



A Study on the Performance of Category ‘A’ Micro Finance Institutions in Ethiopia

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Abstract

The main objective of this study is to examine the factors that affect Category ‘A’ microfinance institutions financial performance. Category ‘A’ microfinance institutions are a type of financial institutions that are providing financial services to unemployed or low income individuals or groups who have no physical collateral to gain financial loan services. The study was based on five years’ secondary data obtained from National Bank of Ethiopia by analyzing quantitatively in terms of descriptive statics using OLS estimation method to measure the effect of determinants of financial performance. The data is analyzed by using basic statistical techniques such as descriptive analysis and multiple regression analysis. The findings revealed that the six factors included in the model were significant in affecting the financial performance of Category ‘A’ microfinance institutions. The results also revealed that company growth rate is the most influential factor followed by capital size and the average disbursed loan size in affecting the financial performance of those institutions.

Keywords: Category ‘A’ microfinance institutions, Descriptive Analysis, Determinants, Financial performance, Multiple regression and Secondary sources.

1. Introduction

In this chapter, the background of the study in general and Category ‘A’ microfinance institutions in particular, the statement of the problem, the objectives of the study, the research questions, significance of the study, scope and organization of the study have been dealt with.

1.1. Background of the study

Micro finance institutions are the most prevalent in developing countries. The development of microfinance institutions is a recent phenomenon in the world. The proclamation which provides the establishment of microfinance institution was issued in July 1996 in Ethiopia. Since then various microfinance institutions have legally been registered and started delivering microfinance service (Wolday, 2000). According to a report by National Bank of Ethiopia (2017), there are about 33 microfinance institutions

operating in the country. The following table shows list of microfinance institutions based on categories.

Table 1.1: List of micro finance institutions

	Name of the institution	Total Assets in 000's
	Category A	
1	Amhara credit and savings institution	27,062,094.2
2	Dedebit credit and savings institution	7,969,143.5
3	Oromiya credit and savings institution	12,280,474.5
4	Omo credit and savings institution	8,628,254.8
5	Addis credit & savings institution	3,955,744.30
	Total	59,895,711.3

Source: National Bank of Ethiopia, 2018.

1.2. Statement of the problem

Usually, micro finance institutions (MFIs) provide financial services to low income, but active customers looking for relatively small amount of source of fund to finance their businesses, manage emergency situations, acquire assets or consumptions as they have no access to financing from conventional banks. So micro-finance institutions have a significant role in the creation of opportunities and poverty reduction. Micro-finance services intervention in Ethiopia has also been considered as one of the policy instrument to enable rural and urban poor citizens to increase output and productivity. To achieve the objective of reducing or alleviating poverty, micro finance institutions (MFIs) should provide financial service in a sustainable way in turn they must be profitable to cover different costs.

In Ethiopia, the study of factors affecting the performance of micro finance institutions in general and the case of category A micro finance institutions in particular is rare. The studies conducted in the area of microfinance institutions are few in number and did not emphasize on factors that determine financial performance. For instance, Tilahun Amero and Dereje Mekonnen (2012) conducted their study on the financial performance and sustainability of microfinance institutions taking the case of Amhara Credit and Savings institution (ACSI). Similarly, the Abebaw (2014) tried to see the determinant factors of MFIs in Ethiopia but have no detail and explanatory result in category 'A' micro finance institutions, and Yonas (2012) focused only on internal factors of micro finance and also never seen category 'A' micro finance institutions separately implying that the studies use limited variables and have no detailed analysis. This research is different from the above studies in that its focus on category 'A' micro finance institutions, determinant factors on its financial performance and finally it is expected to fill the gap that are observed on the other studies.

1.3. Objectives of the study

The general objective of the study is to examine factors that affect financial performance

of category 'A' micro finance institutions in Ethiopia.

Specific objectives

The study focused on the following specific objectives

1. To identify the main factors impeding on the performance of category 'A' micro finance institutions.
2. To examine the effect of these factors on the financial performance of category 'A' micro finance institutions.
3. To determine the most influential factors that hinder category 'A' micro finance institutions' financial performances.

1.4. Research Questions

Drown from the above objectives the study is seeking to answer the following questions

1. What are the key factors hampering the performance of category 'A' micro finance institutions.
2. How do these factors affect the performance of category 'A' micro finance institutions?

1.5. Significance of the study

The study is significant to a number of organizations that is category 'B' and 'C' micro finance institutions, government, research institutions, donors and managers, it helps them know factors affecting the financial performance, thereby take appropriate actions to increase their financial performance and the outcome of this study will provide basic information to other researchers.

