



HAWASSA UNIVERSITY SCHOOL OF GRADUATE STUDIES  
COLLEGE OF LAW AND GOVERNANCE  
SCHOOL OF LAW

EXAMINING THE LAWS REGULATING OWNERSHIP  
STRUCTURE AND FORECLOSURE IN MICRO FINANCE  
INSTITUTIONS IN ETHIOPIA

LL.M. THESIS IN COMMERCIAL LAWS

BY:

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HAWASSA UNIVERSITY, HAWASSA, ETHIOPIA

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EXAMINING THE LAWS REGULATING OWNERSHIP  
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**HAWASSA UNIVERSITY**  
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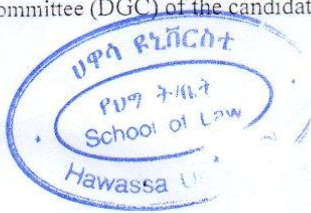
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We, the undersigned, members of the Board of Examiners of the final open defense by **Abriham Petros** under the title “**Examining the laws regulating ownership structure and foreclosure in microfinance institutions in Ethiopia**” and recommend that it be accepted as fulfilling the thesis requirement for the degree of Master in Law with specialization in Commercial Laws

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### CERTIFICATION OF THE FINAL THESIS

I hereby certify that all the corrections and recommendation suggested by the Board of Examiners are incorporated into the final Thesis entitled “**Examining the laws regulating ownership structure and foreclosure in microfinance institutions in Ethiopia**” by Abriham Petros Bassa.

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## **Acronyms and Abbreviations**

<b>ACSI</b>	Amhara Credit and Savings Institution
<b>AEMFI</b>	Association of Ethiopian Micro Finance Institutions
<b>CGAP</b>	Consultative Group to Assist the Poor
<b>CSI</b>	Credit and Savings Institution
<b>FSS</b>	Financial Self-sufficiency
<b>MFIs</b>	Micro Finance Institutions
<b>MSME</b>	Micro, Small and Medium Enterprises
<b>NBE</b>	National Bank of Ethiopia
<b>NGO</b>	Non- governmental organization
<b>OMFIs</b>	Omo Micro Finance Institutions
<b>OCSSCO</b>	Oromia Credit and Savings Institution
<b>SEEP</b>	Small Enterprise Education and Promotion Network
<b>SMFI</b>	Sidama micro finance institution
<b>SNNPR</b>	Southern Nation, Nationality and Peoples of the Region

## **Abstract**

*Many people in Ethiopia have been given access to formal financial services through microfinance programs. However, currently millions of potential clients in the region remain unserved and the demand for financial services far exceeds the currently available supply. Microfinance institutions mainly relied on government, NGOs and associations for their finances. Hence the sectors are characterized by capital constraint. Because of this their service is limited to specific locations of the region. There is weak private investors' participation in the sectors due to absence of dividend of profit and free transfer of shares. More over the sector is characterized by its weak repayment rate of loan because of absence of specific /separate/ foreclosure law which is suitable for their specific future. So the paper found that to establish sustainable and well outreached MFIs, there should be wide shareholders bases or solid ownership base and specific and adequate foreclosure laws that have its own procedural remedies. Hence absence of separate foreclosure law and weak ownership base are identified as the major obstacles for the sustainability of the MFIs. Microfinance institutions should give more emphasis to financial sustainability and making the environment suitable for private investors in order to reduce their subsidy dependence, ensure survival to achieve their social objective and growth in the future. The methodology employed for this study was qualitative and the data were collected from both primary and secondary sources by selecting the institutions purposively. Accordingly, the study recommends the concerning organ to refine the provision that regulate ownership structure and to enact comprehensive specific foreclosure law that have its own procedural remedies for execution.*

**Keywords:** *foreclosure, non-performing loan, weak shareholder base, dividend share, sustainability and liquidity.*

# Chapter One: Introduction

## 1.1. Background of the Study

Microfinance is the financial institution which provides financial services to the poor who are out of the conventional financing institutions particularly in developing countries including Ethiopia especially for those who have financial constrained and vulnerable but have feasible and promising investment ideas.<sup>1</sup> Microfinance enables poor self-employed people to create productive capital, to protect the capital they have, to deal with risk and to avoid the destruction of capital. It attempts to build assets and create wealth among people who lack them.<sup>2</sup>

The development of microfinance institutions in Ethiopia is a recent phenomenon. The proclamation, which provides for the establishment of institutionalize microfinance institutions was issued in July 1996. Since then, various microfinance institutions have legally been registered and started delivering microfinance services to the poor who have not conventional financial service access.<sup>3</sup>

The Ethiopian microfinance sector is characterized by its rapid growth, an aggressive drive to achieve scale, a broad geographic coverage, a dominance of government backed microfinance institutions, an emphasis on rural households, the promotion of both credit and savings products, a strong focus on sustainability and by the fact that the sector is Ethiopian owned and driven.<sup>4</sup> Microfinance institutions have a mission of taking part in playing an important role in the struggle to alleviate poverty and bring about a sustainable economic development in Ethiopia by providing financial service to the economically active but resource poor and stimulate individual initiatives for self-reliance and food self-sufficiency.

Micro-financing institutions collect deposits and extend credit to rural and urban farmers and people engaged in other similar activities as well as micro and small scale rural and urban entrepreneurs, the maximum amount of which may be determined by the National Bank.<sup>5</sup> The

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<sup>1</sup> Drivers of sustainable micro finance sector in Ethiopia: (Birritu no. 122<sup>nd</sup> oct. 2016) 14, Micro-Financing Business Proclamation No. 626/2009; Muluken Alemayehu: Assessment of Factors Affecting the Performance of Microfinance Institutions: The Case of Hawassa City (Vol.6 No. 1 June 2014) 2.

<sup>2</sup> Maria Otero, Bringing Development Back into Microfinance: Journal of Microfinance /ESR, (1999) 11.

<sup>3</sup> Wolday Amaha, Networking Microfinance Activities in Ethiopia: Challenges and Prospects, Occasional Paper No.1 AEMFI, Addis Ababa, Ethiopia (2000) 3.

<sup>4</sup> Ebisa Deribie, Getachew Nigusie and Mitiku F. Filling the breach: Microfinance, Jimma University, Ethiopia (2013) 11.

<sup>5</sup> Micro financing Business Proclamation No. 626/2009 art 1 of Ethiopia, Negarite Gazeta, 15th Year No.33 ADDIS ABABA 12th May, 2009.

objective of MFIs is not only creating access to get capital and combat poverty on an individual level, but also it plays a great role at institutional level.<sup>6</sup>

There were growing needs for financial services among the poor communities especially from those who were financially constrained and vulnerable but have feasible and promising investment idea. While reaching to the poor is very costly, in order to reach its full potential and further grow as a credible development tool, microfinance institutions serve hundreds of millions of clients.<sup>7</sup>

As of June 2018 there are about 38 microfinance institutions registered under national bank of Ethiopia and providing microfinance services. Most of these microfinance institutions' markets are dominated by a few large microfinance institutions and their ownership is linked to regional state government. The ownership structure of Ethiopian MFIs is thought to be very loose in the sense that firstly, the so-called owners have no real control over the shares and hence may not have sufficient interest to control and guide the management of MFIs.<sup>8</sup> Moreover, because of capital constraint microfinance industry of the country is highly concentrated to limited areas of the country. The four largest – Amhara Credit and Saving Institution (ACSI), Dedebit Credit and Saving Institution (DECSI), Oromia Credit and Saving Share Company (OCSSCO) and Omo Micro Finance Institution – are backed by the government account for 81 per cent of client outreach and 85 per cent of total loans outstanding.<sup>9</sup>

From the total of thirty-eight MFIs operating in Ethiopia, seven of them are operating in SNNPR; namely, OMFI, Sidama micro finance, Wisdom, Agar, Leta, Metemamen and Meklit. Sidama micro finance is operating in almost all urban and rural areas of Sidama zone. Wisdom is operating mainly in urban areas of Sidama, Gedeo, Wolayita, Hadiya, Kambata Tembaro, and Gamo Gofa zones; and Agar and Meklit are operating in some urban areas of Gurage zone and Hawassa in the region. Metemamen is operating in Gurage Zone. Of the micro financing

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<sup>6</sup> Otero (n2) 8-19

<sup>7</sup> Birritu (n1)14

<sup>8</sup> Bereket Zerai, Technical Efficiency and its determinants of microfinance institutions in Ethiopia: A stochastic frontier approach, African Journal of Accounting, Economics, Finance and Banking Research Vol. 8. (No. 8, 2012) 2.

<sup>9</sup> AEMFI, Ethiopian microfinance institutions performance analysis report: Bulletin No. 6. (2010).

institutions in the region, OMFI has got relatively larger geographical coverage and number of clients.<sup>10</sup>

For the purpose of this study four of them were selected purposively. As stated in earlier paragraphs, the main mission of microfinance institutions is to create the opportunity for the poor, rural and urban people who are deprived of bank to access finance and poverty alleviation. However, millions of people in the region are still out of financial service access. To make microfinance service accessible to such unserved people of the region, MFIs have expected to ensure their sustainability / potential institutional run/ by improving their service production, widening shareholder base, legal frame work, encourage innovation and policy and its establishment. Hence, the objective of this study is measuring the performance of Ethiopian MFIs particularly in SNNPR and assessing challenges of the sectors in connection with legal and factual problems focusing on ownership base and foreclosure by selecting four microfinance institutions purposively which are the most outreached of clients and last long experienced.

Regulatory approach in a given country must be consistent with the overall financial sector frame work and must consider the variety of institutional types. The challenges facing regulators as they consider appropriate regulatory approaches to this sector is complicated by the fact that MFIs significantly in institutional type, scale of operations and level of professionalism. A number of studies previously conducted notes that sustainable and efficient MFIs management should cover at least all administrative costs, loan losses, and financing costs from operating income within the organization to sustain.<sup>11</sup> But in our case most of the MFIs are not self-sufficient that means financially as well as operationally.

Though the strengths of the micro financing industry outweigh its weaknesses, there are still big challenges facing the microfinance institutions.<sup>12</sup> These challenges were presented differently by different studies. Rural financial intermediation currently constitutes a key development intervention in many poor countries. Yet, the success achieved particularly in countries who implemented such programs a couple of decades ago notwithstanding, there remain many constraints limiting both the supply and demand in very poor countries like Ethiopia. Experience

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<sup>10</sup> OMFI strategic business plan, (2013/14-2015/16)7; Ethiopian National bank report 2018; AEMFI report 2018.

<sup>11</sup> Birritu (n1) 14

<sup>12</sup> Ebisa (n4) 14

from over ten years of financial intermediation reveals that good intentions for expansion of supply are having difficulties due to poorly designed regulations and policies, organizational behaviors, the incentive problem, as well as weak capacity of institutions implementing it.<sup>13</sup> Regarding the performance analysis of sample MFIs in Ethiopia revealed that Ethiopia's MF industries faced with two pronged challenges. The first one is the need to reach the poorest customers and the second one is being financially sufficient.<sup>14</sup> Another study also shows that prudential regulation as a tool to implement MFI's effective governance in Ethiopia and ensure the sustainability and viability of MFIs.<sup>15</sup>

The researcher opted weak ownership base and absence of specific foreclosure law as major challenges that currently affecting the effective performances of microfinance institutions. Debt collection and weak financing bases are some of the limitations that challenging MFIs' viability in the region which may result in the failures of the industries in the long run especially in the occasion of crises and when subsidies from donors and government terminated.

