

Who Benefits From Regulation?



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LIST OF ACRONYMS

AMFIU	- Association of Microfinance Institutions in Uganda
BoU	- Bank of Uganda
CAGR	- Compound annual growth rate
CMF	- Commercial Microfinance Ltd.
D/E	- Debt-to-Equity
DFID	- Department for International Development (of the UK Government)
FIA	- Financial Institutions Act
FIS	- Financial Institutions Statute
FSDU	- Financial Sector Deepening Project Uganda (funded by DFID)
FSS	- Financial Self Sustainability
GTZ	- German Technical Cooperation
LIF	- Loan Insurance Fund
MOP	- Microfinance Outreach Plan
MCAP	- Matching Grant Facility for Capacity Building
MDI	- Micro Deposit taking Institution
MED Net	- Micro Enterprise Development Network
MF	- Microfinance
MFF	- Microfinance Forum
MFI	- Microfinance Institution
MIS	- Management Information System
MoFPED	- Ministry of Finance, Planning and Economic Development
MSCL	- Microfinance Support Centre Ltd
NBFI	- Non-bank Financial Institutions
NGO	- Non Governmental Organisation
OSS	- Operating Self-Sufficiency
PAR	- Portfolio at Risk
PMT	- Performance Monitoring Tool
Rural SPEED	- Rural Savings Promotion & Enhancement of Enterprise Development
SACCO	- Savings and Credit Cooperative
SPEED	- Support for Private Enterprise Expansion and Development
SUFFICE	- Support to Feasible Financial Institutions and Capacity building Efforts
TSC	- Transformation Steering Committee
UCA	- Uganda Cooperative Alliance
UCB	- Uganda Commercial Bank
UCSCU	- Uganda Cooperative Savings and Credit Union
UFT	- Uganda Finance Trust Limited
UML	- Uganda Microfinance Limited
UMU	- Uganda Microfinance Union
USAID	- United States Agency for International Development
USh	- Ugandan Shilling
UWESO	- Uganda Women's Effort to Save Orphans

UWFT - Uganda Women's Finance Trust

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18.0 EXECUTIVE SUMMARY

Mainstreaming of microfinance into the formal financial sector, including regulation, has been a topical issue among microfinance experts in the recent past. Does regulation strengthen the institutions? Does it always result into increased outreach to the poor or the reverse? Is it necessary to promulgate a separate law for MFIs to be licensed and regulated? What happens when regulated MFIs feel they are overregulated in comparison to other formal financial institutions? Is regulation (especially prudential) what MFIs need to enhance their outreach? What happens when new players bring in their venture/ equity capital, transformed MFIs get more of the money from the market for portfolio growth and the regulator has stringent performance requirements for the institutions?

This study sought to answer the above and other questions from the practical standpoint of the Ugandan experience. It follows a study done to assess the effects of the MDI Act 2003 and the MDI Regulations 2004 on the microfinance industry in Uganda. Although it is only two years since the first MDI was licensed, there are vital lessons to be picked from progress so far. Through a combination of document reviews, interviews/ discussions and performance analysis, this study has established that since licensing/ transformation:

- MDIs have become more business oriented and innovative
- MDIs have overall seen a reduction of the number of borrowers and a significant increase in the loan portfolios
- The numbers of savers have increased sharply, while the total Shilling value of savings has risen only modestly
- Loan pricing has not come down – there has been a slight rise in the portfolio yield of MDIs
- Financial and operational performance of the MDIs experienced a temporary setback just after licensing, and are now being corrected
- MDIs have realised that their status is unfavourable in relation to banks, and mature Tier 4 MFIs are less eager to become MDIs
- BoU and MDIs' expectations have largely been met, while Government's expectations have not.

The report draws some conclusions, presents preliminary lessons and, on the basis of the findings, recommends some future intervention areas to address unmet expectations.

1.0 INTRODUCTION

1.1 The assignment and its purpose

More than four years since the MDI Act was promulgated and two years after the first microfinance deposit-taking institution (MDI) was licensed, some stakeholders would like to assess the impact of the MDI Act and its Regulations on the microfinance sector in Uganda. In the last four years, FSDU as a key player in Uganda's microfinance industry has supported a number of initiatives including the transformation of MFIs into MDIs licensed and supervised by Bank of Uganda (BoU). Since 2001, different stakeholders have put significant recourses into preparing MFIs to transform and helping them to remain compliant immediately after transformation. This study is intended to assess the impact of the MDI Act on the various microfinance (MF) stakeholders in Uganda in general and on MDIs and their clients in particular. It is also meant to inform the process of review and implementation of MF frameworks in Uganda and elsewhere.

1.2 ToR summary

The terms of reference required the consultant to:

- Examine the impact of the MDI regulation on MDIs, other MFIs, their clients, commercial and social wholesale lenders, Government and donors
- Assess if the impacts have justified the costs incurred by stakeholders to make legislation, transformation and regulation possible
- Discuss the way forward for the MDI model as a vehicle for microfinance service delivery
- Highlight the upsides and downsides of the MDI Act 2003 and discuss the possible alternative approaches.

1.3 Methodology used

In line with the ToR, the consultants undertook the following tasks to accomplish the assignment:

- Review of the relevant reports, plans and other documents generated before, during and after passing of the MDI Act 2003 and licensing of MDIs
- Review of the MDI Act and MDI Regulation Guidelines
- Interviews with MDI management and Board members
- Interviews with Bank of Uganda NBFU Supervision section

- Interviews with the management of some Tier 4 MFIs¹ management
- Market survey/ interviews with a selection of existing and potential clients of MDIs and Tier 4 MFIs
- Analysis of the performance trends of MDIs
- Analysis of the findings from all the above
- Drafting of the assignment report.²

The explicit focus of this study is on the MDI Act, thereby leaving aside other actors in the microfinance sector such as savings and credit cooperatives (SACCOs) and commercial banks (Tier 1) and credit institutions (tier 2) providing microfinance. They are regulated under different laws, and the limited scope of this study did not allow for a comparison of the impact of these other laws on conducting microfinance.

While the methodology used here brings out indications of the actual and probable impact, it is in no way perfect. One of the most difficult things in regulatory impact assessment is how to prove impact. This is in part a problem of the missing counterfactual: we cannot accurately tell how the sector would have developed without the law coming into place. It is in many cases difficult to clearly attribute developments in the sector to the promulgation of the MDI Act and Regulations. In the Ugandan case, one might argue that the impact of donor support has been at least as strong as the impact of regulatory change (even though the counter argument would be that donor support has in turn increased due to regulatory change). Other limitations of the methodology used are:

- A rather short trend analysis (2002 to 2006); assessment of real impact would have necessitated a longer ex ante and ex post assessment of say six years before and six after licences were given. This is at present not possible
- There are no established best-practice benchmarks for this kind of regulation, and the results are seldom accurately quantifiable
- The total, all inclusive cost of regulation incurred by the different stakeholders before and after MDI transformations is not easy to accurately assess, partly because the costs were not purely financial and partly because it is difficult to distinguish incremental costs (caused by regulation) and “good business costs” (costs of institutional change which would have occurred even without regulation).

In practice this means that we have to define a benchmark against which we measure the development of the sector. The main benchmark chosen in this case is the expectations of various stakeholders regarding benefits of

¹ Under Tier 4 fall all MFIs which are not regulated by BoU. For the purpose of this study, we do not look at Savings and Credit Cooperatives, which are also part of Tier 4.

² See Appendix 1 for a list of persons interviewed.

introducing a separate legal framework for prudentially regulated deposit-taking MFIs (see section 3.2). In addition, we also assess the extent to which the costs of transformation and regulation justify the benefits (see section 15.0). Comparison is also made between the development of the four MDIs from the point when they started to prepare for transformation to date with the development of other mature Tier 4 MFIs that have not yet transformed.

2.0 BACKGROUND TO THE FORMULATION OF THE MDI ACT

2.1 Growth and metamorphosis of Uganda's financial sector

The microfinance industry in Uganda was a natural offshoot of the general dynamics of the country's economy, which left rural and other low income people lacking financial services in the last three decades. The economic breakdown of the 1970s and 1980s caused many banks to close upcountry branches, and cooperatives, including SACCOs, also closed down. Attempts to reverse this through massive branch opening by the then Uganda Commercial Bank (UCB) in the 1980s was not successful as many of the branches made perpetual losses and were closed down.

The issues highlighted above left rural and other poor people in Uganda without formal financial services. In their bid to alleviate poverty through a social agenda, a number of NGOs and other aid organisations started developing some form of microcredit as departments or functional areas in the 1980s and early 1990s. At about the same time, a few specialized MFIs also started operations, mainly delivering microcredit backed by compulsory savings used as collateral substitutes. Owing to the real need for financial services by low income people, these microfinance programmes grew fairly fast in number and size. They helped to fill the void left after BoU in the late 1990s closed four banks³ including Cooperative Bank, then Uganda's second largest bank in terms of branch network.

In the late 1980s and early 1990s, some of the NGO microfinance functions were spun off into fully fledged MFIs or stand-alone microfinance programmes. Examples are MED-Net (from World Vision) and Feed The Children Community Banking Programme (from Feed The Children Uganda). The paradigm of microfinance was, during this time, largely limited to microcredit. The mid and late 1990s was also a time of increased interest and education in microfinance internationally. Through a combination of donor programmes, Government support and keen interest to learn on the part of the MFIs, a lot of fully sponsored training and technical assistance based on "Microfinance Best Practices" was provided during the late 1990s and early 2000s. This resulted into:

³ Cooperative bank, Greenland bank, Trust Bank and International Credit Bank
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- The MFIs and other stakeholders broadening their understanding of microfinance from microcredit to other financial services
- Appreciation by most stakeholders that microfinance should be delivered in a sustainable and businesslike way
- Many MFIs and microfinance programmes developing long and short term plans with a focus on operational and financial sustainability, which when implemented enabled them to attract increasing numbers of clients while adopting a more business oriented focus.

2.2 Move towards commercialising and mainstreaming microfinance

The adoption of sustainability and profitability alongside the social missions of MFIs (which came to be referred to as the *dual mission* or *double bottom-line*) meant that sponsors and management of MFIs moved from seeing microfinance purely as a social service to running the institutions with a focus on profitability and long term commercial viability. The dual mission drove the MFIs to seek greater outreach and the MFIs grew the numbers of their clients significantly. By the end of 1999, for instance, the larger MFIs like PRIDE and UWFT each had more than 30,000 clients. FINCA, UWESO (now Success Microfinance Ltd), Faulu Uganda, Feed The Children and a few others had between 5,000 and 25,000 and were growing. At the same time, stakeholders of the microfinance industry (MFIs, Government, donors, other development partners and other people with interest in the industry) started the Microfinance Forum (MFF), an informal but very effective information sharing mechanism. Among other developments, the MFF started discussions on how to mainstream microfinance into the formal financial sector and create conducive conditions for MFIs to become sustainable, thrive and grow.⁴

3.0 RATIONALE AND SUPPORT FOR THE LEGISLATION PROCESS

3.1 BoU's Rationale for proposing microfinance regulation

From 1996, the larger MFIs and some donors/ industry experts started to lobby for regulation, largely to “differentiate bona fide institutions from opportunists⁵ that were taking advantage of poor people” The MFIs also looked forward to being regulated because they thought this would afford

⁴ For a good overview of microfinance in Uganda from the early years until after the MDI law was passed see Goodwin-Groen (CGAP-2004): *UGANDA Microfinance Sector Effectiveness Review*.

⁵ These were some shoddy organisations promoted by dubious people, which would take people's savings and disappear with them.

them better esteem/ recognition and deposits to finance growth in their loan portfolios. While this was ongoing, the rapid growth in the numbers of people served by MFIs and the fact that some of them were already taking savings in some form or were interested in starting to mobilise savings attracted the attention of Bank of Uganda (BoU) as a regulator in 1998. The massive bank failures at around the same time to some extent undermined confidence of the public in the banking/ financial sector. BoU was therefore keen to restore confidence. To the extent that MFIs were taking “savings” and were seen as financial institutions, BoU sought to prevent the potential effect of more failures in this semi-formal sector.⁶

Based on the consultant’s interviews with BoU officials, BoU at the time saw a clear mandate to regulate MFIs taking and intermediating deposits from the public. The main reasons for proposing to regulate microfinance were to:

- Enhance orderly growth of the financial sector by extending regulatory focus to large and savings taking MFIs
- Build the clients’/ public confidence in the institutions by boosting the safety of their savings and monitoring performance in all aspects
- Recognise microfinance as a line of business that can be operated by any regulated financial institution like commercial bank, credit institution or licensed MFI.
- Provide a framework, law and regulations for the supervision of MFIs that desire to intermediate micro-deposits
- Define the scope of BoU’s microfinance regulation/ supervision, since the bank realised it did not have the resources and capacity to oversee the whole microfinance industry
- Maintain and improve stability of the financial sector.

In 1999, BoU issued a “Policy Statement on Microfinance Regulation”, which for the first time clearly defined the Government’s role as an enabler rather than provider of microfinance, and proposed a tiered structure with Tier 3 – MDIs – to be defined by the upcoming MDI Act. The Policy Statement was also approved by the Cabinet.

