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ETHIOPIA RURAL CREDIT

MARCH 1996

This report contains wide-ranging recommendations regarding interest rate controls; laws and regulations governing entry into banking, deposit-taking and bank ownership; bank supervision procedures; financial service and agricultural input delivery mechanisms; directed or targeted credit; loan repayment incentives and collection procedures; loan guarantees; NGOs as lenders; and related policy, strategy and project design issues. Observations are provided on priorities for increasing agricultural production in East Wellega.

SUBMITTED TO USAID/ETHIOPIA

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Ethiopia Rural Credit

CONTENTS

LIST OF ABBREVIATIONS AND AMHARIC WORDS	
As of 12/27/95	
ACDI	Agriculture Cooperative Development International
AIDB	Agricultural and Industrial Development Bank of Ethiopia - now DBE (see below)
AISE	Agricultural Inputs Supply Enterprise
AKRSP	Aga Khan Rural Support Program
Br	Ethiopian birr, the national currency unit
BRI	Bank Rakyat Indonesia
CAMEL	an analytical system used to determine the safety and soundness of a bank or other deposit - taking institution
CBE	Commercial Bank of Ethiopia
CEE	Corporation of Ethiopian Entrepreneurs
DAP	diammonium phosphate
DBE	Development Bank of Ethiopia
ERDA	(To be provided)
FSDP II	Financial Sector Development Project, Phase II
GOE or GoE	Government of Ethiopia
ha	hectare (2.47 acres)
iddir	Fraternal insurance association or death aid society
IFAD	International Fund for Agricultural Development
iqqub	a rotating savings and credit association (RoSCA)
kg	kilogram (2.2 pounds)
MOA or MoA	Ministry of Agriculture
NBE	National Bank of Ethiopia
NGO	non-governmental organization
REST	Relief Society of Tigray
RoSCA	rotating savings and credit association
SACC	Savings and Credit Cooperative
SACCDO	Savings and Credit Cooperative Development Office, National Bank of Ethiopia
SG2000	Sasakawa - Global 2000
USAID	United States Agency for International Development
VOCA	Volunteers in Cooperative Assistance
woreda	county or district

Exchange Rates as of December 1995

Retail rates based on periodic auctions by the National Bank of Ethiopia ranged for Br 6.25 to Br 6.30 per US dollar

ETHIOPIA RURAL CREDIT

EXECUTIVE SUMMARY

This executive summary includes an overview of each chapter followed by a list of the recommendations and conclusions found in the text. Some recommendations and conclusions have been restated to accommodate this format. Recommendations and conclusions are organized in three sections: 1) the legal and institutional context of banking operations, ownership, regulation and supervision; 2) building a sustainable rural finance system; 3) recommended priorities for promoting agricultural production in Gobu Seyo and Sibu Sire, the two woredas in East Wellega in which USAID/Ethiopia is reviewing the prospects for a pilot project.

A. Legal and Institutional Context for Banking Services

Chapter 1 Legal and Regulatory Framework

Overview

This portion of the study reviewed the legal, regulatory and policy framework affecting rural financial markets. The purpose was to identify requirements and institutional configurations that would provide an enabling environment in which rural financial institutions might be established and sustained.

In reviewing the existing structure, several opportunities were apparent where policies or directives could be used to implement legal authority in a way that might foster growth of the informal sector and rural financial enterprise as well as the banking system.

Findings and Recommendations

Interest Rate Authority.

1. The current interest rate structure tends to be a disincentive to the creation of rural credit by formal institutions. It may be of benefit to periodically measure the results of the current policy against its desired objectives to determine whether the policy is effective.

2. The present maximum allowable interest rate on credit appears insufficient to cover costs plus risks and provide a reasonable rate of return, thereby impairing sustainability of banking operations.

3. There are means available within the existing laws that would enable the National Bank of Ethiopia (NBE) to influence interest rates indirectly. Consideration could be given to using reserve, liquid asset and discount rate powers to influence lending rates and funds availability within the banking system, reducing reliance on direct controls, such as interest rate floors and ceilings.

Development of Informal and Semi-formal Institutions.

4. Several types of informal and semiformal savings and/or credit operations are prevalent in Ethiopia, particularly in rural areas where formal banking services are not readily accessible. These should be allowed to continue to operate and to develop because they serve the community effectively.

5. The informal and semi-formal organizations should be promoted as grass roots vehicles that can form the core membership of a rural banking system.

6. Proclamation No. 84/1994 does not provide for informal and semiformal organizations that conduct "banking business" as defined. Either the existing law should be changed to provide for the informal and semiformal unincorporated financial service providers as a business and business form that is different from commercial banking, or a separate law must be drafted to supervise and regulate this business.

Branch Approval Policies.

7. There are insufficient banking outlets throughout the rural areas. NBE has the legal authority to approve all bank branch locations. NBE may wish to implement this authority by developing a policy to encourage small, low cost branches and other types of facilities as a means of fostering expansion of existing commercial banks into rural areas.

Liquid Asset Authority.

8. NBE has an ability within the law to set liquid asset requirements for banks. NBE in coordination with the other appropriate agencies of Government may wish to implement this authority by structuring liquid asset policies in a way that would enable issuance of rural development bonds to fund a rural development investment pool.

9. Such a pool would provide donors an opportunity to participate in its establishment and maintenance, particularly in the provision of a foreign exchange component.

Investment Prohibitions.

10. Banks are prohibited by law from undertaking nonbanking business without the prior approval of NBE. Also it is not clear to what extent banks may invest in private enterprises. NBE may wish to consider the establishment of a policy that would permit or foster commercial banks' investment in certain types of rural and microenterprise development projects or entities, to a reasonable extent that is consistent with safety and soundness.

Ownership Prohibitions.

11. The existing prohibitions against foreign ownership of banks, and any ownership that would exceed 20% could inhibit development of the banking sector. Consideration could be given to amending the law and establishing ownership policies that would enable larger levels of investment in commercial banks, where such could be determined to be in the public interest.

12. Similarly, consideration could be given to allowing limited entry and participation by foreign banks under certain conditions to identify their potential impact - negative and positive - on the banking system.

13. There is a potential conflict of interest where the Government is both owner and regulator of the primary banks in the Ethiopian banking system. Consideration could be given to a plan for gradual divestiture of the CBE and specialized banks by Government, while at the same time allowing the specialized banks to offer the full range of banking services.

Cooperatives' Activities

14. Under Proclamation No. 85/1994, agricultural cooperatives have the ability to conduct banking business as defined in Proclamation No. 84/1994. These societies cannot comply with bank licensing and registration requirements. Consideration should be given to amending Proclamation No. 84/1994 to exclude specifically agricultural cooperative societies.

15. Agricultural cooperatives are organized under Proclamation No. 85/1994 and register with the Ministry of Agriculture or a local agricultural bureau. Savings and credit cooperatives are organized under Proclamation No. 138/1978 and register with the NBE's Savings and Credit Cooperatives Development Office (SACCDO). Both types of cooperatives may engage in credit and savings activities.

a. Consideration should be given to requiring all agricultural cooperatives (as well as other entities performing similar financial services) to conform to SACCDO guidelines and standards for the conduct of savings and credit activities, and/or

b. Consideration could be given to ensuring that cooperatives' savings and credit activities are registered with the SACCDO of the NBE, and

c. Consideration should be given to unifying supervision of all cooperatives' savings and credit activity under a single agency (SACCDO) or to supervision being performed in accordance with standard guidelines of that agency.

16. Many reorganized cooperatives still carry the debt of their predecessor organization. This debt was not transferred to the Government under the provisions of Proclamation No. 86/1994. The debt is affecting the viability of the reorganized cooperatives. A clear policy concerning treatment of predecessor cooperative debts should be established.

17. SACCDO is finding it increasingly difficult to perform both the role of promoter and the role of supervisor of SACCs:

a. NBE/SACCDO should no longer be charged with promotional responsibilities for SACCs;

b. SACCs should form and underwrite their own trade association.

18. To resolve some of the ambiguities of the two proclamations regarding cooperatives and to ensure consistency of treatment for performance of savings and credit activities by cooperatives, consideration might be given to combining the provisions of Proclamation No. 138/1978 and Proclamation No. 85/1994 into a single comprehensive law.

19. In light of the proposal to establish a rural development bank system that is being studied, consideration might be given to drafting a proclamation to establish such an institution on existing cooperative laws and the manner in which local rural development banks will interact with cooperatives.

Institutional Models.

20. Consideration should be given to a tiered cooperative/mutual structure that, at its base, is geared to attract existing groups in local areas. Local networks would be linked by regional intermediary institutions which would provide a variety of services (usually associated with formal sector banking) to and for the local institutions. The apex institution would administer a national fund that would promote new organizations and projects in rural areas and serve as advocate on rural finance issues.

Chapter 2 Regulatory Institutions

Overview

The objective of this portion of our study was to identify the institutional capacity of those organizations responsible under law to supervise and regulate financial activities, and to note opportunities where technical assistance would benefit those organizations, particularly

with regard to changes that might take place in rural banking activities and banking structures.

Findings and Recommendations

1. NBE is the primary regulator of the financial system. Its institutional capacity needs to be enhanced significantly or the system by which the financial service industry is supervised must be changed.

2. Technical assistance could aid in building the institutional capacity of NBE to supervise and regulate financial institutions.

3. The banking sector and NBE's supervisory activities are in transition. Technical assistance programs should be structured only after basic policy decisions have been made by NBE concerning the structure of the banking/financial system and the manner in which NBE will supervise the system.

4. Activities and decisions by NBE that could enhance the value of technical assistance:

a. The NBE could benefit by first developing a strategic plan for banking regulations and supervision

b. A decision should be made concerning primary and secondary responsibilities of the supervision department.

c. Decisions should be made concerning foreign entry to the banking system.

d. A comprehensive review of the laws governing all financial institutions should be undertaken. (This, in itself, may be an opportunity for technical assistance.)

e. A decision should be made concerning which agencies will supervise which institutions or activities, and such decision incorporated into the governing laws.

f. A review of objectives and cost factors would help determine how NBE might supervise each type of financial institution or activity most efficiently and effectively.

5. Technical assistance for development of on-site supervision capacity might involve:

a. development of standard examination procedures and workpapers;

b. development of a standard report of examination;

c. training of examiners.

6. Technical assistance to develop off-site supervision capacity might involve:

a. design of an appropriate returns package to monitor condition and compliance;

b. development of data collection, verification, organization, analysis and reporting methods;

c. refinement of audit and accounting standards;

d. training of bank analysts.

B. Building a Sustainable Rural Finance System

Chapter 3 Interest Rate Policy and Strategy

Overview

The objective of this chapter is to determine if interest rate levels and structures are sufficient to promote aggressive expansion of rural lending and to identify rate levels and structures that would be consistent with this objective; to examine the case for subsidy and loan targeting; and to explore techniques and the feasibility of tracking subsidy and targeting and measuring lending performance.

Findings and Recommendations

1. Freeing interest rates by gradually and steadily raising ceiling and reducing floor rates would create incentives for banks to determine their own pricing strategies.

2. Rational pricing of financial services requires good accounting information, which CBE and DBE lack. Data on bad debt losses and on credit delivery and administration costs should be improved. Technical assistance in the development of management information systems could be very helpful to these banks if they have incentives to use accounting results as a basis for decision-making.

3. Avoid interest rate and default subsidies. Use subsidies to create administrative capacity and delivery systems.

4. Relentlessly calculate credit program impact on the lender and the degree of subsidy dependence. Use the results of these calculations to identify areas and functions needing remedial action, to determine interest rates for the programs concerned, and to measure progress toward sustainability.

Chapter 4 Financial Service Delivery Mechanisms

Overview

This chapter identifies the types of financial services that are likely to be most useful to rural people. Trade credit is examined as one alternative.

Findings and Recommendations

1. Savings facilities are usually well patronized by rural people in developing countries. Efforts should be made to test savings club methodology in iddirs, using procedures developed in Zimbabwe. It may also be possible to sell savings stamps through bank branches or other outlets. Savings should be affiliated with credit programs where suitable arrangements can be made to protect the value of accumulated savings.

2. Intermediaries between small rural borrowers and CBE and DBE are essential because CBE and DBE are not in a position to expand their lending rapidly to these clients, and DBE intends to discontinue seasonal credit operations. Intermediaries include input suppliers, farmer groups, agricultural service cooperatives and NGOs.

3. Whatever intermediaries are used should accumulate capital to help ensure repayment to CBE or DBE, especially during a bad agricultural year. Group schemes are vulnerable to destruction and blacklisting by the failure of only a few members, making capital accumulation by groups especially important.

4. A means of avoiding the inevitable problems with group credit and cooperative credit is to encourage farmers to self-finance seasonal inputs through their own savings. This strategy is embraced by Region 4 authorities and should be encouraged by donors and others in a position to do so.

5. Efforts to increase the supply of fertilizer should receive top priority. Efforts to free fertilizer prices from all controls should receive second priority. These measures will permit the spontaneous development of fertilizer supply by more retailers and their use of credit to attract customers.

6. Efforts to review the use of banking services by grain traders could be useful in determining how their financing could be made more efficient.

Chapter 5 Collateral

Overview

This portion of our review identifies banks' collateral requirements, their impact on access to credit in rural areas, and their effective benefit to banks. Possible alternatives that could serve as effective collateral substitutes are explored.

Findings and Recommendations

1. Banks require collateral for most types of lending other than input finance. Collateral generally is limited to real property, equipment and vehicles.

2. Land tenure arrangements are the major obstacle to expansion of commercial credit in both urban and rural areas.

3. No tangible collateral is sought from individual farmers because they have none or cannot register those assets they do have in order to be able to pledge them.

4. The group and its pressure on the individual have been found to be the most dependable "security" for lenders to small farmers.

5. Collateral or the access to it by lenders does not really exist and should not be used as the underlying basis for advancing credit.

6. Group reinforcement of obligations would seem to be the only practical means for banks to obtain reasonable assurance.

7. Credit to individuals in rural areas must be distributed through a locally-based intermediary (e.g., cooperative or borrower group) to its members.

Chapter 6 Institutional Limitations on Loan Use and Access

Overview

Institutional arrangements for lending are limited and would have to be expanded and modified to serve large numbers of farmers effectively. This section identifies institutional constraints and suggests how they could be addressed strategically and operationally.

Findings and Recommendations

1. Put sustainable financial development as a first priority in any credit program. Support this priority by careful attention to and measurement of lenders' revenues and

expenses. Tons of grain will follow in a successful input credit program, to the extent permitted by the economics of grain production.

2. Efforts to increase the supply of inputs or to permit more competition with the major parastatal supplier, and to deregulate the retail prices of inputs are essential to encourage private trade in inputs. Technical assistance to CBE in input supply lending would be helpful as supplies increase.

Chapter 7 Loan Collections

Overview

Arrears hinder the availability of new financing. This section of our study identifies possibilities for improving the collection process.

Findings and Recommendations

1. Monitoring the use of proceeds and the borrower's operation is essential to successful lending.

2. An analysis of the borrower's sources and uses of funds would enable the lender to estimate the borrower's total credit capacity over a period and to structure repayment accordingly.

3. Interest rebates for prompt repayment may help create positive incentives for borrowers.

4. Collection experience improves when borrowers keep deposit accounts with the lender.

5. Collection potential would increase if lenders would require borrowers to provide some equity stake in the operation being financed.

6. The lender should have final responsibility for borrower selection, for determination of loan size, for loan approval and for collection.

7. Loan officer salary increments should be based not solely on volume, but also on loan quality and profitability criteria.

8. Good accounting and information systems are essential to support effective loan administration.

9. NGOs may be able to offer a fresh start where official institutions have established reputations as "soft" lenders unwilling to collect debts.

Chapter 8 Third-Party Loan Guarantees Funded by Donors

Overview

ERDA is considering setting up a loan guarantee program to facilitate access to agricultural credit. This chapter reviews one such scheme that operated in Ethiopia and discusses the factors that make it extremely difficult for donor-funded or official guarantee programs to operate successfully as financial ventures.

Findings and Recommendations

1. Guarantee funds established in connection with development projects or institutions seldom work well.

2. Guarantee funds are usually insufficiently capitalized because their founders underestimate the magnitude of the risks covered or are reluctant to charge an actuarially fair fee or premium.

3. Incentive problems contribute to losses and induce sponsors to require mandatory rather than voluntary participation.

4. Administrative problems in settling claims are often more challenging than assumed in guarantee scheme design.

5. An alternative to establishing a separate guarantee fund is simply to provide additional capital to a lending institution making loans for the activities that the donor or government would like to promote through a guarantee. This could solve certain incentive problems, simplify administration and reduce transaction costs, and provide valuable information directly to a major party at risk.

6. Any scheme should be flexible and adjust to experience. It should begin with high fees or premia so that with experience it is possible to reduce these charges, reaping benefits of good will.

Chapter 9 Agricultural Service Cooperatives

Overview

Agricultural service cooperatives are presently the major channels of input credit to farmers. Should they be encouraged to provide further credit and to offer deposit facilities to their members?

Findings and Recommendations

1. Credit is one of many services that can be provided by agricultural service cooperatives. Use of credit as a leading edge in cooperative development, is unlikely to be sustainable when cooperation is weak, especially if nonmember funds are provided to assist because these easily create incentives for opportunism. ERDA should consider alternative focuses for cooperative development.

2. The viability of cooperative credit requires good management, member confidence and means of dealing with risk concentration. These would be difficult to achieve at this time in the grain regions of East Wellega.

3. Savings and credit societies should be well capitalized to facilitate their survival. Institutional capital-to-total asset ratio of 25% or more are recommended. Most institutional capital should be contributed by members or retained by the cooperative from earned surpluses.

4. USAID/E may wish to consider a minor cooperative development initiative in the proposed project area in East Wellega, beginning with two cooperatives.

5. ERDA may wish to review periodically the scope for cooperative credit and other banking services.

Chapter 10 Adoption or Adaptation of Foreign Models

Overview

This chapter discusses the applicability and replicability in Ethiopia of certain rural and microfinance models developed elsewhere. These include Grameen Bank, regional rural banks, rural credit unions, saving and loan associations and rural or community banks.

Findings and Recommendations

1. Replication of the Grameen Bank model among farmers would be difficult and problematic.

2. It is difficult to predict the applicability of different models to Ethiopian conditions. Many models have had patchy performance histories in the countries in which they were originally developed and all have encountered difficulties in replication elsewhere. Those that have worked well in one country have not worked well elsewhere, and the reasons for lack of replicability are not clear.

3. An investment in good banking practice, as demonstrated by the village units of BRI, appears to offer the best scope for long-run sustainability. Replications should be attempted in Ethiopia.

Chapter 11 NGOs

Overview

Consultants have recommended that NGOs offering credit and other financial services should be subjected to national standards, and that adoption of appropriate standards could improve their performance. This chapter reviews the pros and cons of national standards.

Findings and Recommendations

1. Standards are not meaningful without data on performance. Data on performance are costly to collect and analyze. Therefore, standards should be supported by budgets and plans for monitoring and evaluation.

2. Standards should promote transparency so that experience can be used to improve performance. Transparency is assisted by accounting policies and principles and full disclosure.

3. National standards are likely to restrict the activities of NGOs.

4. Standards devised by lenders to NGOs may be more conducive to the encouragement of sustainable behavior by NGOs than standards devised through political and bureaucratic processes.

5. Standards could easily hinder innovation in efforts to provide financial services to the poor.

6. The information required to measure performance against standards should be specified clearly and carefully. The costs of data assembly should be estimated in advance and calculated in practice.

7. Data required in response to standards should be based on a need to know and should be made public.

8. Standards create scope for unproductive behavior or rent-seeking, which should be weighed against the actual benefits of standards. Standards arising from commercial practice and incentives are likely to be less costly in this respect.

Chapter 12 Using Accountability to Refine Policy, Strategy and Project Design

Overview

This chapter reviews developments in generating better cost data on rural finance operations in the Commercial Bank of Ethiopia, and includes notes on mobile banking facilities provided to the DBE.

Findings and Recommendations

1. Profit center accounting is a very useful element in the effective administration of a loan portfolio and for the responsible management of a bank branch.

2. Profit center accounting, including loan performance criteria and incentives to branch management, could usefully be included in any rural finance program initiated in East Wellega with donor assistance.

3. Mobile banking services could be introduced and their feasibility tested in the proposed project area along the main road from Addis Ababa to Nekept, security permitting.

C. Priorities for Increasing Agricultural Production in East Wellega

A pilot project in Gobu Seyo and Sibu Sire in East Wellega could be organized around six priorities in the order given below. These recommendations are derived from various places in the report rather than from a specific chapter.

1. Develop input supply systems. The major hindrance to crop production in the proposed pilot area is the physical quantity of fertilizer available and the timeliness of its arrival (paras. 4.40 ff). Farmers are eager to use fertilizer but find it hard to get on time (para. 3.23). This problem is related to the supply of foreign exchange available for fertilizer imports and the timeliness of procurement by the major importer, AISE. Supply through cooperatives and farmer groups based on peasant associations works reasonably well. Private traders should be provided an opportunity to get into this business.

2. Improve crop husbandry. Fertilizer can double grain yields using otherwise traditional practices (para. 3.22). Fertilizer plus improved husbandry can increase yields by much more, as demonstrated by Sasakawa Global 2000 plots and their replication by the Region 4 Ministry of Agriculture and certain NGOs. A 263% average increase in maize yields was achieved by SG2000 farmers throughout Ethiopia in 1994. These improvements in husbandry involve almost no cash outlays beyond fertilizer, improved seed and plant protection chemicals. They are created by attention to soil preparation, timeliness of planting, plant population and weeding. They are labor intensive. Work on

farming systems by agricultural economists could contribute to a better understanding of how farmers could be encouraged to improve crop husbandry.

3. Improve animal health protection. Farmers and officials in the pilot area reported the death of large numbers of oxen from tripanosomiasis, a tsetse and biting fly borne disease. Official herd size data for East Wellega do not bear out these reports of large losses, but the mission believes the farmers' reports are valid. Death of animals decapitalizes farmers and also reduces draft power, which may diminish planting capacity and the quality of soil preparation. About 10% of all households in the pilot area are headed by women, often war widows, some of whom might be able to maintain oxen for rental to others.

4. Promote savings. This could be attempted using methods developed by the savings club movement in Zimbabwe, which was originally based on saving for target purchases such as fertilizer (paras. 4.15ff). Innovations could include special savings facilities through iddirs and sale of savings stamps by banks and shops. Farmer's present savings are largely in the form of animals; diversification could greatly improve welfare, especially for women.

5. Do not impede the phase out of fertilizer credit through cooperatives, SG 2000 and MOA programs promoting modern husbandry using chemical fertilizer and improved techniques. These improvements increase yields greatly in a normal year, creating savings capacity for participating farmers (see paras. 4.35 ff).

6. Devise contingency plans for fertilizer financing in a bad agricultural year, or following a bad year. It is not clear how the present credit system could survive a bad year when repayment capacity and purchasing power diminish (paras. 3.08, 4.47 ff, 9.13). The blacklisting of defaulters would not be effective if a large number defaulted who were in distress (pares. 4.30 ff). Possibilities for protecting the credit system against the bad year include requiring cooperatives to build up capital, use of smaller groups of farmers as borrowers in order to strengthen joint solidarity (paras. 4.2c ff), or rescheduling over subsequent years, which presumes that sufficient repayment capacity would exist in these years to recoup arrears and interest (para. 11.27).

7. Test the feasibility of mobile banking along the Bako-Nekemt road, serving smaller centers on market days (unfortunately these are often Sundays) or at other times on a weekly schedule (chapter 12). Work to develop a clientele of small savers and traders.

8. Introduce credit programs for women close to market towns, using "essential Grameen" principles (paras. 10.01 ff) or the community banking model containing an external account and/or internal account (paras. 4.08 ff).

9. Consider supporting cooperative development through a minor initiative beginning with two societies that appear willing to save and operate on a businesslike basis (paras. 9.16 ff).

ETHIOPIA RURAL CREDIT

INTRODUCTION

0.1 This report summarizes the findings, conclusions and recommendations of a team of four consultants to USAID who were engaged by Barents Group of KPMG Peat Marwick, Washington DC. Barents Group is the contractor responsible for the Financial Sector Development Project (FSDP II) of USAID's Office of Economic and Institutional Reform. This task was funded through a buy-in by USAID/Ethiopia. Ms Meg Brown of the Office of Agriculture and Natural Resources in USAID/Ethiopia is the Project Officer to whom the team reported. The consultants and their specialization's are: J.D. Von Pischke, chief of party; Ed Nolan, banking supervision; Itana Ayana, agricultural economist; and Mesfin Namarra, financial and regulatory specialist.

0.2 The consultants' task consisted of developing proposals for creation of a sustainable rural financial system that would be responsive to opportunities facing farmers. Fieldwork was conducted in two woredas (districts) of special interest to USAID as sites for pilot activities. These woredas are Gobu Seyo and Sibu Sire in East Wellega, Oromiya or Region 4. These are located along the Addis Ababa-Nekemt road approximately 250 km west of Addis Ababa. (See Annex D)

0.3 The team worked in Ethiopia for four weeks, from 13 November 1995 to 9 December 1995. The team spent a week together in East Wellega and Messrs Von Pischke and Itana later returned to Gobu Seyo and Sibu Sire to gather additional farm data.

0.4 The team's task was detailed in a scope of work prepared by USAID/Ethiopia. This report is likewise organized around the scope of work, which contains questions on 12 topics of relevance to creating a viable rural financial system and related questions pertaining to possible implementation in Gobu Seyo and Sibu Sire. Materials from the scope are reproduced in bold type throughout the report, and the complete scope is included in an appendix to this report. Consultants' conclusions and recommendations are given in underlined bold type in the text of this report.

0.5 The text of this report is divided into parts A and B. A deals with the legal and supervisory content for banking services and B is focused on building a sustainable rural financial system

0.6 The team wishes to thank the many people who made its work possible by sharing data, observations, advice and opinions. A list of those consulted and their affiliations is found in a Annex.

Part A: Legal and Supervisory Context for Banking Services

1. Legal and Regulatory Framework

What are the legislative and regulatory prerequisites for developing sustainable rural financial markets in Ethiopia? Identify the requirements and institutional configurations for establishing and sustainably running non-bank financial institutions, including NGOs:

credit and savings activities

savings and loan activities in the existing cooperative system

Grameen-type savings and lending organizations

community or rural banks

credit unions

Overview

1.01 Legislative and regulatory requirements, if they are to develop and sustain rural financial institutions, must be reasonably permissive during the organizational stages of institutional development. The governing laws must recognize the grass roots nature of such institutions, the level of infrastructure available to them, their relatively unsophisticated management and clientele, the mutual/cooperative group bases on which such informal and semiformal institutions are formed, and the level of funds that can be contributed by clients and founders.

1.02 The existing literature documents and the team's interviews confirm that those groups providing or that are to provide financial services in rural areas have the best chance of becoming sustainable if they are culturally appropriate, natural associations that are voluntary in membership, operate on democratic principles, operate with low overhead costs, and are flexible and responsive. They must be convenient to and trusted by their members, and demand no more than a small amount of their members' time to obtain their services. (Other concerns about sustainability that relate to funding costs, investment and lending rates of return are discussed in Chapter 3 of this report.)

1.03 A rural financial service organization, to be culturally appropriate, should evolve from or closely parallel existing entities in a particular area: the iqqubs, iddirs, credit groups formed by nonmembers of cooperatives or within cooperatives, agricultural and service cooperatives, women's groups, religious affiliation groups, etc. These

associations exist because they meet one or more needs of their members, who are known to one another or by a sufficient number to assure proper performance in accordance with the rules of the group.

1.04 These associations are not government mandated, but are willful undertakings for a common well-being, the rules of which are established by the members to assure proper management and accountability of the common fund. Because they generally are small in comparison to formal sector enterprises, and because they operate outside the formal, regulated financial sector, they do not need (nor could they afford) to conform to the numerous prudential, recordkeeping, reporting and other requirements of a regulated institution and therefore, can keep their operating costs low. They are formed for a specific purpose that each member feels will benefit him/her. This last point is extremely important; potential members (i.e. depositors and "share" holders) will form or join an institution only if there is a clearly defined benefit to doing so. These may be tangible, such as access to a credit facility or pool of funds, or psychological, such as peace of mind in having personal savings in a secure place or a pool of funds available for emergency or social obligations.

1.05 These associations are locally-formed, center on a confined area or common activity, and are therefore convenient to their members. Because members know each other, and often stand as guarantors for each other, paperwork is kept to a minimum and the group is trusted.

1.06 Formal financial institutions, on the other hand, are urban headquartered and appear remote and monolithic to the rural saver or credit seeker. These institutions have structural overhead, imposed regulatory requirements and self-imposed policy constraints that limit their ability to penetrate rural areas profitably. These institutions have shown a reluctance to loan to individuals on any terms or on a medium to longer term basis to groups. Access to these institutions by the rural saver or credit seeker would be time consuming, cumbersome and usually unrewarding due to a variety of associated negative credit factors (discussed in Chapter 4 of this report).

1.07 Although formal financial institutions such as existing, legally organized banks may at some point become financial service delivery mechanisms for the rural populace, they cannot be looked upon to do so directly in the near term. Branching expenses, high transaction costs, low volume of activity per branch and low rates of return on loans are all negative incentives for the commercial banks to participate directly in rural finance. However, they may be of indirect benefit.

Existing Laws, Directives and Policies and an Enabling Environment

1.08 **Proclamation No. 83/1994,** ***Monetary and Banking Proclamation***, establishes the National Bank of Ethiopia (NBE) as the legal authority to license, supervise and regulate banks, insurance companies and other financial institutions. In this

Proclamation, "other financial institutions" are defined as institutions of savings, postal savings, credit cooperatives and other similar institutions engaged in any type of banking business. "Banking business" in this Proclamation is more liberally defined than that which is described in and governed by Proclamation No. 84/1994, discussed below. Essentially, all credit activity and all deposit taking activity may be subjected to the licensing and supervisory authority of the NBE. It appears that the exact form that an institution takes (savings institution, credit union, credit cooperative, bank, etc) is of less importance than the activity it conducts in determining its encompassment within the NBE's supervisory purview.

