Access to Credit for MSEs and Credit Information System in Ethiopia

Policy Environment and Regulatory Issues

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Abbreviations and Acronyms

CBE	Commercial Bank of Ethiopia
CSA	Central Statistical Agency
DBE	Development Bank of Ethiopia
EEPCo	Ethiopian Electric Power Corporation
ERC	Ethiopian Railway Corporation
FCA	Federal Cooperative Agency
GDP	Gross Domestic Products
IMF	International Monetary Fund
MFIs	Microfinance Institutions
MoFEC	Ministry of Finance and Economic Cooperation
MSEs	Micro and Small-Scale Enterprises
NBE	National Bank of Ethiopia
NPC	Ethiopia's National Planning Commssion
PCBs	Private Credit Bureaus
PCI	Precise Consult International
PCRs	Public Credit Registries
SoEs	State Owned Enterprises
WB	World Bank

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Sincerely,

Henok Assefa

Managing Director, Precise Consult International PLC

I Introduction

Background

MSEs are crucial in economic development of any country due to their role being preponderate in terms of employment creation, contribution to Gross Domestic Product (GDP), foreign exchange generation and tax revenue to name a few. Although there is a lack of data to precisely evaluate the value of MSEs in the Ethiopian economy, some surveys have shown that these companies employ large groups of people and add considerable value to the overall economy. As per Central Statistical Agency (CSA) survey, about 155 thousand small-scale manufacturing enterprises were operating nationwide in 2017/18. These establishments generated about 2.1 million job opportunities and added more than Birr 49.0 billion to the GDP in the same period.

Despite their profound economic impact, access to finance is a major obstacle to the growth of Ethiopia's MSEs as reported in the above survey. The World Bank Ease of Doing Business Report and Enterprise Survey also complement the notion that access to finance is a major challenge for Ethiopia's private sector in general and MSEs in particular.

Although private sector credit is limited for a variety of macro- and microeconomic factors, the influence of greater credit access of State-Owned Enterprises (SOEs) through crowding out the private sector remains paramount. At the end of June 2020, private sector credit from banking system amounted to 14.4 percent of the GDP compared to 16.2 percent of credit given to SOEs in the same period. Additionally, according to data from the International Monetary Fund (IMF), the Sub-Saharan African average credit to the private sector stood at 24.3 percent in 2019 which amplifies the lower level of credit extended to the private sector in Ethiopia. Given the high risk and lack of collateral that characterize MSEs, their credit access is generally lower.

Understanding the value of MSEs in sustaining Ethiopia's growth and development, the government has recently introduced some policy measures geared towards increasing access to credit to the private sector in general and MSEs in particular. These policy measures include the introduction of movable collateral registry system and the abolishment of NBE bills directives. However, the playing field for the private sector and SOEs in terms of access to credit does not still seem fair.

The Commercial Bank of Ethiopia (CBE), the country's largest public owned bank, which accounts for more than 60 percent of the outstanding credit of the banking system, continues to channel funds, often through direct government instructions, primarily to SOEs. This leaves limited access to credit for the private sector and even less credit for MSEs.

Furthermore, in the absence of a good Credit Information System (CIS), the financial system depends on collateral to protect itself from credit risk. The collateral requirements by formal financial institutions to access credit is a shared challenge amongst MSEs. Currently, there is only one credit bureau in Ethiopia, the Public Credit Registry (PCR), which is housed under the NBE. The operation of the bureau is limited in its scope and depth, forcing the financial institutions with no choice but to adhere to the collateral-based credit system, leaving some of the potential clients.

Objective of the Study

The main objective of this study is to assess policy and regulatory issues that are vital to equitable access to credit for MSEs and the public sector in Ethiopia. In addition, the study has the objective of identifying critical challenges of CIS and its opportunities to improve the system with the ultimate goal of increasing MSEs credit.

Methodology, Approach and Structure

Data Sources: The study used both primary and secondary data, where the former were collected through key informants' interviews and a focus group discussion with key stakeholders. Relevant secondary data were collected from the NBE, various Commercial Banks, Savings and Credit Cooperative Organization (SACCOs), and micro-finance institutions (MFIs), Ethiopia's National Planning Commission (NPC), CSA, Ministry of Finance and Economic Cooperation (MOFEC), World Bank (WB), International Monetary Fund (IMF), Central Banks, government ministries & agencies, and other pertinent documents.

International Benchmarking and Best Practice: Three successful countries with respect to enhancing access to credit and CIS were selected based on performance analysis, experiences, and relevance to the Ethiopian context. Accordingly, international best practices from Kenya, Rwanda and Malaysia were reviewed and lessons learned.

Method of Analysis: The study employed descriptive data analysis techniques and benchmarking exercises.

Structure of the Study: The study is organized into five parts. Part II gives an overview of access to credit and CIS in Ethiopia. Part III provides the current policy landscape of Ethiopia in terms of credit access and CIS. Part IV discusses other countries experiences to draw lessons for Ethiopia. The final section, Part V, offers policy recommendations to aid the government in improving MSEs access to credit and the CIS.

II Overview of Access to Credit and Credit Information System

Access to Credit

Creditors in the Formal Financial Sector

As specified in Article 2(9) of the Banking (amended) Proclamation No.1159/2019, insurance companies, banks, MFIs, capital goods financing companies, reinsurers, micro-insurance providers, postal savings, money transfer institutions, digital financial service providers, and other institutions as determined by the NBE are all classified as financial institutions in Ethiopia.

SACCOs are not considered formal financial institutions under this definition; however, we opted to include them as essential formal financial institutions because they are the ones which primarily serve MSEs in Ethiopia. Furthermore, as per the proclamation, credit services are only offered by banks, MFIs, and capital goods financing companies. In this study, therefore, the formal credit providing institutions covered are banks, MFIs, capital goods financing companies, and SACCOs.

Currently, there are 16 private banks, one public commercial bank, one development bank, and more than 17 new upcoming private banks. The public owned CBE is the dominant bank in the industry as it has more than 1,800 branches across the country. On the other hand, the 16 operational private banks have 4,729 branches combined. More than 34.0 percent of the commercial banks' branches are located in the capital city, Addis Ababa. In terms of account, commercial banks in Ethiopia have more than 55 million customer deposit accounts while the numbers of credit accounts are less than 300 thousand. The development bank, Development Bank of Ethiopia (DBE), is the other public owned development financing institute. The bank has 82 branches located in different parts of the country and availing credit to SMEs is one of DBE's core objectives.

Similarly, 39 MFIs are currently operational, mainly serving MSEs with approximately 5.5 million credit account holders and with outstanding credit of more than 64.0 billion Birr. These MFIs face a number of obstacles, including strong competition from commercial banks, lack of automation that leads to high operational costs, and lack of linkage with commercial banks, among others. Recently the NBE introduced a directive that set a rule for MFIs to graduate into Micro-Finance Banks. MFIs are therefore one of the major credit providing stakeholders for MSEs. Additionally, NBE's directive allows MFIs to give leasing service without any requirement for additional license.

In terms of SACCOs, Ethiopia had over 21 thousand primary SACCOs with a total membership of 5.8 million as of 2019. As per the data from the Federal Cooperative Agency (FCA), about 42.0 percent of the total members are women. During the same period the total savings of SACCOs was 21.1 billion Birr and extended 3.9 billion Birr fresh credit to their customers. With regard to beneficiaries, over 441 thousand SACCOs members had a credit line access in a single year.

The last formal financial institution that provides credit to MSEs are capital goods financing companies. Currently there are 6 capital goods financing companies in Ethiopia. Unlike other financial services, this space is open to foreign investors, with one foreign owned company (Ethio-Lease) already operating in the market. The outstanding credit of capital goods financing companies stood at 1.1 billion Birr with close to five thousand beneficiaries. The interest rate charged by these companies range from 12-19 percent per annum. Shortage of foreign currency is one of the major hurdles that these companies have been facing for their operations.

Public Sector's Engagement and Access to Credit

Ethiopia's high economic growth registered in the past decades was driven by huge public enterprises investments. Government-owned utility services (such as power and communication), transportation, sugar factories, and so on have contributed to the significant share of public enterprise investments. These investments were financed both from domestic and external borrowing. Public banks, mainly CBE, has been the major creditor to these enterprises. Although NBE and DBE do not directly finance public enterprises, some of their policies are aimed at providing credit to the sectors identified as priority sectors by the government.

CBE is one of the major players in the domestic credit market. Its market share was more than 60 percent measured by its assets, its loans, and its deposits. Although, the bank has more than 30.0 million deposit account holders, only a few public enterprises constitute the majority of the credit extended by the bank. Ethiopian Electric Power Corporation (EEPCo) and Ethiopian Railway Corporations (ERC) are its two biggest borrowers.

CBE's credit exposure to EEPCo was amounted to 302.3 billion Birr at the end of June 2020, which was equivalent to 47.7 percent of CBE's total outstanding credit and 29.3 percent of the whole banking systems outstanding credit. Moreover, CBE's total credit exposure to the public enterprises amounted to 85.6 percent of the bank's outstanding credit. Not only are public enterprises favored in terms of access, but they also benefit from the favorable terms of the bank.

Those public companies often receive loans from CBE through government guarantees, often without thorough financial feasibility review, as the loan is extended by corporate bonds issued by public companies. The interest rate on these corporate bonds ranges from 9-11.5 percent per year, compared to the 14.0-15.0 percent annual interest rate charged by the private banks.

The NBE has also been adopting some polices that adversely impacted credit to the private sector in general and MSEs in particular. One of these policies was the NBE-bill. The NBE-bills purchase directive had compelled private banks to buy NBE bills equivalent to 27 percent of their disbursement, before the bank ceased it in November 2019. According to this directive, the proceeds from the sale of the NBE bills are transferred to the DBE, while the DBE subsequently lends it to the selected priority sectors, such as the manufacturing, and the agricultural sectors. Such policies have an effect on lending to MSEs by making them available with the remaining thin credit. Moreover, as these banks have to make profit on the remaining fund alone, they tend to incline towards lending to well-established corporate firms, leaving loans to MSEs squeezed.

