

## Article

# Sustainable rural finance: Prospects, challenges and implications

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**Market failures in rural finance and related issues of adverse selection, moral hazard, and transaction costs justify targeted interventions to ensure that services reach the poor and the un-banked sustainably. Service providers aiming at sustainability cannot rely on donor money and instead they have to generate their own operational income from provision of efficient services and setting the price for their services appropriately. However, while there is a general consensus on the 'components' that should go into the computation of interest rate to be charged by a micro-credit service provider (particularly those aiming to achieve the 'double-bottom-line' objective), the 'level' under each component is left to be fixed by each actor. This gives rise to various applications, which often is a cause for high level controversies among stakeholders in rural development, some justified while others not. Un-happy with these kinds of applications, some donors, NGOs, etc sought to establish a new model of service provision that aim at reaching and 'benefiting' the poor. Most of such efforts, often run by non-finance professionals, have the un-intended and/or undesirable effect of distorting the financial markets, 'crowding-out' the operations of sustainable microfinance operations as well as damaging the playing field for the private sector in general. While there cannot be a hard and fast rule regarding how a rural financial service should be run, there is clear room for supervisory bodies, the government and other key stakeholders to rectify most of the problems arising in this area. "..... Sustainable development is development that meets the needs of the present without compromising the ability of future generations to meet their own needs...." (Todaro, 1997).**

**Keywords:** Microfinance, sustainability, credit interest rate, transparency

## INTRODUCTION

Ethiopia is still one of the poorest countries in the world. Currently, nearly 40% of the population cannot afford the minimum consumption for survival (the 2200 calories, recommended by the World Health Organisation) (This minimum consumption is estimated in Ethiopia to cost only about \$10 per month/adult. One should therefore note that the poverty rate would be even higher if one considers the \$30 poverty line (in other words, the 'dollar a day' convention) set by the World Bank). There are variations in the poverty rate between regions: some have a substantially higher rate than indicated by this average figure.

The Government has adopted several economic reforms to address poverty in its every aspect. Thus, while on the one hand trying to fulfil the basic needs of the population, it also embarked upon economic measures conducive to free market competition and employment creation. This includes the promotion of policies that will

encourage savings, private investment, increasing income generating opportunities and promotion of small-scale industries in the informal sector, among others. The Government's Rural Development Strategy, the Poverty Reduction Strategy Paper (PRSP), including the most recent "Plan for Accelerated and Sustainable Development Programme (PASDEP) and other documents emphasise, among other things, microfinance as a good entry point in achieving development objectives as well as curbing the dangerous trend in poverty and meeting the United Nation's Millennium Development Goals (MDGs). (Honohan (2004) graphically illustrated that there is a negative correlation between monetary depth (M2/GDP) and poverty. Indeed, for an important subset of poor countries in Africa, "Poverty Gap" (that is, the minimum aggregate amount, expressed as a percentage of GDP which, if appropriately distributed, would bring all people up to the poverty line) is very large.

For these countries, achieving greater financial depth seems particularly important if the *poverty* gap is to be closed. These countries include: Burkina Faso, Burundi, Cameroon, Central African Republic, Ethiopia, The Gambia, Ghana, Lesotho, Madagascar, Malawi, Mauritania, Nicaragua, Niger, Sierra Leone, Uganda and Zambia).

Policies and regulatory frameworks were, therefore, set to that effect. Thus, formal microfinance in Ethiopia started in 1994/5. In particular, the Licensing and Supervision of Microfinance Institution Proclamation No. 40/1996 encouraged the spread of Microfinance Institutions (MFIs) in both rural and urban areas as it authorized them to, among other things, legally accept deposits from the general public (hence diversify sources of funds), draw and accept drafts, and manage funds for the micro financing business (Article 3). Currently, there are 27 licensed MFIs reaching about 1.7 million credit clients and some more saving clients (AEMFI, 2007). This can be considered quite rapid growth by any standard. Yet, considering the potential demand particularly in rural areas, this only satisfies an insignificant proportion. The Association of Ethiopian Microfinance Institution (AEMFI) once estimated that in-order to satisfy the microfinance demand in Ethiopia, we need about 300 MFIs.

The poor need sustainable access to financial services to be out of poverty. So before dealing further on the issue of 'sustainability', it would be prudent to investigate first the key issues that limit the expansion of the service. Why is there still low financial intermediation in Ethiopia, particularly in rural areas? Main reason is that like in many other poor countries, the Ethiopian context also manifests structural problems of market failures and absence of markets as well as low attention to research and innovation to alleviate such problems. So the following paragraphs will highlight on these ever-present challenges in expanding financial services, as they apply in developing countries, as well as in Ethiopia.

### Market failure

According to basic economic theory, credit can be traded through competitive markets where supply and demand forces interact like any other tradable goods. In the absence of externalities, and if these markets are left to operate freely, competitive markets tend to reach a state of equilibrium (Garson, 1999). But credit is a special good because it requires repayment, and repayment is not always made by borrowers. There always exists asymmetric information between lenders and borrowers which creates problems of adverse selection and moral hazard (The main features of credit market is a contract between two parties whereby one gets money for an exchange of promise to repay the principal and interest at an agreed date in the future. *Asymmetric information* exists when the two parties to a contract do not have the same information. Moral hazard is a situation under which one party to a contract could engage in opportunistic behaviour

because of asymmetric information) -- the classic principal-agent problem (Yaron, 2005). However, when loans are relatively sizable, borrowers can usually offer traditional collateral that can conveniently be repossessed in a case of default. Also, when individuals' credit history can be easily and cheaply presented and the legal, judicial and enforcement (In environments with weak public institutions, contract writing and enforcement is difficult and publicly available information scarce. As a result, agency problems tend to be mitigated through arrangements between private parties that rely heavily on *personalized relationships*, *fixed* (preferably real asset) *collateral*, and *group monitoring*. Relationship finance mitigates agency problem through contractual arrangements between private parties that raise the reputation costs of non-compliance and hence foster loyalty. The threat of violence and resort to physical intimidation and punishment are also commonly observed devices -- especially used by loan sharks -- to deal with agency problems in financially underdeveloped markets... In these arrangements, to use North's (1990) words, "parties... have a great deal of knowledge of each other and are involved in repeated dealings... [so that] it simply pays to live up to the agreements (Honohan, 2004)) function effectively, as is the case in most developed countries, the problem of the asymmetric information on the volume and cost of financial intermediation can be effectively mitigated. In contrast, in many developing countries in general, and in poorer ones in particular, most of the instruments that can mitigate asymmetric information do not exist or perform poorly (Thus, even if markets existed and are left free, supply and demand forces in these markets may meet but do not reach equilibrium. That is, banks limit the supply of credit (hence, credit rationing) because (where borrowers limit the information on their activity for fear of not getting new loans) they cannot rely upon the price mechanisms to do its normal market-clearing function. The true "market-determined" (market clearing) price of loans would be high (particularly where capital is scarce), and at high interest rates, only *risk-taking* entrepreneurs, with projects presumed to have *very high rates of return*, would be attracted, which prevents the exploitation of socially valuable opportunities for income expansion (Gonzalez-Vega, 1998)).

### Absence of markets

Yet, in rural areas of developing countries, the "market failure" paradigm simply cannot be applied because in many areas there is no (formal) market at all: supply and demand cannot meet. Supply is weak or missing -- very few banks and other financial providers operate. There is little lending activity and no savings mobilization, mainly due to the high transaction cost involved. For many other reasons e.g. accessibility -- hence transaction cost for the other party, cultural specificities (As we shall see later, 'absorptive capacity' of individual projects is very weak.

