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Review on Performance of Formal Rural Financial Institutions in Ethiopia

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LIST OF ACRONYMS AND ABBREVIATIONS

AEMFIs	Association of Ethiopian Microfinance Institutions
ACSI	Amhara Credit and Saving Institution
CGAP	Consultant Group Assisting the Poor
DECSI	Dedebit Credit and Saving Institution
GDP	Gross Domestic Product
GNI	Gross National Product
NGO	Non Governmental Organization
OCSSCO	Oromia Credit and Saving S.C
OSS	Operational self sustainability
ROA	Return on Asset
ROE	Return on Investment
SFPI	Specialized Financial and Promotional Institution

Abstruct
The main objective of this paper is to review performance and challenges of rural financial institutions in Ethiopia. Performance of the industry was reviewed in terms of outreach, financial sustainability and welfare impact. The main challenges of the industry were also reviewed. Relevant secondary data for the study were collected from published sources. The total number of active borrowing clients of the microfinance institutions in Ethiopia reached over 2.4 million customers in 2011 whereas the total credit extended by all microfinance institutions amounted to Birr 6.9 billion. Of the total credit granted, the share of the three largest Microfinance institutions is Birr 5.1 billion. Dependency ratio measured by the ratio of donated equity to total capital decline, ratio of retained earnings to total capital is rising letting the industry to be financially self-sufficient. Microfinance programs have improved savings of the respondents through letting access to saving services and increasing household income out of which they can use to save. After joining microfinance programs, mean monthly expenditure of the respondents has significantly increased in food, clothing, housing furniture, health, education, and service items. Limited loan products, absence of legal title of assets in rural areas, less willingness from commercial banks to lend to MFIs without collateral, the less conducive legal environment in enforcing the loan contract, and shortage of logistic in rural areas are the major challenges reviewed.
Keywords: Microfinance, Sustainability, Outreach

1. INTRODUCTION

1.1. Background

Microfinance institutions have evolved since the late 1990s as an economic development tool intended to benefit low income people. Ledgerwood (1999) points out that the goals of microfinance institutions as development organizations are to service the financial needs of unserved or underserved markets as a means of meeting development objectives such as to create employment, reduce poverty, help existing business grow or diversify their activities, empower women or other disadvantaged population groups, and encourage the development of new business. In short, microfinance institutions have been expected to reduce poverty, which is considered as the most important development objective (World Bank, 2000).

The importance of microfinance to contribute to the poverty alleviation was widely recognized from the time when Grameen Bank began providing small loans for groups of women in Bangladesh in 1974 (Khan and Rahaman,2007). Since then, in many developing countries a number of organizations were offering financial services to their clients, including loans, saving plans, insurance and payment transfers (International Trade Center, 2011).

Lack of access to financial services is one of the causes of poverty in Ethiopia. Formal financial institutions are inefficient and inaccessible in providing credit facilities to the poor (Assefa *et al.,* 2005). Thus, developing an alternative mechanism for providing financial services to the poor households became critical. In realizing this, the Ethiopian government has created the legal and regulatory framework for the establishment of microfinance institutions. Although informal credit markets operate widely in rural areas of Ethiopia, moneylenders typically charge very high interest rates, inhibiting the rural poor from investing in productive income generating activities. Thus, failure of the formal financial institutions to fulfill the financial needs of the rural poor, on the one hand, and inadequacy and exploitative or costly nature of informal credit sources on the other, led to the establishment of specialized financial institutions known as MFIs with the purpose of extending micro-credit to the rural and urban poor. Accordingly proclamation No. 40/1996 was enacted to provide for the licensing and supervision of the business of micro financing by empowering the NBE to license and supervise them (Fidler and Webster 1996).

Several micro finance institutions (MFIs) have established and have been operating towards resolving the credit access problem of the poor particularly to those participates in the petty business in the country. Interventions through the delivery of microfinance services have been considered as one of the policy instruments of the government to enable rural and urban poor increase output and productivity, technology adoption, improve input supply, increase income, reduce poverty and attain food security. The establishment of sustainable microfinance institution that reach a large number of rural and urban poor who are not served by the conventional financial institutions, such as the commercial banks, has been a prime component of the new development strategy of Ethiopia (Amha, 2000). For sustainable poverty alleviation, the microfinance institutions themselves should be profitable and sustainable.

The main objective of almost all microfinance institutions in Ethiopia is to deliver financial services to the poor. Microfinance became one of the important tools of reaching the poor who had very limited access to the formal financial sector. The provision of financial services to the poor has increased through microfinance institutions in a short period of time in Ethiopia (Wolday, 2003). However, Ethiopian microfinance institutions are faced with many problems. Some of these are low outreach, limited funding alternatives, limited financial products, lack of research to understand client needs and weak internal control system (Wolday, 2001).

It is mostly argued that MFIs could not sustain for long without the back funding of donors, federal government, regional government or others. So to this end, review of MFIs performance particularly answering if they are financially and operationally sustainable would be significant. Therefore, this Paper attempts to review outreach and financial performance of rural financial institutions in Ethiopia.

