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### Possible Mechanisms to Regulate Tier 4 MFIs in Uganda

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## List of Abbreviations

|         |   |
|---------|---|
| AMFIU   | Association of Microfinance Institutions of Uganda  |
| BoU     | Bank of Uganda  |
| CEO     | Chief Executive Officer   |
| COWE    | Caring for Orphans, Widows and the Elderly  |
| D.P.P.  | Director of Public Prosecutions   |
| DANIDA  | Danish International Development Assistance   |
| DENIVA  | Development Network of Indigenous Voluntary Associations  |
| DFID    | Department for International Development  |
| DNBFI   | Director Non-Bank Financial Institutions  |
| EDS     | Executive Director Supervision  |
| FEW     | Financial Extension Worker  |
| FIB     | Financial Institutions Bill   |
| FINCA   | Foundation for International Community Assistance   |
| FIS     | Financial Institutions Statute  |
| FSD     | Financial Systems Development Programme   |
| GoU     | Government of Uganda  |
| GTZ     | Deutsche Gesellschaft für Technische Zusammenarbeit (GTZ) GmbH<br>(German Technical Cooperation)          |
| MDI     | Micro deposit-taking institution  |
| MFI     | Microfinance institution  |
| MFPEd   | Ministry of Finance, Planning and Economic Development  |
| MFRC    | Micro Finance Regulatory Council ( <a href="http://www.mfrc.co.za">www.mfrc.co.za</a> )                   |
| MSEPU   | Micro and Small Enterprise Policy Support Unit  |
| MTCS    | Medium Term Competitive Strategy  |
| NABARD  | National Bank for Agriculture and Rural Development   |
| NGO     | Non-government organisation   |
| PEAP    | Poverty Eradication Action Plan   |
| PMA     | Plan for Modernisation of Agriculture   |
| PRSP    | Poverty Reduction Strategy Paper  |
| SACCO   | Savings and credit co-operative society   |
| SEEP    | Small Enterprise Education and Promotion ( <a href="http://www.seepnetwork.org">www.seepnetwork.org</a> ) |
| SIDA    | Swedish International Development Co-operation Agency   |
| SPEED   | Support for Private Enterprise Expansion & Development  |
| SRO     | Self-regulatory organisation  |
| SUFFICE | Support to Feasible Financial Institutions and Capacity-Building Efforts                                  |

|       |  |
|-------|--|
| UCA   | Uganda Co-operative Alliance                 |
| UCSCU | Uganda Co-operative Savings and Credit Union |
| UMU   | Uganda Microfinance Union                    |
| UWFT  | Uganda Women's Finance Trust                 |
| UWFT  | Uganda Women's Finance Trust Ltd.            |
| WOCCU | World Council of Credit Unions               |

## Executive Summary

This report summarises the results of a study on regulatory options for tier four MFIs in Uganda. It is based on an analysis of available documentation and legislation for this sector and numerous interviews, which the consultants conducted between February 26 and March 18, 2003.

The following are the most relevant laws for tier four MFIs: The Money-lenders Act, 1952; the Companies Act, 1961; the Non-Governmental Organisations Registration Statute, 1989; and the Co-operative Societies Statute, 1991.

Three types of MFIs can be found in the sector: SACCOs, tier four MFIs other than co-operatives (referred to as non-coop MFIs) and money-lenders (the last category comprises not only institutions, but also individuals). Money-lenders should not be regarded as tier four MFIs unless they are registered either as NGO or as a company.

International experience and the theory on financial regulation clearly show that all three types of MFIs need and should not be prudentially regulated by the central bank. Unlike tier one, two and three institutions, they do not intermediate public deposits. A possible exemption to this rule might be, at least in the medium term, very large SACCOs.

The study concludes that tier four MFIs should be subject to non-prudential regulation focusing on performance monitoring. Such a regulatory system would neither be pure self-regulation nor direct government regulation, but self-regulation backed by statutory powers of government agencies.

The following are our recommendations with regard to institutions in tier four:

- **SACCOs:** Preferably, SACCOs are brought under the Ministry of Finance. Even if the decision is taken to leave them under the current Ministry (MTTI), supervisory tasks could be delegated to an existing umbrella body (such as UCA or UCSCU), while some statutory powers (e.g. to deregister errant members) and the authority to conduct on-site inspections would remain with the Ministry.
- **Non-Coop MFIs:** Our findings suggest that neither the NGO Board nor the Registrar of Companies is well positioned to effectively monitor non-coop MFIs. Supervision should therefore be delegated to a Self-Regulatory Organisation (SRO). As for the power to close down non-complying members, this could either remain with a government agency or also be delegated to the SRO. It would be essential to have mandatory membership with the SRO to ensure the effectiveness of this approach. Rules and a code of practice of the SRO are to be approved by a government agency. The government could also be represented on the Board of the SRO. At least as an interim solution, a specialised department in AMFIU could take over the role as SRO.

To implement these recommendations, the following laws would have to be amended:

- **NGO Statute and Companies Act:** In both laws, a provision would be included that companies or NGOs engaged in 'microcredit business' must be registered with an SRO and that a still to be specified government agency is authorised to make microfinance-specific regulations under this Act. Furthermore, the NGO Statute should confer corporate status to non-coop MFIs so that double registration under the Companies Act is no longer required.
- **Co-operative Societies Statute:** Specific sections on SACCOs would be added to the Act, even better were the introduction of a separate Act for SACCOs. A provision has to be included to delegate some supervisory power to an existing umbrella body, approved by the Ministry. In the medium term, larger SACCOs (in terms of number of members or volume of deposits) would be brought under the purview of the central bank.

- Money-Lenders Act: The Act would be repealed. For this sector, the focus would lie on consumer education and an effective complaint mechanism for aggrieved customers.

## 1. Introduction

### 1.1 Background of the Study

When the MDI Bill was discussed in Parliament in November 2002, a number of MPs expressed their concerns about the fact that it does not cater for the majority of MFIs, but only for a tiny fraction of about six to nine micro deposit-taking institutions (MDIs) in the medium term. These institutions are referred to as tier three institutions, while all other microfinance institutions (MFIs) – arguably more than 500 - are called tier four MFIs.<sup>1</sup> After intense discussions, it was agreed to split both issues concerning tier three and tier four MFIs. Firstly, the majority of MPs passed a motion regarding tier four MFIs with the following content:

“It is hereby resolved that the Cabinet undertakes to bring to the August House within 6 months a Bill regulating the activities of Community-Based Financial Institutions referred to as Tier IV in the Report of the Committee on Finance, Planning and Economic Development guaranteeing affordable interest rates and reasonable period of repayment to the borrowers.”

Secondly, the MDI Bill was passed with only minor amendments. The motion underlines the importance to study different options for regulating tier four institutions. As the motion mentions a clear time frame (the six months will be over on May 20, 2003), it is now much more urgent to come up with concrete proposals how to address the concerns raised.

### 1.2 Tasks of the Study

The main tasks of this study were the following:

- To compile and study the different laws under which tier four MFIs are operating and to identify weaknesses in these laws in relation to microfinance business;
- To propose ways and mechanisms through which these legal weaknesses can be overcome;
- To suggest areas for legal amendments to strengthen the existing laws; and
- To propose mechanisms through which these laws can be enforced - either through the central bank, meso level organisations other than existing networks or through existing networks, giving pros and cons in each case.

### 1.3 Structure of the Report

This report is structured in the following way. First, we describe the main subject of our analysis and the methodology we used. In chapter 3, the theoretical background is given and the experiences with regulating similar institutions in other countries summarised. The following chapter then analyses existing legislation, and institutions in tier four in Uganda and list the most important shortcomings in this sector. On the basis of this analysis, some recommendations are given in chapter 5. The concluding chapter describes the way forward to implement our recommendations.

<sup>1</sup> Tier one institutions are commercial banks and tier two institutions credit institutions, both regulated under the Financial Institutions Statute (FIS) 1993.

## 2. Scope and Methodology

### 2.1 Scope of the Study

Tier four is a diverse sector, and it is extremely difficult to get reliable figures on the number of institutions, let alone their performance. As of now, the sector is defined negatively, i.e. all those financial institutions not belonging to tier one, two or three are called tier four institutions. Thus there is a clear upper boundary to this sector, but not a lower boundary. For the sake of this study, the lower boundary has been set by dealing only with those institutions which can sue and can be sued, i.e. which are incorporated or registered under any one law.

The upper boundary has been set by defining 'microfinance business', which in the context of this law is micro deposit-taking business, in the MDI Bill. Contrary to the suggestion of the BoU Policy Statement on Microfinance Regulation (cf. Ch. 2.3), **all** member-based institutions (and not only the very small ones) are excluded from the ambit of this law. Furthermore, compulsory savings are seen as part of the lending technology of MFIs. The mobilised funds, also referred to as 'loan insurance fund', may not be used for on-lending.

As long as MFIs do not mobilise voluntary savings from the public, they are allowed to operate as tier four institutions without being licensed by BoU. Previously, only financial institutions regulated under the FIS (the Financial Institutions Statute) have been authorised to mobilise and on-lend deposits from the public. With the enactment of the MDI Bill, also MDIs, which constitute the small group of strongest MFIs, will be permitted to intermediate savings.

Three types of MFIs can essentially be found between the upper and lower boundary of tier four: First, the savings and credit co-operative societies, for which the availability of data is best; second, MFIs licensed under the Companies Act and (only some of them) under the NGO Registration Statute; and third, money-lenders registered under the Money-lenders Act. Ch. 4.1 will describe these different types of institutions in more detail.

### 2.2 Main Legislation for Tier Four MFIs

Tier four MFIs exist in a number of different legal forms. All informal MFIs, i.e. those that are not incorporated under any law, are explicitly excluded from this study. This means that all MFIs that are only registered on district level are not included in this study because this kind of registration is not a legal requirement. The consultants have focused their attention on the following laws:

- Money-lenders Act, 1952
- Companies Act, 1961
- Non-Governmental Organisations Registration Statute, 1989
- Co-operative Societies Statute, 1991 and Co-operatives (Amendment) Bill, 2002

In addition, the Financial Institutions Statute (FIS) 1993, the Financial Institutions Bill (FIB) 2003, the MDI Bill 2002 and the Bank of Uganda Statute 1993 are important for this study as they guide the conduct of micro deposit-taking and banking business.