The following year, BoU came up with the first draft proposal for the microfinance law, seeking to either regulate or close all MFIs that were taking any form of deposits, including the collateralised or “compulsory” savings, apart from SACCOs and very small informal groups. After a great deal of dialogue, sensitisation, lobbying by the industry and training/ exposure of the key stakeholders to other microfinance regulatory regimes, the draft was changed to acknowledge collateralised savings as a lending mechanism and thus leave out credit-only MFIs that were only taking savings to back group loan grantees. In doing this, BoU effectively

⁶ The history of the MDI Act is summarised in Bell (2003): *Regulating Microfinance in Uganda*.
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acknowledged the need for the development of a sound microfinance sector, while giving room for more flexibility to microfinance activities still in experimental stages and not putting clients' money at risk.

3.2 Support for regulation and expectations of stakeholders

After BoU had made a first proposal for the regulatory framework, many stakeholders eventually supported the idea, but not always for the same reason. The table below summarises the key stakeholders and their expectations (the reasons for supporting regulation of microfinance at the time). The last column of the table gives an indication to which degree the stakeholder group's expectations have been achieved. This will be further explained in the following chapters.

TABLE 1: STAKEHOLDERS AND STAKEHOLDER EXPECTATIONS

STAKEHOLDER GROUP	EXPECTATIONS	EXPECTATIONS ACHIEVED?
Bank Of Uganda	<ul style="list-style-type: none"> ▪ Protection of public deposits ▪ Orderly growth of the financial sector ▪ Provide a legal framework for MFIs desiring to intermediate savings, which takes into account their specific risk profile 	Achieved Achieved Achieved
Government (MoFPED)	<ul style="list-style-type: none"> ▪ Increased outreach for MFIs to serve more poor, rural people and massive branching out immediately after transformation ▪ Reduced pricing of microfinance products, especially loans, resulting from increased efficiency and healthy competition 	Not achieved Not achieved ⁷
Parliament	<ul style="list-style-type: none"> ▪ Control of interest rates charged by MFIs, to curb “exploitation” by the MFIs ▪ Supervision/ regulation of all microfinance business to ensure that impostors do not take advantage of the masses ▪ A lasting check on activities of MFIs that impoverish the poor instead of helping them – like collateral backed lending to people who do not have adequate cash flows to service the loans 	Not achieved Not achieved Not achieved

⁷ Although some clients feel that MDIs have reduced their pricing because of waiving some charges and in some cases, our analysis in this report shows that overall portfolio yield is modestly rising

STAKEHOLDER GROUP	EXPECTATIONS	EXPECTATIONS ACHIEVED?
MFIs that were to be transformed into MDIs	<ul style="list-style-type: none"> ▪ Freedom/ license to intermediate savings considered a cheaper way of financing loan portfolio growth compared to wholesale loans ▪ Being regulated leads to boost in the institutional image and public confidence ▪ Improved legal status enabling regulated MDIs to take legal action in loan recovery ▪ Opportunity to offer more services and thereby widen the business and enhance profitability ▪ Becoming part of the mainstream financial sector, gaining more respect by banks and other financial institutions ▪ Further opportunity to improve on corporate governance, systems and management practices 	Partially achieved Achieved Achieved Achieved Achieved Achieved
Mature Tier 4 MFIs	<ul style="list-style-type: none"> ▪ Being able to transform in the near future ▪ Possibility to learn from transformation lessons of early pioneers 	Not achieved ⁸ would-be MDI candidates less eager Achieved
Donors ⁹	<ul style="list-style-type: none"> ▪ Mainstreaming microfinance into the formal financial sector, and thus further professionalising the industry ▪ Licensed MFIs being able to access commercial funding – both equity and loans – reducing the need for socially oriented or subsidised financing of their loan portfolio ▪ Increasing numbers of poor people having access to secure savings and other financial services ▪ Consolidation of relatively small institutions into bigger, stronger and more viable institutions 	Achieved Achieved Partially achieved Not achieved
AMFIU	<ul style="list-style-type: none"> ▪ Greater recognition of microfinance as part of the financial sector 	Achieved

⁸ Would-be MDI candidates are now less eager to become MDIs, having seen that transformation to an MDI is more costly/ involving and that MDIs are “overregulated” compared to commercial banks.

⁹ Although donors did not originate the idea of the MDI Act, they actively participated in and significantly influenced the and transformation process – through funding transformation activities.

STAKEHOLDER GROUP	EXPECTATIONS	EXPECTATIONS ACHIEVED?
	<ul style="list-style-type: none"> ▪ Overall growth in the clientele and sustainability of MDIs ▪ More effective industry lobbying when some of the member institutions are licensed ▪ Lessons to be provided for the possible approach to Tier 4 regulation 	Not achieved, although sustainability is recently improving Not achieved Not achieved
Clients of MDI candidates ¹⁰	<ul style="list-style-type: none"> ▪ Reduction of the prices of microfinance products ▪ More diversified ranges of products to address the different customer needs ▪ MFIs become stronger financial institutions when regulated ▪ Boost in number of clients being served 	Partially achieved ¹¹ Achieved Achieved Partially achieved

Source: interviews, review of various documents

The intensity of stakeholder involvement varied over time. While Bank of Uganda took the lead in the beginning, MoFPED, practitioners, AMFIU and donors all played an active role in the discussions facilitated by the MFF. The influence of clients was very limited throughout. It is only now that clients can see what it means for an MFI to be regulated. Though attempts were made by the Microfinance Forum's Lobby Committee to educate the MPs about the industry workings and the proposed law, the MPs only came in actively at a later stage when the Bill was finalised and tabled in Parliament

As can be inferred from the above table, each stakeholder category had its own peculiar expectations and reasons for supporting regulation. The degree to which these expectations have been met will be an important benchmark for analysis in this report.

Generally, however, all stakeholders interviewed during this assignment said that their key expectations for MFI legislation and regulation were:

- Safety of public deposits
- Increased savings mobilisation
- Safeguarding the public against unfair lending by MFIs
- Overall stability of the financial sector
- Increased outreach to rural areas

¹⁰ These could only reiterate their expectations in retrospect since they were not very much involved or informed during the law making and transformation process

¹¹ Although overall the portfolio yield slightly increased after licensing, there are specific cases of the reduction of the pricing of group loans, mostly consumed by the poor and more interest paid by MDIs on deposits.

- Increased sustainability of the regulated institutions.

The expectations of BoU as the regulator and those of the MDIs themselves have been achieved to a large extent. However, the expectations of Government and Parliament, which were mostly concerned with increasing access to financial services for the poor¹² in and providing them with more affordable loans, have so far not been achieved. This partly explains why Government support shifted to SACCOs (see chapter 10.0).

4.0 KEY PROVISIONS OF THE MDI ACT 2003

In November 2003, the MDI Bill was passed by Parliament. It became law on the 1st July 2003. In October 2004, BoU issues the implementing Regulations under the Act. This section highlights the key provisions of the MDI Act that are relevant to or affect the realisation of the stakeholders’ expectations. The highlights give an indication of how responsive the Act was to the stakeholders’ expectations.

4.1 Microfinance business & MDI licensing issues

The Act defines microfinance business as the taking of micro deposits from the public and lending the proceeds thereof out¹³. For an institution to be licensed, it has to be a shareholding company whose owners have “deep pockets” – evidence of ability to inject in more money into the institution should a situation arise which requires this. This “deep pockets” requirement works well for the stability of the financial sector and sustainability of the institution. Since the social investors with adequate venture capital are few and typical wealthy persons need a justifiable return on their money, it should have been expected that there would be profit pressure on MDIs after licensing. A highly probable result of this, which should have been expected, was that MDIs would seek more viable avenues of business including diversifying their loan clientele into the not-so-poor.

4.2 Ownership, Governance and Management

Regulation has fundamentally affected MDIs in the areas of ownership, governance and management. The MDI Act requires that:

- Before licensing, an MFI must be a shareholding company with identifiable shareholders, who must be able to rescue the institution should it slide into a bad financial situation¹⁴

¹² Mainly in rural areas

¹³ MDI Act 2003 Sec 2

¹⁴ Implied in MDI Act 2003 sec 7 (4) c

- BoU vets and approves any person or institution proposing to hold 10% or more of the shares of an MDI¹⁵
- Only under very special circumstances and with the approval by BoU, a shareholder or group of related persons can own more than 30% of the shares of an MDI¹⁶
- All proposed board members of any MDI are vetted under the fit-and-proper test by BoU¹⁷
- Board members hold regular board meetings and discuss strategic issues of the MDI¹⁸
- Every MDI employs an internal auditor who continually assesses compliance with the law and internal policies and procedures of an MDI; the auditor reports to the board and to BoU
- MDI board members take joint and personal responsibilities for deterioration in the health of an MDI if they do not report potentially detrimental developments to BoU¹⁹
- Senior managers of an MDI are vetted and approved by BoU²⁰
- Management take official and personal responsibility for timeliness and accuracy of regular reports submitted to BoU

The above and other relevant provisions in the MDI Act are strictly enforced by BoU in supervising MDIs. The effect has been an improvement in the quality and prudence of management, more competent/ effective boards and clear ownership structures. On the whole these provisions are suitable for the good running and growth of the MDIs, even though they have also created substantial supervisory costs for BoU and compliance costs for the regulated institutions.

4.3 Operations and policies

The Act stipulates business that MDIs cannot engage in²¹. The Act and the Regulations also make detailed prescriptions on the operations of MDIs and on policies MDIs have to adhere to. Provisioning/ write-off policy, risk management and other operational aspects are all stipulated in the Act. As an example, an MDI is prohibited from lending to any one individual or related group of individuals more than 1% of its core capital and to any one institution or group of institutions more than 5% of its core capital.²²

¹⁵ MDI Act 2003 sec 21(4)

¹⁶ MDI Act 2003 sec 21(3)

¹⁷ MDI Act 2003 sec 22 (2)

¹⁸ MDI Act 2003 sec 26

¹⁹ MDI Act 2003 sec 25(2)

²⁰ MDI Act 2003 sec 27 and sec 28

²¹ MDI Act 2003 sec 19

²² MDI Act 2003 sec 18

From discussions with their bankers, social lenders and BoU, it is clear that these regulatory aspects have improved the safety, prudence and professionalism of operations in MDIs. These provisions are aimed at safeguarding the MDIs from operational risks, and they do not impact directly on the MDIs' choice of their clientele. They are therefore suitable.

4.4 Financial prudence

The Act and Regulations set out standards for financial management, which BoU keenly monitors. Among the aspects regulated are financial leveraging, liquidity management, asset and liability management, mandatory cash reserves based on a percentage of the deposits, and regular, consistent reporting on all financial aspects of the MDI. A visible impact of this has been that MDIs have more financial discipline than unregulated institutions.

An MDI is required to have, at all times, a minimum capital (unimpaired by losses) of 500 million Uganda Shillings²³, core capital equating to at least 15% of the institution's risk weighted assets and total capital equating to at least 20% of the risk weighted assets.²⁴ While there is no direct prescription on which types of clients to serve, the maintenance of this in international comparison conservative capital adequacy ratio requires safe, profitable lending which MDIs can easier achieve by issuing larger loans to less poor persons or organisations with adequate security.

4.5 Publication of audited accounts

All MDIs are, like other regulated financial institutions, required to publish their accounts annually, four months after the end of each financial year²⁵. This has introduced a discipline in producing audited accounts timely and accurately. It has boosted transparency by MDIs, and given them the impetus to strive for better performance.

4.6 Powers of and supervision by BoU

The law gives BoU wide powers as a supervisor of MDIs, to be able to do all that is necessary to ensure that MDIs are safe places for public deposits. MDIs have to seek BoU approval for any branch opening or introduction of any product. It also has powers to suspend, dismiss or discipline MDI managers and board members. At any time BoU can issue a directive to an MDI on any aspect that the BoU feels needs to be addressed for the soundness of the MDI or the overall financial sector.

²³ MDI Act 2003 sec 15

²⁴ MDI Act 2003 sec 16

²⁵ MDI Act 2003 sec 52

4.7 Remedial measures in cases of weakening MDIs

BoU has a wide range of options to deal with erring MDIs, including warning/ admonition, management take-over, temporary freeze on branch opening, dismissal of management, suspension of one, some or all board members, management takeover, receivership, temporary/ permanent closure and liquidation. This means that MDIs cannot afford to flaunt BoU directives, Regulations or any part of the Act.

