

**REGULATION AND SUPERVISION OF MICROFINANCE
INSTITUTIONS IN ETHIOPIA:
ACHIEVEMENTS, CHALLENGES & PROSPECTS**

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Opinions expressed in the paper are those of the author and do not necessarily reflect the policies and stands of the National Bank of Ethiopia.

Outline

1. Selected Macroeconomic Indicators, the overview of Financial System & Microfinance in Ethiopia
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3. Objectives & principles of Regulating and Supervising microfinance sector in Ethiopia
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7. Major achievements of Regulation and Supervision of the Microfinance Sector
8. Challenges of the current regulatory & supervisory practices
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1.1 Selected Macroeconomic and Social Indicators: Ethiopia

Land Area	1.14 million sq.km
Population (Out of which urban population in percentage)	76.8 Million 15.8 million
GDP per capita	GDP per capita (in USD) 260
Agriculture and allied activities (as % of GDP)	43.2
Industrial sector (as % of GDP)	13%
Service sector (as % of GDP)	45.1

1.2 Overview of the Financial System

- Major economic reforms have been taken by the Ethiopian government after the fall of the socialist government in 1991.
- Consequently, the Ethiopian Financial System has passed through significant reform process since 1992 as a part of transition from a planned to a market economy.
- The major reform measures taken include: Liberalizing and reforming the financial sector, relaxing foreign exchange controls, dismantling the administered interest rate regime, establishing a new regulatory framework for banks, insurance companies, microfinance institutions and cooperatives.

Overview of the Financial System

CONTD...

1. Development Bank	
1.1 No. of Banks	1
1.2 No. of Branches	32
2. Commercial Banks	
2.1 No. of banks	12
2.2 No. of branches	604
3. Microfinance Institutions	
3.1 No. of MFIs	30
3.2 No. of branches	433 branches 598 sub-branches
4. Insurance Companies	
4.1 No. of insurance companies	12
4.2 No. of branches	194

1. 3 THE OVERVIEW OF THE MICROFINANCE SECTOR IN ETHIOPIA

- Ethiopia is a country that has been showing impressive performance in microfinance in Africa
- Until 1996, the provision of microfinance services in Ethiopia has been carried out mostly by donor funded programs through NGOs and government institutions.
- This practice has undermined loan collection performance leading to huge default and hence weakened the development of self sustaining MFIs.
- As a result, ; the first licensing & supervision of microfinance business was issued in 1996. This proclamation was again revised and replaced by Microfinance Business Proclamation no. 626/2009.
- Currently, there are 30 MFIs working through 433 branch offices and 598 sub-branches.
- MFIs are serving over 2.3 million clients.

THE OVERVIEW OF THE MICROFINANCE SECTOR IN ETHIOPIA contd...