1.6. Scope of the study

In Ethiopia category 'A' micro finance institutions represent 89.85% of the total assets held by the sector. Therefore, the researcher limited the study only for the case of category 'A' micro finance institutions. The study also is limited only to the determinant factors of financial performance.

2. Review of Related Literatures

This chapter presents a review of literature that is related to the study. The chapter also describes the theoretical and empirical reviews.

2.1. Theoretical Review

The concept of micro credit became prominent in the 1980s, even though it has been in existence long before then in Bangladesh, Brazil and a few other countries (The Microfinance Gateway, 2005).

Microfinance institutions provide financial intermediation services such as savings, credit funds transfer, and insurance, pension remittances offered to the poor in both

urban and rural areas, including employees in the public and private sectors and those who are self-employed.

On the contrary, the clients of microfinances in Ethiopia include individuals with full-time jobs, government officials and those that do not have access to commercial banks.

Of course, offering loans to economically active people will likely result in high repayment rates and consequently lead to increased levels of MFIs' efficiency.

Specifically, the attainment of financial sustainability by MFIs is however attributed by the "schism", a debate that presents two different propositions to microfinance. These approaches are elaborated in the welfarist and institutionist views. The schism has implications for the future of microfinances in terms of achieving their objectives. Ultimately, both views emphasize poverty reduction as their ultimate goal without ignoring financial sustainability.

2.2. Core Performance Indicators for Microfinance

Microfinance interventions produce better results when design, reporting, and monitoring focus explicitly on key measures of performance. The following are basic tools to measure performance of microfinance institutions (MFIs) in five core areas:

1. Outreach: - how many clients are being served?
2. Client poverty level: - how poor are the clients?
3. Collection performance: - how well is the MFI collecting its loans?
4. Financial sustainability: - is the MFI profitable enough to maintain and expand its services without continued injections of subsidized donor funds?
5. Efficiency: - how well does the MFI control its administrative costs?

2.3. Institutional Sustainability

Institutional sustainability can be defined as the continuous service provision to clients profitably as a going concern without relying on subsidies (Ledgerwood, 1999). The four dimensions of sustainability are continued benefit flows, longevity or survival, ability to meet recurrent costs, and institutional capacity and performance. There are no precisely set and universally acceptable indicators of institutional sustainability. Sustainability is of two types: operational and financial. Operational sustainability is the ability of the firm to cover operational costs from revenue earned from major lines of business. Financial sustainability is the entity's ability to operate without subsidies.

2.4. Financial Self-Sufficiency

Financial self-sufficiency shows cost recovery regardless of size of operation and gives a quick synopsis of the general performance of the institution. It gives a clue on the sustainability of the institution considering the impact of subsidies into account. To continue in the industry as a going concern, MFIs should be or strive to become financially self-sufficient. Progressive lending at a larger scale and efficient operation helps to achieve financial self-sufficiency (FSS) while working with the poorest.

2.5. Profitability

Profitability indicators measure financial performance of a firm over a period of time. It is useful for both internal management and external stakeholders to assess profitability of the business. In these ratios net income is stated as return on assets and return on equity. Return on assets (ROA) measures the average net income earned on a single currency owned and indicates the kind of return the assets are generating. Analysis of ROA helps in policy settings to improve revenue generating capabilities, better delinquency management, and the introduction of new products to clients. High return implies good utilization of assets. It is a measure of the return from a single currency of loans outstanding. Return on Equity (ROE) refers to the maximum return available to shareholders. The ROE gives the rate of return earned on net worth or equity invested. Higher return implies pleased shareholders or owners. Investors may decide to invest or divest by referring to the ROE of the firm. The return on portfolio ratio indicates the productivity of the credit operation. The higher the ratio, the more profitable the MFIs are (Ledgerwood, 1999 and Barres, 2006). Investors, financiers, and clients would determine their future ties with the institution by examining its profitability.

2.6. Empirical Review

MFIs earn financial revenue from loans and other financial services in the form of interest fees, penalties, and commissions. Financial revenue also includes income from other financial assets, such as investment income. An MFI's financial activities also incur various expenses, from general operating expenses and the cost of borrowing to provisioning for the potential loss from defaulted loans. Profitable institutions earn a positive net income (i.e., operating income exceeds total expenses).

The microfinance sector in Africa is quickly expanding, and institutions have increased their activities. In fact, African MFIs are among the most productive globally, as measured by the number of borrowers and savers per staff member.

