ASSOCIATION OF MICROFINANCE INSTITUTIONS IN UGANDA

A SURVEY ON REGULATION OF MICROFINANCE COMPANIES AND NGOS

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<th>Full Form</th>
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</thead>
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<tr>
<td>AMFIU</td>
<td>Association of Microfinance Institutions in Uganda</td>
</tr>
<tr>
<td>ASCAs</td>
<td>Accumulated Savings and Credit Associations</td>
</tr>
<tr>
<td>ARB</td>
<td>Association of Rural Banks (of Ghana)</td>
</tr>
<tr>
<td>ARCBs</td>
<td>Association of Rural Community Banks (of Ghana)</td>
</tr>
<tr>
<td>BoG</td>
<td>Bank of Ghana</td>
</tr>
<tr>
<td>BoU</td>
<td>Bank of Uganda</td>
</tr>
<tr>
<td>CGAP</td>
<td>Consultative Group to Assist the Poor</td>
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<tr>
<td>CIs</td>
<td>Credit Institutions</td>
</tr>
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<td>CMF</td>
<td>Commercial Microfinance Limited</td>
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<tr>
<td>CONGOMA</td>
<td>Council for Non-Governmental Organizations in Malawi</td>
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<tr>
<td>CRB</td>
<td>Credit Reference Bureau</td>
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<tr>
<td>CUA</td>
<td>Credit Union Associations (of Ghana)</td>
</tr>
<tr>
<td>DEMAT</td>
<td>Development of Malawian Enterprise Trust</td>
</tr>
<tr>
<td>FCL</td>
<td>FRIENDS Consult Limited</td>
</tr>
<tr>
<td>FIA</td>
<td>Financial Institutions Act</td>
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<tr>
<td>FINCA</td>
<td>Foundation for International Community Assistance</td>
</tr>
<tr>
<td>FIS</td>
<td>Financial Institutions Statute</td>
</tr>
<tr>
<td>FSDU</td>
<td>Financial Sector Deepening in Uganda</td>
</tr>
<tr>
<td>GTZ</td>
<td>Deutsche Gesellschaft fur Technische (German Technical Cooperation)</td>
</tr>
<tr>
<td>KPOSB</td>
<td>Kenya Post Office Savings Bank</td>
</tr>
<tr>
<td>LIF</td>
<td>Loan Insurance Fund</td>
</tr>
<tr>
<td>MDIs</td>
<td>Micro Deposit Taking Institutions</td>
</tr>
<tr>
<td>MFIs</td>
<td>Micro Finance Institutions</td>
</tr>
<tr>
<td>MFRC</td>
<td>Micro Finance Regulatory Council (of South Africa)</td>
</tr>
<tr>
<td>MOFPED</td>
<td>Ministry of Finance Planning and Economic Development (of Uganda)</td>
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<tr>
<td>MRFC</td>
<td>Malawi Rural Finance Corporation</td>
</tr>
<tr>
<td>MSB</td>
<td>Malawi Savings Bank</td>
</tr>
<tr>
<td>MTTI</td>
<td>Ministry of Tourism Trade and Industry (of Uganda)</td>
</tr>
<tr>
<td>MUSCU</td>
<td>Malawi Union of Savings and Credit Union</td>
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<tr>
<td>MUSCO</td>
<td>Malawi Union of Savings and Credit Cooperatives</td>
</tr>
<tr>
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<td>National Credit Act (of South Africa)</td>
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<td>NCR</td>
<td>National Credit Regulator (of South Africa)</td>
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<tr>
<td>NDFI</td>
<td>Non Deposit-taking Institution</td>
</tr>
<tr>
<td>NGO</td>
<td>Non Governmental Organization</td>
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<tr>
<td>NLR</td>
<td>National Loans Register</td>
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<td>NMP</td>
<td>National Microfinance Policy (of Tanzania)</td>
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<tr>
<td>PMT</td>
<td>Performance Monitoring Tool</td>
</tr>
<tr>
<td>PRIDE</td>
<td>Promotion of Rural Initiatives and Development Enterprise</td>
</tr>
<tr>
<td>PSPCs</td>
<td>Private Sector Promotion Centers</td>
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<tr>
<td>RBM</td>
<td>Reserve Bank of Malawi</td>
</tr>
<tr>
<td>RFSP</td>
<td>Rural Financial Services Program</td>
</tr>
<tr>
<td>RFSS</td>
<td>Rural Financial Services Strategy</td>
</tr>
<tr>
<td>RIA</td>
<td>Regulatory Impact Assessment</td>
</tr>
<tr>
<td>Acronym</td>
<td>Full Name</td>
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<tr>
<td>----------</td>
<td>-------------------------------------------------------------</td>
</tr>
<tr>
<td>ROSCAs</td>
<td>Rotating Savings and Credit Associations</td>
</tr>
<tr>
<td>SACCOS</td>
<td>Savings and Cooperative Credit Organizations</td>
</tr>
<tr>
<td>SACCOL</td>
<td>Savings &amp; Credit Cooperative League (of South Africa)</td>
</tr>
<tr>
<td>SALC</td>
<td>Savings and Loans Companies (of Ghana)</td>
</tr>
<tr>
<td>SEEP</td>
<td>Small Enterprise Education and Promotion</td>
</tr>
<tr>
<td>SRO</td>
<td>Self Regulatory Organization</td>
</tr>
<tr>
<td>UCA</td>
<td>Uganda Cooperative Alliance</td>
</tr>
<tr>
<td>UCSCU</td>
<td>Uganda Cooperative Savings and Credit Union</td>
</tr>
<tr>
<td>UML</td>
<td>Uganda Microfinance Limited</td>
</tr>
<tr>
<td>VSLAs</td>
<td>Voluntary Savings and Loan Associations</td>
</tr>
<tr>
<td>WOCCU</td>
<td>World Council of Credit Unions</td>
</tr>
</tbody>
</table>
Executive Summary

Regulation of the microfinance sector, especially the lower tier institutions, has always posed a challenge in most countries. Government of Uganda proposes to regulate Tier 4 microfinance institutions under two separate laws – one for SACCOs and the other for non-deposit taking Tier 4 MFs. Government has already drafted the two laws and discussed them with selected stakeholders.

As the industry network and custodian of MF sound practices, AMFIU would like to make technically informed recommendations on Tier 4 regulation. This necessitated a survey of relevant aspects nationally, compilation of lessons learnt elsewhere and compiling a report that would inform AMFIU’s recommendations. AMFIU contracted FRIENDS Consult to undertake the survey, whose findings and recommendations are presented in this report.

The current financial sector regulatory framework leaves out Tier 4 MFIs, which are vital in provision of financial services to low income people but whose activities, unless regulated, could also disrupt people’s economic lives. Rationale for Tier 4 regulation lies in the need for continued financial sector stability, safety of people’s deposits, need for inclusiveness of regulation, borrower protection and overall national economic development.

From the experiences of Ghana, Kenya, South Africa, Tanzania and Sierra Leone, the key lessons drawn for Uganda are:

- Combining supervision and promotion of the institutions under one umbrella usually compromises one or both of these objectives
- Regulation of community based institutions is best done with the involvement of their apex(es)
- Full scale prudential regulation for small deposit taking institutions like SACCOs can become self-defeating
- Subsidies must be administered with caution so as to ensure the institutions’ sustainability
- Purely credit-driven microfinance, based on government subsidization, can lead to stunted industry growth
- Self regulation by a member controlled apex can be supportive to but cannot replace independent regulation
- Microfinance regulation for the lowest tier institutions should look at the whole array of unregulated financial service providers
- Multi-level regulation/supervision based on delegation, as long as it is well documented, organized and understood, can work
- Network MF organizations have a role in proper regulation
- A comprehensive national microfinance policy is necessary to support MF regulation
- A new law is not always necessary; it is in some cases more appropriate to amend existing laws to accommodate microfinance regulation
- Regulators’ capacity: Never legislate what cannot be regulated, and never regulate what cannot be supervised
- National policy should always precede, shape and inform law making
- A sustainable funding mechanism for regulation needs to be put in place
- Don’t apply prudential regulation to non deposit takers
- For full prudential regulation, avoid licensing very weak institutions that cannot be effectively supervised
- Regulatory policy should have a single focus or a few related grand objectives, while application of the regulatory function can be suitably delegated to different regulatory units

On the basis of the findings and lessons learnt elsewhere, the following key recommendations are made:

1. The two draft laws should be combined into one. Under this, there should be one Tier IV MF Regulatory Authority that administers two different sets of regulations – one to SACCOs and the other to non-deposit taking MFIs

2. There should be a clear, practical funding mechanism for Tier 4 regulation

3. For SACCOs, the regulatory authority should use abridged prudential regulation while for non-deposit taking MFIs, it should use non-prudential but enforceable regulations

4. Owing to the large number of MFIs to be regulated and the likely capacity needs of the regulatory authority, cost and effort-efficient mechanisms (like delegation and focus on a few indicators) should be adopted in Tier 4 regulation

5. The new law (proposed title: Tier 4 Microfinance Regulation Act) should cover all providers of financial services that are currently not regulated under existing laws

The likely effects of the proposed law are increased financial sector stability, probable increase in graduation of institutions to higher tiers, initial high costs of compliance later offset by benefits of more efficiency, further integration of the financial sector, more accurate reports and financial sector data for national planning, improved performance of institutions that survive the introduction of regulation and a strengthening of MF networks as their member institutions become stronger.
1.0 INTRODUCTION

1.1 The Assignment and its Purpose

This report presents the findings and recommendations of a survey on the regulation of Tier 4 MFIs in Uganda. As microfinance institutions grow in scale, outreach and sophistication, there arises need to review and update regulation of the financial sector, especially microfinance. Since the enactment of the MDI Act in 2003, Uganda’s microfinance stakeholders have actively sought regulation alternatives for Tier 4 institutions. Since the second half of 2007, the Ministry of Finance Planning and Economic Development (MOFPED) has drafted and widely consulted on a proposed SACCO specific law, which has now been drafted. More recently, MOFPED undertook the preliminary steps towards introducing another law to regulate non-SACCO Tier 4 MFIs.

Tier 4 MFIs, including SACCOs, form a significant component of the rural financial landscape in Uganda. Whereas by volume of business or outreach numbers they are modest, these institutions have been more successful in penetrating rural areas than the more formal ones. With the exception of SACCOs which operate under the Cooperative Act 1991\(^1\), Tier 4 MFIs are not regulated under any law.

For Tier 4 institutions to become part of the orderly growth of the financial sector, there is need to include them in a conducive regulatory framework which ensures that they blossom while doing ethical, prudent business. This assignment is meant to help AMFIU come up with proposals that will provide a favourable operating environment for the Tier 4 MFIs and guide their business operations. The assignment required the consultant to propose a regulation and supervision structure, assess the possible effect of the regulation on cost, outreach and service quality and make appropriate recommendations on the way forward with regulation of non-SACCO Tier 4 MFIs.

AMFIU\(^2\), the microfinance industry network organization in Uganda, sought to undertake a survey of ideas, views, experiences and opinions on how best the regulation of non-SACCO Tier 4 institutions could be legislated. For this, AMFIU procured and hired FRIENDS Consult Ltd, through national competitive bidding, to undertake the survey and come up with recommendations. As later explained, the assignment was later broadened to include SACCO regulation because of the change in Tier 4 regulation plan by government.

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\(^1\) A statute which is now largely considered very inadequate for regulation of SACCOs as financial institutions.

\(^2\) With funding from the SEEP network
1.2 TOR Summary

In line with the assignment purpose, the Terms of Reference (ToR) required the consultants to:

i. Study the Financial Institutions Act 2004, the MDI Act 2003, the draft SACCO law and other materials that can inform the outcome

ii. Study the Companies Act and give its provisions on relevant issues

iii. Study the NGO statute and give its provisions on financial service provision, including savings mobilization

iv. Give recommendations on whether the Companies Act and NGO statute should be amended or if a new Act is required

v. Examine how other countries regulate and supervise these kinds of financial institutions

vi. Review secondary information and interview MFIs pre-agreed with AMFIU

vii. Analyze data collected and write a report on the findings.

1.3 Methodology Used

The consultants approached the assignment from the most practical perspective and gave preference to suitability of context during each stage. At the start of the work, consultants held an inception meeting with the AMFIU Executive Director and senior managers. The two parties agreed on the available reports and materials to use, the MFIs to interview, other stakeholders to meet, the work plan and a report format. This set the pace for collaborative work during the rest of the assignment.

Shortly after FRIENDS Consult signed the contract with SEEP, further developments had surfaced. MOFPED had produced a zero draft of a proposed law for non-SACCO Tier 4 MFIs and Parliament has indicated that it preferred one law to govern all Tier 4 MFIs rather than two separate ones. It was therefore agreed that the assignment should study both the SACCO and non-SACCO regulation prospects and propose improvements and/innovations to the proposed laws, in the context of the new development.

Consultants reviewed secondary information, including existing laws, draft laws, relevant prior reports and literature from other countries. On the basis of the ToR, the technical proposal and issues agreed at the inception meeting, guiding questionnaires were developed and later used for interviews with different stakeholders. Representative SACCOs and non-SACCO MFIs to be interviewed were selected based on size category, and agreed with AMFIU. These as well as other stakeholders (MoFPED, RFSP, BoU, GTZ, AMFIU, USCU, UCA and PSPCs) were interviewed.

All the findings were analyzed and options weighed with the view of making suitable recommendations. On the basis of this, the report was drafted.
1.4 Limitations and Challenges

This study, though done with due care and skill, faced a few difficulties – among them:

- Changing views and situation with regard to the proposed laws. By the time the ToR was drawn, for instance, government’s position was that there had to be a SACCO specific law and a separate one for non-SACCO Tier 4 MFIs. By the time the assignment started, government wanted one law for both SACCOs and non-SACCOs.

- Widely differing, sometimes irreconcilable views on the scope, focus and depth of regulation to be applied came up.

- The world wide credit crunch came to its peak during the study dispelling long held views of international best practices based on the efficiency of the free market and its capability to produce both commercial and social results sustainably. A number of fundamentals are now frequently questioned, meaning that there is need to think beyond conventional wisdom.
2.0 REGULATORY FRAMEWORK FOR THE FINANCIAL SECTOR IN UGANDA

2.1 Overall Financial Sector Policy and Regulation

The current financial sector policy in Uganda aims primarily at systemic safety and soundness as a supporting bedrock for orderly growth. The policy, drafted by the BoU and approved by Government following multiple bank failures of the late 1990s, was significantly informed by the bitter lessons learnt from these failures and by incidences of fraudulent organizations that fleece the public. The role of Bank of Uganda, the financial sector regulator, is to ensure systemic safety, soundness and stability of the whole financial sector, and protection of public deposits in the regulated financial institutions.

Bank of Uganda issued the policy statement in July 1999 that established a tiered regulatory framework for microfinance business within the broader financial sector. The policy established four categories of institutions that can do micro-financing business in Uganda:

* **Tier 1: Commercial banks.** Banks are regulated under the Financial Institutions Act revised in 2004. Since these are already sufficiently capitalized and meet the requirements for taking deposits as provided for in this Act, they are allowed to go into the business of microfinance at their discretion.

* **Tier 2: Credit Institutions (CIs).** These institutions are also regulated under the Financial Institutions Act 2004. A number of them offer both savings and loan products but they can neither operate cheque/ current accounts nor be part of the BoU Clearing House. Like banks, they are permitted to conduct microfinance business since they are already sufficiently capitalized and meet the requirements for taking deposits provided for in the Act.

* **Tier 3: Micro Finance Deposit Taking Institutions (MDIs).** This is the category of financial institutions that was created following the enactment of the MDI Act. Originally doing business as NGOs and companies limited by guarantee, these institutions transformed into shareholding companies, changed their ownership and transformed/ graduated into prudentially regulated financial intermediaries. They are licensed under the MDI Act and are subjected to MDI Regulations by BoU. Like Tier I and II institutions (banks and CIs), the MDIs are required to adhere to prescribed limits and benchmarks on core capital, liquidity ratios, ongoing capital adequacy ratios (in relation to risk weighted assets), asset quality and to strict, regular reporting requirements.

* **Tier 4: All other financial services providers outside BoU oversight.** This category has SACCOs and all microfinance institutions that are not regulated - such as credit-only NGOs, microfinance companies and community-based organizations in the business of microfinance. These institutions have a special role in deepening geographical and
poverty outreach, and in other ways extending the frontiers of financial services to poorer, remote rural people.

Tier 4 institutions operate under various laws, none of which regulates them as financial institutions. The SACCOs are registered and in principle supervised under the Cooperative Societies Statute 1991\(^3\) by the Ministry of Trade, Tourism and Industry. The other governing laws for Tier 4 include the Companies Act (1969)\(^4\), the Money Lenders Act (1952)\(^5\) and the NGO Registration Act (1989)\(^6\). Supervision of these institutions is currently so weak that their regulation is of minimal effect because it is generic, all encompassing for all activities and not focused on financial oversight.

BoU, which engages in only prudential regulation, is neither keen nor well endowed with staff and logistics to add Tier 4 institutions under its supervision\(^7\). To some extent, self-regulation\(^8\) of Tier 4 institutions has been taken up by AMFIU, which has a Code of Conduct to which all its members must adhere. UCSCU and UCA, being members of AMFIU, also subject their member-SACCOs to the Code of Conduct. This development is good although it is limited to members of AMFIU, UCA and UCSCU. A majority of Tier 4 MFIs are not members of these three organizations. Another complementary approach championed by AMFIU is to empower the Tier IV consumers of financial services to understand both their rights and their responsibilities. This has increased consumer awareness and their ability to make informed decisions, although it needs to be enriched in content and rolled out to all parts of the country. As was hoped at the time of starting this consumer education campaign, some results have started to show. Increased consumer awareness is starting to drive MFIs to improve the quality of their work, products and customer care. These efforts are playing a critical part in instilling ethics and good conduct in the sub sector. There are two major challenges with self-regulation which makes it less effective:

i. Voluntary nature of compliance: if an institution is not and does not want to be a member of AMFIU, for instance, it can stay out of the Code of Conduct requirements which limits punitive action on errant non-members.

ii. Supervision or regulation by a member-based network organization has in-built conflict of interest (having a supervisor that is controlled by the organizations being supervised).

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\(^3\) General for all types of cooperatives (production, marketing, financial and employee-based).

\(^4\) General for all types of companies and has provisions for incorporation, governance, business conduct, object/ powers, receivership, winding up and liquidation of companies; does not stipulate financial sector-specific issues like regulation

\(^5\) Provides for the registration, licensing and regulation of the conduct and business of free-lance money lenders who are not part of the mainstream/ formal financial sector

\(^6\) Provides for registration, licensing and oversight on the activities of NGOs as welfare organizations

\(^7\) BoU therefore only regulates institutions under tiers 1, 2 and 3.

\(^8\) Self-supervision here refers to arrangements under which the primary responsibility for monitoring and enforcing prudential norms lies with a body that is controlled by the organizations being supervised.
2.2 Government’s Action on Tier IV Microfinance

To address the above challenge, the MoFPED has developed a microfinance policy and regulatory framework\textsuperscript{9}. The policy aims to integrate the microfinance sector by serving a number of objectives including; consolidating all the policies on microfinance development; providing guidelines on the provision and access of financial services and explaining the role of microfinance and rural finance services in poverty alleviation in Uganda. The policy rationalizes the Governments interest in the microfinance sub sector from the fact that about 90% of Uganda’s private sector entities are micro enterprises. Most of these are financed by Tier 4 institutions, which have little effective oversight and in some cases posing significant risk to these enterprises. Government therefore aims to bridge gaps in the policy and laws, so as to ensure that Uganda’s savers are, without exception, ensured of safety of their savings. It also aims to ensure that micro enterprises access financial services from institutions that are sound and sustainable, and that deliver services efficiently, affordably and transparently.

SACCOs, which form the majority of Tier 4 MFIs, are of particular concern because of their potential to achieve greater outreach and to ensure safety of members’ deposits. The non-SACCO Tier 4 MFIs are of concern both because they have a favorable bias for the poor and because of the need to preclude imposters who fleece communities to deposit savings, purportedly ‘loan insurance funds’ or ‘mandatory savings to be collateralized for future loans’ and then disappear with the money.

The policy objectives of the microfinance policy and regulation are to;

- Increase access to microfinance services countrywide,
- Improve safety of savings through effective regulation and supervision,
- Enhance microfinance institutional sustainability,
- Improving consumer awareness and demand for cost effective financial services delivery
- Assisting the development of institutional capacity and products in the microfinance industry through research and training.

The policy strategies include;

- Increasing and deepening outreach to sub county level through establishing and supporting one SACCO in each sub county,
- Establishing an effective and conducive regulation and supervision regime for Tier IV institutions
- Building the capacity of the institutions to deliver services better and to grow
- Strengthening public awareness on financial services,
- Research, policy making, and access to finance for Tier 4 institutions.

\textsuperscript{9} Microfinance Policy and Regulatory Framework in Uganda 2005-2015 (MoFPED)
To implement the policy strategies above, Government has put in place the following institutional mechanisms:

i. MoFPED’s Microfinance Department – to champion policy and regulation development for Tier 4 MFIs and oversee the industry

ii. The IFAD funded Rural Financial Services Program (RFSP) to oversee, administer and coordinate the establishment, nurturing of SACCOs in sub counties

iii. Microfinance Support Centre Ltd – to wholesale funds to SACCOs for retailing/on-lending to their members

iv. UCSCU, under a contract, to implement the establishment, nurturing and strengthening of SACCOs in sub counties

Establishment and strengthening of SACCOs at every sub county by UCSCU is ongoing. Under the RFSP, 264 SACCOs are to be supported through IFAD funding. Government will find funding for the other sub county SACCOs (about 800 of them). As at July 2007, the SACCO count was as follows:

*Table 1: Number of SACCOs as at end of July 2008*

<table>
<thead>
<tr>
<th>Region</th>
<th>No. Of Sub Counties</th>
<th>No. Of SACCOs</th>
</tr>
</thead>
<tbody>
<tr>
<td>Eastern Region</td>
<td>196</td>
<td>274</td>
</tr>
<tr>
<td>Northern Region</td>
<td>119</td>
<td>113</td>
</tr>
<tr>
<td>Teso/Karamoja Region</td>
<td>103</td>
<td>97</td>
</tr>
<tr>
<td>West Nile Region</td>
<td>72</td>
<td>80</td>
</tr>
<tr>
<td>Mid-Western Region</td>
<td>119</td>
<td>160</td>
</tr>
<tr>
<td>Mbarara Region</td>
<td>104</td>
<td>200</td>
</tr>
<tr>
<td>Kigezi Region</td>
<td>56</td>
<td>84</td>
</tr>
<tr>
<td>Central Region</td>
<td>180</td>
<td>375</td>
</tr>
<tr>
<td><strong>Totals</strong></td>
<td><strong>949</strong></td>
<td><strong>1383</strong></td>
</tr>
</tbody>
</table>

*Source: Presentation by the Minister of State for Microfinance at MSC Ltd Strategic Planning Workshop held in Jinja (29th October 2008)*

The spread and total number of SACCOs give an idea of the daunting task involved in regulating them.
2.3 Current Legal Framework for the Banking and Microfinance Sector

As already stated, the safety and soundness of the overall financial sector is under the jurisdiction of the Bank of Uganda, which does this through the FIA 2004, the MDI Act 2003 and the respective Regulations. BoU has powers to inspect and stop any unlicensed institution engaging in banking business or other form of financial intermediation. There are principles in the existing financial sector laws that could be adjusted and applied to Tier 4 regulation. The following two subjections highlight provisions of the FIA 2004 and MDI Act 2003, with the view highlighting principles that Tier 4 regulations, especially of SACCOs, needs to take into account.

2.3.1 Financial Institutions Act, 2004

This Act governs institutions in Tiers 1 and 2. It replaced the FIS of 1993 with the purpose of tightening the supervisory approach and tools that focus on risk detection/anticipation and avoidance. Under the Act, managers and directors are now individually held accountable for mismanagement and imprudent governance of regulated institutions. Banks are required to disclose their full financial and operational performance to BoU regularly, and to fully disclose to the public their fees and charges. Owing to the application of the Act, the banking sector is sound and transparent. The key provisions of the FIA 2004 are highlighted in the table below.