### 2.3 Policy Documents with Relevance for Tier Four

A number of policy documents will guide future policy decisions in Uganda in the field of microfinance. The most important general government policy is set down in the Poverty Eradication Action Plan (PEAP). With regard to financial services, the following objectives have

been stated:

“There is a large unmet demand for financial services among the poor. **Access (availability and affordability)** is the main constraint. Government schemes for providing credit have not been successful. [...] Government will withdraw from direct delivery of credit but will provide a conducive macroeconomic environment; and **provide a legal and regulatory framework for micro finance institutions.**” (Government of Uganda 2002: 20f., emphasis by consultants)

The Medium Term Competitive Strategy (MTCS) is much more detailed when it comes to government policy towards MFIs. Yet it mainly deals with deposit-taking MFIs and the need to bring these under the purview of BoU. With regard to small community-based organisations, it seems to recommend a more cautious approach: “The [new legal] framework should recognise informal and community-based organisations with credit-programs, which bring financial services to the grass roots with little effect on the stability of the whole financial system.” (Government of Uganda 2001: 18) An entire section of the MTCS deals with the need for MFIs to charge market-determined interest rates. It culminates in the sentence: “*The policy of no restrictions on maximum interest rates shall continue in the case of MFIs that want to charge high interest rates for their operations because this is absolutely an essential precondition to the success of credit delivery systems for micro enterprises.*” (Government of Uganda 2001: 19).

Most important for microfinance regulation is the *BOU Policy Statement on Microfinance Regulation* from July 1999 as this document has been approved by Cabinet and defines the general government policy in this field. The policy statement introduces the tiered concept as described above, with tier four MFIs not being subject to BoU regulation and supervision. Tier four comprises two types of institutions:

First, all those that are non-deposit taking institutions such as credit-only NGOs or any other non-deposit taking initiatives. Second, all those very small member-based organisations mobilising subscriptions from their members, whose size will be determined. (Bank of Uganda 1999: 7f.)

The proposed regulatory authority for tier four is an umbrella body, which has not been further specified. It is only stated that “BoU will be actively involved in the discussions on the financial standards of self-regulation under tier 4 and provide guidance in the establishment of the umbrella body”.

The official reports of the parliamentary debates on the MDI Bill (November 19 and 20, 2002) are important background documents. They include the motion moved by Hon. Aggrey Awori. Moreover, they help to identify positions of supporters and opponents on regulating tier four institutions.

## 2.4 Methodology

The study was conducted by an international microfinance expert<sup>2</sup> with contributions of an Ugandan lawyer. The consultant had three weeks to carry out interviews with stakeholders in the industry and to come up with some preliminary recommendations, which he presented in a well-attended stakeholder workshop on March 17, 2003.

<sup>2</sup> The author of this report can be reached at the following address: [s.staschen@lse.ac.uk](mailto:s.staschen@lse.ac.uk).

More than twenty interviews were conducted with individuals or with stakeholder groups (in the case of donor agencies, MPs and tier four institutions). The main stakeholder groups were the following: MPs and Ministry of Finance, (potential) tier three and tier four MFIs, representatives from regulatory bodies such as the Registrar of Co-operatives, the Registrar of Companies and BoU staff, networks and associations (AMFIU, DENIVA, UCA, and UCSCU), and donor agencies. However the consultants did not meet any officer from the NGO Board. A complete list of interviewees can be found in the Annex.

Although at one occasion one of the consultants also talked to a number of representatives of MFIs from upcountry, which happened to be in Kampala, the composition of respondents might nevertheless be biased towards the upper end of the market and those institutions with headquarters in Kampala.

As will be shown in chapter 4.2, data on tier four can at best be described as sketchy and the problem analysis had mainly to rely on anecdotal evidence, as there is no in-depth study available of problems and constraints in the sector. Due to the short time of three weeks, the consultants were not able to collect primary data or to assess unwanted practices in tier four themselves.

### 3 Possible Options to Regulate Microfinance Institutions

Before turning to the Ugandan case, it is essential to define terms, distinguish regulatory approaches and summarise other countries' experience with the regulation of MFIs not mobilising deposits from the public.

#### 3.1 Prudential vs. Non-Prudential Regulation

Prudential regulation can be defined as public sector regulation ensuring the safety and soundness of financial institutions. Two elements are authoritative for prudential regulation. First, governments must be in some way involved in regulation to ensure a credible enforcement mechanism (usually prudential regulation is the task of the central bank or a specialised superintendency). And secondly, the regulatory authority not only monitors performance, but also vouches for the safety and soundness of financial institutions. The two most important objectives of prudential regulation are to protect the deposits of the public and to guarantee the stability of the financial system.

Non-prudential regulation, on the other side, is a much less arduous task. It simply establishes rules and guidelines about appropriate behaviour and business practices in dealing with customers and monitors the performance of financial institutions. A non-prudential regulator can be a government agency, or a private institution such as a federation, a network or an apex institution.

Neither prudential nor non-prudential regulation should be seen as a way to promote the development of the microfinance industry. For deposit-taking institutions it is essential that they are already sound and mature institutions **before** they start deposit-taking. A non-prudential regulatory system can, by definition, not guarantee the soundness of MFIs. It can improve transparency about the performance of institutions, but not the performance of institutions itself.

#### 3.2 Different Approaches to Self-Regulation

There is a general consensus that MFIs need not be subject to prudential regulatory requirements as long as they do not mobilise deposits from the public (i.e. from non-members) and lend them out (what one calls financial intermediation). Non-prudential regulation is at the core of this study as tier four MFIs are those that are not mobilising and intermediating deposits from the public (cf. Ch. 2.3). As became clear from the above definitions, non-prudential regulation is not necessarily the task of a government agency, but can also be carried out by a self-regulatory organisation, i.e. by an organisation that is essentially controlled by the regulated institutions themselves.

Most microfinance publications assert that self-regulation suffers from severe conflicts of interest and thus cannot be effective for deposit-taking MFIs (e.g. Christen and Rosenberg 2000: 20; Hannig and Katimbo-Mugwanyanya 2000: 45 and 125; Consultative Group to Assist the Poorest 2002: 24). The most important reference in this regard is the experience with self-regulatory systems of financial co-operatives, which has in most cases been rather unsatisfactory. Studies of self-regulatory frameworks for non deposit-taking MFIs are rare.

There is a vast amount of literature on self-regulation, yet mostly in other industries than the financial industry. Self-regulation usually plays a much stronger role in areas such as food safety regulation, environmental regulation, or work place security. What becomes clear from this literature is that it is not a decision between self-regulation on one side and external regulation on the other side. One can think of a continuum between pure self-regulation and externally enforced government regulation: "The process of self-regulation may be constrained governmentally in a number of ways – for instance by statutory rules; oversight by a governmental

agency; systems in which ministers (one may add: or the central bank) approve or draft rules; procedures for the public enforcement of self-regulatory rules; or mechanisms of participation or accountability.” (Baldwin and Cave 1999: 126)<sup>3</sup>

Baldwin distinguishes five criteria for comparing self-regulation with government regulation: Expertise, efficiency, mandates, accountability, and fairness of procedures (Baldwin and Cave 1999: 126-133). Expertise refers to the technical knowledge of the regulatory body, efficiency to the costs incurred by this body to fulfil its tasks. Under ‘mandates’ Baldwin understands that the regulation serves legitimate objectives. This, in turn, generally requires that these objectives are set by bodies which are accountable, i.e. democratically elected. Finally, fairness of procedure demands that all institutions affected by the regulation must be consulted while defining regulatory requirements.

It will be useful to refer to these criteria when comparing different regulatory options for tier four MFIs in Uganda. Another important aspect is the question of voluntary or mandatory membership of a self-regulatory organisation. A mandatory system clearly has stronger enforcement mechanisms as deregistration not only means exclusion from the self-regulatory body, but from the industry in general. On the other side, such a system imposes restrictions on non-members and must therefore be accountable for its actions to the government.

The costs and benefits of different regulatory approaches are an important criterion when deciding about the most appropriate approach to regulate financial institutions. The costs of introducing new regulation can be considerable. The main costs are direct (i.e. budget) costs of the supervisory agency, and compliance costs incurred on those MFIs that have to comply with new regulatory provisions.<sup>4</sup> The main benefits of regulating MFIs in tier four should be a decreasing incidence of fraud and exploitation of customers, and access to better products, which are offered on a more sustainable basis. Products can be better because they have become cheaper (through increasing competition and operational efficiency of MFIs) or because customers select better products (through more transparency in the market or a larger choice of products). More sustainable provision of products is made possible through improving the soundness of institutions and thereby their life span.<sup>5</sup>

### 3.3 Other Countries’ Experience with Regulation of Credit-Only MFIs

At this point, it might be helpful to look at other countries’ experience with regulating MFIs that are not mobilising deposits from the public, even though it is scarce.

**South Africa** is probably the most interesting and also a well-documented case when it comes to the regulation of credit-only MFIs. The South African approach has been termed ‘hybrid’ as government agencies are represented on the Board of the Micro Finance Regulatory Council (MFRC), an independent body which supervises all money lending institutions (Staschen 1999; Micro Finance Regulatory Council 2001; Meagher 2002; Meagher and Wilkinson 2002). The South African case is rather unique as it does not use a strong enforcement mechanism such as mandatory membership with the MFRC, but simply relies on the fact that only members of the MFRC are exempted from very strict interest rate limits under the Usury Act. Thus all MFIs have a strong incentive to join. Especially the institutional set-up might be of interest for Uganda as well, as this is a hybrid approach, where the government is strongly represented on the Board of the MFRC and the Department of Trade and Industry must approve MFRC’s rules.

<sup>3</sup>Ogus talks of “a spectrum containing different degrees of legislative constraints, outsider participation in relation to rule formulation or enforcement (or both), and external control and accountability”; Ogus (1998: 376)

<sup>4</sup>A third cost category are structural costs, i.e. costs caused by changing the structure of the market, e.g. through raising the barriers to entry in the market and thereby reducing beneficial competition. These costs are very difficult to measure.

<sup>5</sup>Schreiner (1999) has tried to quantify costs and benefits of access to microfinance services. Of this rather academic paper the categorisation of costs and benefits might be of interest for some readers.