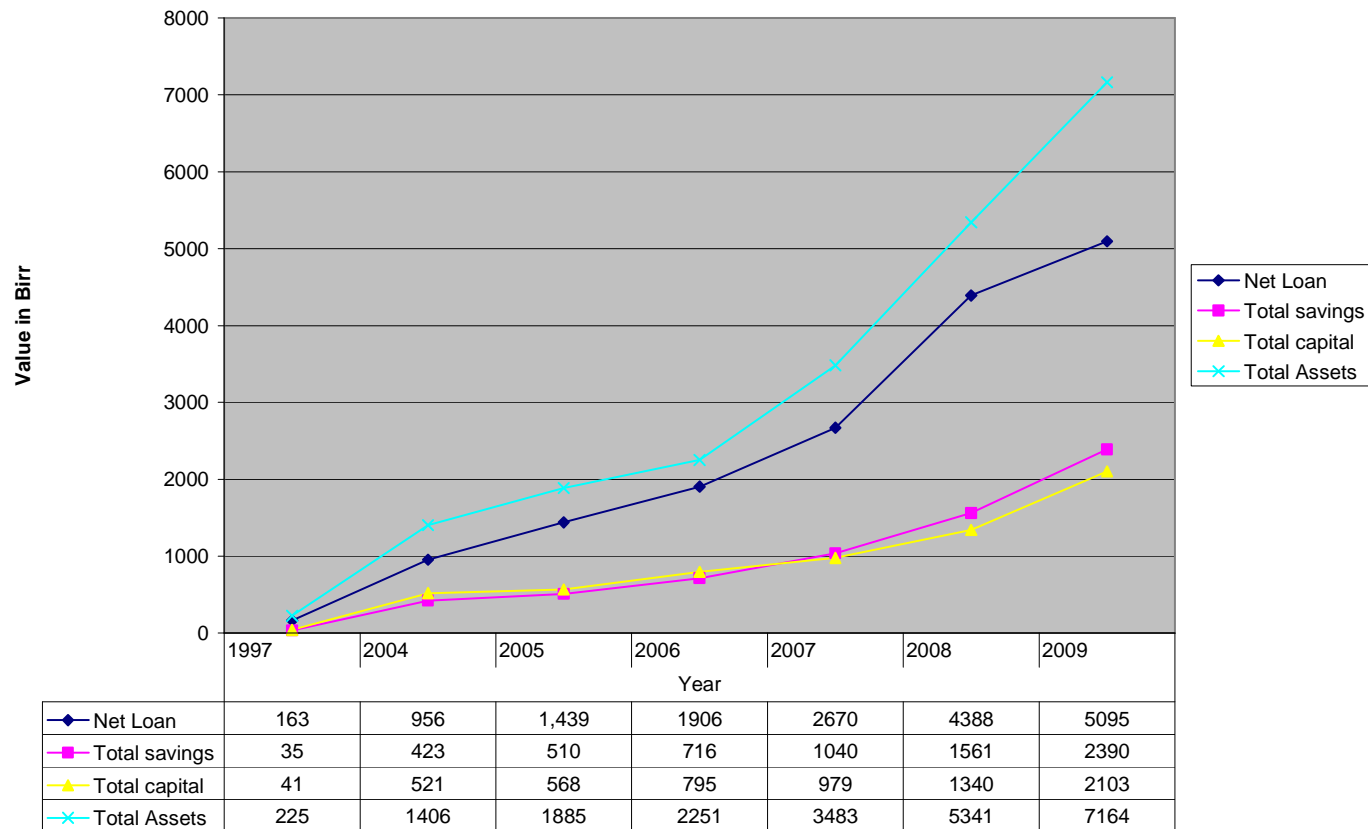
Name of MFI	No. of Clients
1. ACSI	687,586
2. DECSI	412,293
3. OCSCO	339,018
4. ADCSI	115,563
5. Wisdom	56,304
6. Other MFIs	Serve the remaining clients of 2.3 million clients

THE OVERVIEW OF THE MICROFINANCE SECTOR IN ETHIOPIA CONTD...

- MFIs provide wide range of services including lending, savings, money transfer, collecting taxes on behalf of tax authorities, paying pension payments etc.
- The assets of largest MFIs are comparable to those of the smallest private banks
- The institutions are rendering services in all regions except for Somali and Afar regional states
- At December 30,2009 the MFIs mobilized Birr2.4 billion savings (US\$ 178,241,387) which finances almost 50% of the loan outstanding
- Outstanding loan amounts to Birr 5 billion (US\$ 379,920,507)
- Total capital amounts to Birr 2.1 billion (US\$ 156,840,865)
- Total Assets amounts to Birr 7.2 billion (US\$ 534,265,697)

THE OVERVIEW OF THE MICROFINANCE SECTOR IN ETHIOPIA CONTD...

Consolidated Data on Microfinance Sector (In millions of Birr)



Structural Set up of Microfinance Supervision

- Initially it was carried out under bank supervision department
- Separate department was formed starting from 2004,
- In 2009, it was upgraded to Directorate level
- It has policy & licensing & supervision wings lead by principal examiners

2. LEGAL & Ownership Structure

- The current regulatory framework requires microfinance institutions to be formed as share companies owned only by Ethiopian nationals (As defined under art. 304 of the commercial code and Microfinance business proclamation)
- Therefore, all MFIs in Ethiopia are share companies by law
- The code defines Share company as “ a company whose capital is fixed in advance and divided into shares and whose liabilities are met only by the assets of the company
- A share company can not be established by fewer than five shareholders

LEGAL & Ownership Structure

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- Since MFIs are to be formed as share companies they can raise capital by dividing the capital into shares and selling them to interested buyers
- National Bank of Ethiopia Licenses MFIs upon fulfilling the requirements set by the MFI proclamation and directives
- Most of the sample MFIs have regional governments, individuals , commercial banks & NGOs as shareholders
- The number of shareholders range from 6 to 2,805 shareholders
- There are also MFIs like Agar , Dynamic, Lefayda MFI that are purely established by private investors
- Role of the board, composition of board (in terms of qualification, expertise, skill etc, audit and supervision, Disclosure requirements, Accountability and liability, enforcement mechanisms are defined in commercial code, microfinance business proclamation and directives.