It is undeniable fact that the appropriate government intervention is important for the sustainability of MF industries since poor physical infrastructure and unacceptably high risks and transaction costs do not encourage private individuals to engage in the sector.<sup>16</sup> However, when we see most of the MFIs in SNNPR, they are relied on donors and government grants for their finance. Dependence on such sources only will gradually diminish as local financial institutions and private capital markets mature. So this study mainly focused on the factors challenging the effective performances of MFIs by stressing on ownership structure and foreclosure.

Unlike the wealth of studies in other jurisdictions, there are few studies undertaken in Ethiopia related to the subject of MFIs especially with regard to the negative impacts of weak ownership base and foreclosure on efficient performance of microfinance institutions in SNNPR. Most of the previous works on microfinance institutions revealed that sustainability is one of the areas that we need to look at to assess their establishments. Diverse literatures noted that the

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<sup>13</sup> Getaneh Gobezie, 'Assessing Supply and Demand Constraints for Microfinance in Ethiopia: (With Particular Reference to the Amhara Region)'; Bahir-Dar (Nov. 2005) 5.

<sup>14</sup> Letenah Ejigu Wale, 'performance analysis of sample MFIs of Ethiopia' International NGO journal [2009], 4(5), 287-298.

<sup>15</sup> Wolday Amha, Corporate Governance of the Deposit Taking Microfinance Institutions in Ethiopia, (2008) 7.

<sup>16</sup> Charitonenko, Stephanie, Commercialization of Microfinance: The Philippines. Manila: ADB 2003.

contribution of MFIs for poverty alleviation is significant. In the right environments, microfinance can accomplish many roles such as financing people's economic choices, diversifying household income, making household less vulnerable to downturn in the economy or personal, smoothing income flows of the household, improve quality of life throughout the year and strengthen the economic position of women so that they can take greater control of decisions and events in their lives.<sup>17</sup>

Again some others also tried to look the financial and operational performance of Ethiopian microfinance institutions. In this study what investigated is the performance of the institutions by using profitability and sustainability, asset and liability management and efficiency and productivity as performance indicators. The paper suggests that majority of MFIs passed both operational and financial self-sufficiency and few of them are not.<sup>18</sup> Some other scholar also attempted to investigate the performance of MFIs in the country from outreach and financial sustainability perspectives.<sup>19</sup>

The performances of MFIs that have reached self-sufficiency with those that have not compared to regional commercial banks in developing countries are other studies through comparing efficiency, profitability and leverage. The finding of the study proved that self-sufficient MFIs are statistically better from commercial banks on both return on asset and return on equity. Even though it is not statistically significant it is true that the operating expense as a percentage of assets of self-sufficient MFIs considerably high.<sup>20</sup>

In evaluating the sustainability of MFIs two things has to be observed: operational self-sufficiency and financial self-sufficiency. Operational self-sufficiency measures the extent to which financial revenue covers financial expense, operating expense and loan impairment charge.<sup>21</sup>

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<sup>17</sup> Joan Parker, Ira Singh & Kelly Hattel, *The role of microfinance in the fight against HIV/AIDS: Development Alternatives, Inc. (DAI)*, Bethesda, Maryland (2000) 1.

<sup>18</sup> Alemayehu Yisraw, *The Performance of Micro Finance Institutions in Ethiopia: A Case of Six Microfinance Institutions*, MSc Thesis, Addis Ababa University, Ethiopia (2008).

<sup>19</sup> Befekadu Kereta, *Outreach and Financial Performance Analysis of Microfinance Institutions in Ethiopia In African Economic Conference*, Addis Ababa (2007).

<sup>20</sup> Tucker, M., and Miles, G., *Financial Performance of Microfinance Institutions: A Comparison to Performance of Regional Commercial Banks by Geographic Regions*, *Journal of Microfinance/ESR Review*, 6(1), 41-54 (2004).

<sup>21</sup> Richard L. Meyer, *Track Record of Financial Institutions in Assisting the Poor in Asia*, Asian Development Bank Institute Research Paper Series No. 49, ADBI Publishing (2002) 4.

The ability of MFIs to continue its operation if it receives no further subsidies and 100% is considered as the breakeven point of MFI's operation. Financial self-sufficiency reflects the ability of microfinance to earn enough revenue to cover its cost by taking in to consideration adjustments to operating revenue and expenses.<sup>22</sup>

As we can infer from various literatures, the major objectives of MFIs are to maintain striking balance between their missions serving the poor (increase the depth of outreach) and ensure their sustainability. However, attaining the objective of financial sustainability and the objective of poverty alleviation successfully is the real challenge of microfinance institutions<sup>23</sup>. Non refinement of microfinance regulation like government ownership monopoly in most of MFIs hence weak governance, weak technology employment like core finance services, liquidity deficiency makes them unable to meet the liquidity demands of their clients and practically associated problems among the major reasons revealed by previous work.<sup>24</sup>

As we can infer from the studies reviewed above, they mainly focus on how much the viable microfinance important for depth outreach of financial services to the poor who have denied formal financial services in the long term and again how much the MFIs finance sources are limited and relied on government and NGOs.

This study similarly gives more emphasis to the sustainability of microfinance institutions taking wide ownership base and effective loan collection as an essential elements to achieve the social mission. Though there are similar findings with regard to ownership structure of MFIs, it is related with corporate governance and not in the perspective of this study or not in similar scenario, not specific to the region, not observed in detail like this study and have not similar recommendations. There is virtually no research on the impacts of weak ownership base on sustainability and outreach microfinance institutions in SNNPR.

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<sup>22</sup> The SEEP, Network and Alternative Credit Technologies Measuring Performance of Microfinance Institutions, A Framework for Reporting, Analysis, and Monitoring, SEEP Network, Washington, D.C (2005).

<sup>23</sup> Mubarek Sani Hussien, Sustainability of Ethiopian Microfinance Institutions. Available online: [<http://www.etd.aau.edu.et/dspace/bitstream/123456789/804/1/Mubarek.pdf>] 2006.

<sup>24</sup> Birritu (n1) 31

## 1.2. Statement of the Problem

Now a day micro finance institutions playing a great role in supporting the economic activities of the rural and urban poor in developing countries who have not formal financial services access.<sup>25</sup> Many of poor households in the region are now receiving formal financial services because of the expansion of microfinance institutions. However, the potential demand for financial services and the existing supply of financial services to the poor is still very limited in Ethiopia particularly in SNNPR. Because of this still millions of people in the region are not financially served. This is because there is high capital constraint of the existing microfinance institutions and the concentration of its service to limited areas of the region. Many microfinance institutions still depend on government and donor subsidies for their existence. Ensuring the objective of financial sustainability and poverty alleviation successfully is the real challenge of microfinance institutions in the region.<sup>26</sup>

The study area opted for research because many study noted that MFIs in the region still not deeply outreach to the poor and still large number of people in the region is not financially served. MFIs relied on regional government, associations and NGOs for their finances. Hence MFIs are dependent on limited source for their finance and characterized by weak private investors' engagement in the sector. Because of these MFIs services are limited to specific area or concentrated in fixed locations.

For this reason institutional sustainability of MFIs becomes so crucial to make financial services accessible as noted under previous studies to the people who have denied formal financial services. If microfinance institutions are not financially solid, unable to cover their costs by their own and incapable of delivering financial services over the long term, they become a transitory means of reaching the poor and lose their punch as a component of a broader development strategy in any setting.<sup>27</sup>

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<sup>25</sup> Ebisa (n4)

<sup>26</sup> Hussien (n18)

<sup>27</sup> Otero (n2)12

Attaining a high degree of sustainability is crucial to serve significant numbers of clients properly. Reaching the poor is a major objective of MFIs but insuring the sustainability is the means to achieve the objective.<sup>28</sup>

Despite the successes of many MFIs, there are big challenges threatening the sustainability of MFIs in Ethiopia. As we saw in the introduction part of this study, different study noted that poorly designed legal framework and policies, organizational behaviors, weak participation of women, the incentive problem, as well as weak capacity of institutions implementing as the major challenges affecting the sustainability of microfinance institutions in Ethiopia. However, in this study ownership base and the law that regulate foreclosure opted to test how much they are affecting the effective performances of MFIs in SNNPR. The ownership structure of Ethiopian microfinance institution is thought to be very loose in the sense that firstly, the so-called owners have no real control over the shares and hence may not have sufficient interest to control and guide the management of MFIs. Secondly, it is dominated by the groups with different historical and strategic camps –government verses NGO affiliated. In some cases, such dominances have been spoiling the market and remain a threat for the industry due to the practice of some illegal government and NGO operations.<sup>29</sup> The existing law also does not define clearly the amount of share should be owned by a person.

Even though there were studies regarding challenges that affect the sustainability of MFIs, there is no study conducted regarding factors affecting microfinance focusing on weak ownership base and foreclosure in SNNPR. Hence, the study mainly focus on problems that affect sustainability of MFIs focusing on weak ownership base of shareholders especially on the institutions whose source of funds is monopolized by the regional government, associations and NGOs and weak enforcement of foreclosure law over the property mortgaged or pledged / absence of specific foreclosure law/. Since there is no conducive environment that encourages private investors to participate in the industries, there is very weak private investors' participation in the industries because of absence of dividend of profits and weak loan collection and give more emphasis to social objectives. So this paper aimed to critically review the existing MFIs law that govern ownership structure and evaluate the problems faced by MFIs in resolution of non-performing

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<sup>28</sup> Elisabeth Rhyne, "The Yin and Yang Microfinance: Reaching the Poor and Sustainability." *The Micro-banking Bulletin*, Calmeadow (1998, July) 6-8.

<sup>29</sup> Bereket (n8)

loans. Wide ownership base and specific conductive foreclosure law will be identified as the essential instruments to safeguard the viability of the MFIs and outreach. Large parts of the people in the region are not served and hence subjected to illegal money lenders and extraction. As the researcher tried to show above, most of the prior studies focus on assessment of the impact of MFIs on poverty alleviation, impact of MFIs on women's empowerment, on corporate governance, the role of microfinance on agricultural productivity, technological advancement and impact of microfinance institutions on children's education.

Thus, this paper give more emphases to look widening ownership base and having specific foreclosure law as the major instruments to ensure sustainability and outreach of the MFIs in the region.

### **1.3. Research Questions**

Based on legal problems identified above, the study addresses the following major research questions:

1. Does the ownership base of MFIs adequately regulated and monitored in the study area?
2. Are MFIs legally granted and practically enforcing foreclosure right?

### **1.4. Objective of the Study**

#### **1.4.1. General Objective of the Study**

This study in general intends to investigate the potential effects of weak ownership base and non-performing loans on the sustainability of micro financing business and its outreach.

#### **1.4.2. Specific objectives:**

- ✚ Identifying the regulatory framework of MFIs that regulate ownership and analyzing the adequacy of such law for efficient performances of microfinances.
- ✚ To examine whether microfinances are legally granted foreclosure right.

### **1.5. Significances of the Study**

Primarily, the paper will help MFIs to understand the legal and factual issues affecting the effective performances of the institutions. It also enables the readers to grasp the necessary information with respect to the legal aspects of non-performing loans resolution process /foreclosure/ and the impacts of weak ownership base on the sustainability of MFIs.

The study will give some insights to MFIs, government and policy makers in developing policy regarding the importance of clear /strong/ ownership base and conducive foreclosure law to boost MFIs profitability and sustainability. It is also of significant to the researchers and scholars as a reference for future studies and has contributed to the existing body of knowledge.

### **1.6. Scope of the Study**

The paper focused on the major legal and factual gaps of MFIs in Ethiopia particularly in SNNPR basically on non-performing loans /on the recovery of loans/ and analyzing factors affecting performance giving attention to ownership and foreclosure law and its practical applicability and constraints it is facing in SNNPR by selecting four MFIs purposively.

