



FINANCIAL PRODUCTS FOR FARMERS AND SERVICE PROVIDERS REPORT

Ethiopia

Farm Mechanization and Conservation Agriculture for Sustainable Intensification

(FACASI)

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LIST OF ACRONYMS AND ABBREVIATIONS

ACSI	Amhara Credit and Saving Institution
ADSCI	Addis Saving and Credit Institution
AEMFI	Association of Ethiopian Microfinance Institutions
AfDB	African Development Bank
AIO	African Insurance Organization
CBB	Construction and Business Bank
CBE	Commercial Bank of Ethiopia
CGAP	Consultancy Group to Assist the Poor
CPO	Cooperative Promotion Offices
DBE	Development Bank of Ethiopia
DECSI	Dedebit Credit and Saving Association
EIC	Ethiopia Insurance Cooperation
ETB	Ethiopian Birr
FCA	Federal Cooperative Agency
FY	Fiscal Year
IFC	International Financial Corporation
IIS	Integrated Insurance Software
MFI	Microfinance Institution
MOARD	Ministry of Agriculture and Rural Development
MOTI	Ministry of Trade and Industry
MIS	Management Information System
MSME	Micro, Small and Medium Enterprise
NBE	National Bank of Ethiopia
NPL	Non Performing Loan
OCSCO	Oromia Credit and Saving Cooperation
RUSACCO	Rural Saving and Credit Association
SACCO	Saving and Credit Cooperation
SME	Small and Medium Enterprise
SNNPR	Southern Nations, Nationalities and Peoples Region
WB	World Bank

EXECUTIVE SUMMARY

Financial services are a critical enabler for sustainable economic growth and therefore poverty reduction and food security in Ethiopia in general and in the agricultural sector in particular. Credit is used for investments to increase the productivity of agricultural operations or to diversify the economic activities of rural households. Savings products ensure safe and productive "storage" of money and ensure excess capital can be channeled to its most productive use. Payment products facilitate the ease of exchange of agricultural goods and insurance products help to spread risks of agricultural players in an efficient way. Thus, in short, financial services are essential for protecting and improving the livelihoods of rural populations.

However, the financial service offerings to agricultural sector players in Ethiopia face gaps in terms of access to financial services, product quality, and quantity. In terms of access, only few financial institutions serve rural areas in Ethiopia, leading to low levels of financial inclusion. In terms of product quality, gaps exist for all major product categories, including credit, savings, insurance, and payments, and all major types of agricultural players, including producers, traders, and manufacturers of all sizes. Key issues include lack of input credit for agricultural technologies and insurance for smallholders, lack of inventory financing for traders, lack of export financing for exporters, as well as lack of long-term credit, cash-flow-based lending, attractive deposit products, and reliable payment products for all players. In terms of product quantity, the overall Ethiopian economy is significantly credit constrained, with credit supply roughly USD 3 billion short of credit demand. Agriculture is strongly affected by this credit crunch compared with other sectors of the economy.

1. INTRODUCTION

1.1. BACKGROUND

The main financial institutions in Ethiopia constitute banks, insurance companies and microfinance institutions. The number of banks has reached 19 as of March 2015, of which 16 were private. About 2,636 bank branches were opened in total. As a result, bank branch to population ratio went down to 1:34,171.54 from 1:41,088. About 35.4 percent of the total bank branches were located in Addis Ababa, making Ethiopia one of the most under-banked countries in sub-Saharan Africa. Of the total bank branches, the share of private banks increased to 57.9 percent from 53.8 percent in the last year due to the opening of 392 additional branches compared to 136 for public banks.

Meanwhile, the total capital of the banking system depicted a 19.0 percent annual growth and reached Birr 30.5 billion, of which 55 percent was that of private banks. The share of public banks in total capital was 45 percent of which Commercial Bank of Ethiopia accounted for 35 percent while Development Bank of Ethiopia and Construction & Business Bank held 10 percent.

Lending is mainly collateral-based, to the detriment of the vast majority of small entrepreneurs. Credit to the private sector, which is already low, will be held back as banks allocate funds towards NBE bills, following the new directives. Private Banks' lending interest rates could also rise to compensate for the loss, unless the banks fully absorb the costs of the new policy. In the World Bank report *Doing Business 2014*, Ethiopia ranks 109th in getting credit out of 189 countries, slightly worse than 2013 (105th).

The number of insurance companies reached 17 of which 16 were privately owned. The number of branches increased to 369 of which about 53.4 percent were situated in Addis Ababa. The total capital of the insurance industry increased by 34.7 percent on annually basis and reached Birr 2.5 billion of which 81.1 percent was the share of private insurance companies.

As for microfinance institutions, there were 33 micro-finance institutions (MFIs) operating in the country. These MFIs mobilized a total saving deposit of Birr 14.2 billion, which was 40.1 percent higher than 2013/14 fiscal year. Similarly, their outstanding credit expanded by 31.8 percent and reached Birr 18.7 billion. Likewise, their total assets increased by 28.0 percent to Birr 29.0 billion by the end of March 2015. All these indicators show the growing contributions of MFIs to poverty reduction both in rural and urban areas through their focus on low income segments of the society. However, demand for microcredit, far outstrips supply.

The top five largest MFIs (Amhara Credit & Saving Institute, Dedebit Credit & Saving Institute, Oromia Credit & Saving Institute, Omo Credit & Saving Institute and Addis Credit and Savings Institute) constitute 83.8 percent of the total capital, 93.7 percent of the savings, 89.8 percent of the credit and 90.4 percent of the total assets of the MFIs.

1.2. OBJECTIVES

The main objective of the study is to assess the performance and challenges of financial sector especially microfinance institutions products. The specific objectives of the study include:

- To observe micro finance institutions product offered
- To evaluate the performance and challenges of micro finance institutions in the agriculture sector
- To review innovative financial models products for the agriculture sector

1.3. METHODOLOGY

The study used both qualitative and quantitative information gathered from secondary and primary sources. The secondary data were obtained from the Ministry of Agriculture, Federal Cooperative Agency (FCA), Association of Ethiopian Microfinance Institutions (AEMFI), and National Bank of Ethiopia (NBE), Central Statistical Authority (CSA), International Food Policy Research Institute (IFPRI), Ethiopian Economic Association (EEA), Ministry of Health, insurance companies, commercial banks, MFIs, cooperatives, and other reports from various sources. Key informant interview conducted including senior staff of the Association of Ethiopian Microfinance institute, microfinance practitioners, leaders of multipurpose and financial cooperatives, and other relevant institutions.

