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MICROFINANCE REGULATION - WHO BENEFITS?

Uganda's Experience in Regulating Microfinance Deposit-taking Institutions

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1INTRODUCTION

1.1 Microfinance in Uganda in the 1980s

Before I discuss the benefits of regulating microfinance in Uganda, I would first like to go back to the state of microfinance in the early 1980s. In Uganda, microfinance was then popularised by non-government organizations (NGOs), who using donor and Government funds, lent to microfinance clients, often at subsidized interest rates. Microfinance was seen as a social service aimed at reducing poverty, with very limited prospects of Microfinance Institutions becoming sustainable entities. In fact, the focus was on microcredit since the poor were deemed 'too poor to save' and needed subsidized loans.

In the 1980s era, microfinance services in Uganda were largely based on the original Grameen Model of weekly meetings and repayments of very small loans. Due to the features of microfinance, it was ill-suited to many enterprises, particularly agriculture, due to mismatch between weekly payments on one hand, and enterprise gestation period and income seasonality on the other. In Africa, we have a proverb - '***Any wealth that takes only a market week to acquire is sure to contain in it things for which the gods will surely come to make claims'.*** Indeed, the repayment periods were too short for the borrowers to achieve much with the borrowed funds. However, due to the dire need for financial services, the services were embraced by microentrepreneurs.

1.2 Current Development in Uganda's Microfinance Industry

The first four MFIs to be licensed as Microfinance Deposit-taking Institutions (MDIs) in 2003 were a result of efforts of donors, Government and the Central Bank. These were; i) FINCA Uganda Ltd MDI (initiated by FINCA International; ii) Uganda Finance Trust Ltd MDI (a women's movement project was largely support by SNV[1]; iii) Pride Uganda Ltd MDI (by Government of Uganda with support from NORAD): and iv) the then Uganda Microfinance Limited MDI (now Equity Bank) which was established through Bank of Uganda support to a member of staff's post graduate project. All the four were initially NGOs, which prior to licensing, transformed into companies limited by shares.

Deposit-taking microfinance business in Uganda in the 21st Century is an almost entirely different concept from the microfinance of the 1980s. Not only is the capacity of the poor to save presumed obvious, but sustainability of microfinance as a business is well proven and appreciated. Even what would be considered the remaining challenge (suitability of microfinance products) is beginning to pale in the face of innovation and improvements in other sectors, particularly information technology. In this paper, I will focus on benefits that have accrued out of regulation of deposit-taking microfinance institutions.

2 MICROFINANCE DEPOSIT-TAKING INSTITUTIONS REGULATION

2.1 Microfinance Policy

[1] Stichting Nederlandse Vrijwilligers (SNV) or Foundation of Netherlands Volunteers

Efforts to bring microfinance institutions (MFIs) under regulation started in the late 1990s, initiated by some of the larger MFIs that were interested in taking deposits. On July 12, 1999, Bank of Uganda (BoU) issued a **Policy Statement on Microfinance Regulation**. The Statement spelt out microfinance as a business, under which microfinance business would be regulated under a four tier framework. BoU undertook to supervise the first, second and third tiers comprised of Banks, Credit Institutions and Micro-Finance Deposit Taking Institutions (MDIs) respectively.

Tier 4, was (and still is) mainly comprised of Savings and Credit Cooperative Societies (SACCOS), credit only NGOs and private companies, Savings and Loan Associations and Groups. This Tier was left out of prudential oversight because the institutions were; i) non deposit-taking and unlikely to cause systemic risk to the financial sector; ii) just emerging experimental initiatives that could easily be constrained if legislated too early; while at the same time iii) **BoU's principle was to regulate what it could supervise.**

