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# Ethiopian Microfinance Sector Challenges and Problems

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**Abstract**
Primary objective of this paper was to identify the root causes of the problems and challenges faced by Ethiopian microfinance sector and to, subsequently, recommend remedial measures. In depth interview has been used to identify and understand the problems and challenges faced by microfinance institutions. This study depicted that Primary cause for all problems is fund shortage and; in turn, the primary cause for fund shortage is insufficient start up equity capital. In addition, ownership structure is identified as supplementary cause of governance problems. Finally, it is recommended that solving these couple of problems is a must to overcome all challenges of the sector as taking measures on other problems is unlikely to provide long-lasting relief from the undesired effect.

## 1. Introduction

Unlike conventional banks, micro finance institutions provide diverse micro financial services as well as nonfinancial services, so as to address the diverse socio-economic needs of the poor who cannot afford collateral requirement of other formal financial institutions. Literatures have witnessed that microfinance plays indispensible role in poverty reduction, inclusive and equitable development, gender equality and HIV aids. This is because they serve economically and socially deprived groups of the society; they play not only financial intermediation role but also consultancy role in entrepreneurial skills; personal financial management and business plan development. Moreover, they empower and bring women and deprived groups together and let them share socio-economic information and knowledge as mostly they use group lending model. As result, micro financial services not only raise income of deprived groups, but also improve their health and level of education, and their influence on public decisions; these all credit their vital social role. Thus, it contributes a lot for human development which is an increasingly important sphere of development.

Countries may show high average growth rate, but in most countries the question of equitable distribution of income remains unanswered. Lack of equal financial access is one of the biggest reasons for high income inequality which, in turn, leads to crime and political instability which hampers the processes of economic development. These days, those countries which have introduced microfinance into their policy domain have reduced income disparity substantially; meaning these countries have successfully reduced poverty (Hisako Kai and Shigeyuki Hamori, 2009). Thus, micro finance institutions became one of vital tools to ascertain inclusive/equitable and sustainable development. As result, the importance of micro finance for poverty reduction has got momentum in the policy agenda of several countries like Ethiopia.

Since 1990s, reducing pervasive poverty and ensuring human development have been the objectives of the Ethiopian government. Accordingly, Ethiopian government has implemented various types of poverty reduction programs; such as micro and small enterprises development, access to finance, and different donor aided programs; and as result, proportion of population below poverty line has declined steadily to 29.6 percent in the year 2010/11 (Ministry of finance and Economic Development, FDRE). In this respect, the government of Ethiopia has a firm belief in pivotal role of microfinance in poverty reduction. Thus, microfinance is considered as one of the important tools for combating poverty by supplying credit for productive poor and giving them opportunity to save; thereby ascertaining access to finance.

This paper primarily targeted at identifying the current problems and challenges of the Ethiopian microfinance sector and to, subsequently, recommend remedial measures.

## 2. Statement of the problem

Ethiopia is one of world's fastest developing countries which has prepared intensive development plan and exerting greater efforts to alleviate poverty so as to realize inclusive and sustainable development. In this respect, the country has well recognized microfinance services as one of important tools for poverty reduction or inclusive development. Ethiopian microfinance sector is showing high growth trend from time to time, but there are a plenty of financial and governance problems in the industry that may result in systemic risk unless appropriate measures are taken as early as possible. So, the issue is how we can create sustainable microfinance sector that can serve the poor on continuous basis and let the sector realize the very mission of poverty reduction and inclusive development.

Many studies have depicted that Ethiopian microfinance institutions are faced with numerous problems and challenges, such as low outreach, fund shortage, limited product diversification, limited research and innovation, and weak internal control system and MIS (Dr Woldey A, 2001; Yigirem K, 2010; Microfinance transparency, 2011). However, giving solutions for these problems is unlikely to provide long-lasting relief from the undesired effect. Thus, the question is what the root causes of these all problems are? This is yet not answered. Thus, this study is primarily aimed to identify the root causes of aforementioned problems, and to recommend subsequent measures to be taken.

## 3. Research Methods

In depth interview had been conducted where each interviewee is asked the same set of questions so as to reduce bias to reach in right conclusion. Qualitative datum obtained through in-depth interviews with General Managers, Finance managers and other concerned were used in this paper. Interviews were held with 10 General Managers, and their respective finance managers who are selected based on purposive sampling technique. The interviewees were interviewed independently or with no communication among each other.

## 4. Challenges and Problems of the Sector

Ethiopian microfinance sector has faced with many problems and challenges, such as low outreach, limited product diversification, limited research and innovation, and weak MIS and internal control system. But primary cause for these problems is fund shortage and; in turn, the primary cause for fund shortage is insufficient start up equity capital; therefore, root cause for those problems is insufficient start up equity capital as explained below. Whereas another basic problem is governance problem, which is partly caused by fund shortage, and partly by ownership structure. Thus, the basic Challenges of the Ethiopian Microfinance sector are found to be fund shortage and governance problems from which all other problems and/or challenges are emanated. Root causes of these problems and the subsequent consequences are navigated as follows.

### 4.1 Fund shortage

With the current economic progress of the country, it is difficult for Ethiopian MFIs to meet ever increasing financial demand of the poor with the current startup capital (ETB 200,000 which equals US$11 thousand). This insufficient capital has led to creation of some weak MFIs in the country (Yigrem kasa, 2010). Most of the microfinance institutions in Ethiopia are established with the assumption of getting donation or grant from NGOs or government; the intention behind closed door is to operate with about two hundred thousand Birr plus, but sometimes they become unsuccessful; specially private owned and/or NGO backed MFIs. This minimum capital requirement was approved Sixteen years ago; thus inflation is another big issue.