<table>
<thead>
<tr>
<th>Regulatory aspects</th>
<th>Provisions</th>
<th>Remarks</th>
</tr>
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<tbody>
<tr>
<td>Supervision mandate</td>
<td>BoU has full power and authority over banks and credit institution. The minister of finance no longer licenses institutions. BoU now controls institutions right from the licensing stage. Powers in this regard also include removal of directors, disqualification of external auditors, sanction or rejection of external audit reports, and establishing a credit reference bureau.</td>
<td>BoU is in a better and more powerful position as a regulator</td>
</tr>
<tr>
<td>Institutions covered</td>
<td>Commercial banks, Credit institutions, Merchant banks, Mortgage banks, Post Bank, Finance houses and discount houses.</td>
<td>Covers all formal financial institutions outside microfinance</td>
</tr>
<tr>
<td>Ownership, governance and management</td>
<td>Maximum shareholding for a single or related group of shareholders: 49%, except for shareholding by reputable financial institutions</td>
<td>All these have resulted in vivid improvements in governance,</td>
</tr>
<tr>
<td>Regulatory aspects</td>
<td>Provisions</td>
<td>Remarks</td>
</tr>
<tr>
<td>-------------------------</td>
<td>---------------------------------------------------------------------------</td>
<td>-------------------------------------------------------------------------</td>
</tr>
<tr>
<td></td>
<td>Transfer of 5% or more shares are subject to BoU permission</td>
<td>management and health of the institutions</td>
</tr>
<tr>
<td></td>
<td>Fit and Proper test for directors and management</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Limit on powers to control a regulated institution’s board</td>
<td></td>
</tr>
<tr>
<td>Minimum start up capital</td>
<td>Shs. 4bn for banks and Shs. 2bn for non bank financial institutions</td>
<td>Effective entry-level check</td>
</tr>
<tr>
<td>On going capital</td>
<td>Core capital: 8% of total risk adjusted assets; total capital of 12% risk</td>
<td>Has kept the institutions very conscious of ongoing financial health</td>
</tr>
<tr>
<td>requirements</td>
<td>weighted assets</td>
<td></td>
</tr>
<tr>
<td>Operational restrictions</td>
<td>No lending to other financial institutions over 50% of total capital for</td>
<td>More strict and effective in norm than the previous law.</td>
</tr>
<tr>
<td></td>
<td>over one year; not more than 25% core capital to any one or related group of persons; no money laundering; no lending on security of shares or and debt instruments</td>
<td></td>
</tr>
<tr>
<td>Reporting</td>
<td>Strict regular financial and operational reporting to BoU, with punitive</td>
<td>Increased transparency and availability of vital information on the financial sector.</td>
</tr>
<tr>
<td></td>
<td>penalties for inaccuracies or lateness</td>
<td></td>
</tr>
<tr>
<td>Remedial measures</td>
<td>BoU can intervene into management and governance of the institution, sign a</td>
<td>Gives BoU full control even of institutions under distress</td>
</tr>
<tr>
<td></td>
<td>management agreement with the financial institution to comply with agreed actions, issue cease/ desist orders to stop lending, paying dividends, impose penalties, put a freeze on opening new branches, initiate receiverships of regulated institutions, and put them under liquidation.</td>
<td></td>
</tr>
</tbody>
</table>
The overall effect of FIA 2004 is a sounder banking sector. While there is cutthroat competition for the “bankable” clients, this is tempered by a healthy balance with maintenance of healthy financial performance.

### 2.3.2 Micro Deposit Taking Institutions Act 2003

Owing to the growth and increasing importance of the microfinance sector, Bank of Uganda issued a policy statement on microfinance regulation in July 1999. This was the start of a long and eventful journey towards Uganda’s first-ever law (MDI act 2003) specifically for microfinance. This law created another category of formal financial institutions, the MDIs. These institutions are licensed under the MDI act, upgrading them from being non-regulated to formal, regulated financial institutions. The MDI Act explicitly excluded other microfinance institutions (SACCOs, microfinance companies and NGOs) from the jurisdiction of BoU.

Like banks, the MDIs are required to adhere to performance measures. The key provisions of the MDI Act 2003 and the corresponding regulations cover the crucial areas of ownership, governance and management, operations and policies, financial prudence, and audited accounts. The key provisions of the MDI Act are highlighted in Table 2 below.

**Table 3: The Key Provisions of the MDI Act**

<table>
<thead>
<tr>
<th>Regulatory aspects</th>
<th>Provisions</th>
<th>Remarks</th>
</tr>
</thead>
<tbody>
<tr>
<td>Definition of Microfinance Business</td>
<td>Defines microfinance business as acceptance and intermediation of micro deposits from the public&lt;sup&gt;10&lt;/sup&gt;</td>
<td>Might need revisiting in view of the Tier 4 law. Under the MDI Act, “Microfinance business” should be replaced with “micro-deposit taking business” in order to eliminate the confusion</td>
</tr>
<tr>
<td>MDI Institutional Form and Licensing</td>
<td>MDIs have to be companies limited by shares, with shareholders capable of financially backing the MDI</td>
<td>Made ownership structures of MDIs clearer.</td>
</tr>
<tr>
<td>Ownership, Governance, and Management</td>
<td>BOU vets any person or institution proposing to hold 10% or more of the shares of an MDI, board members and senior managers;</td>
<td>Has ensured MDI managerial and governance stability</td>
</tr>
</tbody>
</table>

<sup>10</sup> The Tier 4 law needs to consider how this definition affects it
<table>
<thead>
<tr>
<th>Regulatory aspects</th>
<th>Provisions</th>
<th>Remarks</th>
</tr>
</thead>
<tbody>
<tr>
<td>Requires MDI managers to take responsibility for timeliness and accuracy of regular reports submitted to BOU; No board control by one or a few persons; BoU vets MDI external and internal auditors; directors take collective and personal responsibility for imprudent governance. MDI’s to publish their audited accounts annually, within four months after the end of each financial year.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Operations and Policies</td>
<td>Defines business prohibited to MDI’s (like current accounts, forex transitions); stipulates a strict scheme and procedure for loan provisioning; write off and portfolio management; prohibits intermediation of loan insurance funds (LIF)</td>
<td>Considered by MDIs to be too restrictive and a disincentive to being an MDI</td>
</tr>
<tr>
<td>Financial Prudence</td>
<td>Limits to financial leveraging and guidelines on liquidity management, asset and liability management, mandatory cash reserves, and regular reporting on all financial and operational aspects of the MDI</td>
<td>Though rather tight, has helped the MDIs to be more financially and operationally prudent</td>
</tr>
<tr>
<td>Supervision Mandate and Powers of BoU over MDIs</td>
<td>As under the FIA 2004</td>
<td></td>
</tr>
<tr>
<td>Operational and Financial Reporting to BoU</td>
<td>Similar to the requirements under FIA 2004, but with varied reporting frequency</td>
<td></td>
</tr>
</tbody>
</table>

A study conducted to assess the Impact of the MDI Regulation (Aug 2007) highlighted aspects of the MDI Act and its regulations which are viewed by the MDIs as restrictive and unnecessarily, hindering further growth. These included:

- Prohibition to intermediate loan insurance fund - MDI Act, sec. 19 (h)
- Prohibition to take deposits and lend in foreign exchange and to offer current accounts - MDI Act, sec. 19 (a) and (g)
- More stringent provisioning and asset quality requirements than for banks and credit institutions - MDI Act, sec. 89 (3)(a)
- Maturity of loans restricted to two years - MDI Act, sec. 2

The report highlighted that through regulation, MDIs have registered significant achievements; have upgraded and increased their clientele, become more professional in the way business is conducted, and improved products and processes. These performance indicators imply that regulation has benefited both MDIs and their clients.

On the downside, MDI regulation seems to have had two effects:
- Whereas average loan portfolios are growing, the number of borrowers was seen to be somehow dropping.
- All MDIs have, since regulation, reduced the proportion of lending to groups compared to individuals and have developed products that target the less poor clients.

The above issues need to be taken into account in developing an inclusive regulatory mechanism for Tier 4 institutions.

2.3.3 The Cooperative Statute 1991

SACCOs are currently regulated by the Cooperatives Societies Statute 1991 administered and supervised by the Department of Co-operatives in MTTI. The Statue provides for incorporation/ registration, governance, management, regulation, supervision, operation and business conduct of all cooperative societies (production, marketing, multipurpose cooperatives and SACCOs). With microfinance having become of age as a commercially oriented business and non-financial cooperatives largely inactive, SACCOs are in competition with other MFIs for provision of financial services. This means that SACCOs have taken on more of a financial institution characteristic than the ordinary, multipurpose nature of cooperatives. This now means that the Cooperatives Societies Statute 1991 is largely inadequate for regulating and supervising SACCOs.

As far as regulation and supervision of SACCOs is concerned, the Statute has a number of shortcomings. The key ones are:
- Registration procedures and requirements do not pose any regulatory mechanism for controlling and censuring entry into the sector. Apart from the requirement that the society must have at least 30 members, there are hardly any other conditions to ensure minimum adherence to prudential standards before registration.
The provisions on supervision, while adequate for non-financial cooperatives, are weak and are inadequate for SACCOs. Notably, there are no mandatory requirements for a cooperative to maintain objectively verifiable financial health and performance based indicators.

Provisions on financial performance reporting are somewhat self-defeating. The Statute provides for mandatory audits and submission of annual audited accounts to the Registrar of Cooperatives. It then controversially provides for the Cooperative Officers, who are under the Registrar/ Commissioner for Cooperatives, to act as the “Auditor of Last Resort” in cases where the cooperatives cannot afford to pay certified auditors. Most SACCOs and other cooperatives have resorted to routinely using cooperative officers to audit their accounts. The are two problems with this:

a. Most Cooperative Officers are not trained accountants and therefore they cannot competently audit the SACCO accounts. Evidence of this is in frequent “audited accounts” from SACCOs with glaring material mistakes and inaccuracies.
b. The principle of auditor-independence is severely compromised through this arrangement

The statute is outdated in light of current numbers and activities of cooperatives

The Statute does not place repercussions/ responsibility for failure to supervise or regulate the cooperatives on the supervisor.

2.3.4 Government Initiative to Improve SACCO Regulation

In light of the government’s Rural Financial Services Strategy (RFSS), Government through MoFPED has drafted a prudential regulatory framework for SACCOs. To support this, the Ministry has drafted a SACCO specific Bill and Regulatory Guidelines. The rationale is that poor/ rural Ugandans need to access suitable financial services from prudent, ethical, sound and sustainable grassroots financial institutions.

The MoFPED over the past few months issued the draft SACCO Bill and Regulations to the public for comments. The proposed bill is intended to regulate SACCOs in Uganda as community based financial service providers. The draft bill recognizes the member-based orientation of SACCOs, and creates further opportunity for integration of rural finance into the formal financial system. Currently, there are two draft bills, one for microcredit organisations and another for SACCOs. The general direction of the Government\(^\text{11}\) is to integrate the two drafts to form one law for the Tier IV institutions.

\(^\text{11}\) Ministry of Finance and Economic Planning Interview
### 2.4 Gaps in Tier 4 Non-SACCO Regulation

The latest policy and regulatory framework paper recently completed by the State Minister for Microfinance intends to integrate all microfinance institutions outside Bank of Uganda supervision under the Tier 4 law. This category has all institutions that are non deposit-taking such as credit-only NGOs and companies as well as deposit taking initiatives like SACCOs.

With the draft SACCO Law and regulation well into the final stages, the regulatory gaps will soon be more in non-SACCO Tier 4 institutions. The table below highlights gaps in the other major players in Tier 4 (Microfinance Companies and NGOs).

<table>
<thead>
<tr>
<th>Type of Organization</th>
<th>Related Law/regulation</th>
<th>Limitations in Relation to Effective Regulation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Companies Ltd by Shares and by Guarantee (under the Registrar of Companies)</td>
<td>Companies Act</td>
<td>• The Registrar does not license any of the entities registered with his office. Although financial services business is unique and requires a higher degree of external oversight, the Act does not provide for regulation.</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Provisions for ownership, governance, management, legality of operations and other aspects are generic and do not have specific references to financial or any particular lines of business</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• The registrar does not regulate or supervise companies, and has no powers to stop them from operating except on account of engagement in criminal activities</td>
</tr>
<tr>
<td>Non Governmental Organizations (under NGO board of the Ministry of Internal Affairs)</td>
<td>NGO Registration Act 1989 and (amendment) NGO Registration Act 2006</td>
<td>• The Act is intended for registration and minimal oversight over NGOs as humanitarian organizations – not for regulation or supervision</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Definition of “organization” S(1) is too generic (makes no mention of financial services) and the Act does not anticipate that NGOs</td>
</tr>
</tbody>
</table>
All aspects considered, there is no effective oversight on Tier 4 financial institutions. The above gaps in regulation/supervision have provided conditions for unscrupulous persons to take advantage of the public, purportedly running microfinance institutions. Among the results of this have been:

a. Several NGOs and microfinance companies set up offices, mobilize people, ask them to take savings purportedly as part security for loans they would later be advanced, and suddenly close, leaving poor people who saved with them helpless

b. Pyramidal schemes set up in the name of MFIs, which soon collapsed and several people lost their money

c. Ruthless lending by unregulated MFIs, accompanied by ruthless recovery methods including extreme harassment

d. Gross mismanagement of donor funded MFIs, resulting into collapse of fairly large MFIs and the resultant disruption of the economic activities of their clients

e. Illegal taking of savings from the public by some MFIs, taking advantage of BoU’s lack of personnel capacity to monitor MFI activities in all geographical locations
f. Inept governance of SACCOs and other community owned financial institutions, causing them to collapse and their members to lose their savings.

g. Some MFIs hiding under the guise of an NGO status to escape taxation and other obligations required of financial institutions, while they charge higher than commercial rates of interest and fees on their loans.

h. MFIs collapsing with lots of debt (collateralized savings, bank loans and concessional loans from socially sympathetic wholesale lenders) and no equity.

The above issues need to be taken into account in developing an inclusive regulatory mechanism for Tier 4 institutions.

To further inform the process on the key issues, it is necessary to consider lessons in other countries that have attempted to implement inclusive financial regulation.
3.0 EXPERIENCES AND LESSONS FROM OTHER COUNTRIES

Other countries have had different experiences in their approach to regulation of microfinance business. This section gives summary of the experiences of a few selected countries.

3.1 Ghana

The Bank of Ghana (BoG) is the overall financial sector regulatory authority. The Act’s key provisions include; licensing, operations, sanctions and exit of commercial banks and rural community banks which carry out banking and microfinance operations. The Savings and Loans Companies, (SALC), Cooperative Unions and NGO- MFIs are supposed to be regulated under the Non Bank Financial Institutions Act (NBFIA) of 2004 and the Non Bank Financial Institutions Rules for Deposit-Taking 2000, (NBFIRDT).

Although credit unions are classified in the NBFIA, they are not supervised by BoG because of limited capacity of the BoG. Instead, BoG allows the Ghana Credit Unions Association (CUA) to oversee credit unions (which are the equivalent of Uganda’s SACCOs) as an apex body. These institutions lack enforcement powers, a challenge that the forth coming act is expected to address by increasing their powers. There is an Association of Rural Community Banks and a Ghana Credit Union Association both of which provide minimal oversight to their members. SACCOs in Ghana are doing quite well under the oversight of CUA although they are not regulated prudentially.

The Savings and Loan Companies (equivalent to MDIs in Uganda) are larger MFIs that are licensed and prudentially regulated by BoG.

The Rural Community Banks (RCBs) were also supposed to be regulated by the BoG but they aren’t. Instead, they have oversight by the Association of Rural Banks (ARB), an apex organization of all rural banks. There are 125 rural banks under this umbrella, out of which 20 have been named among the best performing institutions in the country.

NGOs are not regulated, as are informal savings collectors and other smaller organizations.

Constraints facing the provision of microfinance services in Ghana include the following:
- High minimum deposit requirements for banks make it difficult for them to reach the poor section of the market.
- High reserve requirements for RCBs limit available funds for lending.
- Directed, subsidized lending threatens loan portfolios and future self-sufficiency.
- High minimum capital requirements have limited the creation of new SALCs.
- Low interest rates for loans and deposits have discouraged savings mobilization and limited portfolio growth for the Credit Unions.
- Financial performance of NGOs not strong enough to borrow funds on the domestic money market
- Lack of a deposit insurance scheme and credit information service

**Lessons:**
- Trying to combine supervision and promotion of the institutions under one umbrella usually compromises one or both of these objectives
- Regulation of community based institutions is best done with the involvement of their apex(es).
- Full scale prudential regulation for small deposit taking institutions like SACCOs can become self-defeating – thus such regulation/supervision should be delegated and toned down

### 3.2 Kenya

In Kenya, the Banking Act 2004 put the whole financial sector under the supervision of the Central Bank of Kenya. Until April 2007, the regulatory environment was not conducive for most MFIs, which opted to stay outside the regulatory scope. The MFIs that wanted to be regulated had to aim at getting a banking license. MFIs in Kenya are registered under eight different Acts of Parliament namely:
- The Non Governmental Organizations Co-ordination Act
- The Building Societies Act
- The Trustee Act
- The Societies Act
- The Co-operative Societies Act
- The Companies Act,
- The Banking Act

Some of the above forms of registrations do not address issues regarding ownership, governance, and accountability. They have also contributed to a large extent to the poor performance and eventual demise of many MFIs because of a lack of appropriate regulatory oversight. The lack of oversight, however, has enabled them to innovate and develop different techniques of providing micro finance services. To stimulate the development of the sector in an orderly way, a microfinance legislation that clearly defines the roles to be played by the Government, the Central Bank of Kenya, and the microfinance practitioners was enacted. The Micro Finance Act was promulgated in December 2006, with the Central Bank as the regulator, and the Central bank drafted the Regulations in April 2007. The Act covers deposit and non deposit taking institutions. With the MFI Act in place, financial NGOs can transform into regulated Deposit taking Micro finance institutions.

The central bank established a Rural Finance Department to address various policy issues concerning rural finance, including microfinance. This Department, in liaison with the Financial Institutions Department, is involved in developing capacity to regulate and
supervise those microfinance institutions that will be licensed under the proposed Deposit Taking Micro Finance Bill.

SACCOS are regulated and supervised under the Cooperative Societies Act amended in 2004. The Commissioner for Cooperative Development is responsible for the organization, registration, operation, advancement, and dissolution of cooperatives. There were 3,767 SACCOS of which 179 were licensed to offer banking services for fixed deposit accounts and checking accounts\textsuperscript{12} and 4 regulated as NBFIs in 2005.

Constraints faced by the microfinance industry in Kenya include; diversity in institutional form, inadequate governance and management capacity, limited outreach, unhealthy competition, limited access to funds, unfavorable image and lack of performance standard. It is envisaged that the Microfinance Act and its Regulations will address these constraints.

Considering the Microfinance Law is a relatively new experience for Kenya, it is difficult to draw lessons at this point. The suitability and relevance of a new law will soon come to test. The limited number of MFIs that have transformed have gone straight for the commercial bank license and managed to do well. The process was, however, quite costly.

3.3 Malawi

The Reserve Bank of Malawi (RBM) is the overall regulator of the financial sector in Malawi covering commercial banks and non bank financial institutions. Malawi Savings Bank (MSB), a special purpose Government financial institution which provides financial services to low income and rural citizens, is also regulated by RBM, which views it as a non-bank financial institution with banking privileges. MSB is granted exemptions from complying with certain requirements including lending limits and liquidity reserve requirements.

The microfinance sector is currently regulated by an array of legislative instruments. The NGOs are registered under the Trustees Incorporation Act, the parastatals under specific Acts, private sector microfinance companies under the Companies Act and SACCOS under the Cooperative Societies Act. Most of these instruments are difficult to administer since they are outside the jurisdiction of the Reserve Bank Malawi (RBM). The major microfinance players have a well developed outreach network, but are highly dependent on government subsidies.

\textsuperscript{12} Annual Report of Kenya Central Bank 2005
The majority of SACCOs (51%) are affiliated to the Malawi Union of Savings and Credit Cooperatives (MUSCO) and therefore subscribe to specified performance standards, policies, procedures and reporting requirements. Each SACCO that is a member of MUSCCO must contribute 0.25% of its monthly savings and outstanding loans to a micro-insurance fund that reimburses SACCOs for unpaid loans in the event of a borrower's death or disability.

The Registrar of Companies is responsible for reviewing annual returns for all companies and the Council for Non-Governmental Organizations in Malawi (CONGOMA) has limited regulatory role over the microfinance NGOs.

The Government passed a Microfinance Policy and Action Plan (2002) which aimed at creating an environment that would facilitate and encourage the adoption of universally acknowledged best practices by the sector. Such a policy framework will ensure that MFIs are operationally and financially sustainable for the long term benefit of clients. Supervision will enforce compliance with a given legal and regulatory framework. A task force headed by the RBM and comprised of the Ministries of Finance, Agriculture and Industry and Trade, the Malawi Microfinance Network and other donors was set up to implement the action plan.

In January 2005, Government set up a whole sale lending apex with initial funds of $7.2m, called The Malawi Rural Finance Corporation (MRFC), regulated by RBM. It lends at below market interest rates through the Malawi Savings Bank. This has an inherent problem of market distortions and maintaining sustainability that undermine the potential for financial deepening.

The sector is largely controlled and influenced by government, and performance of MFIs is very poor: high loan default/delinquency, low institutional profitability/ sustainability.

Constraints:
- High dependence of institutions providing financial services to rural and low income citizens on government subsidies.
- A considerable number of SACCOs (49%) are not members of MUSCCO, meaning they are not subject to any form of oversight.
- Low application of sound practices in the industry, reinforcing weak performance.
- Insufficient regulatory oversight of SACCOs under the Cooperative Act.

Lessons:
- While subsidies are beneficial in introducing financial services to the low-end market, they must be taken with caution so as to ensure the institutions’ sustainability.
- Purely credit-driven microfinance, especially with heavy dependence on government subsidized wholesale loans, can lead to stunted industry growth.
- Self regulation by a member controlled apex can be supportive to but cannot replace independent prudential regulation.
3.4 South Africa

In South Africa, the Reserve Bank is the prudential regulator and supervisor of banks under the Banks Act (1990). It is supported by 2 other Laws:

i. The National Credit Act (NCA) 2005, a consumer protection legislation, under which, the National Credit Regulator (NCR) regulates all organisations offering credit services. The NRC absorbed the Micro Finance Regulatory Council (MFRC), the non prudential regulator for microfinance.

ii. The Financial Services Board (FSB), which is responsible for regulating financial institutions specifically with regard to their conduct in relation to their non-banking services.

There is self regulation (non prudential) with bodies such as the Savings & Credit Cooperative League (SACCOL) for SACCOs, and Financial Services Association (FSA) for village banks,

The Micro Finance Regulatory Council (MFRC) was established in 1999 as non-profit organization as regulators to the South African micro lending industry. The MFRC had a dual mandate in ensuring the sustainability of the industry in providing access to finance for lower income individuals as well as ensuring consumer protection.

The MFRC was also mandated by South Africa’s Department of Trade & Industry to regulate the micro lending industry by virtue of an Exemption to the country’s Usury Act. The Usury Act establishes a consumer protection framework for money-loans and includes a cap on interest rates. An Exemption was created to the Usury Act which provided exemption from the interest rate ceiling imposed by the Usury Act as long as the lending entity is registered with and gets oversight from the MFRC.

The MFRC was established to introduce compliance rules surrounding market conduct. This market conduct includes:

- Registration with the MFRC, followed by annual re-registration;
- Submission of quarterly financial returns by lenders;
- Submission of annual financial statements prepared by an independent accounting officer or auditor;
- Approval of a lenders loan agreement with its borrower; and
- Inspection of lenders’ premises to monitor compliance with MFRC Rules

Central to the MFRC mandate of consumer protection was the promotion of an environment of responsible lending practices. To this end, the MFRC had implemented a number of mechanisms, which were intended to modify micro-lender behavior, and reckless lending in particular. These included the establishment of the ‘National Loans Register’, the introduction of ‘Reckless Lending Rules’ and the performance of ‘Reckless Lending inspections’. The MFRC outsourced a private credit bureau to create a database
(NLR) which use is mandatory on all registered members, a move that reduces both credit and reputation risk in the industry.

Due to the high cost of supervision of numerous small microfinance institutions, the MFRC funded 80% of its operational expenses through member contributions including application fees, annual registration fees, certificate fees, and fines. While also receiving grants from government and donors, the MFRC used these funds for research, regulatory reform, and consumer education and capacity building.

Other core functions of the MFRC were accreditation and compliance, complaints and enforcement handling, investigation and prosecution, education and communication, pursuing unregistered lenders, and information research and policy advocacy.

Under the National Credit Act (NCA), the National Credit Regulator (NCR) took over all the roles of MFRC in June 2006. The purpose of the NCA is to promote a credit market that is fair, transparent, accessible and responsible, competitive and sustainable. The overriding objective of the Act is to protect consumers. It specifically prohibits practices such as reckless lending and automatic increases in credit limits, and regulates interest and fees. The Act covers all forms of consumer credit, including bank loans, credit cards, store cards, pawn transactions, furniture finance and motor vehicle finance.