Additionally, NBE recently issued a new directive to operationalize the movable collateral registry system, which aimed to address the lack of collateral for the access to credit of MSEs. This directive requires banks and MFIs to extend at least 5.0 percent of their annual credit disbursement in the movable collateral system.

On top of directing the credit allocation of financial institutions, NBE provides direct credit to the central government. Net credit to the government by NBE constitutes significant amount of total domestic credit by the banking system. For example, at the end of June 2020 net credit to the government by NBE amounted to 17.6 percent of domestic credit by the banking system. This credit is mainly used to finance the central government budget deficit, with a subsidized interest rate.

The DBE is also a public owned bank that accounts for about 5.0 percent of the banking system's outstanding credit. DBE is a specialized bank which has a mission to provide working capital and project loans for selected sectors that have difficulty in accessing credit but are believed to have substantive economic impact for the long-run economic growth of the country. The economic sectors that are financed by DBE include manufacturing, agriculture and export sectors. DBE also has special products, such as lease financing that target small and medium enterprises (SMEs).

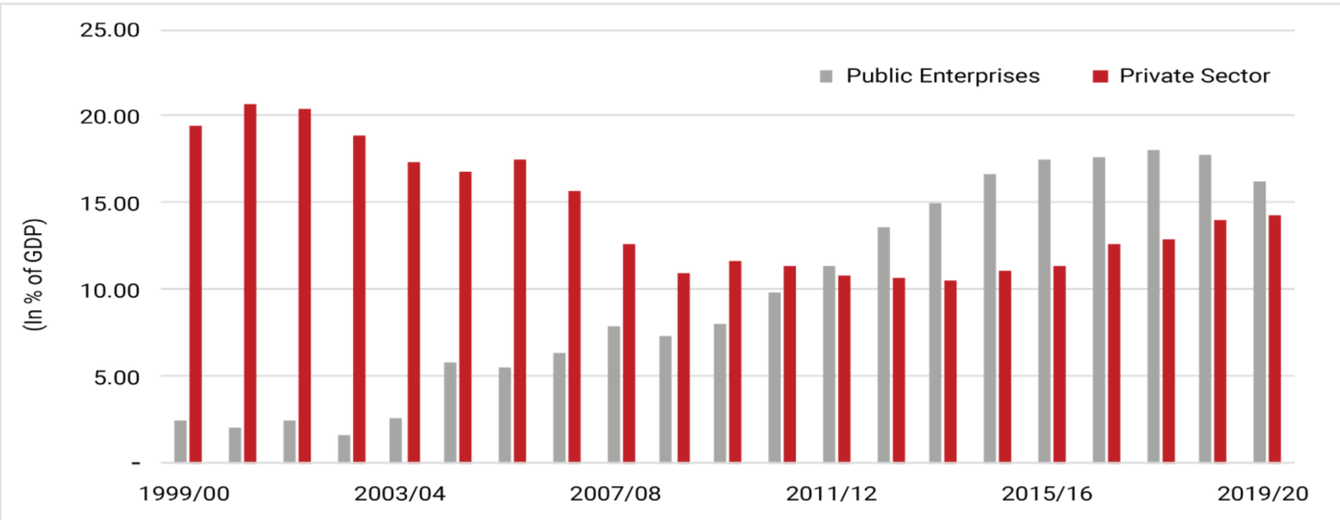
Unlike CBE, DBE's credit mainly went to the private sector. At the end of June 2020, DBE's outstanding credit stood at 51.1 billion Birr which was slightly lower than the first largest private bank (Awash Bank) but higher than the second largest private bank (Dashen Bank). More than 80.0 percent of the bank's credit went to the private sector. DBE, on top of directly extending credit to the selected sectors, it also arranged a refinancing scheme for SMEs (those enterprises that have employees between 1-100 and loan request of less than Birr 10.0 million) through commercial banks. The bank provides credit to commercial banks with below market interest rate so that they can lend to SMEs.

In addition to the direct role played by the public financial institutions in domestic credit allocation, government indirectly alters access to credit to the selected sectors by implementing different policies. The Ministry of Finance gives guarantees to public enterprises to access credit both from domestic and external sources. For instance, the government arranged 10.0 billion Birr in revolving funds for youth employment creation in 2016.

As a result of the government policies discussed above, the share of public sector credit overtakes that of the private sector. In 2010/11, public sector credit amounted to 9.9 percent of GDP compared to 11.4 percent from the private sector. Credit to the public sector overtook credit to private sector as it increased to16.2 percent in 2019/20 versus 14.4 percent for private sector. Private sector accounted for 46.9 percent of the outstanding credit while the public enterprises took the remaining 53.1 percent of the outstanding credit.

The EEPCo, the ERC and housing enterprises are the major borrowers from public enterprises. As shown in the figure 1 below, credit to public enterprises was incessantly increasing starting from 2003/04 and overtook credit to private sector in 2011/12. The widening gap is clearer afterwards, despite the declining trend in the last two years.

Figure 1: Outstanding Credit (in % of GDP)



Source: NBE, 2021

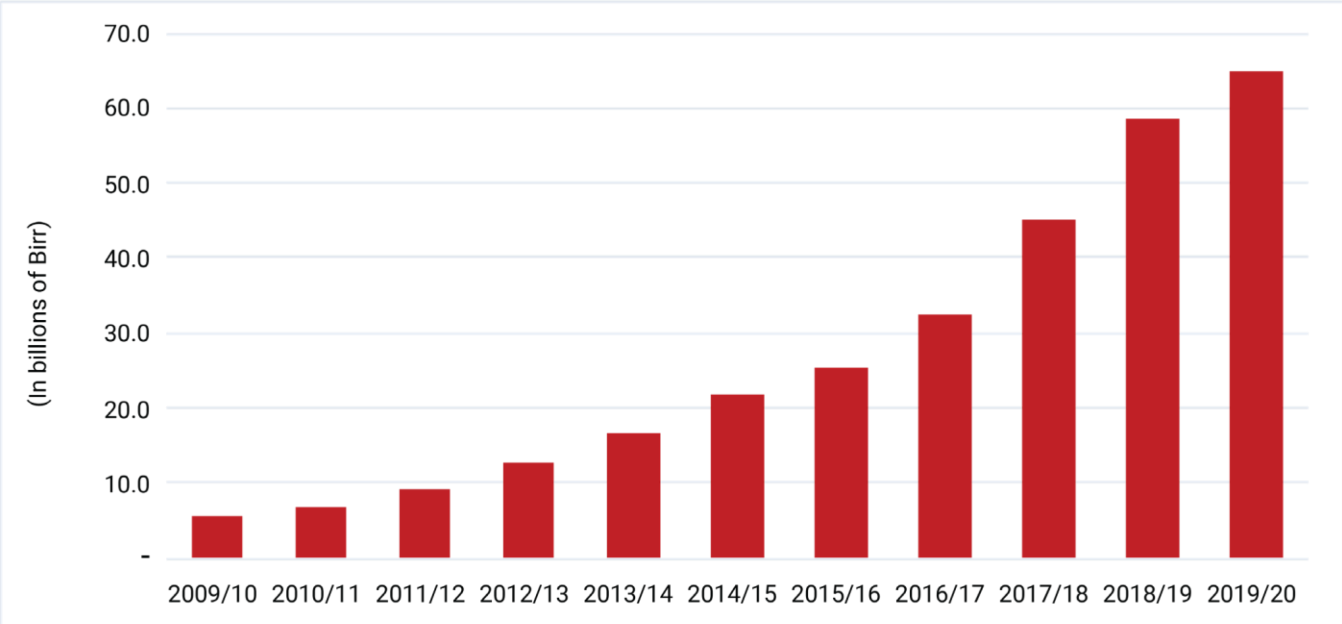
Private Sector's (MSEs) Engagement and Access to Credit

Private Banks, MFIs, capital goods financing companies and SACCOs are the formal financial institutions that provide credit to the private sector. Currently, the 16 private banks in Ethiopia have a total asset size of 577.0 billion Birr and an outstanding credit of 347.1 billion Birr. Industry, international trade, and domestic trade are the top three beneficiaries of private banks' credit. Industry took 53.7 percent of the outstanding credit by private banks followed by 33.7 percent for international trade, and 20.0 percent for domestic trade. The agricultural sector took only 2.5 percent of the outstanding credit by private banks. The credit distribution is in contrary to the value addition of these sectors to the GDP of the country. In 2019/20; agriculture, industry and service sectors contributed 32.7 percent, 29.0 percent and 39.5 percent to GDP, respectively.

Although there are 39 MFIs that are currently operational in Ethiopia, their size is relatively small compared to the banking system. For example, in June 2020, MFIs assets amounted to just 5.8 percent of the banking system. The largest MFIs, namely Amhara, Dedebit, Oromia, Omo and Addis, accounted for more than 86.3 percent of the total assets of the industry. The main customers of MFIs are believed to be MSEs. Hence, it may not be wrong to assume the highest share of outstanding credit of MFIs went to the MSEs.

The outstanding credit of MFIs stood at 64.9 billion Birr in June 2020, which is just 6.3 percent of the outstanding credit by the banking system during the same time. In terms of sectorial distribution, more than 47.0 percent of the MFIs credit went to the agriculture sector followed by trade (22 percent) and other service sector (14 percent). As MFIs serve more than 5.5 million credit users, it implies the importance to the MSEs in terms of providing credit.