4.8 Insurance of deposits and cash

According to the Act, all deposits (voluntary savings) of MDI clients will be covered under the Deposit Protection Insurance by each MD once the MDI Deposit Protection Fund has been set up. Furthermore, the Act requires MDIs to take insurance for cash on the premises and cash in transit. Even now, MDIs are safer places to save with than all unregulated institutions. This provision is good because it offers a last-resort safety net for depositors in MDIs that could fail despite the rigorous regulatory regime. The BoU Regulations for supervision of MDIs detail out the operational level guidelines to enforce the MDI Act 2003. The following main regulations apply to MDI financial and operational reporting:

Every Tuesday of the following week:²⁶

- MDI weekly statement of liquidity

Every ten days after close of the month:²⁷

- MDI Monthly statement of assets and liabilities
- Monthly disclosure of capital adequacy
- Monthly statement of income and expenditure
- Monthly statement of loans extended to insiders
- Monthly schedule of provisions for bad debts
- Monthly report of portfolio quality returns

The Regulations also stipulate onsite and off-site inspection by BoU, submission of audited accounts and financial reports within the first three months following every end of year by BoU, stiff penalties (both to the institutions and to the individual responsible) for negligence or falsified reporting and obligates MDIs to fully cooperate in all cases

BoU and MDIs' bankers all affirm that since they were licensed, the above regulatory aspects have ensured that MDI reporting is timely and more accurate. In turn, this has made MDIs more trustworthy and respected institutions. This is positive from the viewpoint of institutional stability and access to commercial financing. From the viewpoint of serving the

²⁶ MDI Regulations 2004 Sec 7

²⁷ MDI Regulations 2004 Sec 7

poor, there seems to be a trade-off between stringent, prudential regulation and expansion of services to poor people.

The following table summarises some of the sections in the law and its regulations, which have been criticised by stakeholders as unnecessarily hindering their development or being an obstacle for further growth.

TABLE 2: CONTROVERSIAL SECTIONS IN THE MDI LAW AND REGULATIONS

ISSUE	REFERENCE	CRITICISM
Prohibition to intermediate loan insurance fund	MDI Act, sec. 19 (h)	LIF cannot be used for lending, and yet are included among the liabilities for capital adequacy and core capital requirements.
Prohibition to take deposits and lend in foreign exchange and to offer current accounts	MDI Act, sec. 19 (a) and (g)	There is demand for these products, and they are suitable especially if MDIs want to boost their deposits
Provisioning stricter than for banks/credit institutions	MDI Act, sec. 89 (3)(a) and Asset Quality Regulations	MDIs are competing with banks, but are not on a level playing fields with them
Maturity of loans restricted to two years	MDI Act, sec. 2 “short term loan	The limit of two years makes it difficult to offer longer term loans for example for housing and agriculture.

5.0 PREPARATION FOR AND EVENTUAL TRANSFORMATION

5.1 New strategic/ transformation plans and their focus

Vivid impact of the MDI legislation started in 2001, two years before the law was enacted. By that time, the larger MFIs that had either taken on some voluntary savings or were simply too big to continue operating unregulated knew they had to transform, and the final draft of the Bill was available. This meant that broadly, the MDI candidates knew what to expect from the law. Between June 2001 and June 2003, each of the five MDI candidates (PRIDE, FINCA, UWFT, Faulu and UMU) prepared and started implementing a Transformation Plan focusing on critical areas like:

- Complete diagnosis of the present situation
- Determination of eventual MDI form

- Ownership and governance
- Strategic direction
- Management and personnel, including a skills audit
- Policies and procedures
- Systems, controls and reporting
- Signage and physical appearance
- Products and business development
- Financial health and performance
- Assets volumes and quality
- Branch infrastructure
- Preparations for deposit taking and related issues

The transformation plans, which were prepared by experienced consultants with full involvement of the respective institution’s board and management, each started with a detailed, critical review of the then prevailing situation and comparing it with the likely requirements for transformation. This brought out details of the gaps in the different areas, which the transformation plans sought to address. The very process of preparing for transformation challenged the institutions’ senior management and board members to start thinking more like a bank rather than as semi-formal institution.

5.2 Staff and systems reviews in preparation for transformation

Two remarkable operational areas of substantial review and fundamental changes for all the MDIs were in the composition of staff and the functionality of banking and accounting systems. On staffing, BoU by law had to vet all the senior managers, especially the CEO, Finance Manager and Internal Auditor. Internally, the MDI candidates also worked with their respective consultants to identify where they needed staff changes to ensure a full complement of skills by the time the institution applied for the MDI license. There were substantial new hires and in some cases exit of senior staff as a result. Thus just by preparing for the MDI licence application, staff, skills and systems started improving within the institutions that wanted to transform.²⁸

5.3 Support of development partners

Between 2001 and 2003, the USAID funded SPEED Project was the main donor funding agency for MFIs preparing to transform into MDIs. Later on, other agencies picked up increased interest and in 2004, the Transformation Steering Committee was formed, comprising the following agencies:

²⁸ As an example for what was required in terms of operational transformation, see White (2006): *The Creation of Uganda Microfinance Limited*.

USAID-SPEED Project
 DFID-FSDU Project
 Microfinance Outreach Programme – MoFPED Project
 GTZ/SIDA FSD Programme

The major agenda of the TSC was to rationalise financial support for MDI candidates and ensure equal treatment as well as efficiency in donor support to graduating/ transforming institutions. The TSC has played a significant role in coordinating and guiding the transformation process of intending MDIs since its formation, identifying and helping the donors respond to post-transformation technical assistance. With knowledge of how much there money there among donors to support transformation at each of the programmes, TSC drew up a schedule of the amounts already committed for this purpose to the different transforming institutions and how the uncommitted funds would be spread among hem. In late 2004, FSDU offered to take up coordination of the TSC by among other things engaging a transformation consultant, who worked from FSDU offices. In addition to focusing donor programs’ attention to transformation, therefore, the passing of the MDI Act has further consolidated cooperation and coordination among donor agencies in the microfinance sector.

5.4 The different modes of transformation

To transform into an MDI, each of the four institutions took a somewhat different approach to ownership change. FINCA Uganda simply changed from a company limited by guarantee to a company limited by shares, owned 100% by FINCA International;²⁹ UWFT and UMU directors formed new companies (UFT in the case UWFT and UML for UMU) into which the assets and going concern business of respective parent organisations were transferred in return for a combination of equity and debt instruments; while PRIDE, which was a project of the Government, first incorporated a company limited by Guarantee, PRIDE Uganda, which could not be licensed by BoU due to lack ownership clarity, and then formed PRIDE Microfinance Ltd (PML), owned 100% by Government of Uganda. PML was licensed with conditions including 100% divestiture of Government shareholding in five years.

6.0 IMPACT OF THE MDI ACT AND REGULATIONS ON MDIs

The current four MDIs have all been licensed for between just less than two years up to almost three years. This allows us to conduct a first assessment of the early effects of the law on various aspects such us ownership, governance, management, reporting, performance indicators, MIS, and product development.

²⁹ BoU exempted FINCA International from the 30 percent ownership limit.
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Joanna Ledgerwood and Victoria White summarise international experience with transformation as follows:

In addition to facilitating the mobilization of savings, expanding the funding base, and increasing the numbers of clients reached, these institutions, through transformation, have also diversified their ownership and governance structures, increased the professionalism of their staff, improved management information systems, and improved overall internal controls.³⁰

We use also the expectations of various stakeholders as the benchmark in our analysis.

6.1 Ownership

In the area of ownership, the one clear impact of the MDI Law was that the ownership of all the institutions running the microfinance business changed significantly. All MDI candidates used to be NGOs, which by definition lacked real owners. The law required them to transform into companies limited by shares. All except FINCA had to bring in new investors, some of them being purely commercial investors, some social investors, some domestic and some international. One qualitative ownership aspect related to transformation has been that to some extent, ownership of the MDIs has been “externalized). UFT and UML, for instance, which were before transformation considered purely local institutions, are now respectively owned 45% and 60% by foreign institutions.

TABLE 3 INSTITUTIONAL FORM AND OWNERSHIP OF MDIS BEFORE AND AFTER TRANSFORMATION

INSTITUTION	OWNERSHIP BEFORE TRANSFORMATION	OWNERSHIP AFTER TRANSFORMATION
FINCA Uganda	NGO and company limited by guarantee	Company limited by shares, owned 100% by FINCA International
PRIDE	Project of the Government of Uganda, financed by the Norwegian Government	A company limited by shares, owned 100% by Government of Uganda and aimed at 100% ownership divestiture to the private sector
UFT	NGO and company limited by guarantee, with no real owner	A company limited by shares, owned 41.9% by Ugandan institutions, 13.5% individuals and 44.6% foreign institutions
UML	UMU was an NGO and company limited by guarantee, with no real owner	UML is a company limited by shares, owned by 0.2% Ugandan institutions, 40% individuals and

³⁰ Ledgerwood (2006): *Transforming Microfinance Institutions*, p. xxxvii.

INSTITUTION	OWNERSHIP BEFORE TRANSFORMATION	OWNERSHIP AFTER TRANSFORMATION
		59.8%. foreign institutions

Source: MDI records; interviews with managers

6.2 Governance

For a financial institution, good governance is the fundamental requirement from which all the other institutional strengths flow. A well balanced, diversified and sufficiently skilled board will usually put in place management, require systems and exercise oversight that ensure that operations are run in ways that enhance profitability and safety. Without exception, the four MDIs have all had to improve their board composition in terms of complementarity and relevance of skills. This is largely attributed to the strict BoU requirements, including vetting all directors of MDIs using the *fit-and-proper* test, as well as to the coming of new shareholders with international experience in corporate governance. The box below summarises the governance changes in the four MDIs .

FINCA – The pre-transformation board was large, made up of 10 members, 7 of them representatives from FINCA International. The post transformation board is made up 5 members with 3 representing FINCA international and 2 Ugandans.

PRIDE – The pre and post- transformation inspections by BoU resulted in the involuntary resignation of all the former board members and their replacement. The new board members were not part of PRIDE’s difficult past, and seem to be steering PRIDE forward using sound practices of corporate governance. They include bankers, lawyers and other professionals who have undergone BoU’s fit-and-proper test. Like the former board, the current one has seven members.

UFT – Of the six former directors of UWFT, only three qualified to be on the Board of UFT following the BoU fit-and-proper test /screening. Of the three, one board member eventually retired from the Board and BoU vetted a replacement who is now the Board Chair. Two new Board members have come in from the external investors with wealth of experience in governance, running of financial institutions and international best practices. Whereas UFT had 6 board members, UFT has four.

UML – Whereas the UMU Board was quite strong, it was made up of mainly close confidants who had been invited by the two founders. Transformation saw more investors, who seconded 2 new board members (in a five member board³¹), further strengthening governance

³¹ Same number as UMU had previously
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6.3 Management, staffing and skills

Like the case was with governance, BoU's fit-and-proper test, applied in vetting senior MDI managers has ensured that management quality in the MDIs improved. One MDI had to change the entire senior management team; one had to streamline the CEO responsibility from being embedded in two executive directors to having one substantive CEO (with the other becoming a non-executive director), one had to hire in a few senior managers with banking experience and another had to hire a well qualified internal auditor. Similar changes also occurred in the middle management of the MDIs. At least three of the MDIs have taught their staff cash flow based lending, and they now depend less on collateral as a means of loan application assessment. According to BoU officials interviewed, all these coupled with the rigorous risk-based supervision have resulted into more effective management of the MDIs. The evidence is in improving profitability, portfolio quality and accuracy in reporting.

6.4 Prudence and accuracy in reporting

BoU, from its experience with pre and post licensing inspections, confirms that the efficiency of the MDIs' management information systems, and the accuracy and reliability of their reports have improved greatly. Compared to the situation before licensing, MDI management is now also more prudent and risk aware in managing the institutions. The main reasons for this are:

- Upgrades in the MIS
- Strict weekly, monthly and annual reporting requirements by BoU, with deterrent consequences for inaccuracy
- The detailed uniform formats/ templates that MDI have to follow in their reporting
- Significant penalties for late reporting
- Personal responsibilities placed on senior managers for misreporting in some cases.

MDI candidates received substantial donor support to upgrade their systems. It might therefore be argued that improvements in this area can only partly be attributed to the institutions becoming regulated by BoU. However, the donors who supported MIS upgrades linked their support to the MFIs' transformation plan, which means that without the law being in place it is likely that the upgrade would not have happened to the same extent.

To external stakeholders like commercial banks, regulation has made both operational and financial reporting by MDIs far more reliable.

6.5 Financial and operational performance

The graphs below highlight comparative performance of 2002 and 2003 (before transformation), 2004 and 2005 (during the intense transformation period) and 2006 (after transformation). More details can be found in Appendix III.

Alongside greater accuracy in reporting, regulation has had two notable impacts on performance of the institutions: a temporary dipping in most performance indicators and improvement in performance thereafter. The years 2004 and 2005 saw the performance figures of the intending MDIs temporarily worsening for two key reasons: clean-up to make the figures more accurate before licensing and concentration of management time on the numerous challenges of transformation, leaving little time to concentrate on business development/ operations. After licensing, most of the performance indicators have been improving remarkably.