### **1.7. Methodology and methods**

The study employed qualitative type of research methodology. This is because it devoted on the reasons, justifications or logical arguments, legal frame work and practices. To understand the raised issues in depth with the view point of the study participants, qualitative research methodology preferred. The thesis is primarily a doctrinal analysis. The analysis is limited to the extent of relevancy of the laws and policies to the study and purposive sampling techniques were implemented. Supplementing the doctrinal study, the thesis involves some empirical study. It goes beyond the study of the black letters of the law. The researcher opts for this type of legal research to see some the practices.

In this study from the seven micro finance institutions operating in SNNPR, Omo, Vision fund, Sidama and Meklit micro finance institutions were selected purposively. These different categories of respondents were the units from which information were collected. Massive client outreach, long lasting experiences on service delivery and their accessibility to the researcher to

collect data were some of the criteria to prefer them. To get direct information on the legal and practical problems and challenges concerning ownership structure and non-performing loans, the researcher tried to make interview with head offices as well as branch managers and law department as key informants because of information homogeneity in most of the MFIs. So the researcher took head offices managers and legal department employees of the institutions purposively to collect necessary data for the study since they have direct linkage with the day-to-day activities of the institutions and the major obstacles for efficient performances. Since this study aimed to assess factors affecting effective performances of MFI giving due attention on ownership structure and foreclosure, they were considered as the key informant for the relevant information. To gather primary information from the respondents /informants/ purposively selected above, the researcher developed semi-structured interview method. The researcher has first prepared well designed questions to the interviewees but there were questions the researcher has raised based on the information obtained from the interviewee.

To achieve the objectives of the study, data were collected from both primary and secondary sources.

The primary sources of data for this paper were legislations, different policy documents and interviews and regulations.

Secondary data has been collected from published and unpublished materials which are available in the form of journal articles, books, lecture notes, web sites, research papers conducted in similar study area and different reports especially annual report of NBE. Information related to Ethiopian MFIs' financing structure and firm characteristics were collected from AEMFI.

### **1.8. Limitations of the study**

The researcher had encountered with different challenges and limitations during the study; the occurrences of COVID-19 virus as a pandemic globally and declaration of state of emergency in Ethiopia too challenged the researcher from gathering information from some of the microfinance institution selected for this study as proposed by the proposal since there were restriction to move from place to place. Even though many of the interviews and data were collected before the state of emergency, there were limitations in collecting full data as expected. However, the researcher tried to overcome the problems through alternative ways of data

collection those data not collected physically. The researcher collected those data through electronic devices like email and cellphone communications.

The other limitation is many of MFI's key informants were not willful to disclose information with regard to non-performing loans and who the real owners /founders/ of MFIs and not voluntary to give copies of memorandum articles and association (before declaration of the state of emergency). This created some inconvenience in getting full information on the designed themes but the researcher tried as far as he can to access the needed information from different sources like, previously conducted research, journal articles and books. Furthermore, during the interviews, there was limited time with most interviewees because interviews were held in offices that were not completely free from frequent interruptions.

Absence of well-developed studies in the areas the study. Non availability of the respondents in their offices in the instances the researcher wants to collect study data especially before state of emergency. Research cost and time shortage were also another limitations of the study.

### **1.9. Organization of the Study**

The research paper is organized in to four Chapters. Chapter one is all about proposal part. The second chapter presents general overviews and theoretical frameworks of MFIs. It reviews some introductory issues about the concept of microfinances, their definition, objective of their creation /evolution/, thoughts, etc. Chapter three has then assessed the establishment of MFIs, the initial sources of capital of the MFIs specifically the case of SNNPR and who the founding members /shareholders of the MFIs were. More importantly, it examines the laws governing foreclosure and ownership structure and whether the existing foreclosure law is adequate to regulate foreclosure and ownership and its practical implementation. Finally, under the last chapter, findings and recommendations to concerning organ are forwarded.

## Chapter two

### Theoretical framework of micro financing institutions

#### 2.1. Evolution of Microfinances

The emergence of the global micro finance has a history of about three decades, yet has gone through stages of historical development. The micro finance industry is said to be in revolution: the service that was initiated in small scale and small village of South East Asia “Chintanga”, Bangladesh now turned to be international agenda and an issue addressing one of the main problems i.e. poverty in developing countries of the world.<sup>30</sup>

The year 1974 is a landmark in the history of microfinance development. It was by then that Professor Muhammad Yunus, a Bangladeshi economist introduced the idea of providing the poor with small loans. Finally in 1983 he formally established the Grameen Bank (meaning “village bank”)<sup>31</sup> that provide financial services for those who have no access to conventional financial services and subjected to informal money lenders. In 1970s state delivery of subsidized credit programs emerged to assist the agricultural production of small holder farmers who faced great difficulty in obtaining adequate volumes of credit and who were charged high rates of interest by monopolistic money lenders.<sup>32</sup> During the same period, donor agencies also tried to initiate cooperative financial institutions so as to mobilize savings in rural areas.<sup>33</sup> Thus, the limitations of financial institutions in providing the poor with credit have become the driving forces behind the emergence of MFIs. Now a day, microfinance institutions are growing to provide the poor with financial as well as technical assistance. The accomplishment of MFIs is, therefore, a manifestation of a paradigm shift that defeated the old notion that the poor are not credit worthy.<sup>34</sup>

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<sup>30</sup> Giday Gebrehiwot, Outreach and Sustainability of Microfinance Institutions of Ethiopia: A Case Study on Specialized Financial and Promotional Institution (SFPI). (Vol.7, No.5, 2016) 90.

<sup>31</sup> Ibid 91; see also <[www.globalevision.org](http://www.globalevision.org)>.

<sup>32</sup> Susan Johnson and Ben Rogaly, ‘Microfinance and Poverty Reduction (Ox'am):’ Oxfam √ ~’ (UK and Ireland) and ACTIONAID. U.K. (1997).

<sup>33</sup> Muluken Alemayehu, Mesfin Lemma, Assessment of Factors Affecting the Performance of Microfinance Institutions: The Case of Hawassa City. (Vol.6 No. 1 June 2014) 1.

<sup>34</sup> Bamlaku Alamirew Alemu, ‘Micro financing and Poverty Reduction in Ethiopia’: A Paper prepared under the Internship Program IDRC, ESARO, Nairobi 2006.

Generally, the field of microfinance was pioneered by specialized non-governmental organizations and banks. They challenged the conventional wisdom of the 1970s and discovered that with new lending methods, the rural poor repaid loans on time. These new methods included providing very small loans without collateral at full-cost interest rates that were repayable in frequent installments. They demonstrated that the poor majority, who are generally excluded from the formal financial sector, can, in fact, be a market niche for innovative banking services that are commercially sustainable. As a result, current microfinance has made a major shift from subsidized microfinance projects of the past, which ended up serving few people, to the development of sustainable financial institutions specialized in serving the low-income market. Today there are a growing number of successful microfinance institutions worldwide. These are primarily local institutions that are reaching a significant number of poor people and that are becoming commercially viable.<sup>35</sup>

Over the past 13 years or so, microfinance has rapidly evolved and expanded from the relatively narrow field of micro enterprise credit to the more comprehensive concept of microfinance (which includes a range of financial services for poor people, including savings, money transfers, and insurance) to the enormous challenge of building inclusive financial systems.<sup>36</sup>

The ideas and aspirations behind microfinance are not new. Small, informal savings and credit groups have operated for centuries across the world, from Ghana to Mexico to India and beyond. In Europe, as early as the 15<sup>th</sup> century, the Catholic Church founded pawn shops as an alternative to usurious money lenders.<sup>37</sup> These pawn shops spread throughout the urban areas in Europe in the 15th century. Formal credit and savings institutions for the poor have also been around for generations, offering financial services for customers who were traditionally neglected by commercial banks. The Irish loan fund system started in the early 1700s is an early (and long-lived) example. By the 1840s, this system had about 300 funds throughout Ireland.<sup>38</sup>

In the 1800s, Europe saw the emergence of larger and more formal savings and credit institutions that focused primarily on the rural and urban poor. Primarily the financial cooperative was

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<sup>35</sup> Available at <[www.undp.org/evaluation/documents/Essential-on-microfinance.pdf](http://www.undp.org/evaluation/documents/Essential-on-microfinance.pdf)> No. 3 December 1999.

<sup>36</sup> Giday (n30) 91

<sup>37</sup> Ibid.

<sup>38</sup> Ibid.

developed in Germany. It aimed to help the rural population break from their dependence on money lenders and to improve their welfare. The movement emerged in France in 1865 and Quebec in 1900.

Many of today's financial cooperatives in Africa, Latin America, and Asia find their roots in this European movement. Another early example is the Indonesian People's Credit Banks that opened in 1895 and became the largest microfinance system in Indonesia, with close to 9,000 branches.<sup>39</sup> In the early 1900s, variations on the savings and credit theme began to appear in rural Latin America and elsewhere. These rural finance interventions aimed to modernize the agricultural sector, mobilize "idle" savings, increase investment through credit, and reduce oppressive feudal relations that were enforced through indebtedness.<sup>40</sup> In most cases, these new banks for the poor were not owned by the poor themselves, as they had been in Europe, but by government agencies or private banks. Over the years, these institutions became inefficient and at times corrupt.<sup>41</sup>

Between the 1950s and 1970s, governments and donors focused on providing agricultural credit to small and marginalized farmers in hopes of raising productivity and incomes. These efforts to expand access to agricultural credit used state-owned development finance institutions, or farmers' cooperatives in some cases, to make loans to customers at below-market interest rates. Many countries funds provided for microcredit by governments and donors continue to be misdirected into large subsidized credit programs. This leaves most of the economically active poor without access to credit for working capital or investment.<sup>42</sup> These subsidized schemes were rarely successful. Rural development banks were unable to cover their costs with subsidized interest rates. Customers had poor repayment discipline, because they saw their loans as gifts from the government.<sup>43</sup>

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<sup>39</sup> Ibid.

<sup>40</sup> Ibid.

<sup>41</sup> Ibid.

<sup>42</sup> Marguerite S. Robinson, 'the Microfinance Revolution: Sustainable Banking for the Poor', Washington, DC: The World Bank (2001) 34.

<sup>43</sup> Giday (n30)

## 2.2. Definitions of microfinance

Despite slight differences, the definitions proposed by different scholars and organizations are more or less the same. Most of them share the same view in that the service targets poor people who can't access formal banking services. For the purposes of this study some of the definitions pertaining to microfinance are highlighted below;

The highly respected microfinance information exchange recognizes many general definitions of microfinance.

*“Microfinance refers to a variety of financial services that target low-income clients, particularly women. Since the clients of microfinance institutions (MFIs) have lower incomes and often have limited access to other financial services, microfinance products tend to be for smaller monetary amounts than traditional financial services. These services include loans, savings, insurance, and remittances.....”<sup>44</sup>*

Some argues microfinance as a provision of financial services (generally saving and credit) to low income clients and as the most efficient instruments to promote economic development and to fight poverty in poorer countries.<sup>45</sup>

Microfinances are also explained as small financial institutions that have traditionally provided small loans to low income citizens with the objective of helping them to engage in productive activities (micro enterprise)<sup>46</sup>.

A more wider definition of microfinance by Robinson describes it as;

*"Small scale financial services - primarily credit and savings - provided to poor people who farm or fish or herd; who operate small enterprises or microenterprises where goods are produced, recycled, repaired, or sold; who provide services; who work for wages or commissions; who gain income from renting out small amounts of land, vehicles, draft animals, or machinery and tools; and to other individuals and groups at local levels of developing countries, both rural and urban."*

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<sup>44</sup> Microfinance Information Exchange (2010) Available at <<http://www.themix.org>> (accessed 15 May 2011).

