

Draft

## Corporate Governance of the Deposit Taking Microfinance Institutions (MFIs) in Ethiopia

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**Abstract:** Good governance involves effective guidance of the board of MFIs to manage the management team by implementing the regulatory framework of the National Bank of Ethiopia (NBE) and developing systems and procedures. The regulators in Ethiopia have provided a clear directives which focus on governance and management by introducing strict licensing and minimum capital requirements; capital adequacy rules; fiduciary responsibilities and standards regarding owners, directors and executive managers of MFIs; providing guidelines on risk management and related policies. Despite the efforts of the regulators, many of the MFIs have given very little attention to corporate governance and risk management, which affects their entire performance. MFIs face problems related with governance, emanating from internal and external factors that threaten their operational and financial sustainability.

Although governance problems of Ethiopian MFIs vary from one MFI to another, there are issues that should be properly addressed by all key stakeholders in the entire microfinance industry which include: lack of clear ownership; lack of skilled and experienced board members who can balance the financial and social objectives; inadequate incentives of board members to conduct regular meetings and address the core risk of the MFIs; absence of regular evaluation of the boards and management teams; lack of well-defined performance indicators; absence of succession plan; absence of board committees to support the activities of the board and management; and the limited capacity of the regulators to implement the microfinance law and the directives of NBE. Addressing the above issues will require revisiting the governance structure of MFIs, including the regulatory framework.

## I. Introduction

Corporate governance is the set of processes, customs, policies, laws and institutions affecting the way a company is directed, administered or controlled and defines the relationships among the various stakeholders. In the real world, all enterprises, irrespective of size and ownership structure, need some principles and guide to conduct a business. However, firms of different size and ownership structures (small size firms, share companies, government owned companies, commercial banks and microfinance institutions) may require different sets of complexities of governance (Tilahun and Kibre 2007). In small firms, there is no need of separation of ownership and management (owners monitor the managers) and legal institution would not be serious concern. However, as the size of a company increases, there is a need to separate the owners from the management, which takes the responsibility of running the day-to-day activities of a firm. The board of directors is created to systematically link the owners and the managers (non-owners).

According to Tilahun and Kibre (2007) the term corporate governance has come to mean a process by which companies (where separation of ownership and control prevail) are directed and controlled. This separation of ownership from control (management) implies a loss of effective control by shareholder over managerial decisions. As a result of this separation between the two parties, a system of corporate governance controls is implemented to assist in aligning the incentives of the managers with those of the shareholders. Under this circumstance, the role of the state is very crucial. To this end, Ethiopia has put up basic governance institutions for firms as early as in 1960 (Commercial Code, 1960). It includes corporate law, disclosure law, auditing, and basic structure, duties and responsibilities of shareholders, board of directors, and managers.

The experience of corporate governance for deposit taking MFIs is drawn from best practices of any organization or share company, particularly commercial banks, which should be customized to features and environment and address the specific problems of these institutions. Corporate governance is the process by which a board of directors, through management, guides an MFI in fulfilling its corporate mission and protects the institution's assets over time (Rock M, et al 1998). Effective governance occurs when a board provides proper guidance to management regarding the strategic direction for the institution, and oversees management's effort to move in the direction of the approved strategy. The board carries out this function on behalf of a third party, referred to as shareholders in the case of for-profit corporations. Because of there are no owners in non-profit corporations, that third party is not as easily identified to include the corporation's clients, staff board, and donors. The fundamental to good governance is the ability of individual board of directors to work with each other to accomplish an effective balance between strategic and operational responsibilities (Otero M 2001). The interplay between board and management centers on this

relationship between strategy and operation, and assumes that both of these components are essential for the successful evolution of the institution.

Good governance in the Ethiopian deposit taking MFIs plays an important role in increasing outreach, improving transparency, accountability, sustainability, profitability, efficiency, effectiveness, responsibility and responsiveness to the changing environments. Effective governance depends on both forms- the structures and processes of control, and content-and the specific individuals involved, particularly in the leadership. The board, which plays a critical role in ensuring good governance of MFIs, has five major responsibilities, namely,

- (i) Legal obligations: this includes understanding the regulatory framework of MFIs and compliance with bylaws, procedures, legal requirements which are clearly stated in the microfinance law (Proclamation 40/96) and the 19 directives of the National Bank of Ethiopia (NBE). On the other hand, the board of directors should have personal responsibility as the directors for the activities of MFIs which is implicitly stated in the directives of NBE;
- (ii) Relationship between board and executives which mainly includes operational distance of the board from day to day operations, drawing on the institutional memory of the directors and making binding decisions as a board (Otero M, 2001). Apart from this role, the board must ensure management accountability by bringing competent professionals as executives, establishing clear goals for their performance, monitoring performance closely, and confronting weaknesses when these surface (Otero M, 2001). In the Ethiopian context, although the formal institutional (legal) context determines the broad framework for the governance structure, the roles and responsibilities of directors of MFIs and management is not clearly defined and varies from one MFI to another MFI;
- (iii) Setting policy and providing strategic direction consistent with the MFI, mission, vision and objectives;
- (iv) Fiduciary obligation to ensure that the financial solvency of MFIs is maintained. This is a very serious responsibility of board of Ethiopian MFI, as the all MFIs take deposits from the public, as of day one of their registration under NBE. The board must be able to assess the risks associated with the provision of financial services. As per our communication with board members, this responsibility has been overlooked in many of the boards of MFIs;
- (v) Board assessment of its own performance is a major responsibility which should be exercised on regular basis. Very few boards of MFIs in Ethiopia evaluate their own performance, even once a year. Some boards did not conduct regular meeting (Itana, et al 2003).

On top of the above responsibilities, factors such as the competence and skill of the board members and the quality of the board chairperson are very critical for

effective governance. For example, board members are expected to have skills as leaders, visionary thinkers, and managers. They should have independent mind, genuine commitment, technical expertise and experience relevant to manage MFIs (financial, legal, marketing, etc), and willingness to set time to participate in the activities of an MFI. The lack of commitment of board members to the mission of the MFI and lack of clearly defined board policies and procedures affected the implementation of effective governance.

In the last ten years, MFIs in Ethiopia have been preoccupied with developing systems and procedures; developing financial products; building the capacity of their staff, mobilizing resources; developing their strategic and operational plans; and balancing the growth of outreach and sustainability. As a result, by the end of 2007, the 29 MFIs licensed and supervised by NBE mobilized about 1.2 billion Birr (128,479,657 USD) in the form of voluntary and compulsory savings and disbursed about 3.2 billion Birr (342,612,419 USD) to 1.8 million active clients. Moreover, the MFIs had total capital, asset and liability of 1.2 billion Birr (128,479,657 USD), 4.2 billion Birr (449,678,800 USD) and 3.1 billion Birr (331,905,781 USD) respectively (annex 1). The financial and operational sustainability have improved significantly in the last five years (see Wolday 2008 for the details). As per the reports of MFIs to NBE (October-December 31, 2007), 63% of the MFIs were profitable, which stood at 73.6 million Birr (7,880,086 USD) (Muluneh 2008).

As the size of the outreach and saving mobilization from the public increases, there is a dire need to ensure transparency, accountability and good governance in the microfinance industry. However, governance issues have not been given due attention by owners or shareholders, regulators, and board members. It has been documented that weak governance, poor risk management practices, weak internal control system and weak regulatory and supervisory systems contributed to the collapse of many of MFIs (Mekonen 2007, Sabana 2006). Muluneh (2008) identified , irregular meeting of the general assembly and the board, lack of commitment and technical knowledge on microfinance of the board, weak follow-up and supervision of the management team to ensure the implementation of policies and procedures, and poor internal control system as key governance problems of MFIs in Ethiopia. The one liquidated in Ethiopia, Asser MFI, had similar weaknesses. There is virtually no research on the impact of governance on microfinance institutions.