1.09 Such an interpretation is consistent with the purposes of the NBE, which are, in part "...to foster...a sound financial system and such other credit and exchange conditions as are conducive to the balanced growth of the economy of Ethiopia." It is also consistent with a specific duty of the NBE to "...Promote and encourage the dissemination of banking and insurance services throughout the country."

1.10 In this context, the National Bank of Ethiopia clearly is responsible for the promotion, development and supervision of banking, in whatever form. The NBE's motivation and enforcement of laws, regulations and especially policies have a profound effect in establishing and maintaining the environment in which the various financial institutions operate.

1.11 Interest rate controls. This Proclamation also gives the National Bank the authority to fix maximum and minimum rates of interest which banks and other financial institutions may charge for loans, advances and other credit transactions and which these institutions may pay on various classes of deposits. The crucial word in the section of Proclamation No. 83/1994 is "may". The NBE is not compelled to set these rates and can let the market operate freely, if desired. If the market shows abuse, this section enables the NBE to intervene. As discussed in Chapter 3 of this report, the current interest rate policy tends to serve as a disincentive to the expansion of lending as well as the continuing mobilization of deposits. Although other factors in addition to the promotion of credit and deposit mobilization bear upon the NBE's interest rate policy decisions, **it may be of benefit to periodically measure the results of the current policy against its desired objectives to determine whether the policy is effective. The present maximum allowable interest rate on credit transactions appears insufficient to cover costs and provide a reasonable rate of return, thereby impairing sustainability of banking operations at any level.**

1.12 It would seem that the NBE could influence interest rates toward a desired norm by increasing and decreasing the required reserve against deposits and the required level of liquid assets. The NBE also has the ability under Proclamation No. 83/1994 to set the discount/rediscount rate in ways that could serve as the basis upon which other rates would be determined in the market. This would hold true particularly when banks are fully invested up to the allowable amount of their deposits and are acquiring loanable funds at the margin. (This situation does not yet exist within the

Ethiopian banking system.) A tiered structure for discount/rediscount rates and collateral margin requirements by the NBE for lending to the banking system also can be used to promote lending into desired areas. If structured appropriately, market rates that would sustain banking (and credit operations in particular) might be attained.

Consideration could be given to using reserve, liquid asset and discount rate powers as an indirect means of influencing lending rates and funds availability within the banking system, permitting less reliance on direct controls, such as interest rate floors and ceilings.

1.13 Regulating banking business. The present banking law, **Proclamation No. 84/1994,** *Licensing and Supervision of Banking Business Proclamation*, addresses only commercial banks and commercial banking rather than rural developmental banking. Its requirements for organization and licensing are prohibitive to the size and type of informal and semiformal financial institutions that exist or could be formed in rural areas of Ethiopia. In fact, it could be argued that the law does not apply to these types of institutions at all since they do not, in a sense, "receive funds from the public...," but rather from their own members. Nor do such institutions use the funds that they accumulate "...for the account and at the risk of the person undertaking the banking business." Rather, these institutions, due to their mutual/cooperative nature, use their members' funds for the account and at the risk of those same members.

1.14 The Proclamation provides that only incorporated institutions may conduct banking business, and only if they are licensed by the National Bank of Ethiopia to do so.

Either the existing law must be changed to provide for the informal and semiformal unincorporated types of financial services providers as a business and business form that is different from commercial banking, or a separate law must be drafted to supervise and regulate this business.

1.15 The amendment or the separate law could exempt from registration and regulation all institutions that are informal, possibly defined on the basis of size, such as those with fewer than a specified number of members or shareholders. If a separate law is issued to govern the financial activities of mutual/cooperative groups, Proclamation No. 84/1994 should be amended to exclude specifically these unincorporated, cooperative type groups as a distinct class of financial services providers.

1.16 Proclamation No. 84/1994 contains authorities which could be implemented by the NBE through directives (regulations) or policies in a manner that would promote penetration of rural areas by commercial banks.

1.17 Branch banking. Chapter 2, Section 5(5) states that a bank cannot conduct banking business at any location other than the one specified in its license without the prior

written consent of the NBE. This section gives the NBE approval authority over branching by commercial banks. Because the commercial banks are economically motivated, they tend toward establishing branches in urban areas, high population density areas, and/or high commercial trading areas where the profitability and the volume of business are attractive. As a result, these areas can become overbanked, while rural, sparsely populated, low trading areas remain without access to banking services.

1.18 Rural branches can be quite simple, to minimize overhead costs. These branches could be subsets of "Class 1 branches:" as transaction centers they could take deposits, disburse loans, and take applications for opening accounts or loans. Full documentation/recordkeeping for these transactions and credit decisions could be made at the next higher level. Banks that would allow "instant" approval of certain types and sizes of loans might attract customers who would not otherwise consider using the bank.

The NBE may wish to encourage small branches of the type described as a means of fostering expansion of commercial banks into rural areas.

1.19 Requiring each licensed commercial bank to open branches annually in an unbanked area is not recommended because it could tend to weaken banks by imposing overhead costs. The banking system is in a transitional stage and is susceptible to numerous risks. It would be of no benefit to add to those risks.

1.20 Promotion of branches into rural areas may not necessarily increase credit and, therefore, economic activity in those areas. Commercial banks often transfer to and pool at the head office the deposit funds mobilized in their outlying branches. This pool is then redistributed to the urban/commercial center branches experiencing strong loan demand. This is efficient for the institution and helps savers by directing their deposits to high yielding activities, providing a basis for paying attractive interest rates and reducing deposit transaction costs. It does little to foster development directly in the rural areas that are the source of those deposits. Policies or regulations that would require a certain minimum percentage of the deposits obtained within a specific branch's service area to be loaned or invested within that same service area create inefficiencies.

1.21 Financing a rural development fund. Chapter 2, Section 16 of Proclamation 84/1994 enables the NBE to require banks to maintain liquid assets equal to a specified percentage of their deposits and similar liabilities and to designate the form and distribution of those liquid assets. This is an additional opportunity for the Government, through the NBE's regulation or policy to implement this section, to obtain indirect participation by commercial banks in the development of rural credit and enterprise. The Government or designated agency (such as the proposed Rural Development Bank) could issue Rural Development Bonds of long maturity (say 10 years) that would fund a Rural Development Fund or which could be used as a liquidity pool for a rural cooperative banking system. The model for this

institutional structure is described later in this chapter. These bonds could be designated as eligible assets to satisfy commercial bank's liquidity requirements as allowed by Section 16 of the Proclamation.

1.22 There are several ways these bonds could be made attractive. One would be to give them some form of tax advantage to the interest they would pay, which would enable the Government to issue them at a low rate. The banks and other holders benefiting from the tax advantage would obtain a market rate of return. Alternatively, the bonds could be offered at auction, which would produce market rates. The bonds could also be offered at no stated interest rate but with periodic distributions that would provide a return reflecting the earnings of the credit pool created by their proceeds. In this case, the more the pool is used to fund eligible projects, and the better the repayment rate of those projects, the better the potential return to the bond holders. This could also motivate banks and other bondholders to identify and arrange credit or investment funding packages for viable projects.

1.23 Donors and others may wish to participate in this pool as well, and could perhaps provide some of the initial funding on a grant, loan, or investment basis. Donors might consider providing foreign exchange to the pool to fund imports (such as fertilizer) for project purposes.

NBE in coordination with the other appropriate Government agencies may wish to structure liquid asset policies for banks to accommodate the issue and purchase of rural development bonds to fund a rural development investment pool.

Donors may wish to consider participating in establishing and maintaining the rural development investment pool, particularly a foreign exchange component.

1.24 Proclamation No. 84/1994 is not clear about the types and extent of investments banks are permitted to make. The definition of "banking business" includes use of funds for loans or investments. Section 27(3) allows a bank to engage in nonbanking or nonfinancial enterprises only with the authorization of the National Bank. A clarification or interpretation would be useful. If the NBE were to permit (subject to some prudential limit) certain types of investments in or joint ventures with enterprises that are involved in rural or microenterprise development, this might prompt banks to find innovative ways of providing funds to such activities at rates of return that could be better than the maximum prescribed lending rate.

The NBE may wish to consider establishing a policy that would permit or foster commercial banks' investment in certain types of rural and microenterprise development projects or entities, to an extent consistent with safety and soundness.

1.25 Bank ownership is an issue. The Proclamation precludes a foreign national from conducting banking business in Ethiopia, and no person is permitted to own more than 20% of a banking company's shares. This would seem to limit the development of the banking system. The focus should be whether such ownership

would be harmful or beneficial to the institution or the banking system. There may be instances where allowing foreign investment or an individual domestic investment in excess of 20% would promote competition and extension of services to rural areas.

1.26 Certain potential owners may have substantial capital that could be invested to assist a troubled institution and keep it solvent without calling upon the NBE or Government to provide resources for this purpose. Or permission for ownership in excess of 20% could be given by the NBE in situations where the owner is committed to establishing a banking network in a rural area.

Consideration should be given to ownership policies that would enable larger investment in commercial banks, when in the public interest.

1.27 Foreign ownership could bring expertise in banking practices, management and improved technology for better, more efficient service. Better services would encourage more people to use the banking system, moving money from the informal sector into the formal sector. Foreign ownership would bring an inflow of capital and promote competition. The existing structure is a virtual monopoly of the Commercial Bank of Ethiopia. Newly licensed commercial banks are too small to compete with CBE on a large scale. Competition could prompt CBE to improve its services and their availability.

1.28 Many countries have allowed foreign entry to their banking systems under certain conditions, such as a requirement that the foreign institution have a management development plan that would provide technical and management training and progression for local employees.

1.29 Although there is always the fear that the foreign banks would destroy the ability of locally owned institutions to compete, their entry may have the opposite effect, causing local banks to strengthen themselves to meet the competition.

Consideration could be given to allowing limited entry and participation by foreign banks under certain conditions that would strengthen the banking system.

1.30 A final note on ownership. Government is both an owner and regulator of the three major banking institutions. This creates potential conflicts of interest that tend to undermine rather than strengthen trust in the banking system by the populace. Four Council of Ministers Regulations were issued to give rebirth to the banking system:

Council of Ministers Regulation No. 200/1994 established the Development Bank of Ethiopia;
Council of Ministers Regulation No. 202/1994 established the Commercial Bank of Ethiopia;
Council of Ministers Regulation No. 203/1994 established the Construction and Business Bank.

1.31 The fourth regulation, **Council of Ministers Regulation 201/1994,** which established the Ethiopian Insurance Corporation and **Proclamation No. 86/1994,** *Proclamation for the Licensing and Supervision of Insurance*, are not discussed in this report. Their relevance to rural credit is not significant without a domestic capital market and a mortgage market for private land.

Consideration could be given to a plan for gradual divestiture of the CBE and specialized banks by Government, while at the same time allowing the specialized banks to offer the full range of banking services.

1.32 The regulations cited above gave the banks new juridical status, provided for their recapitalization, and gave them public enterprise status, which indirectly curtails their managerial and operational authority. These regulations also placed some restrictions on the breadth of banking business that could be undertaken by the DBE and CBB. Allowing competition across the board by all banks in all banking activities could stimulate the interest of potential investors and make divestiture more plausible. Concerns about the availability of credit for special purposes could be met by phasing in the entry of the specialized banks into the broader system over several years.

1.33 Regulation of cooperative savings and credit. **Proclamation No. 85/1994,** *Agricultural Cooperative Societies Proclamation* provides for the establishment of primary and higher levels of agricultural cooperative societies in accordance with voluntary, democratic principals. It repeals sections of Proclamation No. 138/178 that deal with agricultural producer cooperatives and agricultural service cooperatives. Under the 1994 law a primary society can be formed with a minimum of ten members, while a higher level society can be formed by two or more primary societies. The registration process is quite facilitative: societies must have by-laws, membership lists, management committee lists, and leadership lists with names, addresses and signatures. The registration authority may be either an agricultural bureau or, if more than one national/regional self-government is involved, the Ministry of Agriculture (MoA). Registration gives the society juridical personality. Upon decision of the General Meeting, a society can amalgamate with another or divide into separate societies. Societies appear to be, in a sense, limited liability entities (Part Two, Section 10.2). Societies must keep records of accounts and proceedings and have an annual audit.

1.34 Although there is no direct reference in the law to govern the provision of savings and credit operations, Part Six, Sections 34 and 35 indicate that such activity is permissible if and as permitted by the society's by-laws. Section 34 states, "A society shall receive deposits or loans from its members or other organizations to such extent and on such conditions as may be specified in the by-laws of the society." Section 35 states, "A society shall not extend loans other than to its members or a society established under this proclamation.

1.35 These two sections raise some difficulties because they permit the society to take deposits, receive funds (loans) and to make loans beyond the members of the society. In this sense, a society would be taking funds from the public for its own use. This is banking business as defined by Proclamation No. 84/1994 that, strictly interpreted, is governed by that proclamation. Without a specific exemption for the agricultural service societies in Proclamation No. 84/1994, they are not conforming to the business form and other licensing requirements prescribed. Nor are they in compliance with the various other financial requirements established by that law.

1.36 Surely, the intent of Proclamation No. 85/1994 is to promote the development and growth of agricultural service cooperatives. Credit and savings activities would be an integral part of these societies' operations and an attraction for membership. Therefore, based upon the perceived national objective, their initially small volume, and their mutual/cooperative form of ownership, it would be beneficial to exclude them specifically from the umbrella of Proclamation No. 84/1994.

Consideration should be given to amending Proclamation No. 84/1994 to exclude specifically agricultural service cooperative societies.

1.37 At the same time, because these financial activities are being conducted by agricultural service societies, there should be some uniform guidelines or principles governing their deposit taking and lending. Because these activities are performed legitimately within the registered savings and credit cooperatives governed by the Savings and Credit Cooperatives Development Office of the NBE (SACCDO), the SACCDO guidelines and requirements should be made applicable. These guidelines would standardize the performance of and accounting for these financial activities among agricultural and savings and credit cooperatives.

Consideration should be given to requiring all agricultural cooperatives (as well as other entities performing similar financial services) to conform to SACCDO guidelines and standards for the conduct of savings and credit activities.

1.38 These guidelines could form the basis for any national standards that might be applied to NGO's that are involved in credit and savings activities. (Please refer to Chapter 11 in this report for a discussion of national standards).

1.39 Another related problem is evident. The agricultural cooperatives register with the agricultural bureau or the Ministry of Agriculture, not SACCDO. Savings and credit activity could be conducted inconsistently and outside the supervision and guidelines of the NBE, which is not the intent of Proclamation No. 83/1994.

1.40 At least two options are available to resolve this inconsistency: (1) require that agricultural service cooperatives that wish to conduct savings and credit activities apply for registration with SACCDO in the same manner as the savings and credit cooperatives. Differences in the minimum number of members (10 for agricultural cooperatives and 20 for savings and credit cooperatives) could be resolved easily;

application would not have to be made to SACCDO until the number of members in the agricultural society reached 20; (2) the appropriate authority under which the agricultural cooperative is registered (the local agricultural bureau or the Ministry of Finance) could apply to SACCDO on behalf of the agricultural cooperative if the cooperative's by-laws permit savings and credit activity and there is an intention to undertake that activity.

1.41 Proclamation 85/1994 is silent as to the form and source of supervision of the agricultural societies. However, Section 47 enables the Ministry of Agriculture to issue directives for the implementation of this Proclamation. Because the supervision of savings and credit activities is the responsibility of the NBE, as per Proclamation 83/1994, it may be better, again for consistency of treatment and standardization of activity, that SACCDO be assigned responsibility under an amendment to Proclamation 85/1994. Alternatively, SACCDO and the agricultural bureaus (or better still, the MoA) could formally agree on the supervisory strategies and methodology for supervising agricultural cooperatives' financial services. Under such an agreement, reports and information would be shared by those agencies.

Consideration could be given to ensuring that cooperatives' savings and credit activities are registered with the SACCDO of the NBE.

Consideration should be given to unifying supervision of all cooperatives' savings and credit activity under a single agency (SACCDO) or to supervision being performed in accordance with standard guidelines issued by that agency.

1.42 Such standardization would provide reasonable assurance of the proper conduct of the activities and perhaps encourage donors and NGOs to participate to a greater extent by making loans to or deposits in these societies, as they legally can do under Section 34 of Proclamation 85/1994, by-laws permitting. One possible means of promoting donor and NGO participation is to allow nonmember deposits up to a certain percentage, for example 30%, of total deposits or shares. This is an allowable practice for credit unions in the United States.

1.43 The cooperative legacy and potential. The team's field interviews disclosed that agricultural cooperatives have been slow to organize or reorganize. The stigma of cooperatives organized under the Derg, the manner in which they were operated, the lack of benefit they provided to their members, inter alia, have created a psychological distaste among potential members. This might be overcome through an educational process and, perhaps, demonstration cooperatives or projects initially underwritten by outside assistance.

1.44 Another problem faced by these reorganized cooperatives is that many are still faced with the bank debt owed by their predecessor organization. These debts were not repaid when the cooperatives dissolved upon the change in government. Productive assets often were stolen or destroyed, and records were lost. The debt owed by

2.13 Off-site supervision is less labor intensive but more capital intensive. Hardware, shelf type software and special programming, back-up power supplies, a reasonably dust free and cool environment all would be necessary investments to maintain a data base, perform analyses, and generate meaningful reports. However, these front-end costs can be amortized over many years, and there would be fewer recurrent costs. Analysts would have to be trained. However, their number and, therefore, their cost would be significantly less than a cadre of on-site examiners. A comprehensive package of returns would have to be developed to properly monitor condition and compliance. (The existing package of returns forms and instructions is not adequate for this purpose.) A decision would have to be made at what level data would be collected: branch, region or on a consolidated bank basis. The lower the level, the greater the requirement for processing and storage. Consideration would have to be given to the need for and use of data to be collected, its reliability and ways to test and verify reliability. If data are to be collected only on a consolidated basis, the need for automation, given the number of banks that now exist, is less pressing. Given the number of SACCs and the possibility of an additional rural banking system, the merits of automation are more apparent.

2.14 Corporate activities would not appear to require a large staff at this time, particularly if SACCDO is to transfer its promotional responsibilities. However, if the volume of new registrations and bank and branch applications is anticipated to increase, staffing must be increased accordingly to ensure adequate analyses and investigations. It is important that this division be staffed with more senior, experienced bank supervisors.

c. Identify the budget and financial impact of any investments and changes proposed.

2.15 As noted above, each additional examiner would bring an average cost of Br 875 plus benefits and an allocation of overhead, such as office space and other indirect costs estimated at 25% of salary. This would approximate Br 13,100 annually for each additional examiner. Travel costs vary with the option chosen. Each examiner should receive intensive training during the first six months of employment (both classroom and OJT), and then at least two weeks of formal training annually thereafter, some of which might involve overseas travel and attachments to supervision agencies or central banks.

2.16 The cost of a small PC-based local area network using a standard shelf package such as MS Office (word-processing, spreadsheet and presentation/report software) considered adequate for present volume would approximate US$4000 per unit. Printers could be shared; a satisfactory printer, such as an HPLaserJet III or IV, might cost approximately $1,600 each. A single printer could support at least five work stations. Any special programming would add to the unit cost.

d. Is any technical assistance recommended strongly desired by top NBE officials?

2.17 Technical assistance definitely could be of benefit and indications have been made to the team that such would be desired. Given the existing plans for a Supervision Department and SACCDO, and the possibility of establishing a rural development banking system, the following types of technical assistance would be of value for:

i) drafting new or revised laws and directives;
ii) organization, staffing, supervisory policies and strategic planning;
iii) developing examination procedures, standardized workpapers and a report of examination format, and classroom and on-the-job training in their use;
iv) designing a returns package to monitor condition and compliance by individual institutions and trends in the financial system, and in implementing the package;
v) designing the computerized data base/management information system, analysis and reporting formats;
vi) training in bank financial analysis;
vii) designing a training curriculum and management development program for banking supervision staff at entry level, intermediate level, at the fully technically qualified level, and at management levels; and
viii) possibly, troubled bank resolution techniques and policies.

2.18 Technical assistance could be provided through a resident advisor, through shorter term tasks of various duration's, and/or through training materials and courses.

2.19 Technical assistance could also be useful in setting up new organizations discussed elsewhere in this report, especially for their funding and accounting. These include a national rural development pool, a rural or mutual banking structure and policies, etc.

2.20 Financial assistance to fund study tours and attachments to supervisory agencies abroad also is desirable.

Technical assistance should be considered as a means of building the NBE's capacity to supervise and regulate financial institutions.

Any technical assistance program should be structured only after basic policy decisions have been made by the NBE concerning the structure of the banking and financial systems and the manner (on-site; off-site; both; through intermediaries; using agents, etc.) by which NBE will supervise the system. To build technical competence in banking supervision from apprentice level to a fully qualified level (pre-management) a period of three to five years is necessary.

It is not yet apparent that NBE strongly desires technical assistance as outlined above.

Priorities

2.21 Strategies. Before embarking on a reorganization of the supervision function, **the NBE could benefit by developing a strategic plan.** The NBE's Board and senior management could initiate the strategic planning process bankwide; comments here will deal only with the banking supervision department.

2.22 The Board and senior management should clearly specify the mission of NBE; its goals and objectives both for the near term (within one year) and for longer periods (within three years; five years, etc.) should be defined. The mission of the NBE is stated in Chapter I, Section 2 of Proclamation No. 83/1994: "...to foster monetary stability, a sound financial system and such other credit and exchange conditions as are conducive to the balanced growth of Ethiopia." This basic statement could be expanded as desired.

2.23 The question that underlies the strategic planning process is, "How can the NBE best satisfy its legal purpose?" The answer lies in a clear statement of goals, objectives, duties and responsibilities. This statement should be prepared by the heads of each department in NBE. The statements prepared by each department head should list those duties and responsibilities that are necessary for the department to perform to contribute to NBE's mission fulfillment. These then would need to be integrated and reconciled by the Board and senior management of the NBE in light of budgetary constraints, socio-political concerns, economic factors and the national government's policies and objectives. Once adopted by the Board, the statements of each department head can then be translated into a work plan, which, in turn, will form the basis of its budget.

2.24 For banking supervision, Proclamation No. 83/1994 lists some specific powers and duties:

> *to license, supervise and regulate banks, insurance and other financial institutions; and
>
> *to promote and encourage the dissemination of banking and insurance services throughout the country.

2.25 The latter duty might seem to be in conflict with the first, on one hand to regulate financial services and on the other hand to promote their growth and dissemination. In truth, particularly in developing economies, the two go hand in hand. The laws, regulations, and policies of a central bank to govern financial services and the manner in which these are implemented will create the environment that will either foster or frustrate the growth of that industry. For banking supervision, the difficulty is to balance the desire for rapid growth of the financial sector throughout the country with the risks that such growth entails. A sound financial system, based upon banks and other financial institutions that operate according to prudent

principles and that are competently managed and supervised, will create confidence in the system and, therefore, its growth. Financial development may be somewhat slower under a supervisory system designed to protect depositors, but it will be more sound and enduring.

2.26 **Specify priorities between the primary and secondary responsibilities of the supervision department** - protection of depositors, consumer protection (to guard against unfair lending or deposit taking practices), promotion and expansion of the banking system, all of these, or a combination of these. Or, there may be other responsibilities desired.

2.27 The preceding decision will help the NBE to **decide which financial activities and types of institutions should be regulated and supervised** - deposit taking, credit, investment, some or all of these. Should informal financial institutions be regulated? Should NGOs that operate credit or savings schemes be regulated? Is there a certain size of institution (total amount of loans or deposits) or level of activity (number of accounts or members) below which the NBE should not impose supervision and regulation?

2.28 Foreign participation. The next consideration for the NBE and the supervision department concerns the structure of the financial system. **Decisions concerning foreign entry to the banking system should be reviewed**, keeping in mind that most countries practice reciprocity. If Ethiopia does not allow foreign banks to be established within its boundaries, then foreign governments may not permit establishment of branches of an Ethiopian bank. Prohibiting foreign entry may jeopardize the opportunities for Ethiopia's banks to expand beyond its borders.

2.29 Another structural consideration is the form of foreign entry which could be permitted: joint ventures, a locally incorporated bank with foreign ownership, branch offices, or any of these.

2.30 Privatization. Decisions concerning divestiture by Government of the specialized banks - if, when and how the Government transfers ownership to the private sector will affect supervisory treatment and the demands upon the supervision department. In general, privatization would increase the need for supervision.

2.31 Nonbanks. How should the savings and credit cooperatives be organized? Should credit or savings schemes operated by agricultural or other cooperatives be registered in accordance with SACCDO guidelines and requirements, and what activities will be permitted to savings and credit cooperatives before they must register as banks under Proclamation No. 84/1994?

2.32 Decisions concerning establishment of a rural development banking system are important. The manner in which this system is established and the form of ownership it will take will have a bearing on the supervision department of the NBE.

2.33 Legal consistency. Once these decisions with regard to system structure are agreed, **a comprehensive review of the laws governing these institutions should be undertaken** to ensure that they are not contradictory, that definitions of the activities and institutions covered and excluded by those laws are specific, that licensing or registration authority is specified, that adequate supervisory powers are provided to the regulatory agency, and that these laws provide a means for orderly exit from the system or conversion to another institutional form. The content of these laws will heavily influence the ability of each type of institution to organize and to compete.

2.34 In the drafting of these laws. it is important to **consider which agencies will supervise which institutions or activities.** Ideally, supervision and regulation should be unified in order to provide consistency of treatment, particularly for entry to the financial system, systemic data collection and the development of financial service industry policies. A single supervision department within the NBE that would have divisions responsible for supervision of banks, savings and credit cooperatives, rural development banks, credit schemes, insurance companies, etc. It would provide the opportunity for consistent, integrated supervision, and better implementation of government and NBE's own policies concerning the financial sector.

2.35 If the regulatory agencies are to be separate, then the law or implementing regulations should provide for coordination of these agencies' supervisory activities, perhaps through an interagency committee. Such an organization would provide a forum for the discussion of systemic issues and problems, and enable unified treatment of matters affecting more than one type of institution. One such model is the Federal Financial Institutions Examination Counsel which is the legally prescribed medium through which the federal bank regulators in the USA (Federal Reserve System, Federal Deposit Insurance Corporation, Office of the Comptroller of the Currency, National Credit Union Administration, and the Office of Thrift Supervision) coordinate their policies and activities.

2.36 The law or laws governing financial institutions and activities, in providing adequate authority to the regulator(s), should provide sufficient latitude for the regulator to implement those authorities through regulations, directives or policies that will enable the regulator to respond to changes in the financial system, emerging concerns or problems. If Ethiopian law permits, the general authorities could be provided within the law in a way that is not too prescriptive or inflexible; the regulator(s) could then implement those authorities through a series of regulations. It is a much easier process to amend or supersede a regulation than a law. This type of legal-regulatory framework enables the regulator to be flexible and responsive. Care must be taken, however, to provide a reasonable level of predictability to ensure that the law will be applied as its drafters intended.

2.37 Administration of the supervisory function. In designing the legal-regulatory framework, the drafters must **consider how best to supervise each type of financial institution or activity**. Decisions in this regard will affect the organization and staffing requirements of the supervision department or agencies.

2.38 As noted previously, the manner in which on-site supervision is conducted, either directly or through an intermediary organization or agent, will influence the number and type of staff needed. If the regulator(s) perform on-site examinations, **policies will have to be developed to determine the scope and frequency of examination** based upon the condition of an institution and/or its impact on the overall financial system. The manner in which banks' account for their operations, whether they have centralized or decentralized recordkeeping, will have a bearing on whether the regulator can satisfactorily examine the institution through its head office or whether, at a minimum, several significant branch offices must be examined also. These factors affect the number of staff required and the duration of an examination. This consideration is especially important for the supervision of SACCs and the proposed rural development bank system, where supervision through an intermediary organization could result in efficiency and savings for the regulator.

2.39 If on-site examinations are to be conducted, **standard examination procedures must be developed** to cover major activities and departments of each type of institution. A standard examination report format should be designed. Both these items, standard procedures and standard report form, will provide consistency of approach and reporting of findings to facilitate analysis and comparisons. **Examiners would have to be trained in these procedures**, bank analysis and report preparation.

2.40 Similarly, off-site supervision can be effective only if the information provided by banks in the package of returns is timely, comprehensive, accurate and reliable. For this to occur there must be accounting and audit standards developed for the financial system. **The returns package must be appropriately designed** to enable determination of each institution's compliance with laws and regulations and its overall condition, as well as to identify trends within the financial system. Proper off-site supervision requires trained bank analysts who are technologically equipped.

2.41 The present reporting package consisting of a monthly balance sheet, semiannual income statement, and weekly or biweekly liquidity and reserves position reports is not sufficient for effective prudential supervision. The reporting package, at a minimum, should include a basis for determining capital adequacy (Ethiopian banks appear greatly undercapitalized), concentrations in the credit portfolio and funding sources, loan delinquency and portfolio quality, foreign exchange exposure, off-balance sheet exposures, insider and related party transactions, and asset-liability maturity and repricing opportunities. The **data collected must be verified, organized, analyzed and reported upon.**

2.42 In the area of corporate activities, decisions with regard to structure and financial system promotion as well as the legal registration requirements in any new laws or amendments could lead to a significant increase in applications for banks, savings and credit cooperatives, rural banks, and branches. If other institutions are required to register with the NBE, such as NGO credit schemes, then an additional investigatory and application processing burden will be imposed. Staffing of this division, and training of that staff in application evaluation will be necessary.

2.43 All the preceding are opportunities where technical assistance can be of value, once the basic decisions described are taken.

Part B: Building A Sustainable Rural Finance System

3. Interest Rate Policy and Strategy

Some officials favor low interest rates for agricultural loans due to the extreme poverty of small farmers. The banks believe they cannot cover costs at low rates. With respect to loans to cooperatives, to traders in agricultural inputs and produce, and to rural individuals, provide the following information:

Are positive real interest rates sufficient to cover costs (i.e., market rates) being charged in government credit programs through the Commercial Bank (CBE) and the Development Bank (DBE)?

