

# The Regulation and Supervision of Micro Finance Institutions in Ethiopia:

## The Need to Balance Social Objectives with Financial Sustainability

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### Abstract

Microfinance Institutions (MFIs) play an important role in providing access to finance in developing countries. However, how to effectively regulate MFIs remains one of the challenges that needs attention. The need for legal and financial innovation to enable MFIs to continue to provide the much-needed financial service to society is apparent. One of the proposals is to use regulatory frameworks that are closely related or similar to those we use in banks. Ethiopia is currently using laws that are in many ways similar to its banking laws to regulate Microfinance Institutions. However, this approach is not without its limitations. Complex and burdensome regulations greatly affect the efficiency of Microfinance Institutions. We need MFIs not to be just commercial banks. We need them to fill the gap that is created by the existing banking system. We need them to be more open to small-scale borrowers, to use flexible credit packages and to give priority to women and vulnerable groups in society. Therefore, we need a legal regime that considers these special traits of MFIs and provides the required support to these institutions to be sustainable and viable in the market. This article examines the legal regime in Ethiopia, outlines its limitations and provides suggestions to make it more efficient.

### Key terms:

Access to finance · Social objective · Financial sustainability · Mission drift · Financial regulation

DOI <http://dx.doi.org/10.4314/mlr.v16i1.5>

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**Received:** 20 March 2022

**Accepted:** 23 July 2022

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### NB-

This article was written before two of the most dominant government-affiliated MFIs were converted into Siinqee Bank and Tsedey Bank.

**Suggested citation:**

Gebreysus Abegaz Yimer (2022). “The Regulation and Supervision of Micro Finance Institutions in Ethiopia: The Need to Balance Social Objectives with Financial Sustainability”, 16(1) *Mizan Law Review*: 131-158.

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## 1. Introduction

The relevance of law and its effective implementation for the development of the financial industry is a well-established theory.<sup>1</sup> Quality of laws and their effective implementation helps to improve financial inclusion and reduces the probability of exclusion from the formal credit market, particularly for small and micro enterprises.<sup>2</sup> Effective and efficient laws that can be enforced without a prolonged procedure and with minimum cost also reduce cost of credit and increase the probability of repayment.<sup>3</sup> Furthermore, Hanedar’s empirical analyses revealed that lack of an effective and efficient legal procedure is one of the reasons for small and medium

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<sup>1</sup> K Pistor, M Raiser, & S Gelfer (2003), Law and finance in transition economies. *Economics of Transition*, 8(2), 326-368.

<sup>2</sup> C Grant, & M Padula (2006), Informal credit markets, judicial costs and consumer credit: Evidence from firm level data. Working Paper. Centre for Studies in Economics and Finance.

<sup>3</sup> D Fabbri, & M Padula (2004), Does poor legal enforcement make household credit constrained. *Journal of Banking and Finance*, 28(10).

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enterprises (SME's) dependence on informal credit markets.<sup>4</sup> An empirical research study that relies on a rich database collected from more than 30 countries has shown that there is a significant positive relation between the poor quality of legal systems and increased dependence on informal credit markets.<sup>5</sup> When the legal system of a country lacks predictable, stable and efficient laws, and enforcement of contracts requires prolonged litigations, and the result is a high rate of financial exclusion of small-scale borrowers. Staschen *et al.* outline how laws hinder the attempts of formal financial institutions to provide financial services to the poor, thereby aggravating financial exclusion.<sup>6</sup>

Micro finance Institutions (MFIs) play an essential role in providing access to finance in developing countries. However, the need for legal and financial innovation to enable MFIs to continue to provide the much-needed financial service to society is apparent. One of the proposals that are made, among others, is to use regulatory frameworks that are closely related or similar to those we use in banks and other corporations. The other option that those activists of MFIs often advocate is to use the non-for-profit structure and to avoid any temptation for profit in the sector. Profiting from the poor is considered both unwanted and immoral by some.

The two approaches have their own advantages and limitations. It is apparent that we need MFIs not to be just commercial banks. Applying the banking system to MFIs erodes the very purpose they are established for. We need MFIs to fill the gap that is created by the existing banking system. Therefore, we should be careful not to convert them just into a commercial bank. We need them to be more open to small-scale borrowers, use flexible credit packages, and prioritize women and vulnerable groups in society.

On the other hand, MFIs need to be self-reliant and sustainable, at least in the long run; therefore, remaining a not-for-profit organization limits their potential and the possibility of staying a reliable development and business partner to customers. Therefore, we need a legal, financial and governance

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<sup>4</sup> E Yaldiz Hanedar (2013), *Essays on loan markets in less-developed economies*. PhD dissertation. University of Toronto.

<sup>5</sup> E Hanedar, Y Altunbas & F Bazzana (2014). Why do SMEs use informal credit? A comparison between countries. *Journal of Financial Management and Markets and Institutions*, 2(1), 65-86.

<sup>6</sup> S Staschen, & C Nelson (2013), The role of government and industry in financial inclusion. In J Ledgerwood, J Earne, & C Leson (2013), *The new microfinance handbook a financial market system perspective*. (pp. 71-96). The World Bank. Elibrary, [https://elibrary.worldbank.org/doi/full/10.1596/978-0-8213-8927-0\\_ch3](https://elibrary.worldbank.org/doi/full/10.1596/978-0-8213-8927-0_ch3).

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structure that considers these particular traits of MFIs. This article examines the arguments on both sides based on literature review in the field and some comparative legal analyses with particular focus on the financial structure of MFIs.

This article mainly examines the possibilities and challenges of using equity finance in Microfinance Institutions. The questions that are addressed include: the most appropriate financial structure of Microfinance Institutions, the balance between financial motives and social objectives, and whether we can rely on shareholders with a pure profit motive in MFIs, and if so, the manner in which this may affect the social mission of MFIs. With regard to sequence, Section 2, provides a historical background of MFIs, and the third section briefly deals with the financial structure of MFIs. Sections 4 and 5 respectively discuss MFIs and the legal regime of MFIs in Ethiopia followed by conclusion.

## 2. Historical Background

Microfinance can be defined as a system that provides access to finance for individuals or small-scale businesses that do not have access to financial services.<sup>7</sup> It is an innovative economic, financial and social response to rectify market failures that exclude the poor from accessing the most important resource to fight poverty.<sup>8</sup>

### 2.1 Generous lending as the origin of micro credit programs

The innovative and generous lending program in Bangladesh by Muhammad Yunus is considered as the origin of the modern microcredit program. Muhammad Yunus, an economist by profession, lent small amounts of money to poor women from his own pocket.<sup>9</sup> The little money he provided helped the women to improve their income and most importantly he observed that they were honest and prepared to repay him. From his experiment, he concluded that access to credit improves the lives of the less fortunate significantly and it also contributes a great deal to fight poverty in the community. He successfully persuaded the Central Bank of Bangladesh to allow him to establish a special bank branch dedicated to serving the poor

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<sup>7</sup> A Vanroose & B D'Espallier (2013), Do microfinance institutions accomplish their mission? Evidence from the relationship between traditional financial sector development and microfinance institutions' outreach and performance. *Applied Economics*, 45(15), 1965-1982.

