microNOTE #28

Serving Poor Rural Clients Efficiently in East Africa: An Ethiopian Model

WISDOM Micro-financing Institution, a regulated Ethio-pian MFI, has been serving very poor rural households since 1999. Even though most of its lending has been in rural areas to support ag-ricultural activities of house-holds, it is twice as efficient as the average African MFI, it serves clients at a third of the cost, and it charges half of the rate of other African MFIs. WISDOM offers impor-tant lessons for African MFIs on how to serve very low in-come rural clients and achieve sustainability without charging high rates.

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A Large and Growing Market

Ethiopia is a lesser-known microfinance market in East Africa, but it boasts one of the largest potential markets in Africa. With a popula-tion of over 70 million people, a stable low growth econ-omy, and the second lowest per capita income in the world (IFAD 2001), Ethiopia has the potential to be one of the largest microfi-nance markets in the world. There has been no definitive survey of the potential market in Ethiopia, but it is estimated that there are more than six million potential clients, [1] only one million of whom are currently served.

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[1] Leslie, L.P. Blake, *Benchmarking the marketing practices within the micro finance industry in Ethiopia*, Occasional paper #10, AEMFI, Addis Ababa, 2004.

Ethiopian society is predominantly rural and its economy is largely based on agriculture, including the cash crops of coffee and chat.[2] As a result, most rural households are subject to the fluctuation in international commodity prices, particularly coffee, and reliant on annual rainfalls. Rural Ethiopians are vulnerable to natural disasters, primarily drought, and manmade environmental degradation. Population growth and is causing former rural towns are to evolve into secondary cities with families seeking new economic activities. In 2004 it was estimated that services surpassed agriculture as the major contributor (at 45.5%) to gross domestic product.[3]

A clear but challenging legal and regulatory environment

Ethiopia has a well-established microfinance law and hosts several institutions that serve from tens of thousands to hundreds of thousands of clients each. Although Ethiopia was one of the first East African countries to create a special framework for MFIs, it remains a difficult legal and regulatory operating environment. Proclamation No. 40, initiated in 1996, required that all organizations engaged in microlending microfinance be established as share companies, register with the government, and be subject to the supervision of the National Bank of Ethiopia (NBE). Ethiopian law stipulates that all banking institutions, including MFIs, must be 100%-owned by Ethiopian nationals. The Proclamation permitted MFIs to engage in most banking transactions, although it also placed a limit on maximum loan size and interest rates as well as minimum deposit rates. While the restrictions on loan size and interest rates were subsequently removed, minimum deposit rates of 3% remain.

Ethiopia still lacks private ownership of land, the basis for collateral in most financial sectors. Technically, all land is leased by an individual from the state and may not be transferred or pledged to another. The government is currently developing a certification scheme for rural land that should allow for the transfer of leasehold rights and improve the existing leasehold scheme in urban areas.

Moving from microcredit to regulated microfinance

World Vision entered Ethiopia in the 1980s to provide famine relief. Its partner office, World Vision Ethiopia (WVE), operates in designated "area development programs," (ADPs), which are primarily rural. WVE's programs now perform multiple interventions related to food security, health, and education in these communities. WVE experimented with a number of microcredit schemes in its ADPs, many related to agriculture. In 1998, WVE facilitated the creation of a separate for-profit entity called WISDOM Micro-financing Institution.

WISDOM had the difficulty of designing a governance structure that both complied with a law that requires board members to be Ethiopian shareholders and reflected the reality of funds originating from international sources, namely World Vision and USAID. WISDOM met this challenge by designating members of WVE senior and middle management as shareholders. All shareholders must agree to forgo any profits into WISDOM's operations and bylaws prohibit shares from being transferred or sold to third parties. This compromise allowed WISDOM to develop as a local institution with international support.

WISDOM's initial focus was to provide microcredit to community groups in rural ADPs. It drew on WVE's staff, reputation in the community, and its experience with agricultural microcredit schemes. Within two years it was serving over 8,000 clients in ADPs of the rural central and southern parts of the country. In 2001, WISDOM received a grant from USAID to expand its operations beyond rural ADPs into adjacent secondary towns. The MFI developed a four-year business plan to triple its client base, expand its product line, and become financially sustainable while maintaining a strong rural client base.

[2] Chat is drought resistant shrub that is chewed and acts as a mild stimulant.