Figure 2: MFIs Outstanding Credit



Source: NBE, 2021

SACCOs and capital goods financing companies are the remaining formal financial institutions that provide credit services in Ethiopia. There are more than 20 thousand SACCOs that are currently operational in Ethiopia. SACCOs are regulated by the Federal Cooperative Agency (FCA). Though latest data is hard to find, as of the end of June 2018, the associations mobilized 11.9 billion Birr in savings from their members and disbursed 8.4 billion Birr in loans. In terms of members' size, these associations serve close to five million members. Like MFIs, SACCOs are also expected to serve MSEs and relatively poor households.

On the other hand, the capital goods financing companies (CGFC) are the first financial services that are allowed for foreign investment. Currently there are 6 businesses that are involved in the leasing business. The services provided by CGFC is especially helpful for MSEs as it eases the collateral requirement by banks. In fact, the latest data shows that CGFCs have provided more than 1.1 billion Birr in financing their customers.

Credit data on MSEs is not possible to find. However, given the distribution of the credit both in terms of economic sector and client wise (i.e. public vs private sectors) we can infer that credit to this sector is very low. This is supported by the survey evidence in which small scale enterprises mentioned access to credit as one of the major challenges for their businesses. According to CSA's survey of 2017/18 on small scale industries, the top three problems faced by small scale industries to solve their working capital shortage are insufficient permitted loan, high collateral requirement, and long loan processing periods.

Summary of Unfair Practices & Policies for Public vs. MSE's Access to Credit

The major policies that create an unfair playing ground for public and MSEs are the credit disbursement practice of the public owned largest bank, CBE. This is supported by government guarantees for credit to SOEs while other sectors including MSEs did not get this kind of favor from the government. Even though both CBE and DBE have an objective to provide credit to MSEs on paper, the fact on the ground is that MSEs get only a tiny portion of the total credit.

In addition, the lack of clear and universal definition of MSEs is one of the causes for ineffectiveness of policies targeting MSEs in Ethiopia. As per the information from NBE, the initiative to have a single definition of MSEs is now in its final stage and expected to be implemented in the current fiscal year. Commercial banks for example have their own definition for SMEs that are based on their business interest.

Furthermore, the Ethiopian banking system relies heavily on collateral-based lending. In the case of small enterprises, the collateral coverage ratio reached more than 320 percent (2015 World Bank Enterprise Survey), which is serious. Similarly, another main issue is the absence of both MSE dedicated windows and the paucity of MSE tailored products in the financial sector. The non-existence of private credit information bureau coupled with weak public credit reference bureau makes also MSEs disfavored in access to credit.

Financial institutions designed to serve MSEs, such as SACCOs and MFIs, receive little government attention and funding, which also restricts their capacity to provide MSEs with the credit they require. Finally, some of interventions by the government on the credit market are not market friendly, which leads to negatively affect the resource allocation. DBE's direct lending practices and NBE's 27.0 percent directive could be mentioned as examples.

Credit Information System

Stakeholders Mapping of Credit Information Providers

The mapping of stakeholder in CIS is viewed from four perspectives. These are: CIS service providers, CIS users, CIS ultimate beneficiaries, and regulatory and supervisory body.

CIS service providers: Credit Reference Bureau (CRB) –the primary duty of CRB is to collect and share credit information from and to the financial institutions.

CIS Users: Banks- while other financial institutions such as micro-finance and SACCOs can use the CIS, the service is currently limited to banks in the case of Ethiopia. By minimizing the information asymmetry about a borrower's creditworthiness, strong CIS can reduce adverse selection thereby lessening default rate.

CIS ultimate beneficiaries: Borrowers-by providing evidence of their credit worthiness, the CIS could benefit borrower's chances of getting loan conjointly at a reasonable credit term. By reducing collateral requirement, lowering interest rate via minimizing the credit risk premium, strong CIS will increase MSE chances of obtaining the loan.

Regulatory and Supervisory Body: NBE- the NBE is accountable for ensuring the credit reference system runs smoothly and efficiently.

Overview of the Credit information System

The theoretical rationale for CIS emerged from the following justifications, as documented by Jappelli and Pagano (2000). The first emanates from CIS's role in combating adverse selection problem. Getting information about the creditworthiness of borrowers will reduce the probability of selecting risky borrowers, which in turn increase the pool of borrowers, while reducing the default and average lending rate.

The second justification originates from the importance of CIS's in eliminating lenders hold-up problems. Without good CIS, a particular bank with detail client information would have a market leverage to charge higher interest rates in the future because the client will not be able to pass his or her good credit history to other lenders. On the borrower's side, expecting the bank to charge unreasonable rates over time, they would make poor performance attempts, resulting in high default rates and interest rates. The implementation of the CIS would do the opposite, meaning that banks would reduce their own future ability to extract information rent, resulting in lower default risk, lower interest rates and higher loans compared to the situation without sharing information thereby avoiding potential hold-up problems.

The third stems from the role of the CIS in removing the 'disciplinary impact of default disclosure' of lenders. In an attempt to escape from higher interest rate penalties associated with poor loan quality, borrowers could expend more effort resulting in lower default and interest rates at the same time increasing overall lending.

Finally, credit information sharing removes the incentives to over-borrow from different sources. By disclosing the borrower's credit history, lenders will remove such moral hazard problem that would ultimately decrease borrowers' repayment capacity.

Once the importance of the CIS is well established, the other issue is to discuss the ownership structure options available when forming up the CIS. Worldwide experience has shown that the CIS can be established as an independent Private Credit Bureau, Lender-owned Credit Bureau or Public Credit Register (PCRs). As documented by Jappelli and Pagano (2006), in the case of Private Credit Bureaus (PCBs), access to a shared database is given for data collected from corresponding creditors on borrowers and, in return, for creditors providing private information to credit bureaus. The second choice is to establish credit bureaus by lender ownership. Nevertheless, such type of ownership structure could trigger free riding problem as each lender would like to obtain the data provided by other creditors without disclosing their own. It could also potentially trigger entry barrier.

Finally, public credit registers (PCRs) established by the government mainly by the Central Banks and creating bidirectional information flow between creditors and the credit bureau. As Jappelli and Pagano (2006) have pointed out, PCR differs from other forms of ownership structures in which one, participation is compulsory and its laws are not negotiated but enforced by legislation, and second, PCRs have wide coverage as loan must be reported at specific intervals, however the data mostly consist of the total loan exposure of each borrower without detail information on individuals' loans and other relevant information. PCRs could also possibly lead to conflict of interest as the Central Bank will be both the owner and the supervisory body.

In the case of Ethiopia, CRB is established as a PCR within the NBE. The Ethiopian CRB, however, is yet not developed. Ethiopia is classified as one of the weak or almost non-existent levels, according to the WB Depth of Credit Information Index, which measures the rule that affects the scope, accessibility and quality of credit information obtained from the credit bureaus

Overview of CIS Quality Enhancement Mechanisms

The CIS can be enhanced through a number of quality enhancement mechanisms.

- The first is enriching the information collected by gathering both positive and negative information of borrowers to better reflect their creditworthiness.
- The second is to increase the information outreach by expanding both the sources as well as beneficiaries of the data. In terms of data source, expanding it towards such as MFIs, SACCOs, lease companies, digital creditors, utilities companies (power, water and telecom), revenue and tax authority, insurance and court records. Such comprehensive data is relevant in improving the predictive power of the credit information.
- The third one is to improve the operating system. Through automation and use of state-of-art technologies, thereby introducing fast and reliable real-time updating. And use of borrower's information between the credit bureaus and users is also another important aspect of the quality improvement mechanism.
- Fourthly, adding value to the existing information by introducing value-additions such as credit risk rating, scoring and undertaking industry analysis and the like. Aligned with this, improving the skill and knowledge of the credit bureaus' experts is critical.
- Fifth, introducing PCBs. Not only there are studies which supported that PCBs are relatively efficient and provide detail information and analysis. The improvement in the CIS landscape associated with the competition arises from the introduction such PCBs is worth mentioning.
- The six is to ensure data protection of borrowers. Introducing legislative that ensures the data security of borrowers including, but not limited to, avoiding use of data without borrowers consent as well not to use too specific and private information.
- Seven, use of digital information sharing such as Application software., SMS or web-based information sharing between credit bureaus and borrowers.

Summary of Key Practices and Policies to Strengthening CIS

The key areas of polices relevant to strengthen the CIS of Ethiopia include.

- Expanding the CIS landscape by including financial institutions other than Banks such as MFIs, SACCOs, Insurances companies, and digital creditors as electronic credits grows in the future.
- Similarly, moving towards gathering and incorporating information from other public records such as utilities, revenue and tax authority, telecom, and court records.
- Introducing unique identification number to harmonize data about a particular borrower obtained from different sources. Moreover, without the country introducing the National ID that uniquely identifies each borrower, it would be practically too difficult to integrate public records with the credit information collected from the financial institutions.
- Improving the skill and knowledge of the credit bureaus' professionals thereby introducing value-additions such as credit risk rating, scoring and undertaking industry analysis and the like.
- Moving gradually towards digital information sharing.
- Introducing PCBs to bring about competition, better service delivery and outreach.

III Current Policy Environment and Regulatory Issues

Access to Credit

Current Supportive Policies to Improve MSE's Access to Credit in Ethiopia

The inherited characteristics of MSEs refrain the private sector from providing credit. The characteristics of MSEs which make them high risky borrower in the eyes of formal financial institutions include lack of quality collateral, high per unit operational cost, lack of documentations and zero credit history. Thus, taking into account the importance of this segment the governments of many countries try to jump-in to fill the market gap and to improve access to credit for SMEs. Some of the common government intervention to increase access to credit for MSEs are direct lending through state owned banks, capacity building, partial guarantee and issuing a regulation which compels private sector to provide some fixed amount of loan to the sector.

The Ethiopian government also put in place different intervention mechanisms that aimed to increase access to credit for MSEs. Despite the intervention, the volume of credit to MSEs is still very low compared to the economic role they play in the country. The Ethiopian government interventions to increase access to credit to the MSEs are both through issuances of regulations as well as direct lending through state affiliated financial institutions. The direct lending by state affiliated financial institutions covers the credit provided by state owned banks (CBE and DBE) as well as some of the MFIs in which the regional governments have major stake.