Women often do not engage in micro-enterprise activities. In some localities, Muslims do not take credit or save in banks or MFIs, because paying or receiving 'interest' is forbidden by their religion (or considered to be *Haram*), etc., there is little or no explicit demand (A *lack of access and problem of access* are two different things. A lack of access is simply the fact that financial services are not being used. But this may reflect either supply or demand factors. For example, households and firms may be observed not to use credit simply because they may not need to borrow (either because they lack viable investment projects or because they find it beneficial to use internal funds to finance their investments. A problem of access to credit exists when a project that would be internally financed if resources were available, does not get external financing (from outside financiers). This happens because there is a wedge between the expected internal rate of return of the project (that is generated by the project's fundamentals) and the rate of return that external investors require to finance it. This wedge is mainly introduced by two well known constraints that hamper the ability to write and enforce financial contracts, namely, principal-agent problems and transaction costs (Honohan, 2004)) for financial services (from formal markets). All sorts of financial transactions are concluded at the village level. Money is borrowed or lent by individuals and households, hoarded or saved at home, in Rotating Savings and Credit Associations (the *Equb* system), social insurance systems (such as *Iddirs*), etc (For an excellent narration of informal financial systems in Ethiopia, see Aredo (1993). For an overall review, see Kropp et al. (1989), or the individual money lender (the *Arata Abedari*).

The problem is further exacerbated in poor countries like Ethiopia because of low attention accorded to innovation in new methodologies. Such innovation in new methodologies and information is fundamentally a public-good, in the sense that it is non-rival in consumption (the consumption of the good by one individual does not detract from that of another individual) and non-excludable (it is very costly to exclude anyone from enjoying the good). Such goods are undersupplied in a competitive equilibrium. Thus, financial intermediaries in poor countries like Ethiopia, on top of their weak capacity, have low incentive for investing on such innovations since while they will bear all the costs on such efforts, it is often difficult to prevent others who will NOT share the research cost from adopting the new technology once it has proven successful.. Absence of alternative methodologies further limit outreach financial services. [The logic behind the government role in innovations on new financial methodologies with a view to sustainably expanding outreach to the poor (Fernando, 2006) is presented in the ANNEX 1 (Figure 1)].

Yet, while outreach is by far lower than potential demand, the sustainability of the service has proved challenging and often controversial. Sustainability can be re-

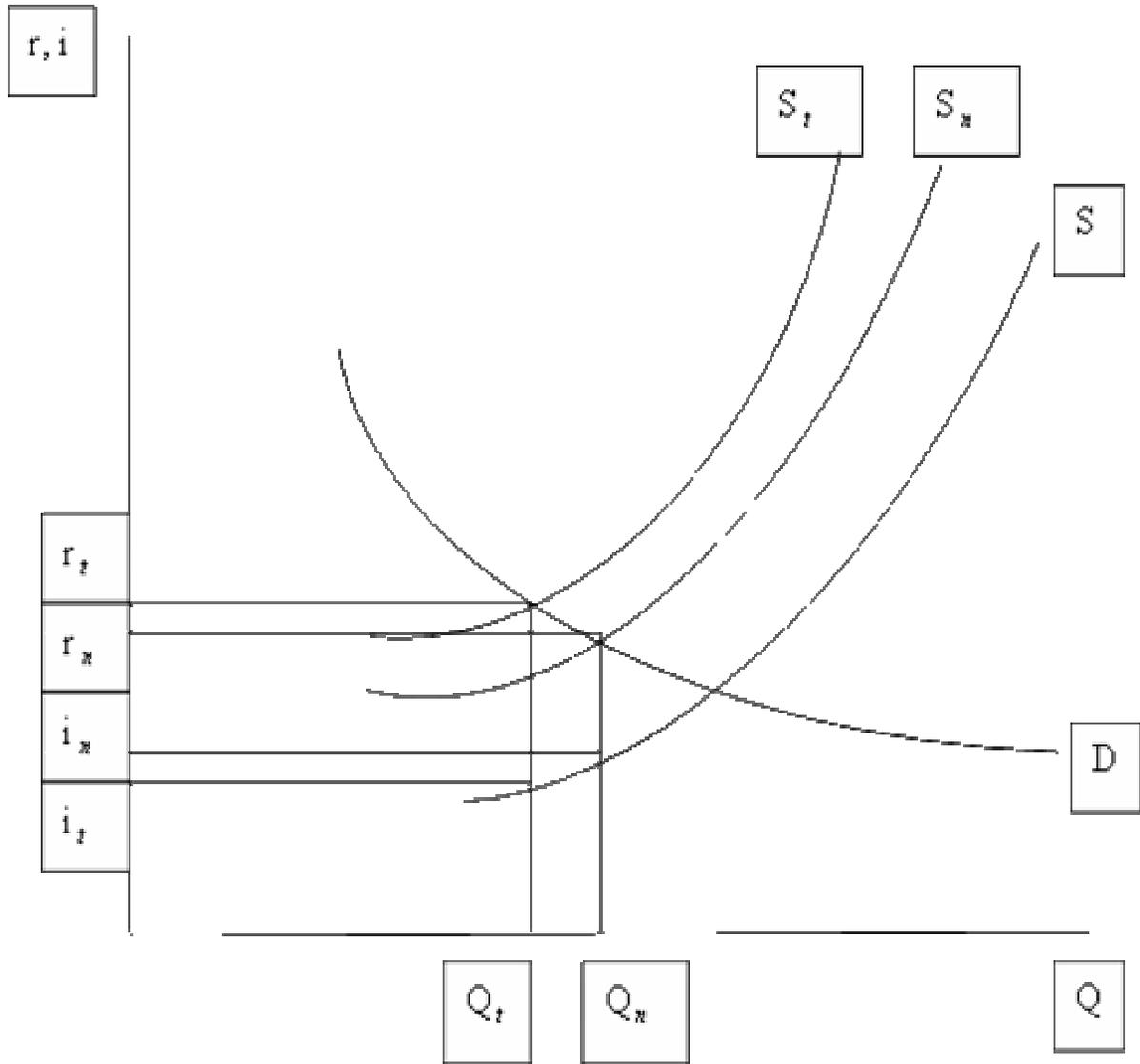
lated to wider issues. A micro-financial program, whether formal or informal, is said to be sustainable if it can pursue its activities and provide the required services in a "continuous" and objective oriented manner (Garson, 1999). Sustainability is therefore a primary issue for successful micro finance services. In seeking to achieve sustainability in financial intermediation and financial market development, consideration has to be given to the sustainability of the lender, the intermediate institution, the depositor, the borrower and the sector as a whole. If borrowers become chronically indebted, nothing else can be sustained. If savings cannot be mobilized on a consistent and continuing basis, there will not be resources to lend. If the lenders do not recover all the money they lend, they will soon cease to exist. If a financial intermediary cannot fully recover the cost of mobilizing resources (money cost -- interest paid to depositors, plus administrative costs of intermediation), the institution will soon have to shut its doors.

However, in this paper, emphasis will be given to 'institutional sustainability' which comes first if the service is to be available in the first place. Thus, the paper will try to explore factors affecting institutional sustainability focussing on microcredit interest rate, which not only plays a pivotal role in determining institutional sustainability, but also reflects on other dimensions of institutional efficiency. The key issue is that while there is a general consensus on the 'components' that should go into the computation of interest rate to be charged by a microcredit service provider, the 'level' under each component is left to be fixed by each actor. This gives rise to various applications, which often is a cause for high level controversies. Clarity and 'consensus' around this very issue will help practitioners, supervisors, government, donors, NGOs, and other stakeholders to identify those practitioners which are on the right track in pursuing this desirable objective, galvanize support towards them, as well as monitor and evaluate their progress. It will specifically explore the Ethiopian context, but reference will also be made to experiences in other similarly poor countries that also face more or less same challenge.

So, the next part will assess key elements in setting the microcredit interest rate for sustainable financial intermediation. The third chapter will highlight on the various proposals put forward towards 'certification' of practitioners in the industry. The fourth will address key challenges in establishing sustainable financial services in rural areas. And the final chapter will provide some conclusions and recommendations.

### **Setting microcredit interest rate for institutional sustainability**

As outlined above, sustainability is a primary issue for successful micro finance services. Establishing a system of sustained provision of modern financial services has, however, been challenging and most controversial. The



**Figure 1.** Impact of Operating Costs on the Supply of and Demand for Microcredit. Key: Horizontal axis measures the quantity of lending or borrowing per unit of time. Vertical axis measures the interest rate ( $r$ ) borrowers pay and gross return ( $i$ ) lenders receive. The economy’s demand for microcredit is shown by the demand curve,  $D$ . The industry’s supply of microcredit, if there were no lender operating costs, is shown by the supply curve,  $S$ .  $S_t$  is the industry’s supply of curve of microcredit with operating costs.