3.01 Rates presently charged by CBE and DBE are 14% on short-term credit to farmers and 15% on term loans. These rates are within a legal maximum lending rate of 15% decreed by the National Bank of Ethiopia, which also specifies a 10% minimum rate on savings and time deposits. (In December 1995 there rates were raised to 16% and 11%, respectively).

3.02 CBE and DBE's lending rates are insufficient to cover rural lending costs in the long run and are not prudent even in the short run. With inflation at around 10%, a cost of funds of between 3% and 5%, administrative expenses of about 3% and bad debt losses of about 3% as reported by successful NGOs, it would appear that the minimum viable rate would not be less than 19% in nominal terms. Even this rate, however, would represent bad strategy if the objective is to expand lending to agriculture, especially small operators.

3.03 The cost of funds is likely to rise as the economy grows and the financial sector becomes more competitive. The present cost of funds is low because the Commercial Bank pays no interest on the demand deposits that constitute half its deposit base. (Ten percent is paid on the savings and time deposits that constitute the other half.) The Development Bank uses funds available through the Ministry of Finance and is permitted to add a 3% spread on its ordinary lending.

3.04 The present costs of funds, approximating 3-5%, could easily double if a credible demand for loans were to expand or if interest rates were adjusted to reflect market valuations. (CBE's loan-to-deposit ratio of less than 50% is below the levels of 60-80% found in many countries most of the time, suggesting a slack demand for credit for credible projects and borrowers.) A more competitive demand for loans would cause banks' cost of funds to rise because they would be willing to pay more for funds. Competition is not likely to be a strong force in Ethiopian finance for some time to come, however, because of the overwhelming dominance of State-owned banks, the prohibition of foreign investment in the

financial sector, and the tendency toward cartel-like behavior in small financial sectors.

3.05 Administrative expenses of around 3% of loans outstanding are within the customary range for banks and may not change markedly with the expansion of the formal financial sector. However, expansion is not necessarily development, because the latter requires structural change through innovation. Innovations that would serve agriculture would include a wider branch network and possibly different types of branches. The typical business available in rural areas would be relatively more costly than that entertained by branches in urban areas because of lower volumes of transactions, greater use of cash rather than other negotiable instruments, greater seasonality of activity and more assistance to customers who may be illiterate or not accustomed to modern commerce.

3.06 Innovative financial services or instruments also tend to be more costly to provide than existing services because they are hard to price correctly until experience is gained about their performance. Innovation is risky, and generous margins should be built in to protect against unexpected costs. If these margins can be reduced subsequently on the basis of experience the lender can reap huge, competitive public relations benefits and goodwill.

3.07 Bad debt loss rates of around 3% are reported by successful NGOs, which is roughly equal to that experienced by US bankers on their credit card portfolios. CBE reports that about 10% of its agricultural loans, which are largely short-term, become bad debt losses. DBE estimates that its 20% bad debt loss rate arises primarily from factors other than borrowers' ability to pay. However, this 20% appears to represent only amounts actually overdue rather than the entire outstanding balances of loans affected or infected by arrears. These balances, including installments not yet due, are clearly of lower quality than similar balances on loans for which payments are current. They are more likely to accumulate losses as more installments fall due. DBE's recovery rate on input loans issued in 1994 stood at 82% in November 1995.

3.08 A 3% or a 10% shortfall in repayment would be extraordinarily low in a bad agricultural year, which is relatively frequent in many parts of Ethiopia and never entirely absent in any rain-fed agriculture. (The Sasakawa Global 2000 program reports that 8% of the demonstration plots it assists suffer a total loss.) No pro-active strategy currently exists for dealing with the inevitable accumulation of bad debts in these years. They result simply in the accumulation of overdues, and it appears that the determination of loan size does not include any "space" or cushion that would enable borrowers easily and relatively painlessly to repay arrears in a normal agricultural year or years following a bad year.

3.09 In addition, there is a tendency for repayment rates to fall over time in development lending in many countries, especially in government-sponsored and

donor-funded credit programs. The reasons for this deterioration are not entirely clear and have not been explored in the rural finance literature. Several factors may contribute where this occurs. (a) Relatively low-risk borrowers and activities may naturally be financed first. Over time, more marginal borrowers and more risky activities are embraced. (b) Administrative energy and attention may be intense during a start up phase or when rapid expansion is just getting underway. As a program matures or stabilizes supervision may become more lax and routine. takes over from initiative, watchfulness and curiosity. (c) Rapid expansion may result in loss of control because management information systems and training do not keep pace with growth in transactions. (d) Lenders may not have any plan to deal with adversity, reacting to shocks rather than planning for risk management, which consists essentially of developing techniques to maintain good relationships with clients that will survive bad times, such as an agricultural weather cycle, a business cycle or a personal set-back. (e) Borrowers test credit programs. This may occur innocently, without malicious intent. For example, a borrower may repay several days late. If the lender expresses no dissatisfaction with this minor transgression, the borrower may be tempted to miss repayment deadlines again and for longer periods. Likewise, if a borrower who repays on time notices that others who delay payment do not suffer any consequences, the good payer may begin to wonder if he is naive. (f) Programs may become politicized if they are highly subsidized or if they are so successful that they attract political attention. Politicians may try to capture credit programs to provide patronage to their constituencies.

3.10 It is not yet possible to know whether this tendency is present in Ethiopia. This will become apparent only as the post-Derg economy progresses. But in view of these uncertainties, it can safely be concluded that interest rates presently charged on agricultural lending are significantly inadequate. It can also be safely predicted that the costs of the present interest rate policies will become increasingly apparent over time.

Are rates currently in use sufficient to encourage rural lending?

3.11 Lending rates. Present rates are unlikely to result in aggressive rural lending by CBE and DBE because they do not cover these lenders' costs. The interest rate structure set by the NBE allows a spread of 5% between the minimum savings and time deposit rates of 10% on one hand and a maximum lending rate of 15% on the other. (These rates were raised to 11% and 16%, respectively, in December 1995). The 5% spread would barely cover administrative costs, as explained in paras. 3.05 - 3.06 above. Hence, expanded rural lending is not likely to occur within the present rate structure unless intermediaries between the banks and small farmers can be enlisted to incur the additional costs of rural credit delivery.

3.12 Rural lending tends to be more costly than lending in general because of smaller volumes of transactions, higher transaction costs and higher risks. Rural loans tend to be relatively small, and for many types of transactions the costs do not vary greatly with loan size. Transaction costs are high because of the dispersion of borrowers, possibly because of added costs of dealing with illiterates, and because of the costs of transporting cash to and from rural locations. Higher risks result from the uncertainties of agricultural production and because of the small margin above subsistence of many rural households. Small shocks can have a relatively large impact on the repayment capacity of these households.

3.13 Deposit rates. Another dimension of how interest rates encourage or discourage rural lending is their impact on savings. In general, low lending rates require banks to offer low rates of interest on deposits, or to avoid mobilizing small deposits. In the present situation in Ethiopia deposits are unlikely to be mobilized aggressively for reasons explained in para. 4.12 below, but this situation is likely to change and interest rate strategy should anticipate this change.

3.14 Deposit mobilization is an important part of sustainable rural financial systems. Its importance is based on the creation of durable relationships with clients, who will value more highly an institution that offers them a range of services than one that only lends them money. At the very worst, institutions that only lend money may give the communities they serve an incentive to destroy them through default.

3.15 Deposit flows also provide extremely valuable information to bankers, information that puts them in a better position to manage risk. At a simple level, someone who deposits Br 50 each month in a savings account could probably service a loan that requires a Br 50 monthly payment. The seasonality of flows and depositors' financial behavior in adverse times are also important indicators for lenders.

3.16 Equity also favors a return on deposits that is not less than the rate of inflation, especially for the poor and others able to save only modest amounts. This requires realistic lending rates.

What market rate(s) would be needed to cover costs?

3.17 Sustainable lending could be achieved only at interest rates considerably higher than those presently charged by State-owned lenders. Rational rates can be established only when the costs of bad debt losses are known. This requires the comparison of amounts falling due with amounts collected, the aging of arrears, and ceasing to accrue interest income on loans with balances in arrears for longer than a certain period of time, such as 90 days, and creation of bad debt reserves to facilitate writing these loans down or off as more time passes without adequate

repayment by defaulters. Nonaccrual reflects the problematic quality of loans in arrears; they may not be income-earners for the lender. Continuing to accrue interest on them and failure to establish reserves overstates the lender's profits. This means that risk is not accurately reflected in the lender's calculations and financial statements. (When payments are received on nonaccrual loans interest income is of course calculated and recognized. When recoveries are made on loans written down or off the recovery is written back, reversing the earlier recognition of loss.) Data such as the above on loan quality are not readily available in Ethiopia and such practices are not always followed.

3.18 A 20% per annum real rate. Efforts should be undertaken to gather data and implement modern banking practices oriented toward cost control and portfolio quality. In the meantime rates should be increased significantly but gradually. It is probably safe to assume from experience elsewhere that real annual rates of at least 20% would be reasonable on short-term credit, especially as efforts are made to bring more small farmers into the formal credit system. Roughly, these would include overheads of 5%, a cost of funds of 5% and an allowance for losses of 10%, which may be low (paras. 7.02 ff). A real rate of 20% per year is low compared to informal market rates of about 4% per month in relatively wealthy grain producing areas in Ethiopia and informal rates of up to 300% per year.

3.19 To these should be added additional charges that would enable borrowers and/or intermediaries to build up capital to help them through the bad year and an additional 3% or 5% that could be refunded to borrowers who repay in full and on time. (Interest rate penalties on arrears close the door after the thief has gone -- they are very hard to collect. A rebate, by contrast, makes good borrowers feel even better.) Finally, a profit for the lender would be helpful in providing resources for the expansion of financial services, and an additional 3% for this important purpose would not be unreasonable.

3.20 A 30% real rate. In view of these considerations, short-term real rates of between 30% and 35% would not be out of order as a means of achieving the objective of creating a sustainable rural financial system serving large number of people, most of whom are poor.

3.21 Realistic rates such as these would of course encourage savings for cash purchases of inputs, helping to create a self-sufficient peasantry. Rates at this level remain relatively modest and are therefore reasonable compared to the returns that can be achieved from the application of modern inputs. As farmers testify and as SG2000 amply demonstrates, improved inputs can easily double or triple yields, with an incremental return equal to two or three times incremental input costs. (Agricultural impact is per season, while the rates discussed above are annual, in effect making them equivalent to a smaller share of output than suggested by the interest rate.) Modern husbandry creates the ability to pay interest charges that cover lenders' costs.

3.22 In East Wallega traditional maize yields of 3-5 quintals per hectare can be increased to 10-15 quintals with chemical fertilizer. Assuming an increment of 5 quintals and a value of Br 80 per quintal, the incremental value of Br400 is more than double the Br 178 cost of one quintal of DAP during the last crop season, applied at the dosage one quintal per ha.

3.23 The ACDI/CEE study and survey results clearly indicates that use of savings and credit by rural people is most closely related to their proximity to services, and not strongly related to the interest rates paid for these services. The present team's field interviews in Gubu Sayo and Sibu Sire found that officials of agricultural service cooperatives spend considerable time traveling between their farms and bank branches to negotiate loans. This, coupled with cumbersome procedures, contributed to late arrival of inputs. These costs are much larger than the subsidy received from low interest rates, suggesting that realistic rates and efficient lending institutions with offices in rural areas would greatly improve the present situation for lenders and for borrowers.

Is the Government likely to establish market interest rates for its programs?

3.24 A market rate of interest on a credit program is defined as one that permits the lender to achieve a rate of return on capital equal to the opportunity cost of capital in the long run. The Government of Ethiopia is not likely to establish or permit market lending rates to be established by regulated financial institutions on their rural lending activities any time soon. However, GoE may be willing to move toward realistic rates by occasional increases in maximum lending rates.

3.25 The National Bank of Ethiopia is empowered to set interest rates pursuant to the Monetary and Banking Proclamation No.83. A minimum rate of 10% to be paid on deposits and a maximum lending rate of 15% was fixed for banks and other financial institutions effective as of January 1995. Rates of 11% and 16% were specified in December 1995.

3.26 The steps taken by the National Bank of Ethiopia so far seem to indicate movement toward gradual introduction of free interest rates and competition into the financial sector. Continued frequent small movements in this direction would be a clear signal of intent. The GoE task force currently at work on rural finance is reportedly considering a recommendation that the maximum legal rate be increased to 24%.

What are the pros and cons of establishing differential interest rates?

3.27 Differential interest rates consist of different rates for different types of loans, types of borrowers, or loan purposes. Differential rates are normal, in fact essential, in developed financial markets and for the development of financial markets generally. The case for differential rates can be examined in three dimensions: across borrowers, across time and for different loan purposes.

3.28 Across borrowers. Uniform rates for all borrowers or for a few large classes of borrowers are common only in cartelized government programs and in poorly developed financial markets. (Uniform rate structures or scales of rates are common in highly competitive financial markets, however.) Governments may prefer uniform rates for all borrowers because these may give the appearance of fairness. However, government programs usually reach relatively few farmers because loanable funds are determined by budgetary allocations rather than by market decisions. These programs also do not receive much competition from other formal lenders. This is because of subsidy and because bringing more potential borrowers into the market is usually more costly than serving those already having access. New borrowers are most costly to serve because they may not be known to the lender, raising the lender's information costs. They are more costly to serve because they are more dispersed and therefore harder to monitor or supervise. They may also be more risky by virtue of their economic status and activities. Uniform rates tend to restrict access because they do not recognize lenders' incremental costs of expanding access to credit.

3.29 Uniform rates can give the appearance of fairness, but they often cover significant differences in repayment performance. Some borrowers unfairly subvert the system by not repaying, while others do their best to repay on time. Why should rates be the same for borrowers with good records and for borrowers who are just beginning to establish credit histories with formal institutions? Why not provide interest rebates, as in Bank Rakyat Indonesia village units, to those who repay on time, while charging full rates to those who do not?

3.30 Across time. Uniform rates are most likely to be found where markets have short time horizons. Such markets offer relatively few medium- and long-term loans except where these are funded by donors on soft terms. Developed financial markets offer medium- and long-term loans because of differential interest rates which usually produce a "normal yield curve." This curve is illustrated graphically by interest rates on the vertical axis and term to maturity on the horizontal axis. The normal yield curve rises steeply for financial instruments having maturities from, say, 30 days to two or three years, and then tends to level off as maturities extend to 5 and 10 years and beyond. Rates are higher on longer term than on shorter term instruments because risk increases with longer maturities. More can go wrong in the long term than in the short term. Unless there is a normal yield curve it is unlikely that longer term deposits or other

domestic, market-based sources of term funds can be teased out to fund longer term loans. Therefore, uniform rates across time, or rates that vary little across time, retard financial market development.

3.31 The difference between short-term and medium- or long-term agricultural lending rates in Ethiopia, which amounts to one percentage point, fails to reflect risk and does not contribute to financial market development.

3.32 By loan purpose. Loan purposes vary in riskiness as well as in potential returns. In East Wellega, for example, the risk of accidental mortality resulting from disease among draft oxen may reach 25% in a bad year. A harvest failure, or a harvest insufficient to produce any mature grain (what little is produced is consumed green), is expected by farmers to occur about once every eight years. Also, loans for oxen may be considerably larger than loans for fertilizer: an ox can cost Br 800 while a one hectare package of seeds, fertilizer and chemicals may not exceed Br 500. Which loan carries more risk, and what is the risk profile for each? Differential interest rates can be used to encourage small farmers to choose the less risky. This pricing strategy would not be effective if loan default cannot be meaningfully penalized and timely repayment effectively rewarded. In addition, fungibility of money will result in substitution and diversion, as discussed below. Farmers with some savings could obtain additional funds through borrowing for fertilizer which they could sell (rather than use) to have sufficient funds to purchase an ox.

Recommendation: Freeing interest rates by gradually and steadily raising ceiling and reducing floor rates would create incentives for banks to determine their own pricing strategies.

Recommendation: Rational pricing of financial services requires good accounting information, which CBE and DBE lack. Data on bad debt losses and on credit delivery and administration costs should be improved. Technical assistance in the development of management information systems could be very helpful to these banks if they have incentives to use accounting results as a basis for decision-making.

Is it possible to target subsidized loans for agricultural credit? If so, how?

3.33 Subsidized credit is almost always targeted. Targeting is the only means by which the providers of subsidy can be confident that the subsidy is benefiting the group for which it is intended. Subsidies most visibly are transferred through preferential interest rates, but the largest source of gain to the recipients of subsidized loans in many countries is failure to repay. The transfer through default is often ignored because of: a) an economic bias in program design that concentrates on interest rates and inappropriately considers bad debt losses as

costless "transfers" using the norms of national income accounting rather than the norms of financial accounting, b) accounting records may not be kept in a manner that clearly shows bad debt losses, c) losses become apparent only after the initial euphoria, publicity and enthusiasm accompanying program launch is past, and d) there are few incentives to discuss these losses openly.

3.34 In addition, subsidized loans are not always equitable because the subsidy is related to loan size. Large borrowers get a large subsidy, small borrowers get small ones, and nonborrowers get none. Thus the incidence of subsidy may not coincide with "need", which is often invoked to justify subsidy.

3.35 Targeting is usually done by identifying a group of potential borrowers to be helped or a specific purpose that the government wants to encourage. Targeted borrowers are often farmers, small businesses, women or people residing in a poor area. Targeted purposes may include food crop, cash crop and export crop production, women's occupations, exports generally or import substitution industries, and activities using local raw materials.

3.36 While targeting may appear straightforward and precise, its effects are often extremely difficult to measure. This problem of impact analysis is smallest when the size of the loan is large relative to existing stocks of assets or flows of cash. A relatively large loan to purchase a house, for example, is likely to result in a purchase that otherwise might not be made. (This does not mean the would-be purchaser is homeless: a less expensive house or rental accommodation are alternatives.) A small loan for the purchase of consumer goods, for example, may simply replace other funds that would have been used for that purchase.

3.37 In agricultural development, production loans for poor households are difficult to target effectively, especially when they are subsidized. If farmers can obtain formal loans only for fertilizer, it is worth their while to take these loans because they are the cheapest credit they can obtain. Targeting may be subverted by loan substitution and by loan diversion. Substitution occurs when the farmer borrows for fertilizer that he would have purchased in any event. The added liquidity provided by the loan is utilized at the margin for some other purpose, which may or may not have a return higher than that obtained from fertilizer. Diversion is more serious because it is fraudulent and degrades contracts: the farmer borrows for fertilizer under a program designed to increase target borrowers' crop production, and then sells the fertilizer (probably to a nontargeted user) to obtain the cash desired for some other purpose. This behavior retards financial development, which requires good contracts.

3.38 Interest rate and default subsidies embedded in targeted loans present incentives for capture by nontarget borrowers through rent seeking or directly unproductive behavior. These are usually better-off individuals who have sufficient influence with those responsible for lending decisions to obtain the subsidized credit. Those

with decision-making power may be quite willing to entertain nontarget borrowers because they, too, can participate in rent seeking by accepting bribes from the nontarget borrowers. This dissipation of credit program performance may take several years to occur, as initially much attention may be devoted to ensuring that the interest rate subsidy reaches those for whom it is intended. Pressure to speed up disbursements, increasing program size, may also provide an incentive for those with decision-making control to accommodate nontarget borrowers because these may be easier to reach than those for whom the program was designed.

3.39 The problems associated with interest rate subsidy are increasingly being avoided by subsidizing program overheads rather than interest rates. Many of these overheads have social characteristics that make them better targets of subsidy because of externalities. NGOs thrive on these sorts of subsidies, and targeting is easier. Sustainability may also be more likely if portfolios earn sufficient interest income to offset costs of funds and risk and contribute increasingly to full recovery of administrative costs. Levels of cost recovery that would permit sustainability are unusual, but a number of large NGOs claim to be moving toward this objective.

Recommendation: Avoid interest rate and default subsidies. Use subsidies to create administrative capacity and delivery systems.

How could such subsidy be targeted to the desired groups in East Wellega?

3.40 Subsidized credit could be targeted to relatively poor farmers in East Wellega through fertilizer loans of a relatively small size, such as for 100 kg of DAP plus 100 kg of urea, which are the per hectare dosages generally recommended for all grains in the area. (SC2000 is an exception using 100 kg of each per half hectare plot). These loans could be issued through some intermediary agent, because the banks in the area (CBE and DBE) are not equipped to deal directly with small borrowers in the countryside. Intermediaries could include farmer groups and agricultural service cooperatives with established repayment records. NGOs might also be useful, especially those firmly committed to establishing profitable lending operations. Private traders could be considered, but investigations in the field failed to locate relationships of sufficient strength between farmers and traders that would easily accommodate good lending.

3.41 While it would be impossible to ensure that these loans actually and fully contributed to production, such lending could serve several useful purposes in the short run. One would be to benefit the target borrowers generally. As many as 75% of the farmers in the area may be at or below subsistence, defined as unable to grow sufficient food to feed the farm household in a normal year. Survival is achieved by the sale of noncereal crops, such as oil seeds and peppers, and from

off-farm income obtained by working for other farmers or others. In this situation subsidized credit could contribute to household welfare, but with decreasing efficiency over time because of increased farm incomes and rent-seeking, which consists of nonmarket efforts to create or capture economic inefficiencies through political action, bribes and other economically unproductive behavior.

3.42 Another useful purpose of such a package would be to establish credit limits, such as a maximum loan equal to the value of inputs suitable for one hectare, although subsidy is not essential to this process. Lenders would have to do relatively little research or information gathering on the farm or household because the loan purpose is so straightforward. Loan sizes would remain in some more-or-less feasible relation to target group farm size and income. Cases of multiple loans to single households would occur over time through rent-seeking, but little fertilizer is likely to be wasted, even if not used by target group members.

3.43 Finally, such loans could provide a medium for testing alternative approaches to small scale rural lending. Different sorts of intermediaries could be used, providing scope for accumulating information about the performance of each. CBE and DBE could also learn more about small scale lending. Different types of loans could also be offered, such as for beekeeping, pottery making, blacksmithing, embroidery and petty trade.

3.44 However, subsidized lending would still remain unattractive commercially, making lending program sustainability at best problematic, more realistically a great loss-maker. In the longer run subsidies create their own constituencies that protect their interests at the expense of others. Subsidies tend to create unrealistic expectations on the part of subsidizers (such as donors hoping to establish sustainable programs), those subsidized (who believe government has endless financial resources) and those expecting or demanding to be subsidized in the future (on the grounds of equity or political allegiance to those presiding over allocation of the subsidy).

Describe a system that could clearly track and quantify subsidy, to provide the government accurate information on the cost of a subsidized program.

3.45 The main prerequisite for a system to track subsidy transparently is adequate accounting. From accounting data, two relatively simple procedures for quantification of subsidy are sufficient to provide indicators meaningful to bankers and policymakers. The first calculates the financial impact of a credit program on the lender. Either the lender loses money, breaks even or profits from undertaking a credit program. If there is a loss, the program is being subsidized from some source, which may be assumed to be the lender's capital. These losses

decapitalize a lender, just the opposite of what is required for the development of a sustainable financial system.

3.46 The second is calculation of the Subsidy Dependence Index, which was developed, but not widely applied, at the World Bank. The SDI indicates the extent to which a lender's lending rates would have to be increased to earn the lender a return equal to the opportunity cost of capital. Any returns below this level represent a subsidy -- the funds could have been employed more profitably elsewhere in the economy.

3.47 Further sources of subsidy are not difficult to find, as in the cost of extension services, for example. These can be added to routine calculations of subsidy in the financial system if this addition is regarded as useful.

3.48 Calculating the impact on the lender: The first step in this analysis is to evaluate the performance of the loan portfolio under consideration. This is done on a cash basis, excluding accruals. Portfolio flows consist of outward movements of funds through disbursement to borrowers and debt service to any borrowed sources of funds that finance the portfolio. Inward flows consist of receipts of funds for lending, as from a donor agency, and debt service payments received from borrowers. The net difference between inflows and outflows is available to fund overheads.

3.49 Inward and outward flows are most usefully compared at two levels: contractual and actual. The contractual flows are those that would occur if all parties behaved precisely according to their loan contracts. Actual flows differ from contractual ones, and this difference constitutes the cash absorbed by arrears (or provided by prepayments).

3.50 The next step in the analysis adds to the net actual loss or subtracts from the net actual surplus the direct costs of portfolio creation and administration. These largely include the salaries of those working directly on the portfolio, computer and other accounting costs for the program, the costs of program vehicles used and charges for office space. The next and final step is to include indirect costs, such as some share of the salaries of senior executives that can be allocated to the time they spend on the program or portfolio being analyzed, costs for common services, etc.

3.51 Any losses appearing at any stage in this analysis represent subsidies to the lending operation for which the calculations are being made. This analysis shows the effects of all relevant flows, permitting management or funders to pinpoint areas where losses arise or where costs could be reduced.

3.52 A full discussion of this technique is provided in J.D. Von Pischke, *Finance at the Frontier: Debt Capacity and the Role of Credit in the Private Economy.* Washington, D.C.: World Bank, 1991. Chapters 13 and 14.

3.53 The Subsidy Dependence Index: The SDI expresses the overall level of subsidy for a program or a lender relative to the lending rate. An SDI of 0 indicates that no subsidy has been received by lender; 100 indicates that the lending rate would have to be doubled for the lender or program to earn a return equal to the opportunity cost of capital. An SDI of 50 indicates that the lending rate would have to be increased by half (by 50% of the actual lending rate) to achieve this economic break-even point.

3.54 The SDI is calculated as follows:

$$S = A(m - c) + [(E * m) - p] + K$$

where

S = annual subsidy received
A = concessional borrowed funds outstanding (annual average)
m = interest rate the lender would have to pay for funds if it did not have access to concessional funds
c = weighted average annual concessional rate of interest actually paid by the lender on its average concessional funds outstanding
E = average annual equity or capital position of the lender
P = reported annual before-tax profit, adjusted when necessary for insufficient loan loss provisions, inflation, etc.
K = sum of all other subsidies received during the year

3.55 Using these data:

$$SDI = S/LP*i$$

where

SDI = the Subsidy Dependence Index
S = annual subsidy received by the lender, as calculated above
LP = annual average loan portfolio outstanding
I = weighted annual rate of interest earned on the portfolio

In other words, SDI = Subsidy/Loan portfolio*Lending rate

3.56 A full exposition of the SDI and its application is found in Jacob Yaron, "Assessing Development Finance Institutions: A Public Interest Analysis," World Bank Discussion Paper No. 174, 1992.

Recommendation: Relentlessly calculate credit program impact on the lender and the degree of subsidy dependence. Use the results of these calculations to identify areas and functions needing remedial action, to determine interest rates for the programs concerned, and to measure progress toward sustainability.

4. Financial Service Delivery Mechanisms

What banking services would be most useful for various groups such as small farmers, input retailers and wholesalers, and produce buyers in East Wellega? Usefulness should be defined in terms of ERDA's objective of sustainably increasing agricultural production through private provision of services.

4.01 Retail banking services for small farmers. The most valuable banking services for poor people are usually savings facilities, and no evidence to the contrary was found in East Wellega. Poor peoples' need for savings is great because of their precarious existence involving low levels of income and high vulnerability to shocks. Accordingly, most people want to save most of the time, while some people want to borrow from time to time. More people can be reached through the provision of savings facilities than through the provision of credit.

4.02 Protecting rural savings. Alternative means of saving, outside the financial system, may not be good stores of value if adversity has high covariance, striking large numbers at the same time. Livestock as a store of value exhibits this pattern: when adversity hits everyone wants to sell, driving prices down at the same time that purchasing power is drying up.

4.03 Of course, financial savings may also be a poor store of value when interest rates do not compensate for inflation. Because of the probability of poor macroeconomic management in many countries, savings deposits in regulated formal institutions should be promoted cautiously. However, two mitigating factors to the store of value problem provide a basis for promoting formal sector savings facilities for the poor. One is convenience yields, which consist of the gains to depositors from having funds physically in a safe place, away from threats of theft and requests from those having a social claim on the saver. The second is diversification, offering the poor an additional means of hedging against adversity, an asset with a pattern of fluctuation different from those of traditional stores of value.

4.04 Another problem with savings mobilized by lenders using nontraditional models, such as NGOs or even cooperatives that are not well managed, is that savers' funds may be lost if they are invested in money-losing operations undertaken by these lenders. This problem is dealt with by some NGO and cooperative credit programs in developing countries that offer savings services to their members or beneficiaries, by segregating these funds from those that support their lending and trading operations. This is done by depositing savers' funds in a bank account, and use of external or other funds for lending and as working capital for trading activities, such as input supply and produce purchases. Segregation of savings

offers protection to depositors and does not expose these balances directly to the risks of bad lending decisions.

4.05 Segregation may be compromised by the right of offset, which permits the lender to seize the savings balances of defaulters to recover arrears. If an NGO, for example, were to open a deposit account for clients' savings with a bank from which it also borrowed, the bank could block or seize the funds saved by the NGO's clients if the NGO defaulted. One means of avoiding this would be to establish the deposit account with another bank or to open the account in the name of a separate organization, such as a village association formed by the NGO as a means of organizing its clients.

4.06 However, the right of offset is a good idea because it helps to create a commitment on the part of the borrower and offers a form of collateral. A cooperative, for example, might be encouraged to place savings with the bank from which it borrows, as this would provide an incentive to keep loan repayments up to date. But, it may also reduce the amount of savings that can be mobilized.

4.07 Risks of fraudulent behavior by those responsible for collecting savings and depositing them in banks can be reduced by audit procedures that include verification of bank balances.

4.08 Another model, used by certain NGOs that organize borrowers into groups or village banks, is to have two separate lending accounts. An "external" account is funded by a donor organization. Loans to members made from the external account are in accordance with terms and conditions agreed with donors. An "internal" account is funded by members or participants' savings. The funds in the internal account are used as members collectively wish, usually by issuing loans to specific members or even to trusted nonmembers. Terms and conditions are set by the members collectively, and as a consequence interest rates on internal account loans are usually much higher than those charged on borrowing from the external account.

4.09 Organizations using this system usually have a uniform lending cycle for all members as a group: external account loans are to be repaid in weekly or other period installments with repayment in full required of everyone on a specified date. Internal account loans also have to be repaid by the close of the cycle, limiting risk and abuse.