As per the information obtained from CBE, the bank has products tailored to MSEs, where it uses MFIs to provide on-lending services to reach MSEs. However, it is hard to get secondary data on the magnitude of CBE's financing to MSEs due to various reasons. One reason that is common across all banks in their credit classification is lack of clear definition of MSEs which also applies to CBE. However, the balance sheet of the bank implies most of the bank's credit exposer is to large SOEs and big private companies,.

DBE is also providing credit to MSEs directly as well as through banks and MFIs in forms of on-lending. DBE has a lease financing product to address the challenges faced by MSEs to provide quality collateral required by private banks. As discussed earlier due to the lack of a national definition of MSEs, DBE has its own definition of small and medium scale enterprises (SMEs). Accordingly, SME is an enterprise which is engaged in agriculture, or agro-processing, or manufacturing, or tour operations, or mining & quarries, or construction sectors, and employed more than six people, and has a total capital of 500 thousand Birr to 7.5 million Birr. This implies micro enterprises are overlooked by DBE. According to the data from the bank, the total outstanding loan of DBE at the end of June 2020 was Birr 51.1 billion. From this total amount, the bank's exposure of 4.6 billion Birr was to medium and small-scale industries, 4.6 billion Birr to SMEs and 5.1 billion Birr was an on-lending to the MFIs. These three loans are equivalent to 28.5 percent of the total outstanding loans of DBE. Though we cannot disentangle the specific amounts that went to MSEs the above figure would tell us the low proportion of loans that goes to MSEs by DBE.

As discussed earlier, the regional governments have the major shareholders of the top five MFIs in terms of market share. This implies one of the mechanisms for the government to intervene in the credit market is through these MFIs to provide credit to MSEs. The total outstanding credit extended by MFIs at the end of June 2020 was 64.9 billion Birr. The majority of the credit by MFIs indeed goes to the MSEs; however, given the importance of these sectors on the general economy of Ethiopia the size of the credit is very small.

The other form of intervention by the government is through issuances of different proclamations, regulations and/or directives which aim to increase credit to the MSEs. These policies include the recently introduced movable collateral registry system and a directive that compels banks and MFIs to provide at least five percent of their annual loan disbursement in the form of movable collateral system. It is difficult to measure the outcome of this directive as it is in the first year of implementation. However, the information obtained from the stakeholders shows that financial institutions tend to give loans against vehicle as a collateral which is against the main objective of the directive to increase credit to the enterprises engaged in the agricultural sector.

There are some policy measures taken by the government which are expected to have a positive impact on the access to credit for MSEs. These policies include abolishment of NBE-bills purchase directive, allowing technology providers to give digital financial services, allowing establishment of capital good financing companies, allowing MFIs to grow to micro finance banks and etc. Private Banks have an outstanding NBE-bills worth of Birr 72.6 billion. These bills have a maturity of less than four years, so as these bills mature the loanable fund available to private banks will increase which gives banks a room to provide credit to MSEs by developing credit products that are tailored to the interest of MSEs. In addition to the releasing of the maturing NBE-bills, the abolishment of the directive removes the requirement by private banks to purchase the central bank bills, which leaves them with additional loanable fund that they can lend to the private sector in general and MSEs in particular.

Furthermore, the recently issued directive to relicense MFIs as micro finance banks based on fulfillment of some requirements is believed to address the major challenges of MFIs which is shortage of funds as well as poor linkage with banks to access liquidity. This directive requires MFIs that are relicensed as banks to provide micro-finance services as one of their core business. Thus, it is expected to enhance the growth of MFIs and then improve access to credit for MSEs.

The federal as well as the regional governments approved revolving youth funds at different times to avail funds for unemployed youths across different part of the country to get credit without collateral. For example, in 2016 the federal government allocated 10.0 billion Birr for revolving youth fund with the objective of creating employment and promoting saving among the young generation.

There are initiatives by some private banks to enhance access to credit for micro enterprises. The initiative by Enat Bank to avail credit to startup business owned by women who cannot provide collateral is worth mentioning. The bank's shareholders dedicated 5 percent of their profit as a source of financing for business owned by women. They provide subsidized credit with personal guarantee and feasibility of business plan.

Current Policy Challenges Impeding Equitable Access to Credit for MSE's

As mentioned earlier CBE is the largest bank in the industry accounting for more than 60 percent of the market share. More than 85 percent of the CBE's outstanding credit went to the public enterprises. In contrary, the other government owned bank DBE credit exposure is mainly to private sector. In June 2020, only 6.9 percent of DBE's outstanding credit went to the public enterprises. Both public banks credit is given in below the market interest rate. For example, CBE's credit to public enterprises is given at 8 percent annual interest rate before it was recently revised upward by 2 percentage point. The loans provided to SOEs usually have a long maturity period. The corporate bonds issued by SOEs and sold to CBE have a maturity of 10 years during issuances. In addition, CBE provides credit to SOEs against the governments guarantee without any financial feasibility studies of the projects, a favor that the private sector did not get.

Even under positive real interest rate situation, firms with access to credit become more competitive compared to those firms that do not have access to credit. Access to credit under a negative real interest rate is a means to transfer the nation's wealth from savers to borrowers. The inflation rate in Ethiopia is in double digit range in the last three years despite the single digit target by the NBE leading the real interest rate either negative or hardly positive for private banks lending rate. With 8 percent interest rate on corporate bonds issued by SOEs the real interest rate is negative, implying inefficient resource allocation.

Challenges of Formal Financial Institutions to Provide Credit to MSEs

A formal financial institution faces different challenges to provide credit to MSEs without compromising its main objective of maximizing profit in healthy and sustainable ways. The challenges discussed in this section are mainly caused by characteristics of MSEs, which pushback formal financial institutions from providing credit to these enterprises.

Weak documentation by the MSEs about their business is one of the factors that hinder formal financial institutions from providing credit to MSEs. Quality data on the volume of sales, bank transactions, financial statements and etc. is not provided to financial institutions when MSEs apply for credit. Lack of capacity and informality on the side of MSEs is the main causes for weak documentation.

In addition, MSEs usually apply for credit to financial institutions by providing feasibility studies or business plans that are poor in quality. Thus, financial institutions face challenges to extend credit by basing on these poor-quality feasibility studies/business plans. Usually, the business proposals presented by MSEs to apply for credit come with over exaggerated outturn from the business, which raise the question of reliability by financial institutions. Moreover, high per unit cost faced by financial institutions as the magnitude of loan requested by MSEs is low compared to corporate and large size enterprises discourage financial institution to provide credit to MSEs.

Credit Information System

Current Supporting Policies to Improve CIS in Ethiopia

For a long time, the lack of a timely and adequate CIS in Ethiopia has been one of the biggest problems, impacting both lending decisions in particular and the soundness of the financial sector in general. The first attempt to address this problem dates back to 2004, when the NBE launched the first Credit Information Sharing under the Directives No SBB/36/2004. The directive;

- Mandated banks to provide credit information to the Credit Information Center (CIC) set up under the NBE Supervision Department.
- Require banks to first obtain borrowers' credit details for each of the loans and advances exceeding ETB 200,000 Birr. Banks were also mandated not to lend to borrowers whose outstanding loans were substandard, doubtful or loss.
- Encouraged banks, regardless of the size of the loan, to obtain credit information. It is, however, only in writing to and from the CIC that banks request and obtain credit information, suggesting a lengthy access to the credit register database.

- Indicated that CIC of the NBE is not liable for any problems that may occur as a result of inaccurate, misleading or incomplete information given by the banks to the Center as well as shared to banks.

In 2012, through the Directive No CRB/01/2012, the NBE attempted to further improve the national CIS by introducing a Credit Reference Bureau. The new directive allows both submission and dissemination of information electronically. The directive also

- Provided a legal ground for addressing borrowers complain from inaccurate, misleading or incomplete information. Accordingly, Banks will be liable too for such kind of problems.
- Lifted Bank's mandatory retrieval of borrowers' credit information for loans and advances exceeding ETB 200,000 Birr.
- Introduced data standardization manual and data submission specification.

The Directive was followed by a move towards the sharing of electronic data, a unique identification of borrowers via Tin number, an increase in the information parameter reaching 40 entries for a given borrower, and a faster response time demonstrating an improvement in the improvement of credit information compared to the prior years.

The landscape of the CIS changed in 2019, with its coverage extended to include micro-finance institutions (CBR/02/2019), collecting both positive and negative credit information. In terms of ensuring the data security of borrowers, the new directive requires financial institutions to get prior written consent from borrowers in using credit information of borrowers.

Current Policy Challenges Impeding Strong CIS in Ethiopia

The current CIS lags in including MFIs, SACCOs, lease companies and other public records. Although Microfinance inclusion, while not yet fully graduated, is also on a pilot project. The absence of a national ID has also been one of the biggest challenges hampering the unique identification of borrowers' credit information. When Microfinance and SACCOs start implementing CIS, the issue will be much more profound, since most of those clients do not have Tin numbers. Currently, the Ethiopian PCR is also not adding value such as credit scoring and risk ratings, thereby restricting the significance of the credit information to the lending decision of the financial institutions. With regard to human resources, the bureau is not only structured under the Directorate of Banking Supervision simply as a team, but also has a small number of employees with negligible senior skilled workers. The other problems arise from the lack of a clear policy roadmap that provides a detail and clear timeline on how and where the country is moving with respect to CIS, thereby avoiding accountability. Finally, the lack of PCBs could also impede the growth of the CIS in the country.