2. KEY CHARACTERISTICS OF THE FINANCIAL SECTOR

2.1 MICROFINANCE

2.1.1 Historical background

The Ethiopian financial sector has shown an unprecedented growth during the last 15 years. In line with the government's aim of enhancing the role of private sector, the number of private actors in the industry has been constantly growing. With new entrants to the banking sector, which used to include only state owned banks, improvements have been seen in the outreach (both in terms of number of clients and geographical coverage), type and quality of services provided and the availability of finance among other things. Microfinance institutions, nonexistent prior to 1996, have now reached 33 and the country boasts some of the world-leaders in microfinance. This has made a considerable impact in availing credit for the underserved low income and rural households

Since the 1970s many NGOs such as World Vision, Save the Children, Christian Children's Fund, Care, etc. have directly been providing credit services to their organizational and project beneficiaries. Even though the size, term and condition of those loans differed from one to the other, most of them charged very little or no interest on those loans. Loans were not always collected on and huge amounts of overdue loans contaminated the credit environment.

After a series of consultations between 1992 and 1995 involving concerned government bodies and the NGOs, it was agreed to establish a specialized institution, governed by a board of trustees, which would handle the financial interventions of NGOs. Before the specialized institution could be established, the government passed proclamation No. 40/1996 which prohibited other forms of organization to cater to such financial services apart from the newly regulated "Microfinance Institutions"⁴⁴. Proclamation 40/1996 allowed for the establishment of deposit-taking MFIs and supported the development of the microfinance sector for the subsequent decade.

The microfinance sector has experienced a notable change from humanitarian-oriented organizations (ex-NGOs) to specialized MFIs targeting financial sustainability and outreach.

2.1.2. Current status

There are 33 MFIs with a total capital of close to ETB 6.6 billion serving around 3 million clients in Ethiopia. The services provided by MFIs include collecting savings, providing group and individual loans, micro-leasing activities, micro insurance and domestic money transfer services. The industry is largely dominated (market share) by the top five MFIs (ACSI, DECSI, OCSSCO, ADSCI and OMO) – who are all government-affiliated and have a market share of ca. 80 %.

2.1.3. Ownership structure

While all of the 33 Ethiopian MFIs are Share Companies, designed to engage in business for profit, most of them (excluding 3) are governed and run as not-for-profit organizations due to their origins.

A minority are affiliated to the regional governments and most are affiliated to NGOs. In most cases, they are used as vehicles of their affiliates' objectives, with shareholder value being compromised by company resolutions that prohibit the taking of dividends or selling of shares with capital gain. The result being that MFIs are not as commercially aware as needed to serve the large and underserved market that currently exists

2.1.4. Outreach

In March 2015, the microfinance sector mobilized a total saving deposit of 14.2 billion birr. In terms of regional coverage, the industry covered all of the regional states except Somali and Afar Regions. For the same period, the industry mobilized assets amounting to 29.0 billion birr, out of which, client savings contributed 40% followed by equity, loans from banks and loans from RUFIP covering 33%, 14.8% and 11.9% respectively. (NBE, 2015)

2.1.5. Market share

The large, regional government-affiliated MFIs namely Amhara, Dedebit, Oromiya, Omo and Addis micro-finance institutions have dominated the industry (80% market share). Looking at the distribution of MFI branches among regions, Wisdom takes the lead by operating in four regions followed by Ghion and Meklit MFIs, each with branches in three regions. The rest of the MFIs have only one branch per region (including the top 5).

2.1.6. Policy context

The national development policy of Ethiopia, geared towards decreasing poverty and bringing about sustainable development created a favorable environment for the emergence of MFIs. Accordingly, many of the MFIs in Ethiopia are operating in the rural parts of the country, where over 80% of the population reside.

A new microfinance proclamation that redefined the micro financing business and repealed the 1996 proclamation was enacted on 12th May, 2009. The new proclamation is characterized by articles and sub articles that, more broadly and in detail, explained the licensing, operational, and financial requirements in the MFI industry. The amendments made are summarized as follows.

- The purpose and activity of MFIs have been broadened to include providing financial leasing services and providing local money transfer services.
- Banks that are licensed under the appropriate law are allowed to engage in microfinancing without a separate license for it.
- The NBE is obliged to decide upon the MFI business application within 60 days from the last date of receipt of all information.

- A new sub article, where maintaining share register is now a prerequisite to enhance governance via transparency of owners.
- In addition to the customary areas, the NBE is given the privilege to issue directives on the maximum number of years after licensing within which the MFI shall be profitable and the capital and liquidity requirements to be maintained by different MFIs depending on their risk profile.
- MFIs might be relicensed to operate as a bank in accordance with the law

2.1.7. Operations

2.1.7.1. Product and services

The range of products MFIs offer has expanded slowly over time. For many years, compulsory savings and group lending were the only financial products offered, and this limited range still characterizes many MFIs. Individual lending was introduced only recently, and plays a minor, but increasing role. A few MFIs have also started to provide micro insurance, money transfer and administration of pension funds.

Loan products: MFIs' loans fall broadly into agricultural loans, micro-business loans, small enterprise loans (micro bank loans), employee loans, package loans and housing loans. Most of the loans are group loans, followed by individual loans and cooperative loans. Individual lending to MSEs have also been recently introduced.

Lending rates: Lending rates of Ethiopian MFIs range between a 9% year-declining rate to a 24% flat rate. The industry's minimum rates are charged by (Addis credit and Saving Institution) ACSI, Benishangul, Meqit and Sidama MFIs.

Saving products: Compulsory (10% of loan value) and voluntary savings are the common products supplied by all MFIs in Ethiopia. Some MFIs succeeded in offering additional services like pass book saving, time deposit and loan insurance funds.

Saving rates: Each MFI requires the client to deposit 10% to 40% of the loan amount. MFIs pay a 4% to 6% interest rate on voluntary savings and cover, on average, 36% of their loan portfolio with savings funds.

2.3.8. Ownership structure

There are three main types of owners among the 30 MFIs. Regional Governments of ten regions either own or back MFIs: Amhara, Tigray, Oromia, Benishangul Gumuz, Harar, SNNPR, Dire Dawa, Addis Ababa, and most recently Gambella and Ethiopian Somali.

14 MFIs are owned or backed by NGOs, local or international (by proxy). The oldest being AVFS, Gasha, Sidama and Wisdom.

Aggar, Lefayeda, SFPI and Letta are the only MFIs owned by private investors.

2.1.9. Demand for loans

Ethiopia's rural and poorer households, as well as (Micro, Small and Medium Enterprise) **MSMEs, continue to be significantly underserved with financial services.** An estimated 80% of potential rural demand for loans is still unmet, out of a target group of approximately 4.2m rural households that represents an aggregate demand of as much as 2.6m ETB (\$260m).

An approximated potential credit demand of 3.4 billion ETB for 35,000 enterprises (of between ETB 20,000 and ETB 500,000 in capital) exist in Ethiopia. Only a small portion of this demand is currently met by commercial banks and MFIs.

Rural smaller enterprises/business with capital of 250 to 10,000 ETB, however, are also a major segment with unmet needs. Approximately 125,000 of these enterprises/business exist in Ethiopia, and have identified access to finance as their major constraint.