Although there are significant number of microfinance institutions in Ethiopia since the late 1990s, this sector's concern in achieving widespread outreach and sustainability, hence compromising on client impact remained to be investigative. Furthermore, poverty levels have deepened as a consequence of the increasing level of unemployment. In light of this, the existences of MFIs in Ethiopia have implications for sustainability in achieving poverty reduction.

2.6.1. Financial Performance

There are many ways to measure financial performance, which are return on invested capital (ROIC), return on equity (ROE) and return on assets (ROA). Amal et al. (2012) used financial performance as dependent variable, and where it was proxied by return on assets (ROA) by using the equation $ROA = \text{net profits} / \text{total assets}$. Literatures indicated that ROA, the ratio of net profit to total assets, is the appropriate measure of financial performance (Ahmad et al. 2011 & Malik, 2011).

2.6.2. Factors affecting financial performance of micro finance institutions

In most literatures, financial performance with regard to micro finance institutions usually expressed in as a function of controllable or internal factors (Malik, 2011, Ahmed et al., 2011, Adams et al., 2008). These variables, investigated by most researchers, include company growth rate, average disbursed loan size, personnel productivity, growth rate of capital size, number of clients and portfolio quality.

Capital Size: Capital size of a firm, as measured by the percentage change in total size of capital, affects its financial performance in many ways. Large firms can exploit economies of scale and scope and thus being more efficient compared to small firms (Swiss Re, 2008). In addition, small firms may have less power than large firms; hence they may find it difficult to compete with the large firms particularly in highly competitive markets. On the other hand, as firms become larger, they might suffer from inefficiencies, leading to inferior financial performance. The relationship between size and performance and the influence of company capital size on its financial performance was also analyzed by other previous studies (Amal et al., 2012 and Malik, 2011).

Personnel productivity: It measures the overall productivity of MFIs' personnel in terms of managing clients, including borrowers, savers, and other clients. Amal et al. (2012), described the term personnel productivity as an underlying characteristic of a person like motive, trait, and skill, aspect of one's self-image or social role or a body of knowledge which he or she uses. The higher the qualified employees, the better the financial performance of micro finance institutions (Amal et al., 2012).

Company Growth Rate: Growth is the change in size of the company as measured by the percentage change in total assets. According to Renbao & Kie (2004), it is one of the factors significantly affects firms' financial health. Darzi (2009) found a positive and statistically significant relationship between growth rate and financial performance Micro financial institutions having more and more assets over the years have also better chance of being profitable for the reason that they do have internal capacity though it depends on their ability to exploit external opportunities.

Portfolio Quality: Since the largest source of risk for any financial institution exists in its loan portfolio, the quality of portfolio is crucial for MFIs. In case of microfinance institutions, whose loans are typically not backed by property collateral, the quality of portfolio is absolutely crucial. The most widely used measure of portfolio quality in the microfinance industry is portfolio at risk (PAR), which measures the portion of the loan portfolio 'contaminated' by arrears as a percentage of the total portfolio (Asmelash,2013). A study of Imai (2011) investigated that the effect of both institutional factors and the macro economy on the financial performance of MFIs and concluded that portfolio quality is among the firm level factors which have an influence on the financial performance. The significant source of risk for any financial institution is attached to its loan portfolio hence portfolio quality is a focal area of performance analysis

Number of Clients: The number of customers being served by an MFIs are core performance indicator for them. A study of Yeshe (2015), aimed at establishing the

relationship between loan outreach as measured by number of clients and microfinance institutions' financial performance in Ethiopia and found that significant positive relationship between breadth of outreach measured as number of active clients and financial performance was evident among microfinance institutions in Ethiopia.

Average disbursed loan size: By using the average loan size that is disbursed to clients, MFIs should be careful to distinguish between disbursed loan size and outstanding loan size (CGAP, 2003). Though it is not precise, loan size is one of the simpler indicators that small loans represent poor clientele (Robert Cull et al., 2007). The logic is that better off clients are not interested in smaller loans. Larger loans as well as higher interest rates would result in more income for MFIs and make them more profitable due to cost and some scale effects.

An increase in asset quality ratio leads to an increase in profit margin (Imali, 2013). Average loan size and financial sustainability as this variable have shown statistically significant association with financial sustainability (Yesi, 2015).