[3] Economist Intelligence Unit, 2005.

Table 1: WISDOM At A Glance

	As of 30 June 2005
Active Borrowers	24,421
Average Loan Size	US$110
Percentage Female Borrowers	44%
Branches and Sub-branches	26
Staff	169
Gross Loan Portfolio	$2,696,015
Portfolio at Risk > 30 days	6.8%
Operational Self-sufficiency	110%
Financial Self-sufficiency	95%
Portfolio Yield	27%
Operating Expense Ratio	17%

Government-sponsored competition keeps market rates low

Government involvement in business remains strong in many sectors and banking and microfinance is no exception. Regional governments hold equity in five of Ethiopia's 25 MFIs, including most of the largest MFIs. The government-owned Commercial Bank of Ethiopia is the bank with the largest branch network. The bank is not active in microfinance but is the only institution capable of transferring money throughout the country. It suffers from similar problems as state-owned banks in former socialist countries: bureaucracy, slow service, and poor branch to branch connections. This poses challenges to private MFIs such as WISDOM who rely on the Commercial Bank for banking services.

In Ethiopia, however, government-sponsored MFIs keep interest rates artificially low. WISDOM's major competitors are the state-owned MFIs, Oromia Credit and Savings Share Company (OCSSCO), OMO Microfinance, and, Amhara Credit and Savings Institution (ASCI), Addis Saving and Credit Institution (ADSCI), and Dedebit Saving and Credit Institution (DECSI). These institutions benefit from implicit state government guarantee and subsidies. Each has a large network in its region and offers loans at lower effective interest rates (15-18% as compared to WISDOM's 18-35%), fewer fees (if any), longer loan terms, and less frequent payments than WISDOM. WISDOM's yield of 27% compares with the African average of 41%.

Despite these larger and cheaper competitors, WISDOM had no trouble attracting clients. A substantial segment of the population did not have access to the other MFIs' services due to either their location, or the MFIs' requirements. In addition, the larger MFIs have several policies that are unpopular among clients. For example, they allow local village ("kebele") councils to assign clients to groups rather than allow community members to organize themselves. They also provide fixed sized loans to all group members rather than considering group input to determine loan size. Several of the MFIs are hampered by local kebele involvement in the credit decision-making process, slow disbursement, personal guarantee requirements, and in some cases, political bias. While WISDOM cannot and does not compete on fees, it does offer a less bureaucratic methodology and competitive loan sizes.

Finding efficiency in products and services

WISDOM's rural clients are mostly smallholder farmers who have seasonal or irregular cash flow, uncertain harvests, and lack physical collateral. WISDOM modified the traditional village banking methodology to allow large group sizes (up to 35) to spread risk. Groups make a single balloon payment of principal and monthly interest payments over a term of 8-12 months. WISDOM requires clients to contribute to programmed savings with monthly interest payments. For loans greater than Br. 1000 ($115) clients are also required to provide some form of collateral: a security deposit of 15% of the value of the loan, a personal guarantor outside of the group, or some moveable asset which is pledged to the group.

Efficiency is inherent in WISDOM's lending methodology. Community banks are recorded as single borrowers, reducing necessary data and monitoring. Balloon payments require fewer meetings, less monitoring, and only a handful of accounting entries. WISDOM also recognizes the risk of this product: credit risk is concentrated and subjected to the success of harvests, lack of regular payments can mask potential delinquency problems; the product provides low yields; and irregular cash flow puts WISDOM itself at risk. In fact, drought and political unrest have lead to occasional spikes in delinquency. Obligatory savings has helped groups avoid delinquency such that portfolio at risk (> 30 days past due) has averaged a respectable 1-3% on community banking loans. Past due loans, on the other hand, have been written off at a fairly high rate. Annual losses run at a rate of 5-8% of the average portfolio outstanding. The lesson is that once single installment loans are past due, they are difficult to collect.

WISDOM noted that many of their clients in rural areas were involved not only in crop and livestock, but also in short-term activities such as petty trade and cattle fattening. WISDOM introduced a solidarity group loan product with shorter terms and regular installments of principal and interest to better match these clients' cash flow and reduce the portfolio's exposure to agricultural crises. With expansion funds from USAID, WISDOM is taking its solidarity group methodology into secondary cities. By 2005 solidarity groups of five to eight members accounted for 41% of its group lending activities. This has helped WISDOM increase its yield and smooth its cash flow. The regular installments allow credit officers to detect delinquency sooner. Although PAR > 30 days tends to be higher than those of the community bank loans (staying at 3-6%), write-offs are lower compared to community bank loans.

