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Microfinance and Poverty Alleviation in Ethiopia

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Contents

Acronyms

AEMFI	Association of Ethiopian Microfinance Institutions
DFID	UK's Department for International Development
ESRC	UK's Economic and Social Science Research Council
EI	Expert interview
FCA	Federal Cooperative Agency
GTP	Growth Transformation Plan
ICA	International Cooperative Alliance
MFI	Microfinance Institution
MSE	Micro and Small Enterprises
NGO	Non-governmental Organisation
NBE	National Bank of Ethiopia
SACCO	Savings and Credit Cooperative
VAT	Value Added Tax
VESA	Village Economic and Social Association
VSLA	Village Saving and Loan Association

1. Introduction

1.1 The Study

This report outlines findings from a study of access to finance and microfinance regulation in Ethiopia. The research examines the challenges faced by micro-enterprises and informal-economy businesses working in growth sectors of the economy, and their requirements for strengthening access to finance and consumer protection.

The study, *Inclusive Growth: Improving Microfinance Regulation to Support Growth and Innovation in Micro-enterprise,* is one of a series of projects funded under DEGRP (DFID-ESRC[1] Growth Research Programme) focussing on three themes of financial sector development, agriculture and growth, and innovation and productivity. The report starts with a literature review on microfinance in Ethiopia and then discusses survey findings and policy recommendations.

1.2 Objectives

This research examines the link between microfinance and urban livelihoods, exploring the challenges of access to finance for micro-enterprises, the vulnerabilities caused by unscrupulous lending practices, and the potential for improved financial access to contribute to poverty reduction and economic growth.

Since 1983 when the Grameen Bank in Bangladesh began making tiny loans to village savings groups, microfinance has emerged as a key tool of development policy based on the assumption that improved access to finance will trigger entrepreneurship and smooth shocks. Microfinance is now a major supplier of financial services to millions of people in the developing world. Yet concerns have emerged about its reach, regulation and oversight, application in urban areas, and impact on growth, poverty reduction and indebtedness.

Research on the impact of micro-credit and microfinance on poverty is inconclusive, and there is an imperative need to examine further the conditions in which savings and micro-credit help or harm low-income households. For example van Rooyen *et al* (2010 and 2012) concluded that microfinance may make some people poorer, not richer, and the focus on reaching the poorest-of-the-poor may be flawed.

Against this background, the project analyses the barriers, benefits and risks to micro-enterprises in accessing a range of financial services and the potential of improved consumer protection to address problems. It explores demand and supply-side opportunities and barriers influencing micro-enterprises' access to finance, and potential alternatives, particularly in urban settings. The philosophy of the research is that, while microfinance is not a guaranteed route out of poverty, micro-enterprises and informal-economy businesses should have access to secure savings and borrowings with transparent costs, and without excessive interest rates or time burdens.

1.3 Approach

The study is based on comparative research in four countries of East Africa: Tanzania, Rwanda, Kenya and Ethiopia, and a comparison with India's more developed financial system, with a focus on major cities and secondary towns and on micro-enterprises in growth sectors of the economy – vending, construction, tourism, manufacturing and services. The findings in Ethiopia draw on 201 semi-structured interviews with micro-enterprises in Addis Ababa and Hawassa and expert interviews (EIs) with regulators, microfinance providers/promoters and solidarity savings groups.

[1] DFID = Department for International Development (UK Aid); ESRC= the UK's Economic and Social Science Research Council

2. Micro-credit Landscape in Ethiopia

2.1 Microfinance Providers

Microfinance provides a small but significant and expanding role in Ethiopia's developing finance sector. According to the National Bank of Ethiopia (NBE 2015a) the number of banks operating in the country reached 19 in December 2014, of which 16 are privately owned. The banks operated 2,502 branches, equating to a branch/population ratio of 1:35,957. Some 35% of all bank branches are located in Addis Ababa. The total capital in the banking system increased by 21% between 2013 and 2014, reaching Birr 30.2 billion[2].

There were 17 insurance companies operating in Ethiopia, of which 16 were privately owned. Of the 359 insurance company branches 53% were located in Addis Ababa. The total capital of the insurance industry was Birr 30.2 billion.

There were 32 microfinance institutions (MFIs) operating in the country, all of which are deposit taking. These MFIs mobilized a total saving deposit of around Birr 13.0 billion. The five largest MFIs are regional institutions supported by the government (Amhara, Dedebit, Oromia, Omo and Addis Credit and Savings Institutes) which accounted for 93.6% of the savings and 90% of the credit of the MFI sector.

A wide variety of organisations provide micro-savings and micro-credit services and these are categorised into three sub-sectors (discussed further in Sections 2.4–2.9 below):

Informal

- Informal providers (eg: money lenders, friends/relatives, *Iddir*, *Iqqub (Ekub)*, and *Meskel Aksiyon*);
- Community savings groups (VESAs *[previously VSLAs]* and Savings Groups);

Semi-formal

- Savings and Credit Cooperative Societies (SACCOs);

Formal

- Microfinance Institutions (MFIs)
- Formal banks

Meanwhile there has been very limited development of mobile money, in contrast to experiences in many other countries in the region. The number of mobile subscribers is growing rapidly and reached 28.3 million in 2013/14, suggesting there is a clear market. Expert interviews (EIs) suggest that this area is currently being developed, but poor reliability of the mobile phone network may hamper progress.

The Association of Ethiopian Microfinance Institutions (AEMFI) has been the network for all registered MFIs in Ethiopia since it began in 1999. According to MFTransparency (2011) AEMFI is well regarded both nationally and internationally as one of the strongest microfinance networks in Africa. AEMFI provides a forum through which MFIs can exchange information as well as providing training and conducting research, advocacy and policy development activities.

Unlike many of the other countries examined in this study, particularly Kenya and Tanzania, international donors do not appear to play an influential advocacy role, largely because law prohibits NGOs and any other institution from offering financial services.

[2] USD 1 = ETB 20.58 (US dollars to Ethiopian Birr, March 2015)

2.2 Microfinance Regulation and Policy

The Ethiopian economy and financial policy has evolved through three major phases: an initial focus on state-led industrial and agricultural development; an emphasis since 1991 on market-led development through liberalisation, and since the mid-1990s a focus on financial inclusion and promotion of micro-enterprise (Zwedu 2015).

Job-creation through the development of micro- and small-scale enterprise is a key area of government policy. The 5-year poverty strategy reduction paper, the *2005/06-2009/10 Plan for Accelerated and Sustained Development to End Poverty* (PASDEP) included a target to create 1.5 million jobs through promotion of micro- and small enterprise, with substantial support for credit, training, technology and information. The 2011 *Micro and Small Enterprise Development Strategy: provision framework and methods of implementation* set out the implementation framework (GoFDRE 2011) and the current *2010/11-2014/15 Growth and Transformation Plan* (GTP) envisages 3 million more jobs will be created in MSEs; during 2013/14 some 200,319 new micro and small enterprises (MSEs) employing 2.5 million people were established (MoFED 2011: 10).

The primary legislation affecting MFIs is listed below:

- *Licensing and Supervision of Banking Business Proclamation No. 84/1994.*
- *Licensing and Supervision of Micro Financing Institutions Proclamation No. 40/1996.*
- *Cooperative Societies Proclamation No. 147/1998.*
- *Banking Business Proclamation No. 592/2008.*
- *Micro Financing Business Proclamation No. 626/2009.*
- *National Payment System Proclamation No. 718/2011.*

Microfinance institutions

Microfinance was first established in Ethiopia in the late 1980s, with a range of NGO and government micro-credit programmes. However, these were not seen as well-organised or capable of operating on a continuous and sustainable basis (Wolday 2012). Major criticism included the heavily subsidised nature of many NGO programmes, with low interest rates for credit, high rates of default, and lack of saving products. In response, the Government introduced legislation regarding the licensing and supervision of banking businesses (*Proclamation No. 84/1994*) which allowed the establishment of private financial institutions, thus breaking the state monopoly in the banking sector (Gobezie 2005). Shortly after, the first microfinance law was passed (*Proclamation No. 40/1996*) with the aim of protecting small depositors, ensuring stability, and promoting the efficient performance of MFIs (Fite 2013). Moreover, it brought all MFIs into the monetary and financial system, enabling deposit taking while placing the National Bank of Ethiopia (NBE) in charge of regulation and supervision.