2.7. Conceptual framework/research model

With the support of the available literatures (theoretical and empirical), in this study, the researcher tried to identify the most important factors that can affect the financial performance of selected micro financial institution. These factors include: company growth rate, average disbursed loan size, personnel productivity, growth rate of capital size, number of clients and portfolio quality. Hence, the following conceptual framework is planned to serve as a bridge for the entire study.

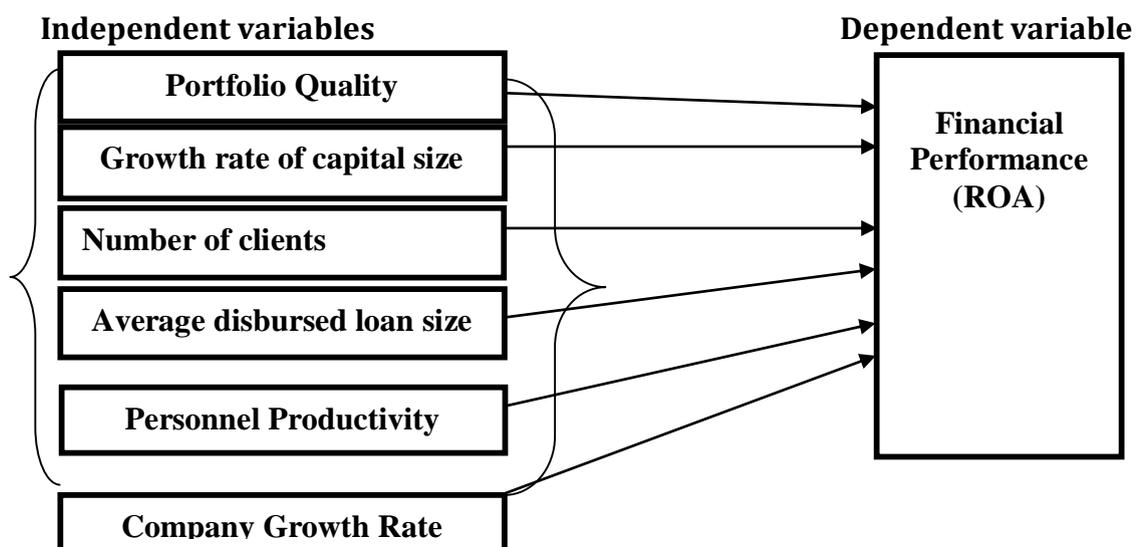


Figure 2.1: Conceptual framework of the study/Research model

3. Research Methods

It includes the approach adopted to examine the effect of main determinants, the type of data used and the techniques employed to collect the data, the sampling mechanism including sample size, the methods utilized to manage and analyze the data, and the process of constructing empirical model with identification and measurement of its components and measurement and selection of variables.

3.1. Research Approach

A deductive approach is adopted by constructing an empirical model and hypothesizing its linear relationship between determinants and its dependent variable.

3.2. Research Design

To comply with the objectives, the study was primarily based on survey of quantitative research, which constructed an econometric model to identify and measure the determinants of selected MFIS' profitability.

3.3. Sample Design

Given the research objectives coupled with research questions, it is considered that in the sampling design target population and the samples taken to the study are appropriately identified. All category 'A' institutions are included in the study.

3.3.1. Target population

The target populations for this study were all years' consolidated financial statements of selected MFIs. The data of those MFIs for a period of 2013-2017 collected from National Bank of Ethiopia.

3.3.2. Sampling techniques and sample size

Firstly, Category 'A' MFIs are selected purposely because of their overall capacity compared to all MFIs in Ethiopia and five years consolidated annual reports was collected.

3.4. Source of data

Secondary source of data was used because secondary data generally provides a source of data that is both permanent and available in a form that may be checked relatively easily by others, i.e more open to public study.

3.4.1. Secondary data source

Data was obtained from the consolidated annual financial and non-financial reports of MFIs submitted to National Bank of Ethiopia from 2013 to 2018, five years' cross-sectional data.

3.4.2. Data Gathering Instrument

In order to collect the data from data sources, the researcher employed survey of document analysis.

3.4.3. Data presentation and analysis

The researcher used classical regression mode to analyze the determinant factors of the selected MFIs financial performance. Since the objective of the study is to examine and

establish causal relationship between the dependent and independent variables in the model, the researcher used linear form of the regression.

3.5. Variable Selection, Measurement and expectation

The empirical part of this paper attempts to examine the main factors affecting the financial performance of micro financial institutions.