2.1.10. Funding sources

Institutional capacity and lack of loan capital are the main constraints to growth in outreach and sustainability of MFIs. Even the relatively more successful MFIs that are largely expected to be self-sustaining, can neither grow based on retained earnings and mobilized saving, nor raised capital from financial markets. To make MFIs more vibrant contributors to economic growth and poverty reduction, they must be scaled-up significantly, which can mainly be done by injecting capital from various sources. That is, if adequate funding is not available, it would take MFIs a relatively longer period to reach larger number of households. It should be also noted that even if a MFI becomes profitable, accumulated profit will not support the kind of large scale growth required to reach the large number of poor households. So, MFI should be furnished with adequate loan capital. Like any other business, addressing the problem loan capital for scaling up microfinance activities will also require innovation in the financing strategies of MFIs. MFIs in Ethiopia have been obtain their loan capital from various source such as saving mobilized by MFIs, grants from donors, selling bonds, equity ty from various sources and loans. However, these resources have not been sufficient to meet the existing large demand for loans.

2.2. CHARACTERISTICS OF THE AGRICULTURAL SECTOR WITH RELEVANCE FOR FINANCE

Agriculture is the core driver for Ethiopia's growth and long-term food security. The stakes are high 15 to 17 percent of the Government of Ethiopia's (GOE) expenditures are committed to the sector, agriculture directly supports 85 percent of the population's livelihoods, 43 percent of gross domestic product (GDP), and over 80 percent of export value. Thirteen million smallholder farmers account for 95 percent of total production, and five to seven million households are chronically food insecure. Ethiopia's agricultural sector has witnessed consistent growth since 2003: maize production has expanded at 6 percent per year, and the aggregate export value across all commodities has grown at 9 percent, underpinning an, 8 percent annual growth rate in GDP. Public investment has expanded access to productive inputs, like hybrid maize seed and

fertilizer. Concerted government spending in extension has also established nearly 10,000 Farmer Training Centers (FTCs) and trained over 63,000 Development Agents (DAs) from 2002 to 2008. The GOE has made marked progress in agriculture over the past decade. However, the sector continues to face a set of constraints: markets are underdeveloped, federal and regional governments lack capacities to implement, safety nets account for a large proportion of agricultural spending, irrigation is below its potential, shortages of improved inputs hinder growth, and key areas of the enabling environment require improvement.

However, from the point of view of the financial sector, agriculture is a less attractive field of business than other sectors of the economy such as construction, tourism, trade, and other services. One key reason for this is the sector's **risk-return profile**. A lack of profitability of many small-scale farming activities due to a lack of economies of scale in land use and the use of outdated farming practices. Moreover, subsistence farming is likely to be a loss-making activity and even commercial farmers face an unfavorable, mostly weather-dependent risk return.

In addition to this, a well-documented group of six other interdependent sector characteristics causes high transaction costs for commercial banks, MFIs, cooperatives, and other financial providers that directly or indirectly serve the sector and therefore further impede the provision of financial services to agricultural players. These characteristics are:

- **Small transaction sizes.** Transaction sizes in the agricultural sector are usually small, at least with regard to smallholder farmers. The average size of agricultural loans of an Ethiopian MFI in 2007 was ETB 1,250 (equivalent to less than USD 60). This increases the share of the – mostly fixed – costs of loan origination, monitoring, and collection of financial institutions relative to other sectors with higher average transaction sizes.
- **"Lumpy" cash flows.** Typical cash flows in the sector consist of one large cash outflow/loan (e.g., for fertilizer), followed by one large cash inflow/repayment several months later (harvest). Because the ease of monitoring individual customers increases for financial institutions with the frequency of repayments (since each individual repayment provides a monitoring opportunity), agricultural customers are more difficult to monitor compared with businesses with multiple cash inflows and outflows. Apart from complicating monitoring, "lumpy" cash flow patterns also complicate financial intermediation for financial institutions where agriculture is the primary economic activity. In this case, the savings and investment patterns of customers match and savers are likely to withdraw their savings at the time of greatest demand from borrowers (e.g., when inputs need to be purchased).
- **Illiquid and perishable collateral.** Typical collateral in the agricultural sector is agricultural output, farming equipment, land or buildings. Agricultural output is typically perishable, which limits its use as collateral. The limited amount of standardization of agricultural output in Ethiopia and the availability of few "neutral" storage facilities further complicate the use of agricultural output as collateral. While a legal framework for moveable collateral such as farming equipment exists, practical considerations limit this type of collateral to large, standardized machinery that is mostly in use by a relatively limited number of commercial farmers. Since farmers generally cannot own land titles, land is also not acceptable collateral in this business. This also complicates the use of

buildings as collateral. A lack of risk management skills among most financial institutions and the strong focus on highly collateralized lending (further details in the next section) further exacerbate the collateral issue in Ethiopia.

- **High covariance across borrowers.** The variance of cash flows compared with alternative businesses is high, making lending relatively more risky. Also, all borrowers are similarly affected by the same macro-risks, especially climate, which increases the individual and portfolio risk of lenders. The fact that about 95 percent of agricultural production in Ethiopia is rain fed
- **Geographically dispersed clients living in difficult to reach locations.** With on average 81 people per square kilometer, the Ethiopian population is more dispersed. This is especially problematic in the rural sector, where 83 percent of the population live. Adding to the problem is the fact that only 12 percent of the road network in Ethiopia is paved, and road density remains at only 30 km of road per square kilometer of land, one of the lowest densities in Africa.
- **Diverse sub-businesses with distinct dynamics.** Agriculture consists of many different sub-industries with significantly varying investment and risk patterns. This causes high specialization costs in monitoring within a cash-flow-based lending model, providing incentives to financial institutions to lend based on collateral or limit activities to easy-to-understand, homogenous parts of the business such as input credit.

3. CHALLENGES

3.1 GENERAL

In spite of the rapid strides and strength of microfinance institutions in Ethiopia such as existence of an enabling policy environment, strong government support and political will, increase in outreach and performance, the existence of strong national network and donor support, there are several problems.

The main barriers of MFI s are categories into lack of loan capital; policy, legal and regulatory constraints, limited outreach, high risk, inflexibility financial products, limited capacity and external factors.

3.1.1. Funding sources

- Lack of loan capital to expand the activities of MFIs is currently identified as number one problem. This is aggravated by inadequate donor funding, lack of equity capital and limited opportunities to access foreign capital and attract social investors. A further challenges is the lack of an autonomous institution which can provide wholesaling activities and facilitates that allow access to loan from various sources. There are also no solid linkage between MFIs and commercial banks and insurance companies.

3.1.2. Access to Financial Services

- For financial institutions, traditional bank branches are not a cost-effective channel to serve Ethiopia's large but mostly poor and rural population. The lack of technical infrastructure also inhibits the use of remote channels as an alternative. Consequently, few people have access to formal or semiformal financial services. With 35,000 people per commercial bank or MFI branch, Ethiopia is below comparable low-income countries where the respective ratio is one branch per 35,000 customers. Moreover, branches are concentrated in urban areas where only a small fraction of the population lives. Those numbers indicate that millions of poor households in Ethiopia are excluded from formal financial services, particularly in rural areas where over 80 percent of households reside. In fact, a recent Women's World Bank study estimates that only one percent of Ethiopian rural households maintain bank accounts. These households are then forced to rely on informal channels, generally at significantly worse conditions than those that could be offered by financial intermediaries. Although MFIs and SACCOs have significantly enhanced financial inclusion among rural households over the past decade, their penetration rate and reach remains limited

3.1.3. Outreach

- Limited outreach, particularly with respect to women, is a serious issue of MFIs in Ethiopia. Unlike Asian MFIs, women clients account for about 38 percent. This is partly the result of supply driven financial product which are not tailored to meet the need of women.