In **India**, self-regulation of all microfinance NGOs has been recommended as the preferred way forward, while the central bank has delegated the supervision of *co-operative banks* and *regional rural banks* to the apex institution NABARD. The regulatory structure for NGOs is still very much in change. The report of the Task Force on Supportive Policy and Regulatory Framework for Microfinance recommends the establishment of self-regulatory organisations (SROs) and the compulsory registration of **all** microfinance NGOs with one of these SROs.<sup>6</sup> According to the report, major functions of the SRO would be i) overseeing functioning of MFIs as base-level regulators, (ii) undertaking registration, (iii) evolving proper systems for maintenance of accounts and reporting, (iv) setting performance standards, (v) conducting inspections, (vi) undertaking training and, (vii) representing MFIs in various fora.<sup>7</sup> Certain thresholds have been defined which will trigger the application of tighter regulatory requirements.<sup>8</sup> The rules of the SRO are supposed to be approved by a government agency (a proposal is the Reserve Bank of India as the central bank).

What becomes clear from these examples is that self-regulation needs some kind of backing from the government to be credible and effective. This can be achieved by, for example, representing government on the board of the self-regulatory organisation or by charging the banking supervisor with the approval of rules and regulations.

### 3.4 Other Countries' Experience with Regulating Cooperatives

An interesting case with regard to regulating co-operatives is the *co-operatives with a limited banking transaction license* in **Nepal**. As co-operatives, they are supervised by the Registrar of Co-operative Societies. Yet in 2002, the central bank issued a directive stipulating regulatory requirements for obtaining a limited banking transaction license. This directive brings all financial co-operatives under the purview of the central bank (currently 34) without curtailing the responsibilities of the Registrar of Co-operative Societies. The central bank has now the authority to issue directives for all *co-operatives with a limited banking transaction license*, i.e. for all SACCOs, and to supervise them.

In at least ten Latin American countries, the bank supervisor directly supervises large SACCOs, as this seems to provide for the most reliable prudential supervision.<sup>9</sup> Yet there is no uniform criterion for defining the threshold, above which co-operatives come under the purview of the banking supervisor. Four possible options are to stipulate a specific number of members, a volume of deposits, assets or capital. The criterion 'volume of deposits' might be preferable to 'volume of capital' (can easily be manipulated, e.g. by increasing the leverage) and to 'volume of assets' (without risk-weighting, this is a very crude measure of overall risk). After all, deposit protection is the main rationale for regulating co-operatives.<sup>10</sup> Using 'number of members' as criterion, takes directly into account that the more members a co-operative has the less internal surveillance by members will be possible. An additional criterion might be number of branches, as this, again, makes it more difficult for members to exert control over the co-operative.

Finally, some countries distinguish closed, affinity-based and open, community-based SACCOs. In affinity-based co-operatives, all members have for instance the same employer or come

<sup>6</sup>Cf. <http://www.gdrc.org/icm/country/india-mftaskforce.html>

<sup>7</sup>The full version of the report is available at: <http://www.nabard.org/whats/tfr.htm>

<sup>8</sup>MFIs having mobilised savings not exceeding USD 4,200 are only required to register with an SRO. Savings mobilisation above USD 4,200 triggers prudential regulatory requirements, while the mobilisation of savings exceeding USD 53,000 leads to even stricter prudential requirements.

<sup>9</sup>Another country with direct central bank supervision of SACCOs is Mozambique, yet there are only seven of them and the capacity of the central bank is not sufficient.

<sup>10</sup>This goes in line with the view of Tor Jansson from the Inter-American Development Bank, as expressed in personal correspondence with the author.

from the same, clearly defined geographical area. These co-operatives need not be regulated by the bank supervisor, but are only required to follow certain reporting and external audit requirements. An interesting case is Brazil, where SACCOs (all of them must be of the closed, affinity-based type) are only subject to off-site supervision, but the superintendency can summon a co-operative if the figures appear problematic (Vogel 2002). This reduces supervisory costs, but allows for at least some degree of external oversight.

With regard to regulation of co-operatives, the World Council of Credit Unions (WOCCU) has extensive experience. It has recently published a Model Law for Credit Unions, which is very informative with regard to appropriate legislation for savings and credit co-operative societies (SACCOs) (WOCCU 2002).

In summary, one cannot necessarily rely on strong enough internal controls by members of SACCOs. How much external oversight by a prudential regulator is required very much depends on the size of the co-operative (in terms of number of members, assets, deposits and/or branches) and the affinity of its members.<sup>11</sup>

<sup>11</sup> Vogel (2002: 5) mentions another important aspect for determining the need for external regulation, which is the composition of capital. In some co-operatives, the possibility to take “automatic loans” of up to 90 percent of the share contribution blurs the distinction between deposits and share capital.

## 4 Current State of Tier Four Institutions

This chapter is looking at the current state of the tier four microfinance sector in Uganda from four different angles: firstly and most importantly, by critically analysing existing legislation catering for this sector; secondly, by looking at different institutional types operating in this sector; thirdly, by describing the main sector-wide problems; and finally by describing role and performance of networks and associations in the sector.

### 4.1 Existing Legislation for Tier Four Institutions

A critical review of the current legislation under which tier four MFIs operate is imperative. Tier four institutions in Uganda are currently regulated and registered under four different laws. It is important to examine how each piece of legislation affects the operations of MFIs registered thereunder.

#### 4.1.1 The Non-Governmental Organisations Registration Statute 1989

“Organisation” is defined under S.13 of the Statute as an NGO established to provide voluntary services including religious, educational, literary, scientific, social or charitable services to the community or any part thereof. In simple terms these are organisations outside the traditional government which provided charitable social services to the communities they operate in.

Prior to the enactment of the NGO Registration Statute in 1989, charitable organisations could register as companies limited by guarantee under the Companies Act, 1961. However some of the organisations operated informally, i.e. without any legal registration. Under the Statute, S.1(1), it is provided that no NGO shall operate in Uganda unless it has been registered with the Board established under S.3 of this Statute. The provisions of S.1 are mandatory, i.e. before an NGO can register with the Registrar of Companies it is a requirement that it obtains a Certificate of Registration from the NGO Board. However, some of the NGOs have continued to operate informally without any registration with the NGO Board.

The Ministry responsible for the registration, operations and monitoring of the NGOs is the Ministry of Internal Affairs. The responsible body is the National Board for Non-Governmental Organisations formed under S.3 of the Statute, called the NGO Board. The Board consists of two members of the public and one member from the following ministries or departments:

- a) Ministry of Internal Affairs;
- b) Ministry of Relief and Social Rehabilitation;
- c) Ministry of Justice;
- d) Ministry of Lands and Surveys;
- e) Ministry of Planning and Economic Development;
- f) Ministry of Finance;
- g) Ministry of Foreign Affairs;
- h) Ministry of Local Government;
- i) Office of the Minister of State for Women in Development in the President's Office;
- j) Office of the Prime Minister
- k) Internal Security Organisation; and
- l) External Security Organisation.

However, it must be noted that some of the above ministries have been merged or abolished

and this has affected the composition of the board as envisaged by the law.

### **Critical Issues for MFIs registered under the NGO Registration Statute 1989**

#### *Financial services are not mentioned in the law*

The definition of the term “organisation” under S.13 of the Statute omits “financial services” as a category of services provided by the NGOs. While the definition is inclusive, a reference to financial services would be important for NGOs engaged in provision of financial services to the community.

#### *Incorporation only with simultaneous registration as company*

Under S.1(3) it is provided that no NGO shall be incorporated under the Companies Act or Trustees Incorporation Act, before that NGO is registered with the NGO Board.<sup>12</sup> The effect of this section is that Registration with the NGO Board does not confer a corporate status to the applicant organisation. Yet financial institutions and other legal entities insist on presentation of the Certificate of Incorporation under the Companies Act before they enter into any contractual dealings with NGOs. As a result, all microfinance NGOs have to register twice, under the NGO Statute and under the Companies Act. It is important to note that limited companies engaged in microfinance business are permitted to share dividends whereas NGOs engaged in micro finance business and also registered under the Companies Act, are not allowed to do so but must re-invest profits into the business.

#### *Irregular meetings of NGO Board*

Under S.10 of the Statute, the Board shall meet at least once a month. It was established during our interviews that the meetings of the board were very irregular with the result that most of the urgent business such as applications for registration remains unattended to for long periods.

#### *Lack of guidance and monitoring by NGO Board*

Under S.6 of the Statute, one of the functions of the Board is to “guide and monitor organisations in carrying out their services”. During our interviews, it was established that the NGO board or its officers do not guide or monitor the operations of the MFIs registered thereunder. The Board lacks the capacity to effectively monitor MFIs. Furthermore there are no monitoring criteria upon which such monitoring exercise can be done. Although the Board has the authority to withdraw the license, this instrument has only rarely been used due to the lack of regular information about MFIs.

#### *Narrow conditions for revocation of license*

The board is empowered under S.9 of the Statute to revoke a certificate of Registration under certain circumstances. The conditions for revocation are narrow and do not include revocation on grounds of fraud, unfair practices and such other matters which are peculiar to MFIs. It is therefore not surprising that the NGO Board has rarely invoked this provision, not even where it was considered appropriate. De-registration by the board creates a practical problem as the concerned NGO may remain registered under the Companies Act and would therefore still be able to enter into contractual dealings with other parties.

#### *Proposed changes under the NGO Registration (Amendment) Bill*

It must be observed that the Non-Governmental Registration Statute 1989, is to be amended. The salient features of the bill are as follows:

<sup>12</sup>Trusts are corporate bodies formed under the Trustees Incorporation Act, 1939. Under this Act, trustees or a trustee may be appointed by anybody or association of persons established for any religious, educational, literary, scientific, social or charitable purpose and such trustees or trustee may apply to the Minister for a Certificate of Registration. The Ministry responsible is the Ministry of Lands. The Trustees Incorporation Act, confers corporate status under S.2(3). A trust may sue and be sued under the law. According to our knowledge, some MFIs which are engaged in microfinance business are registered as trusts

1. The organisations which choose to register under the Companies Act or Trustees Incorporation Act will not be required to register under the NGO Statute.
2. Upon registration, the organization shall become a corporate body under the statute.
3. The bill also introduces currency points as a basis for imposing fines for offences created under the statute.

In summary, the most critical issues for MFIs registered under the NGO Statute are the lack of effective oversight by the Board and the need for dual registration to become incorporated.