According to the World Bank's report on the ease of doing business in Ethiopia, the Depth of Credit Information Index revealed that Ethiopia is among the countries with the least developed CIS. Lack of distributed data on individuals and firms; lack of dissemination of both positive and negative credit; lack of data dissemination from retailers or utilities; failure to distribute historical data of at least two years; lack of data distribution on loan below 1% per capita income; lack of borrower's right of access to their credit data from the credit bureaus by law; lack of access to borrowers' credit information from financial institutions through an online portal or system-system connection; and lack of credit scores, are some of the major challenges in the Ethiopian credit information system identified by the WB report.

IV Lessons from Other Countries

Access to Credit

Current Supportive Policies to Improve MSE's Access to Credit in Ethiopia

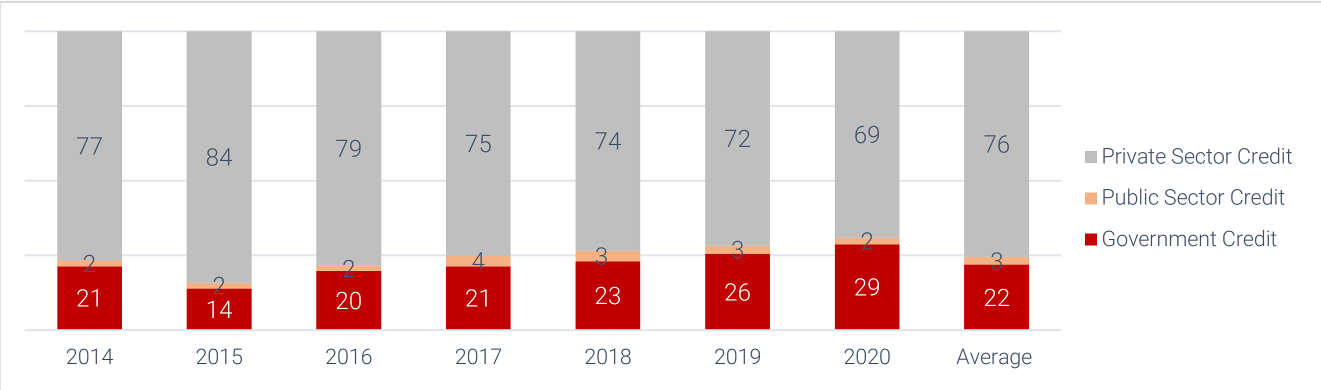
Kenya

In Kenya, domestic borrowing mostly goes to the private sector. Looking at the trend in government, public and private sector share over the past couple of years, it has been seen that the private sector's share is slightly less than four fifths. The remaining total domestic credit is constituted by the government and public sector.

On the other hand, given the large share of total loans in Kenya for SMEs, which could hit 50 percent of total loans according to Calice, Chando and Sekioua (2012), the higher share of loans to the private sector indicates that loans to small enterprises is substantial.

On the contrary, the lower level of public sector credit, which is less than 3% of the total, means that Kenya's share of state-owned enterprises is considerably lower.

Figure 3: Domestic Credit to Private Sector in Kenya (% of Total Credit)



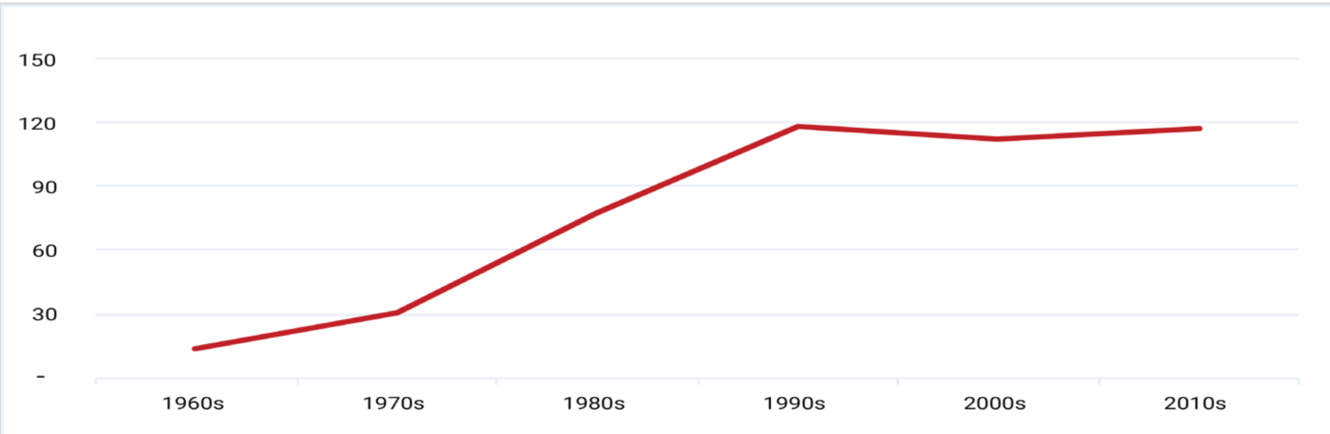
Source: Central Bank of Kenya

Malaysia

As can be seen from Figure 4, in Malaysia, the level of private sector borrowing as measured by domestic private sector credit (percentage of GDP) has increased significantly, starting from an average of 13 percent in the 1960s, then exceeding 100 percent since the 1990s.

In addition, when comparing public sector credit access with that of the private sector in Malaysia, recent experience has shown that private sector's credit access is dominant. According to the World Bank Bank Regulation and Supervision Survey, in recent years, the proportion of the banking sector's assets in the public sector claims has been less than 5%.

Figure 4: Malaysia's Domestic Credit to Private Sector by Banks (% of GDP)

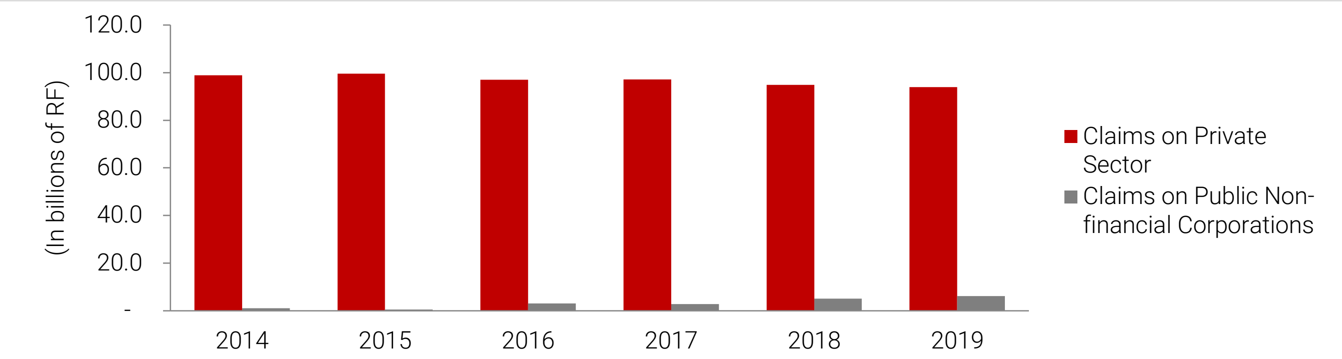


Source: World Bank

Rwanda

The domestic credit distribution of Rwanda mainly goes to the private sector as the public enterprises only get a small portion of the credit. The data from IMF shows that in 2019 Rwandan Franc 129.0 billion outstanding credit is held by public enterprises, compared to Rwandan franc 1,997.5 billion by the private sector. This implies the fact that the Rwandan economy is mainly driven by the private sector.

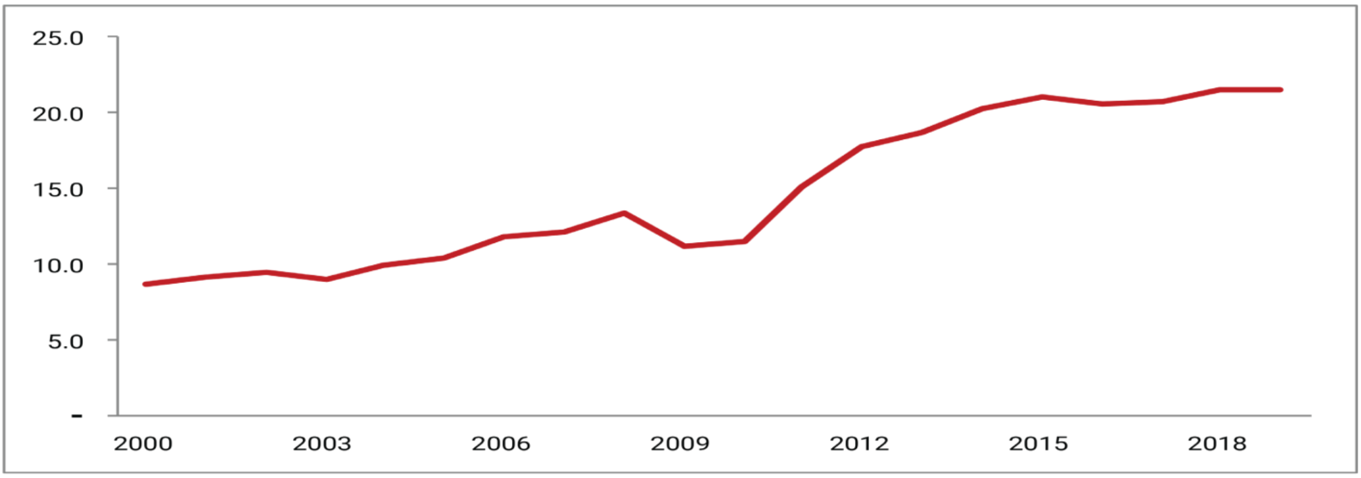
Figure 5: Credit to Private and Public Enterprises in Rwanda



Source: IMF. IFS

Credit to the private sector in Rwanda witnessed significant growth. Domestic credit to the private sector Amounted 8.7 percent of the GDP in 2000 and increased consistently to reach 21.5 percent in 2019 as shown above.