> "*Lack of access to affordable capital/fund to finance growth is a major challenge faced by Ethiopian MFIs. …The government supported MFIs are reinforced by equity finance from regional governments….Not only has this hampered the ability for MFIs to scale up, but also it has resulted in some MFIs having to make some products dormant whilst they seek new funding streams. This lack of capital/fund has also hindered MFIs from investing in their own development." (Microfinance transparency, country survey (Ethiopia), page 8 &14, Dec 2011)*

As result, they are compelled to suffer from lack of fund to scale up their operations; increase outreach, diversify products and services, to invest in their own developments like MIS and internal control, and office development; and consequently, operate with loss for many years and unable to build their goodwill; and finally their fate is going to be acquisition or liquidation which, in turn, severely affects public confidence on financial institutions; thus long term negative impact in credit and saving culture of the country is cumbersome. This is going to be their ultimate choice because they could not attract external investors (equity investors, lenders) as well as social investors, and depositors under this situation.

Relatively strong financial muscle/profitability is considered as prerequisite by lenders, equity investors and donors who focus on such promising MFIs, whereas internal developments such as office layout and professional man power can attract a plenty of depositors who are sustainable funding sources; but these are difficult to achieve for Ethiopian MFIs with the current startup capital. So, root cause for fund shortage is insufficient startup capital and other challenges are derived from it. Thus, most of microfinance institutions operating in Ethiopia are unable to strengthen their competitive influence as well as unable to achieve economies of scale and economies of scope (bigger portfolios, not bigger loans), under the current macroeconomic environment with the current startup equity capital. Therefore, there is a need for transformation for Ethiopian micro finance sector, like that of conventional banks.

### 4.2 Governance problem

Currently, most of the MFIs in Ethiopia are more than 90% owned by government or local NGOs and/or associations, and who appoint representative to act on their behalf. The remaining less than 10% shares are owned by individuals; even though, most of them are nominal shareholders. In case of government owned microfinance institutions, by default, regional government officials are appointed as board of directors who might be changed while things are jumbled or on periodical shift; thus it has been a great challenge for MFIs to acquaint ever changing board members with special nature of financial sector and the importance of MFIs in poverty reduction; which demands special expertise and experience than other sectoral offices, Sometimes, this is also true for local NGO owned MFIs. In both NGO owned/backed and government owned MFIs, nominal shareholders are not committed to attend General assembly and board meetings in order to settle concerning issues and give directions on timely basis.

Whereas it is difficult for MFIs to recruit and retain qualified Chief Executive Officers (CEOs) and experienced staffs as they are unable to operate at least at equilibrium. This is because of insufficient capital which does not let them scale up their operations, especially beginners as most of them are unsuccessful to get donations as per their intention. In addition, for some government owned MFIs, lack of commitment to appoint qualified CEOs and recruit professional staffs has been remained as a challenge. Thus, ownership structure and insufficient equity capital/weak financial capacity/ of MFIs can be cited as root causes of governance problems of Ethiopian microfinance sector.

## 5. Conclusion

Ethiopian microfinance sector has faced with many problems and challenges, such as low outreach, limited product diversification, limited research and innovation, and weak MIS and internal control system. This study depicted that Primary cause for all these problems is fund shortage and; in turn, the primary cause for fund shortage is insufficient start up equity capital; therefore, root cause for those problems is insufficient start up equity capital. This is because relatively strong financial muscle is considered as prerequisite by lenders, equity and social investors who focus on such promising MFIs; operational self sufficiency of certain years is required by lenders, donors and equity investors, whereas internal developments such as office layout and professional man power can attract a plenty of depositors who are sustainable funding sources.

This fund shortage is a constriction for microfinance institutions to increase their outreach i.e. to increase both geographical coverage and number of loan clients or to serve more poor, to study and introduce new financial products as well as to invest in their own developments like MIS and office development, and skilled manpower recruitment. Whereas, the root causes for governance problems are ownership structure and weak financial capacity of MFIs. Thus, solving these couple of problems is a must to overcome all challenges of the sector as taking measures on other problems is unlikely to provide long-lasting relief from the undesired effect.

## 6. Recommendations

- ✓ In order to strengthen competitive ability of microfinance institutions as well as encourage economies of scale & economies of scope, and also strengthen capital base to the level considered adequate by taking the current macroeconomic indicators into account, it is advisable to increase minimum paid up capital by the concerned authority as soon as possible.
- ✓ The government should design strategy to solve governance problem from now, if not, things will be highly complicated and it will be difficult to solve. Thus, the responsible organ of the government should study ownership structure of microfinance sector; and put appropriate short-term and long-term remedies to strategically solve the problem. In the short term, for government owned MFIs, building strong management; its commitment to recruit trained and experienced executive management members is highly recommended, whereas for private owned and NGO backed MFIs' governance problem will be solved meanwhile fund shortage is solved.
- ✓ In addition to regulatory and supervisory support, the government should introduce capacity (financial, expertise, and others) building measures so as to raise efficiency of micro finance institutions in order to improve financial access or saving and credit culture and quality of financial services.

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