Regulation & Supervision of Microfinance Business in Ethiopia:

Achievements, Challenges & Prospects (To be presented at International Conference on Microfinance Regulation, March 15-17, 2010, Bangladesh, Dhaka)

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List of Acronym and Abbreviations

ACSI	Amhara Credit and Saving Institution
ADCSI	Addis Credit and Saving Institution
AEMFI	Association of Ethiopian Microfinance Institutions
AIB	Awash International Bank
BOA	Bank of Abyssinia
BOU	Bank of Uganda
CAMEL	Acronym for Capital, Asset Quality, Management, Earning, Liquidity
CBE	Commercial Bank of Ethiopia
CSA	Central Statistics Authority
DECSI	Dedebit Credit and Saving Institution
DBE	Development Bank of Ethiopia
GDP	Gross Domestic Product
MFC	Microfinance Companies
MFI	Microfinance Institutions
MSE	Micro and Small Enterprises
NBE	National Bank of Ethiopia
NIB	Nib International Bank
NGO's	Non Government Organizations

PEACE Poverty Eradication and Community Empowerment MFI

PEARLS Acronym for Protection, Effective Financial Structure, Asset Quality, Rate of Return and Cost, Sign of Growth

SFPI Specialized Financial and Promotional Institution

Abstract

Until 1996, the provision of microfinance services in Ethiopia has been carried out mostly by donor funded programs through NGOs and government institutions. Most of the time a poverty lending approach was followed with subsidized interest rates. This practice has undermined loan collection performance leading to huge default and hence weakened the development of self sustaining MFIs.

After 1996, however, a regulatory framework for Licensing and Supervision of MFIs was introduced, and as a result, most of the donor funded micro credit programs that were carried out by NGOs were transformed to be regulated institutions. The proclamation 40/1996 was issued in 1996 based on the limited microfinance experience which was prevailing at the time. In order to address various problems related with regulation and go with the development of the sector, the Government and National Bank of Ethiopia have been making effort to gradually improve the regulatory framework. The findings of this research paper suggest that the regulation and supervision of MFIs in Ethiopia brought many benefits. These are the following: The regulatory framework in Ethiopia has created an enabling environment for establishment of specialized formal financial institutions that provide financial service to those who were considered as unbankable, enabled MFIs to offer a wide range of products (for example credit, savings and money transfer etc.) and promoted standardization and transparency in the sector. In general, the regulatory and supervisory framework, in addition to other factors, has benefited the microfinance institutions in Ethiopia to show impressive performance in terms providing wide range of finical services including: extending credit, saving mobilization, money transfer and providing other related services to lower income section of the population. The regulatory and supervisory framework

has also its own constraints and challenges which are discussed in detail in this paper by highlighting appropriate recommendation to tackle them.

In general, this paper discusses and assesses:

1. Theoretical aspects of Regulation and supervision of microfinance (i.e. Rationale, Principles, Methodology and Instruments of Regulation and Supervision of Microfinance Institutions (MFIs).
2. Regulation and Supervision of Microfinance Institutions in Ethiopia:
    2.1 Overview of Financial System and Historical Development of Microfinance in Ethiopia.
    2.2 Regulatory Framework of Microfinance in Ethiopia.
    2.3 Supervisory Approaches and its Performance in Ethiopia
    2.4 Major Achievements of Regulation and Supervision of Microfinance in Ethiopia.
    2.5 Challenges of Regulation and Supervision of Microfinance in Ethiopia.

These all issues are assessed following the new financial system approach to microfinance and creating business based microfinance sector in Ethiopia. Unlike the other papers made on the subject, this paper based its findings on the response of MFIs, commercial banks and central bank staff, which helps to consider reaction of various stakeholders. In addition, comparative assessment of regulatory framework of Ethiopia is made with that of Tanzania and Uganda and effort was made to take lesson for this research paper. Finally, principal conclusions and recommendations are discussed in this paper.

1. Introduction

As it is well known, regulation and supervision of microfinance institutions is one of the major issues that governments of different countries consider in reform of financial sector. Prudential regulation and supervision are the most talked topics in development finance (Michael Fiebig, 2001). Even though these issues have been frequently discussed in relation to traditional banking sector, it is relatively new for the microfinance sector.

From the out set, we would like to indicate the basic premises upon which this research paper is founded. This paper tries to follow the new financial system approach which emphasizes shift from credit delivery to sustainable financial intermediation. The current literature and actual practice tells us that the government and donor funds can supply only a tiny fraction of global microfinance demand and hence financial intermediation by self sufficient institutions is the only way that financial services can be supplied to lower-income people world wide (Marguerite S.Robinson , 2001). Only an MFI that is able to cover its cost (on a medium term) can be able to continue its operation in a sustainable way and also generate benefits to its clients (H.Schmidt and Zeitinger, 2003). In addition, this paper is based on the belief that the microfinance sector could reach it s full potential in regulated situation. In order to reach full potential, the microfinance industry must eventually be able to enter the arena of licensed, prudentially supervised financial intermediation, and regulations must eventually be crafted that allow effective and efficient development of the MFIs (Peck Cristen and et.al, 2003). Since it is usually a prerequisite for savings mobilization it will be difficult for MFIs to get access various source of funds and also provide wide range of financial services. Therefore, this paper tries to shed light on how the regulatory and supervisory framework of MFIs contributes to the achievement of these objectives and its limitations and prospects.

1.1 Background

Ethiopia is found in the horn of Africa having a large population of 76.8 million (in the year 2008/2009). 76.8% of the population is living in rural area where there main activity is subsistence agriculture. Sectored breakdown of goods and services produced during fiscal year 2008/2009 showed that agriculture, industry and services contributed 43.2, 13, and 45 percent share to GDP respectively.

Table 1 : Selected Macroeconomic and Social Indicators: Ethiopia

Land Area	1.14 million sq.km
Population (Out of which urban population in percentage)	76.8 Million 15.8
GDP per capita (in USD)	420
Agriculture and allied activities (as % of GDP)	43.2
Industrial sector (as % of GDP)	13
Service sector (as % of GDP)	45.1
General inflation (In percent)	36.4
Exchange rate ($1) Period weighted average)	10.4205

Source: Extracted from Annual Report (2008/2009) of National Bank of Ethiopia (NBE)

The main problems of the country include poverty and unemployment. The government of Ethiopia has been providing attention to reduce poverty in the country. Microfinance is considered as one of the tools for fighting poverty. Until 1996, loans for the low income population section of the population or micro-entrepreneurs in Ethiopia were provided through government programs, cooperatives and Non government Organizations. These programs were charging subsidized interest, based on the view that the poor do not have the capacity to pay their debt at market interest rates (Dr. Wolday Amaha, 2000). Most of such programs have been experiencing lower repayment rates, high arrears. Most of the Non Governmental Organizations were not taking at most care in collecting the loan disbursed by them. As result, it has contributed to uncontrolled default and loss of saving of people. In addition, it has also hampered the credit culture in urban and rural areas of the country (Dr. Wolday Amaha, 2000).

The formal banking system in the country presents many restrictions to the lower income section of the population to access economic resources to finance their productive activities. This has lead to give more attention to microfinance as financial intermediary through which the poor section of the population gets access to financial services.

In order to provide microfinance services to the lower income section of the population and to carry out microfinance service in a sustainable way, the proclamation of licensing and supervision of microfinance institutions (proclamation number40/1996) was issued in 1996 and was latter on revised in the year 2009. After the issuance of this proclamation 30 microfinance institutions (MFIs) have been licensed by NBE. The microfinance industry has been able to serve more than 2.3 million clients through their 433 branch and 598 sub branch offices. Various studies show that this only covers 10-15% of the total microfinance demand in the country.

1.2- Objective of the research

The basic objective of this research paper based on Ethiopia will be:

i. examine review the recent development in the performance of the microfinance sector after implementation of the regulatory and supervisory framework which was implemented in 1996;

ii. To critically review, identify and analyze the basic regulatory and supervisory weaknesses, constraints and challenges that are obstacle to efficient performance of the microfinance sector.
iii. To suggest some course of action (suggestion) to enhance the regulatory and supervisory framework of microfinance institutions in Ethiopia.

1.3- Methodology

The study basically used secondary information. In addition, in order to identify the notable achievements and constraints of the regulatory and supervisory framework of MFIs, a questionnaire containing approximately 30 question was distributed to Association of Microfinance Institutions (AEMFI), 11 MFIs and 6 commercial banks.

Therefore, the survey may provide insights on the reaction of MFIs and banks on the effectiveness of the regulatory and supervisory frame work of microfinance business.

1.4 Significance of the Study

It is believed that the study will contribute to the effort of strengthening the regulatory and supervisory framework of microfinance institutions by pinpointing the problems. Moreover, it will also be a basis on which to conduct further studies on the topic.

1.5 Organization of the paper

The paper will first briefly discuss the need to regulate and supervise microfinance institutions and then will discuss various principles, approaches and instruments of regulating and supervising MFIs from various literatures available from books and theoretical papers. Chapter three exclusively assesses the financial system, historical development of microfinance in Ethiopia and also review of regulatory and supervisory framework of Ethiopia with critical discussion of major achievements and challenges. The final section (Chapter 4) will summarize the findings, conclusion and set out some recommendations for future action.

2. Literature Review

This chapter tries to discus the basic issues in regulation and supervision of microfinance institutions. An attempt is made to capture and present what is available in the literature from recent books and theoretical papers written by well known authors in the subject. Effort is also made to discus also recent countries experience (Ghana, Uganda and Tanzania) in regulating and supervising of MFIs and take lessons by adapting to the Ethiopian context. Let us first look in to definition of some concepts.

2.1 Definition of key terms and Concepts

According to Peck Christen, R.Lyman and Rosenberg (2003) regulation refers to a set of enforceable binding rules that govern the conduct of legal entities or individuals, whether they are adopted by a legislative body (laws) or an executive body (regulations). Where as prudential regulation “refers to the set of general principles or legal rules that aim to contribute to the stable and efficient performance of financial institutions and markets (Chaves and Gonzalez_Vega, 1994). Therefore, the purpose of prudential regulation is to ensure the financial soundness of financial intermediaries (in our case MFIs) and try to prevent if not reduce financial system instability and losses of depositors money. Where as prudential supervision refers to external oversight of the financial intermediaries though examination and monitoring mechanisms to verify compliance with regulation.