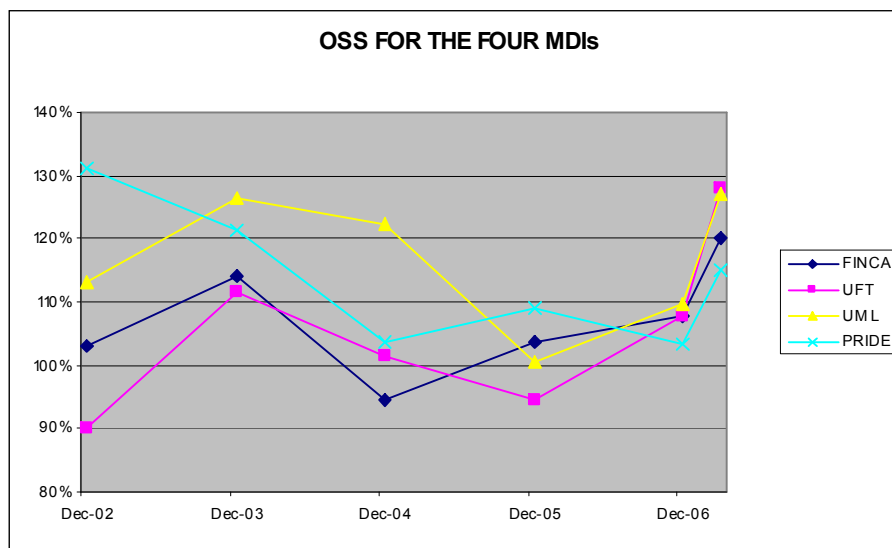
Profitability – For three of the MDIs, the pattern was similar: they made modest operating profits³² before the transformation preparations started, the profits reduced during the transformation years and then started rising again in 2006, after licensing (See Figure 1)

From unaudited figures, the rise in profitability during the first quarter of 2007 was even more substantial. This means that the seemingly disruptive effect of transformation on the performance of MDIs was temporary and after they have fully streamlined their structures and operations, the improvement in performance has started. The fourth MDI continued to show declining profitability performance³³ in 2006 but has reversed this trend fairly impressively in the first quarter of 2007. The figure below shows the trend in Operating Self-Sustainability (OSS), a profitability measure, for the MDIs.

³² One of the three made a loss

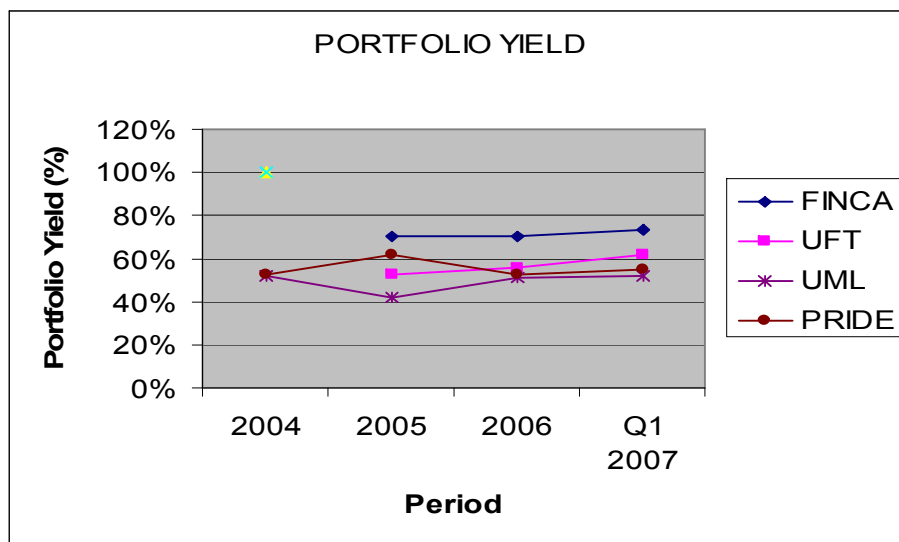
³³ Despite a very good portfolio quality, the fourth MDI's OSS still slightly deteriorated in 2006. According to information from senior management, this has to do with high costs for the relocation of some of their branch offices to more convenient locations. Another significant cause could be the difficulties this MDI has faced with its structures and governance during the transformation, resulting some fundamental issues which are yet to be resolved.

Figure 1



Portfolio Yield – Overall, the portfolio yield of MDIs has seen a modest increase since 2004. It could be argued that this is good for the institutions from the sustainability viewpoint, and counter-argued (more importantly) that regulation has not on the whole made MDI loans any more affordable for its clients.

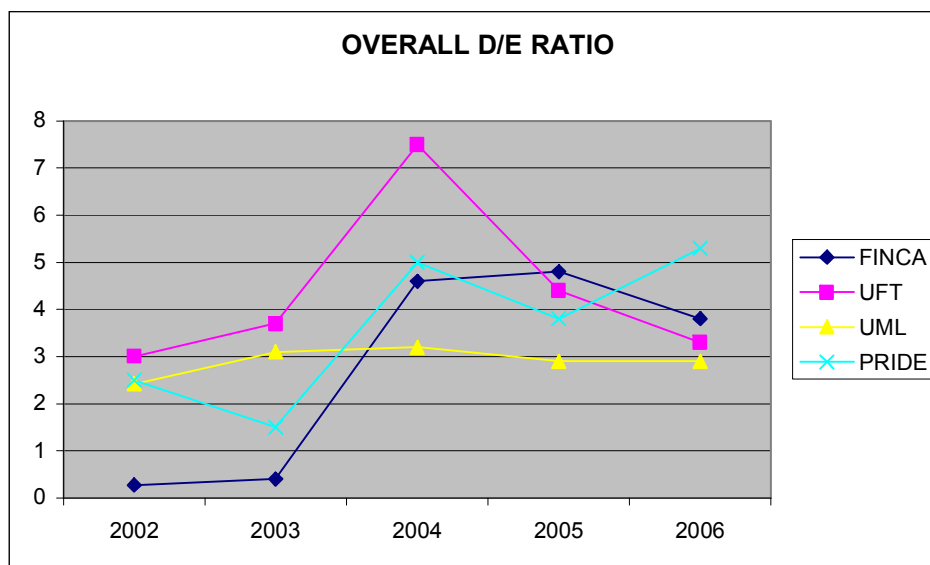
Figure 2



Capital/ funding structure – Generally, the MDIs have leveraged their equity more after licensing than before (see Figure 3). This reflects both the more commercial orientation that licensing brought and the fact that commercial and other lenders’ confidence in the MDIs grew after licensing. Another reason is that the two MFIs that were already

intermediating savings had to free up the compulsory savings, called loan insurance fund (LIF) which they previously intermediated, as BoU regulations require these to be held in liquid assets. To do so and maintain their portfolio volumes, they had to increase their overall borrowing

Figure 3

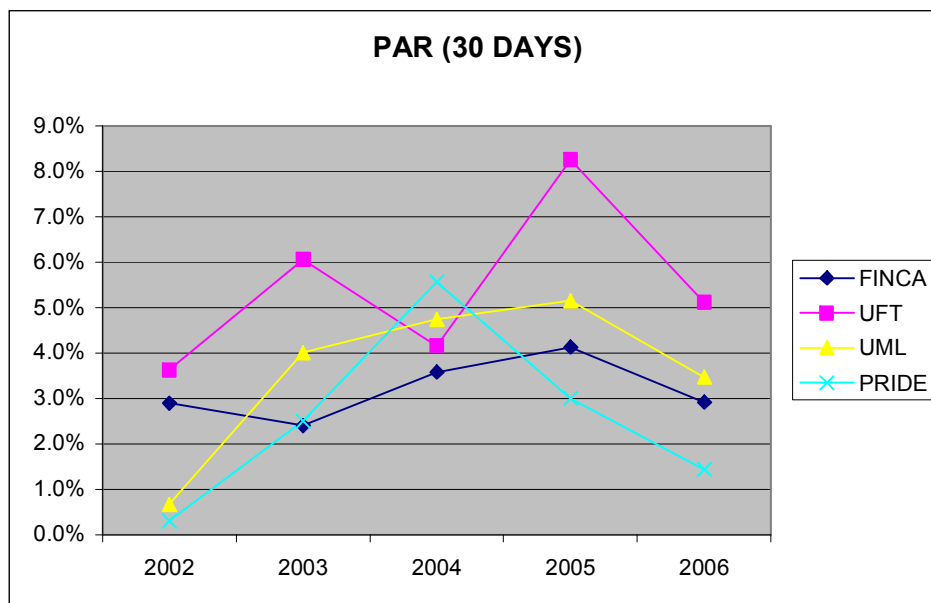


Portfolio quality – All the four MDIs reported a very good portfolio quality with Portfolio at Risk (PAR)³⁴ for 30 days and above of less than 4% before transformation. During the transformation years, this worsened in all four MDIs. In 2006, the year after the transformations, the portfolio quality started improving again (*see Figure 4*). This pattern is attributable to two main causes:

- i) Management’s time during the transformation was taken up so much by transformation issues that concentration on loan portfolio quality and related operational issues was reduced.
- ii) Reporting before licensing was not very strict and as part of the conditions for licensing, BoU demanded a detailed review and clean-up of the loan portfolio, including a review of the loan ageing and provisions. This corrected some previous reporting which overstated the portfolio quality.

³⁴ Total outstanding principal balances of all loan with a portion past due for 30 days or more
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Figure 4

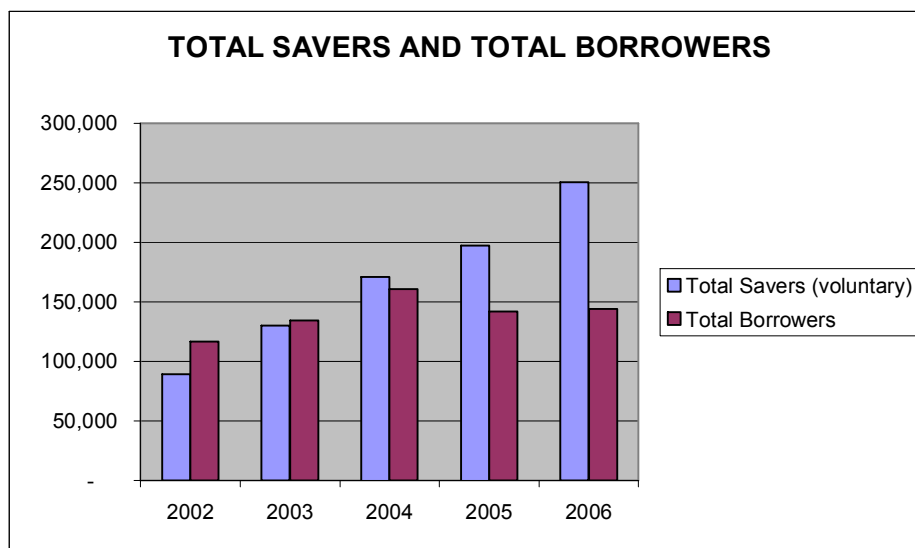


Outreach/ Focus on the poor – The general trend is that the number of loan clients of MDIs have tended to follow their natural growth.³⁵ The exception is change in numbers between 2004 and 2005, where the numbers reduced slightly. This can again be explained by the distracting influence of the preparations for transformation. Another reason is that a better MIS produced more accurate figures on the numbers of borrowers, and reduced the problem of double-counting. For the MDI that experience the most drastic fall in the numbers of borrowers (while the loan portfolio was growing), another cause was the speedy switch from predominantly group to individual loans (between 2003 and 2006, the ratio between the group and individual portfolios changed from 81: 19 to about 25:75).

The number of voluntary savers has increased more rapidly (*see Figure 5*). This is not surprising as this was a new line of business for the MDIs.

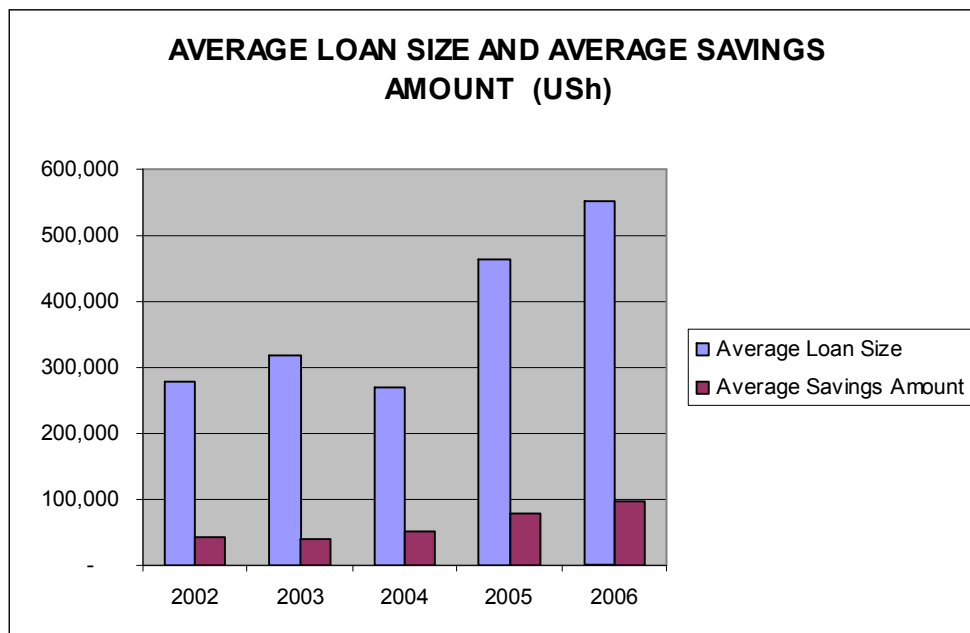
³⁵ The kind of growth they experienced before transformation, which the unregulated but mature MDIs are also experiencing

Figure 5



The average loan balance and average savings balance for the four MDIs both grew substantially after licensing (*see Figure 6*), while the number of loans disbursed dropped sharply by 55% between 2004 and 2006. The result is that whereas the numbers of borrowers and loans disbursed have fallen between 2004 and 2006, the loan portfolio volumes have risen significantly over the same period. The question worthy asking is – where did all the poor clients who drop off go for their loan needs? They might have gone to less conventional lenders who might have taken advantage of them; but this should be a subject of future studies. During the stakeholders’ workshop to share the preliminary findings of this assignment, the MDIs explained that to enhance sustainability, they have had to add more of the not-so-poor among their borrowing clients and to develop products for this new category, without abandoning their focus on the poor. The other way of saying this is that MDIs have had to diversify their loan clientele to include more viable borrowers, which implies a reduction of their focus on the poor in relative terms.