The NBE supervises MFIs, which report their statistics to the bank for risk-based supervision. *Proclamation No. 40/1996* also required that Ethiopian microfinance institutions should be owned fully by Ethiopian nationals and/or organisations wholly owned by Ethiopian Nationals, thus excluding international NGOs and other overseas agencies from owning and running microfinance institutions in Ethiopia (Deribie *et al* 2013). The 1996 statute dictated that loans should to be delivered to clients using the group-loan methodology, without the requirement for property collateral. Until 2009, *Proclamation No. 40/1996*, with NBE directives, constituted the major legal and regulatory framework used to regulate and supervise the microfinance sector in Ethiopia.

Proclamation No. 40/1996 was replaced by *Proclamation No. 626/2009*, which addresses institutional financial discipline, prudent lending and transparency (Wolday 2012). The proclamation prohibits the operation of microfinance businesses without a license from the NBE, however banks licensed under the appropriate law do not need a separate micro-financing business license (Deribie *et al* 2013). The 2009 proclamation states that the main purpose of a micro-financing institution is to collect deposits and extend credit to rural and urban farmers and people engaged in other similar activities as well as micro- and small scale rural and urban entrepreneurs, the maximum amount to be determined by the NBE (Deribie *et al* 2013).

Changes in 2009 permitted the loan methodology used by MFIs to be selected at their discretion – moving away from mandatory group-lending. The NBE determined that the maximum loan size for MFIs whose savings fell below Birr 1,000,000 was Birr 5,000. For MFIs whose savings portfolio exceeded Birr 1,000,000 the maximum loan size was unrestricted, but loans over Birr 5,000 should not surpass 20% of total loans. *Directive MFI/17/2002* sets the maximum loan period to 24 months for loans of up to Birr 5,000 and 60 months for larger loans, albeit changes are to loan lengths are frequently under discussion (EI). The NBE has imposed the limits in an attempt to dissuade MFIs from drifting from their poverty alleviation mission (MF Transparency 2011).

Banking business laws applicable to MFIs, including requirements for obtaining a bank license, and matters not covered by *Proclamation No. 626/2009,* are contained in *Proclamation No. 529/2008*. Other relevant primary legislation includes *Proclamation No. 718/2011*, which focuses on the regulation of the national payment system, including the “sending, receiving and processing of orders of payment or transfers of money” (*Proclamation No.718/2011*) by a bank or MFI.

Other savings and credit mechanisms

Savings and Credit Cooperatives (SACCOs) were initially licensed and supervised by the NBE (*Proclamation No. 84/1994*). However, since the issue of *Proclamation No. 147/1998*, there has been a separate authority for cooperatives, including SACCOs, which is now called the Federal Cooperative Agency (FCA). *Proclamation No 147/98* incorporated all the International Cooperative Alliance (ICA) principles and the standard legal aspects of cooperatives. It was amended by *Proclamation No. 402/2004*, which focuses on the issues of interest rates and the promotion of higher forms of cooperatives.

Traditional self-help associations, such as *Iddir* and *Iqqub* are self-regulated.

There is also a *Remittance Directive* (BUCFLP 2015) which has three primary aims: 1] to improve the operations of the formal remittance service; 2] to reduce the costs of remittance transfer; 3] to increase access to international remittance services for Nationals and make the service reliable, fast and safe.

Key regulatory challenges

A review of key literature suggests there are three key challenges relating to the regulation of the microfinance sector:

- The **size of some MFIs** (which exceeds some private banks). There is no tiered approach in existing regulation, nor is there a clear regulatory framework for transforming, or “up-grading” the largest MFIs into microfinance or rural banks (Kassa, 2010).
- Overly **restrictive prudential regulation**, in particular the existing maximum loan ceiling and loan term, which Wolday (2012) argues limits the scope of MFI services.
- There is **no separate law for SACCOs**, consistent with microfinance proclamation and directives, which recognises SACCOs as specialised financial cooperatives. Wiedmaier-Pfister et.al. (2008) argue that the SACCOs should be brought under regulatory control of the NBE.

Policy development

Government policy establishes that MSEs and MFIs have a key role to play in economic development in Ethiopia. There are two primary areas of policy which steer the development of microfinance in Ethiopia.

The first core policy area is the government's national economic development strategy, implemented in a series of five-year strategic plans – *Sustainable Development and Poverty Reduction Programme* (SDPRP, 2001-2005), *Plan for Accelerated and Sustainable Development to End Poverty* (PASDEP, 2006-2010), and the ***Growth and Transformation Plan*** (GTP, 2011-2015).

The GTP is the most recent economic plan. Launched in late 2010 the GTP aims to sustain current economic growth, achieve the 2015 Millennium Development Goals (MDGs), and set the longer term vision for Ethiopia as being:

> *'to become a country where democratic rule, good-governance and social justice reign, upon the involvement and free will of its peoples, and once extricating itself from poverty to reach the level of a middle-income economy as of 2020-2030'* (GoE 2010: p21)

The Ethiopian economy recorded an average annual growth of 10.1% over the period 2010/11-2013/14, and is projected to grow by 11.4% in 2014/15 (NBE, 2015: 1).

The GTP makes explicit reference to the role of MFIs. They are viewed as key to establishing an accessible, efficient and competitive financial system within the five year GTP period, in order to increase Gross Domestic Saving from 6% of GDP % in 2010, to 15% by 2015 (MoFED 2010: 30). MFIs are also expected to play an important role in facilitating access to finance for Ethiopians, targeted to reach 67% by the end of the plan period from 20% in 2010 (MoFED 2010: 34). This is a significantly more ambitious target than the commitment by the National Bank of Ethiopia at the Maya Declaration, 2011[3].

The second core policy area is the support for MFIs in the *Micro and Small Scale Enterprise Development Strategy* (2010-2015) (GoFDRE 2011) which recognises the importance of MFIs and their role in the development of MSEs. The strategy aims to address six major challenges that impede the growth of micro-enterprises, including: skills development, technology transfer, market facilitation, access to finance, the reduction of entry barriers, and improving information (World Bank 2015a). To address these challenges the government has introduced one-stop-shop facilities at *woreda* (district) level providing a broad range of support services to MSEs (WB 2015). As one EI explained, at these 'one-stop-shops' people can access a MSE (micro and small enterprise) officer and a MFI officer all in one place. The office also provides oversight of local enterprises.

2.3 Access and Reach of Financial Services

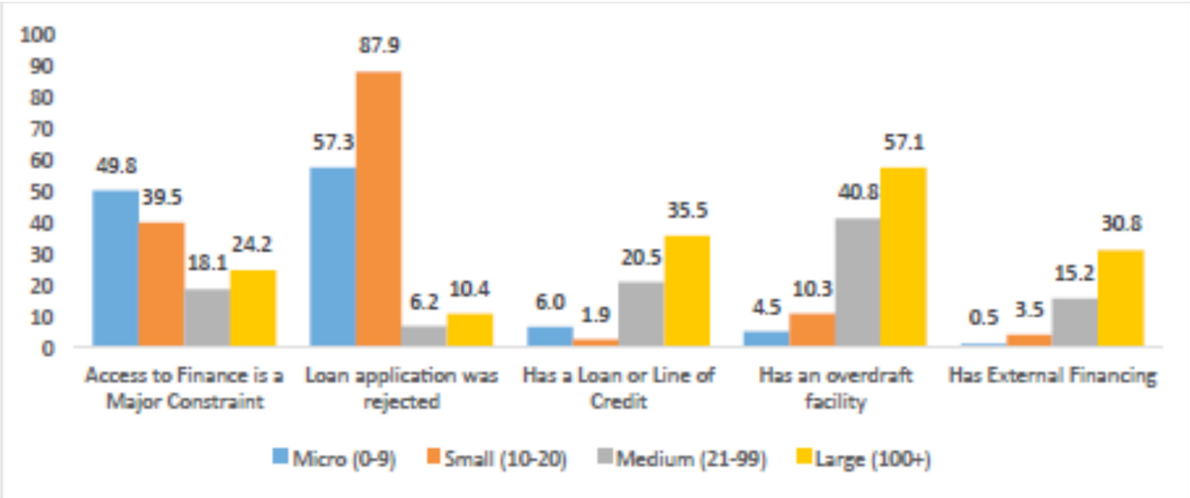
Our assessment of the access and reach of financial services draws primarily on data from a World Bank report (World Bank 2015a) which analyses World Bank Enterprise Survey data. Enterprise Surveys were conducted by the World Bank in Ethiopia from July 2011 – July 2012 with 644 firms, 32% of which were MSEs. An employment definition of MSEs was used for the report with micro-enterprises employing 0-9 employees and small enterprises employing 10-20 employees. The study interviewed 1,926 of whom the majority were micro-enterprises, including at least some that were informal, although proportions were not given.

