0	1046803	Non-Operating revenue	0	0
Subsidized costs of Funds Adjustment	0	0	Non-Operating expense	0	0
In-kind subsidy Adjustment	0	0	Net income (Before taxes and donations)	-603522.99	-4919414.59
Reserves	0	0	Taxes	0	0
Other Equity Accounts	0	0	Net income (after taxes and before donations)	-603522.99	-4919414.59
Total Equity	11019284.29	7750195.69	Donations to subsidize financial services)	76093.84	76093.84
Total liabilities and Equity	48542745.67	45273657.07	Net income(after taxes and donations)	-527429.15	-4843320.75

## Appendix 4

### OMO Microfinance Institution Adjusted financial Statements

Financial year 2004					
Currency Ethiopian Birr					
Balance sheet	Unadjusted accounts	Adjusted Accounts	Income statement	Unadjusted accounts	Adjusted Accounts
Cash and due from banks	19651414.20	19651414.20	Financial Revenue	5447418.57	5447418.57
Reserves from Central Bank	0	0	Financial Revenue from Loan portfolio	5298420.68	5298420.68
Short term financial Assets	0	0	Interest on loan portfolio	4113087.22	4113087.22
Net loan portfolio	32079355.01	29391160.28	Fees and commissions on loan portfolio	1185333.46	1185333.46
Gross loan portfolio	37927053.28	30807793.28	Financial Revenue from other financial assets	0	0
(Loan loss Reserve)	5847698.27	1416633	Other Revenue related to financial services	148997.89	148997.89
Interest Receivable	3508192.73	3508192.73	Financial Expense	618502.24	1534835.24
Accounts Receivable and other Assets	8120952.34	8120952.34	Financial expense on liabilities	618502.24	618502.24
Long term financial Assets	0	0	Interest and fess expense on deposits	618502.24	618502.24
Net Fixed Assets	1153465.65	1228868.65	Interest and fee expense on Borrowings	0	0
Total Assets	64513379.93	61900588.20	Net inflation adjustment expense	0	916333
Demand Deposits	25969672.27	25969672.27	Inflation adjustment expense	0	991736
Voluntary Savings	3113561.59	3113561.59	Inflation Adjustment revenue	0	75403
Compulsory Savings	22856110.68	22856110.68	Subsidized cost-of-funds adjustment expense	0	0
Time Deposits	0	0	Other financial expenses	0	0
Borrowings	0	0	Net financial income	4828916.33	3912583.33
Borrowings at confessional interest rates	0	0	Net loan loss provision expense	11216.87	2699411.60
Borrowings at commercial interest rates	0	0	Loan loss provision expense	11216.87	2699411.60
Interest payable	0	0	Recovery on loans written-off	0	0
Accounts payable and other liabilities	27097735.34	27097735.34	operating expense	4488579.45	4488579.45
Total Liabilities	53067407.61	53067407.61	Personnel expense	2639937.12	2639937.12
Paid-in-capital	500.000	500.000	Administrative expense	1848642.33	1848642.33
Donated equity	14429213.13	14429213.13	Rent and utilities	88161.59	88161.59
Prior years	1433794.49	1433794.49	Transportation	0	0
Current year	95418.19	95418.19	Office supplies	172564.71	172564.71
Retained Earnings	-3483240.81	-7087768.44	Depreciation and amortization	152086.57	152086.57
Prior years	-3812360.82	-3812360.82	Other administrative expenses	1435829.46	1435829.46
Current years	329120.01	-3275407.72	Net operating income	329120.01	-3275407.72
Adjustments	0	991736	Net non-Operating income	0	0
Inflation Adjustment	0	991736	Non-Operating revenue	0	0
Subsidized costs of Funds Adjustment	0	0	Non-Operating expense	0	0
In-kind subsidy Adjustment	0	0	Net income (Before taxes and donations)	329120.01	-3275407.72
Reserves	0	0	Taxes	0	0
Other Equity Accounts	0	0	Net income (after taxes and before donations)	329120.01	-3275407.72
Total Equity	11445972.32	8833180.69	Donations to subsidize financial services)	95418.19	95418.19
Total liabilities and Equity	64513379.93	61900588.20	Net income(after taxes and donations)	424538.20	-3179989.53