#### **4.1.2 The Companies Act 1961**

Under the Companies Act, a company engaged in microfinance business may be registered as private limited liability company or as a company limited by guarantee. In both cases, registration under the Companies Act confers corporate status, i.e. the company attains the capacity to sue and be sued under the law. The Registrar of Companies in the Ministry of Justice and Constitutional Affairs is the legal authority over companies.

##### **Critical Issues for MFIs registered under the Companies Act 1991**

###### *Lack of capacity to monitor companies*

In our interviews, it was established that the Registrar of Companies deals with all companies generally. Several Assistant Registrars assist him in his tasks. The Registrars Office has no capacity to provide adequate oversight for MFIs registered under the Companies Act.

###### *Poor availability of data from the company registry*

The company registry is not yet computerized and it was not possible to establish the number of companies, let alone of MFIs registered under the Companies Act.

###### *Fines under the Act are outdated*

The Companies Act creates offences under SS.396 – 397. It shall be an offence under S.396 of the Companies Act for any officer of the company to make false statements. The penalty is two years of imprisonment or a fine not exceeding US\$ 10,000. It is clear from this that the fines that are imposed under the Companies Act are outdated.

###### *Responsibilities and capacity of the Director of Public Prosecutions*

Under S.399 of the Companies Act, the Director of Public Prosecutions (D.P.P.) is mandated to initiate investigations into the company's affairs. Investigations can be ordered by court on application by the D.P.P. or the Registrar of Companies acting on a complaint or on their own motion.

This procedure presupposes that there is a good record keeping mechanism in place at the Company Registry. It was established that the office of the D.P.P. is overstretched with prosecution of serious offences and has no capacity or training to follow up frauds and other malpractices within the area of MFIs registered under the Companies Act.

###### *Legal redress for members*

Furthermore, under S.402 of the Companies Act, any member of the company or any other person who is aggrieved may institute criminal proceedings against the offender. The law therefore provides a mechanism where the persons aggrieved by actions of the officers of the company may seek redress. However it is noted that the consent of the Director of Public Prosecutions' office has to be sought. Taking into account the above-mentioned limited capacity of this office, this avenue of redress may be inaccessible to the members who are aggrieved.

### *Legal redress for third parties*

The provisions of the Companies Act apply both to companies limited by shares and companies limited by guarantee. Most of the MFIs are registered as companies limited by guarantee. This means that members undertake to contribute a certain amount to offset the company's liability. The sum guaranteed is usually very small. In effect any third party aggrieved by the actions of MFIs may not be in a position to recover its money.

In summary, the most critical issues for MFIs registered under the Companies Act are to be found in a lack of supervision from the Registrar of Companies and inaccessible avenues for redress for members aggrieved by actions of MFIs.

#### **4.1.3 The Co-operative Societies Statute 1991**

The law regulating the conduct of co-operative societies is to be found in the Co-operative Societies Statute, 1991. It must be observed that the law is currently under review and the Co-operative (Amendment) Bill 2002 has been drafted and is pending discussion by the Cabinet.

The Ministry of Tourism, Trade and Industry is responsible for the co-operatives in Uganda. S.1(1) of the Statute provides for the Registrar for Co-operatives who shall also be the Commissioner for Co-operative Development. The Registrar is the responsible person for registering all co-operative societies.

There are several co-operative societies engaged in various activities. Only co-operative societies engaged in microfinance business, popularly known as Savings and Credit Co-operative Societies (SACCOs), are of interest for our study. The SACCOs must have bye-laws which are designed to assist SACCOs in management. Bye-laws must be approved by the Registrar of Co-operatives. Model bye-laws for SACCOs have been developed and are widely used. Adoption of these bye-laws is optional, but, according to the Commissioner, some areas are more or less compulsory.

Co-operative societies are permitted by law to give loans to members under S.41 of the Co-operative Societies Statute 1991. However the law restricts loans to non-members except with the approval of the Registrar.

#### **Critical Issues for MFIs registered under the Co-operative Societies Statute 1991**

##### *Limited capacity of the Office of the Commissioner*

S.1(1) of the Co-operative Societies Statute 1991, provides for the office of the Registrar of Co-operatives, who shall also be the Commissioner for Co-operatives. The Statute also provides for Deputy Registrars to assist the Commissioner in supervising co-operative societies.

The Registrar is given powers of supervision and inspection under the Statute. Our interviews indicate that the Registrar has limited capacity to monitor the performance of the SACCOS countrywide. The Commissioner and only two more staff in his office are responsible for the registration and supervision of about 5,000 co-operatives currently operating in Uganda, out of which at least 680 are SACCOs.

##### *Weak reporting*

S.21 and 22 of the Co-operative Statute imposes a duty on every society to subject its account to audit at least once in every year by an auditor appointed at the Annual General Meeting approved by the Registrar.

It is observed that the requirement for approval by the registrar is not practicable due to the huge number of co-operatives countrywide. Furthermore, the Registrar does not receive all audit reports from co-operatives on a regular basis, but lacks the capacity and instruments to follow up non-submission of reports.

*Fines under the Act are outdated*

S.79 of the Statute creates offences. Any registered society or officer who fails to do any act required by the Statute commits an offence. The offender shall be liable on conviction to a fine of US\$ 5,000 or a period of imprisonment not exceeding six months or both. It is observed that the fines imposed under the statute are very low and outdated.

*Weak supervision*

With regard to Co-operative Societies engaged in microfinance, the Office of the Registrar has no mechanism for monitoring the performance of MFIs. In addition, it is not specialised on financial services business, which bears higher risks and therefore demands a higher degree of external oversight than other business areas.

Uganda Co-operative Alliance (UCA) is provided for under S.28 of the Statute and is charged with the responsibility of making recommendations to government on matters of policy relating to the co-operative movement. However, UCA lacks any enforcement mechanism for errant members. There is no delegation of supervisory task from the Ministry to UCA.

*Proposed changes under the Co-operative (Amendment) Bill 2002*

It is to be pointed out that the Co-operative Societies Statute 1991 is to be amended by The Co-operative (Amendment) Bill 2002. There are a number of provisions in the new law, which touch the operations of SACCO's.

Under the proposed amendments Part IVA thereof, the law makes provisions for the proper and efficient administration of SACCOs. However these amendments do not exhaust the specific concerns of SACCOs. The Bill has to date not been tabled before Parliament for debate.

It has become clear from our interviews that some stakeholders would have preferred a higher degree of consultation in drafting the Amendment Bill.

In summary, the most critical issue for SACCOs registered under the Co-operative Societies Act is that they are not subject to regulations, which are specifically addressing the needs of financial institutions. Furthermore, the capacity of the Office of the Commissioner is not sufficient to effectively supervise the large number of SACCOs, which do not even report on a regular basis.

**4.1.4 The Money-Lenders Act 1952**

This Act makes provision for the regulation of money-lending. A money-lender is defined as a person who engages in money-lending as his sole business or who does it as part of his business whether as an agent or principal. Under S.3(20 and 4(3) of the Money-Lenders Act, companies, firms and individuals may lawfully engage in money-lending business.

The Money-Lenders Act is a legacy from colonial times. It has not been revised since its enactment. Its approach is to control all money-lending transactions, what is not consistent with the requirements of a market-oriented economy. A money-lending contract should be governed by the general principles of the law of contract and it is unnecessary to provide specifically for a money-lending contract. The general law of contract would handle any disputes arising out of money lending transactions.<sup>13</sup> It was difficult to establish the responsible Ministry, as there seems to be no strong feeling of ownership in any single agency. To our knowledge, it is the Ministry of Finance, Planning and Economic Development.

**Critical Issues for MFIs registered under the Money-Lenders Act 1952***No reporting or follow-up after granting of the license*

Under S.4(2) of the Money-Lenders Act, money-lenders are required to obtain a licence from

<sup>13</sup> In the United Kingdom, the corresponding Money-Lenders Act was repealed in 1987.

the Magistrate who has jurisdiction over the respective area. The law requires that money-lenders obtain licences annually in order to operate money-lending business under S.3(1) of the Act. The procedure for obtaining a licence is to be found in Money-Lenders Rules made by the Ministry of Finance under this Act. The application is lodged with the Magistrate and if not opposed by the police, the magistrate will usually grant the licence. S.4(5) provides for reasons upon which the license may be refused, which are, inter alia, failure to adduce satisfactory evidence of good character.

*Interest rate limit too low and not enforced*

Under S.13 of the Act, the money-lender is prohibited from charging interest beyond 24% per annum. The interviews confirmed that interest charged by most money-lenders is well beyond this limit. Even formal microfinance institutions must charge much higher interest rates to cover the relatively high costs of granting small loans.

*Fines under the Act are outdated*

The law creates offences under S.14 and 15 of the Money-Lenders Act. It is an offence for any money-lender to make false statements in order to induce any person to borrow from him. The penalty imposed is a term of imprisonment not exceeding two years or a fine not exceeding US\$ 10,000 or both.

It is observed that the fines imposed under the Act are too low and outdated.

*Illegal practice of concluding sales agreements instead of loan contracts*

Under S.7(1) of The Money-Lenders Act, all money lending contracts should be in writing.

*The interviews we conducted established that the money-lenders would instead cause the borrower to sign "sale agreements" for the property given as security. This practice offends S.7(2) of the Money Lenders Act, which clearly prescribes the specifics of a loan contract. A money-lending transaction must not be a sale. A sale of security should only be conducted where the borrower has failed to pay. However there is no enforcement mechanism under the law.*

*Poor record keeping*

The Money-Lenders are required under S.10 to keep proper record of accounts. However, money-lenders do not comply with this provision.

*No supervisory authority exists or could possibly exist*

The Magistrate is given power under the law to licence money-lenders. There is no complaint mechanism against errant money-lenders. Furthermore there is no recognized authority over money-lenders. After obtaining the licence, the money-lenders are not duly bound to report their activities to any regulatory office or authority. Instead to a supervisory authority, aggrieved customers must direct their complaints directly to the courts. Even if such authority existed, there would be too many money-lenders in the market so that regulation would be almost impossible.

In summary, the most critical issue of the Money-Lenders Act is that it is an outdated piece of legislation. The Act does not provide for an effective institutional structure to supervise money-lenders after granting a license. In addition, it would be virtually impossible to effectively supervise the large number money-lenders.