4.10 The advantages of this system is that members accept responsibility for their own savings and lending decisions. Net interest income on the internal account accumulates rapidly and members have an incentive to save in this manner because they earn attractive interest rates, they may have the opportunity to borrow from the internal account, and they have control over its use. The

promoters' objective is that the internal account will eventually dominate these organizations, at which time they will be commercially self-sufficient.

4.11 Ethiopian savings institutions. Ethiopian society does a tremendous job in providing savings and insurance mechanisms in the form of iqqubs and iddirs. The majority of people belong to iqqubs while virtually everyone is a member of an iddir. Iqqubs are rotating savings and credit associations (called RoSCAs in the considerable literature on this world-wide form of collective saving and borrowing). Iddirs are primarily death-aid societies or fraternal insurance organizations. These organizations are informal, which is the source of their strength, flexibility or appropriateness, and economy. They are likely to grow as the economy improves. There would be no benefits from external or official attempts to formalize them at a more rapid pace than might occur otherwise, if at all. The challenge to the formal financial sector is to provide services that compete freely and fairly with these informal institutions.

4.12 Barriers to rural savings mobilization. The principal barrier to increased access to savings services is the situation in the banking sector. The current level of liquidity makes banks unlikely to seek new sources of deposits, especially small deposits. The costs of mobilizing small deposits is another reason why banks are unlikely aggressively to expand savings facilities. These costs may exceed the returns currently available to the banks from the employment of such funds. This situation is temporary but could last for several years until marked improvement in the economy occurs.

4.13 Another reason why deposit facilities are not widely available is the geographic coverage of the banks, which are concentrated in urban areas, some of which are small and essentially rural. This reflects their cost structure, which is high relative to the penny economy in which the majority of the population operate. Part of this cost is inevitable in view of the functions and responsibilities of commercial banks. But part may also be the result of overstaffing and unnecessary expenses. CBE is reported to have Grade 1 branches having three functional staff: manager, cashier, bookkeeper. This type of branch holds great promise for expansion into smaller market towns in rural areas, especially if branch quarters are modest and therefore inexpensive and if suitable security arrangements can be made.

4.14 The typical rural branch in most countries most of the time is a net supplier of funds to the rest of the banking system because rural savings typically greatly exceed the amount a commercial bank can profitably lend in a rural area. In view of the excess liquidity in the system, aggressive expansion of the number of Grade 1 branches would be uneconomic and is therefore unlikely any time soon if governed by commercial considerations. (CBE branch expansion in the past has not been based solely on commerical calculations).

4.15 Target savings programs. A means of promoting rural savings for the purchase of agricultural inputs that has enjoyed considerable success in Zimbabwe is savings clubs. These function through periodic meetings of their members, who may be quite numerous, at which deposits are made. Members have passbooks into which they paste savings club stamps that they purchase at each meeting. When a book is filled the member has saved an amount sufficient to obtain a given amount of fertilizer. These associations provide a form of contractual savings and are something like the Christmas clubs operated by some banks in the US and like the "partner" programs operated by banks in Jamaica. However, savings clubs meetings are usually festive occasions where transactions are conducted openly. Members witness each others' purchases of stamps from the club president and secretary. Money collected is promptly placed in a savings account at a bank.

4.16 The savings club concept has much in common with the iddir, which would provide the logical place to test the possibility of using savings club techniques in Ethiopia. Iddirs also have periodic meetings at which contributions are made to a fixed fund that is used to compensate members suffering a death in the family and for iddir expenses connected with members' funerals. It may be possible to establish a parallel fund in the iddir that would incorporate the savings club methodology.

4.17 A major question would be the amount that each member would have to subscribe at each meeting to be able to obtain a significant amount of fertilizer and the relation of this amount to the usual subscription required by the iddir. Subscriptions in rural areas are typically small, often less than Br 1 per week.

4.18 If the amount to be saved for fertilizer were much greater than the customary contribution it would be unlikely that the savings club technique would work through iddirs. Members might not be able to afford the savings required, or only some of the members might participate in the savings club portion of iddir activities. Partial participation of the iddir membership and the flows of unprecedented amounts of contributions could compromise the social bond of the iddir, weakening its traditional functions and failing to provide a sustainable savings vehicle for the purchase of agricultural inputs. An alternative possibility might be to focus on savings for improved seeds, which are much less expensive than fertilizer.

4.19 The possibility of obtaining technical assistance for savings club formation from the foundation in Zimbabwe that sponsors savings clubs there should be explored. Promotion in Ethiopia could possibly be undertaken by special bank workers (in CBE), by agricultural extension staff, or by NGOs. Costs would be relatively small, limited to stationery and supplies, the salary of promoters, and transport costs. SG2000 is providing bicycles to extension staff, and if these are used effectively it could also be possible for savings club promoters to use bicycles.

Once the savings club technique is understood, members of an iddir experienced in using it could provide assistance to other iddirs interested in adopting it.

4.20 If iddirs are not a suitable vehicle, branches of CBE and DBE might be in a position to sell small denomination savings stamps that could be pasted in passbooks for eventual redemption once the amount saved, represented by stamps, reached a specified level. This could reduce the transaction costs of the banks because individual entries would not be required for each customer. (CBE branches already sell revenue stamps.) Other outlets, such as shops and coffee houses, might also be considered as potential vendors if suitable incentive fees could be arranged.

Savings facilities are usually well patronized by rural people in developing countries. Efforts should be made to test savings club methodology in iddirs, using procedures developed in Zimbabwe. It may also be possible to sell savings stamps through bank branches or other outlets. Savings should be affiliated with credit programs where suitable arrangements can be made to protect the value of accumulated savings.

4.21 Credit facilities are also of course useful to small farmers. The present lack of widespread access to credit is the result of the same factors that inhibit the development of deposit account business: costs and sparse geographic coverage. In addition, the risks of lending to small borrowers directly can be quite high, especially when collateral is problematic as in Ethiopia. Rural land is not titled in any form acceptable to banks, and realization of defaulters' land could be difficult even if clear titles existed and efficient registration of liens were possible.

4.22 Provision of bank credit to small farmers appears possible only through intermediaries that could reduce risk and overhead expenses. Risk reduction would occur through creation of relationships that reduce information costs and create incentives to honor contracts. Overhead expenses would be reduced by intermediaries with cost structures different from those of banks and possibly also through access to subsidies.

4.23 Potential intermediaries, based on experience in other developing countries, could include traders who supply inputs on credit, relatively wealthy individuals who borrow in order to lend money or inputs or cattle to others who are less wealthy, agricultural service cooperatives that borrow in bulk and lend the proceeds to their members, farmer groups formed spontaneously to bulk orders for fertilizer so that the supplier will deliver it to their village, and subsidized NGOs that introduce credit-backed income-generating activities to beneficiaries. However, this list of potential intermediaries may be severely abbreviated in Ethiopia. The best prospects would appear to be input suppliers and farmer groups, followed by agricultural service cooperatives and NGOs.

4.24 Information costs in lending arise from procedures used to separate good risks, i.e., loan applicants who are likely to repay in full and on time, from bad risks. These costs are typically high for bankers lending to small farmers because of their "distance" from potential borrowers, both physically and socially. For these reasons, and to permit concentration on term lending, DBE wants to discontinue its seasonal input credit operations.

4.25 Local organizations or individuals that are closer to the grassroots have lower information costs, especially if they are entirely indigenous. Risk reduction occurs when organizations are able to offer collateral acceptable to banks in the form of a solidarity guarantee, as agricultural service cooperatives and farmer groups currently do, or when individuals with established credit histories can use bank loans to on-lend to others.

4.26 Group lending and solidarity. Virtually all fertilizer credit in Ethiopia is provided through agricultural service cooperatives and farmer groups organized on the basis of joint liability for loan repayment. Farmer groups have many fewer members than the service cooperatives, and are often based on peasant associations. (Agricultural service cooperatives typically include the members of four or five peasant associations.) The advantage of the groups is that they are formed and reformed each season, which permits periodic elimination of bad risks. They are also smaller and therefore more easily managed than the cooperatives. The Region 4 MoA reports there are 420 such credit groups in Oromiya.

4.27 The repayment record achieved so far by both cooeratives and groups is surprisingly good, although not sustainable. For example, by November 1995 DBE had recovered a reported 82% of its advances made for inputs during the 1994 season. CBE branches in East Wellega reported a 98% recovery rate for principal advanced during the 1994/95 crop year. In certain areas repayment rates have reached 100%.

4.28 Overall, CBE did less well: As of November 1995 Br 35 million remained uncollected out of advances of Br 106 million that fell due at the end of June for the 1994/95 crop year. MoA was reported to be following up on defaulters in its role as the overseer of agricultural service cooperatives, the promoter of farmer groups, the developer of lists of borrowers and their input orders that are submitted to CBE and DBE, and the party responsible for organizing collections and following up defaulters. Large losses were apparently experienced in the Southern Region, and CBE reportedly no longer is willing to lend to agricultural service cooperatives there as a result, preferring farmer groups of 10 members patterned on microenterprise credit arrangements.

4.29 While the upper end of these recovery rate ranges are encouraging, they do not necessarily provide a basis for sustainable systems. Reasons include the pattern of declining repayment performance found in many countries (see paras. 3.09 - 3.10) and the problem posed by the bad agricultural year. Also, joint solidarity has its limitations.

4.30 A number of donor-funded credit programs use group solidarity to establish creditworthiness and as a means of obtaining continued access to credit. When a group member fails to repay, the other members of the group are expected to make up the amount owed by the defaulting member. Unless the group repays the amount due from all its members, all members of that group are excluded from future access to credit (at least from the scheme or program concerned). Some of these programs work quite well, but others suffer from increasingly exclusionary sanctions. Shocks are predictable, especially among the poor, and over time more groups are likely to fail. As a result of an event affecting one member, or an act or failure of one member, all members become ineligible for further credit.

4.31 This development may be interpreted in several ways: a) as a requirement for keeping a "clean" system, b) as permitting the program to engage more new clients as old ones are weeded out, c) as equitable according to contracts freely entered into, d) as giving many an opportunity, only some of whom can fully realize, or e) as undermining the objectives of the credit program.

4.32 As with risk in finance generally, the implications of exclusion of individuals who have met their primary personal obligations while failing to cover for others who may have been distressed or who behaved irresponsibly, should be considered in advance. Without detailed planning for the adverse event, appropriate strategies are difficult to shape around program objectives.

4.33 The present institution most vulnerable to this risk are agricultural service cooperatives that are poorly capitalized. Well capitalized cooperatives that maintained sufficient liquidity could be in a position to cover for defaulting members while having the strength to have alternatives at their disposal for recovering amounts due from defaulters. This is especially important in the absence of meaningful collateral. Therefore, emphasis on using agricultural service cooperatives as credit vehicles should be accompanied by the build up of capital and liquidity, possibly in the form of emergency funds or guarantee funds. These could be funded by deductions from loan proceeds, through loan application fees or by income from earmarked increases in interest rates. Without this type of cushion, credit programs using such cooperatives can be weakened by the actions of a relatively small number of borrowers, and large numbers of otherwise good risks can end up being excluded from the system.

4.34 Agencies that could promote capitalization include CBE through its processing of loan requests from farmer groups and agricultural service cooperatives,

agricultural extension staff, and NGOs. CBE would already have information on the capitalization of input suppliers. Capital should be sufficient to see the intermediary through a bad agricultural year or series of consecutive bad years.

4.35 However, accumulation of capital presents managerial difficulties and challenges, and it is unlikely that this could be accomplished without a significant amount of fraud by managers and elected leaders. Problems of this sort could destroy the basis for cooperation. A means of avoiding this problem is to have farm households become well capitalized through savings, and protected against risk through diversification. Household capitalization is in fact the strategy of the Region 4 Ministry of Agriculture, which foresees credit provision through cooperatives as an interim measure that will assist borrowers to join the fertilizer revolution. Agricultural service cooperatives in Region 4 are expected to discontinue input credit operations after an initial cycle of three or four years (paras. 5.10 ff).

4.36 This exit would be accomplished by introducing increasingly higher down payments for fertilizer obtained on credit. Present terms frequently require no down payment, although some cooperatives and groups require a 25% down payment. The first year of phase-out would require a 25% down payment, the second a 50% down payment and the third a 75% down payment. Credit would be discontinued in the fourth year, and it is expected that most farmers would not bother taking credit when down payments reached 75%. This is a realistic and prudent strategy. Relative to conventional international practices of development agencies, this strategy soars as an appropriate and courageous measure by seeking to create financially independent farmers. It is also consistent with DBE's desire to discontinue seasonal credit operations in order to concentrate on term lending.

Intermediaries between small rural borrowers and CBE and DBE are essential because CBE and DBE are not in a position to expand their lending rapidly to these clients, and DBE intends to discontinue seasonal credit operations. Intermediaries include input suppliers, farmer groups, agricultural service cooperatives and NGOs.

Whatever intermediaries are used should accumulate capital to help ensure repayment to CBE or DBE, especially during a bad agricultural year. Group schemes are vulnerable to destruction and blacklisting by the failure of only a few members, making capital accumulation by groups especially important.

A means of avoiding the inevitable problems with group credit and cooperative credit is to encourage farmers to self-finance seasonal inputs through their own savings. This strategy is embraced by Region 4 authorities and should be encouraged by donors and others in a position to do so.

4.37 Retail banking services for traders in agricultural inputs and commodities. Traders can benefit from money transfer services, often based on deposit account relationships, and from working capital finance. Term finance may be sought to erect storage facilities and simple processing machinery. Supplier credit and trade credit may be more attractive to traders than bank credit because of lower transaction costs, including those relating to collateral. In many countries bankers are eager to finance traders because these accounts can be lucrative.

4.38 Traders in Ethiopia, among others, can be financed through DST (domestic service and trade) loans. CBE has about 22,500 of these accounts on its books, but relatively few are engaged in agricultural supply. About 2000 agents of Ethiopia Amalgamated Ltd., the private importer and wholesaler of fertilizer, are reported to have such facilities through arrangements fostered by Amalgamated. This constitutes a valuable beginning in financing trade networks. Their facilities have 6 to 12-month maturities due in a single installment. These terms are likely to become more flexible as banks gain experience with trader financing and compete to obtain accounts.

Are private input retailers and wholesalers and produce buyers able to provide credit and others services competitively with parastatals that offer government credit to their customers? If not, how can access to financial services be organized to encourage more private operators to enter the input and produce markets?

Input Supply

4.39 As indicated above, limited numbers of private operators in input and produce markets are financed by CBE through short-term domestic trade and service (DST) loans. These traders can obtain credit because they have the collateral CBE requires. Smaller traders, known as "collectors" or "assemblers" who do not have collateral acceptable to CBE cannot obtain DST loans. Some traders are willing to buy a farmer's crop before it is mature, but trade credit for agricultural inputs and produce does not seem to be well developed.

4.40 Input market conditions preclude credit. Private input suppliers remain unlikely to provide fertilizer on credit to small farmers. This occurs for several reasons. The fertilizer market is not yet sufficiently competitive, panterritorial pricing tends to concentrate sales in areas where transport costs are low, and the level of the fixed commission to retailers discourages potential entrants into fertilizer handling.

4.41 In this situation, it appears that all fertilizer that is received by retailers that is not committed to credit programs can be sold for cash. This makes it unnecessary to offer credit. In the areas visited in East Wellega it appeared that a high proportion of fertilizer was in fact sold on credit provided by DBE and CBE to agricultural

service cooperatives for purchases from the parastatal supplier, which is currently the only wholesale source in the area with direct access to imports.

4.42 For all of East Welega in the 1995 season, 47,326 quintals of fertilizer were supplied by the parastatal supplier, Agricultural Inputs Supply Enterprise (AISE), to 179 agricultural service cooperatives. Farmers buying this fertilizer did so on credit issued to their cooperatives by CBE and DBE on the recommendation of MoA staff. Cash sales to private retailers amounted to 8,552 quintals, and 1,520 quintals were sold to a private wholesaler. Farmers bought 3,128 quintals for cash directly from AISE facilities. Sales through service coops were 1.340 and 2.189 quintals in Sibu Sire and Gobu Seyo, respectively, compared to 1.468 and 797 through pribate traders and 97 and 368 purchased directly, respectively.

4.43 Lack of a vibrant retail market arises because of the shortage of fertilizer in Ethiopia and controls over its price at each level in the distribution network. All chemical fertilizer is imported, which reflects the absence of a local source of raw materials. The parastatal importer estimates that imports equalled between 60% and 80% of potential demand in 1995. Virtually all fertilizer imports are currently financed by bilateral and multilateral donor agencies. Conditions are attached to all these funds. These include procurement procedures and also policy conditionality contingent on GoE reforms. GoE officials and others in the import chain complain that these conditions delay imports each season. (Tenders remain open for 30 days for imports funded by USAID and for 90 days for those funded by EC). Fertilizer arrives late at the port. In an area visited in East Wellega this resulted in the application of fertilizer to finger millet, which is the last grain to be planted and which has the lowest proportional incremental financial return from fertilizer.

4.44 One industry source reported that purchases from June to August for arrival at the port by October could catch seasonal lows in annual or short cycle price fluctuations that could apparently more than cover costs of storage until seasonal peaks in demand. Main season planting occurs from May through September, starting in the north, while short season planting occurs from January through April.

4.45 Dependence on donors. It appears that at this time there is no meaningful private sector alternative to donors' funding. The private importer, Ethopia Amalgamated, indicated that using the foreign exchange auction to finance imports, which are by the shipload, would absorb so much of the volume of the typical auction that the price of foreign exchange would be significantly increased. There is reportedly discussion within GOE of establishing a separate fund for fertilizer imports, which could ease this constraint.

4.46 Policy reforms supported by donors include annual decreases in the proportion of fertilizer subsidy to fertilizer price with complete elimination by 1998. Subsidies

in 1995 amounted to Br 78 per quintal on DAP sold to peasant farmers, who paid Br 178 per quintal. It is possible that these conditions may be reconsidered in 1996, when world prices for fertilizer are expected to rise, on the grounds that fertilizer subsidy is more efficient than food subsidy through concessional grain imports. Another approach would be to require decreases in the proportion of subsidy only in years in which the world price declines, while maintaining a constant proportion or possibly a constant amount in years in which the world price increases. This could help to protect consumers from the double shock of increased world prices and decreased subsidies, while eventually resulting in the elimination of subsidies.

4.47 Financing levels. The present system of fertilizer credit operated by CBE and DBE through many farmer groups or agricultural service cooperatives provides credit equal to 100% of the purchase price, although some of these local organizations require down payments of up to 25%. The Ministry of Agriculture's replications of the SG2000 program requires a 25% down payment by farmers in their first year of participation and 50% in their second. It is expected that farmers will be self-financing by their third year of participation, which is consistent with the desire of Region 4 authorities to phase out cooperative credit for inputs.

4.48 The SG2000 program requires a 50% down payment and offers access to credit for only two years. This strategy is based on the tremendous yield increases achieved under the program, which enable farmers to be self-financing. In addition, repayment rates tend to decrease as programs such as these expand explosively, and reduction in financing proportions limits lenders' losses on SG2000 operations. Greatly declining repayment performance was experienced by SG2000 in Ghana, while in Ethiopia rates of 99% were achieved in 1993, 96% in 1994, and an estimated 95% in 1995. Maintenance of relatively high levels of repayment are reported by SG2000 to be a function of follow-up.

4.49 Financing 100% of fertilizer costs may be unwise as a financial strategy if it creates a greater risk than partial financing. Farmers may have little of their own funds at risk, which may lessen their commitment to fertilizer application and to repayment. Requiring a down payment could be a good risk management tool for banks. If the banks were not highly liquid 100% financing might result in fewer loans being issued because of the liquidity constraint. However, in many countries input suppliers in competitive markets do good business by offering 100% financing, but these suppliers, who usually deal in many goods and commodities, may be able to offer borrowers more incentives to repay than banks can.

4.50 Increased entry of private operators into input supply is being supported by donor-induced reforms. In 1996 AISE is expected to be allocated 228,000 tons while

private importers will be allocated 122,000 tons. Private interest in the fertilizer trade will grow as supplies increase and as price controls are removed. Margins permitted to retail traders, at Br 7 per quintal, are presently too small to result in aggressive entry. Even if the retailer's margin were to be decontrolled, continued dependence on donor financing of fertilizer imports would quite probably continue to result in shortages in supply relative to what farmers would be willing to pay for.

Efforts to increase the supply of fertilizer should receive top priority. Efforts to free fertilizer prices from all controls should receive second priority. These measures will permit the spontaneous development of fertilizer supply by more retailers and their use of credit to attract customers.

Produce Markets

4.51 Specialized produce buyers are potentially in a position to offer credit to farmers as a means of locking in sources of supply. Credit arrangements vary. One consists of buying a standing crop at some point between germination and harvest. In this situation the lender may also take responsibility for harvesting the crop, using hired labor. Risks to the lender include yield shortfalls and harvesting of green or immature crop by the farmer. Risks to the farmer include potential loss of income if yields and prices work out better than expected. Another means consists simply of a pre-harvest advance from the buyer to the grower. The lender bears the risk that the farmer may avoid repayment by selling the crop to someone else or failing to repay in cash. These forms of production credit are reported in several parts of Ethiopia, including East Wellega, but they appear to be used by relatively few farmers.

4.52 A more complex form of linked credit tends to arise when produce buyers are also input suppliers. In this case provision of input credit, and possibly also of subsistence credit, is tied to the delivery of the crop to the lender. The credit situation of these providers is outlined above (paras. 4.37 ff).

4.53 Seasonality is a major factor determining credit strategies by farmers and produce buyers. The peak season in the grain trade is from December to April, immediately following harvest periods in major grain producing regions. Deliveries decline after April, interrupted by a small upsurge around early September because of the Ethiopian new year. Prices likewise vary, and a USAID/Ethiopia study of grain markets found that prices for major grains and beans increased from between 23% and 110% from April through September 1994. (KUAWAB Business Consultants and Development Studies Associates, "Structure of the Ethiopian Grain Market: A Repid Appraisal." Addis Ababa, July 1994, but apparently mis-dated because the study includes data for September 1994.) Farmers interviewed for the present study in East Wellega

reported seasonal lows of Br 25 for one quintal of maize, and seasonal highs of more than Br 100. The reported low price was regarded as exceptional, resulting from an extremely good harvest and the impact of SG2000 and MoA activities successfully promoting maize production.

4.54 Seasonal price changes permit owners of grain to profit from obtaining stocks in the peak season when prices are low, holding them and disposing of them as prices rise. For example, farmers were reported to get very poor prices when young standing crops were sold to buyers before harvest. It is difficult to calculate effective interest rates arising from credit transactions incorporating seasonal price differences because the lender often provides a number of services other than credit, including handling, bulking, transport, storage and possibly even harvesting. (Geographical differences in price may also offer opportunities for gain to those with grain in storage.) An interesting and constructive feature of CBE and DBE input loans are that they are repayable at the end of June, following the peak season. This enables farmers to store their crop following harvest while waiting for prices to rise.

4.55 From the USAID-funded study, the grain trade appears to be reasonably competitive overall. The least competitive parts of the trade appear to be at the wholesale level and possibly at the village level in areas where there is only one or a very small number of collectors. Thus, provision of additional credit to produce buyers generally could promote competition and would be unlikely generally to create greater monopolistic behavior. Using nonmarket criteria to target specific buyers could, of course, generate monopoly gains by permtting these buyers to expand at the expense of competitors lacking access to credit.

4.56 Several arrangements govern the ownership of grain delivered to the market in Addis Ababa. Some is provided to brokers on a consignment basis, and payment is reported to be made through the commercial banking system. In other cases dealers buy and sell on their own account. Trade credit is most likely to work through dealers who buy from local collectors. Credit to dealers could be passed on to collectors and then possibly on to farmers. Credit to collectors directly might also be passed on to farmers.

4.57 The USAID-funded study indicates that grain market participants complained of lack of access to credit. This would be the normal and expected finding if the persons being interviewed knew that the study were sponsored by government or by a donor. However, the constraints on credit access noted elsewhere in this report would apply also to the grain market. Some traders interviewed in the north indicated that they belonged to iqqubs.

4.58 Further work is required to ascertain how additional credit might most usefully be deployed in the grain market. The present team noted hints of an interesting reliance on bank credit rather than on trade credit, but this was not substantiated

by the team. It appears that CBE would have considerable information about the performance of grain merchants because of their use of the banking system to remit funds to collectors and regional wholesalers, and through their DST portfolios, although it is not clear that this information is effectively organized for business development purposes.

Efforts to review the use of banking services by grain traders could be useful in determining how their financing could be made more efficient.

5. Collateral

Lack of Collateral can severely limit access to formal credit. What are the current collateral requirements and practices regarding loans to farmers, traders, retailers, wholesalers and produce buyers?

5.01 Traders, retailers, wholesalers and produce buyers are required by all banks to pledge tangible collateral in the form of fixed assets. The fixed assets either must be located in urban areas or registered with the concerned government agency. The lack of flexibility by banks in this regard reduces the access of these potential borrowers to credit. Banks, at present, do not seem inclined to look beyond basic asset values in their lending. The problem of adequate, acceptable collateral affects all categories of borrowers.

5.02 In rural areas land cannot be taken as collateral, nor can any investment on rural land because it cannot legally be transferred to a third party. Farmers have land use rights but not title of ownership. This diminishes the pool of mortgagable assets to practically nil for a rural borrower.

5.03 A commercial borrower in a rural area usually must pledge collateral in the form of fixed assets, such as dwellings, commercial buildings, or vehicles, separate from the project financed, equal to 100% of the loan amount. This is almost always urban property. This limitation causes this policy inadvertently to favor wealthy urban individuals who have properties to pledge. They can obtain credit for commercial farming and other activities in rural areas, while the local farmers cannot.

5.04 For projects in urban municipalities, a borrower is usually required to pledge fixed assets (including those of the project to be financed) equal to 125% of the loan amount. This applies to industrial and other projects.

Land tenure arrangements are the major obstacle to expansion of bank credit in urban and rural areas.

Are these requirements meaningful and effective in providing security to the lender?

5.05 These policy requirements have little relevance because banks have difficulty effectively realizing their claims. Discussions indicated that courts have shown little inclination to dispossess borrowers of their homes or businesses. These requirements, then, seem to be only an abundance of caution; knowledge and trust of the borrower is critical. In rural areas, banks have little direct experience with the small borrower, and therefore little basis on which to lend. They also have had

unfavorable experience with cooperatives as borrowers; many loans to cooperatives are considerably overdue.

5.06 There is little lending to the small farmer due to the lack of collateral. To obtain credit, farmers must be members of registered cooperatives or band together in small "credit groups" that are then recommended to the banks as dependable by local officials of the Ministry of Agriculture. For short term input loans, the MoA's letter of recommendation suffices. For longer term loans, the cooperative's registration or certificate of legal personality is required. In essence, **no tangible collateral is sought from individual farmers because they have none or cannot register those assets they do have in order to pledge them.**

If they are not meaningful and effective, how can they be modified?

The group and its pressure on the individual have been found to be the most dependable form of "security" for lenders. Experience has shown that this is particularly true for input loan repayment. However, this can break down as the size of the group increases. And there is no real security in the event that cooperative management is weak or if groups disintegrate.

5.07 Experience also shows that repayment risk diminishes for banks when the cooperatives have active savings or current accounts with them. This enables the bank to monitor the operations of the cooperatives, control income and expenses, and also offset delinquent loans against these accounts. It also indicates the cooperative remains active. The account relationship provides a basis for building trust, confidence and a credit history.

What practical alternative collateral mechanisms could realistically be used by lenders to increase access by farmers, traders, retailers, wholesalers and produce buyers to formal short-, medium-, and long-term loans?

5.08 Intermediaries of some sort are required to bridge the gap between banks and farmers. These intermediaries include cooperatives, farmer groups, traders, produce buyers and others, possibly including NGOs. These intermediaries should be able to operate a lower costs than the banks and to undertake tasks the banks are not willing or able to implement. To develop into sustainable links in the credit chain, these intermediaries must be able to realize a spread over their costs that will make it worthwhile for them to continue to provide credit.

5.09 Cooperatives. One suggestion to improve security and hence willingness to lend to cooperatives is to require an amount of savings equal to some percentage of the loan. The percentage would depend on risks and other associated credit factors. The balance could be blocked until the loan is repaid. Cooperative promoters in Region 4 believe that cooperative should not remain in the input supply business

indefinitely and that farmers should be encouraged and assisted, through increased production resulting from better husbandry and access to fertilizer, and through increased down payment requirements, to finance their own input purchases. This strategy is bold, commendable and realistic in the absence of meaningful collateral or legally enforceable loan contracts. However, in many countries with more favorable legal systems cooperatives do good business by providing input finance to their members.

5.10 Credit groups. In the absence of credit through cooperatives, individuals may form groups that provide a mutual guarantee. There seems to be very little room for other options until banks move away from asset-based lending and begin to analyze debt service capacity of borrowers as the primary basis for repayment. Although group credit appears to have performed relatively well, it is potentially vulnerable. If all members who repay in full and on time fail to make up the arrears of any single member, the solidarity contract with the lender would blacklist the entire group from obtaining further credit. Thus, large numbers of farmers are likely to be excluded in the long run, assuming the solidarity contract can be enforced (paras. 4.35 - 4.2)..

5.11 The SG 2000 model seems to be a reasonable approach for input financing for the individual farmer. SG2000 requires farmers to pay 50% of the cost of fertilizer in the first and second years of the program. Afterwards, no credit is provided through SG2000. The increased yields from the first year onward enable the farmer to be self-financing. Although the farmer's 50% payment is not really collateral, it does create an equity stake in the goods financed. Government finance programs modeled on SG2000 require a lower initial contribution (25%) by the farmer in the first year and 50% for the two following years. Thereafter, farmers are assumed to be in a position to buy fertilizer out of the incremental income produced by increased yields achieved under the program.

5.12 Over the long run, experience with borrowers should lessen reliance on collateral. In the near term, credit risk can be managed in part by strong collection efforts.