Table 1: Features and Service Range of Institutions by Tier

Tier	Type of Institution	Start –Up Capital*	Deposit Taking	Other Services			
				Checking Account	Foreign Currency Account	Foreign Exchange Business	Money Remittance Business
1	Banks	UGX 4bn/= **USD 2.06m**	Yes	Yes	Yes	Yes	Yes
2	Credit Institutions	UGX 1bn/= **USD 0.52m**	Yes	No	No	**Requires BoU Licence	**Requires BoU Licence
3	MDIs	UGX 0.5bn/= **USD 0.26m**	Yes	No	No	**Requires BoU Licence	**Requires BoU Licence
4	SACCOS Moneylenders Associations Groups	Not specified	No	No	No	Only companies limited by shares (Moneylenders) would qualify but none have applied	

*** One USD is currently equivalent to Uganda Shilling (UGX) 1,940**

**** This is an additional licence.**

Table 1 provides a summary of the features and range of products by tier. The tiered approach recognises the dynamics of Uganda's financial sector and i) limits deposit taking to the first three prudentially regulated tiers; and ii) set progressively increasing start-up capital requirements in line with increasing product range and need to absorb risk. Once the Policy was in place, a consultative and participatory process, to discuss regulation of deposit- taking in MFIs, was initiated.

2.1 The Microfinance Deposit-taking Institutions Act (2003)

With the adoption of the Policy on Microfinance Regulation in 1999, work on drafting the Microfinance Deposit-taking Institutions (MDI) Act and MDI Regulations began. The MDI Act was enacted in 2003 and the Regulations gazetted in the following year (2004). Licensing of the first MDI and the other three MDIs was done in November 2004 and 2005 respectively. The decision to enact a separate law for MDIs was to avoid overly burdensome requirements on microfinance business for institutions that were going under prudential regulation for the first time.

Start up capital requirement for MDIs (as indicated in Table 1) was set lower than that for Banks and Credit Institutions (Tiers 1 and 2 respectively). However, due to the volatile nature of savings (small values, frequent withdrawals) and the alternative collateral forms used, MDIs were required to comply with higher capital adequacy standards. Consequently, minimum core capital and total capital to risk weighted assets ratios for MDIs were set at 15% and 20% respectively (while for banks and credit institutions, they stand at 8 and 12% respectively).

3 BENEFITS OF REGULATING MICROFINANCE BUSINESS

3.1 Government

From Uganda's experience, regulation of deposit taking microfinance institutions has indirectly helped to redefine the nature and degree of government's involvement in the industry. Previously, Government's interventions were focused on directing credit to particular economic sectors as well as setting lending rates at levels that were deemed favourable to small and poor borrowers.

With microfinance now widely acceptable as a business and with a number of institutions demonstrating capacity to attain financial sustainability, Government's focus has shifted towards supporting sustainable, market-based microfinance. Most of the Government programmes now support communities to form savings and credit cooperatives and capacity building of these entities. Though in some instances, these efforts have been overridden by political pressures towards nationwide coverage rather than sustainability, the approach is still better than attempts to impose caps on lending rates.

3.2 The Central Bank (Bank of Uganda)

There have been lessons and benefits for the central bank as well. Accommodating deposit taking microfinance institutions within the banking legal framework has improved central bank supervisors' appreciation of the peculiarities of microfinance supervision. And as some MDIs begin to transform into NBFIs and banks, the specialised skills for analysing microfinance operations (particularly group lending methodologies) and portfolio quality performance, are being shared among commercial bank and MDI supervisors.

Both bank and MDI supervisors have benefitted from each others skills and the fusion of both conventional banking and microfinance supervision skills are improving financial sector supervision and integration. However, integration of microfinance into the banking sector has raised challenges particularly in the definition of the terms '*deposit*' and '*deposit taking business*'. With savings used as collateral not recognised as a deposit in conventional law, there have been cases of illegal deposit taking. Bank of Uganda is currently reviewing these definitions to bring them in line with the special features of microfinance deposit taking business.

The benefits of reviewing these definitions is that unsuspecting public can be better protected from being misled into putting money into unlicensed institutions and pyramid schemes that has led to loss of savings. To protect its image as '*protector of savers*', it is important to Bank of Uganda that all attempts to take deposits illegally are minimised.