At this initial level of operating costs, borrowers pay an interest rate of  $r$  and the lenders’ gross return after deducting operating cost is  $i$ . The quantity borrowed (lent) is  $Q$ . Now assume that lender operating costs are reduced through some innovations and improvements in financial infrastructure. And this shifts the supply curve to  $S_n$ . Now the amount of microcredit lent (the amount of microcredit borrowed) increases from  $Q_t$  to  $Q_n$  and the gross return to lenders increases from  $i_t$  to  $i_n$ . And the interest rate to borrowers declines from  $r_t$  to  $r_n$ . Source: Fernando, A. Nimal (2006): Understanding and Dealing with High Interest Rates on Microcredit, A Note to Policy Makers in the Asia and Pacific Regions, Asian Development Bank.

sustainability of financial intermediation obviously depends on the operational locations, the infrastructure, the economic conditions, the technology level, the credit culture of the society, the efficiency of the Institution, etc. These all are reflected in the amount of interest that needs to be charged from credit clients as well as the one that can be paid to depositors. This chapter assesses the

different factors that go into setting the ‘desirable’ level of microcredit interest that can sustain the provision financial services in poorer areas.

**Any lender has costs comprising four basic components which (should) determine the interest rate charged: a) Cost of funds, b) Operating or processing**

**costs, c) Cost of risk or loan losses, d) Net income, surplus or profit**

**The cost of fund**

The cost of funds is usually a composite figure as any lender is likely to be utilising funds from a variety of sources that have been obtained at different rates. For example, many NGO-MFIs will have donor capital that has been provided in the form of a grant. They will also, hopefully, have built up some surplus income or equity from their own operations. Whilst there is no interest as such to be charged on these two sources of equity, account should be taken of the rate of inflation in order to maintain its 'real' value. In some cases an MFI will have funds from a foundation or trust which has provided 'patient capital' at say, 3-5% (if this is required to be repaid in any currency other than local currency, eg US\$, then provision should be made for the possible depreciation of the local currency against the \$). Apparently, 'generosity' from the donors' side is dwindling by the days, and MFIs who are planning to reach the vast number of poor in their localities can no longer count on such grants and soft loans. The other main source can be domestic saving mobilization, if that is allowed in the country. Few MFIs are entering into this operation, and if and when they do, they have a serious capacity problem. For example, the best sources for saving mobilization by MFIs may be rural clients -- with very small savings, which are difficult to efficiently manage (because transaction costs would be higher) unless there is a huge capacity development. Finally there will be loans from lending institutions, notably the commercial banks. The average cost of funds depends therefore both on what proportion of an MFI's resources come from all these different sources, and also what rates of interest are being paid (or should be charged) on each source (This average figure varies enormously. In the case of most Bangladesh and similar countries, it is usually in the range 5-10% (Wright et al., 2004)).

**Operating costs**

Operating costs are relatively straightforward, and represent an important portion in the cost structure of the microfinance service. According to a recent study of 1003 MFIs in 84 countries by the Microfinance Information Exchange, Inc in 2006, operating expenses (both personnel and administrative) represented 62 percent of charges to borrowers, financial expenses 23%, profits 10 percent, and losses from defaults 5% (Gonzalez, 2007). They include the costs of: staff identifying clients, checking their creditworthiness, processing loan applications, disbursing loans, monitoring and collecting repayments, and following up non-repayments. In addition there are also all the overheads in running any operation: the costs of the space occupied, communications, transport, support

staff, auditors, etc, etc. However, the % cost of lending will vary enormously depending on a number of factors, notably: (i) the size of the actual loans; (ii) pay structure, notably of the loan officers; (iii) the efficiency of the organisation, the number of borrowers/loan officer often being taken as a good indicator; and (iv) its scale of operations.

The loan size is the primary reason why the processing costs of micro-loans to poor customers are so much higher than the costs of much larger loans made by commercial banks to their business clients. Delivering low value financial transactions (credit and savings) entail relatively high fixed cost per \$ outstanding of credit or savings. In other words, costs are relatively flat at different levels of loan size -- it costs nearly as much to give a \$100 loan as to give a \$1000 loan. This is the most common reason why so many observers of the micro-finance sector cannot understand why MFIs have to charge a higher rate of interest than commercial banks.

The pay\_structure of the Institution is very important in determining the credit interest to be charged. This is important because labour cost constitutes a significant portion of total operational cost. Analysts usually compare loan size with per-capita national income to shed light on two separate issues: client poverty and administrative cost of lending. In terms of clients poverty, the logic is that the lower the loan size compared to the country's per-capita national income, the more likely is that the MFI is reaching the poor (The definition of the 'low-end', however, vary. The MicroBanking Bulletin's definition of institutions reaching the low-end of the population includes those with an average loan size of less than 20% of GNP per capita or less than \$150. The median is 43.5% for MFIs globally (Rosenberg, 2007)). On the other hand, comparing loan size with per-capita national income (or other variables like the 'Minimum Wage Rate') can shed light on 'administrative costs', since the latter in most cases is the only available proxy -- albeit a rough one -- for labour costs across countries. Hiring a loan officer costs much more in Mexico than it does in Bangladesh, so the administrative cost associated with processing a \$100 loan will be much higher in Mexico than in Bangladesh. Comparison of MFI costs and efficiency between countries would be grossly distorted without some adjustment to reflect the difference in the cost of labour and other locally produced inputs (Rosenberg, 2007).

The efficiency of the\_organization depends on many factors, which can broadly be categorized into two -- internal and external.

**Internal facilities**

Staff efficiency could be substantially enhanced through automating the MIS, as well as introducing different technologies such as the ATM, availing transport facility (e.g. motor-bicycles), innovation in products, staff incentives, etc. Many of these require resources and capacity. But recently, many MFIs are increasingly introducing dif-

ferent varieties of 'staff incentive' schemes that motivate staff for great achievements in loan disbursement, outreach, reaching the poorest, efficiency, etc, while keeping operating costs low. These include direct monetary benefits, bonuses, promotion, etc., as well as enhancing some moral-building up mechanisms. For example, some organizations in Asia have been successful in making staffs feel that they belong to a special kind of culture, peculiarly committed to serving the poor, and in this they both reflect and are helped by microfinance's historic evolution out of socially-committed private development agencies (Morduch and Rutherford, 2003).

The external environment, especially the location, geography, infrastructure, the economic situation, working culture, etc have a huge impact on institutional efficiency. Most critical is the limited and costly access to services caused by long distance from farming households to a financial institution's branch, particularly in low population density areas and dispersed geographical set up [A model indicating how loan size and population density determine the 'frontiers' of rural finance is given on ANNEX 2 (Figure 2)]. This greatly enhances operational costs. Indeed, the available evidence indicates that most successful early starter MFIs like Bank Rakyat Indonesia (BRI) and Gra-meen Bank operate in countries like Indonesia and Bangladesh where the population density averages between 700-900 people per square kilo-meter, which sharply contrasts with Sub-Saharan Africa and Latin American case which is fewer than 10 people per square kilo-meter (CGAP, 2004).

