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"Microfinance Institutions operating in Addis Ababa: Institutional Viability and Financial Performance" the case of ADCSI, SFPI and Wisdom MFIs

By:
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Advisor: Degefe Duressa (PhD)

March, 2011
Addis Ababa

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A Research Project Submitted to School of Business and Public Administration in Partial Fulfillment of the Requirements for the Master of Science Degree in Accounting and Finance

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Declaration

I, the undersigned, declare that this thesis is my original work and has not been presented for a degree in any other university.

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List of Tables

Acronyms

ADCSI	Addis Credit and Saving Institution
ADB	African Development Bank
AEMFI	Association of the Ethiopian Microfinance Institutions
AROA	Adjusted Return on Assets
AROE	Adjusted Return on Equity
CCE	Commercial Code of Ethiopia
CEO	Chief Executive Officer
CGAP	Consultative Group to Assist the Poor
CSA	Central Statistics Agency
EBDSN	Ethiopian Business Development Service Network
ETB	Ethiopian Birr
GDP	Gross Domestic Product
GOE	Government of Ethiopia
HDI	Human Development Index
IFAD	International fund for Agricultural Development
I-PRSP	Interim Poverty Reduction Strategy Paper
MDGs	Millennium Development Goals
MF	Microfinance
MFIs	Micro-Finance Institutions

MIX	Microfinance Exchange
NBE	National Bank of Ethiopia
NDP	National Development Program
NGO	Non-Governmental Organization
PaR	Portfolio at Risk
RUFIP	Rural Financial Intermediation program
SFPI	Specialized Financial and Promotional Service
UNCDF	United Nations Capital Development Fund
UNDP	United Nations Development Program
USD	United State Dollar
WOCCU	World Council of Credit Unions

Abstract

Currently micro-financing is one of the most powerful tools for combating poverty primarily by providing loan to the poor section of the society. The number of micro financing institutions serving the poor in Ethiopia has grown to over 30 with in short period of time. The growth and expansion of microfinance programs and increasing attention to microfinance as a poverty reduction strategy has given rise to a number of questions. What are the factors that are necessary for strong institutional viability and financial performance? What are the problems in achieving institutional sustainability and strong financial performance of MFIs? The case of three microfinance institutions namely, ADCSI, SFPI, and Wisdom operating in Addis Ababa were used to respond to the above questions. The main objective of the study is to assess the institutional viability and financial performance and draws conclusions and make recommendations for improving the institutional viability and financial performance of the MFIs. The study used both quantitative and qualitative methods to obtain information on institutional viability and financial performance of the three sample MFIs. Primary data were collected through unstructured interview. Secondary data were mainly collected from audited financial statements. Finally, adjustments to financial data were made and the performances of the MFI were measured by taking selected indicators. The results of the study revealed that the ADCSI and Wisdom MFIs have achieved financial self-sufficiency in the years 2005 and 2006 respectively. SFPI has not achieved the level of financial self-sufficiency at all. However, the trends of their financial performance demonstrate that there is a good and steady progress towards improving financial self-sufficiency in the three MFIs. Both ADCSI and SFPI already achieved operational self-Sufficiency. The main constraints in institutional and financial sustainability of MFIs Operating in Addis Ababa are: - Lack of experienced and competent board of directors, Lack of trained manpower and efficient legal system to enforce contracts. In order to improve, institutional and financial viability of microfinance institution, the need to have competent board of directors and management body is emphasized. Furthermore, the importance of having human resource development strategy and putting in place an efficient legal system to enforce contracts has been recommended.

Chapter One: Introduction

1.1. Background of the study

One of the most stylized facts of developing economies is that formal financial institutions leave the poorest population tightly constrained in their access to financial services. It is also widely recognized that economic progress relies largely on access to financial services such as savings, insurance, and credit. Where formal financial institutions fail the large majority of the poor population, there is evidence to support the proposition that microfinance institutions & credit unions can fill some of the gap (Barham, et. al., 1996).

Micro-Finance Institutions (MFIs) can be defined as any activity that includes the provision of financial services such as credit, savings, and insurance to low income individuals which fall just above the nationally defined poverty line, and poor individuals which fall below that poverty line, with the goal of creating social value. The creation of social value includes poverty alleviation and the broader impact of improving livelihood opportunities through the provision of capital for micro enterprise, and insurance and savings for risk mitigation and consumption smoothing (Smith, 2006).

Most poor people manage to mobilize resources to develop their enterprises and their dwellings slowly over time. Financial services could enable the poor to leverage their initiative, accelerating the process of building incomes, assets and economic security. However, conventional finance institutions seldom lend down-market to serve the needs of low income families and women headed households. Therefore, the fundamental problem is not so much of unaffordable terms of loan as the lack of access to credit itself (Kim, 1995). The lack of the access to credit for the poor is attributable to practical difficulties arising from the discrepancy between the mode of operation followed by financial institutions and the economic characteristics and financing needs of low income households.

Several studies noted different causes for poverty in a country. Some argued that the cause of poverty in developing economies among other things is that the poor does not have access to credit for the purpose of working capital as well as investment for its small business (Jean-Luc 2006). The major causes of the high prevalence of poverty in Ethiopia include lack of asset, employment opportunities, income, skill, education, health, etc. This is aggravated by soil degradation, deforestation, drought, civil war, and inappropriate government policies (Wolday, 2000). Poverty reduction is one of the declared objectives of the Ethiopian Government since the replacement of the socialist Dergue regime. This commitment has been reaffirmed repeatedly. Poverty reduction is one of the declared objectives of the first National Development Program (NDP) of 1995 and of the second NDP for 2000/05. A major result of latter NPD is the creation of the Interim Poverty Reduction Strategy Paper (I-PRSP) (Al-Bagdadi and Brüntrup, 2002).

In Ethiopia, the poverty reduction strategy is becoming the operational framework to translate the global Millennium Development Goals (MDGs) targets in to national action (UNDP 2005).

Microfinance (MF) is seen as one of the most efficient instruments to promote economic development and to fight poverty in poorer countries.

Numerous microfinance institutions (MFIs) all over the world have proven that financial services can be offered on a sustainable basis with high outreach (Al-Bagdadi and Brüntrup, 2002).

The goal of most MFIs is to alleviate poverty by targeting clients who previously have not had access to formal financial services. To a large extent, MFIs around the globe have succeeded in meeting this goal; indeed, it is safe to predict that the more MFIs are there, the more poor people will be able to invest in income-generating activities, accumulate savings, put their families on a more secure financial footing and generally improve their lives (Kristin, 2009).

Microfinance leads to more education, better health, improved diet and nutrition, and greater resilience to disasters for poor families. In addition, it lays a foundation that allows other humanitarian intervention to be effective while providing the economic engine that allows the transition from dependency to sustainability (VisionFund Annual Report, 2008).

Formal credit and savings for the poor are not recent inventions: for decades, some customers neglected by commercial banks have been served by credit cooperatives and development finance institutions (CGAP, 2000). The formal microfinance industry began in Ethiopia in 1996 with the government's the Licensing and Supervision of Microfinance Institution Proclamation designed to encourage Microfinance Institutions (MFIs) to extend credit to both the rural and urban poor of the country. Since then, 30 MFIs have registered with the National Bank of Ethiopia and operate under the auspices of this Proclamation (NBE, 2007/08). The total capital of MFIs was Birr 1.3 billion and their total asset reached Birr 5.3 billion. They also mobilized deposits to the tune of Birr 1.9 billion and advanced loans amounting to Birr 4.6 billion by the end of the review period (NBE, 2008/09). According to the AEMFI of the Ethiopian MFIs performance report (2009), Ethiopian MFIs reached over 1.8 million borrowers, representing an outstanding loan portfolio of Birr 3.1 billion.

The microfinance institutions in Ethiopia aim at poverty alleviation by targeting specific groups particularly to poor. The delivery of financial services is based on creating sustainable microfinance institutions using innovative methodologies and systems, which can deliver services to recover loan at lowest cost. But, in Ethiopia the NGO and Government projects have been pumping financial services without estimating the demand and analyzing the felt needs of the rural and urban poor (Chao-Beroff et.al., 2000).

Generally, to meet the objectives of poverty alleviation, MFIs ought to be viable and sustainable in the provision of services. This means they must provide quality and flexible financial services that target the poor, culturally fit, subsidy free and must be profitable in all respect. Besides, good governance of the MFIs which consists of different mix of expertise of boards, innovative and committed management and staffs that are capable to evaluate and working towards the achievement of superior efficiency and eventually leads their organizations to sustainability. Furthermore, there must be adequate financial structures (legal, regulation and supervision) set by the government and policy makers that are focused on creating and building sound financial infrastructure that support, strengthen and ensure their sustainability.

This study examined institutional viability and financial performance of the three MFIs that are operating in Addis Ababa.

1.2. Statement of the problem

The establishment of sustainable MFI that reach a large number of rural and urban poor who are not served by the conventional financial institutions, such as the commercial banks, has been a prime component of the new development Strategy of Ethiopia (Wolday, 2000). This indicates that there is a clear need, first in establishing the viability and importance of microfinance as a poverty alleviation approach for low income groups. It also helps in mainstreaming the concept of microfinance within the large development economic thought.

Institutional viability in this study refers to the extent to which institutions under takes projects that will help cover its costs, have its loans repaid and make profit (Seible, 1996 and Gutubig et. al., 1998).

MFIs face a double challenge, not only do they have to provide financial service to the poor (outreach), but they also have to cover their costs in order to avoid bankruptcy (sustainability). Both dimensions must therefore be taken into account in order to assess their performance (Luzzi and Weber, 2006).

MFIs in Ethiopia are facing problems of loan loss, limited fund for lending, unprofitable, problems related entrepreneurial quality of the client, staff with limited technical and banking skills, and weak supervision. Therefore, MFIs in Ethiopia lack the above qualities which are crucial for the viability and

sustainability and able to be in business on its own and it is doubted that MFIs will continue as viable institution in future following the past condition as means of alleviating poverty, “creating social capital” and financial intermediation (Wolday, 2000).
MFIs should start by defining a market gradually deal with finding the right client and appropriate mix of products, this means providing quality services in terms of timeliness, appropriateness of loan terms and condition given the customer; convenience and transaction cost of customer, clients relations etc. however, Chao-Beroff’s study explains, the service delivery methodologies and product of Ethiopian MFIs are supply driven instead of being demand driven. The MFIs usually start by copying the lending methodologies and products from other MFIs. In addition, clients are forced to fit into the procedures of the MFIs.

The research, thus, is conducted to answer the following basic questions:

- Are the MFIs that operate in Addis Ababa institutionally viable?

- What are the factors that are necessary for strong institutional viability and financial performance?

- What are the problems in achieving institutional sustainability and strong financial performance of MFIs?

1.3. Objectives of the study

1.3.1. General objective of the study

The main objective of the study is to assess the Microfinance institutions operating in Addis Ababa, institutional viability and financial performance of the three microfinance institutions namely ADCSI, SFPI, and Wisdom.

1.3.2. Specific objectives of the study

The specific objectives of the study are:

1. assessing institutional viability of microfinance operating in Addis Ababa;
2. assessing financial sustainability and performance of microfinance institutions, mainly in ADCSI, SFPI, and WISDOM;
3. to assess the factors that are necessary for strong institutional viability and financial performance.
4. To assess the problems in achieving institutional sustainability and strong financial performance of MFIs.

1.4. Significance of the study

As discussed in the background and problem statements sections, the success of micro-financing operations has a paramount importance in the development endeavor of the country.

The institutional sustainability in line with the two basic objectives is to improve the living standard of the poor and promote the mass mobilization in the nation's wealth creation as well as initiate other capable Ethiopians to participate in playing their role in the different sectors of the economy.

Equally important, the micro-financing effort is currently backed by foreign donor countries and international agencies. So the effective coverage rate and service provision is expected to generate more assistance in the short-run while sustainable financial resource must be secured internally in the long-run. Besides, the government and pertinent offices have their own responsibilities.

In line with the above facts, it is hoped that the results of this study will:-

- Provide relevant information to decision makers (investors, donors, creditors, clients, or government) about how well the institutions are performing in reaching the poor and their contribution to poverty alleviation;
- Give the management of the institutions the strengths and weaknesses of the current operating systems, and identifies the challenges of the MF industry; and
- Suggest possible recommendations to improve or revise the existing financial performances of the institutions.