<sup>8</sup> *Id.*, p. 3

<sup>9</sup> B Armenda'riz & J Morduch (2010), *The Economics of microfinance*, (2<sup>nd</sup> edn.). MIT Press, p. 10.

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and as a result, the Grameen Bank was established in 1976.<sup>10</sup> The Grameen Bank introduced group lending as its main lending strategy.<sup>11</sup> Group lending with joint liability enabled the Grameen Bank to operate without a need for collateral. Group lending enabled the Grameen Bank to use soft information, social pressure, and social capital to minimize the effects of loans being issued to unreliable or amoral debtors.

The success of Grameen Bank has been considered as a breakthrough in fighting poverty. Microfinance presents itself as the latest solution to the age-old challenge of finding a way to combine the bank resources with local information and cost advantages.<sup>12</sup> Development agents in many developing countries have introduced microfinance as a main strategy to reduce poverty. MFIs commonly use group lending to assure repayment and to avoid requiring high value property as collateral.<sup>13</sup> This has opened up opportunities for those who have the good will to work hard to escape from poverty.

The group lending system requires no real security and it is based on the personal security system that all group members act as unconditional guarantors for each other. Individuals form groups voluntarily, select their team members, and take the responsibility of screening who joins their group. However, some MFIs also randomly form groups among those who are willing to participate in a group system. Empirical researchers claim that there is no significant difference between the two approaches in terms of repayment rates.<sup>14</sup>

In many countries, MFIs have been introduced by national and international development agents. Initially, MFIs were launched as NGOs with the objective of providing access to finance for those who are excluded by the formal banking system as “credit unworthy;” these have been mainly subsidized by international development actors.<sup>15</sup> Although microfinance initially used group lending as its main strategy, it later embraced different

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<sup>10</sup> Ibid.

<sup>11</sup> Ibid.

<sup>12</sup> Id., p. 9.

<sup>13</sup> K Tsai (2004), Imperfect substitutes: The local political economy of informal finance and microfinance in rural China and India. *World Development* 32, 1487-1507. <https://www.sciencedirect.com/science/article/pii/S0305750X04000956>.

<sup>14</sup> *Supra* note 9, Armenda’riz. & Morduch (2010).

<sup>15</sup> B D’espallier, J Goedecke, M Hudon, & R Mersland (2017), From NGOs to banks: Does institutional transformation alter the business model of microfinance institutions? *World Development*, 89, 19-33.

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strategies and techniques and also broadened its services to the poor segment of society by including saving and insurance services among its products. MFIs also take part in providing trainings and other activities that empower the poor, especially women. In addition to group lending, MFIs now use other security systems depending on the nature of the credits and the social and economic circumstances of their clients.<sup>16</sup>

## 2.2 Three periods in the history of microfinance

Haldar and Stiglitz divide the history of microfinance into three periods.<sup>17</sup> The period from the mid-1970s to the late 1980s is considered as the *first phase* in the evolution of microfinance. During this era, microfinance was mostly informal, unregulated, and operating mainly at a local level. Group lending was the main strategy. Groups were obliged to attend mandatory trainings and ritual ceremonies before they gained access to credit. Creating strong social connections among the group was considered an important element to strengthen repayment.<sup>18</sup>

During this phase, the focus was mainly to provide very small loans to women. The credit providers were described as “bicycle bankers” in Bangladesh and the loan providers established a very strong connection with the local community; they focused on empowering debtors. Honest defaulters who failed to repay because of natural disaster, illness, or business failure were released from their debts.<sup>19</sup> During this phase, microfinance was operating mainly based on the practices among family members and friends who lend money out of altruism rather than for financial gain. Family and friends commonly exonerate debtors from their obligation whenever it is expected by norms and customs of society, and microfinance officers were doing the same. The main motive behind microfinance during this phase was to protect the poor from heavy usury in informal loans; such loans were considered to be impeding the development of local communities by imposing high interest rates and keeping the poor trapped in poverty. As Haldar & Stiglitz noted, “[t]he initial impetus for microfinance was to provide respite from the oppressive regime of traditional moneylenders.”<sup>20</sup>

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<sup>16</sup> N Hermes, R Lensink & A Meesters (2011), Outreach and efficiency of microfinance institutions. *World Development* 39(6), 938-948.

<sup>17</sup> A Haldar & J Stiglitz (2016), Group lending, joint liability, and social capital: insights from the Indian microfinance crisis. *Politics and Society*, 44(4), 459-497.

<sup>18</sup> *Ibid.*

<sup>19</sup> *Id.*, p. 466.

<sup>20</sup> *Supra* note 17, Haldar & Stiglitz (2016).

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The *second phase* was from the late 1980s up until 2006 and was considered the golden age of microfinance. During this period, the microfinance movement emerged as a global phenomenon and was crowned as the best strategy to put “poverty into museum.”<sup>21</sup> The microfinance movement is considered by international development actors as an intrinsic element of the global effort for development and empowerment of people who are living in poverty. Access to finance is considered a key element for social and economic development of societies. Some go to the extent of arguing that access to finance is a human rights issue and that governments and the international community should maximize efforts to provide affordable credit to everyone who is qualified.<sup>22</sup> Access to finance implies a possibility to receive a financial service at a reasonable distance and affordable price.<sup>23</sup> However, the majority of the population in the developing world have no access to affordable finance. MFIs therefore fill the objective of providing access to finance for those who have no access to adequate financial services.<sup>24</sup>

The idea that the poor cannot save has been challenged; and the microfinance movement started based on the idea that the poor shall and should save for sustainable development to be achieved.<sup>25</sup> The microfinance movement has also challenged the hidden assumption that the poor would not repay debts. The system has proved that with an appropriate approach and with systematic support, the poor can repay debts and become free from dependency on aid.<sup>26</sup> The microfinance system also emphasizes how a credit security system that relies on collateral is against the interests of the poor; an alternative security system should be used by finance institutions to increase access to credit for the poor. The requirement for collateral as a security for credits favors those who have already created wealth and it discriminates against those who are not in a position to own a property which would be accepted by banks as collateral.