Table 3.1: measurement methods for variables of the current study

Variables	Measured by:	Expected sign
Portfolio quality	Portfolio-at-risk (PAR) ratio which is the ratio of portfolio at risk (X days) to gross loan portfolio	+
Number of clients	The total number of active clients plus the number of Individuals who are neither active borrowers nor depositors, but members.	+
Company growth rate	The percentage change in total assets	+
Average disbursed loan size	The Value of loans disbursed divided by total number of loans disbursed during period	+
Capital size	The percentage change in total capital size	+
Personnel productivity	Number of active clients divided by number of personnel	+

3.6. Design of Empirical Model

The literature generally, in so far as it is discussed, comes to the conclusion that the appropriate functional form for testing is a linear function although there are dissenting opinions. The liner regression model was used to identify the relationship between the performance of the selected MFIs and Portfolio quality, size of capital, educational level, amount of loan dispersed and number of clients. Data was analyzed with one dependent variable that is financial performance of those MFIs and it is measured by ROA.

For estimation purposes, the following general linear model is used:

$$\text{ROA}_{ti} = f(PQ, CS, NC, ADLS, PP, CGR)$$

Hence, the question for this study can be stated as:

$$ROA_{ti} = a + \beta_1 PQ_{ti} + \beta_2 CS_{ti} + \beta_3 NC + \beta_4 ADLS_{ti} + \beta_5 PP_{ti} + \beta_6 CGR_{ti} + u_{ti} \dots \dots (1)$$

Where:

ROA = Return on Assets as a proxy to financial performance of ACSI

CS= Capital size of MFIs

PP=Personnel Productivity

NC=Number of clients

PQ=Portfolio quality

ADLS =Average disbursed loan size

CGR= Company growth rate

4. Results and Discussion

4.1. Ordinary Least Squares (OLS) Tests for the Regression Model

The four classic assumptions are tested in undertaking the regression analysis including; Normality, Multicollinearity, Heteroskedasticity and Autocorrelation.

4.2. Regression Analysis

The table below presents the results from the regression analysis carried out using the six explanatory variables.

Table 4.3: Random Effect Regression Outputs and Coefficients

Source	SS	DF	MS		
Model	0.002138918	6	0.000523153	Number of obs. =	25
Residual	0.000008429	3	0.000039442	F(6, 3) =	186.205
Total	0.002147347	9	0.000562595	Prob. > F =	0.0001
				R-squared =	0.70616
				Adj. R-squared =	0.47825
				Root MSE =	0.00168
				Durbin-Watson stat=	1.93666

ROA	Coefficients	Standard error	t	P > t
(Constant)	-0.1021061	0.0063201	-16.16	0.001
PQ	0.0017096	0.0001646	10.39	0.002
NC	0.0033274	0.0005619	5.92	0.010
CGR	0.1152602	0.0308521	3.74	0.033
ADLS	0.0113223	0.000667	16.97	0.000
CS	0.0658845	0.0052877	12.46	0.001
PP	0.0082213	0.0015272	5.38	0.013

Source: Regression output

As shown above, 70.1% of variations in dependent variable (ROA) are explained by the variations in the independent variables. Adjusted R square in the model is 0.478 which means on average 47.8% of the change in financial performance as measured by ROA can be explained by the variables in the model.

Company Growth Rate had a high positive influence on financial performance ($\beta=0.1153$, $p<0.01$). The results of the regression analysis also shows that the capital size, average size of disbursed loans and number of clients have high positive influence on financial performance which is significant at 99% ($\beta = 0.0659$, 0.0113 and 0.0033 respectively). Personnel productivity and portfolio quality also have positive influence on the financial

performance of MFIs at a significant level of 95%. This indicates that all the six variables influence ROA positively and significantly. Hence, the general regression equation for predicting financial performance becomes:

$$\text{ROA} = -0.1021 + 0.1153\text{CGR} + 0.0659\text{CS} + 0.0113\text{LnADLS} + 0.0082 \text{LnPP} + 0.0033\text{LnNC} + 0.0017\text{LnPQ} + \varepsilon$$

4.3. Findings and discussion of results

After analyzing the data, major factors affecting the financial performance of Ethiopian micro finance institutions are identified and presented here under against the ones found in other empirical studies.

Capital Size: Capital Size has a significant statistical impact on Financial Performance of companies. The regression estimation result revealed that there exist a significant and positive relationship between growth rate of capital size and financial performance of MFIS with regression coefficients of 0.0659, p-value of 0.001. Hence, the variables have statistically significant positive relationship. This has an implication that larger micro finance institutions can maintain high ROA. Thus, the result of the regression output is consistent with other previous studies as mentioned above.