[3] The *Maya Declaration* was the statement on financial inclusion principles agreed by a group of developing countries at the 2011 meeting of the Alliance for Financial Inclusion held in Mexico.

Despite considerable and rapid progress, access to financial services remains limited all over Ethiopia with only 2.78 commercial bank branches (World Bank 2015a) and 0.33 ATMs (World Bank 2013) per 100,000 adults. This compares, for example, with Kenya where there are 5.17 commercial branches and 9.46 ATMs per 100,000 adults (World Bank 2015a). More specifically, when access to finance for MSEs are explored we find the following (see also Figure 1):

- Almost 93% of MSEs have either a checking or a savings account.
- Despite the positive trend in saving, access to credit is problematic as only 6% of micro-enterprises and 1.9% of small enterprises have a loan or a line of credit. The Enterprise Surveys showed 41% of MSEs felt access to finance was a major constraint (similar to the SSA average of 43%), although problems tend to be more complex than this.
- Among firms who applied for a loan or line of credit in the last fiscal year, 57.3% and 87.9% of applications submitted by micro and small firms respectively were rejected (World Bank 2015a: 21-29).

Figure 1: Access to finance is an obstacle for young and smaller firms (World Bank 2015a: 29)



Notes: Micro firms 0-4 employees were surveyed in Addis Ababa only. Weights are applied to the calculations. Loan application refers to the most recent application that was submitted in the last fiscal year. If no loan applications were submitted in the last fiscal year, then this question was skipped.

Exploring why MSEs face difficulties accessing credit, many contributing factors were identified by financial institutions (World Bank 2015a). These factors reportedly relate to SME characteristics (poor quality financial statements, inability to manage risk, lack of knowledge of business management, lack of collateral, informality) and macroeconomic conditions (inflation, exchange rate, tax regulation, high vulnerability of the agriculture sector).

The final, particularly relevant question in the Enterprise Survey asked whether competition from the informal sector was seen as problematic amongst MSEs. Interestingly, only 11% of MSEs identified practices of competitors in the informal sector to be a major constraint, which compares favourably to the SSA average of 40%. This is perhaps due to the significant scale of 'formalisation' that has been undertaken through government MSE and MFI policies.

Ethiopia has adopted an unique model where the promotion and development of MSEs and MFIs lies at the heart of government strategy but still many people are unable to access loans. Options for improving access to credit include introducing more capital to enable MFIs to meet their goals; improving management of SACCOs or savings groups.

2.4 Informal Saving and Borrowing

According to MFTransparency (2011) informal finance is often the only option available for those who require financial services but who are unable to access the formal financial sector. It is also attractive to some due to the accessibility of loans and the speed of loan processing.

Reportedly, more than two thirds of the population has access to an informal finance provider, whether it is from money lenders, friends/relatives, or from one of the three popular Ethiopian-specific systems of informal finance: *Iddir* (financial assistance during mourning periods), *Iqqub* (cash savings organisations), and *Meskel Aksiyon* (group collaborations to purchase meat for the Meskel festival) (MFTransparency 2011).

A study in 2004 found funeral societies to have significant development potential. Drawing on panel data from the Ethiopian Rural Household Survey conducted since 1989, and interviews in 15 communities, Dercon *et al.* (2004) concluded that funeral societies are based on well-defined rules and regulations and appear to be remarkably inclusive offering mutual support to members of different economic groups. The groups were also offering other forms of insurance and credit to cope with hardship, and the paper argued that these institutions were well-placed as a springboard for other development activities.

2.5 Collective Saving and Borrowing

The SAVIX reporting system (savinsgroups.com) collects and validates financial and operational data from over 75,000 savings groups in all regions of the developing world and the agencies that promote them. It provides a wealth of data on collective saving and borrowing in Ethiopia.

In total there are 6,828 recorded collective saving and borrowing groups in Ethiopia, with 136,547 members, equating to an average of 20 members per group. The total savings is approximately US$ 1,280,414, equating to US$ 9.38 per member. These groups are clearly being used for borrowing as the loan fund utilisation rate is 68.6% and the average value of loans outstanding per member is US$ 17.67. Collective saving and borrowing is clearly extending financial services as the majority of these projects are in rural areas and 54% of members are women. Average attendance rates at group meetings is approximately 93% (SAVIX 2015).

Many of these groups operate as Village Savings and Loan Associations (VSLAs), voluntary groups which come together to save money on a weekly basis, and borrow against the weekly savings, forming a 'self-organised' financial sector. Many of the VSLAs operate in rural areas to support agricultural livelihoods, and seek to develop transparent methods of regular saving and borrowing. VSLAs are an improved version of traditional savings groups, which are not usually linked to formal institutions once they have received NGO training.

CARE Ethiopia is the main facilitator of collective saving and borrowing groups in Ethiopia (5,206 groups), with a much smaller role played by World Vision (640), Plan International (293), and Mercy Corps (232), with other facilitators assisting the remaining 457 groups. The report reflects briefly on the approaches being pursued by the two primary facilitators, CARE Ethiopia and World Vision.

The Village Economic and Social Association (VESA) model (CARE Ethiopia)

The Village Economic and Social Association is an evolution of the VSLA model and includes savings, loans and resilience development, promoted by Care Ethiopia. The resilience element focuses on working with group members to address issues such as women's economic empowerment; nutritional support; climate change adaptation; and improving aspirations.

Each VESA has its own byelaws but conforms to broadly the same model, with two types of savings: 1) regular saving, and 2) a social fund. Loans are short-term and small (generally Birr 200-500) and always restricted to group members. Normal loans are charged at an interest rate of 10% per month but byelaws can set any agreed interest rate. Borrowing from the social fund can take the form of either a grant or a 0% loan. There is a 5-member committee which decides on how to prioritise the loans. Significantly CARE Ethiopia does not provide up-front capital, but provides a savings box and passbooks.

The savings groups model (World Vision)

World Vision uses a savings group model, based on the principle of 'borrowing when you need to, and saving when you can' (EI). Groups are formed by members who live nearby. There are three components to group savings: 1) the social fund (insurance), the loan fund, and the saving fund. The maximum interest rate on loans is 10%, which can be per month if the group decides. Ultimately the rates are decided by the group. The maximum loan in the savings groups is up to three times their investment. To date the repayment rate for loans has been 99%.

No up-front capital is provided on the basis that participation must be voluntary and not coerced. It is anticipated that groups supported by World Vision will 'graduate' after a year and become self-sustaining, without the need for ongoing facilitation. However, groups often require longer support and will receive help until they reach graduation. Where savings groups grow and need to borrow more than can be saved by the group, World Vision links them to an MFI, which usually provides loan facilities linked to training in business development and planning.

Governance and development of collective saving and borrowing in Ethiopia

Many EIs described the problems in developing group saving practices due to historic errors in offering financial services to communities. EIs described a plethora of government and NGO programmes where loans were provided but recipients treated these as grants, or when it was unclear to recipients where and how loans should be repaid. These historic practices are problematic because: 1) communities are often initially sceptical of group saving because past engagement included some form of up-front capital payment; and 2) government was sceptical of NGO involvement in the sector.

Contemporary community saving and borrowing programmes appear to be working extremely well and are widespread. As one EI stated said, *'VSLAs are not a threat – just as kindergarten is not a threat to school. VSLAs are a fantastic way of teaching people saving and borrowing at low level and using it appropriately'*. VESAs and saving-and-borrowing groups are not legal entities, but government policy now seeks to promote the graduation of these groups into SACCOs which are legal entities, although proponents of VSLAs argue that formalisation undermines the critical social welfare element of VSLAs.

2.6 SACCOs (Financial Cooperatives)

Ethiopians have a long history of working together in cooperative-like institutions such as; *Iddir Iqqub (Ekub)* and *Meskel Aksiyon*. This history of collective saving provides a strong basis for more formalised SACCOs. According to MFTransparency (2011) Ethiopia's cooperative sector has been increasing in size, doubling every few years, since the regime change in 1991. However, due to a lack of robust data on SACCOs it is extremely difficult to estimate their number and membership.

In 2013 there were reportedly 7,154 SACCOS, representing a membership of 706,200 (WCCU 2013). The penetration rate is just 1.4%, compared to 19% in Kenya, 16.9% in Rwanda and 4.4% in Tanzania (penetration rate is calculated by dividing the total number of reported credit union members by the economically active population age 15-64 years old). According to one EI a more up-to-date estimate of the total number of SACCOs is 10,000. If, like Tanzania, membership averages around 200, SACCOs could reach perhaps 2 million people.