Addressing governance issues of Ethiopian MFIs should be given due importance for the following reasons. Firstly, Ethiopian MFIs take deposits from the public and any mismanagement of assets and resources will result in eating the savings of the poor people. Secondly, the outreach of MFIs in Ethiopia has significantly increased in the last four years which forced them to take loans from commercial sources such as local commercial banks and Rural Financial Intermediation Program (RUFIP). Managing the significant growth of MFIs in Ethiopia will require effective governance, involving both the board and

management. Moreover, any financial insolvency in one MFI will have a negative repercussion on the entire microfinance industry. Thirdly, the MFIs in Ethiopia operate in a difficult and risky environment which require their boards to regularly assess the risks and provide proper oversight to manage them.

The key elements of sound corporate governance in an MFI include:

- a) A well articulated corporate strategy against which the overall success and the contribution of individuals can be measured.
- b) Setting and enforcing clear assignment of responsibilities, decision making authority and accountabilities that is appropriate for the risk profile.
- c) A strong financial risk management function (independent of business lines), adequate internal control system (including internal and external audit function), and functional process design with the necessary checks and balances.
- d) Corporate values, codes of conduct and other standards of appropriate behavior and effective system used to insure compliance. This includes special monitoring of the risk exposures of MFIs where conflicts of interest are expected to appear (e.g. relationships with affiliated parties).
- e) Financial and managerial incentives to act in an appropriate manner offered to the board of management and employees including compensation, promotion and penalties (I.e. compensation should be consistent with the MFIs objective performance and ethical values).
- f) Transparency and appropriate information flows internally and to the public (adopted from Van Greuning et al 2003).

Corporate governance of MFIs in Ethiopia involves there major elements, namely (a) prudential regulation; (b) shareholders, board and management; and (c) policies, systems and procedures. The three key dimensions of governance indicated above are used as the conceptual framework of the this study. The key stakeholders in corporate governance include the regulators, shareholders, board of directors, executive management, audit committee members, internal auditors, external auditors and the public. The National Bank of Ethiopia (NBE) has set a clear regulatory framework including the duties and responsibilities of board members. The task of the supervisors of NBE is to monitor the financial viability and effectiveness of MFIs. As per the regulation, the shareholders appoint “fit and proper” boards, management and auditors. The board and the executive management develop the strategies, set performance indicators and take the responsibility for the performance of the MFI. The management creates systems, policies and procedures to implement the decisions of the board. The board of directors of MFIs approves the policies and procedures and monitors their implementation.

The purpose of this study is to examine the main regulatory features affecting good governance of MFIs in Ethiopia; assess the performance of the board of

directors of MFIs and executive management; and study the outcome and challenges of governance of MFIs in Ethiopia.

The paper is organized in five sections. Section two describes the prudential regulation of Ethiopian MFIs which affect the implementation of effective governance. Section three reviews the scope of the board and executive management of MFIs. Section four summarizes the systems and procedures required to manage risks. Section five deals with the key governance issues of MFIs. Section six describes the challenges of governance and section seven presents the conclusions.

## **II Prudential regulation as a tool to implement an MFI's effective governance in Ethiopia**

Based on the development of the microfinance industry at national and global level, Ethiopia took the direction of building sustainable deposit taking MFIs to deliver financial services to those who have no access to formal banks. This required establishing sustainable financial institutions operating on sound commercial principles that can attract private capital investment and private savings in order to increase permanent access to financial services.

In order to clearly separate between charity (handout) and finance, the policy makers in Ethiopia introduced a clear regulatory environment that will have a direct impact in building sustainable MFIs. Unlike many countries, the microfinance is part of the financial sector. The need for prudential regulation and supervision has also brought the activities of the MFIs under Ethiopia's monetary and financial policy framework. It should be noted that although regulation contributes to stable and efficient performance of the MFIs, regulation and supervision entail significant cost.

Currently, there is consensus among practitioners in Ethiopia that enabling prudential regulation and supervision of MFIs has been effective in promoting and guiding effective governance of MFIs. Government prudential regulation and supervision has also shifted from the traditional prescriptive approach to a new approach of extensive consultation between NBE and MFIs. The regulation and supervision of MFIs in Ethiopia has also ultimately helped in enhancing access to financial and capital markets for MFIs and leveraging commercial funds to increase outreach.

### **2.1 Review of the prudential regulation affecting effective governance of MFIs in Ethiopia**

Prudential regulation is very critical in ensuring the sustainability and viability of MFIs. It also plays a key role in ensure effective governance. According to Chaves and Gonzalez-Vega (1993), prudential regulation of MFIs refers to government regulation that should serve three basic goals. The first one, macroeconomic in nature, is to ensure the solvency and financial soundness of all intermediaries, in order to protect the stability of the country's payments system. The second objective is to provide consumer protection against undue risks of losses that may arise from failure, fraud, or opportunist behavior of the suppliers of financial services. The third goal of financial regulation is to promote the efficient performance of institutions and markets and the proper working of competitive market forces.

MFIs providing financial services to the poor with numerous repeated loans attempting to provide their services physically to clients, quick repayment, using group lending methodology, highly decentralized system and with high operating cost per loan or deposit amount and management orientation towards poverty reduction (not always profit) do have specific risk profiles different from those of conventional banks. The high-risk profiles of MFIs will then increase the importance of prudential regulation, and strict supervision, and effective governance. Ensuring the safety of clients and building healthy institutions for the development of the financial sector appears to require microfinance regulation and supervision which also assisted in improving the governance of MFIs.

The prudential regulatory framework criteria and supervision methods of MFIs in Ethiopia are based more or less on the core principles for effective supervision established by Basel Committee on banking supervision. These include:

1. A sound legal framework, including satisfactory licensing systems;
2. Prudential standards covering capital adequacy, liquidity ratio, income recognition, asset classification and provisioning;
3. Prudential operating policies and procedures for credit and investment management including single individual, company or group exposure limits;
4. Risk management strategies;
5. Efficiency and performance standards;
6. Sound governance structures;
7. Internal controls that are adequate for the nature and scale of their business;
8. Management information systems;
9. Disclosure norms including publication of annual accounts; and
10. Effective banking supervisory systems.

Although the prudential regulatory framework for MFIs was guided by the above core principles, limited adjustments have been made to fit to the special characteristics of MFIs in Ethiopia. The regulatory framework of MFIs is expected to improve governance and strike an appropriate balance between flexibility to encourage innovation and outreach expansion.

Proclamation No. 83/1994, Monetary and Banking Proclamation has clearly indicated that the NBE has the legal authority to license, supervise and regulate banks, insurance companies and other financial institutions. The other financial institutions in the proclamation include MFIs, postal savings, credit cooperatives and other similar institutions engaged in any type of banking business.

Proclamation No.84/1994, Licensing and Supervision of Banking Business provides that only incorporated institutions may conduct banking business, and only if they are licensed by the NBE to do so. The proclamation allowed, for the first time, the establishment of private financial institutions, thus breaking the



state monopoly in the banking sector. To date, nine private banks and nine private insurance companies have been established. The proclamation precludes a foreign national from undertaking banking business in Ethiopia, and no person is permitted to own more than 20% of a banking company's shares. This law also applies to the MFIs. The law also prohibits foreign banks from bringing expertise in banking practices, management and improved technology, more efficient services; increase the inflow of capital and competition. It is argued that, unless protected, the foreign banks would destroy the ability of the young private banks owned by Ethiopian nationals to compete and expand in the future. Thus, before allowing foreign banks to invest in Ethiopia, enough time (with definite time table) should be given to strengthen the locally owned private banks. Moreover, the supervision department of the NBE should be given definite time to build its capacity in supervising foreign banks. On the other hand, this limits competition, efficiency and transfer of technology to MFIs. There should be a specific timetable showing when foreign banks will be allowed to operate in the financial sector, including MFIs.