## **4.2 Institutions Offering Financial Services in Tier Four**

In the following, problems with tier four institutions are described according to their institutional type.

### 4.2.1 SACCOs

In October 2002, 6,580 co-operatives were registered with the Registrar of Co-operatives, of which 680 were SACCOs. The Commissioner estimates that at least 60% of tier four MFIs (except money-lenders) are SACCOs. Yet a high percentage of these is dormant or have already been dead for some time. According to the General Secretary of UCA, about 300 SACCOs are active, a number which is increasing rapidly.

From the early 1970s onwards, the co-operative movement in Uganda has suffered from political interference, mismanagement and accumulating losses. It is only now that the government has created a high-level task force for the revival of the co-operative movement, chaired by the Deputy Speaker of Parliament. The SACCOs play a very strong role in this as their number is increasing by about 30% annually. They are seen as “the engine for the revival of the co-operative sector”. Some people say that the current government strategy is too much focused on increasing the number of SACCOs without sufficiently taking into account the demand side and the capacity of these new institutions.

According to our interviews, the most serious problems in the sector are weak management and leadership, fraud, insider lending, poor financial performance, and improper record keeping. There is not a strong sense of ownership and leadership tends to change too often. In addition, some of the District Co-operative Officers, which are responsible for the reporting to the Commissioner’s Office, suffer from conflicts of interest as they at the same time supervise SACCOs and assist with the bookkeeping. They lack strong incentives to regularly report to the Ministry.

WOCCU is currently supporting 16 SACCOs with an overall membership of about 15,000 members, all of which are members of UCSCU.<sup>14</sup> These SACCOs, which are certainly some of the biggest and best performing in the country, have an average share contribution of US\$ 34,000 and are sufficiently capitalised.<sup>15</sup> Reportedly, many other SACCOs collect only symbolic share contributions from their members, sometimes as low as US\$ 5,000. This definitely leads to weak ownership of these institutions.

It was reported that some microfinance NGOs, which do take deposits from the public, have now applied for a license under the Co-operatives Statute as alternatively they would have to apply for a license under the upcoming MDI Act.<sup>16</sup> These NGOs are taking advantage of much less onerous regulatory requirements under the Co-operative Statute. This is an alarming development as the NGOs do not really change from a credit-driven institution to a member-based institution, but simply ask their clients to contribute small amounts as share subscriptions to put a co-operative structure on.

According to our interview partners, some co-operatives have a strong growth potential and might even outgrow some of the tier three MFIs in the future. International experience shows that such large institutions with more than 10,000 members are not any longer effectively controlled by their members. Thus the need for prudential regulation by a specialised financial regulator becomes much more acute. The Co-operative Department in MTTI presumably cannot fulfil this role in its current capacity.

A recent trend seems to be that village banks, which were either informal or simply registered

<sup>14</sup> At the end of 2002, these 16 SACCOs together held a share capital of US\$ 270,000 (of which 98.7% were mandatory share contributions), had mobilised US\$ 1.85m in savings and had an outstanding loan portfolio of US\$ 1.25m. The same figures as averages per member are US\$ 18 share contribution, US\$ 124 savings and US\$ 84 outstanding loans.

<sup>15</sup> The leverage ratio, computed as total capital over total assets, is 6.8.

<sup>16</sup> Even though it was also prohibited under the FIS 1993 to mobilise deposits from the public, this provision has generally not been enforced by the central bank in relation to MFIs. It is expected that this will change in the future as there is now a specific regulatory window for deposit-taking MFIs.

on district level, but not registered under any one law, apply for a license as SACCO. The Financial Institutions Statute does not allow other institutions than banks licensed under this law to bear the name bank, but BoU up to now has not enforced this provision.

#### 4.2.2 NGOs and Companies Limited by Shares

A second large group of tier four institutions are microfinance NGOs and/or companies. The majority of these institutions are registered both as NGOs and as companies limited by guarantee. Yet there are also some examples of MFIs which are only companies limited by shares without being an NGO (e.g. FAULU). This brings the advantage that transformation to an MDI does not require a change of the legal form and commercial borrowing is much easier as banks are interested in having real owners of an MFI.

There are twelve market leaders in this segment, of which six to nine are expected to apply, at least in the medium term, for a license as MDI.<sup>17</sup> The number of tier four MFIs other than co-operatives (from now on called 'non-coop MFIs') is not exactly known, as neither the NGO Board nor the Registrar of Companies keeps separate records of registered MFIs. Yet there are certainly hundreds of them.

Two strong supporters of smaller MFIs are the Microfinance Support Centre Limited and the SUFFICE project. These two donors exert a certain degree of external oversight as they monitor the performance of MFIs they support. To our knowledge, this oversight might yet not be strong enough to prevent unwanted behaviour like fraud. Yet the largest number of non-coop MFIs (even though these are certainly the rather small institutions) has simply been registered with the Registrar of Companies and maybe also with the NGO Board without being subject to any follow up supervision by one of the agencies.

#### 4.2.3 Money-Lenders

Money-lenders are quite different from the other tier four institutions as they are not incorporated, but mainly individuals lending money from their own sources and on their own account. All those money-lenders not being incorporated under any other law should not be regarded as tier four institutions.<sup>18</sup> The simple reason why they have been included in this study is that there is a specific law for them.

As there is no central registry for money-lenders, the size of the sector is completely unknown. Even magistrates cannot tell how many licenses they have issued in their area of operation. Money-lenders can be found on all social levels, from the remote rural village to the Parliament's floor. Experience from all over the world shows that money lenders have always been around and will always be around as long as there is a demand for their services. Reportedly some of them are dealing with large sums of money.

It became quite clear from our interviews that a high number, if not the majority of money-lenders either have never applied for a license or have failed to renew it on an annual basis. This is not surprising as there are no mechanisms for follow-up after the granting of a license and there is no strong incentive to register in the first place. The only possible incentive is that a money-lender may find it difficult to enforce a transaction in a court of law without being able to present a valid money lending license. But then most of the money-lenders prefer to seize the security pledged, what they can easily do if a sales contract instead of a loan agreement had been signed.

According to our knowledge, lending rates vary between 10% to 25% per month. A common practice seems to be that borrowers sign a sales contract instead of a loans contract. In case of

<sup>17</sup> According to AMFIU's categorisation, these are all category A and B MFIs, which do not have a license as bank or credit institution. All of them are members of AMFIU. There are no co-operatives in category A or B.

<sup>18</sup> The consultants came across cases where MFIs are registered both as money-lenders and as companies.

a default, the money-lender simply appropriates the security, even if it is of higher value than the original loan amount. Yet for such a transaction not the Money-Lenders Act applies, but the Mortgage Decree 1975. S.22(1) of the Money-Lenders Act does not allow for transactions secured by a mortgage over immovable property. Under the Mortgage Decree, transforming a mortgage loan into a sale is explicitly prohibited.

#### 4.2.4 Community-Based Organisations

There are other community-based organisations engaged in microfinance business, which are only registered at District Level. It must be pointed out that registration at the district level confers no corporate status. The registration at the district level is for administrative purposes. It is to be noted that these informal organisations are outside the scope of our study.

### 4.3 Sector-Wide Problems in the Industry

Some of the current problems in tier four do affect all MFIs regardless of their institutional type. According to anecdotal evidence from our interviews, illegal deposit-taking from the public and the prohibited intermediation of loan insurance funds (i.e. compulsory savings) are major problems in the sector. As there is currently no mechanism to follow-up on these activities, they are usually not avenged.

A typical case is the NGO under the beguiling name 'Caring for Orphans, Widows and the Elderly' (COWE) which last year promised customers access to US\$ 180,000 loans after having deposited US\$ 63,500 with the institution. When it came to paying out the loans, the NGO did not hold its promise. Subsequently, it was deregistered by the NGO Board. Many similar cases were reported to the consultants. It is quite easy to mobilise savings unnoticed by masking them as compulsory savings. Furthermore, only experienced accountants would be able to prove that these savings have been intermediated.

In theory, BoU has the authority to investigate such cases and to close down institutions doing banking business without holding a license (cf. S.48 FIS 1993 and S.8 FIB 2002). Yet it does neither have the capacity nor the necessary physical proximity to know about such illegal activities and to initiate the adequate investigations. BoU sees its own role limited to the regulation and supervision of financial institutions such as banks and credit institutions (and MDIs in the future), as it is defined in S.5 (2) of the Bank of Uganda Statute 1993.

Closely related to this is the current trend of new MFIs mushrooming all over the country. There are some indications that the growth rate of the sector is huge. The danger is that this high growth can only be achieved by compromising on soundness and professionalism of new institutions.

Another sector-wide problem is that private law remedies and criminal sanctions do not provide adequate redress for the aggrieved party. Criminal sanctions only impose fines and imprisonment on the wrongdoer, which do not benefit the aggrieved party. The introduction of Commercial Courts has made the justice system faster and more efficient. But still there are many cases where the disputed amount is lower than the direct and indirect costs of using the justice system. In addition, many clients are not aware of the legal options available to them for redress in case of any grievances. To give an example: While it is not allowed to do money-lending business without being registered as a money-lender, reports of clients complaining about unregistered lenders are rare.

Finally, as has become clear from the last sub-chapter, the legal system for tier four MFIs is characterised by considerable overlap and fragmentation. Quite a number of institutions are

registered under more than one law.<sup>19</sup> Furthermore, MFIs doing basically the same business might be registered under different laws, i.e. there is no level playing field.

#### 4.4 Networks

There are three networks with relevance for tier four, the Uganda Co-operative Alliance (UCA) and the Uganda Co-operative Savings and Credit Union (UCSCU) in the co-operative sector and the Association of Microfinance Institutions of Uganda (AMFIU) for all tier four institutions.

##### 4.4.1 The Association of Microfinance Institutions of Uganda

AMFIU is a network of MFIs from all different tiers. Currently it has 78 MFIs as members. Among these there is one commercial bank, and one credit institution, both also being registered as companies limited by shares. Of the remaining 62 MFIs, of which we could establish the legal form, 39 are registered both as NGOs and companies limited by guarantee, 5 as companies only and 18 as SACCOs.

AMFIU's main activities are lobbying and advocacy, information dissemination, performance monitoring and capacity building for members. The capacity building support does not target single members, but is open for non-members and visitors from abroad.