1.2. Objectives of the Review

The general objective of this paper is to review performance of formal rural financial Institutions in Ethiopia.
The specific objectives are:

- To review performance of formal rural financial Institutions in terms of outreach, financial sustainability and welfare impact
- To review challenges faced by these Institutions

2. DISCUSSIONS

2.1. Concept of Microfinance

The definition of Microfinance institutions proposed by some authors and organizations are seemingly different from one another. However the essence of the definition is usually the same in which microfinance refer to the provision of financial services primarily savings and credit to the poor and low income households that don't have access to commercial banks (Arsyad, 2005).

Léger wood (1999), defines it as the provision of financial services (generally saving and credit) to low income clients. Robinson (2001) defines it as small scale financial services primarily credit and saving provided to people who farm or fish or herd who operate small enterprises or microenterprises where goods are produced, recycled, repaired or sold; who provide services; who work for wage and commission; who gain income from renting out small amount of land, vehicles, draft animals, or machinery tools; and other individual and groups at the local level of developing countries both rural and urban area. Microfinance is the provision of financial serves to the poor people with very small business or business projects (Mayou, 2006). Only a small fraction of the world population has access to financial instruments, essentially because commercial banks consider the poor people as unbendable due to their lack of collateral and information asymmetries.

Microfinance is the "provision of a broad range of financial services such as deposits, loans, payment services, money transfers, and insurance to poor and low-income households. In some cases, the microcredit programme involves saving services, but the services are limited to the collection of compulsory deposit amounts from the borrowers to collateralize the loans issued. Borrowers cannot access these compulsory deposits and cannot have voluntary saving accounts in microcredit programmes (World Bank, 2008).

According to Dokulilova *et al*., (2009) microfinance is an effective tool to fight poverty by providing financial services to those who do not have access to or are neglected by the commercial banks and other financial institutions. The poor, having no or very little income, cannot offer any collateral which banks require, have no credit history, banks are too far away to verify and observe their behavior and the loans are generally far too small compared to transaction costs.

2.1.1. Microfinance Activities

As mentioned earlier, microfinance means financial services to those without access to traditional sources of finance. Microfinance is mostly associated with microcredit, but many MFIs also provide other financial services, such as savings and insurance as well. Many organizations employ mandatory savings for their clients as an additional technique to improve their clients' personal economy and the deposits can also play an important role, as a relatively cheap source of funding for the loans (Cull *et al.,* 2009). To be able to facilitate savings and insurance do, however, require specific legal structures, why not all MFIs can offer those services (CGAP, 2011). There is also a large amount of MFIs that facilitates non-financial services, such as business training and health education (Zaman, 1999).

The method for executing the actual lending differs between organizations and globally, but two main approaches have been identified; the individual lending technique and the group-based lending technique. While the individual approach is similar to the traditional way of lending, facilitated through direct interaction between the lender and the borrower, the group-based approach relies upon groups of borrowers that facilitate some of the tasks that are normally carried out by the lender (Gine, 2006). Group-based lending usually implies that the group members have joint liability for repayment or that the other members are not granted to anymore loans if one member fails to repay the loan (Brau & Woller, 2004).

This entails that the borrowers, when forming a group, are concerned with finding reliable group members and thus the group does some of the screening process that are traditionally carried out by the lending institution. According to Hermes and Lensink (2007) group-based lending make up a majority of all microfinance programs and Baydas *et al.,* (1997) has found evidence that non-profit organizations use group-based lending to a greater extent than more business-driven organizations.

The microfinance clientele is diverse but constitutes mainly of self-employed women whom often run home-based businesses. The main reason for targeting women is that they are considered poorer and have less access to credits, why they are utilizing their loans in a sounder manner. As a social side-effect, especially in the developing world where women usually have a lower social standing than men, women are also considered to be empowered in the society and towards their men thanks to the loans (Bredberg and EkS., 2009).

2.2. Performance Indicators of Rural Financial Institutions

Performance of an institution shall be measured from the objectives of the organization angel. Microfinance's goal is to eradicate poverty. In the early days when MFI started they were financed by donor funds that have a poverty eradication goal. Hence the performance of the MFI was measured on how much MFI reach to the poor (outreach) and impact (how far the live of those who get financial services are changing as compared to those who don't get these services). But as the MF industry grows in size, the need for increased financing coupled with unpredictability of donor funds trigger the issue of building a sustainable MFIs that stand on their own leg i.e. MFIs shall start covering their own cost of operation from their program revenues. Sustainability is loosely defined as the ability of a MFI to cover its operating and other costs from generated revenue and provide for profit. It is an indicator which shows how the MFI can run independent (free) of subsidies. This change in emphasis has created a different perspective on the analysis of performance of the MFIs. Today many key plays in the industry use sustainability as one core criteria to evaluate the performance of MFIs besides the outreach and impact measures described earlier (Letenah, 2009).

2.2.1. Outreach

Efforts to extend microfinance services to the people who are underserved by financial institutions are classified as *outreach.* Outreach can be measured in terms of *breadth* number of clients served and volume of services (i.e., total savings on deposit and total outstanding portfolio) or *depth* the socioeconomic level of clients that MFIs reach. Outreach is the hot area in the MF industry among researchers to study whether MF reaches the poorest of the poor who is in need of financial services. There are some studies that show MF doesn't reach the poorest of the poor. Rather they are reaching the marginally poor or non poor. Besides most MFIs have no clear rules and criterion to target the poorest of the poor. This indicates that the MFIs are drifting away from their original mission of reaching and serving the poor (Hishigsuren, 2004).