Furthermore, the result of the study is hoped to serve as a base for further research that enable the sustained operation.

1.5. Scope of the study

This study was delimited only to the assessment and examination of the institutional viability and financial performance of selected MFIs operating in Addis Ababa, mainly ADCSI, SFPI, and WISDOM. The study was included

Operation managers, human resource heads, and finance managers and Accountant of MFIs within Addis Ababa.

The problems related to the different aspects of financial performance and organizational viability were the points pointed out.

1.6. Research Methodology

1.6.1. Sources of data and gathering techniques

The descriptive type of study was used to obtain information concerning the institutional viability and the quality of financial services offered by MFIs and to draw conclusions from the facts that were discovered. The research was conducted based on two types of data. Primary data were collected through self-administered unstructured interview questionnaires to Operation managers, human resource heads, and finance managers of the selected MFIs. The secondary sources of data were the main sources of data in this research project. The data were collected from an audited financial reports and annual reports of the institutions such as income statement and the balance sheet of Selected MFIs; business plan and policy documents; internal reports, data from books, journals, and publications and reports of various governmental and non-governmental organizations such as Association of Ethiopian Micro Finance Institutions (AEMFI) and national bank of Ethiopia and national bank of Ethiopia were used.

1.6.2. Target population and sample size

The actual numbers of registered MFIs as per the National Bank of Ethiopia (NBE) database are nearly 30. These MFIs operates at the different regions of the country and among them 12 MFIs are operating in Addis Ababa. Nonetheless, it will be much better and exhaustive for the study if there will be a chance of accommodating all MFIs found in Addis Ababa. However, to make the study manageable and to evaluate the problem in detail, the researcher was forced to delimit the study to incorporate only 3 of the MFIs found and operated in Addis Ababa. The selected microfinance institutions were:

- Addis Credit and Saving Institution
- Wisdom Microfinance Institution
- Specialized Financial and Promotional Institution

One of the criteria of selecting the above three MFIs is the activities of MFIs which operate and provide microfinance services in Addis Ababa. In addition, these micro-finance institutions were selected based on their affiliations (some of them are government affiliated, while others are NGO affiliated and privately owned). This criterion is included in order not to misstate the finding due to the different degree of support received from the government, donors and others.

From these selected MFIs, the sample size comprised of 6 respondents was taken for the unstructured interview questionnaire. Out of these 4 respondents were form general managers and human resources head and the rest were finance manager and accountant of the selected MFIs.

1.6.3. Sampling techniques

To select the three MFIs out of the twelve that are operating in Addis Ababa according to their perceived performance, purposive sampling technique was used. The same sampling technique was used to draw respondents from the management and credit officers that are believed to provide the necessary information for the intended research.

1.6.4. Data analysis and Discussion

Different factors may be considered affecting the Institutional viability of MFIs. The institutional viability of the MFIs was evaluated with respect to the attainment of institutional goals, Ethiopian legal and regulatory framework for ownership and governance of MFIs, the capacity of employees of the MFIs, and Products and Services Offered by the Selected MFIs. The financial performance of the MFIs was assessed on the Portfolio Quality, Sustainability and Profitability, and Efficiency and Productivity of the selected MFIs.

Qualitative data generated using the unstructured interview were analyzed in the course of data collection with the help of the target respondents by describing or narrating and interpreting the situation deeply so that the real picture of the institutional viability and financial performance will be understood vividly. Moreover, data generated from the financial statements were analyzed by using descriptive statistics such as percentages and was used in reporting the results. The results will be presented in tables.

1.7. Limitation of the Study

The research involves majority of secondary data. Researcher expects that the project paper may have some limitations due to the following reasons:

- Limited coverage of the study, i.e. the study covers only three of the twelve MFIs operating in Addis Ababa,

- Limited data sources of the microfinance industry of Ethiopia and lack of adequate reports and statements from the institutions under Study,

1.8. Structure of the Study

This research has four chapters. The first chapter is an introduction which includes background of the study, statement of the problem, objective of the study, delimitation, and methodology that was used to collect and analyze data. The second chapter discussed on review of related literature including conceptual framework for the analysis. Under this section relevant published and unpublished literatures, journals and other researcher's work that are previously done on similar areas were thoroughly discussed in a manner to achieve the objective of the study and help the data analysis. The analysis of data and major findings is included in Chapter three. It deals with the MFIs viability and financial performance that are operating in Addis Ababa. Finally, in chapter four, conclusions and recommendations are included.

Chapter Two: Literature Review

2.1. Microfinance: Overview

The emergence of the global microfinance has a history of about three decades, yet has gone through stages of historical development. The microfinance industry is said to be in revolution: the service that was initiated in small scale and small village of South East Asia “Chintanga”, Bangladesh now turned to be international agenda and an issue addressing one of the main problems i.e. poverty in developing countries of the world (Arega, 2007).

The term microfinance is of recent origin and is commonly used in addressing issues related to poverty alleviation, financial support to micro-entrepreneurs, gender development etc. There is, however, no statutory definition of micro finance. The taskforce on supportive policy and Regulatory Framework for Microfinance has defined microfinance as "Provision of thrift, credit and other financial services and products of very small amounts to the poor in rural, semi-urban or urban areas for enabling them to raise their income levels and improve living standards". The term "Micro" literally means "small". But the task force has not defined any amount. However as per Micro Credit Special Cell of the Reserve Bank Of India , the borrowed amounts up to the limit of Rs.25000/- could be considered as micro credit products and this amount could be gradually increased up to Rs.40000/- over a period of time which roughly equals to $500 – a standard for South Asia as per international perceptions. (Biswas, 2002)

Narrower definitions equate microfinance with microcredit, following early practice of NGO credit schemes. Microcredit is the provision of small loans to poor households and small business operators with or without guarantee (Degefe, 2009).

In reality, poor people need access to so many more financial services than just micro-credit, including a range of micro savings and insurance products. Indeed, the first step for poor people on the path out of the poverty cycle is social and economic security. Appropriate savings and insurance, as well as loans for emergency expenditures or basic assets such as housing and education, can contribute significantly to such security, not least among poorer and more vulnerable households. These services can protect poor people from the impact of unforeseen crises and emergencies in their households or micro-business, from failing yet further into debt, and enable poor households to plan and manage their limited resources more effectively to meet their basic needs (Fisher and Sriram, 2002).

Gonzalez and Rosenberg, (2005) often defined “Microfinance” as financial services for poor and low-income clients. In practice, the term is often used more narrowly, referring to services delivered by self-described “microfinance institutions” (MFIs) who usually use techniques developed over the last three decades to make and manage tiny uncollateralized loans. These techniques include group lending and liability, pre-loan savings requirements that test clients’ willingness and ability to make regular payments, graduated loan sizes, and most importantly an implicit guarantee of quick access to future loans if present loans are repaid promptly.

According to Robinson (2001), Microfinance refers to small-scale financial services – primarily credit and savings provided that to people who farm or fish or herd; who operate small enterprises or microenterprises where goods are produced, recycled, repaired, or sold; who provide services; who work for wages or commissions; who gain income from renting out small amounts of land, vehicles, draft animals, or machinery and tools; and to other individuals and groups at the local levels of developing countries, both rural and urban. Many such households have multiple sources of income.

Savings services allow savers to store excess liquidity for future use and to obtain returns on their investments. Credit services enable the use of anticipated income for current investment or consumption. Overall microfinance service can help low-income people reduce risk, improve management, raise productivity, obtain higher returns on investments, increase their incomes, and improve the quality of their lives and those of their dependents.

Such services are rarely accessible through the formal financial sector, however. Credit is widely available from informal commercial money holders but typically, as will be documented, at very high cost to the borrowers – especially poor borrowers. Banks generally assume that providing small loans and deposit services would be unprofitable. It is widely believed – wrongly, as will be demonstrated – that the cost of delivering small-scale financial services at the local level is too high for nonsubsidized institution and that the informal financial market satisfies demand. NGOs and other nonbank financial institutions have led the way in developing appropriate credit methodologies for low-income borrowers. But with few exceptions, these institutions are able to operate only on a very small scale.

The problem is exacerbated by the limited influence of the poor people who required microfinance. They are usually unable to informal formal markets about their creditworthiness or about their demand for savings services and loans. Accordingly, services are not provided. Those who hold the power do not understand the demand; those who understand the demand do not hold the power.

There are differences among countries and regions in the availability of microfinance services and in the level of unmet demand for these services. There are also differences in demand among small businesses, microenterprises, farmers, laborers, low-income salaried employees and others. Common to nearly all parts of the developing world, however, is a lack of commercial microfinance institutions – a shortcoming that unnecessarily limits the options and lowers the financial security of poor people throughout the world.

But this pattern is changing. The microfinance revolution is emerging in many countries around the world. As used her the term refers to the large-scale, profitable provision of microfinance services – small savings and loans – to economically active poor people by sustainable financial institutions. These services are provided by competing institutions at the local level – near the homes and the workplaces of the clients – in both rural and urban areas. Financial services delivered at the local level refer to those provided to people living in villages and other types of rural settlements and to people living in low-income neighborhoods in semiurban or urban areas. Large-scale as used here means coverage by multiple institutions of millions of clients; or, for small countries or middle - and high-income countries with low demand, outreach to a significant portion of the microfinance market. Probability means covering all costs and risks without subsidy and returning a profit to the institutions.

The evolution of the microfinance industry has led to a greater focus on the financial viability of MFIs (MIX, 2002).

Microfinance services are provided by three types of sources:

- Formal institutions, such as rural banks and cooperatives;
- Semiformal institutions, such as nongovernment organizations; and
- Informal sources such as money lenders and shopkeepers.

Institutional microfinance is defined to include microfinance services provided by both formal and semiformal institutions. Microfinance institutions are defined as institutions whose major business is the provision of microfinance services (ADB, 2000, 3).

2.2. The Development of Microfinance Institutions

The history of informal financial institutions, especially private money lending, can be traced to ancient Egypt and the Middle East. The Old Testament documents restriction on lending for interest among the Jews and describes morality issues related to collateral from the poor. (e.g. in the books of Deuteronomy, 23:20; 24:10-13, and Ezekiel, 18:8, 12,13,18) Thus, money lending to the poor with or without collateral must have been widely practiced, not only for commerce, but also for private consumption, since the provisions in these books of laws at the time were attempts to regulate the practice along religious and moral values, rather than to prohibit them (Degefe, 2009).

According to Ledgerwood, J (1999), microfinance arose in the 1980s in response to the doubts and research finding about the delivery of subsidized in credit to the poor framers through government-owned specialized banks. The significant role of microfinance for development efforts around the world, particularly poverty reduction efforts, is undeniable. Where delivered appropriately, microfinance enables clients to protect, diversify, and increase their income, as well as to accumulate assets, reducing their vulnerability to income and consumption shocks. Thus, microfinance is an important component in strategies towards the achievement of the Millennium Development Goal (MDG) of halving absolute poverty by 2015 (Simanowitz, Anton, 2003).

In the 1970s government agencies were the predominant methods of providing productive credit to those with no previous access to credit facilities people who had been forced to pay usurious interest rates or were subject to rent seeking behavior. Governments and international donors assumed that the poor required cheap credit and saw this as a way of promoting agricultural production by small landholders. In addition to providing subsidized agricultural credit, donors set up credit unions inspired by the Raiffeisen model developed in Germany in 1864. The focus of these cooperative financial institutions was mostly on savings mobilization in rural areas in an attempt to "teach poor farmer how to save" (Ledgerwood, J. 1999).

Creating a financial system capable of lending to micro-enterprises and low income households is an integral part of the World Bank's strategy for developing the indigenous private sector and alleviating poverty. Micro-enterprises typically foster little productive employment growth, but they do alleviate the severe unemployment that threatens the survival of the poor in Africa. Micro-enterprises often need access to very small loans to survive and grow as demand fluctuates. They rely heavily on the informal system of relatives, suppliers' credit, savings and credit associations, and moneylenders for their financial needs. The performance of international best practice institutions shows that the self-employed repay their loans at high rates and are willing to pay high rates of interest in order to obtain access to financing. The key challenge in micro-enterprise development is to strengthen the capacity of the financial system—both informal and formal—to lend sustainably to micro-enterprises (Pitamber, 2003).