Underdevelopment of rural infrastructure (physical and human) is yet another challenge. The inadequate rural infrastructure has direct and indirect adverse impact on the level and cost of financial intermediation. It directly increases the cost of financial intermediation to both clients and financial institutions as a result of poor performing roads, electricity, telecommunication and security systems that increase the cost and risk associated with lending to farming households and servicing their savings. Urban-biased development approaches (Yaron, 2005) (There are well-known 'Eight

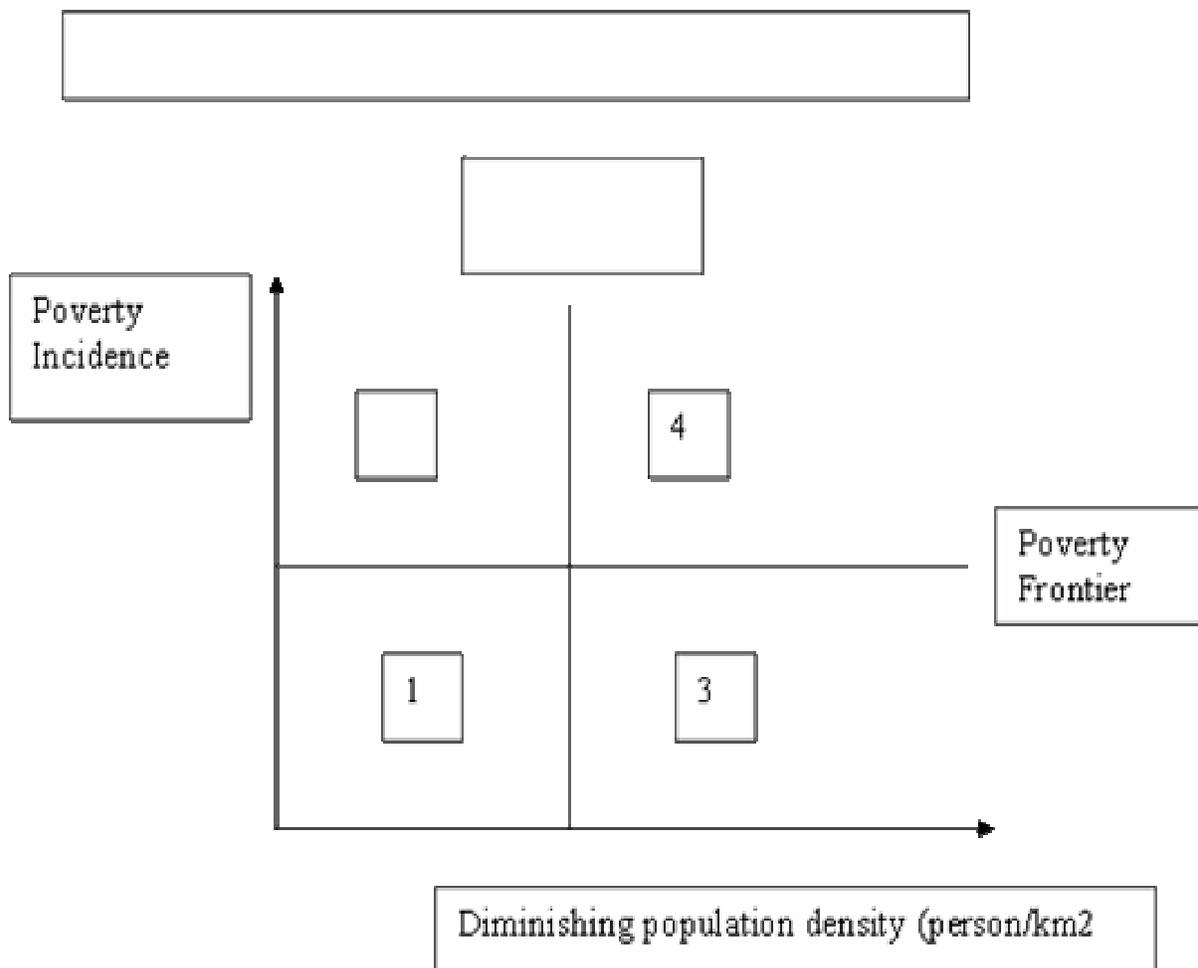
Pillars' of Urban-Biased Policies that impede Promotion of Rural Finance System. Economic development plans have historically been characterized by policies that were implemented in pursuit of accelerated industrial development. The following "eight pillars" of urban-biased policies have often hampered the development of rural communities and the ability of Rural Financial Institutions to become financially viable entities while serving clients (especially those involved in agriculture). 1) Overvalued exchange rates.; 2) Low, controlled and seasonally invariant prices for agricultural products; 3) High effective rates of protection for domestic industry, the output of which are used for agricultural inputs; 4) Disproportionately high budgetary allocations for urban over rural infrastructure (roads, electricity, and water supply); 5) Disproportionately high investment in human resources in

urban over rural areas (health and education); 6) Usury laws that rule out the loans typical in rural areas: small, risky, and high-cost loans; 7) Underdeveloped legal and regulatory provisions regarding land titling and collateral for typical rural assets (land, crops, and farm implements) relative to urban assets (cars, durables, and homes); and 8) Excessive taxes on agricultural exports (Yaron, 2005)), which characterise many developing countries, resulted in unfair distribution of infrastructure that is essential for development which benefits the majority. Those residing near cities and towns can access services (including finance) more cheaply than those in rural and remote areas. The logical argument should then be: who should be responsible for such urban-biased development plans and policies in the past – the MFI or the public/government or still the poor who happen to live there?

It also indirectly reduces the profitability, and increases the volatility of income, of agricultural operations, particularly with respect to rain-fed agriculture, thereby adversely affecting the farmers' debt service capacity. In such poorer areas, where the majority derive their livelihoods from small scale 'subsistence' agriculture, utilizing less than 1 ha of land, and engaged in age-old traditional agriculture little served with modern technology, the absorptive capacity of the business of individual clients is apparently very low. Skills in non-farm activities and the BDS support, markets, networking, etc, which are critical in the value-chain system are largely lacking. In some circumstances, even where such supports are available, one still has to remove the 'cultural-bias' against some otherwise profitable activities which people, even very poor people, do not like to take-up or enter into: e.g. blacksmithing, weaving, tannery, pottery, embroidery, etc. The problem of 'Aspiration Failure' (A more problematic issue is the '*low income perspective*' or '*aspiration failure*' that prevail among most dwellers in many rural areas, who after getting the additional ox or the 'subsistence' level of income that has been set as a target (construction of residential house of local standard, for example) most would stop asking for more loan or only take a small amount. In a detailed study, CHF (2007) reported a much more convincing findings of aspiration failure from a detailed qualitative and quantitative survey conducted in five biggest regions of Ethiopia (Tigray, Amhara, Oromia, South, and Afar) covering nine *Woredas* (districts), involving 144 households from each of the nine *Woredas*. The study strongly argues that due to 'satisfaction' (or 'happiness') with one's circumstances, and absence of 'role models' in the localities, there is a widespread occurrence of aspiration failure – individuals being unwilling to make pro-active investments to better their own lives. For example, a question was asked to respondents:

"... A banker came to you and offered to lend any amount of money you ask – How much would you ask for it if the loan was payable in one year, 5, 10 years? ..."

The response clearly comes out that the amount that



**Figure 2.** Defining frontiers of service delivery.

Defining frontiers for microfinance. In order to consider where the frontier of sustainable rural service delivery currently lies, this paper uses two dimensions to map coverage: population density and poverty incidence. Lower population density relates to high transactions costs on both the supply and demand sides. Higher poverty incidence implies smaller transaction sizes on the demand side.

For the purposes of sustainable financial service delivery, high population density areas with low poverty incidence (quadrant 1) present the most promising environments. Quadrant 2 offers high population density and higher poverty incidence, so that transactions costs related to distances are lower, but providers are likely to encounter lower transactions sizes and the weaker economic environment in such areas is also likely to make productive investments more risky. Quadrant 3 reflects areas of low population density but low poverty incidence: the service delivery problem here is also less severe if transactions sizes are high enough and risks sufficiently diversified, that is, through investments in a range of sectors including manufacturing, trade and services and not solely agriculture. Quadrant 4 reflects the most extreme cases of high poverty incidence and low population density, and hence the most challenging environment for service delivery. [Source: Johnson, Suzan, Markku Malkamaki, and Kuria Wanjau (2005): Tackling the 'frontiers' of microfinance in Kenya: the role for decentralized services. Decentralized Financial Services, Nairobi, Kenya.]

be borrowed remain relatively small, even for a 10-year would repayment period (Gobezie, 2007). Is the theory of 'Backward-bending Labour Supply Curve' at work? Can the award ceremonies for best 'role-model' farmers at the federal and regional levels in Ethiopia help solve this ever-present challenge?) has indeed been another real problem at many instances. Thus, even repeat clients, who have taken loans from MFIs for more than 10 years have scarcely increased the loan size taken.