SACCOs are regulated under *Proclamation No. 147/98* by the Federal Cooperative Agency. They are owned and controlled by their members. SACCO regulation and monitoring differs significantly from MFIs and there is no NBE involvement. In contrast to MFIs SACCOs are unable to take savings from non-members, typically provide loans for a term of less than a year, and offer interest rates lower than those of MFIs and moneylenders. Ethiopia has no structures in place for monitoring the performance of SACCOs or to supervise their operations. According to one EI, this approach to regulation and monitoring of SACCOs is problematic, and is one reason for unreliability of data.

SACCOs offer considerable potential for outreach, but face a number of challenges in reaching their potential. For example, a 2011 study of 10 SACCOs with 1,037 members in a *woreda* of southern Tigray State concluded that, based on several criteria such as capital adequacy, rate of return on equity and profitability, SACCOs were able to mobilise huge financial resources, and the SACCOs interviewed had achieved impressive growth and outreach in the years under study - 2007-2010 (Sebhatu 2011). However, the study also identified critical problems of a poor savings culture, weak governance capacity, and limited regulatory scope due to lack of specific SACCOs legislation that inhibit their growth. There is urgent need for a more widespread study of SACCOs and their potential and barriers.

2.7 Microfinance Institutions

Ethiopia has one of the largest microfinance markets and fasted growing microfinance sectors in Africa, and Ethiopian MFIs are charging some of the lowest interest rates in Africa, with a gradual shift from group to individual lending (MFTransparency 2011).

> *MFIs have mobilized money from the poor. (EI, 2014)*
>
> *In a nutshell, MFIs are contributing to poverty reduction and asset building through by provision of loans to and mobilization of savings from the low-income segments of the population.* (NBE, 2015a)

The growth and development of deposit-taking MFIs in Ethiopia has been rapid since the formalisation of the sector in 1996 (*Proclamation No. 40/1996*), and according to the latest National Bank of Ethiopia (NBE) quarterly report (NBE 2015a) there are 32 microfinance institutions (MFIs) registered by the NBE to deliver financial services to the financially excluded. Unusually in Ethiopia, all MFIs are required to be registered as deposit-taking institutions with the National Bank of Ethiopia and are thus supervised under bank regulations.

The NBE annual report (NBE 2015b) suggested in 2013/14 the overall performance was positive and total capital had increased by 24.6% (to Birr 5.7 billion) while assets grew by 38.6% (to Birr 24.5 billion). At the same time, deposit mobilisation and credit provision had expanded. According to the second quarterly report for 2015 (NBE 2015a) MFIs mobilised Birr 13 billion in the form of savings. However, although the number of active clients has been increasing (2.6 million, by the end of 2012), MFIs operating in Ethiopia are estimated to have met less than 20% of the demand for financial services (Wolday 2012). The overwhelming majority of the population has no access to financial services, but by providing financial services to micro-enterprises in both urban and rural areas, MFIs are a key route to financial inclusion (Zwedu 2015). Nevertheless, MFIs are expected to provide much of the financial intermediation for communities with low access to formal financial institutions over the coming years.

Microfinance provision in Ethiopia is highly concentrated, with the five largest MFIs (Amhara, Dedebit, Oromia, Omo and Addis Credit and Savings Institutes) together accounting for 93.6% of the savings and 90% percent of the credit of the MFI sector. The strength of the regional MFIs means that there is a low level of competition in the industry.

Useful information is available from two global donor-funded platforms, MIX Market and MFTransparency, to which the larger MFIs submit information on a voluntary basis. Both MIX Market and MF Transparency promote financial inclusion and global transparency in the microfinance industry and collect MFI data from audited financial accounts etc., but provide slightly different indicators – MIX Market examines portfolio performance, and MFTransparency focuses on prices and products.

MFTransparency launched the Transparent Pricing Initiative in 2011, in partnership with the association of Ethiopian Microfinance Institutions (AEMFI). This provided standardised pricing data from 17 MFIs, representing an estimated 95% of microcredit borrowers.

As mentioned above, five MFIs dominate the market in Ethiopia:

- Amhara Credit and Savings Institution (portfolio US$ 103.2 million, 694,993 active clients with loans)
- Oromia Credit and Savings S.C (portfolio US$ 69.6 million, 503,000 active clients with loans)
- Dedebit Credit and Savings Institution (portfolio US$ 96.3 million, 397,000 active clients with loans)
- Omo Microfinance (portfolio US$ 31.4 million, 327,888 active clients with loans)
- Addis Credit and Saving Institution (portfolio US$ 30.8 million, 165,464 active clients with loans.

At the time the data was recorded, Oromia and Amhara had the largest number of branches, 242 and 229 respectively, and both had a predominately rural focus (with less than 20% urban clients). The most popular financial products were loans intended for business or agriculture, which used the group lending methodology. These entry-level group solidarity loans, where typically 3-7 members provide collateral or a loan guarantee through a group repayment pledge, are frequently regarded as the first step towards the use of proper banking services, enabling farmers or MSEs to build up the credit history necessary to be eligible for an individual loan (Wolday 2012). However, although widely recognised as a successful solution to the issue of access to credit for individuals and businesses lacking sufficient asset collateral, the loan ceiling of Birr 5,000 on many group loans severely restricts investment, although also encourages MFIs not to abandon smaller-scale clients.

Of the above MFIs, Addis and Omo have the strongest urban focus (approx. 80%-100% and 40%-60% urban clients respectively). Among Omo's most popular financial products was a flexible loan specifically designed for urban borrowers. The loan could use either the individual, solidarity group or self-help group methodology, and reflected the urban credit market by offering a range of loan categories for different trades, including construction (materials supply and services), food processing, metalwork, petty trade, transportation and urban agriculture. The lending interest rates of the five largest MFIs vary from 9.9% to 18% (annual, declining balance rate – except Addis which uses flat rate). By international standards, these rates are remarkably low, suggesting that MFIs may find difficulty in covering costs.

The majority of MFIs offer two main saving products, voluntary and compulsory. Compulsory saving requires the borrower to save a stipulated percentage of the loan, for example, the urban loan provided by Omo described above required a minimum compulsory saving of 10% in the first loan cycle, 8% in the second cycle, and 5% in the third. Voluntary saving includes making demand and time deposits. Oromia provides voluntary saving accounts to its borrowers, non-borrowers, and MSEs, in addition to a coin bank, paying an interest rate of 5% on each with voluntary and flexible deposit and withdrawal. Ethiopian MFIs have succeeded in mobilising a significant amount of savings improving their own financial stability and sustainability, and contributing to the growth of an overall culture of domestic saving identified as a key objective in the GTP 2010-15. However, committing to the development of more demand-driven saving products and the promotion of financial literacy regarding the benefits of saving will greatly assist the necessary transformation of MFIs into fundamentally savings-led institutions, although it is costly for MFIs to offer flexible small-savings services, so many seek easier forms of finance.

Lending and interest rates of Ethiopian MFIs are much lower than other MFIs in the region and APR rates of 18% to 24% are common. Although NBE removed all interest rate ceilings in 1998, this has not led to market-based rates for various reasons, including political pressure, cheap regional government funding, and failure to allow for inflation, and government-owned MFIs do not calculate the cost of credit commercially – this represents a form of subsidy in which influence and patronage reportedly favour the distribution of subsidised credit to the better off (GTZ et al 2008: 27-28).

An important role in developing the sector and shaping policy is played by AEMFI. Generally regarded as one of the strongest microfinance networks in Africa, its mission is to promote information exchange, facilitate enabling environment and build the capacity of Ethiopian microfinance system.

Challenges facing MFIs

Microfinance had developed rapidly in Ethiopia and it has been seen as a key tool in prompting development. However, several key challenges remain:

Lack of access to affordable capital: to finance growth is a major challenge faced by Ethiopian MFIs. It is thought that most MFIs have the capacity to at least double their outreach and portfolios in the foreseeable future, but lack of access to capital is preventing this. As decreed by microfinance law, the main source of funding for MFIs in Ethiopia is savings mobilization (EI).

An imbalance in the finance sector: There is a huge imbalance in the finance sector as people tend to save in the banking sector (eg. Commercial Bank) as it is trusted, but take loans from SACCOs or MFIs (EI), although this is common elsewhere.