In order to measure outreach we need to look in to different dimensions. The first is simply the number of persons now served that were previously denied access to formal financial services. Usually these persons will be the poor because they cannot provide the collateral required for accessing formal loans, are perceived as being too risky to serve, and impose high transaction costs on financial institutions because of the small size of their financial activities and transactions (Meyer,2002).

The same author states that women often face greater problems than men in accessing financial services so number of women served is often measured as another criterion.... Although difficult to measure, depth of poverty is a concern because the poorest of the poor face the greatest access problem. Some measure of depth of outreach is needed to evaluate how well MFIs reach the very poor. Finally, the variety of financial services provided is the criterion because it has been shown that the poor demand and their welfare will be improved if efficient and secure savings, insurance, remittance transfer and other services are provided in addition to the loans that are the predominant concern of policy makers.

2.2.2. Financial sustainability

Financial sustainability of microfinance institutions is probably the key dimension of microfinance sustainability. It refers to the ability of MFIs to cover all its costs from its own generated income from operations without depending on external support or financial sustainability is the ability to keep on going towards microfinance objective without continued donor support (Dunford 2003). These definitions center on one point, that is, the ability to depend on self-operation. The definitions also imply the possibility of making profit out of the microfinance operations. Financial sustainability can be measured in two stages namely operational sustainability and financial self-sufficiency. Operational sustainability refers to the ability of the MFI to cover its operational costs from its operating income regardless of whether it is subsidized or not. On the other hand, MFIs are financially self- sufficient when they are able to cover from their own generated income, both operating and financing costs and other form of subsidy valued at market prices (Meyer, 2002).

Historically MF has started operation with donor funds and now the industry has almost aged around 30 years. There is an intense debate on whether MFIs should continue to be donor supported or get relived from donation and stand on their own leg. There are one school of thought which say MF should be sustainable with donor funds (called welfarists) and the others say the MF should generate enough revenue to cover their own costs as donors funds are unpredictable (called institutionsist). Hence the issue of building a sustainable MF industry that can operate without a donor funds is of an empirical enquiry (Basu and Woller, 2004).

MFIs across the world have for long been accused of charging their clients too high interest rates on the loans. While some organizations charge up to 80% interest, the global average in 2008 was approximately 35% (Kneiding and Rosenberg, 2008). In order to determine whether or not this is too high, it is motivated to look into what determines the interest rates. MFIs, just as banks, must use their interest to cover the costs of lending if they are to be sustainable in the long run. CGAP (2011) states that MFIs face three different kinds of costs that must be covered by the interest, the cost of the money lent the cost of defaulted loans and lastly, the transaction cost. While the former two types of costs are proportional to the amount lent, the latter cost is not. As MFIs' loans are much smaller than loans issued by traditional banks, it still takes the same amount of personnel and administration to facilitate a small loan as it does to facilitate a larger one (CGAP, 2011). Consequently, MFIs face a much higher cost per dollar lent than for example a traditional bank; hence they need to charge higher interest rates to cover the costs (Cull *et al.,* 2009).

MFIs should, according to CGAP (2001), however, strive to become more efficient and reduce their transaction costs as much as possible to ensure that the poor are not being exploited by too high interest rates.

2.2.3. Welfare impact

Welfare impacts of the services of MFIs are also argued to be another indicator to evaluate the performance of the institutions. It is to mean that whether the provision of financial service mostly of credit and saving has improved the lives of the poor in terms of economic, social and political indicators of poverty. Using much type of quasi experimental designs the studies about the impact of the microfinance in changing the lives of the poor have shown mixed results (Hishigsuren, 2004). Poverty is viewed as lack of money, lack of adequate food, shelter, education and health and the poor are vulnerable to ill health, economic dislocation and natural disaster. These perspectives of poverty can be used to assess the impact of the MFIs on those who receives the services (Mery, 2002).

Rural financial market facilities the economic growth and rural poverty reduction through smooth financial intermediation. Financial intermediaries help to mobilize funds, channel them from surplus units to the deficit units, create money and smoothen the payment system. The efficient provision of loans, deposits, payments, and insurance service encourages rural entrepreneurship and help to rural economy to grow. Presence of financial services helps to rural economy to grow and reduce the poverty. Access to working capital can substantially accelerate the adaptation of modern agricultural technologies and production and thereby improving the ability of the rural sector to meet the subsistence need of the poor. It also helps to produce the surplus in primary and intermediary products required for urban consumption, export, and avoid environmental degradation (World Bank, 2003).

Inter-American Development Bank (2001) reported that the overall financial sector development can be viewed as an important catalyst for economic growth and development for three reasons. First, financial sector development ensures to accelerate the economic growth thorough efficient intermediation and risk management. Countries with developed financial markets with greater financial depth have high economic growth than the countries with less developed financial markets. Second, lack of adequate financial services hinder the formation of new enterprises and the modernization of existing one. Third, improved financial intermediation could directly reduce vulnerability and alleviate poverty. Microfinance as a tool of rural financial services has clear impact on poverty by positively affecting the household economic development, ensuring Income Generating Activities (IGA), sources of income, reducing vulnerability, housing tenure, enterprise growth.