This has been aggravated by some supply-driven approach to rural credit in the past many years. Often, long lasting lax approach to loan repayments of credit granted by state-owned financial institutions, as well as NGOs led to a wide perception that a loan is tantamount to a grant and that repayment is not a must. These 'give-and-forgive' credit projects undermine systematic, long-term efforts to strengthen the financial system. Loan clients have thus been conditioned to expect concessio-

sional terms for institutional credit. Under these circumstances, the incidence of moral hazard, and thus monitoring costs, is high.

### **Cost of risk of loan losses**

The cost of risk or loan losses may also vary considerably. Almost all lending institutions make a standard provision for loan losses at the time of disbursement -- it is usually 2% of disbursements. This goes into the loan loss reserve and at regular intervals the actual loan losses, and whatever proportion of poor-performing loans are judged to be irrecoverable, are written off against this reserve. A well managed institution which carefully selects and then closely monitors repayments by its customers will have to write off only a small proportion of its loans, say 1-2%. One which is poorly managed and/or lending to customers who either do not have the resources to repay their loans, or who refuse to do so, possibly for political reasons, will suffer much higher loan losses, say 10-30% pa. In the Ethiopian context, thanks to the comparatively good culture of high financial discipline in most Ethiopian cultures (usually NOT reported in MFIs performance!!) some may logically argue that the risk of default has indeed been comparatively very low for most MFIs. Indeed, given the high level financial discipline of Ethiopian society, particularly in rural areas, may be a readjustment of this 'standard' rate (downwards) is essential.

### **Net income, surplus or profit**

Finally, there is the net income or surplus, often misunderstood, especially if the word 'profit' is used. Generating some surplus income is essential for a number of reasons. First, all financial organisations must have some reserves against unforeseen contingencies and demands (which is why banking laws always specify a minimum capital adequacy ratio for any regulated financial institution). In similar manner, every NGO-MFI must be looking to generate a surplus in order to cover itself against various contingencies: natural disasters when customers in the affected area lose all their assets and therefore ability to repay; opening up a new line of credit for existing or new customers which is very unlikely to be wholly funded by donors, loans from banks, etc; unforeseen high loan losses not covered by the loan loss reserve; and losses which occur through internal fraud, embezzlement, etc.

Second, many NGO-MFIs may want to finance, at least in part, their social programmes, notably health and primary education. If sufficient net surplus can be generated from their microfinance operations, then this reduces their dependency on donor or government funds which have obvious benefits. Indeed many NGOs have initiated microfinance operations as a later activity, precisely in order to help fund their social programmes.

Third, it should also be noted, however, that in those

countries which have introduced legislation for MFI banks, there is another powerful reason for such MFIs to build up their equity base through retained earnings. This strengthens their capacity both to leverage that equity with bank loans and also, if the return on the equity is good, to attract additional equity. In both cases, the MFI can then expand its activities and serve a greater number of clients.

Fourth, when an MFI is looking to expand or improve its systems in pursuit of providing sustainable services as is often the case, then these costs (These costs may include: recruiting and training new staff, marketing the services of the MFI in the new areas, introducing improvements such as a new financial information system, new computers in field offices, constructing new offices, etc) have to be met from somewhere. Unless these costs are covered by a donor, or a grant, they have to be met from the accumulated surplus that an MFI has built up from the total interest rate paid by customers net of the costs. Expanding outreach to those who are still un-reached, as well as sustaining the service for future-generation poor is most desirable social objective. Indeed, more recent arguments on the contribution of microfinance on enhancing social welfare, focuses on the net increase in total 'social welfare' over and above the 'benefit to (private) customer' that result from consumption of financial services. The net social benefit is determined by the 'depth', 'breadth', and 'length' of outreach. Depth of outreach matters because society places greater value on helping the poor people than the better-off; breadth of outreach matters because society values helping more people than fewer people; finally, length of outreach matters, because society cares about the poor both now and in the future. Other things remaining equal, the greater the depth, breadth, and length of outreach, the greater the net social benefit (Woller and Schreiner, 2004). Thus, the ability to survive without looking for donations or other subsidies matter for sustainability – first, for the poor to get out of poverty, they require sustained micro-enterprise services like credit; (A World Bank study conducted in the early 1990's based on an intensive survey found that it takes about five years for Grameen Bank programme participants to rise above the poverty line income level and about eight years to reach a situation where they do not require loans from targeted credit programme (Hashemi, 1997)), second, the bulk of the poor people who are still out of the reach of any modern financial services needs to be reached; and finally, the 'future poor' need to be taken account of in any policy decision on (current) resource allocation. Thus the length of outreach matters very much. This requires ensuring both full repayment and profitability. The latter – profitability – is perhaps the most controversial issue in the industry.

More importantly, as indicated in previous chapters, while there is a general consensus on the 'components' that should go into the computation of interest rate to be charged by a micro-credit service provider, the 'level'

under each component -- hence the level of institutional 'profitability'-- is left to be fixed by each actor. In particular, given the few choices for alternative sources of finance for the poor in rural areas, and their weak bargaining power, there is a growing consensus that there should be a checking mechanism to monitor how service providers, working in diverse geographic and economic circumstances, are setting their micro-credit interest. We turn to this very issue in the following chapters.

### **Toward 'certification' of microfinance institutions: new proposals**

The argument in the micro-credit interest rate determination can be broadly divided into two major categories. On the one hand, there are some who maintain that we should not intervene in such 'market' transaction, and we should let the micro-credit clients to judge for themselves what is valuable service for them, and the interest that they are willing to pay. The second strongly argues that we need to act and take care of the poor clients, living in isolated areas, often dis-organized and therefore have weaker bargaining power, to voice out what is good for them.

#### **Clients' judgements**

The first proposal is to let the client value the service. Clients themselves obviously can judge that the loans are good for them and their household. Often they do so by flocking to the service in large numbers, often attracted by words of mouth from neighbours who are satisfied clients. Perhaps more importantly, they repay their loans repeatedly and faithfully, when there are few incentives to do so except a desire to maintain future access to a service the borrower think is useful to them.

Indeed, there are also increasing evidence that interest is not the major cost item, in the production function of micro-projects. Richard Rosenberg, senior advisor at CGAP (Rosenberg, 1996) argues that there is overwhelming empirical evidence that huge numbers of poor borrowers can indeed pay interest rates at a level high enough to support MFI sustainability. He sees abundant proof that people's tiny businesses can often pay interest rates that would strangle larger businesses. Number of empirical studies show that the interest rate of a loan is not an important part of the input cost, that demand for credit is largely inelastic with respect to the interest rate (Schmidt and Kropp, 1987). Studies covering India, Kenya and the Philippines found that the average annual returns on investments by micro-businesses ranged from 117 to 847 percent (CGAP, 2004). Similarly, a study in Chile, Colombia, and the Dominican Republic found that a six percent monthly interest rate represented less than 0.4 - 3.4% of a typical micro-entrepreneur's total assets. Thus, the interest charged is obviously an insignificant portion of the total input cost.

Of course, borrower demand does not prove borrower benefit (– no one would make this judgement in the case of cigarettes, for instance). Not every one makes a wise use of credit. But when lenders are getting significant proportions of their borrowers in trouble, it shows up sooner or latter, in high delinquency and default levels. But there are increasing numbers of studies indicating a clear positive impact on the livelihoods of the poor (A World Bank study conducted in the early 1990's based on an intensive survey found that it takes about five years for Grameen Bank programme participants to rise above the poverty line income level and about eight years to reach a situation where they do not require loans from targeted credit programme (Hashemi, 1997)) (Rosenberg, 2007).