2.2 Rationale, Principles and Instruments of Regulation and Supervision of MFIs

2.2.1 Rationale of Regulation and Supervision of MFIs

The need and rationale for regulation of economic activities is often justified as a policy instrument to minimize the effects of market failure, maintain financial stability and gained substantial attention by governments of different countries recently, particularly in the course 0f reform measures in developing countries (Armstrong and et.al cited in Thankom Arun, 2004). The regulatory framework of any country should have clear rationale and objectives for regulating the financial sector, otherwise it will lead to wastage of scarce supervisory resources, unnecessary compliance burdens of licensed institutions and the development of the financial sector will be constrained. In general, there are three reasons for regulating the financial intermediaries, theses are discussed below.

a) **Protecting Small depositors**: The primary reason for regulating financial institutions is protection of for public deposits in general and small depositors (in case of microfinance) who are not in well positioned to monitor the institutions financial performance and soundness of deposit taking institutions (Christen and et.al, 2003). Since deposit taking involves a potential risk of loss depending on how the deposits are employed, microfinance institutions that intend to mobilize savings must be regulated and supervised by an external body to ensure that deposits are prudently employed and cushioned by adequate capitalization.

b) **Ensuring Integrity and Stability of the Financial Sector**

Various literature indicates that due to asymmetric information distribution between the savers and financial information distribution , Bank runs have been emerging where depositors line up to withdraw all their savings before the institution is closed down. It is difficult if not possible for depositors to differentiate between temporary liquidity and severe solvency problems due to difficulties in assessing the solvency of a financial institution (Michael Fiebig, 2001). The whole financial system may be destabilized due to a chain reaction that arises due to withdrawal of savings of a significant number of depositors. Bank problems can be easily transferred from one bank to the other banks regardless of their soundness and hence the protection of the whole banking and payment system becomes an additional objective of regulation and supervision (Joselito Gallardo, 2001).

c) Promote efficient performance of institutions.

The third rationale for regulation and supervision of financial intermediaries is the assurance of competitive market structure. This has some linkages with the second objective in that a stable financial system is based on financial institutions striving for efficiency while competing for their customers. A well functioning financial system provides important capital allocation contributions as well as payment transfer services to the real economy and in such a situation, financial institutions will strive for efficiency by providing well-priced and well-customized products which benefits clients while getting savings and loan services(Michael Fiebig, 2001). This type of practices will also help a lot in building a stable financial system.

2.2.2 Principles of Regulation of Financial Intermediaries

The current debate in relation to regulation and supervision of financial intermediaries is not about whether there should be regulation or not but it is to determine how much regulation and what kind of regulatory framework to introduce for microfinance institutions. In order to appropriately design the regulatory framework, the optimal type and degree of regulation should be very specific in terms of time, location, and institutional structure of the organization to be regulated (Chaves and Gonzalez-Vega, 1994). The regulation which is not specific to these situations may hinder financial institutions to effectively carry out their activities by demanding regulatory requirements that is not appropriate to their specific characteristics. Therefore, appropriate principles of regulation that are worked out through experience and research should be followed. The principles of regulation are discussed as follows:

a. Competitive neutrality: This principle underlines that there should be fair competition between financial institutions. There should be some sort of level playing field and regulation must be established to avoid distortion of competition among the financial intermediaries. Regulation should attempt to allow a competitive balance among financial intermediaries and if this balance is not maintained distortions my happen in the financial market (Chaves and Gonzalez-Vega, 1994).

b. Efficiency:

Financial regulation could have negative effects on efficiency of the financial system and hence the negative effect of regulation up on efficiency in the financial system should be minimized (Chaves and Gonzalez-Vega, 1994). It should be noted here that measures taken such as high equity requirement to safeguard the soundness of the financial system always affect competition and hence may tend to incur efficiency losses.

c. Cost and benefit analysis.

All regulatory guidelines and supervisory methods should be subject to a cost-benefit analysis because overregulation can hamper innovation. For example, when the number of MFIs is high, the cost of supervision could also be high when compared with the risk that the MFIs may impose on the financial system. Therefore, applying cost saving and effective methods to regulate and supervise MFIs is one of the major challenges for regulators and supervisors.

d. The regulatory framework should not be static

In financial markets there is more innovation of financial products and services that could be a basis for revising the original regulation. When innovations spread in the market, the efficiency of the process of prudential regulation is reduced. This indicates that when regulators tend to react to change more slowly than the financial institutions they supervise, regulations may become less effective.

e. The regulatory framework should be flexible

In order to regulate different intermediaries in different manner when necessary, the regulatory framework has to be flexible. The regulatory frameworks should fit with the environment in which the intermediaries operate, the market niches they serve, and their institutional design and it is only in this way regulatory frameworks could fulfill their purposes (Chaves and Gonzalez vega,1994). According to Chaves and Gonzalez-Vega, the idea is to allow for diversity of organizations compatible with the diverse needs of the market, but at the same time to assign the regulatory burden with maximum efficiency.

2.2.3 Instruments of Prudential Regulation

Different countries apply different instruments of prudential regulation. Therefore, there is a variation on type and scope of government regulation of depository financial intermediaries. The two frequently adopted instruments of regulation are preventive and protective regulation.

2.2.3.1Preventive Regulation

Preventive regulation is a pre-crisis measure that is taken by external supervisors. In order to reduce the probability of failure of depository financial institutions, preventive regulation tries to control the risk exposure of the system. External supervisors use entry and ongoing requirements as instruments of preventive regulation, which are discussed below.

a) Entry Requirements

In order to ensure that only financially healthy institutions are joining the market place, entry requirements should be clearly and appropriately defined. Financial institutions with flawed governance and organizational structures, staff quality, portfolio quality, or other deficiencies should not enter the market since they will negatively affect the financial system and hence the economy as a whole (Michael Fiebig, 2001). This is one of one of the most powerful actions that can be lay down by external regulators. Therefore, almost every government tries to ensure that there is adequate capital and availability of sound management during the licensing process of depository financial intermediaries. The entry requirements are discussed below:

Minimum Capital requirement

Financial institutions may face shocks in their future activities. Therefore, external supervisors should ensure that sufficient capital (minimum capital requirement) is made available by the institution before moving in to its operational activities. Such type of requirements help the institution to absorb financial shocks, shield the institution from becoming a captive of bad debtors. “In a very real sense, equity capital is the magic key that qualifies the bearer to accept deposits from the public” (Chaves and Gonzalez-Vega, 1994). Besides, it will also serve as assign of commitment and stake for effectively running the institution from the side of the owners by investing their own resources which could be lost when the institution is not able to maintain good portfolio quality.

Owners, Governance structure and Institutional Type.

External supervisors lay down ownership requirements to promote strong owners (who have invested adequate amount of their own initial capital, having adequate number of owners and appropriate percentage of shareholdings, having satisfactory educational background and effective board of directors etc.) for financial intermediaries. When financial intermediaries have strong owners, they operate in the best achievement of their mission and the governing bodies including the board of directors will effectively oversee the institution by being fully informed about the institution’s activities and performance. Besides, many regulators require a formal financial intermediary to be a share holding company in order to ensure owners with capital at stake and an incentive for active monitoring (Michael Fiebig, 2001).

Feasibility Studies

Almost every external supervisor requires a feasibility study from new entrants in to the financial market. Most of the time, a comprehensive business plan with detailed institutional information are required by regulators. These documents are provided by new license applicants who are interested to be engaged in the financial sector. The feasibility study most of the time comprises of economic, legal and political environment, the financial system, the area of the market segment and the level of competition and unsatisfied demand of the products, the type of financial products to be offered, the economic impact of the financial service to be offered and related issues. All these information will help the supervisors to ensure that the institution is adequately prepared to serve the market segment with specific risk profile before commencing its operation.

b) Ongoing requirements

Almost every country has external regulatory rules constituted by a set of different on going requirements which have to be complied after the institution has become operational. These generally include the following.

Table 4: **On Going Requirements From MFIs**

d) Capital to Asset Ratio	**i)** Branching Regulation
e) Loan Portfolio Classification	**j)** Internal Control Requirement
f) Liquidity Management	**k)** Qualification Requirement
g) Provisioning and Write-Off	**l)** Reporting Requirements
h) Product Restrictions	**m)** Change Notification

Source:Michael Fiebig, 2001

The rationale for capital to asset ratio requirement is the fact that asset need to be essentially backed by a financial institution's equity so that the institution could be in a position to cushion the risk of loss. When there is adequate equity contributed from owners backed up by effective and efficient managerial capability, asset and liability management, the financial institution will have strong owners that are interested to success of the institution. The challenge for regulators is to seek optimum relation between that may ensure the financial intermediation process, while at the same time not imposing excessive costs to the financial institution.

The Basle Accord has set a capital to risk weighted assets ratio of 8% which has gained acceptance to be used for banks (Basle Committee on Banking Supervision 1988). According to A.Chaves and Gonzalez-Vega (1994), since the MFIs do not have owners in the traditional sense, this may suggest the need for a different type of regulation for microfinance institutions. Michael Fiebig (2001) also proposes similar idea in that for developing countries a higher capital adequacy rate than 8% to cushion the specific risks of narrow and volatile financial systems and for microfinance providers in particular to buffer the danger of rapidly deteriorating short term credit portfolios. According to Stefan Staschen (2003) also generally recommends for MFIs to impose stricter capital adequacy requirements than commercial banks. Elisabet Rayne (1996) also has similar view like Stefan Staschen.

2.2.3.2 Protective regulation

Protective regulation is a post crisis measure taken by external regulators so that to avoid run on deposit by assuring the depositors that he or she is the first to withdraw the funds from the financial intermediary. In such a manner the regulators ensure the depositors that they will not loss their deposits when a financial institution experiences distress.

Protective regulatory instruments include government as a lender of last resort, deposit insurance and the formalized process of financial intermediaries restructuring and reform. When solvent but temporarily illiquid financial institutions that are fit for long term survival face liquidity problems, the central bank may provide loan to solve the temporary problem. Where as deposit insurance ensures the depositors that they can get their deposit even though the institution has gone bankrupt. Deposit insurance could cause a major problem like that of adverse incentives from the side of the financial institutions by being attracted by risky business activities that may endanger the financial system (Michael Fiebig, 2001). Therefore, adequate legal framework of preventive regulation is vital for reducing the negative consequences may arise in efficient protective regulation.