Personnel productivity: Measures the MFI may wish to measure the overall productivity of MFI personnel in terms of managing clients, including borrowers, savers, and other clients. The results of the regression analysis show that there is a positive and statistically significant relationship between personnel productivity and financial performance with a regression coefficient of 0.0082 and p-value of 0.013. It has a significant statistical impact on financial performance of microfinance institutions. Empirical evidence by Amal et.al (2011) found a positive and statistically significant relationship between personnel productivity as proxied by management competence. Hence, companies having higher ability to manage clients, the better quality of their competence and thus the company's ability to be healthy in their financial performance.

Company Growth Rate: The result of the regression analysis for this study shows that there is a positive and statistically significant relationship between company growth rate and financial performance of selected MFIs with a regression coefficient of 0.1153 and p-value of 0.001. This is also consistent with the empirical evidence by Ahmad et al (2011) in their investigation that found a positive and statistically significant relationship between growth and profitability of microfinance companies. Hence, micro finance institutions having more and more assets over the years have also better chance of being profitable for the reason that they do have internal capacity though it depends on their ability to exploit external opportunities.

Portfolio Quality: Portfolio quality is a measure of how well or how best the institution is able to protect the portfolio against all forms of risks. The result of the regression analysis

for this study shows that there is a positive and statistically significant relationship between portfolio quality and financial performance of selected MFIs with a regression coefficient of 0.0017 and p-value of 0.002. This is also consistent with the empirical evidence by (Imai, 2011) however, it is against what (Abebw, 2014) found that was a negatively and not significant relationship between portfolio quality and financial performance of microfinance companies.

Number of Clients: The result of the regression analysis shows that there is a positive and statistically significant relationship between number of clients and financial performance of ACSI with a regression coefficient of 0.0033 and p-value of 0.001. This is also consistent with the empirical evidence by (Yeshi, 2015) found positive and statistically significant relationship between number of clients and financial performance financial performance. Hence, micro finance institutions having more and more clients over the years have also better chance of being profitable.

Average disbursed loan size: The result of the regression analysis for this study shows that there is a positive and statistically significant relationship between size of disbursed loan and financial performance of selected MFIs with a regression coefficient of 0.0113 and p-value of 0.001. Imali (2013)), Yeshi (2015) both found positive and statistically significant relationship between number of clients and financial performance financial performance. Hence, micro finance institutions having larger loans as well as higher interest rates would of course result in more income and make them more profitable due to cost and some scale effects. This leads to focus on offering loans to economically active people that will likely result in high repayment rates and consequently lead to increased levels of MFI efficiency.

5. Conclusions and Recommendations

The purpose of this last chapter is to recap the whole thesis in a comprehensive manner. In view of that, the first part presents conclusions of the thesis and indications of empirical results and the second part shows recommendations provided by the researcher.

5.1. Conclusions

The objective of this study is to examine the factors affecting financial performance of the selected MFIs as measured by ROA. The study examines the effect of company growth rate, portfolio quality, capital size, personnel productivity, number of clients and average disbursed loan size (these were considered as explanatory variables) on ROA as a measure of financial performance (was taken as dependent variable) of selected MFIs over the period of five years from 2013 to 2017. This study used secondary data collected from selected MFIs. Regression analysis was performed to identify the determinants of financial performance of selected MFIs.

In general, the findings revealed that the six factors included in the model were significant in affecting the financial performance MFIs. The results also revealed that company growth

rate is the most influential factor followed by capital size and the average disbursed loan size in affecting the financial performance of selected MFIs. Hence, growth rate as measured by the percentage change in assets is the dominant factor that positively affecting the financial performance of MFIs.

5.2. Recommendations

The micro finance sector in general and selected MFIs in particular needs more effort on their development and to have relatively stable financial performance over the years. Micro financial institutions should work aggressively for their profitability and growth by identifying major factors affecting the financial performance. Based on the major findings obtained from the result, the researcher provided the following additional recommendations:

- It is worthwhile to have high consideration of increasing the company capital. Because the capital size of the company is an important factor as it influences its competitive power.
- MFIs should build the client management capacity by proving staff development as well as leadership training.
- MFIs should increase the number of clients by designing customer attracting strategies. This in turn, is an important tool to increase the amount of loan disbursed and total assets. The increment in loan size and total assets has a positive contribution to the growth of the institution in general.

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