Figure 6: Domestic Credit to the Private Sector (% of GDP)



Source: World Bank, WDI

Credit Information System

Kenya

Kenya's Credit Reference Bureaus (CRBs) are owned by the private sector, with licensing requirements from the Central Bank. The first was Credit Reference Bureau Africa Ltd (Transunion), which was licensed in February 2010, followed by the licensing of Metropol, and Creditinfo in April 2011 and April 30, 2015, respectively . According to Getenga (2016), in terms of service and product delivery, the increase in the number of CRB has improved both in diversity and competition.

There are two lines with regard to data providers in the Kenya's CIS framework (National Treasury and Planning, 2019). There are the compulsory lines and the voluntary ones. While Banks and Microfinance Banks, as per the CRB Regulations 2013, are mandated by the Central Bank of Kenya to submit borrower credit details to the CRB, the participation of third-party providers, namely SACCOs, MFIs and other credit providers, is, to date, voluntarily. Additionally, those Banks and Microfinance Banks have been providing both positive and negative credit information, but SACCOs primarily provides negative credit information. MFIs and other third-party credit providers, on the other hand, share, on a voluntary basis, decisions which are at the discretion of each institution.

Table 1: Kenya's CIS Mechanism Data Providers

Institutions mandated by the central bank of Kenya (CBK)	
Banks	40
Microfinance Banks	13
Sub-total	53
Institutions submitting data voluntarily	
Unregulated SACCOs	1,240
Regulated SACCOs	154
Microfinance Institutions incl. digital lenders	337
Trade Institutions	502
Insurance Companies	43
Development Finance	3
Learning Institutions	1
Sub-total	2,279

Source: The National Treasury and Planning (2019)

With respect to regulatory bodies, the CIS mechanism is currently regulated by the Central Bank of Kenya (CBK). However, the CBK only has jurisdiction with respect to the market conduct of commercial banks and micro-finance banks and is thus unable to enforce compliance and market conduct amongst institutions that make use of the CIS mechanism (such as the SACCOs) that are regulated by other bodies as well as unregulated credit providers.

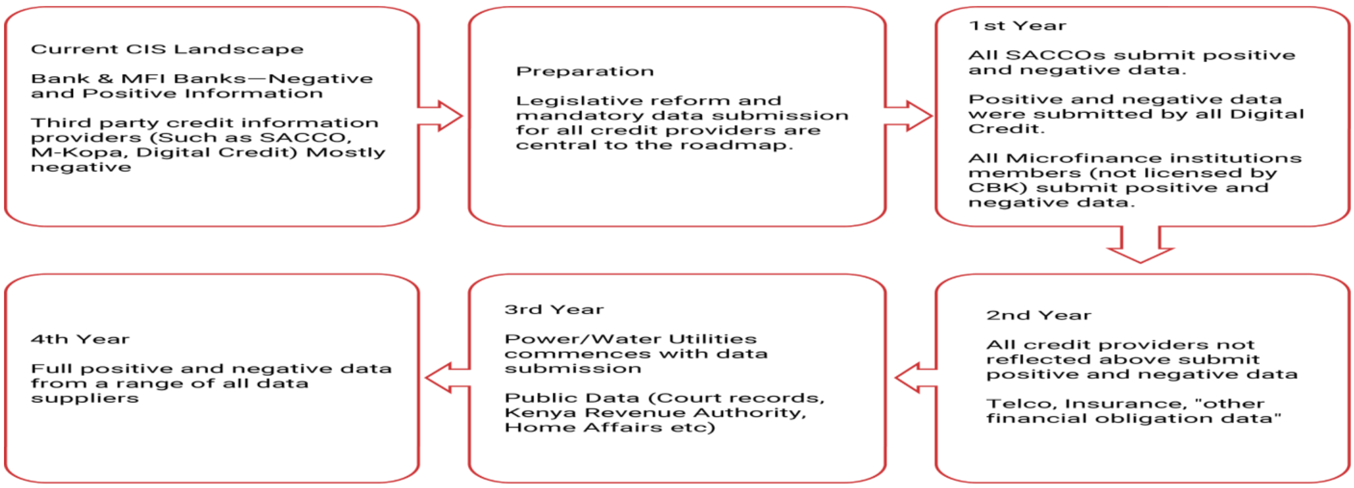
However, with the issuance of the CRB Regulations in April 2020, which replaced the 2013 CRB Regulations, the CBK attempted to extend the coverage of the CIS. Under the new regulation, SACCOs are mandated to be authorized subscribers of credit information to the CRB and are also required to share their members' credit information with the CRBs as well as receive credit reports directly from those Bureaus.

The new legislation is also an indication of how Kenya is going forward with respect to ensuring the data security of borrowers. An example of such policies includes data providers are now required to obtain their borrowers' specific and detailed permission to share their credit information, and unregulated digital and credit-only lenders are now prohibited from sending CRBs credit information. Those unregulated digital and credit-only lenders engaged voluntarily in credit sharing, they mostly submit negative credit information to CRBs, distorting the real creditworthiness of borrowers.

In 2013, Kenya founded CIS Kenya on the basis of a self-regulatory organization (SRO). In 2014, the CIS Kenya launched its first five-year strategic plan. Accordingly, among other things, the organization focuses on capacitating credit information providers; continuously updating the CIS's legal and regulatory framework; and raising awareness through communication(Association of Kenya Credit Providers, 2014).

The National Treasury and Planning of Kenya launched a National Policy to Support the Credit Information Sharing mechanism in 2019, which provides a detailed five-year timeline that, among other things, clearly sets out the roadmap for sharing credit information. Accordingly, in terms of expanding the scope of the information, Kenya has aspired to include credit information from all SACCOs, all microfinance, telecom, insurance, utilities, court records, and Tax Authority and Home Affairs. Similarly, the country is also moving towards full-file reporting by all providers, with a view of improving the quality of credit information (see Diagram 1).

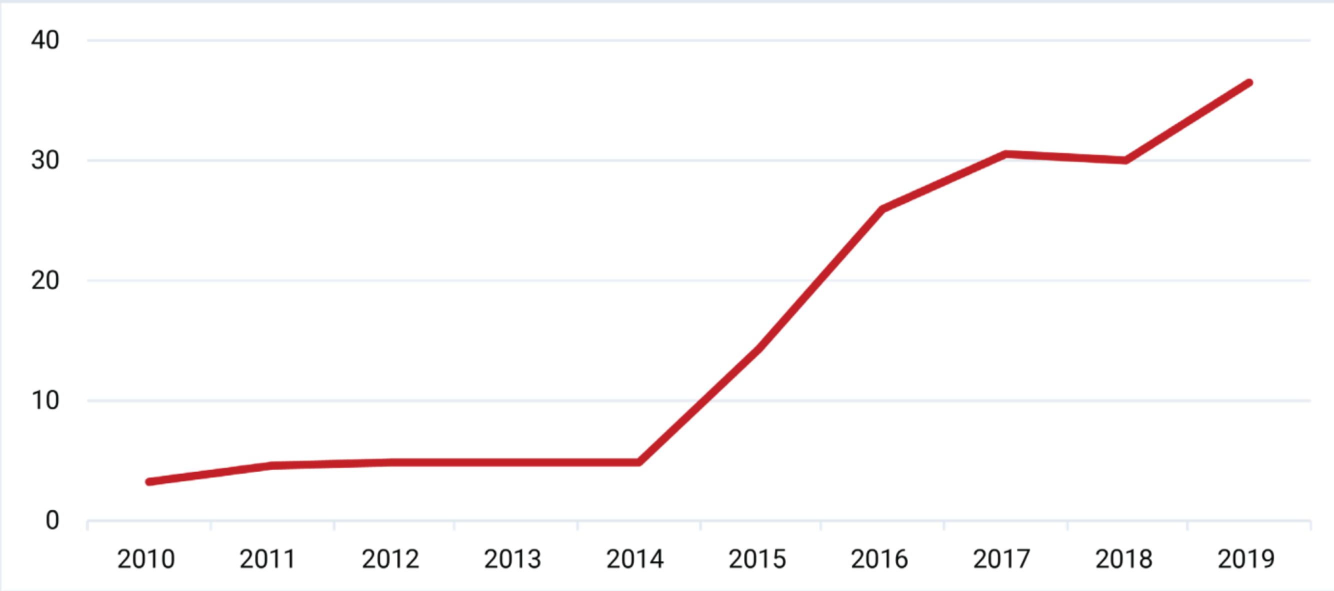
Diagram 1: Credit Information Sharing Roadmap of Kenya



Source: The National Treasury and Planning (2019)

With respect to the effect of the CIS, nearly all commercial banks and MFIs reported using the CIS when processing loans, but only nearly half of SACCOS and other credit providers reported using it, according to a survey conducted by Ipsos (2015). Similarly, according to CBK (2019), as of June 2019, the aggregate credit reports requested by banks, micro-finance banks and customers reached 13.9 million, 231,644 and 1.5 million, respectively. As can be seen in Figure 7, the number of individuals or firms credit information recorded by a private credit bureau as a proportion of the adult population showed a rise in overtime. It increased from 4.9 percent in 2014 to 36.4 percent in 2019.

Figure 7: Private Credit Bureau Coverage (% of adults)



Source: WDI, December 2020

Moreover, innovative products such as the MSME's Commercial Score Card and value-added credit scoring have been introduced in tandem with the introduction of CRBs, facilitating the improvement of access to credit and credit terms for MSMEs (CBK, 2016). Additionally, the introduction of CRBs in Kenya not only reduced the overall cost of borrowing and default risk moderately, but also raised micro credit to a larger degree (Gaitho, 2013). In addition, it is anticipated that the recent mandate of SACCOs in the CIS framework, as well as the plan to integrate all micro-finances in the country, will further increase credit to MSEs, given the affinity of large MSEs to those institutions.

Malaysia

The historical development of the CIS in Malaysia is summarized as follows, as documented by Saari (2013) and Central Bank of Malaysia (2017).