- The exclusion of the very poor and disadvantage group is a serious issue which should be revisited. This could partly be the result of the inherent problem of group lending methodology itself and the overemphasis of some MFIs on financial sustainability
- The high dropout rate of clients is also another challenge of MFIs to expand outreach and efficiency.
- Poor infrastructure increases transaction cost and affect sustainability of MFI and outreach

3.1.4. Risk

- MFIs are exposed to financial and operational risks. There has been hardly any attempt by all MFIs in Ethiopia in identifying risks, measuring risk and managing risk.
- Drought, seasonality of rural activities and local market failures negatively affect the performance of MFIs.
- Insurance and derivative product that helps MFIs and clients to manage production and price risk are virtually absent

3.1.5. Products

- MFIs in Ethiopia do not provide flexible and responsive financial service to clients. They entirely concentrate on delivering mono product. The MFIs should be involved in developing varieties of loan products, insurance products, etc and provide diversified service to clients. The product development efforts are affect by the capacity of MFIs to develop new products
- Low competition, gaps in regulation in financial institutions, lack of ICT and transport infrastructure, high transaction costs within the sector, and low risk management have led to a financial product offering for rural areas that is limited in terms of both product breadth and depth,. This affects all types of players in the agricultural sector. Specific overarching issues include lack of long-term credit facilities, attractive savings products, and efficient payment mechanisms. Due to unattractive savings rates and low access to financial products, farmers keep savings in the form of agricultural outputs (i.e., livestock) rather than fiduciary deposits. Most other issues vary by player within the agricultural value chain and are addressed below.
- **Input suppliers** such as private seed producers and fertilizer and agro-chemical suppliers lack access to capital to acquire or upgrade physical assets such as buildings and machinery. This results in limited private sector presence, limited competition, and reduced ability to procure equipment and supplies from abroad and expand services to farmers and other end users
- **Smallholders** lack of **input credit**, especially for fertilizer and machineries. This is a relatively recent problem that was caused by channeling input credit through "regular" cooperatives. While cooperatives still have access to fertilizer using government credit guarantees, fertilizer access for farmers is now primarily cash-based. This could turn into a major issue should the quality of harvests decrease. If smallholders do have access to

credit, **debt repayment schedules** are often unaligned with agricultural production cycles. Since most loans have payback periods under one year, loans are likely to either require installments before the first harvest or to demand repayments in periods when further input credit is required.

3.1.6. Capacity building

- Weak management information system (MIS) has affected the efficiency of MFIs significantly. This is aggravated by lack of standards software, skilled manpower, and infrastructure to support MIS network in remote area
- Very limited capacity of MFI industry in terms of trained manpower, equipment, transport facilities, offices, research and innovations. Moreover, MFIs don't have the capacity to assess and manage their risk.
- Lack of market research to understand the need of clients
- Weak market strategies of MFIs

4. INNOVATIVE FINANCIAL MODELS

This report examines innovative models to finance farmers and agricultural SMEs with the goal of finding ways to deal with credit risks, given the lack of financial information, track record, or acceptable collateral by these entities. The vast majority of farmers and agricultural SMEs, particularly the smaller ones, operate in the informal sector and in rural areas that are not usually covered by financial infrastructure (e.g., credit bureaus) and where banks or other financial institutions have scant local presence in terms of branches. These factors make it very challenging to assess credit risks. As such, it's important to seek innovations to identify models and approaches that would help financial institutions find ways to reduce impediments and risks in lending to farmers, particularly smallholder farmers. Additional objectives of this report are to find models that reduce the transaction costs of providing financial services to smallholders and provide risk management instruments to smallholders in order to protect them against risks, mostly systemic ones such as price and weather risks.

In defining innovation, we considered the following three criteria:

- New models and approaches not yet widely used
- Adaptation of established models and approaches in use elsewhere but adapted to the context of new market
- Downscaling to smallholders those models and approaches that have worked in other sectors, commodity sub-sectors, and/or for the larger and medium-sized commercial farmers segment (e.g., value-chain financing).

Financial innovation has the overall objective of using models that would mobilize additional resources to the agricultural sector and increase the participation of private institutions in financing agricultural SME's and farmers. Innovation could also foster new partnerships between various stakeholders, both within the private sector (e.g., agribusinesses, input suppliers, farmers, financial institutions) and between the public and private sectors (PPPs).

In financing models targeting the farmer or groups of farmers, collateral generally involves cash flow analysis by banks in order to underwrite anticipated earnings, overall savings, and/or group guarantees. Financing models using movable assets as collateral often include leased equipment or harvested commodities in warehouses. Financing models that rely on buyers as the repayment source are based upon an overall value chain analysis in which strong business relationships persist between farmers and buyers; formal or informal contracts provide security to lenders.

Financing Models		
Farmers	Movable Collateral	Buyer
Direct smallholder lending	Equipment finance	Tight market value chain finance
Indirect lending through FBOs/Cooperatives	Leasing	Loose market VCF with output buyer
Emerging farmers Finance	Infrastructure finance	Nucleus farm/out grower
Saving account linked input finance	Collateral management	VCF with input supplier
		Factoring

Figure 1: Financing models

The classification of financing models is based on the sources of repayment or collateral on which the financial institution can rely. The first column in Figure 1, above, shows how the bank can look to the *farmer* by relying on his or her overall cash flow, on his or her savings, or a group guarantee. The second column outlines where the bank has access to *movable collateral*, either in the form of equipment or commodities. And the third column indicates where the bank looks to the *buyer* in value chain or trade financing, specifically looking at the relations the buyer has with other actors along the supply chain. Before delving into the various financing models, it is important to put financing in context within the overall agricultural value chain. The various models of financing for agriculture can exist at many different points along a given agriculture supply chain, as depicted by the following figure.