2.3. Microfinance Development in Ethiopia

Non-governmental credit schemes and informal sources of finance such as Rotating Saving and Credit Associations, known as Iquub and Iddir, and money lenders have existed in Ethiopia for many years (Aredo D., 1993). After economic liberalization in 1994, poverty and food insecurity led the government to adopt microfinance as a prime component of its new economic development agenda. The government, supported by international development community (bilateral donors, international NGOs, multilateral projects), promoted microfinance in the context of the poor performance of traditional banks in supplying suitable financial products for small framers. As in many developing countries, the banks had focused on granting medium-and long-term credits to more solvent clients.

From the 1970s, some local and international NGOs granted credits to poor populations, often to try out innovative methods. However, the mixed humanitarian and financial targets led to many problems and an alarming lack of professionalism. As in many other countries, NGOs active in Ethiopia microfinance were also criticized because loans were granted according to the NGO's perception of the client's needs rather than on the basis of a thorough analysis of the demand; because of the lack of the borrower's ability to pay back the loan within the agreed period; and because of the lack of follow-up of the loans. Furthermore, loan terms and sizes were often appropriate; risk insufficiently diversified; systems to manage lending properly were not in place; and interest charges did not cover the true cost of capital, operations, inflation rate, loan loss provisions and at least a modest return on assets (Wolday, 2005).

Ethiopia is one of the developing countries facing severe poverty. Ethiopia is located in the horn of Africa with a total surface area of 1.016 million square kilometers (CSA, 1997) and huge potential resources to produce agricultural output far beyond the need of its people. Despite its vast natural resource base Ethiopia is one of the most underdeveloped countries in the world (Al-Bagdadi and Brüntrup, 2002). As estimated by the World Bank the per capita income of Ethiopia is USD 110. It ranks 169 out of 175 countries in terms of the overall Human Development Index (UNDP, 2003). The country's economy is predominantly based on agriculture, which accounts for about 50% of GDP, 85% of exports and 85% of employment of the country (IFAD, 2001). Poverty and food insecurity are the main challenges and fundamental issues of economic and social development in Ethiopia (Gebrehiowot, 2002). It is estimated that in Ethiopia 44 percent of the population is living below absolute poverty line (Wolday, 2003). Poverty in this country is a manifestation of complex factors. Poverty in Ethiopia is not only indicated through the UNDP's Human Development Index (HDI), on which Ethiopia is ranked 169 of 175 countries, but also confirmed by national information sources (Al-Bagdadi and Brüntrup, 2002).

The Microfinance Sector

The cooperative system has remained strong in Ethiopia. During the socialist regime, cooperatives have been used by the Government of Ethiopia (GOE) to channel credits, agricultural inputs etc. to the respective target groups. In addition, cooperatives were highly politicized and instrumental for politics. The cooperative system collapsed with the fall of the socialist regime. It revitalizes nowadays due to two new cooperative societies proclamations which have been launched in 1995 and 1997. The first proclamation provides for the establishment of primary and secondary agricultural cooperatives on voluntary basis and democratic principles whereas the latter proclamation aims to develop and promote savings and credit services for members to participate actively in the free market economy (Al-Bagdadi and Brüntrup, 2002).

In the year 2002, there were 7,366 cooperatives of different types in Ethiopia which comprise 3.7 million members involving 18.4 million family members (Wolday, 2002).

The microfinance industry in Ethiopia has shown a remarkable qualitative and quantitative growth since the early 1990.

Despite these major achievements of Ethiopian MFIs, in sight of the large population size the outreach of MF in Ethiopia is still relatively limited. It was estimated that the 20 registered MFIs meet less than 9% of the demand for financial services of the active poor (Chao-Beroff et al. 2000). This indicates that there is significant unmet potential demand for MF services in Ethiopia.

2.4. Conceptual framework for Supervision and Regulation of MFIs

Building sustainable financial institutions was accordingly considered by the government as a first priority for the microfinance industry. A next one was to build a genuine national microfinance industry. And, equally important, the old instrument of directed credit delivery was included in the regulation package. The government wanted MFIs to serve the rural subsistence farmers, as they represented the vast majority of the country's poor; microfinance had to play an important role in the national poverty reduction agenda (Ethiopian MFIs Country Scan, 2007).

The main objective of regulation and supervision of any financial institution is to ensure sound practices and stability within the financial system. It is to protect the small depositors and maintain confidence in the financial system. In the case of MFIs, the key objective is to promote and protect the sustainability and stability of the rural financial system so as to ensure access by poor rural households to financial services. The other key objective of regulation and supervision of MFIs is to enhance their access to capital markets for leveraging commercial funds to expand their outreach. The laws governing the establishment and operations of MFIs in Ethiopia are directly or indirectly based on these objectives (Derk, et. al., 2009).

The Monetary and Banking Proclamation of 1994 lays down the legal basis for the financial sector in Ethiopia. In this proclamation, the government clearly assigns the task of licensing and supervising banks, insurers and other financial institutions to the NBE. The key criterion for institutions is that they carry out banking business. This means the country follows a rather broad approach to banking supervision, which does not concentrate on deposit taking only, but instead explicitly includes lending of money as a banking activity, independent of the sources of this money. This formulation in the Monetary and Banking Proclamation has significant implications for the financial sector in general, as well as for the prudential regulation of microfinance. Unlike in many other countries, which focus on regulating only those intermediaries that mobilize deposits, the implication of the logic laid down is that the NBE also has to supervise and license all institutions that are involved only in credit extension.

2.4.1. Legal Framework for MFIs

The legal framework governing microfinance Institutions (MFIs) in Ethiopia comprises the Commercial Code of Ethiopia, proclamations issued by Government of Ethiopia (GOE) (Proclamation No. 40/1996, and Proclamation No. 147/1998) and directives issued by the National Bank of Ethiopia. Microfinance institutions are required to incorporate as share companies in accordance with the provisions of Article 304 of the Commercial Code of Ethiopia. The applicable Articles of Proclamation No. 84/1994 dealing with the licensing and supervision of banking business and the Commercial Code of Ethiopia also provide the needed legal framework for incorporation and operation of MFI as well as their regulation and supervision by the National Bank of Ethiopia.

2.4.2. The Commercial Code of Ethiopia

The Commercial Code of Ethiopia clearly defines the manner of incorporation, governance and operation of all commercial companies and provides the criteria for formation, governance and winding up of such companies. The duties and responsibility of the shareholders, directors and the Chief Executives are also explicitly stated. The Commercial Code also provided that the elected board of directors is the decisive governing body of a share company next to the general assembly of shareholders, and accordingly is expected to safeguard the financial and business interests of the shareholders. The Commercial Code also defines share and the rights and duties of shareholders (Itana et. al., 2003).

Prudential financial regulation according to Chaves and Gonzaliz - Vega (1994) has three major objectives (i) ensure the solvency and financial soundness of all intermediates; in order to project the stability of the country's payment system (ii) provide consumer (for example depositor) protection against undue risks that may arise from failure, fraud, or opportunities behavior on the part of the suppliers of financial services and (iii) promote the efficient performance of institutions and markets and the proper working of competitive market forces (Wolday 2000).

Until very recently, the formation and governance of MFIs in Ethiopia were governed by the Licensing and Supervision of MFIs Proclamation (Proclamation No. 40/1996). This law is now repealed and replaced by the Micro Financing Business Proclamation (Proclamation No. 626/2009, herein after the MFI Proclamation). In addition, there are quite a few directives issued by the NBE that are still applicable. The Proclamation in force makes reference to the Commercial Code of Ethiopia (currently under revision) when it requires MFIs to be established in the form of a share company. When it comes to governance, we find provisions in all the above legal instruments.

2.4.3. Governance and framework of MFI ownership

In Ethiopia, MFIs are to be established in the form of share companies as defined under article 304 of the Commercial Code (CC). The Code defines a share company as "a company whose capital is fixed in advance and divided into share and whose liabilities are met only by the assets of the company." The NBE registers and licenses MFIs upon the latter fulfilling the requirements set by the MFI Proclamation and directives.

A share company may not be established by fewer than five shareholders (Article 307 CC). An initial capital of ETB 200,000 is required to form an MFI. Like in the other financial services sub-sectors, capital/share of MFIs must be fully owned by Ethiopian nationals and registered under the laws of and having their head office in Ethiopia (Article 2(3) Proclamation No. 626/2009). Foreigners must not own an MFI, fully or partially. Any foreign national or organization fully or partially owned by foreign nationals may not be allowed to establish an MFI. Open branches or subsidiaries of a foreign micro-financing institution in Ethiopia or acquire the shares of an Ethiopian MFI (Article 25 of Proclamation No. 626/2009). This rule is a confirmation of what is seen in the investment regulation (Investment Regulation 84-2004).

In Ethiopia, the commercial banking system could not address the financial needs of poor households for the very fact that they are not their ultimate target clients. On top of that, the transaction costs and risks involved in serving poor households are perceived to be too high. In addition, even if there are few private banks that are interested in providing financial services to poor households, they have not developed yet a suitable credit methodology for micro lending activities and they do not have trained personnel for that (EBDSN, 2004).

The first micro-finance service was introduced as an experiment in 1994 when the relief society of Tigray attempted to rehabilitate drought and war affected people through rural credit scheme (Micro-finance Development Review, 2000).

Governance refers to a system of check and balance whereby a board of directors is established to oversee the management of the MFIs. The board of directors is responsible for reviewing, confirming and approving and plans and performance of the senior management, ensuring that the vision of the MFI is maintained of fulfilled (CGAP, 2000).

Discussions on corporate governance have largely centered around large firms and in most cases in advanced economies. Stephen and Backhaus (2003) have highlighted that the problem of corporate governance is that of ensuring that enterprises operate in the interest of their owners and not the interests of managers and this emanates from the concept of separation of ownership and control. We focus on corporate governance because we believe the measures of corporate governance employed each have the ability to substantially influence the ability of investors to pressurize management to efficiently use resources available to microfinance institutions (MFIs). It is believed that, good governance generates investor goodwill and confidence. Thus corporate governance has been identified to have a significant impact on the performance of firms. For instance, Dittmar and Mahrt-Smith (2007) show that good corporate governance is able to double the value cash holdings of firms as compared to poorly governed firms. They again show that the market value of excess cash for well-governed firms is about one half times of the market value of excess cash of poorly governed firms. More interestingly it is shown that well governed firms have their cash resources better “fenced” in and that firms with poor corporate governance structures dissipate excess cash more quickly Dittmar and Mahrt-Smith (2007). In other studies, Pinkowitz et al. (2006) in their study on governance, cash and dividends show that good corporate governance enhances the value of cash holdings. Thus, it is clear that poorly governed institutions are less efficient in their performance. The value and contribution of the current study to the evolving literature on governance is not directly looking at cash holdings, but to show how good governance is essential for outreach and profitability of MFIs.

According to Ledgerwood, J. (1999), Microfinance has evolved as an economic development approach, intended to benefit low-income women and men. The term may also refer to the provision of financial services to low-income clients, including the self-employed. Financial services generally include savings and credit; however, some micro-finance organizations also do provide insurance and payment services. In a nutshell, the term microfinance could be defined as not simply banking; rather it involves making financial resources available to the productive poor. It must be pointed out that for microfinance to perform a creditable function as a poverty reduction and development tool, governance is of critical importance.

2.5. Quality of Financial Service

Service quality according to Ledgerwood (1999), defined as the degree of fitness for the purpose or function indicating that it is a measure of the satisfaction of customer needs. The quality of product or service has meaning only when related to its function- that which makes it works well. Accordingly, the quality of a bank or other service is the extent to which it meets the requirement of the customers.

What would enable MFIs to improve service delivery? One popular recommendation is to link them to commercial banks. Branch network-sharing, for example, benefits both the MFIs and the banks.

It provides the latter with a wider client base and facilitates the extension of credit to MFI clients, especially among the owners of small enterprises (a development known as "the formalisation of the informal economy"). Linking MFIs to commercial banks, however, does not guarantee that enough of the poor will be reached. The effects of such endeavors are limited by the shortage of commercial banks, particularly in rural areas.

Ultimately, public policy will have to include direct lending to reach enough of the poor. In this regard, China's rural credit cooperatives and Vietnam's Bank for Social Policies are two examples worth considering. These countries provided selective interest rates, investment guarantees and export-promotion credit. Public policy focused on rural development through credit programs in labour-intensive sectors. Available information shows that half of the loans were provided to poor households, a third went to beneficiaries in remote areas, and more than a fifth was devoted to job creation.