5.13 Traders, retailers and wholesalers. Trade credit for agricultural inputs is not yet well developed in Ethiopia for reasons discussed elsewhere in this report (paras. 4.40 ff), involving primarily the nature of banking services and limited supplies of inputs and distribution systems that preclude the development of a competitive market. Over the longer run, as markets are liberalized and become more competitive, sellers of agricultural inputs can be expected to provide credit as a competitive measure to obtain and retain clients. The sellers' funds are likely to come from their suppliers, e.g., from importers or manufacturers to wholesalers, from wholesalers to retailers, etc., and also directly from commercial banks. Where credit is through the trade, banks would be the most likely sources of funds for those at the top of the chain, such as importers and manufacturers, who initiate credit sales of inputs. Downstream transactions, however, are informal.

5.14 This funding through the trade will enable retailers to finance farmers' purchases. Collateral will not be an important feature of these transactions, which are built on business relationships and the assumption that these will endure, building an established clientele and resulting in continued or repetitious transactions. The status of an established business relationship is especially strong and valued in Ethiopia, denoted by "dumbunya" in Amharic.

5.15 Produce buyers are already in a position to provide limited amounts of credit to farmers in the form of forward purchases of standing crops. These advances are usually given early in the crop season at considerable discounts over the eventual value of the harvest. Better terms for farmers can be expected as markets become more competitive.

5.16 Cooperatives dealing in coffee currently market their members' produce. Other agricultural service cooperatives may at some point be in a position to market their members' produce, and it will be important at that they are able to pay competitive prices in cash. This will probably require that they borrow from the banking system to be able to pay members immediately, just as private buyers would. These cooperatives may also want to finance members' input purchases, which they may also want to finance by loans from the banking system or from their suppliers. When this level of operations is feasible, the banking system and trade credit arrangements will hopefully be willing and able to accommodate well-run cooperatives that have established a reputation for fair dealing and prompt settlement of obligations.

Collateral and lenders' access to it are problematic and cannot offer a basis for credit to small farmers. Group enforcement of obligations seems to be the only practical means for banks to obtain reasonable assurance. Credit to individuals in rural areas must be distributed through a locally-based intermediary, e.g., cooperative, borrower group, NGO or trader.

6. Institutional Limitations on Loan Use and Access

Government-supplied agricultural credit is narrowly focused and channeled through CBE and DBE for the purchase of fertilizer (and possibly improved seeds) from the parastatal supplier. The only persons who have access to this credit are members of service cooperatives which have not defaulted.

6.01 The pattern of distribution of credit reflects lending strategy. Changes in lending strategy will produce different patterns of access. Therefore, lending strategy is critical to the expansion of loan use and access for agriculture and for rural people in general. There are fundamentally three stages in the evolution of rural lending strategy in the formal sector as financial markets develop and liberalize. Each stage creates dramatically different patterns of use, access and, usually, repayment.

6.02 Lending to produce tons of grain. Ethiopia is currently largely at the first stage, which may be termed the "tons of grain" approach to rural lending, which is usually dominated by government institutions. This strategy is based on physical relations: x incremental units of input (e.g., fertilizer or concentrate) will produce y incremental units of output (e.g., grain or milk). Credit is seen as a vehicle for getting inputs to the right producers, who will bring cropping patterns and production into line with government priorities. Disbursement is viewed as the most important part of the credit transaction because it is thought to increase production.

6.03 This strategy is based on broader official policies about food production, national self-sufficiency in basic grains, enhancement of export crops, or subsistence requirements of rural households. Risks affecting production and credit may not receive much attention. Interest rates are set in ways which have little to do with the costs of credit provision, which include default risk. (Default is defined as any contravention of a loan contract, including failure to repay in full and on time.)

6.04 Portfolio quality is an expendable element in the tons of grain strategy: loan delivery and administration costs and bad debt losses are sacrifices on the altar of national food policy. Securing incremental production is generally accorded such overwhelming priority that the costs of providing credit are not seriously considered. Subsidy and bad debt losses are considered trivial compared to the overall strategy, or even an indispensable element in policy and strategy. Loans are often large in relation to producers' incremental costs. Disbursements and incremental production are measured carefully and compared to targets, while loan accounting is not highly developed.

6.05 In CBE and DBE, for example, amounts falling due are not accorded much importance in reporting formats and classification of arrears is done centrally and relatively infrequently. Disbursements and collections are accorded greater importance. Without comparisons of collections against amounts falling due, portfolio quality is not easily ascertained and the overall costs of lending are not easily known because bad debt losses are not transparent. The sustainability of the financial mechanism used to support the tons of grain strategy is not clear and is therefore unlikely in the long run.

6.06 The tons of grain approach characterizes command economies, such as existed in Ethiopia until a few years ago, the objectives of certain donors, and often the agenda of ministries of agriculture in all types of economies. These ministries, after all, are concerned with food production and the development of industrial crops. However, their credentials as bankers are another matter.

6.07 Lending against repayment capacity. The second stage in the evolution of rural lending strategy might be termed the "repayment capacity" approach. Ethiopia is entering this stage. This strategy focuses on the loan applicant's ability to service debt, that is, to pay interest and to repay principal in full and on time. At this stage crop, farm and household budgets are perceived as useful tools to forecast the cash flows that create repayment capacity. Incremental production remains the basic building block in lending strategy, but prices assume greater importance in implementation of lending strategy, leading to a more comprehensive view of borrowers' activities and of the role of credit.

6.08 Initial steps toward lending based on repayment capacity usually retain loan sizes that are large in relation to incremental costs. Attention to risk and its management is focused on the selection and promotion of economically attractive innovations and cropping patterns, i.e., perfecting extension recommendations in response to farming systems or farm management concerns and avoiding obvious errors, such as the introduction of exotic livestock breeds in areas where they would be highly susceptible to endemic diseases to which local breeds are largely immune. Interest rates receive more attention as sources of income for lenders and as a means of screening out opportunistic borrowers. Officials begin to consider the usefulness of financial intermediaries other than commercial and development banks in development strategy. Novel intermediaries such as NGOs may be embraced as vehicles for financial development

6.09 More advanced development of the repayment capacity strategy includes attention to loan applicants' ability to save and finally to a broader view of risk, essentially represented by the bad agricultural year and the accidental death of livestock. Efforts are also likely to be turned toward the creation of good loan contracts and the search for collateral or "collateral substitutes" such as guarantees and solidarity groups. (If one uses the standards of the largest part of the financial sector, which is informal finance, collateral *is* the substitute -- credit is basically

built on trust based on performance and meaningful sanctions.) Portfolio quality is examined in more detail and thoughts turn to the possibility of constructing sustainable financial systems that serve large numbers of ordinary people without subsidy. Interest rates gradually come to be based on perceptions of cost, although costs may not be calculated in a comprehensive way.

6.10 Creating debt capacity. In the third stage of the evolution of lending strategy financial intermediaries and developers focus their attention on actions that create debt capacity. Debt capacity is defined as the amount of debt a loan applicant or borrower can obtain and service on a sustainable basis. This stage occurs most easily in liberalized, competitive financial markets. In fact, lenders may not be conscious that they are creating debt capacity, but this is the result of their competitive efforts to increase their client base and their profits. Official institutions operating in retail finance appear rarely to contribute to this process in a sustainable manner, and their pricing strategies may make it harder for private institutions to gain market share.

6.11 Creation of debt capacity devotes even greater attention to what goes on the borrower's farm or business, as this creates the cash flow to service debt. In this process intervening factors including "senior claims" and risk are accorded equal importance. Senior claims are those obligations that a borrower considers more important than repaying the lender that is attempting to develop business by lending more and safely.

6.12 Common examples in Africa include payment of school fees and taxes, contributions to informal social and financial institutions such as iqqubs and iddirs, sharing with family members and those in need, participation in ceremonies, etc. Lenders take steps to ensure that their claim on a borrower's cash flow is near the top of the borrower's hierarchy of claims. This requires building a relationship with the borrower, which requires respect for the client. The elements at a lender's disposal include the hint or promise of continued and expanded access to credit if loans continue to be repaid on time, low transaction costs through quick service, provision of more useful services, and meaningful sanctions in the event of fraudulent behavior by borrowers.

6.13 Risk also receives great attention, and the lender sees risk management as a source of income and cost reduction. Strategies include plans made in advance about how to accommodate a borrower suffering a shock, such as a bad year. The lender knows that the borrower is likely to attach greatest importance to credit immediately following a bad year in order to get back on his or her feet. This concern may lead to reconsideration of levels of financing, i.e., loan size, so that sufficient repayment capacity exists in a normal year to service debt falling due in that year as well as to clear arrears or some portion of arrears that resulted from the bad year. Savings are also promoted as tools of risk management.

6.14 Finally the lender may gain sufficient experience to be in a position to help minimize real risk, i.e., the things that go wrong in the business or on the farm. Loan applications for risky ventures are modified to reduce risk, often through technology selection criteria. More capital may be solicited from the applicant to support a more risky venture, reducing the lender's exposure.

6.15 Lenders using a debt capacity strategy take competitive steps to increase borrowers' access to credit and to other financial services. This is based on considerations of expenses and revenue. Lenders will be acutely aware of portfolio quality and of returns on total assets (the common measure of overall banking performance). Innovative financial services and instruments will be designed and priced based on these considerations. Interest rates will be based on lenders' costs as well as on competitive considerations, and lenders will be bold in their pricing strategies.

6.16 As an example, BancoSol in Bolivia charges real rates in excess of 50% per annum on its microenterprise lending portfolio; its clientele continues to grow and prosper and Bolivia has possibly the most innovative and vibrant microenterprise credit system in the world. More lenders are attracted and more innovations are undertaken when potential rewards to lending are high.

6.17 Major innovations that create debt capacity include lengthening of term structures, reduction of transaction costs and refinement of valuation processes. Term structures lengthen when loans are offered with longer maturities. These are most prudently financed by term deposits. If a lender makes a loan against a borrower's next paycheck or harvest, loan size will not exceed the size of the paycheck or the value of the harvest. If a lender makes a loan against five years' worth of paychecks or harvests, loan size will be much larger. Thus, longer term structures create greater debt capacity.

6.18 Transaction costs are borne by savers, financial intermediaries and borrowers. Intermediaries will compete by attempting to lower clients' transaction costs by reducing queuing time, offering convenient combinations of services and by minimizing fees. Intermediaries will attempt to reduce their own transaction costs by streamlining procedures and by training staff and using them more efficiently. Reduction in transaction costs enables more people to be able to afford financial services and to use them more extensively than they did previously, creating debt capacity.

6.19 Refinement of valuation processes occurs as lenders' change their views of what they are lending against, about what creates creditworthiness. Grameen Bank in Bangladesh presents a stunning example of this sort of refinement. By appealing to women in landless households and organizing them in a certain manner, Grameen is able to make these women's promises to repay worth something in financial terms, as represented by the sizes of loans issued to them. Some of these

women have never touched a banknote or coin before they joined Grameen -- other banks would never consider them creditworthy. In other words, Grameen Bank's innovative approach creates debt capacity.

6.20 The distinguishing feature of the debt capacity strategy is that the financial sector rearranges or restructures itself through competitive innovations that enable it to lend more to more people and firms. There is no reason why strategies to create debt capacity will not eventually become commonplace in Ethiopia. The increasing entry and consequent potential competitiveness in commercial banking is a good sign in this direction. Saturday openings, for example, reduce clients' transaction costs.

Recommendation: Put sustainable financial development as a first priority in any credit program. Support this priority by careful attention to and measurement of lenders' revenues and expenses. Tons of grain will follow in a successful input credit program, to the extent permitted by the economics of grain production.

How could USAID/E, through ERDA, help to broaden loan use and access under this line of credit?

6.21 Broadening loan use. Loan use could easily be broadened to include purchase of seeds, agricultural chemicals, tools and livestock, as well as the fertilizer financed at present. This could be done initially through agricultural service cooperatives that have good repayment records on fertilizer loans. The simplest means of achieving this expansion would be to extend credit for seeds and chemicals which every borrower could use and which would create only modest increments in indebtedness.

6.22 Loans for livestock, especially mature large animals, would probably be taken by a relatively small number of members, which could strain the solidarity or mutuality of credit through the cooperatives. Default by a relatively large borrower could prompt smaller borrowers also to default rather than leading them to rally to cover the default so that credit could be available for the next cropping season. Hence, loans for large animals should be kept relatively small by requiring a large downpayment. An ox costing Br 800 could be partially financed by a loan of Br 400, for example. Ox loans could also be given directly by CBE or DBE, as under the IFAD project.

6.23 Broadening loan access. Expanding the range of small rural borrowers beyond the present clientele consisting of members of agricultural service cooperatives that have not defaulted requires the development of more intermediaries between CBE and DBE on the one hand and rural people on the other. Intermediaries are essential because of efficiency and information considerations. This development could also be fostered by using mobile banking facilities for towns along main

roads that do not have bank branches. This would reduce transaction costs and facilitate more regular repayment of loans.

6.24 Currently, the line of credit available to farmers in both Gubu Sayu and Sibu Sire woredas is limited to agricultural inputs. According to information obtained from the Agricultural Inputs Supply Enterprise, fertilizer sold on credit during the 1995 crop season amounted to 1340 quintals in Sibu Sire and 2189 quintals in Gubu Sayo Woreda. This was only about 38% and 69% of the total fertilizer sales in Sibu Sire and Gubu Sayu woreda's respectively during the 1995 crop year. While both shortage and timely availability of fertilizer contribute to the low level of fertilizer credit, the lack of credit institutions within a reasonable distance is another constraint in both woredas. Farmers and service cooperatives visited complained about the time taken to process loan requests, which contributed to the delay in getting the inputs.

6.25 Moreover, the current level of management of the service cooperatives is very weak. In their current status, the service cooperatives are not expected to provide credit services and accept savings from their members. Nor are the cooperative promoters and development agents in the area skilled enough in training cooperative leaders and managers to a level that would enable them to provide efficient financial services to their members.

6.26 The farming system in both woredas is mixed, and crop production seems to be dominant. According to interviews with farmers in the area, the risk of crop loss due to drought and pests is high. Livestock production, particularly in the lowland areas, is also limited by diseases. Few households use small scale irrigation. This is indicative of the potential benefits from diversification of activities and sources of income to ensure household food security.

6.27 On the other hand, the potential to increase productivity and total crop and livestock production seems to be great. The results of SG 2000 and other adopters in the area is evidence of this scope in crop production. Recommendations for assistance to cooperative savings and credit are given in paras. 9.16 ff.

Are the Government, CBE and DBE willing to allow farmers to use credit for broader purposes?

6.28 GoE's appointment of its rural finance task force is indicative of its willingness to consider alternatives. However, while DBE and CBE's crop production input loan portfolios approximate Br 350 million, their disbursement projections for the next cropping season are based only on expected increases in fertilizer use and price. It is not yet clear that a much more broadly-based approach is feasible (paras. 3.11 ff)

6.29 One dimension of alternative uses of credit consists of the different opportunities presented by short-term and by term credit. CBE is best suited to lend for short-term purposes because of the short term nature of its resources. CBE does not want to lend for medium and long-term purposes, particularly for farmers because of the high risk that is involved. CBE is also constrained by lack of staff experienced in term lending.

6.30 On the other hand, DBE is willing to allow farmers to use credit for broader purposes because it has access to long-term financial resources from bilateral and multilateral sources. In the process it has gained experience in appraising activities funded by medium and long-term loans. These have included grain and oil mills, draft oxen and dairy stock, coffee pulping stations and purchase of red cherries for processing, storage facilities, farm machinery and implements, cattle fattening and various types of agricultural inputs.

6.31 Cooperatives were used as channels for credit delivery to small farmers by the Derge. Dissolution and weakening of these institutions since the declaration of the Mixed Economy Policy in March 1990 have greatly affected their ability to provide financial services (paras. 9.01 ff).. Lack of appropriate credit intermediaries in the rural areas is a major constraint to broadening credit distribution and use.

Are the Government, CBE and DBE willing to lend to private retailers who could in turn offer credit to farmers for input purchases?

6.32 The banks have no plans to increase or initiate lending to private retailers. CBE has about 22,500 DST (domestic service and trade) loan accounts, many of which are to traders. While input supply constraints persist, such lending is likely to develop slowly (paras. 4.40 ff). Collateral is another constraint (see chapter 5). CBE and DBE are willing to lend to private retailers provided that they can pledge material collateral.

6.33 Whether and under what conditions retailers may be willing to lend to farmers for input purchase is another matter. Three reasons for retailers' reluctance in this regard may be identified. First, retailers and farmers may have conflicting interests while input supplies are short and prices are controlled, and these may work against establishing the confidence required for credit relationships. Second, retailers cannot afford the risk of default by farmers while their margins on fertilizer are controlled, and there is insufficient documented experience to know precisely how retailers could enforce timely repayment. The present legal mark-up is Br 7 per 100 quintal bag of fertilizer. While mark-up controls exist, retailers interested in lending would have to charge additional, informal fees to cover risks. Incentives for repayment would presumably relate to scope for repeat business and retailers' relationships with clients that go far beyond input supply.

If so, how could this be implemented by CBE and DBE?

6.34 DBE wants to ABANDON input supply financing. CBE is unlikely to lend to retailers who cannot offer collateral, and there is no way to force retailers to onlend to farmers when underlying conditions of supply and repayment incentives are weak. However, some retailers who may also handle fertilizer among other products are no doubt lending to their close relatives or customers on small scale, and as the trade expands credit is likely to follow naturally.

6.35 Implementation of credit lines by CBE would be a relatively simple matter, but would have to be undertaken carefully in view of lack of experience in this area. Special attention would be required to loan sizing and to realistic repayment terms for retailers. Technical assistance in this area would be useful, especially in determining where in the import and distribution chain new credit would be most useful.

Recommendation: Efforts to increase the supply of inputs or to permit more competition with the major parastatal supplier, and to deregulate the retail prices of inputs are essential to encourage private trade in inputs. Technical assistance to CBE in input supply lending would be helpful as supplies increase.

7. Loan Collections

Collection of loans has been problematic. CBE and DBE rely on local government officials to enforce collection; they do not appear to have adequate staffing to collect, nor incentives to do so since the provision of agricultural loans to the service cooperatives is dictated by the central government.

What actions could be taken to strengthen CBE and DBE collection systems and incentives? (Any recommendations made should be discussed with Ethiopian government officials for their reactions and comments.)

7.01 The Government has provided input credit to increase food production. DBE and CBE have been obliged to provide credit in support of this objective, although they do not have the institutional mechanism to reach small farmers. Therefore, DBE and CBE have depended on Government structures for borrower identification and loan collection. Recoveries of agricultural input loan collection during the 1994/1995 period are estimated at between 80% and 90% of amounts due. In high potential agricultural areas, where soils are good and farm incomes are relatively high, recovery levels are very high, approaching or reaching 100%. In other areas lower recoveries are achieved. In a sense, these levels of recovery in a good year are remarkable in view of the structure of the credit mechanism.

7.02 Portfolio quality and sustainability. However, lending that achieves recovery levels of 90% cannot be sustained without subsidy. Credit quality overall and rural credit in particular is indeed a problem. CBE's portfolio statistics are indicative. At 30 June 1995, CBE had a loan portfolio with outstanding balances aggregating Br 4,877 million. Of this total, the bank categorized Br 580 million as "irregular" meaning that there was a problem in their collection. This is roughly 12% of the portfolio and 200% of the bank's capital and capital reserves. Prior year data were proportionately similar. Between 1981 and 1992, irregular loans constituted between 38%-23% of the portfolio.

7.03 Rural credit data show a significantly worse situation. At 30 June 1995, CBE had outstanding rural loans amounting to Br 166 million, split 66% to cooperatives and 33% to individuals and private operations. 72% of these loans were to purchase inputs, primarily seed and fertilizer. Rural lending comprised only 3% of the total portfolio, yet accounted for about 13% of the bank's total overdue loans. The rural portfolio's average delinquency rate was 28%, with the bulk of the delinquencies attributable to unpaid input loans, principally to cooperatives. It is not clear how much of the cooperative debt relates to predecessor cooperatives that was not transferred to the Government under Proclamation No. 86/1994.

7.04 The severity of delinquency in the rural credit portfolio is cause for concern. Although 57% of the rural overdue is delinquent less than 6 months, 36% is

delinquent in excess of a year and is probably a loss. The remaining 7% overdue between 6 months and one year could be considered as of highly doubtful collectability. A substantial amount of the most severely overdue accounts (in excess of 18 months) relates to cooperatives.

7.05 Root causes of delinquencies should be analyzed. Some can be attributed to theft and destruction of assets as the previous cooperatives disintegrated in the transition of government; some might also be attributed to the mentality created by the operation of so-called credit schemes by NGO's that are in fact donations disguised as credit; some can be attributable to a failure of the borrower to recover from the "bad year." But in many cases, it may be likely that the purpose of the delinquent loans was not achieved; either the proceeds were used for purposes other than intended (such as a fertilizer loan being used for living costs because fertilizer was not available for purchase) or marketed production was insufficient to repay the credit.

7.06 The latter causes relate to credit practices and policies. As mentioned in other places in this report, the relationship between banker and borrower is important. The more distant the banker is from the borrower, the less control s/he will have over the repayment of the credit. **Monitoring and control over the use of proceeds and the borrower's operation is essential.** For the small farmer, fledgling cooperative and microenterprise owner, the lender must act also as a technical advisor, financial advisor, and partner.

7.07 Continued reliance on asset based lending, disregarding cash flow and, with it, the probability of repayment, is a weakness in lending technique. **An analysis of the borrower's sources and uses of funds would enable the lender to estimate the borrower's total credit capacity over a period and to structure repayment accordingly.**

7.08 Measures to reduce delinquency. DBE is not interested in developing or continuing its activities as a supplier of input credit (and has never supplied input credit in Gobu Seyo and Sibu Sire). It wants to concentrate on term lending, which it regards as consistent with its mandate as a development bank rather than as a commercial bank. That means that CBE will be the principal supplier of input credit.

CBE should have autonomy to select borrowers on the basis of sound banking principles. It should be able to identify borrowers who have the capacity to repay based on the area they cultivate and other productive assets. Second, it should use repayment periods that coincide with the time at which farm products are harvested and marketed. Third, CBE must strengthen its follow-up activities to secure repayment on time. Loan collections can be made at convenient locations in the field using a mobile banking approach. Fourth, prompt repayment could be encouraged through interest rate rebates. Fifth, lenders should be free to refuse further loans to

defaulters. Finally, branch staff incentives such as salary increments, bonuses and training opportunities could be attached to loan collection performance.

7.09 Lenders tend to have better experience with borrowers who also **keep deposit accounts** with them. Promotion of "full service banking" might be helpful. A variation would be to **require borrowers to provide some equity stake** in the project being financed or the product being purchased. For projects, it could be so-called "sweat equity" or a contribution in kind that the bank either would match in value or provide funds in some multiple of the value contributed by the borrower. Disbursements for activities with a long development phase could be made on a progress basis (percentage of completion) rather than all at the front-end of the loan. For goods purchased on credit, the lender could require the borrower to co-pay or deposit a percentage of the purchase price prior to any loan funds being advanced. 100% financing, particularly of commodities, carries a high risk.

7.10 Essentially, the fundamental principle to establish better collection systems is to give the responsibility for lending decisions and for collection to the lender, and to have means of holding the lender (in this case State-owned institutions) accountable for performance. Making management remuneration dependent upon financial results is one means of providing appropriate incentives.

7.11 The mode of collection is also important. Using local government officials (who have nothing at stake in the transaction) to collect loans is not a good practice. The bank has no control over the collector. It tends to weaken the relationship between lender and borrower, and it creates room for fraud. **The lender should have final responsibility for borrower selection, for determining loan size, for loan approval and for collection.** If a loan officer makes a loan that she is not responsible for collecting, she will be less careful in screening the credit and be more concerned with producing a certain volume of loans rather than with their quality. Banks may wish to adopt a "you made the loan, you collect it" policy. **Loan officer salary increments should be based not solely on volume, but also on quality and profitability criteria.**

7.12 Loan accounting. In order for collection performance to be evaluated, **accounting systems have to be in place that indicate clearly when loans fall due, the extent of overdue loans, the amount of loans that are affected by arrears, and aging of amounts in arrears**. In addition, procedures for halting the accrual of interest on amounts beyond a certain number of days overdue and for establishing realistic bad debt reserves are required.

7.13 Clerical procedures are required to ensure that timely action is taken on loans that are not repaid on time. Action includes notation in credit files, communications with the defaulter, blocking deposit balances, etc. Legal recourse would of course be helpful, but this cannot realistically be expected to provide much comfort to lenders any time soon. Publishing the names of willful defaulters in local papers

has had positive effects on recoveries in certain countries. Pakistan has barred defaulters from seeking political office, which reduced arrears.

Collection is also a problem for private sector retailers because of lack of legal recourse in case of loan collection and defaults by farmers. How serious is this problem?

7.14 Data were not available to analyze the extent of collection problems encountered by private retailers. However, this problem may not be very serious because the volume of such lending is probably not very high and because retailers engaging in such transactions probably have relationships with their clients that produce high levels of loan recovery.

What strategies and actions could be used to provide meaningful security, including legal recourse, for such retailers?

7.15 Meaningful security for informal input supply credit is usually simply the relationship between borrower and lender. In countries with reasonably effective legal systems and extensive property rights, promissory notes, bills of sale and crop liens may be used as security and can be realized relatively simply in cases of default. These mechanisms reflect social traditions and values that are unlikely to be readily transferable. In the absence of any clear means of enforcing contracts, these matters are probably best left for resolution through relationships in the informal market. Retailers might encourage "layaway" plans or agreements with their purchasers, where physical possession of the goods will not be transferred until all or a certain percentage of the purchase price has been contributed by the buyer. Also, group based credit arrangements could be used. These are based on informal contracts that may have some teeth, especially when the group is relatively small.

Outstanding bad debts impede new initiatives to provide credit: what can be done to resolve bad debt losses without creating expectations among borrowers and lenders that poor collection rates will be routinely tolerated and debt forgiven in new credit programs?

7.16 Forgiving financial debts owed to large institutions or state-owned institutions usually creates some expectation that a repetition may occur. Exceptions to this tendency occur when defaulters are stripped of their possessions, or a sizable proportion of their possessions, following which no further efforts are undertaken to recoup any balances remaining. Bankrupting the defaulter is effective because the defaulter suffers the most in relative terms.

7.17 Where this type of recourse is not available alternatives include barring defaulters from further credit, embarrassing the defaulter, and creating a new atmosphere through high political leadership. Barring from further credit is unlikely to be effective because this action is made difficult by the atmosphere that tolerates or encourages default in the first place or that provides debt forgiveness. Embarrassing the defaulter may be effective if it can be done in a context in which most people will sympathize with the lender rather than the defaulter, so that the defaulter is not seen as a victim or martyr. A new atmosphere can be created by a strong leader who sets a new moral or cultural tone, such as Ataturk did in Turkey.

7.18 Credit programs that are truly new, in the sense of significantly refining valuation processes, can enjoy some immunity from a history of debt forgiveness. These programs create their own context and atmosphere which engenders good contracts based on a high degree of loyalty among participants. Such programs have to be unique, with high degrees of product differentiation to succeed. Grameen Bank thrives in a region where loans have frequently been forgiven through political processes for more than 200 years.

What would be required to implement these strategies and actions?

7.19 In addition to the recommendations given above, it appears that **NGOs are most likely to make the sort of appeal and fresh start that would be needed**. This is possible when NGOs are highly value-driven, which usually is possible only when they are highly independent and not merely contractors to donors or government. A problem will occur if the NGOs' values do not include good accounting and financial integrity.

8. Third-Party Loan Guarantees Funded by Donors

ERDA is considering setting up a loan guarantee fund to ensure the availability of credit in East Wellega and to test this mechanism for future expansion throughout Ethiopia.

What has been DBE experience with insurance of oxen purchased on credit?

8.01 The draft oxen insurance scheme was initiated under an IFAD line of credit to the Agricultural and Industrial Development Bank of Ethiopia (AIDB) in 1984. (AIDB is now the Development Bank of Ethiopia - DBE.) The scheme was developed under a tripartite agreement of the Ministry of Agriculture, the Ethiopian Insurance Corporation and AIDB. Under the agreement MoA was to provide veterinary services, undertake physical examination of animals as they were purchased, vaccinate and ear tag them, and provide death certificates after post-mortum exams. The Insurance Corporation agreed to provide ear tags and underwrite policies covering accidental loss. AIDB was to select borrowers and provide credit for purchase of draft oxen from the proceeds of the IFAD credit.

8.02 Loans were scheduled for repayment over four years, the average economic life of draft oxen. The insurance scheme also provided coverage for four years. The insurance premium was 8.9% over four years, approximating 2.2% per annum. Reported mortality was less than 2% over the four years.

8.03 The scheme faced a number of problems. MoA veterinary doctors were not available as envisaged because of lack of budget. Veterinary drugs and vaccines were not available to vaccinate and treat the animals when they are purchased. Ear tags were not available in the country and the Ethiopian Insurance Corporation was not in a position to import. AIDB incurred almost all of the processing costs. Since MoA veterinarians were not in a position to report animal deaths, many claims were not processed and some borrowers could not obtain compensation. The scheme did not work smoothly.

8.04 For an effective livestock insurance scheme, the institution selling the policy must be able to provide most or all of the services required for fulfilling the formalities. An alternative strategy would be development of local draft ox insurance based on the social tradition of the community involved and worked out in cooperation with the community. It could involve the accumulation of a fund or simply work on a call basis, soliciting contributions of an agreed amount whenever a member lost a draft ox through accidental mortality. The call procedure would be appropriate only when deaths occurred randomly and at less than catastrophic levels.

What are the pitfalls in setting up and running guarantee funds? How can these be avoided?

8.05 The problems associated with guarantee funds are not well documented. A recent study by Meyer and Nagarajan at Ohio State University, funded by USAID's Africa Bureau under the Financial Sector Development Project, failed to locate meaningful performance data for most of the schemes that could be identified. Accordingly, it is difficult to make inferences from hard data. This problem apparently also hindered the work of Levitsky and Prasad, as their World Bank Discussion Paper on guarantee funds contain virtually no financial data. In view of these omissions, it is probably reasonable to assume that guarantee funds used by developing country governments and by donors are generally a flop. Good performance would be more likely to be reported than bad performance.

