ESSAYS ON REGULATION AND SUPERVISION

Uganda's Experience with the Regulatory and Supervisory Framework for Microfinance Institutions

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ABOUT THE SERIES

The *Essays on Regulation and Supervision* series has been commissioned for the Microfinance Regulation and Supervision Resource Center, funded by the Consultative Group to Assist the Poor (CGAP) and implemented by the IRIS Center. These essays are intended to provide additional insights and perspectives on the experiences of microfinance institutions, regulators, donors, and others regarding specific microfinance legal and regulatory environments.

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Introduction

MICROFINANCE, i.e. the provision of financial services to poorer people, holds enormous potential to support economic activities and contribute to the alleviation of poverty. In most of the countries in the region, microfinance is a growth area and is set to be an important element in the development strategy.

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The Bank of Uganda (BoU) was a key player in formulating a regulatory framework for microfinance. This endeavor greatly benefited from a consultative process that began in April 1996. This paper reflects on the process of regulating and supervising microfinance in Uganda.

This process went through three main stages, namely formulating the Bank of Uganda policy on microfinance, formulating the MDI Act 2003, and formulating the 'Implementing Regulations on Capital Adequacy, Liquidity, Asset Quality, Reporting and Licensing'. The details of each of these stages are covered in more detail below.

The Initial Situation for Microfinance in Uganda

IN THE 1980s, access to financial services was limited and difficult for the rural poor because they were considered a risky, unbankable clientele. In most cases this was exacerbated by the lack of conventional collateral.

Furthermore, as part of a wider financial sector reform in 1987, Uganda embraced a structural adjustment program with the support of the International Monetary Fund (IMF). These reforms brought to light the issue of liberalization of the financial sector in Uganda, the major aim of which was to enhance effectiveness and efficiency to bring the economy back to a sound economic footing. Many government-owned institutions, especially commercial banks, had to realign their strategies to fit within the liberalized environment. The immediate impact of these reforms was that the biggest government-owned bank (which has since been privatized) contracted its branch network significantly across the country, leaving many rural districts without any financial services. This situation made the activities of non-governmental organizations (NGOs) offering microfinance services more prominent in filling the gap that had been created with the closure of these branches. As a result, many rural people looked to these institutions as a substitute for meeting their financial needs.

Moreover, when the Financial Institutions Statute (FIS) was passed in 1993, it did not cover microfinance in its current form.

For instance, the FIS 1993 did not provide for the use of unconventional collateral. Furthermore, the initial legal framework under which financial institutions were licensed in Uganda did not permit the existence of public deposit-taking MFIs.

Such glaring differences between the services that financial institutions offered and the financing needs of the rural poor meant there was an inevitable desire to re-engineer the financial services to suit the poor better. Otherwise, the gaps would have widened and alienated the rural poor from these institutions.

The NGOs in microfinance were quick to study this gap and subsequently organized themselves into an association of microfinance institutions to help deliver financial services to the poor. During early 1995, these microfinance NGOs came up with their own draft law for regulating microfinance. The draft law was sent to the Central Bank for comment. It was at this point that the Central Bank took interest in the subject of microfinance and took the lead in developing a regulatory framework for microfinance, even though it did not see the proposed draft law as appropriate. Instead, it initiated a consultative process for developing a microfinance law.

This new regulatory framework for microfinance deposit-taking institutions (MDIs) is, as its name suggests, mainly concerned with deposit mobilization. It also pays particular attention to the question of whether MDIs can raise sufficient capital and have the capacity to survive in a regulated environment.

The Regulatory Design Process

THE PROCESS of designing a regulatory framework in Uganda has drawn closely on the current financial landscape. The formal financial sector includes the central bank, i.e. Bank of Uganda; 15 commercial banks, seven credit institutions; and one MDI (although more are expected to be licensed in the next year). In addition, there are many more registered NGOs, companies or savings and credit cooperatives (SACCOs) that offer microfinance services. Many more unregistered microfinance organizations exist. A typical clientele consists of women groups in urban or peri-urban areas carrying out petty trade and produce buying.

The regulatory design process took into consideration these different types of existing financial institutions and how each could contribute to the overall growth of the industry. Bank of Uganda also drew lessons from several regulatory approaches used the world over.

Dialogue between the Central Bank and MFIs

Recent developments clearly indicate that the argument has become widely accepted that MFIs be brought under the formal legal and regulatory system as soon as they try to reduce dependence on donor funding and instead mobilize public deposits. The Bank of Uganda, as the financial institution regulator, took the lead in steering the process to its final conclusion. Uganda's process has benefited greatly from a consultative process that started in April 1996 and is still ongoing.