Urban MFIs: The initial focus of MFIs was on agricultural finance when group methods worked. However, when people need larger loans the group method does not work and there were problems in translating group lending to urban areas (eg. urban groups are less cohesive than in rural areas and social pressure for repayment is less). In urban areas individual lending needs to be embraced more by MFIs (EI). Whilst this challenge was raised by several EIs, it is notable that data from MFIs participating in the MFTransparency Pricing Initiative revealed a shift in the focus of lending methodology to individual lending (MFTransparency 2011)

Historic lending practices: The government maintains a register of outstanding loans provided between 1998 and 2004 which were not recovered. Households with an outstanding loan under this system cannot get a new loan. However the lists are reportedly inaccurate with many households unaware they are on the list and others unaware of how or where to repay these loans (EI).

2.8 Agent Banking

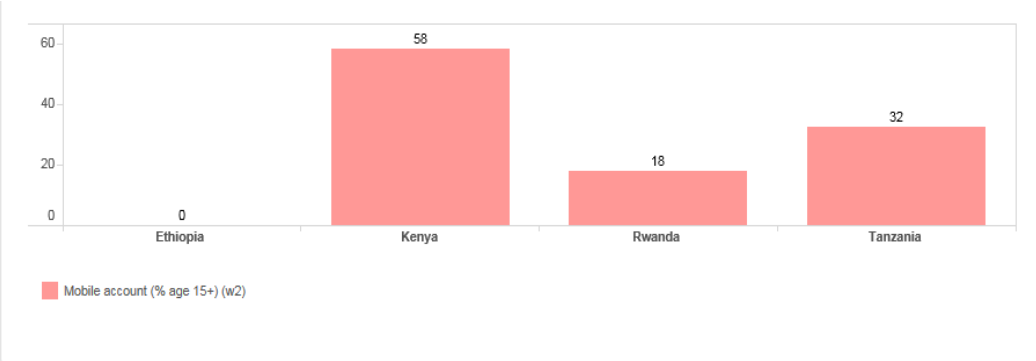
The agent banking model allows retail outlets such as shops, post offices, pharmacies and petrol stations to act as agents for banks. The agents provide banking services to the bank customers on behalf of the banking institution under a valid agency agreement.

In Ethiopia agent banking is still in early stages of development. According to one EI, agent banking is currently being piloted with MFIs. In order to support and regulate the development of both agent banking and mobile banking the National Bank of Ethiopia directive number FIS/01/2012 was introduced. The directive sets out regulations relating to both innovative forms of banking and it is anticipated that together they will make a significant contribution in deepening financial service accessibility to a wider section of population at an affordable price (World Bank 2015a).

2.9 Mobile Money

Mobile money is effectively a branchless banking service allowing users to deposit money in an account stored on their mobile phones. Money can be transferred to other users with password-restricted text message, and users can deposit and withdraw cash for a small fee from registered agents. In many countries mobile money has now largely replaced buying airtime as a way of transferring money to another user. However, according to Demirgüç -Kunt *et al* (2015) mobile money developments in Ethiopia lag significantly behind other SSA countries included in this study. Figure 2 below shows the percentage of adults aged 15+ with mobile money accounts in 2014 (World Bank 2015b).

Figure 2: Percentage of adults aged 15+ with mobile money accounts



Note: w1 denotes 2011 Global Findex data (wave 1) and w2 denotes 2014 Global Findex data (wave 2).

In 2013/14, the number of mobile subscribers surged by 19.2% and reached 28.3 million from 23.8 million a year ago (NBE 2015a) and yet despite increasing mobile phone use there has been only limited development of mobile money in Ethiopia. One EI identified this as an emerging priority and the introduction of the aforementioned National Bank of Ethiopia *Directive Number FIS/01/2012* will certainly pave the way for mobile money development. We would expect rapid change in this area of financial services in the future, with substantial impacts on levels of financial inclusion. Given that developments in many other sub-Saharan African countries have preceded action in Ethiopia, lessons can certainly be drawn from the experiences of development and governance in other countries, albeit the context differs as all financial institutions in Ethiopia come under National Bank of Ethiopia governance. Only 6.1m people had access to the internet (NBE 2015a).

2.10 Consumer Protection

The World Bank's Global Survey on consumer Protection and Financial Literacy assesses financial capability and consumer protection in 114 countries. The framework for review is set out in the *Guidelines for Good Practice on Financial Consumer Protection* (World Bank 2012), which argues that a well-functioning consumer protection regime provides safeguards for financial services consumers while empowering them to claim their legal rights and fulfil their obligations. The assessment is based upon agreed high-level principles on financial consumer protection endorsed by the G20. In reporting there are seven core areas: legal frameworks; institutional arrangements; fair treatment; disclosure; responsible lending; dispute resolution and recourse; and financial education. This provides an exceptionally useful overview and comparison of consumer protection, but unfortunately data for Ethiopia is not included in the most recent survey. Efforts should be made to redress this absence in future reports.

EIs explained that consumer protection is being addressed in Ethiopia. AEMFI is playing a role through its Social Performance Management Unit which explores whether clients are protected and whether procedures are transparent. They also deliver training on transparency and social protection to their MFI members. In addition to the work of AEMFI, according to MFTransparency (2011), the existing Trade Practice Proclamation was modified to include issues of consumer protection.

The new law proposed the establishment of the Trade Practice and Consumer Protection Agency, accountable to the Ministry of Trade and Industry. The law protects the rights of consumers to get satisfaction, accurate information on the type of goods and services offered, and compensation for damages suffered due to misleading transactions. Despite these positive steps, Ethiopia does not have a Truth in Lending Law, designed to promote the informed use of consumer credit by requiring disclosures about its terms and cost to standardise the manner in which costs associated with borrowing are calculated and disclosed (MFTransparency 2015). Also, MFIs are not yet exchanging information through the credit bureau at the National Bank of Ethiopia (World Bank 2015a). Consideration must be given to the potential benefits of improved credit information. Many countries now have quite good credit rating agencies for microfinance clients, which might also be possible in Ethiopia.

3. Financial Needs of Micro-entrepreneurs

In this chapter of the report, key results from surveys with 201 micro-entrepreneurs are discussed, including 100 interviews with micro-enterprises in Addis Ababa and 101 in Hawassa (see Appendix 2). The majority of those interviewed were individual members of cooperatives or associations, working in a micro-enterprise of less than 10 people, or own-account workers.

The government has supported the development of manufacturing and trade through an extensive programme of building industrial estates and markets managed by the *woreda* (district authorities), usually available to those who register and form cooperatives or associations (EIs). These government-provided locations allowed some degree of protection for the micro-enterprises, although they were not always well-located or built.

3.1 Saving

Means of saving: Micro-entrepreneurs were asked a multiple choice question about where they saved. Amongst the 201 micro-entrepreneurs who gave valid responses to this question, 48% used banks, 30% used MFIs, and 10% used an *Iqqub*. Nobody reported saving with SACCOs of CSSGs and surprisingly few people reported saving at home (3%).

Respondents were more likely to use banks in Addis Ababa than Hawassa (57% vs. 40%), but much less likely to use MFIs (6% vs. 55%). Whilst this may reflect poorer access to banking in second tier cities such as Hawassa, and therefore a greater reliance on alternative savings institutions such as MFIs, a higher proportion of respondents in Hawassa were interviewed in estates for small industries and markets support by government which have priority access to MFIs and may have influenced the results. Interestingly there was only a limited gender difference in savings mechanisms, with men slightly more likely to save in banks than women (52% vs. 42%) and women slightly more likely to save with MFIs than men (34% vs. 28%).

There were widespread differences in the savings location accessed by entrepreneurs in different sectors. Those working in construction and manufacturing were more likely to save with banks (63% and 54% respectively), which is predictable given the likelihood of larger capital requirements in these sectors. MFIs were often used for savings by those in the services sector (57%), tourism (49%) and manufacturing (44%), whereas those using *Iqqubs* were more likely to be vendors. It would appear vendors are saving in the least formal locations.

Reasons for saving: Reasons for saving were varied: 58% saved for business investment (eg: buying stock or investing in tools and premises), 27% for business emergencies, 21% for family/medical emergencies, 18% for land/house costs, and 17% for school fees. Clearly business costs constitute the main reason for saving but non-business reasons or income smoothing activities also play an important role in the decision to save, and personal income is often not separated from business income.

Reasons for saving were broadly similar between sectors and by gender but there were marked differences between areas, with business investment more likely in Hawassa (70%) compared to Addis Ababa (45%). Non-business reasons are then more likely in Addis Ababa, where 21% save for school fees (14% in Hawassa), and 21% save for land/house costs (15% in Hawassa).