Although the capacity of AMFIU has improved considerably since the recruitment of an Executive Director and an Accountant/Administrator in 2001 and a Database Manager and Front Desk Officer in 2002, the Secretariat is still small compared to the diverse range of tasks it is trying to shoulder.<sup>20</sup>

Of particular interest for this study is the recently launched Performance Monitoring System. This system is planned to be rolled out in May to all AMFIU members and later on also to non-members on a voluntary basis. It will allow for standardised reporting to AMFIU and increase transparency in the industry. MFIs will be categorised into category A to E and will then be able to compare their performance with that of their peers, i.e. those in the same category.

##### 4.4.2 The Uganda Co-operative Alliance

UCA is the umbrella organisation of all co-operatives. It currently has 300 ordinary members, of which around 80 are SACCOs. In former times, UCA only worked with tertiary (national co-operative unions) and secondary (district unions) co-operatives. Under the new network structure, it can also deal directly with primary co-operatives.

UCA manages a number of projects with funding from different donors. One of these projects aims to improve accounting standards of cooperatives. Another specifically assists old SACCOs, which have failed, to become profitable institutions. Since 1998, UCA has started more than 60 new SACCOs.

Under the Co-operative Societies Statute, UCA is not charged with any supervisory tasks. The General Secretary of UCA favours the delegation of some supervisory responsibility from the Ministry to UCA. At the moment, UCA monitors its members' activities, but it does not have a strong enforcement mechanism. Good performance is rewarded by better access to promotional activities. UCA currently supports 60 SACCOs, some of them being old SACCOs that have failed and are now transformed into new, well-performing societies.

<sup>19</sup> Yet it should be mentioned here that also banks, credit institutions and MDIs are both regulated under the FIS and MDI Act, respectively, and registered as companies.

<sup>20</sup> During the course of this year, a Programme Officer is to be recruited who will directly assist the Executive Director.

#### 4.4.3 Uganda Co-operative Savings and Credit Union

Finally, UCSCU is another umbrella body in the co-operative sector. Other than UCA, it has only SACCOs as members and, as a tertiary co-operative, it is member of UCA itself. UCSCU has a political (promotion of and advocacy for SACCOs), a financial (liquidity support to members) and a developmental role (technical assistance to members).

Currently UCA has about 300 SACCO members. After UCA has started working with primary co-operatives, the division of tasks between the two networks has not always been clear. While UCSCU is specialised on SACCOs, UCA has also a strong interest in this sub-sector as it has the highest growth potential. In addition, UCA has recently been much more successful in acquiring donor support. UCSCU sometimes feels left out if it comes to discussions about the reform of the co-operative sector, although it is also a member of the Task Force for the Revival of the Co-operative Movement.

In 1999, UCSCU (together with WOCCU) spearheaded the process of drafting a Savings and Credit Co-operative Societies Act. Yet at that time, such a separate Act for SACCOs was met by reservations from the Office of the Commissioner. Enacting a specialised Act for SACCOs would require the transfer of the responsibility from the current Office to a newly created specialised department for SACCOs, whereas the Commissioner of Co-operatives preferred to keep the responsibility for all co-operatives in one office.<sup>21</sup> Thus this plan was ultimately abandoned.

The table below summarises some features of the four main pieces of legislation with relevance for tier four MFIs.

**Table: Legal Frameworks for Tier Four Institutions**

| Name of Parent Act                  | Co-operative Societies Statute, 1991 and Co-operative (Amendment) Bill, 2002                | Non-Governmental Organisations Registration Statute, 1989 | Companies Act, 1961                        | Money-Lenders Act, 1952  |
|-------------------------------------|---|---|--|--|
| Secondary Legislation               | None  | Non-Governmental Organisations Regulations, 1990          | None                                       | The Money-Lenders (Licences and Certificates) Rules                      |
| Responsible Ministry                | Ministry of Tourism, Trade and Industry   | Ministry of Internal Affairs                              | Ministry of Justice                        | To our knowledge: Ministry of Finance, Planning and Economic Development |
| Licensing Authority                 | Registrar of Co-operatives / Commissioner   | NGO Board   | Registrar of Companies                     | Chief Magistrates  |
| Associations / Networks             | Uganda Co-operative Alliance (UCA) and Uganda Co-operative Savings and Credit Union (UCSCU) | NGO Forum; DENIVA (for indigenous NGOs)                   | None                                       | None   |
| MFIs falling under this legislation | SACCOs  | Microfinance NGOs   | Microfinance NGOs and/or limited companies | Individual and corporate bodies doing money-lending business             |
| Number of MFIs                      | around 680, of which maybe 300 are active   | Hundreds  | At least as many as NGOs                   | Thousands  |

<sup>21</sup> The SACCO Bill from 1999 does not specify, in which Ministry the new department would have been set up.

## 5 Recommendations

On the basis of the analysis of existing literature on self-regulation and the current state of and legislation for tier four MFIs in Uganda, the consultants came up with recommendations in the following three areas: Firstly, for drawing the line between different regulatory tiers; secondly, for evaluating options for self-regulation of SACCOs and non-coop MFIs; and, thirdly, for specifying the role of AMFIU.

### 5.1 Drawing Lines Between Regulatory Tiers

It has become clear from the analysis that tier four is not a homogenous sector, but can be broken down into two sub-tiers. First, the SACCOs are a distinct institutional type, which – at least if they have 10,000 or more members from a wide community – are more similar to tier three institutions than to the non-coop MFIs. Second, all tier four institutions other than co-operatives form the second large group in the tier.

As for the upper boundary of tier four, drawing the line according to the question whether deposits are mobilised from the public or from members does not seem to sufficiently take into account the fact that the more members a co-operative has the weaker its internal control through members is. In addition, there is no clear distinction between closed, affinity-based and open, community-based SACCOs in Uganda.

One option, which was also part of earlier drafts of BoU's Policy Statement on Microfinance Regulation, would be to set a limit in terms of number of members above which SACCOs would have to come under central bank regulation. Such an approach would provide a disincentive for SACCOs to grow beyond this hurdle. Yet this disincentive could easily be offset by introducing certain advantages for all SACCOs under the purview of BoU.<sup>22</sup> Another option would be to stipulate a cut-off amount for deposits mobilised without being subject to BoU supervision.

Available data on SACCOs in Uganda is scarce. What seem to be clear is that none of the SACCOs currently has more than 10,000 members (most of them having less than 5,000 members), but that annual growth rates for numbers of members above 100 percent are quite common. Thus at least in the medium term, the upper boundary of tier four should be reconsidered.<sup>23</sup>

Another critical point is that currently no ceiling has been set for compulsory savings, which are allowed even without a license as MDI. MFIs in tier four might accumulate compulsory savings in a way that they ultimately outgrow the outstanding loan portfolio.<sup>24</sup> To prevent this, one could limit the size of the loan insurance fund to a percentage of the outstanding loan portfolio. This could easily be stipulated in statutory regulations to be issued by the central bank.

With regard to the lower boundary, in our view only those MFIs should be included in tier four which are registered either as NGO or as company or both. It is a demanding task to set-up a non-prudential regulatory system even only for these. Even if it might be politically desirable to include small, community-based organisations in such a framework, it is practically not feasible.

Individual money-lenders should definitely not be regarded as part of tier four. Our recommendation is to repeal the Money-Lenders Act 1952 (cf. Ch. 6.1.4).

<sup>22</sup> One option is to allow all SACCOs under central bank supervision to mobilise deposits from the public.

<sup>23</sup> In Ecuador, all credit unions that have assets above USD 1m should be supervised by the Superintendency. These are currently around 350 co-operatives. In Paraguay, the threshold is much higher as only co-operatives having a deposit volume above USD 1.5m are under direct central bank regulation. Finally, Bolivia uses a limit of USD 207,000 in capital. In the case of Uganda, more detailed figures than those available to the consultants would be required to propose such a cut-off level.

<sup>24</sup> This would contradict the net-borrower concept, which assumes that most clients are most of the time net-borrowers with the MFI, i.e. cannot lose any money when the MFI experiences financial problems.

## 5.2 Scope for Self-Regulation of Tier Four

We share the view that pure self-regulation without any legal backing suffers from conflicts of interest and the lack of a credible enforcement mechanism. Yet we must also concede that neither SACCOs nor non-coop MFIs can be effectively supervised by government agencies without huge efforts to build their capacity to do this job. We therefore recommend the division of tasks between a government agency and a self-regulatory organisation (SRO), an approach that can bring down costs while not comprising on the effectiveness and thus the benefits of regulating tier four MFIs.

### 5.2.1 Self-Regulation of SACCOs

We have clearly established from our interviews that the current degree of external regulation of SACCOs is insufficient. We would like to make two recommendations, which can be considered separately.

#### *Recommendation 1: Move SACCOs from MTTI to MFPED*

SACCOs should be treated differently from other, non-financial co-operatives. One way to do this is to bring them under the Ministry, which is responsible for the financial sector, that is the MFPED. This would require the enactment of a separate law for SACCOs as all other co-operatives remained under the MTTI. This might meet reservations from the current Ministry, which is clearly in favour of keeping all co-operatives under its roof. UCA has also expressed some reservations as it sees the danger of the fragmentation of the movement. Furthermore, to move SACCOs to another Ministry would require the consent of the President and setting-up a new department in MFPED responsible for SACCOs. This is therefore a far-reaching change of the current structure. Nevertheless, we think that SACCOs as financial institutions would be better placed under the MFPED. We also think that it is better to separate SACCOs from other co-operatives as financial services business is unique in so far as it requires a higher degree of external oversight.

When SACCOs remain under the MTTI, the legislation for co-operatives should still be amended in a way to cater specifically for SACCOs, either through the introduction of SACCO-specific requirements under the current Statute or through the enactment of a separate SACCO Act.

#### *Recommendation 2: Delegate Supervisory Authority to UCA or UCSCU*

Notwithstanding the question whether SACCOs are moved to MFPED or not, it is in our view recommendable to delegate the supervisory authority for SACCOs to a self-regulatory organisation. The statutory powers, e.g. to deregister errant members, would stay with the responsible Ministry. The Ministry would also be authorised to do on-site inspections itself in case need arises.