8.06 Unpublished work in the Philippines, Mexico, Egypt and elsewhere done from time to time by Mike Gudger, a noted consultant in crop insurance and guarantee mechanisms, has failed to locate any funds that appear sustainable other than one in Mexico that guaranteed banks participating in a large central bank rediscounting operation for highly commercialized farmers.

8.07 The role of donors and governments. Guarantee funds are typically capitalized by a donor and/or by a government. The objective is to encourage lending for the purpose supported by the guarantee. The capital is an insurance reserve. It is invested to provide income for the operation of the fund, for accumulation to bolster reserves, and to enable the fund to meet a catastrophic situation in which an unusual number of claims are submitted. Guarantees are issued against fees (or premium payments) from beneficiaries, which may be banks or other lenders, or borrowers directly. Where guarantees are in favor of lenders, which is the usual case, the premium charges are often passed on to borrowers.

8.08 Technical difficulties. Two technical problems regarding pricing can be documented or inferred in most cases. The first is that guarantee fees cannot easily be established on a rational basis because the incidence of the risks they cover is not well documented. In technical terms, there is insufficient experience to permit sound rate making, that is, to determine the actuarially fair fee or premium. This ideal fee or premium would provide sufficient income over the long run to meet valid claims submitted by those suffering guaranteed losses. It does not cover administrative expenses. In the absence of data and because the guarantee is generally intended to provide some type of subsidy, fees are generally set at relatively low levels expressed by single digit percentages of the value of the cover provided. A low rate is further defended on the grounds that income from the initial capital contribution is intended to help reduce the fee or

premium income required for long-run viability. Experience with crop insurance suggests that farmers are generally unwilling to pay an actuarially fair premium.

8.09 The second technical problem, also stemming from the absence of actuarial experience, is that a viable ratio between the guarantor's capital or reserves and its exposure or amount of guarantees or insurance outstanding cannot be determined. An ideal leverage or underwriting ratio would enable the guarantor to have sufficient capital or reserves to meet catastrophic losses. This problem is sometimes dealt with by providing counterguarantees for losses in excess of expectations. The counterparties may be an aid agency or a nationalized insurance company.

8.10 Results of inadequate funding. Work done by Gudger indicates that a typical pattern is that coverage, guarantees issued, expands rapidly. Losses at the outset are relatively small and covered by premium income. As time passes losses occur that eat into investment income and eventually into reserves. At this point donors or the government often provide additional capital. Expense ratios also tend to rise as administrative costs consume an increasing proportion of fee and investment income.

8.11 In a number of cases settlement of claims, a second order problem, is also messed up. This may arise from lack of clarity in program design about what has to be done to establish a valid claim. Ambiguity permits the issuer to delay payment of claims, diminishes the value of insurance, creates incentives for opportunistic behavior and frustrates the purpose of the guarantee.

8.12 Settlement of claims can also be compromised by the impending exhaustion of the guarantor's reserves and liquidity. Nepal's Credit Guarantee Corporation's coverage for livestock exhibits this pattern, The Corporation is owned and largely capitalized by the central banks and nationalized commercial banks. These commercial banks are also the beneficiaries of the guarantee program. The Corporation has periodically run out of funds because claims outrun its reserves. Payment of claims slows and is eventually in effect suspended. The central bank and the nationalized commercial banks then subscribe more capital, which is returned to the commercial banks to settle unpaid claims. It is difficult to identify value added by this activity.

8.13 Market failure and value added. The economic case for guarantees is often based on market failure, the assumption that lenders have insufficient information or incentives to lend for target groups or purposes. The guarantee strategy assumes that these lenders overestimate the risks of this potential business, and that by underwriting these risks the guarantee will enable these lenders to gain experience and an unbiased view of risks. At this stage the guarantee should no longer be necessary. A variant might be that the guarantee simply helps to sketch risk

profiles as a sort of pilot or exploratory exercise, providing valuable information to guide development initiatives.

8.14 This economic case should be expanded to include use of information gained by the guarantor to reduce real risks. In this way the guarantor can add value for beneficiaries by discouraging certain types of risky behavior and encouraging more prudent behavior. Incentives may be provided by refusal to underwrite certain risks and by variable premium rates for different risks.

8.15 Incentive problems. Two incentive problems include moral hazard and adverse selection. Moral hazard is the possibility that the guaranteed party will attempt to benefit through behavior that increases the probability of the occurrence of the guaranteed loss. Loss sharing arrangements are one means of controlling moral hazard. For example, the guarantee may cover only part of the loss through a deductible portion that is carried entirely by the beneficiary or through a partial share of any loss. Supervision of claims adjustment (i.e., determining the cause and degree of loss) and of the borrower's activities covered by the guarantee can help to control moral hazard.

8.16 Adverse selection is the tendency for high risk individuals or firms to apply for coverage because they think it will be useful and the tendency for low risk individuals or firms not to apply for coverage because they regard it as superfluous. This works against the insurance principle of pooling. Eligibility criteria, and fees or premiums differentiated by risk class can reduce adverse selection, but these tools may not be favored in government schemes because of equity considerations. Compulsory coverage is often adopted as an alternative. For example, every borrower under a credit program is required to take out a guarantee as a condition for receiving the loan, as in the oxen insurance exercise undertaken in Ethiopia.

Guarantee funds established in connection with development projects or institutions seldom work well. They are usually insufficiently capitalized because their founders underestimate the magnitude of the risks covered or are reluctant to charge an actuarially fair fee or premium. Incentive problems contribute to losses and induce sponsors to require mandatory rather than voluntary participation. Administrative problems in settling claims are also often more challenging than assumed in guarantee scheme design.

What would be the primary objectives of the fund: e.g., coverage of targeted agricultural loans or of targeted farmers?

8.17 Coverage of targeted loans is probably preferable because it would require the lender to exercise diligence in collection efforts, which could reduce the guarantor's administrative costs.

Under what conditions would the Government, CBE, DBE and private banks accept as collateral donor-funded agricultural credit guarantees?

8.18 To serve effectively as collateral, guarantees must be credible and their associated transaction costs should be low. Credibility relates to the coverage provided relative to the risk and also to the probability that claims will be honored as agreed. Transaction costs include the paperwork required to document a claim and delays in receipt of funds against claims filed. Procedures should be specified precisely and in advance, and funding should be adequate.

Where should the guarantee fund be located: NBE, CBE, DBE, or a private bank?

8.19 An alternative to a separate guarantee fund would simply be to provide additional capital directly to the lending banks as part of a targeted lending scheme. This would avoid the expense and bother of setting up a new organization and would reduce the administrative costs of risk-bearing. The banks could use this capital to support increased lending for targeted purposes. Attention to information about risks could make the banks better lenders by having flexible responses to adversity. Attention to gathering experience through the provision of risk capital could also lead to better loan accounting by the banks, including treatment of arrears and of bad debt losses. Better accounting would increase transparency and hence reduce moral hazard on the part of bankers who might feel that the guarantee could be tapped to avoid odious efforts at debt collection. The amount of the capital required would be a function of expected risk.

An alternative to establishing a separate guarantee fund is simply to provide additional capital to a lending institution making loans for the activities that the donor or government would like to promote through a guarantee. This could solve certain incentive problems, simplify administration and transaction costs, and provide valuable information directly to a major party at risk.

What would be a reasonable initial contribution to capitalize such a fund?

8.20 In view of the uncertainties arising from a lack of information on risks in Ethiopia, capitalization should be conservatively large if the program is meant to have a long life. A guarantee fund equal to, say, one-half of coverage outstanding could be a good start. As experience is gained leverage could be increased if warranted, possibly increasing from 2:1 to 5:1 or beyond.

How should interest earned on the fund be used (e.g., to fund training, operations and increase the reserves of the fund)?

8.21 Money is fungible and there is no particular optimum disposition of interest earned. The guarantor should have a priority-based budget that is acceptable to those capitalizing the fund.

How and in what proportions should losses be shared by borrowers, lenders and the fund?

8.22 Proportions should be determined against objectives and with regard to the risks covered. A variable scale of fees and coverage's could be offered and revised as experience is gained, permitting all concerned to select different levels of coverage. The beneficiaries, i.e., covered borrowers and lenders, should share materially in losses so that moral hazard is reduced. Lenders should also share in losses so that they have an incentive to lend prudently and attempt diligently to collect loan repayments.

Should these shares be altered over time? If so, why?

8.23 Loss sharing arrangements and guarantee fees should be altered to reflect experience. This flexibility will enable the fund to approach viability faster than it could if it gets locked into untenable contracts. Accordingly, **premia should initially be high and capital larger in order to permit reductions in premia.**

What should determine the life of the fund?

8.24 If the fund is viable it should enjoy a perpetual corporate life. If it is not viable its life will be determined by the rate at which it decapitalizes and the extent and frequency with which it is rescued by government subsidy and donor infusions.

At the end of its life, what should be the disposition of any funds remaining?

8.25 No funds of any significance are likely to remain at the end of the fund's life.

9. Agricultural Service Cooperatives

The only existing formal credit for agriculture is supplied through service cooperatives. USAID/E is considering assisting this system in the short run.

Is this a reasonable activity for ERDA for the next several years? Why or why not? If so, what types of interventions would be most useful?

9.01 Most agricultural service cooperatives were established by the Derg in 1977 and 1978 as means of organizing farmers and the food procurement system. These coops were actually formed by two or more peasant associations. They tended to lack autonomy and were not operated according to commercial principles or cooperative principles as understood in developed countries. Membership was obligatory for farmers, but member control was weak and member participation was often less than enthusiastic. Activities included fertilizer credit and distribution, and often the operation of consumer shops dealing in controlled commodities such as salt, sugar and soap. Cooperatives generally included a service area having a radius of about 7 km.

9.02 These societies took loans to build offices, stores and to procure equipment. Most of these loans came to be regarded as unrecoverable following the effort to return to a mixed economy, and actions were initiated to have them assumed by the state. However, the situation regarding these debts is not entirely clear. Definitive action to resolve the cooperative debt question would greatly contribute to creating a framework for cooperative development (para. 1.45).

9.03 Cooperatives' attractive features include their closeness to members, which is essential for responsiveness to the opportunities facing members individually and collectively; their potentially democratic nature; the ability of well-managed cooperatives to survive on small margins; and the advantages of economies of scale and of "bargaining power" that can be generated by collective action. In addition, cooperatives may be able to function satisfactorily where other private sector businesses would be unwilling to operate, and cooperatives may be able to contribute to market efficiency by offering competitive prices and greater choice.

9.04 The Agricultural service societies that remain are based on individual membership. They are vehicles for fertilizer credit, as noted in Chapter 6 and elsewhere in this report. The question is whether this function is or can become a commercially viable activity for cooperatives, and whether other functions can be added. As might be expected, questions of management and efficiency require considerable attention in efforts to build a responsive cooperative structure. In addition, the entire fragmented system of input supply credit requires reform, which would presumably place more of the responsibility for loan collection on

cooperatives that serve as intermediaries between their members and banks. (See paras. 7.08 ff for a discussion of the responsibility of CBE as a lender).

9.05 Region 4 has about 1,600 agricultural service cooperatives with an estimated membership of 1.5 million people, of whom 1.3 million reportedly obtained fertilizer through their coop in 1995. In East Wellege 179 agricultural service cooperatives provided fertilizer credit for their members in 1995. Grain marketing is reported to be the principal activity of 1,155 of these coops. The Cooperative Development Department of the Region 4 Agricultural Development Bureau has 427 officers.

9.06 In view of the desire of Region 4 agricultural officials to phase cooperatives out of the fertilizer credit business, and the feasibility of doing so based on SG2000 and MoA efforts to promote grain production, ERDA may wish to consider directing its attention to activities other than credit at this stage. Using credit as a key element in the development of cooperatives could easily create perverse incentives for members and potential members, especially if funds were to be provided by the government or by a donor. If, however, cooperation were developing well around commercial activities, credit would be a useful additional function.

9.07 The scope for introducing savings activities is discussed in paras. 4.01 - 4.20 of this report.

Credit is one of many services that can be provided by agricultural service cooperatives. Use of credit as a leading edge in cooperative development, is unlikely to be sustainable when cooperation is weak, especially if nonmember funds are provided to assist because these easily create incentives for opportunism. In general, ERDA should consider alternative focuses for cooperative development.

One proposal is to establish savings and loan facilities in service cooperatives:

Does cooperative legislation allow this?

9.08 Cooperative legislation permits agricultural service cooperatives to engage in lending and deposit-taking. However, this legal capacity may conflict with banking regulations, as discussed in paras. 1.33 ff of this report.

Is this likely to be a viable activity?

9.09 Cooperative savings and credit services are important in many countries and can be conducted in a commercially viable manner. However, provision of these services requires a high standard of care because of the risks and responsibilities involved when people entrust their savings and take loans. It would take a good

deal of effort to make cooperative savings and credit viable on a wide scale in Ethiopia, with special emphasis on record keeping, audit, credit standards and decisions, and loan administration.

9.10 Evaluations of cooperation in East Wellega indicate that, as a generalization, managerial capacity is weak and the capital base is small. These stand in the way of developing member confidence and achieving commercial success.

9.11 A major technical issue in cooperative savings and credit is concentration of risk. If individual societies were to offer credit and savings facilities, this risk would arise in the form of events that would diminish the saving capacity and the repayment capacity of members of the cooperative. These events would include crop failure. In this case borrowers would not be in a position to repay at the same time savers would want to tap their savings to compensate for their reduced income. One means of addressing this problem consists of centralized facilities that would permit societies to obtain liquidity from an apex institution. These arrangements have performed poorly in many developing countries, however, and in Ethiopia could themselves be subject to risk concentration because of the agrarian character of cooperation and the vulnerability of the country to drought that affects large areas in a bad year. Another means would be to stress money-keeping services and to de-emphasize credit.

The viability of cooperative credit requires good management, member confidence and means of dealing with risk concentration. These would be difficult to achieve at this time in the grain regions of East Wellega.

9.12 Viable cooperative banking requires a strong capital base. The purpose of the capital base is to fund operations and to manage risk. Risk management is important because members' savings require protection and because the survival of the cooperative can be threatened by defaulting borrowers. (Default is defined legally as any breech of a loan contract, including failure to repay on time). Capital also represents commitment by members, their participation in ownership.

9.13 The soundest form of risk capital in a cooperative is institutional capital, which is nonwithdrawable except in liquidation of the cooperative. In cooperatives generally accumulation of institutional capital is achieved by retaining all or part of the annual surplus or profit. It is also achieved in credit cooperatives by deducting a fixed percentage, say 5%, from each loan issued and retaining this as capital. Cooperatives often classify members' shares as capital, but these are normally withdrawable when a member terminates her membership. Termination is most likely to occur when things are going badly, which is also when the cushion against risk that capital provides, is most important.

9.14 In view of the high levels of risk that cooperative savings and credit operations are likely to face, high levels of capital are appropriate. An 8% capital-to-total assets ratio is a popular standard in commercial banking. As a rough estimate, rural savings, and credit cooperatives are likely to face risks three or four times greater than commercial banks, indicating that capital ratios of between 24% and 32% of total assets would be prudent.

9.15 Most capital should be provided by members so that members who are the cooperatives' depositors and borrowers, have a stake in ensuring viability. Any nonmember capital, as from donors, should be tied to prior or simultaneous cash accumulations of capital by cooperation or by their society.

Savings and credit societies should be well capitalized to facilitate their survival. Institutional capital-to-total asset ratios of 25% or more are recommended. Most institutional capital should be contributed by members or retained by the cooperative from earned surpluses.

How should this be set up?

9.16 In spite of the difficulties surrounding cooperative credit prospects in rural Ethiopia, a minor project initiative could be undertaken to test feasibility over a specified period.

9.17 Two alternatives can be considered for the provision of financial services to members of cooperatives in the grain regions of East Wellega: facilitation of access to the commercial banking system, and cooperative banking services.

9.18 Facilitation of access to the banking system is currently a cooperative activity in the form of preparing applications for fertilizer credit to members. This could possibly be expanded to include helping members make deposits and withdrawals from bank accounts maintained at the nearest commercial bank branch. One or two persons could be responsible for going to the bank and conducting transactions on a specific day each week, fortnight or month. (This could coincide with the timetable of any mobile branches that might be established, as discussed in Chapter 12 of this report.) This service could be especially useful for illiterate members.

9.19 Cooperative banking services could be developed in East Wellega by selecting two relatively strong societies, one in Gobu Seyo and one in Sibu Sire, as guinea pigs for the introduction of basic, prototype banking services. (A potential problem in locating suitable societies is their small number: there are only six in Guru See with total membership of 6,292 and five in Sib Sire with a total membership of 2,542 as of December 1994. These two societies should have

relatively strong management, satisfactory bookkeeping, and physical facilities adequate for banking services, including safe storage for cash and documents. These societies would be the focus of training and technical assistance. If these activities were successful over a period that included survival of a bad year, they could be considered for expansion to other societies. One means of providing this service would be for the members of a cooperative to form a credit union which could use the facilities of the agricultural service cooperative. A separate entity could facilitate transparency and diminish scope for use of members' savings for trading by the cooperative, which would put them at considerable risk.

What type of service cooperative management structure would be required?

9.20 The management structure would depend upon the level and types of services provided. Collaboration with the banking system could be managed through simple procedures. Provision of cooperative banking services would be the most demanding of management skill.

9.21 The credit union model consists of a board of directors or management committee, a credit committee and a supervisory, control or audit committee. The credit committee should be selected by the board to ensure consistency between policy and implementation. The board and the supervisory committee should be elected by the membership. This format appears relevant and useful even if a credit union format is not selected for the conduct of cooperative banking. A board would already exist, necessitating only the establishment of credit and supervisory committees. (Education and arbitration committees are also used by societies registered with SACCDO).

9.22 Volunteer management is preferable from a cost point of view, but few rural residents may know how to keep financial records or to audit them. This could require that a paid manager be appointed. Managerial duties could be relatively simple. For example, the banking facility could be open only once a week for a few hours, and the credit committee could meet once or twice a month. A paid manager could serve a number of cooperatives, each one different day of the week.

9.23 A structure proposed by VOCA consists of the formation of cooperative unions as apex bodies, and the establishment of saving and loan associations within unions. This alternative merits further definition and consideration, within the context of the prospects for the commercial viability of the proposed unions.

What are the preconditions for setting up a savings and credit facility in a service coop?

9.24 Preconditions include:

- reorganization of the service cooperative along business lines under an appropriate constitution and by-laws, samples relating to credit and savings (obtainable from the World Counsel of Credit Unions in Madison in, Wisconsin or the African Confederation of Cooperative Savings and Credit Associations in Nairobi);
- resolution of any uncertainties and irregularities in existing credit or deposit activities, including past debt;
- a business plan and budget incorporating capitalization objectives and demonstrating the financial feasibility of the proposed services;
- a majority vote of the membership to approve he plan and budget and to undertake savings and credit facilities, which probably requires member education about the proposed services, how they would operate, and the benefits from their use;
- democratic and participatory constitution of committees;
- introduction of an appropriate accounting and information system;
-mastery of record keeping and management by at least three people, which probably requires training (SACCDO currently provides training in accounting for savings and credit societies);
- policies and procedures governing provision of services;
- a commitment to earn and retain a profit on the provision of financial services;
- appropriate books of account and stationery for recording transactions and other communications;
- a hand or desk calculator;
- an account with a bank for the safe keeping and employment of cash not required for lending or operations;
- initial deposits or share purchases by members;
- agreement on a location at which business will be conducted;
- a table, a couple of chairs and physical safekeeping facilities; and
- a plan to evaluate results formally and periodically.

How could the proposed project support the establishment of this function?

9.25 Technical assistance would be a major requirement. This could be provided as a continuation of USAID activities in this area directed at cooperatives.

Recommendation: USAID/E may wish to consider a minor cooperative development initiative in the proposed project area in East Wellega, beginning with two cooperatives.

Should ERDA support other activities of service cooperatives?

9.26 Activities other than credit could be much more fruitful to support because they involve less operational risk.

How should service cooperatives be selected to receive project support?

9.27 Any service cooperatives that are to receive assistance in the provision of financial services should be relatively well-managed and willing to receive assistance. They should have an exceptional record in the provision of seasonal input credit. They should have a willingness and inclination to price services so that a profit can be retained by the cooperative. They should also be selected with some attention to location as defined by the woredas that USAID/E is interested in assisting.

Should ERDA work with service cooperatives after other alternative financial service mechanisms are in place and serving target groups and objectives?

9.28 **ERDA may wish to review periodically the scope for cooperative credit and other banking services.** These may be able to reach people who would not otherwise have access, they may be low-cost providers in areas where other financial intermediaries are not operating, and well-functioning cooperative financial services may assist cooperative development generally. Ethiopia is a large country with difficult topography -- it will take a long time before the majority of the population have access to formal financial services.

10. Adoption or Adaptation of Foreign Models

The central bank has expressed willingness to experiment with different mechanisms for rural credit delivery.

What are the pros and cons of applying the Grameen Bank model for Ethiopia?

10.1 Grameen Bank (GB) in Bangladesh offers a highly attractive model for lending to large numbers of poor people, especially women from landless households. GB provides small loans to individuals who are members of groups consisting of five members. GB's lending rate is between 25% and 30%, depending upon certain assumptions. It is not necessarily a profitable bank, but its losses appear to be quite small. It is organized like a bank and follows banking practices.

10.2 Replication of GB has been attempted in many countries, but none appears to have reached the scale and scope of operations obtained in Bangladesh. It has attracted much international attention and people from many nations have witnessed its operations in the field during stays ranging from one week to three weeks or longer. An estimated 50 Ethiopians have visited GB in Bangladesh.

10.3 Replication is framed in terms of "the essential Grameen." This consists of an emphasis on women from very poor households, loan size and use determined by individual borrowers with the consent and support of their peers, the use of groups of five formed without outside intervention and "centers" consisting of six groups, weekly meetings of groups and centers, savings mobilization at each meeting, weekly loan installments, an expectation that each borrower will at some point buy one share of stock in GB, no training of borrowers in loan use, and a willingness to encourage borrowers to expand their visions and to express this through their groups and centers. GB loans are usually for one year. It is not clear if "the essential Grameen" includes a charismatic leader such as Md. Yunus in Bangladesh.

10.4 It is clear that "the essential Grameen" is distant from the Government of Bangladesh. Although the state was the sole shareholder initially, the Bank's management has always been fiercely independent. It has complete freedom in staffing decisions. Where the Government has leaned on it, the result has generally been to increase costs and reduce effectiveness. Examples include wage settlements that are imposed on an industry-wide basis in Bangladesh, and efforts to enlist GB's formidable management capacity to bail out government projects that have performed poorly, such as deep tubewells and shrimp farming, which resist being bailed out.

10.5 Could this system, or a coherent subset of these features, be replicated in Ethiopia?

Could this model effectively provide credit to farmers? If so, how could this be structured and set up in East Wellega?

10.6 GB in Bangladesh excludes farmers by defining its clientele as landless, which means landholdings of less than one-half acre or no landholdings at all. This excludes landlords, who control the power structure of many villages in Bangladesh. The Bank's loan repayment terms consist of repayment of principal in 50 weekly payments and payment of interest in two final, larger installments. This purposely and effectively excludes farmers, who generally want credit at planting time and have the funds to repay following the harvest.

10.7 In the few cases in which farmers are involved, token payments are made weekly and larger payments are made following harvest. A similar technique could be considered for Ethiopia, but it appears that the dynamics of weekly meetings would be constrained if everyone were on the same borrowing cycle and if repayments were trivial for most of the year. Other models that devote meetings to training employ a simultaneous borrowing cycle for all members. Important features of the group and center meetings are collection of savings, collection of repayments, and review and discussion of loan applications and proposals by group and center members. This mix sustains activity and enthusiasm through the year. Therefore, **replication among farmers would be difficult and problematic.**

Could this model be applied to agriculture input retailers?

10.8 Individual input retailers who also handle other goods throughout the year could be organized into borrower groups and centers along GB lines. Sales of goods other than agricultural inputs throughout the year would permit continuous saving and borrowing, enabling members to build their businesses generally while maintaining program momentum through all seasons.

10.9 Success would be most likely if these retailers were women who could spend several hours each week at group and center meetings. Men are also served by GB. Although they account for fewer than 10% of borrowers, they account for a much larger share of total loan volume, signifying that their businesses are considerably larger than those of women borrowers. Men are apparently less willing to collaborate intensely and to spend time at group and center meetings.

10.10 It would seem that the population density of Ethiopia, which is less than that of Bangladesh, could make it difficult in many locations to assemble centers consisting of self-selected groups of 30 borrowers engaged in agricultural input supply. (Centers might consist of only 15 members). There would be no reason to exclude other microentrepreneurs, however, who were willing to join and who could make repayments throughout the year.

10.11 GB field workers are assigned to cover centers, where they are involved in cash transactions, in training leaders elected by groups and centers, and in guiding or participating in the business of center meetings, which includes the review and discussion of loan applicants' project proposals. A bank worker in Bangladesh may cover up to three centers a day for as many as five days a week. They report to a zonal GB branch in a larger rural center. Bank workers often have college degrees (there is a surplus of graduates in Bangladesh relative to employment opportunities) but live in humble quarters in their work area and walk or bicycle to their centers. Their most distant center is not more than 90 minutes away by whatever mode of transport they use, i.e., walking or pedaling. GB makes huge investments in the training of its staff at all levels and uses a participatory approach that involves criticism of procedures and practices, through suggestions for improvement, by all staff. (This approach, in effect criticizing those in authority, could take some work to perfect in many countries). This has resulted in an unusual level of corporate introspection and a willingness to change practices and procedures frequently. A major example was an attempt to lend to collective enterprises, many of which failed and had to be abandoned by GB.

10.12 A project patterned on GB could easily be established in East Wellega. This effort could start by assembling all those Ethiopians who have visited Grameen Bank in Bangladesh and using a brain-storming approach for several days to define objectives and parameters for a project. Many of these Ethiopians are already involved in banking or in NGOs, representing a tremendous reservoir of relevant talent, interest, enthusiasm and practice. Whatever project approach or approaches appear feasible in East Wellega should be initiated on a small scale and in a flexible manner. Grameen started with groups of 10 and with procedures different from those it uses today. Significant changes could quite possibly be required in whatever arrangements would appear to hold promise for replication of "the essential Grameen" in Ethiopia.

10.13 Grameen Bank affiliates in Bangladesh provide training for those attempting replication, and this should be availed if a decision were made to apply the model in Ethiopia.

The government has also contemplated using regional development banks. How could this work in Ethiopia?

10.14 The case for a new institution should be made on the basis of the value that it can add, the debt capacity that it can create, the efficiencies it can achieve relative to existing lenders and what might be expected of existing lenders if efforts were directed at their improvement rather than toward the establishment of a new institution. From this perspective it is important to describe the objectives of the new institution and to explain precisely how it would achieve them.

10.15 Not much detail is currently available on any new institutions that may be under consideration by Ethiopian authorities, and therefore specific conclusions are also not possible at this time. An initial test of the willingness of CBE and DBE to innovate would be their implementation of profit center accounting for rural branches. This would gives these banks a more informed window on costs, creating opportunities for designing systems that would work for both outreach and sustainability. (Profit center possibilities are explored in chapter 12 of this report.)

10.16 The case for a new institution can also be made on its usefulness as a foreign exchange "earner," regardless of its performance as a lender on the assumption that official institutions tend to behave in similar ways in the long run, that is, by losing money. Therefore, the particular form may not be terribly important, as illustrated by the agricultural credit portfolio of the nationalized, commercial banks, the cooperative credit system and the regional rural banks in India. A new institution or institutional framework such as regional development banks would probably attract funds from donors that existing institutions might not be able to obtain so easily. The amount forthcoming would depend upon how well the newcomer could relate to donor priorities, which presently include emphasis on microenterprise lending and development in favor of the poor; enhancing the economic, social and legal role of women; and being kind to the environment. Credit programs that contain these elements should be good foreign exchange earners for Ethiopia if the institution's management is credible and the government commitment to the institution and its mission seems serious.

10.17 At their worst, these three donor priorities are merely modern versions of the tons of grain credit strategy. At their best, as exhibited in some microenterprise activities, they have a good chance of being brilliant creators of debt capacity among the poor. The trick for the local institution is to know the difference and to be able to manage the conflict without alienating donors or fouling relationships with its potential clientele of poor borrowers.

10.18 The challenge of an institution patterned on donor priorities is to maintain independence and a reasonable cost structure. An example of heavy donor efforts in micromanagement of imposed priorities is the innovative and quite successful Aga Khan Rural Support Program (AKRSP) in Pakistan. Equity among clients, villages and districts are priorities of the European and Canadian agencies that currently fund the Program, as are special activities for women. These are generally consistent with but only a small part of AKRSP's village development program.

10.19 AKRSP has managed to maintain considerable program independence and control of its costs in dealing with donors by reaching agreements with them to have joint monitoring missions. These replaced annual or more frequent supervision missions by each of a number of donors, which took up lots of management and

staff time throughout the year. Different donors supply different specialists to these annual joint missions. AKRSP's strong local board and support by the Aga Khan Foundation in Geneva are also important in managing relations with donors and in maintaining an independent planning and development agenda. (Grameen Bank has maintained considerable independence, relying heavily on the stature of its founder, who is the managing director.)

10.20 In spite of its independence and systematic approach, AKRSP agreed in the early 1990s to participate in a World Bank/Dutch-designed and -funded microenterprise credit project that is unlikely to be sustainable because of unrealistic loan maturities for borrowers and a strategy that trades off increased bad debt losses on small initial loans against the costs of carefully screening loan applicants. Survivors of the first round of borrowing who pay their loans on time will be eligible for larger loans, and so on. Those who do not are to be abandoned. This portfolio it likely to perform much below levels achieved by AKRSP on its own credit programs that have been carefully tended since the program's initiation in 1983.

10.21 The number of regions in Ethiopia and the corresponding number of regional development banks could discourage donors, but this might be remedied by a federal or central organization with some responsibility for the regional banks, their funding and technical support. Models include the US system of regional cooperative farm credit institutions including land banks, and the role of the People's Bank in overseeing provincial investment banks in China. (Even in the US, however, the cooperative farm credit system suffered a very large loss and subsequent reorganization in the 1980s, largely from misguided policies made centrally and in the political realm.)