The Association of Microfinance Institutions of Uganda (AMFIU, Uganda's MFI Network) has been key and has always participated actively in the consultations with the Central Bank ever since the process began. AMFIU has provided a vital link and a platform between the Central Bank and all other stakeholders in microfinance development.

The consultations were in the form of workshops, conferences, field trips and monthly meetings at the Ministry of Finance. An important step was the early establishment of the Microfinance Forum. The Microfinance Forum is chaired by the Director of Economic Affairs of the Ministry of Finance on behalf of the Minister. It brings together MFIs, donors, the Central Bank and other stakeholders. This forum discusses issues of microfinance regulation and supervision in addition to other related issues such as the Plan for Modernization of Agriculture that would directly affect the microfinance industry. Besides, the Central Bank also held discussions with individual MFIs, especially the key players, donors and other government departments.

The dialogue between the Central Bank and MFIs was aimed at promoting a mutual understanding of the operations of the BOU and MFIs; to study the extent of the applicability of the present prudential norms to microfinance institutions; and to develop a workable solution through consultations between policy makers and practitioners. These discussions have led to the formulation of the Microfinance Deposit-Taking Institution Act 2003 (MDI Act 2003) and thereby facilitated the development of the microfinance sector.

Major Issues Raised During the Dialogue

Adequate Start-up Capital

The above issue remains relatively controversial in the microfinance industry. Very divergent opinions emerged in the course of consultations. On the practitioners' side, smaller MFIs were advocating for a far smaller capital amount (USh 20m [US$ 15,000]) than what the Central Bank had suggested (USh 700m [US$ 388,000]). However, all parties agreed in principal that the capital requirements for MFIs needed to be smaller than those for the formal financial institutions. It was already evident that the bigger MFIs, especially internationally based MFIs, did not have a problem with the USh 700m requirement, but the BOU

had to justify this figure. It was highlighted that sufficiently high capital requirements were intended to ensure that owners of MFIs have a sufficient stake in the institution to prudently manage operations and also allow the institution to expand without relying on depositors' funds. Neither losses in an MFI nor the regular payment of salaries should be covered by depositors' funds.

Above all, Uganda's experience shows that sufficient capital makes the incentives of owners compatible with those of savers or depositors. Higher capital amounts modulate opportunistic behavior of the owners of these institutions to avoid undue risks.

It was also recognized that deposit mobilization is an enormous responsibility and entails accepting a risk. Without sufficient capital an institution may not have adequate capacity to organize deposit mobilization.

Despite the above justification, the issue of capital was finally left to the legislators who made the final decision during the promulgation of the MDI Act 2003. Minimum capital was finally set at USh. 500m (US$ 250,000).

Transformation from "Donorship" to Ownership

The key MFIs in Uganda are donor-funded, which raises the issue of ownership. The key question was how donor-funded institutions would become deposit-taking financial institutions and what would be the appropriate ownership structure? From the current discussion of regulation, it appears that a crucial prerequisite for a license as a microfinance intermediary is to have an appropriate ownership structure with incentives for owners to monitor the institution's performance. This is best achieved by ownership that puts private profit-motivated funds at risk, which poses considerable difficulties for NGOs seeking to transform into regulated financial entities.

From the discussion with stakeholders, there was general agreement that all donor funded institutions were to transform into limited liability companies if they are to mobilize voluntary deposits from the public.

Some recent experience has shown how ownership and governance structures of the aforementioned institutions can be improved by bringing in private investors and by stipulating an arms-length relationship between the founding NGO and the licensed institution. By nature most NGOs used to have a stronger emphasis on social concerns than on business concerns, even though such commercial considerations are important in sustaining and maintaining the value of money, hence the need to make a profit. When business concerns are not clearly separated from social concerns, it is possible for the NGO to confuse issues. Private investors may bring in the right balance between both because of the drive to make profit or secure a return.

Appropriateness of Implementing Regulations

Initially, there was a fear that the Central Bank had limited experience with MFIs, which would results in MFIs being subjected to the same rigorous regulations as those applicable to banks. However, through consultations the Central Bank was able to convince the practitioners that MFIs were seen as unique in their circumstances and as such their regulations were going to differ from those that would be applicable to banks. Special regulations tailored to MFIs were developed and subsequently gazetted. The implementing regulations for MFI cover Licensing, Capital Adequacy, Reporting, Liquidity and Asset Quality.