Savings problems: Micro-entrepreneurs were asked whether they had faced any problems in attempting to save, and of the 194 who responded, nearly a quarter reported some form of problem. Notably, there was almost no difference in the extent to which problems were reported according to location, gender and sector of the respondent. Discussions with those who had faced problems revealed that problems with electronic communications were the main challenge as this prevented banks from disbursing money. Other problems were only reported by one respondent and included irregular collection of savings by an MFI representative and difficulties withdrawing savings from an MFI.

> *We can't withdraw the money we save whenever we want to because of network (connection) problems.* (Male, selling construction materials, Addis Ababa)

> *There are network problems with banks when you need to withdraw money for urgent business.* (Male, selling electrical goods, Addis Ababa)

Reasons for not saving: Approximately three quarters of micro-entrepreneurs claimed that they saved regularly (of the 185 who responded to the question). This figure is reassuringly high for both men and women and across sectors, however there are differences by area. Nearly 40% of respondents in Addis Ababa claimed that they do not save regularly. Amongst those who claimed not to save, the most frequently cited reasons were not having enough money (11% of all micro-entrepreneurs) and not earning regularly enough (8%). Clearly there is a perception amongst a significant minority that they do not have enough money to save. However, inflation has been high at periods over the last decade, so people may use non-monetary forms of saving, which is not usually reported. There do not appear to be significant structural barriers to saving, although relationships with MFIs were sometimes a problem.

> *The saving that we make with XX MFI is to some extent not voluntary; they come and ask us to give them the money even if we don't have money at hand sometimes* (Male selling construction materials, Hawassa)

> *There are problems with getting back what you have saved specially with MFI. They don't let you withdraw your money easily and they require precondition of saving up to 2,000 Birr to give a loan of 10,000 birr* (Male, selling cultural items, Hawassa)

3.2 Borrowing

Means of Borrowing: By far the most common form of borrowing is from friends and family (23%), although a significant proportion of micro-entrepreneurs did report borrowing from MFIs (13%). Alternative sources of borrowing, such as Banks, SACCOs and *Iqqubs* were only used by a small number of people, if at all. Results suggested micro-entrepreneurs in manufacturing are more likely to borrow from MFIs (27% compared to an average of 13%), whereas respondents in the tourism sector are more likely to borrow from friends (33% compared to an average of 23%). To a lesser extent, means of borrowing also differed according to location, with respondents in Hawassa more likely to borrow from MFIs (15% compared to 11% in Addis Ababa), whereas respondents in Addis Ababa were more likely to borrow from friends and family (29% compared to 17% in Hawassa).

Reasons for borrowing: The reasons for borrowing were mostly for business development (44%), although a minority borrowed for business emergencies (15%), family/medical emergencies (10%), or school fees (8%). Borrowing for business development is particularly true for respondents in the manufacturing sector (56%), whereas those in the tourism sector are more likely to borrow to pay for family/medical emergencies (15%) or school fees (15%), which may reflect a focus of MFI assistance on sectors such as manufacturing rather than tourism.

Borrowing practices: Trends in borrowing unsurprisingly differed between the two major sources of borrowing. Loans from family and friends ranged from Birr 100 to Birr 200,000. With more than half of all borrowing from family and friends equating to over Birr 50,000 it is clear that this is for more than meeting short-term, small-scale borrowing needs. The key common characteristic in this type of borrowing was that no interest was paid, although there are often social obligations to repay. Repayment regimes varied, with some paying in a single lump sum, whilst others paid in instalments.

Loans from MFIs equated to much larger sums, ranging from Birr 2,500 to Birr 1.2 million, hence whilst there is clearly some overlap in the roles of family/friends and MFIs, the latter are far more likely to be providers of larger loans. Respondents were asked about collateral payments required for an MFI loan. Most respondents access a loan by having a third party guarantor (44% of MFI borrowers), whilst others used their house (26% of MFI borrowers), a vehicle (13%), or by agreeing to save a percentage (usually 20%) of the loan required before the loan would be made available. Interestingly, two respondents claimed to have paid a friend to offer their house as collateral. Whilst this range of options clearly offers some flexibility in the mechanisms used to access a loan, these 'formal' types of collateral are generally not available to poorer people.

Reassuringly, approximately 83% of people who borrowed from an MFI and who responded to the question, reported that they had received information and advice on savings and loan repayment. This is a strong indicator of active consumer (and lender) protection.

Borrowing problems: Micro-entrepreneurs were asked whether they had faced any problems in attempting to borrow, and of the 182 who responded, a quarter reported some form of problem. Respondents were more likely to report borrowing problems if they worked in the manufacturing and tourism sectors, were located in Hawassa, or they were male. It is important to understand the nature of borrowing problems and it appears that problems fall into two categories: 1] accessing a loan; and 2] meeting repayments.

Accessing a loan: Many micro-entrepreneurs, particularly in the construction sector, described how there is a shortage of finance available, possibly due to the unwillingness of MFIs to lend to the construction sector, which is seen to be risky. For others, access problems related to the processes involved in borrowing rather than capital available, for example there were difficulties meeting the collateral/savings requirements of banks and MFIs, and the requirement to borrow as a group in order to access finance from government MFIs. Finally, one respondent claimed that there were insufficient products for Muslims who might wish to borrow but cannot pay interest.

> *Financial shortage is a major problem. The construction sector requires huge amounts of investment as compared to other sectors. Most of our customers take our products on a credit basis and they don't give us cash.* (Male, selling cement, Addis Ababa)
>
> *When you want to borrow from banks their requirement [collateral] is difficult and MFIs require long periods of saving as a precondition to let you borrow.* (Male, supply of construction goods, Hawassa)
>
> *Since we took the loan in a group, the process takes time. Some people don't show up on the date of the appointment and unless all of us are present and sign the loan we won't be given it so it takes time.* (Male, selling glasses and watches, Addis Ababa)
>
> *At present the main problem is that I do not have access to loans without interest because I am a strict Muslim who is committed to all issues stated in the Holy Quran.* (Male, clothes seller, Hawassa)

Meeting repayments: When asked about possible borrowing problems, many micro-entrepreneurs talked of their experiences attempting to repay loans to family and friends or MFIs. There were very many accounts of repayment difficulties and the impacts of on individuals who reported feeling worried or guilty, and in two cases people reported sacrificing food in order to make payments, or leaving the area to escape debts.

> *I have debt currently which is not repaid and I worry about repaying it on time, however I will do all my best to repay it.* (Male, selling construction materials, Addis Ababa)
>
> *When someone from whom I took a loan comes to get it repaid I always feel bad because delaying someone's money who helped in times of difficulty irritates me.* (Male, selling food and drink, Hawassa)
>
> *We repaid the loan by sacrificing food because we had no job or source of income sufficient for repaying the loan.* (Female, preparing and selling fish, Hawassa)
>
> *I relocated to Hawassa from Yergachefe because I could not pay back the money I borrowed as I had expected.* (Male, dairy farming and processing, Hawassa)

Reasons for not borrowing: By far the most frequently cited reason for not borrowing was the worry of not being able to repay the debt (23%). Many other reasons were cited, including: did not need a loan (10%), not earning regularly enough (6%), or found it too expensive to borrow (6%). Given the problems experienced by those who have borrowed, fears about repayment difficulties appear to be well founded.

3.3 Infrastructure Challenges

Physical infrastructure is fundamentally important to a strong economy and to ensuring inclusive growth, and access to finance is just one of many challenges that micro-entrepreneurs face. Two main concerns about physical infrastructure were raised. First, the reliability of electricity supply was repeatedly raised amongst micro-entrepreneurs. It has already been shown how this affects the ability to withdraw money from banks, and to operate banking computers but it also had direct consequences for business productivity.

> *The fact that there is serious electricity interruption is significantly affecting our business because we preserve most of our dairy products in the refrigerator. We even need electricity to process the products. So whenever we come across an interruption we lose quite large sums of money in the form of products that expire.* (Male, dairy farming and processing, Hawassa)

Second, respondents found that the mobile phone network is unreliable for business use, and not yet adequate for supporting the growth of mobile money. Mobile money has significant potential to overcome problems of financial exclusion but it is yet to be effectively developed in Ethiopia. Approximately 85% of micro-entrepreneurs use their mobile phones for business and yet only 4% make m-payments and even fewer receive them.

Improvements in infrastructure to enable mobile money development would also have potential implications for international money transfer. The sending and receiving of remittances plays an important role in the financial security of families. Approximately 20% of the 195 micro-entrepreneurs who responded to the question about remittances reported *receiving* remittances, with the vast majority doing so via a bank (83%). A higher proportion of respondents *sent* remittances (36%), with banks still the most frequent means of sending money (69%), albeit 21% of people sent money via friends. Developing mobile money transfer would reduce transaction costs and offer almost instant availability of local funds to the recipient.