Proclamation No. 40/1996 "A proclamation to provide for the licensing and supervision of the business of microfinance institutions" is the major law, which is used to regulate and supervise MFIs. In the proclamation, microfinance business is defined as " an activity of extending credit, in cash or in kind, to peasant farmers or urban small entrepreneurs". The NBE is empowered to license, supervise and regulate the delivery of financial services to the rural and urban poor through microfinance institutions. Proclamation 40/1996 and the 19 directives of the NBE currently serve as the basis for prudential regulation affecting good governance. The proclamation and the directives served as the basis for the new MFIs and the transformation of the NGOs to deposit taking MFIs in Ethiopia to build their governance structure. The main regulations that have a direct impact on the governance structure MFIs in Ethiopia are summarized as follows:

## **2.1 Minimum Capital Required of New MFI Entrants**

Directive No. MFI/01/96 states that MFI applying for a license shall have a minimum paid up capital of 200,000 Birr (21,414 USD). However, the minimum capital required by the NBE is low. This is a deliberate action of the government to improve entry and growth in the microfinance industry. On the other hand, as of December 31, 2007, the two largest MFIs, DECSI and ACSI, have mobilized 289,742,247 Birr (31,021,654 USD) and 565,522,000 Birr (60,548,394 USD) of savings, respectively, (see annex 1 for details). Thus, the law which requires an equity capital of 200,000 Birr (21,414 USD) compared to 75 million Birr (8,029,978 USD) for banks would on the other hand endanger the safety of depositors. On top the minimum capital requirement, an MFI applying for a license should submit memorandum and articles of association, work plan indicating major financial services to be offered, overview of economic conditions of the area, cash flow, income statement and balance sheet projections for the

first year of the operations, curriculum vitae of board of directors and the Chief Executive Officer (Directive No. MFI/01/1996 of NBE).

## 2.2 Ownership of MFIs

Proclamation No.84/1994 clearly states that financial institutions including MFIs should be owned by Ethiopian nationals. MFIs in Ethiopia should be established as share companies as defined under Article 304 of the Commercial Code, the capital thereof owned fully by Ethiopian Nationals and/or organizations wholly owned and having its head office in Ethiopia. The Commercial Code of Ethiopia indicates that a share company is a company whose capital is fixed in advance and divided into shares and whose liabilities are met only by the assets of the company. The members shall be liable only to the extent of their shareholding. Only members of a company may manage the company. A company shall have not less than three or more than twelve directors who shall form a board of directors. The microfinance law and directives of the NBE has the intention of creating business like shareholders and board of directors who control, guide and monitor the activities of the MFIs as a private share company.

**Table 1: Year of Establishment and Ownership Structure of Microfinance Institutions in Ethiopia**

Microfinance Institutions	Year of Establishment	Regional Government	Associations and NGOs	Individuals	Total
Amhara Credit & Savings Institution S.C	1995	25	75	-	100
Dedebit Credit & Savings Institution S.C	1994	25	75	-	100
Oromia Credit & Savings Institution S.C	1997	25	70	5	100
Omo Microfinance Institution S.C	1997	80	19.5	0.5	100
Specialized Financial & Promotional Institution S.C	1997	-	80	20	100
Gasha Micro-Financing S.C	1998	-	61.9	38.1	100
Wisdom Micro-Financing Institution S.C	1998	-	-	100	100
Sidama Micro-Financing Institutions S.C	1994	-	70	30	100
Asser Micro-Financing S.C	1998	-	97	3	100
Africa Village Financial Services S.C	1998	-	-	100	100
Buussa Gonofa Microfinance S.C	1999	-	19.6	80.4	100
Mekket Microfinance Institution S.C	1999	-	-	100	100
PEACE Microfinance Institution S.C	2000	-	16	84	100
Addis Credit and Savings Institution S.C	2000	96.7	3.3	-	100
Meklit Microfinance Institution S.C	2000	-	91	9	100
Eshet Microfinance Institution S.C	2000	-	20	80	100
Wassasa Microfinance Institution S.C	2000	0	20	80	100
Dire Microfinance Institution S.C	2000	97	2.5	0.5	100
Metemamen Microfinance Institution S.C	2001	0	0	100	100
Benishangul Microfinance Institution S.C	2001	40	60	0	100
Shasehemene Microfinance Institution S.C	2001	0	0	100	100
Agar Microfinance Institution S.C	2004	0	0.2	99.8	100
Digaf Microfinance Institution S.C	2005	-	81.4	19.6	100
Ghion Microfinance Institution S.C	2005	-	100	-	100
Harbu Microfinance Institution S.C	2005	-	-	100	100
Harar Microfinance Institution S.C	2006	96.6	3.3	0.1	100
Letta Microfinance Institution S.C	2004	-	-	100	100

Source: National Bank of Ethiopia, Addis Ababa.

The shareholders in the Ethiopian MFIs are individuals, regional government and local NGOs (see Table 1). Although Proclamation (40/96) clearly indicates that the shareholders are investors who buy shares from their own resources, in reality, with few exceptional cases, the shareholders in MFIs are nominal shareholders who are not investing their own money in the institutions (without real stake). As a result, the nominal shareholders of MFIs may not have sufficient interest to seriously oversee the activities of the MFIs. Moreover, many of the MFIs, through their Memorandum of Association, have made it clear that shareholders will not receive any dividend from the profits of MFIs. We believe that, the ownership structure of MFIs should create true stakeholders.

### **2.3 Board Structure and the Requirement to be appointed as Executive Director**

Directive No. MFI/03/96 of the NBE clearly indicates the criteria for selection of officers and directors of MFIs. The directive states that the chief executive director of an MFI should have first degree in the field of social science or equivalent in relevant field, minimum of three years experience in a senior post in a financial institution and the director should not be less than 30 years of age. Board members of MFIs should be high school complete with preferably adequate managerial experience and with a minimum age of 25 years. However, the experience in the industry indicates that board members did not have the right mix of professionals to guide an MFI and support management. Moreover, given the current objective condition in Ethiopia, it will be difficult to attract highly qualified Chief Executive Officers as per the directives. Actually, some MFIs such as Meket MFI, Omo MFI, Shashemene Idir MFI, Dire Dawa MFI, Agar MFI, and Gambela MFI had problems of meeting these criteria in recruiting their chief executive directors.

### **2.4 Re-registration of MFIs: Tiered approach to Regulation**

As per the Proclamation No. 40/1996, the MFIs in Ethiopia should re-register when the savings mobilized by these MFIs equal Birr 1,000,000 (107,067 USD). However, although many of the MFIs mobilizing more than 1,000,000 Birr (107,067 USD) and re-registered by the NBE, there are no clear implications and details on what re-registration means and lack on how re-registered MFIs should be regulated and supervised compared with those MFIs, which did not re-registered. Moreover, since the difference between the larger and smaller MFIs is huge, there is no sound rationale for re-registration and fixing the one million Birr (107,067 USD) as a benchmark for re-registration.