<sup>45</sup> Joanna Ledgerwood, 'Sustainable banking with the Poor - Microfinance Handbook: An Institutional and Financial Perspective. The World Bank. Washington D.C. USA. (1999); Susan Johnson and Ben Rogaly, 'Microfinance and Poverty Reduction (Ox'am):' Oxfam √ (UK and Ireland) and ACTIONAID. U.K. (1997).

<sup>46</sup> Robinson (n42) 46

The micro financing proclamation defined micro-financing business as the provision of financial services as specified under Article 3(2) of this Proclamation by authorized institution. For example, it collects both voluntary and compulsory savings as well as demand and time deposits; and extending credit to rural and urban farmers and people engaged in other similar activities as well as micro and small-scale rural and urban entrepreneurs.<sup>47</sup>

The definitions described by different scholars above are more or less similar. That is microfinance as provision of a small amount of loan for the poor, specifically to the rural and urban poor denied formal financial services. Thus, MFIs are different from traditional financial institutions because they only provide services to low income customers and often provide loans with or without collateral.

### **2.3. The School of Thoughts on Microfinances**

As we have seen in the definitional part, microfinance institutions have evolved as an economic development tool intended to benefit low-income people.

The schools of thought on how to deliver financial services to the poor are the minimalist, institutionalist, self-sustainability, the integrated service delivery, welfarist and poverty approaches.<sup>48</sup> However, in most cases these thoughts categorized in to two thoughts that is institutionalist and welfarist approach. In this study the two leading views will be discussed since the other schools of thoughts have more or less similar with either of the two approaches.

#### **2.3.1. Institutional thought:-**

This thought centers on “financial deepening” of building sustainability to serve those excluded from services of conventional banks.

Achieving financial self-sufficiency /FSS/ and the number of clients served (in other terms breadth of outreach) are at the heart of the institutionalist approach. Institutionalists do not agree

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<sup>47</sup> Micro Financing Business Proclamation (n5) art 3(2)

<sup>48</sup> Nitin Bhatt, and Shui-Yan Tang, Delivering microfinance in developing countries: controversies and policy perspectives (2001). Policy Studies Journal, Vol. 29(2); Brau, J. and Woller,G, Microfinance institutions: a comprehensive review of the existing literature and an outline for future financial research(2004). Journal of Entrepreneurial Finance and Business: Ventures Vol. 9; Woller, G. & Woodworth, W., Microcredit as a grass roots policy for international development (2001), Policy Studies Journal.Vol.29 (2). Cited on Adeno K., Outreach and Sustainability of the Amhara Credit and Saving Institution (ACSI), Ethiopia (2007). A Master’s Thesis; Department of International Environment and Development Studies, (Noragric) Norwegian University of Life Sciences (UMB), May 2007.

on directly targeting the very poor. Targeting the very poor is costly that hinder financial self-sufficiency.

The overall goal is to provide sustainable financial services to low income group, but not necessarily to the poorest.

This thought believes that Non-governmental organization/NGOs/ do not have an important role in micro finance development and subsidized programs may undermine the development of a financial system for low income groups.<sup>49</sup>

### **2.3.2. Welfarists thought:-**

This thought argues that it is possible to realize breadth and depth of outreach with poverty targeted services. The overall goal is poverty reduction and empowerment, and hence the target should be the poor.

The institutionalist and welfarist approaches have practical inferences on differences in the devise for service delivery, institutional structures and financing, and segregation of the potential clients to be served. Their basic difference lies at focusing on the institutional sustainability on the part of institutionalists but social benefits of welfarists.<sup>50</sup> Hence, institutionalists give main concern to the business where as welfarists focus on clients or outreach.

Poverty and sustainability are the yin and yang of microfinances. They are two sides of a whole, each incomplete without the other. This view emphasizes that reaching the poor and sustainability are in large measure complementary, and particularly that sustainability serves outreach. Only by achieving a high degree of sustainability have microfinance programs gained access to the funding they need over time to serve significant numbers of their poverty-level clients.<sup>51</sup>

*"Reaching the poor and sustainability are inlarge measure complimentary, and particularly that sustainability serves outreach....There is in fact only one objective - outreach. Sustainability is*

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<sup>49</sup> Robinson (n42) 8

<sup>50</sup> Gary M. Waller and Warner Woodworth, Microcredit as a grass-roots policy for international development (2001). Policy Studies Journal, Vol.29 (2); Adeno K., Outreach and Sustainability of the Amhara Credit and Saving Institution (ACSI), Ethiopia, A Master's Thesis; Department of International Environment and Development Studies, (Noragric) Norwegian University of Life Sciences (UMB) May 2007.

<sup>51</sup> Robinson (n42) 24

*but the means to achieve it. Sustainability is in no way an end itself; it is only valued for what it brings to the clients of micro finance.*"<sup>52</sup>

Despite the arguments of the two approaches, the truth seems to lie somewhere in between the two approaches. Both reaching the poor and sustainability objectives are complimentary in many instances.<sup>53</sup>

#### **2.4. Micro finance institutions in Ethiopia**

Similarly with that of other jurisdictions, micro-finance in Ethiopia has its origin in traditional informal methods used to accumulate saving and access credit by people who lacked access to formal financial institutions.

The Ethiopian economy has been state controlled through a series of industrial development plans since the Imperial Government of Haile Selassie. Under state socialism (1974-91), popularly referred to in Ethiopia as the 'Derg regime', financial institutions were directed to finance some public projects that may not have passed proper financial appraisal.<sup>54</sup>

Ethiopia has one of the largest microfinance markets and fastest growing microfinance sectors. Microfinance is now a major supplier of financial services to millions of people in the developing world. In developing countries, including Ethiopia, micro finance institutions emerged with unique opportunity to poor people who do not have access to commercial Banks. Microfinance involves the provision of micro-credit, savings, and other services to the poor that are excluded by the commercial banks for collateral and other reasons. Microfinance is relatively new to Ethiopia and came to appear in 1994/95 with the government's Licensing and

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<sup>52</sup> Graham, A.N. Wright and Aleke Dondo, Client Selection by Microfinance Institutions: In Small Enterprise Development, an International Journal of Micro Finance and Business Development, Vol. 12, No. 1, ITDG Publishing, 103 - 105 Southampton Row London (March 2001).

<sup>53</sup> Hege Gulli and Marguerite Berger, Microfinance and poverty reduction - evidence from Latin America. In Small Enterprise Development, an International Journal of Micro Finance and Business Development, Vol. 10, No.3, ITDG Publishing, 103 - 105 Southampton Row London September 1999.; Wright, Graham, A.N. and Dondo, Aleke, Client Selection by Microfinance Institutions: In Small Enterprise Development, an International Journal of Micro Finance and Business Development, Vol. 12, No. 1, ITDG Publishing, 103 - 105 Southampton Row London. March 2001.

<sup>54</sup> Yesuf Legas, performance evaluation of the commercial bank of Ethiopia: pre and post liberalization Unpublished MSc. Thesis, Department of Accounting and Finance, Mekelle University 2010.

Supervision of Microfinance Institution Proclamation.<sup>55</sup> The program believes to reduce the poverty by giving loans for the poor<sup>56</sup>.

Following the political changes in 1991 a subsequent policy changes has been made towards a free market economy, agriculture focused development and to liberalize the financial sector. To this effect, Proclamation No. 84/94 was issued, which allows private domestic investors to participate in banking and insurance activities, which were previously monopolized by the government. However, the issuance of this proclamation alone does not totally solve the financial problem of the economically active poor people in rural and urban areas.<sup>57</sup>

Ethiopian microfinance has made remarkable progress over the past few decades, reaching millions of Ethiopian people. Nevertheless, financial services for the low-income population, poor farmers and micro, small and medium enterprises/ MSMEs/ are still characterized by limited outreach, high transaction costs for clients, generally weak institutional base, weak governance and a nominal ownership structure as well as dependence on government and mother NGOs.<sup>58</sup> Sustainable finance for the poor enables them to change their life entirely, but many study revealed that the currently existed MFIs does not meet the demand for financial service of active poor. Another Proclamation, No. 40/96 was issued to solve the problem of the delivery of financial services to the poor. Under this proclamation, microfinance finance business is "defined as an activity of extending credit, in cash, or in kind, to peasant farmers or urban small entrepreneurs, the loan size of which shall be fixed by bank" and micro financing institutions means " a company licensed under this proclamation to engage in micro financing business in urban and rural areas."<sup>59</sup> Since then, various microfinance institutions have legally been registered and started delivering microfinance services.<sup>60</sup> In particular, the Licensing and Supervision of Microfinance Institution Proclamation of the government encouraged the spread

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<sup>55</sup> Bereket (n8)

<sup>56</sup> Getaneh Gobezie, 'Livelihoods through Micro-enterprise Services': Assessing Supply and Demand Constraints for Microfinance in Ethiopia (With Particular Reference to the Amhara Region). Paper Presented at the 3<sup>rd</sup> International Conference on the Ethiopian Economy, (2005) 36.

<sup>57</sup> Seifu Ali, 'The Demand for Micro Credit Services in the Afar National Regional State': The Case of Gewane Woreda MSC Thesis, Department of RLDS (2002) 3.

<sup>58</sup> Martina Wiedmaier- Pfister, Deginew Gesesse , Wolday Amha, Mommart zRochus, William Steel, Eric Duflos, Access to Finance in Ethiopia: Sector Assessment Study, German Technical Cooperation, Vol.2 (2008)12.

<sup>59</sup> The Licensing and Supervision of the Business of Micro-financing Institutions: article 2(3) of Proclamation No. 40/1996.

<sup>60</sup> Wolday (n3)

of microfinance institutions in both rural and urban areas as it authorized them among other things, to legally accept deposits from the general public (hence diversify sources of funds), to draw and accept drafts, and to manage funds for the micro financing business.<sup>61</sup>

Following the issuance of this proclamation different NGOs have shifted themselves into microfinance institutions and formed their own local microfinance wings as independent, regulated MFIs by putting their Ethiopian employees up as shareholders, a strategy used by World Vision, Care Ethiopia and Catholic Relief.<sup>62</sup> Beside banks and insurance companies, microfinance institutions have continue to play a significant role in giving credit and saving facilities to the micro sectors of the economy.

Consequently, the microfinance industry of Ethiopia showed a remarkable growth in terms of outreach and sustainability.<sup>63</sup>

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.<sup>64</sup> 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.<sup>65</sup>

Furthermore, the National Bank of Ethiopia issued a new directive on May 2002 to improve the regulation limits on loan size (Br. 5000), repayment period (one year), and lending methodology (social collateral).<sup>66</sup>

Currently there are 38 microfinance institutions in Ethiopia, licensed and registered by National bank of Ethiopia.<sup>67</sup> However, this proclamation latter repealed by the proclamation cited as the “Micro- Financing Business Proclamation No. 626/2009”.<sup>68</sup>

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<sup>61</sup> Getaneh Gobezie, Regulating Microfinance in Ethiopia: Making it more Effective. Amhara Credit and Savings Institution (ACSI) April 2005.

<sup>62</sup> Wiedmaier (n58) 32

<sup>63</sup> Giday (30) 92

<sup>64</sup> Wolday (n15)

<sup>65</sup> Ibid

<sup>66</sup> Muluken (n33)

<sup>67</sup> Ethiopian National Bank report (2018).