10.22 Local boards of regional institutions in Ethiopia could operate within an overall framework of powers and limitations, and could also be free to solicit funds on their own. These sources could be located within their regions, people from the area living elsewhere in Ethiopia and even expatriate Ethiopians, possibly patterned on the highly successful system of selling State of Israel bonds to millions of Jews in the US. An early precedent is the Gurage Road Organization, and other initiatives have occurred with the formation of the regions and regional institutions.

10.23 Any new institution that wants to distinguish itself from the existing financial system has to create a separate identity. Its branches should not look like those of CBE and DBE, its systems of reporting and responsibility should be different, and staff incentives, deployment and work rules should not resemble those of CBE and DBE. Unless significant breaks with tradition are made, the new institution will probably have or will probably develop cost structures similar to those of these two predecessor institutions, in effect inheriting their problems in working

with small farmers and other poor people. Not many percentage points reduction in bad debt losses can be achieved by ethnic loyalty alone.

10.24 Grameen Bank is an excellent example of an innovative institutional mission and format in a country with a nationalized commercial banking industry that is one of the worst in the world by the usual standards of commercial banking performance. The importance of a fresh vision and a fresh start is demonstrated by Grameen Bank. BancoSol in Bolivia is also significantly different from the traditional commercial banks in Bolivia, which are reasonably good by Latin American standards of banking performance. The regional rural banks in India, by contrast, are much like the nationalized and cooperative banking system's rural operations, characterized by a few brilliant performers but also by massive political interference, large bad debt losses overall and other inefficiencies that are system-wide.

What are the pros and cons of a regional or federal model?

10.25 The advantages of a decentralized financial system include responsiveness to local priorities, opportunities and values, involvement of more people in the management and direction of financial institutions, more rapid decision-making, scope for innovation that might not be forthcoming from a monolithic or centralized financial system, and the development of market niches that have the potential greatly to reduce information and administration costs and to manage risk better. Effective decentralized financial institutions also can enhance investment in the areas in which they mobilize funds, creating debt capacity that would be unlikely to materialize with highly centralized national institutions.

10.26 The disadvantages of a decentralized system can include loss of economies of scale, "borrower domination" or capture by a small local elite for its own interests, insufficient numbers of local people trained in finance and banking to master decentralized management, concentration of risks and limited capacity to fund large projects. Some critics add that a decentralized system is difficult to regulate and supervise, but this may be a mixed curse or blessing depending on the nature, quality and efficiency of banking regulation and supervision (see Chapter 2). The problems of scale economies and lending capacity can be partially remedied through links with other banks or participation in a federal system.

What other models might be appropriate for Ethiopian conditions: e.g. rural credit unions, saving and loan associations, rural/community banks?

10.27 Rural credit unions take quite a while to develop aggressive credit programs. They typically begin by saving, which may continue for several years before any

loans are issued. The accumulation of savings can create "ownership" and a sense of accomplishment.

10.28 Their specific structure makes credit unions attractive in certain respects. Objectives, governance, functions and operations conform more or less to a worldwide model. This provides certain assurances that many NGOs cannot provide - although large international NGOs tend to develop their own models. However, credit union performance has a patchy history.

10.29 Once credit operations are underway it is important to ensure that credit unions do not become borrower dominated, which may compromise the interests of savers looking for a sound institution in which to place their funds at attractive rates of interest. Lending limits and realistic interest rates tend to reduce borrower domination. Some researchers have recommended that only net savers be entitled to vote in credit union elections and general meetings, i.e., that net borrowers' voting rights be suspended, and that key committees contain a majority of net savers. This potentially robust structure is not consistent with cooperative principles and has not yet been embraced by credit union promoters or tried on a significant scale.

10.30 Rural credit unions might be based on iddirs, which have a savings agenda for long-term purposes of service to members. Credit could be introduced gradually after a special fund is initiated and built up that would in effect become the credit union. A major question would be whether the addition of a credit union would compromise the operations of the iddir, and how the iddir and the credit union might eventually attain separate identities.

10.31 Savings clubs for farm input purchases are discussed in chapter 4 of this report and may hold promise for introduction in Ethiopia.

10.32 The Philippines and Ghana are the two developing countries with the most extensive systems of rural banks. These appear to have performed better in the Philippines than in Ghana, although in each case a number have failed or become illiquid. There were once more than 1000 rural banks in the Philippines and about 125 in Ghana.

10.33 The Philippine model was based on capital provided by the government in the form of preferred stock and by private investors from the area in which the bank was located. The government's participation enabled the Central Bank of the Philippines to regulate the rural banks very closely. The Central Bank was a very efficient gatherer and analyzer of data and an effective watchdog over the actions of rural bankers. The private investors tended to be relatively wealthy by rural standards, including large landowners, rice millers, traders and professionals such as medical doctors. The question for many of these investors was whether they could make more money as rural bankers than they could from lending

informally. Government capital and the ability to mobilize savings made the opportunity attractive, and many rural banks perform extremely valuable services for their rural clientele.

10.34 The rural banks did well initially in the 1960s and 1970s. Later, they suffered greatly from the imposition of a large government program that attempted to use credit to increase rice production. This program was inspired by several bad years including devastation by a typhoon. It involved the national staple grain and was implemented while the Philippines was under martial law. A number of rural banks collapsed as a result of their participation in this program which could not be considered wholly voluntary, and only about 135 rural banks were considered in good condition as the program unwound under the weight of its own failure.

10.35 As with other credit programs, the experience with rural banks appears to be that the particular form of the lending institution is not a significant factor in its performance when government, or possibly donor, priorities are imposed.

10.36 Community banks, as supported with USAID assistance in Latin America, are a newer development. Their experience appears to be quite varied and little data is available to paint a comprehensive picture of their financial performance and condition. The concept of a simple form of village intermediary that could be run largely by villagers, with some outside assistance and guidance, is attractive and has also animated the promotion of credit unions by donors.

10.37 Attempts by local people, using their own funds, may provide the best indicators of what may or may not work in a given society and economy.

It is difficult to predict the applicability of different models to Ethiopian conditions. Many models have had patchy performance histories in the countries in which they were originally developed and all have encountered difficulties in replication elsewhere. Those that have worked well in one country have not worked well elsewhere, and the reasons for lack of replicability are not clear.

10.38 The village unit model developed by the Bank Rakyat Indonesia (BRI) has performed very well, on a large scale and for a number of years. It consists of small, low-cost branches, having a minimum of three staff members engaged in the business of banking; services designed in response to the ways in which local people save, borrow and transact; and organized along traditional commercial banking lines. This model deals with individuals, not groups. It does not necessarily reach the very poorest, but it does serve large numbers of villagers and is an important part of the village economy. It also is profitable and therefore commercially sustainable. In fact, the village units are the most profitable part of BRI, which is a very large bank. Because it is based on good banking practice it is probably the most replicable model. Best practice is widely known internationally, and where it is not information on what constitutes best practice

can be easily accessible. However, this model has little romance and glitter and does not appeal to the group-based emphasis of many donors.

10.39 Replication of this model, taking banking to the people, would require a greatly different style of banking than found in many developing and developed countries, especially where banks are state-owned. It requires good management and attention to detail. It also requires a continual quest for economy. It requires innovation and attention to building relationships with clients. Banking at this level must be part of the village as well as part of the financial system. to become part of the village it must serve a majority of the households in the village. This model is explained in Richard H. Patten and Jay K. Rosengard, *Progress with Profits: The Development of Rural Banking in Indonesia. Ian Francisco: IS Press, 1991.*

An investment in good banking practice, as demonstrated by the village units of BRI, appears to offer the best scope for long-run sustainability. Replications should be attempted in Ethiopia.

What would be required, in terms of time, funding, changes in legislation, etc., to set up these different types of institutions?

10.40 Establishment of village units by a commercial bank could be undertaken under existing legislation. Credit unions as described above would be broadly consistent with present legislation. The other models would require special acts for specific institutions, such as the present DBE and CBE charters, or proclamations permitting business to be conducted according to the parameters of the model being adopted.

11. NGOs

There are numerous NGOs in Ethiopia offering credit; some also have savings activities. Each has its own philosophy and its own approach to credit. ACDI/CEE recommended that the Government develop national standards for NGO programs, including use of market interest rates, mandatory development of a savings component and others.

Would national standards be useful? If so, what should they include?

11.01 The ACDI/CEE Report, "Ethiopia: Rural Finance and Microenterprise Assessment - Final Report," July 1995, includes a valid list of common shortcomings of NGO financial services and a strong plea for the application of sound banking principles to such activities in Ethiopia. These are reproduced as an appendix to this chapter. The observations given below attempt to offer a framework for evaluation of the ACDI/CEE recommendations and for the development and application of nonbank lending standards generally.

11.02 There are more than 30 NGOs offering credit in Ethiopia. Approximately half are international NGOs, while the remainder are local. Their activities are concentrated primarily in urban areas.

11.03 Objectives and national standards for NGOs. The usefulness of national standards should be examined against objectives. The objective of getting the money out in response to an overwhelming sense of urgency, based on concern for stunted or dying babies, women's role as beasts of burden, and unemployed men, would seem to favor an open-ended approach. The more NGOs that want to participate the better, with any feasible model acceptable if it responds to the perceived crisis or overwhelming sense that something must be done.

11.04 If the objective is to use NGOs to create sustainable rural financial systems, selectivity is more important and standards may appear to be desirable. NGOs that provide financial services but which fail within a reasonable period of time to develop sustainable systems, defined as achieving full cost recovery for financial services and the overhead costs of their provision, may be perceived as not having the desired long-run developmental impact but rather creating dependence and rent-seeking, tolerating inefficiency and wasting resources.

11.05 Donors and standards for NGOs. Most large NGOs are donor-funded and most donors have adopted policy stances that include development of sustainable financial systems that would continue to serve the clients of the NGOs they fund. These clients usually consist of microentrepreneurs, poor women, and small farmers. The natural and ideal situation would be for donors to exercise discipline

in pursuit of their objectives, applying performance standards to the NGOs they fund. This would enable donors clearly to measure performance against objectives.

11.06 NGOs that want to provide financial services but that fail to create sustainable systems should be abandoned by donors, or their programs should be reshaped to eliminate elements that do not contribute to the sustainable provision of financial services. Many donor-funded NGOs are international in scope and have used donor funds for a number of years. Donors could quickly acquire sufficient information from the operations of these NGOs in a number of countries. This information would put donors in a position to evaluate the performance of different models and different NGOs.

11.07 For a variety of reasons, donors have accumulated relatively little hard information on the contributions made to sustainable finance by the NGOs they support. This is demonstrated in the ACDI/CEE Report by Annex X, "Summary of Relevant Successful Programs in Other Countries." Data are partial, not comparable across institutions and not sufficient to provide a complete picture. BancoSol is the most fully documented, reflecting its status as a commercial bank and the relatively good performance of banking regulators in Bolivia. This observation is *not* meant in any way to suggest that the ACDI/CEE report is deficient: the sources cited in the references section of Annex X contain some of the best data available and reflect donors' data demands on the NGO credit operations they fund.

11.08 Measurement tools for evaluation against performance-based standards. Hard information on the performance of a financial intermediary consists of a) detailed financial information on credit and savings activities, b) assembled using accounting conventions and standards generally accepted businesses in donor countries, c) presented in customary formats for commercial activities (i.e., income statements, balance sheets and sources and uses of funds statements, with accompanying worksheets or break-downs), d) accompanied by opinions and long-form reports by accredited independent auditors, e) published and f) made available to anyone requesting this information. Such data should be available for each national or regional program funded by every donor and using large NGOs. In other words, there should be page after page or screen after screen of performance data by NGO, model, clientele, country and year.

11.09 This information would have to include full disclosure of all relevant details, the most important of which are summarized by the CAMEL system of bank and credit union examination used in the US: Capital adequacy, Asset quality, Management, Earnings and Liquidity. The performance of the loan portfolio would be transparent, as would be program delivery costs and trends in key indicators.

11.10 Small NGOs and those for which credit is only a small and possibly dispensable part of their programs could not be reasonably subjected to the same reporting standards as those that specialize in credit. Compilation of financial information is costly, and small operators with simple programs should not be required to provide the same level of detail as larger ones. Different levels of disclosure are appropriate for different NGOs.

11.11 Standards cannot be meaningful unless data are available to permit comparisons between standards and performance. Without such comparison, standards are a waste of time. Adoption of standards implies a serious commitment to monitoring and evaluating performance, which is costly. The introduction of standards should be accompanied by budgets and systems for measuring performance.

Standards are not meaningful without data on performance. Data on performance are costly to collect and analyze. Therefore, standards should be supported by budgets and plans for monitoring and evaluation. Standards should promote transparency so that experience can be used to improve performance. Transparency is assisted by accounting policies and principles and full disclosure.

11.12 National standards and data bases. In view of donors' lack of incentives to gather financial information adequate for definitive analysis of progress toward the sustainability of their interventions in finance, and the consequent lack of detailed standards, should the governments of recipient countries be encouraged to obtain such data through the definition of standards and the establishment of reporting requirements?

11.13 Considerations in formulating a response to this question include: impact on the flow of funds, the role of diversity in innovation, costs of compliance, scope for rent-seeking and uses of data obtained.

11.14 Impact on the flow of funds: Would national standards accelerate or restrict the flow of credit to rural areas, microentrepreneurs and the poor generally?

11.15 Standards that are too restrictive and that absorb too much bureaucratic time, through having to obtain approvals and providing excessive amounts of information, would restrict the flow of funds.

11.16 The more diligent the regulation and the more comprehensive the regulations, the greater the costs and delays that can be expected. Standards can be expected to diminish the flow of funds for the poor.

11.17 Governments often use some sort of standard to attempt to control NGOs that are regarded as unfriendly. Examples include mistrust of foreign evangelical Christian NGOs in Moslem countries, fundamentalist Islamic organizations in

moderate Islamic countries, other groups that are suspected of espionage or other seditious activities, etc. In general governments faced with these concerns have other means of obtaining information and of protecting themselves against any NGOs that appear particularly threatening. National standards of the type discussed here should not be framed to deal with this type of problem because inclusion of measures to deal with these unusual problems would impose costs of all NGOs, including well-known international NGOs and others which are not threatening.

11.18 NGOs are often critical of government. Where democratic procedures are repressed, NGOs are most likely to take on political overtones. NGOs that are value-driven will tend to be critical of government policies that NGOs perceive to be in conflict with their values. Standards imposed by governments are likely to make it more costly for NGOs to be critical.

National standards are likely to restrict the activities of NGOs.

11.19 The role of diversity in innovation: Would national standards stimulate experimentation and the development of alternative models, or would their application tend to nudge programs toward a uniform pattern?

11.20 Credit programs provided by multinational NGOs are developing rapidly in many countries, predominantly because of donor funding. In addition there are even more national NGOs in developing countries, each with its own specific aims and objectives that determine the content of its credit program. The NGO world is diverse. It may continue to develop new approaches to credit provision and delivery systems, or it may tend to move toward certain models, in much the same pattern found in other industries. For example, in the early part of this century there were more than 200 manufacturers of cars in the US. Now there are only three domestic makers of any significance, the result of competition and economies of scale. Would government controls applied at an early stage have produced a better car at a lower price? The most useful standards that contribute to development appear to be created by development rather than to initiate development.

11.21 However, starting an NGO is a relatively simple matter, and economies of scale are not entirely obvious, so their numbers are likely to remain large even if their credit models come to resemble each other over time. There is already an effective communications network among NGOs, usually provided by or funded by donor organizations. This permits rapid communication of best practice and information about things to avoid, even if it fails to communicate much commercially useful financial data. It also permits NGOs rapidly to adjust their programs to appeal to donor whims or priorities. For example, credit unions in developing countries have always made small loans, many to small businesspersons. As donor enthusiasm for supporting the establishment of credit

unions faded, credit unions responded by portraying themselves as providers of microenterprise finance, which is currently a dominant program theme in development assistance.

11.22 National standards would ideally encourage diversity and experimentation because there are no standard models developed to date in any country that have been successfully and widely replicated in other countries. This suggests that the conditions and methods required for success are not known in detail -- each relatively successful NGO credit program seems to be the creature of its own creation, or sui generis (see Chapter 11). This in turn implies that the discovery of successful models for Ethiopia will have to include dimensions that are uniquely suited to Ethiopian conditions and opportunities.

11.23 From this perspective, any national guidelines that are developed should be quite general with respect to approaches. They should also be highly specific about the requirements for sustainable provision of financial services, which are widely known and commonplace in commercial lending. Fundamentally, revenue should cover costs, including the costs of risks that can reasonably be expected to occur. Capital should be accumulated to cushion shocks and to give comfort to creditors, such as depositors and other lenders (paras. 9.12 ff). Achieving commercial levels of operation takes several years. (New banks in the US, for example, generally do not expect to be profitable before their fifth year of operation.)

11.24 Should NGOs be tolerated that are not interested in, or that after considerable period fail to achieve financial viability as lenders? This is a key policy decision if a national policy is in order (which it may not be). On the one hand, such NGOs could get in the way of implementation of a policy of financial development. They could also be a threat to any poor people or others who place deposits with them unless such deposits were protected from the risks of poor lending performance and high overheads. (Protection could probably be arranged through escrow arrangements and by placing these deposits in separate bank accounts, as discussed in paras. 4.02 ff). On the other hand, there will be a lot of poor people around for a long time, and sources of charity that seek to improve livelihoods should not be discouraged.

11.25 One means of reconciling these concerns would be to assume that because of its poverty and other features that make Ethiopia attractive to donors and private charity from abroad, the strategic trick is to entice some portion of this annuity from the rest of the world into systems that serve the very poor. Here it could be useful to encourage NGOs to use their sources of foreign funds to build capital positions. This would diminish the risks to depositors and others who fund them on grounds other than charity, and it would provide a source of free money that could be invested to earn income that could be employed to help meet overheads and to expand support to the poor.

11.26 If any formal financial institution, either existing or newly formed, decides to lend to NGOs to support their credit operations, national standards may in effect be set by this institution or these institutions. In this case, entry or eligibility standards would be required to establish the seriousness of NGOs requesting funds. Measures to manage risk of default by NGOs would also be required. Finally, those NGOs that fail to perform well as lenders would have to be subjected to exit procedures.

11.27 A system was designed by the World Bank, but never implemented, that sought to achieve these objectives while protecting the financial integrity of a foundation that was established in a poor country to lend funds to government programs and to domestic and international NGOs that on-lend to the poor. Features of this system included scope for assisting many different models of lending to the poor and entry, exit and risk management procedures based on:

a) simple performance-based eligibility standards for NGOs and government lending programs;

b) identification of small borrowing units in government programs or NGO operations that would be used to determine performance and continued eligibility to borrow from the foundation. This would permit the foundation to exclude poorly performing borrowing units within a large program, because it would be in practice impossible to cut off funds entirely and all at once to a government program or to a large and prominent NGO;

c) initially modest assistance increasing at a specified rate from year to year depending on the performance of government programs and NGOs using the foundation's funds;

d) specification of performance standards based on recoveries of funds on-lent to poor people and on repayment of amounts due the foundation. Short maturates offering negligible float were specified on loans from the foundation so that any repayment problems encountered by government programs or NGOs would be quickly apparent;

e) alternative ways for NGOs and government programs to remain clients in good standing if they suffered reverses that could reasonably be expected to occur in lending to the poor. These alternatives included rescheduling formulas, capitalization requirements and graceful exits through declining access to funds if the NGOs or government programs proved inept at managing lending risks.

11.28 Considerations underlying these criteria were that NGOs are in abundant supply in poor countries, that many models may hold out a promise of success, and that lending quality and other dimensions of financial performance are the best guide to identifying workable models and to protecting the funds of the apex lender that was to have been supported by the World Bank. Details are found in J.D. Von Pischke, "The Exit Problem in Credit Projects" *Small Enterprise Development. Volm 3, No. 4, 1992.*

Standards devised by lenders to NGOs may be more conducive to the encouragement of sustainable behavior by NGOs than standards devised through political and bureaucratic processes.

Standards could easily hinder innovation in efforts to provide financial services to the poor.

11.29 Regardless of pleas and good intentions, the effect of standards and regulations tend to confine, to reduce diversity and to be administered using a one-size-fits-all approach, which protects the regulator from criticism and difficulty. The costs of standards and regulations are seldom considered fully in advance. Once in place, standards and regulations are difficult to dislodge and create a constituency, based to some degree on rent-seeking, for their continuation, extension and refinement. In the process, regulators are of ten captured by those regulated.

11.30 Costs of compliance: Could national standards be administered in a cost-effective way? Would they unduly divert NGO energy into bureaucratic paperwork and away from interaction with target group?

The information required to measure performance against standards should be specified clearly and carefully. The costs of data assembly should be estimated in advance and calculated in practice.

11.31 The probability of rent-seeking in donor supported activities is material, especially when a program says it is helping the poor and is supported by a powerful constituency or an inattentive or only partially attentive funder. There appears to be no particular tradition or value in Ethiopia (as in many other countries, highly developed and less developed) that would greatly discourage rent-seeking behavior. For this reason, the context in which standards are devised and administered needs to be carefully considered. The best enforcers are likely to be local entities with funds at risk through loans to NGOs or other programs lending to the poor, and with incentives to ensure that these funds are used wisely. Oversight by a government commission, ministry or department would not appear likely to be effective based on the information available, which is not complete.

11.32 Uses of data obtained: What would data be good for? How would they be used to refine performance? Is an official institutional capacity likely to exist that could analyze data meaningfully? Is data likely to be used for rent-seeking purposes?

11.33 Each piece of information that would be requested should be based on a specified need to know. Commercial accounting standards as practiced by lending institutions and regulators in the US, for example, should be applied to the determination of performance. Any financial data obtained from NGOs or similar

lenders should periodically and promptly be made public, available to anyone who asks for it.

Data required in response to standards should be based on a need to know and should be made public.

Are they necessary for the healthy development of rural financial markets in Ethiopia?

11.33 NGOs can be useful, but their ability to create sustainable systems has not been widely and consistently demonstrated and is problematic. Their promotion worldwide or vehicles for financial development should be treated cautiously and with some skepticism. Much more attention should be devoted to measuring their financial results.

Standards create scope for unproductive behavior, which should be measured against the actual benefit of standards. Standards arising from commercial practice and incentives are likely to be less costly in this respect.

Uniform Standards for Rural Credit Schemes

as proposed in

"Ethiopia: Rural Finance and Microenterprise Assessment - Final Report"

by Agricultural Cooperative Development International
and Corporation of Ethiopian Entrepreneurs
and submitted to the
United States Agency for International Development
Addis Ababa, Ethiopia, July 1995
(excerpted from pp. 50-51)

The Government needs to negotiate uniform standards for NGO rural credit schemes. The proper development of a country's financial system is extremely important for overall economic development. Financial schemes and institutions that do not follow sound, sustainable financial principles, and facilitate real community economic growth, may cause more harm than good.

Although the social goals of NGO rural credit schemes are laudable, they frequently dominate the direction and operation of scheme. Any lending scheme must be designed to be self-sustaining. Achieving financial break-even within a reasonable period of time must be the primary objective. If the institution wants to achieve additional social goals, these can be served by non-financial programs in literacy and business training, child care, and vocational skills training.

The most common causes of NGO credit scheme failures are as follows;

- Real effective interest rates and fees do not cover the true cost of capital and program operations, the inflation rate, a realistic loan loss reserve, and at least a modest return on assets;
- Sound lending and collection policies and procedures have not been developed or are inconsistently or inadequately applied;
- Sufficient systems are not in place to verify borrower integrity and business skills;
- Lending is based upon NGO staff perceptions of borrower needs, rather than on sound credit analysis;
- Loan terms do not reflect borrower repayment capacity, i.e., production/sales cycles and cash flow;
- Loans are provided without serious expectation of repayment and a realistic system for collecting delinquent loans:
- Loans decisions are made based on inaccurate market or source of supply information;
- Risk in loan portfolio is insufficiently diversified by location, type of business activity, number of borrowers, or aging of loans;
- Loan security or collateral is either not required, or if required, not exercised upon default;
- Loan size is inappropriate for the borrower's income -producing opportunity; and
- Loans are granted to staff friends, relatives, or influential community leaders whom staff are reluctant to press for collection.

Credit schemes that do not follow sound banking and business practices not only are not sustainable but actually do a disservice to the borrowers and the community by distorting the efficient allocation of scarce financial resources in the local economy. Credit schemes must follow banking fundamentals to

avoid distorting the local credit market, filling borrowers with false expectations, and lowering aggregate credit supply.

Sustainable financial institutions have certain basic characteristics and follow the same banking principles throughout the world; regardless of the market or customers being served. Any type of banking can be profitable and sustainable where sound banking principles are followed. Financial institutions and schemes that place certain social or political goals first, while ignoring or inconsistently applying banking principles, will be neither sustainable, economical to operate, nor independent, and are likely to distort the financial marketplace in which they are operating. The government should develop a working group to draw from all rural credit schemes to develop and agree to a charter of sound banking principles that all schemes must follow in order to operate in Ethiopia. These principles should include:

- No direct or indirect subsidies,
- A primary emphasis on saving mobilization and local capital formation,
- Market rates of interest on savings and loans,
- Loan packaging based on projected cashflow,
- Small, short-term working capital loans for new borrowers,
- Lend only to depositors,
- Lend only to existing businesses, however modest,
- Penalties for late loan payment,
- Collateral or guarantee collection upon default,
- Performance-based incentives for staff, and
- Accounting of all administrative expenses.

To be sustainable, NGO rural credit schemes require considerable capital contributions and saving from the community, and from the users themselves. Hence, the NGO rural credit schemes must be allowed to mobilize deposits as banks do. However, responsibility for solvency of the institution and protection of depositors' funds must be addressed at the national banking policy level and by bank supervision and regulatory functions of the national bank.

12. Using Accountability to Refine Policy, Strategy and Project Design

ACDI/CEE recommended that target DBE and CBE branches operate as autonomous profit centers on an experimental basis. Do current legislation and regulations permit this?

12.01 Current regulations and legislation permit banks to determine their own management information systems provided that they can provide data required by the Bank of Ethiopia in its capacity as banking supervisor.

Are DBE, CBE and the Government willing to undertake this kind of experiment?

12.02 DBE has already begun to decentralize its activities and to evaluate branches on the basis of their profitability. Each branch has been assigned loan approval limits. In coffee areas these include limits on coffee processing loans of up to Br 2.5 million. Br 500,000 approval limits on loans to individuals have also been established for some branches.

12.03 DBE has established billing systems so that branches are charged for services rendered by head office and vice versa. DBE branches are expected to submit annual and quarterly budgets, with progress measured against annual budgets and quarterly review meetings to monitor performance and initiate corrective action.

12.04 Profit-center accounting is therefore partially established within DBE, and the management is willing to develop this system further.

12.05 CBE has similar lending limits, reporting and review requirements. CBE is in principle prepared to undertake experiments in decentralized, profit-center accounting.

12.06 The Bank of Ethiopia represents the Government in this sphere and has no objection to experiments of this nature that might be undertaken by DBE and CBE.

12.07 An important element in the design and implementation of decentralized profit-center systems would be to ensure that measures of portfolio quality are calculated by the profit center. These would include, for example, monthly ageings of arrears and quarterly or more frequent classification of problem loans. These are now done centrally in conjunction with the annual closing of accounts and audit. Criteria for ageing and for classification may have to be revised in order for profit center accounting to be meaningful. Profit center accounting works best where

managers have incentives to control costs and increase revenues. Systems should be reviewed to ensure that adequate and appropriate incentives are provided.

Is East Wellega a useful test site?

12.08 East Wellega presents a reasonable test site, handicapped only by the small number of branches that could be included. The CBE branch in Bako would be the only one active in the two woredas proposed for consideration under the project, and the DBE branch in Nekemte would be the only DBE candidate. The CBE branch in Nekemte does almost no agricultural lending, and the DBE has no other branches close to Gubu Sayo and Sebu Sire woredas. Each of these branches has manual accounting systems.

Profit center accounting is a very useful element in the effective administration of a loan portfolio and for the responsive management of a bank branch. Profit center accounting, including loan performance criteria and incentives to branch management, could usefully be included in any rural finance program initiated in East Wellega with donor assistance.

ACDI/CEE recommended that CBE and DBE consider using mobile agents to provide banking services in remote areas. What has been DBE's experience with mobile banking?

12.09 DBE has two mobile offices obtained under the IFAD line of credit for drought affected areas. These offices were made by customizing trucks. They were envisaged as sub-branches with their own managers, loan officers and other staff. They were placed under the Administration Department of DBE.

12.10 These vehicles have been used only for collection of loan applications and for following-up fertilizer loans issue by certain branches. Branches request mobile assistance when they are short of vehicles or during peak periods of fertilizer distribution and loan collection. In the off-season, the vehicles are idle. Staff consists of a loan officer and a driver.

12.11 These vehicles have been used more as means of transport than as banking centers. They may have reduced costs, enhanced loan recoveries and helped in the provision of more efficient services to clients. However, DBE experience does not include mobile banking in the usual sense of the term, which involves the conduct of branch banking at different locations at different times using a vehicle to transport staff, cash, stationery and records to and from mobile banking sites according to a fixed schedule of rotation.

How has this model worked in other countries?

12.12 Mobile banking has been effective in other countries when the banking system has wanted to obtain additional deposits or to obtain additional transaction fees, or when influential clients have been able to persuade their bankers to provide mobile services in connection with large payments.

12.13 Mobile banking was used in Malawi by a new bank, for example, that was hungry for loanable funds. That bank was willing to pay the extra expenses of mobile units in order to obtain deposits. Mobile banking services in Kenya and Ireland utilize offices that are open only one or two days a week. In Kenya these are often open on market days. In Ireland credit unions have collection routes through rural locations once a week where a van stops and the driver conducts transactions. In Pakistan the Aga Khan Rural Support Program has persuaded its bankers, with which it holds large balances, to make loan disbursements for the Program at rural locations on specified days several times a year. These involve relatively large amounts distributed to many borrowers. The bank operates as a paying agent for this purpose. Similar arrangements existed in Kenya for quarterly payments to smallholder coffee growers prior to the advent of the Cooperative Savings Scheme in the early 1970s. It was discontinued with the opening of savings accounts accessible six days a week at coffee cooperative union offices in district towns.