Potential institutions that could take over the role as SRO are UCA and UCSCU. It goes beyond the scope of this study to compare the potential of these institutions to play a stronger role in the supervision of SACCOs. There are indications that UCA is the stronger network and has therefore more potential for this role. On the other hand, UCSCU has the advantage of being specialised on SACCOs and having more SACCO as members as UCA. In both cases, membership with the SRO would have to be mandatory. The creation of a separate supervisory department of the SRO would be highly recommendable.<sup>25</sup>

### 5.2.2 Self-Regulation of Non-Coop MFIs

The non-coop MFIs in tier four are not yet supervised by any single authority. Neither the NGO Board nor the Registrar of Companies has the capacity and the potential to effectively monitor

<sup>25</sup> A longer-term plan could be to move this department out of UCA/UCSCU, i.e. to create an specialised SRO. Both UCA and UCSCU and the Commissioner could then be represented on the Board of this SRO.

the performance and the conduct of these MFIs. A self-regulatory organisation with a strong enforcement mechanism is probably the most cost-effective solution for this part of tier four.

There are basically two options to create such an enforcement mechanism. The first option is to use the legal power of BoU to follow-up on breaches of current legislation, namely the FIS and in the future also the MDI Act. BoU could suspend the microfinance operations of tier four MFIs.<sup>26</sup> The SRO would be able to use its greater proximity to smaller MFIs for generating relevant information. It would be legally authorised to report misconduct to BoU. A clear disadvantage of this approach is that BoU can only follow up violations of current financial laws, of which none is specifically targeting tier four. Besides, BoU does not have sufficient capacity to follow-up on tier four MFIs nor the explicit mandate under the 1999 policy statements to look into this sector.

The second option is to authorise the SRO itself to suspend microfinance operations of non-coop MFIs. This option has the advantage that the rules of the SRO can be much more detailed and more specific to the kind of problems in the sector.

There is no need for prudential regulation of non-coop MFIs. The focus should lie on performance monitoring and conduct of business regulation. The latter can be achieved by introducing a Code of Practice.<sup>27</sup> The compliance with this code should be easily verifiable and enforceable.

The main elements of this self-regulatory system could be the following:

- A standardised financial reporting system along the lines of AMFIUs Performance Monitoring System;
- Minimum fit and proper criteria for directors/CEOs of MFIs;<sup>28</sup>
- Mandatory follow-up of complaints by clients or MFIs through the SRO;
- On-site inspections either by the SRO staff or by authorised third party (e.g. accounting professionals) at the discretion of the SRO without the need to give notice before;
- Introduction of a “cooling-off period” of some days during which a loan contract can be reversed and all moneys will be paid back.<sup>29</sup>

To be effective, membership with such an SRO must be mandatory. We understand that a voluntary system relying on the signalling effect of a ‘stamp of approval’ would not be understood by many of the frequently illiterate customers of tier four MFIs.

Each member of this self-regulatory framework would have to sign a contract with the SRO which clearly spells out the SRO’ power to sanction misconduct. To ensure sufficient accountability of a mandatory self-regulatory framework, government must be involved in defining the rules and code of practice of the SRO. MFPEd or, as the regulator of the entire financial sector in Uganda, BoU would have to approve the SRO’s rules. Furthermore, government could be represented on the Board of the SRO, which in turn is responsible for disciplinary actions against MFIs.<sup>30</sup>

An important decision will be the funding of such an SRO. As self-regulation can be seen as a

<sup>26</sup> As long as these MFIs are still registered as NGO or company, it would not be possible for BoU to completely close down all their operations.

<sup>27</sup> Cf. McAllister (2003).

<sup>28</sup> They could be asked to sign a self-declaration as criminal and civic clearance.

<sup>29</sup> This list has borrowed heavily on the South African case of the Micro Finance Regulatory Council.

<sup>30</sup> The composition of the SRO’s Board is a delicate issue, as one would have to balance different objectives such as accountability, effectiveness, and independence. Wide participation of different stakeholder groups would be preferable. Too much government involvement has not proven to be recommendable as one could observe in the case of the NGO Board.

service of an umbrella body for its members, it is usually financed by membership fees. Yet if the membership becomes mandatory and the SRO takes on statutory tasks, which have been delegated by the government, at least a partial funding through the government seems reasonable. Besides, the supervision of financial institutions in tier one to three is fully financed by the central bank, so that some government support in tier four can also be expected.<sup>31</sup>

How could be ensured that all MFIs apply for registration with the SRO? Obviously, it would be difficult to charge the SRO alone with this task. We recommend three strategies in this regard.

Firstly, all donor agencies should agree to assist only those MFIs, which are registered with the SRO.

Secondly, a complaint office should be set up, where people could report about MFIs doing business without being registered. The same complaint mechanism could be used for reporting tier four MFIs (be they registered or not), which do take illegal deposits. Presumably, there is a strong incentive for competitors in tier three to report about these activities. In addition, the licensing agencies, i.e. the NGO Board and the Registrar of Companies, should report regularly about deposit-taking activities of NGOs or companies.

Thirdly, doing microfinance business without being registered with the SRO must have clear legal consequences. It could, for example, deprive lenders of their rights to seize a security.

### 5.3 Role of AMFIU

Establishing a new SRO for non-coop MFIs from scratch is an expensive and time consuming undertaking. The question arises whether AMFIU as an existing, well established umbrella institution could take over this role. During our interviews, this idea evoked both reservations and support. The main reservations expressed were the following:

- AMFIU is a voluntary membership organisation. Mandatory membership would change its character;
- AMFIU does not have sufficient capacity to take over the role as SRO for non-coop tier four;
- Membership of AMFIU is still very limited. Only 39 of the 62 ordinary members, of whom AMFIU has information about their legal status, belong to this segment of tier four. Furthermore, SACCO-members of AMFIU might get marginalised as they would not fall under this self-regulatory system;
- The tasks of promoting the industry and at the same time policing non-compliant members can lead to conflicts of interest.

These points have to be taken seriously. Yet we are convinced that these reservations can be counteracted and that they do not outweigh the advantage of making use of an already existing and well-established institution.

Including non-practitioners such as BoU on the Board of AMFIU can alleviate potential conflicts of interests. In addition, AMFIU should establish a separate supervisory department to organisationally separate its different tasks. Support to members should be granted in a non-discriminatory manner. If AMFIU would promote individual member institutions, it would take

<sup>31</sup> Such a self-regulatory framework would fall in the category of “alternatives to state regulation” according to the UK Better Regulation Task Force: “Self-regulatory schemes that have developed as genuine alternatives to state regulation, such as codes of practice initiated or encouraged by government, work effectively if they harness the commercial interests of the industry. For example, a scheme that helps to raise standards in the industry or to improve its image could encourage more business. To ensure that these schemes operate effectively, government needs to monitor their operation and to retain a credible mechanism for intervening if problems arise. Government and consumers benefit from the operation of these schemes through lower costs and, arguably, better enforcement. Industry benefits from its involvement in the rule-making process and the flexibility to adapt to changing circumstances that such schemes offer.” Better Regulation Task Force (1999: 5)

over some responsibility for their well-being, which makes it difficult to sanction these members.

Finally, looking at Baldwin's five criteria for the assessment of regulatory frameworks (cf. Ch. 3.2), charging AMFIU with the self-regulation of non-coop MFIs seems clearly preferable to direct government regulation:

1. Expertise: AMFIU's Board represents experts from the industry. Its Secretariat has gathered considerable expertise about tier four institutions.
2. Efficiency: Self-regulatory frameworks in general have a number of advantages, which render them more efficient than government regulation. AMFIU has much lower costs to generate the necessary information about the tier four sector. It enjoys trust and good reputation in the industry, which makes it easier to resolve disputes. Finally, a complaints mechanism will be much more cost-effective than dispute resolution via the legal system.
3. Mandates: This is the question whether regulation serves legitimate ends. It can be achieved by clearly spelling out the objectives of such a self-regulatory framework in the beginning. All regulatory initiatives of AMFIU would then be measured against these previously agreed upon objectives.
4. Accountability: Rules and the Code of Practice of AMFIU would be approved by a government agency with a good knowledge of the sector, such as the central bank.
5. Fairness of procedures: A consultative process for setting-up the self-regulatory system, which includes all stakeholder groups which will be affected by it and the government, can ensure fairness of procedures.

## 6 The Way Forward

As mentioned earlier, the Ugandan Parliament has resolved that Cabinet should come up with a proposal to regulate tier four institutions by May 2003. Thus there is some time pressure to come up with concrete proposals for the next steps. In this final chapter, we would like to clearly spell out the next steps in the fields of legal amendments, capacity building, consumer education, and, finally, further research which is still needed to be done.

### 6.1 Laws to Be Amended

In the following, we have summarised the main legal amendments, which would be required to put our recommendations into practice.

#### 6.1.1 Non Governmental Organisations Statute 1989

It should be pointed out that the Non-Governmental Registration (Amendment) Bill 2000 has been tabled before Parliament. The object of the amendment is to provide, inter alia, for the modification of the functions of the NGO Board and to remove dual registration. It should be therefore quite easy to include some microfinance-specific requirements in the current Bill.<sup>32</sup>

First, the NGO Statute should be amended so that registration under the board confers corporate status to the organisation. Such an amendment would remove the need for dual registration so that there is no requirement to register under the Companies Act or Trustees Incorporation Act.

Second, there should be an amendment of the Statute requiring NGOs engaged in 'microcredit business' to register with a Self-Regulatory Organisation formed for that purpose. 'Microcredit business' is different from the definition of 'microfinance business' under the MDI Bill as it does not allow for deposit taking. It could be defined as "the provision of short term loans to small or micro enterprises and low-income households, usually characterized by the use of collateral substitutes, such as group guarantees or compulsory savings". The maximum amount of compulsory savings (e.g. as a percentage of the outstanding loan amount) should also be specified.

Furthermore, a government agency (e.g. BoU) should be authorised to issue regulations specifying minimum requirements for the SRO.

#### 6.1.2 Companies Act

It is to be noted that the Companies Act is under review by the Commercial Justice Reform Programme. A number of areas have been proposed for amendment. This, again, provides a good opportunity to include some microfinance-specific requirements.

In our view, the areas proposed for amendment affect the management of companies generally, but not the specific needs of tier four MFIs registered as companies. The registrar of companies cannot and should not play the main role in monitoring tier four MFIs.

Even if the NGO Statute is amended in a way that no double registration under the Companies Act will be required, some MFIs may still choose to be registered as companies only. It is therefore necessary to amend this Act in the same way as the NGO Statute, i.e. to include a requirement that companies engaged in 'microcredit business' must be registered with a Self-Regulatory Organisation, and to authorise BoU to make regulations under this Act.