2.3 Methodology of Prudential supervision of MFIs

2.3.1 Mechanism and Approaches to Supervision

This paper deals only with external supervision of MFIs that is usually performed by central bank or specialized supervisory agencies. External supervision is usually provided to central banks or specialized supervisory agencies working outside the central bank. Some other counties experience indicates that all or a part of the supervisory work can be delegated to auditors or consultancy firms. According to Chaves and Gonzalez vega (1994), prudential supervision refers to the process of enforcing the regulatory framework. The financial intermediaries are monitored and directed to ensure that they comply the regulatory requirements and not threaten the financial system as a whole. Efficient regulatory policies are useless they are backed by enforcement mechanisms of efficient supervision (Christen and Rosenberg, 2000).

Since the main purpose of regulation is to reduce risk and its negative effects, the challenge of the central bank or any supervisory authority is to design indicators to measure the risks, to monitor and analyze the impact of external events might have on the performance of the financial intermediaries. Therefore, the supervisory system work as an early warning system that shed lights on the possibility of financial intermediaries could be illiquid, insolvent , or both and endanger the financial system. Consequently, the important task of supervision is to prevent if not reduce MFIs failures by identifying problems at an early stage and intervene before the situation goes out of hand.

An adequate mechanism of the supervision of financial intermediaries has two components. These are off-site and on-site supervision. The off-site component is an early warning system based on the analysis of the data reported to the supervisory authority. The on-site component involves actual visit to the financial intermediaries. On-site inspection is necessary to make those inspections that cannot be performed by an off-site analysis (for example quality of internal control and performance of management) and to verify the data fed to the off-site system are accurate. The most commonly applied tools for on-site supervision include CAMEL and PEARLS. Recent development indicates that central banks are moving towards introducing risk based supervision approach.

The recent literature indicates that there are two types of approach to supervision. These are the traditional and risk based supervision. The traditional approach focuses on historical and a point on time performance and does not concentrate on future performance of the financial institution. Where as Risk Based Supervision is a dynamic approach which gives special emphasis to risk management of process in the institutions. Comparison of the traditional versus the Risk based supervision approach is shown below.

Comparison of Traditional and Risk Based Supervision approach

Traditional Approach	Risk Based Approach
Transaction based testing	Process oriented
Point in time assessments	Continuous assessments
Standard procedures	Risk profile driven procedures
Historical performance	Forward looking indicators
Focus on risk avoidance	Focus on risk mitigation

2.3.2 Role of External and Internal audit for Supervision

The role of external audit and internal audit of MFIs is critically important to make supervisory tasks effective. This is for the fact that the external auditors and internal audit departments of MFIs can be source of information for the supervisory work. However, the reliability of information provided by them is determined by the quality of the external and internal audit practice. The problem of quality of audits negatively affects the quality of data provided to supervisors and hence hinders the quality of off-site analysis which demands increased need of on-site examination and higher cost of supervision.

2.4 African Experience in Regulating and Supervising MFIs: The case of Tanzania and Uganda

2.4.1 The case of Tanzania

The microfinance sector in Tanzania is highly segmented which is provided by banks, financial institutions, community banks, saving and credit societies and NGOs. There are three commercial banks (National Microfinance Bank, CRDB Bank and Akiba Commercial Bank) that provide microfinance services. The postal banks also provide a variety of saving deposit services. Most of the banks are concentrated in the capital city (Dare salaam) and three banks are involved in microfinance. Saving and Credit Cooperatives (SACCOS) and foreign donor assisted NGOs are the main providers of microfinance services.

The regulatory framework of Tanzania which was issued in 2004 includes the licensing process whereby the central bank evaluates the adequacy of capital, verifies that the owners of the Microfinance Companies (MFC) are capable of practicing financial intermediation and engaging in the granting of micro credit in a professional and business like manner and with high degree of prudence that is required by public interest. Besides, in order to be licensed as MFC, adequate evidence should be provided to the central bank to show the institution has successful experience in microfinance with the competent manpower at the top and medium level positions. In Tanzania, branch opening is subject to review process. The microfinance companies and microfinance activities law issued in 2004 stipulates that the internal auditor is appointed by and is accountable to the board.

The primary functions of the microfinance companies in Tanzania as stipulated in the law include accepting savings deposits, and fixed (time) deposits from the public, making microfinance loans making remittances, payment orders and transfer of funds domestically for its clients. Besides, there is no restriction on lending methodology to be used by MFIs. The microfinance institutions are allowed to provide loans to individuals, groups, micro and small enterprises.

A specialized directorate is formed at the central bank which is responsible for regulating and supervising the MFIs.

Main regulatory requirements in Tanzania are summarized below:

Table 5 : Regulatory Requirements for Microfinance companies (MFC) of Tanzania

No	Description	Requirement
1	Minimum Capital Required to establish MFC with a nation wide branches	TSHS 800,000,000 (US$ 587,000)
2	Minimum Capital Required to establish unit MFC	Tshs 200,000,000 (US$ 147000)
3	Maxim Lending Limit	.3% of core capital if Granted against collateral .1% of core capital if Secured by other than registered collateral
4	Capital Adequacy Ratio	Core capital of 10% of RWA or total capital of 15% RWA
5	Provisioning	
	No. of Days Past Due **Classification**	**Provisioning Percentage**
	0 days (Current)	2%

	up to 15 days (Specially mentioned)	25%
	16 – 30 days (substandard)	50%
	31 – 45 days (Doubtful)	75%
	More than 45 days (Loss)	100%

Source: Microfinance companies law of Tanzania (2004)

*RWA Weighted Assets

2.4.2 Uganda's Experience with Tiered Banking Regulation

The formal financial institutions in Uganda are composed of Central Bank, 15 commercial banks, seven credit institutions and one MDI (Microfinance Deposit taking Institution) (David D Kalyango, 2005). Many other institutions like NGOs, SACCOs and unregistered microfinance institutions also provide microfinance service.

The regulatory and Supervisory framework in Uganda is based on tiered approach. The tiered approach of Microfinance regulation is considered as the key feature of the financial regulatory framework in Uganda. According to David D Kalyango (2005) the tired approach reflects microfinance as a line of business and it is conductive to the development of a sound microfinance sector and it does not constrain the numerous valuable microfinance activity in the country.

The tired approach of Uganda microfinance regulatory and supervisory framework has created more flexibility in microfinance business by identifying four categories of MFIs that can provide microfinance service to various sectors of the economy. By so doing, different MFIs in the tier system are regulated following different approaches that are compatible with their nature. The four categories have different requirements and MFIs are allowed to graduate form the first tier to the next when they meet the requirements of that tier.

Table 6: The Tiered Regulatory Framework in Uganda

Cr iteriaLevel	Deposit Taking	Initial Capital Required	Regulated and Supervised by
Tier 1 - Banks which are licensed under the provision of Act 2004 by which microfinance is considered as a new Financial product in their lending portfolio.	Yes	US$ 2 million	BOU
Tier 2 - Credit institutions are licensed under provision of the Financial institutions act 2004.	Yes (but not allowed to take demand deposits)	US$ 500,000	"
Tier 3 - Microfinance Deposit taking Institutions (MDIs), which are regulated under microfinance deposit taking institutions Act. 2003.	Yes	US$ 250,000	"
Tier 4 - Non deposit taking institutions or credit only institutions.	No	NA	Under discussion with Ministry of Finance and umbrella body.

* BOU refers to Bank of Uganda

Source: Adapted from: How to regulate and supervise microfinance (Kampala, 2000) and Kalyango (2004).

The Micro Finance Deposit - Taking Institutions regulation issued in 2004 requires suitable shareholders, adequate financial strength and management with sufficient expertise and integrity to operate the institution in a sound and prudent manner. This regulation contains the liquidity, capital adequacy and provisioning requirements to be complied by MFIs which are summarized as follows:

The Uganda's MDIs act (which was issued in the year 2003) is a comprehensive one, which covers issues such as procedure to be followed during liquidation, management takeover and receivership, mechanism of deposit protection, application of Credit Information Bureau, duties and responsibilities of external auditors and other related issues.

Table 7: Prudential Norms set for Uganda Deposit Taking Microfinance Institutions

No.	Item	Requirement	Frequency of the report
1	Liquidity	15% of total deposits	Weekly basis
2	Capital Adequacy	- Core capital not less than 15% of risk weighted assets.	Monthly basis
		- Total capital not less than 20% RWA	" "
3	**Provisioning**		
	- Substandard (Un paid for 30-60 days)	25% of outstanding balance	Monthly basis
	- Doubtful (un paid for 60-90 days)	50% " " "	
	- Loss (un paid for > 90 days)	100% of " "	

Source: Extracted from Uganda's Micro Finance Deposit Taking Institutions Regulation Issued in 2004.

3. Regulations and Supervision of Microfinance Institution in Ethiopia

3.1 The overview of Financial System and Development of Microfinance Sector in Ethiopia.

3.1.1 The overview of financial system in Ethiopia

Major economic reforms have been taken by the Ethiopian government after the fall of the socialist government in 1991. Consequently, the Ethiopian Financial System has passed through significant reform process since 1992 as a part of transition from a planned to a market economy. Prior to this reform process, there had not been any competition within the financial sector due to the fact that all of the formal financial institutions were state owned and private financial institutions were not allowed to operate. After the implementation of the reform process starting from 1992, there have been significant measures undertaken by the government. The major reform measures taken include: Liberalizing and reforming the financial sector, relaxing foreign exchange controls, dismantling the administered interest rate regime, establishing a new regulatory framework for banks, insurance companies, microfinance institutions and cooperatives.

The Ethiopian Financial system, generally speaking falls into three categories. These include: Formal, semi-formal and informal financial system. The formal financial system is a regulated sector, which is well organized and provides financial services mainly to urban areas. This formal Financial system in Ethiopia is mainly compared of financial institutions such as banks, insurance companies and microfinance institutions. At the end of 2008/2009, there are 12 Commercial Banks (two government owned), 1 government owned development bank, 12 insurance companies (one of which is government owned,) and 30 microfinance institutions (owned by regional governments, NGOs, individuals, associations etc.)

	Type of Institution	Branch 2007/2008	Network 2008/2009
1	Development Bank 1.1 No. of Banks 1.2 No. of Branches	 1 32	 1 32
2	Commercial Banks 2.1 No. of banks 2.2 No. of branches	 10 530	 12 604
3	Microfinance Institutions 3.1 No. of MFIs 3.2 No. of branches		 30 433 branches and 598 sub-branches
4	Insurance Companies 4.1 No. of insurance companies 4.2 No. of branches	 10 172	 12 194

Source: Annual Report of National Bank of Ethiopia

The saving and credit cooperative are considered as semi-formal financial institutions, which are not regulated and supervised by NBE. The informal financial system includes Equib, Eddir and others, which are not regulated.