The Act empowers the NCR to also deal with any contraventions of existing loan and credit agreements. Although the National Credit Act replaced the Usury Act and Credit Agreements Act, the NCR also assists consumers with problems that fall under these previous Acts, and investigates the relevant complaints.

The SACCOs are subject to three regulators:

- The Registrar of Cooperatives is responsible for registering cooperatives and has powers to monitor and inspect cooperatives.
- Cooperatives that are involved in the provision of financial services and hold deposits in excess of ZAR 20 million are also subject to regulation and supervision by a supervisor appointed by the SARB
- Cooperatives that are involved in the provision of financial services and hold deposits of ZAR 20 million or less are subject to regulation and supervision by a supervisor appointed by the Development Agency for Cooperative Banks.

The major challenge facing South Africa’s microfinance industry is that there is no comprehensive national microfinance policy and the dissolution of the MFRC left the MFIs operating without microfinance specific regulation.
Lessons:

- Microfinance regulation for the lowest tier institutions should look at the whole unregulated financial services rather than narrowly focusing on MFIs. The whole credit market, should be subject to some form of regulation to ensure proper integration and consistency.
- For an apex institution to be successful in regulation, it requires backing of the law to enable it enforce compliance, and it needs to draw its mandate from a stronger regulator.
- A special (non-prudential) regulation, focusing on consumer protection and good business conduct, is necessary as the MF industry grows. The laws and regulations should be strong and enforceable though non-prudential in nature.
- To increase attractiveness of the microfinance sector to the upper market lenders, there needs to be a credit reference bureau which helps reduce the credit and reputation risk in the industry.
- Multi-level regulation/supervision based on delegation, as long as it is well documented, organized and understood, can work.
- Network MF organizations have a role in proper regulation.
- A comprehensive national microfinance policy is necessary to support MF regulation.

3.5 Tanzania

Tanzania’s Banking and Financial Institutions Act of 1997 was amended in 2004, expanding Bank of Tanzania’s mandate to include microfinance institutions. Tanzania developed a National Microfinance Policy (NMP) in 2000 to guide microfinance operations. The underlying principles of the NMP are based on sustainability and best practices. The NMP outlines three tools for its implementation:

i) Regulation and supervision

ii) Development and application of standards

iii) Capacity building.

NMP also establishes a best practices framework for all microfinance service providers to extend their services under reasonably similar conditions with respect to quality and sustainability. The NMP assigned Bank of Tanzania the responsibility of ensuring development of a supportive regulatory and supervisory framework.

A national task force and steering committee on MF regulation analysed the regulatory environment including the Banking and Financial Institutions Act 1991, The Bank of Tanzania Act 1995, Cooperative Societies Act 1991 and concluded that there was no need for special legislation for microfinance. In this regard, the Micro Credit Activities Regulations of 2004 were established to create a new category of regulated financial institutions called Microfinance Companies, regulated by Bank of Tanzania. It was felt
that incorporating microfinance into the existing legal framework for the banking system would facilitate integration of microfinance into the broader financial sector, encourage innovation and competition, enable proper harmonization of the regulatory changes with the existing regulatory framework, and minimize possibilities of regulatory arbitrage. It was however found necessary to introduce amendments to selected aspects of the legal framework in order to accommodate special features of microfinance operations.

The microfinance regulations focus on specific risks related to the business of microfinance, promotion of best practices facilitating growth in outreach and depth of pro-poor financial services.

Key aspects of the Regulations include:

- Conditions related to minimum core capital and other licensing provisions, lending limits, capital adequacy, asset quality, and reporting requirements
- A new set of regulations (under the Financial Cooperatives Societies Regulations 2005), which establish the circumstances under which SACCOs become subject to regulation and supervision applicable to banks, taking into account the cooperative principles
- Savings and Credit Cooperative Societies (SACCOs) Regulations 2005: subjecting SACCOs to the cooperative rules, and requiring the Registrar of Cooperatives to apply similar prudential regulations on SACCOS as those applied on microfinance companies.
- Amendments to existing regulations to address Non-Governmental Organizations

Lessons

- The existence of an overall government policy on microfinance prior to the development of the regulatory framework is crucial
- A comprehensive review of the financial laws (including other relevant legislation) should be part of the development of the regulatory framework
- Involvement of key stakeholders (particularly practitioners) from the initial stages of the process is important
- While stakeholder involvement is critical, it is equally important for the process to reside in the relevant government-backed authority
- Effective microfinance regulations should cover all institutional types
- A new law is not always necessary; it is in some cases more appropriate to amend existing laws to accommodate microfinance regulation.
3.6 Sierra Leone

The main financial sector laws in Sierra Leone are the Banking Act 2000, Bank of Sierra Leone Act 2000 and Other Financial Institutions Act 2001. These are supported by the National Microfinance Policy (2003).

The Banking Act 2000 comprehensively provides for regulation and supervision of all deposit taking institutions by the BoSL. It has clear and detailed provisions for application, licensing, supervision, financial health, prudence in operations & financial management, reporting, restriction/ license variation, conservation, receivership, liquidation and termination/ closure of licensed institutions. Although in principle MFIs can apply for licensing under the Act, none of them is currently regulated under this Act.

The Other Financial Institutions Act 2001 provides for licensing, regulation and supervision of institutions carrying out financial activities other than banking. It covers all other financial service providers of whatever nature but by implication leaves out those that are not cooperatives, companies or statutory bodies. Thus financial institutions in the country must be regulated by BoSL if they are coops or companies but those that are registered by the Ministry of Finance, Planning and Development (MoFDEP) as NGOs are outside the loop of BoSL supervision. This has created a bit of confusion which could develop into a bigger problem unless addressed soon. The challenge of this Act is that it seeks to regulate all institutions engaged in financial services. The Bank of Sierra Leone (BoSL) lacks adequate capacity even for normal bank supervision and adding other FIs would ground its effectiveness. Consequently, the country has a well done, redundant law in this Act.

The National Microfinance Policy 2003 (NMP) is a systematic policy document developed by government with its development partners and other stakeholders. The policy aims at developing an enabling framework and helping market led, poverty-responsive and largely accessible microfinance services to flourish. Government’s vision in the policy is to develop and eventually integrate microfinance into the formal financial sector. While the policy is well formulated, however, it came two years after the passing of the Other Financial Institutions Act. The law was therefore not shaped or informed by the policy. The result is a good policy which is in some practical aspects inconsistent with the law, giving rise to some major disagreements between the regulator (BoSL) and the policy makers (MoFDEP). In the meantime (before the issues are resolved and BoSL develops adequate regulatory competence), MFIs and community banks in Sierra Leone remain unregulated.

Lessons:

- Never legislate what cannot be regulated, and never regulate what cannot be supervised
- Policy should always precede, shape and inform law making
- Regulator capacity is key in the success of any regulation
3.7 Overall Lessons for Uganda

From the above experiences, we can draw the following lessons for Tier IV Regulation in Uganda:

- Sustainable funding mechanism for regulation needs to be put in place
- Regulation establishment should recognize the microfinance industry’s unique characteristics that often render traditional financial regulation inadequate - including the social mandate, operation in infrastructure deficient areas, high administrative costs due to disbursement and collection of numerous small loans, and diversity of institutional types.
- An independent body needs to be set up with clearly defined powers for the enforcement of rules, regulations, and sanctions for the whole Tier 4
- Owing to the high number of MFIs to be involved, some regulation-related activities could be delegated by the Regulatory Authority to national apexes and other competent institutions
- The board of the regulatory authority should be fully representative of all stakeholders
- It is necessary to include microfinance in the activities of the credit reference bureau
- Keep a keen focus on regulatory capacity during the formulation and implementation of the regulatory law
- Don’t apply prudential regulation to non deposit takers
- Do not confuse MFI regulation with promotion or outreach enhancement; while the two can coexist, regulation does not necessarily mean deeper outreach
- For prudential regulation, avoid licensing very weak institutions that cannot be effectively supervised (for example those that do not have the capacity to produce financial reports and those not able to contribute the stipulated fees to the regulator).
- Regulatory policy should have a single focus, while application of the regulatory function can be suitably delegated to different regulatory units.
4.0 SUITABLE REGULATORY REGIME FOR TIER 4 INSTITUTIONS IN UGANDA

4.1 Rationale for Tier 4 Regulation

The reasons for regulating Tier 4 MFIs include:

- **Safety and soundness of the financial system:** Proper regulation and supervision will ensure that microfinance institutions work in an ethical way while maintaining acceptable levels of financial sustainability, so that they do not disrupt the wellbeing of the financial sector. This will reduce systemic risks on the financial sector.

- **Safety of public deposits:** For SACCOs, more effective regulation is intended to ensure that people’s savings are secure and available when needed. The resulting confidence should increase savings mobilization.

- **House cleaning:** An observed trend is for MFIs to change status and registration so as to escape regulation and supervision by taking advantage of the loop holes in the law. With proper, all embracing regulation and supervision, each institutional type will have to adhere to a specific set of rules.

- **Legitimacy and confidence with customers and investors:** Regulation provides a benchmark of acceptable institutional conduct, which increases certainty and transparency. A well regulated microfinance sector will also help in attracting capital into the sector.

- **Consumer protection:** Some microfinance institutions employ abusive and reckless lending practices to lend and recover money because the clients of Tier IV institutions usually have very limited choice or bargaining power. Regulation is therefore justified for safeguarding the public against unfair lending practices by institutions.

- **Economic development:** The realization of the benefits accruing from microfinance activities to overall poverty alleviation and economic development calls for proper regulatory systems and structures for the sector to effectively foster economic development. Government also hopes for increased outreach to rural areas and increased sustainability of the regulated institutions.
4.2 Prudential Vs Non Prudential Regulation

4.2.1 Prudential regulation

Prudential regulation, in general, aims at protecting the integrity and stability of the financial system. At the consumer level, it is aimed at protecting the safety of public deposits. Prudential regulation involves the regulatory authority setting guiding benchmarks/standards for compliance and verifying the compliance of institutions with them. Among the thematic areas for such standards are core capital requirements, liquidity management, asset quality, solvency, governance, management and license issuance/revocation.

The basic elements of prudential regulation are;

- Authoritative government involvement through the central bank or other mandated regulatory authority
- Regulatory authority ensuring safety and soundness of the financial sector
- Non-optional compliance by all regulated institutions, with penalties for failure
- Annual license renewals, which can be withheld if the regulator is unsatisfied with the financial health or operations of an institution
- Close supervision of the regulated institutions and administration of penalties and other corrective action in cases of errant conduct.

Advantages of Prudential Regulation

- Stronger enforcement powers for the regulator
- Improves the safety and soundness of all regulated institutions, creating public confidence in the financial sector
- Facilitates the process of filtering out institutions that cannot measure up, leaving only adequately strong and sound players in the regulated sector
- Able to realize the positive benefits of regulation including transparency, accountability and financial sector stability.

Limitations of Prudential Regulation

- High costs (including the direct costs to the regulator, supervision costs and compliance costs the institutions)
- Insufficient capacity at any one regulatory body in areas such as mandate, human resources and technological systems to prudentially regulate the whole of Tier IV institutions.
- Unlikely viability/sustainability of regulation in cases where there are many institutions to be regulated and the regulation aspects are detailed
- Can trigger escape from prudential regulation by some institutions that change their registration status into a category of financial institutions that has weak or no regulations.

Considering the focus, costs involved and other practical modalities in prudential regulation, it is unjustifiable for credit-only institutions. For member-based savings taking institutions like SACCOs, prudential regulation is necessary.

### 4.2.2 Non-Prudential Regulation

Non-prudential regulation aims at ensuring that credit-only MFIs conduct their business in an orderly, transparent and non-disruptive manner that is fair to the clients and non-prejudicial for the health of the rest of the financial sector. It involves far less rigorous measures, is less intensive than prudential regulation and does not require highly specialized skills for oversight. Typically, prudential regulation should simply set rules and guidelines regarding acceptable behavior and business practices in the operation of the financial institutions to protect the interests of clients, and monitor that the institutions comply. This is the type of regulation recommended for the various categories of credit only MFIs.

**Advantages of Non-Prudential Regulation**
- Low costs of operationalization
- More realistic, viable, and sustainable especially for credit-only institutions
- Places less demand on capacity requirements for the regulator

**Limitations of Non-Prudential Regulation**
- Less pronounced enforcement powers for the regulator
- Focuses less on ensuring the safety and soundness of the institutions, only increases transparency and fairness in business dealings
- Questionable ability to achieve the positive effects of regulation due to weaker mandate

In the case for Uganda, the Tier IV law under consideration should stipulate non-prudential regulation of credit-only MFIs. Adopting prudential standards for credit only MFIs would mean unnecessary strain on the regulator, unwarranted compliance burdens on the supervised institutions and possible eventual failure of Tier IV regulation. On the other hand, some form of “abridged” prudential regulation is necessary for the SACCOs. This should ensure compliance with a few core indicators such as capital, liquidity, asset quality, governance and management.
4.3 Regulatory Capacity Issues

The capacity of the regulator is an important issue in to be considered because it has to match the type and scope of regulation. Important issues in this regard are the technical capacity, cost considerations and the extent to which regulatory authority should be centralized, decentralized or delegated.

4.3.1 Technical Capacity and Cost Considerations

In assessing the technical capacity and cost implications of regulation for microfinance, the following key questions should be addressed:

- Does or should the supervisory authority have dedicated staff assigned to the supervision and examination of the microfinance sector? In this case the regulatory authority is yet to be established and thereafter it needs to develop both the regulatory and microfinance industry competence capabilities (like acquaintance with MF operational methodologies, analysis of MF financial and operational reports based on the industry standards, appreciation of the different MFI types and knowledge of the key MF risk areas).

- What is the comparative workload (number of licensed institutions and number of days needed to complete onsite and offsite examination or supervision)? There are 1,383 SACCOs\textsuperscript{13} country wide and 191 Microfinance Companies and NGOs\textsuperscript{14}. How effectively can these all be covered by close supervision? Unless a creative methodology (including delegation and efficiency focused supervision methods) is worked out, regulation will be practically difficult.

- Is there adequate accounting and auditing capacity and mechanism for all the institutions to be regulated? For proper implementation of regulation, a critical issue is how to establish adequate accounting and auditing to ensure accuracy and prudence in their financial reporting.

- Is it possible to estimate and compare the costs and benefits associated with regulation of microfinance, and are the costs justifiable? This will have to be worked on by the regulatory authority. The regulatory regime recommended in this study aims to minimize costs while maximizing regulatory effectiveness.

- Are the deposits substantial enough to warrant prudential regulation? According to the July 2008 SACCO data from UCSU, the national total of members savings and share capital was given as 59.7bn and loan portfolio as 51.7bn. Prudential regulation is justifiable for SACCOs in view of the aggregated level of savings. Given that the savings volume is spread among 1,383 SACCOs, however, the average savings volume per SACCO is Sh 43.2 million – too low for meaningful application of full

\textsuperscript{13} Statistics from UCSCU
\textsuperscript{14} Tier IV Census Report - 2006
scale prudential regulation. A somehow toned down version of prudential regulation, based on the revised PMT, will do for SACCOs. Loan Insurance Funds (LIF) or “compulsory savings” held by the non-SACCO MFIs, on the other hand, have less risk if linked to loans. Experience in Uganda, however, has shown that unscrupulous people find loopholes in the law to capture deposits with a promise of a loan only to disappear with their money without giving the credit. Checking this needs non-prudential regulation involving both enforcement and persuasion-based approaches.

- Does the regulatory authority require the institutions to pay for the costs associated with examination and supervision? If so, what charges are to be imposed? In South Africa, the institutions regulated contribute substantially to the costs of regulation. In Uganda, full cost of regulation should initially be borne by Government.

Design of microfinance regulation should not proceed very far without estimating supervision costs realistically and identifying a sustainable mechanism to pay for them. A core principle is not to issue regulations that cannot be realistically enforced. Bank of Uganda undertook substantial capacity building efforts for over five years to prepare for supervision of a limited number of MDIs. Recognizing the much greater problems in dealing with the large number of Tier 4 MFIs there is need for relevant capacity building for the potential regulator. For cost effectiveness, the capacity of the potential Tier 4 could be built in part BoU.

A well designed strategy will balance the nature and extent of supervision required, the capacity of the potential regulators and the attendant costs in relation to benefits.

4.3.2 Delegated Supervision

Delegated supervision refers to a situation where the country’s main regulatory authority delegates direct supervision of an identified set of institutions to a body or agency outside of itself. The regulatory authority then monitors and supervises the regulatory agent’s work.

In Ghana, a delegation approach to supervision has been prescribed by legislation. Under the framework, the Bank of Ghana is to delegate its responsibility to the Cooperative Unions’ Association CUA) to supervise SACCOs and rural community banks, with the costs of regulation are borne largely by the members. In practice, however, CUA non-prudentially oversees SACCOs based on its norms and code of conduct for members. If this approach were to be chosen, will be critical to address the following questions:

- Who bears the costs (which may be substantial) of the delegated regulatory/supervisory agency and the additional costs of the main supervisory authority’s oversight? (We recommend government does)
- Should the delegated or auxiliary supervision arrangement prove to be unreliable or ineffective, and should the mandate to the delegated or auxiliary supervisory agency
need to be withdrawn, does a realistic and practicable fallback exist? (Not yet, in Uganda’s case)

- In the event that a supervised institution fails, which agency—the main or delegated supervisory agency - will have the authority and capability to clean up and rectify the situation? (Delegated agency in this case)

- Does a delegated or auxiliary supervisory agency bear any legal liabilities in the exercise of the delegated or auxiliary responsibilities? (Yes)

### 4.3.3 Credit Reference Bureau (CRB)

This is a service that should support regulation. CRB allow borrowers to build up a credit history and can assist lenders in cost-effectively assessing risk. Credit registries that give easy and reliable access to a client’s credit history can dramatically reduce the time and costs of obtaining such information and therefore facilitate cost-effective financial intermediation. To further assist Tier 4 regulation, the MFIs should be helped to join the already established CRB.

### 4.4 Review of the Proposed Laws

Through MOFPED, Government has drafted a prudential regulatory framework for SACCOs and a Micro-Credit Act for non-deposit taking Tier IV institutions. Parliament’s preference now is for a single bill covering all Tier 4 financial institutions. This necessitates combining the proposed SACCO Bill and the proposed Micro Credit Bill into one. A combined law would be cost-effective and could potentially be more effective in regulating the industry than would two separate laws. The combined law will of necessity have two different sets of provisions – one for SACCOs and the other for non-SACCOs. This subsection examines the proposed laws in the context of the SACCO and the non-SACCO portions of the overall Tier 4 Microfinance Bill to be prepared.

#### 4.4.1 Micro Credit Bill

*Focus of the Draft Bill*

The draft bill seeks to bring credit-only microfinance institutions under regulation and supervision. The main aim is to minimize incidences of fraudulent persons fleecing the public under the guise of opening MFIs, taking public savings disguised as loan guarantee/ loan insurance funds and disappearing with them. Many such institutions have sprung up since the late 1980s and taken advantage of poor people. Prevention of such incidences is a good enough justification for the proposed laws to govern Tier IV MFIs.
The draft Micro Credit Act was intended to apply only regulation of non deposit taking Tier 4 institutions. The draft Act establishes the fundamental legal principles regarding the undertaking of micro-credit activities. The draft defines a borrower as an individual/legal entity that is the owner or potential owner of a small scale business under the laws of Uganda. It also defines micro credit as the funds extended by a micro credit organization to the borrower in the amount under the procedure specified by this Act. It defines micro credit activities as those legal activities which involve micro lending in an amount not to exceed one stipulated in the Act.

Key Provisions in the Draft

a. A law to establish legal principles under which non-SACCO Tier 4 MFI s will operate – prescribing the size, procedure and acceptable conditions for micro lending, the range of activities NDFIs would be allowed to engage in, licensing, supervision and procedures for establishing NDFIs

b. Rights and duties of the NDFIs

c. Rights and duties of the borrower

d. No profit or earnings motivation by an NDFI (implying that private, profit motivated companies doing microfinance will either be outside the regulation loop or be closed down)

e. Limit of the NDFI liability to the extent of its assets (basically putting lenders to the NDFI at risk and absolving erring NDFI incorporators, directors and managers of any liability)

f. A “Pooled Reserve Fund” to be contributed to by all NDFIs, for purposes such as boosting the sustainability of NDFIs and protecting their interests

g. Insurance of NDFIs’ inherent risks

h. A regulator of NDFIs to be appointed by the Government; the regulator to be responsible for setting the regulations for the supervision of NDFIs

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15 This definition will be to be reviewed. A borrower does not necessarily have to be an SME owner
Although the draft Micro Credit Act explains the above issues, it does have a few salient issues that need to be agreed upon before it is enacted to become a law. The table below summarizes the key strengths and weaknesses of the draft.

*Table 5: Strengths and Weaknesses of the Proposed Bill*

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<thead>
<tr>
<th>Strengths</th>
<th>Weaknesses</th>
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<tr>
<td>Good attempt, showing that Government and stakeholders take the semiformal financial sector, outside of SACCOs, seriously</td>
<td>Incoherent in some aspects (like the definition of a micro borrower) and most ideas in the draft do not seem to be fully thought through and developed (like the requirement for a board of directors under the draft while the NGO Statute requires a board of trustees).</td>
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<tr>
<td>Proposes to restrict NDFIs from engaging in activities which are detrimental or harmful to stakeholders</td>
<td>Tries to restrict the objectives of NDFIs only to supporting MSMEs – this is not necessary and cannot be easily monitored</td>
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<td>The liability provisions would encourage wayward behaviour by insiders of an NDFI and penalize lenders thereof in cases of bad management or misconduct</td>
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<td>Narrowly defines NDFI (to be regulated) as those MFIs that are not-for-profit in focus, thus potentially leaving out or creating a loophole for many MFIs to opt for a private company (for-profit) status and escape regulation</td>
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<td></td>
<td>No clear definition and the actual size of a micro loan and the definition of a deposit taking institution</td>
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<td></td>
<td>The powers, rights and duties of the proposed regulator have not been proposed, and thus the proposed type and scope of regulation is not defined</td>
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<td></td>
<td>The draft does not explain the concept of the Pooled Reserve Fund in sufficient detail</td>
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Overall, the draft bill is still very sketchy and basic. It will need to be substantially enriched and revised to guide the process of formulating the law. Among the areas that will need to be included or adjusted in the document are:

a) The “credit only” MFIs should be renamed “Non Deposit Financial Institutions (NDFI). This will clearly distinguish to the public between SACCOs and credit-only MFIs.

b) Directors’ responsibilities, liability and consequences of inadequate governance - There should be adequate collective and personal responsibility and liability of directors and managers for their errors, omissions and misconduct that affect the institution and its suppliers negatively.

c) Clear statement on the nature and types of institutions to be covered by the law – we propose that it should cover all dealers in financial services outside the banks, credit institutions and MDIs.

d) Proper definition of a micro loan and micro borrower - The current definition is skewed and covers only a portion of potential micro borrowers (we propose “a micro loan is an amount of loan, credit or other debt advanced to any person by an NDFI” and “a micro borrower is any person or persons that take a loan or advance from an NDFI”)

e) Drop the idea of stating the maximum amount of a micro loan in the Regulations - This would limit the retention of growing MFI clients who need larger loans. Additionally, such a cap will limit the MFI’s ability to mix poor and not-so-poor clients to achieve sustainability.

f) Restrictions of NDFIs from taking savings – this should be very clear and no NDFI should be allowed to take people’s savings, purporting they were to be collateralized for loans, unless it has paid up capital, represented by actual cash in the bank(s) in prescribed types of deposits, matching the loan amounts to be applied for (using a multiple based on the proportion of mandatory savings/LIF to the loan amount).

g) Remove the requirement that NDFIs to be regulated will be strictly those with a non-profit focus. This Act, to be very effective in protecting financial service consumers, should cover all the financial service providers not included in other legislations.

h) Stipulate minimum initial paid up capital for an NDFI to be licensed, and ongoing capital requirements in relation to both the loan portfolio and total book value of assets. We propose at least 15% of loan portfolio and at least 10% of total book value of assets.

i) Further articulate the governance structure of an NDFI (we propose the Board reports to the AGM or to trustees, whichever the case might be).

j) The Act should prohibit any institution from dealing in financial services (defined as the giving of loans, taking of savings, money transfers etc) without being licensed.

k) This Act should repeal the Money Lenders Act and bring money lenders under it.

l) Replace “charter” with constitution” or “memorandum of association” in the draft.
m) On governance, legislate the board rotation and maximum office holding for a director. Further, spell out broadly the minimum qualifications of directors (age, aptitude, competencies, integrity based on previous performance)
n) Stipulate practical provisions for effective and affordable audit services for NDFIs
o) Introduce a requirement that NDFIs have cash reserves in special accounts that at least equate to the LIF they have taken from their borrowers
p) A provision that no clause in this Act will not in any way affect the applicability of the MDI Act 2003 and the Financial Institutions Act 2004.
q) Provide for the regulatory authority’s right to suspend, remove or otherwise discipline directors and managers of NDFIs
r) Create a provision for revocation and suspension of the license
s) Stipulate the minimum financial records that must be kept and financial reports that must be produced by NDFIs
t) Include a clear provision for the structure and modality of supervision
u) Include provisions on receivership and liquidation (we propose the regulatory authority should be responsible)
v) There should be a lead period, starting from the date the bill becomes law, for existing NDFIs to comply (we propose 12 months).
w) The NGO Registration Act (Amendment) 2006, S(7)c requires the NGO board to guide and monitor NGOs in carrying out their services. There is need for harmonization between the supervisory roles of the NGO Board and those of the proposed regulator for NGO-MFIs

4.4.2 Draft SACCO Bill

Government intends to have SACCOs regulated as community financial service providers. The draft SACCO law recommends that “a SACCO be registered as a cooperative society owned and operated by and for its members in accordance with democratic principles for the purpose of encouraging savings and extending loans to members at reasonable rates of interest.” The draft also proposes that a separate corporate body be set up to be responsible for licensing, supervising and regulating SACCOs. The draft SACCO bill, which should now become part of the Tier 4 MFI Act has been fully drafted and is at a more mature stage than the draft Micro Credit Bill

The key provisions of the SACCO Bill are:

a. Registration to remain under the MTTI and prudential regulations to be undertaken by the SACCO Regulatory Authority
b. SACCOs would have between 6 and 24 months after the law is passed, to comply

16 We now propose this should become “Tier 4 Microfinance Regulatory Authority” under the combined law.
c. There will be a regulatory authority responsible for licensing, enforcing compliance, collecting and publishing performance statistics and advising the Minister of Finance, Planning and Economic Development on SACCOs

d. No SACCOs will be allowed to operate without a license

e. For the purposes of regulation and supervision, SACCOs are to be categorized in four groups, A to D

f. SACCOs will be allowed to intermediate deposits only among their members, and to serve non-members through non-core activities like money transfers

g. There is a provision for liability of members, under which the draft explains governance issues like AGMs, voting rights and other meetings

h. Strict governance and management provisions on board membership, board responsibilities, qualifications of a board member, disciplining of board members, annual audits and SACCO committees

i. Treatment of equity/share capital

j. Loan operations including restrictions on insider borrowing

k. Maintenance of equity (“institutional capital”) at or above 8% of total assets at all times

l. Investments in non-core activities to be limited to 5% of the aggregate of the SACCOs institutional capital, and investments in fixed assets to be kept at or below 5% of total deposits

m. SACCOs will be required to deposit 10% of their liquid assets into a Central Finance Facility managed by a national association of SACCOs

n. To be licensed, SACCOs have to be members of a national association of SACCOs

o. Liquidation procedure in cases of insolvency (although the draft is short in stipulating non-liquidation distress management situations like receiverships)

The draft SACCO law could further be improved by addressing the following issues:

- Merge it with the draft Micro Credit Bill to form the Tier 4 MFI Bill
- Extending the minimum qualifications set for positions like posts like chairperson, treasurer and secretary to the entire board membership
- Non-members should not be eligible to have access to any financial services provided by SACCOs

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17 Our advice is that this categorization is not suitable: assets of any SACCO fluctuate widely in value according to seasons and thus they are not a good yardstick for classification; asset based classification, meaning higher rated SACCOs are more intensely supervised, would be a disincentive to assets accumulation by SACCOs; the poorer people who save with smaller SACCO need just as much safety of their savings as those saving with the bigger SACCOs.