China and Vietnam experienced a dramatic fall in poverty levels. Their experience provides a lesson to be learned (Chandrasekhar, C. P., 2004).

2.6. Institutional Viability

According to Ledgerwood, J. (1999), Institutional viability refers to institutional capacity, management information system, and financial viability of the MFIs that is committed by management and staff pursuing the organizational as a potentially profitable and provider of permanent and reliable access to the poor. An institution is a collection of assets – human, financial and other combined to perform activities such as fetching loans and deposits over time. A one-time activity such as “project” is not an institute. Thus, by its very nature, an institution has a function and certain permanence.

According to Yaron, J. (1997), institutional sustainability is necessary to attain a high level of financial sustainability and outreach. Institutional sustainability is possible where there is: a responsive organizational structure which encourage participation; a system and a procedure, which are client focused, efficient flow of information, and sufficient transparency; a management team capable of translating the organization’s objective into action; a system to secure appropriate human, financial and technical resources; motivated and skilled staff with the ability to efficiently execute and continuously refine and improve the operational methodology to better meet the organizational need.

The success of most innovative microfinance institutions is mainly the result of their strong organizational culture and management system. Staff motivation and development is one of the most common characteristics of these institutions. Best performing staffs in assessing, extending and collecting loans are rewarded (Yaron, J., 1994).

Institutional capacity refers to the culture and operating system of an organization that has sustained service delivery system to a significant growing number of low income clients; has a sounding governing structure; freedom from political interface; food fit for local context; competent and stable staff; mission and vision which create a sense of purpose, ownership and accountability (Hans & Bijay, 1998).

Most institutions do not have adequate capacity to expand the scope and outreach of services on a sustainable basis to most of the potential clients. Many institutions (i) lack capacity to leverage funds, including public deposits, in commercial markets; (ii) are unable to provide a range of products and services compatible with the potential clients' characteristics; (iii) do not have an adequate network and delivery mechanisms to cost-effectively reach the poorest of the poor, particularly those concentrated in resource-poor areas and areas with low population densities; (iv) do not show a vision and a commitment to ensure their financial soundness and sustainability within a reasonable period, and become subsidy independent; and (v) do not have the capacity to manage growth prudently. Most of the state-sector institutions or programs that provide microfinance services have been created within and nurtured by a distorted policy environment characterized by various degrees of financial repression. They do not have a business culture. Even new institutions created by the governments in most DMCs are unable to provide good quality services, let alone expand their services on a sustainable basis.

Most NGOs are also characterized by a high level of operational inefficiency, and have a very limited capacity to serve an increasing segment of the market on a continuing and sustainable basis. They suffer from governance problems mainly because they lack "owners" in the traditional sense of the term, and their management assumes a great deal of power. Heavy reliance on and relatively easy access to donor funds have aggravated the governance problems of some NGOs. Inadequate emphasis on financial viability is the most serious problem of MFIs in the Region. This prevails among many NGOs, government-directed microcredit programs, state-owned banks, and cooperatives providing microfinance services. As a result, only a few MFIs are sustainable; most are not moving toward sustainability. In a context where resources are limited, "without self-sufficient financial institutions, there is little hope for reaching the numbers of poor firm households that are potential borrowers and depositors" (Ledgerwood, J. 1999). Viability is also important from an equity perspective because only viable institutions can leverage funds in the market to serve a significant number of clients and contribute to broad-based development. Viability is fundamental to reach a larger number of the poor which in turn is essential to have a significant impact on poverty reduction (ADB, 2000).

Table 1: Key Characteristics of a strong Microfinance Institution

Key areas	*Characteristics*
Vision	A mission statement that defines the target market and services offered and is endorsed by management and staff. * A strong commitment by management to pursuing microfinance as a potentially profitable market niche (in terms of people and funds). * A business plan stating how to reach specific strategic objectives in three to five years.
Financial services and delivery Methods	* Simple financial services adapted to the local context and in high demand by the clients described in the mission statement. * Decentralization of client selection and financial service delivery.
Organizational structure and Human resources	* Accurate job descriptions, relevant training, and regular performance reviews. * A business plan spelling out training priorities and a budget allocating adequate funds for internally or externally provided training (or both).
Administration and finance	* Appropriate performance-based incentives offered to staff and management. Loan processing and other activities based on standardized practices and operational manuals and widely understood by staff. * Accounting systems producing accurate, timely, and transparent information as inputs to the management information system.

Management information system	* Internal and external audits carried out at regular intervals. * Budgets and financial projections made regularly and realistically. * indicators that are most relevant to operations and are regularly used by staff and management in monitoring and guiding Systems providing timely and accurate information on key operations.
Institutional viability	*Legal registration and compliance with supervisory requirements. *Clearly defined rights and responsibilities of owners, board of directors, and management. *Strong second level of technically trained managers.
Outreach and financial sustainability	* Achievement of significant scale, including a large number of underserved clients (for example, the poor and women). * Coverage of operating and financial costs clearly progressing toward fill sustainability (as demonstrated in audited financial statements and financial projections).

Source*:* Ledgerwood, J. 1999.

Financial Viability

Financial viability refers to the ability of an MFI to cover its costs with earned revenue. An institution financial viability is crucial to provide financial service over a sustainable period. To achieve its goal MFIs should attain viability. Viability would allow it to maintain its operation indefinitely without reliance to charitable donations. Financial viability would also help institutions to access more sources of funds from client saving (Christen et. al., 1995).

MFIs must achieve financial viability and independence from a continuous flow of subsidies remaining in business, which not only demands that the MFIs establish a firm basis on which to earn an income flow from the microfinance services of delivers, but develop a cost structure that is affordable beyond the time when startup grants or soft loans are no longer available (Yaron, 1994).

To make MFIs viable and self sustained, it is recommended to build up their equity base through capital infusion from existing owners and new investors; diversifying credit saving other financial products in response to demand. In addition, it is important rising share of loan portfolio form internally generated resources, especially voluntary savings (Seibel, 1999).

The NGOs, the microcredit service providers in Ethiopia, are in a transition from highly subsidized credit providers to organs that have become a finance based system. Though the efforts or MFIs in Ethiopia in saving mobilization are encouraging, there is a lot to be done in return of improving savings etymology. Moreover, the saving technology compared with the lending technologies in Ethiopia is far inadequate (Wolday, 2002). The above argument implies that MFIs in Ethiopia do not or sufficiently use their voluntary savings as a source of lending. Besides, the relatively low interest rates in the microfinance industry affecting the financial health and viability of MFIs. The interest rate is extremely low to cover operating costs, including the provision for bad debts and other institution building costs. Therefore, in one or other, they have got subsidy form government and NGOs. This affects the sustainability of the institutions and also it limits the capacity of the microfinance industry in terms of trained manpower) equipment, management information system (MIS) research and innovation.

2.7. Financial Performance of MFIs

MFIs earn financial revenue from loans and other financial services in the form of interest fees, penalties, and commissions. Financial revenue also includes income from other financial assets, such as investment income. An MFI's financial activities also generate various expenses, from general operating expenses and the cost of borrowing to provisioning for the potential loss from defaulted loans. Profitable institutions earn a positive net income (i.e., operating income exceeds total expenses). For the purpose of this review and to account for the institutional scale of operations, financial revenue and expense indicators as well as returns are compared against the institution's assets (MIX, 2005, 9).

Effective financial management requires periodic analysis of financial performance. Performance indicators collect and restate financial data to provide useful information about the financial performance of an MFI. By calculating performance indicators, donors, practitioners, and consultants can determine the efficiency, viability, and outreach of MFI operations.

The achievements of MFIs are examined through the lenses of standard industry performance metrics over a series of variables: Outreach (breadth and depth), financial structure, financial performance, efficiency and productivity, and portfolio quality (Lafourcade, et.al, 2005, 6).

Several levels of sustainability can be applied to microfinance. In general, the first stage, operational sustainability, is referred to when a microfinance institution covers its administrative costs and loan loss expenses from its client revenues. A second level of sustainability, referred to as financial sustainability, is attained when an institution which is operationally sustainable is able to cover the cost of funds, including inflation. By borrowing from a commercial bank, the equity of the MFI is leveraged, and the institution is able to pay the additional cost of commercial borrowing from its income stream. Financially sustainable institutions can become licensed financial institutions. The implications of getting such license are considerable, since MFIs which have reached this stage can raise resources from their national financial market and are likely to have access to rediscount lines from central banks, in amounts that are five to ten times their equity (UNCDF, 1999, 12).

Zeeler and Meyer (2002, 4) indicated, "Measuring financial sustainability requires that MFIs maintain good financial accounts and follow recognized accounting practices that provide full transparency for income, expenses, loan recovery, and potential losses."

2.7.1. Portfolio Quality

The loan portfolio is an MFI’s most important asset (CGAP, 2003). Portfolio quality is a crucial area of analysis, since the largest source of risk for any financial institution resides in its loan portfolio. The loan portfolio is by far an MFI’s largest asset and, in addition, the quality of that asset and therefore, the risk it poses for the institution can be quite difficult to measure. For microfinance institutions, whose loans are typically not backed by bankable collateral, the quality of the portfolio is absolutely crucial. Fortunately, many microfinance institutions have learned how to maintain loan portfolios of very high quality. In fact, leading microfinance institutions typically better at maintaining a higher portfolio quality than their commercial bank peers in many countries.

The most widely used measure of portfolio quality in the microfinance industry is Portfolio at Risk (PaR), which measures the portion of the loan portfolio “contaminated” by arrears as a percentage of the total portfolio. Although various other measures are regularly used, PaR has emerged as the indicator of choice. It is easily understandable, does not understate risk, and is comparable across institutions. A microenterprise loan is typically considered to be at risk if a payment on it is more than 30 days late. This rule is much stricter than what is practiced among commercial banks, but it is justified given the lack of bankable collateral in microfinance (Stauffenberg, Ramirez, 2003).

2.7.2. Efficiency and Productivity

Efficient institutions minimize costs of delivering services. The efficiency of a MFI can be calculated in various ways; it may be measured by costs per borrower and costs per saver as indicators of efficiency. Productivity often is measured in terms of borrower per staff member. Productivity is a combination of outreach and efficiency. Productive MFIs maximize services with minimal resources, including staff and funds. In general the specific indicators of the efficiency and productivity of MFIs are (Lafourcade, et.al, 2005, 6):

- Total costs per average loan
- Revenues per average loan
- Clients per loan officer/staff person
- Staff expense as a percentage of average assets
- Net interest margin
- Unit cost ratio

- Cost per currency unit lent

Whether annual volume of clients is increasing and whether costs are decreasing per loan.

Efficiency and productivity indicators are performance measures that show how well the institution is streamlining its operations. Productivity indicators reflect the amount of output per unit of input, while efficiency indicators also take into account the cost of the inputs and/or the price of outputs. Since these indicators are not easily manipulated by management decisions, they are more readily comparable across institutions than, say, profitability indicators such as return on equity and assets. On the other hand, productivity and efficiency measures are less comprehensive indicators of performance than those of profitability (Stauffenberg, Ramirez, 2003).

2.7.3. Profitability and Self-Sustainability

Profitability measures, such as return on equity and return on assets, tend to summarize performance in all areas of the company. If portfolio quality is poor or efficiency is low, this will be reflected in profitability. Because they are an aggregate of so many factors, profitability indicators can be difficult to interpret. The fact that an MFI has a high return on equity says little about why that is so. All performance indicators tend to be of limited use (in fact, they can be outright misleading) if looked at in isolation and this is particularly the case for profitability indicators. To understand how an institution achieves its profits (or losses), the analysis also has to take into account other indicators that illuminate the operational performance of the institution, such as operational efficiency and portfolio quality. The profitability analysis is further complicated by the fact that a significant number of microfinance institutions still receive grants and subsidized loans. “Comparing apples with apples” is always a problem in microfinance, because subsidies are still widespread and accounting practices vary widely (Stauffenberg, Ramirez, 2003).

The issue of financial sustainability of MFIs is one of the areas that have got attention in the microfinance industry. Historically microfinance has started operation with donor funds and now the industry has almost aged around 30 years. There is an intense debate on whether MFIs should continue to be donor supported or get relived from donation and stand on their own leg. There are one school of thought which say microfinance should be sustainable with donor funds (called welfarists) and the others say the microfinance should generate enough revenue to cover their own costs as donors funds are unpredictable (called institutionist) (Basu and Woller, 2004). Hence the issue of building a sustainable microfinance industry that can operate without a donor funds is of an empirical enquiry (Letenah Ejigu, 2009, pp 2).