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<sup>21</sup> *Id.*, p. 464.

<sup>22</sup> O Bayulgen (2013), Giving credit where credit is due: Can access to credit be justified as a new economic right? *Journal of Human Rights*, 12(4), 491-510.

<sup>23</sup> M Hudon (2009), Should access to credit be a right? *Journal of Business Ethics*, 84, 17-28.

<sup>24</sup> *Supra* note 9, Armenda’riz & Morduch (2010).

<sup>25</sup> *Ibid.*

<sup>26</sup> *Ibid.*

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Microfinance during this phase was considered as both a social innovation and a successful business model which could be reproduced throughout the world. Providing access to credit in a sustainable way needs to attract funding from investors who prioritize financial over social interests. The question is, therefore, how microfinance can both sustain affordable credit for the poor and attract private investors for funding.

The *third phase* started in 2006 when repayment rates by debtors started to decline. The reported increase in defaults in repayment challenged expectations based on the high repayment rates recorded ubiquitously during the first phase of the evolution of microfinance.

The third period is referred to as “the age of crisis.” Following this crisis, many countries introduced laws to regulate microfinance institutions, to ensure sustainability of the institutions and to provide protection to debtors. The commercialization of MFIs and the introduction of individual loan systems with strong enforcement mechanisms have negatively affected the goodwill of MFIs. Moreover, interventions by governments have become fashionable thereby removing the freedom that MFIs enjoyed previously. Haldar *et al.* argue:<sup>27</sup>

The challenge for microfinance, then, is fundamentally to regain what it once built itself on trust. It is unlikely that this can be achieved without a reversion to the not-for-profit model and the careful cultivation of social capital, which in turn will place inherent limits on the speed at which microfinance can be scaled up. If these brakes fail to be put on the evolution of the industry, the noble vision with which microfinance started runs the risk of being reduced to mere moneylending.

### 3. Financial Structure of MFIs

Like most financial institutions, MFIs have multiple sources of finance that can be divided into debt and equity. MFIs collect voluntary deposits or tied-up or mandatory deposits that they request as a condition to provide loans. They also get a debt from development and commercial banks, sometimes in a favorable situation and sometimes based on the market value. Most MFIs also receive essential support from international development actors in the form of interest-free debts. International development actors commonly provide funds without interest and sometimes with low interest. Some

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<sup>27</sup> *Supra* note 17, A Haldar, A. & J Stiglitz, 2016), p. 481.

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findings have indicated that MFIs are not financially sustainable without global and local development agents' robust support.<sup>28</sup>

MFIs also receive funding in the form of equity, and some MFIs issue shares to be offered to the general public. Equity is an essential source of funding in MFIs. Investors with pure financial interest and impact investors, who are interested in supporting the social objective of MFIs, invest in MFIs. Investments with MFIs can be considered pioneers when it comes to social impact investments.<sup>29</sup> Access to finance is included in the Sustainable Development Goals (SDGs).<sup>30</sup> So, access to finance is an essential target that attracts the attention of social investors. Hereunder, we will succinctly discuss the different sources of finance. For clarity purposes, we divide the sources of finance into two groups: Equity and debt.

### 3.1 Equity in MFIs

Equity is an essential source of finance in MFIs that are established as business enterprises.<sup>31</sup> Some researchers also indicated that equity is the best means to finance MFIs as it enhances the financial performance of the institutions.<sup>32</sup> According to Chikalipah, findings of a study 'demonstrate that the optimal source of finance for MFIs ...is equity.'

The equity investors in MFIs may have different interests and backgrounds. In MFIs that have been converted from NGOs into companies, the founders of the original MFIs remain dominant shareholders, at least at the initial stage of the company. The founders of the converted MFIs continue to be dominant shareholders at an early stage of the MFIs, and most of them also remain on the board of directors.<sup>33</sup> This has allowed them to

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<sup>28</sup> I Bayai & S Ikhide (2018), Financing structure and financial sustainability of selected SADC microfinance institutions (MFIs). *Annals of Public and Cooperative Economics*, 89(4), 665-696.

<sup>29</sup> H Hummels & M de Leede (2014), The emergence of impact investments: The case of microfinance. In *Socially Responsible Investment in the 21st Century: Does it Make a Difference for Society?* Emerald Group Publishing Limited.

<sup>30</sup> Goal 8. Promote sustained, inclusive, and sustainable economic growth, full and productive employment, and decent work for all.

<sup>31</sup> V Bogan (2012), Capital structure and sustainability: An empirical study of microfinance institutions. *Review of Economics and Statistics*, 94(4), 1045-1058.

<sup>32</sup> S Chikalipah (2019), Optimal sources of financing for microfinance institutions in sub-Saharan Africa. *Development in Practice*, 29(3), 395-405.

<sup>33</sup> U Varottil (2012), Microfinance and the Corporate Governance Conundrum. *Berkeley Business Law Journal*, 9(2), 242-292.

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influence the decision-making of the MFI, including in the election of the board and the executive.<sup>34</sup>

The founders have tried to put the social objective on the far front in all decisions that the MFIs have made<sup>35</sup>. However, once this dominance of the founders was minimized by the growth of the shareholders who joined the company exclusively for-profit motive or with limited interest in the social objectives of the MFIs, it becomes apparent that the MFI faces a firm pressure from shareholders to shift attention from social objectives to financial interests of the shareholders.<sup>36</sup> Krauss and Walter<sup>37</sup> argued that some investors have joined the microfinance business because of the very attractive return on investment around 1990.<sup>38</sup>

Most investors have profit as their objective. This somehow pressurized MFIs to focus more on the financial performance and sustainability of the business as otherwise, investors will move away from the sector. Employees and directors are also pushed to demonstrate a solid balance sheet to keep investors and attract new investors.<sup>39</sup> This is particularly important in listed companies where most investors have only a financial interest and a possibility to sell their shares so quickly.<sup>40</sup> This is a serious challenge to the development of MFIs. The new directors and investors who focus on maximizing shareholders' interest and disregarding the interest of other stakeholders disregard the social objectives of MFIs and some refer to this scenario as mission drift. However, it must be noted here that some investors are supporters of the social objective of the MFIs. Therefore, they are willing to receive a little lower than the profit they might have obtained from alternative investments.

International development actors and NGOs also buy shares in MFIs.<sup>41</sup> They commonly buy the shares to support the organizations' missions. The NGOs appoint nominal shareholders who receive no profits. However, in countries like Ethiopia, where there is no clear law that regulates the position of nominal shareholders, it has created uncertainties about the rights and

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<sup>34</sup> Ibid.

<sup>35</sup> Ibid.

<sup>36</sup> Ibid.