18 This should change so that under Liability of Members, the draft stipulates the limit and extent of liability of SACCO members for the debts of the SACCO (should be limited to paying up the allotted share capital)
- Remove the proposed categorization of SACCOs for regulatory purposes, so that all SACCOs are subjected to similar levels of supervision and oversight
- Stipulate the limit of liability of the members of a SACCO
- Fix the maximum lead period between the law being passed and all SACCOs complying to a maximum of 12 months – not two different dates as proposed at the moment
- Change the regulatory authority’s name to “Tier MFI Regulatory Authority”
- On SACCO Management and Administration (Part IV of the draft), the prohibition from becoming a SACCO director should be extended to anyone convicted under any financial services law (not just the SACCO law) and to persons who have served on a board of any liquidated or failed financial institution, not just SACCOs
- State the responsibility and home of the proposed SACCO Audit Fund and broadly indicate the contracting/working mechanism for this.
- In addition to the stated roles of the NAS, it should also be tasked with collecting financial and operational performance information (through regional offices) and sending them to the regulatory authority.

### 4.5 Recommendations on General Issues

The specific issues to be addressed by the Tier 4 MFI Bill (which should combine the current draft SACCO Bill and draft NDFI Bill into one) have been identified under subsections 4.4.1 and 4.4.2 above. In addition, there are more general or overarching issues to be addressed. These are outlined below:

#### 4.5.1 Policy Framework and Regulatory Authority

The current policy favors a holistic approach to provision of microfinance services. In view of its regulation/supervision objective, the policy is the front runner of the proposed financial sector law(s) outside of the FIA 2004 and the MDI Act 2003.

In line with the policy, Tier 4 MFI Act should cover both SACCOs and credit only MFIs. Registration of the different institutional types should continue under the current legal and administrative arrangements, while licensing of all these institutions (a new mandatory requirement) should be done by a single regulatory authority. To achieve the objectives of the policy, the Tier 4 law needs to cover all providers of financial services that are not regulated under the FIA 2004 or MDI ct 2003.

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The following aspects therefore need to be considered:

- Given the stated need for an integrated approach, the law should cover both prudential and non-prudential regulation, the former for SACCOS and the latter for all non-SACCOS.

- The law should have two distinct sets of provisions one for SACCOS (stipulating prudential regulation) and the other for non-SACCO (stipulating non-prudential regulation). The starting point should be to combine the existing draft bills into one, and to improve them as proposed under subsections 4.4.1 and 4.4.2 above.

- One regulatory authority (the Tier 4 MFI Regulatory Authority) should be set up for enforcing and monitoring compliance. The regulatory authority should, after the enactment of the law, develop two sets of regulations – one for SACCOS and the other for non-SACCO MFIs.

- The regulatory authority should use the PMT for monitoring and the institutions should use the PMT for reporting. This tool was revised to make it more applicable to both SACCOS and non-deposit taking MFIs, and is currently in use by majority of MFIs including SACCOS.

- All providers of loans and other financial services who are not regulated under the existing laws should be brought under this law – including money lenders.

- Explicitly prohibit dealing in financial services (deposits and/or loans) for institutions not licensed under the law, unless they fall under MDI Act or FIA.

- Stipulate the maximum size in terms of capital base, loan portfolio and numbers of clients/members served, beyond which a SACCO or NDFI must transform into a higher level tier.

- This law should repeal the Money Lenders’ Act (1952)

The regulatory authority will need to have a suitable home, competent management, some operational linkages with BoU (through mentoring by the BoU MF Supervision Unit and a board with representation of Tier 4 financial apexes, BoU, the microfinance sector and whose membership is screened by the Bank of Uganda for fit and proper testing.
4.5.2 The Regulations

Regulations give more details on how to implement the law. They are easier to change and do not need a change in the law. While this assignment was not meant to go to the level of suggesting components of regulations to be developed under the law, there are some key areas of regulation that are worthwhile mentioning. They are highlighted below:

Management of the LIF
The institutions interviewed during this assignment proposed that MFI’s keep the LIF as fixed deposits in prudentially regulated financial institutions. This is also the requirement under the MDI Act and although the MDIs criticize the requirement for limiting their loan funding sources, it has ensured that LIF deposited by clients are secure – which is one of the primary aim of Tier 4 regulation.

Licensing Fee
During the field survey, a number of institutions expressed their favor for a renewable license arrangement. Under this all Tier 4 licenses issued would be renewed annually. This has an advantage of affording the regulatory authority the option not to renew a license for non-compliant institutions.

Micro Insurance Premium
The law should state the agency role of the MFIs in insurance – the MFIs should not play the role of principal insurers since they are not licensed to carry on insurance business. Currently, some MFIs charge insurance premium and just keep it to themselves. The law should state where the insurance business falls, for both operations and regulation. Insurance premiums collected should be remitted to the respective insurance companies, which are regulated by the Insurance Commission.

Regulating New High- tech Products
Advances in ICT have started posing challenges to financial regulators, including BoU. Regulators need to have tools and mechanism to enable them to respond quickly to the fast growing new products which can pose a big risk in a short time. An example is the mobile phone money transfer mechanisms that are fast growing, but operating completely outside of the recognized financial sector. It is conceivable that in the near future, these mechanisms might be used for lending and loan repayments. It is necessary that this law includes provisions for such, and that both the FIA 2004 and MDI Act 2003 are revisited in view of the developments.

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20 This does not refer to the LIF. Rather, it refers to the 1% or 2% insurance premium often charged by MFIs for compensation in case the client dies or gets permanently incapacitated.
Provisions for public limited liability companies:
There are cases in Uganda of microfinance institutions that are operating as public limited companies in order to attract more share capital and intermediate savings among its members. Some of these do not want to become cooperative societies and yet they would like to retain the advantage of being able to intermediate savings. Government should explore two possibilities with the regard to these:

i) Amend the MDI Act so that it can cover large public companies in the business of microfinance

ii) Require such companies to either become non-deposit taking or convert either to MDIs or SACCOs

In Bangladesh, the Grameen Bank is a hybrid institution which was established by the Grameen Bank Ordinance of 1983. Its objective is to provide credit and other financial services to poor landless people especially in rural areas whereby the borrowers, had an ownership stake in it. Whereas 15% of the shareholding was held by the Government, 85% was set aside for the borrower shareholders. Additionally, the law provided for them to have 9 out of the 11 board membership and had special provisions outside the Banking Companies Ordinance of 1962, such as establishing its regulations, submitting returns to Government and tax exemptions. This example of a law to establish the status of just one institution can work for a very large institution like Grameen Bank but not for small institutions like the public companies we are talking about in Uganda.
4.5.3 Proposed Regulatory Structure

The figure below presents the proposed regulatory structure for the Tier 4 institutions.

Figure 1: Proposed Regulatory Structure
The above structure agrees with the Microfinance Policy (2005-2015). The policy among other issues states that regulation of Tier 1V institutions should contribute towards sector integration. Tier 4 regulation should therefore consolidate the two draft laws and close loopholes that can be used by unscrupulous people to perpetrate misconduct.

As already stated, this report recommends one law to cover both Tier 1V deposit-taking institutions (SACCOS) and non-deposit taking Tier 1V institutions. The draft SACCO Bill and draft Micro-Credit Act should be amalgamated and improved.

This framework will be overseen by the Ministry of Finance, Planning and Economic Development to which a single Regulatory Authority will report. The Regulatory Authority’s duty will be to license, monitor, and supervise Tier 4 MFIs and to ensure their compliance with the law and regulations.

The regulatory authority should have a representative board with members from the Bank of Uganda, MTTI, UCA, UCSCU and AMFIU, Tier 1V institutions and consumer representatives.

While all Tier 4 institutions should be regulated under this framework, the larger ones should be supervised directly by the Regulatory Authority while the rest should be supervised by the national associations under delegation from the Regulatory Authority. The following scheme could provide indicative guidelines in this regard:

- **SACCOs** with either USh 100 million or more in combined savings and share capital, a gross asset value of USh 300 million or more, or more than 2,000 members should be supervised directly by the Regulatory Authority; the rest should be supervised through the national association of SACCOs

- **NDFIs** serving more than 5,000 people and/ or with gross asset value of more than 500 million or more than five branches/ service points should be supervised directly by the Regulatory Authority; the rest should be supervised through the national association of MFIs

For the SACCOs, the regulator can sub-contract institutions like national apexes through their regional branches or other microfinance-knowledgeable agencies at the regional level, to which all SACCOs will send their mandatory periodic reports for onward submission to the regulatory authority. These will be a minimum set of vital information consistent with SACCO norms and microfinance sound practices – based on the PMT. Having the information collected regionally is to ensure that the attendant costs are minimized and that there is an effective interim check before the information goes to the regulatory agency.

Under the non deposit taking institutions, the national association of MFIs (which may work in conjunction regional agencies can be sub-contracted) to gather information, analyse it and submit to the Regulatory Authority.
The choice of sub-contracted institutions should be made after the regulatory authority conducts a capacity audit of all eligible institutions to establish capacity for each institution, gaps and the cost of closing them. It is critical that the Bill clearly spells out the responsibilities and liability for non-regulation, improper or under-regulation in cases where the regulator has been mandated by the law to delegate some of its activities or functions. Ideally, the Regulatory Authority should retain full responsibility as far as MoFPED is concerned. It should be the Regulatory Authority, in turn, to ensure that the association, as an agent of the Regulatory Authority, does its work with full diligence and care.

It is proposed that the current Performance Monitoring Tool, (PMT), be used for all Tier IV institutions reporting under the Act. The PMT is compatible with reporting requirements of both types of institutions (SACCOs and credit-only MFIs). The national association of MFIs should collect all NDFI performance information in PMT format and submit to the regulatory authority. The national association of SACCOs should do the same for SACCOs. In doing this, the two associations should screen the reported information and confirm them to the regulator at a minimum cost, even electronically on a regular basis. This role for the association is natural and does not conflict with their other roles as national networks. Based on the warning signs and watch lists of the SACCOs and credit-only MFIs, the regulator can organise on-site visits and even request the Bank of Uganda to make an inspection when necessary. This would be a practical way of using the proposed law and the FIA 2004 in harmony.

For the purpose of regulation, all SACCOs in the country should be required to affiliate to the national SACCO network chosen by the Regulatory Authority. Similarly, all NDFIs should be required to affiliate to the chosen microfinance national association. The recommendation in this paragraph only refers to the mandatory affiliation for the sake of regulation. This should not affect additional affiliation based on preference and value addition that the SACCOs and NDFIs may which to have with these or other associations.

With all the above in place, all financial institutions will be covered by at least one regulatory law. Activities of each financial institution will in some way be monitored to ensure they are ethical and not detrimental to sector stability. There will be capacity issues for the regulator, which is why delegation of information collection and screening to regional agencies is proposed. The overall focus should be to reap the advantages of regulation at affordable costs.
PROBABLE EFFECTS OF THE REGULATING TIER 4 INSTITUTIONS

The following subsections discuss the probable effects of regulating Tier IV institutions – exploring the potential results of taking up the recommendations given in section 4.4. The term regulation is used broadly, referring to both prudential and non-prudential forms proposed in the draft laws, adjusted in view of the recommendations made in section 4.4 of this report.

Effects on the Financial Sector

*Enhanced financial sector stability and public confidence in it* - Regulation of microfinance institutions will close regulatory gaps and foster orderly development of the financial sector. There will be less incidences of public rip-off by unscrupulous people due to a regulatory vacuum. In identifying the better performing institutions, formal financial institutions are likely to have more confidence in SACCOs and MFIs once they are regulated. These linkages and disciplinary conduct should boost financial sector cross-businesses and linkages

*Graduation of more microfinance institutions to higher tiers* - Regulated MFIs will improve professionalism and hopefully boost profitability. Mandatory compliance to regulatory requirements could eventually prepare a few of these institutions for graduation into higher tiers.

*Availability of accurate information on the financial sector* - Regulation of all the major players in the Tier 4 will enhance availability of accurate information on key information and statistics on the financial sector. This will be good for national planning and for stakeholders who work with financial sector institutions.

*Integration of the financial sector* - Regulation of all Tier 4 MFIs will increase the level of integration of the financial sector.

Effects on the Tier 4 MFIs

The effects to the regulated institutions may include:

*Improved Governance and Management* - For a financial institution, good governance is the fundamental requirement from which all the other institutional strengths flow. A well balanced, diversified and sufficiently skilled board will usually put in place management, require systems and exercise oversight that ensure that operations are run in ways that enhance profitability and safety. Like the case with governance, if the regulator vets the top management of the institutions, professionalism in operations will be improved.
**Accuracy in Reporting** - Regulation will enhance prudence and accuracy in financial reporting. To external stakeholders, regulation will make both operational and financial reporting by MFIs far more reliable.

**Improved performance** - Although there may be reduced profitability in the short run as institutions put in place systems to comply with the regulations, there is bound to be eventual improvements in financial performance.

**Better Product Offering to Clients** - Additional products could be developed resulting from exposure to other financial institutions (from increased integration of the financial sector) and the institutions’ own drive for business growth. In this sense, regulation may make MFIs more responsive to clients.

**Outreach** - The number of clients may increase as a result of increased public confidence and availability of more funding from wholesale lenders. On the down side, however, rural outreach could somehow slow down (at least initially) considering the institutions may be more focused on sustainability. The experience of MDIs has not proved that prudential regulation is a reliable route to improved rural outreach. This downside possibility is somehow addressed by the fact that Government now proactively supports a SACCO in every sub county.

**More funding sources** - A well regulated microfinance sector will help in attracting increased funding into the sector. This will be as a result of increased trust and confidence with local and international wholesalers of funds.

**Costs of operation** – Whereas additional costs of compliance are bound to set in, eventually other operating costs are likely to go down because current high costs are largely attributable to inherent inefficiencies among MFIs.

**Effects on Clients**

**Costs of borrowing** – Could initially increase slightly due to increased compliance costs and eventually go down due to improved transparency, efficiency and competition.

**Consumer protection and awareness** - will be enhanced due to regulatory requirements of disclosure. Reduced confusion about which financial institution offers what, at what costs and terms will help clients to make more informed choices. With regulation, consumers will also have better access to complaint mechanisms and legal redress.

**Improved service quality** - There will be improved systems and efficiency leading to reduced delays in loan disbursements, loan processing and the overall transaction time in the regulated institutions. Customer care may also improve since MFIs will be professionally run.
Effects on Other Stakeholders

*Government* – is likely to realize a more organized set up for provision of inclusive financial services, which has for long been its objective

*MFI networks* – Should have a more organized membership from which information is more easily obtained, thus strengthening the MFI networks

*The Tier 4 Regulator* – Likely to be overwhelmed with work initially, might eventually work out ways to efficiently carry out its mandate. Logistics and practicalities for supervising more than a thousand institutions spread all over the country will be a big challenge. Therefore, the regulatory authority should take a phased approach and adopt cost effective methods of operation like those proposed in the section 4.5.1 and 4.5.3.

*Bank of Uganda* – Will find itself in a slightly better position as the Tier 4 regulatory Authority will be a good complement to its efforts in further organizing the financial sector

*Donors/ Development partners* – will find their work somehow easier because of ease of information access and streamlined operations among Tier 4 MFIs
APPENDIX I: LIST OF RESPONDENTS

Henry Mbaguta          Assistant Commissioner – Microfinance - MoFPED
Lance Kashugyera       Coordinator - Rural Financial Services Strategy
Prossy. T. Bahiigwa    Research & Development Officer - MSC Ltd
Wilson Wamatsembe      Capacity Building Manager - MSC Ltd
Peter Kabanda          Project Officer - Oiko Credit
Saliya Kanathigoda     Programme Advisor – German Technical Cooperation
Grace Kasisira         Deputy Director - NBFIS - Bank of Uganda
Enid Kiiza             NBFI Department, Bank of Uganda
Edward Nsereko         NBFI Department, Bank of Uganda
David Baguma           Executive Director - AMFIU
Solomon Kagaba         Operations Manager - AMFIU
William Steel          Adjunct Professor, University of Ghana, and former Africa Region Specialist on Rural and Microfinance, World Bank
Patrick Mumba          Head of Audit Supervision - UCA
Wilson Kabanda         Manager - UCSCU
Ben Eyabu              Product Development Manager - Centenary Bank
Florence Soro          Ag. General Manager - UGAFODE
Edward Kiyaga          Business Development Manager – MED-Net
Jennifer Mugalu         CEO- PEARL Microfinance Limited
Eve Nangendo           Operations Manager - SUCCESS Microfinance Limited
Emmanuel Kimbowa       General Manager - GATSBY Microfinance Limited
Sam Onyee Oyo          Ag. GM - Northern Recovery Microfinance Services Ltd
Dan Matovu             Manager - Micro Uganda Ltd
Amon Ndyamuba          Ag. GM - Rubare Modern Rural Savings & Credit Association
Joseph Zabasajja       General Manager - MAMIDECOT
George Odira           Manager – Pader Branch - Agaru Sacco
Charles Isingoma       General Manager - Hoima Fort Portal Kasese Microfinance
Annet Muwonge          MFO - Eastern Private Sector Development Company Ltd
Okalebo David Onyoin   CEO - Teso Private Sector Development Centre Limited
Kensita Sharon         Microfinance Advisor - South Eastern Private Sector Promotion Enterprise Ltd
Nelson Tasenga         CEO - Acholi Private Sector Development Company Ltd
Edward Mukanya        Microfinance Officer - Masaka Private Sector Dev’t Co. Ltd
APPENDIX II: LIST OF DOCUMENTS REVIEWED

1. Microfinance Regulation in Seven Countries: a Comparative Study  (Sa-Dhan Microfinance Resource Centre-2006)
2. Regulating and Strengthening Tier IV Microfinance Institutions in Uganda (AMFIU-2005)
6. Financial Institutions Act 2004
7. The MDI Act 2003
8. The Companies Act,1961
10. The Cooperative Statute 1991
11. Draft SACCO Bill (MoFPED -2007 )
12. Draft Micro credit Bill (MoFPED - 2008)
15. Uganda Microfinance Industry Assessment (FRIENDS Consult, AMFIU – 2008)
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<table>
<thead>
<tr>
<th>Key Issue</th>
<th>SACCOS</th>
<th>Micro Finance NGOs</th>
<th>Companies and NGOs</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>A. Licensing</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Legal Status</td>
<td>SACCOs to register with first Registrar of Coops, then licensed under new law</td>
<td>Agrees with reality and our recommendations</td>
<td>Change status to company limited by shares to identify clearly the owners</td>
</tr>
<tr>
<td>Licensing/regulating body</td>
<td>New regulatory body to be set up, to enforce compliance and better performance to reduce financial risk..</td>
<td>Agrees with Government’s thinking</td>
<td>New Regulatory Body</td>
</tr>
<tr>
<td>Lead Time from enactment to compliance</td>
<td>6 months depending on requirements</td>
<td>Rather short</td>
<td>6 months to 1 year</td>
</tr>
<tr>
<td>Licensing Fees</td>
<td>-Charge a standard fee per category. -To be paid and maintained annually</td>
<td>Good idea to make annual</td>
<td>Should be pegged to size of loan in order to raise reasonable income in comparison to supervisory work load</td>
</tr>
<tr>
<td>Validity of License</td>
<td>Annual</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Key Issue</td>
<td>SACCOs</td>
<td>Micro Finance Companies and NGOs</td>
<td></td>
</tr>
<tr>
<td>---------------------------------</td>
<td>----------------------------------</td>
<td>----------------------------------------------------------</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Recommend.</td>
<td>Remark</td>
<td>Recommend.</td>
</tr>
<tr>
<td><strong>Minimum Capital Requirements</strong></td>
<td>Regulator to set</td>
<td>To be stipulated in Regulations, for flexibility</td>
<td>200 million</td>
</tr>
<tr>
<td></td>
<td>Leave to discretion of SACCO</td>
<td>Leave the discretion of SACCO, subject to concentration limits</td>
<td>-Not more than 1% of capital</td>
</tr>
<tr>
<td><strong>Maximum Loan Size</strong></td>
<td>Gives guide for integrity &amp; should be applied</td>
<td>Good to weed out undisciplined potential SACCO directors</td>
<td>-Left to MFI discretion</td>
</tr>
<tr>
<td><strong>Prohibitions</strong></td>
<td>Loans to non members must have greater security.</td>
<td>Do not limit money transfer</td>
<td>No deposit taking, forex dealing and other unauthorized transactions</td>
</tr>
<tr>
<td><strong>Reporting tools</strong></td>
<td>PEARLS</td>
<td>Already in place. Must be learnt by Regulator</td>
<td>PMT used by all AMFIU members including SACCOS</td>
</tr>
</tbody>
</table>

21 View of Category A MFIs.
APPENDIX III: PROBABLE INDICATORS FOR ABRIDGED PRUDENTIAL REGULATION

In this report, “abridged prudential regulation” is used to mean that the regulatory authority could select key aspects on institutional health and performance in core strategic and operational areas. The following list is an indicative scheme of indicators for an abridged prudential regulation.