<sup>68</sup> Micro Financing Business Proclamation (n5) art 1

The proliferation of microfinance institutions could indicate the emphasis given to the strategy to fight against poverty in the country. Microfinance initiatives are policy instruments (prime components of the new development strategy). They can create an enabling environment for the poor to increase output and productivity by inducing technology adoption, improving input supply, and increasing income, reducing hunger and thereby reducing poverty.<sup>69</sup>

Unlike other jurisdiction, there are few works conducted by different scholars in Ethiopia with regard to microfinances. For example the work of Alemayehu Yisraw tries to look the financial and operational performance of Ethiopian microfinance institution. This investigated the performance of the institutions by using profitability and sustainability, asset and liability management and efficiency and productivity as performance indicators.<sup>70</sup>

The other studies revealed that the performance of Ethiopian microfinance institutions by using micro banking bullet in benchmarks. The result of the study conclude that the Ethiopian MFI in general has poor performance in properly using of debt capacity, depth of outreach and they allocate lower proportion of their asset into loans.<sup>71</sup>

Again other study attempts to investigate the performance of MFIs in the country similar with the study conducted above with regard to outreach and financial sustainability perspectives. In the study it is expressed that the reach of MFIs to the very poor is limited. In addition he proofed that there is no trade-off between outreach and financial sustainability.<sup>72</sup>

As of June 2018 there are about 38 MFIs registered under national bank of Ethiopia. The Ethiopian microfinance market is dominated by a few large MFIs, all of which are linked to regional state government ownership.

Microfinance provision in Ethiopia is highly concentrated, with the five largest MFIs (Amhara, Dedit, Oromia, Omo and Addis Credit and Savings Institutes) together accounting for 93.6%

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<sup>69</sup> Wolday Amha, 'Development of Microfinance Industry in Ethiopia: Performance, Problems and Prospects'. A Paper Presented for the 11th Annual Conference of the Ethiopian Economy. Adama Mimeographed (2001).

<sup>70</sup> Alemayehu (n18)

<sup>71</sup> Letenah (n14)

<sup>72</sup> Befekadu (n19)

of the savings and 90% percent of the credit of the MFI sector. The strength of the regional microfinance institutions means that there is a low level of competition in the industry.<sup>73</sup>

From the total of thirty-eight MFIs operating in Ethiopia, Seven of them are operating in SNNPR; namely, OMFI, Sidama micro finance, Wisdom, Agar, Leta, Metemamen and Meklit. Sidama micro finance is operating in almost all urban and rural areas of Sidama zone. Wisdom is operating mainly in urban areas of Sidama, Gedeo, Wolayita, Hadiya, Kambata Tembaro, and Gamo Gofa zones; and Agar and Meklit are operating in some urban areas of Gurage zone. Metemamen is operating in Gurage Zone. Of the micro finance institutions in the region, OMFI has got relatively larger geographical coverage and number of clients. In this study from the seven micro finance institutions operating in SNNPR, Omo, Vision fund, Sidama and Meklit micro finance institutions were selected purposively. The reason is that they are dependent on NGOs, government and associations for their finance and relatively better outreach.

Many people in Ethiopia have been given access to formal financial services through microfinance programs. Nevertheless, millions of potential clients still remain unserved and the demand for financial services far exceeds the currently available supply.

The establishment of sustainable MFI that reach a large number of rural and urban poor who are not served by the conventional financial institutions has been a prime component of the new development strategy of Ethiopia.<sup>74</sup> Healthy financial and efficient performance of microfinance institutions is very important for their well-functioning and to serve their clients properly.<sup>75</sup> In this study due regard is given to the sustainable microfinance institutions to realize the objective of reaching a greater number of poor effectively. Several studies have been conducted to determine factors affecting financial sustainability of MFIs using large and developed MFIs in various countries. The level of significance of these factors in affecting the financial sustainability of MFIs, however, varies with studies.<sup>76</sup> For the purpose of this study weak shareholder base and foreclosure were opted to assess how they are affecting the sustainability of

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<sup>73</sup> Peter Mackie, Alison Brown, Alastair Smith and Ben Gas coyne, 'Microfinance and Poverty Alleviation in Ethiopia': Inclusive Growth: Ethiopia Country Report June 2015.

<sup>74</sup> Research Journal of Finance and Accounting: available at <[www.iiste.org](http://www.iiste.org)> ISSN 2222-1697 (Paper) ISSN 2222-2847 (Online) Vol.7, No.5, 2016.

<sup>75</sup> Ibid.

<sup>76</sup> Robert Cull, Asli Demirgüç-Kunt, and Jonathan Morduch, 'financial performance and outreach': A global analysis of leading micro banks 2007. (Economic Journal, vol.117) 107-133.

MFIs in Ethiopia particularly in SNNPR. The viability of the MF sectors is essential to achieve the objective outreach. For the purpose of this study the existing legal framework with regard to foreclosure and ownership and its practical enforcement were preferred to test its adequacy to regulate and its practical applicability.

Even though the existing MFIs law does not preclude foreclosing of property mortgaged or pledged and private participation in the microfinance business, this law does not practically get implementation in most of the microfinance sectors in Ethiopia particularly in SNNPR consistently and not efficient in collecting defaulted loans. There is no specific directive that determines the amount of shares that should be owned by a person. As we know the major mission of the MFIs are to make access financial services to the poor who are out of conventional financial services. Based on this the researcher tried to show in the next chapters how weak ownership base and absence of specific comprehensive laws of foreclosure affect the viability of microfinance institutions.

## Chapter Three

### 3.1. Findings and Discussion of the study

As noted in previous chapter microfinance institutions predominantly originated with a mission of a social objective. However, in the last few decades there has been a major shift in emphasis from the social objective of poverty reduction towards the economic objective of sustainable and market based financial services<sup>77</sup>. Hence, healthy financial performance of microfinance institutions is very important for their well-functioning and to serve their clients properly.<sup>78</sup>

As of June 2018 there are about 38 MFIs registered under national bank of Ethiopia. Seven of them are operating in SNNPR; namely, OMFI, Sidama micro finance, Wisdom, Agar, Leta, Metemamen and Meklit.

From the seven microfinance institutions operating in the region, OMFI has large outreach in the region compared to others. Sidama in all urban and rural areas of Sidama zone, Wisdom in urban areas of Sidama, Gedeo, Wolayita, Hadiya, Kambata Tembaro, and Gamo Gofa zones, Agar and Meklit in some urban areas of Gurage zone and Metemamen in Gurage Zone serving financial services for those who have not access to conventional bank.<sup>79</sup> This suggests that MFIs services in the region are limited to fixed areas and still there are millions of people out of financial access. So to assess the reasons why MFIs accessibility is limited to specific area, the researcher opted OMF, vision fund, sidama and Meklit MFIs purposively. Long lasting services, large geographical coverage and accessibility to the researcher considered to prefer.

Even though MFIs in the region serving the poor in better manner than other conventional financial sectors, still millions of people in the region have not access to finance and hence they are exposed to unlawful money lenders and high interest rate. This is because for one thing, MFIs have limited area coverage in the region and concentrated in few locations and since the industries are characterized by significant capital constraints. So to avoid this capital constraint the establishment of sustainable MFI that reach a large number of rural and urban poor who are

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<sup>77</sup> Rauf Shahnza A. and Mahamood, T., "Growth and Performance of Microfinance in Pakistan" *Pakistan Economic and Social Review* 47(1), (2009) 99-122.

<sup>78</sup> Giday, (n30) 92

<sup>79</sup> Omo microfinance institution strategic business plan, (2013/14-2015/16)7; Ethiopian National bank report, AEMFI report, 2018

not served by the conventional financial institutions has been a prime component of the new development strategy of Ethiopia.<sup>80</sup> The financial performances of MFIs in nature need to be economically viable and sustainable so that they can continue reaching their objectives.

Different literatures noted that financial sustainability is one of the areas that we need to look at to assess the performance of micro finance institutions. The poor needed to have access to financial service on long-term basis rather than just a one-time financial support<sup>81</sup>. The idea is that lending capital to poor people can be done in ways which ensure the sustainability of the institutions delivering the service became prominent from time to time.<sup>82</sup>

The main aim of this paper is to examine factors affecting performances of microfinance institutions focusing ownership base and foreclosure. In this study strong ownership base and specific foreclosure law taken as the major drivers for the sustainability of MFIs in the region. Unless microfinance institutions become viable and sustainable financial institutions, they can never fully realize their objective of reaching a greater number of poor people and alleviate poverty. Several studies have been conducted to determine factors affecting financial sustainability of MFIs using large and developed MFIs in various countries including Ethiopia. The level of significance of these factors in affecting the financial sustainability of MFIs, however, varies with studies.<sup>83</sup> However, in this study the researcher tried to assess the negative impacts of weak ownership base and absence of adequate MFIs law that regulate foreclosure on the sustainability of the industries in Ethiopia particularly in SNNPR which is not yet revealed by any studies to the maximum of the researcher's knowledge.

### **3.1.1. The laws that regulate ownership structure and defaulted loans**

There is law in Ethiopia that regulates both ownership structure and defaulted loans. But what the researcher wants to assess in this study is whether the existing MFIs law is adequate and comprehensive to regulate and to assess factors affecting practical implementation such law. The existing law that regulate foreclosure is not specific to MFIs but simply refers to apply the law of bank to foreclose property pledged or mortgaged without considering the specific characters of

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<sup>80</sup> Giday (n30)

<sup>81</sup> Richard (n21)

<sup>82</sup> Rogaly, Ben and Roche, Chris; *Learning from South - North links in Microfinance*; Oxfam Working Paper. U.K.(1998).

<sup>83</sup> Robert Cull (n76).

both microfinance institutions and banks and again this law does not define the amount of shares that should be owned by a shareholder in MFI like that of bank.

In this chapter the researcher tried to analyze the adequacy of the existing MFIs' law that regulate ownership structure and foreclosure and limitations of such law for its consistence enforcement in the region and finally the sources of finance to MFIs and whether the existing shareholder base are strong enough to improve the viability and outreach to the client and the effectiveness of the law in regulating it based on primary as well as secondary sources in the following parts.

### **3.1.2. Institutional assessment of Omo, Vision fund, Sidama and Meklit Microfinance institutions**

Widening the finance sources of MFIs results in benefits to the clients associated with an increase in the diversity of products and services available to the client, or an increase in scope of outreach. Increasing the scope of outreach, also called segment diversification, provides a variety of financial products to meet the needs of clients.<sup>84</sup>

Most microfinance programs are small and vulnerable to resource constraints. Because of this they operate in a few locations and serve specific clusters of clients. So they are exposed to the systematic risks of undiversified loan portfolios.<sup>85</sup> In countries where microfinance is oldest, the financing structure tends to be diverse. Where microcredit is new and growing including Ethiopia, donors, government and associations are the dominant funding sources of MFIs.

Because of weak base of finance sources, MFIs in Ethiopia mobilize few savings and hence they are not financially self-sufficient since they are mainly dependent on the funds of donors and government for their existence.<sup>86</sup> If the donors fund and government subsidies are terminated in the region for some reasons, most of the microfinances cannot survive by their own to provide financial services since they are relied on them for their finance. This tells us that microfinance institutions have not solid finance base, not self-sufficient and accessible to poor as expected.

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<sup>84</sup> Courtney Johnson, "The Impacts of Commercialization on Depth, Breadth, Scope, and Quality of Outreach in Mozambique: A Case- Study" (2017)11.

<sup>85</sup> Yaregal Tilahun Geremewe, The Role of Microfinance Institution for Poverty Reduction in Ethiopia: Journal of Economics and Sustainable Development <[www.iiste.org](http://www.iiste.org)>ISSN 2222-1700 (Paper) ISSN 2222-2855 (Online) Vol.10, No.5, (2019) 40.

<sup>86</sup> Richard (n21)

In surveying the ownership structure of MFIs, the researcher has made efforts to meet the key informants / managers and lawyers/of the selected microfinance institutions in the region. Accordingly, the researcher has met key informants who had been very close to information about the management and ownership structure of the MFIs and the exercising of foreclosure right and its effectiveness. Here under, the major issues are assessed.