3.1.2 The Historical Development of the Microfinance Sector in Ethiopia

Micro-finance in Ethiopia has its origin in traditional informal method used to accumulate saving and access credit by people who lacked access to formal financial institutions.

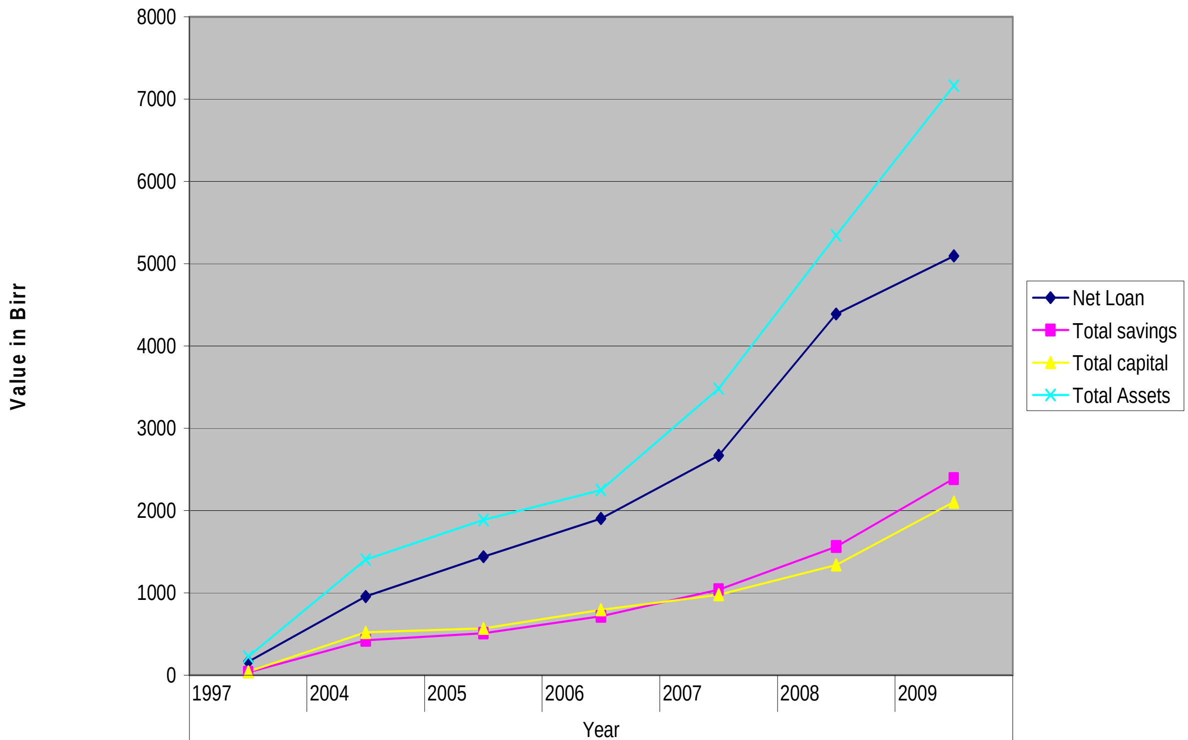
The history of formal establishment of Ethiopia Micro finance institution is limited to about twelve years. The first group of few MFIs were established in early 1997 following the issuance of Proclamation No. 40/1996 in July 1996.

The objective of the MFIs is basically poverty alleviation through the provision of sustainable financial services to the poor who actually do not have access to the financial support services of other formal financial institutions.

After the issuance of licensing and supervision of microfinance Proclamation No. 40/1996, 30 MFIs have been licensed by NBE. Since then these MFIs have been playing the role of promoting and accessing financial services to mainly the rural area. The microfinance sector is growing in terms of number and size. The sector is currently serving more than 2.3 million clients. The total asset of the Microfinance sector which was Birr 225 million at the end of 1997 has reached Birr 7,164 million (US$ 534 million) as at December 2009, showing a remarkable growth of 3084%. Net loan grew from Birr 163 million to Birr 5,095 million (US$ 380 million), total saving grew from Birr 35 million to Birr 2,390 million (US$ 178 million) and that of total capital grew form Birr 41 million to Birr 2,103 million (US$ 157 million) for the same period under consideration.

Chart1:

Consolidated Data on Microifnance Sector (In millions of Birr)



	1997	2004	2005	2006	2007	2008	2009
Net Loan	163	956	1,439	1906	2670	4388	5095
Total savings	35	423	510	716	1040	1561	2390
Total capital	41	521	568	795	979	1340	2103
Total Assets	225	1406	1885	2251	3483	5341	7164

Source: National Bank of Ethiopia

MFIs in Ethiopia have been able to serve the productive poor people mainly with savings, credit, money transfer, micro-insurance and other related services. Governmental and other developmental organizations have played a vital role for impressive performance the microfinance sector in the country. Total number of clients which was only 1.6 million in the year 2006/2007 now has reached 2.3 million as shown in the table below. The big MFIs like ACSI are considered biggest MFIs in Africa.

Table 20: Active Borrowers of Micro Finance Industry in Ethiopia End of Year 2008/09

No	MFI	Total No of Active Borrower
1	Amhara Credit and Savings Ins. (ACSI)	687,586
2	Dedebit Credit and Savings Ins. (DECSI)	412,293
3	Oromiya Credit and Savings Ins.	363,469
4	Omo Credit and Savings Ins.	339,018
5	Specialized Fina. & Prom. Ins.	28,729
6	Gasha Micro-financing Ins.	6990
7	Wisdom Micro-financing Ins.	56,304
8	Sidama Micro-financing Ins.	34,450
9	African Village financial Serice	13,397
10	Buussa Gonofa MFI	42,146
11	PEACE Micro-financing Ins.	21,441
12	Meket Micro-financing Ins.	3,356
13	Addis Credit & Savings Ins.	115,563
14	Meklit Micro-financing Ins.	13,400
15	Eshet Micro-financing Ins.	24,767
16	Wassassa Micro-financing Ins.	41,925
17	Ben. Gum. Micro-financing Ins.	29131
18	Sha.Idi.Ye.Ag. MFI	2,964
19	Metemamen MFI.*	14,415
20	Dire Micro-financing Ins.	9,526
21	Agar Micro-financing Ins.	3,608

22	Harbu MFI	11,491
23	Ghion MFI	307
24	Leta MFI	455
25	Digaf MFI	1,155
26	Harar MFI	2,427
	Total	2,280,313

Source: National Bank of Ethiopia

3.2 The Regulatory Framework in Ethiopia

3.2.1 Objectives of Regulation and Supervision

As per National Bank of Ethiopia Establishment Proclamation no. 591/2008, its purpose is to maintain stable rate of price and exchange, and to foster a healthy financial system in the country. The microfinance institutions are a part of the formal financial system that are regulated and supervised by national bank of Ethiopia. The objectives of regulation and supervision of MFIs focus on the following:

1. Protecting Small Depositors
2. Ensuring Integrity and Stability of the microfinance sector in particular and Financial Sector in general
3. Promote Efficient Performance of the institutions

3.2.2 Key Principles Followed in Regulation and Supervision of microfinance Institutions

Key Principles Followed in Regulation and Supervision of microfinance Institutions are the following:

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

The regulatory framework that governs the financial system in Ethiopia among others consists of National Bank of Ethiopia establishment proclamation no. 591/2008, licensing and supervision of Banking Business Proclamation No. 592/2008, licensing and supervision of Insurance business Proclamation and licensing and supervision of Microfinance Business Proclamation No. 626/2009. National Bank of Ethiopia establishment proclamation no. 591/2008 has provided authority for NBE to set prudential standards for banking and other financial institutions. 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.

As explained before, Ethiopia has adopted a specific regulatory framework to microfinance business starting from 1996. It follows not a tier system like Uganda but a single legal framework for regulating and supervision the microfinance sector. Accordingly, some NGOs that have been running micro credit programs were forced to be transformed in to regulated institutions by fulfilling the requirement. Some of the NGO's who are not interested to come to the licensed setting were forced to go out of their microfinance activities.

3.2.3 Important Feature of Proclamation No. 626/2009 and Directives issued by NBE.

The Licensing and Supervision of Microfinance Business proclamation number 626/2009 and directives issued by NBE contain a comprehensive package of rules for licensing, registering and supervising MFIs. There are 19 directives issued by NBE that govern the operation of microfinance institutions. A detailed discussion of main components of the regulatory system in Ethiopia is as follows:

3.2.3.1 Definition of Micro financing Business

Licensing and supervision of Microfinance business Proclamation No. 626/2009 defines micro-financing business as "the provision of financial services like accepting savings, extend credit, drawing and accepting drafts payable, providing money transfer services and others specified in the Article 3(2) of the proclamation. This definition of microfinance business does not confine microfinance business to only credit as done else where in other countries. Therefore, it is inline with the best practice which defines Microfinance as the provision of a wide range of financial services to the low income people and micro and small enterprises that usually lack access to formal financial institutions (Banks). Microfinance is not limited to borrowing but also includes other financial services such as savings, insurance, transfer facilities, etc. (Gallardo, 2001).

3.2.3.2 Types of Activities that could be carried out MFIs.

According to Article 3(2) of the aforementioned proclamation, MFIs are allowed to carry out the following activities:

- Accepting both voluntary and compulsory savings as well as demand and time deposits
- extending credit to rural and urban farmers and people engaged in other similar activities as well as micro and small scale rural and urban entrepreneurs
- drawing and accepting drafts payable within Ethiopia
- Micro-insurance business as prescribed by NBE
- purchasing such income generating financial instruments as treasury bill and other income generating activities

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

Therefore the definition (indicated in the proclamation) of microfinance is broad as discussed before and Article 3 (2) allows MFIs to mobilize savings from the public and borrow money for its business. Therefore, the proclamation encourages MFIs to gradually move out from dependence on donated and subsidized funds to commercial source of funds.