1. Governance and Management
   a) Full control by the institution’s board and membership, with no significant external control except for regulation
   b) Able / knowledgeable board who pass a well defined “fit-and-proper” test
   c) Effective responsibility and accountability practices among the organs of the institution
   d) Qualified and experienced management who pass a well defined “fit-and-proper” test
   e) Suitable and adequate risk management policies and procedures

2. Asset and Liability Management Effectiveness
   a) Loan Portfolio Management (PAR)
   b) Cash safety (security, insurance)
   c) Gearing ratio (Debt / Equity)

3. Accounting and Reporting
   a) Suitable book keeping and accounting practices
   b) Proper financial management policy and practices

4. Institutional Sustainability
   a) Return on investment (unadjusted)
   b) Operating sustainability ratios (OSS)
   c) Financial sustainability (FSS)
ASSOCIATION OF MICROFINANCE INSTITUTIONS IN UGANDA

A SURVEY ON REGULATION OF MICROFINANCE COMPANIES AND NGOS

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January 2009
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LIST OF ACRONYMS

AMFIU Association of Microfinance Institutions in Uganda
ASCAs Accumulated Savings and Credit Associations
ARB Association of Rural Banks (of Ghana)
ARCBs Association of Rural Community Banks (of Ghana)
BoG Bank of Ghana
BoU Bank of Uganda
CGAP Consultative Group to Assist the Poor
CIs Credit Institutions
CMF Commercial Microfinance Limited
CONGOMA Council for Non-Governmental Organizations in Malawi
CRB Credit Reference Bureau
CUA Credit Union Associations (of Ghana)
DEMAT Development of Malawian Enterprise Trust
FCL FRIENDS Consult Limited
FIA Financial Institutions Act
FINCA Foundation for International Community Assistance
FIS Financial Institutions Statute
FSDU Financial Sector Deepening in Uganda
GTZ Deutsche Gesellschaft fur Technische (German Technical Co-operation)
KPOSB Kenya Post Office Savings Bank
LIF Loan Insurance Fund
MDIs Micro Deposit Taking Institutions
MFIs Micro Finance Institutions
MFRC Micro Finance Regulatory Council (of South Africa)
MOFPED Ministry of Finance Planning and Economic Development (of Uganda)
MRFC Malawi Rural Finance Corporation
MSB Malawi Savings Bank
MTTI Ministry of Tourism Trade and Industry (of Uganda)
MUSCU Malawi Union of Savings and Credit Union
MUSCO Malawi Union of Savings and Credit Cooperatives
NCA National Credit Act (of South Africa)
NCR National Credit Regulator (of South Africa)
NDFI Non Deposit-taking Institution
NGO Non Governmental Organization
NLR National Loans Register
NMP National Microfinance Policy (of Tanzania)
PMT Performance Monitoring Tool
PRIDE Promotion of Rural Initiatives and Development Enterprise
PSPCs Private Sector Promotion Centers
RBM Reserve Bank of Malawi
RFSP Rural Financial Services Program
RFSS Rural Financial Services Strategy
RIA Regulatory Impact Assessment
<table>
<thead>
<tr>
<th>Abbreviation</th>
<th>Description</th>
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<tbody>
<tr>
<td>ROSCAs</td>
<td>Rotating Savings and Credit Associations</td>
</tr>
<tr>
<td>SACCOs</td>
<td>Savings and Cooperative Credit Organizations</td>
</tr>
<tr>
<td>SACCOL</td>
<td>Savings &amp; Credit Cooperative League (of South Africa)</td>
</tr>
<tr>
<td>SALC</td>
<td>Savings and Loans Companies (of Ghana)</td>
</tr>
<tr>
<td>SEEP</td>
<td>Small Enterprise Education and Promotion</td>
</tr>
<tr>
<td>SRO</td>
<td>Self Regulatory Organization</td>
</tr>
<tr>
<td>UCA</td>
<td>Uganda Cooperative Alliance</td>
</tr>
<tr>
<td>UCSCU</td>
<td>Uganda Cooperative Savings and Credit Union</td>
</tr>
<tr>
<td>UML</td>
<td>Uganda Microfinance Limited</td>
</tr>
<tr>
<td>VSLAs</td>
<td>Voluntary Savings and Loan Associations</td>
</tr>
<tr>
<td>WOCCU</td>
<td>World Council of Credit Unions</td>
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Executive Summary

Regulation of the microfinance sector, especially the lower tier institutions, has always posed a challenge in most countries. Government of Uganda proposes to regulate Tier 4 microfinance institutions under two separate laws – one for SACCOs and the other for non-deposit taking Tier 4 MFs. Government has already drafted the two laws and discussed them with selected stakeholders.

As the industry network and custodian of MF sound practices, AMFIU would like to make technically informed recommendations on Tier 4 regulation. This necessitated a survey of relevant aspects nationally, compilation of lessons learnt elsewhere and compiling a report that would inform AMFIU’s recommendations. AMFIU contracted FRIENDS Consult to undertake the survey, whose findings and recommendations are presented in this report.

The current financial sector regulatory framework leaves out Tier 4 MFIs, which are vital in provision of financial services to low income people but whose activities, unless regulated, could also disrupt people’s economic lives. Rationale for Tier 4 regulation lies in the need for continued financial sector stability, safety of people’s deposits, need for inclusiveness of regulation, borrower protection and overall national economic development.

From the experiences of Ghana, Kenya, South Africa, Tanzania and Sierra Leone, the key lessons drawn for Uganda are:

- Combining supervision and promotion of the institutions under one umbrella usually compromises one or both of these objectives
- Regulation of community based institutions is best done with the involvement of their apex(es)
- Full scale prudential regulation for small deposit taking institutions like SACCOs can become self-defeating
- Subsidies must be administered with caution so as to ensure the institutions’ sustainability
- Purely credit-driven microfinance, based on government subsidization, can lead to stunted industry growth
- Self regulation by a member controlled apex can be supportive to but cannot replace independent regulation
- Microfinance regulation for the lowest tier institutions should look at the whole array of unregulated financial service providers
- Multi-level regulation/ supervision based on delegation, as long as it is well documented, organized and understood, can work
- Network MF organizations have a role in proper regulation
- A comprehensive national microfinance policy is necessary to support MF regulation
- A new law is not always necessary; it is in some cases more appropriate to amend existing laws to accommodate microfinance regulation
- Regulators’ capacity: Never legislate what cannot be regulated, and never regulate what cannot be supervised
- National policy should always precede, shape and inform law making
- A sustainable funding mechanism for regulation needs to be put in place
- Don’t apply prudential regulation to non deposit takers
- For full prudential regulation, avoid licensing very weak institutions that cannot be effectively supervised
- Regulatory policy should have a single focus or a few related grand objectives, while application of the regulatory function can be suitably delegated to different regulatory units

On the basis of the findings and lessons learnt elsewhere, the following key recommendations are made:

1. The two draft laws should be combined into one. Under this, there should be one Tier IV MF Regulatory Authority that administers two different sets of regulations – one to SACCOs and the other to non-deposit taking MFIs

2. There should be a clear, practical funding mechanism for Tier 4 regulation

3. For SACCOs, the regulatory authority should use abridged prudential regulation while for non-deposit taking MFIs, it should use non-prudential but enforceable regulations

4. Owing to the large number of MFIs to be regulated and the likely capacity needs of the regulatory authority, cost and effort-efficient mechanisms (like delegation and focus on a few indicators) should be adopted in Tier 4 regulation

5. The new law (proposed title: Tier 4 Microfinance Regulation Act) should cover all providers of financial services that are currently not regulated under existing laws

The likely effects of the proposed law are increased financial sector stability, probable increase in graduation of institutions to higher tiers, initial high costs of compliance later offset by benefits of more efficiency, further integration of the financial sector, more accurate reports and financial sector data for national planning, improved performance of institutions that survive the introduction of regulation and a strengthening of MF networks as their member institutions become stronger.
1.0 INTRODUCTION

1.1 The Assignment and its Purpose

This report presents the findings and recommendations of a survey on the regulation of Tier 4 MFIs in Uganda. As microfinance institutions grow in scale, outreach and sophistication, there arises need to review and update regulation of the financial sector, especially microfinance. Since the enactment of the MDI Act in 2003, Uganda’s microfinance stakeholders have actively sought regulation alternatives for Tier 4 institutions. Since the second half of 2007, the Ministry of Finance Planning and Economic Development (MOFPED) has drafted and widely consulted on a proposed SACCO specific law, which has now been drafted. More recently, MOFPED undertook the preliminary steps towards introducing another law to regulate non-SACCO Tier 4 MFIs.

Tier 4 MFIs, including SACCOs, form a significant component of the rural financial landscape in Uganda. Whereas by volume of business or outreach numbers they are modest, these institutions have been more successful in penetrating rural areas than the more formal ones. With the exception of SACCOs which operate under the Cooperative Act 1991¹, Tier 4 MFIs are not regulated under any law.

For Tier 4 institutions to become part of the orderly growth of the financial sector, there is need to include them in a conducive regulatory framework which ensures that they blossom while doing ethical, prudent business. This assignment is meant to help AMFIU come up with proposals that will provide a favourable operating environment for the Tier 4 MFIs and guide their business operations. The assignment required the consultant to propose a regulation and supervision structure, assess the possible effect of the regulation on cost, outreach and service quality and make appropriate recommendations on the way forward with regulation of non-SACCO Tier 4 MFIs.

AMFIU², the microfinance industry network organization in Uganda, sought to undertake a survey of ideas, views, experiences and opinions on how best the regulation of non-SACCO Tier 4 institutions could be legislated. For this, AMFIU procured and hired FRIENDS Consult Ltd, through national competitive bidding, to undertake the survey and come up with recommendations. As later explained, the assignment was later broadened to include SACCO regulation because of the change in Tier 4 regulation plan by government.

---

¹ A statute which is now largely considered very inadequate for regulation of SACCOs as financial institutions.
² With funding from the SEEP network
1.2  TOR Summary

In line with the assignment purpose, the Terms of Reference (ToR) required the consultants to:

i. Study the Financial Institutions Act 2004, the MDI Act 2003, the draft SACCO law and other materials that can inform the outcome

ii. Study the Companies Act and give its provisions on relevant issues

iii. Study the NGO statute and give its provisions on financial service provision, including savings mobilization

iv. Give recommendations on whether the Companies Act and NGO statute should be amended or if a new Act is required

v. Examine how other countries regulate and supervise these kinds of financial institutions

vi. Review secondary information and interview MFIs pre-agreed with AMFIU

vii. Analyze data collected and write a report on the findings.

1.3  Methodology Used

The consultants approached the assignment from the most practical perspective and gave preference to suitability of context during each stage. At the start of the work, consultants held an inception meeting with the AMFIU Executive Director and senior managers. The two parties agreed on the available reports and materials to use, the MFIs to interview, other stakeholders to meet, the work plan and a report format. This set the pace for collaborative work during the rest of the assignment.

Shortly after FRIENDS Consult signed the contract with SEEP, further developments had surfaced. MOFPED had produced a zero draft of a proposed law for non-SACCO Tier 4 MFIs and Parliament has indicated that it preferred one law to govern all Tier 4 MFIs rather than two separate ones. It was therefore agreed that the assignment should study both the SACCO and non-SACCO regulation prospects and propose improvements and/innovations to the proposed laws, in the context of the new development.

Consultants reviewed secondary information, including existing laws, draft laws, relevant prior reports and literature from other countries. On the basis of the ToR, the technical proposal and issues agreed at the inception meeting, guiding questionnaires were developed and later used for interviews with different stakeholders. Representative SACCOs and non-SACCO MFIs to be interviewed were selected based on size category, and agreed with AMFIU. These as well as other stakeholders (MoFPED, RFSP, BoU, GTZ, AMFIU, USCU, UCA and PSPCs) were interviewed.

All the findings were analyzed and options weighed with the view of making suitable recommendations. On the basis of this, the report was drafted.
1.4 Limitations and Challenges

This study, though done with due care and skill, faced a few difficulties – among them:

- Changing views and situation with regard to the proposed laws. By the time the ToR was drawn, for instance, government’s position was that there had to be a SACCO specific law and a separate one for non-SACCO Tier 4 MFIs. By the time the assignment started, government wanted one law for both SACCOs and non-SACCOs.

- Widely differing, sometimes irreconcilable views on the scope, focus and depth of regulation to be applied came up.

- The world wide credit crunch came to its peak during the study dispelling long held views of international best practices based on the efficiency of the free market and its capability to produce both commercial and social results sustainably. A number of fundamentals are now frequently questioned, meaning that there is need to think beyond conventional wisdom.
2.0 REGULATORY FRAMEWORK FOR THE FINANCIAL SECTOR IN UGANDA

2.1 Overall Financial Sector Policy and Regulation

The current financial sector policy in Uganda aims primarily at systemic safety and soundness as a supporting bedrock for orderly growth. The policy, drafted by the BoU and approved by Government following multiple bank failures of the late 1990s, was significantly informed by the bitter lessons learnt from these failures and by incidences of fraudulent organizations that fleece the public. The role of Bank of Uganda, the financial sector regulator, is to ensure systemic safety, soundness and stability of the whole financial sector, and protection of public deposits in the regulated financial institutions.

Bank of Uganda issued the policy statement in July 1999 that established a tiered regulatory framework for microfinance business within the broader financial sector. The policy established four categories of institutions that can do micro-financing business in Uganda:

*Tier 1: Commercial banks.* Banks are regulated under the Financial Institutions Act revised in 2004. Since these are already sufficiently capitalized and meet the requirements for taking deposits as provided for in this Act, they are allowed to go into the business of microfinance at their discretion.

*Tier 2: Credit Institutions (CIs).* These institutions are also regulated under the Financial Institutions Act 2004. A number of them offer both savings and loan products but they can neither operate cheque/ current accounts nor be part of the BoU Clearing House. Like banks, they are permitted to conduct microfinance business since they are already sufficiently capitalized and meet the requirements for taking deposits provided for in the Act.

*Tier 3: Micro Finance Deposit Taking Institutions (MDIs).* This is the category of financial institutions that was created following the enactment of the MDI Act. Originally doing business as NGOs and companies limited by guarantee, these institutions transformed into shareholding companies, changed their ownership and transformed/ graduated into prudentially regulated financial intermediaries. They are licensed under the MDI Act and are subjected to MDI Regulations by BoU. Like Tier I and II institutions (banks and CIs), the MDIs are required to adhere to prescribed limits and benchmarks on core capital, liquidity ratios, ongoing capital adequacy ratios (in relation to risk weighted assets), asset quality and to strict, regular reporting requirements.

*Tier 4: All other financial services providers outside BoU oversight.* This category has SACCOs and all microfinance institutions that are not regulated - such as credit-only NGOs, microfinance companies and community-based organizations in the business of microfinance. These institutions have a special role in deepening geographical and
poverty outreach, and in other ways extending the frontiers of financial services to poorer, remote rural people.

Tier 4 institutions operate under various laws, none of which regulates them as financial institutions. The SACCOs are registered and in principle supervised under the Cooperative Societies Statute 1991\(^3\) by the Ministry of Trade, Tourism and Industry. The other governing laws for Tier 4 include the Companies Act (1969)\(^4\), the Money Lenders Act (1952)\(^5\) and the NGO Registration Act (1989)\(^6\). Supervision of these institutions is currently so weak that their regulation is of minimal effect because it is generic, all encompassing for all activities and not focused on financial oversight.

BoU, which engages in only prudential regulation, is neither keen nor well endowed with staff and logistics to add Tier 4 institutions under its supervision\(^7\). To some extent, self-regulation\(^8\) of Tier 4 institutions has been taken up by AMFIU, which has a Code of Conduct to which all its members must adhere. UCSCU and UCA, being members of AMFIU, also subject their member-SACCOs to the Code of Conduct. This development is good although it is limited to members of AMFIU, UCA and UCSCU. A majority of Tier 4 MFIs are not members of these three organizations. Another complementary approach championed by AMFIU is to empower the Tier IV consumers of financial services to understand both their rights and their responsibilities. This has increased consumer awareness and their ability to make informed decisions, although it needs to be enriched in content and rolled out to all parts of the country. As was hoped at the time of starting this consumer education campaign, some results have started to show. Increased consumer awareness is starting to drive MFIs to improve the quality of their work, products and customer care. These efforts are playing a critical part in instilling ethics and good conduct in the sub sector. There are two major challenges with self-regulation which makes it less effective:

i. Voluntary nature of compliance: if an institution is not and does not want to be a member of AMFIU, for instance, it can stay out of the Code of Conduct requirements which limits punitive action on errant non-members.

ii. Supervision or regulation by a member-based network organization has in-built conflict of interest (having a supervisor that is controlled by the institutions being supervised).

\(^3\) General for all types of cooperatives (production, marketing, financial and employee-based).

\(^4\) General for all types of companies and has provisions for incorporation, governance, business conduct, object/ powers, receivership, winding up and liquidation of companies; does not stipulate financial sector-specific issues like regulation

\(^5\) Provides for the registration, licensing and regulation of the conduct and business of free-lance money lenders who are not part of the mainstream/ formal financial sector

\(^6\) Provides for registration, licensing and oversight on the activities of NGOs as welfare organizations

\(^7\) BoU therefore only regulates institutions under tiers 1, 2 and 3.

\(^8\) Self-supervision here refers to arrangements under which the primary responsibility for monitoring and enforcing prudential norms lies with a body that is controlled by the organizations being supervised.
2.2 Government’s Action on Tier IV Microfinance

To address the above challenge, the MoFPED has developed a microfinance policy and regulatory framework\textsuperscript{9}. The policy aims to integrate the microfinance sector by serving a number of objectives including; consolidating all the policies on microfinance development; providing guidelines on the provision and access of financial services and explaining the role of microfinance and rural finance services in poverty alleviation in Uganda. The policy rationalizes the Governments interest in the microfinance sub sector from the fact that about 90% of Uganda’s private sector entities are micro enterprises. Most of these are financed by Tier 4 institutions, which have little effective oversight and in some cases posing significant risk to these enterprises. Government therefore aims to bridge gaps in the policy and laws, so as to ensure that Uganda’s savers are, without exception, ensured of safety of their savings. It also aims to ensure that micro enterprises access financial services from institutions that are sound and sustainable, and that deliver services efficiently, affordably and transparently.

SACCOs, which form the majority of Tier 4 MFIs, are of particular concern because of their potential to achieve greater outreach and to ensure safety of members’ deposits. The non-SACCO Tier 4 MFIs are of concern both because they have a favorable bias for the poor and because of the need to preclude imposters who fleece communities to deposit savings, purportedly ‘loan insurance funds’ or ‘mandatory savings to be collateralized for future loans’ and then disappear with the money.

The policy objectives of the microfinance policy and regulation are to;
- Increase access to microfinance services countrywide,
- Improve safety of savings through effective regulation and supervision,
- Enhance microfinance institutional sustainability,
- Improving consumer awareness and demand for cost effective financial services delivery
- Assisting the development of institutional capacity and products in the microfinance industry through research and training.

The policy strategies include;
- Increasing and deepening outreach to sub county level through establishing and supporting one SACCO in each sub county,
- Establishing an effective and conducive regulation and supervision regime for Tier IV institutions
- Building the capacity of the institutions to deliver services better and to grow
- Strengthening public awareness on financial services,
- Research, policy making, and access to finance for Tier 4 institutions.

\textsuperscript{9} Microfinance Policy and Regulatory Framework in Uganda 2005-2015 (MoFPED)
To implement the policy strategies above, Government has put in place the following institutional mechanisms:

i. MoFPED’s Microfinance Department – to champion policy and regulation development for Tier 4 MFIs and oversee the industry

ii. The IFAD funded Rural Financial Services Program (RFSP) to oversee, administer and coordinate the establishment, nurturing of SACCOs in sub counties

iii. Microfinance Support Centre Ltd – to wholesale funds to SACCOs for retailing/on-lending to their members

iv. UCSCU, under a contract, to implement the establishment, nurturing and strengthening of SACCOs in sub counties

Establishment and strengthening of SACCOs at every sub county by UCSCU is ongoing. Under the RFSP, 264 SACCOs are to be supported through IFAD funding. Government will find funding for the other sub county SACCOs (about 800 of them). As at July 2007, the SACCO count was as follows:

Table 1: Number of SACCOs as at end of July 2008

<table>
<thead>
<tr>
<th>Region</th>
<th>No. Of Sub Counties</th>
<th>No. Of SACCOs</th>
</tr>
</thead>
<tbody>
<tr>
<td>Eastern Region</td>
<td>196</td>
<td>274</td>
</tr>
<tr>
<td>Northern Region</td>
<td>119</td>
<td>113</td>
</tr>
<tr>
<td>Teso/Karamoja Region</td>
<td>103</td>
<td>97</td>
</tr>
<tr>
<td>West Nile Region</td>
<td>72</td>
<td>80</td>
</tr>
<tr>
<td>Mid-Western Region</td>
<td>119</td>
<td>160</td>
</tr>
<tr>
<td>Mbarara Region</td>
<td>104</td>
<td>200</td>
</tr>
<tr>
<td>Kigezi Region</td>
<td>56</td>
<td>84</td>
</tr>
<tr>
<td>Central Region</td>
<td>180</td>
<td>375</td>
</tr>
<tr>
<td><strong>Totals</strong></td>
<td><strong>949</strong></td>
<td><strong>1383</strong></td>
</tr>
</tbody>
</table>

Source: Presentation by the Minister of State for Microfinance at MSC Ltd Strategic Planning Workshop held in Jinja (29th October 2008)

The spread and total number of SACCOs give an idea of the daunting task involved in regulating them.
2.3 Current Legal Framework for the Banking and Microfinance Sector

As already stated, the safety and soundness of the overall financial sector is under the jurisdiction of the Bank of Uganda, which does this through the FIA 2004, the MDI Act 2003 and the respective Regulations. BoU has powers to inspect and stop any unlicensed institution engaging in banking business or other form of financial intermediation. There are principles in the existing financial sector laws that could be adjusted and applied to Tier 4 regulation. The following two subjections highlight provisions of the FIA 2004 and MDI Act 2003, with the view highlighting principles that Tier 4 regulations, especially of SACCOs, needs to take into account.

2.3.1 Financial Institutions Act, 2004

This Act governs institutions in Tiers 1 and 2. It replaced the FIS of 1993 with the purpose of tightening the supervisory approach and tools that focus on risk detection/anticipation and avoidance. Under the Act, managers and directors are now individually held accountable for mismanagement and imprudent governance of regulated institutions. Banks are required to disclose their full financial and operational performance to BoU regularly, and to fully disclose to the public their fees and charges. Owing to the application of the Act, the banking sector is sound and transparent. The key provisions of the FIA 2004 are highlighted in the table below.

Table 2: Key Provisions of the FIA 2004

<table>
<thead>
<tr>
<th>Regulatory aspects</th>
<th>Provisions</th>
<th>Remarks</th>
</tr>
</thead>
<tbody>
<tr>
<td>Supervision mandate</td>
<td>BoU has full power and authority over banks and credit institution. The minister of finance no longer licenses institutions. BoU now controls institutions right from the licensing stage. Powers in this regard also include removal of directors, disqualification of external auditors, sanction or rejection of external audit reports, and establishing a credit reference bureau.</td>
<td>BoU is in a better and more powerful position as a regulator</td>
</tr>
<tr>
<td>Institutions covered</td>
<td>Commercial banks, Credit institutions, Merchant banks, Mortgage banks, Post Bank, Finance houses and discount houses.</td>
<td>Covers all formal financial institutions outside microfinance</td>
</tr>
<tr>
<td>Ownership, governance and management</td>
<td>Maximum shareholding for a single or related group of shareholders: 49%, except for shareholding by reputable financial institutions</td>
<td>All these have resulted in vivid improvements in governance,</td>
</tr>
<tr>
<td>Regulatory aspects</td>
<td>Provisions</td>
<td>Remarks</td>
</tr>
<tr>
<td>---------------------------</td>
<td>-----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------</td>
<td>---------------------------------------------------------------------------------------------------</td>
</tr>
<tr>
<td></td>
<td>Transfer of 5% or more shares are subject to BoU permission</td>
<td>management and health of the institutions</td>
</tr>
<tr>
<td></td>
<td>Fit and Proper test for directors and management</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Limit on powers to control a regulated institution’s board</td>
<td></td>
</tr>
<tr>
<td>Minimum start up capital</td>
<td>Shs. 4bn for banks and Shs. 2bn for non bank financial institutions</td>
<td>Effective entry-level check</td>
</tr>
<tr>
<td>On going capital requirements</td>
<td>Core capital: 8% of total risk adjusted assets; total capital of 12% risk weighted assets</td>
<td>Has kept the institutions very conscious of ongoing financial health</td>
</tr>
<tr>
<td>Operational restrictions</td>
<td>No lending to other financial institutions over 50% of total capital for over one year; not more than 25% core capital to any one or related group of persons; no money laundering; no lending on security of shares or and debt instruments</td>
<td>More strict and effective in norm than the previous law.</td>
</tr>
<tr>
<td>Reporting</td>
<td>Strict regular financial and operational reporting to BoU, with punitive penalties for inaccuracies or lateness</td>
<td>Increased transparency and availability of vital information on the financial sector.</td>
</tr>
<tr>
<td>Remedial measures</td>
<td>BoU can intervene into management and governance of the institution, sign a management agreement with the financial institution to comply with agreed actions, issue cease/ desist orders to stop lending, paying dividends, impose penalties, put a freeze on opening new branches, initiate receiverships of regulated institutions, and put them under liquidation.</td>
<td>Gives BoU full control even of institutions under distress</td>
</tr>
</tbody>
</table>
The overall effect of FIA 2004 is a sounder banking sector. While there is cutthroat competition for the “bankable” clients, this is tempered by a healthy balance with maintenance of healthy financial performance.