The country started to collect credit information in the early 1980s, with the establishment of the Public Credit Registry (PCR) under the Central Bank of Malaysia. Until the late 1980s, both the submission and distribution of data were carried out via hard copy, until the diskette replaced the former. In 1994, the mode of diskette data submission shifted to computerized batch submission, though hard copy still used to disseminate data. In 1999, the Bank moved towards computerized online data submission and distribution and subsequently to real-time online data transfer via the Central Credit Reference Information System (CCRIS) since 2001.

With regard to the scope of the PCR, initially it was limited to the banking sector, however, later on it was extended to non-banks, including hire purchase and leasing companies, card companies and government agencies providing specific purpose credit, with voluntary participation in the CCRIS.

Currently, three departments of the Central Bank of Malaysia govern the operation of the PCR. The financial surveillance department is responsible for policy formulation and business development; the department of statistics is focused on system administration, training & education, data reporting and quality management; the Central Contact Point (LINK) and the Regional Offices are devoted to the management of general inquiries and public concerns relating to the Credit Register.

On the other hand, the Private Credit Bureaus (PCBs) also began to operate in 1990. There are seven PCBs currently operating in the country. One of the key distinctions between PCBs and the PCR is that the former adds value, including credit scores and ratings. PCBs are required to obtain customer approval for the disclosure of information to third parties.

Some of the PCBs were specialists in specific services, according to the Central Bank of Malaysia. Accordingly, there is a PCB focusing on providing credit information and ratings in general and creating a platform for SMEs to improve their credit ratings and track records in particular (SME Credit Bureau Malaysia).

The second PCB organizes, from public records, information on legal proceedings against individuals and companies. The third PCB collects, registers, and disseminates vehicles and equipment data. The remaining four PCBs provide information with respect to company details, court information about prior property disputes, credit information, financial information and analysis, industry analysis, business operations and credit risk rating.

Overall, according to the World Bank depth of credit information index data, Malaysia is found to be among the world's leaders in terms of scope, accessibility, and quality of the CIS. Malaysia has scored 8 in recent years, with the index ranging from 0 to 8, where a value reaching 8 indicates the existence of higher quality credit information that can facilitate lending decision. Similarly, according to the WB data, Malaysia's private credit bureau coverage (% of adults) reached 89.1 percent in 2019. Similarly, according to the Doing Business Reports, Malaysia ranked 37 in terms of getting credit rank. Moreover, in Malaysia the proportion of loans requiring collateral is comparable among small, medium and large businesses, according to the WB Enterprises Survey.

In addition, the value of collateral for a loan (percent of the total amount of the loan) decreases as the company's size decreases (see Table 2). The combination of these two indicates that small companies have not experienced unfavorable treatment when seeking access to finance. This could be attributed to the role of efficient and quality CIS in the country. Haron, Said, Jayaraman and Ismail (2013) have also reported that the existence of the Credit Reference Information System in Malaysia has affected the likelihood of loan approval. Vinayan et al. (2010) also found a significant relationship between the creditworthiness of small and medium-sized businesses and their access to finance, irrespective of whether or not they establish ties with large firms.

Table 2: Collateral Requirement in Malaysia by Firm Sizes

Firm size	Proportion of loans requiring collateral (%)	Value of collateral needed for a loan (% of the loan amount)
Small (5-19)	66.1	139.7
Medium (20-99)	60.2	224.7
Large (100+)	66.1	364.6

Source: World Bank 2015 Enterprise Survey
Note: The number in parenthesis refers to the total number of employees

Overall, according to Yoshino and Taghizadeh-Hesary (2018), SME in Malaysia produces 35 percent of the total output, employing 65 percent of the total employment in the country.

Rwanda

According to the latest World Bank ease of doing business report, Rwanda scored eight out of the maximum score of eight for depth of credit information index. This is in comparison to a score of 3.9 for sub-Saharan average and 6.8 for OECD high income countries average. Rwanda's score was two out of six for the same category in 2010. To reach on the top of the table Rwanda went through a number of reforms in terms of CIS.

Currently Rwanda has both the public credit registry and privately owned credit reference bureaus. National Bank of Rwanda-the central bank of the country- is the one that owned and operated the public credit registry database. The public credit registry of Rwanda has been operational since 1990. Rwanda's public credit registry collects and provides both the negative and positive credit information to the credit providing financial institutions.

As per a study conducted by the African Development Bank, an estimate of USD 0.84 floor was set to be included in the public credit registry of Rwanda before it was abolished in 2011. During the same period, National Bank of Rwanda allowed borrowers the right to inspect their own credit report and mandated loans of all sizes to be reported to the central bank's public credit registry. In the aftermaths of the global financial crises, the Rwandan government set a legal framework to regulate private credit information bureau in 2009.

Then both domestic and foreign firms that worked in the area started joining the industry. And then with tough competitions the private credit bureaus came-up with products that are tailored to their customers need.

In 2012 the private credit bureau started to collect and distribute information from utility companies and also started to distribute more than two years of historical information. Furthermore, in 2016 Rwanda's credit bureaus began to provide credit scores to banks and other financial institutions while the credit registry expanded borrower coverage.

In addition, the National Bank of Rwanda reformed the data collection system to automate the data collection system of the public credit registry. The system was developed by the National Bank of Rwanda and was called automated data-pull system. It enables the public credit registry to access data from the systems of supervised financial service providers and then process the data using the bank's software. This system reduces the need for manually produced reports and improves the accuracy and consistency of data. The electronic data warehouse also facilitates daily automated data pulls for certain types of data.

In 2020, more than one million individuals' information was expected to be captured by the private credit bureaus while the public credit registry has about 700 thousand individuals in its database.

During the same period, more than 85 thousand firms were part of the private and public CIS combined. The coverage of both public credit registry and private credit bureau showed tremendous growth during the last twenty years. The coverage of public credit registry was 1.4 percent of total Rwandan adults which increased to 10.4 percent in 2019. Likewise, the private credit bureaus coverage also grew from 2.2 percent of adults in 2012 to 15.8 percent in 2019.

Other Prevailing MSE Financing Instruments in the World

Public Credit Guarantee Scheme: The Experience of FOGAPE of Chile

Public guarantee scheme is one form of government intervention to address the issue of lack of collateral that micro and small-scale enterprises face to access credit from formal financial institutions. Governments around the world established different forms of public credit guarantee scheme at different times with mixed results. Some of these guarantee schemes uphold for delivering their mission while others fails to do the same. The success of public guarantee scheme mainly depends on their design, implementation and assessments, among other things. In designing the public credit guarantee scheme, the ownership of the scheme is one of the factors that determines the success of the scheme. A credit guarantee encompasses tasks such as management of the guarantee fund, assessing the loans to be guaranteed and recovering the defaulted loan. The public credit guarantee scheme usually involved in management of the guarantee fund leaving the remaining task for the private sector.

The coverage ratio by the public guarantee scheme is also another important component of the design of the public guarantee scheme that determines the success of the scheme. Too high coverage ratio encourages adverse selection by financial intermediaries while too low coverage ratio discourages the financial intermediaries to use the scheme and provide credit for the intended user. Levitsky (1997) suggested that at least 30-40 percent of the risk shall be covered by the financial institution to align the incentives of the scheme and the lender.

In addition, the times it takes to recover the claim by the financial intermediaries have significant impact on the success of the scheme. If the financial intermediaries are able to get the claim in the shortest time possible, they will be willing to work with the guarantor. Furthermore, the fee charged by the credit guarantee scheme also plays important role for the success of the scheme. Aligning the fee with the performances of the loans is advisable.

In deciding to have the public credit guarantee scheme there are some important questions that needs to be answered. These are whether the scheme leads to financial additionality, economic additionality, and its impact on overall economic growth. Financial additionality refers to the impact the scheme has on the volume of credit extended to the intended group, say MSEs, whereas economic additionality is the benefit of the intended group after getting the credit through improved performance, innovation employment and completion. The final question is whether the scheme contributes for overall economic growth of the country.

FOGAPE is one of the examples of public credit guarantee schemes that are successful in supporting MSEs to access credit from formal financial institution in Chile.

FOGAPE is a Chilean credit guarantee scheme administered by another public owned commercial bank called BancoEstado. FOGAPE provides guarantee to new loans up to a maximum amount of USD 200,000.00 with a coverage ratio ranging from 80 percent for loans below USD 120,000 and 50 percent for loans above this amount. The maximum maturity of the guarantee is 10 years. Legally FOGAPE is given a maximum leverage ratio of 11 implying with a paid-up capital of USD 260.0 million, the scheme can provide credit guarantee amounting 11 times its paid-up capital. The loans are originated by financial intermediaries while FOGAPE only provides the total amount of guarantees to financial institutions.

Allocation of FOGAPE's fund is based on auctions held four to six times a year. In the auction FUGAPE offers a fixed volume of guarantees and the financial institutions bid for certain volume of loans with minimum coverage ratio to win the auction.

According to the auction rule, the maximum coverage ratio that a financial institution can bid is 80 percent for long-term loans and 70 percent for short term loans. Then the winning financial institutions (banks) have three months to grant the allotted loans and if the performance of that bank is below 80 percent it will be excluded from the subsequent auction. To further address the issue of adverse selection, the fee that financial institutions charge depends on the past default rates of the guaranteed loans with a ceiling of 2 percent of the guaranteed amount. The loans guaranteed by FOGAPE are subject to lower capital requirement by bank supervisor that incentives banks to use further the scheme.

As a result of these well-designed credit guarantee schemes, FOGAPE increased both the number of loans guaranteed as well as the value of guaranteed loans. At the end of 2014, FUGAPE guaranteed more than 50 thousand loans with a total value of USD 1.1 billion. Loans to MSEs guaranteed by FOGAPE accounted for more than 10 percent of all commercial loans to these enterprises.