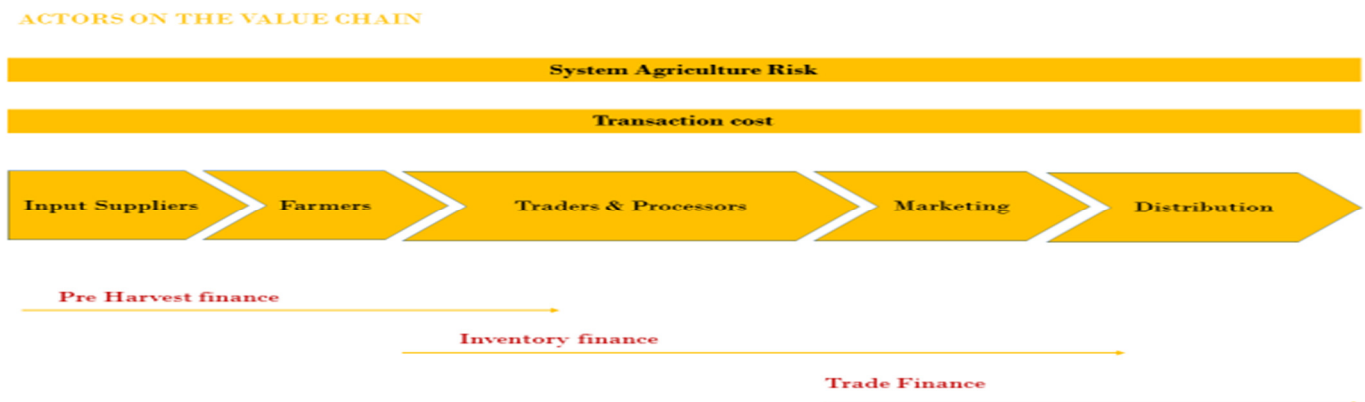


Figure 2: Value chain actors

The figure above includes all the actors along a given agricultural supply chain and indicates the place of various financial instruments in relation to their target users. The target users include input supply SMEs, farmers, and agriculture SMEs in processing, trading, marketing and distribution activities. The financial instruments cover pre-harvest loans, inventory financing, and trade financing, as well as ways to deal with systemic risks and transaction costs. These risks and transaction costs apply to all actors along the supply chain but are much more pronounced in the case of financing farmers.

4.1. FINANCING FARMERS

This section looks at models for financing farmers, either directly or indirectly, through farmer-based organizations (FBOs) or cooperatives. The primary source of repayment is usually the farm's conversion of working capital into cash flow through the production season. If, for some reason, this conversion fails to generate sufficient cash flow to service the loan requirements, the bank has to consider other options, many of which are still dependent on the farmer's ability to generate cash flow or liquidate various assets to repay the loan. Key success factors generally involve investment by the bank to understand the needs of the farmers and the primary cash flow strengths and weaknesses in order to adequately underwrite cash flow and rely less on collateral. Thus the following models innovate through new types of finance arrangements, such as group lending, parametric lending methodologies, emerging farm business finance, out-grower models, or savings linked approaches.

4.1.1. Direct smallholder lending

Direct smallholder finance models seem to be more effective than indirect or wholesale models in providing access to financial services for agricultural SMEs. The main advantage of the direct model is that it enables distribution of a full range of financial services, whereas the wholesale model mainly focuses on credit. Retail models also allow for a segmented approach to agricultural SMEs. For example, smallholders may be served only with small credits, whereas growing farmers could eventually apply for investment financing as well.

Key risk mitigate for this model are: (i) deep knowledge of the farmer and his or her business; (ii) a cap on the exposure to a single farmer; (iii) group lending (collective responsibility); (iv) integration into a supply chain; and, (v) providing cash to the farmer during the lean season to lower the side selling risk. The direct model allows the bank to attract deposits as well, which lowers funding costs and facilitates more effective asset/liability management.

4.1.2. Indirect lending through FBOs/cooperatives

This model, also known as a wholesale model, is based on a bank lending indirectly to smallholders through an aggregator organization, such as a farmer-based organization or cooperative. In the wholesale model, the entire group is the borrower, and therefore group members guarantee each other. In the agent model, the group's organization only administers the loans, and individual group members are the borrowers. The benefits of this approach are savings on costs of creditworthiness assessment and loan administration. The security of the

model can be enhanced by cash collateral requirements at the organization level, instead of traditional collateral or claims on harvest proceeds at the individual farmer level, as well as direct integration with input suppliers to reduce the amounts of cash disbursed directly to farmers.

4.1.3. Savings -account linked input finance

Savings are a very important part of the financial services package that banks want to offer farmers. Savings accounts are a stepping stone to turning a smallholder farm into a more commercial business. In addition, deposits are usually the most economical way for bankers to fund their business; they are de facto long-term savings. Finally, savings can be an effective part of the loan security package, and they can become the principal collateral to secure a loan. Success factors of this model are strong checks and balances that prevent farmers from “gaming” the system. “Checks” include “know your customer” (KYC) signals, such as requirement of references or membership of farmer associations, and “balances” include strong savings incentives and bonuses for high savings balances over longer periods of time.

4.2. FINANCING MOVABLE ASSETS

This sub-section reviews the experience and cases with movable assets as secondary repayment source. Movable assets can be anything from equipment to small infrastructure and commodities (post-harvest). This sub-section discusses term equipment finance separately from leasing cases. Although there is essentially no economic difference between the two structures, often the choice between the two is driven by tax and preferences with regard to ownership.

Challenges to long-term financing for investments such as irrigation, and farm equipment are even greater than providing seasonal working capital loans to agricultural SMEs in Ethiopia. In addition to constraints around enforceability of collateral, banks do not wish to have a long term local currency exposure and a mismatch with their liabilities on the funding side.

Funding of long-term deposits in local currency is often problematic. Some multilateral institutions are interested in providing long-term funding to local banks, but these are often denominated in USD and thus create a risk of a mismatch with the local currency long-term loans. The following models innovated to support long term financing for movable items are

4.2.1. Equipment finance

Equipment finance denotes financing of usually movable assets acquired as additions or supplements to more permanent assets. An important factor in this type of asset finance is close collaboration between the equipment providers (vendors) and the bank. Asset finance is based on a loan and pledge structure rather than a lease structure, due to specific local circumstances (tax issues) as well as the farmers’ preference to own their equipment. The following are some of key success factors for equipment finance, (i) understanding the farmers’ payment capacity; (ii) avoiding intermediates; (iii) local network and local decision processes with short response times; (iv) products that suit farmers and account for seasonal payment patterns; (v) a platform

for effective repossession and remarketing of equipment for defaulting farms; and, (vi) efficient handling of cash payments in the absence of bank relationships with its clients.

4.2.2. Leasing

A lease is a contractual arrangement between two parties whereby a party that owns an asset (the “lessor”) lets another party (the “lessee”) use the asset for a predetermined time in exchange for periodic payments. Leasing focuses on the lessee’s ability to generate cash flow from business operations to service the lease payment, rather than on the balance sheet or on past credit history. This explains why leasing is particularly advantageous for young companies, as well as for small and medium businesses that do not have a lengthy credit history or a significant asset base for collateral.

Furthermore, the absence of traditional collateral requirements offers an important advantage for weak business environments, particularly those with weak creditors’ rights and collateral laws and registries. Because the lessor owns the equipment, it can be repossessed relatively easily if the lessee fails to meet lease rental obligations; this is particularly advantageous where secured lenders do not have priority in the case of default.