### 2.3.2 Micro Deposit Taking Institutions Act 2003

Owing to the growth and increasing importance of the microfinance sector, Bank of Uganda issued a policy statement on microfinance regulation in July 1999. This was the start of a long and eventful journey towards Uganda’s first-ever law (MDI act 2003) specifically for microfinance. This law created another category of formal financial institutions, the MDIs. These institutions are licensed under the MDI act, upgrading them from being non-regulated to formal, regulated financial institutions. The MDI Act explicitly excluded other microfinance institutions (SACCOs, microfinance companies and NGOs) from the jurisdiction of BoU.

Like banks, the MDIs are required to adhere to performance measures. The key provisions of the MDI Act 2003 and the corresponding regulations cover the crucial areas of ownership, governance and management, operations and policies, financial prudence, and audited accounts. The key provisions of the MDI Act are highlighted in Table 2 below.

<table>
<thead>
<tr>
<th>Regulatory aspects</th>
<th>Provisions</th>
<th>Remarks</th>
</tr>
</thead>
<tbody>
<tr>
<td>Definition of Microfinance Business</td>
<td>Defines microfinance business as acceptance and intermediation of micro deposits from the public(^\text{10})</td>
<td>Might need revisiting in view of the Tier 4 law. Under the MDI Act, “Microfinance business” should be replaced with “micro-deposit taking business” in order to eliminate the confusion</td>
</tr>
<tr>
<td>MDI Institutional Form and Licensing</td>
<td>MDIs have to be companies limited by shares, with shareholders capable of financially backing the MDI</td>
<td>Made ownership structures of MDIs clearer.</td>
</tr>
<tr>
<td>Ownership, Governance, and Management</td>
<td>BOU vets any person or institution proposing to hold 10% or more of the shares of an MDI, board members and senior managers;</td>
<td>Has ensured MDI managerial and governance stability</td>
</tr>
</tbody>
</table>

\(^{10}\) The Tier 4 law needs to consider how this definition affects it
<table>
<thead>
<tr>
<th>Regulatory aspects</th>
<th>Provisions</th>
<th>Remarks</th>
</tr>
</thead>
<tbody>
<tr>
<td>Regulatory aspects</td>
<td>Requires MDI managers to take responsibility for timeliness and accuracy of regular reports submitted to BOU; No board control by one or a few persons; BoU vets MDI external and internal auditors; directors take collective and personal responsibility for imprudent governance. MDI’s to publish their audited accounts annually, within four months after the end of each financial year.</td>
<td></td>
</tr>
<tr>
<td>Operations and Policies</td>
<td>Defines business prohibited to MDI’s (like current accounts, forex transitions); stipulates a strict scheme and procedure for loan provisioning; write off and portfolio management; prohibits intermediation of loan insurance funds (LIF)</td>
<td>Considered by MDIs to be too restrictive and a disincentive to being an MDI</td>
</tr>
<tr>
<td>Financial Prudence</td>
<td>Limits to financial leveraging and guidelines on liquidity management, asset and liability management, mandatory cash reserves, and regular reporting on all financial and operational aspects of the MDI</td>
<td>Though rather tight, has helped the MDIs to be more financially and operationally prudent</td>
</tr>
<tr>
<td>Supervision Mandate and Powers of BoU over MDIs</td>
<td>As under the FIA 2004</td>
<td></td>
</tr>
<tr>
<td>Operational and Financial Reporting to BoU</td>
<td>Similar to the requirements under FIA 2004, but with varied reporting frequency</td>
<td></td>
</tr>
</tbody>
</table>

A study conducted to assess the Impact of the MDI Regulation (Aug 2007) highlighted aspects of the MDI Act and its regulations which are viewed by the MDIs as restrictive and unnecessarily, hindering further growth. These included:

- Prohibition to intermediate loan insurance fund - MDI Act, sec. 19 (h)
- Prohibition to take deposits and lend in foreign exchange and to offer current accounts - MDI Act, sec. 19 (a) and (g)
- More stringent provisioning and asset quality requirements than for banks and credit institutions - MDI Act, sec. 89 (3)(a)
- Maturity of loans restricted to two years - MDI Act, sec. 2

The report highlighted that through regulation, MDIs have registered significant achievements; have upgraded and increased their clientele, become more professional in the way business is conducted, and improved products and processes. These performance indicators imply that regulation has benefited both MDIs and their clients.

On the downside, MDI regulation seems to have had two effects:
- Whereas average loan portfolios are growing, the number of borrowers was seen to be somehow dropping.
- All MDIs have, since regulation, reduced the proportion of lending to groups compared to individuals and have developed products that target the less poor clients.

The above issues need to be taken into account in developing an inclusive regulatory mechanism for Tier 4 institutions.

### 2.3.3 The Cooperative Statute 1991

SACCOs are currently regulated by the Cooperatives Societies Statute 1991 administered and supervised by the Department of Co-operatives in MTTI. The Statue provides for incorporation/registration, governance, management, regulation, supervision, operation and business conduct of all cooperative societies (production, marketing, multipurpose cooperatives and SACCOs). With microfinance having become of age as a commercially oriented business and non-financial cooperatives largely inactive, SACCOs are in competition with other MFIs for provision of financial services. This means that SACCOs have taken on more of a financial institution characteristic than the ordinary, multipurpose nature of cooperatives. This now means that the Cooperatives Societies Statute 1991 is largely inadequate for regulating and supervising SACCOs.

As far as regulation and supervision of SACCOs is concerned, the Statute has a number of shortcomings. The key ones are:

- Registration procedures and requirements do not pose any regulatory mechanism for controlling and censuring entry into the sector. Apart from the requirement that the society must have at least 30 members, there are hardly any other conditions to ensure minimum adherence to prudential standards before registration.
The provisions on supervision, while adequate for non-financial cooperatives, are weak and are inadequate for SACCOs. Notably, there are no mandatory requirements for a cooperative to maintain objectively verifiable financial health and performance based indicators.

Provisions on financial performance reporting are somewhat self-defeating. The Statute provides for mandatory audits and submission of annual audited accounts to the Registrar of Cooperatives. It then controversially provides for the Cooperative Officers, who are under the Registrar/ Commissioner for Cooperatives, to act as the “Auditor of Last Resort” in cases where the cooperatives cannot afford to pay certified auditors. Most SACCOs and other cooperatives have resorted to routinely using cooperative officers to audit their accounts. The are two problems with this:

a. Most Cooperative Officers are not trained accountants and therefore they cannot competently audit the SACCO accounts. Evidence of this is in frequent “audited accounts” from SACCOs with glaring material mistakes and inaccuracies.

b. The principle of auditor-independence is severely compromised through this arrangement

The statute is outdated in light of current numbers and activities of cooperatives

The Statute does not place repercussions/ responsibility for failure to supervise or regulate the cooperatives on the supervisor.

2.3.4 Government Initiative to Improve SACCO Regulation

In light of the government’s Rural Financial Services Strategy (RFSS), Government through MoFPED has drafted a prudential regulatory framework for SACCOs. To support this, the Ministry has drafted a SACCO specific Bill and Regulatory Guidelines. The rationale is that poor/ rural Ugandans need to access suitable financial services from prudent, ethical, sound and sustainable grassroots financial institutions.

The MoFPED over the past few months issued the draft SACCO Bill and Regulations to the public for comments. The proposed bill is intended to regulate SACCOs in Uganda as community based financial service providers. The draft bill recognizes the member-based orientation of SACCOs, and creates further opportunity for integration of rural finance into the formal financial system. Currently, there are two draft bills, one for microcredit organisations and another for SACCOs. The general direction of the Government\footnote{Ministry of Finance and Economic Planning Interview} is to integrate the two drafts to form one law for the Tier IV institutions.
2.4 Gaps in Tier 4 Non-SACCO Regulation

The latest policy and regulatory framework paper recently completed by the State Minister for Microfinance intends to integrate all microfinance institutions outside Bank of Uganda supervision under the Tier 4 law. This category has all institutions that are non deposit-taking such as credit-only NGOs and companies as well as deposit taking initiatives like SACCOs.

With the draft SACCO Law and regulation well into the final stages, the regulatory gaps will soon be more in non-SACCO Tier 4 institutions. The table below highlights gaps in the other major players in Tier 4 (Microfinance Companies and NGOs).

<table>
<thead>
<tr>
<th>Type of Organization</th>
<th>Related Law/ regulation</th>
<th>Limitations in Relation to Effective Regulation</th>
</tr>
</thead>
</table>
| Companies Ltd by Shares and by Guarantee (under the Registrar of Companies) | Companies Act | ▪ The Registrar does not license any of the entities registered with his office. Although financial services business is unique and requires a higher degree of external oversight, the Act does not provide for regulation.  
▪ Provisions for ownership, governance, management, legality of operations and other aspects are generic and do not have specific references to financial or any particular lines of business  
▪ The registrar does not regulate or supervise companies, and has no powers to stop them from operating except on account of engagement in criminal activities |
| Non Governmental Organizations (under NGO board of the Ministry of Internal Affairs) | NGO Registration Act 1989 and (amendment) NGO Registration Act 2006 | ▪ The Act is intended for registration and minimal oversight over NGOs as humanitarian organizations – not for regulation or supervision  
▪ Definition of “organization” S(1) is too generic (makes no mention of financial services) and the Act does not anticipate that NGOs |
<table>
<thead>
<tr>
<th>Type of Organization</th>
<th>Related Law/ regulation</th>
<th>Limitations in Relation to Effective Regulation</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>would get involved in provision of financial services</td>
</tr>
<tr>
<td></td>
<td></td>
<td>▪ Lack of monitoring by the NGO board. Although the amendment of the Act emphasizes the monitoring of NGOs, this is not done in practice</td>
</tr>
<tr>
<td></td>
<td></td>
<td>▪ Revocation of certificate of registration S(10). The conditions provided for revocation of license do not cater for the uniqueness of financial services business.</td>
</tr>
<tr>
<td>AMFIU members and affiliates</td>
<td>Self regulation and consumer education by AMFIU</td>
<td>▪ Optional and does not affect non-members of AMFIU</td>
</tr>
<tr>
<td></td>
<td></td>
<td>▪ Repercussions are only limited to warnings or termination of membership – which do not go far enough in ensuring effective deterrents to inappropriate institutional conduct.</td>
</tr>
</tbody>
</table>

All aspects considered, there is no effective oversight on Tier 4 financial institutions. The above gaps in regulation/supervision have provided conditions for unscrupulous persons to take advantage of the public, purportedly running microfinance institutions. Among the results of this have been:

a. Several NGOs and microfinance companies set up offices, mobilize people, ask them to take savings purportedly as part security for loans they would later be advanced, and suddenly close, leaving poor people who saved with them helpless

b. Pyramidal schemes set up in the name of MFIs, which soon collapsed and several people lost their money

c. Ruthless lending by unregulated MFIs, accompanied by ruthless recovery methods including extreme harassment

d. Gross mismanagement of donor funded MFIs, resulting into collapse of fairly large MFIs and the resultant disruption of the economic activities of their clients

e. Illegal taking of savings from the public by some MFIs, taking advantage of BoU’s lack of personnel capacity to monitor MFI activities in all geographical locations
f. Inept governance of SACCOs and other community owned financial institutions, causing them to collapse and their members to lose their savings.

g. Some MFIs hiding under the guise of an NGO status to escape taxation and other obligations required of financial institutions, while they charge higher than commercial rates of interest and fees on their loans.

h. MFIs collapsing with lots of debt (collateralized savings, bank loans and concessional loans from socially sympathetic wholesale lenders) and no equity.

The above issues need to be taken into account in developing an inclusive regulatory mechanism for Tier 4 institutions.

To further inform the process on the key issues, it is necessary to consider lessons in other countries that have attempted to implement inclusive financial regulation.
3.0 EXPERIENCES AND LESSONS FROM OTHER COUNTRIES

Other countries have had different experiences in their approach to regulation of micro finance business. This section gives summary of the experiences of a few selected countries.

3.1 Ghana

The Bank of Ghana (BoG) is the overall financial sector regulatory authority. The Act’s key provisions include; licensing, operations, sanctions and exit of commercial banks and rural community banks which carry out banking and micro finance operations. The Savings and Loans Companies, (SALC), Cooperative Unions and NGO- MFIs are supposed to be regulated under the Non Bank Financial Institutions Act (NBFIA) of 2004 and the Non Bank Financial Institutions Rules for Deposit-Taking 2000, (NBFIRDT).

Although credit unions are classified in the NBFIA, they are not supervised by BoG because of limited capacity of the BoG. Instead, BoG allows the Ghana Credit Unions Association (CUA) to oversee credit unions (which are the equivalent of Uganda’s SACCOs) as an apex body. These institutions lack enforcement powers, a challenge that the forth coming act is expected to address by increasing their powers. There is an Association of Rural Community Banks and a Ghana Credit Union Association both of which provide minimal oversight to their members. SACCOs in Ghana are doing quite well under the oversight of CUA although they are not regulated prudentially.

The Savings and Loan Companies (equivalent to MDIs in Uganda) are larger MFIs that are licensed and prudentially regulated by BoG.

The Rural Community Banks (RCBs) were also supposed to be regulated by the BoG but they aren’t. Instead, they have oversight by the Association of Rural Banks (ARB), an apex organization of all rural banks. There are 125 rural banks under this umbrella, out of which 20 have been named among the best performing institutions in the country.

NGOs are not regulated, as are informal savings collectors and other smaller organizations.

Constraints facing the provision of microfinance services in Ghana include the following:

- High minimum deposit requirements for banks make it difficult for them to reach the poor section of the market.
- High reserve requirements for RCBs limit available funds for lending.
- Directed, subsidized lending threatens loan portfolios and future self-sufficiency.
- High minimum capital requirements have limited the creation of new SALCs
- Low interest rates for loans and deposits have discouraged savings mobilization and limited portfolio growth for the Credit Unions.
Financial performance of NGOs not strong enough to borrow funds on the domestic money market
Lack of a deposit insurance scheme and credit information service

Lessons:
- Trying to combine supervision and promotion of the institutions under one umbrella usually compromises one or both of these objectives
- Regulation of community based institutions is best done with the involvement of their apex(es).
- Full scale prudential regulation for small deposit taking institutions like SACCOs can become self-defeating – thus such regulation/supervision should be delegated and toned down

3.2 Kenya

In Kenya, the Banking Act 2004 put the whole financial sector under the supervision of the Central Bank of Kenya. Until April 2007, the regulatory environment was not conducive for most MFIs, which opted to stay outside the regulatory scope. The MFIs that wanted to be regulated had to aim at getting a banking license. MFIs in Kenya are registered under eight different Acts of Parliament namely:
- The Non Governmental Organizations Co-ordination Act
- The Building Societies Act
- The Trustee Act
- The Societies Act
- The Co-operative Societies Act
- The Companies Act,
- The Banking Act

Some of the above forms of registrations do not address issues regarding ownership, governance, and accountability. They have also contributed to a large extent to the poor performance and eventual demise of many MFIs because of a lack of appropriate regulatory oversight. The lack of oversight, however, has enabled them to innovate and develop different techniques of providing microfinance services. To stimulate the development of the sector in an orderly way, a microfinance legislation that clearly defines the roles to be played by the Government, the Central Bank of Kenya, and the microfinance practitioners was enacted. The Micro Finance Act was promulgated in December 2006, with the Central Bank as the regulator, and the Central bank drafted the Regulations in April 2007. The Act covers deposit and non deposit taking institutions. With the MFI Act in place, financial NGOs can transform into regulated Deposit taking Micro finance institutions.

The central bank established a Rural Finance Department to address various policy issues concerning rural finance, including microfinance. This Department, in liaison with the Financial Institutions Department, is involved in developing capacity to regulate and
supervise those microfinance institutions that will be licensed under the proposed Deposit Taking Micro Finance Bill.

SACCOS are regulated and supervised under the Cooperative Societies Act amended in 2004. The Commissioner for Cooperative Development is responsible for the organization, registration, operation, advancement, and dissolution of cooperatives. There were 3,767 SACCOS of which 179 were licensed to offer banking services for fixed deposit accounts and checking accounts\(^\text{12}\) and 4 regulated as NBFIs in 2005.

Constraints faced by the microfinance industry in Kenya include; diversity in institutional form, inadequate governance and management capacity, limited outreach, unhealthy competition, limited access to funds, unfavorable image and lack of performance standard. It is envisaged that the Microfinance Act and its Regulations will address these constraints.

Considering the Microfinance Law is a relatively new experience for Kenya, it is difficult to draw lessons at this point. The suitability and relevance of a new law will soon come to test. The limited number of MFIs that have transformed have gone straight for the commercial bank license and managed to do well. The process was, however, quite costly.

### 3.3 Malawi

The Reserve Bank of Malawi (RBM) is the overall regulator of the financial sector in Malawi covering commercial banks and non bank financial institutions. Malawi Savings Bank (MSB), a special purpose Government financial institution which provides financial services to low income and rural citizens, is also regulated by RBM, which views it as a non-bank financial institution with banking privileges. MSB is granted exemptions from complying with certain requirements including lending limits and liquidity reserve requirements.

The microfinance sector is currently regulated by an array of legislative instruments. The NGOs are registered under the Trustees Incorporation Act, the parastatals under specific Acts, private sector microfinance companies under the Companies Act and SACCOS under the Cooperative Societies Act. Most of these instruments are difficult to administer since they are outside the jurisdiction of the Reserve Bank Malawi (RBM). The major microfinance players have a well developed outreach network, but are highly dependent on government subsidies.

\(^\text{12}\) Annual Report of Kenya Central Bank 2005
The majority of SACCOs (51%) are affiliated to the Malawi Union of Savings and Credit Cooperatives (MUSCCO) and therefore subscribe to specified performance standards, policies, procedures and reporting requirements. Each SACCO that is a member of MUSCCO must contribute 0.25% of its monthly savings and outstanding loans to a micro-insurance fund that reimburses SACCOs for unpaid loans in the event of a borrower's death or disability.

The Registrar of Companies is responsible for reviewing annual returns for all companies and the Council for Non-Governmental Organizations in Malawi (CONGOMA) has limited regulatory role over the microfinance NGOs.

The Government passed a Microfinance Policy and Action Plan (2002) which aimed at creating an environment that would facilitate and encourage the adoption of universally acknowledged best practices by the sector. Such a policy framework will ensure that MFIs are operationally and financially sustainable for the long term benefit of clients. Supervision will enforce compliance with a given legal and regulatory framework. A task force headed by the RBM and comprised of the Ministries of Finance, Agriculture and Industry and Trade, the Malawi Microfinance Network and other donors was set up to implement the action plan.

In January 2005, Government set up a wholesale lending apex with initial funds of $7.2m, called The Malawi Rural Finance Corporation (MRFC), regulated by RBM. It lends at below market interest rates through the Malawi Savings Bank. This has an inherent problem of market distortions and maintaining sustainability that undermine the potential for financial deepening.

The sector is largely controlled and influenced by government, and performance of MFIs is very poor: high loan default/delinquency, low institutional profitability/sustainability.

**Constraints:**
- High dependence of institutions providing financial services to rural and low income citizens on government subsidies.
- A considerable number of SACCOs (49%) are not members of MUSCCO, meaning they are not subject to any form of oversight
- Low application of sound practices in the industry, reinforcing weak performance
- Insufficient regulatory oversight of SACCOs under the Cooperative Act

**Lessons:**
- While subsidies are beneficial in introducing financial services to the low-end market, they must be taken with caution so as to ensure the institutions’ sustainability
- Purely credit-driven microfinance, especially with heavy dependence on government subsidized wholesale loans, can lead to stunted industry growth
- Self regulation by a member controlled apex can be supportive to but cannot replace independent prudential regulation
3.4 South Africa

In South Africa, the Reserve Bank is the prudential regulator and supervisor of banks under the Banks Act (1990). It is supported by 2 other Laws:

i. The National Credit Act (NCA) 2005, a consumer protection legislation, under which, the National Credit Regulator (NCR) regulates all organisations offering credit services. The NRC absorbed the Micro Finance Regulatory Council (MFRC), the non prudential regulator for microfinance.

ii. The Financial Services Board (FSB), which is responsible for regulating financial institutions specifically with regard to their conduct in relation to their non-banking services.

There is self regulation (non prudential) with bodies such as the Savings & Credit Cooperative League (SACCOL) for SACCOs, and Financial Services Association (FSA) for village banks,

The Micro Finance Regulatory Council (MFRC) was established in 1999 as non-profit organization as regulators to the South African micro lending industry. The MFRC had a dual mandate in ensuring the sustainability of the industry in providing access to finance for lower income individuals as well as ensuring consumer protection.

The MFRC was also mandated by South Africa’s Department of Trade & Industry to regulate the micro lending industry by virtue of an Exemption to the country’s Usury Act. The Usury Act establishes a consumer protection framework for money-loans and includes a cap on interest rates. An Exemption was created to the Usury Act which provided exemption from the interest rate ceiling imposed by the Usury Act as long as the lending entity is registered with and gets oversight from the MFRC.

The MFRC was established to introduce compliance rules surrounding market conduct. This market conduct includes:

- Registration with the MFRC, followed by annual re-registration;
- Submission of quarterly financial returns by lenders;
- Submission of annual financial statements prepared by an independent accounting officer or auditor;
- Approval of a lenders loan agreement with its borrower; and
- Inspection of lenders’ premises to monitor compliance with MFRC Rules

Central to the MFRC mandate of consumer protection was the promotion of an environment of responsible lending practices. To this end, the MFRC had implemented a number of mechanisms, which were intended to modify micro-lender behavior, and reckless lending in particular. These included the establishment of the ‘National Loans Register’, the introduction of ‘Reckless Lending Rules’ and the performance of ‘Reckless Lending inspections’. The MFRC outsourced a private credit bureau to create a database
(NLR) which use is mandatory on all registered members, a move that reduces both credit and reputation risk in the industry.

Due to the high cost of supervision of numerous small microfinance institutions, the MFRC funded 80% of its operational expenses through member contributions including application fees, annual registration fees, certificate fees, and fines. While also receiving grants from government and donors, the MFRC used these funds for research, regulatory reform, and consumer education and capacity building.

Other core functions of the MFRC were accreditation and compliance, complaints and enforcement handling, investigation and prosecution, education and communication, pursuing unregistered lenders, and information research and policy advocacy.

Under the National Credit Act (NCA), the National Credit Regulator (NCR) took over all the roles of MFRC in June 2006. The purpose of the NCA is to promote a credit market that is fair, transparent, accessible and responsible, competitive and sustainable. The overriding objective of the Act is to protect consumers. It specifically prohibits practices such as reckless lending and automatic increases in credit limits, and regulates interest and fees. The Act covers all forms of consumer credit, including bank loans, credit cards, store cards, pawn transactions, furniture finance and motor vehicle finance.

The Act empowers the NCR to also deal with any contraventions of existing loan and credit agreements. Although the National Credit Act replaced the Usury Act and Credit Agreements Act, the NCR also assists consumers with problems that fall under these previous Acts, and investigates the relevant complaints.

The SACCOs are subject to three regulators:

- The Registrar of Cooperatives is responsible for registering cooperatives and has powers to monitor and inspect cooperatives.
- Cooperatives that are involved in the provision of financial services and hold deposits in excess of ZAR 20 million are also subject to regulation and supervision by a supervisor appointed by the SARB.
- Cooperatives that are involved in the provision of financial services and hold deposits of ZAR 20 million or less are subject to regulation and supervision by a supervisor appointed by the Development Agency for Cooperative Banks.