<sup>37</sup> Ibid.

<sup>38</sup> N Krauss & I Walter (2009), Can microfinance reduce portfolio volatility? *Economic Development and Cultural Change*, 58(1), 85-110.

<sup>39</sup> Ibid.

<sup>40</sup> Ibid.

<sup>41</sup> S Ghosh & E Van Tassel (2011), Microfinance and competition for external funding. *Economics Letters*, 112(2), 168-170.

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duties of the nominal shareholders and how to replace them when they leave. Generally, attracting private investors without eroding the novel social objectives is essential.<sup>42</sup>

### 3.2 Debt as source of financing in MFIs: Long term debts

Debt is another critical source of financing in MFIs. Empirical research indicates that most MFIs use debt more often than equity as a source of funding.<sup>43</sup> Private investors, governments, development agents, and commercial and development banks provide loans to MFIs.<sup>44</sup> Mersland & Urgeghe indicated that 'access to commercial debt is related to strong financial performance and a high level of professionalization'.<sup>45</sup> There is also evidence that indicates in well-developed financial markets 'debt is the primary funding instrument which Microfinance Investment Vehicles (MIVs) invest in Microfinance.'<sup>46</sup>

Private institutions may be motivated to participate in the MFIs purely for financial gains or dual objectives. They may provide loans to MFIs because they share the values and goals of MFIs.<sup>47</sup> When they give the debt intending to support the purposes of the MFI, they provide a favorable term to the MFIs. They may provide the debt interest-free, or a meager interest rate may be charged. Commonly, national development banks and commercial banks offer such support to MFIs. Banks may be required by law to offer loans to small and medium enterprises that normally use MFIs. That is, the banks grant funds at good terms to MFIs, and MFIs, in turn, provide small-scale loans to end-users of the fund at a reasonable cost. MFIs have more expertise and experience to deal with small-scale loans; therefore,

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<sup>42</sup> O Adejumo, U Efobi, & S Asongu (2021), Financing Sustainable Development in Africa: Taking Stock and Looking Forward. In *Handbook of Research on Institution Development for Sustainable and Inclusive Economic Growth in Africa* (pp. 140-152).

<sup>43</sup> J Lislevand (2012), *The effect of capital structure on microfinance institutions' performance* (Master's thesis, Universitetet I Agder; University of Agder).

<sup>44</sup> G Dorfleitner, MRöhe & N Renier. (2017), The access of microfinance institutions to debt capital: An empirical investigation of microfinance investment vehicles. *The Quarterly Review of Economics and Finance*, 65, 1-15.

<sup>45</sup> R Mersland & L Urgeghe (2013), International debt financing and performance of microfinance institutions. *Strategic Change*, 22(1□2), 17-29.

<sup>46</sup> H Tchuigoua (2014), Institutional framework and capital structure of microfinance institutions. *Journal of Business Research*, 67(10), 2185-2197. (2196).

<sup>47</sup> G Dorfleitner, et al *supra* note 44.

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banks offer loans to MFIs as part of their social contribution to be further distributed to SMEs.

Development agents provide loans to MFIs to support the social objectives of MFIs. However, they do not commonly give the fund without attaching some conditions and terms that explain how the fund has to be used to benefit end-users or the target beneficiaries. The conditions can be specific, for example, requiring a certain percentage of the loan to be allocated to women or other interest groups.

Debt financing provides some benefits to firms –tax advantage due to the deductibility of the interest rate as taxable income. Most MFIs pay taxes, and it is obvious that they will consider the tax advantages of the debt in their decisions. The reduction of agency costs is another advantage of debt financing.<sup>48</sup> Directors and employees will give proper attention to the performance of the MFIs because failure to pay timely interest or principals will invite a risk of insolvency.<sup>49</sup> It is obvious that the bankruptcy of the institution directly or indirectly affects the directors and employees of the institution.

In MFIs, founders with social objectives may prefer to maintain their power as dominant decision-makers in the MFI. Founders may continue to prioritize their social goals as far as they can pay their debts. Furthermore, founders may prefer to remain as the only residual owners of the MFI, if they expect to obtain a significant amount in a grant. Getting a significant amount in grants will help the MFI to become profitable; therefore, they may not want financially oriented shareholders to make a fortune from grants and donations that are meant to support the social objectives of the MFI.

On the other hand, debt financing may encourage the practices of earning management by directors.<sup>50</sup> Therefore, it may affect the quality of information that they send to grant providers and donors. There is also evidence which shows that a high level of leverage affects outreach and service to the poorest of the poor because of the increased cost of capital.<sup>51</sup>

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<sup>48</sup> I Bayai & S Ikhide (2016), Financing and financial sustainability of microfinance institutions (MFIs): a conceptual view. *Banks and Bank Systems*, 11(2), 21-32.

<sup>49</sup> Ibid.

<sup>50</sup> N Lassoued (2021), Capital structure and earnings quality in microfinance institutions. *International Journal of Managerial Finance*.

<sup>51</sup> M Hoque, M Chishty, & R Halloway (2011), ‘Commercialization and changes in capital structure in microfinance institutions: An innovation or wrong turn?’ *Managerial finance*.

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### 3.3 Deposits (as short term debts)

Not all MFIs are allowed by law to collect deposits. Some countries restrict the scope of business activities that MFIs can undertake. Countries may prohibit MFIs from collecting deposit –from the public. However, in most countries, MFIs are allowed to collect deposits. MFIs often require a certain amount of mandatory savings to provide credits to their customers. Sometimes they need debtors to deposit a certain amount periodically. The primary purpose of the forced saving mechanism is to minimize risk and see if the client is creditworthy. They also consider saving as an essential means to alleviate poverty; hence, they motivate savings to improve the saving culture.

Tang *et al*, state various uses of deposits.<sup>52</sup> They noted that deposits of MFIs have some advantages over other funding sources and allow the poor to accumulate liquid assets and develop fiscal discipline. Specifically, deposits add to MFIs' available funds, enhance MFIs' monitoring incentives, reduce the information asymmetry between lenders and borrowers, and allow MFIs to diversify their loans. However, managing deposits also entails costs, such as interest payment, operating expenses, and regulatory costs.

As Tang *et la* observed, deposits are also essential sources of funding for microfinance institutions, and deposit mobilization has the following advantages: (1) It is less expensive, (2) it helps to change the overall social welfare of the community, and (3) the fact that the community knows the money they take as debt is money that is deposited by themselves or by a neighbor reduces defaults.<sup>53</sup> Evidence has shown that when debtors know they are borrowing money deposited by their neighbors, not money from the government or donors, they incline to pay more frequently than to default.<sup>54</sup>

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<sup>52</sup> JJ Tang, S Quayes, & G Joseph (2020), Microfinance institutions, financial intermediation, and the role of deposits. *Accounting & Finance*, 60(2), 1635-1672. (1671).