## Appendix 5

### Sidama Microfinance Institution Adjusted financial Statements

Financial year		2003			
Currency		Ethiopian Birr			
Balance sheet	Unadjusted accounts	Adjusted Accounts	Income statement	Unadjusted accounts	Adjusted Accounts
Cash and due from banks	2,392,074	2,392,074	Financial Revenue	1,020,434	1,020,434
Reserves from Central Bank	0	0	Financial Revenue from Loan portfolio	938,279	938,279
Short term financial Assets	1,000,000	1,000,000	Interest on loan portfolio	938,279	938,279
Net loan portfolio	7,953,073	7,953,073	Fees and commissions on loan portfolio	0	0
Gross loan portfolio	8,375,810	8,375,810	Financial Revenue from other financial assets	29,221	29,221
(Loan loss Reserve)	422,737	422,737	Other Revenue related to financial services	52,934	52,934
Interest Receivable	0	0	Financial Expense	131,846	1,139,227
Accounts Receivable and other Assets	2,517,799	2,517,799	Financial expense on liabilities	131,846	131,846
Long term financial Assets	0	0	Interest and fess expense on deposits	131,846	131,846
Net Fixed Assets	2,509,669	2,761,372	Interest and fee expense on Borrowings	0	0
Total Assets	16,372,615	16,624,318	Net inflation adjustment expense	0	1,007,381
Demand Deposits	2,448,583	2,448,583	Inflation adjustment expense	0	1,259,084
Voluntary Savings	41,234	41,234	Inflation Adjustment revenue	0	251,703
Compulsory Savings	2,407,349	2,407,349	Subsidized cost-of-funds adjustment expense	0	0
Time Deposits	0	0	Other financial expenses	0	0
Borrowings	0	0	Net financial income	888,588	-118,793
Borrowings at confessional interest rates	0	0	Net loan loss provision expense	125,459	125,459
Borrowings at commercial interest rates	0	0	Loan loss provision expense	125,459	125,459
Interest payable	0	0	Recovery on loans written-off	0	0
Accounts payable and other liabilities	687,939	687,939	operating expense	1,526,015	1,526,015
Total Liabilities	3,136,522	3,136,522	Personnel expense	812,816	812,816
Paid-in-capital	200,000	200,000	Administrative expense	713,199	713,199
Donated equity	17,321,952	17,321,952	Rent and utilities	43,322	43,322
Prior years	17,321,952	17,321,952	Transportation	105,715	105,715
Current year	0	0	Office supplies	40,179	40,179
Retained Earnings	-4,285,859	-5,293,240	Depreciation and amortization	316,691	316,691
Prior years	-3,522,973	-3,522,973	Other administrative expenses	207,292	207,292
Current years	-762,886	-1,770,267	Net operating income	-762,886	-1,770,267
Adjustments	0	1,259,084	Net non-Operating income	0	0
Inflation Adjustment	0	1,259,084	Non-Operating revenue	0	0
Subsidized costs of Funds Adjustment	0	0	Non-Operating expense	0	0
In-kind subsidy Adjustment	0	0	Net income (Before taxes and donations)	-762,886	-1,770,267
Reserves	0	0	Taxes	0	0
Other Equity Accounts	0	0	Net income (after taxes and before donations)	-762,886	-1,770,267
Total Equity	13,236,093	13,487,796	Donations to subsidize financial services)	0	0
Total liabilities and Equity	16,372,615	16,624,318	Net income(after taxes and donations)	-762,886	-1,770,267