## **2.5 Interest Rates**

The interest rates of MFIs were revised four times by the NBE. Initially, the NBE issued Directive No. MFI/09/96 that sets the lending and saving interest rates of MFIs. According to this directive, the lending interest rate of MFIs should not be higher than 2% above the maximum lending interest rate charged on loans extended by formal banks. Thus, the maximum lending interest rate was set at 12.5% per annum. The interest rate on savings and time deposits shall not be less than 1% higher than the minimum interest rate paid on such deposits extended by formal banks. In May 1998, the NBE increased the maximum ceiling of the lending interest rate of MFIs to 15.5 percent per annum (Directive No. MFI/10/98). However, both directives did not state whether the lending interest rate was flat rate or declining rate. In June 1998, the NBE removed the ceiling of the lending interest rate of MFIs. It has clearly stated that the board of directors of each MFI can set its own lending interest rate (Directive No. MFI/11/98 and Directive No. MFI/13/2002). Initially, the minimum interest rate on savings and time deposits was 7% per annum. Directive No. MFI/12/98 was issued to reduce the minimum interest rate on savings and time deposits from 7% to 6% per annum. However, in 2002 (Directive No. 13/2002) the NBE reduced the lower ceiling of saving interest rate for formal banks and MFIs to 3%. The minimum saving interest rate for the MFIs was increased to 4% in 2007 (Directive No. 19/2007 of NBE).

## **2.6 Reporting**

Reporting is one of the tools to supervise MFIs in Ethiopia. MFIs are required to provide quarterly reports on income statements, balance sheet, loan, saving and status of impaired loans and loan provision to the NBE. Moreover, MFIs with deposits of 1 million Birr (re-registered) are required to submit quarterly liquidity and capital adequacy reports within one month after the close of each quarter (Directive No. MFI/07/96). However, the relatively larger MFIs have not reported regularly because of their large geographical coverage (e.g. covering the entire woredas in Tigray and Amhara), concentration on rural poor and the weak Management Information System (MIS). As a result, complete and timely reporting was difficult for these MFIs. The regular on-site supervision is expected to verify the reports submitted by the MFIs. However, given the limited capacity of the Supervision Department of the NBE, it has only made limited on-site supervisions per year for MFIs by sending inspection teams to perform on-site supervisions. Normally, after on-site supervision, the inspection teams prepare summary reports of their findings, which should be discussed with the board and management of MFIs. A lot remains to be done in improving the reporting system and building capacity of the NBE to conduct regular on-site supervision.

## **2.7 External Audit**

The proclamation (No.40/1996) states that an independent auditor acceptable to the NBE prior to the payment of dividends to shareholders shall audit accounts of MFIs annually. The directive of the NBE requires MFIs to submit an external audit report to the NBE within six months from the end of its financial year. Currently, all MFIs have provided external audit reports to the NBE.

## **2.8 Minimum Provisioning Requirements**

According to Directive No. MFI/17/2002, MFIs are required to classify non-performing loans, based on number of past due days, into the following three categories:

- i) Sub-standard: 91-180 past due days, 25 % of the outstanding balance as provision;
- ii) Doubtful: 180-365 past due days, 50% of the outstanding balance as provision; and
- iii) Loss: Over 365 past due days, 100% of the outstanding balance as provision.

The directive also states that MFIs should deduct any deposit held with the institutions as security against the loans from the outstanding balance of non-performing loans before making the provisions. However, the provision directive is only applicable to MFIs, which have re-registered, i.e., MFIs whose total deposits equal or exceed Birr one million (107,067 USD).

## **2.9 Capital Adequacy Ratio**

Technically, capital adequacy is a measure of an institution's capacity to absorb loan losses and still have adequate fund to maintain regular financial services. The rule of the thumb is that capital should be commensurate with the volume and risk involved in business and adequate to absorb losses related to defaults in loan portfolio and other operational losses.

Directive No. MFI/16/2002 of NBE states that MFIs should maintain at all times a minimum capital ratio of 12 percent (ratio of risk-weighted assets to total capital). MFIs are also required to submit quarterly report on capital position within three weeks after the close of each quarter. However, this directive is only applicable to MFIs, which are re-registered, i.e., MFIs whose total deposits equal or exceed Birr one million (107,067 USD). The capital adequacy ratio requirement for commercial banks is 8% (much lower than MFIs). As of December 31, 2007, the capital adequacy ratio of the MFIs in Ethiopia stood at 31% (Muluneh 2008). Even for the re-registered MFIs at various stages, capital adequacy ratios should have been based on size, experience and financial sustainability.

## **2.10 Minimum Liquidity Requirement**

Until May 2002, there were no reserve and liquidity requirements for MFIs. However, as per Directive NBE No. MFI/15/2002, MFIs are required to maintain, at all times, at least 20 percent of their total savings in liquid assets (ratio of liquidity assets). This directive is only applicable to MFIs, which are re-registered. As of December 31 2007, the liquidity ratio of MFIs in Ethiopia stood at 55%. It should be noted that commercial banks in Ethiopia are required to maintain with the NBE 15% of their deposit liabilities in the form of liquid assets such as cash, bank deposits, treasury bills and other short-term assets that can readily be liquidated or discounted.

### **2.11 Restriction on investment, single borrower limit and penalty for non-compliance**

MFIs are restricted to invest not more than 10% of equity capital of the institution in allied activities and equity investment of an MFI in any single enterprise shall be limited to 3% of the net worth of the institution (Directive No. MFI/o6/96). The loan extended by an MFI to a single borrower and group borrowers should not exceed 1% and 4% of total capital respectively. In May 2002, as per the proclamation 40/96 article 25, the law clearly stated the implementation of a system of penalties for MFIs not complying with applicable laws and regulations. Directive No. MFI/14/2002 states that if MFIs fail to comply with the microfinance law and the NBE directives, they will pay penalty fees and remove their chief executive directors from their managerial positions.

### **2.2 Outcome of Prudential Regulation on Governance**

Prudential regulation of MFIs in Ethiopia has significantly reduced market distortions or the potential disruption of the overall stability of the financial system and improved corporate governance. Obviously, the regulatory framework has affected the welfare-oriented NGOs in Ethiopia, which focused on welfare programs by providing free or subsidized micro-credit services. They provided credit services at very low interest rate (below market interest rate) focusing on the poorest of the poor (based on humanitarian reasons) rather than on sound credit management principles. As a result, many of the NGOs that have been providing micro-credit services are in a transition from highly subsidized credit providers to organs that have become a finance-based system. Moreover, although the initial reactions of the NGOs in Ethiopia to the implementation of the regulatory framework (Proclamation No. 40/96) were negative, they have now realized that the framework has institutionalized and streamlined microfinance services in the country to work toward operational, financial and institutional sustainability.

Prudential regulation has also improved the performance of MFIs. The prudential regulation has encouraged MFIs to meet minimum performance standards and increased their commitment to operational and financial sustainability. As a

result, the MFIs have demonstrated remarkable repayment performance and introduced financial risk management tools.

The prudential regulation, particularly the requirement of annual external audit report and the on-site and off-site supervision of NBE have improved transparency and governance of MFIs. This has also helped MFIs to build trust and mobilize public deposits and access donor and bank credit line. However, most external audits fail to verify accurately the loan portfolio quality of MFIs and thus, the independent external auditors should gain the skill of auditing MFIs by developing appropriate procedures sufficient to warrant real confidence about the state of MFI's portfolio.

Regulators require more formal documentation of policies and procedures to implement risk management. Although prudential regulation can lead to improved governance and accountability of MFIs, the financial sustainability and profit motive alone does not guarantee good governance. Since regulatory interventions usually arises only after the MFI showed external signs of distress, the institution should rely on its own system of evaluating its risks and selecting the appropriate tools to mitigate risks. For deposit taking MFIs with relatively higher risks, there is a need of using additional risk management policies and procedures, enhance security and staff trainings, and adopt management information systems to address the additional risk exposure.