The leasing entities that do have a focus on the agricultural sector are often linked to manufacturers or distributors of agricultural equipment in one way or another. Lease financing only partially overcomes the typical constraints to credit financing. Leasing firms often take additional collateral from rural clients, this practice is different from the typical lease transaction, in which the leased asset itself is considered adequate security. The security deposit or down payment required tends to be higher than typically demanded in developed economies.

In addition, a World Bank study finds that nonfarm enterprises account for a significant proportion of rural leases; rural leasing can be profitable, but jumpstarting rural leasing may require government and donor support; and, rural leasing companies may not always be viable. Given that leasing is a very specialized financial activity, economies of scale, cost, and risk factors may require leasing companies have large urban operations.

4.2.3. Warehouse receipt financing

Warehouse receipt finance is a form of secured lending to owners of non-perishable commodities, which are stored in a warehouse and have been assigned to a bank through warehouse receipts. Warehouse receipts give the bank the security of the goods until they have been sold and the proceeds collected. Given the limited collateral available to support farmers’ financing needs, such post-harvest commodities and warehouse receipts represent a liquid form of collateral against which banks can lend. When a well-functioning warehouse receipt system is in place, farmers have a choice in deciding whether to sell immediately after harvest (when prices are often lowest) or to store in a licensed warehouse and to apply for a short-term credit (thus enabling farmers to sell at a later date, when prices may be higher). Warehouse financing also

enables aggregators and processors to secure their sourcing throughout the year and to purchase their raw materials.

There is significant upfront work required to create, operate, and monitor a full warehouse receipt system. Necessary preconditions for a warehouse receipts system in which smallholder farmers can participate are many: (i) a legal environment that ensures easy enforceability of the security, and makes warehouse receipts a title document; (ii) reliable and high-quality warehouses that are publicly available; (iii) a system of licensing, inspection, and monitoring of warehouses; (iv) a performance bond and/or indemnity fund; (v) banks that trust and use the system; (vi) agricultural market prices that reflect carrying costs; (vii) supportive public authorities; and, (viii) well-trained market participants.

Even with the necessary preconditions in place, there remain risks in warehouse receipt systems, including: (i) fraud or collusion; (ii) credit and counterparty risk; (iii) storage risk and misappropriation by warehouse operators; (iv) price risks, given the volatility in agricultural commodity prices and government price intervention; (v) marketing or buyer risks; and, (vi) legal risks concerning perfection of security, registration of prior claims, and enforceability.

Collateral management agreement financing

A collateral management agreement (CMA) is a tripartite agreement between a collateral manager/warehouse operator, a named depositor or owner of the commodities, and a bank. The collateral manager acts as the custodian of the commodities held in storage at the warehouse on behalf of the bank. The collateral manager will not release the goods to the depositor or a buyer until the bank provides a written form of release to the collateral manager, usually only upon receipt of loan repayment or other payment assurance against its loan secured by the goods in storage. CMAs are generally costly and thus are often not accessible to smallholder farmers and agricultural SMEs. Nonetheless, agricultural SMEs might benefit from CMAs. Banks in developing countries often provide financing to aggregators, processors, and exporters backed by agricultural commodities held in warehouses under collateral management agreements in the absence of a fully-developed warehouse receipt system (according to the defined pre-conditions above). The same risks as outlined above for warehouse receipts also apply to CMA-backed financing, such as fraud, collusion, storage risks, credit risks, price volatility, and buyer risks.

However, as the bank maintains physical control over the commodity in storage via its custodian (the collateral manager) until its loan repayment is secure, there is limited risk that the bank's security interest will not be perfected.

4.3. FINANCING FARMERS IN VALUE CHAINS

Rather than relying on the creditworthiness of individual farmers, value chain financing and other approaches that rely upon buyers are based on business relationships in the value chain. Broadly speaking, value chain finance includes financial flows between value chain actors, such as buyers or input suppliers, as well as flows from financial institutions into the chain, or combinations of

both. The buyer security models are structured so that the bank relies upon the buyer contracts (verbal or written) to help secure its loans. From the bank's perspective, having a strong buyer in the chain in itself provides comfort, because it helps to reduce or manage the risks of limited market access and price volatility, especially if the farmer has an off-take agreement with a trusted counterparty, and is therefore less likely to default. Bankers may be further secured when the buyer helps to minimize default risk with the pledge of buyer receivables to the lender or some other form of guarantee, and by sale proceeds flowing through the bank.

Under these models, bankers base lending decisions on the strength of the value chain as much as on the creditworthiness of individual farmers. The downside of these arrangements is the dependence of farmers on a single buyer: when the buyer disappears or defaults on his or her obligations, the whole supply chain collapses and takes farmers repayments with it. An additional constraint of value chain finance is that it does not address other financial services needs of the farmers, given its focus on credit only. These models do not facilitate development of the smallholder into an emerging farm business. At least in traditional contract farming models, the farmer's role is limited to execution of the production plan of the off-taker/processor. The advantage for the farmer is that he or she hardly needs any working capital and that the income becomes predictable. The major benefit for the farmer and the bank is that cash flows become more predictable compared to standalone farmers, and that there is a risk of side-selling in tight value chains. A risk for the bank is that the buyer gets into financial/operational problems and is no longer capable of buying the produce under the contract. In addition, there is often a strong monitoring role for the buyer and there are often high set-up costs, given that the financing structure, related contractual arrangements, and procedures for monitoring and enforcement need to be tailored to each specific value chain situation. Buyers are interested in involving banks in the farmer financing, because they do not want to use significant capital for the non-core business lending to farmers. Bringing banks into tripartite arrangements allows buyers to leverage banks' balance sheets. Banks benefit from the buyer's knowledge of the chain and some level of buyer guarantee of farmer risk, given its higher risk tolerance. The value chain finance (VCF) models are divided into four categories, according to the characteristics of different value chains: (i) tight VCF with output buyers; (ii) loose VCF with output buyers; (iii) nucleus out grower models; and, (iv) VCF with input suppliers.

These distinctions are made according to the tightness of the value chain, which affects the magnitude of side selling risk, and according to the actor in the chain with which the bank interacts to implement its financing model (output buyers vs. input suppliers). The risk of side-selling is the biggest challenge for any actor that provides inputs, input finance, or working capital to farmers in a value chain with the expectation to generate repayment via sale proceeds, whether it is the bank, the buyer, or an input supplier. *Tight value chains*, such as sugar and cotton, have integrated value chains where farmers face only one de facto buyer for certain types of crops: highly specialized export crops; highly perishable crops; and crops with constriction points in the chain, usually transport costs or specialized processing. In these tight VCs, side-selling is very costly or even impossible. These characteristics are also applicable to most *nucleus/out grower financing models*, in which nucleus farms typically give out grower farmers' access to processing, transport, and markets for cash crops. *Loose value chains* are typical of

crops that are more easily marketable and therefore attract third-party buyers to purchase crops directly from farmers in the value chain. While farmers may have contracts with value chain buyers, they can be tempted to side-sell to these third party buyers. *VCF for input suppliers* includes farmer financing by other value chain actors, such as agro-dealers, who access financing from banks for their own working capital to finance their farmer customers.