#### **The need for 'certification'**

The other proposal is that there should be a checking mechanism, since customers of microfinance are usually NOT organized nor protected by a range of supervisory regulations that are strictly enforced. Indeed, since most micro-enterprise credit programmes operate in an environment with little direct competition, first of all such programmes must challenge themselves to control their costs, provide efficient services, and become self-sufficient. Borrowers should not have to pay high interest rates to cover a programme's inefficiencies. However, ensuring that this is actually happening by service providers calls for a new approach to certification for micro-finance service providers. In mature markets, on top of more limited formal regulation, this usually takes the form of certification and code of conduct enforced by peer control. Consumers in mature markets can buy certified coffee, bananas, cocoa, wood, rug and what not. Likewise, consumers in emerging markets need access to certified financial service providers in order to have their customers' rights exercised. There are two main proposed parameters.

#### **The Yunus parameter**

The first proposal is put forward by Professor Yunus. Professor Yunus recently (February, 2008) gave lecture at the London Microfinance club (E-mail correspondence at the DevFinance listserve, coordinated by the Ohio State University. Secondly, he was challenged on Islamic finance, in that Grameen charged interest. He had two answers. First, if people produced a suitable plan to introduce the classic forms of Islamic Banking, then he was perfectly happy to support it. However, he had been advised that Grameen were already a "perfect" Islamic lender, in that the concept of charging interest was seen as exploitative by the Quran - but that assumed that an "owner" was doing the exploiting. Where the organisation was owned by the people, it was deemed that they could not exploit themselves, and therefore the charging of interest was perfectly acceptable). He described fair mi-

crofinance as follows. Cost of money plus 10%, that was the acceptable "green zone" of business. Cost of money plus 15%, and you were entering the yellow zone, bordering on being questionable. More than 15% over the cost of money, and he had no doubts - that was the red zone.

However, some analysts argue that ground realities are different across continents, countries, and even across organisations in a country that should be taken into consideration while taking up, or talking about a pricing policy of microfinance product or services. Others would come up with their realities, but the cost of funds for microfinance operation in Bangladesh has historically been low due to huge pumping of grants as well as ability to mobilize savings. Apart from that, there is a government sponsored, and donor supported, discounted facility in Bangladesh, PKSF, that wholesales funds to MFIs at 4-7 percent. All these contributed a lot to keep the cost of fund for MF operation very low, and the weighted average is far below the 10% level. This may not be the case elsewhere.

Regarding operational cost, Bangladeshi MFIs, including Grameen, again, are fortunate enough to keep the cost low due to high density of clients in a given geographical area, and low salary of the loan officers. Though the loan size in Bangladesh is smaller than other countries, and the amount of money traded per staff is lower than many other countries, this does not hinder the profitability of the Bangladeshi MFIs, and the cost of operation is also lower than 10 or 15% suggested. This also may not be the case elsewhere.

### **The 'Alliance for fair microfinance' parameter**

The 'Alliance for fair microfinance' is a new partnership among practitioners, donors, consultants, interested groups to advocate for fairness of microcredit interest charged from poor clients who have no one to voice out their real interest. Based on some 'common senses' and detailed knowledge of rural finance, a new proposal is put forward that can fairly serve the interest of the majority clients around the world. The common sense of logic goes like this: the cost of micro-loan should not exceed a third of the loan amount, of which a third is cost of capital, another third is for operational cost, and the last third is for investments, provisioning and profit (Key people behind this initiative include Herman Abels and others. More background and resources about initiative can be accessed from their web: [www.fairmicrofinance.org](http://www.fairmicrofinance.org)).

### **Interest rates: the 1<sup>st</sup> third**

The cost of a micro-loan by and large should not effectively exceed a third of the loan amount (which usually is substantially higher than pricing in conventional finance) and in many countries can be well kept below that level. This does not mean that in some circumstances this one-

third criterion could be too rigid for building sustainable microfinance institutions, but it also tells us that passing this criterion must be well motivated in order to be considered fair.

### **Cost of capital: the 2<sup>nd</sup> third**

Costs of capital should not compose more than a third of the costs of microfinance services. Against the preferred 33% interest rate maximum, that would constitute 11%. That seems an altogether reasonable return for making available one's capital to the benefit of poor people; and a fairly competitive proposition for working at the bottom of the pyramid on top of that. In many developing countries local banks would be happy to provide wholesale loans to MFIs at that rate to dispose of their excess liquidity, if central banks would only clear such uncollateralized investments. And many socially responsible investors also consider an 11% return quite acceptable and in line with their trade-off between social and profit considerations.

### **Operational costs: the 3<sup>rd</sup> third**

Likewise, as a rule of thumb a third of the interest income should be enough to cover recurring operational expenses. In most markets a third of a third, or 11%, is not enough to cover current expense levels, whereas in others it works well. Why is that? Usually it requires scale to bring down operational costs (and interest rates). This is not happening in practice though, probably because lack of competition or donor dependency keeps inefficiencies in place, and ever higher investor expectations have made microfinance managers throw the towel on pursuing efficiency and cost control runs and simply off-load all high costs to customers.

### **Investments, provisioning and profits: the 4<sup>th</sup> third**

The above calculation would leave another third of interest income to cover investments, provisioning and profits. Can that possibly be enough? That all depends on several variables: cost of inflation, currency risk, taxes and portfolio performance but common sense tells us that it should be quite enough.

### **Challenges to establishing sustainable rural finance**

There are three key challenges to establishing sustainable rural financial system in many areas in Ethiopia and other poor countries – related to the incentive problem in organizations, charity-oriented credit programmes, and problems in targeting.

### **The incentive problem (organizational culture)**

The ownership structure of many MFIs is such that it

does not provide real incentive to take enough care of the sustainability of the MFI. Indeed, the microfinance law and directives of National Bank of Ethiopia 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 company (Amha, 2003 and 2008). The shareholders in the Ethiopian MFIs are individuals, regional government and local NGOs, and although the Proclamation clearly indicates that the shareholders are investors who buy shares from their own resources, the reality in the microfinance industry tells us that the shareholders in MFIs are nominal shareholders who are not investing their own money in the institutions. As a result, the nominal shareholders of MFIs may not have sufficient interest to seriously oversee the detail 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.

On the other hand, although it is assumed that MFIs with a double-bottom line objective have people at the board who work to maintain or improve their "reputation" and good public image, and therefore see to it that MFI is operating in accordance with the vision/mission set at the outset. This is often not affected – board members have many other duties and responsibilities, not enough background and exposure to the industry, no regular meetings to discuss about MFI issues, etc

Moreover, whereas foreign ownership of MFIs is "officially" restricted in the country, lack of transparency in capital ownership poses a real threat to the health of the industry. It is clear that in some MFIs equity structures are sponsored by foreign donors who have contributed the initial capital required for registration. In these cases, the real owners are not listed as shareholders. "Nominal" shareholders act as "fronts" for the real owners. These shareholders are precluded from selling or transferring their shares and "voluntarily forsake" their claim on dividends, if any, declared by the MFI. Such shareholders do not have a real stake in the organization and would be unlikely to lend it support at a time of financial crisis (IFAD, 2001).