Decentralization to maximize efficiency

In the first few years, much of the funding for WISDOM's portfolio was linked to specific ADPs. WISDOM created a decentralized organizational structure from the onset to manage in multiple rural areas as a small organization. Rural offices ("sub-branches") could be started with a staff of only two persons: a credit officer and cashier. These sub-branches were linked to the nearest of its three regional branch offices which could be more than a day's drive away. To avoid approval delays, sub-branches had loan approval authority up to a specified limit and most had their own local bank accounts. Loan approvals and bank accounts were monitored by the branch staff on a monthly (or more frequent) basis.

Once WISDOM secured funding to expand into secondary cities, the MFI made efforts to maximize the efficiency of its organizational structure. It decided to develop more branch offices in order to bring them closer to the sub-branches. Some of these branches are used to establish lending operations in urban areas. They are designed as profit centers with their own staff and clients and are responsible for the overall financial performance of the sub-branches which they manage.

Efficiency measurements and comparisons

WISDOM has little flexibility to raise interest rates due to the competition. Instead, WISDOM has focused on being efficient. For the past three years, WISDOM has averaged a remarkably low operational efficiency ratio (total operating and personnel expenses/average gross loan portfolio) of 19% and is currently at 17%. This compares with an African average of 41.7%.[4] Its average cost per borrower, in absolute terms, is $17 compared with an East African average of $58.[5] WISDOM maintains these numbers while its average loan outstanding has remained near $110 as compared to and East African average of $132.[6]

WISDOM's personnel expenses account for less than half (42%) of its operating expenses compared to more than half (56%) for other African MFIs. Lower salaries in Ethiopia compared to the African average contribute to these figures. At WISDOM, credit officer salaries range from $90 to $170 per month and average approximately $115 per month. This is approximately 12 times the GNI per capita whereas other African MFIs pay an average of 18 times GNI (MicroBanking Bulletin, Issue No. 10).

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[4] MicroBanking Bulletin, Issue No. 10.

[5] Lafourdcade, Anne-Lucie, Isern, Jennifer, Mwangi, Patricia, and Brown, Matthew, _Overview of the Outreach and Financial Performance of Microfinance Institutions in Africa._ The Mix, April 2005.

[6] Ibid.

In the field, WISDOM decided to replace cashier positions with "field assistant/tellers." These field assistants still disburse and collect cash for sub-branch credit officers, but they also manage their own portfolio of clients. This dual role boosted the number of income-generating staff at WISDOM; some 66% of staff is now actively managing the loan portfolio, up from 50%. If field assistants are considered 50% the full-time equivalent of credit officers, WISDOM is managing approximately 350 clients per loan officer compared to the African MFI average of 334 (MicroBanking Bulletin Issue 10). It also maintains a borrower per staff ratio of 145, slightly higher than the East African average of 132.[7] WISDOM maintains a lean management team, which has recently grown from three (including the General Manager, Finance Manager, and Operations Manager) to six (adding an Internal Auditor, HR Manager, and Marketing Officer).

WISDOM seeks to achieve economies of scale through the transformation of its branch offices from cost centers to profit centers. The cost to disburse one dollar has declined from 13 to 8 cents. In 2006, WISDOM will begin to mobilize deposits from the general public in several of its branches and sub-branches. To accomplish this, WISDOM will need to invest in infrastructure, implement a new MIS system, hire tellers, and bolster the internal audit function. WISDOM can expect its efficiency ratios to remain constant or increase slightly as it expands its services.

Balancing rural outreach while serving more female clients

WISDOM, assisted by Johns Hopkins University, conducted a study which revealed that the prevalence of moderate to severe wasting (measured by the World Health Organization as middle upper arm circumference) is 40% lower in children of female clients as compared to children of non-clients or male clients.[8] This finding induced WISDOM to increase the percentage of female clients to 50% from 44%. WISDOM has hired more female credit officers, added an incentive scheme to target female clients, and linked WISDOM's credit operations to more capacity building and training. Moving to secondary cities is also helping to increase the percentage of female clients.