### **III. The scope of the board and executive management of MFIs**

Governance is a system of checks and balances whereby a board is established to manage the managers. It is also conceived as a virtuous circle that links the shareholders to the board, to the management, to the staff, to the customer, and to the community at large (CGAP 1997). Effective governance requires empowered boards which understand their duties and responsibilities. On top of the board, the CEO, executive managers and internal and external auditors are accountable for the effective governance of MFIs. The responsibilities of the key players in governance should be clearly defined. On behalf of the shareholders, boards delegate responsibility to management and hold management internally accountable to a set of objectives and performance standards that the board has defined.

Shareholders or owners of MFIs play a key role in implementing effective governance and oversee their affairs. The shareholders, through the general assembly meeting, appoint competent board of directors, audit committee and external auditors. However, unlike non-financial institutions, the responsibilities of the board and executive management of MFIs and banks (playing an intermediary function in the economy) are not only to shareholders but also to depositors, who provide leverage to owners' capital.



### **3.1 Selection and composition of board members**

Since the ultimate responsibility of guiding an MFI is placed with the board of directors, the first step towards effective governance is in the selection. The composition of a board of directors is crucial to implement governance. An MFI should have strong, skilled, knowledgeable and experienced board members who can set sound policies and objectives, adopt a suitable business strategy, supervise the performance or financial position of the institution, maintain reasonable capitalization, etc. Ideally, the selection of board members should be done by establishing an independent selection panel. However, in the case of Ethiopian MFIs, board members are selected all shareholders (20%), vote of majority shareholders (50%), the members of the old board (12.5%) and other processes (12.5%) (Mekonen 2007). Both the board of directors and executive management must adhere to high ethical standards and be fit and proper to serve an MFI. Experience in Africa and other countries indicate that the failed MFIs had deficient senior management and board members who either lacked financial knowledge or were uninformed and passive regarding the supervision of the MFI's affairs. Thus, although the MFI's directors will not necessarily be experts in banking, microfinance, accounting, IT, law, marketing, etc., they should have the skills, knowledge, experience and the commitment to serve the poor which enable them to perform their duties and responsibilities effectively. The board members are expected to be independent, have decision making skills, communication skills, willing to work in a team and have the willingness to learn.

### **3.2 Duties and responsibilities of the board**

Although the board should leave day-to-day operations to management, it should retain overall control of the MFI. The most important duty of the board of MFIs is to ensure that the management team has the necessary skills, knowledge, experience and sense of judgement to manage the affairs of an MFI. The board should oversee and support the efforts of management and make sure that adequate controls and systems are in place to identify and address the major risks of an MFI by evaluating the magnitude of the problems and take corrective actions before they become major problems. The dictation of a board's actions by management indicates that the board is not fulfilling its responsibly. The board should have a sound understanding of the risks of MFIs and take reasonable steps to ensure that management has established strong systems to monitor and control those risks. The board should ensure that the MFI has adequate internal audit arrangements in place. It should also ensure that microfinance regulations are strictly followed by the executive management.

### **3.3 Responsibilities of management**

While the board and management of an MFI need to support each other, each has its own distinct role and responsibilities to fulfil. The chief executive officer

and the management team should be directly accountable to the board, and their relationship should be supported by robust structures. The chief executive officer and management team of an MFI should run the day-to-day activities of the institution in compliance with board policies, laws, and regulations, and should be supported by a sound system of internal controls.

Management should provide the board with the information they need to meet their responsibly, and should respond quickly and fully to board requests. The management should involve in placing adequate policies and procedures to increase the accountability of management and identify innovative interventions which improve the overall performance of an MFI. The executive management should appoint middle-level management positions with adequate professional skills, experience, and integrity; establish adequate performance incentives and personnel management systems; provide staff training; and implement adequate management information system.

### **3.4 Performance of the board of directors of MFIs in Ethiopia**

The boards of MFIs can perform their duties and responsibilities effectively if they are empowered to guide and decide on critical issues affecting the institution. The empowerment does not come from outside. However, the board itself should realize that its performance is critical to the success or failure of an MFI. Rachel R et al (1998) classified boards of MFIs into four categories, namely, rubber stamp board, representational board, hands – on board, multi-type board<sup>1</sup>.

The performance and effectiveness of the board of Ethiopian MFIs varies from one MFI to another. In most of the Ethiopian MFIs, enormous responsibilities and power are placed in the hands of the Chief Executive Officer (CEO) or the general manager. Mekonen (2007) reported that only 35.5%, 12.5% and 25% of the board of directors of MFIs determine the purpose, values and strategy respectively. This is quite alarming trend which could lead to mismanagement and fraud. On the other hand, there are boards which are involved in micro management and hinder management's ability to perform effectively or management's accountability. Some CEOs of MFIs depend and wait for a go ahead from the board and request the intervention of the board chairperson for decisions which are outside of the board's domain. Some board chairpersons act as CEOs denying the management independence and accountability. Some of the MFIs in Ethiopia have very influential board chairpersons and members who helped the MFIs to establish key linkages with the government, and banking sector which allowed the MFIs to be more effective in achieving their objectives. These board members, who have been successful in providing the necessary oversight in their institutions, also provided a solid support to the development of the microfinance industry as whole. There are few MFIs with hands-on boards, which are engaged in constructive and challenging discourse with management and provide useful analysis that enables management to pursue increasingly

high level of performance by making a clear difference between its strategic-base role and operational responsibilities of management.

Effective governance of MFIs requires boards to perform the following functions:

- Define and uphold the mission and purpose of the MFI
- Develop and approve strategic directions (with management) and monitor achievement of strategic goals
- Oversee management performance
- Select, support and evaluate the CEO by maintaining a healthy balance between management and board
- Ensure that the MFI manages risks effectively, assuming fiduciary responsibilities
- Foster effective organizational planning, including succession planning
- Ensure adequate resources to achieve the mission, including the provision of assistance in raising equity and debt capital
- Represent the MFI to the community and the public
- Ensure that the MFI fulfils its responsibilities to the larger community
- Ensure that the MFI changes to meet emerging conditions particularly in terms of distress
- Uphold the ethical standards of the MFI
- Maintain transparency and avoid conflicts of interest
- Evaluate (or seek external evaluation) its own performance and commit to improving performance (Sabana B, 2006)

#### **IV. Developing systems and procedures to manage risks**

The key responsibilities of the board and management of an MFI is to ensure that all major MFI functions are carried out in accordance with clearly formulated policies and procedures, and that the MFI has adequate systems in place to effectively manage risks and improve governance. The board must ensure that the MFI has adequate systems to monitor and control management risk and assure that these systems are being properly applied. According to Mekonen (2007), only 50% of MFIs reported that risk management was an agenda of the board of directors.

Effective systems underpin both the efficient implementation of governance and the management of an MFI. Developing appropriate system and procedures assists in ensuring efficient delivery of financial services, maintaining the integrity of the operations to ensure accuracy and prevent fraud (through an appropriate internal and external control system) and generating the information necessary to manage the portfolio. The availability of accurate, relevant and timely information is essential for both front-line staff, the varying levels of management and the board to be able to take effective actions.

Information technology (IT) has a potential role in increasing outreach, improving sustainability and governance of an MFI. Efficiency achieved through the use of information technology has an immediate bearing on transaction costs and potentially rendering new markets or product. Nevertheless, it does not appear that the full computerization of an MFI operation is a prerequisite for the sustainability and efficiency of management and governance in all contexts. There are cases in Bangladesh, India, Ethiopia and others, where much of the loan tracking is carried out manually without apparently undermining sustainability. However, it is clear that IT provides better management information which can significantly improve managerial and board decision making at various levels. Although there are efforts by some MFIs in Ethiopia to apply software such as TMS, Loan Performer, and Emerge to track financial and operational information, there is a need in the industry to address the issue holistically.