2.3. Challenges of Micro Finance Institutions

Helsinki (2009) reported that many impediments make rural households to access financial services. In general both the users and providers of financial services face some common obstacles in getting and providing financial services like: High transaction costs: This is due to the underdevelopment of rural infrastructure, inadequate communication and information technology and the remoteness of the local areas. Moreover, small average loans and small saving further compound this problem of higher transaction costs. Higher risks: Credit risk in rural areas is higher since the incomes of the rural households depend and seasonality of agriculture that is being susceptible to natural disasters (such as flood, drought, plant diseases, fluctuating weather). The covariant risk (in prices and yields) is high in the agricultural sector. Rural households mostly depend on one or two sources of income and thereby increasing the risks of financial intermediation. Many households are either entirely lack collateral or do not have the legal title to land. Social Factors: In most developing countries illiteracy rate is higher especially in rural areas. Poorly educated households find it increasingly difficult to assess the credit risk and profitability of loans and savings. On the other hand, financial institutions willing to work in rural areas may lack motivated and trained staffs to work in rural areas. This leads to poor institutional capacity among rural financial institutions especially in developing countries.

Country-level constraints inhibiting rural financial market include unsound macroeconomic management restrictive agricultural or financial policies (particularly interest rate controls) insufficient institutional capacity within rural financial institutions to achieve high levels of outreach in a sustainable manner under developed legal systems, particularly with respect to marketable property inadequate regulation and supervision of financial intermediaries Poor governance, corruption and other political factors (Helsinki 2009).

According to World Bank (2003), the most common factors inhibiting the rural financial markets include: Weak institutional capacity of Rural Microfinance Institutions (MFIs) due to poor governance and operating systems and low skills of management staffs; Low business and financial skills of potential clients especially; Policy constraints on financial and agricultural markets that limit profitability of both RFMIs and their clients; Inadequate physical and financial infrastructure to penetrate rural areas; Dominance of state-owned banks operating on non-commercial principles.

2.4. Ownership Structure of Microfinance Institutions in Ethiopia

Formal commercial banking has been unable to provide access to poor rural and urban Ethiopians that comprise 45% of the overall 82 million populations. These people live below the national poverty line even more they live in absolute poverty not attaining the minimum calorie intake per day and of course are living witnesses of a structural and endemic poverty (AEMFI, 2012). The ownership structure of Ethiopian Micro-Finance Institutions is the direct effect of regulatory provisions (Degefe, 2009). According to the Proclamation No. 40/1996 of the Business of Micro Financing Institutions, micro-financing institution should be owned fully by Ethiopian nationals and/or organizations wholly owned by Ethiopian Nationals and registered under the laws of, and having its head office in, Ethiopia. This legislation excluded international NGOs and other overseas agencies not to own and run microfinance institutions in Ethiopia.

In support of the various regional development plans and to address the social and economic problems of regions, the regional state governments own some shares in Micro finance institutions. Table1below indicates that many regional state governments are involved in the ownership of the micro finance Institutions. As it is indicated in the table Dire Microfinance Institution, Addis Credit and Savings Institution, Harar Microfinance Institution and Omo

Microfinance Institutions are almost owned by the regional state governments. On the other hand, Amhara Credit & Savings Institution, Dedebit Credit & Savings Institution and Oromia Credit & Savings Institution though their major share goes to the Associations and NGOs, the Regional Governments control quarter of the total ownership (Wolday 2008).

According to the same author, although individuals control a minimal proportion of the micro finance institutions, they remain actors in the composition of ownerships structure. Proclamation No. 40/1996 of the Business of Micro Financing Institutions prohibits the involvement of international organizations in the micro-financing business. However, many local NGOs are shareholders in many of the MFIs. After the microfinance law of 1996, NGOs (which used to have micro-credit programs) established MFIs by being shareholders and gave nominal shares to individuals working in the mother NGO and affiliated institutions. The mother NGOs have been providing capital, expertise and technical support to these MFIs.

Table 1 : Ownership structure of microfinance institutions in Ethiopia

Micro finance institutions	Regional Government (%)	Associations and NGOs (%)	Individuals
Amhara Credit & Savings Institution	25	75	-
Dedebit Credit & Savings Institution	25	75	-
Oromia Credit & Savings Institution	25	70	5
Omo Microfinance Institution	80	19.5	0.5
Addis Credit and Savings Institution	96.7	3.3	-
Dire Microfinance Institution	97	2.5	0.5
Benishangul Microfinance Institution	40	60	-
Harar Microfinance Institution	96.6	3.3	0.1

Source: National Bank of Ethiopia, 2011

2.5. Client Outreach Performance of Microfinance Industry in Ethiopia

Almost all microfinance institutions aim ultimately at expanding the number of clients being served. One measure of outreach is the number of active clients served. The number of active client includes borrowers, depositors and other clients who are currently accessing any financial service (Rosenberg, 2009). Since the first Proclamation of 1996 that gave the legal background for the operation of the micro-financing business, the industry has witnessed a major boom .Today, there are 31 MFIs registered with the National Bank of Ethiopia serving clients. The Ethiopian microfinance market is dominated by a few large MFIs, all of which are linked to regional state government ownership. The three largest institutions account for 65% of the market share in terms of borrowing clients, and 74% by loan provision. These are Amhara (ACSI), Dedebit (DECSI) and Oromia (OCSSCO) Credit and Savings Institutions (Deribe *et al*., 2013).