The major challenge facing South Africa’s microfinance industry is that there is no comprehensive national microfinance policy and the dissolution of the MFRC left the MFIs operating without microfinance specific regulation.
Lessons:
- Microfinance regulation for the lowest tier institutions should look at the whole unregulated financial services rather than narrowly focusing on MFIs. The whole credit market should be subject to some form of regulation to ensure proper integration and consistency.
- For an apex institution to be successful in regulation, it requires backing of the law to enable it enforce compliance, and it needs to draw its mandate from a stronger regulator.
- A special (non-prudential) regulation, focusing on consumer protection and good business conduct, is necessary as the MF industry grows. The laws and regulations should be strong and enforceable though non-prudential in nature.
- To increase attractiveness of the microfinance sector to the upper market lenders, there needs to be a credit reference bureau which helps reduce the credit and reputation risk in the industry.
- Multi-level regulation/supervision based on delegation, as long as it is well documented, organized and understood, can work.
- Network MF organizations have a role in proper regulation.
- A comprehensive national microfinance policy is necessary to support MF regulation.

3.5 Tanzania

Tanzania’s Banking and Financial Institutions Act of 1997 was amended in 2004, expanding Bank of Tanzania’s mandate to include microfinance institutions. Tanzania developed a National Microfinance Policy (NMP) in 2000 to guide microfinance operations. The underlying principles of the NMP are based on sustainability and best practices. The NMP outlines three tools for its implementation:

i) Regulation and supervision
ii) Development and application of standards
iii) Capacity building.

NMP also establishes a best practices framework for all microfinance service providers to extend their services under reasonably similar conditions with respect to quality and sustainability. The NMP assigned Bank of Tanzania the responsibility of ensuring development of a supportive regulatory and supervisory framework.

A national task force and steering committee on MF regulation analysed the regulatory environment including the Banking and Financial Institutions Act 1991, The Bank of Tanzania Act 1995, Cooperative Societies Act 1991 and concluded that there was no need for special legislation for microfinance. In this regard, the Micro Credit Activities Regulations of 2004 were established to create a new category of regulated financial institutions called Microfinance Companies, regulated by Bank of Tanzania. It was felt
that incorporating microfinance into the existing legal framework for the banking system would facilitate integration of microfinance into the broader financial sector, encourage innovation and competition, enable proper harmonization of the regulatory changes with the existing regulatory framework, and minimize possibilities of regulatory arbitrage. It was however found necessary to introduce amendments to selected aspects of the legal framework in order to accommodate special features of microfinance operations.

The microfinance regulations focus on specific risks related to the business of microfinance, promotion of best practices facilitating growth in outreach and depth of pro-poor financial services.

Key aspects of the Regulations include:

- Conditions related to minimum core capital and other licensing provisions, lending limits, capital adequacy, asset quality, and reporting requirements
- A new set of regulations (under the Financial Cooperatives Societies Regulations 2005), which establish the circumstances under which SACCOs become subject to regulation and supervision applicable to banks, taking into account the cooperative principles
- Savings and Credit Cooperative Societies (SACCOs) Regulations 2005: subjecting SACCOs to the cooperative rules, and requiring the Registrar of Cooperatives to apply similar prudential regulations on SACCOS as those applied on microfinance companies.
- Amendments to existing regulations to address Non-Governmental Organizations

Lessons

- The existence of an overall government policy on microfinance prior to the development of the regulatory framework is crucial
- A comprehensive review of the financial laws (including other relevant legislation) should be part of the development of the regulatory framework
- Involvement of key stakeholders (particularly practitioners) from the initial stages of the process is important
- While stakeholder involvement is critical, it is equally important for the process to reside in the relevant government-backed authority
- Effective microfinance regulations should cover all institutional types
- A new law is not always necessary; it is in some cases more appropriate to amend existing laws to accommodate microfinance regulation.
3.6 Sierra Leone

The main financial sector laws in Sierra Leone are the Banking Act 2000, Bank of Sierra Leone Act 2000 and Other Financial Institutions Act 2001. These are supported by the National Microfinance Policy (2003).

The Banking Act 2000 comprehensively provides for regulation and supervision of all deposit-taking institutions by the BoSL. It has clear and detailed provisions for application, licensing, supervision, financial health, prudence in operations & financial management, reporting, restriction/license variation, conservation, receivership, liquidation and termination/closure of licensed institutions. Although in principle MFI can apply for licensing under the Act, none of them is currently regulated under this Act.

The Other Financial Institutions Act 2001 provides for licensing, regulation and supervision of institutions carrying out financial activities other than banking. It covers all other financial service providers of whatever nature but by implication leaves out those that are not cooperatives, companies or statutory bodies. Thus, financial institutions in the country must be regulated by BoSL if they are coops or companies, but those that are registered by the Ministry of Finance, Planning and Development (MoFDEP) as NGOs are outside the loop of BoSL supervision. This has created a bit of confusion which could develop into a bigger problem unless addressed soon. The challenge of this Act is that it seeks to regulate all institutions engaged in financial services. The Bank of Sierra Leone (BoSL) lacks adequate capacity even for normal bank supervision and adding other FIs would ground its effectiveness. Consequently, the country has a well done, redundant law in this Act.

The National Microfinance Policy 2003 (NMP) is a systematic policy document developed by government with its development partners and other stakeholders. The policy aims at developing an enabling framework and helping market led, poverty-responsive and largely accessible microfinance services to flourish. Government’s vision in the policy is to develop and eventually integrate microfinance into the formal financial sector. While the policy is well formulated, however, it came two years after the passing of the Other Financial Institutions Act. The law was therefore not shaped or informed by the policy. The result is a good policy which is in some practical aspects inconsistent with the law, giving rise to some major disagreements between the regulator (BoSL) and the policy makers (MoFDEP). In the meantime (before the issues are resolved and BoSL develops adequate regulatory competence), MFI and community banks in Sierra Leone remain unregulated.

Lessons:
- Never legislate what cannot be regulated, and never regulate what cannot be supervised
- Policy should always precede, shape and inform law making
- Regulator capacity is key in the success of any regulation
3.7 Overall Lessons for Uganda

From the above experiences, we can draw the following lessons for Tier IV Regulation in Uganda:

- Sustainable funding mechanism for regulation needs to be put in place
- Regulation establishment should recognize the microfinance industry’s unique characteristics that often render traditional financial regulation inadequate - including the social mandate, operation in infrastructure deficient areas, high administrative costs due to disbursement and collection of numerous small loans, and diversity of institutional types.
- An independent body needs to be set up with clearly defined powers for the enforcement of rules, regulations, and sanctions for the whole Tier 4
- Owing to the high number of MFIs to be involved, some regulation-related activities could be delegated by the Regulatory Authority to national apexes and other competent institutions
- The board of the regulatory authority should be fully representative of all stakeholders
- It is necessary to include microfinance in the activities of the credit reference bureau
- Keep a keen focus on regulatory capacity during the formulation and implementation of the regulatory law
- Don’t apply prudential regulation to non deposit takers
- Do not confuse MFI regulation with promotion or outreach enhancement; while the two can coexist, regulation does not necessarily mean deeper outreach
- For prudential regulation, avoid licensing very weak institutions that cannot be effectively supervised (for example those that do not have the capacity to produce financial reports and those not able to contribute the stipulated fees to the regulator).
- Regulatory policy should have a single focus, while application of the regulatory function can be suitably delegated to different regulatory units.
4.0 SUITABLE REGULATORY REGIME FOR TIER 4 INSTITUTIONS IN UGANDA

4.1 Rationale for Tier 4 Regulation

The reasons for regulating Tier 4 MFIs include:

- **Safety and soundness of the financial system:** Proper regulation and supervision will ensure that microfinance institutions work in an ethical way while maintaining acceptable levels of financial sustainability, so that they do not disrupt the wellbeing of the financial sector. This will reduce systemic risks on the financial sector.

- **Safety of public deposits:** For SACCOs, more effective regulation is intended to ensure that people’s savings are secure and available when needed. The resulting confidence should increase savings mobilization.

- **House cleaning:** An observed trend is for MFIs to change status and registration so as to escape regulation and supervision by taking advantage of the loop holes in the law. With proper, all embracing regulation and supervision, each institutional type will have to adhere to a specific set of rules.

- **Legitimacy and confidence with customers and investors:** Regulation provides a benchmark of acceptable institutional conduct, which increases certainty and transparency. A well regulated microfinance sector will also help in attracting capital into the sector.

- **Consumer protection:** Some microfinance institutions employ abusive and reckless lending practices to lend and recover money because the clients of Tier IV institutions usually have very limited choice or bargaining power. Regulation is therefore justified for safeguarding the public against unfair lending practices by institutions.

- **Economic development:** The realization of the benefits accruing from microfinance activities to overall poverty alleviation and economic development calls for proper regulatory systems and structures for the sector to effectively foster economic development. Government also hopes for increased outreach to rural areas and increased sustainability of the regulated institutions.
4.2 Prudential Vs Non Prudential Regulation

4.2.1 Prudential regulation

Prudential regulation, in general, aims at protecting the integrity and stability of the financial system. At the consumer level, it is aimed at protecting the safety of public deposits. Prudential regulation involves the regulatory authority setting guiding benchmarks/standards for compliance and verifying the compliance of institutions with them. Among the thematic areas for such standards are core capital requirements, liquidity management, asset quality, solvency, governance, management and license issuance/revocation.

The basic elements of prudential regulation are;

- Authoritative government involvement through the central bank or other mandated regulatory authority
- Regulatory authority ensuring safety and soundness of the financial sector
- Non-optional compliance by all regulated institutions, with penalties for failure
- Annual license renewals, which can be withheld if the regulator is unsatisfied with the financial health or operations of an institution
- Close supervision of the regulated institutions and administration of penalties and other corrective action in cases of errant conduct.

Advantages of Prudential Regulation

- Stronger enforcement powers for the regulator
- Improves the safety and soundness of all regulated institutions, creating public confidence in the financial sector
- Facilitates the process of filtering out institutions that cannot measure up, leaving only adequately strong and sound players in the regulated sector
- Able to realize the positive benefits of regulation including transparency, accountability and financial sector stability.

Limitations of Prudential Regulation

- High costs (including the direct costs to the regulator, supervision costs and compliance costs the institutions)
- Insufficient capacity at any one regulatory body in areas such as mandate, human resources and technological systems to prudentially regulate the whole of Tier 1V institutions.
- Unlikely viability/sustainability of regulation in cases where there are many institutions to be regulated and the regulation aspects are detailed
- Can trigger escape from prudential regulation by some institutions that change their registration status into a category of financial institutions that has weak or no regulations.

Considering the focus, costs involved and other practical modalities in prudential regulation, it is unjustifiable for credit-only institutions. For member-based savings taking institutions like SACCOs, prudential regulation is necessary.

### 4.2.2 Non-Prudential Regulation

Non-prudential regulation aims at ensuring that credit-only MFIs conduct their business in an orderly, transparent and non-disruptive manner that is fair to the clients and non-prejudicial for the health of the rest of the financial sector. It involves far less rigorous measures, is less intensive than prudential regulation and does not require highly specialized skills for oversight. Typically, prudential regulation should simply set rules and guidelines regarding acceptable behavior and business practices in the operation of the financial institutions to protect the interests of clients, and monitor that the institutions comply. This is the type of regulation recommended for the various categories of credit only MFIs.

**Advantages of Non-Prudential Regulation**

- Low costs of operationalization
- More realistic, viable, and sustainable especially for credit-only institutions
- Places less demand on capacity requirements for the regulator

**Limitations of Non-Prudential Regulation**

- Less pronounced enforcement powers for the regulator
- Focuses less on ensuring the safety and soundness of the institutions, only increases transparency and fairness in business dealings
- Questionable ability to achieve the positive effects of regulation due to weaker mandate

In the case for Uganda, the Tier IV law under consideration should stipulate non-prudential regulation of credit-only MFIs. Adopting prudential standards for credit only MFIs would mean unnecessary strain on the regulator, unwarranted compliance burdens on the supervised institutions and possible eventual failure of Tier IV regulation. On the other hand, some form of “abridged” prudential regulation is necessary for the SACCOs. This should ensure compliance with a few core indicators such as capital, liquidity, asset quality, governance and management.
4.3 Regulatory Capacity Issues

The capacity of the regulator is an important issue in to be considered because it has to match the type and scope of regulation. Important issues in this regard are the technical capacity, cost considerations and the extent to which regulatory authority should be centralized, decentralized or delegated.

4.3.1 Technical Capacity and Cost Considerations

In assessing the technical capacity and cost implications of regulation for microfinance, the following key questions should be addressed:

- Does or should the supervisory authority have dedicated staff assigned to the supervision and examination of the microfinance sector? In this case the regulatory authority is yet to be established and thereafter it needs to develop both the regulatory and microfinance industry competence capabilities (like acquaintance with MF operational methodologies, analysis of MF financial and operational reports based on the industry standards, appreciation of the different MFI types and knowledge of the key MF risk areas).

- What is the comparative workload (number of licensed institutions and number of days needed to complete onsite and offsite examination or supervision)? There are 1,383 SACCOs\(^{13}\) country wide and 191 Microfinance Companies and NGOs\(^{14}\). How effectively can these all be covered by close supervision? Unless a creative methodology (including delegation and efficiency focused supervision methods) is worked out, regulation will be practically difficult.

- Is there adequate accounting and auditing capacity and mechanism for all the institutions to be regulated? For proper implementation of regulation, a critical issue is how to establish adequate accounting and auditing to ensure accuracy and prudence in their financial reporting.

- Is it possible to estimate and compare the costs and benefits associated with regulation of microfinance, and are the costs justifiable? This will have to be worked on by the regulatory authority. The regulatory regime recommended in this study aims to minimize costs while maximizing regulatory effectiveness.

- Are the deposits substantial enough to warrant prudential regulation? According to the July 2008 SACCO data from UCSU, the national total of members savings and share capital was given as 59.7bn and loan portfolio as 51.7bn. Prudential regulation is justifiable for SACCOs in view of the aggregated level of savings. Given that the savings volume is spread among 1,383 SACCOs, however, the average savings volume per SACCO is Sh 43.2 million – too low for meaningful application of full

\(^{13}\) Statistics from UCSCU

\(^{14}\) Tier IV Census Report - 2006
scale prudential regulation. A somehow toned down version of prudential regulation, based on the revised PMT, will do for SACCOs. Loan Insurance Funds (LIF) or “compulsory savings” held by the non-SACCO MFIs, on the other hand, have less risk if linked to loans. Experience in Uganda, however, has shown that unscrupulous people find loopholes in the law to capture deposits with a promise of a loan only to disappear with their money without giving the credit. Checking this needs non-prudential regulation involving both enforcement and persuasion-based approaches.

- Does the regulatory authority require the institutions to pay for the costs associated with examination and supervision? If so, what charges are to be imposed? In South Africa, the institutions regulated contribute substantially to the costs of regulation. In Uganda, full cost of regulation should initially be borne by Government.

Design of microfinance regulation should not proceed very far without estimating supervision costs realistically and identifying a sustainable mechanism to pay for them. A core principle is not to issue regulations that cannot be realistically enforced. Bank of Uganda undertook substantial capacity building efforts for over five years to prepare for supervision of a limited number of MDIs. Recognizing the much greater problems in dealing with the large number of Tier 4 MFIs there is need for relevant capacity building for the potential regulator. For cost effectiveness, the capacity of the potential Tier 4 could be built in part BoU.

A well designed strategy will balance the nature and extent of supervision required, the capacity of the potential regulators and the attendant costs in relation to benefits.

### 4.3.2 Delegated Supervision

Delegated supervision refers to a situation where the country’s main regulatory authority delegates direct supervision of an identified set of institutions to a body or agency outside of itself. The regulatory authority then monitors and supervises the regulatory agent’s work.

In Ghana, a delegation approach to supervision has been prescribed by legislation. Under the framework, the Bank of Ghana is to delegate its responsibility to the Cooperative Unions’ Association CUA) to supervise SACCOS and rural community banks, with the costs of regulation are borne largely by the members. In practice, however, CUA non-prudentially oversees SACCOS based on its norms and code of conduct for members. If this approach were to be chosen, will be critical to address the following questions:

- Who bears the costs (which may be substantial) of the delegated regulatory/supervisory agency and the additional costs of the main supervisory authority’s oversight? *(We recommend government does)*

- Should the delegated or auxiliary supervision arrangement prove to be unreliable or ineffective, and should the mandate to the delegated or auxiliary supervisory agency
need to be withdrawn, does a realistic and practicable fallback exist? *(Not yet, in Uganda’s case)*

- In the event that a supervised institution fails, which agency—the main or delegated supervisory agency - will have the authority and capability to clean up and rectify the situation? *(Delegated agency in this case)*
- Does a delegated or auxiliary supervisory agency bear any legal liabilities in the exercise of the delegated or auxiliary responsibilities? *(Yes)*

### 4.3.3 Credit Reference Bureau (CRB)

This is a service that should support regulation. CRB allow borrowers to build up a credit history and can assist lenders in cost-effectively assessing risk. Credit registries that give easy and reliable access to a client’s credit history can dramatically reduce the time and costs of obtaining such information and therefore facilitate cost-effective financial intermediation. To further assist Tier 4 regulation, the MFIs should be helped to join the already established CRB.

### 4.4 Review of the Proposed Laws

Through MOFEPD, Government has drafted a prudential regulatory framework for SACCOs and a Micro-Credit Act for non-deposit taking Tier IV institutions. Parliament’s preference now is for a single bill covering all Tier 4 financial institutions. This necessitates combining the proposed SACCO Bill and the proposed Micro Credit Bill into one. A combined law would be cost-effective and could potentially be more effective in regulating the industry than would two separate laws. The combined law will of necessity have two different sets of provisions – one for SACCOs and the other for non-SACCOs. This subsection examines the proposed laws in the context of the SACCO and the non-SACCO portions of the overall Tier 4 Microfinance Bill to be prepared.

#### 4.4.1 Micro Credit Bill

*Focus of the Draft Bill*

The draft bill seeks to bring credit-only microfinance institutions under regulation and supervision. The main aim is to minimize incidences of fraudulent persons fleecing the public under the guise of opening MFIs, taking public savings disguised as loan guarantee/ loan insurance funds and disappearing with them. Many such institutions have sprung up since the late 1980s and taken advantage of poor people. Prevention of such incidences is a good enough justification for the proposed laws to govern Tier IV MFIs.
The draft Micro Credit Act was intended to apply only regulation of non deposit taking Tier 4 institutions. The draft Act establishes the fundamental legal principles regarding the undertaking of micro-credit activities. The draft defines a borrower as an individual/legal entity that is the owner or potential owner of a small scale business under the laws of Uganda. It also defines micro credit as the funds extended by a micro credit organization to the borrower in the amount under the procedure specified by this Act. It defines micro credit activities as those legal activities which involve micro lending in an amount not to exceed one stipulated in the Act.

**Key Provisions in the Draft**

a. A law to establish legal principles under which non-SACCO Tier 4 MFIs will operate – prescribing the size, procedure and acceptable conditions for micro lending, the range of activities NDFIs would be allowed to engage in, licensing, supervision and procedures for establishing NDFIs

b. Rights and duties of the NDFIs

c. Rights and duties of the borrower

d. No profit or earnings motivation by an NDFI (implying that private, profit motivated companies doing microfinance will either be outside the regulation loop or be closed down)

e. Limit of the NDFI liability to the extent of its assets (basically putting lenders to the NDFI at risk and absolving erring NDFI incorporators, directors and managers of any liability)

f. A “Pooled Reserve Fund” to be contributed to by all NDFIs, for purposes such as boosting the sustainability of NDFIs and protecting their interests

g. Insurance of NDFIs’ inherent risks

h. A regulator of NDFIs to be appointed by the Government; the regulator to be responsible for setting the regulations for the supervision of NDFIs

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15 This definition will be to be reviewed. A borrower does not necessarily have to be an SME owner
Although the draft Micro Credit Act explains the above issues, it does have a few salient issues that need to be agreed upon before it is enacted to become a law. The table below summarizes the key strengths and weaknesses of the draft.

**Table 5: Strengths and Weaknesses of the Proposed Bill**

<table>
<thead>
<tr>
<th>Strengths</th>
<th>Weaknesses</th>
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<tr>
<td>Good attempt, showing that Government and stakeholders take the semiformal financial sector, outside of SACCOs, seriously</td>
<td>Incoherent in some aspects (like the definition of a micro borrower) and most ideas in the draft do not seem to be fully thought through and developed (like the requirement for a board of directors under the draft while the NGO Statute requires a board of trustees).</td>
</tr>
<tr>
<td>Proposes to restrict NDFIs from engaging in activities which are detrimental or harmful to stakeholders</td>
<td>Tries to restrict the objectives of NDFIs only to supporting MSMEs – this is not necessary and cannot be easily monitored</td>
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<td></td>
<td>The liability provisions would encourage wayward behaviour by insiders of an NDFI and penalize lenders thereof in cases of bad management or misconduct</td>
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<tr>
<td></td>
<td>Narrowly defines NDFI (to be regulated) as those MFIs that are not-for-profit in focus, thus potentially leaving out or creating a loophole for many MFIs to opt for a private company (for-profit) status and escape regulation</td>
</tr>
<tr>
<td></td>
<td>No clear definition and the actual size of a micro loan and the definition of a deposit taking institution</td>
</tr>
<tr>
<td></td>
<td>The powers, rights and duties of the proposed regulator have not been proposed, and thus the proposed type and scope of regulation is not defined</td>
</tr>
<tr>
<td></td>
<td>The draft does not explain the concept of the Pooled Reserve Fund in sufficient detail</td>
</tr>
</tbody>
</table>
Overall, the draft bill is still very sketchy and basic. It will need to be substantially enriched and revised to guide the process of formulating the law. Among the areas that will need to be included or adjusted in the document are:

a) The “credit only” MFIs should be renamed “Non Deposit Financial Institutions (NDFI). This will clearly distinguish to the public between SACCOs and credit-only MFIs.

b) Directors’ responsibilities, liability and consequences of inadequate governance - There should be adequate collective and personal responsibility and liability of directors and managers for their errors, omissions and misconduct that affect the institution and its suppliers negatively.

c) Clear statement on the nature and types of institutions to be covered by the law – we propose that it should cover all dealers in financial services outside the banks, credit institutions and MDIs.

d) Proper definition of a micro loan and micro borrower - The current definition is skewed and covers only a portion of potential micro borrowers (we propose “a micro loan is an amount of loan, credit or other debt advanced to any person by an NDFI” and “a micro borrower is any person or persons that take a loan or advance from an NDFI”)

e) Drop the idea of stating the maximum amount of a micro loan in the Regulations - This would limit the retention of growing MFI clients who need larger loans. Additionally, such a cap will limit the MFI’s ability to mix poor and not-so-poor clients to achieve sustainability.

f) Restrictions of NDFIs from taking savings – this should be very clear and no NDFI should be allowed to take people’s savings, purporting they were to be collateralized for loans, unless it has paid up capital, represented by actual cash in the bank(s) in prescribed types of deposits, matching the loan amounts to be applied for (using a multiple based on the proportion of mandatory savings/LIF to the loan amount)

 g) Remove the requirement that NDFIs to be regulated will be strictly those with a non-profit focus. This Act, to be very effective in protecting financial service consumers, should cover all the financial service providers not included in other legislations.

h) Stipulate minimum initial paid up capital for an NDFI to be licensed, and ongoing capital requirements in relation to both the loan portfolio and total book value of assets. We propose at least 15% of loan portfolio and at least 10% of total book value of assets.

i) Further articulate the governance structure of an NDFI (we propose the Board reports to the AGM or to trustees, whichever the case might be)

j) The Act should prohibit any institution from dealing in financial services (defined as the giving of loans, taking of savings, money transfers etc) without being licensed.

k) This Act should repeal the Money Lenders Act and bring money lenders under it.

l) Replace “charter” with constitution” or “memorandum of association” in the draft.
m) On governance, legislate the board rotation and maximum office holding for a director. Further, spell out broadly the minimum qualifications of directors (age, aptitude, competencies, integrity based on previous performance)

n) Stipulate practical provisions for effective and affordable audit services for NDFIs

o) Introduce a requirement that NDFIs have cash reserves in special accounts that at least equate to the LIF they have taken from their borrowers

p) A provision that no clause in this Act will not in any way affect the applicability of the MDI Act 2003 and the Financial Institutions Act 2004.

q) Provide for the regulatory authority’s right to suspend, remove or otherwise discipline directors and managers of NDFIs

r) Create a provision for revocation and suspension of the license

s) Stipulate the minimum financial records that must be kept and financial reports that must be produced by NDFIs

t) Include a clear provision for the structure and modality of supervision

u) Include provisions on receivership and liquidation (we propose the regulatory authority should be responsible)

v) There should be a lead period, starting from the date the bill becomes law, for existing NDFIs to comply (we propose 12 months).

w) The NGO Registration Act (Amendment) 2006, S(7)c requires the NGO board to guide and monitor NGOs in carrying out their services. There is need for harmonization between the supervisory roles of the NGO Board and those of the proposed regulator for NGO-MFIs

### 4.4.2 Draft SACCO Bill

Government intends to have SACCOs regulated as community financial service providers. The draft SACCO law recommends that “a SACCO be registered as a cooperative society owned and operated by and for its members in accordance with democratic principles for the purpose of encouraging savings and extending loans to members at reasonable rates of interest.” The draft also proposes that a separate corporate body be set up to be responsible for licensing, supervising and regulating SACCOs. The draft SACCO bill, which should now become part of the Tier 4 MFI Act has been fully drafted and is at a more mature stage than the draft Micro Credit Bill

The key provisions of the SACCO Bill are:

a. Registration to remain under the MTTI and prudential regulations to be undertaken by the SACCO Regulatory Authority

b. SACCOs would have between 6 and 24 months after the law is passed, to comply

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16 We now propose this should become “Tier 4 Microfinance Regulatory Authority” under the combined law.
c. There will be a regulatory authority responsible for licensing, enforcing compliance, collecting and publishing performance statistics and advising the Minister of Finance, Planning and Economic Development on SACCOs

d. No SACCOs will be allowed to operate without a license

e. For the purposes of regulation and supervision, SACCOs are to be categorized in four groups, A to D\(^\text{17}\)

f. SACCOs will be allowed to intermediate deposits only among their members, and to serve non-members through non-core activities like money transfers

g. There is a provision for liability of members, under which the draft explains governance issues like AGMs, voting rights and other meetings\(^\text{18}\)

h. Strict governance and management provisions on board membership, board responsibilities, qualifications of a board member, disciplining of board members, annual audits and SACCO committees

i. Treatment of equity/share capital

j. Loan operations including restrictions on insider borrowing

k. Maintenance of equity (“institutional capital”) at or above 8% of total assets at all times

l. Investments in non-core activities to be limited to 5% of the aggregate of the SACCOs institutional capital, and investments in fixed assets to be kept at or below 5% of total deposits

m. SACCOs will be required to deposit 10% of their liquid assets into a Central Finance Facility managed by a national association of SACCOs

n. To be licensed, SACCOs have to be members of a national association of SACCOs

o. Liquidation procedure in cases of insolvency (although the draft is short in stipulating non-liquidation distress management situations like receiverships)

The draft SACCO law could further be improved by addressing the following issues:

- Merge it with the draft Micro Credit Bill to form the Tier 4 MFI Bill
- Extending the minimum qualifications set for positions like posts like chairperson, treasurer and secretary to the entire board membership
- Non-members should not be eligible to have access to any financial services provided by SACCOs

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\(^{17}\) Our advice is that this categorization is not suitable: assets of any SACCO fluctuate widely in value according to seasons and thus they are not a good yardstick for classification; asset based classification, meaning higher rated SACCOs are more intensely supervised, would be a disincentive to assets accumulation by SACCOs; the poorer people who save with smaller SACCO need just as much safety of their savings as those saving with the bigger SACCOs.