### Charity-oriented 'credit' programmes

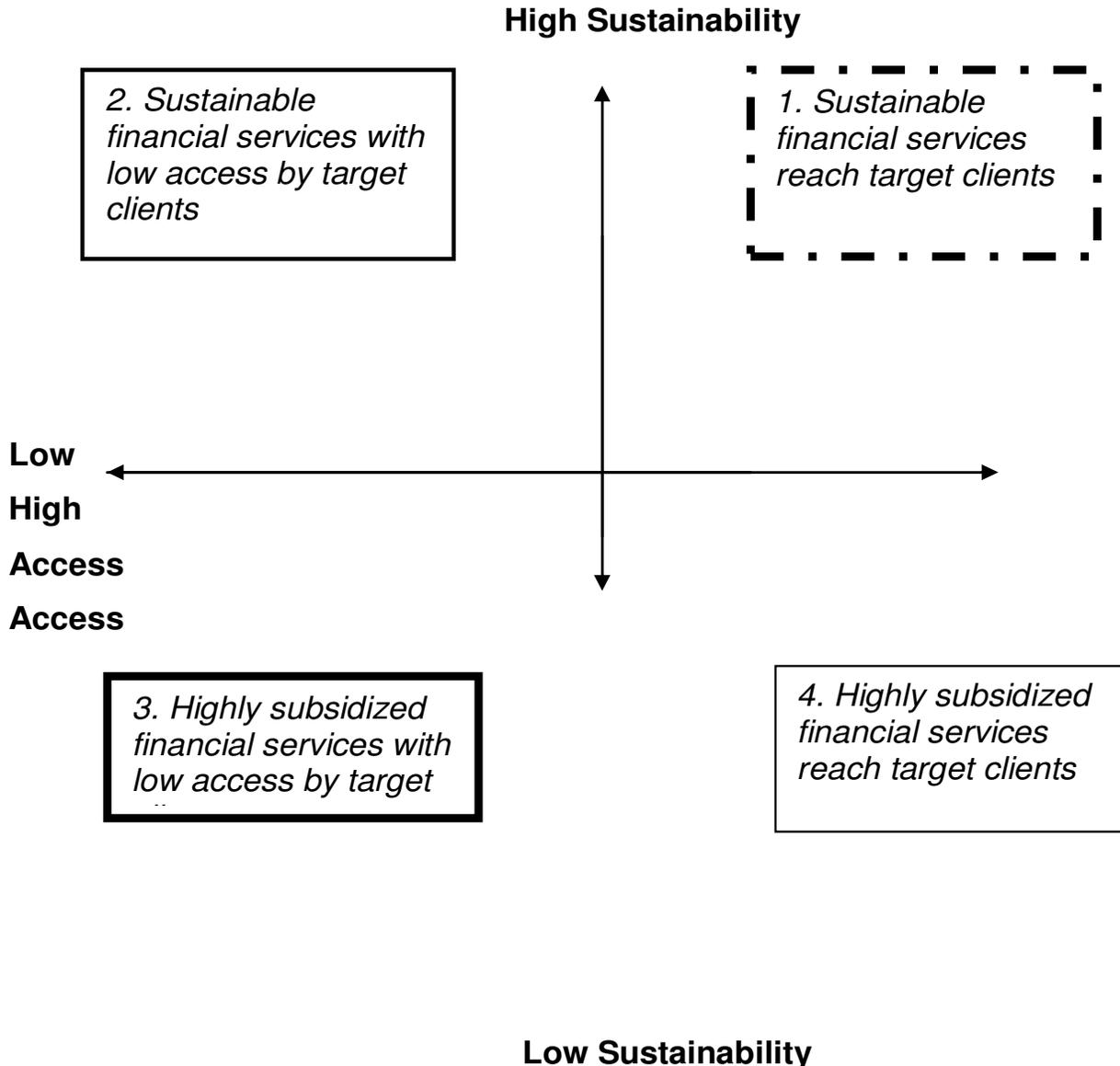
NGOs involved in micro-finance delivery without a license are becoming real dangers to the growth of the industry. Often, their system of lending involves some irregularities including subsidized interest rate, mixing business with charity and not following strict business discipline in the treatment of delinquency etc, which would make clients dependent on such operations and would potentially endanger the healthy operation of the whole micro finance industry. This in large part emanates from the firm believe maintained by some donors', NGOs, "outside experts" etc, that the way out of poverty for the poor is only through extending charity handouts (John Robinson

once remarked: '*Beggars provide the service of allowing their fellow citizens to feel charitable*'. But the motivation is not always rooted in altruism and even more rarely perhaps in solidarity. Indeed, anti-poverty is often a polite euphemism for anti-poor. It is the unpalatability of having to coexist and share habitats with the poor that is the problem that lies behind a good deal of "garibi hatato" [Remove poverty] sentiments; but this can easily mutate into "garibon ko hatao" [Remove the poor], as reflected in the periodic derives to resettle urban slum dwellers to out-of-the-city out-of-sight sites (Ashawi, 2005)) to existing (current) 'beneficiaries' (not 'clients'), without worrying about sustainability.

The reality is that the poor people do not necessarily lack business skills and are not looking only for charity hand-outs, as is often assumed. They are not passive recipients of money transferred from other segments of the economy in a top-down approach. Rather, they need to be empowered to create their own jobs and enhance private income and, in fact, they are too proud to look for charity!! They only lack the opportunity for income generation and employment. Such service providers may be troubled by taking money from current clients to help 'future' clients. But such approaches based on higher subsidies can exhaust resources (which are in scarce supply) on current projects and the current poor, and lack sustainability as shown on Quadrant 3 and 4 of the chart 1.

The micro-credit industry has sought to resolve the tensions between a focus on (current) poverty and a commitment to sustainability by integrating them within a matrix defined by two axes, or outreach (or access) and financial sustainability. The formal financial sector (e.g. commercial banks) may achieve financial sustainability, but has little outreach to poor clients (quadrant 2). Traditional efforts by non-governmental organizations (NGOs) may reach poor clients, but are often unsustainable (quadrant 4 and 3). Good microfinance practice, on the other hand, combines both outreach and sustainability in the virtuous quadrant 1.

Indeed, there can always be sections of the population who may be right targets to 'pure subsidies' for various reasons, including inability to be productively employed. But such sections of the population should be 'well targeted' and served in a different kind of programmes than microfinance [An example of such models – a 'Productive Safety Net' approach – is presented on ANNEX 3 Figure]. The Government strategy in this regard is very clear, particularly regarding targeting services. The "Plan for Accelerated and Sustainable Development to End Poverty" (PASDEP) (2005-2010), Ethiopia's current guiding strategic framework document, provides a clear approach on this, based on key principles such as: (a) enabling people, communities, businesses – not crowding out personal responsibilities, (b) achieving the objectives through decentralization, private sector promotion and liberalizing market controls while recognizing market failure and (c)



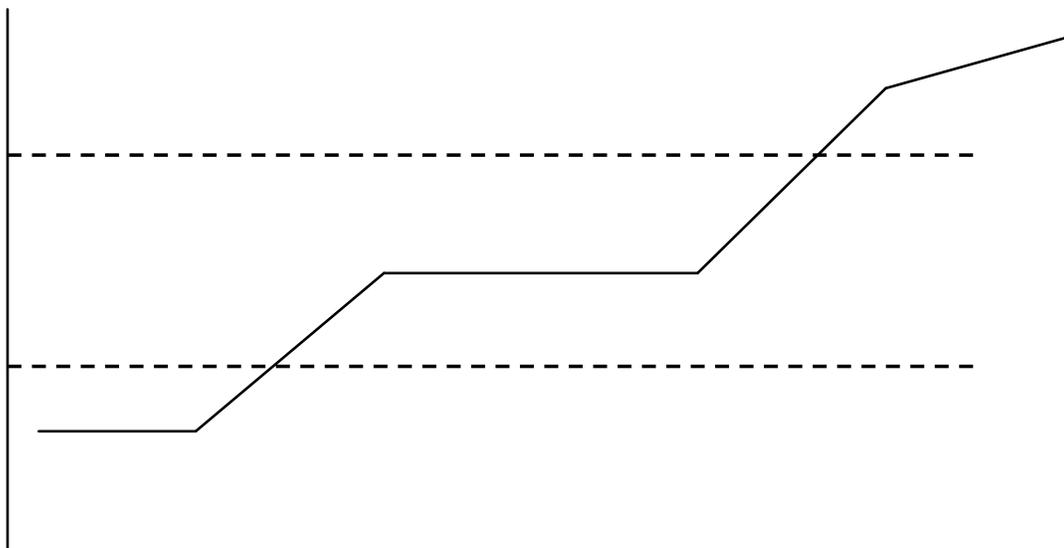
**Chart 1.** Optimizing performance. The micro-credit industry has sought to resolve the tensions between a focus on (current) poverty and a commitment to sustainability by integrating them within a matrix defined by two axes, or outreach (or access) and financial sustainability. The formal financial sector (e.g. commercial banks) may achieve financial.

targeting services to vulnerable groups (The basic philosophy behind who need to be targeted in microfinance (and indeed also in other similar interventions) needs to be clear. Prime targets are those who are suffering because of limiting factors which are beyond their control. For example, no one chooses their *gender, ethnicity, native language, or age*, and many people – especially women and ethnic minorities – have limited choices regarding *marital status or place of residence*. Yet, all these characteristics are visible at a glance and thus can be – have been and are – used to oppress one group for the benefit of another. Traditional lenders have disproportionately excluded people with these markers ('protected characteristics') both because lenders participated in their

oppression and because their oppression made these applicants worse risks. A central purpose of microfinance is to help change this (Schreiner, 2003).