### **3.1.3. Ownership structure of selected microfinances**

As noted in previous chapters different literatures revealed the institutional setup specially the ownership structure of MFIs in Ethiopia is problematic. The literatures witnessed that most of the MFIs in Ethiopia have limited sources of finance and unclear ownership structure. Hence their accessibility to the poor is very limited. Government, associations and NGOs are the principal sources of finance for MFIs in Ethiopia. Each funding source embraces charitable motives to support the beneficial poverty reduction strategies of the microfinance. In the current economic environment, these traditional sources of MFI financing may not be sufficient to allow providing maximum services to the large numbers of people.<sup>87</sup> Most MFIs in the region have equity structures supported by foreign donors who have contributed initial capital, but are not listed as shareholders. Because of these MFIs in the region are few in number hence weak competition among MFIs. Not only that but the shareholders even in those MFIs that are established by private capacity, the shareholder is nominal and only for legality requirement to establish MFIs as share company.<sup>88</sup> 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.<sup>89</sup> There is also restriction on free transfer of shares among non-shareholders of MFIs. If the shareholders are not getting dividend of profit, they may not be encouraged to effectively monitor the institutions performance. So this is another challenge that discouraging private investors to enter the industries.

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<sup>87</sup> David Fehr\*and Gaamaa Hishigsuren, Raising capital for microfinance: sources of funding and opportunities for equity financing, Southern New Hampshire University Working Paper No. 2004-01 (2004)1.

<sup>88</sup> Interview with Tamirat Ebrihem, lawyer in the head office of vision fund microfinance institution (Hawassa, January 1, 2020); interview with Mr. Fikru H/Mariam, lawyer in kembata tembaro zone durame branch of Vision fund MFI responded in similar manner with that of Tamirat February 10, 2020.

<sup>89</sup> Wolday Amha, (n15)12

### **3.1.3.1. Omo Micro Finance Institution**

From the micro financing institutions operating in SNNPR, OMFI has got relatively larger geographical coverage and number of clients.

The ownership structure of the institution is divided into share and is owned by five shareholders namely, the southern nations, nationalities and peoples regional state (SNNPR (80%), South Ethiopia peoples development association (SEPDA (6.25%), Wondo trading company (13.25%), southern Ethiopia youth association (0.25%) and southern Ethiopia women's association (0.25%).<sup>90</sup> The regional government hold 80% of the company directly and the remaining 20% indirectly through associations. This shows that the financial sources of OMFI are very limited and totally government affiliated. That means it mainly relies on regional government for its financing.

There is no dividend of profits and transfer of shares freely among shareholders in this institution. This is because the profit gained from the business is reinvested for the expansion of the institution since its inception this institution is not established for profit making and business motive, rather creating financial accessibility for those who are ignored by conventional financial services specially women and children as well as ensuring its sustainability. However, this does not mean the institution is not creating profit rather to it is to show how much the institution give more emphasis to social objectives.<sup>91</sup> This suggests that there is nothing that encourages private investors to participate in the industries. Not only that but the institution characterized by weak supervision of its operation regularly.

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<sup>90</sup> Interview with Mr. Alemayehu H/Giorgis, General manager of Omo microfinance Head office SNNPR (february 10, 2020, Hawassa); The Memorandum of association Omo microfinance.

<sup>91</sup> Ibid.

The following table suggests that OMFI is totally government affiliated.

No	Shareholder	Par value	No of shares		Total contribution	
			subscribed	Paid up	subscribed	Paid up
1	SNNPR Gov't	1000	1600	1600	1,600,000	1,600,000
2	SEPDA	1000	125	125	125,000	125,000
3	Wondo Trading Company	1000	265	265	265,000	265,000
4	Southern Ethiopia Youth Association	1000	5	5	5,000	5,000
5	Southern Ethiopia Women's Association	1000	5	5	5,000	5,000
	<b>Total</b>	<b>1000</b>	<b>2000</b>	<b>500</b>	<b>2,000,000</b>	<b>2,000,000</b>

Source: OMFI report

OMFI have five-tier organization structure, general assembly, board of directors, and head office; branch office and sub branch offices. Next to general assembly of shareholders, the highest and the decisive governing body of a share company is the board of directors elected among the shareholders.

### 3.1.3.2. Sidama microfinance institution

Sidama microfinance is established as Share Company and totally owned by public ownership and represented by few nominal shareholders like Sidama coffee cooperatives, Sidama development association and Sidama Development Corporation who don't have legal right to claim dividend at any time and simply they assigned to fulfill the legal requirement.<sup>92</sup>

Sidama microfinance only operate on sidama zone and it has no branch out of its region hence its service is limited to one zone. The general assembly consisting of a nominal shareholders and it is considered as the supreme organ in all the affairs of the organization.<sup>93</sup>

Development bank of Ethiopia, commercial bank of Ethiopia and CARE Ethiopia and SOS Sahel (donors) are the major sources of finance of Sidama microfinance.<sup>94</sup>

<sup>92</sup> Memorandum and articles of association of Sidama microfinance institution share company.

<sup>93</sup> Ibid.

<sup>94</sup> Sidama microfinance 2018 report

### 3.1.3.3. Vision Fund/Wisdom/ Micro finance institution

This microfinance institution characterized 100% private owned however, the ownership structure is not different from that of OMF and Sidama micro finance institutions that is their source of finance is NGOs affiliated.

Even though the Articles and Memorandum of Association of Vision Fund/Wisdom/ microfinance show individuals are the shareholders of it, these individuals have not invested their own money but they are trustees of NGO's Fund.<sup>95</sup>

Its sources of finance is from world vision, vision fund international, development bank and nominal shareholder who are employees of the mother NGO's who can't participate in key decision making.<sup>96</sup>

Different company especially NGOs disburses fund to the poor especially to children and women through vision fund since NGOs are not allowed to provide financial services by engaging in MFIs business directly.<sup>97</sup>

Although this MFI is organized as Share Company, the shareholders are not the real owners of the shares and represents international NGOs in Ethiopia for formality purpose only. Shares are distributed between the employees of the institution who have not role in the key decisions of the institutions and who cannot claim dividend of profit and transfer their shares to other parties freely. Shareholders are not investors in the sense of earning dividends and having a real interest in the economic benefits.<sup>98</sup>

The board of directors also created to systematically link the owners and the managers (nominal owners). When this institution is dependent on donors they are vulnerable to the “whims of donors” meaning that MFIs must respond to the demands of the donors regardless of what may be best for the organization.<sup>99</sup> So we can understand from this institution that the shareholders are not true share- holders and the sector is monopolized by international NGOs finance source. So the ultimate decision maker in the sector is mother NGOs that finance it rather than the shareholders. More of the loan they are providing is program based and not regular. So there is nothing that motivates private investors to participate in the industries.

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<sup>95</sup> Fikru H/Mariam, lawyer in kembata tembaro zone durame branch of Vision fund MFI (Durame, February 10, 2020); see also Articles and memorandum of association of Wisdom microfinance institution.

<sup>96</sup> Interview with Mr. Tamirat (n 88)

<sup>97</sup> Ibid

<sup>98</sup> Ibid Fikru (n95)

<sup>99</sup> Johnson (n84) 9

### 3.1.3.4. Meklit Microfinance Institution

Similarly with that of the previous three microfinance institutions above, most of the shares of Meklit microfinance institution are owned by NGOs, associations and nominal private investors who have no power to challenge the influence of their mother NGOs. 90% of the shares are owned by NGOs, associations and cooperatives. It only operates in the urban areas of Gurage zone and Hawassa city of the region.

The following table shows the four MFIs selected for this study providing financial services in the SNNPR and their ownership structure or sources of fund.

Microfinance institutions	Year of establishment	Regional Government	Associations and NGOs	Individuals	Total
Omo Microfinance Institution S.C	1997	80	19.5	0.5	100
Vision fund S.C	1998	-----	---	100	100
Sidama Micro-Financing Institutions S.C	1994	-----	70	30	100
Meklit Microfinance Institution S.C	2000	-----	91	9	100

Source: National Bank of Ethiopia.

It is easy to infer from the table that almost all microfinance institutions selected for the purpose of this study and their source of finance are dominated by government, associations or NGOs.

In Ethiopia MFI law's does not preclude private investors to engage in the sector but practically most of the institutions are still dominated by large public financial institutions. The reason is that private investors have the intention to get dividend of profit from his investment and need transparency of information in the sector but this is not the case in most of the MFIs. Also with in the microfinance sector, the major microfinance institutions in SNNPR are owned by regional governments /endowment companies, associations and NGOs<sup>100</sup> which is against competition since there is monopoly of the industries by such few owners.

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<sup>100</sup> Ebisa (n4) 10

Grants have a negative relationship with sustainability since it hinders the development of MFIs into competitive, efficient and sustainable operations.<sup>101</sup> Subsidized credit programs often have high default rates. Even the lending institutions typically put little efforts into collection and usually do not foreclose on collateral in case of default. This is because NGO support could weaken financial discipline in MFIs and dependence on donor money rather than deposit mobilization could constrain growth and sustainability. At the same time, NGO based MFIs are limited in their outreach by their dependence on external sources of donor funds, and their reach is generally limited to specific locations. In many cases, NGOs and government have tended to focus on social programs and services for which they have particular expertise, including programs aimed at reducing poverty.<sup>102</sup> In some cases, such dominances have been spoiling the market and remain a threat for the industry due to the practices of some illegal governments and NGO operations.<sup>103</sup> The downside is that these MFIs depend on this support and are subject to political influence, which could threaten their financial performance and the clients' credit discipline. Furthermore, there is some artificiality in their sustainability because there are hidden subsidies, such as government staff time and low-cost funds.

Microfinances in Ethiopia are not interested in selling shares and attracting other shareholders which could increase the possibility of improving the viability of MFIs. 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.<sup>104</sup> So the government and mother NGOs are using MFIs to implement their missions rather than to give priority for sustainability of MFIs or funds are often provided by government or donors who may want to influence operational policies to benefit a specific group or attain political or other (disbursement) objectives.<sup>105</sup>

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<sup>101</sup> Vicki Bogan, Willene Johnson, and Nomathemba Mhlanga, Does Capital Structure Affect the Financial Sustainability of Microfinance Institutions? (July 2007) 26.

<sup>102</sup> Anupam Basu, Rodolphe Blavy, Murat Yulek, Microfinance in Africa: Experience and Lessons from Selected African Countries. (September 2004) 14.

<sup>103</sup> Wolday Amaha, "a decade of microfinance institutions" development in Ethiopia: growth, performance, impact and prospect." Occasional paper NO. 21, AdisAbaba , for/by the association of Ethiopian microfinance institutions(AEMFI 2008-2017).

<sup>104</sup> Wolday (n15) 31

<sup>105</sup> Biruk Tadesse, assessment of potential and challenges of microfinance institutions to enable the uptake of household biogas in the national biogas program, University of Twente Netherlands. (December 2010) 88.

There is an illegal way of doing the micro financing business from the side of the government, NGOs and other agencies which continue to provide uncollectible loans to achieve their mission. Apart from this, there are deep concerns within the microfinance sector about the growing issue of inflation on the profitability of MFIs, and the ability to maintain low interest rates.<sup>106</sup>

Many of MFIs in the region relies on regional governments, associations and NGOs for their capital or finance. This dependence on fixed funding sources from donors and governments will gradually diminish as local financial institutions and private capital markets mature.