The same study indicates that total number of active borrowing clients of the microfinance institutions in Ethiopia reached over 2.4 million customers in 2011 whereas the total credit extended by all microfinance institutions amounted to Birr 6.9 billion. Of the total credit granted, the share of the three largest Microfinance institutions is Birr 5.1 billion. The market shares based on the number of borrowing clients are 28.1, 16.1 and 20.4% for Amhara Credit and Saving Inst (ACSI), Dedebit Credit and Savings Inst (DECSI) and Oromia Credit and Savings (OCSSCO), respectively.

Kereta (2007) studied outreach and financial performance of Ethiopian Microfinance institution using simple descriptive analysis and percentage growth rates. The result of his study showed that in terms of breadth of outreach, MFIs are serving an increasing number of clients in each year from 2003-2007. The industry's growth rate in terms of number of clients is 22.9%. In terms of depth of outreach measured by average loan size Ethiopian MFIs have a loan size which is on average nearer to the standard $150. So they can be considered pro-poor. However he indicated that the MFIs reach to the disadvantages particularly to the poor is limited (38.4%).

According to Letenah (2009) all MFIs in Ethiopia have low average loan size. So it seems that Ethiopian MFIs are good at depth of outreach. This is probably because Ethiopia is so poor that it extends very meager loans as compared to many countries. The small absolute size of the loans doesn't make Ethiopian MFIs to be better performers in reaching the poor rather we have to use a good measure for cross country comparison. On this measure it is found that all MFIs are poor performers as they extend larger loans than the MBB benchmark.

This indicates that on depth of outreach parameter Ethiopian MFIs are poor performers with respect to average loan size per GNI per capita as they are not reaching the poorest. The percentage of women borrowers served also triggers this.Ethiopian microfinance has made remarkable progress over the past decade, reaching almost two million clients in a country of 77 million people. Nevertheless, financial services for the low-income population, poor farmers and MSEs are still characterized by limited outreach, high transaction costs for clients, a generally weak institutional base, weak governance and a nominal ownership structure as well as dependence on government and mother NGOs (Pfister *et al*., 2008).

Ethiopian MFIs did better than their African counterpart, as the average number of active borrower per MFI is five times higher than an African MFI. Average number of savers, deposit and loan balances per MFI are also significantly higher for Ethiopian MFIs than that of Africa. However, women are significantly underrepresented in the Ethiopian case, as they constitute only 30% of the active loans clients against 65% of their African peers. With regard to the financial structure, Ethiopian MFIs are highly debt ridden compared to their African counterpart, as the average debt-equity ratio is 81% for Ethiopia compared with 1.5% for Africa. However, the ratio of commercial funding for the Ethiopian MFIs is only 7% against 46.4% for Africa, suggesting that Ethiopian MFIs rely mostly on low cost donors funds compared to their African counterpart. Average loan per borrower is also lower for Ethiopia than that of Africa, perhaps because Ethiopian MFIs tend to concentrate more on the very poor (Getachew and Yishak, 2006).

Amhara Credit and Saving Institution (ACSI) which is the largest microfinance Institution in the country, has served more than half a million clients. Over 1.6 million loans have been disbursed worth Birr 1.5 billion. By 2005, the institution was operationally and financially self sufficient. ACSI is among a few MFIs that is able to achieve the highest efficiency at the lowest cost per borrower. The operating cost was as low as five cents in 2005. ACSI also has a high portfolio quality, as delinquency rates are around 1.9% (Kidane, 2007). Study on performance and sustainability of microfinance institutions in Ethiopia with reference to Amhara Credit and Saving Institution has been conducted by Tilahun and Dereje in 2012. The result of the study reveals that ACSI's outreach is increasing from year to year.

In the year 2004, ACSI was able to serve about 350,000 borrowers. In four years time (2004 to 2008), the number of borrowers served increased to more than double. This shows that ACSI has shown a remarkable growth in terms of outreach, particularly in the number of active borrowers. However, the number of active borrowers declined in the year 2009 by 4.37 percent from the preceding year (2008). The non-earning liquid assets as a percentage of total assets increased from 7.43% in 2008 to 18.29% in 2009. It seems that there was a change in loan provision direction of ACSI from increasing number of outreach to quality to reduce the risk of default.

Study on outreach and Financial Performance of Microfinance Institutions in Ethiopia by Befekadu (2007) indicates that the number of clients being served by MFIs has been noted in literatures as core performance indicator for a given MFIs. To this end, the study's finding to Ethiopian case is hopeful. Number of active clients of the individual MFIs and at the industry level is surging as individual MFI's outreach has shown increment over the period of the study with different rates of growth, leading the industry's outreach to rise in the period from 2003 to 2007 on average by 22.9 percent.

2.6. Sustainability of Microfinance industry in Ethiopia

Sustainability is loosely defined as the ability of a MFI to cover its operating and other costs from generated revenue and provide for profit. It is an indicator which shows how the MFI can run independent (free) of subsidies. This change in emphasis has created a different perspective on the analysis of performance of the MFIs. Today many key plays in the industry use sustainability as one core criteria to evaluate the performance of MFIs besides the outreach and impact measures (Letenah, 2009).

Operational sustainability examination, as component of financial sustainability measurement, revealed that Ethiopian MFIs are operationally sustainable measured by return on asset and return on equity. It is identified also that the industry's profit performance is also improving over time. The reduction in dependency ratio over the years in the MF industry is also another indication that MFIs can be self-sustainable, profitable, and meet their social missions. Dependency ratio measured by the ratio of donated equity to total capital decline, ratio of retained earnings to total capital is rising letting the industry to be financially self-sufficient. While dependency ratio reduces from 63 percent in 2001 to 31 percent in 2007, retained earnings to total capital ratio went up to 16.3 percent in 2007 from -2.5 percent in 2001.