<sup>53</sup> Ibid.

<sup>54</sup> Ibid.

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#### 4. MFIs in Ethiopia

In 2021 there were 42 MFIs in Ethiopia, they mobilized 52.4 billion Birr in saving deposits, and their total assets reached 85.7 billion Birr.<sup>55</sup> However, the microfinance sector in Ethiopia is dominated by government affiliated microfinance institutions.<sup>56</sup>

MFIs in Ethiopia provide both saving and credit services. In relation to savings, they use both voluntary saving and compulsory saving. Compulsory saving is commonly a condition for releasing credits.<sup>57</sup> MFIs in Ethiopia use group lending with joint liability.<sup>58</sup> Groups are formed based on self-interest with no intervention of microfinance institutions. Under Ethiopian laws, debtors are assumed to be jointly and severally liable unless it is expressly provided otherwise by contract.<sup>59</sup>

In joint and several liability, any one of the debtors is responsible for the whole debt and can be sued in a court of law for the total amount of the loan the group has borrowed. The microfinance institution, therefore, can bring a legal action against one of the debtors for the payment of the whole unpaid loan and the member's properties can be used to satisfy the loan. Generally, the group lending system is a good screening mechanism to select potential beneficiaries, who are considered to have high moral value, to be free from other debts, and ready to use the money for productive engagements.

The group loan system is also closely related to Ethiopian values, norms, and traditions of sharing risks. In the tradition of Afar, for example, a tribe shares responsibilities for damages incurred by a member of the specific tribe. The tribe also has a right to claim for damages upon its members.<sup>60</sup> Wrongs done to individuals are considered an attack on the whole tribe. Another example relates to Iddirs and Eqqubs whereby social capital including reciprocity and altruism are well entrenched values in traditional

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<sup>55</sup> National Bank of Ethiopia, *Quarterly Bulletin*, 36, 2 Second Quarter 20120/21 Fiscal Year Series, p. 20.

<sup>56</sup> *Ibid.*

<sup>57</sup> B Kereta (2007), *Outreach and financial performance analysis of microfinance institutions in Ethiopia*. Conference Paper at African Economic Conference, United Nations Conference Center (UNCC), Addis Ababa, Ethiopia 15-17 November.

<sup>58</sup> *Ibid.*

<sup>59</sup> The Civil Code of Ethiopia. Article 1896.

<sup>60</sup> Y Kebede, I Ayele, M Gebregziabher & G Gebrewahid (2013), Case Study on seven customary laws in Ethiopia. In E. Stebek & Muradu A. (2013). *Law and development and legal pluralism in Ethiopia*. Justice and Legal System Research Institute, Addis Ababa.

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financial institutions in Ethiopia. The bedrock thus already exists for MFIs to use group lending (social collateral) effectively to serve those who were unbanked.

MFIs have recently included individual loans as one of their services. They provide individual loans with a personal guarantee or by using vehicles or houses as collateral. Individual loans are allowed for those who can find a personal guarantor, who have a permanent job in government offices or in government affiliated enterprises, and those who can adduce a collateral such as buildings, vehicles, or machines. MFIs are also allowed to engage in leasing finance.<sup>61</sup> Accordingly, they provide financial leasing services for those who take part commonly in government backed project works. For example, recently, MFIs have provided credits using the leasing finance system to business entities that are taking part in the universal road access project initiated and financed by the federal government.

MFIs commonly provide loans for agriculture (mainly to support the production of domestic animals), for SMEs, civil servants and employees in government owned or government affiliated enterprises or agencies, and for housing projects both in collaboration with government or independently. The vision statements of Most MFIs in Ethiopia expressly state that poverty reduction is their priority and they also work very closely with local and regional governments.<sup>62</sup> They usually take part in financing projects that are initiated by government to create employment, to build infrastructure for the people, or to build affordable houses. MFIs also receive political and administrative support in their effort to enforce contracts and to pressure debtors to repay their debts.<sup>63</sup>

Enforcement of contracts using the formal legal system is both expensive and lengthy in Ethiopia. The long time that is needed to obtain and execute judgments makes formal court litigation processes unaffordable for microfinance institutions, given the small size of the loans they provide for a large number of customers. Lack of a proper property registration system and sometimes the fact that a property can be owned by family members jointly further complicates the already slow and complex legal procedures,

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<sup>61</sup> Micro Financing Business Proclamation No. 626/ 2009. *Negarit Gazette*, No. 33. 4703. Article 3 (k).

<sup>62</sup> G Ageba (1997), Microfinance institutions in Ethiopia: Issues of portfolio risk, institutional arrangements and governance. *Ethiopian Journal of Economics*, 7(2), 25-45.

<sup>63</sup> *Ibid.*

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particularly in rural areas. The support of local administration is therefore critical for MFIs to increase repayment rates. Sometimes, the local administrators may be too zealous in collecting payments and use inappropriate means, including detention, taking domestic animals by force from the defaulter without a court order, or excluding the defaulter from receiving services and donations from the government.<sup>64</sup>

## 5. The Legal Regime for MFIs in Ethiopia

Microfinance was officially recognized in 1996 as a business organization by Proclamation No. 40/1996. Currently, Proclamation No. 626/2009 regulates microfinance businesses. This Proclamation has made it mandatory that MFIs should be organized as share companies in Ethiopia. NGOs or institutions other than banks are not allowed to provide microfinance services in Ethiopia.<sup>65</sup> It is therefore very important to provide some leeway to NGOs that seek to provide access to finance for the poor and thus help overcome the lack of access to credit in the country.

The rigid one-fits-all approach that is currently applied by the National Bank of Ethiopia greatly compromises the role of NGOs that are more interested in the social aspect of microfinance than profit-making. W Amha & T Alemu recommend that Ethiopia should provide different legal frameworks for MFIs that operate at different levels and scale. Some of the MFIs in Ethiopia are very large and they are even larger than some of the banks. The MFIs that are controlled by regional governments have already finished their preparation to be registered as banks. Therefore the one size fits all approach may not work given the diversified objectives and sizes of MFIs in Ethiopia.<sup>66</sup>

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<sup>64</sup> G Yimer (2011), *Civil detention as a means to execute civil judgments: Is the wrong practice superseding the law? A case study in Tigray Regional State social courts.* Research Paper presented at Mekelle University College of Law and Governance Research Review Day.  
<https://www.academia.edu/10695189/>

<sup>65</sup> See, Microfinancing Business Proclamation No. 626/2009, Article 4.