Has this model been cost effective?

12.14 The model can be cost effective if the transport costs are relatively low while the return on additional deposits (as in Malawi) or from transaction fees (as in Kenya) are relatively high. As banking systems have become more liquid or staff costs have increased in certain countries, mobil banking has been cut bank (in Kenya) or discontinued altogether (in Malawi). The model is not suitable where security problems are serious, because of the cost of multiple guards and the threat to bank staff.

12.15 DBE's use of mobile officers reduced clients' transaction costs and shortened the processing time for fertilizer loans. No estimates are available of costs and benefits to the various parties concerned.

How could mobile banking be structured to work in Ethiopia?

12.16 Mobile banking could be used in the proposed project area to test the concept and to ascertain its costs and benefits. As indicated above, the relationship between

costs and benefits is least likely to be attractive when the banking system has a relatively low loan-to-deposit ratio.

12.17 Formal banking services do not exist in the eastern portion of East Wellega as there are no bank branches between Nekemt and Bako, although there are several market towns along the main road. Mobile banking could be attempted by establishing a route from Nekemt. to Sire, or beyond to the east if security conditions permit. Weekly banking points could be established near markets on market days, possibly with stops at MoA or cooperative offices. These offices would primarily process cash transactions including remittances. They could get involved in credit decisions gradually in response to interest and repayment performance, possibly beginning with monthly loan application and review by a traveling credit officer.

12.18 The DBE pattern of providing mobile assistance to additional locations at peak periods could be continued and enhanced. Vehicles might be rented for this purpose in order to avoid the overheads of idle vehicles. In Moscow, for example, buses with most of the seats removed are used as foreign exchange offices near Red Square.

12.19 If these services proved beneficial they could be expanded to areas off the main roads. This could require four-wheel drive vehicles.

12.20 As DBE plans to discontinue its activities as a supplier of seasonal finance to small farmers, CBE would be the primary candidate for the introduction of mobile banking. Private banks might at some point enter this activity, but would be unlikely to do so while the banking system remains highly liquid with a capacity to lend that significantly outstrips loans outstanding.

Mobile banking services could be introduced and their feasibility tested in the proposed project area along the main road from Addis Ababa to Nekept, security permitting.

ETHIOPIA RURAL CREDIT

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ETHIOPIA RURAL CREDIT

LIST OF PERSONS AND ORGANIZATIONS CONTACTED

Agricultural Inputs Supply Enterprise

- Ato Belissa Gobosho. Head, Sales and Distribution Department

Awash International Bank

-Ato Bulcha Demeksa. Chairman and CEO

-Dr. Lakew Alemu. Manager, Business Development Department

Bakanissa Gambella Service Cooperative

-Ato Birhanu Oli, Chairman

-Ato Teferi Kanno, Secretary

-Ato Senbeto Faissa, Vice Chairman

-Ato Dibissa Galeta, Treasurer

-Ato Tesfaye Abate, Member

Burka Gudina Service Cooperative

-Ato Garemu Gutu, Chairman

-Other members of the Executive Committee

Chari Farmers' Service Cooperative

-Ato Jirata Olana, Chairman

-Ato Wako Negassa, Secretary

-Ato Garomsa Ifa, Treasurer

-Ato Baissa Deressa, Bookkeeper

-Ato Mamiru Memberu, Member

Commercial Bank of Ethiopia

-Ato Eshetu Fantaye. Manager, Planning and Business Development Division

- Ato Abreham Haileyesus. Head, Rural Credit Department

-Ato Kabeta Barkessa. Regional Loan Officer, Western Region

-Ato Olana Agaa. Manager, Nekemte Branch

Corporation of Ethiopian Entrepreneurs

-Ato Debebe Habte-Yohannes. Chairman

Development Bank of Ethiopia

-Ato Moges Chemere. A/General manager

-Ato Belay Egigu. Extension Team Leader, Cooperative Promotion and Agricultural Development Department

-Ato Ketema Damte. Head, Ambro Branch

- Ato Yewondwossen Teshome. Manager, Nekemte Branch

Ethiopia Amalgamated (Ltd.)

-Ato Gebrewold Lemma. Directory Branch Operations, Control and Coordination Department

-Ato Mengistu Kebede. Manager, Agricultural Inputs Divison

Ethiopian Evangelical Church Mekane Yesus, Central Synod

- Ato Debella Kanaa. Project Coordinator

Institute of Agricultural Research, Bako

-Ato Yohannes Gojam, Center Manager

-Dr. Benti Tolessa, National Maize Research Coordinator

-Ato Mulugeta Kebede, Technial Coordinator, Animal Production Unit

-Ato Abubajar Hussen, Head, Extension Resarch

-Ato Abdissa Gemeda, Head, Agricultural Economics Division

Institute of Development Research. Addis Ababa University

- Dr. Dessalegn Rahmato. Research Officer

International Livestock Research Institute, ILRI

-Dr. Sarah Gavian. Socio-economist

Ministry of Agriculture, Region 4

-Ato Wolensu Rebu. Cooperative Promotion Team Leader, Cooperative Promotion and Agricultural Development Department

- Ato Wagshum Gurmessa. Development Agent, Gobu Seyo District
- Ato Sadeta Sibu, Cooperative Promoter, Gobu Sayo District
- Ato Assefa Gemetchu. Development Agent, Sibu Sire District

National Bank of Ethiopia

-Ato Abate Mitiku. Head, Cooperative Development Division, Savings and Credit Cooperative Development Office

-Ato Berhane Tesfaye. Manager, Savings and Credit Cooperatives Development Office

-Ato Eshetu Erana, Manager, Department of Legal Services

Oromiya Agricultural Development Office

-Ato Mitiku Wakgira. Head, Nekemt
- Ato Furgassa Badhadha. Deputy Head
- Ato Hailu Gabre. Head, Cooperative Promotion
- Ato Mitiku Gobena. Head, Planning Department
- Ato Abera Geyessa. Head, Input Distribution and Credit Department
-Ato Broock Challa. Extension Expert, Nekemt

Redd Barna-Ethiopia

-Ato Hailu Wondafrash. Program Consultant

Relief Society of Tigray, REST

-Ato Kidane Wonde. Project Coordinator

Sasakawa-Global 2000

-Ato Takele Gebre. Project Coordinator
-Dr. Marco Quinones. Advisor

VOCA/Ethiopia

- Ato Werqu Mekasha. Country Director

ETHIOPIA RURAL CREDIT

USAID Financial Sector Development Project
Delivery Order 26

SCOPE OF WORK BREAK OUT

Consultants' recommendations must be clear and prioritized in order of importance or logical sequence, and in order of probable cost effective impacts. Any training recommended requires specific descriptions of the areas and institutions that would be supported and topics and activities to be included in the training. No technical assistance should be recommended unless requested by the agency(ies) for which the TA is recommended. TA recommendations should include a detailed description of objectives, the skills to be transferred to Ethiopians, and levels of effort.

The consultants' report should cover the following 12 topics:

1. Legal and Regulatory Framework

What are the legislative and regulatory prerequisites for developing sustainable rural financial markets in Ethiopia? Identify the requirements and institutional configurations for establishing and sustainably running non-bank financial institutions:

Credit and savings activities,
Savings and loan activities in the existing cooperative system, and
Grameen-type savings and lending organizations
Community or rural banks in Ethiopia.

Make practical and implementable recommendations..

2. Regulatory Institutions

For rural banking to develop and flourish, regulatory institutions must be capable of interacting with an increasingly complex rural financial system. They must therefore have certain skills and resources.

Does the National Bank of Ethiopia (NBE) have the institutional will and capacity to undertake changes and experimentation in rural banking?

What specific investments and operational changes are required to strengthen NBE as the regulatory agency for banking services?

Identify the budget and financial impact of any investments and changes proposed.

Is any technical assistance recommended strongly desired by top NBE officials?

3. Interest Rates

Some officials favor low interest rates for agricultural loans due to the extreme poverty of small farmers. The banks believe they cannot cover costs at low rates.

Are positive real interest rates sufficient to cover costs (i.e., market rates) being charged in government credit programs through the Commercial Bank and the Development Bank?

Are rates currently in use sufficient to encourage rural lending?

What market rate(s) would be needed to cover costs?

Is the Government likely to establish market interest rates for its programs?

What are the pros and cons of establishing differential interest rates?

Is it possible to target subsidized loans for agricultural credit? If so, how?

How could such subsidy be targeted to the desired groups in East Wellega?

Describe a system that could clearly track and quantify subsidy, to provide the government accurate information on the cost of a subsidized program.

4. Financial Service Delivery Mechanisms

What banking services would be most useful for various groups such as small farmers, input retailers and wholesalers, and produce buyers in East Wellega? Usefulness should be defined in terms of ERDA's objective of sustainably increasing agricultural production through private sector provision of services.

Are private input retailers and wholesalers and produce buyers able to provide credit and others services competitively with the parastatals that offer government credit to their customers? If not, how can increased access to financial services be organized to encourage more private operators to enter the input and produce markets?

5. Collateral

Lack of collateral can severely limit access to formal credit.

What are the current collateral requirements and practices regarding loans to farmers, traders, retailers, wholesalers and produce buyers?

Are these requirements meaningful and effective in providing security to the lender?

If they are not meaningful and effective, how can they be modified?

What practical alternative collateral mechanisms could realistically be used by lenders to increase access by farmers, traders, retailers, wholesalers and produce buyers to formal short-, medium- and long-term loans?

6. Institutional Limitations on Loan Use and Access

Government-supplied agricultural credit is narrowly focused and channeled through CBE and DBE for the purchase of fertilizer (and possibly improved seeds) from the parastatal supplier. The only persons who have access to this credit are members of service cooperatives which have not defaulted.

How could USAID/E, through ERDA, help to broaden loan use and access under this line of credit?

Are the Government, CBE and DBE willing to allow farmers to use credit for broader purposes?

Are the Government, CBE and DBE willing to lend to private retailers who could in turn offer credit to farmers for input purchases?

If so, how could this be implemented by CBE and DBE?

7. Loan Collections

Collection of loans has been problematic. CBE and DBE rely on local government officials to enforce collection; they do not appear to have adequate staffing to collect, nor incentives to do so since the provision of agricultural loans to the service cooperatives is dictated by the central government.

What actions could be taken to strengthen CBE and DBE collection systems and incentives? (Any recommendations made should be discussed with Ethiopian government officials for their reactions and comments.)

Collection is also a problem for private sector retailers because of lack of legal recourse in case of loan collection and defaults by farmers.

How serious is this problem?

What strategies and actions could be used to provide meaningful security, including legal recourse, for such retailers?

What would be required to implement these strategies and actions?

8. Third-Party Loan Guarantees funded by Donors

ERDA is considering setting up a loan guarantee fund to ensure the availability of credit in East Wellega and to test this mechanism for future expansion throughout Ethiopia.

What are the pitfalls in setting up and running guarantee funds?

How can these be avoided?

What would be the primary objectives of the fund: e.g., coverage of targeted agricultural loans or of targeted farmers?

Under what conditions would the Government, CBE, DBE and private banks accept as collateral donor-funded agricultural credit guarantees?

Where should the guarantee fund be located: NBE, CBE, DBE, or a private bank?

What would be a reasonable initial contribution to capitalize such a fund?

How should interest earned on the fund be used (e.g., to fund training, operations and increase the reserves of the fund)?

How and in what proportions should losses be shared by borrowers, lenders and the fund?

Should these shares be altered over time? If so, why?

What should determine the life of the fund?

At the end of its life, what should be the disposition of any funds remaining?

9. Agricultural Service Cooperatives

The only existing formal credit for agriculture is supplied through service cooperatives. USAID/E is considering to assist this system in the short run.

Is this a reasonable activity for ERDA for the next several years? Why or why not? If so, what types of interventions would be most useful?

One proposal is to establish savings and loan facilities in service cooperatives:

- Does cooperative legislation allow this?
- Is this likely to be a viable activity?
- How should this be set up?
- What type of service cooperative management structure would be required?
- What are the preconditions for setting up a savings and credit facility in a service cooperative?
- How could the proposed project to support the establishment of this function?
- Should ERDA support other activities of service cooperatives?
- How should service cooperatives be selected to receive project support?
- Should ERDA work with service cooperatives after other alternative financial service mechanisms are in place and serving target groups and objectives?

10. Adoption or Adaptation of Foreign Models

The central bank has expressed willingness to experiment with different mechanisms for rural credit delivery.

What are the pros and cons of applying the Grameen bank model for Ethiopia?

- Could this model effectively provide credit to farmers credit?
- If so, how could this be structured and set up in East Wellega?
- Could this model be applied to agriculture input retailers?

The government has also contemplated using regional development banks, as in India.

- How could this work in Ethiopia?
- What are the pros and cons of this model?

What other models might be appropriate for Ethiopian conditions: e.g. rural credit unions, saving and loan associations, rural/community banks?

- What would be required, in terms of time, funding, changes in legislation, etc., to set up these different types of institutions?

11. NGOs

There are numerous NGOs in Ethiopia offering credit; some also have savings activities. Each has its own philosophy and its own approach to credit. ACDI recommended that the Government develop national standards for NGO programs, including use of market interest rates, mandatory development of a savings component and others.

Would national standards be useful?

If so, what should they include?

Are they necessary for the healthy development of rural financial markets in Ethiopia?

12. Using Accountability to Refine Policy, Strategy and Project Design

ACDI recommended that target DBE and CBE branches operate as autonomous profit centers on an experimental basis.

> Do current legislation and regulations permit this?
> Are DBE, CBE and the Government willing to undertake this kind of experiment?
> Is East Wellega a useful test site?

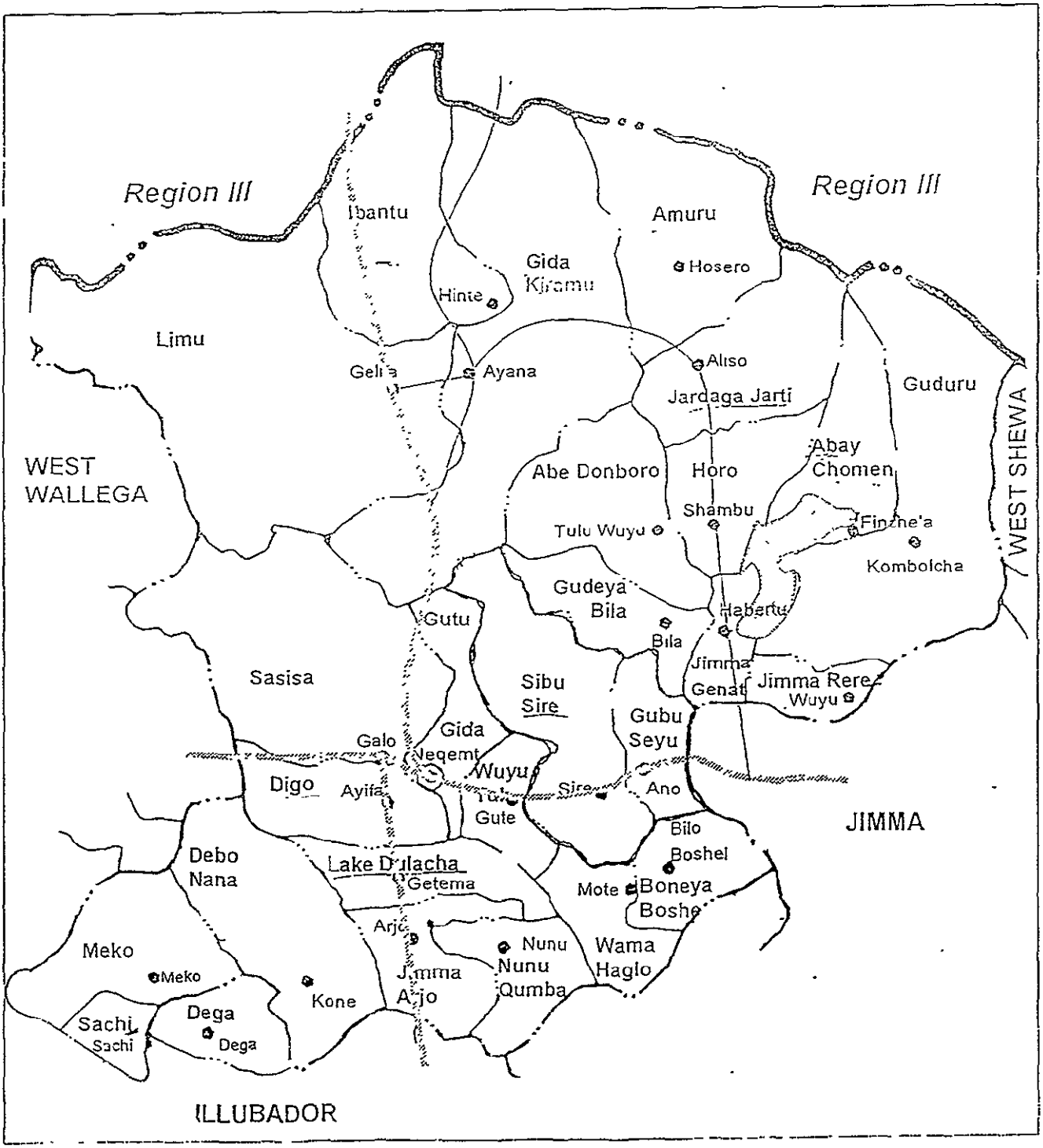
ACDI recommended that CBE and DBE consider using mobile agents to provide banking services in remote areas.

> How has this model worked in other countries?
> Has this model been cost effective?
> How could mobile banking be structured to work in Ethiopia?

ETHOPIAN RURAL CREDIT

Oromya

East Wellega Zone



ANNEX E

ETHIOPIA RURAL CREDIT

FIELD NOTES
(Farm Visits in Gobu Seyo and Sibu Sire)

Farmer # 1

1.1. Location : Gobu Seyo Woreda
Gambella Peasant Association

1.2. Family Size: Male, 4; Female, 3; Total, 7.

1.3. Land Ownership: The farmer does not have land of his own since he moved to the area from Sibu Sire. But, his sister has given him 4 timads (a local measure of land) for use. He assists his sister by paying Birr 5 for taxation.

1.4. Production this Year (1995/1996)

Crop	Timad	Hectares	Prod.	Y/H_2 (qts)
Maize	2	.3	4	13.3
Sorghum	2	.3	2	6.7
Total	4	.6	6	

1.5. Inputs Purchased during the crop season

- Fertilizer - Took 50 kgs of DAP through the Bakanissa Gambella Service Cooperative.

- Seed - Used local seeds, because he did not have the cash to pay for improved seeds.

The farmer used 50 kgs of fertilizer during the previous crop year. He got the fertilizer on credit and settled the loan by selling labor to other farmers. He had to work for about three months to pay for his fertilizer loan which amounted to Birr 80. The farmer has a Dado arrangement of 6 members with other landless farmers in which he gets two days service of the group every two weeks and sells at Birr 8.

1.6. Livestock ownership

The farmer does not have draft oxen. He works Araso for three days for the oxen owner and gets two days for ploughing on his farm. He usually plants late and gets lower yield because he does not get oxen on time. The farmer does not own other livestock.

1.7. Other sources of income

The farmer's other source of income is sale of labor to other farmers.

1.8. Source of credit

The farmer reported that the only source of credit for consumption is the well-to-do farmer. He will provide credit to those people who are relatives or who he believes are trustworthy. Credit is usually provided in cash or in kind. Interest is not charged. Repayment could be in kind or in labor.

1.9. Social Organization

The only social organization in which he is a member is the Iddir. The members of the Iddir meet twice a month and contribute Birr 2/month. The Iddir is meant for funeral purposes and does not lend for other economic activities.

1.10. Bad Year

According to the farmer, the 1992/93 crop year was a drought year and hence there was insufficient production in the area. He also reported that there was an army worm outbreak during 1994/1995 which decreased production by about 50%.

1.11 Reported Problems

Lack of land is reported to be a major problem. Those young farmers who do not have land form the Dado and sell labor to farmers who have enough land.

Farmer # 2

2.1 Location: Gobu Seyo Woreda
Ongobo Peasant Association

2.2 Family size: Male, 6; Female, 3; Total, 9.

2.3 Land Ownership: about 3 hectares

2.4 Production during the 1995/96 crop season

Crop	Timad	Hectares	Prod.	Y/ha (qt)
Maize	6	1	20	20
Teff	3	.5	2	4
Sorghum	4	.7	2	2.8
Nueg	2	.3	1	3.3
Total	15	2.5	24	

2.5 Inputs purchased

- Fertilizer - The farmer took 50 kgs of DAP on credit and used it on 3 timads of Maize. he reported that he did not want to take more fertilizer on credit because of fear of risk of crop failure

- Seeds - Purchased two Kunas of local teff seed at Birr 11/Kuna. A Kuna Weights about 5 kgs. He also purchased noug seed at Birr 5/Kuna.

2.6 Livestock Ownership:

Draft oxen, 2; Cows, 1; Heifers, 2; Calf, 1.

He sold two calves at Birr 180 during this season to cover the subsistence requirement of the household.

He also reported that he has a Ribbi arrangement for sheep rearing. In Ribbi an individual keeps a mother sheep for one or two years and equally shares the lambs with the owner when the mother sheep has a litter.

2.7 Other sources of income

The farmer does not have any other source of income. However, he reported that he worked as a daily laborer for the Research Station at Bako during 1992/93. That year was reported as a drought year.

2.8 Sources of Credit - No other source except friends.

2.9 Membership in Social Organizations

This farmer is a member of an Iddir which has 50 members. Each member contributes Birr 0.30 every two weeks. Birr 0.20 of the contribution is saved, while Birr 0.10 from each member is given to the household in which the meeting is held. When the head of the household or the wife dies, Birr 50 will be given to the affected household for covering the cost of the funeral ceremony. When other members of the household die, Birr 20 is given to the affected household. In very special cases, the Iddir also provides credit to members for hospitalization.

2.10 Bad Year

The farmer reported that there was 10-20% of reduction in crop yield during the 1994/1995 crop season.

2.11 Problems Reported

- Livestock diseases
- timely availability of fertilizers

Farmer # 3

3.1 Location: Sibu Sire Woreda
Chari Peasant Association

3.2 Family size: Male, 4; Female, 2; Total, 6.

3.3 Land Ownership and crop production

The farmer reported that he had 10 hectares, which were taken by a producer cooperative during the Derg. Now he has only .5 hectares of land of which 1000 m^2 is located around his house. He grows maize on the 1000 m^2 of land for consumption at the green stage

through maturity. On his other plot he grows some chat, 100 trees of coffee 7 trees of mango and two trees of oranges under irrigation.

3.4 Inputs purchased

The farmer does not use fertilizer since he does not have sufficient land for cultivation.

3.5 Livestock Ownership: One cow and 2 calves. He uses Ribbi for sheep rearing. The owners are from Sire town and are relatives. The mother sheep is kept for one or two years and the off-spring are equally shared with the owner.

3.6 Other Sources of income

The wife makes tella and arakie. She also collects firewood and sells it in Sire market. They also sell labor to other farmers.

3.7 Sources of Credit - He does not get credit of any sort.

3.8 Social Organizations

The farmer is a member of an Iddir with 200 members. Each member of the Iddir contributes one birr every month and the money raised will be given to the household where the meeting is held. No saving is made. Members will raise some money when the member or any member of the household dies for covering funeral ceremony costs. According to the farmer, no member is trusted for keeping savings.

3.9 Problems Reported

- Problem of land quantity and rights

Farmer #4

4.1 Location: Sibu Sire Woreda
Chari Peasant Association

4.2 Family Size: Male, 4; Female, 3; Total, 7.

Consumption Requirement- About 12 quintals per year

4.3 Land Ownership: one hectare.

4.4 Estimated crop production during the 1995/96 crop Year

Crop	Hectares	Prod.	Y/Ha (qts)
Maize	.75	20	27
Teff	.25	1	4
Total	1.00	21	

He has also planted pepper on a small piece of land.

4.5 Inputs purchased

- Fertilizers - DAP - 100 kg on credit through the Service Coop.
Urea - 100 kg on cash from ASCE marketing center.

- Seed - Improved Maize seed at Birr 75.00.
Applied Urea on Maize and 50 kgs of DAP on teff.

The farmer used fertilizer during the 1994/95 crop season and harvested 15 quintals of maize and 1.5 quintal of teff. He sold grain to buy urea on cash and also borrowed from his friend Birr 150.

4.6 Livestock Ownership: one heifer and two she goats. The heifer was bought at Birr 300 during the previous crop season.

4.7 Other Sources of income - The wife makes some tella.

4.8 Sources of Credit - Reported that there are no money lenders in the area.

4.9 Social Organization

The farmer is a member of an Iddir with 200 members. He contributes Birr 1 every month. The money will be given to the host where the meeting is convened. There is no saving, because there is no trust among members. Some members have embezzled their money in the past.

4.10 Problems Reported

- Use of fertilizer require additional labor for raw planting, weeding, and harvesting.
- Availability fertilizers on time

Farmer # 5

5.1 Location: Sibu Sire Woreda
Motta Chekorsa Peasant Association

5.2 Family Size: Male, 5; Female, 4; Total, 9;

5.3 Land Ownership: about 4 hectares

5.4 Estimated production during 1995/96 crop season

Crop	Timad	Hectares	Prod. (qts)	Y/Ha
Maize	.75	4		
Teff		.25	2.5	
Finger Millet	.25	1.5		
Total	1.25	8		

5.5 Grain Consumption requirement is about 1.35 quintal per month.

5.6 Inputs used

- Fertilizer - DAP 50 kgs
The fertilizer was obtained on credit from Burka Gidina Service Cooperative.

- Seed: - No improved seeds were used.

5.8 Livestock ownership: Draft Oxen, 2; Cows, 1; Calfe, 1.

The farmer uses Araso since he is usually occupied with other activities. His children are now grown up and he hopes that they will take over the farming while he will continue with his other occupation, blacksmithing.

5.9 Other sources of income

This farmer is a part-time farmer and part-time black smith. He earns about Birr 10 per week by repairing farm tools for other farmers. He used to make new farm implements, but now he does not get scrap iron easily. He is also constrained by lack of cash for purchase of scrap iron when it is available.

5.10 Sources of Credit

He knows no money lender in his village.

5.11 Social Organization.

The farmer is a member of an Iddir having 70 members from his peasant association. Each member contributes Birr 1/month. Birr 0.5 is saved, while Birr 0.5 is given to the individual who prepares coffee for the meeting of members. Meetings are rotated and held at each individual's house every month. Members can borrow money from the savings for medical purpose under special conditions only.

5.12 Problems reported

- Non-fertility of the land.
- Availability of scrap iron for tool making.
- Lack of cash for purchase scrap iron.

ETHIOPIA RURAL CREDIT

GENERAL INFORMATION ON GOBU SEYO AND SIRE DISTRICTS

1. GOBU SEYO DISTRICT

	Hectares	%
Arable land	20,732.32	60.0
Grazing land	6,910	20.0
Forest land	5,183	15.0
Waste Land	1,727	5.0
Total	34,552.32	100.0

2. SIBU SIRE

	Hectares	%
Arable Land	86,934	61.0
Grazing Land	32,777	23.0
Forest	10,129	7.1
Waste Land	12,675	8.9
Total	142,515	100.0

3. HOUSEHOLD AND POPULATION SIZE

HOUSEHOLDS, BY HEAD OF HOUSEHOLD

	MALE	FEMALE	TOTAL	% F
GOBU SEYO	5362	961	6323	15.2
SIBU SIRE	8334	1313	9647	13.6

FAMILY MEMBERS

	MALE	FEMALE	TOTAL	GRAND TOTAL	%F
GOBU SEYO	15521	16460	31981	38304	45.5
SIBU SIRE	24103	37043	61146	70793	54.1

4. PRODUCTION

GOBU SEYO

CROP	AREA (HA)	PRODUCTION (QUINTALS)	Y/HA	AREA %
MAIZE	5720	73347	12.8	34.9
SORGHUM	1989	17920	9.0	12.1
TEFF	6180	30172	4.9	37.7
F. MILLET	980	6300	6.4	6.0
NOUG	1407	4221	3.0	8.6
H. BEAN	60	240	4.0	0.4
FLAX	15	45	3.0	0.1
RAPE SEED	26	78	3.0	0.2
TOTAL	16377	132323	100.0	

Average cultivated area/household = 2.6 ha.
Average production /household 20.9 quintals

SIBU SIRE

CROP	AREA (HA)	PRODUCTION AREA (Quintals)		Y/HA2%
MAIZE	3988	67511	16.9	22.5
SORGHUM	1511	15110	10.0	8.5
TEFF	6940	37206	5.4	39.2
F.MILLET	2100	15777	7.5	11.9
WHEAT	330	1980	6.0	1.9
BARLEY	780	4680	6.0	4.4
NOUG	1280	3840	3.0	7.2
H.BEAN	517	2585	5.0	2.9
F.PEA	230	1150	5.0	1.3
HARICT BEAN	25	150	6.0	0.2
TOTAL	17701	149,989	100.0	

Average cultivated area/household = 1.8 ha
Average production/household 15.5 quintals

ANNEX F

VALUE COST RATIO FOR MAIZE CALCULATED FROM NATIONAL AVERAGE PRODUCTIVITY

1993/94

WOREDA	0	1	2	3	4	5	6	7	8
GOBU	MAX	16	52	36	100	3600	351	3249	9
SEYO	AVE	16	43	27	100	2700	351	2349	7
SIBU SIRE	MAX	16	94	78	100	7800	351	7449	21
	AVE.	16	53	37	100	3700	351	3349	10

1. Baseline productivity prior to the project involvement
2. Maximum and average productivity of EMTPs
3. Additional Yield gain per hectare (2-1)
4. Current farm gate price Birr/qt
5. Additional income Birr/ha
6. Cost of input (fertilizer + Seed)
7. Net income Birr/ha (5-6)
8. Value Cost ration (7/6=VCR)

SOURCE: Annual Report 1993/94, SASAKAWA-GLOBAL 2000/ETHIOPIA