<sup>32</sup> For a critical view on this NGO Amendment Bill, check DENIVA's webpage: [www.deniva.or.ug/deniva\\_meet.htm](http://www.deniva.or.ug/deniva_meet.htm)

### 6.1.3 Co-operative Societies Statute 1991

As mentioned above, the Co-operative Societies Statute 1991 is to be amended. Currently the Co-operatives (Amendment) Bill 2002 has been tabled before Cabinet for discussion. The process is ongoing, which gives us the opportunity to suggest some additional amendments for SACCOs.

It is proposed that the Co-operative Societies Act be amended to provide specifically for SACCOS, i.e. for co-operatives engaged in microfinance business. We understand that the Amendment Act includes a separate section for SACCOs only. We also understand that this section does not yet satisfy the requests of the main stakeholder groups. More consultation would be required.

A separate Savings and Credit Co-operative Societies Act would be clearly preferable, particularly if SACCOs were moved to MFPED. The draft Act from 1999 would be a good starting point for discussion. A comparison with the Model Law for Credit Unions from WOCCU could help to show areas, which have not yet been sufficiently covered.

It is also proposed that either UCA or UCSCU is given a role in monitoring the performance of SACCOS on behalf of the Registrar of Co-operatives, even though statutory powers would stay with the Ministry. In order to perform its functions, UCA/UCSCU must be authorised to supervise SACCOs and report to the responsible Ministry (be it MTTI or MFPED). The Ministry, in turn, should be legally bound to act if problems arise. It might be useful to look at the system of prompt corrective actions under the MDI Bill.

Finally, we recommend considering at least in the medium term to bring larger SACCOs under the purview of BoU. Such an approach would not require the introduction of a new law, but only the authorisation of BoU to issue specific regulations for SACCOs, which are beyond a still to be specified cut-off level (in terms of numbers of members or volume of deposits). Similar to the *co-operatives with a limited banking transaction license* in Nepal, these larger SACCOs would then still be subject to the regulations under the Co-operatives Societies Act, but in addition come under direct central bank supervision. The regulations would be quite similar to those under the MDI Bill, only that they take the specific governance structure of co-operatives into account.

### 6.1.4 Money-Lenders Act 1952

The Money-Lenders Act of 1952 is outdated. The Magistrates lack the capacity to monitor and supervise this sector. There are numerous money-lenders in the market and regulating them would be an impossible task. The Act itself lacks any complaint and enforcement mechanism. The general law of contract is sufficient to govern the relationship between the money-lender and the borrower since this is a freely entered agreement.

Thus it is proposed that the Money-Lenders Act is repealed. Money-lenders will always be around. The best way to protect costumers is to enable them to make an informed choice between a number of institutions offering microfinance services. A self-regulatory system for tier four is trying to achieve this. In addition, consumers must be educated about their rights and options (cf. Ch. 6.2).

Furthermore, the Money-Lenders Act is not needed as a legal basis for preventing the transformation of lending contracts into sales contracts as such a transaction is prohibited under the Mortgage Decree 1975.

## 6.2 Consumer Education and Protection

Consumer education will be essential to make whatever regulatory system is chosen effective. Clients of tier four institutions must know about their rights. They must understand the difference between well and poor performing MFIs. They must be empowered to make an informed choice. To give an example: The best mechanism to bring interest rates down is to improve transparency and educate clients. Only then MFIs have an incentive to undercut the rates offered by their competitors.

The following steps can be taken:

- More choice and more transparency in the market will be the single most important way to protect consumers from exploitation. Setting-up a self-regulatory system for tier four institutions leads in this direction.
- AMFIU is best positioned to educate consumers about their legal rights and potential pitfalls of lending from informal sources. For example, instead of the current prohibition to offer a sales contract instead of a lending contract under the Money-Lenders Act, which cannot be effectively enforced and potentially creates huge costs for the aggrieved lender ex post, consumers should know about the implications of signing such a contract ex ante. Different media such as radio, newspapers, TV, flyers, and workshops could be used to reach as many borrowers as possible.
- To improve information dissemination in rural areas, the planned Financial Extension Workers (FEWs) under the “Strategic Plan for Expanding the Outreach and Capacity of Sustainable Microfinance in Uganda” could play a potential role in educating consumers.
- Currently, the Consumer Protection Bill 1999 is pending before Parliament for debate. It is important that Parliament recognises the need to protect consumers of microfinance services. Provisions to this effect could be incorporated in the proposed law. With regard to consumer protection in lending, the analysis of experiences in other countries such as the Truth in Lending Act in the US might be of interest.<sup>33</sup> Yet one should not expect too much of this as, one again, enforcement will be the main bottleneck.
- A complaint mechanism can play a major role as a cost-effective alternative to enforcing a case in a court. As mentioned earlier, the SRO should set-up such a complaint mechanism. In addition, an independent appeals committee can serve as an effective dispute settlement instrument.<sup>34</sup>

## 6.3 Capacity Building

Except for the repeal of the Money-Lenders Act, all these recommendations require some capacity building. While regulating tier four, the relation between costs and benefits should always be born in mind. The more regulation you want, the higher the supervisory and compliance costs for the sector. Capacity building should focus on the following two institutions:

- AMFIU: Charging AMFIU with the task of supervising non-coop MFIs, educating consumers about their rights and setting-up a complaint mechanism will require more staff and better funding of this institution. This task has the character of a public good and should at least partly be funded from third sources.
- UCA/UCSCU: The same is true for UCA or UCSCU, if one of these networks will be responsible for the supervision of SACCOs.

<sup>33</sup> The full text of the Act can be accessed here: <http://tinyurl.com/af7l>

<sup>34</sup> Cf. the Disciplinary & Appeals Committee of the MFRC

The Bank of Uganda and the Ministry of Tourism, Trade and Industry will only play a minor role in the supervision of tier four institutions. They will retain the power to close down MFIs or at least suspend microfinance operations of non-complying institutions.

#### **6.4 Fields for Further Investigations**

The scope of this study was limited. As mentioned earlier, the consultants were not able to collect primary data on the sector or to do an in-depth analysis of problems in the sector. Even under the current time pressure, it would be recommendable to collect more information about institutions and problems in tier four.

This is particularly true for the money-lenders. There are numerous money lenders in the market. Most of them are not registered. It is impossible to make a serious analysis of this sector without proper investigations. It is proposed that a serious study of this sector is undertaken to assess its impact on the economy and the most critical issues.

On the institutional side, the potential of UCA, UCSCU and AMFIU to play a stronger role in supervising tier four institutions should be assessed. None of these institutions should be charged with any additional tasks without having been subjected to an analysis of strengths and weaknesses and the preparation of financial projections.

AMFIU, in particular, should be scrutinised with regard to its potential role as Self-Regulatory Organisation. In our opinion, AMFIU is a good starting point for developing a self-regulatory system for non-coop MFIs. Yet it has to prove that it can fulfil this role in an effective and efficient way. There is always the option of sourcing the supervisory tasks out at a later point in time.

## Annex: List of Interviewees

The following interviews were conducted between February 27 and March 18, 2003:

|                      |  |   |
|----------------------|--|---|
| Clare Wavamunno      | National President   | AMFIU   |
| Suleiman Namara      | Executive Director   | AMFIU   |
| Collins Adyera       | Database Manager   | AMFIU   |
| Anthony Opio         | Director Non-Bank Financial Institutions                     | BoU   |
| Agnes Kamyia         | Assistant Director, Credit Institutions                      | BoU   |
| Titus Mulindwa       | Legal Officer  | BoU   |
| David Kalyango       | Principal Examiner, Microfinance Division On Site Inspection | BoU   |
| Robinah Nakato       | Principal Banking Officer                                    | BoU   |
| Jane Nabunnya        | Programme Co-ordinator                                       | DENIVA  |
| Paul Rippey          | Manager  | DFID Financial Sector Deepening Fund                    |
| Axel Kakuru          | General Manager  | Faulu Uganda Ltd.                                       |
| David Baguma         | Operations Director Community Banking                        | Feed the Children Uganda                                |
| Fabian Kasi          | Country Director   | FINCA Uganda  |
| Gabriela Braun       | Programme Advisor  | GTZ/SIDA Financial System Development Programme         |
| Night Tuhaise Percy  | Member of the Commission                                     | Law Reform Commission                                   |
| Opifeni              | Chief Magistrate   | Mengo Court   |
| Henry Mbaguta        | Senior Economist   | MFPEd   |
| Patrick Mbonye       | MSE/MFI-Component Manager                                    | MFPEd   |
| Henry Bagazonzya     | Technical Advisor  | Microfinance Support Centre Ltd.                        |
| Leonard Mutesasira   | Uganda Representative  | Microsave Africa  |
| Fred Mwesigye        | Commissioner for Co-operative Development                    | MTTI  |
| Hon. Fred Badda      | MP   | Parliament of Uganda                                    |
| Hon. Ephraim Kamuntu | MP   | Parliament of Uganda                                    |
| Hon. John Kawanga    | MP   | Parliament of Uganda                                    |
| Ben Turyasingura     | Assistant Registrar  | Registrar of Companies                                  |
| Jacob Spangenberg    | Technical Advisor, DANIDA                                    | Rural Financial Services Component, Development Finance |

|                      |  |                           |
|----------------------|--|---------------------------|
|                      |  | Department, BoU           |
| Joanna Ledgerwood    | Microfinance Advisor                       | SPEED                     |
| Lene Hansen          | Programme Manager                          | SUFFICE                   |
| Div. (joint meeting) |  | Tier Four MFIs            |
| Leonard Msemakweli   | General Secretary                          | UCA                       |
| Chrissie Ongura-Mong | General Secretary                          | UCSCU                     |
| Tumwine Swithern     | Executive Director                         | UGAFODE Ltd.              |
| Rodney Schuster      | Executive Director                         | Uganda Microfinance Union |
| Harriet Mulyanti     | Act. General Manager                       | UWFT                      |
| Michael Osegge       | Chief Manager – Operations                 | UWFT                      |
| David Richardson     | Senior Manager of<br>Technical Development | WOCCU                     |
| William Bonilla      | Project Director                           | WOCCU/ SACCO NET Uganda   |

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