Forced Savings as Part of the Credit Technology

The original thinking at the Central Bank was that any form of deposit/savings, whether voluntary or involuntary, were to be regulated and supervised by the Central Bank. To the practitioners, such a measure looked too restrictive. They strongly believed this could stifle innovation especially for those MFIs that were not intending to mobilize voluntary deposits due to their own lack of capacity. The practitioners urged that the future of unregulated MFIs was in accepting forced savings as a form of collateral. Most microfinance loans are character-based and an important way of securing their portfolios from default is to encourage forced savings from clients. Besides, such savings help the MFIs to develop a credit history of the clients. In a bid to promote the industry and through the consultative process, it was agreed that forced savings would not trigger licensing requirements as long as they were not intermediated.

Milestones in Developing the Legal Framework for MDIs

Bank of Uganda Policy on Microfinance

In 1999, the Bank of Uganda drafted a 'Policy Statement on Microfinance Regulation in Uganda', which was subsequently approved by the Cabinet. The policy spells out the principles of regulation that guided the development of the MDI Bill. The objective was to facilitate the growth of safe and sound microfinance deposit taking institutions.

The policy statement maps out the Bank's future strategy in the regulation and supervision of all microfinance deposit taking institutions in Uganda. It also attempts to provide a linkage between established institutions and the small outreach organizations. The key feature of the regulatory approach adopted by BOU is the "Tiered Approach".

The Tiered Approach

BOU is guided by what is feasible for its own operations and conducive for the development of the financial market. BOU regulates microfinance business under a tiered framework. The tiered approach reflects the concept of microfinance as a line of business. It is conducive to the development of a sound

microfinance sector. It gives room for more flexibility to microfinance activities, which are still in an experimental stage. The tiered approach incorporates the fact that it may be necessary to regulate different intermediaries in a different manner. This is one important innovation in the regulation of this type of business in Uganda.

BOU therefore identified four categories of institutions that can do microfinance business in Uganda.

- **The first category (Tier 1)** of institutions is banks. Banks are sufficiently capitalized (with a minimum paid-up capital of Ush. 4bn or approx. US$ 2m) and already meet the requirements for taking deposits as provided for in the Financial Institutions Act of 2004 (FIA 2004). These will be formally allowed to conduct the business of microfinance. One commercial bank, Centenary Rural Development Bank has been doing microfinance business for many years.

- **The second category (Tier 2)** of institutions is Credit Institutions. These institutions are also sufficiently capitalized (with a minimum paid-up capital of Ush. 1bn or US$ 500,000) and already meet the requirements for taking deposits as provided for in the FIA 2004. Like banks, credit institutions will be able to do microfinance business. Commercial Microfinance Limited, a credit institution, is already doing microfinance business as its main activity.

- **The third category (Tier 3)** includes all institutions referred to as Microfinance Deposit-Taking Institutions (MDI). MDIs are regulated, supervised and licensed to accept public deposits. A minimum required capital is defined such that it is sufficient for deposit-taking and intermediation. Capital adequacy ratio for MDIs is 15% of risk weighted assets, while it is only 8% for commercial banks. MDIs are also required to maintain liquid assets of 15% of their total deposits.

- **The fourth category of institution (Tier 4)** comprises two types of institutions. First, all non-deposit taking institutions such as credit-only NGOs or any other non-deposit taking initiatives (although they are allowed to use forced savings as long as these funds are not intermediated). Second, all those member-based organizations taking savings or subscriptions from their members. These institutions are not regulated under the new Microfinance Deposit Taking Institutions legislation by BOU.

Bank of Uganda regulates microfinance business of tier 1 and 2 institutions under the FIA and tier 3 under the special law, the MDI Act 2003. The question of regulating organizations under tier 4 is still being debated. For tier 1 and 2, the regulation on asset quality in these institutions makes reference to the regulation on asset quality under the MDI Act. This applies only to that part of the loan portfolio which has been separately identified as microfinance.

The Micro Deposit Taking Institutions Act 2003 (MDI Act 2003)

The MDI Act 2003 was passed by Parliament in November 2002 and promulgated into law in May 2003. The law clearly provides conditions on entry, operations and exit of licensed microfinance deposit-taking institutions. The MDI Act 2003 is structured as follows:

- The definition of microfinance (clarification of basic terminology, line of business)
- Licensing
- Restrictions on certain transactions and dealings by micro deposit taking institutions
- Ownership and Corporate Governance
- Supervision by the Bank of Uganda
- Receivership, Liquidation and Exit.

Prudential regulations on reporting requirements, licensing, liquidity, capital adequacy and asset quality were laid down in a statutory instrument. This statutory instrument made provisions for MDIs as well as for banks and credit institutions holding a microfinance portfolio.