3.Objectives and principles of regulation and Supervision of MFIs

3.1 Objectives of Regulation & Supervision

1. Protecting Small Depositors
2. Ensuring Integrity and Stability of the microfinance sector in particular and Financial Sector in general
3. Promote Efficient Performance of the institutions
 - The regulation focuses on the attainment of the above objectives

3.2 Key Principles (policies) followed in Regulation and Supervision

- All supervisory decisions of the Bank shall primarily focus on the stability of the financial system and also consider safety and soundness of FIs and protection of small depositors.
- Prudential regulation focuses on type of transaction rather than the type of institution (microfinance is a line of business)
- Supervision of microfinance especially portfolio testing is made based on specific techniques and skills that are different from those used to supervise commercial banks
- Efficiency: Negative effects of regulation should be minimized.
- Cost & benefit analysis: All regulatory & supervisory methods and practices should be cost effective.
- Degree of supervisory intervention of the Bank shall be in accordance with clear guidelines and commensurate with risk profile of FI and the expected benefits.
- The Bank shall increasingly use works of third parties like external auditors and actuaries for its supervisory work and endeavor to improve their performance standards.
- Key supervisory outputs of the Bank like examination reports shall pass through quality assurance.

4. THE REGULATORY FRAMEWORK

- According to Article 3(2) of the aforementioned proclamation, MFIs are allowed to carry out the following activities:
- Accepting both voluntary and compulsory savings as well as demand and time deposits
- extending credit to rural and urban farmers and people engaged in other similar activities as well as micro and small scale rural and urban entrepreneurs
- drawing and accepting drafts payable within Ethiopia
- Micro-insurance business as prescribed by NBE
- purchasing such income generating financial instruments as treasury bill and other income generating activities

THE REGULATORY FRAMEWORK

CONTD...

- acquiring, maintaining and transferring any movable and immovable property including premises for carrying out its business
- Supporting income generating projects of urban and rural micro and small scale operators
- Rendering managerial, marketing, technical and administrative advice to customers and assisting them to obtain services in those fields
- managing funds for micro and small scale business
- Providing money transfer services
- Providing financial leasing services

4. THE REGULATORY FRAMEWORK

- The regulatory framework consists of the commercial code, proclamation for banking & microfinance business, and other 19 directives issued by NBE

Instruments of Regulation

4.1 Preventive Regulation : It is used as a pre-crisis measure by National Bank of Ethiopia.

4.1.1 Entry Requirements.

4.1.1 Entry Requirements.

No.	Description	Requirement
1	Minimum Capital Requirement	US\$ 21,500 (Birr 200,000)
2	Ownership structure	Fully owned by Ethiopians
3	Feasibility studies requirement	-Financial Projections
4	Other requirements	-CEO & BODs should meet qualification and experience requirement set by NBE

4.1.2 Ongoing requirements

No	Description	Requirement
1	Capital Adequacy	12% of RWA
2	Liquidity	20% of total deposits
3	Loan portfolio Classification & Provisioning	-25% (Substandard), 50%(Doubtful), 100% (Loss)
4	Lending limit	-1% of total capital to a single borrower -4% of total capital to group borrowers
5	Branching requirement	-Required to notify NBE in writing when MFIs opened new branches -Closure of branches is conducted after obtaining approval from NBE -NBE should be notified at least three month prior to conducting intended closure
6	Frequency and contents of reporting	-MFIs are required to report their capital adequacy, liquidity, loan classification and provisioning, balance sheet, Income statement position etc. to the NBE at least every quarter
7	External audit reports	-MFI shall appoint external auditors satisfactory to NBE & should submit audit report within six months form the end of the financial year -NBE may issue directives on minimum qualification of external auditors, scope and depth and tenure of audit

ONGOING REQUIREMENTS CONTD...

No	Description	Requirement
8	Restriction on Investment	-MFIs are not allowed to invest more than 10% and 3% of their equity capital and net worth in allied activities and single enterprise,
9	Taxation	-Microfinance institutions that make profit and distribute to shareholders shall pay profit tax and those that fully plough back shall not pay profit tax

Instruments of Regulation Continued...