In the context of Ethiopian MFIs, technology has served to manage information (MIS), that is, primarily on the back end. This has helped MFIs to standardize their operations, produce timely and transparent financial reports on their operations and otherwise needed by management and the board. However, there are huge opportunities where Ethiopian MFIs can use new technologies in the front end. Among the technologies that available to be used in the front end include: magnetic stripe and chip (smart) cards, point of sales devices, ATMs, cell phones, satellite communications, the internet, credit scoring, data mining, biometric recognition and more. These technologies will require MFIs to redesign their business models and educate their employees and customers to master new ways to deliver and receive services. Such changes will not always be easy, but the benefits will be dramatic.

## **V. Governance issues of MFIs in Ethiopia**

As microfinance increases in financial sophistication, reaches vast number of clients, manages very large sums of money, engages highly professional staff, taps financial markets more progressively, and in more and more cases earns a profit, governance becomes far more complicated (Otero M, 2001). The challenges and effectiveness of governance in Ethiopian vary from one MFI to another, depending on type of ownership, level of growth, etc. The critical issues which affect the effective governance of Ethiopian MFIs are categorized as follows:

### **5.1 Ownership of MFIs**

Ownership is intrinsically linked to effective governance. Ideally, the board of directors consists of owners or represents the interest of owners. Aligning the interests of individual directors with interests of the MFIs is a key to effective governance (Otero M 2001). Many of the MFIs in Ethiopia are not-for-profit

organizations where ownership is often unclear. There are not clearly definable owners of the assets who can take actions where performance is poor. Although lack of clear owners is a structural weakness of not-for-profit MFIs, this may not necessarily result in poor performance of these MFIs. Moreover, the performance criteria of these MFIs are often both poorly defined and difficult to measure. This is especially the case where different stakeholders who are represented on a board have diverging objectives. In Ethiopia, the ownership of MFI takes four types of structure.

### 5.1.1 Public sector entities as investors

In Ethiopia, the government has refrained from direct delivery of financial services using its structures and institutions. However, the regional national states in the eight regions have been involved in initiating and supporting microfinance institutions in the last 12 years. The regional states have been shares in the eight MFIs (Table 2).

**Table 2: MFIs supported by regional states**

<b>MFI</b>	<b>Regional government</b>
DECSI	Tigray
ACSI	Amhara
OCCSCO	Oromia
OMFI	SNNP state
AdCSI	Addis Ababa municipality
BSG MFI	Benishangul Gumuz
Harari MFI	Harari
DD MFI	Dire Dawa

Although the regional governments have shares (which vary from one region to another), they are not interested in getting financial returns from these MFIs. The MFIs are used as tools to implement the regional development plans and address the social and economic problems of regions. Although there are no direct budget supports from the regional governments, the MFIs can count on the regional governments to get additional capital and support, when needed. Unlike the experience of many countries, the government supported MFIs such as ACSI, DECSI and OCCSCO have been successful in registering high outreach and performance in the last five years which is partly the result of the commitment of the CEOs and board members. A good example is ACSI, which was ranked as the 6 best MFI in the world in 2007. The result of the success is partly attributed to good governance and management independence of these MFIs which significantly minimized political interference and corruption. However, this does not mean that there are not governance problems in the above MFIs.

### 5.1.2 NGOs and donors as investors

Although international NGOs and donors in Ethiopia are prohibited, by law, from delivering financial services to households, local NGOs are shareholders in many of the MFIs (Table 3). After, the microfinance law of 1996, NGOs (which used to have micro-credit programs) established MFIs by being shareholders and gave nominal shares to individuals working in the mother NGO and affiliated institutions. The mother NGOs have been providing capital, expertise and technical support to these MFIs.

**Table 3: MFIs and their mother NGOs**

<b>MFI</b>	<b>Mother NGO</b>	<b>Remarks</b>
AVFS	Africa Village	Initially supported by CARE
Bussa Gonofa	Hunde	
Digaf	Addis Hiwot Mahber	
Eshet	Ersha	
Gasha	Pro Pride	Pro Pride itself was established with the support of Action Aid
Ghion	Christian Aid	
Harbu	Facilitator for change Ethiopia (FCE)	
Letta	American volunteers residing in the USA	
Meket	SOS Sahel	
Meklit	Progynist	
Metemamen	CRS	
PEACE	Agri Service Ethiopia	
SFPI	Initially established with the support of Radda Barna	Commercial Bank of Ethiopia and Dashen Bank are shareholders
Shashemena	ACCORD	
Sidama	Sidama Development Program	Initially established by Irish Aid
Wasasa	Oromia Development Association	
Wisdom	World vision	

The board members of the NGO and donor initiated and supported MFIs are not real shareholders and usually fail to provide critical support to management team to improve the performance of the MFI. Many of the board members tend to implement the social objectives of the mother NGO, giving less emphasis to the financial sustainability of the MFI.

### **5.1.3 Clients as investors**

After visiting the Grameen Bank in Bangladesh, the founding board chairperson and CEO of Gasha MFI attempted to involve clients in the ownership of the MFI. Basically, the MFI was established with the financial support of Action Aid-Ethiopia. However, since the donor was not interested in owning the MFI, the ownership of the MFI was transferred to a local NGO, Pro-Pride. Clients were invited to buy shares and be owners of the MFI. A significant number of clients bought shares (equivalent of 10 USD) from the MFI. The clients who bought the shares were represented in the board. Although this was an innovative initiative,

the results were not encouraging. Since the MFI was not distributing dividend to shareholders (clients), some clients who bought the shares demanded to get back their money invested as shares. The experience of involving clients (shareholders) in the board was not found value adding.



#### **5.1.4 Private sector investors**

Ideally, private ownership in combination with an unrestricted profit orientation appears to be the basis for securing an efficient provision of financial services as long as MFI supervision functions properly and competition ensures that no single MFI is in a position to charge monopolistic prices. In an MFI for-profit, shareholders own the assets and a board of directors has a fiduciary responsibility to those shareholders for the effective use and protection of those assets. The board's competency in exercising that fiduciary role can be measured relatively easily in terms of the financial performance of the MFI. Where performance is unsatisfactory, owners will be expected to take action, with the ultimate sanction of dismissing the board. There are two key points here: First, in an MFI for-profit, there is generally a performance framework which is readily understood by senior management, the board and others. Second, the owners of the assets are empowered to take action where performance is unsatisfactory in the MFI.

Some argue against private ownership of MFIs in Ethiopia stating that although granting credit to poor borrowers may turn out to be a profitable business in a liberalized financial system over the medium term, financial entrepreneurs are likely to find out market niches to be more profitable than small and micro enterprise lending. This might lead them to turn to other groups of customers and thus give up the delivery of financial services to the poor households and marginalized areas. However, despite the favorable environment to attract for-profit MFIs, there is little private capital flowing to the microfinance sector in Ethiopia.

Although there are two new MFIs on the pipe line, which are owned by individuals from the private sector, it is only Agar MFI which was established by selling shares to the public. This MFI has the objective of maximizing profit and distributing dividend to private shareholders. Agar MFI was expected to be a role model to attract private sector to the microfinance industry in Ethiopia. However, Agar MFI has not yet distributed dividend to its shareholders and failed to meet the expectations of the shareholders. It should be noted that Agar's experience has nothing to do with the form of ownership structure.

The experience of Ethiopia reveals that the structure of ownership of MFIs affects the effectiveness of governance and overall performance. It is difficult to generalize that ownership of an MFI by government by itself results in poor performance. The experience of Ethiopia reveals the contrary, where some of the government supported MFIs in Ethiopia registered a remarkable performance both in outreach and efficiency. On the other hand, some of the MFIs initiated by NGOs have no real owners. Although ownership in Ethiopia has not expanded significantly beyond NGOs and public entities, the experience of private and

client ownership of MFIs has not proved to be effect in ensuring effective governance and performance.