<sup>66</sup> W Amha & T Alemu, (2014), *Household saving behavior and saving mobilization in Ethiopia.* Ethiopian Inclusive Finance Training and Research Institute (EIFTRI), Addis Ababa.

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Hailu argues that commercial microfinance in Ethiopia faces multifaceted challenges to be successful.<sup>67</sup> The perception that MFIs should give priority to social objectives and not focus on profit is a very dominant view in Ethiopia and may make the journey of commercial MFIs uncertain.<sup>68</sup> Interest rates are commonly higher in MFIs than in banks due to a higher cost of transaction in microfinance institutions. International and national donors provide support to MFIs to keep interest rates low so that the poor can benefit from affordable credits.<sup>69</sup> However, it is now becoming more common for microfinance to depend on credits from banks to provide credits to their clients.<sup>70</sup>

As MFIs are becoming more dependent on commercial banks and other sources that operate with the sole purpose of making profit, they have to remain profitable to survive. The small loans that MFIs provide for poor people to increase outreach is another reason for higher interest rates; the unit cost of loans are inversely related to the amount of loans.<sup>71</sup>

As indicated above, MFIs are required to be organized as share companies, and MFIs in Ethiopia are therefore considered as business enterprises and should be organized, registered, and regulated as business entities.<sup>72</sup> They are also subject to a prudent financial regulation. Organizing MFIs as business entities is becoming very common in other countries too, and most MFIs that were originally organized as NGOs are transforming into business entities.<sup>73</sup> The transformation of MFIs from NGOs to for profit commercial entities is a common phenomenon throughout the world.<sup>74</sup> MFIs are therefore expected to blend together commercial with social objectives. Maintaining the objective of serving the poor with affordable credit and the need for self-reliance and sustainability demand a very innovative approach

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<sup>67</sup> L Hailu (2014), Commercial microfinance in Ethiopia and challenges and prospects: A case of Aggar microfinance. In S. L. Narayana (Ed.) (2014), *Evolution of inclusive finance in Ethiopia*. Papers and Proceedings of the 8<sup>th</sup> biennial conference of AEMFI, Ethiopian Inclusive Finance Training and Research Institute (EIFTRI), Addis Ababa.

<sup>68</sup> Ibid.

<sup>69</sup> N Hermes et al, *supra* note 16.

<sup>70</sup> *Supra* note 9, Armenda'riz & Morduch, (2010).

<sup>71</sup> N Hermes et al, *supra* note 16.

<sup>72</sup> Requirements for Licensing and Renewal of Microfinancing Business Directive MFI/123/2003/. National Bank of Ethiopia.

<sup>73</sup> *Supra* note 15, B D'espallier *et al* (2017).

<sup>74</sup> Ibid.

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both by the MFIs and by the regulators.<sup>75</sup> Microfinance will have to be treated as a social enterprise that is judged by different standards, a field that is to be occupied by capital providers with a long-term focus and lesser expectations on commercial returns, and one where social goals are not forsaken.<sup>76</sup>

As share companies, MFIs are governed by boards of directors. The law provides that the board may constitute between five and 13 members. Although the board members are to be selected by shareholders, the National Bank of Ethiopia has the mandate to review the profile of board members and can reject any member it finds unfit for the job. The challenge encountered by the board in microfinance governance is to meet two expectations: the social expectation to reduce poverty and the expectation of shareholders to gain profit from their investment.

Varottil argues that the governance of microfinance should be different from traditional corporate governance in many ways. He argues that the boards of MFIs should be measured using parameters of the social impact of the company.<sup>77</sup> According to Varottil,<sup>78</sup> the corporate governance framework must transcend beyond a “shareholder primacy” or “agency cost” approach into a “customer primacy” approach that maintains focus on the customers and the communities that [microfinance institutions] MFIs serve. MFIs will have to be treated as social enterprises that are subject to different standards, where emphasis is placed on attracting investors with long-term goals and lesser expectations on commercial returns, and with a continued focus on social goals.

Organizing MFIs as business organizations has the advantage of promoting sustainability of the institutions and improving their efficiency.<sup>79</sup> MFIs are under pressure from growing competition among themselves and also from banks that are now interested in providing microfinance services directly or via other microfinance institutions.<sup>80</sup> Most prominent MFIs are therefore restructuring themselves to become business entities that provide financial services, thus departing from their previous not-for-profit organizational objectives.

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<sup>75</sup> *Supra* note 9, Armenda’riz, & Morduch (2010).

<sup>76</sup> U Varottil (2012), Microfinance and the corporate governance conundrum. *Berkeley Business Law Journal*, 9(2), 242-292 (p. 288).

<sup>77</sup> *Id.*, pp. 242-292.

<sup>78</sup> *Id.*, p. 246.

<sup>79</sup> A Vanroose & B D’Espallier, *supra* note 7.

<sup>80</sup> *Supra* note 15, D’espallier *et al* (2017).

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The transfer of MFIs to business entities, however, is not welcomed by all stakeholders because there is a fear that structural changes will compromise their mission, commonly referred to as a mission drift by researchers.<sup>81</sup> It is argued that the transformation of MFIs into business entities controlled by investors, who are motivated by personal gain, minimizes the social objectives and results in declining financial outreach and depth.<sup>82</sup> Some argue that earning large profits by serving the poor is inherently immoral and illogical.<sup>83</sup>

Researchers have also discovered that subjecting MFIs to banking laws and regulations positively affect their financial sustainability. However, their effect on the social objective of the MFIs is negative. MFIs that are subjected to banking laws and subjected to supervision in the same manner as banks focus on financial sustainability and they minimize their effort to reduce poverty in the society.<sup>84</sup>

Empirical research also proves that MFIs organized as business entities are focusing on the less poor rather than on the poorest of the poor and they are also providing larger loans to individuals with good financial circumstances. MFIs that follow the business model also provide fewer loans for women.<sup>85</sup> The preference to adopt the business model approach with strict regulation by the National Bank of Ethiopia seems to have favored efficiency and sustainability of MFIs –rather than the social objectives. Haldar & Stiglitz underline the impact of shifting to more formal systems with strict regulation on microfinance:<sup>86</sup>

Although legal enforcement of the credit contract may, at least in theory, be the most normatively desirable and procedurally

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<sup>81</sup> J Copstake (2007), Mainstreaming microfinance: Social performance management or mission drift? *World Development*, 35, 1721-1738.

<sup>82</sup> E Assefa, N Hermes & A Meesters (2013), Competition and the performance of microfinance institutions, *Applied Financial Economics*, 23 (9), 767-782.