Generally, a credit programme or institution is self-sustaining when income exceeds expenditures (including the opportunity costs of equity). When an institution providing credit receives a subsidy, it may be profitable but unable to sustain that profitability (CGAP, 2003).

Chapter 3: The Institutional Viability and Financial Performance of the Selected MFIs

3. Introduction

This chapter is organized in to two main parts. Part one reviews the institutional sustainability (viability) of MFIs, in the study. Part two analyzes the performance in terms of financial sustainability. Institutional Viability and financial sustainability are measured using several indicators which are indicated in chapter 2. The findings stated below are extracted and analyzed from the financial statements of each microfinance institutions under considerations. In order to increase the reliability of data audited reports were used.

3.1. Institutional Viability

Building sustainable financial institutions was considered by the government as a first priority for the microfinance industry. A next one was to build a genuine national microfinance industry. And, equally important, the old instrument of directed credit delivery was included in the regulation package. The government wanted MFIs to serve the rural subsistence farmers, as they represented the vast majority of the country's poor; microfinance had to play an important role in the national poverty reduction agenda. Different factors may be considered affecting the Institutional viability of MFIs. The institutional viability of the MFIs was evaluated with respect to the attainment of institutional goals, Ethiopian legal and regulatory framework for ownership and governance of MFIs, the capacity of employees of the MFIs, and Products and Services Offered by the Selected MFIs.

3.1.1. Vision and Mission of the Selected MFIs

The vision and mission of the MFIs under study are basically poverty alleviation through provision of sustainable financial services to the poor who do not have access to the financial support services of other formal financial institutions. The mission and vision of the selected MFIs have been well articulated in their documents of incorporation or their business plans.

Table 2: Vision and Mission of the MFIs

MFI	Vision	Mission
ADCSI	To become active contributor towards poverty reduction effort and would like to see improvement in the life of low-income people.	To promote micro and small enterprises to alleviate poverty and unemployment prevailing in Addis Ababa City Administration territory through provision of sustainable financial and other related service with particular attention to women
SFPI	To enhance the socio-economic empowerment of disadvantaged people especially women by accessing them to support services like credit saving and business training.	To facilitate socio-economic empowerment of under privileged people in rural and urban Ethiopia.
Wisdom	Improved economic, social and moral well being of the productive poor in the rural and urban settings of Ethiopia by way of promoting development of economically viable and sustainable micro enterprises though quality financial and non-financial services within accepted societal values and business ethics	Promoting development and expansion of economically viable and sustainable micro-enterprise through quality financial and non-financial services.

Source: From documents of the selected MFIs.

3.1.2. Ethiopian Legal and Regulatory Framework for Ownership and Governance of MFIs

In Ethiopia, there are numerous policies, laws and directives that affect the development of microfinance industry. The Monetary and Banking Proclamation No. 83/1994 empower the National Bank of Ethiopia (NBE) to license, supervise and regulate financial institutions such as banks, insurance companies, microfinance institutions and saving and credit cooperatives. The Licensing and Supervision of Banking Business Proclamation No. 84/1994 allowed for the first time the establishment of private financial institutions, thus breaking state monopoly.

Until very recently, the ownership and governance of MFIs in Ethiopia were governed by the Licensing and Supervision of MFIs Proclamation (Proclamation No. 40/1996). This law is now repealed and replaced by the Micro Financing Business Proclamation (Procl. No 626/2009, herein after the MFI Proclamation). In addition, there are quite a few directives issued by the NBE that are still applicable. The National Bank of Ethiopia (NBE) is authorized to license, regulate and supervise MFIs, which are required to be incorporated under Section 304 of the Commercial Code of the country as for-profit share companies, wholly owned by Ethiopian nationals or organizations owned by Ethiopian nationals. The Proclamation in force makes reverence to the Commercial Code of Ethiopia (currently under revision) when it requires MFIs to be established in the form of a share company. When it comes to governance issues, we find provisions in all the above legal instruments. In Ethiopia, the proclamations are enacted by the parliament and secondary legislations or directives that govern the operation of financial institutions are issued by the central bank.

The Commercial Code of Ethiopia clearly defines the manner of incorporation, governance and operation of all commercial companies and provides the criteria for formation, governance and winding up of such companies. The duties and responsibilities of the shareholders, directors and the Chief Executives are also explicitly stated. The commercial code also provides that the elected board of directors is the decisive governing body of a share company nest to the general assembly of shareholders, accordingly is expected to safeguard the financial and business interests of the shareholders. The commercial code also defines shares and the right and duties of shareholders.

3.1.2.1. Legal Structure and framework of MFI ownership

In Ethiopia, MFIs are to be established in the form of share companies defined under article 304 of the Commercial Code of Ethiopia (CCE). The Code defines a share company as "a company whose capital is fixed in advance and divided into share and whose liabilities are met only by the assets of the company." The NBE registers and licenses MFIs upon the latter fulfilling the requirements set by the MFI Proclamation and directives.

A share company may not be established by fewer than five shareholders (Art. 307 of CC). An initial capital of ETB 200,000 is required to form an MFI. Like in the other financial services sub-sectors, capital/shares of MFIs must be fully owned by Ethiopian nationals and/or organization wholly owned by Ethiopian nationals and registered under the laws of and having their head office in Ethiopia (Art. 2(3) Proclamation No. 626/2009). Foreigners must not own an MFI, fully or partially. Any foreign national or organization fully or partially owned by foreign nationals may not be allowed to establish an MFI, open branches or subsidiaries of a foreign micro-financing institution in Ethiopia or acquire the shares of an Ethiopian MFI (Art. 25 of Procl. 626/2009). This rule is a confirmation of what is seen in the investment regulation (Investment Regulation 84-2003).

This restriction of ownership in MFIs to Ethiopian nationals has led to the existence of nominal shareholders who normally hold shares effectively provided by foreigners, and who do not have real stake in the MFIs (cf. e.g. Ayana et al. 2003).

In fact, most MFIs in Ethiopia receive a substantial amount of their capital either from foreign or local NGOs or regional governments. Some MFIs have grown out of NGO credit activities operating before 1996, i.e. before the MFI Proclamation was issued, while others have been newly established. From the NGOs, World Vision, Catholic Relief Services, and Christian Relief and Development Associations are known to have assisted some of the existing MFIs. ADCSI MFI receives its substantial amount of capital from regional governments. In recent years, banks have shown interest in contributing capital to the formation of some MFIs. Typical examples here are Dashen Bank and CBE both of which are shareholders of the Specialized Financial and Promotional Institution (SFPI). The banks' motive in investing in this particular MFI is not financial returns or to diversify their investment, but rather to fulfill their corporate social responsibility. For that matter, the Memorandum of Association of SFPI does not allow division of dividends among the shareholders.

The Regulatory Framework has been quite relaxed on the maximum loan size that MFIs can lend to an individual borrower, with a view to accommodate clients who can manage a loan size beyond the ceiling of Birr 5000. Specifically, the latest regulation states that MFIs can lend to an individual borrower a loan size equal to 0.5% of their (the MFI's total) capital, with a precondition that the total sum of money to this kind of lending not exceed some 20% of the preceding year's disbursement. This has greatly helped MFIs to accommodate the demands of successful clients who need higher loan sizes. But, the absence of a well functioning and efficient legal system to enforce contracts and denying the foreclosure law to MFIs affects the implementation of prudential regulation and the MFIs' ability to utilize collateral effectively, especially for larger loan sizes. Prolonged delays in obtaining legal redress from the courts encourage unscrupulous borrowers to default with impunity. Clear property rights are critical to utilizing collateral and implementing asset-based lending. Although there are some improvements, the legal system in Ethiopia is still very weak in enforcing contracts and facilitating microfinance activities.

In addition, revising the loan size should be handled more cautiously. As explained above, in the revised NBE directive, MFIs are allowed to extend a loan amount to a single borrower up to 0.5% of their total capital. But if, as Proclamation No. 626/2009 (Art. 22) states, MFIs can "… obtain a line of concessional credit or any assistance from foreign sources for the purpose of on-lending or capitalization", and if a substantial portion of the MFI capital is obtained from such sources, some relatively new MFIs may find themselves in a position to be able to lend at very large loan sizes before they actually get the experience and maturity to handle or manage them. Such

MFIs, if they cannot manage their portfolio quality, would tend to damage the microfinance industry at large. Thus, it may be important to set separate rates based on the composition of capital.

3.1.2.2. Ownership Composition and Concentration

All MFIs in Ethiopia are share companies are by law (and are subject to the regulatory purview of the National Bank of Ethiopia, the country's central bank). Hence they are shareholder owned, even though some nominal. The MFIs under studied have regional governments or NGOs as dominant shareholders (having controlling position), basically reflecting the promoters/investors behind them. ADCSI is largely owned by the respective regional government while SFPI is NGO owned. Wisdom is the exception where individual ownership is high (100%) though it is NGO sponsored. The number of shareholders ranges from less than ten in most of the government affiliated MFIs.

However, in many of the investor-owned MFIs (regional government or NGOs), those classified as "individual shareholders" are not real owners with personal stake in the MFIs in the sense that they actually paid for the shares, hence have something to lose. Instead, the funds for the shares were actually contributed by the institutions/NGOs promoting the MFIs and the individuals are merely acting as nominal shareholders representing these institutions so as to satisfy (somewhat superficially though) the legal requirement of establishing them as share companies with at least five shareholders. In the case of Wisdom for example, World Vision Ethiopia paid for all the means that the shareholders are 100% nominal. Regional governments are also nominal.

The ownership structure of the 3 surveyed MFIs is shown in table 3 below. It is clear from the table that ADCSI, one of the biggest among the selected MFIs was established with paid up capital of Birr 517,000 where 96.7 % is owned by regional government and the remaining 3.3% by Associations and NGOs. It should be noted that the region-based and supported MFIs in Ethiopia do not get direct funding from the budget of the regional government. 50.6% of SFPI is owned by Commercial Banks and Insurance companies, 39.5% by Associations and NGOs, and the remaining by Individuals MFIs and it was established with paid up capital of Birr 406,000. Wisdom MFI was established with paid up capital of Birr 200,000 and has shown an ownership structure with 100% individuals as shareholders.

In ADCSI MFI, board members are high government officials. The major problem of the MFI is which high-ranking government officials are board members is the irregularity of board meetings because of the engagement of the officials in priority government duties and responsibilities and unexpected absence for official travels.

As Degefe (2009) indicates, the ownership structure of microfinance institutions in Ethiopia actually is dominated by regional governments with a strong financial and political stake by the ruling party. ADCSI MFI where the regional government have the majority of the ownership, it can be used as the government organ so that it depends on the government heavily. This shows that it has a problem of sustainability if the regional government does not stay in power.

The National Bank of Ethiopia at initial stage has shown more flexibility in allowing a shareholder to own more than 20 % of the total capital of the MFIs. This was made to encourage those who are interested to be engaged in Microfinance. However, the NBE has not required these institutions to improve their ownership structure with a given planned period of time and hence it has created governance problem.

Table 3: Ownership of MFIs – number and composition of owners

MFI	No. of shareholders	Percentage share of shareholders by type			
		Regional government	NGOs/ Associations	Individuals	Total
ADCSI	7	96.7	3.3	-	100
SFPI	8	-	80	20	100
Wisdom	37	-	-	100	100

Source: AEMFI, Ethiopian MFIs Performance Analysis Report: Bulletin, Addis Ababa, Ethiopia.

In ADCSI the respective regional governments own 96.7% of the Shares and there is no provision in its document of incorporation to transfer these shares to clients or to private investors. Under normal circumstances, government ownership sometimes may facilitate resource flow but it has some negative implication on loan recovery in case of say, political unrest. There is also risk of lack of diversification in ownership of this MFI. Shareholders in the sample MFIs were mobilized mainly to fulfill the requirements of the proclamation and the guide lines of the National Bank of Ethiopia. Therefore, the shareholders are just nominal owners. Moreover, when programs that were operated by NGOs or other subsidized government programs are converted into financial institutions, it is obvious that people deployed into the new system either as board members or chief executive, always come with dual mission. It is difficult for them to easily discard the welfare orientation and lead the MFIs as purely profit oriented financial institutions. These issues have their own implications in the effectiveness of the governance of the MFIs.