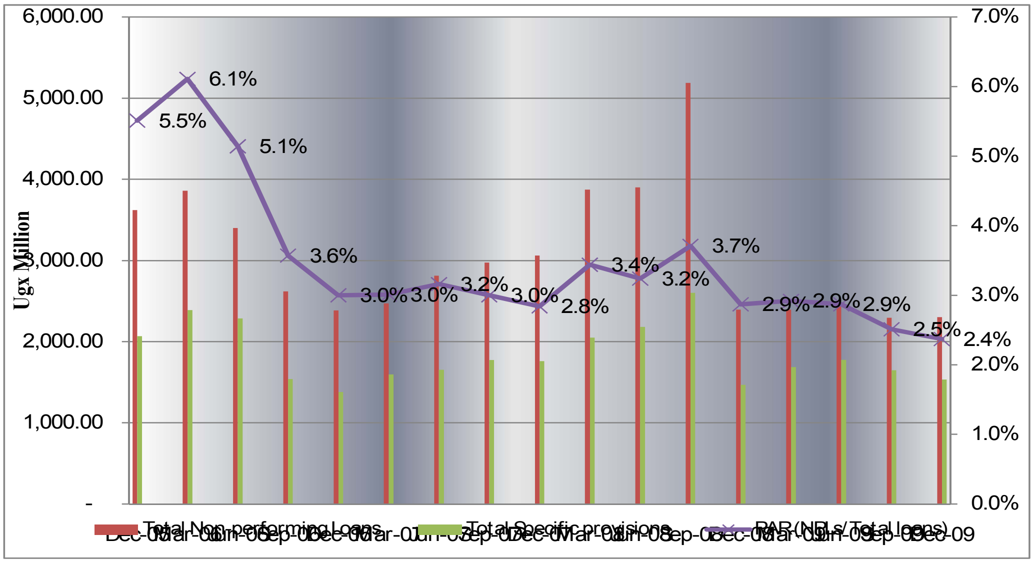
3.3 Benefits to the MDI Client

Loan provision has increased considerably from the time that the four MDIs were licensed. As at the end of December 2005, the four MDIs had a total loan portfolio of UGX 65.7 billion. By September 2008, the portfolio had grown to Ug shs 139.9billion. Though the total MDI loan portfolio fell to Ug shs 83.4billion at end of December 2008 (due to graduation of one of the MDIs into a bank), it had by end of December 2009, risen to UGX 97.3 billion.

MDI clients have also benefitted from the group methodologies applied by MDIs, which help clients improve entrepreneurial and managerial skills. Group meetings and trips to markets expose them to new ideas and technologies as reflected by the new business ventures that can be discerned from loan records. There is also evidence of repeat borrowing, business expansion and diversification, increase in frequency and volumes of savings. Additionally, there is evidence of good loan repayment as reflected by the MDIs' low level of portfolio at risk. (see *Diagram* 1).

In terms of easing access, the number of MDI branches, had from the 64 in 2005, risen to 76 by end of December 2009. Apart from internally designed products for school and health needs, MDIs have also been subcontracted by agencies like Western Union to offer money transfer and this has expanded the range of products they offer to their clients.

Diagram 1: <u>MDI Asset Quality Trends 2005-2009</u>



3.4 Microfinance Deposit Taking Institutions (MDIs)

Initially, when the MDI Act 2003 was enacted, there was intense criticism within and outside Uganda of its provisions that seemed too stringent to be sustained. However, *Diagram* 1 demonstrates that MDIs asset quality has consistently improved from 2005 to 2009. Starting with a Portfolio at Risk (PAR) rate of 5.5% in 2005, the overall PAR had, by the end of December 2009, reduced to 2.4%. This is testimony of improved loan portfolio management.