Factoring

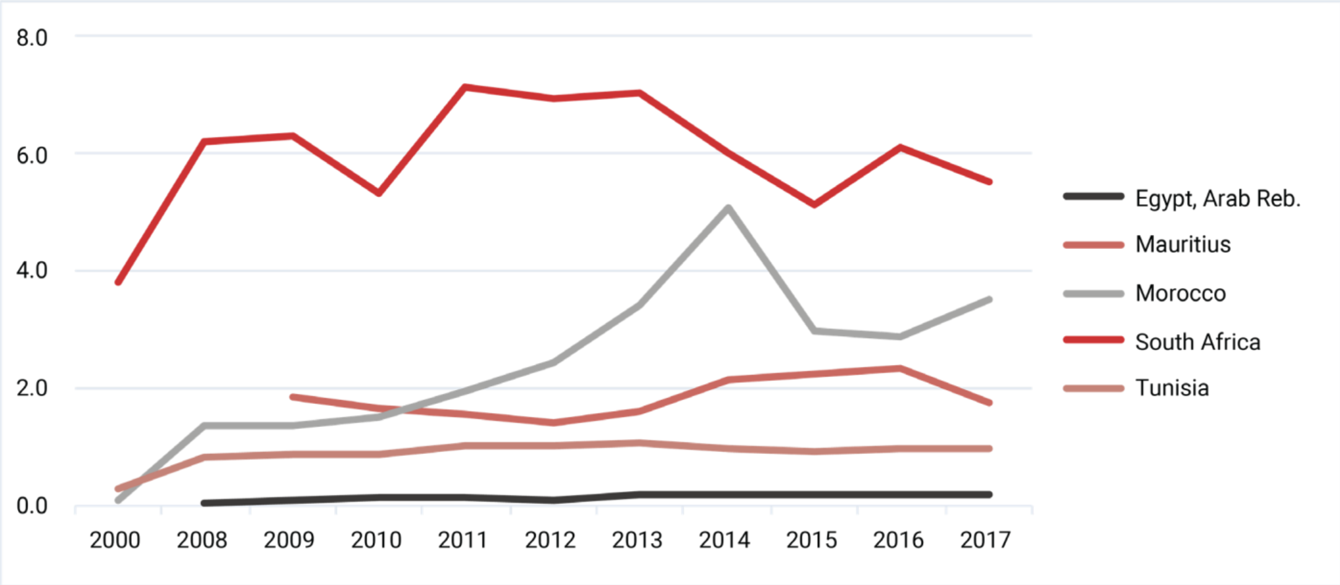
Factoring is an agreement between an enterprise and a financial institution known as a factor in which the former receives an advance payment from the latter in exchange for an upcoming receivable. In turn, the financial factoring institution benefits from the factoring fee collected from the receivable. Since MSEs are often constrained by working capital financing, factoring could provide a good opportunity for funding. As Klapper (2005) indicated, factoring is particularly relevant for SMEs as they are often unable to secure finance from the formal banking sector and hence depend on their large customers and suppliers to provide them with the working capital finance.

As described by the Asian Financial Service Association (2018), factoring involves the following six steps.

1. The enterprise supplies goods and service to the customer, and produce invoice,
2. The enterprise presents the receivable to the factoring company,
3. The factor typically gives the company between 70 and 90 percent of the face value of the invoices,
4. Making payment by the customer to the factor to an account in the name of the enterprise.
5. The remaining 10-30 percent of the invoice value minus a small charge will be back into the company's bank account.

Global factoring volume has been rising continuously over the past decades, according to Factors Chain International (2019) statistics. Factoring has been used as an alternative financing tool in Africa by countries such as Egypt, Mauritius, Morocco, South Africa, and Tunisia. In Africa, South Africa and Morocco have a higher factoring volume relative to the national GDP, as can be seen from Figure 8.

Figure 8: Total Factoring Volume to GDP (%)



Source: WB, Global Financial Development (2019)

Other MSE Financing Instruments

Purchase Order Finance (POF): This mechanism provides companies with a specific customer order, with the funding needed to purchase the inputs and deliver the output, thus completing the order.

Warehouse Receipts (WHR): Secured funding through commodities stored in a licensed warehouse. In the case of Ethiopia, WHR finance is currently operational via ECX warehouse.

Crowdfunding: To collect funds, often via online, from a wide audience where a small portion of the funding requested is provided by each person either through donation, reward, equity participation, lending or on a condition that they will receive an early version of the product or at a reduced price.

Venture capital and angel investment: Although venture capital (VC) is an equity investment in seeds, in the early and later stages of companies, with a greater potential for growth, the majority of VC capital funds intervene at the later stage in practice. While, in the case of angel investment, at the seed and early stages.

Through bond issuance.

SMEs Exchange: Some of the world's SME exchanges include, as indicated by Harwood and Konidaris (2015), NSE India Emerge, JSE AltX of South Africa, Bovespa Mais of Brazil, BIST ECM of Turkey, WSE NewConnect of Poland and GreTai of Taiwan.

For SMEs exchange to succeed, the authors recommended (1) to focus on small and medium-sized businesses with a significant growth rate, (2) making SME exchanges legally connected to the main board, (3) not reducing the disclosure content (4) allowing private placements (5) having a well-regulated examiner issuers' advisors and that can provide investors with comfort about the quality of the issue, (6) having outreach, public awareness initiatives and SME training, (7) and introducing tax incentives for investors.

V Recommendations

Access to Credit

The fact that the SOEs are the major borrowers of the banking system has led to lower credit access to the private sector in general and to the MSEs in particular. While government spending is arguably justified in areas where market failures and positive externalities are pronounced, the greater dominance of such skewed loans could have a negative impact on the overall economic growth by crowding out the private sector, requiring a paradigm shift to restrain loan growth to these SOEs. Therefore, the government needs to intervene in the market only if there is a clear market failure that cannot be addressed by the private sector. The fiscal sector also needs to be consolidated to reflect the impact of SOEs borrowing on the government fiscal balance.

The government of Ethiopia is now in a reform program through a three years Homegrown Economic Reform Program, which aims to create a conducive environment for the private sector to lead the economic growth. The reform of SOEs is one of the agendas in the program. To this end, privatization of some of the big SOEs is already in the process which reduces their burden on public banks especially that of CBE. Given that the government has signaled the importance of the private sector in its home-grown economic reform program and its forthcoming ten-year development plan, this study recommends that the government change its financing policy to SOEs and establish a level playing field for the private sector's access to finance instead. In addition, it also recommends the following policy instruments and strategies in order to increase credit to the MSEs.

Partial Guarantee Scheme: Because lack of sufficient collateral is hampering MSEs from getting credit, introducing a well-designed partial public credit guarantee scheme could support access to finance for MSEs. However, as experienced in different countries, public credit guarantee may be financially unsustainable if not well designed. In this respect, the good experience of FOGAPE can easily be customized to the Ethiopian context.

Digital Credit: Fintech revolutionized how the financial system works in a lot of countries. Digital financial services have become an important source of credit for MSEs. The NBE issued a directive last year which allows technology operators to provide digital financial services. In addition, the government is in the final stage to privatize Ethio-telecom and issue two licenses for foreign telecom companies. However, the upcoming foreign companies are not allowed to give mobile money services. These will potentially hamper the development of the digital financial sector in one hand and reducing government revenue from privatization and opening up the telecom sector on the other hand.

We, therefore, recommend the government to allow foreign owned technology companies participation on digital financial services with close supervision by the government to minimize the possible negative impact on the financial sector stability.

Regulatory Sandbox: As experienced in other countries regulatory sandbox enhanced the innovation in the digital financial service without compromising the sector's stability. Thus, NBE needs to have a regulatory sandbox to reap the benefit of digital technology and hence increase access to credit of MSEs.

Factoring: To allow MSEs to access alternative sources of funding, factoring may be used to ease the over-reliance on traditional sources of financing instruments. The NBE, the factor, the supplier and the buyer will be the four key stakeholders in the factoring process.

The regulatory body will be the NBE. The factor, non-bank financial institution that buys short-term receivables, is the legal entity requiring licensing from the NBE. The operation will require a legal framework that allows account receivables to be assigned and sold as well as to enforce the underlying contract, and hence requires NBE to issue Factoring Proclamation. The proclamation will provide the provisions for registration as well as the rights and obligation of parties to contract for the assignment of receivables and related issues.

Venture Capital and Angel Investment: The government should encourage the development of venture capitalists and angel investors to support seeds and early stages companies. In addition, the government could provide finance to a seed and early-stage companies through DBE.

Purchase Order Finance (POF): Introduction of POF to support MSE's businesses with a specific customer order, which enable them to get the finance they need to buy inputs and to complete their order. The purchase order would serve as collateral in such a case.

Warehouse Receipts (WHR): Strengthening the Warehouse Receipts financing scheme.

Credit Information Systems

While some efforts have been made over the past few years to improve Ethiopia's CIS, given that the CIS is still in its infancy, it is important to further develop the CIS. Some of the relevant policies and practices to strengthen the existing CIS include:

- Gradually expanding the CIS coverage towards Microfinance, SACCOS, lease companies, insurance companies, court records, utilities (power, telecom and water payments), and rental payment.
- The government should give due importance to the introduction of biometric national identity cards (National ID), given the greater role it plays in facilitating the collection of data on borrowers from different sources.
- Strengthening the Ethiopian Public Credit Registry's capacity in terms of both human resources and technology to accelerate the bureaus' value addition, including credit scoring and risk rating.
- Formulation of a comprehensive national CIS policy and hence, introducing accountability.
- Allowing the operation of PCBs in order to diversify products and service delivery and enhance its quality through competition.
- Distributing both positive and negative information.
- Ensuring borrower's right of access to their credit data from the credit bureaus.
- Gradually moving towards digitization, which enables real time credit information sharing through an online portal.

These CIS measures and policies alongside the above-discussed policy instruments are anticipated to improve the credit access to MSEs in Ethiopia.

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