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

3.1.2.3. Governance of MFIs

A sound governance is fundamental in creating efficient and sustainable microfinance institutions. Governance according to rock, et. al. (1998) is a process by which a board of directors, through management, guides an institution fulfilling its corporate mission and protects the institutions assets. Experience has shown that MFIs have yielded important successes when board members have identified strongly with institutional mission and been able to guide the MFI strategically and hold management accountable to performance. Institutions have to question whether their board members in a position to provide proper guidance to management regarding strategic direction for the institution and oversees management efforts to move in this direction. Governance issues in the Ethiopian MFIs appear to be common in almost all of the MFIs assessed. In Ethiopia, the issue of governance emanates basically from the ownership structure of the MFIs, dual mission and from the limited experience in the sector.

The major elements of sound governance are board size and accountability, board members' qualification and experiences, dedication and commitment of members to the mission and activities of the institution, policies and procedures that the board follows and the skills of the chairperson (skills in leadership, vision in thinking and management). Moreover, members of the board should have a clear understanding of the institution's client base. The objective here is to assess whether the governance of MFIs in Ethiopia is effective in directing the institution to achieve its mission.

As the commercial code of Ethiopia states, next to the general assembly of shareholders, the highest and decisive governing body of a share company is the board of directors. The board is expected to protect or safe guard the shareholders business interest by providing policy guidance and decisions for the management of the company. The highest governing body in three sample MFIs is the general assembly of the shareholders. The board members in three sample MFIs were drawn from among the shareholders. The general assembly elects the board of directors. The chair person of the board of directors is elected from among the representatives of highest share holding organization in sample MFIs.

As per the response to the unstructured interview by the selected MFIs managers and CEO, there are certain criteria set by the institutions in line with those criteria for selection of members of the board of directors issued by the National Bank of Ethiopia in Directive No. MFI/3/1996. The board members are selected by considering the academic qualifications, adequate managerial experience in business and/or similar organizations, and being a member of the founder in the institution.

Board Structure

Board Size

The general rule for size of boards is that they should neither be too small nor too big: "Boards should be large enough to complete their work effectively (without overburdening members), to provide continuity, and to ensure quorums for meetings. That said, boards should be small enough for the group to work together to make substantive decisions" (CMEF 2005). The CMEF recommends not fewer than seven as the quorum becomes very small, especially if management is on the board and sets the typical upper number at nine, although "effective boards may have as many as eleven or more."

The Commercial Code of Ethiopia article 37 indicates that only a member of a company may manage the company and the number of board of directors managing the company shall be no less than three and no more than twelve at any time. The number of board members of the selected MFIs varies from 5 at SFPI to 9 at Wisdom. The number of board member of ADCSI MFI is 7.

Qualification of Board Members

There is only a degree of diversion in best practice papers as to which qualifications of boards members are preferable. Thus, CGAP (1997) does not refer to qualifications at all. WOCCU (2007) recommends that "all members of the board should have basic financial literacy, including the ability to interpret financial statements and standards, or commit to acquiring these skills through education or training within the first year of service", and this basic requirement should be complemented by "specialized financial or business skills and/or a member-focused viewpoint" of individual members.

Directive No. MFI/03/96 is related to the criteria for selection of officers and directors. It says a minimum of first degree in the field of social science or equivalent in relevant field and a minimum of three (3) years experience in a senior post in a financial institution or related institutions. The minimum age required is 30. The board members are selected by considering the academic qualifications, adequate managerial experience in business and/or similar organizations, and being a member of the founder in the institution.

Table 4: No. and Qualifications of The board members of the MFIs

MFIs	No. of Board Members	Qualification of Board Members	
		2nd Degree	1st Degree
ADSCI	7	3	4
SFPI	5	1	4
Wisdom	9	3	6

Source: From author's computation, 2011.

Table 4 above indicates that, in almost all of the MFIs, the board members are qualified people who are committed to the cause of the MFIs. The educational level of each selected MFIs board members ranges from a first degree to masters level and complies with the requirements of the NBE directives. However, they have limited experience in microfinance management.

The academic profile of the board members in ADCSI MFI fulfills. The competency of some board members in ADCSI MFI in terms of diversified skills and effectiveness in guiding the managers of MFIs is questionable. When documents of the ADCSI MFI reviewed by the researcher, it was identified that even though the boarded of directors of the institution consists well-educated and experienced on their own past duties, who can contribute significantly to good governance, there is an immense need for capacity building as most of the board of directors lack experience in microfinance business.

Capacity Building for Board Members

For any board to fulfill its regular duties there needs to be a system to ensure that it is capable of doing same. However, the vast majority of MFIs in addition to the MFIs under studied have no system in place to ensure that board members are obtaining adequate training when they join the board or subsequently during their tenure. The only exception is Wisdom MFI which has a system of ensuring that all board members receive training on all relevant topics both locally and internationally. The other MFIs i.e. ADCSI and SFPI will require that all board members receive training on all relevant topics both locally and internationally.

Board Responsibility

The review of financial statements receives the most prominent attention from the boards. The following are the major responsibilities of the board of directors of the selected MFIs and managing the above tasks expected to be handles by MFI board members.

- Determine overall strategic plan and policies for the organizations.
- Ensure compliance with the institutions' bylaws, policies, procedures and legal requirements.
- Ensure management accountability for results in the areas of financial, personal, operation etc.
- Supervise and evaluate the performance of the CEO.
- Represent the organization to major stakeholders when the need arises.
- Review and approve annual plans/budgets.
- Ensure adequate resource (finance and manpower), and
- Effectively manage own affairs through self-appraisal.

On the other hand, the management of the MFIs for the unstructured interview replied that board members rarely participated in hiring/firing management and review of mission and vision. Hence, these incidents may hint to the possibility of a rubberstamp board.

The fact that boards' roles in the definition and review of the institution's vision and mission as well as in evaluating management performance and remuneration is comparatively limited is somewhat surprising. Even more surprising is the fact that in two MFIs the management claimed that the board never participated in mission definition.

Frequency of Board Meetings

In almost all of the MFIs, the board members are qualified people who are committed to the cause of the MFIs. The board meetings as a rule are to be held monthly. In practice, however, meetings are held quarterly. In ADCSI, board members are high government officials. The major problem of this MFI where high-ranking Government officials are board members is the irregularity of attending urgent or even regular board meetings because of the engagement of the officials in priority government duties and responsibilities and unexpected absence for official travels. Similarly, in SFPI and Wisdom MFIs where NGO promoted in which board members are high-ranking officials, there is an irregularity of their attendance in the meetings. Even though the Articles of Association of these MFIs stipulate that boards shall meet every month, they meet every three months.

In order to increase sense of responsibility and accountability it is necessary to develop code of conduct for board members regarding attendance in meetings and mechanisms of self-evaluation and individual contribution.

Organizational Structure

The only structure for MFIs in Ethiopia is that prescribed by law. Thus, the highest level institutional design must take a corporate form, where the general assembly of shareholders forms the highest decision-making level (in principle), followed the board of directors, which is elected by the general assembly (Degefe, 2009).

ADCSI adapts three-tier organization structure, head office, branch and sub-branch. It has a head office in charge of overall coordination, 9 branch offices coordinating the activities of the real service outlay and 88 service delivery posts. Service delivery posts in kebele are staffed by branch manager, Accountant, Cashier and Loan officer. Service delivery posts are authorized to loan up to 20,000 birr. Loans between 20,000 and 100,000 birr are authorized at branch level.

SFPI has two-tier organizational structure, head office and branches that are directly accountable to the head office regardless of their distance or location. It has a head office located in Addis Ababa and 8 branches where three of them is in Addis Ababa City administration and while the remaining are in Oromiya Regional State. The size of the loans given to its clients ranges from Birr 100 up to Birr 15,000. Wisdom adapts the same type of organizational structure as ADCSI, with head office in charge of overall coordination and branches coordinating the activities of the real service outlets, sub-branches. It has a head office located in Addis Ababa and 5 branches and 45 sub branches and special branches located in different places outside Addis Ababa.

Human Resources Development

Once savings are introduced, the MFI becomes a true financial intermediary, and the consequences for the institution and its human resources are considerable. Since microfinance is relatively a new sector in Ethiopia, skilled manpower in the area is not easy to find and the MFIs have a problem in recruiting competent and skilled labour in the market. These institutions argue that efficient, appropriately trained and motivated staff can further improve and sustain micro-financing activities. The MFIs under studied have business development and promotion unit, which provide training to its staffs and clients. This training and human development policy of the institution aims at improving the skills of its employees so that it is one of the ways for the institutions to meet its objectives. The Association of the Ethiopian Microfinance Institutions (AEMFI) is playing a major role in training and facilitating a forum to learn from each other's experience. The Association also has the objective of promoting and supporting net working activities among MFIs initiate and support policy dialogue, providing up-to-date information on the status of MFIs in Ethiopia. MFIs are thinly manned as far as qualified manpower at senor level is concerned. Moreover, as the nature of work demands deployment of large number of staff at grassroots level, high school graduates dominate the composition of the manpower.

In spite of the above efforts, most of branch and sub branch staff of the Institution lacks the necessary qualification and knowledge of microfinance, particularly in the areas of accounting, and financial management. Furthermore, the staff lacks experience of Management, supervision, monitoring and follow up of the microfinance operation. ADCSI has developed an incentive system to credit officers based on their performance or output such as portfolio quality, number of active clients, and level of saving collected.

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

3.1.3. Products and Services Offered by the Selected MFIs

There are six types of loan products that ADCSI MFI provides. A *micro business loan* product has a nature of installment repayment and it is disbursed for high turnover activities like retail trade activities, “gult” and so on. Ranging from Birr 700, the maximum loan size for this loan product is Birr 5,000.00. The other type is a *small business loan* that is disbursed relatively for well established businesses and technical and vocational school graduate students who want to enter in to productive venture and the size of the loan is usually greater than 5,000.00 birr and less than 50,000.00 for each entrepreneur. *Micro lease loan* is offered when clients choose the machines for their operations and ADCSI purchases these machines and hand it over to them. The operators assume ownership after completion of payment. This type of loan is rendered mostly to people who are organized into cooperatives.

The other type loan product is *housing loan* which has the aim of enabling clients construct a new house or complete a construction in progress. The maximum loan size is 50,000 birr with loan term of 60 months (or 5 years) and repayable monthly. *Consumer loan product* targets government and related employees that have fixed monthly salary; the loan is guaranteed by employers and deducted from payroll on monthly basis. The loan size depends on the borrower’s salary and loan term is up to 24 months.

Short-term loan is a short-term loan repayable with in maximum of six months. It targets clients that face very urgent financial problem or working capital shortage to do some urgent business.

SFPI offers five types of loan products as well as voluntary savings. The three loan products SFPI has had since its inception are loans for petty trade, services and processing & manufacturing. The first two have the same terms where it is only the business focus that differs. The loan amounts range from 500 - 15,000 ETB, have a term of 6 to 18 months and have monthly repayments. The loan is based on group guarantee. Long standing clients can also avail of these loans on an individual basis requiring a personal guarantor or other hard collateral if available. The processing & manufacturing loan only varies in relation to the loan amounts which range from 1,500 - 50,000 ETB. There is a specific loan targeting cooperatives of specific craftsmen (e.g. carpenter, construction) with support of the European Development Fund which can go up to 200,000 ETB for the whole cooperative.

This requires a signed sales agreement as collateral. All three carry a 16% flat interest rate without commission resulting in an average effective interest rate of 27.5%.

In 2001, SFPI introduced an agricultural loan product ranging from 1,000 - 5,000 ETB in rural areas and 2,000 - 15,000 ETB in peri-urban areas. There is a single bullet payment at the end including all interest but monthly meetings are held to collect compulsory savings of 6 ETB. The effective interest rate is 16% per annum.

2004 saw the introduction of a salary loan for consumption purposes ranging from 500 - 5,000 ETB at 16% flat backed by a personal guarantor and an employers' letter.

Although since inception the offering has been limited. From all disbursements compulsory savings are withheld, 10% for loans below 5,000 ETB and 5% for loans above. Also voluntary savings are offered. Both savings receive 4% interest per annum paid out semi-annually. SFPI also offers non-financial services (free of charge) to its client in the form of business skills training.