Although many national and international donors continue to be vital in financially supporting MFIs, many policy makers consider this method to be unsustainable. This is because when donor's pockets run dry in the occasion of adverse situation, MFIs will not have working capital to be able to expand or even continue providing financial services.<sup>107</sup>

Appropriate government intervention as well as donor support is necessary to mainstream microfinance into the financial sector since empirical evidence indicates that microfinance services thrive in areas with relatively better infrastructure.<sup>108</sup> Conversely, there is a severe lack of microfinance services in areas with poor physical infrastructure since there are unacceptable high risks and transaction costs in the industries.<sup>109</sup>

Similarly the government of Ethiopia is playing an active and important role in developing financial services for the poor and micro, small and medium enterprises MSMEs, which has been a key driver of microfinance. Regional governments continue to support the strongest MFIs with funding, guarantees and other support such as staff time or office space.<sup>110</sup> As a result, the government-backed MFIs operate at low cost and serve large parts of the clients of all MFIs. However, there is a downside to strong government involvement, which includes:

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<sup>106</sup> Panda and Mohanty, product Mix and product innovation of micro finance in about the author 2006. Microfinance Gateway available at: <<https://www.micrifinancegateway.org/sites/default/files/>> mfg-en-paper-product-Mix-and-product-innovation-of-micrifinance-in-india-2006.

<sup>107</sup> Johnson (n84) 9

<sup>108</sup> Charitonenko, Stephanie, Anita Campion, and Nimal Fernando, Commercialization of Microfinance: Perspectives from South and Southeast Asia. Manila: ADB 2004

<sup>109</sup> Charitonenko (n16)

<sup>110</sup> Reports from MFIs confirm that staff from government agencies and government-affiliated NGOs such as the local administration or women associations assists in client selection for lending programs and repayment.

Pressure to handle subsidized lending or grant programs that tend to distort MFIs' markets by crowding-out their services, diverting their clients, and undermine borrower selection based on credit worthiness;

Overemphasis on growth rather than on the consolidation of operating systems, with the risk that too rapid growth could become unmanageable and lower performance of the MFIs; Lack of transparency and accountability in the capitalization and cost structures of MFIs; and dependence on subsidies and cheap funds from government to offset low interest rates, undermining financial self-sufficiency as growth outstrips funds available.<sup>111</sup>

For this reason government's business in the microfinance industry should be to provide policy directions so that it will attract more private sector participation in microfinance. More entry means greater competition and greater access by the poor to not only credit but other financial services since still the demand and supply finance is not complied with one other. And again donor assistance should consider capacity-building for MFIs to promote MFIs viability and sustainability rather than running the business by holding major shares of the institutions.

The Ethiopian micro finance law authorizes Ethiopian nationals and foreign nationals of Ethiopian origin to undertake micro financing business and again the shareholders should buy shares from their own pocket. However, in reality the shareholders in most MFIs are nominal who are not investing their own money in the institutions (without real stake).<sup>112</sup> Because of fake ownership structure and reliance on government subsidies and donors for their finance, microfinance institutions exposed to certain risks since there is lack of clear responsibilities and its non-transparent nature. 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.<sup>113</sup> If this is the case there is no better environment that can attract private investors to sector.

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 in Ethiopia and discouraging competition

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<sup>111</sup> Bogan (n101) 48

<sup>112</sup> Wolday (n15)

<sup>113</sup> Ibid

among MFIs. This implies that, MFIs are currently unattractive investment opportunities to private equity investors<sup>114</sup> and dependent on limited finance sources. 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.<sup>115</sup> Because of this limited shareholder base of MFIs in Ethiopia particularly facing loan constraint and challenging the outreach financial services in the expected manner and finally results in mismatch of the demand and supply of loan. This finally leads to leave most of the economically active poor without access to credit for working capital or investment. If MFIs have weak ownership base, there is negative impacts on the sustainability of the institutions especially in the occasion of the industry face crises or potential fails.

When MFIs have wide shareholder base, there is a possibility of risk transferring among the shareholders and assure the sustainability of the sector. However, if the MFIs have weak shareholder base, the possibility to sustain is similarly weak and it cannot achieve its main objectives that are outreaching the poor who are out of formal banks and poverty alleviation. 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.<sup>116</sup>

#### **3.1.4. Foreclosure:-**

Foreclosure is a legal proceeding to terminate a mortgagor's interest in property instituted by the lender (the mortgagee) either to gain title or to force a sale in order to satisfy the unpaid debt secured by the property.<sup>117</sup>

Loan repayment delinquency is recognized as the major threat to maintain the value of fund. A high rate of non-repayment erodes the value of the loan portfolio and reduces income, which undermines the hope of achieving sustainability. Most successful microfinance institutions have a good record of repayment rate. High repayment rate in some microfinance institutions has been

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<sup>114</sup> Ibid 28

<sup>115</sup> Ibid 11

<sup>116</sup> Ibid.

<sup>117</sup> Black's law dictionary (9th edition)

associated with group formation, close monitoring and follow-up.<sup>118</sup> So appropriate legal protection and regulation plays important role in minimizing the existence of non-performing loans within financial institutions.

Ethiopia issued a foreclosure law which gives banking institutions wider rights than other institutions. Thus unlike other creditors, creditor banks can be authorized by the debtor to sell the property if he does not make the payment on time.<sup>119</sup>

Before the issuance of the foreclosure law, banks in Ethiopia used to resort to courts as a recovery mechanism. This mechanism proved to be inefficient. Recognizing this inefficiency, Ethiopia has issued a law which deals with property mortgaged or pledged with banks. Proclamation No. 97/1998 is issued aiming to achieve different objectives. The objectives include avoiding long time takes to obtain judgment from the court of law for sale of property mortgaged or pledged with banks, avoiding problem in execution of judgments and avoiding its adverse effect on public money received by banks by way of saving deposits or acquired from other sources.<sup>120</sup> This law makes banks relatively efficient and effective in collecting defaulted loan.

Similarly the micro financing business law refers to apply the law of bank *mutatis mutandis* in the clients default to return his loan on time. However, this law is not practically in most of the MFIs get implementation for reasons discussed below.

The question is that does the existing law made MFIs efficient in collecting defaulted loan like that of bank and practically this right gets practically implementation? The researcher reviewed from the primary as well as the secondary sources that many of MFIs in the region not exercising this law like that of bank and not effective in collecting defaulted loans through exercising this law. This is because the existing foreclosure law has not its own procedural remedies for the well resolution of non-performing loan. Failing to collect the disbursed loan on time have its own

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<sup>118</sup> Tamrat Ludego Fitamo, Concepts And Measures of Outreach and Sustainability in Microfinance Institutions: A comprehensive literature review, Research Journal of Finance and Accounting <[www.iiste.org](http://www.iiste.org)> ISSN 2222-1697 (Paper) ISSN 2222-2847 (Online) Vol.5, No.21, (2014) 46.

<sup>119</sup> Tihitina Ayalew, Legal Problems in Realizing Non-Performing Loans of Banks in Ethiopia: (December, 2009) 2.

<sup>120</sup> Preamble, Property Mortgaged or Pledged with Banks, Proclamation No. 97/1998, Federal Negarit Gazeta, No 16, 19th February, 1998.

negative impacts on the liquidity, efficiency, limited capital and finally sustainability of microfinance institutions.

Improving the repayment rate could help to reduce the dependence on subsidies and help the microfinance institutions to reach a better sustainability level.

The researcher tried to review how much microfinance institutions practically implementing the existing foreclosure law and how much it is effective and the reasons for the non-enforcement of such law consistently. Many of microfinance institutions are not exercising the existing foreclosure rights but exercising this right through court proceedings.<sup>121</sup> Hence, based on the information given above, the researcher interviewed the key informants of the institution collected the following data in the study area. Even though the existing microfinance law authorizes to apply the law of banks regarding foreclosure, it is not adequate enough to MFIs to implement in the same manner with that of bank since it does not recognize the specific futures of MFIs and absence of its own procedural remedies difficulty to execute easily such law. What is making microfinance difficult to implement this law is the way they use to disperse loans and give more emphasis to social missions to provide financial services for those who are denied formal financial services whereas bank provide huge loan with huge collateral.<sup>122</sup> They may not always provide loans with solid collateral like that of bank rather it may provide loans based on group based and through holding land ownership certificate against loan which is difficult during execution. This law is not effective even on those MFIs that are exercising this right.

The property mortgaged or pledged with banks proclamation No. 97/98 does not have its own procedural remedies. It refers them to apply the civil procedure code during auction proceedings.<sup>123</sup> Because of this microfinance institutions are not efficient in collecting the disbursed loans easily since this law is not without limitations during execution even in case of bank.

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<sup>121</sup> Mr. Mulneh Gebeyehu, lawyer at the head office of Omo microfinance institution Hawassa. February 17, 2020; and interview with Abreham Jarra, lawyer at head offices of sidama microfinance (Hawassa, February, 2020)

<sup>122</sup> Ibid

<sup>123</sup> Property Mortgaged or Pledged with Banks Proclamation No. 97/1998 article 6 of Ethiopia, 4th Year No. 16' ADDIS ABABA – 19<sup>th</sup> Feb, 1998.

The researcher conducted key informants of selected MFIs in the region regarding factors affecting the performances of MFIs focusing on foreclosure and ownership structure. Currently many of microfinances do not exercising this law since it is not specific and recognizes the unique futures of MFIs rather it simply authorize to apply the law of banking without considering the differences between banks and MFIs.

For another thing the loan disbursement method is different from that of bank that means bank give loans to their clients with security/collateral/ whereas MFIs may disburse loans to its client with collateral, without collateral and by solidarity /group lending/ and again the client of MFIs more of poor who may not have collateral to securitize and get loan. In this occasion it is difficult to collect the disbursed loan easily like that of bank since there are challenges especially during execution.<sup>124</sup> So separate foreclosure law of microfinance that eases the collection of defaulted loan recognized the specific future is necessary.

Vision fund /wisdom/ microfinance Share Company is established as provided by the commercial code. Regarding the implementation of foreclosure right, vision fund MFI is exercising this right in client's default to repay its loan if the loan is secured by collateral even though there are challenges to exercise it.<sup>125</sup>

Not only that, most of micro credit is not secured with collateral, hence many of the cases are enforcing through negotiation or court proceedings, it expose the institutions to high litigation costs and consume time beginning from court proceeding to judgment execution and further leads to liquidity problem. And this will lead the institutions to financial inefficiency.<sup>126</sup> Microfinance institutions gives more emphases to social objectives and provide program based loan hence, their services is limited to fixed areas.

If this is so what are the major reasons that prohibit most of the microfinance institutions in the region not to apply the law of banks at default of MFI loans'? Subsidized loan programs, especially state owned MFIs often have high default rates. Even the lending MFIs typically put little efforts into collection and usually do not foreclose on collateral in case of default.<sup>127</sup>

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<sup>124</sup> Biniyam Petros, lawyer in kembata tembaro zone durame branch of Omo MFI responded in similar manner with that of Tamirat February 11, 2020.

<sup>125</sup> Interview with Tamirat (n 88)

<sup>126</sup> Ibid.

<sup>127</sup> Robinson (n42)142&143

### **3.1.4.3. The need to enact separate MFI law that regulate foreclosure**

The existing MFIs' law authorizes the microfinance institutions in Ethiopia to apply the law of bank with regard to foreclosure in the event of the client's default. However, it is difficult to say this law is comprehensive and efficient to collect the defaulted loans effectively in case of microfinance institutions. This is because for one thing exercising foreclosure right effectively is even not without limitations in case of banks especially during execution of the right since this law obliges banks to follow the auctioning procedure provided under civil procedure code of Ethiopia during public auction. For another thing MFIs provide small loans compared to banks and these institutions are established to play the role of financial inclusion for those denied financial access by banks. Since this law has not its own procedural remedies to enforce the right immediately, it exposes the microfinance institutions to additional costs. The loan size of microfinance institutions is very small compared to bank and the collateral secured for the loan also relatively low. If MFIs obliged to follow this civil procedure auctioning procedures, it leaves additional costs on it and consumes time. So based on the findings, the researcher reviewed both primary as well as secondary sources to evaluate the adequacy of the existing MFIs law with regard to foreclosure and its practical problems that challenge its enforcement.