<sup>83</sup> G. Bethlehem (2014), Commercialization and *Regulation of Microfinance*. In S. L. Narayana (Ed.) (2014), *Evolution of inclusive finance in Ethiopia*. Papers and Proceedings of the 8<sup>th</sup> biennial conference of AEMFI, Ethiopian Inclusive Finance Training and Research Institute (EIFTRI), Addis Ababa.

<sup>84</sup> N Zainal, AM Nassir, F Kamarudin & SH Law (2020), Does bank regulation and supervision impedes the efficiency of microfinance institutions to eradicate poverty? Evidence from ASEAN-5 countries. *Studies in Economics and Finance*.

<sup>85</sup> R Cull, A Demirgüç-Kunt & J Morduch, (2009), *Microfinance tradeoffs: regulation, competition, and financing*. World Bank Policy Research Working Paper No. 5086. <http://agris.fao.org/agris-search/search.do?recordID=US2012416757>.

<sup>86</sup> *Supra* note 17, Haldar & Stiglitz, (2016), p. 483.

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just enforcement mechanism ([and even if] formal regulation is an increasingly important part of the microfinance industry) –at least in the context of the developing world– the shift from informal to formal lending will come with significant increases in cost and a concomitant adverse impact on inclusivity. That leaves social enforcement as the most likely choice, at least in the case of rural credit markets of the developing world. [This may relate] to either a reversion to the ... mode of enforcement of traditional moneylenders, namely, brute force and coercion (of which there are increasing reports in the microfinance industry), or a return to the more innocent, if less ambitious, version of microfinance based on social capital, norm creation, and preference shifting. In resorting to coercion, microfinance sacrifices its normative value, and in lapsing to formal regulation –while preferable– it risks losing its novelty.

Microfinance is highly regulated in Ethiopia and operates under strict supervision of the National Bank. Regional states are totally stripped of any control in relation to MFIs in Ethiopia. Solomon Yimer suggests that regional powers should be given more regulatory power in relation to MFIs to avoid unnecessary costs and to provide effective support to help them achieve their social and business objectives efficiently.<sup>87</sup> The National Bank could delegate some of its powers to regional offices, which could regulate and support institutions operating in their respective regions. However, giving regional governments the mandate to provide prudent supervision and support to MFIs requires considering the nature and purpose of microfinance institutions.

The procedural requirements and the paperwork required to establish MFIs in Ethiopia is *mutatis mutandis* similar to the procedures that are required for banks.<sup>88</sup> The law expressly provides that banking laws including directives are applicable to MFIs unless their application is expressly limited or they contradict with laws specifically enacted for the regulation of microfinance institutions.<sup>89</sup> This is in stark contradiction to the principle that

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<sup>87</sup> S Yimer (2011), *Financial market development, policy and regulation: the international experience and Ethiopia's need for further reform*. PhD thesis. University of Amsterdam, Digital Academy Repository. p. 11.

<sup>88</sup> Requirements for Licensing and Renewal of Microfinance Business Directives No. MFI/23/2013.

<sup>89</sup> Micro Financing Business Proclamation No. 626/ 2009. *Negarit Gazette*, No. 33. 4703. Article 3 (k).

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MFIs should be provided more flexible regulations to enable them play their irreplaceable role in poverty alleviation efforts.<sup>90</sup>

The National Bank has the mandate to provide onsite or offsite supervision and there are obligations to submit various reports to the National Bank. These requirements may also affect the depth and outreach of MFIs in Ethiopia as they may lead to concentration of head office staff on the duty to provide the required reports to the National Bank.<sup>91</sup> Furthermore, researchers also suggest that strict supervision may encourage MFIs to avoid small-scale loans.<sup>92</sup>

Given the fact that Ethiopia prefers the business model approach in relation to microfinance institutions, it is expected that they may have limited outreach and limited incentive to provide credits to the poorest of the poor. This may explain why informal financial institutions are still prevalent alongside microfinance institutions, as preferred saving tools as well as an important source of credit in Ethiopia. Researchers have also noted that the poor's preference for informal credit markets rather than MFIs is because of the lack of flexibility in repayment schedules. This may also be influenced by the strict legal requirements that MFIs need to follow and the complex governance structure they need to maintain.<sup>93</sup>

The effect of the rigid loan contracts used by MFIs have been investigated by Pearlman, who concludes that lack of flexibility in loan contracts is inhibiting MFIs from providing the required service to the poor. This in turn affects the role of MFIs in poverty alleviation.<sup>94</sup> Pearlman argues that inflexibility is a major variable that prevents many of the poor from borrowing from microfinance institutions.<sup>95</sup> Studies also suggest that social norms and values play a large role in people's decisions on how and

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<sup>90</sup> *Supra* note 85, Cull *et al* (2009).

<sup>91</sup> C Chiumya (2006), *The regulation of microfinance institutions: a zambian case study*. PhD Dissertation, University of Manchester.  
<https://www.microfinancegateway.org/sites/default/files/mfg-en-case-study-the-regulation-of-microfinance-institutions-a-zambian-case-study-2006.pdf>. The research indicated that regulations can affect the development of microfinance institutions if the regulation is strict and inflexible.

<sup>92</sup> *Supra* note 85, Cull *et al* (2009).

<sup>93</sup> *Supra* note 62, Ageba, (1997), pp. 25-45.

<sup>94</sup> S Pearlman (2010). *Flexibility matters: Do more rigid loan contracts reduce demand for microfinance?* CAF Working paper No. 2010/10.

<sup>95</sup> *Ibid*

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when to save.<sup>96</sup> In Ethiopia, therefore, it may be concluded that most people's preference for traditional financial institutions for serving their financial needs is partly influenced by social values and traditional norms.

It is also important to note that the microfinance business in Ethiopia is dominated by government affiliated microfinance share companies. Dedebit Credit and Saving Institute (DECSI) in Tigray regional state, Amhara Credit and Saving Institute (ACSI) in Amhara regional state and Oromia Credit and Saving Share Company (OCSSCO) in Oromia regional state together dominate the microfinance markets in Ethiopia.<sup>97</sup> The fact that the dominant MFIs are affiliated with regional governments may have two important implications for the direction in which MFIs evolve in Ethiopia. First, the regional governments may somehow help to minimize the possible effects of the business model that the MFIs follow on outreach and financial depth. Regional governments may provide direct and indirect support to MFIs to enable them to serve the most excluded part of society.

This may be one reason why Kereta's research found no trade-off between suitability and outreach in Ethiopia.<sup>98</sup> Second, MFIs being highly related and having political support may shield them from penalties and measures imposed by the National Bank for violating regulatory requirements. This unequal treatment of government affiliated and nongovernment affiliated MFIs may distort the market, making it difficult for autonomous commercial MFIs to remain in the sector as viable businesses.