As WISDOM has moved into more urban areas its proportion of poor clients served has decreased. Incoming clients tend to be wealthier on average than existing clients. WISDOM has set a maximum of 60% for non-rural clients. However, it believes that it can serve a higher number of poor clients overall, particularly women, if it builds a sustainable, balanced portfolio of rural, urban, very poor, and less poor clients.

The way forward

WISDOM has a great need to invest in infrastructure, training, and product development. However the market does not permit it to increase interest rates and it is already operating at high efficiency levels. Trend analysis of WISDOM's personnel expenses ratio shows that it has remained at 8% to 9% over the past three years and has kept pace or exceeded loan portfolio growth. In other words, improved efficiency in recent years was not due to increased efficiency of personnel. Rather, other administrative expenses are growing at a slower rate than the portfolio growth. In other words, WISDOM's model appears to have limited room for increasing caseloads. The only way for WISDOM to continue to breakeven while making large investments in the medium-term is to maintain loan portfolio growth at the same rapid rate of 25-50% per year. WISDOM's recognizes that it can no longer compete by reducing costs. Rather, it seeks to improve its client service.

Few of WISDOM's existing markets are saturated so that the existing branches can exploit this potential with the addition of new sub-branches. WISDOM is also looking for new market segments, including salaried persons and community-based indigenous organizations, as both borrowers and depositors. To fund portfolio growth, WISDOM has secured its first borrowing of $863,000 from an African Development Bank program at a subsidized rate of 6%. This reduces the interest margin from 25% to 19%,

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[7] Lafourdcade, Anne-Lucie, Isern, Jennifer, Mwangi, Patricia, and Brown, Matthew, *Overview of the Outreach and Financial Performance of Microfinance Institutions in Africa.* The Mix, April 2005.

[8] SEEP Progress Note No. 4

just 3% above its already low operating expense ratio.

WISDOM's greatest risk is portfolio growth will lead to further problems with portfolio quality. Expenses related to impaired delinquent loans currently cost WISDOM the equivalent of 8% of its average loan portfolio and 15-20% of its annual financial revenue. Drought has contributed to delinquency, yet the delinquency is now highest among peri-urban and urban clients who are utilizing WISDOM's new loan products. This is partially due to political unrest, but also results from insufficient training for loan officers in the policies and procedures of the new products. WISDOM has begun the process of reviewing the problems in its new product offerings and is hiring an internal trainer to design an orientation and ongoing training program. It has also hired a new Internal Auditor and will be adding several junior auditors to its roster to improve its monitoring.

The downside of the MFI's exceptional efficiency is that it has spent relatively little on areas key to client satisfaction such as training, marketing, and product development. WISDOM's success has been its ability to better serve clients through faster service, better products, and qualified staff. This will be even more important in the future. Focus groups and client interviews have shown that many clients are underserved; they have a greater need and capacity to borrow than WISDOM's methodology currently permits. WISDOM is considering a number of steps to reorient its operations to better serve clients including improved analysis of the financial situation of the household, tracking individuals' performances within groups, and developing a credit scoring system. That resulting data will contribute to individualized terms for group members. WISDOM is also working to improve credit officer's' abilities to manage more flexible loan products so that decisions are based primarily on financial analysis rather than methodology or a group guarantee.

Conclusion

The WISDOM experience shows that an African MFI can serve rural areas efficiently and profitably without charging high interest rates. The case also demonstrates that portfolio growth is needed if WISDOM is to make the investments need in personnel and infrastructure necessary to start deposit-taking. Rapid portfolio growth will place a number of pressures on WISDOM, including mediocre portfolio quality, a greater need to train staff, and a more investment in information systems and internal control.

WISDOM hopes that it can take advantage of its presence in secondary cities to balance its loan portfolio with non-agricultural loans, increase the number of female clients, and better manage its branch network. WISDOM's choice to enter urban markets will allow it to grow faster and serve more clients than in rural areas alone. However, it also means that many new clients will be less poor than older clients. WISDOM believes it can eventually serve one hundred thousand clients, half of which are in poor rural areas, rather than a tens of thousands who are all located in poor rural areas. In short, overall impact in rural areas will be greater if it uses urban areas to fuel growth, boost profitability, and raise deposits. This new strategy requires a difficult transition for WISDOM, but it promises to deliver a larger, more successful operation.