At present, Wisdom has three types of loan products, namely individual loan product ranging from 8,000 – 15,000 ETB. The individual loan products were rolled out in November 2003 and have so far proven successful in boosting portfolio growth. Solidarity loan products which ranging from 1,200 – 6,600 ETB consists two types of loan products, namely the Business loan and Enterprise loan. The other type is community banking loans that range from 1,500 – 2,500 ETB.

The purely private (Wisdom) and NGO (SFPI) related MFIs in the sample seem to have a more serious shortage of funding than those associated with regional governments. In ADCSI MFI in which regional governments are involved as shareholders seem to enjoy better possibilities of raising additional capital. Almost all such MFIs in the sample indicated that the respective regional governments are ready and able to provide additional capital injections if required. This is so because development strategies of the Government. It thus intends to support such activities through, among other things, provision of credit as well as creation of market links, training as well as tools/machinery improvement.

3.2. Financial Performance Measurement in Microfinance

Microfinance institutions, regardless of their social mission, are financial intermediaries. Therefore, it is important to assess the viability and soundness of MFIs. To evaluate the performance of micro finance institutions SEEP Network and CGAP (most widely used) evaluate financial and operational performance in terms of:

- Portfolio Quality
- Sustainability and Profitability
- Efficiency and Productivity

Financial Statements Analysis

The starting point for sound financial management is the timely and accurate production of financial reports, which requires timely and accurate financial records. Frequently, MFIs must produce financial statements based on a format required by lenders, donors, and regulators (NBE), or network organizations (AEMFIs).

Such statements may satisfy reporting requirements of one or more of those groups. Furthermore, to make financial statements to be useful, managers and investors need to analyze and interpret the statements. Careful analysis of financial statements can help decision makers evaluate an organizations past performance and predicts its future performance. Such evaluation help managers, investors, and others make intelligent and informed financial decisions.

Therefore, in line with this the financial statements of the sampled MFIs are analyzed to show how well they are performing.

3.2.1. Portfolio Quality

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

Loan repayment is the most revealing of the performance areas. A retail lender's ability to collect loans is critical for its success: if delinquency is not kept to very low levels, it can quickly spin out of control. Furthermore, loan collection has proved to be a strong proxy for general management competence. Long experience with evaluating microfinance projects has shown that very few successful projects have bad repayment, and very few

unsuccessful projects have good repayment. More than any other indicator, this one deserves special care to ensure meaningful and reliable reporting.
The repayment rate, below 95% is commonly agreed as the limit for good performance. ADCSI and Wisdom MFIs, have the highest repayment rate of over 97% for the period of the study. However, SFPI reports a repayment rate of 71.48% on average for the five years under consideration. Generally, SFPI performs well in this regard.

On average all ADCSI, SFPI and Wisdom achieved relatively better portfolio quality as shown by low portfolio at risk rate which is on average below 5% for the fiscal years under consideration.

The portfolio at risk rate of ADCSI improved from year to year. It registered 0.00% rate of portfolio at risk for the year 2007. The portfolio risk decreases from 3% in the year 2008 to 2.4% in the year 2009. The portfolio at risk rate for SFPI was high in the year 2007 (7.5%) but showed a significant decline in the subsequent periods, 4% and 3.2% in the year 2008 and 2009 respectively. Wisdom registered low rate of portfolio at risk in the year 2007. However, this rate continued to increase in the subsequent years. For example, from 3% in the year 2008 to 5% in the year 2009.

The risk coverage ratio gives the indication of how the institution is prepared for the worst case scenario. For microfinance institutions, loan loss reserves usually range on average between 33% and 65% of portfolio at risk for the selected MFIs. SFPI and Wisdom MFIs, provide higher provision, almost two times greater than an average for ADCSI.

One of the most impressive characteristics of Ethiopian MFIs is that the loan recovery rate is generally high. According to AEMFI's recent Ethiopian Microfinance Institutions performance Analysis Report (Peck and Ephrem 2009), the loan loss rate of Ethiopian MFIs ranges from 0% to 17%, at a weighted average of 5%. The selected MFIs showed a better performance in this regard.

The write-off ratio measures the actual loan loss the MFI is suffering from loan provision service. The writing off of a loan is accounting transaction to prevent asset from being unrealistically inflated by loan that may not be recovered. The write-off ratios for ADCSI were below 2% on average and it indicates that ADCSI is good in this regard. SFPI registered write-off ratio of 4.92% on average and for the year 2009 registered 8.18% which is high as compared to the other years and above ADCSI and Wisdom MFIs. The higher write off rate contribute for low portfolio at risk of SFPI in the 2009 fiscal year. Like ADCSI the Wisdom's write of ratio is below 2% on average for the years under study.

Table 5: Portfolio Quality of Microfinance Institutions

ADCSI	**2009**	**2008**	**2007**	**2006**	**2005**	**Average**
Repayment rate	97.00%	97.10%	97.90%	98.10%	98.30%	97.68%
Portfolio -At-Risk (PAR) Ratio > 30 days	2.40%	3.00%	3.20%	3.50%	0.90%	1.96%
Write-offs-Ratio	1.00%	1.00%	1.30%	1.50%	2.20%	1.40%
Risk coverage ratio	20.00%	23.00%	27.00%	47.90%	70.00%	32.18%
Loan Loss Rate	1.00%	1.00%	1.30%	1.50%	2.20%	1.40%
SFPI						
Repayment rate	79.78%	78.03%	76.08%	29.80%	93.69%	71.48%
Portfolio -At-Risk (PAR) Ratio > 30	3.2%	4.00%	7.5%	4.0%	4.5%	4.6%

days						
Write-offs-Ratio	8.18%	2.00%	6.1%	2.9%	5.40%	4.92%
Risk coverage ratio	71.00 %	72.00 %	70.5%	57.6%	51.20 %	64.46 %
Loan Loss Rate	2.40%	2.00%	5.40%	2.90%	6.10%	3.76%
Wisdom						
Repayment rate	98.00 %	97.00 %	96.00%	98.00 %	98.00 %	97.40 %
Portfolio -At-Risk (PAR) Ratio > 30 days	5.0%	3.0%	2.70%	4.70%	3.30%	3.7%
Write-offs-Ratio	1.38%	2.0%	3.30%	2.20%	2.80%	1.94%
Risk coverage ratio	62.00 %	60.00 %	51.30 %	35.50 %	85.00 %	58.76 %
Loan Loss Rate	0.73%	0.97%	2.20%	1.20%	2.20%	1.12%

Source: Researcher's own computation from financial statements

3.2.2. Sustainability and Profitability of Microfinance Institutions

Profitability and sustainability ratios reflect the microfinance institutions' ability to continue operating and grow in the future. Regardless of their nonprofit or for profit status; donors and investors alike look to fund sustainable institutions. Sustainability and profitability of microfinance institutions were measured and analyzed using Adjusted Return on Assets (AROA) and Adjusted Return on Equity (AROE); and operational and financial self sufficiency as follows:

3.2.2.1. Adjusted Return on Assets Ratio and Adjusted Return on Equity

Adjusted Return on Assets Ratio

Adjusted Return on Assets (AROA) indicates how well an institution is managing its assets to optimize profitability. The ratio includes not only return on portfolio, but also all other revenue generated from investments in other operating activities.

Balance sheet percentages are usually based on the total assets (as 100%). This analysis was based on the statement of financial position and the profit and loss reports of the selected MFIs. For ADCSI MFI, from the year 2005 to 2009 the total assets show an increasing figures and the net worth at the end of 2009 increased compared to the previous years, whereas the firm's total liabilities during the years showed increasing pattern. The increase in assets and net worth are attributed to the higher operating income generated by the firm and thus, the adjusted return on assets showed positive ratios for the fiscal years of 2008 and 2009. This shows that ADCSI was good in managing its assets to optimize profit and related with the increase in net income. Whereas, in the fiscal year 2006 and 2007, its adjusted return on assets showed negative ratios of -6.50% and -8.10% respectively and this shows that ADCSI was not good in managing its assets to optimize profit in these years. Generally, the AROA showed an improvement on the recent years and this is because ADCSI improves how to manage its assets to optimize profit.

The adjusted return on assets (AROA) for SFPI from 2005 through 2007 fiscal periods was -9.0%, -2.7% and -3.5%, respectively. From 2005 through 2007 fiscal periods the return on assets ratio showed negative ratio together with the decrease in net income. The return on assets reported in 2008 was 3% which is good of all the years under consideration. While this ratio in the fiscal year 2009, reduced to 1.5%. This low return on asset ratio reported in the fiscal year 2009 is mainly due to the low level operating income reported by the firm. Thus, this tells us that the firm did accomplish better in the years 2008 and 2009 as compared to the other year under consideration.

On the other hand, in 2007, in its full year operation, Wisdom MFI reported a return on assets ratio of -7.80% which is a bad achievement for the firm. However, in 2008 the firm generated a total income of birr 17,728,420. As a result, it reported positive return on assets (0.0%). According to the officials the income reported in 2008 were due to the higher financial revenue generated during the period and the lesser expensed incurred during the same period. This shows a relative good performance made by the firm. However, the firm could not maintain its positive ratio in the fiscal year of 2009 and this shows that there is a problem in managing its assets.
Based on the summary of the table 6 below, ADCSI MFI secured a better positive return on assets. But the remaining with SFPI performing well in the year of 2008, MFIs had a negative return. Thus, it can be concluded that microfinance institutions operating in Addis Ababa were doing well in the year 2008 from profitability and sustainability point of view. However, in general, the MFIs performance is not sufficient since the ratio showed negative in most of the years under study.

Adjusted Return on Equity (AROE)

Adjusted Return on Equity (AROE) measures net operating income less taxes as a percentage of total equity. The ratio indicates a microfinance institutions ability to build equity through retained earnings and demonstrates an institutions capacity to generate income from its core financial activity (SEEP, 2005).

For ADCSI MFI the adjusted return on equity was measured based on its financial statements from 2005 to 2009 fiscal years. The results for both 2008 and 2009 show a positive ratio even though there were a decrease ration in the fiscal year of 2009 as compared to 2008 and this was because of the decreasing operating income over the year. Generally, the performance of the MF in this regard is better.

When we look at the results of SFPI again in the same Table 6 below, the AROE in 2008 shows a good performance as compared to the previous year. However, in the fiscal period of 2009 it decreased as compared to the year 2008. This is due to the decreased amount of operating income. As many commercial financial institutions target AROE of about 15% to 25%, the results obtained for SFPI is also very low. But generally, the institution performed better in the 2008 and 2009 fiscal years.

For Wisdom MFI the results of AROE reflected mostly negative ratio except for the fiscal years 2006 and 2008 which are 2.60% and 0.00% respectively. The negative return on equity in 2005, 2007 and 2009 were due to the higher operating expenses incurred during the fiscal periods by the firm. Generally, under the years considered, this microfinance institution reported a negative return on equity. This shows that the institution's ability to generate income from its core financial service activity was not good. For a MFI that began formal operation in 2005, the result reported during the same year is not encouraging.

Based on the summary of the tables 6 below still ADCSI MFIs secured a positive return on equity and were good in using retained earnings and donor money to become sustainable. But Wisdom MFI had a negative return.

Therefore, from the table summary it can be concluded that microfinance institutions operating in Addis Ababa were doing well in the year 2008 and 2009 from profitability and sustainability point of view. However, in general, the MFIs performance is not sufficient since the ratio showed negative.

3.2.2.2. Operational Self-Sufficiency and Financial Self-Sufficiency

Operational self sufficiency indicates whether revenues from operations are sufficient to cover all operating expenses. It reflects the MFI's ability to continue its operations if it receives no further subsidies. The breakeven point of an MFI's operation is 100 percent. Whereas, financial self sufficiency measures not only MFI's ability to cover its operating costs but also its ability to maintain the value of its equity relative to inflation and to operate and expand without subsidies.

Operational Self-Sufficiency

The operational sustainability is the ability of the institution to cover operational costs with the interest and possibility other recurrent revenue. ADCSI and SFPI have attained operational self-sufficiency in all the years from 2005 to 2009 by scoring above 100%. Whereas, Wisdom MFI except for the years 2007, 2008 and 2009 where it is in close to operational self-sufficiency, achieving 99.1%, 96% and 92% respectively, it has attained operational self-sufficiency for the remaining years. From this it can be concluded that ADCSI and SFPI MFIs were in a position to generate sufficient revenue to cover their operating expenses. Whereas, Wisdom MFI has relatively high operational expenses in relation to its size – it should therefore position itself to take advantage of the benefits offered by their economies of scale and attempt to reduce their administrative and personnel costs.