During the approval of the MDI Act (2003) minimum capital requirement which had been set at UGX 700m/= (USD 0.37million) was reduced to Ug shs 500m/= (USD 0.26million) due to perceptions that the capital requirement was too high. The four MDIs that were licensed in 2005 had core capital of UGX 17.3 billion (USD 8.9million) and total capital UGX 24.0billion (USD 12.5million) respectively. Both figures were well above the total expected for the four institutions i.e. UGX 2 billion (USD 1.04million). And by end of December 2009, even after one of the four

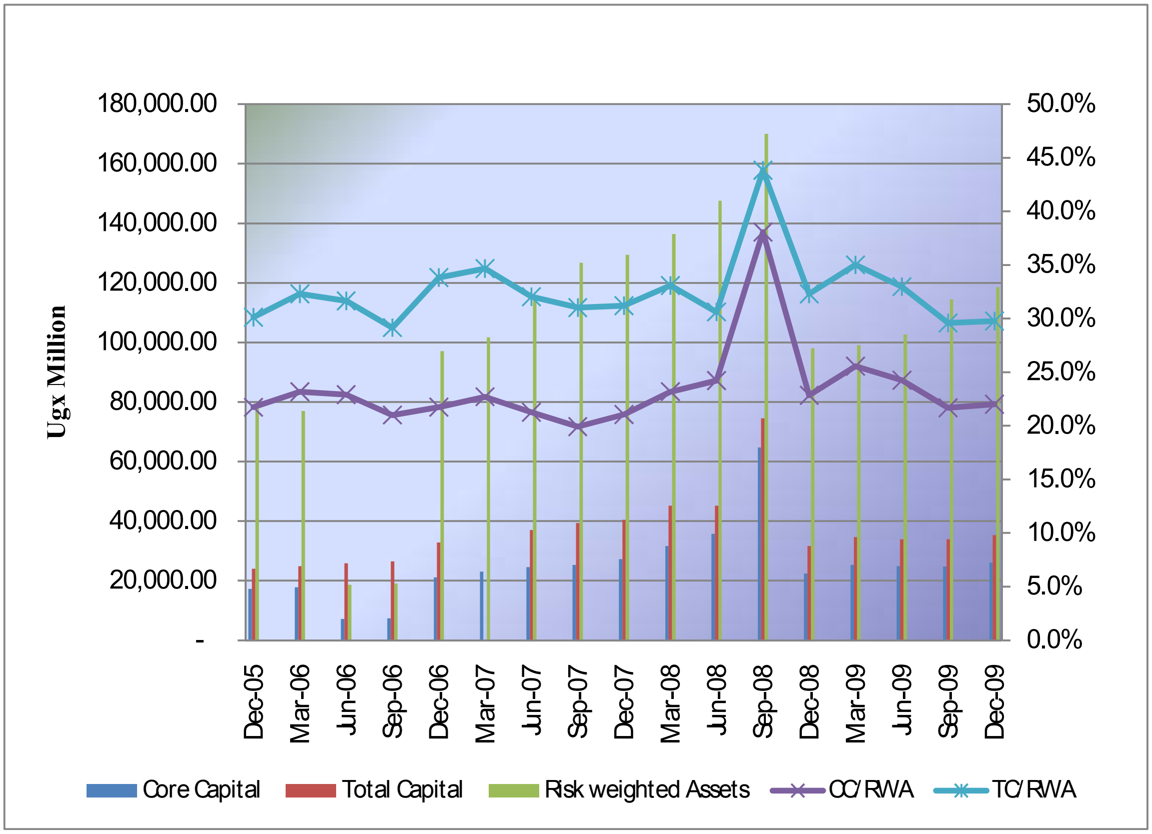
MDIs had graduated to a commercial bank, capitalisation levels for three remaining MDIs stood at UGX 26.1billion (USD 13.5 million Core Capital) and UGX 35.3billion (USD 18.2 million Total Capital).

The increase in capital levels arose from a number of factors. First, the limit on maximum shareholding (30%) compelled the MDIs to bring in other investors who boosted capital levels. Additionally improved management and governance not only made MDIs an increasingly attractive investment option, but they have also accessed new funding sources (commercial funds and deposits) and achieved higher volumes of business and retained earnings.