Figure 6



Comparison with non-regulated, mature MFIs - It is interesting to compare the growth rates of some loan portfolio aspects of MDIs and those of mature Tier 4 MFIs.³⁶ As

Table 4 below shows, the growth in number of borrowers among three mature MFIs has been more than three times that among MDIs, while the outstanding loan portfolio has grown at almost exactly the same rate for MDIs and these Tier 4 MFIs.³⁷ This can be explained by a stronger growth in long size among the MDIs. Although it is a crude measure, significant growth in the average loan sizes and amounts disbursed suggest the possibility of at least a partial shift of focus to the less poor (more acceptably³⁸ referred to as diversification to the not-so-poor)

TABLE 4: COMPOUND ANNUAL GROWTH RATE (CAGR) OF MDIS AND TIER 4 MF

MEASURE		2003	2006	CAGR
TOTAL NUMBER OF BORROWERS	MDIs	134,180	143,817	2.3%
	Tier 4 Control Group	33,473	41,468	7.4%
OUTSTANDING LOAN PORTFOLIO (USh million)	MDIs	42,859	79,402	22.8%
	Tier 4 Control Group	7,411	13,707	22.8%
AVERAGE LOAN SIZE	MDIs	319,414	552,104	20.0%

³⁶ This is the difference in differences approach. We are only comparing the lending business as Tier 4 MFIs are not permitted to offer voluntary savings services.

³⁷ The three MFIs in the control group are UGAFODE, PEARL and Faulu.

³⁸ To the MDIs

(USh)	Tier 4 Control Group	221,408	330,532	14.3%
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Source: Self-reported data³⁹

Projected and realised outcomes - Another interesting comparison is between projected and actual figures among the four MDIs. While there is a lot of variation among the individual MDIs, the following picture emerges from the aggregated figures for all three⁴⁰ of them (see Table 5). According to a former General Manager of one of the transformed MFIs, the shortfall between actual savings mobilisation and the projections can be mainly attributed to over-optimism on behalf of the MFI candidates.

TABLE 5: VARIANCE OF PROJECTIONS VS. ACTUAL FIGURES

	Savings ⁴¹	No. Of Savers	Average Savings Balance	Gross Loan Portfolio	No. Of Active Loan Clients	Average Outstanding Loan Balance
2006	-31%	-14%	-14%	-24%	-30%	13%

Source: Transformation Plans/ Feasibility Studies; PMT Reports

There are several possible explanations for the more than projected growth in average loan balances, which is the only one of the above parameters in which the MDIs' actual performance has exceeded projections in. It could suggest that the MDIs focused more on higher income clientele than they previously did (confirmed by MDIs during this assignment). However, it is well known that average loan size is only a crude measure for depth of outreach and counter-possibilities have been considered:

- The probability that the number of small loans has actually not decreased, but that some new, larger loans have led to an increase in the average loan balance. This would not be consistent with the observation that the number of total active borrowers actually declined between 2004 and 2006.
- The argument that MDIs might still be serving the same people, only that some of them have graduated and are now demanding larger loans. This can also not stand the qualitative test -MDIs have come up with products⁴² that target the higher income clients, and have themselves clarified that they have had to add the not-so-poor in their clientele in order to improve their financial viability.

Looking at the numbers of loans disbursed below USh 200,000 and above USh 3 million, there is a general trend that MDIs have increased the number of large loans granted (see *Figure 7*). The trend for small loans is

³⁹ By the MFIs/ MDIs

⁴⁰ One MDI has had a difficulty tracing the projected figures and thus has not provided them

⁴¹ Voluntary savings in Shilling value

⁴² Like micro-leasing, solar loan products, housing/ mortgage loan products

not as clear, but overall the number has decreased between 2004 and 2006 (see Figure 8) This limited data suggests that MDIs now have a stronger focus on better off customers, although it is not obvious that this is at the expense of poorer customers. In between the two indicators is the scenario of increased big loans (more than Sh 200,000 but less than Sh 3,000,000), which could indicate a significant shift to the higher income clients but cannot be captured by the two parameters. At least one MDI strongly appears to have experienced this.

Figure 7

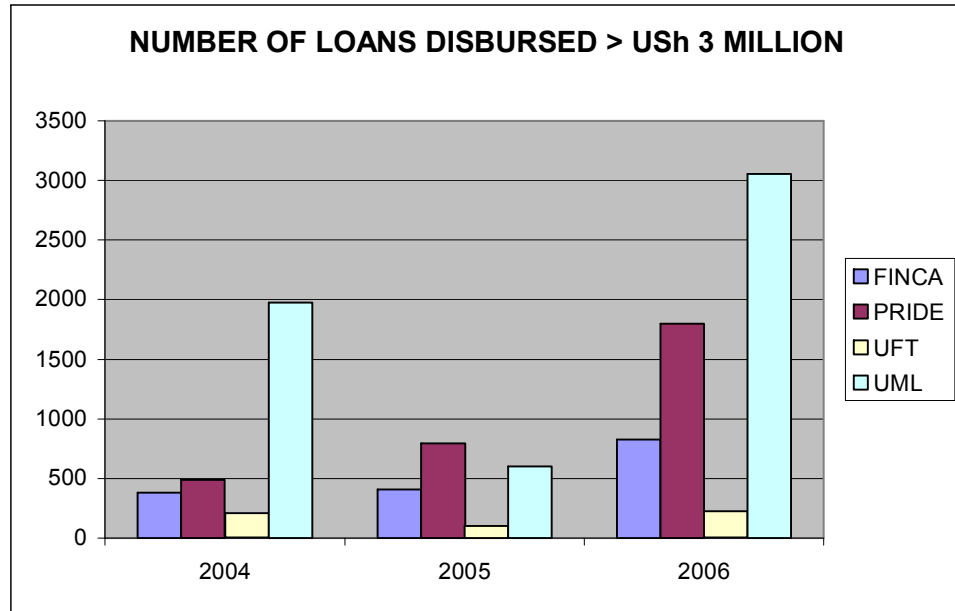
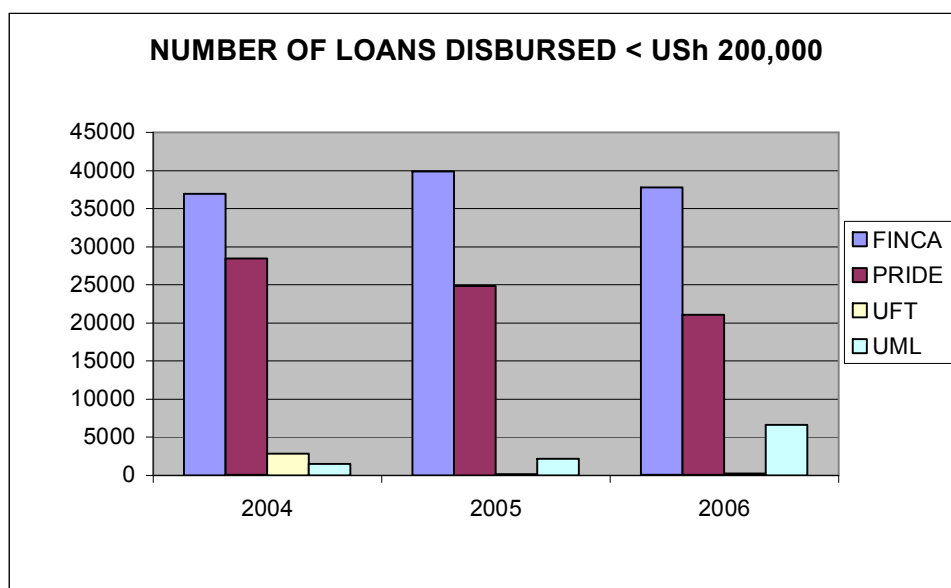


Figure 1



Another indicator of a shift of focus in lending is the percentage of disbursements to group clients, as these tend to be poorer than borrowers taking individual loans. Table 6 below shows that all MDIs have reduced the percentage of group loans, one of them sharply.

ABLE 6: PERCENTAGE OF DISBURSEMENTS TO GROUP CLIENTS

INSTITUTION	FINCA	PRIDE	UFT	UML
BEFORE (2003)	100%	98%	81%	74%
AFTER (2006)	92%	83%	25%	66%

Source: MDI PMT and other reports

As has already been stated, MDIs during our interviews asserted that they have not abandoned the low income people as their core focus. They all explain that they have had to spread their focus to include the less poor. This has been done to bring the profitability and sustainability drive more into focus.

The evident pattern on outreach is that MDIs have focused more on the not-so-poor than they did before licensing. The average loan and savings sizes went up while the percentage of people accessing services as group members declined significantly. These are both indicators that after licensing, MDIs focus on the poor clients, who were previously their major focus, reduced. The percentage of MDI loan clients being served by rural branches has remained more or less the same (72% in 2006 vs. 75% in 2004).

6.6 Management Information Systems

Because there was no specific mandatory reporting requirement for MFIs prior to licensing, the unregulated MFIs often sought cheap MIS solutions, which were not the most effective or efficient. With the Act and Regulations in place, MDIs are required to use systems that enable them to prepare accurate weekly, monthly and quarterly reports. The MDIs have accordingly had to upgrade or change their banking and accounting software to more reliable ones. The following table summarises the changes.

TABLE 7: MIS USED BY MDIS

Institution	FINCA	PRIDE	UFT	UML
Before	SIM 6	Bankers Realm (Credit Only)	Loan Performer	Manual, then Bankers Realm (introduced during transformation period)
After	SIM 7; and now in the process of acquiring Equinox	Bankers Realm (upgrade, integrated)	Equinox	Bankers Realm (upgraded, integrated)
COMMENTS	Progressive improvement; now getting an integrated system	Improved in anticipation of the deposit taking and reporting requirement after licensing	A very great improvement from a modest to a fully integrated banking software	Substantial upgrade for post licence reporting

Source: Interviews with MDI managers

The improved MIS has enhanced speed and accuracy of information processing and reporting. The MDIs are also working on connectivity. At least one of them now has full connectivity of the branches to the head offices, and the others are working on this, which will further improve the efficiency of reporting.

Improvement in the MIS together with stronger internal control and the prescribed establishment of an internal audit function reporting to the Board should also be able to help reduce incidences of fraud.

6.7 Product Development

The table below summarises the product offering before and after MDI licensing

TABLE 8: PRODUCT DEVELOPMENT

INSTITUTION	FINCA	PRIDE	UFT	UML
Before Licensing				
Loan Products	3	2	3	5
Deposit Products	None	None	2	1
Other Products	None	None	None	None
<i>Total</i>	<i>3</i>	<i>2</i>	<i>5</i>	<i>6</i>
After Licensing				
Loan Products	5	4	5	9
Deposit Products	2	1	3	6
Other Products ⁴³	1	1	1	1
<i>Total</i>	<i>8</i>	<i>6</i>	<i>9</i>	<i>16</i>

Source: Interviews with MDIs; document reviews

All the MDIs have developed and now offer more loan and deposit products after licensing. Whereas the additional loan products could be resulting from the institutions' own drive for business growth, the new deposit products are no doubt a result of the MDI status. In this sense, therefore, regulation has made MDIs more responsive to clients in product innovation.

Most MDIs state that they have continued offering their previous loan product targeting typical microfinance customers, but they have also developed new products serving better off customers such as SME loans and payroll-based loans. This confirms the hypothesis that MDIs added a new target group to their existing clientele rather than replacing the old ones.

6.8 Signage, premises and image

Three MDIs (PRIDE Microfinance Ltd, Uganda Microfinance Ltd and Uganda Finance Trust Ltd) have had to change their names to reflect their new status and business focus. They have also changed or improved their corporate logos to be more pronounced and appealing to the public. All the MDIs have improved their business premises to look like a normal bank branch, with well secured teller cubicles, well designed banking halls with a customer care desk, a strong room/ safe room and guarded entrance. These security provisions are part of BoU's branching requirements. This has served to boost public confidence in the MDIs as safe place for their deposits.