3.2.3.3 Entry Requirements

The regulatory framework (Proclamation No 626/2009 and directives issued by NBE) has defined entry requirements that have to be fulfilled by those who are interested to be engaged in Microfinance business. The most important entry requirements include minimum capital requirement, institutional form, ownership restrictions, feasibility study and conditions to be fulfilled by Board of Directors and General Managers of microfinance institutions.

a) Minimum Capital Requirement

The minimum capital requirement for establishing new MFI is Birr 200,000, which is approximately equivalent to US$23,000. The amount of initial capital requirement in Ethiopia for establishing MFI is the lowest from the world. Low capital requirement for MFIs range world wide from US$25,000 to US$250,000 (Michael Fiebig, 2001). It is by far below the initial capital requirement required by Bank of Uganda for establishing MDIs which is $ 250,000. The lower capital requirement in Ethiopia at initial stage was made to encourage investors, regional government, and others to be engaged in microfinance business.

However, the initial minimum capital requirement is too low that it may not enable applicants to establish strong MFIs that have the capacity to withstand adverse external conditions and unfavorable market situations. Moreover, it is also overburdening the NBE with relatively high number of small institutions. Therefore, it is desirable to seek optimum balance between limited supervisory capacity of NBE on one hand, and the growth of the number of MFIs on the other.

b) Institutional Form and Ownership Restrictions

The current regulatory framework requires microfinance institutions to be formed as share companies owned only by Ethiopian nationals. Foreign nationals are not allowed to invest in the financial sector, including in microfinance business. Most of the shareholders of the MFIs are regional governments, associations, individuals and NGO's.

The ownership structure of the 11 surveyed MFIs is shown in the following table. It is clear from the table that ACSI, one of the biggest MFI was established with paid up capital of one million Birr where 25% is owned by Amhara regional government. DECSI has a similar ownership structure. Addis Credit and Saving Institution and Omo Microfinance Institution are 96.7 and 80%, respectively owned by regional governments. The other MFIs such as SFPI and Agar have commercial banks as shareholders which indicate the interest of commercial banks to be involved in Microfinance service. There is only one MFI (Agar MFI) that is establishes purely by commercial conventional investors. If this institution will be successful in the future, it could serve as an example to attract other investors to be involved in microfinance.

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.

Table 9: Ownership Structure of the Assessed MFIs

	License Date	Regional Government	Commercial Banks and Insurance companies	Associations and NGO	Individuals
ACSI	4/9/97	25		75	-
DECSI	4/28/97	25		75	-
OCSSCO	8/4/97	25		70	5
Omo	10/1/97	80		19.5	0.5
SFPI	11/25/97	-	50.6	39.5	9.9
Gasha	5/15/98	-		61.9	38.1
Wisdom	6/17/98	-		-	100
Sidama	7/27/98	-		70	30
Buussa Gonofa	5/17/98	-		19.6	80.4
PEACE	11/18/98	-		16	84
Addis	01/27/00	96.7		3.3	-
Agar	03/18/04	0	12.2	0.2	87.6

Source: Ethiopian Microfinance Ownership and Governance, Occasional Paper no. 7 & Extracted from their Articles and Memorandum of Association for few MFIs

c) Feasibility studies and other Licensing Requirements

Detailed licensing requirements are stipulated on proclamation no. 626/2009 Article 5 and on Directive no. MFI/101/1996. Applicants are required to submit memorandum and articles of association, work plan (including major financial services to be offered, overview of economic condition of the area, cash flow and income statement and balance sheet projections) for the first year of operation and curriculum vitae and additional necessary documents of board of directors and chief executive offices. According to directive number MFI/03/96, the chief executive officer must have a minimum of first degree in one of social science fields and a minimum of three years experience in a senior position in a financial or related institution.

Members of Board of directors are required to hold at least completion of high school education with the ability to read and grasp reports, especially financial statements. Qualification required for board of directors is lower than that of chief executive officer. In such a situation, the board can not be in a position to oversee and control the activities of the manager and hence it could negatively affect the performance of the institutions.

One of problems faced by MFIs during licensing process is that it was difficult for new MFIs to fulfill requirement of general manager stipulated by the central bank. This mainly is due to lack of skilled manpower in microfinance. It was also possible to understand from the response colleted from MFIs that the minimum capital is not difficult to fulfill. This implies that the low minimum capital requirement would facilitate easy entry to microfinance sector. But the challenge is in creating strong MFIs having appropriate ownership structure with high incentive and commitment to control and monitor the MFIs performance.

3.2.3.4 Ongoing Regulatory Requirements /Preventive Regulation/

The microfinance regulatory framework put into place a set of on going requirements that should be complied by the microfinance institutions while being involved in microfinance operations. These on-going requirements are discussed below.

a) Capital Adequacy

The principal objective of capital adequacy is to require institutions to have an adequate amount of capital to protect the interest of depositors, creditors and the public in general, and to ensure that institutions maintain capital standards that ensured financial solvency. Therefore, capital adequacy standards help to prevent insolvency of MFIs and to ensure that the capital base can absorb unexpected losses and the risk inherent in MFIs business activities. According to directive number MFI/16/2002, MFIs whose total deposits equal or exceed Birr 1 /one/ million are required to maintain at all times a minimum capital ratio of 12% computed as a ratio of total capital to total risk weighted assets. The total capital as defined in the aforementioned directive is a sum total of paid up capital, donated capital, retained earnings and any other free resources of a microfinance institution. The capital adequacy ratio requirement of MFIs is more conservative than that of Banks, which is 8%. This is due to volatile nature of microfinance loans and the perception that they hold risky assets provided without tangible collateral.

Table 11: Capital to Risk Weighed Assed Ratio (in percentage terms)

No.	**MFIs**	**September 30, 2009**
1	Amhara Credit and Saving Institution	29.8
2	Dedebit " " " "	36.7
3	Oromia " " " "	28.6
4	Omo " " " "	38.5
5	Specialized Financial and Promotional Institution	47.6
6	Gasha Microfinancing Institution	27.7
7	Wisdom Microfinancing Institution	47.3
8	Sidama " "	38.2
9	Buussa Gonofa Microfinancing Institution	48.2
10	PEACE Microfinancing Institution	35
11	Addis Credit and Saving Institution	77.2
12	Agar Microfinancing Institution	33.3

Source: National Bank of Ethiopia

b) Liquidity Requirement

In Ethiopia the minimum liquidity standard prescribed for microfinance institutions is 20% which is higher than liquidity requirement prescribed for commercial banks (15%). Only microfinance institutions that have mobilized savings more than one million birr are subject to such requirement. The main objective of the liquidity requirement is to ensure that MFIs maintain an adequate level of liquidity to meet all known and unexpected obligations and hence promotes public confidence.

All MFIs have maintained the minimum statutory liquidity requirement, which is 20% of total deposits. The liquidity requirement in Ethiopia is 5 percentage points less than that of Uganda. This indicates that more conservative approach is followed by Ethiopia.

c) Provisioning Requirement

The provisioning requirement are designed to ensure that MFIs keep their financial statements (balance sheet and income statement) in such a way that it reflects the real financial position of MFIs by considering the financial impact of non performing loans. According to Directive No. MFI/17/2002, non-performing loans are defined as outstanding loan and advances of a microfinancing institution that are past due for more than 90 days. MFIs whose total deposits equal or exceed Birr 1 (one) million are required to held provision of 25%, 50% and 100% for substandard, doubtful and loss loans.

Table 12: Provision Requirement for MFIs in Ethiopia

Category	No of days Past due	Minimum Requirement
Substandard	91 - 180 days	25% of the outstanding balance
Doubtful	181 - 365 days	50% " " "
Loss	over 365 "	100% " " "

Source: Directive No. MFI/17/2002

Where as MFIs whose total deposits is below 1 million total deposits are required to make provision of 50% and 100% for doubtful and loss loans. According to Directive No. MFI/05/96, a loan is deemed bad loan/loss when the loan or outstanding balance has been overdue for more than one year and the borrowers has no capacity to make further payments and a loan is deemed doubtful when monitory payment of the loan or outstanding balance is in arrears for more than six months.

Loan provisioning should be commensurate with loan maturities, risk weighting that consider the quality of security and standard methods that can easily be and consistently replicated. Most of the credit facilities of MFIs in Ethiopia comprise numerous small repeat loans, with quick payment (weekly and bi-weekly payments) and the loans are granted based on collateral substitutes (group lending). Therefore, the provisioning requirement set for MFIs seem more lenient. Once micro credit loans fallen delinquent they have less probability of repayment and the fact that they are unsecured and have short (weekly, bi-weekly or in rare cases monthly) maturity period justifies requiring them to be provisioned more aggressively than conventionally collateralized portfolio (Robert Peck Christen et.a1, 2003). In Ethiopia, however, the provision requirement set for MFIs seems similar to Banks. The provisioning directive for banks classifies loans under five categories, interalia, pass, special mention, substandard, doubtful and loss loans having provisioning requirement of 1%, 3%, 20%, 50% and 100%, respectively. Therefore, provisioning requirement does not go with the specific nature of the MFIs.

The experience of Uganda and Tanzania indicates that they follow more conservative provisioning requirement for MFIs than that of Ethiopia. Their provisioning requirement seems more appropriate that goes with specific feature of the MFIs. The Uganda experience indicates that it has a specific guideline to be followed when MFIs restructure their credit facilities and specific provision is more conservative is required for restructured loans. The Ethiopian regulatory framework does not have requirement of such provisions for restructured loans.

d) Branching Requirements

The current regulatory framework of MFIs allows every licensed MFI to open new branches without prior approval of NBE. MFIs are only required to notify NBE not latter than 15 days the opening indicating commencement operation of the new branch including information such as the full address of the new branch, date of commencement of operation, and the overview economic conditions of the area. This requirement is put in place to ensure that branching is carried out on prudent basis by doing market analysis and feasibility study.

When MFIs have intentions to close branch offices due to inefficiency of operation, least cost recovery, poor loan portfolio quality or any other reason; they are required to notify NBE prior to conducting the intended closure of the branch office. Considering the wide areas of operation of MFIs in rural areas, allowing MFIs to open new branches without prior approval of NBE seems appropriate. Branching opening in other countries such as Tanzania is subject to review and approval by the Central Bank.

f) Lending limit

Proclamation number 626/2009 allows MFIs to extend loans to groups and to individuals. It also allows MFIs to extend loans without collateral, secured by collateral or secured by group or individual guarantees as appropriate and at the discretion of the institution. Such provisions may encourage innovation and makes easy to meet the need of clients. Currently, most of the MFIs use both group and individual lending methodology as shown in the table below. However, group lending methodology is predominantly used by the MFIs. Loan extended by MFIs to any single borrowers and group should not exceed 1% and 4% of total capital respectively. The imposition of lending limit prescribed by NBE may help to ensure that MFI remain focused on their mission i.e. to serve the lower income section of the population and also to limit risk concentration.