5. RECOMMENDATIONS

The ability of the financial sector to further serve the Ethiopian agricultural sector could be enhanced through a four key areas of focus. These include: (a) improving incentives and regulation for financial institutions to serve the agricultural sector, (b) increasing the participation of financial institutions in rural sectors by starting to use them as a channel for government cash flows, (c) accelerating the introduction of new product offerings, and (d) improving the overall "fitness" of the financial sector.

5.1 IMPROVING INCENTIVES AND REGULATION

1. Setting the right incentives for financial institutions to serve the rural sector.

To ensure a sufficient supply of credit in rural areas, the government could provide additional and targeted incentives for financial institutions to serve it. The purpose of these incentives would be to make the rural sector financially attractive to serve for both public and private financial institutions.

Incentives could be fiscal in nature, e.g., tax reduction for banks active in rural areas, or co-investments such as a government contribution to investment made by the financial institution as subsidy. Regulatory advantages can also be used as incentives, e.g., providing temporary monopolies to some players who commit to banking the rural areas and especially the agricultural sector. Temporary monopolies would lead to higher probability and quicker realization of pay-off on investments, and therefore private players might also be interested in serving the agricultural sector. However, this would need to be carefully balanced and assessed with the negative effect of such a regulation, which may keep some innovative players out of the market and reduce competition. In many cases, this is a necessary prerequisite to improve product offerings and customer service.

The government and donors could also consider well-designed guarantee schemes (e.g. with first-loss-absorption elements) to reduce the risk for credit lenders or a dedicated guarantee on rural deposits to increase savings mobilization in rural areas (as mentioned earlier, NBE is already developing a countrywide deposit insurance system). Incentives for banks to mobilize deposits are generally key in such a program, since – as shown above - much of the required additional capital is currently lying "idle" with customers that do not have access to or sufficient trust in the banking system. Additional direct capital injection into the agricultural sector, via CBE, regional and international development banks, or other donors is also an option, if it is coupled with improvements in the capabilities of the financial sector and the proper incentives for banks to lend these funds profitably to the sector. Providing direct funding support without restrictions or setting up a system of "directed lending", e.g., in the form of mandating local banks to provide their excess liquidity to the agricultural sector, is not recommended. Such an approach, often coupled with the setup of a dedicated government owned agricultural banks that were mandated to lend a certain amount of money to agriculture, has not been very successful in the past.

Especially in Africa, many such approaches and institutions have failed or led to massive performance problems. Examples include the Principal Bank for Development and Agricultural Credit in Egypt, the Agribank North West province in South Africa, the Agribank, Zimbabwe, the Land Bank of South Africa and Banrural in Mexico). The issues discussed above regarding asset quality and risk management capabilities in DBE indicate that Ethiopia is also not immune to the problems associated with directed lending.

2. Improving the regulatory environment for rural financial institutions.

Although there is an overall sound regulation for financial institutions in Ethiopia, there are two broad areas that could be improved:

- **Dedicated regulatory framework for financial cooperatives.** The FCA currently regulates financial cooperatives under the same framework as all other multipurpose cooperatives. Should the importance of financial cooperatives in rural areas increase, there will be a clear need for a dedicated regulatory framework that is similar to regulation of MFIs. Due to the fact that some financial cooperatives are engaged in finance on a (relatively) large scale, they need specific governance structures, proper risk management systems, and a regulator that deeply understands financial markets.
- **Countrywide deposit-insurance system.** Although limited access to financial institutions might be the primary cause of low savings rates, increased trust in the financial sector from a nationwide deposit-insurance system would help increase savings mobilization. A first step could be a guarantee for all deposits given to banks and MFIs. In later stages, financial cooperatives could be included. The deposit insurance should be under the oversight of NBE, which has already started to conceive a deposit insurance system.

5.2 STRENGTHENING RURAL FINANCIAL INSTITUTIONS BY USING THEM AS A CHANNEL FOR GOVERNMENT CASH FLOWS

3. Providing input credit

Including financial institutions in the supply of input credit to increase the effectiveness of the system and to help financial institutions in rural areas to strengthen their position is an area of immediate opportunity.

4. Increasing financial inclusion and further strengthening rural financial institutions by using them as a channel for other non-credit government payments.

To strengthen the role of financial institutions in rural areas and, at the same time, increase financial inclusion among the very poor, channeling public payments through existing financial institutions is recommended. Doing this would give more individuals the chance to interact with financial institutions and become familiar with this system. To date, many people in rural areas have no incentive to visit an MFI branch – this would change by implementing such a system.

One possible example is the integration of financial institutions into a PSNP payment system, as detailed in the following.

This recommendation is based on a larger report published separately by a study funded by the World Bank and the BMGF. Working together with an initiative commissioned by the Food Security Coordination Directorate of the MoARD, the MoFED, and development partners supporting the PSNP to assess the ideas for improving the timeliness and predictability of PSNP transfers, a multipart intervention has been developed based on a social payments-led model.

This builds on the premise that existing financial systems can be used to increase the rate of financial inclusion in the rural sector. One example of such a system is the PSNP, a USD 450 million annual program to distribute payments, usually in exchange for work, to 7.8 million individuals in critically food-insecure areas of Ethiopia. Currently, funds are generated by donors and government agencies and channeled through NBE and the CBE before they reach *kebele* payment points, where cash payments are distributed directly to recipients in paper envelopes once every month. Such a payment system excludes linking recipients to financial service providers.

Linking the large PSNP payment base to existing financial institutions (MFIs or other financial service provider) could have significant positive impact. The role of the financial institution would thus be expanded sequentially from merely supporting the distribution of these funds and offering paper-based financial services to distributing payments electronically and offering electronic financial services. The proposed intervention has three parts:

- **Manual system improvement.** Reform the existing manual-based cash payment system implemented by the MoFED in coordination with the FSCD. This aims to improve the efficiency and effectiveness of the current PSNP payment system nationwide.
- **Electronic reporting.** Exploit the potential of the PASS to address bottlenecks in the current PSNP reporting system by introducing electronic reporting. This aims to relieve current bottlenecks in the timeliness and quality of PSNP reporting that result in delayed payments
- **Payments with financial services.** Pilot innovative linkages between the PSNP and financial intermediaries such as MFIs or rural financial cooperatives, including the use of technology. This aims to test innovations that could significantly improve the predictability of payments to PSNP clients, while also improving the accessibility of financial services.

The latter has especially strong potential to address the lack of access to financial services for rural populations. The PSNP offers a base to reach rural populations at a lower cost compared with other methods. This arrangement will also have the potential to increase the impact of PSNP payments, as studies have shown that distributing payments with financial services increases the impact of those payments.

This part of the proposal includes three phases of interventions. First, financial intermediaries, such as an MFI or SACCO loan officer, should be present at the payment point to offer financial services to recipients. Initially, services offered will be paper based. Second, recipients will

receive an ID card and each payment point will receive a POS. This POS will interface with a third-party central server to verify identity and track payments. Third, electronic financial services will be added, expanding the financial intermediary capacity and creating new opportunities for innovative services. The creation of the electronic channel will also encourage other donors to leverage the installed infrastructure.