4.2 Protective regulation:

- Is a post-crisis measure taken by National Bank to avoid run on deposits
- It includes the bank acting as lender of last resort, introducing deposit insurance, restructuring & reform, receivership and liquidation and others

4.3 OTHER ADDITIONAL FEATURES OF THE REGULATORY FRAMEWORK

- As far as the MFIs meet the requirement set by National bank of Ethiopia, they can transform to a bank or other type of Financial Institution. However, NBE may require such MFI to continue providing micro-financing services as apart of business
- Unlike the previous proclamation, Microfinance is clearly defined containing provision of wide range of financial services & it is defined as a business and hence banks licensed by NBE are allowed to engage in microfinance without a separate microfinance business license
- The mandates of the bank were clearly defined in relation to safeguarding financial stability & soundness of microfinance sector.
- Clear accountability of people running the MFIs is included. The new proclamation also stipulates conditions up on which penalties can be imposed on director, office or employee of an MFI
- Unlike the previous proclamation, the new proclamation contains provisions on know your customer, receivership and liquidation of MFIs.
- Unlike the previous proclamation, it allows MFIs to apply any lending methodology at their own discretion.

5. SUPERVISORY APPROACH & Its PERFORMANCE

- In Ethiopia, as done else where the microfinance supervision consists of off-site surveillance & on-site examination.

5.1 Off-site Surveillance

- The off-site surveillance involves analysis of data reported to the NBE
- For off-site monitoring, MFIs are required to submit quarterly reports that show their financial & operational performance.
- The off-site returns that should be submitted by MFIs include: income and expense statements, balance sheet, capital adequacy report, liquidity report, loan status & provisioning report etc.
- In order to effectively carry out the off-site surveillance, a data base is established at Microfinance Supervision Directorate
- The overall performance of the MFIs is assessed and determined based on analysis and evaluation of capital adequacy, asset quality, earning, and liquidity
- Quarterly off-site reports with key findings in above areas are produced and are submitted to senior policy makers to inform them about on-going view of MFIs soundness in key financial areas
- Pilot testing is being carried out to provide quarterly off-site rating reports to MFIs

5.2 ON-SITE EXAMINATION

- During on-site examination the supervision staff physically visit the MFIs to check the accuracy of reports submitted to NBE & assess the overall performance of the MFIs based on CAMEL approach.
- Helps NBE to have first hand information on compliance of prudential standards & performance of MFIs
- Type of on-site examination includes: Full scale, special, or follow up examination
- Introduction of Risk Based Supervision is underway

5.3 SUPERVISION

- Risk based supervision for MFIs is mainly drawn from a more comprehensive understanding of risk profile of MFIs
- The supervisory practice has tried to address some difference of traditional banks & MFIs in terms of their clientele, nature of loan, among others.
- In microfinance supervision more focus is given to the system and process rather than emphasizing on individual transactions
- Specific Directorate has been established for regulating and supervising the microfinance sector

5.4 Role of Internal & External Auditors

- Currently not satisfactory
- In order to strengthen the role of internal and external auditors in supervision, external consultant has been hired & the proposal will be introduced soon.
- This will help to get more reliable and timely information from MFIs and hence decrease in time spent during on-site examination and cost of supervision

6.COMPARATIVE ASSESSMENT OF REGULATORY FRAMEWORK OF ETHIOPIA, UGANADA & TANAZANIA

COUNTRY	TYPE OF INSTITUTION	REQUIREMENT IN US\$
Ethiopia	Micro Financing Institution	21,500
Uganda	Micro Deposit – Taking Institutions	250,000
Tanzania	MFC nationwide Branches	800,000
	Unit MFC	200,000

COMPARATIVE ASSESSMENT OF REGULATORY FRAMEWORK OF ETHIOPIA, UGANADA & TANAZANIA

COUNTRY	CAPITAL ADEQUACY REQUIREMENT
Ethiopia	12% (Risk weighted Assets to total capital)
Uganda	15% of RWA to core capital and 20% of RWA to total capital
Tanzania	10% of RWA to core capital and 15% of RWA to total capital