The following are some of the additional reasons that justify the introduction of specific MFIs law with regard to foreclosure:

- MFIs target populations are the low income earners who are unable to secure a loan in a conventional commercial bank.
- In case of bank loans are most of the time secured by collateral where as in case of MFIs it may be without collateral, with collateral and group lending.
- The major goal of microfinance is to alleviate poverty in the population through credit provision while banks focus more of on profitability and growth business concept.
- MFIs are smaller in size, limit their services towards poor households and often provide small collateral or free group loans<sup>128</sup>.

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<sup>128</sup> Mamiza Haq, Michael Skully and Shams Pathan, Efficiency of Microfinance Institutions: A Data Envelopment Analysis November, 2009.

- MFIs mainly target poor households in rural areas to access financial services who are out of conventional financial services such as very small loans (micro credit) to help them to invest in or scale up their small businesses.<sup>129</sup>
- Banks have strong mechanisms for credit appraisal of borrowers whereas the MF industry is still at its infancy in risk management.
- The mechanism for handling delinquencies and default is weak in the case of MFIs as there is weak supervision and monitoring.
- Different physical and technological infrastructures: banks mostly integrate state-of-the art equipment to maintain digital records of client's information. However, MFIs are unable to catch up with this technological pace, mainly due to their capital and funding constraints.
- Finally the non-consistence enforcement of foreclosure law justifies the separate/ specific/ MFIs law with regard to foreclosure.

The differences listed above necessitated the specific and comprehensive foreclosure law for microfinance institutions.

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<sup>129</sup> Panda (n106)14

## **Chapter Four**

### **Conclusion and Recommendation**

#### **4.1. Conclusions**

Many people in Ethiopia have been given access to formal financial services through microfinance programs. Nevertheless, millions of potential clients still remain unserved and the demand for financial services far exceeds the currently available supply.

To achieve its objective of social mission, sustainability of MFIs is not-questionable. It is noted that high dependence on limited finance sources should decrease the viability or encouraging private investors to participate in the industries helps to ensure sustainability and outreach. But still most of the MFIs in the region are characterized by their limited sources of finances since they are backed by government, NGOs and associations. Absence of dividend of profit among shareholders and free transfer of shares in microfinance influenced private investors' not to participate in the sectors. Many of the shareholders 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, Ethiopian 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 Ethiopian microfinance institutions. Absence of specific and comprehensive foreclosure law that recognize the unique future of microfinance is another limitations that microfinance facing in the region. Most of the MFIs are not implementing bank regulation in relation with foreclosure because this law is not specific and conducive enough to enforce and not making microfinance efficient in collecting none performing loans.

#### **4.2. Recommendations**

Based on the findings, conclusion, exploring literatures, analyzing interviews and relevant legal documents, the study has come up with the following recommendations to ensure sustainability and improve the performance of microfinance institutions in SNNPR.

- By considering the role of microfinance institutions for poverty alleviation, the researchers recommend microfinance institutions, regulators and funders to improve the infrastructure that encourages private investors to participate in the industry and improve its capacity through training and strong monetary for better microfinance services rather than granting subsidies and holding lion shares of the microfinance institutions. It is clear that highly subsidized and targeted loan programs can distort and threaten sustainable financial services and also destroys credit discipline and harms the business of MFIs. Since microfinance institutions are backed by government, NGOs and associations for their funds, they are striving mainly to achieve social missions. Hence private investors are not interested to engage in the sectors since it is difficult to private owned MFIs to compete with that of subsidized one. On the other hand when there are private investors engagement in the industry, competition will follow and financial access will be diversified and finally the client will benefit from such diverse financial services. Microfinance demand can be met worldwide only through a substantial increase in the number of profitable, sustainable institutions providing commercial financial services to low-income clients. Hence government, associations and NGOs should refrain from their major shareholder position and regulate the institutions by supervisory capacities, technical assistance and encourage private investors to engage in the industries and make the ownership and governance of MFIs more transparent and independent, make funds available on increasingly commercial terms and develop guarantee schemes to facilitate greater financing from private commercial sources and make the full cost of services transparent.
- The researcher also recommend to the government, AEMFIs and the MFIs to improve ownership and governance structures of MFIs to mature and to become increasingly independent of the influences of government and donors because of their potential adverse effects on the operation of MFIs. External finance source based MFIs are limited in their outreach by their dependence on external sources, and also by their need to allocate their limited resources to a wide range of activities outside the microfinance sector. Improvements are needed to raise additional capital, especially from the private sector, real shareholder ownership, transfer of shares, profit distribution, and the capacity and composition of the boards. Substantial international funds, and accompanying technical assistance, would be

available if MFIs were permitted to have limited amounts of equity from foreign investors, particularly socially oriented investment funds.

- The law should explicitly define ownership structure and determine the amount of shares that shareholders can own /make the ownership relations clear/ like that of bank. The banking business proclamation clearly states that no person, other than the federal government of Ethiopia, may hold more than five percent of a bank's total shares either on his own or jointly with his spouse or with a person who is below the age of 18 related to him by consanguinity to the first degree.<sup>130</sup> But there is no such kind of prohibition or limits under micro financing proclamation and simply give mandate to national bank to issue directives regarding the amount of shares that should be owned by a person.<sup>131</sup> There is no clear government directive on the amount of shares that should be owned by individual shareholder for MFIs. Hence many MFIs in the region primarily dependent on limited sources of fund and lion shares of the industries are owned by government, NGOs and associations. When financial intermediaries have strong owners, they operate in the best achievement of their mission and the governing bodies including the board of directors will effectively oversee the institution by being fully informed about the institution's activities and performance. So there should be clear government directive on the amount of share that should be owned by a person and revisit ownership structure of microfinance institutions in connection with the amount of shares an individual owned at a time.
- In general, ownership diversification could enhance the quality of MFI financial services, ensure healthy growth, transparency, and help in achieving long-term sustainability. Ethiopian MFIs should encourage saving mobilization rather than relying on limited finance sources since dependence on limited sources of finances could constrain growth and sustainability of the industries and finally left the poor unserved of financial inclusion mission specially in the time the company faces bankruptcy /crisis/ or when the donors pocket run dry and illiquid because repayment rates are low, or funds promised by donors or governments have not materialized. Whereas when microfinance institutions have diverse sources of finance especially private investors' capital, the risk will be highly minimized

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<sup>130</sup> Banking Business Proclamation No. 592/2008 art 11 of Ethiopia, Negarite Gazeta, 14th Year No 57. ADDIS ABABA 25th August, 2008.

<sup>131</sup> Micro financing Business Proclamation (n5) art 10(1)

when the company faces bankruptcy since there is distribution of risks between real owners in such occasion. Client ownership should strengthen their identity with the institution, reduce the dropout rate, enhance the equity base, and improve the public image of MFIs, accountability and transparency and ensure sustainability.

- Although MFIs set up is as share companies, they do not distribute dividends or profits to their shareholders. Typically, their articles of Association state that the dividends are to be utilized for the benefit of the target group – the poor. As such, shareholders are not investors, and private capital investment for all practical purposes does not exist. Shareholders often act as fronts who cannot sell or transfer the shares and forego their claim on profits or dividends. So to attract private investors to enter in to the industries, microfinance institutions should recognize in their memorandum of articles dividend of profit and transfer of share freely.
- The researcher grasps from the study result that MFIs are facing weak repayments rates in the region for different reasons. The researcher found that absence of separate foreclosure law that is suitable for their specific characters that has its own procedural remedies significantly affecting the efficiency of microfinance industries. The law which is not specific to MFIs and not comply with its institutional structure and specific characteristics may threaten effective and efficient resolution of defaulted loans. As noted under chapter three of this study, there is no consistent implementation and supervision of such law in all the MFIs in the region. So the regulators have to design effective rules and regulations of contract enforcement and the implementation that should be supervised strictly. Banks and MFIs have their own unique futures that necessitate separate foreclosure law to minimize default of repayment in microfinance institutions. When we see the existing foreclosure law, it is not without limitations even in case of bank especially during execution because it has no its own procedural remedies. What the major problems during the implementation of civil procedure code is that there is no defined time that is provided regarding how much time can be spend without issuing the second auction. This may take much time and expose the sector to unnecessary costs and consume time and it may finally leads to liquidity problems. As we know microfinance institutions provide micro credit not provide huge loans like that of bank. Hence sale of the collateral may not cover even the debt of the borrower. Hence separate foreclosure law that help to realize defaulted loans easily without following strict civil procedure auctioning procedures should be enacted.

- Not only that but some clients obliged to secure huge collateral for micro loans and at default this huge collaterals are sold to satisfy such limited loans and later disturbing the rest life of the debtor. Hence the existing foreclosure law is not conducive enough for both the lender and the borrowers. So in order to create a climate of confidence conducive to private sector business activities and to avoid liquidity problem in the industries, appropriate foreclosure law that have its own procedural remedies and which covers the gaps regarding the auction procedures that clearly define how and when second auction could be passed by regulators. The new specific foreclosure law should determine some distinct entities with the sole purpose of managing non marketable collateralized assets that can administer or improve the property until such time the market is improved like AMC/Asset Management Companies/ in other jurisdictions.

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**Interview:**

Interview with Mr. Alemayehu H/giorgis, General Manager of Omo microfinance Head office SNNPR (February 10, 2020, Hawassa);

Mr. Mulneh Gebeyehu, lawyer at the head office of Omo microfinance Hawassa. February 17, 2020;

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Fikru H/Mariam, lawyer in kembata tembaro zone durame branch of Vision fund MFI (Durame, February 10, 2020);

## **ANNEX: INTERVIEW GUIDING QUESTIONS**

Hawassa University

Collage of Law and Governance Studies

School of Law

L.L.M in Commercial Laws

The researcher employed semi structured interview techniques to gather information from key informant of the selected MFIs

The main reason for this interview questions are to collect in-depth information from organizational authorities to retrieve relevant information on the issue of **“Examining the laws regulating ownership structure and foreclosure in microfinance institutions in Ethiopia.”** The data will be applied for the master’s thesis requirement in master of Laws in Commercial Laws (LLM). The information you will provide in this interview will be kept confidential and will be utilized only for the purpose of the study, your authentic responses is highly valuable for the achievement of the objectives of this research.

Thank you in advance for your cooperation!!!

1. What does the institutional set up looks like? By what motive does the institution established?
2. Who are the founding members of the institution? Who are the shareholders of the institution?
3. From where does the institution get their finance?
4. Do the shareholders are the real investors of their own capital? What are the reasons for the absence of private capital in the microfinance industry? Is there a good environment for in the MFIs that attract private investors?
5. Do you think that the existing sources of finance ensure the depth of outreach and sustainability of the institution?
6. Do you think that this institutions accessible to most of the people of SNNPR? How much its services outreached? And what is the reason?

7. How much the institution is profitable? How do the shareholders get dividend of profit? Is that possible to transfer shares easily like that other share company?
8. What does the regulation governing ownership looks like? Is it clear how much does a shareholder can hold?
9. Does the institution exercising the existing foreclosure right over the property pledged or mortgaged? If not why?
10. What are the legal and practical challenges to exercise foreclosure right? Do you think that the existing bank law with regard to foreclosure adequate law to regulate foreclosure right in MFI similar manner with that of bank?
11. Does the existing foreclosure law has its own procedural remedies?
12. Who are the managing directors of the institution? Are they shareholders of the institution? How much they are out of the influence government and other funding sources?
13. How do you see the economic policy of Ethiopia and privatization with the current ownership structure? Does the current MFI ownership structure encourages private investors to enter in the industries ensure efficiency?

Thank you!!!