\(^{18}\) This should change so that under Liability of Members, the draft stipulates the limit and extent of liability of SACCO members for the debts of the SACCO (should be limited to paying up the allotted share capital)
• Remove the proposed categorization of SACCOs for regulatory purposes, so that all SACCOs are subjected to similar levels of supervision and oversight
• Stipulate the limit of liability of the members of a SACCO
• Fix the maximum lead period between the law being passed and all SACCOs complying to a maximum of 12 months – not two different dates as proposed at the moment
• Change the regulatory authority’s name to “Tier MFI Regulatory Authority”
• On SACCO Management and Administration (Part IV of the draft), the prohibition from becoming a SACCO director should be extended to anyone convicted under any financial services law (not just the SACCO law) and to persons who have served on a board of any liquidated or failed financial institution, not just SACCOs
• State the responsibility and home of the proposed SACCO Audit Fund and broadly indicate the contracting/working mechanism for this.
• In addition to the stated roles of the NAS, it should also be tasked with collecting financial and operational performance information (through regional offices) and sending them to the regulatory authority.

4.5 Recommendations on General Issues

The specific issues to be addressed by the Tier 4 MFI Bill (which should combine the current draft SACCO Bill and draft NDFI Bill into one) have been identified under subsections 4.4.1 and 4.4.2 above. In addition, there are more general or overarching issues to be addressed. These are outlined below:

4.5.1 Policy Framework and Regulatory Authority

The current policy\textsuperscript{19} favors a holistic approach to provision of microfinance services. In view of its regulation/supervision objective, the policy is the front runner of the proposed financial sector law(s) outside of the FIA 2004 and the MDI Act 2003.

In line with the policy, Tier 4 MFI Act should cover both SACCOs and credit only MFIs. Registration of the different institutional types should continue under the current legal and administrative arrangements, while licensing of all these institutions (a new mandatory requirement) should be done by a single regulatory authority. To achieve the objectives of the policy, the Tier 4 law needs to cover all providers of financial services that are not regulated under the FIA 2004 or MDI ct 2003.

\textsuperscript{19} Microfinance Policy and Regulatory Framework in Uganda 2005 - 2015
The following aspects therefore need to be considered:

- Given the stated need for an integrated approach, the law should cover both prudential and non-prudential regulation, the former for SACCOS and the latter for all non-SACCOS.

- The law should have two distinct sets of provisions one for SACCOS (stipulating prudential regulation) and the other for non-SACCO (stipulating non-prudential regulation). The starting point should be to combine the existing draft bills into one, and to improve them as proposed under subsections 4.4.1 and 4.4.2 above.

- One regulatory authority (the Tier 4 MFI Regulatory Authority) should be set up for enforcing and monitoring compliance. The regulatory authority should, after the enactment of the law, develop two sets of regulations – one for SACCOS and the other for non-SACCO MFIs.

- The regulatory authority should use the PMT for monitoring and the institutions should use the PMT for reporting. This tool was revised to make it more applicable to both SACCOS and non-deposit taking MFIs, and is currently in use by majority of MFIs including SACCOS.

- All providers of loans and other financial services who are not regulated under the existing laws should be brought under this law – including money lenders

- Explicitly prohibit dealing in financial services (deposits and/or loans) for institutions not licensed under the law, unless they fall under MDI Act or FIA.

- Stipulate the maximum size in terms of capital base, loan portfolio and numbers of clients/members served, beyond which a SACCO or NDFI must transform into a higher level tier.

- This law should repeal the Money Lenders’ Act (1952)

The regulatory authority will need to have a suitable home, competent management, some operational linkages with BoU (through mentoring by the BoU MF Supervision Unit and a board with representation of Tier 4 financial apexes, BoU, the microfinance sector and whose membership is screened by the Bank of Uganda for fit and proper testing.
4.5.2 The Regulations

Regulations give more details on how to implement the law. They are easier to change and do not need a change in the law. While this assignment was not meant to go to the level of suggesting components of regulations to be developed under the law, there are some few key areas of regulation that are worthwhile mentioning. They are highlighted below:

Management of the LIF
The institutions interviewed during this assignment proposed that MFI’s keep the LIF as fixed deposits in prudentially regulated financial institutions. This is also the requirement under the MDI Act and although the MDIs criticize the requirement for limiting their loan funding sources, it has ensured that LIF deposited by clients are secure – which is one of the primary aim of Tier 4 regulation.

Licensing Fee
During the field survey, a number of institutions expressed their favor for a renewable license arrangement. Under this all Tier 4 licenses issued would be renewed annually. This has an advantage of affording the regulatory authority the option not to renew a license for non compliant institutions.

Micro Insurance Premium
The law should state the agency role of the MFIs in insurance – the MFIs should not play the role of principal insurers since they are not licensed to carry on insurance business. Currently, some MFIs charge insurance premium and just keep it to themselves. The law should state where the insurance business falls, for both operations and regulation. Insurance premiums collected should be remitted to the respective insurance companies, which are regulated by the Insurance Commission.

Regulating New High-tech Products
Advances in ICT have started posing challenges to financial regulators, including BoU. Regulators need to have tools and mechanism to enable them to respond quickly to the fast growing new products which can pose a big risk in a short time. An example is the mobile phone money transfer mechanisms that are fast growing, but operating completely outside of the recognized financial sector. It is conceivable that in the near future, these mechanisms might be used for lending and loan repayments. It is necessary that this law includes provisions for such, and that both the FIA 2004 and MDI Act 2003 are revisited in view of the developments.

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20 This does not refer to the LIF. Rather, it refers to the 1% or 2% insurance premium often charged by MFIs for compensation in case the client dies or gets permanently incapacitated.
Provisions for public limited liability companies:
There are cases in Uganda of microfinance institutions that are operating as public limited companies in order to attract more share capital and intermediate savings among its members. Some of these do not want to become cooperative societies and yet they would like to retain the advantage of being able to intermediate savings. Government should explore two possibilities with the regard to these:

i) Amend the MDI Act so that it can cover large public companies in the business of microfinance

ii) Require such companies to either become non-deposit taking or convert either to MDIs or SACCOs

In Bangladesh, the Grameen Bank is a hybrid institution which was established by the Grameen Bank Ordinance of 1983. Its objective is to provide credit and other financial services to poor landless people especially in rural areas whereby the borrowers, had an ownership stake in it. Whereas 15% of the shareholding was held by the Government, 85% was set aside for the borrower shareholders. Additionally, the law provided for them to have 9 out of the 11 board membership and had special provisions outside the Banking Companies Ordinance of 1962, such as establishing its regulations, submitting returns to Government and tax exemptions. This example of a law to establish the status of just one institution can work for a very large institution like Grameen Bank but not for small institutions like the public companies we are talking about in Uganda.
4.5.3 Proposed Regulatory Structure

The figure below presents the proposed regulatory structure for the Tier 4 institutions.

*Figure 1: Proposed Regulatory Structure*
The above structure agrees with the Microfinance Policy (2005-2015). The policy among other issues states that regulation of Tier 1V institutions should contribute towards sector integration. Tier 4 regulation should therefore consolidate the two draft laws and close loopholes that can be used by unscrupulous people to perpetrate misconduct.

As already stated, this report recommends one law to cover both Tier 1V deposit-taking institutions (SACCOS) and non-deposit taking Tier 1V institutions. The draft SACCO Bill and draft Micro-Credit Act should be amalgamated and improved.

This framework will be overseen by the Ministry of Finance, Planning and Economic Development to which a single Regulatory Authority will report. The Regulatory Authority’s duty will be to license, monitor, and supervise Tier 4 MFIs and to ensure their compliance with the law and regulations.

The regulatory authority should have a representative board with members from the Bank of Uganda, MTTI, UCA, UCSCU and AMFIU, Tier 1V institutions and consumer representatives.

While all Tier 4 institutions should be regulated under this framework, the larger ones should be supervised directly by the Regulatory Authority while the rest should be supervised by the national associations under delegation from the Regulatory Authority. The following scheme could provide indicative guidelines in this regard:

- SACCOs with either USh 100 million or more in combined savings and share capital, a gross asset value of USh 300 million or more, or more than 2,000 members should be supervised directly by the Regulatory Authority; the rest should be supervised through the national association of SACCOs

- NDFIs serving more than 5,000 people and/or with gross asset value of more than 500 million or more than five branches/service points should be supervised directly by the Regulatory Authority; the rest should be supervised through the national association of MFIs

For the SACCOs, the regulator can sub-contract institutions like national apexes through their regional branches or other microfinance-knowledgeable agencies at the regional level, to which all SACCOs will send their mandatory periodic reports for onward submission to the regulatory authority. These will be a minimum set of vital information consistent with SACCO norms and microfinance sound practices – based on the PMT. Having the information collected regionally is to ensure that the attendant costs are minimized and that there is an effective interim check before the information goes to the regulatory agency.

Under the non deposit taking institutions, the national association of MFIs (which may work in conjunction regional agencies can be sub-contracted) to gather information, analyse it and submit to the Regulatory Authority.
The choice of sub-contracted institutions should be made after the regulatory authority conducts a capacity audit of all eligible institutions to establish capacity for each institution, gaps and the cost of closing them. It is critical that the Bill clearly spells out the responsibilities and liability for non-regulation, improper or under-regulation in cases where the regulator has been mandated by the law to delegate some of its activities or functions. Ideally, the Regulatory Authority should retain full responsibility as far as MoFPED is concerned. It should be the Regulatory Authority, in turn, to ensure that the association, as an agent of the Regulatory Authority, does its work with full diligence and care.

It is proposed that the current Performance Monitoring Tool, (PMT), be used for all Tier IV institutions reporting under the Act. The PMT is compatible with reporting requirements of both types of institutions (SACCOs and credit-only MFIs). The national association of MFIs should collect all NDFI performance information in PMT format and submit to the regulatory authority. The national association of SACCOs should do the same for SACCOs. In doing this, the two associations should screen the reported information and confirm them to the regulator at a minimum cost, even electronically on a regular basis. This role for the association is natural and does not conflict with their other roles as national networks. Based on the warning signs and watch lists of the SACCOs and credit-only MFIs, the regulator can organise on-site visits and even request the Bank of Uganda to make an inspection when necessary. This would be a practical way of using the proposed law and the FIA 2004 in harmony.

For the purpose of regulation, all SACCOs in the country should be required to affiliate to the national SACCO network chosen by the Regulatory Authority. Similarly, all NDFIs should be required to affiliate to the chosen microfinance national association. The recommendation in this paragraph only refers to the mandatory affiliation for the sake of regulation. This should not affect additional affiliation based on preference and value addition that the SACCOs and NDFIs may which to have with these or other associations.

With all the above in place, all financial institutions will be covered by at least one regulatory law. Activities of each financial institution will in some way be monitored to ensure they are ethical and not detrimental to sector stability. There will be capacity issues for the regulator, which is why delegation of information collection and screening to regional agencies is proposed. The overall focus should be to reap the advantages of regulation at affordable costs.
PROBABLE EFFECTS OF THE REGULATING TIER 4 INSTITUTIONS

The following subsections discuss the probable effects of regulating Tier IV institutions – exploring the potential results of taking up the recommendations given in section 4.4. The term regulation is used broadly, referring to both prudential and non-prudential forms proposed in the draft laws, adjusted in view of the recommendations made in section 4.4 of this report.

Effects on the Financial Sector

*Enhanced financial sector stability and public confidence in it* - Regulation of microfinance institutions will close regulatory gaps and foster orderly development of the financial sector. There will be less incidences of public rip-off by unscrupulous people due to a regulatory vacuum. In identifying the better performing institutions, formal financial institutions are likely to have more confidence in SACCOs and MFIs once they are regulated. These linkages and disciplinary conduct should boost financial sector cross-businesses and linkages.

*Graduation of more microfinance institutions to higher tiers* - Regulated MFIs will improve professionalism and hopefully boost profitability. Mandatory compliance to regulatory requirements could eventually prepare a few of these institutions for graduation into higher tiers.

*Availability of accurate information on the financial sector* - Regulation of all the major players in the Tier 4 will enhance availability of accurate information on key information and statistics on the financial sector. This will be good for national planning and for stakeholders who work with financial sector institutions.

*Integration of the financial sector* - Regulation of all Tier 4 MFIs will increase the level of integration of the financial sector.

Effects on the Tier 4 MFIs

The effects to the regulated institutions may include:

*Improved Governance and Management* - For a financial institution, good governance is the fundamental requirement from which all the other institutional strengths flow. A well balanced, diversified and sufficiently skilled board will usually put in place management, require systems and exercise oversight that ensure that operations are run in ways that enhance profitability and safety. Like the case with governance, if the regulator vets the top management of the institutions, professionalism in operations will be improved.
Accuracy in Reporting - Regulation will enhance prudence and accuracy in financial reporting. To external stakeholders, regulation will make both operational and financial reporting by MFIs far more reliable.

Improved performance - Although there may be reduced profitability in the short run as institutions put in place systems to comply with the regulations, there is bound to be eventual improvements in financial performance.

Better Product Offering to Clients - Additional products could be developed resulting from exposure to other financial institutions (from increased integration of the financial sector) and the institutions’ own drive for business growth. In this sense, regulation may make MFIs more responsive to clients.

Outreach - The number of clients may increase as a result of increased public confidence and availability of more funding from wholesale lenders. On the down side, however, rural outreach could somehow slow down (at least initially) considering the institutions may be more focused on sustainability. The experience of MDIs has not proved that prudential regulation is a reliable route to improved rural outreach. This downside possibility is somehow addressed by the fact that Government now proactively supports a SACCO in every sub county.

More funding sources- A well regulated microfinance sector will help in attracting increased funding into the sector. This will be as a result of increased trust and confidence with local and international wholesalers of funds.

Costs of operation – Whereas additional costs of compliance are bound to set in, eventually other operating costs are likely to go down because current high costs are largely attributable to inherent inefficiencies among MFIs.

Effects on Clients

Costs of borrowing – Could initially increase slightly due to increased compliance costs and eventually go down due to improved transparency, efficiency and competition.

Consumer protection and awareness - will be enhanced due to regulatory requirements of disclosure. Reduced confusion about which financial institution offers what, at what costs and terms will help clients to make more informed choices. With regulation, consumers will also have better access to complaint mechanisms and legal redress.

Improved service quality - There will be improved systems and efficiency leading to reduced delays in loan disbursements, loan processing and the overall transaction time in the regulated institutions. Customer care may also improve since MFIs will be professionally run.
Effects on Other Stakeholders

*Government* – is likely to realize a more organized set up for provision of inclusive financial services, which has for long been its objective

*MFI networks* – Should have a more organized membership from which information is more easily obtained, thus strengthening the MFI networks

*The Tier 4 Regulator* – Likely to be overwhelmed with work initially, might eventually work out ways to efficiently carry out its mandate. Logistics and practicalities for supervising more than a thousand institutions spread all over the country will be a big challenge. Therefore, the regulatory authority should take a phased approach and adopt cost effective methods of operation like those proposed in the section 4.5.1 and 4.5.3.

*Bank of Uganda* – Will find itself in a slightly better position as the Tier 4 regulatory Authority will be a good complement to its efforts in further organizing the financial sector

*Donors/ Development partners* – will find their work somehow easier because of ease of information access and streamlined operations among Tier 4 MFIs
APPENDIX I: LIST OF RESPONDENTS

Henry Mbaguta  Assistant Commissioner – Microfinance - MoFPED
Lance Kashugyera  Coordinator - Rural Financial Services Strategy
Prossy. T. Bahiigwa  Research & Development Officer - MSC Ltd
Wilson Wamatsembe  Capacity Building Manager - MSC Ltd
Peter Kabanda  Project Officer - Oiko Credit
Saliya Kanathigoda  Programme Advisor – German Technical Cooperation
Grace Kasisira  Deputy Director - NBFIS - Bank of Uganda
Enid Kiiza  NBFI Department, Bank of Uganda
Edward Nsereko  NBFI Department, Bank of Uganda
David Baguma  Executive Director - AMFIU
Solomon Kagaba  Operations Manager - AMFIU
William Steel  Adjunct Professor, University of Ghana, and former Africa Region Specialist on Rural and Microfinance, World Bank
Patrick Mumba  Head of Audit Supervision - UCA
Wilson Kabanda  Manager - UCSCU
Ben Eyabu  Product Development Manager - Centenary Bank
Florence Soro  Ag. General Manager - UGAFODE
Edward Kiyaga  Business Development Manager – MED-Net
Jennifer Mugalu  CEO- PEARL Microfinance Limited
Eve Nangendo  Operations Manger - SUCCESS Microfinance Limited
Emmanuel Kimbowa  General Manager - GATSBY Microfinance Limited
Sam Onyee Oyo  Ag. GM - Northern Recovery Microfinance Services Ltd
Dan Matovu  Manager - Micro Uganda Ltd
Amon Ndyamuba  Ag. GM - Rubare Modern Rural Savings & Credit Association
Joseph Zabasajja  General Manager - MAMIDECOT
George Odira  Manager – Pader Branch - Agaru SACCO
Charles Isingoma  General Manager - Hoima Fort Portal Kasese Microfinance
Annet Muwonge  MFO - Eastern Private Sector Development Company Ltd
Okalebo David Onyoin  CEO - Teso Private Sector Development Centre Limited
Kensita Sharon  Microfinance Advisor - South Eastern Private Sector Promotion Enterprise Ltd
Nelson Tasenga  CEO - Acholi Private Sector Development Company Ltd
Edward Mukanya  Microfinance Officer - Masaka Private Sector Dev’t Co. Ltd
APPENDIX II: LIST OF DOCUMENTS REVIEWED

1. Microfinance Regulation in Seven Countries: a Comparative Study  *(Sa-Dhan Microfinance Resource Centre-2006)*

2. Regulating and Strengthening Tier IV Microfinance Institutions in Uganda *(AMFIU-2005)*

3. Regulation: The Conventional View V Poor People’s Reality *(CGAP/MicroSave – 2000)*


6. Financial Institutions Act 2004

7. The MDI Act 2003

8. The Companies Act,1961


10. The Cooperative Statute 1991

11. Draft SACCO Bill *(MoFPED -2007 )*  

12. Draft Micro credit Bill *(MoFPED - 2008)*


15. Uganda Microfinance Industry Assessment *(FRIENDS Consult, AMFIU – 2008)*


18. A Study of the Microfinance Sector Capacity Building in Sierra Leone *(Andrew Obara & Poul Iben Hansen, EU/Bizclim - 2008)*
<table>
<thead>
<tr>
<th>Key Issue</th>
<th>SACCOs</th>
<th>Micro Finance NGOs</th>
<th>Companies and NGOs</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>A. Licensing</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Legal Status</td>
<td>SACCOs to register with first Registrar of Coops, then licensed under new law</td>
<td>Agrees with reality and our recommendations</td>
<td>Change status to company limited by shares to identify clearly the owners</td>
</tr>
<tr>
<td>Licensing/ regulating body</td>
<td>New regulatory body to be set up, to enforce compliance and better performance to reduce financial risk..</td>
<td>Agrees with Government’s thinking</td>
<td>New Regulatory Body</td>
</tr>
<tr>
<td>Lead Time from enactment to compliance</td>
<td>6 months depending on requirements</td>
<td>Rather short</td>
<td>6 months to 1 year</td>
</tr>
</tbody>
</table>
| Licensing Fees               | -Charge a standard fee per category.  
                               | -To be paid and maintained annually | Good idea to make annual | Should be pegged to size of loan in order to raise reasonable income in comparison to supervisory work load | Not fair and difficult to implement |
| Validity of License          | Annual | | Open license to ensure weeding out of noncompliant institutions  
<pre><code>                           | Should be valid for at least 3 years before | The report recommends annual validity |
</code></pre>
<table>
<thead>
<tr>
<th>Key Issue</th>
<th>SACCOS</th>
<th>Micro Finance Companies and NGOs</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Recommendati on</td>
<td>Remark</td>
</tr>
<tr>
<td>Minimum Capital Requirements</td>
<td>Regulator to set To be stipulated in Regulations, for flexibility</td>
<td></td>
</tr>
<tr>
<td></td>
<td>200 million</td>
<td>-150 million</td>
</tr>
<tr>
<td></td>
<td>-150 million</td>
<td></td>
</tr>
<tr>
<td>Maximum Loan Size</td>
<td>Leave to discretion of SACCO Leave the discretion of SACCO, subject to concentration limits</td>
<td>-Not more than 1% of capital -Left to MFI discretion</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Fit and proper test</td>
<td>Gives guide for integrity &amp; should be applied</td>
<td>Good to weed out undisciplined potential SACCO directors</td>
</tr>
<tr>
<td>Prohibitions</td>
<td>Loans to non members must have greater security,</td>
<td>Do not limit money transfer</td>
</tr>
<tr>
<td>Reporting tools</td>
<td>PEARLS Already in place. Must be learnt by Regulator</td>
<td>PMT used by all AMFIU members including SACCOS</td>
</tr>
</tbody>
</table>

21 View of Category A MFIs.
APPENDIX III: PROBABLE INDICATORS FOR ABRIDGED PRUDENTIAL REGULATION

In this report, “abridged prudential regulation” is used to mean that the regulatory authority could select key aspects on institutional health and performance in core strategic and operational areas. The following list is an indicative scheme of indicators for an abridged prudential regulation.

1. Governance and Management
   a) Full control by the institution’s board and membership, with no significant external control except for regulation
   b) Able / knowledgeable board who pass a well defined “fit-and-proper” test
   c) Effective responsibility and accountability practices among the organs of the institution
   d) Qualified and experienced management who pass a well defined “fit-and-proper” test
   e) Suitable and adequate risk management policies and procedures

2. Asset and Liability Management Effectiveness
   a) Loan Portfolio Management (PAR)
   b) Cash safety (security, insurance)
   c) Gearing ratio (Debt / Equity)

3. Accounting and Reporting
   a) Suitable book keeping and accounting practices
   b) Proper financial management policy and practices

4. Institutional Sustainability
   a) Return on investment (unadjusted)
   b) Operating sustainability ratios (OSS)
   c) Financial sustainability (FSS)