Addressing these large-scale infrastructure challenges would have impacts far beyond the lives of the micro-entrepreneurs engaged in this study.

3.4 VAT and Micro-entrepreneurs

Efforts to support micro-entrepreneurs in Ethiopia have focussed on formalising their activities. One of the intended consequences of the formalisation process is that micro-entrepreneurs are expected to pay VAT and this has caused challenges. First, many respondents explained that whilst their businesses were growing their incomes were unpredictable, and yet collection of VAT did not allow for this variability.

> *The Sub City Office forces me to get registered for VAT. I have been arguing and counter-arguing in that the business transactions are not regular and the capital is not too much, except the building.* (Male, restaurateur, Hawassa)

> *Tax related problems are the major problem for the business. For instance, we paid 20,000 birr annual sales tax last year but after a government audit they have asked me to pay an additional 200,000 birr. The way they calculated the tax is quite a story. They claim since our sales for the year are smaller compared to our purchases they have considered some of the stock we have as sales so that we pay larger tax. What kind of system is this?* (Male, sale of construction materials, Hawassa)

Second, respondents often found suppliers unwilling to provide receipts. This leaves micro-entrepreneurs in a precarious position as they are unable to comply with tax laws.

> *Suppliers are unwilling to provide materials using the VAT rule because we have the obligation to buy and sell using receipts since we're a VAT registered business.* (Male, electrical goods supplier, Addis Ababa)

Finally, many micro-entrepreneurs were now registered to pay VAT and were therefore incorporating these costs charges to customers but this left them disadvantaged relative to others who were not paying VAT (essentially those who remained informal). There is clearly a need for consideration to be given as to how these tax-related challenges can be managed in order to support micro-enterprises in improving productivity as they begin to formalise.

3.5 Business development in groups and associations

The context of poverty reduction in Ethiopia is unique in that micro-enterprise development and access to microfinance underpins the approach. Access to this support requires people to form groups and associations (EIs), supporting the country's economic and political agendas. This solidarity model is a fascinating development approach that has been very successful in rural areas, but its success in urban areas is less proven. In Ethiopia it received praise from EIs but it was also inevitable that some micro-entrepreneurs would report concerns. It has already been discussed that group borrowing can be problematic because loans may not be given unless all members attend.

Broader challenges related to business development include problems identifying the necessary number of people to form a group and the sense that opportunities to work alone and grow individual enterprises are not available.

> *We faced problems starting our business, like the government agents set criteria which are difficult to meet in order to establish a business. For example you must have 10 members for the government to register you to start a business.* (Male, manufacturing shoes and belts, Addis Ababa)

> *There is pressure from the government for us to enter into an association to get permission to work here.* (Male, sells fish and drinks, Hawassa)

3.6 Vulnerabilities

Many of the micro-enterprises are working in very uncertain environments which can undermine their financial security. Respondents working outside government-provided locations frequently faced evictions, confiscations and theft of their goods. Efforts must be made to reduce such insecurity.

> *We were working on the roadside when the government wanted the area for investment and road construction. They came and destroyed our working place without giving us a grace period even to arrange for an alternative working place.* (Male, sells ethnic clothes and gifts, Hawassa)

> *I have suffered from property confiscation so many times. They always chase us and the Demb Askebaris (security forces) don't wear uniforms when they want to take our property for themselves.* (Male, sells household utensils, Addis Ababa)

> *In this work place thieves take my property which is estimated at around 20, 000 birr in total in the last three years. This leads me to have to borrow in order to solve this financial crisis.* (Male, sells ethnic clothes, Hawassa)

The issue of workspace was very frequently cited as a concern. Many respondents explained that the areas where they were working were insecure, not large enough, or poorly located and this applied to both government-provided locations and those operating elsewhere.

> *By far the most pressing problem for us is the quality of the structure of our shed. It is nearly impossible to work when it rains because the flood on the floor spoils most of our things.* (Male, sells fruit, vegetable and water to tourists, Hawassa)

> *There is a lack of working space. At present we are working only for two days in a week and eight days in a month. We want a permanent place to work throughout the week.* (Female, sells women and children's clothes, Addis Ababa)

Those working outside government-provided locations had much weaker access to MFI savings and borrowings than those operating under a government-sponsored programme. Of the 81 respondents at government-supported locations, 53% saved in MFIs and 22% borrowed. Of the 120 respondents operating elsewhere, only 15% saved with MFIs and 7% borrowed. These results suggest that registered SMEs have better access to formal microfinance that those outside.

4. Conclusions and Recommendations

There is no shortage of people willing to offer views on the regulation of microfinance agencies, and savings and loan associations, but limited experience on which to draw. Thus a cautious approach to regulation to enable innovation is important (Christen and Rosenberg, 2000).

4.1 Inclusive Growth: Reaching the Most Vulnerable

In recent years, government policy has emphasised the growth potential of MSME (micro- small and medium-sized) sector, with an impressive programme of support through the provision of land, premises and equipment for potential growth sectors of the economy. The policy has included strong promotion of financial inclusion for participants, with access to microfinance services integral to this programme.

For beneficiaries of the programme, evidence on the effectiveness of financial inclusion is mixed, with some studies reporting a 'missing middle' that micro-enterprises were well-served but small and medium-sized companies were missing out, while other research suggested that micro-enterprises have difficulties in meeting access criteria for credit, a finding that is common elsewhere.

Our interviews suggest that some (usually informal sector) businesses are doubly excluded, suffering problems of insecure operating space and poorer access to microfinance services than their government-supported counterparts. Government support has been highly influential but will never reach everyone. On-going research on the accessibility of programmes is needed.

1] Financial Inclusion as part of Ethiopia's MSME programme is a key component of national development, but an enabling policy for supporting inclusive growth should address the needs of all small businesses. A key issue is the need for secure space to work. The Ethiopian government's MSME policy of government-provided locations is impressive but does not reach all micro-enterprises, and unless an enabling environment is created that addresses conflict, harassment and other insecurities, particularly for those working outside government-provided locations, who then will not fulfil their potential for innovation to provide jobs and growth.

4.2 Micro-enterprises: Strengthening Financial Inclusion

2] Policy should embrace the collective savings and borrowing model developed by leading NGOs, which should be supported through enabling policy and good practice guidance. Self-help groups have many strengths in creating social support, enabling peer learning and bringing borrowers face-to-face with lenders. Best practice guidance from successful models in the Ethiopian context should be widely available to groups.

3] Self-help groups should be a stepping stone to encourage members to graduate to a full range of individual financial services, with groups encouraged to develop MFI, SACCO or bank linkages. Solidarity groups are expensive – for providers to supervise, and for participants in terms of cost, time and covering for default by a group member. They will remain important for community development, but should not be the only financial service to which members have access. Providers should work closely with groups to support transition to individual MFI, SACCO or bank accounts.

4] Good practice guidance on successful adaptation of the VESA model to urban settings should be disseminated: The VESA model works well to build community solidarity, particularly in groups with stable membership and those with a majority of women members. Although developed as a rural model there are now a number of successful urban groups; but knowledge on successful adaptations in urban settings is not well-disseminated (eg: for young people trying to set up businesses). More research on self-help groups in urban settings is needed**.**

5] Financial literacy should be tackled at all levels, through training by MFIs, and in government programmes, media campaigns, and schools. Training for micro-enterprises should be a priority. Many people working in micro-enterprises are vulnerable and rely heavily on informal borrowing from family, friends and savings groups. There is widespread lack of knowledge about financial services including lack of understanding of basic financial concepts (eg: how savings are held by MFIs and how interest is calculated), and low awareness of charges and the overall cost of borrowing. There is need to stress the benefits of savings *per se,* emphasising the "why" (i.e. future returns) and not just the "how" (understanding compound interest etc.) (see Bernard, T., Dercon, S., Orkin, K., Taffesse, A., 2014).

6] A VAT model should be introduced that allows graduated payments and micro-enterprises to 'formalise' gradually. VAT registration was raised by a number of respondents as a major hurdle for micro-enterprises with irregular incomes. There is a need to consider whether tax-related challenges can be managed in a way that does not stifle enterprise eg: through introducing a simple tax or lower rate of VAT.

7] Consumer protection should be improved through appropriate regulation and good practice, for example the provision of annual or monthly percentage rates for all loans. Many micro-enterprises have no idea of the real rate of interest that they pay, and know only the weekly or monthly cost of borrowing. More transparent lending practices would contribute towards this agenda.