## Appendix 6


### Sidama Microfinance Institution Adjusted financial Statements

Financial year		2004			
Currency		Ethiopian Birr			
Balance sheet	Unadjusted accounts	Adjusted Accounts	Income statement	Unadjusted accounts	Adjusted Accounts
Cash and due from banks	3303129.07	3303129.07	Financial Revenue	1307224.49	1307224.49
Reserves from Central Bank	0	0	Financial Revenue from Loan portfolio	1099449.48	1099449.48
Short term financial Assets	2000000	2000000	Interest on loan portfolio	1099449.48	1099449.48
Net loan portfolio	8770837.86	8770837.86	Fees and commissions on loan portfolio	0	0
Gross loan portfolio	9216374.07	9216374.07	Financial Revenue from other financial assets	22828.67	22828.67
(Loan loss Reserve)	445536.21	445536.21	Other Revenue related to financial services	184946.34	184946.34
Interest Receivable	0	0	Financial Expense	106126.26	1115124.26
Accounts Receivable and other Assets	2608197.32	2608197.32	Financial expense on liabilities	106126.26	106126.26
Long term financial Assets	0	0	Interest and fess expense on deposits	106126.26	106126.26
Net Fixed Assets	2197987.64	2423857.64	Interest and fee expense on Borrowings	0	0
Total Assets	18880151.89	19106021.89	Net inflation adjustment expense	0	1008998
Demand Deposits	2906439.80	2906439.80	Inflation adjustment expense	0	1191248
Voluntary Savings	1766.50	1766.50	Inflation Adjustment revenue	0	225870
Compulsory Savings	2904673.30	2904673.30	Subsidized cost-of-funds adjustment expense	0	43620
Time Deposits	0	0	Other financial expenses	0	0
Borrowings	0	0	Net financial income	1201098.23	192100.23
Borrowings at confessional interest rates	2181.000	2181.000	Net loan loss provision expense	22799.29	22799.29
Borrowings at commercial interest rates	0	0	Loan loss provision expense	22799.29	22799.29
Interest payable	0	0	Recovery on loans written-off	0	0
Accounts payable and other liabilities	819712.31	819712.31	operating expense	1444126.92	1444126.92
Total Liabilities	5907152.11	5907152.11	Personnel expense	759026.28	759026.28
Paid-in-capital	200000	200000	Administrative expense	685100.64	685100.64
Donated equity	17324686.87	17324686.87	Rent and utilities	43269.79	43269.79
Prior years	17324686.87	17324686.87	Transportation	0	0
Current year	0	0	Office supplies	29199.41	29199.41
Retained Earnings	-4551687.09	-5560685.09	Depreciation and amortization	311681.60	311681.60
Prior years	-4285859.11	-4285859.11	Other administrative expenses	300949.84	300949.84
Current years	-265827.98	-1274825.98	Net operating income	-265827.98	-1274825.98
Adjustments	0	1234868	Net non-Operating income	0	0
Inflation Adjustment	0	-1191248	Non-Operating revenue	0	0
Subsidized costs of Funds Adjustment	0	43620	Non-Operating expense	0	0
In-kind subsidy Adjustment	0	0	Net income (Before taxes and donations)	-265827.98	-1274825.98
Reserves	0	0	Taxes	0	0
Other Equity Accounts	0	0	Net income (after taxes and before donations)	-265827.98	-1274825.98
Total Equity	12972999.78	13198869.78	Donations to subsidize financial services)	0	0
Total liabilities and Equity	18880151.89	19106021.89	Net income(after taxes and donations)	-265827.98	-1274825.98

### Declaration

I under signed, this thesis is my original work and has not been presented for a degree in any other university and that all sources of material used for the thesis have been duly acknowledge.


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This thesis has been submitted for examination with my approval as university advisor.

Dr. Wolday Ambe  
Name

  
\_\_\_\_\_  
Signature

August 11, 2006  
\_\_\_\_\_  
Date