⁴³ In all cases, Money Transfer – UFT in franchise with Money Gram and the others with Western Union

7.0 IMPACT ON CLIENTS

The success of the MDI Act and its Regulations should ultimately be measured by the impact it has on the welfare of clients, i.e. how many of them have been reached, how poor they are, and what kind of products they are offered. From the performance graphs and tables in section 6 above, the conclusion was that a diversification to the less poor clients meant some reduction in the MDIs focus on the poor. The licensing of MDIs did a number of things with regard to their competitive environment, which made them more responsive to their clients, and also caused them to seek other types of clients (the not-so-poor). Below is a summary of the impact the legal framework for MDIs has had on clients:

- i) Transformation brought the MDIs to closer competition with commercial banks. The banks were downscaling to serve SMEs while the MDIs, in a bid improve profitability/sustainability⁴⁴, were in part up-scaling to serve SMEs in addition to their traditional micro level clients. This caused the MDIs to strive and measure up in customer care, to the advantage of all types of clients.
- ii) The new status has encouraged the MDIs to develop more products so as to serve their clients more satisfactorily. In particular, they introduced loan products that do not rely on the Loan Insurance Fund as the main security, but being granted on the basis of a cash-flow/ viability analysis of the borrower.
- iii) MDIs have broadened their customer target groups from low income people to include the not-so-poor, and to prefer doing more individual rather group based lending.
- iv) The new status has encouraged the MDIs to review their product pricing for more competitiveness such as a fair interest on the savings balances, low or no charges on savings accounts and reduced minimum balances. While the law does not have a direct impact on lending rates, increased transparency, competition, and efficiency of operations might eventually lead to lower prices. While the low income clients confirm that they now pay less to access services of the MDIs and some MDIs have modestly lowered their monthly loan interest, MDIs' overall portfolio yield shows modest growth. The more probable reason for the apparent inconsistency is that the poor clients more commonly use the savings/ deposit facilities (borne out by the graphs showing average savings), and that while loan products pricing has overall somehow increased,

⁴⁴ This does not mean that the MDIs did not have an option of innovating more ways to increase profitability without diversifying their clientele to the not-so-poor.

deposit products have become more cost effective for the savers. This could be an area of future in-depth study.

- v) After licensing, the MDIs have increased awareness through more advertising and as a result, customers are more informed of the products provided by the different MDIs (*example: although UML has not yet gone to Iganga, PML clients in Iganga interviewed said they are already asking for the leasing product being advertised by UML*)
- vi) MDIs have improved their efficiency i.e. reduced delays in loan disbursements, loan processing and the overall transaction time in branches
- vii) MDIs have attracted some safety-conscious low income earners who used to have accounts in commercial banks. With the MDIs also becoming prudentially regulated and more used to serving low income people, a number of them have joined MDIs
- viii) Inter branch connectivity by some MDIs enables clients to withdraw money from any branch – thus affording more convenience of service to their clients
- ix) Clients who are employed and are required to receive their salaries through a bank are now able to do so through the MDIs – again adding convenience of service to clients where there is no commercial bank branch.
- x) Increased gender sensitivity: male clients can now directly save with and borrow from the MDIs rather than through their wives.

8.0 IMPACT ON BUSINESS WITH COMMERCIAL WHOLESALE LENDERS

Better access to commercial sources of funding is usually not regarded as one of the objectives for prudential regulation of MFIs. However, being regulated and supervised by the central bank can also have benefits for commercial wholesale lenders. Representatives interviewed during this study affirmed that MDIs have become more worthwhile corporate clients to them because of:

- The confidence arising from regulation/ supervision by BoU
- MDIs now have more transparent, comprehensive and reliable financial/ operational performance reports
- MDIs now have more rigorous controls and are thus deemed to be more prudent and safer as corporate clients than they were before they were licensed.
- Better time keeping in report submission to the lenders

- Better risk and liquidity management by the MDIs, because of regulation
- Improved quality of management and governance, which gives the commercial lenders comfort about the stability of the institutions
- More commercial as opposed to social orientation in business dealings
- Being regulated institutions, banks find MDIs less costly to work with; the MDIs also understand better what the banks need, from their understanding of their own regulatory requirements from BoU

At branch level, MDIs are seen as effective competitors for deposits and loans. Thus while the senior level management in the banks are happy with regulation of MDIs, their branch level management faces challenges of new, credible competition from the MDI branches. These two aspects (senior management's satisfaction with MDIs as corporate clients and branch level recognition by commercial banks as competitors) demonstrate the fact that MDI regulation has mainstreamed them into the formal financial sector.

9.0 IMPACT ON BUSINESS WITH SOCIALLY ORIENTED WHOLESALE LENDERS

Like the commercial wholesale lenders, the socially oriented lenders also affirm that it is now easier and more comfortable to lend to MDIs than before they were licensed. These wholesale lenders, whose pricing is now very close to that of commercial lenders, respect the MDIs more as business partners. They do not treat the MDIs as recipients of subsidised money. The four socially oriented lenders⁴⁵ interviewed during this study, also confirmed that MDIs continue to apply for funds for loan capital even after transformation.

10.0 IMPACT ON GOVERNMENT SUPPORT

Government has in the past been supportive to the whole microfinance industry, including MDIs. In 2005, Government came up with the rural development strategy under which the Rural Financial Services Programme (RFSP) was to concentrate and work exclusively with SACCOs. There is now no Government support to MDIs or any other non-SACCO MFIs. This is not just a result of the MDI regulation, since even non-MDIs that are not SACCOs are now excluded from Government support.

It can, however, be argued that because MDIs did not fulfil Government's expectation of massively branching out shortly after transformation,

⁴⁵ Oikocredit, Stromme Microfinance (EA), MSCL and SUFFICE
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Government changed its focus of MF assistance to SACCOs. Thus indirectly, the shift to SACCO support was partly a result of unfulfilled expectations regarding MDIs.

Naturally, the Government takes a broader perspective when looking at the success of the MDI Act, not only looking at what has been achieved so far and how MDIs have changed, but also setting this in perspective with overall outreach of MDIs. Figures from the recently completed FinScope study show that only 2% of the population and 8% of those that have access to financial services are served by MDIs. They also reveal that 3% of people who currently save use MDIs and 28% of these people also save with a commercial bank. The figures are even lower for rural areas.⁴⁶ From this perspective, outreach of MDIs is still very limited and the impact of the MDI Act has not met the Government’s expectations.

11.0 IMPACT ON INTERACTIONS WITH BOU

For MDIs, BoU has become the regulatory and supervisory authority. In this capacity, BoU can issue directives that MDIs have to follow – making MDIs more streamlined and transparent in their dealings. The institutions have had a tough time coming to terms with the rigorous reporting requirements and in the process BoU has helped to get them to work like banking institution.

The BoU Regulations for MDIs were viewed as negative by some board members of MDI candidates when it came to applying the fit and proper test. Management of these institutions, on the other hand, saw the fit and proper test as a positive requirement in terms of getting competent board members and streamlining governance/ management.

Before licensing, BoU looked at some large MFIs (now MDIs) with suspicion. They were taking savings without licence and BoU on the other hand did not want to suddenly deny poor people access to financial services. The ones who did not take voluntary savings had such large amounts of LIF in relation to the loan balances that it was not clear whether all the LIF was purely collateralised savings to secure loans. This suspicion has now waned out since the MDIs can officially intermediate savings under BoU’s supervision.

12.0 IMPACT ON RELATIONSHIPS WITH DONORS

With the new profile, status, board composition, management aptitude and corporate image of the MDIs, the donors are more respectful of them. They see the MDIs as the not-so-needy MFIs, yet some of the donor

⁴⁶ FSDU (2007): *FinScope Uganda (Draft)*
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programmes' own deliverables⁴⁷ can best be accomplished by or with MDIs. Some donor programmes have clearly shifted their focus to support only those MFIs which have a clear and realistic plan for transformation. At least one donor representative has repeatedly stated that “the days of credit-only MFIs are over, and it is time for them to merge or transform”.

After the first four licences have been granted, donors are now promoting linkages and supporting the introduction of more advanced products such as micro-leasing, money transfers and technology-based improvement in service delivery. Most donors stopped providing MDIs with grants for loan portfolio funding from 2002.

13.0 IMPACT ON TIER 4 MFIS

The mature Tier 4 MFIs find themselves at a disadvantage because MDIs are licensed and publicised by BOU as “the only institutions authorised to carry on microfinance business (meaning savings intermediation) in Uganda”. In interviews we conducted, clients said that they are more attracted to MDIs. Government interest is no longer to assist any non-SACCO MFIs with capacity building and there is also reduced interest of donors in working with the numerous Tier 4 non-SACCO MFIs. As mentioned above, donors now prefer linkages, consolidation or transformation related technical assistance, or activities that would directly result in greater rural outreach. However, this approach has proven not be very popular for stakeholders of Tier 4 MFIs.

At the same time, Tier 4 MFIs are now more cautious about rushing for the MDI license. They are aware of the costs and efforts required. They have learnt from the MDIs that transformation is a grand, costly affair.

The above issues notwithstanding, the mature MFIs still feel the need to be regulated. It is easy for unscrupulous operators to discredit the image of all unregulated MFIs. They would also like to escape being tarnished (as a category) by failures of a major MFI like what happened to FOCCAS when it when it became insolvent and was placed under receivership by Nile Bank in July 2007. The MFIs want the credibility and client confidence that comes with being regulated. One more institution plans to submit its license application to BOU for a Tier 2 instead of an MDI licence, due to its major stake holders' desire to convert into a commercial bank thereafter. Of the two other probable transformation candidates for the next five years (UGAFODE and PEARL Microfinance), one is exploring the possibility of preparing to apply for a Tier 1 (Commercial bank) license.

⁴⁷ Like developing and testing new, seemingly sophisticated products and introduction of technology based outreach methodologies

14.0 PROBABLE ALTERNATIVES TO MDI LAW

The main objective of the MDI Act in Uganda was not support for industry growth; it was the prevention of the possible effects of the failure of large, unregulated MFIs, especially loss of savings by poor people. Given the strong focus on safety of deposits, prudential regulation had to be the way forward for BoU. However, looking back one could ask whether there were alternatives to the introduction of a separate law for deposit-taking MFIs, an approach which is also referred to as the tiered structure.

In retrospect, it is not possible to determine whether the tiered approach chosen in Uganda was the best one. So far we have only tried to assess whether it was a good one. For the sake of other countries that might still be at the beginning of their deliberations on microfinance regulation, a reasonable question would be what other alternatives Uganda might have chosen.

The idea of the MDI Act – according to the 1999 policy paper and numerous public declarations - was to define microfinance as a line of business, and not as a specific institutional type. However, the MDI Act defines a new type of institution – the MDI. Centenary Bank still provides microfinance as a commercial bank and Commercial Microfinance (CMF) as a credit institution, both regulated under the Financial Institutions Act (FIA) 2004. Centenary Bank is not subject to the microfinance-specific provisions in the MDI Act and CMF is subjected to the MDI Act only in respect of its portion of the loan portfolio classified and “microfinance” loans.

MDIs are now finding themselves “overregulated” because of some requirements which are more stringent for them than the case is with commercial banks. The MDIs may consider converting into commercial banks if they see the law as continuing to disfavour them compared to banks. The key areas of MDIs’ discomfort are loan loss provisioning, prohibition from engaging in certain transactions, maximum loan period and treatment of LIF (compulsory savings). At least one MDI plans to graduate into a commercial bank in the years to come. If MDIs turn into banks and mature Tier 4 institutions continue to seek transformation into Tier 1 or 2, Uganda might soon have a redundant law called the MDI Act 2003. This would be a culmination of needless legislation.

Comparing the FIA 2004 and the MDI Act 2003, both cover broadly the same areas. There are differences, but many of them could have been prescribed in a single “Financial Institutions Act” (note -it is not called Banking Act) by defining microfinance as a line of business to be conducted by financial institutions. Microfinance-specific provisions such as the treatment of unsecured lending, loan insurance funds, and more

aggressive provisioning requirements could have been covered in sections under the FIA 2004.

In the Ugandan case, the regulation of microfinance, commercial banking and other financial institutions business under one single law could have been a cheaper option, as the revision of the Financial Institutions Statute (1993) – the predecessor of the FIA 2004 – was already under way by the time the MDI Bill was being considered. Under such an approach, all microfinance activities would be subject to the same prudential regulations, irrespective of the type of institution by which they are offered.

Such an approach of an all-encompassing FIA certainly also bears a couple of risks. In Uganda, the MDI candidates initially had reservations in being associated too closely with the banking sector. The Banks' reputation was not the best, and the MFIs were proud to be different as institutions with a double bottom line. The advantage of the tiered concept is that institutions can gradually climb up the ladder and will only eventually (or not at all) become a bank.

Another risk could have been that the regulator, because of the minor importance of microfinance from a financial sector perspective (at least when looking at gross assets/ deposits and not at customers served), would focus on commercial banking at the expense of microfinance. A separate law forces everyone to think hard on what is special about microfinance, while a single law might easily oversee some of the peculiarities of microfinance.

There is no ultimate answer on which approach is superior, the single law approach or the tiered approach. It depends on the country context. In the Ugandan context, there are a number of indications that microfinance regulated under a single FIA might have produced at least as good results as the MDI Act.