## **5.2 The dual mission: Balancing the social and financial objectives**

With the exception of one MFI (namely Agar MFI), all microfinance institutions in Ethiopia have both the dual mission, reaching large number of poor clients while generating profits (financial sustainability). Boards are expected to play a key role in assuring that these MFIs are responding adequately to both of these objectives. Ideally those MFIs trying to strike the balance should have board members who can themselves represent the necessary balance. Another option is to have a balanced number of board members representing the financial objective (bankers and business persons) and social objective (development and social workers or community leaders). An effective board should design strategic policies where the MFI is profitable at the same time reach large number of poor households. The issue of balancing the social and financial objectives has created a heated debate and misunderstanding between the managing directors, who push for financial sustainability and the board members who focus on social objectives.

## **5.3 Fiduciary responsibilities of MFIs**

The fiduciary responsibility of the board of any financial intermediary, in general, is considered greater for other corporate entities (Otero M 2001). Protecting financial institutions and hence the financial system is a high priority for governments. Without solvent financial institutions, business, commerce and the economy become dysfunctional (Otero M 2001). Moreover, liquidity is essential for the development of a financial institution and requires more stringent internal controls than non-financial entities. In the absence of deposit insurance, as is the case in Ethiopia, the fiduciary responsibility of the board of an MFI should be seriously considered. On top of maintaining the solvency of an MFI, the board has several additional issues to consider which relate to its fiduciary responsibility.

Oversight of the fiduciary responsibility of MFIs in Ethiopia by board members significantly minimizes the insolvency of an MFI. For example, if ACSI in Amhara region is insolvent, it means that it will deny financial access to more than 600,000 clients in the region. This will have also a negative impact on the development of the entire microfinance industry. Thus, since all Ethiopian MFIs are deposit taking (from the public), delivering financial services to agricultural sector with huge covariant risk and borrowing from RUFIP and commercial banks, the boards of MFIs should take extra measures to ensure the fiduciary responsibilities of MFIs.

## **5.4 Transformation of MFIs**

One of the main objectives of transformation is to upgrade MFIs so that they increase their capacity and reach large number of clients on a sustainable basis. This has two components, namely growth and qualitative transformation. It is important that MFIs grow rapidly in order to expand the scope of their operations and acquire expertise in lending, thus allowing them to reduce their costs to the extent that they become acceptable to pass them on, in full, to borrowers. Transformation partly refers to changes in the legal status of MFIs (say from an MFI to rural bank or from NGO to licensed depositing MFI), or changes in the relationship between an MFI and the mother NGOs, or changes in the internal structure, as well as the kinds of financial services, which they offer to clients. The major factors that need to be addressed in building the institutional capacity of MFIs in the process of transformation include good governance, developing systems, training the staff and developing new products. The transformation-related governance issues include working with a strict regulatory framework, involving in international banking, raising equity funding, managing exponential growth, financial restructuring, training and retraining the staff, revisiting the mission and vision, etc.

## **5.5 Risk assessment in MFIs**

The provision of financial services in general has an associated set of risks that the board of directors must be able to assess in its fiduciary role. Risk management is a dynamic process, in which an MFI regularly evaluates the effectiveness of its policies and procedures in controlling risks and makes adjustments as necessary. The significant growth of MFIs, the existence of huge uncollateralized loans, mobilization of savings from the public and weak MIS in Ethiopia require a greater ability on the part of the board and management to identify, assess and prioritizing risks; develop strategies to measure risks; design policies and procedures to mitigate risks; implement controls into operations and assign responsibilities; test effectiveness and evaluate results; and revise policies and procedures as necessary.

The risks of MFIs fall into four categories: financial, operational, business and event risks. The financial risks, such as liquidity, credit, solvency, interest rate, and currency risks, can result in loss of an MFI, if they are not properly managed. Operational risks are related to an MFI's overall organization and functioning of internal systems, including computer-related and other technology related risk; risks related with non-compliance with policies and procedures of an MFI; and fraud risk. Business risks are associated with an MFI's business environment, including macroeconomic and policy concerns, legal and regulatory factors, and the overall financial sector infrastructure and payment system. Event risks comprise political, financial sector crisis and other exogenous risks which could

jeopardize an MFI's operations or undermine its financial condition and capital adequacy.

MFIs in Ethiopia face many risks that threaten their operational and financial sustainability. These risks come from external environment and internal operations of MFIs. All MFIs Ethiopia have given very little attention to identify and manage these risks. However, the regulatory framework in Ethiopia have provided a clear directives which focus on financial risk management by introducing strict licensing and minimum capital requirements; capital adequacy rules; fiduciary responsibilities and standards regarding owners, directors and executive managers of MFIs; providing guidelines on risk management and related policies; statutory guidelines with respect to risk positions, etc. We believe that the board and management of MFIs in Ethiopia should consider risk management as their priority. Based on the experience of other countries, Anita Campion (2000) emphasized on the involvement of the board in managing the risks through the implementation of internal control system as follows: Those MFIs that do address internal control often delegate this responsibility to management. For example, many MFIs have their internal audit department report solely to upper management, rather than directly to the board. Without a sufficient level of independence, internal auditors cannot conduct an objective review of the entire MFI's operations. If the internal audit department answers only to management, MFI boards may not receive a thorough assessment of internal controls beyond the branch level of operations, or they may receive information that is tailored to management's agenda. Nonetheless, not all internal audit departments have the professional expertise to report directly to the board and may require senior management to consolidate reports and present findings to the board. But for the internal control process to be effective, board members should play an active role in reviewing internal control reports and ensuring proper and timely management responses to control issues.

## **VI. Challenges of effective governance of MFIs**

The prudential regulation in Ethiopia has been successful in providing a clear guide to implement effective governance of MFIs. Although this has contributed to improvement of governance of MFIs, governance is still a major issue of MFIs. The major challenges include:

- (a) Many of the board members of MFIs are not formal owners with any capital investment to lose. They are not real investors in the sense of risking capital and earning dividends. That is, there is very limited private capital investment in the MFIs. This implies that, MFIs are currently unattractive investment opportunities to private equity investors. The nominal shareholders may not have sufficient interest and commitment to control and guide the management of MFIs. Yet again, they may not be willing to provide capital quickly whenever the MFIs are in crisis. This is the real challenge for MFIs in Ethiopia.

- (b) In some of the NGO initiated MFIs, the mission and vision of mother-NGOs influence the decisions of the board of the MFIs. After all, the board members of these MFIs are mainly employees of the NGOs, a situation that makes the relationship between the two (the mother NGO or the MFI) undefined.
- (c) In some of the MFIs, regular board meetings do not take place which implies that these boards are inactive boards, placing huge responsibility on management. According to the study by Itana et al., (2003), there are no regular board meetings and self-evaluation of boards in many of the MFIs. Mekonen (2007) reported that 75% of the boards had 4 meetings in a year.
- (d) The competency of some board members in terms of diversified skills and effectiveness in guiding the managers of MFIs is questionable. The study of Itana et al., (2003) reveals that board members have limited knowledge and capacity to support management and monitor the performance of MFIs. Majority of the board members have training in finance and accounting (Mekonen 2007).
- (e) Some board members are very busy to spare enough time and contribute to the effective governance of MFIs (Muluneh 2008). About 50% and 65% of the boards of MFIs provided effective decision making and effective leadership of the MFIs respectively (Mekonen 2007).
- (f) Regular assessment and evaluation of the board and the management team has been rarely practiced which affected the effective governance of MFIs.
- (g) Many of the boards of MFIs did not have well-defined performance indicators to measure the effectiveness of management
- (h) Although many of the MFIs in Ethiopia are established as private share companies, dividends are not distributed to shareholders. The entire resources (dividends) are to be utilized for the benefit of the target group, i.e., the poor. (See Itana Ayana, et al, 2003).
- (i) Conflict of interest is a serious issue among board members of MFIs. Mekonen indicated that 75 % of the board members had conflict of interest.
- (j) The structure of ownership and governance makes the role of regulators much difficult in the microfinance industry compared with commercial banks, i.e., the board members of MFIs will not observe seriously the management and performance of MFIs compared with business investors.