Similarly, financing loan through donated capital has also shown reduction over the years from 42.5 percent in 2001to 11.1 percent in 2007 (Kereta, 2007). The same author reported that provision of different kind of product by MFIs is also noted as performance indicator. Although all MFIs in the country focus on loan provision and saving product, few also provide micro insurance, leasing, pension, money transfer and consultancy. They provide credit to all kind of business on both individual and group loans basis. Concerning client screening mechanisms to identify credit worthiness of the borrowers, his study indicates that the institutions use various mechanisms to select their clients. Some of these mechanisms are: client self selection mechanism, type of business, income of the client during the last three years, gender, credibility in the community, age (active age group), permanent residence, character assessment, etc. Similarly, it is well articulated that less default rate is critical for financial sustainability. Concerning this matter, the study finds from the representative sample MFIs that the default rate is very low for most but it is showing steady growth. For instance, in one microfinance in period 2001 and 2002 it was 0% but in 2003, 2004 and 2005 it steadily grow to 6.9%, 3.2% and 7.6% respectively.

Similarly, in another Microfinance the default rate has increase on average from 2001(default rate of 2%) to 2005(default rate of 5%) by 39%. For now, this low default rate is encouraging to support the financial sustainability of the institutions. Yet, the growth trend of the default rate might endanger their financial sustainability.

Ethiopian MFIs are operationally sustainable as measured by ROA and ROE and the industry's profit performance is improving overtime. Dependency ratio as measured by the ratio of donated equity to capital decline and the ratio of retained earnings to total capital is rising letting the industry to be financially self sufficient. MFIs in Ethiopia charge low interest rates and hence they all have low financial revenue ratio. Interest rates have positive and negative effect for the twin goals of sustainability and outreach that MFIs have to balance for. But they are poor performers on depth of outreach and their sustainability seems to go hand in hand with their size. So still it seems that they have to lower down their interest rates even further to reach more poor as they will secure their sustainability from economies of scale and size effect rather than from charging high rates from the upper end of the market.

Study by Haileselassie (2005) on financial sustainability of microfinance institutions by taking a case study of SFPI and PEACE revealed that outreach, financial self-sustainability and institutional building are the main indicators of microfinance performance. His findings indicated that MFI's have achieved extensive outreach in providing financial services to the urban and rural poor. Saving mobilization was significantly increased and at the same time repayment rate was very high in both institutions (98 percent and 99.6 percent of SFPI and PEACE respectively). The trend of financial performance showed that there is a good and steady progress towards reaching operational self-sufficiency. But both institutions are still subsidized. It is possible to say that the performance of the institution affects the impact of the intervention in poverty reduction.

According to Getachew and Yishak (2006) in terms of financial self-sufficiency, Ethiopian MFIs are also worse than their African counterpart. The adjusted return on assets and equity suggest that like their African peers, the MFIs in Ethiopia are not operationally and financially self-sufficient, but tend to be worse than the average for Africa when the magnitude of the loss is considered. Ethiopian MFIs, on average, tend to charge a lower lending rate on their loan clients compared with their African peers, which may have negative implication on their operational performance although outreach expansion requires lower lending rate. On efficiency grounds, Ethiopian MFIs tend to reach out more clients at lower costs than their African peer. The loan quality of the MFIs in Ethiopia generally looks good, though slightly worse than that of the average for Africa.

2.7. Welfare Impact of Microfinance in Ethiopia

In spite of methodological difficulties involved in measuring the impact of credit, studies have demonstrated that the availability of credit for micro-enterprises can have positive effects on income. A study by the government, NGOs, and banks involved in providing financial services for poor household that had received credit were compared with households, which had not. The results demonstrated that credit provision could enable household incomes to rise (Susan and Rogaly, 1997). If credit were found to be adequate and productive, it would enable optimum use of resources and fuller application of improved technology.

Farmers must spend additional sums of money on improved seeds, fertilizers, and farm implements to increase their agricultural productivity. However, a study Heidhwes (1995) have observed, because of low level of real income small farmers in particular cannot undertake such investments without external credit support. Their studies have asserted that such farmers do not have sufficient capital to invest. Although a detail or comprehensive study research has yet to establish whether the delivery of financial services to the poor through the MFIs actually eliminated or reduced poverty, the results of the few case studies have clearly indicated that access to finance did indeed reduce poverty. Meehan (2001), in her case study of DECSI, reveals that overall credit provision had a significant impact on increasing agricultural production through build-up of production assets, particularly draught oxen, and increasing the amount of land formed by clients who were able to retrieve land previously rented out and farm it themselves, and clients who were able to get more land through rent. Trading activities engaged in by clients also increased in scale. Female clients were particularly able to take on trading activities, which had previously been inaccessible, to them due to lack of capital. The increased income generated by the credit input had a possible impact primarily on household food supply, and on educational provision for children as well as clothing and other basic necessities.