The Uganda and Tanzania loan size limit is related to core capital and total capital. In Uganda, the loan size limit for deposit taking MFIs depends on whether the loan is granted to an individual (1% of core capital) or to group of borrowers (5% of core capital). The rationale is that group loans are larger and that the regulatory framework should not favor one lending technology over the other. Tanzania has allowed microfinance institutions to provide loan size limit of 3% of their core capital when the loan is backed by a registered physical collateral and loan size of 1% of core capital when the loan is not backed by a registered physical collateral.

g) Frequency and Content of Reporting

MFIs are required to submit quarterly reports such as income statements, balance sheets, report on Loans and savings and status of impaired loans and loan provisioning on the form prescribed by NBE. Besides, MFIs are required to submit quarterly liquidity and capital adequacy reports within three weeks after the close of each quarter. The reporting requirement is more lenient than that of Ghana. Ghana requires MFIs to submit liquidity reports on weekly basis and the rest of the reports (such as financial statements, capital adequacy ratio and others) on monthly basis.

Ethiopia has followed more lenient approach due to wider branch network of MFIs in rural areas which makes more frequent reporting difficult due to infrastructure problems.

The response (on reporting requirement) of MFIs indicated that some MFIs due to inadequate MIS and wider branch networks in rural areas, it has become difficult to comply with the existing reporting requirement prescribed by the central bank.

h) Restriction on Investment

According to Directive number MFI/06/1996, MFIs are restricted to invest not more than 10% of equity capital of the institution in allied activities. It is also envisaged in the directive issued by NBE that the equity investment of a licensed MFI in any single enterprise shall be limited to 3% of the net work of the institution.

i) Interest Rate

Until the year 1996, interest rate has been set by NBE (central bank). However, starting from 1996, the central bank has been only setting minimum deposit rate amount. After this period, the interest rate to be charged for loans and advances has been liberalized to be determined by Board of Directors of microfinance institutions. MFIs are only required to apply minimum deposit rate of 4% above which they are free to set the level of the deposit rate. All the MFIs have appreciated liberalizing of the interest rate by the central bank to be determined by the MFIs, however, some of the MFIs during the discussion have raised the question to totally abandon the minimum ceiling rate (4%) prescribed by central bank for saving. They say that it has to be freely determined by the market.

The current minimum ceiling prescribed by central bank is meant to encourage savers to deposit at banks by generating some amount of income and hence to speed up the financial intermediation process. This could be on the assumption that people are interested to keep their money at the bank not only for the purpose of safety but also for earning income. As the country economy grows, knowledge of the importance of saving is enhanced and the financial intermediation process is well strengthened, we hope the minimum interest rate will gradually be abandoned.

j) Taxation

Clear guideline on whether the MFIs are subject to tax exemptions or not is issued in microfinance business proclamation no.626/2009. It is also stipulated in Article 23 of the microfinance business proclamation that any microfinance institution that makes profits form its business and : a) distributes to shareholders shall pay profit tax as any business entity. b) Fully ploughs back shall not pay profit tax.

K) External Audit Report

It is stipulated in Proclamation number 626/2009 (microfinance business proclamation) that financial statements of the MFIs should be audited by an independent auditor acceptable to the central bank prior to the payment of dividend to shareholders. It is also stipulated in the directive 12(B) that NBE may determine minimum qualification of external auditors scope, depth of audit & tenure of audit. According to Directive no. MFI/14/2002, MFIs are required to submit external audit report to the central bank within six months from the end of its financial year. Initially, it has been difficult for MFIs to comply with this directive and submit the external audit report within the specified time. However, currently all the MFIs are fulfilling the requirement.

L) Penalty

Various penalties to be imposed on directors, officers and employees of MFI are also specified in article 25 of proclamation no. 626/2009. Before the issuance of Directive number MFI/14/2002 (directive on penalty to comply with the regulation) in the year 2002, the type of measures to be taken when MFIs do not comply with the rules was not clear and thus it was difficult to take appropriate measures on MFIs that were not complying with the directives. Therefore, in order to enforce compliance of the regulation by MFIs, NBE has issued the aforementioned directive which sets the type of measures to be taken on MFIs that violates any of the provisions stipulated in the proclamation and directives issued by the central bank. According to this directive, any MFI that does not comply or violates any of the laws and directives shall be liable to a penalty of Birr 3,000. This directive indicates that in case of a microfinance institution that has been penalized three times, the central bank shall order the removal of the Chief Executive Officer of the concerned institution and his replacement by a qualified individual.

M) Other Additional Features of Microfinance Business Proclamation Number 626/2009

Proclamation No. 40/1996 (licensing and supervision of the Business of Microfinance) has been revised and replaced by microfinance business proclamation no.626/2009. The new proclamation has accommodated the following:

- Unlike the previous proclamation, microfinance is clearly defined containing providing wide range of financial services including credit, savings, money transfer, micro-insurance and many others specified in the proclamation.
- Microfinance is defined as a business and hence banks licensed by NBE are allowed to engage in microfinance without a separate microfinance business license
- Emphasis is made that micro financing services is not only to people residing in rural areas but also to urban development and hence certain provisions of the previous proclamation were amended and additional articles were inserted to address this circumstances;
- Some articles/provisions of the previous proclamation that lack clarity were amended and revised;
- The mandates of the Bank were clearly specified in relation to maintaining (safeguarding)financial stability and soundness of the microfinance sector;
- Clear accountability of the people running the institutions were clearly included since the sizes of the institutions are increasing. The new proclamation stipulates conditions up on which penalties can be imposed on director, office or employee of an MFI
- As far as the MFIs meet the requirement set by National bank of Ethiopia, the new proclamation indicates that they can transform to a bank or other type of Financial Institution.
- Unlike the previous proclamation, the new microfinance business proclamation contains provisions on know your customer, receivership and liquidation of MFIs.

- Unlike the previous proclamation no. 40/1996, it allows MFIs to apply any lending methodology at their own discretion.

3.3 Supervisory Approach and its Performance in Ethiopia

The major purpose of NBE as stated in National bank of Ethiopia establishment proclamation no. 591/2008 is maintaining stable rate of price and exchange and fostering a healthy financial system. Microfinance Supervision is one Diretorate that is responsible for supervising MFIs to ensure that the sector may not negatively affect the integrity of the Financial Sector and hence contributing to safe guarding of the whole economy. This is ensured through supervision of MFIs.

Until October 2001, the supervision of MFIs and banks has been carried out under bank supervision division. However, due to the increase of the number of MFIs and expansion of the microfinance industry in terms of number, lending and deposit mobilization, a separate microfinance division was created starting from October 2001, which was then upgraded to the Department level in the year 2004 and Directorate level in the year 2009.

3.3.1 Supervisory Methodology of MFIs and its performance in Ethiopia

In Ethiopia the microfinance supervision consists of two components. The first one is the off-site and the second approach is on-site examination.

a) Off-site Surveillance

The off-site surveillance in Ethiopia as done elsewhere in other countries relies on the continuous analysis of data reported to supervisory authority by MFIs themselves. Its main purpose is to provide a frequent depiction of the financial health and risk of each MFI.

The NBE, for off-site monitoring and surveillance of MFIs, requires quarterly reports that show the financial condition of MFIs. The off-site returns that should be submitted by MFIs include:

income and expense statement, balance sheet, capital adequacy report, liquidity report, loan status and provisioning reports. In order to carry out the off-site surveillance, a data base is established at Microfinance Supervision Department. The overall financial condition of financial institutions is determined based on analysis and evaluation of capital adequacy, asset quality, earning and Liquidity.

Quarterly off-site reports with key findings in above areas are produced and are submitted to senior policy makers to inform them about on-going view of MFIs soundness in key financial areas.

The major problems in off-site surveillance of MFIs include: incomplete information to assess the financial position of MFIs, lack of standardized format and guideline for reporting, delay of reports form MFIs and lack of supervision manual that may provide guideline for central bank supervision staff about preparing off-site report. Besides, under the existing reporting practice, MFIs are not required to report information that may not be reflected in the conventional accounting practice. These include information on subsidies such as amount of concessionary credit (with amount of interest, date granted etc.), in kind donation and grants with detailed information so as to enable off-site supervision staff be in a position to make financial adjustments and determine financial sustainability of MFIs.

b) On-site Examination

During on-site examination, the Microfinance supervision staff physically visit the MFIs to check the accuracy of reports submitted to NBE and also assess the overall performance of the institution based on CAMEL approach. Therefore, the on-site examination helps NBE to have first hand information on compliance of prudential standards and performance of MFIs. The current on-site examination carried out by NBE is more of compliance checking and not risk based supervision. However, the NBE is now preparing itself to follow more of a risk based supervisory approach in examining the MFIs and banks.

The duration period for completion of on-site examination varies with the size of the MFIs and type of examination (Full-scale, special or follow up examination). Since there are large numbers of MFIs (30) when compared with the number of Microfinance Supervision staff, the directorate has not been able to supervise the MFIs at least once on annual basis.