Does the subsidy reach the poor? -- The problem of (Mis) Targeting

The objective of reaching poor people, especially women, through micro-enterprise services is a holistic task worth undertaking. However, there are often "targeting errors" and the services which are intended to reach poor and "marginalized" people would end up in the hands of the better-off, or those who can access alternative 'non-subsidized' services.



**Figure 3.** The idea behind the strategic linkage approach.

The productive safety net approach. Not every poor is the right target for microfinance services, as the majority of them may not have ready made business ideas on the shelf. It is also equally true that there is no reason why poor people, even the very poor, would not be able to turn out to be good entrepreneurs if appropriate 'packages' of services and support are availed to them. The Income Generation for Vulnerable Groups Development (IGVGD) program of BRAC (Bangladesh) provides the best documented evidence for a Productive Safety Net, that the poorest can be bankable if provided sufficient non-financial support services. The program targets destitute, rural Bangladeshi women who have few or no income-earning opportunities. The IGVGD program has provided food grain assistance and savings and credit services to nearly a million participants over a ten-year period. About 85 percent of its members also received training and support in poultry and livestock rearing, vegetable gardening, agriculture, fishery production, or grocery business. They get this "special support" for about 18-24 months, and they are expected to join the "mainstream" financial sector afterwards. Two-thirds of these women have graduated from absolute poverty to become microfinance clients, and have not slipped back into requiring government handouts. The IGVGD experience confirms that programs that combine livelihood protection (food aid) and livelihood promotion (skills training and microfinance) can reach deeper than purely promotional schemes to benefit the chronic poor).

The logic is very clear. Subsidies would normally induce excess demand from all types of applicants, poor and non-poor. Influence and patronage and better connections inevitably bias the distribution of the "subsidized" credit in favour of the better off -- more so when the local targeting mechanism is lax (Braverman and Guasch, 1993). And this is not just limited to the case of credit delivery. Any trade which involves any kind of subsidy, is prone to some kind of corruption, or black-marketing. A good example of this is the one of the household goods supply in local Kebele shops which is subsidised by the government, with the good intention of supporting the poor through lower prices. Who manages to buy this commodity and ultimately benefits from the subsidy? More often than not, the better-off. The World Development Report 2000/2001 (World Bank, 2001) reports a similar story: a large study in two African countries – Guinea and Mozambique - found that eliminating food subsidies did not hurt poor people because the subsidies had not reached them in the first place!

The basic philosophy and principle behind microfinance targeting is that the poor, although spurned by traditional

banks because they cannot provide collateral, are actually a great investment: No one works harder than someone who is striving to achieve life's basic necessities, particularly a woman with children to support. Sadly, it is also true that when the targeting is so lax, very little of the cash so generously given ever gets all the way down to the very poor. There are too many "professionals" ahead of them in the line, highly skilled at diverting funds into their own pockets. This is particularly regrettable because very poor people need only a little money to set up a business that can make a dramatic difference in the quality of their lives (Yunus, 2006).

There are practical problems with regards to such mis-targeting. Although the regulatory framework for micro-finance operations and its environments is put in place, effective supervision of its implementation is still lacking. Credit programmes, intended to target very poor and vulnerable people, under a 'safety-net' programme, ended up benefiting mainly non-target people. In Amhara Region, the total amount of disbursement under such circumstances reached more than Br.100,000,000 in 2005, 2006 period alone. This amounts to about 30-40% of

ACSI annual disbursement, giving rise to a number of dropouts, costing the Institution (in terms of, for example, lost investment on client training), thus threatening institutional sustainability. There are many similar interventions still going on. In fact, if such kinds of programmes do not follow proper targeting in their services properly, the "subsidized" fund pumped in the economy will affect the economy as a whole.

Moreover, if same type of people (in terms of income and risk profile) receive different terms and conditions for credit and other micro-enterprise services, this results in unfair competition in the market among entrepreneurs, by creating market segmentation. Such market segmentation and lack of competition results in inefficiency. That is, clients with identical loan demand and risk profiles can receive different terms and conditions depending on source of funding (Inter-American Development Bank, 2001). Thus, for example a producer that has access to sub-sidized credit can price her/his product lower than the one who borrowed at market interest rate, and thus the latter will be placed at a disadvantaged position. In addition, since repayment is linked to the profitability of the activity being financed, borrowers who expect to have to repay their loans tend to be more careful in their choice of micro-projects than those who do not expect to repay. Low repayment, like low interest rate, may lead to capital mis-allocation, since borrowers can make money even from socially unprofitable projects (Inter-American Development Bank, 2001; World Bank 2003).

## CONCLUSIONS AND RECOMMENDATIONS

The need for sustainable financial services is very clear. How to realize this desirable objective is a bit controversial. As we have seen, the first option would be to let the market decide on such items like the micro-credit interest rate and the clients to judge for themselves. One may even argue that it is better if the poor can access finance even if they pay higher interest rate – that is, if the alternative is NOT having the access at all". Since the poor are fully repaying and coming back for repeated loans, this means that, under the given circumstances, they 'value' the service and have the real demand.

However, borrowers should not have to pay high interest rates to cover a programme's inefficiencies. Because most micro-enterprise credit programmes operate in an environment with little direct competition, and in circumstances where poor clients are not organized to voice out issues affecting them, first of all such programmes must challenge themselves to control their costs, provide efficient services, and become self-sufficient. This, however, is not often happening and therefore calls for a new approach to certification for micro-finance service providers. Mechanisms should be in place to check that the MFI is working at the "desirable" (what is the benchmark?) level of efficiency. The next logical question is

whether the profit so generated is actually used for the intended purpose of service expansion.

The role of Government in sustainable rural finance is significant, as has been discussed. These roles can be summarized as follows:

\*Monitoring market distortions, capacity development to MFIs Good regulations and ambitious policies, visions and missions to reach the poor through microfinance, reaching the women, etc, are NOT enough. Whatever policies and regulation that are established need to be monitored to check if they are being implemented properly. The role of its different organs in monitoring market distortions in the microfinance industry, capacity development to MFIs, need to be made more effective.

\*Rural infrastructure, particularly the road network needs special attention by government and others for a healthy microfinance operations. Given that the poor are largely involved in few enterprises, the risk is indeed high if similar products cater only for the small market nearby, which easily saturates, diminishing potential profitability. Relevant market information and networks are also vital.

\*Expand BDS service: Credit must, above all, be accompanied by some kind of marketable skill development, which the poor seriously lack. Credit alone can only increase the "scale" of existing activities rather than enabling the poor to move into new or higher value activities. Some kind of cultural transformation may also be called for at this particular juncture in order to change the attitudes of some otherwise poor people who are reluctant, for cultural reasons, or lack of 'role models' to engage themselves in non-traditional activities which are much more rewarding indeed.

\*Support Innovation in Financial Services: Challenges in expanding microfinance outreach to the majority poor, both in rural as well as urban areas, emanate in no small part from the absence of appropriate microfinance methodology suitable for the local circumstances. For example many MFIs are still mainly using the one-size-fits-all type group lending methodology. While many potential borrowers do not like this modality, and while they also have the ability to offer enough material collateral that more than match the 'value' of the borrowed money, they cannot access the loan simply because the material wealth they have do not have the 'legal title' to serve them as collateral. There are various potential solutions to this, being effectively implemented elsewhere. But, many institutions are not interested in further investigating, re-searching, piloting such new credit technologies, because while they will bear all the costs, it is often difficult to prevent other institutions or investors who will NOT share the research cost from adopting or using the new technology once it has proven successful. This reduces incentives for innovation, not just for micro-credit, but also for microsaving, microinsurance, etc. Essentially, innovations in financial services are a public good, and therefore due attention need to be given to it by government, donors, etc.

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