Generally, the regulatory approach to MFIs in Ethiopia is burdensome. The establishment requirements, operational laws, reporting requirements, and auditing requirements that are *mutatis mutandis* similar to the banking laws are costly that may create a stress on MFIs. Article 28 of the Micro Financing Business Proclamation No. 626/ 2009 provides that 'Banking business laws shall, *mutatis mutandis*, apply to micro-financing business concerning matters not covered by this Proclamation.' This provision makes it clear that MFIs in Ethiopia are in most part required to pass through the burdensome financial regulation process.

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<sup>96</sup> J Goedecke, I Guérin, B D'Espallier and G Venkatasubramanian (2018), Why do financial inclusion policies fail in mobilizing savings from the poor? Lessons from rural south India. *Development Policy Review*, 36, 201–219.

<sup>97</sup> E Deribie, G Nigussie, & F Mitiku, (2013), Filling the breach: Microfinance. *Journal of Business and Economic Management* 1(1).

<sup>98</sup> *Supra* note 57, Kereta, (2007).

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It may be helpful to briefly provide the comparative experience of two countries –India and Indonesia– even if it cannot be considered as a comprehensive comparative analyses. In India the financial industry is divided into two. Banks and Non-Banking Financial Company (NBFC). Most MFIs in India operate as a Non-Banking Financial Company (NBFC), and they have been officially recognized as NBFC-MFIs.<sup>99</sup> However, it is essential to note that under Indian law, MFIs can be organized as civil societies, trusts, or other not-for-profit organizations.<sup>100</sup> Most of these MFIs –organized as not-for-profit organizations– are not subjected to prudential regulation and they are registered at the regional level.<sup>101</sup>

On the other hand, MFIs organized as business entities or as a company can provide almost all banking services and obtain financing from domestic and foreign investors. Some of them are listed public companies participating in the international stock markets. NBFC-MFIs in India are qualified as beneficial of the priority sector lending by banks. Banks in India are required by law to allocate fund for sectors identified by the government as priority areas. Providing access to finance is considered as one of the identified priority areas of interest that banks must prioritize.

Indonesia provides two options under its regulatory frameworks to MFIs. MFIs can be organized as cooperatives or as private limited companies.<sup>102</sup> MFIs can also apply Islamic banking principles.<sup>103</sup> The kind of regulation that applies to MFIs is to be determined by the size of the institution and whether the MFIs collect deposits.<sup>104</sup> In Indonesia, foreigners are not allowed to own shares in MFIs. The Law under section 5 also

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<sup>99</sup> K Gupta (2017), Funding Gap Analysis of Microfinance Institutions (MFIs) Converted into Small Finance Banks in India. *International Journal of Business Insights & Transformation*, 10(2).

<sup>100</sup> The Micro Finance Institutions (Development and Regulation) Act, Bill No. 62 of 2012.

<sup>101</sup> K Kline, & S Sadhu (2011), Microfinance in India: A new regulatory structure. *IFMR Centre for Microfinance Working Paper*.

<sup>102</sup> E Mulyati & N Harieti (2018), Model of business activities of microfinance institutions in Indonesia. In *IOP Conference Series: Earth and Environmental Science* (Vol. 175, No. 1, p. 012194). IOP Publishing.

<sup>103</sup> P Prananingtyas & H Disemadi (2020), Legal consequences of dualism regulations on micro waqf banks as sharia microfinance institutions in Indonesia. *Varia Justicia*, 16(1), 1-14.

<sup>104</sup> Law Number 1 of 2013 on microfinance institutions (MFI Law). See for more explanation on the laws <https://www.ojk.go.id/en/kanal/iknb/Pages/Microfinance-Institutions.aspx>. Law Number 1 of 2013 on microfinance institutions (MFI Law).

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provides that local governments should control 60% of the share in MFIs. This requirement aims to avoid mission drift and ensure that MFIs remain focused on their primary objective of reducing poverty.

## 6. Conclusion

The microfinance sector in Ethiopia has played an irreplaceable role in providing access to credit for those who have no access to banks' services. MFIs use group lending as their main lending strategy and they provide small loans in both urban and rural areas. The microfinance sector so far performs well. However, the need for financial services is so high that it is not possible to satisfy the demand for credit with the existing capacity of the microfinance institutions. The demand for consumption loans and the demand by SMEs in Ethiopia is beyond the capacity of the MFIs that operate in the country.

As a result, the informal credit markets still operate alongside microfinance institutions. Although there are few data, some researchers indicate that clients of MFIs use the informal credit markets both to meet repayment obligations to MFIs and as matching funds, because MFIs commonly only provide part of the capital required to start or expand businesses.<sup>105</sup> The relation between MFIs and the informal credit markets in Ethiopia therefore seems complementary rather than competitive.

A microfinance institution in Ethiopia is required by law to be organized as a business entity in the form of a share company. Thus NGOs or other institutions –except banks– are prohibited by law from providing microfinance service. The National Bank regulates and supervises microfinance institutions. There are multiple directives that are issued by the National Bank that MFIs need to follow strictly.

In Ethiopia, the microfinance sector is dominated by government affiliated MFIs that enjoy a great deal of support from local, regional, and federal governments. The National Bank may not use its full power over the government affiliated microfinance institutions. However, it can impose cumbersome administrative and legal requirements on small microfinance institutions, disadvantaging them in the market. The burden of conforming to costly legal and administrative requirements and the fact that the regulator

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<sup>105</sup> K Segers, S Dessein, P Develtere, S Hagberg, G Haylemariam, M Haile & J Deckers (2010), The role of farmers and informal institutions in microcredit programs in Tigray, Northern Ethiopia. *Perspectives on Global Development and Technology*, 9 (3-4), 520-544.

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has no branch or other offices in regional states (to avoid transport and other communication costs) may increase the administration costs of smaller microfinance institutions, thereby raising the interest rates they charge. This presents a challenge because it may force them to set aside the social objectives (that microfinance promises) and focus on financial sustainability.

MFIs may be more effective if they rely on local knowledge, concepts, and practices that are used by Eqqubs (as rotating savings and credit associations) and Iddirs to provide vital financial services to the community. The legal and administrative requirements that the National Bank imposes on MFIs need to be lightened. With the current regulatory requirements in place, in the near future, MFIs in Ethiopia will be smaller banks serving only those who have a certain amount of wealth, rather than serving the poorest. The government affiliated They may also incline to operate just like commercial banks focusing more on financial interests by compromising the social objectives for which they were initially established. \_\_\_\_\_■

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