4.3 Microfinance Institutions: Standards and Regulation

8] There is a critical need to promote diversity in the MFI sector and extend the sources of loan capital. The MFI sector still relies mainly on the support of NGOs and regional government, but NGOs operations are constrained by charity laws and funds through regional government were reportedly not always fully or promptly released. However, maximum APR's in Ethiopian MFIs are lower than other countries visited in this study, which is of considerable benefit to micro-enterprises, and care should be taken that this advantage is not eroded, and to ensure that MFI operations remain viable.

9] MFIs should develop medium-term strategies to strengthen savings. Our surveys suggest that micro-entrepreneurs tend to save with banks and borrow from MFIs. MFIs need to build the trust of clients, and improve access and outreach eg: by improving office functions, improving their balance sheets to provide safe lending, and exploring the potential for mobile phone deposits.

10] MFIs should consider the potential for product diversification, which recognises the specific challenges of micro-enterprises, for example fluctuating incomes. Products should be sector specific, and allow variable monthly repayments. For example loans needed for a trade enterprise may be very different for those needed for manufacturing.

11] There is an urgent need to establish modern MIS (Management Information Systems) for MFIs, with linked facilities for branch networks. IT systems should be designed with appropriate backup to accommodate erratic electricity supply and irregular internet access. Systems should also allow different language functionalities. MFI staff training should take place at all levels.

12] SACCOs are an undervalued model with considerable outreach, but regulation and oversight should be based on similar principles to that of MFIs. SACCOs are based on cooperative principles of self-help and mutual support but face critical problems of weak savings culture, governance capacity and regulatory oversight. There is urgent need for a more widespread study of SACCOs and their potential and barriers. Regulators should develop a standard code of conduct for all savings, credit, insurance and remittance organisations, which avoids over-regulation, for example drawing on existing good practice in Kenya.

13] The role of AEMFI as a voice in advocating for best practice in Ethiopian savings has the potential to be strengthened. Ethiopia is unusual in two respects. First, all MFIs are deposit-taking and thus regulated by the National Bank of Ethiopia, but field access for a central bank is difficult. Second, AEMFI is a well-respected institution with considerable expertise. Drawing on experience of other countries, AEMFI may oversee aspects of MFI reporting and oversight.

4.4 Policy and Regulatory Innovations

15] Regulations to underpin the introduction of mobile money should be developed as a matter of urgency. Mobile money has huge potential to increase financial inclusion by providing access to savings/credit facilities. Although poor telecommunications and electricity infrastructure is hindering its spread, experience suggests that once supply side constraints have been addressed, take-up will be extremely rapid. Drawing on experience in Kenya and Tanzania, regulators have a very short window in which to establish appropriate regulation.

Appendices

APPENDIX 1. Expert Interviews

ACCORD Savings Group, Addis Ababa
African Bank for Development
Amara Sub-City, SME Office, and Woreda 7
Association of Ethiopian Micro-Finance Institutions (AEMFI)
ATW Engineering, small business
CARE Ethiopia, Addis Ababa and Hawassa
Ethiopian Economic Association
Federal Micro- and Small-Enterprise Development Agency (FEMSEDA)
Hawassa City Council, MSEs, City Enterprise, Informal Economy and Finance Departments
Minister of State for Finance and Economic Development
National Bank of Ethiopia
Omo Microfinance Institution (OMFI) Hawassa
Organisation for Women in Self-Employment, WISE
Quacha Birra Savings Group, World Vision
SNNP (Southern Nations, Nationalities & People's Region) Regional Cooperative Regulation
Tigal Fruit Sellers Association, Hawassa
UN-Habitat
UNCDF (UN Capital Development Fund)
World Vision Ethiopia, Addis Ababa and Hawassa

APPENDIX 2. Survey Data

Saving

Saving (Multiple Choice Question)

	Bank	%	SACCO	%	MFI	%	CSSG/SHG/VSL	%	MobileMoney	%	Ekub	%	Jirite/Edir	%	Home	%	Other	%	Missing	Total
Addis Ababa	57	57	0	0	6	6	0	0	0	0	12	12	0	0	6	6	1	1	0	100
Hawassa	40	40	0	0	55	55	0	0	0	0	9	9	1	1	0	0	0	0	0	101
Total	**97**	**48**	**0**	**0**	**61**	**30**	**0**	**0**	**0**	**0**	**21**	**10**	**1**	**1**	**6**	**3**	**1**	**1**	**0**	**201**

Regular Saving

	Yes		%	No	%	Missing	Total
Addis Ababa	55		60	36	40	9	100
Hawassa	80		85	14	15	7	101
Total	**135**		**73**	**50**	**27**	**16**	**201**

Saving Motivation (Multiple Choice Question)

	Business	%	Business Emergencies	%	School Fees	%	Family/Medical Emergencies	%	Land/House	%	Other	%	Missing	Total
Addis Ababa	45	45	26	26	21	21	22	22	21	21	19	19	0	100
Hawassa	71	70	29	29	14	14	20	20	15	15	25	25	0	101
Total	**116**	**58**	**55**	**27**	**35**	**17**	**42**	**21**	**36**	**18**	**44**	**22**	**0**	**201**

Reasons for not Saving (Multiple Choice Question)

	Don't need savings	%	Don't have money to save	%	Don't earn regularly enough	%	Too complicated and/or expensive	%	Didn't know about options	%	Other	%	Missing	Total
Addis Ababa	1	1	16	16	13	13	2	2	1	1	2	2	0	100
Hawassa	0	0	7	7	3	3	0	0	0	0	3	3	0	101
Total	**1**	**1**	**23**	**11**	**16**	**8**	**2**	**1**	**1**	**1**	**5**	**3**	**0**	**201**

Saving Problems

	Yes	%	No	%	Missing	Total
Addis Ababa	25	27	68	72	7	100
Hawassa	20	20	78	80	3	101
Total	**45**	**24**	**146**	**76**	**10**	**201**

Loan (last 24 months)

	Yes	%	No	%	Missing	Total
Addis Ababa	48	78	52	52	0	100
Hawassa	48	78	53	52	0	101
Total	**96**	**48**	**105**	**52**	**0**	**201**

Borrowing

Borrowing (Multiple Choice Question)

	Bank	%	SACCO	%	MFI	%	CSSG/SHG/VSL	%		MobileMoney	%	Ekub	%	Jirite/Edir	%	Supplier/Boss	%	Friend	%	Other	%	Missing	Total
Addis Ababa	1	1	2	2	11	11	0	0		0	0	1	1	1	1	1	1	29	29	4	4	0	100
Hawassa	3	3	2	2	15	15	0	0		0	0	3	3	1	1	2	2	17	17	10	10	0	101
Total	**4**	**2**	**4**	**2**	**26**	**13**	**0**	**0**		**0**	**0**	**4**	**2**	**2**	**2**	**3**	**2**	**46**	**23**	**14**	**7**	**0**	**201**

Borrowing Motivation (Multiple Choice Question)

	Business	%	Business Emergencies	%	School Fees	%	Family/Medical Emergencies	%	Land/House	%	Other	%	Missing	Total
Addis Ababa	39	39	14	14	8	8	13	13	5	5	7	7	0	100
Hawassa	50	50	17	17	7	7	8	8	4	4	2	2	0	101
Total	**89**	**44**	**31**	**15**	**15**	**8**	**21**	**10**	**9**	**5**	**9**	**5**	**0**	**201**

Reasons for not Borrowing (Multiple Choice Question)

	Don't need a loan	%	Don't earn regularly enough	%	Worried about not paying back debt	%	Don't trust banks or MFIs	%	Too expensive	%	Other	%	Missing	Total
Addis Ababa	10	10	6	6	29	29	1	1	6	6	16	16	0	100
Hawassa	9	9	6	6	17	17	0	0	5	5	25	25	0	101
Total	**19**	**10**	**12**	**6**	**46**	**23**	**1**	**1**	**11**	**6**	**41**	**20**	**0**	**201**

Borrowing Problems

	Yes	%	No	%	Missing	Total
Addis Ababa	17	20	70	80	13	100
Hawassa	29	31	66	69	6	101
Total	**46**	**25**	**136**	**75**	**19**	**201**

Mobile Use (Multiple Choice Question)

	Business	%	Send M-Payments	%	Receive M-Payments	%	Missing	Total
Addis Ababa	77	77	6	6	3	3	0	100
Hawassa	94	93	1	1	1	1	0	101
Total	**171**	**85**	**7**	**4**	**4**	**2**	**7**	**206**

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