Microfinance regulation has also positively impacted on the credibility of MDIs. In addition to accessing long term finance to finance their loan portfolios, most MDIs have arrangements for banks to provide liquidity in case of liquidity constraints. MDI credibility has been further boosted by a Kenyan bank (Equity Bank), which on entry into the Ugandan financial sector, acquired one of the MDIs. Other MDIs have since then, also been approached for acquisition, but they seem to have more confidence that they can transition into Tier 1 without being taken over.

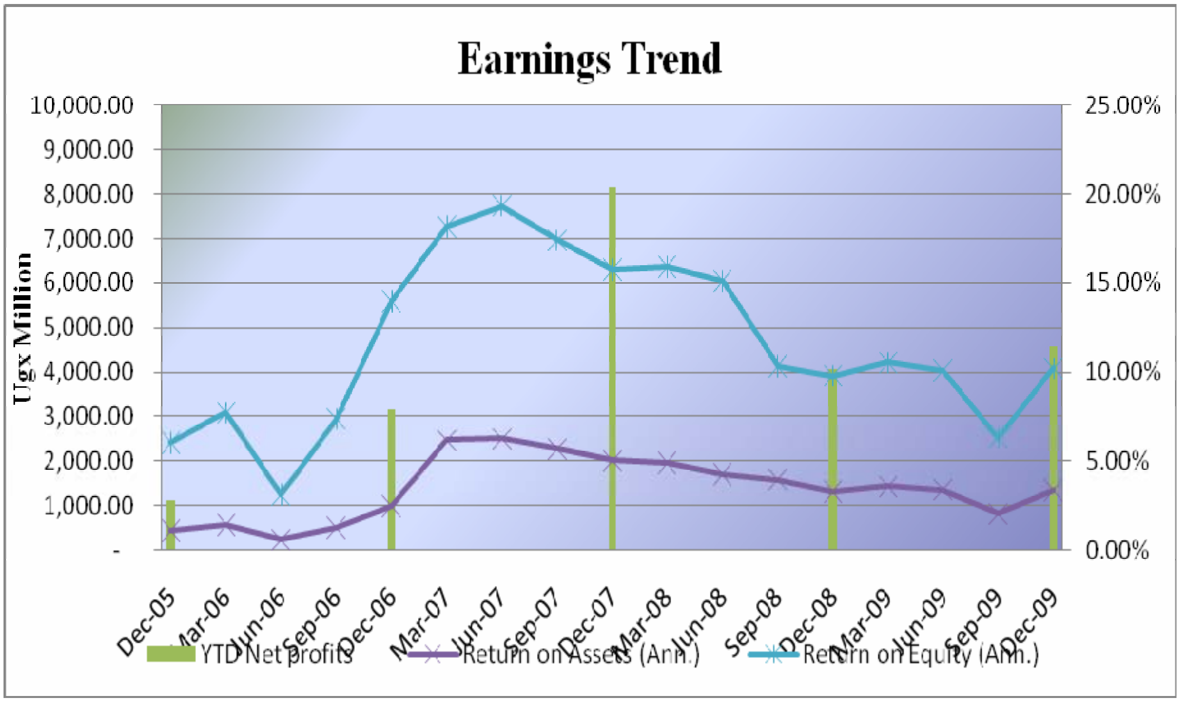
Improved capital base has enabled MDIs to sustain capital adequacy standards for core capital and total capital to risk weighted above 20% and above 30% (respectively) well above the minimum required 15% and 20%. This has enabled the MDIs to retain earnings which have supported organic growth of their business. The spike experienced in September 2008 is as a result of one of the MDIs being acquired and transforming into a bank and is similarly reflected in other diagrams in this Paper, as that MDI ceased to report as an MDI in the quarter ending December 2008.

Diagram 2: <u>MDI Capital Adequacy Trends 2005 to 2009</u>



Earnings have also shown a positive trend as depicted in *Diagram* 3. Starting with a fall in Return on Assets (RoA) and Return on Earnings (RoE) between Dec 2005 and June 2006, MDIs' RoE peaked at 19% in June 2007. The initial fall (after licensing in 2005) was due to new investments in information systems, branch upgrades and staff recruitment to meet licensing and on-going regulatory requirements. MDIs' RoA and RoE have thereafter, moderated to levels more in keeping with returns expected of the sector.