Study by Decon (2000) on the impact of Gasha Micro finance Institution also reveals that only those clients who had used the loan on productive activities have increased their income to some extent. His study further reveals that there were signs of consumption, poverty reduction and rapid improvement in primary enrolment rates in rural Ethiopia. The results also suggest improvement in primary health care delivery. Another study by Getaneh (2001) reveals that the financial services of ACSI has increased income and improved food security of clients. Access to finance in the rural area has improved access to education and health services. The clients reported that they were that they were better off after obtaining the financial services ACSI provided. Credit to small farmers increases their productivity and improves their standard of living.

Bisirat (2011) has conducted study on role of Microfinance in alleviating urban poverty in Jimma town of Ethiopia. His study indicates that microfinance programs have increased the income of households of the respondent clients i.e. in terms of both nominal and real income. The employment opportunities created following microfinance use of clients is encouraging, though mostly in the form of self-employment and family-employment.

Microfinance programs have improved savings of the respondents through letting access to saving services and increasing household income out of which they can use to save. After joining microfinance programs, mean monthly expenditure of the respondents has significantly increased in food, clothing, housing furniture, health, education, and service items. Women respondents have increased their individual income by the amount men respondents increased their individual income.

Padma and Getachew (2005) conducted a study on women economic empowerment and microfinance in Awassa. The finding revealed that 83 percent of respondents reported that credit was a very supporting tool to their business. The majority of clients built up some additional rooms for the purpose of living and business. They have better asset ownership, better educational expense and participation in decision-making. There is a positive influence of microfinance in asset formation, increasing income and employment generation, in business improvements, and increasing decision-making process.

Meehan (1999) in her study on the impact of credit provision by DESCI in Tigray region revealed that the majority of respondents (85 percent) reported that an initial increase in households' income due to credit services. But it has fallen to 52 percent after five years. The incremental income is mainly used for basic household food supply, clothing and education of children 80 percent, 60 percent and 40 percent respectively. The provision of credit in response to demand and the impact of credit access and usage has resulted in increasing household income and decreasing poverty levels in the study area is depend on continued access to credit. She also, concluded that the expansion of business opportunities and strategic planning for clients' economic activities could contribute to the scale and sustainability of the impact of loans on poverty levels.

Another impact study on SFPI conducted by Jimbed consult P.L.C (2001) concluded that at the individual level personal income and savings have shown improvements. Additionally household income and welfare has been increased. It can be evidenced by the study that most of school aged children are in school and there is an improvement in household diet as a result of the microfinance services of SFPI. The microfinance intervention has also an impact at the enterprise level by enterprise expansion, addition of new products, improving quality of products, improving management skills, and cost reduction. However, improvements in net worth have been insignificant. Most of the improvements observed are achieved over a short period than long period. The study also confirmed that most of one-year and two-year clients have better improvements than third-year respondents. In general the study concluded that SFPI's credit program has positive impacts on its target clients.

Likewise, Asmelash (2003) indicated that the overall household income of frequent clients has increased than the overall household income of the new clients in both urban and rural areas in 12 months. The result suggested that DECSI has a positive impact on diversification of income sources for clients. The frequent borrowers have a better housing condition and increased asset ownership, improved ability to pay educational and medical expenses than non-participants. In the same token frequent borrowers have better diet improvement, job opportunity creation and participation in decision- making (empowerment) than the non-participants. Similar conclusion has made in micro-credit income diversification case study in central Tigray conducted by Tassew (2005). In general the findings revealed that microfinance intervention has a positive impact on the livelihoods of the households. Thus, it has an impact in poverty reduction.

Borchgrevilk *et al*., (2005) conducted a study on the impact of credit on marginalized groups such as young households, rural landless households, and urban house-renting households by taking a case study of DECSI in Tigray regional state. The study targeted more on extremely marginalized groups of female-headed households. They concluded that DECSI's program has a positive impact on the livelihoods on its clients compared to non-clients. The clients have greater improvements in terms of their assets, income, consumption, food security, less vulnerability to shocks, and social and political empowerments.

Padma and Getachew (2005) conducted a study on women economic empowerment and microfinance by reviewing Awassa women clients. The finding revealed that 83 percent of respondents reported that credit was a very supporting tool to their business. The majority of clients built up some additional rooms for the purpose of living and business. They have better asset ownership, better educational expense and participation in decision-making. There is a positive influence of microfinance in asset formation, increasing income and employment generation, in business improvements, and increasing decision-making process.

Generally, credit removes the financial constraint to production and helps to accelerate the adoption of new technologies, increase productivity, and improve national and personal incomes. In addition, it constitutes an integral part of the process of commercialization of the rural economy and a convenient means of addressing rural poverty (MoA, 1995).

2.8. Challenges of MFIs in Ethiopia

One of the obvious challenges of the MFIs in Ethiopia and indeed elsewhere in the world is the question of financial sustainability. The stated mission of the MFIs is to expand their outreach and their impact is partly evaluated by the number of their clients on the one hand, and on their capacity to manage their operating cost on the other. The fact that the MFIs are dealing with clients with low-income base would mean that the outreach objective could not be achieved at the desired speed without compromising self-sustainability. MFIs may desire to set a high lending rate to cover their high operating cost so that they would be able to earn a certain level of profit margin. But given their client are poor, and the activities they carry out may not be profitable at a lending rate high enough to generate profit to the MFIs, the need to set a high lending rate would be diluted (Getachew and Yishak , 2006).