Some Details on Regulation and Supervision of MDIs

In order for the BOU to focus on the specific risks related to microfinance, regulatory principles for the new Tier 3 institutions are stricter than for banks and credit institutions providing conventional financial services. The Bank of Uganda uses a risk-based supervisory approach in the supervision of MDIs. The key concept is that supervisory resources focus on areas of significant risk in the individual institution. Major risks that are considered include strategic, credit, liquidity, interest rate and operational risks. The risk-based approach combines both qualitative and quantitative indicators and encourages efficient use of supervisory resources.

- Since Tier 3 institutions are new and therefore more vulnerable to economic crises, it was decided to measure capital adequacy more strictly than for standard financial institutions, which are guided by the 1988 Basle Capital Accord. Therefore, capital adequacy ratios for MDIs are significantly higher than for banks and credit institutions.

- From BOU's point of view, liquidity requirements for Tier 3 institutions should be more conservative than for traditional banking business given the circumstances under which they will operate. Suspension of lending due to liquidity shortfalls directly affects clients' motivation to repay loans. Above all, due to the preferences of small savers (quick and easy access to saving accounts), special care should be taken to ensure

that sufficient liquidity is available to immediately meet clients' demand for withdrawals.

- With Tier 3 institutions relying heavily on the loan portfolio as the single most important asset, it necessitates having a high quality loan portfolio in order to maintain the overall health of the institutions. The microfinance portfolio is characterized by short-term loans. Their non-collateralized lending warrants more strict provisioning policies than those of banks. It is stipulated in the regulation on asset quality that MFIs will need a shorter duration when recognizing problem loans, e.g. starting at 30 days past due whereas banks are required to start at 90 days.

- BOU requires simple and concise reporting using a clear uniform format designed to capture key financial information. MFIs will be required to report on balance sheet, profit and loss, portfolio quality and any other such information that the Central Bank will require.

Challenges Ahead

Organization and Economics of Supervision

Underlying the discussion of regulation and the attendant questions of whom and how to regulate is the unavoidable constraint of costs and limits to capacity in supervising regulated institutions. In addition to the attention required by the traditional financial sector, government authorities face a supervisory challenge in dealing with the unique characteristics of microfinance operations. Organizing the supervision of different categories of microfinance institutions needs to be accompanied by economic considerations of its relative costs and benefits.

In response to the above issue, Bank of Uganda carved out the institution to be regulated as those intending to mobilize deposits from the public. The supervision function has established a special division in its organizational structure to look specifically at MDIs. To take on the challenge, the supervision department has been building capacity of staff to supervise MFIs. Supervision staff have participated in both local and international workshops, conferences and short courses to develop a deeper insight into microfinance regulation and supervision. Countries visited include Bolivia, India, and Indonesia. All officers in the department responsible for MDI supervision have been to the microfinance training course in Boulder, Colorado, USA.

Conclusion

MFIs have an important role to play in credit delivery and savings mobilization, particularly in poor and remote areas of the country, and in the development of the financial system as a whole. Microfinance is an engine in the development of efficient rural financial institutions.

The Bank of Uganda is committed to ensuring that MFIs operate effectively and provide efficient financial services to their clients. Together with the relevant stakeholders, an appropriate regulatory framework has been designed, which takes into account Uganda's circumstances and level of development in the financial sector.

Bank of Uganda's effort is aimed at creating an enabling environment for the growth of the rural financial system.

To summarize the entire process, Bank of Uganda went through three major phases as explained above. These include formulating the Bank of Uganda Policy on Microfinance; formulating the MDI Act 2003; and creating the implementing regulations on capital adequacy, liquidity, asset quality, reporting and licensing.

As of now, one MDI has been licensed and three more MFIs have submitted their application to BoU. Several other microfinance institutions have already approached the Central Bank to consult on prospects of applying for an MDI license.

We however advise that the choice and design of the regulatory framework for microfinance is a daunting task and is greatly conditioned on individual country circumstances, including the political landscape. The process took close to eight years and – regardless whether this is perceived as too long or too short - the process must respect the level of maturity of the financial system existing in a country. Substantial time and resources must be devoted to understanding how individual country financial systems work.

With the scant attention that was paid to the promotion of the MFIs in the past, the future outlook is quite promising. There is now a serious effort to mobilize all the necessary resources to ensure the proper and adequately-supervised expansion of MFIs, maximizing their contribution to poverty alleviation.

Uganda's limited experience in the workings of MFIs clearly supports the widely held notion that properly supervising these institutions can play a key role in economic development, with tangible results in the area of poverty reduction. It is with this objective in mind that the relevant authorities have pledged to continue to work closely to achieve these objectives for the mutual benefit of developing the microfinance institutions.