Based on the summary of the tables 6 below, except the years 2008 and 2009 for wisdom MFI, all the selected MFIs have attained operational self-sufficiency in all the years from 2005 to 2009 by scoring above 100%. Accordingly, it can be concluded that microfinance institutions operating in Addis Ababa were operationally self-sufficient in the years under study.

Financial Self-Sufficiency

The financial self-sufficiency was analyzed after standard provisional adjustments are made. ADCSI and Wisdom MFI did well in the year 2005 and 2006 respectively in terms of financial self-sufficiency because their ratios showed that they have achieved beyond the threshold level (100%). Whereas, for the other years financial self-sufficiency showed below the threshold level (100%). ADCSI has almost achieved financial self-sufficiency in the year 2008. SFPI's financial self-sufficiency showed an improvement for the year 2009 but still this MFI ratio is below the mentioned threshold level. From this it can be concluded that this MFIs's ability to operate and expand without subsidies is difficult.

Based on the summary of the tables 6 except for SFPI MFI where its financial self-sufficiency is below 85%, all the selected MFIs have attained financial self-sufficiency in the years from 2005 to 2006 for ADCSI and Wisdom MFIs respectively by scoring above 100%. Accordingly, it can be concluded that microfinance institutions operating in Addis Ababa were not financially self-sufficient in the years under study.

Table 6: Sustainability and Profitability of Microfinance Institutions

ADCSI	2009	2008	2007	2006	2005
Return on Assets	3.00%	4.00%	-8.10%	-6.50%	5.00%
Return on Equity	4.00%	6.00%	-11.90%	-9.20%	7.00%
Operational self-sufficiency	156.0%	192.0%	156.00%	135.20%	197.30%
Financial sustainability	49.10%	98.00%	63.10%	50.40%	106.60%
SFPI					
Return on Assets	1.5%	3.0%	-9.0%	-2.7%	-3.4%
Return on Equity	3.4%	6.0%	-23.0%	-5.1%	-6.5%
Operational self-sufficiency	110.0%	119.0%	111.3%	127.0%	104.0%
Financial sustainability	83.4%	54.0%	59.6%	84.60%	80.7%
Wisdom					
Return on Assets	-2.0%	-5.10%	-7.80%	1.10%	-2.10%
Return on Equity	-4.5%	-8.90%	-19.0%	2.60%	-4.90%
Operational self-sufficiency	92%	96.0%	99.10%	129.10%	107.1%
Financial sustainability	69%	56.0%	72.7%	105.2%	90.9%

Source: Researcher's own computation from financial statements

3.2.3. Efficiency and productivity of MFIs

Efficiency and productivity indicators reflect how well an MFI uses its resource, particularly its assets and personnel. This particular study employed operating expense ratio; personnel productivity (borrowers per credit officers); and cost per borrower as efficiency and productivity indicators.

Operating expense Ratio

This ratio shows administrative and personnel expense to the MFI's yield on the gross loan portfolio. It is the ratio of operating expense to average gross loan portfolio. The lower the ratio, the more efficient the MFI is. An attempt was also made to evaluate the operating expense ratio of the selected MFIs. The results obtained are presented for each of the MFIs as follows:

From table 7 below, it can be observed that ADCSI's cost per unit of money lent ratio is 3.15% on average for the years under study for administration and personnel in order to provide a Br 1 loan to their customers. Thus, for ADCSI this cost for 2007 was 3.30% per unit of money lent which is less than the 3% ratio shown for 2008. However, in 2009 the ratio increases to 3.23%. Therefore, one can deduce from this that even though the operating cost ratio in 2009 increases, compared to SFPI and Wisdom, ADCSI was efficient in its operating expense. The results obtained for SFPI from the annual reports showed medium ratio as compared to ADCSI and Wisdom. The cost per unit of money lent for SFPI for the years under study reported 9.82% on average. Hence, one can infer from this that the institution seems efficient compared to Wisdom whereas inefficient compared to ADCSI. Wisdom has relatively high operational expense in relation to the other MFIs. In that, the firm reported an operating cost ratio of 17% on average for the years under consideration. Hence, it seems a bit inefficient and unproductive compared to the ADCSI and SFPI.

All in all, from the results presented in the above paragraphs, one can easily infer that the financial efficiency ratios of the ADCSI are favorable compared to SPFI and Wisdom. However, the selected MFIs operating cost ratio is high in the years under consideration and not satisfactory in this regard. Thus, from this it can be said that MFIs operating in Addis Ababa performed poor in this regard.

Productivity Ratio

All MFIs are productive in the sense that they serve a large number of borrowers per staff. But care has to be taken that large number of borrowers per staff also signals lower service quality delivered to customers as loan officer will give less attention to the need of each customer and thereby quality of outreach will decline.

Number of Active Borrowers Per Credit Officers.

Regarding the productivity ratio, the total number of active borrowers for each of the selected MFIs was compared with the total number of loan officers for the fiscal periods under consideration.

Accordingly, in 2007 ADCSI's result showed a significant increment (732) showing that it achieved well in its productivity whereas, this ratio declined in the subsequent years and reached to 245 in 2009. The reports obtained for SFPI indicated significantly increased results, evidencing the firm's productivity. In 2006, the results as per the analysis indicated quite an impressive achievement 484. Generally, in this regard, SFPI was more productive for it reported more than what was reported by ADSCI and Wisdom in the fiscal periods from 2005 and 2009 except for the year 2007 reported by ADCSI. A ratio of active borrowers per credit officer for Wisdom MFI declined from 2006 through 2009 and reached to 254. Hence, one can see that the number decreases significantly each year.

Even though the number increased and decreased from year to year, MFIs operating in Addis Ababa were productive in the fiscal periods under study in this regard.

Cost per borrower

It indicates an institution how much it currently spends in personnel and administrative expenses to serve a single borrower. It informs the MFI how much it must earn from each borrower to be profitable.

The cost per borrower amount showed an increasing pattern throughout the fiscal periods under consideration for all the MFIs under study. However, when it is compared, from SFPI and Wisdom MFIs, ADCSI spends the least (efficient) in personnel and administrative expenses to serve a single borrower. Still the MFIs operating in Addis Ababa reach more clients at lower costs as shown in their low average cost per borrower. Their productivity in terms of loan officer is slightly good.

Table 7: Efficiency and Productivity

ADCSI	**2009**	**2008**	**2007**	**2006**	**2005**
Operating Cost Ratio	3.23%	3.0%	3.30%	3.00%	3.20%
Borrowers per credit officers	245	248	732	141	498
Cost per borrowers	102	99	93	89	76
SFPI					
Operating Cost Ratio	10.90%	9.0%	9.90%	9.70%	9.60%
Borrowers per credit officers	433	453	434	484	531
Cost per borrowers	146	139	135	126	121

Wisdom					
Operating Cost Ratio	21%	15%	16.90%	15.20%	15.20%
Borrowers per credit officers	254	263	295	358	351
Cost per borrowers	295	243	229	179	188

Source: Research's own computation from financial statements

Chapter Four: Conclusion and Recommendations

4.1. Conclusion

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

Paramount objective for MFIs to be successful is financial self-sustainability and in achieving this objective, MFIs have challenge in how to become viable institution that built a firm foundation of efficient operation. Institutional and financial viable microfinance institutions play a leading role in poverty reduction. Given this state of affairs the assessment of microfinance programs remains an important field for researchers, policy makers and development practitioners. This paper is designed to assess institutional viability and financial performance of the MFIs operating in Addis Ababa based on the case study of three institutions namely, ADCSI, SFPI and Wisdom. The study has used both quantitative and qualitative method to obtain information on institutional viability and financial performance of the three sample MFIs. After the gathering of the primary and secondary date, adjustment to financial data was made and then the performances of the MFIs were measured by using financial ratio analysis.

Microfinance institutions, regardless of their social mission, are financial intermediaries. Therefore, it should be financially viable and sound to achieve its mission.

Institutional Sustainability:-

The ownership structure of the three sample MFIs reveals that the ownership is mainly a mixture of NGOs, government, associations and private individuals. In ADCSI the respective regional governments own 96.7 percent of the shares of MFI. The shareholders in sample MFIs are nominal owners that were mobilized to fulfill the requirements of the proclamation. The size of the board in the selected MFIs is appropriate ranging between 5 at SFPI to 9 at Wisdom. The number of board member of ADCSI MFI is 7. Board members in sample MFIs are qualified people except limited experience in microfinance management. Most of them are high government officials that are busy to attend the board meeting regularly. The only structure for MFIs in Ethiopia is that prescribed by law. Both ADCSI and Wisdom MFIs have three tire organizational structure whereas SFPI has two tire organizational structure. The study identified that the practice of Board of directors evaluating themselves is not common in sample MFIs.

The three institutions are providing training to their staff at various levels. In spite of the above efforts, most of branch and sub-branch staff of the institution lacks the necessary qualification and knowledge of microfinance. ADCSI has developed an incentive system to credit officers based on their performance. However, SFPI and Wisdom didn't have any incentive system yet. The study identified that; compared to the work load, the salary paid by sample MFIs is low.

Financial sustainability:-

From profitability and sustainability point of view, Most of the microfinance institutions were doing well in terms of Operational self sufficiency and financial self sufficiency. ADCSI and Wisdom MFIs have achieved the level of financial sustainability in the fiscal years 2005 and 2006 respectively. The trend of SFPI financial performance demonstrates that there is a good and steady progress towards reaching financial sustainability. Both ADCSI and SFPI already achieved operational sustainability. All of the MFIs were good in using retained earnings and donor money to become sustainable and were brilliant in managing their assets to optimize profit. In general, during the year 2006 MFIs were doing well.

From efficiency and productivity point of view, ADCSI MFI has the lowest operating expense ratio (more efficient) and Wisdom MFI the highest operating expense ratio represented by operating expense over average gross loan portfolio. Salary dominates the operating cost of the MFIs. However, the increasing trends in total expense ratio in sample MFIs for the fiscal year 2009 indicate that the institutions are not improving their efficiency.

From the sample MFIs, ADCSI MFI spends the least (efficient) in personnel and administrative expenses to serve a single borrower. The number of borrowers per credit office has somewhat higher for SFPI and Wisdom.

5.2. Recommendations

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

1. Ownership and Governance structure:-

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

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

- In order to increase sense of responsibility and accountability it is necessary to develop code of conduct for Board members regarding attendance in meeting and mechanism of self evaluation and individual contribution.

- Providing the necessary incentives to Board members could maximize the benefits by involving them in strategic issues.
- In ADCSI where regional government own the majority shares, diversification in MFIs should be done by gradual relinquish of shares to clients of MFIs, private organizations like bank, universities and foundations.

2. Human resource Development

Lack of staff development primarily affects staff motivation and then the performance of institution itself. Secondly, it might end up in high staff turnover that force MFIs to lose the most experienced employee. Hence, sample MFIs should develop and put in place clear staff development strategy such as, carrier structure with attractive pay scheme and staff training policy. SFPI and Wisdom should consider introducing performance related incentive system and packages of benefits based on their financial capability. Moreover, it is important for sample MFIs to work closely with the regional government to get scholarship and sponsorship for best performing staff. Once staff training policy is developed, the project document developed and submitted to those donors in capacity building. In addition, policy could be adopted to allocate certain percentage of personnel cost for staff development each year to be built in annual plan.

3. Financial Sustainability

Even though the MFIs were doing well in terms of profitability and sustainability, certain MFIs should exert maximum effort to pass the minimum threshold level in connection with financial self-sufficiency to cover their costs, grow and sustain by their own.

Since return on equity for Wisdom MFI is negative for majority of the years under consideration, this institution should work on it and move towards positive return on equity because this is the means to assure its survival in the market by its own, without the immense support of donors. MFIs should devise a means to obtain funds from diversified sources in order to minimize the risks associated with obtaining funds from few sources.

SFPI and Wisdom MFIs should decrease their operating expenses in order to become more efficient through experience sharing with the most efficient counterparts and benchmarking themselves against best performers in the industry. ADCSI MFI should reappraise itself to ascertain whether it is reaching the poorer section of the society or not and act accordingly.

MFIs operating in Addis Ababa should improve profitability and sustainability since the trend was not good in those periods under study by decreasing their operating expenses. In addition SFPI and Wisdom MFIs should devise a mechanism to obtain funds at lowest cost like that of ADCSI MFI.

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