Appendix IV to this report highlights some of the alternatives that could have been explored had the original motive for proposing the MDI Bill been mainly support for industry growth. Given that the main aim was prudential regulation for safety of clients' deposits, however, the option of extending the FIA to include regulation of micro-deposit intermediation might have been the most viable one.

15.0 COSTS INCURRED BY STAKEHOLDERS

15.1 Estimated Costs

The total amount of money spent on transformation by all the relevant stakeholders cannot be easily ascertained. Government, BoU, the MDIs and donors spent substantial amounts in preparation for MDI regulation,

and BoU as well as the MDI continue to incur the respective costs of supervision and compliance. Whereas for the donors it is easy to ascertain the amount disbursed for transformation-related technical assistance, this is not as obvious for the MDIs, Government and BoU. These three spent money in training, recruitment of new staff with new desired skills, market and feasibility studies for the licence application, drafting the law, salaries and allowances of the Members of Parliament while considering the Bill, and the opportunity cost of management, board members' and other staff members' time. In addition, BoU and donors spent money organising sensitisation seminars and conferences, training supervision staff in microfinance regulation, pre-licence onsite and offsite inspections, seminars and conferences. All these are one-off costs for setting-up the new legal framework, transformation, and licensing.

In addition, there are ongoing costs for regulating the industry: direct costs incurred by BoU for supervising MDIs, compliance costs for MDIs and structural costs for any market distortions created by the legal framework.⁴⁸

From the file information of the TSC and Joanna Ledgerwood's status notes as she was leaving, donors have spent between US\$ 470,000 and US\$ 910,000 per MDI with an average of US\$ 736,000 on transformation/graduation.⁴⁹

Including the costs borne by the MDIs themselves, on average US\$ 1.3 million were spent directly in preparing for transformation. Adding to this the expenses by other stakeholder, each MDI's transformation could have cost an estimated US\$ 1.8 to 2.0 million

15.2 Justification of the costs

Proper justification of the cost of transformation would require that there are established standard costs for such transformation, and a set of outcomes agreed by all stakeholders,⁵⁰ or that there can be a quantification of the benefits⁵¹. None of these exists and thus there is no established, objective measure to use for the justification. Results are mainly qualitative and are subject to value judgment. Furthermore, not all the existing quantitative and qualitative results can be fully attributed to regulation and not all costs are incremental in the sense that they would not have occurred without regulation.

In trying to develop the cost/ benefit justification of regulation, it has to be borne in mind that regulation is a public good on which calculation of

⁴⁸ Few studies have tried to measure costs of regulation. See, for example, Franks (1998): *The Direct and Compliance Costs of Financial Regulation*, and Europe Economics (2004): *Costs of Compliance*.

⁴⁹ Details are in Appendix V

⁵⁰ Cost-effectiveness analysis

⁵¹ Cost/benefit analysis

short term (2 year) benefits would be misleading. Its impact is long term and, as the number regulated institutions grows, incremental. As stated by the Tier 4 Working Group Sub Committee of the Microfinance Forum:

A core principle is that the benefits should exceed the costs of regulation (to the MFI and to the regulator). Savings products can only be offered by institutions in Tiers 1, 2 and 3 that are licensed by BoU. BoU provides prudential supervision to verify the compliance of these institutions with specific regulations that are intended to assure their financial soundness and the safety of the savings. While such regulation is costly, it is justified by the benefit of ensuring the stability of the financial systems and the safety of savings, which in turn facilitate the growth of the Ugandan economy⁵²

In retrospect, two sets of expectations on regulation were unrealistic and misplaced:

- That regulation would facilitate immediate, massive branching out into rural areas;
- That regulation would bring down the costs of loans to the borrowers significantly.

MDIs have had to consolidate their business, perfect the new controls/reporting and to deal with many compliance issues after licensing. This cannot be prudently done at the same time they are massively branching out. As can be inferred from the different parts of this report, the major benefits of regulation – increased deposits, profitability, stability of the MDIs, branching out into rural areas, product development, and outreach through linkages with other institutions – are yet to come. The immediate results are already showing in terms of improving profits of the MDIs, better structured and organised institutions, improved governance and management, increased access to funds from the commercial money market, and safety of poor people’s deposits. It is hoped that MDI product prices will slowly come down, as mentioned by some clients during interviews. However, there is no clear empirical evidence for this yet.

16.0 CONCLUSIONS

The enactment of the MDI Act and application of the Regulations have generated some positive results and also some challenges.

16.1 Positive effects

On the positive side, it has brought about the following benefits:

- Increased access by low income people to safe saving/ deposit facilities

⁵² Tier 4 Working Group Sub-Committee: *Regulating and Strengthening Tier 4 Microfinance Institutions in Uganda*, p. 8

- Created public confidence in the MDIs, putting them at a level of commercial banks in the perception of many of their clients
- Increased competition for MDIs from other MDIs and commercial banks. This has caused MDIs to diversify their product range, look for innovation and improve customer care. At the same time, unregulated MFIs have also started improving their customer care to compete with MDIs, again to the benefit of the clients
- Owing to regulation, MDIs have become stronger, more sustainable institutions with improving performance, improved efficiency of operations, professionalism and integrity..
- Clear ownership structures, which support more sustainable/commercial operations, better quality of corporate governance and management practices
- Better access to wholesale loan financing from commercial sources
- Exposed the real weaknesses (governance, management and operational) in some institutions which were otherwise considered strong and profitable.
- MDIs have provided good ground for development of capacity of local top level managers of financial institutions. CEOs of all MDIs are Ugandans compared to only 1 commercial bank (Orient Bank) with a Ugandan CEO out of the 15 commercial banks in the country.
- Closer donor coordination, through the TSC, which has done a good job with transforming and transformed institutions

16.2 Shortcomings

Implementation of the Act and the Regulations has also not lived up to expectations in some areas:

- The branch infrastructure requirements are perceived as being too costly limiting the opening of new branches in rural and remote areas, which was one of Government's reasons for supporting regulation
- The overall cost of transformation has been enormous, compared to what the then intending MDIs thought it would cost.
- Unintended undermining of the reputation of SACCOs and other MFIs, some of which are doing a good job in their communities. Because of the MDI status and improved image, some potential clients see Tier 4 MFIs as risky institution.
- Unfavourable provisions prohibiting LIF intermediation and yet including it among the liabilities for calculation of capital adequacy

- Deposit mobilisation has been slower than was anticipated before the MDIs were licensed (although the number of savers grew impressively)
- The expectations of the Government – to massively increase access to financial services through secure, regulated institutions – has not been fully met and is unlikely to be met in the near future through the MDI regulatory regime. Whereas Government expected a transformation of a financial market segment (the entire micro-finance industry) to make it more responsive to the financial service needs of low income/ poor people, what we have achieved through the MDI Act is a transformation of institutions. This has not yielded the results that would have been expected of a transformation of the entire microfinance industry.
- Expectations of employees (which came later in the process of transformations) to own shares were not met.

17.0 PRELIMINARY LESSONS AND RECOMMENDATIONS

17.1 Lessons

So far, the key lessons from Uganda’s experience with microfinance regulation is that prudential regulation should not be expected to automatically result in greater outreach and more advantages for poor people. In future interventions and other efforts related to regulation, the stakeholders should:

- Explore the possibility of varying existing banking/ financial institutions laws to accommodate prudential regulation of micro-finance, before deciding to establish a separate law
- Fully educate Government and legislators on the focus of the proposed law, to ensure expectations are as realistic as possible
- Support self regulation, consumer education and transparency efforts so as to help microfinance clients to choose the most responsive and cost-effective institutions/ products
- Calculate the likely transformation, regulation and supervision costs and develop a sustainable mechanism for financing them
- Assess the likelihood of a shift⁵³ in client focus by the regulated institutions and the impact this might have on access to financial services by the poor
- To the extent practical, ensure that prudential regulation of microfinance is less stringent than that of commercial banks, and aims only at safeguarding deposits and/ or checking potential systemic risk to the financial sector.

17.2 Recommendations

⁵³ To include more of the not-so-poor
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To help the microfinance industry stakeholders maximise the overall benefits from both prudential regulation and outreach focused support, Government and its development partners should consider supporting initiatives in the following areas:

- Strengthening providers of rural finance to establish branches upcountry, and to link with local enterprise based or savings and credit groups. This should take into account the lessons learnt from MCAP, Entandikwa, the MDIs and earlier schemes like the Rural Farmers Scheme. Emphasis needs to be on the services to be provided rather than institutional types
- Education of rural/ low income Ugandans to become more informed and enlightened consumers of financial services
- Review of the provisions which appear to be disincentives for MFIs to become or remain MDIs (see Table 2).
- Effective industry self regulation⁵⁴ through codes of conduct and commitment to sound practices
- Prompt and effective enforcement of the provisions prohibiting non-licensed institutions from taking people's savings (to address the issue of good Tier 4 institutions being undermined by unscrupulous organizations that take advantage of poor people)
- Exploring the possibility of scrapping the MDI Act and amending the FIA 2004 to accommodate regulation/ supervision of the microfinance business. This could be more suitable for regulation of microfinance as a line of business⁵⁵ rather than an institutional type.
- To effectively use the information in this report for other countries and for future benefit, the following should be done by way of dissemination:
 - Keep the report in the FSDU website for as long as the website exists, and thereafter transfer it to DFID Uganda website;
 - Review the report every two years by carrying out similar studies, for the periods since the end of the study period of this report (June 2007). The updates will be insightful or Governments and their development partners in terms of policy related to microfinance regulations in Uganda and elsewhere.
 - Maintain the final report on the FRIENDS Consult Ltd website, where anyone can also access it freely
 - Distribute soft copies of the report at the African Microfinance Conference, August 2007

⁵⁴ Non-prudential, non-punitive but effective

⁵⁵ Which was the original idea of the MDI law.

- Avail the report to institutions of higher learning that have a Microfinance course, like Makerere University Business School, Uganda Matyrs University, Uganda Institute of Bankers and Makerere University.
- Publish abridged hard copies of the report and disseminate them through post and in the different microfinance forums

APPENDIX I: PERSONS INTERVIEWED

Paul Rippey – Manager, FSDU

Christopher Musoke – Deputy Manager, FSDU

Godfrey Jjoga Sebukulu – Transformation & Consolidation Consultant, FSDU

Charles Nalyaali – CEO, UML

Anthony Opio – Director, Non-bank Financial Institutions Supervision, BoU

Grace Kasisira – Deputy Director, Non Bank Financial Institutions Supervision, BoU

Enid Kiiza – Head, Offsite Inspection, Non Bank Financial Institutions, BoU

Mathias Katamba – CEO – UFT

Harriet M. Wamasali – Chief HR & Administration – UFT

Samuel Baguma – Chief Manager MIS – UFT

Ann Aliker – Regional Director (Corporate Banking); Stanbic Bank Uganda

Shafi Nambobi Chief Operations Manager, Business Dev't & Marketing – UFT

Robert Kakande- Financial Controller –UFT
Mark Abulu Chief Manager, Internal Audit – UFT
UML – Charles Nalyaali – CEO – UML
Saliya Kanathigoda – Programme Advisor – GTZ
Edith Tusubira –Country Manager – OIKO Credit
Lucy Bugonzi – Operations Manager – MSCL
Wilson Wamatsembe – Capacity Building Manager – MSCL
Henry Mutabazi – MD – SUFFICE
Richard Kigozi – Head of Treasury – PRIDE
David T Baguma – Executive Secretary – AMFIU
FAULU – Finance Manager
Harriet Mulyanti – Deputy CEO – MEDNET
Paul Mayanja – CEO -STROMME Microfinance East Africa (SMEA)
Priscilla Sserukka – Regional Director- Stromme Foundation and Chairperson
SMEA
Leonard Msemakweli –General Secretary, UCA
Fabian Kasi – CEO – FINCA (U) Ltd
Peter Okaulo – CEO – UGAFODE
Jennifer Mugalu Ag CEO- PEARL Microfinance
Henry Mbaguta – Assistant Commissioner –Microfinance- MoFPED
Helton Achaye – Programme Administrator – MOP
Stephen Mukweli - MD PostBank
James Kabogoza - Credit Manager and at Centenary Bank,

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Competition and Microcredit Interest Rates Interest Rates⁵⁶ (CAGP Focus Note) <http://www.cgap.org>

Regulating and Strengthening Tier 4 Microfinance Institutions in Uganda 2005: *Compiled by Tier 4 Technical Working Sub Committee*