Currently, the national Bank of Ethiopia is implementing Business Process Re-engineering study to radically enhance its regulatory and supervisory practices and performance. The current supervisory practice of the bank has been relying basically on historical performance of the MFIs. However, the bank has now finalized all preparations to introduce risk based supervision approach which concentrates an assessment of MFIs capability to manage current and future risks. NBE has conducted a stocktaking analysis of risk management practices in Microfinance institutions. In addition, NBE has issued draft risk management guideline for MFIs. This risk management guideline tries to convey to the microfinance industry what framework NBE expects institutions to have in place to manage the various types of risk with which they are faced. MFIs are expected to send their risk management program which will enable NBE to review what institutions propose or already have in place to manage the risk with which they are faced. Subsequent work and actions will also be carried out to effectively introduce risk based supervision.

c) Difference of Supervisory Techniques of Banks and Microfinance Sector

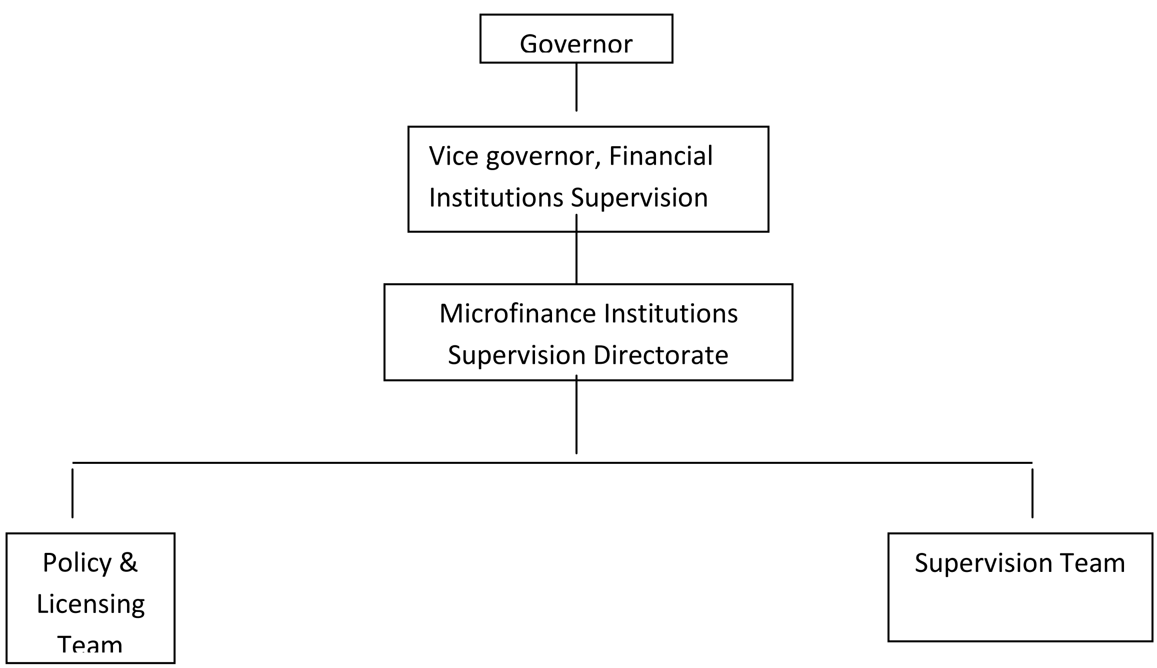
It is believed that Risk Based Supervision that has been applied to traditional banks is also relevant for MFIs. However, Risk Based Supervision for MFIs is drawn from a more comprehensive understanding of risks profile MFIs. The risk profile of MFIs differs in many different ways with that of banks and hence CAMEL rating and risk based supervision practice is developed in such a way that it reflects specific risk profile of MFIs. The supervisory practice has tried to address some difference of traditional banks and Microfinance institutions in terms of their clientele, nature of loan and saving products, lending and collection technologies, associated risks surrounding their loan portfolios, among others. The types of clientele of the MFIs are those that are not accessed by traditional banking system due to perceived risks. The risk based supervision manual and CAMEL rating system are prepared in such a way that it addresses the specific risk profile of MFIs. Therefore, taking these all in to consideration, NBE is following different approach for supervision of MFIs. In microfinance institutions more focus is given to system and processes rather than small risk associated with individual transactions. In banks, however, more focus is given assessment of individual loan transactions because of higher risk associated with each loan.

d) Role of External and Internal Audits in Supervision

Currently, the role of external and internal auditors in supervision is not satisfactory which increased the time spent during on-site examination and hence cost of supervision. Since the basis for prudential supervision is reliable and timely information on financial status of MFIs, the bank is working on strengthening the role of external and internal auditors to supervision. External consultants are already hired by NBE to work on this area.

3.3.2 Organizational Structure Microfinance Institutions Supervision Directorate and Staff Capacity

The Microfinance Institutions Supervision Directorate has the following Organizational structure:



Source. National Bank of Ethiopia

The number of staff of the Directorate grown from six in 2004 to 15 in the year 2010 .Currently, the Microfinance Institutions Supervision Directorate works with 14 supervisory and 2 support staffs. Even though the institution has tried to enhance the skill of the staff through in country and training abroad, it has been difficult to retain the staff and improve the supervisory quality due to high staff turnover.

The current organizational structure gives emphasis to both research and policy analysis and supervision. Tanzania experience shows us that the microfinance supervision is organized on Directorate level where there is also a department that is concerned with policy analysis.

The MFI supervision Directorate is also encountering some challenges and difficulties during on-site inspection. These include, lack of understanding of managers and board of directors of MFIs concerning the purpose and importance of on-site supervision, lack of appropriate MIs and internal control system that makes the supervision work more time consuming, lack of adequate number of experienced supervisory staff etc.

3.4 Up Grading of MFIs and Downscaling of Commercial banks

There is no clear regulatory framework for graduating MFIs from their current status to rural Banks. The sector is moving faster than the regulation. As discussed above, some MFIs like ACSI have started Micro-banking services on pilot basis to serve their clients who graduate to a higher loan size and to meet the credit constraint of small business sector. There is a debate in allowing MFIs to graduate into rural banks in that graduating MFIs to rural bank could be the driving force that encourage the MFIs to go to the upper market. The other challenging aspect of graduating MFIs to rural bank are setting criteria to be fulfilled for graduation, how to solve or if not reduce problems related to ownership and governance problem, adaptation required in lending technology during graduation, setting of a higher initial capital requirement and others.

Commercial banks in Ethiopia have a number of competitive advantages to be engaged in microfinance. Among other things, they have: the management expertise, system and physical infrastructure in place, well established internal control, accounting system and others. Therefore, the interviewed banks have indicated that they have begun examining the microfinance market. They have indicated that engaging in microfinance could help them in risk diversification, tap a new market, diversify assets and increase revenue. However, they also consider microfinance as risky business, which also involves high transaction cost.

The interviewed banks have indicated that it has become a part of their loan policy to provide credit to the MFIs and they are also interested to finance MSEs provided that they are able to meet the lending requirement. Banks have various criteria to be fulfilled while they provide credit. These include: having legal business license, submitting business plan, providing collateral that covers the loan and related things.

Currently, the exploration of the microfinance market in Ethiopia is facilitated by donors funded loan guarantees. Some banks have already participated as shareholders of MFIs. The involvement of banks in microfinance is summarized as follows:

1- The United States Development Agency (USAID) is working with AIB and BOA through guarantee funds to lend to small farmers. For example, BOA has extended 19.6 million birr lending to farmers cooperatives. The guarantee fund covers 50% of the loss.
2- NIB International Bank, Dashen Bank, and Commercial Bank have shareholding participation in MFIs.
3- Commercial Bank of Ethiopia (the biggest bank in the country having a wider branch network) has recently established SME financing unit. The bank is providing loan to MFIs from its own source of fund.
4- The development Bank of Ethiopia is providing equity and credit funds for MFIs which is a part of rural financial intermediation program initiated by IFAD. It has allocated 18.7 million $ for this component.

3.5 Major Achievements and Challenges After the Introduction of the Regulatory Framework

Microfinance institutions were asked (through questionnaire) to express their views about the importance of the regulatory and supervisory framework of MFIs in Ethiopia. 11 MFIs (91.7%) replied that it is moderately appropriate and have benefited from being regulated and one institution (8.3%) replied it is least appropriate. This indicates that the current regulatory framework is enabling and is not a major threat to the performance of MFIs. Major achievements registered after the introduction of the regulatory framework are discussed and summarized below, which are sterilized facts gathered by the author of this research paper after discussing the issue with supervisory staff at the central bank, Managers and staff of assessed MFIs and banks. This does not mean that the regulatory framework does not have limitations. Some of its limitations are also discussed following the major achievements.

3.5.1 Major Achievements of the Regulatory and Supervisory Framework

a) The regulatory framework has created an enabling environment for establishment of specialized financial institutions for those who were considered as un bankable. Before the introduction of the regulatory framework there was no formal financial institution that provides financial service to the low-income section of the population. The banking sector in the country has been creating many restrictions for rural and urban low-income people to provide financial services.

b) The regulatory framework has enabled MFIs to offer a wide range of products such as credit, savings and money transfers and hence increased customer satisfaction and stabilized source of funds. Before the introduction of the regulatory framework, only subsidized microcredit services were provided by NGOs. In this respect, it has been difficult to provide financial services to lower income section of the population in a sustainable way.

As at December 31, 2009 the microfinance industry in Ethiopia has mobilized savings of US$ 178 million. Small savers whose saving was considered as insignificant are now getting the opportunity to save their money at MFIs. Besides, MFIs are also getting unimaginable source of fund (to finance their lending activity) from small savers. From the survey, it is understood that except two MFIs, all the others are mobilizing savings from non loan clients of the institution. Collecting public savings enables widespread services to poor savers, makes more funds available for small loans , and helps the MFIs attain institutional profitability that is one of the basic elements of commercialization of MFIs (Marguerite S. Robinson, 2001).

There are also MFIs such as ACSI which is providing money transfer and pension payment which otherwise could not be performed without getting license to operate as a microfinance institution. In addition, there are also other MFIs that collects taxes on behalf of tax authorities. These all activities are broadening the income of the MFIs. The MFIs are preferred to be engaged in such activities due to their wide area branch network and their proximity to the general public.

c) The regulatory framework has promoted standardization and transparency in the microfinance sector. The MFIs are required to submit quarterly reports, to be annually audited by external auditors. Besides, MFIs are supervised by the Central Bank supervision staff. These all factors have promoted standardization and transparency in the sector.

d) It has enabled MFIs to borrow from banks and other lending agencies. The regulatory framework has allowed MFIs to borrow money from banks and related lending institutions. Previously the MFIs run by NGOs were not in a position to leverage their equity base from borrowing and mobilization of savings from the internal source. They were not having credibility to get loan from banks and to mobilize savings from the public. However, the existing regulatory framework has benefited the microfinance sector to get increased legitimacy and acceptance by banks and depositors since MFIs are now regulated institutions that are subject to on going supervision by the central bank.

e) The regulatory framework has helped to shift the microfinance service from subsidized credit delivery to commercial financial service. There were unhealthy lending practices run by NGOs before the issuance of the regulatory framework. This practice has damaged the credit culture and has created market distortions.

F) The regulatory framework has created ability for MFIs to achieve growth and expand their outreach. Currently, there are 30 MFIs that are licensed by NBE. Mobilization of savings and borrowing of money from banks enabled the MFIs to grow and increase their outreach. With increased access to savings and other cheaper source of funds, transformation of MFIs to be regulated institutions helps them to increase market penetration, open new branches, and increase its loan portfolio (Marguerite Robinson, 2001).

g) The regulatory framework contributed to improvement of overall performance of the MFIs. In order to promote strong and viable financial institutions, NBE provides license for MFIs after ensuring they have adequate financial strength and board and management with sufficient experience and integrity. Moreover, the compliance of on-going regulatory requirements by MFIs is checked through off-site and on-site surveillance. Weaknesses identified during on-site inspection have to be rectified by MFIs. These are all meant to improve the performance of MFIs.