Diagram 2: <u>MDI Trends in Earnings 2005 to 2009</u>



4 IMPROVING BENEFITS OF MICROFINANCE REGULATION

Uganda's microfinance industry has the potential of providing more benefits to its stakeholders. However, there are some limitations that need to be overcome for more of these benefits to be realised.

4.1 Weaknesses in the Regulatory Framework and Other Regulators

The number of institutions expected to transform into MDIs have been fewer than anticipated. One of the reasons is the loopholes in regulatory frameworks that have enabled many of the targeted institutions to continue operating outside the MDI Act (2003). Tier 4 institutions currently operate under at least three legal frameworks which have not been streamlined and where supervision is weak.

SACCOs are currently regulated under a general law that caters for all types of cooperatives under the supervision of the Registrar of Cooperatives. Moneylenders, in form of NGOs (companies limited by guarantee) and private companies (limited by shares) comply only with the requirements of the registrar of companies and only submit reports to the NGO board. With the number (over 3000) and size (some reaching over 50,000 persons) of Tier 4 institutions growing considerably, cases of illegal deposit taking and fraudulent money collection/pyramid schemes have increased.

Bank of Uganda is currently reviewing the MDI Act (2003) as well as the Financial Institutions Act (2004) to ensure the loopholes are removed and definitions refined. Bank of Uganda and Ministry of Finance Planning and Economic Development have also initiated discussions on how best to bring order in the activities of Tier 4 institutions. The option of establishing a second regulator to supervise all those institutions outside Bank of Uganda's ambit is being explored. Consequently, Bank of Uganda participants at this Conference will spend some extra time here in Bangladesh to learn from your experiences in setting up the Microcredit Regulatory Authority.

Additionally a Tier 4 census is currently being undertaken by the Uganda Bureau of Statistics with the aim of benchmarking the Tier into segments, on the basis of which, regulatory requirements can be proposed.

4.2 High Cost of Transformation

One of the main reasons that has been cited by some institutions (for not transforming into MDIs) is the high cost of transformation. For the four MDIs that were licensed in 2005, the average transformation cost per MDI was almost USD one million. This money was used to meet the following expenses; technical assistance (mainly sourced from abroad); acquisition of new information system (by each MDI); branch premise upgrades bank-like branches; and recruitment of professional staff. This is a prohibitive amount that cannot be afforded by most MFIs yet donor support for transformation has reduced.

Fortunately, it is now possible for Tier 4 institutions to use local technical assistance to successfully and cost effectively transform into an MDI. Recent proposals from MDIs submitted to Bank of Uganda for approval also indicate that there are viable options for reducing branching costs (e.g. mini branches) and sharing of information systems. Ministry of Finance Planning and Economic Development has been alerted of the need for financial support to transforming Tier 4 institutions.

4.3 Fears of Loss of Control and Mission

Most of the NGO type Tier 4 institutions were established with a social mission and turning their microfinance operations into a business operation could jeopardise their access to grants. However, the NGO type of MFI is more prone to illegal deposit taking and resorting to pyramid schemes as a way of raising capital thus the need to bring those taking deposits under the regulatory framework.

On the other hand, some MFIs (including existing MDIs) have expressed concern over ownership dilution (maximum shareholding required under the MDI Act 2003 is 30%). In their view, the requirement to bring in other shareholders is likely to lead to mission drift, particularly when the business approach used by MDIs overrides their social mission. Similarly SACCOS have met a bottleneck when required to register as companies in order to become MDIs. Unless they change their legal form, they cannot currently be licenced as MDIs due to the high number of shareholders.

Bank of Uganda has in these cases explained the benefits that come with shareholder diversification for deposit taking institutions. The Bank has also taken note that an upward review of the period within which new entrants have to comply with the 30% limit may provide adequate time to identify and attract socially minded investors. For the SACCOS, review of the particular provisions to allow other legal entities to be licensed as MDIs is needed.