COMPARATIVE ASSESSMENT OF REGULATORY FRAMEWORK OF ETHIOPIA, UGANADA & TANAZANIA

COUNTRY	LOAN SIZE LIMITS
Ethiopia	<p>Total loans extended by a microfinance institution to any single borrower shall at no time exceed 1% (one percent) of the total capital of the microfinance institution.</p> <p>Total loans extended by a microfinance institution to a group of borrowers on the basis of group guarantee shall at no time exceed 4% of the total capital of the microfinance institution</p>
Uganda	<p>1% of core capital for a single borrower 5% of core capital for a group of borrower</p>
Tanzania	<p>3% of core capital if Granted against collateral 1% of core capital if secured by personal guarantee or collateral not registered by public institution. 2% by both</p>

7. MAJOR ACHIEVEMENTS

- Created an enabling environment for those who were considered un-bankable.
- Enabled MFIs to offer a wide range of financial services.
- Promoted standardization and transparency in the microfinance sector.
- Increased the MFIs legitimacy and acceptance by banks and depositors. Enabled MFIs to borrow from commercial banks and other lending institutions.
- Helped to shift the microfinance service delivery from subsidized credit delivery to a business entity.
- Helped MFIs to achieve growth and outreach
- It has helped to build public confidence.

8. CHALLENGES IN THE CURRENT REGULATORY & SUPERVISORY PRACTICES

- ✓ Ownership & Governance problems on some MFIs
- ✓ There is no clear guideline or regulatory framework on transformation of MFIs to banks or other form of FIs
- ✓ There is no clear regulatory framework when banks are interested to offer microfinance products.
- ✓ There is a gap in offering financial services to the small and medium enterprises
- ✓ Encouraging developments seen in saving mobilization but needs to be enhanced
- ✓ The country has the big MFIs in Africa. However, setting of low capital requirement has lead to creation of some weak MFIs.
- ✓ There is no proper regulatory and legal support such as property right law especially for registering movable assets of micro and small enterprise
- ✓ Inadequate database (not automated and networked);
- ✓ On-site inspection takes long time
- ✓ Weak MIS of MFIs
- ✓ Staff capacity

9. LESSON THAT MAY BE DRAWN FROM OTHER COUNTRIES EXPERIENCE

- Regulatory framework for graduation(up scaling) of MFIs is necessary
- It is advisable to raise the current initial minimum capital so that MFIs will be in a position to withstand shocks and provide sustainable financial services.
- Optimum balance should be sought between limited supervisory capacity of regulatory authorities on one hand and the rapid growth in the number of MFIs on the other
- It is advisable to put in place Credit Reference Bureau & deposit insurance scheme
- Prudential norms set for MFIs should be more stringent than conventional Banks, for example, a more conservative loan loss provisioning requirement should be prescribed that goes with the specific nature of MFIs
- The responsibility and scope of external auditors should be clearly defined so that to avoid duplication of work
- Issues related to regulatory arbitrage should be seriously considered

10. THE WAY FORWARD

- ✓ There are areas where the current regulatory framework needs revisiting (e.g. form of the institutions, initial capital requirement, loan classification & provisioning, returns etc.)
- ✓ Comprehensive, clear and effective return formats need to be developed & introduced;
- ✓ Appropriate technology need be employed and modern database need to be established;
- ✓ All relevant international standards and practices including auditing, & accounting standards need to be introduced;
- ✓ The implementation of risk-based supervision to significantly shorten the duration of on-site examination; Supervision should not only focus on historical performance but on future performance
- ✓ Reliance on third parties (such as external auditors) after enhancing the existing regulatory framework & capacity.
- ✓ Deposit Insurance scheme is proposed need to be introduced & implemented ;
- ✓ The regulatory and supervisory system should be made a subject of continuous assessment and review.
- ✓ Supervisory staff capacity needs to be enhanced;

11. CONCLUSION

- ✓ Ethiopia is one of the few countries that has established specific regulatory & supervisory framework for microfinance
- ✓ The Government & NBE has made efforts to gradually improve the regulatory framework.
- ✓ In general, the regulatory framework has created conducive environment for microfinance business.
- ✓ Currently, NBE is being implementing BPR study to radically improve its regulatory and supervisory practice
- ✓ The issue of regulation & supervision hamper or enhance the performance of MFIs
- ✓ There is no best solution for regulating Microfinance business.
- ✓ Each regulatory consideration has to be adjusted to the exceptional situation of the country.

CONCLUSION CONTD...

- Regulatory framework needs to be reviewed with the development of the sector
- The microfinance sector could reach its full potential in regulated situation. In order to reach full potential, the microfinance industry must eventually be able to enter the arena of licensed, prudentially supervised financial intermediation,

Thank you!