- (k) The owners of the larger government supported MFIs in Ethiopia are not clear. It was difficult to find true owners of some MFIs, such as SFPI, which were initially established with the support of NGOs/donors and, at a later stage, the mother NGOs or donor disappears from the scene. Moreover, the experience Gasha MFI which introduced client ownership was not a success story.
- (l) The experience of Ethiopian MFI, even the successful MFIs in Bangladesh, indicates that success in MFIs depends on key persons, usually the managing directors and board chairpersons. Many of the MFIs do not have fixed term for replacing board chairpersons and held the position since inception. Depending on one person and lack of a succession plan are critical issues that should be address in the immediate future.
- (m)With the exception few MFIs, boards of MFIs do not have board committees (such as audit and finance committee, human resource committee, fundraising committee, etc) to properly address specific issues of MFIs. Mekonen (2007) reports that only 25% of the MFIs have various committees. There are no technical advisory committees to provide technical advice to the boards of MFIs.
- (n) The documentations and reports of MFIs are poorly organized, which is partly the result of weak management information system. There is compliant from regulators that MFIs do not submit reports on time (Muluneh 2008).
- (o) The NBE has limited capacity to enforce prudential regulation. Currently although the cost of supervision of MFIs is not a serious problem of the NBE, the cost will eventually increase significantly, at times higher than the cost of supervising commercial banks and insurance companies, if the central bank attempts to strictly implement prudential regulation and the number of MFIs increases.

## **VII. Conclusions**

Effective governance in Ethiopia is a prerequisite for growth, improve performance and sustainability and managing the risks which requires effective prudential regulation, developed systems and procedures, and sufficiently empowered board and management to discharge its duties and responsibilities. Compared with commercial banks, MFIs in Ethiopia face unique operational risks such as ownership and governance risk, the risk of political interference, donor and NGO interference, over emphasis on social objectives, weak MIS and internal control increasing management risk, absence of property collateral

increasing portfolio risk and lack of adequate professional experience which makes prudential regulation of the NBE challenging. This will require the MFIs to implement a unique governance and management. The prudential regulation in Ethiopia has given MFIs the basic guidelines to ensure effective governance. However, there is a need to build the capacity of NBE to implement the regulatory framework and enforce the accountability of the board and management of MFIs. We believe that the prudential norms and regulatory framework should be regularly reviewed to fit the dynamic growth of MFIs and improve governance.

The issue of good governance in the Ethiopian MFIs is a serious issue which needs to be addressed immediately. With the exception of one MFI, the shareholders are not real shareholders who share the benefits of the operation of an MFI. The issues of accountability and fiduciary responsibility the board and management of MFIs are questionable. MFIs in Ethiopia are not interested in selling shares and attracting other shareholders which could increase the possibility of improving governance. Since board members are predominately NGO staff or government employees, there is a tendency to promote and share the vision and mission of the mother-NGOs and government development interventions and limiting their independence. The board an MFI should have a well-defined performance indicators and system to communicate its expectation from the management. There has to be a trust between the management and the board. Effective governance also requires constant interaction of the board with management on detailed review of financial statements, annual performance reports, external and internal audit reports, etc.

Regulators and shareholders should assess the status of governance of MFIs in Ethiopia. The regulatory framework should be revised to address the critical issues of governance of MFIs. There is a need to develop an industry wide code of governance of MFIs to which every MFI should be required to subscribe and comply. There is a need for a detailed research on the impact of governance on outreach, performance and sustainability of MFIs.

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### Annex1:Outreach of MFIs in Ethiopia as of December 31, 2007

	Name	No of Active client	loan outstanding	Client Savings	Total asset	Total liability	Total Capital
1	ACSI	597,723	1,016,337,000	565,522,000	1,275,581,000	960,442,000	315,139,000
2	ADCSI	79,421	220,085,000	54,442,000	259,574,000	82,248,000	177,326,000
3	Aggar	2,056	4,005,882	1,757,722	6,288,753	3,151,151	3,137,602
4	AVFS	9,267	9,603,572	2,464,971	14,585,395	5,636,630	8,948,765
5	Benshangul	24,339	25,458,250	8,671,626	39,636,058	19,677,747	19,958,311
6	Bussa Gonofa	30,519	21,288,464	4,331,767	26,850,220	15,320,657	11,529,563
7	DECSI	425,172	1,060,336,423	289,742,247	1,540,322,287	1,239,516,568	300,805,719
8	Dire	5,126	10,107,635	2,193,642	27,697,454	10,311,476	17,385,978
9	Digafe	698	755,180	583,780	878,150	619,870	258,280
10	Eshet	28,315	34,580,858	4,624,999	39,320,484	27,769,905	11,550,579
11	Gasha	9,424	14,394,215	4,777,282	19,008,473	14,497,040	4,511,433
12	Ghion	233	286,268	311,112	492,236	319,805	172,431
13	Harbu	7,125	5,849,162	3,114,529	8,055,095	5,819,423	2,235,672
14	Letta	313	473,253	57,619	738,003	60,973	677,030
15	Meket	599	2,270,961	374,481	3,084,860	937,233	2,147,627
16	Meklit	12,728	16,484,534	5,308,693	17,803,569	12,816,778	4,986,791
17	Metemamen	10,811	6,564,000	1,577,000	9,316,000	1,681,000	7,635,000
18	Ocssco	263,971	430,547,020	139,229,781	533,632,419	375,605,864	158,026,555
19	Omo	120,277	135,418,534	35,757,852	178,958,567	157,703,600	21,254,967
20	PEACE	19,471	31,987,816	7,772,522	37,414,071	25,831,935	11,582,136
21	SFPI	25,397	27,401,990	11,924,241	33,910,051	19,701,392	14,208,659
22	Shashimene	1,924	2,559,842	626,965	4,028,149	768,374	3,259,775
23	Sidama	26,567	17,932,215	4,852,850	25,208,115	12,610,624	12,597,491
24	Wasasa	30,147	28,131,754	9,030,043	38,001,858	26,934,593	11,067,265
25	Wisdom	48,185	63,544,438	16,392,445	73,582,041	49,759,167	23,822,874

26	Harar	555	3,116,851	958,234	7,362,023	594,584	6,767,439
	Total	1,780,363	3,189,521,117	1,176,400,403	4,221,329,331	3,070,336,389	1,150,992,942

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<sup>i</sup> (i) Rubber stamp board represents a board of directors that is generally reactive in its relationship with management. Management tends to present strategic thinking as well as plans and decisions to the board merely for its official approval.

(ii) Representational board includes influential and well-respected persons who provide important visibility for the institution and give it a level of credibility it would not otherwise have. This board type depends heavily on management to play a key role in strategic and operational decisions.

(iii) Hands-on board consist of members who offer strong expertise and are actively involved in defining and monitoring the activities of the institution. Directors are kept informed of the ongoing operations and issues of the institution, are well prepared for meetings, and play a proactive role in overseeing the management of the institution.

(iv) Multi-type board combines the representational and bands-on boards where the former provides the role of visibility and stature, whereas the latter provides useful input to strategic decisions facing the institution and , to some extent, specific operational issues.