5.3 ACCELERATING THE INTRODUCTION OF NEW PRODUCT OFFERINGS

5. Putting in place the right conditions to increase the offering of insurance products, starting with index-based weather insurance.

Insurance products play a very important role in mitigating the high risk of the agricultural sector for both customers and financial institutions, and should be rolled out in the whole sector. This includes all types of insurance, such as health, life, and weather. Implementing a working weather insurance system can be a first step; however, other insurance products (e.g., life, health) should follow in the long run. There is also a need to increase financial literacy and awareness of insurance products among the farming community. This can be done in Farmer Training Centers, MFIs, or SACCOs. MFIs and SACCOs can be leveraged to advise farmers on and sell them the correct insurance products for their needs. However, most MISs and SACCOs will also need training to understand insurance basics and to get advice on how to sell insurance products. A regulatory framework for micro-insurance should be put in place and the government should potentially subsidize the ramp-up of a national insurance system to speed up the process. In the long run, the goal should be to have a working weather insurance system in place and also to be able to offer the full suite of standard insurance products to the population in Ethiopia.

6. Leasing

In Ethiopia, operating leases have been practiced widely for quite a long time. Hire-purchase schemes were introduced and practiced by car dealers and household furniture retailers in the 1960s and early 1970s. With the advent of socialism hire purchase schemes were discontinued, but operating leases were still around though in a disorganized and fragmented manner. Recently, microfinance institutions have been introducing leasing for MSEs based on successful models in Tanzania and Bangladesh.

Leasing is one of the most important instruments to resolve the problem of collateral not only for medium and large scale types of industry but also it is a tool for micro and small scale enterprises and rural service providers. This is actually proved by various leasing companies as well as financial institutions like Grameen Bank of Bangladesh and Bank Rakiyta of Indonesia.

To realize the benefits of leasing in Ethiopia, it is appropriate to treat and regulate leasing companies as financial institutions. This should be allowed for all institutions getting a license to

run leasing business and with more emphasis being given to Banks and MFIs so as to attract them. When we look at proclamation number 67/1997 article 20(1) (c), The Ministry of Trade and Industry shall not issue licensee for banking and insurance activities. The same is also true according to proclamation number 83/84; National Bank of Ethiopia has power to issue license for financial institutions. Thus, leasing proclamation must consider such laws to avoid contradictions.

7. Fostering the buildup of IT infrastructure and mobile banking technologies.

Further government investments in mobile technology infrastructure are important for the further development of Ethiopia; however, the GOE must also create the right incentives for others to invest in the development of mobile technology. There are already intensive discussions in Ethiopia on mobile banking and the development of a uniquely Ethiopian solution that centers on the financial institutions rather than the technology provider. An acceleration of those discussions is encouraged as the benefits to the rural sector from such development are substantial.

Mobile banking enables people to safely store or transfer money and get access to funds in distant areas, thereby expanding access to the thus far unbanked populations. The advantages for the agricultural sector will be increased access to financial services, the opportunity to receive money without having bank access, lower transaction costs than traditional banking channels, and the opportunity to use the mobile banking system for different purposes (buy airtime, send money, save money, pay bills). There are also advantages for financial institutions. For banks, the key opportunity is the huge market of so-far unbanked people in remote areas who can be addressed with a branchless banking approach. Case studies from other countries show that it is possible to establish a profitable mobile banking system (e.g., M-PESA in Kenya) in developing countries and therefore the goal of the government should be to attract investors to set up the right system and the necessary infrastructure. There will have to be a sound regulatory framework that ensures adherence to the interests of the government, the population, and the system provider. It is important especially for system providers to have reliable regulation that ensures some security for investments (e.g., regulation regarding technical standards or security requirements).

5.4 IMPROVING THE OVERALL "FITNESS" OF THE FINANCIAL SECTOR

8. Putting in place a coordinated capability-building program for financial institutions and customers.

Changes in the policy framework and in the distribution of responsibility in the financial sector need to be accompanied by strong efforts to change the mindset and capabilities of stakeholders, on both the customer and supply sides.

Within the agricultural finance sector, the majority of potential customers lack basic business skills and understanding of financial products such as financing and risk management tools

Financial institutions, such as MFIs, SACCOs, and commercial banks, lack understanding of farming economics, especially risk management.

In order to develop these critical skills and change mindsets, a systematic assessment is first required to understand knowledge gaps and priority areas. In a second step, coherent training modules and other supporting elements, such as change stories, incentive structures, and role models, need to be designed. For financial institutions, this would entail developing standard curricula with regard to key banking processes, with a strong focus on risk management. This training program should be delivered through existing channels (e.g., extension system to educate rural populations) and newly developed institutions (e.g., national banking or MFI training academy to support financial institutions). To ensure the highest quality standards, a broader perspective and expertise from outside the country can be brought in to build a first-class training system that could be available for public and private players. With regard to the rural sector, there are already plans to leverage the existing extension system to develop financial literacy in the farming community.

9. Increasing "systemic readiness" for possible further liberalization of the financial sector.

This report recognizes the strong regulatory framework in the Ethiopian banking sector and the advancement that has been made in this framework, especially liberalization efforts which enable the growth of new private banks. The regulation in Ethiopia is very much in line with regional benchmarks. However, in order for the sector to further expand those gains, broaden its reach among the rural population, and become a driver of agricultural growth, further innovations and improvements should be considered. In addition to the other recommendations outlined above, one issue that the government may consider is the possibility of slowly opening up the banking sector to foreign institutions. Although such a policy comes with risks and needs to be considered and rolled out very carefully, it could have positive implications for the entire Ethiopian economy.

Consideration of such a policy, however, should only be undertaken when the local banking sector is in a strong enough position to benefit from any introduction of outside players. This requires a long-term commitment by the GOE and local stakeholders to address some system issues, which can provide benefits even if external partners are never invited into the domestic economy.

Slowly and carefully opening the market to selected international player(s) might help to speed up the capability-building process and deliver other benefits. In particular, the potential for fast skill transfers with regard to new technologies, products, and management techniques can be seen as one of the key advantages. Customers would benefit from the new competition, especially from innovative product offerings and increased customer support. With regard to funding/capitalization of banks, a foreign investor could help provide access to international capital markets. Another advantage would be better overall economic diversification as the risk of the banking sector would be shared among international investors, not just nationally. There would also be potential to strengthen regulatory framework through "imported" regulation.

However, there are also significant risks when of liberalizing a market and introducing foreign bank participation in an environment that is not sufficiently prepared. Foreign banks might "skim" the most attractive market segments and leave local banks with unprofitable customers (potentially causing massive exits). Local regulators could have challenges coping with foreign players, causing potential systemic instability. Moreover, Ethiopia could be exposed to risks connected to new players in the market (risks in foreign banks' home countries, potential short-term engagement mindset, failures of new entrants due to inability to cope with local market conditions).