3.5.2 Costs of Supervision

The response of MFIs collected through questionnaire has indicated that the MFIs are incurring costs from being regulated. These costs include: training staff, modifying or replacing the management information system (MIS), decreased flexibility in operation, increased work load of staff during supervision, and increased administrative cost incurred due to reporting requirement imposed by NBE. However, 10 MFIs (91%) have replied the benefits of regulation outweigh the costs and one MFI has not replied to the question. This indicates that the MFIs are happy for being regulated. It should be noted that the central bank also incurs a lot of costs to regulate and supervise the MFIs however, its benefits are assumed to be better than the cost.

The regulatory framework has also limitations and challenges which are discussed below.

3.5.3 Constraints and Challenges of the Regulatory and Supervisory Framework

There are also areas in which the regulatory framework has constraints and limitation and there are also issue not covered by the regulation. These are discussed below:

a) Ownership and Governance Problems: The major shareholders of MFIs in Ethiopian case are individuals, regional governments, associations and local NGO's. In some MFIs, although private investors participate as shareholders, they are not real owners (Derk Bienen etal.., 2009). This may create problem in effectively managing the institution.

b) Problems related to upgrading of MFIs. There is no clear guideline or regulatory framework that MFIs may broaden their range of operations until they are in a condition to conduct every operation authorized for banks. There is only microfinance regulatory framework which requires initial minimum capital of Birr 200,000 and the banking law which requires initial minimum capital of Birr 75 million. The microfinance institutions are providing loan mainly to lower income section of the population and banks specialized in conventional collateral based lending. It is difficult for MFIs to directly be graduated to banks by fulfilling the initial capital and all other regulatory requirements.

c) A significant number of SMEs are experiencing real constraints in financial market in the sense that they are unable to borrow from existing banks and MFIs. This indicates that there is a gap in offering financial services to the small and medium enterprises.

d) There is no clear regulatory framework when banks are interested to offer microfinance products. Currently, Commercial Banks are providing loan to microfinance institutions. Besides, they are also providing microfinance services in a very limited scale from their own source of funds and by guarantee provided by international aid agencies. in microfinance once specialized MFIs show microfinance is a profitable sector. If a full-service bank decides to offer microfinance products or partner with microfinance to offer those products, it should have a clear regulatory path to do so; otherwise continued fragmentation of financial sector is guaranteed (Robert Pack Christen and et.al, 2003).

e) Capital Adequacy requirements and lending limit should be linked to not only total capital but also to the core capital which is the common practice exercised by other countries. This may encourage MFIs to gradually increase their capital and hence helps to create strong institutions. The experience of Uganda and Tanzania tells us similar practice.

f) Even though the current minimum capital requirement is considered by practitioners and researchers as low and affordable, it is important to take in to account that setting a very low amount may lead to creation of weak and fragile institutions which can not overcome the risks to which MFIs are exposed. Besides, the low capital requirement is creating supervisory burden to the NBE. Therefore, optimum balance should be sought between limited supervisory capacity of NBE on one hand, and the rapid growth in the number of MFIs on the other.

g) The current external audit report of MFIs is not found supportive to the supervision activity of NBE. The external audit reports lack application of auditing practices that are suitable to specific nature of MFIs. The supervisory body (NBE) has not yet defined the scope of work of the external auditors to ensure reliable and sufficient information is provided to supervisors. The Ghana regulatory framework of MFIs has clearly defined the scope of work of external auditors, the responsibility of external auditor to provide information to supervisors and the duration period (number of years) in which an external auditor audits MFI which could be a good lesson for Ethiopia.

h) There is no proper regulatory and legal support such as property right law especially for registering movable assets of micro and small enterprise. This has restricted MFIs to be involved in collateral based lending.

i) MFIs are reporting that some NGO's and government institutions are involved in subsidized lending activities and hence the practice is hampering the performance of regulated microfinance sector. National Bank of Ethiopia should take appropriate measures to resolve such issues.

j) The bank has been following traditional form of supervision which resulted in assessment of the historical performance of MFIs without focusing on future performance and hence making supervisory activities relatively less effective.

k) The other challenges include weak MIS of MFIs which created difficulty in getting timely reports from MFIs that specially operate in rural areas having poor infrastructure.

l) Finally there is Shortage of adequate skilled manpower from the side of the central bank and high turn over of employees.

3.6 Lesson Learned form Other Countries Experience

Lesson learned from other countries experience especially from that of Uganda and Tanzania are the following:

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

4. Conclusion and Recommendation

Most of the literature in the area of regulating and supervision MFIs confirms that the Microfinance Sector has to be regulated in order to have massive and sustainable delivery of Financial service to the lower income section of the population. Therefore, the issue of prudential regulation and supervision of MFIs is a key issue in success of MFIs. It should be noted that regulation of MFIs is a complex matter that is recently evolving. There is no best solution for regulating the Microfinance business. Each regulatory considerations has to be adjusted to the exceptional situation in the country. One size fits all cannot be applied and no single model offers a panacea.

The main objectives of prudential regulation of MFIs are: 1) protecting depositors; 2) ensuring integrity and stability of the financial sector; 3) promote efficient performance of the microfinance sector. If the prudential regulation is not focusing on these objectives, it will be wastage of scarce resources and creating unnecessary compliance burdens on MFIs and hence regulation will constrain the development of the microfinance sector.

Ethiopia is among the countries that has established specific regulatory and supervisory framework for microfinance business. Licensing and supervision of microfinance institutions proclamation number 40/1996 which was repealed and replaced by proclamation no. 626/2009 and consequent directives issued by National Bank of Ethiopia has helped to set general principles, rules and standards that has to be complied by MFIs. The Government and National Bank of Ethiopia have made efforts to gradually improve the regulatory framework by liberalizing the interest rate, increasing the lending size and loan term, allowing MFIs to extend loans with lending methodology at their own discretion, introducing capital adequacy, liquidity and provisioning requirements. The National Bank of Ethiopia is also currently carrying out Business Process Re-engineering that will enable to improve its current overall performance.

Based on the survey made and discussed in the previous sections of this paper, the regulatory framework of microfinance business in Ethiopia is conductive and encouraging. The MFIs have drawn many benefits form being regulated. Among other things, it created enabling environment for establishment of specialized financial institutions for those who were considered as un bankable, enabled MFIs to offer a wide range of products such as saving and money transfers, promoted standardization and transparency in the sector, enabled MFIs to borrow from banks, shifted the practice of microfinance from subsidized credit delivery to commercial finance, created ability for MFIs to achieve growth and outreach and contributed improvement of overall performance of MFIs. With wider access to various sources of funds (savings, loan and others), the regulation has enabled them to increase their outreach, increase their loan portfolio and stabilize the sources of funds.

Nevertheless, this does not mean that the regulatory and supervisory framework has no constraints and challenges. Based on the result of this survey the constraints include: ownership and governance problems, weak management information system and internal control of MFIs, and lack of adequate supervisory capacity from the side of the central bank.

The main recommendations of this paper that may enable to tackle the major challenges and constraints of the regulatory and supervisory framework in Ethiopia are summarized as follows:

- Design clear tier regulatory framework for graduating MFIs to rural bank, commercial bank or other form of financial institutions. A tier regulatory framework which contains a lower (but higher than existing) capital requirement for small MFIs that serve relatively limited market and a higher capital requirement for establishing large commercially oriented MFIs seems advisable. Such type of arrangement coupled with other additional requirements (stated below) of significant structural and operational changes will enable smooth transition of MFIs from lower tier to the upper tier without creating problem of regulatory arbitrage. A stricter initial capital, improving ownership and governance structure, introducing new organizational structure, improving MIS and internal control, appropriate lending methodology and saving policies, good performance truck in terms of loan portfolio quality and profitability and other related issues should be critical considered and evaluated during graduation process to the upper tier.

- In a similar manner, the capital adequacy requirement should be linked to not only to total capital but also to core capital of MFIs. Such type of measures will encourage MFIs to increase their capital and ensure that MFIs are maintaining the capital standards that ensure their financial solvency.

- Increase the initial minimum capital requirement for establishing MFIs by seeking optimum balance between limited supervisory capacities of NBE on hand, and rapid growth of MFIs on the other. Further research should be done to determine the actual minimum requirement. This will enable to create MFIs that have the capacity to withstand shocks and unfavorable market situations and hence will be able to provide sustainable financial services without causing major problem to the financial system.

- In order to improve the ownership and governance problems of MFIs, MFIs should to search potential investors and exceptional treatments should be given for international MFIs, and agencies and NGOs by allowing them to own equity in MFIs. Such measures could be a practical solution for the ownership and governance problem of MFIs in Ethiopia.

- A more conservative provisioning requirement should be prescribed that goes with the specific nature of MFIs. The following loan classification and provisioning amount is proposed.

Loan Classification	Provisioning Percentage
Current	1%
1-30 days late	25%
31-90 days late	50%
More that 90 days late	100%

Besides, when loan are restructured, a different provisioning requirement which more stricter than the above should be prescribed.

- Design a clear regulatory framework to encourage banks to be involved in microfinance. Currently, the attitude of commercial banks in microfinance is changing and has started examining the microfinance market. This encouraging development is becoming more facilitated by guarantee funds provided by donors. Therefore, a special incentive should be provided by the regulators and supervisors (National bank of Ethiopia) to such positive developments and also clear regulatory path should be designed when banks decide to offer microfinance services.

- The central bank should clearly define the responsibility and the scope of work of external auditors. Such measures will help to ensure that reliable and sufficient information is provided to the supervisors.

- Measure should be taken to strengthen the MIS and internal control of MFIs
- Put in place risk based supervision of MFI and well-organized, timely and orderly off-site reporting system.
- There should be clear property right law that enables to low income section of the population to get access to financial services.
- Strengthen the current dialogue that is taking place between regulatory body and practitioners.
- Build up the capacity of NBE, strengthen skills of Supervision staff in knowledge of efficient and effective regulatory and supervisory practices and experience of other countries through training and exposure visits, enhance the existing logistical support to increase on-site inspection

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