Another challenge is the fact that deposit mobilized from the MFIs target group is rather weak: only a third of the fund lent out by MFIs is covered from internally mobilized funds. Nearly half of the loans have to be funded from other sources including NGOs, IFAD and other donors, which is unsustainable. Obviously deposit mobilization from low-income group to the extent of covering the credit needs would continue to be a difficult task. The culture of saving itself is also generally perceived to be low though improving. The MFIs' saving is normally small and variable because their cash flow varies due to seasonality and crop price variations (Nur 2004).

Loan repayment rate for nearly all the MFIs operating in Ethiopia is generally high. However, loans repayment and deposit mobilization of MFIs clients could potentially be hamstrung by recurrent droughts, and product prices shocks that often swing depending on the level of harvest and developments in the international market. These factors also discourage the whole purpose of credit taking on the part of the client as farmers would still be expected to repay despite crop failures. Rescheduling does not also provide a sufficient relief as the overall indebtedness increases, further discouraging clients from taking loans even during good rain years (Getachew and Yishak, 2006).

Group lending, which is becoming less popular among the client, could also turn against the MFIs main objectives of expanding outreach because group members and the community level credit and saving committee tend to exclude individuals with limited asset and perceived to be of high risk, but able to generate income. The committee does not want to take responsibility for approving loans it perceived to be risky, while group members do not admit "unreliable" member because of the joint liability involved. An important group of people would therefore be outside the purview of the MFIs. The group lending is also less popular on another ground. As part of the task of monitoring the loan, group members are expected to attend regular meetings, which are felt by the group members as time taking (Assefa *et al.,* 2005).

Particularly, the screening process of clients has also noted as challenging area. Lack of adequate information about the client's financial management and absence of recorded evidence is the main challenge. This makes the MFIs to rely on fellow group member's oral information. Additionally, problem of certifying the real ownership of business, problem of clients to target on profitable business, and sometimes lack of understanding of clients about the operation of the institutions, are the challenges. The selection of group members itself is another time consuming task, suggesting that accessibility to MFIs loans though better than formal loans have not been as simple as that of the informal money markets (Bezabih *et al*., 2005).

The same author indicated the following as a major challenges of MFIs: Many donors are not keen about MFI and reluctant to fund; less saving habit; limited loan products; absence of legal title of assets in rural areas; and easy dissemination of bad mouthing (some clients are not visionary; they obt for immediate benefits in illegal way). Less willingness from commercial banks to lend to MFIs without collateral; the legal environment is not conducive enough in enforcing the loan contract; shortage of experienced human resources and shortage of logistic in rural areas such as road, telephone etc.

3. CONCLUSION AND RECOMMENDATIONS

3.1. Conclusion

The paper reviews the performance of MFIs in relation to outreach and financial sustainability. It reviews literatures on core performance indicators of MFIs. The literatures noted that MFIs could be examined through three main polar: outreach to the poor, financial sustainability and welfare impact. From the outreach angle, it is found that individual MFI's outreach has shown increment with different rates of growth, leading the industry's outreach to rise on average by 22.9 percent. It is also identified that while MFIs reach the very poor, their reach to the disadvantages particularly to women is limited 38.4%.

From financial sustainability angle, it is found that MFIs in Ethiopia are hopeful. They are operationally sustainable measured by return on asset and return on equity and the industry's profit performance is also improving over time. While, dependency ratio measured by the ratio of donated equity to total capital decline, ratio of retained earnings to total capital is raising letting the industry to be financial self-sufficient. Using non performing Loan (NPLs) to loan outstanding ratio indicator the study found out that MFI financial sustainability is in a comfort zone with average NPLs ratio of 3.2%.

The microfinance programs have increased the income of clients. i.e. in terms of both nominal and real income. The employment opportunities created following microfinance use of clients is encouraging, though mostly in the form of self-employment and family-employment. Microfinance programs have improved savings of households through letting access to saving services and increasing household income out of which they can use to save. After joining microfinance programs, mean monthly expenditure of the clients has significantly increased in food, clothing, housing furniture, health, education, and service items. Women respondents have increased their individual income by the amount men respondents increased their individual income.

In general, the review has also identified various challenges that constrain MFIs from efficient operations. The stated mission of the MFIs is to expand their outreach and their impact is partly evaluated by the number of their clients on the one hand, and on their capacity to manage their operating cost on the other. The fact that the MFIs are dealing with clients with low-income base would mean that the outreach objective could not be achieved at the desired speed without compromising self-sustainability. MFIs may desire to set a high lending rate to cover their high operating cost so that they would be able to earn a certain level of profit margin. But given their client are poor, and the activities they carry out may not be profitable at a lending rate high enough to generate profit to the MFIs, the need to set a high lending rate would be diluted.

3.2. Recommendation

As women access to microfinance services is still minimal, women access to microcredit and saving should be strengthened. Policy makers have to design effective rules and regulations for contract enforcement and the implementation should be followed strictly. The review also indicates limited loan products. Therefore microfinance Institutions are supposed to diversify their loan products. National Bank of Ethiopia or any government concerned authority should nurture small MFIs by building their capacity, may be by establishing a fund raising unit for loan able capital, appropriate screening mechanism should be sought. Strict follow up and capacity building of both clients and credit officers should be organized. Market infrastructures like rural road construction and exertion of information technology need to be fulfilled in order to make rural communities to be benefitted from microfinance industry.

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