4.4 Credit Assessment Skills

One area where we believe improvements can be made by MDIs is in credit assessment. The improvements should address challenges posed by increase in multiple borrowers, growing number of borrowers and increase in MDI loan sizes. There is need to share information on borrowers and to use quicker and more objective credit appraisal mechanisms as MDI loan sizes and total loan portfolios grow. **On information sharing, Bank of Uganda has supported the establishment of the Credit Reference Bureau services, which is now operational. MDIs can complement this initiative with automated credit scoring to ease processing of the large number of loan applications so that loan officers devote more time to loan follow-up and enlisting new clients.**

4.5 Weaknesses in Other Sectors

Proposals for improving benefits of microfinance regulation would be incomplete if no mention is made of limitations arising from other sectors that affect the operations of regulated financial institutions and in turn the benefits realised by their customers. If there is to be an increase in the Scope (number of individuals reached), Impact (effect on the well-being of borrowers), and Depth (ability to reach the poorest of the poor) of microfinance, there is need to improve service delivery by other sectors.

First, there is urgent need to develop infrastructure, especially in rural areas to ease access to markets, reduce the cost of travel and information – which are key aspects in determining access to finance and reducing cost of borrowing. Secondly, the establishment and streamlining of registration and titling systems for assets owned by rural and poor urban households is key to improving lenders' security. The third area is on improving agricultural extension and to refocus it on improved agricultural productivity. Without improvements in per unit farm productivity, it will remain difficult for Ugandan farmers to attain per unit returns that can support loan repayments even with reduced MDI lending rates.

5 GOING FOWARD

5.1 Matching Regulation to the Need

In Uganda, the underlying needs for maximizing benefits of financial services have already been met i.e. macroeconomic stability and a strengthened banking system regulatory and supervisory framework. But for any country to improve outreach to its 'unbanked' people there is need to continuously review the structure of its financial services and the needs of the unbanked. This approach has been the genesis of many innovations and indeed led to the rise of formal microfinance institutions in developing countries, with the Grameen Bank here in Bangladesh, taking the lead as early as in the 1970s.

Microfinance regulation does bring a number of benefits to the industry and as more MFIs enter the arena of licensed, prudentially supervised financial intermediation, and regulations, capacity to mobilise deposits is improved. The challenge is to avoid over-regulation while putting well-tailored rules and systems in place.

Though there have been warnings of possible mismatches between microfinance regulation and microfinance lending technologies, it is worth the effort because without trying, we cannot begin addressing (and in some cases dispelling) the notion of '*excessive risk*' that is frequently associated with microfinance operations. In Uganda's case, though only a few deposit taking microfinance institutions have been licensed so far, what we have learnt in this process, gives us a firm foundation for tackling the challenges of bringing order to Tier 4 institutions and charting out a feasible course for more institutions in this tier to graduate to deposit taking.

If microfinance is to reach larger parts of our population and become more relevant to all sectors of our economy, serious efforts in deposit mobilisation are required. This in turn means more MFIs transforming into deposit taking institutions, alongside banks scaling down to offer more microfinance products. To again quote from our African proverbs; ***No elephant is burdened by the weight of its tusks***. The tusk/task is big but it is a reflection of the confidence that our people and nations have in us. We therefore must make every effort to improve the benefits they derive from regulated microfinance. Like other emerging financial markets, Bank of Uganda appreciates that supervision costs of the microfinance sector are high and cannot be absorbed by the sector. Mother Teresa said, ***'To keep a lamp burning, we have to keep putting oil in it'***. The Bank will provide technical and financial support towards the establishment of an effective regulatory framework for Tier 4 institutions.

5.2 Concluding Remarks

Finally, I wish to thank the management of the Microcredit Regulatory Authority, the Central Bank of Bangladesh as well as the Government of Bangladesh for providing a forum to the different countries here present, to share and find solutions to improving benefits of microfinance and other financial services in our countries.

THANK YOU