⁵⁶ Based on in-depth country studies of Bangladesh, Bolivia and Uganda
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APPENDIX III: PERFORMANCE OF MFIS					
PERFORMANCE MEASURE	2002	2003	2004	2005	2006
FINCA					
Operating profit (Sh m)	97	297	(242)	95	385
OSS	103%	114%	94.6%	103.6%	107.9%
FSS	102%	103%	90.1%	101.7%	103.5%
Total savers (Voluntary)	0	0	11,659	39,185	41,165
Total borrowers	35,610	36,912	48,331	42,382	46,236
Gross loan portfolio(Sh m)	4,240	4,860	10,503	11,392	14,587
PAR (> 30 days)	2.9%	2.4%	3.58%	4.13%	2.92%
Voluntary savings	0	0	2,215.583	4,607.113	5,866.130
LIF	2,828	3,104	357	524	939
Total savings(Sh m)	2,828	3,104	2,573	5,132	6,805
Long term D/E ratio	0.07	0	2.2	2.3	1.92
Overall D/E ratio	0.3	0.4	4.6	4.8	3.8
PERFORMANCE MEASURE	2002	2003	2004	2005	2006
UFT					
Operating profit (Sh m)	(327.6)	512.1	106.6	(440.3)	636.5
OSS	90%	111.6%	101.5%	94.5%	107.9%
FSS	86%	106.5%	94.1%	93.2%	101.5%
Total savers (Voluntary)	77,049	82,220	98,003	78,707	93,154
Total borrowers	21,979	19,581	20,600	17,052	15,629
Gross loan portfolio(Sh m)	6,400	8,506	11,855	13,375	13,490
PAR (> 30 days)	3.63%	6.06%	4.16%	8.26%	5.12%
Voluntary savings	2,500	2,900	4,195	5,064	6,635
LIF	1,900	2,300	3,036	3,148	2,070
Total savings(Sh m)	4,400	5,200	7,231	8,212	8,705
Long term D/E ratio	0.4	0.4	2.05	1.1	1.0
Overall D/E ratio	3.0	3.7	7.5	4.4	3.3
PERFORMANCE MEASURE	2002	2003	2004	2005	2006
UML					
Operating profit (Sh m)	290	1,200	1,817	247	1,596
OSS	113.3%	126.4%	122.3%	100.5%	109.7%
FSS	90.2%	103.8%	105.3%	69.1%	93.2%

Total savers (voluntary)	12,100	47,529	61,538	58,127	51,838
Total borrowers	20,955	28,099	35,787	31,145	30,235
Gross loan portfolio(Sh m)	6,557	12,274	18,812	20,601	24,856
PAR (30 days)	0.67%	4.01%	4.74%	5.15%	3.47%
Voluntary savings	2,511	2,145	2,225	4,455	6,073
LIF	2,231	2,163	3,464	2,406	3,442
Total savings(Sh m)	2,257	4,308	5,690	6,862	9,514
Long term D/E ratio	0.44	0.93	1.44	1.15	0.84
Overall D/E ratio	2.4	1.0	3.2	2.9	2.9
PERFORMANCE MEASURE	2002	2003	2004	2005	2006
PRIDE					
Operating profit (Sh m)	1,003	1,423	409	1,207	484
OSS	131%	121.	103.%	109 %	103%
FSS	102%	116%	91%	99%	92%
Total savers (voluntary)	0	0	37	21,578	64,098
Total borrowers	38,003	49,588	56,135	51,002	51,717
Gross Loan Portfolio	15,287	17,219	21,934	20,369	26,469
PAR 30 days	0.3%	2.5%	5.6%	3.0%	1.4%
Total Savings	6,298	7,984	9,498	10,530	14,140
Voluntary savings (Sh m)	0	0	4.5	1,430	5,319
LIF	6,298	7,984	9,493	9,099	8,821
Long term D/E ratio	n/a	1.0	1.42	1.57	5.1
Overall D/E ratio	2.5	1.5	5.0	4.1	5.3

Source: PMTs and audited accounts of MDIs

APPENDIX IV

REGULATION OPTIONS FOR INDUSTRY GROWTH

If the law for regulating microfinance business in Uganda had been aimed at supporting industry growth as the main objective, there some options that might have been suitable to explore. Some of these are:

- i) *Self regulation through apexes* – Apexes, because they are member based and they render capacity building and other services to the MFIs, would not be in a strong enough position to undertake prudential regulations, which MDIs needed. They are, however, suitable for encouraging best practices for Tier 4 MFIs through enforcement of member codes of conduct. This could be a way of helping the MFIs adhere to sound practices while they grow without the rigour of prudential regulation
- ii) *Extension and strengthening of the Cooperative Statute*, under which SACCOs are regulated, to include non-SACCO Tier 4 MFIs, while the MDIs are subjected to prudential regulations under the FIA 2004

This option would be an attempt to regulate the whole microfinance sector, which in Uganda has more than 1,000 institutions of different sizes and are thus extremely expensive and unviable to supervise. To be effective, it would necessitate fundamental improvements in skills, procedures and competencies that exist within the SACCO regulation structures

- iii) *Establish a scheme similar to the South African “hybrid” scheme* – under which Government would back some apex(es) to engage in industry self-regulation of Tier 4, with strong incentives for compliance to sound practices and penalties for not complying

It is apparent that the MDIs needed prudential regulation while the smaller MFIs need more of self regulation and capacity building. Trying to regulate weak, poorly informed institutions would end up the way SACCO regulation in Uganda is at the moment: ineffective. The only viable option to the MDL Act, therefore, would be the revision of the FIA 2004 to include regulation/ supervision of MDIs.

Tier 4 institutions, apart from two or three that could transform in the next five years, cannot at the moment stand prudential regulation, and the cost of this would be too high to be justified. They need capacity building and education of their members/ clients to know their rights responsibilities as

consumers of financial services. As concluded by the Tier 4 Working Group:

- The primary regulatory issue for Tier 4 MFIs is to ensure they do not take savings (the MDI Act can be invoked by BoU to ensure this)
- The number of Tier 4 institutions is too big to make supervision of their credit-only business viable, and there is little need for prudential regulation of these credit only institutions
- Empowering Tier MFI clients would help them to effectively sanction the institutions by choosing who to get services from
- Even the most basic supervision of Tier 4 MFIs would require substantial capacity building for transaction processing and financial/ operational reporting.

Government is proposing to regulate SACCOs directly through the MoOFPED Department of Microfinance. In 2003, consultants engaged by Government to study regulation options for Tier 4 MFIs in Uganda recommended that SACCO supervision be transferred from MTTI to MoPED. Government's current move seems to in part an implementation of that recommendation. The industry waits to see how direct supervision by MoPED will work and what lessons there will be to learn from it. This seems to be a somehow modified implementation of the recommendations Tier 4 regulation recommendation.

**APPENDIX V
DONOR AND GOVERNMENT GRANT SUPPORT FOR
TRANSFORMATION / UPGRADING (IN US DOLLARS)**

MDI Candidate	SPEED Funding	MOP	FSDU	Other Funding			Total Received
				WWB	NORAD	AFRICAP	
UFT	22,000	443,936	300,000	60,000			825,936
FAULU	25,000	141,527	300,000			-	466,527
PRIDE	175,000				370,000	190,000	735,000
FINCA	450,000	22,959	-			-	472,959
UML	630,000	22,959	259,300			-	912,259
TOTAL	1,302,000	631,381	859,300	60,000	370,000	190,000	3,412,681

GTZ / FSD – Post Licensing Funding (in Pounds)

MDI	Amount Received
UML	54,559.00
U-TRUST	32,083.00
FINCA	54,436.00
PML	57,243.33
TOTAL	198,321.33

APPENDIX VI

BRIEFS OF ISSUES RAISED IN DURING THE WORKSHOP

On July 31st 2007, the consultants presented the draft report to a workshop of about 60 key industry stakeholders. The participants all appreciated the consultants for the effort and level of analysis. The following table summarises their contributions/ questions and responses/ what has been done to address them.

ISSUE	ADDRESSED-SECTION	REMARKS
Were MDIs simply a donor creation?	3.1 and 3.2	No. These sections give a genesis of the law. Donors supported but did not create MDI transformation
Why don't we have many more?	Table 2 and Sec 13	They have learnt that MDI transformation is costly and MDI status is less attractive
Was it a process highly patronized by donors?	n/a	Transformation process was patronized by donors who were the main funders. Effects wouldn't have been different with the same law even if donors had not patronised
Why savings growth not higher? What do clients say?	Figure 6	Number of savers grew impressively. Poor people can each only save so much.
Safety of poor people's savings: main rationale for regulation – has this been achieved?	Sec 16 bullet 1	Yes, deposit safety has been achieved
Fraud: has the incidences of fraud stopped?	Sec 6.6	Though the question is outside this ToR scope, better systems provide a good environment for fraud reduction.
PRIDE: Why not higher PAR if OSS was lower in 2006	n/a	PAR and OSS do not have obvious correlation
Was there a need for tier 3? Some now think of going straight to tier 2!	Sec 14	There was need for MDI type regulation but there was at least one cheaper, effective alternative
Transforming financial institutions or financial markets? What is the future?	Sec 16.2(last bullet) & Sec 17.2	We got transformed institutions instead of a transformed financial market. Hence Govt frustration.
Details of MDI Act, reservations about specific	Table 2	List of the sections that MDIs say are unfavourable to them

ISSUE	ADDRESSED-SECTION	REMARKS
sections limiting MDIs		
Looked only at savings for MDIs, not for MFIs?	n/a	Tier 4s not permitted to take voluntary savings
Did transformation play the poor former clients of MDIs into less stable or unscrupulous institutions?	n/a	Outside the scope of this assignment; but an interesting area for future studies.
Why is MDI Act not suitable, when the regulator thought this was the best option?	Table 2	Clauses and conditions that are seen as more stringent than equivalent regulation for banks
Why were government expectations not met?	17.1	Well meant but misplaced expectations.
Strategic move of Ggovt. to support SACCOs: might this have a positive impact on MDIs performance in rural areas?	n/a	Too early to tell whether Govt support to SACCOs will take shape, succeed or have impact.
New customers or old customers served with larger loans?		Either way, substantial increase in average loan sizes would imply increased focus to the not-so-poor. New products developed for a new market segment. MDIs confirmed they got in new a customer category – the not-so-poor
Setting up deposit insurance fund might stimulate deposit-taking (to include) Shift from heavy reliance on LIF towards better loan analysis?	n/a	1) No Deposit insurance caters for depositors in cases of institutional insolvency: not loan security. 2) MDIs already do more cash flow/ appraisal based lending.
Reduction of cost of accessing financial services partially achieved, why? Portfolio yield has gone up plus LIF remain additional costs	6.5 Figure 2 7.0 (iv)	Loans are slightly more expensive (portfolio yield a bit higher) while savings are more cost effective. MDIs have scrapped some fees on savings and pay interest on deposits.
PAR going down, maybe due to “brutal recovery measures”?	n/a	Recovery from a defaulting borrower is usually unpleasant, and MDIs are in business (answer given by Godfrey, FSDU)
Expectations by founders not mentioned?	Table 1	Included in expectations by MFIs that were to transform

ISSUE	ADDRESSED-SECTION	REMARKS
Reduced numbers of borrowers: Maybe also due to changes in MIS, which doesn't double count borrowers?	6.5 para 2	Yes. Partly because of the clean up and partly actual reduction in the numbers of borrowers
Impact of the learning curve – take stock of that	1.3 para 1 bullet 1	Explained that it is too early to assess full impact, and part of the reason is the “learning curve”
Recommendations, way forward? Didn't hear enough on this	17.2	Addressed
Are MDIs going into rural areas?	6.5 last paragraph	Modest increase in the proportion of rural clients from 72% to 75% from 2004 to 2006
Impact: MDIs changed focus; point out the change of focus; was it caused by law?	Various sections & 6.5	Explained that MDIs included the not-so-poor. Regulations partly the cause
Operating cost ratio was controversial, show trend	n/a	Not necessary. Consultants chose to use OSS, which is a more commonly used profitability yardstick
Divide between motives of practitioners and of Govt, can you advise us how to deal with unmet expectations of govt?	17.2	Recommendations
Reduction of prices: law had some impact through 1)transparency/disclosure requirements; 2)competition; 3) efficiency	7.0 (iv)	Noted; had already been addressed
Talked about limited outreach, and more focus on not so poor people, new products targeting different people. Have the former products been discontinued serving the poor people?	6.7	Added more products for the new category but did not abandon the former ones or former clients (the poor).
Limited outreach: geographical? Savings growth: takes time, low income earners can only save so much, it's necessary to bring in slightly bigger savers, but these would want chequing accounts	Table 2	No criticism on the number of savers. It is only the outreach viz Govt expectations (which were unsuitable of prudential regulation) which was a challenge

ISSUE	ADDRESSED-SECTION	REMARKS
and forex accounts		
Bank of Uganda has not come out to tell people who can take savings and who not	n/a	Not a fair statement. BoU comes out with a public statement quite regularly, including during the week of the workshop, on who the MDIs are
Hindering provisions in law: LIF, checking accounts, forex accounts	Table 2	Point taken and explained as a constraint
Why have MDIs been restricted in intermediating LIF?	Table 2	Explained as a constraint to MDIs
Would be good to interview staff and not only senior management	n/a	1) Study scope stipulated interview of managers 2) lower level staff were not strategically involved in the law formulation & transformation – and here we are examining a strategic question.
For confidentiality reason don't give names of institutions in graphs	n/a	Found not necessary. The info is not competitive and largely public.
Burden of reporting: mention! Reports take time to prepare	n/a	Not a fair comment. Reporting shouldn't be burdensome with improved IT. Also, reports are a good management tool, not necessarily occasioned by regulation
Govt. did not know what to expect! MSCL wholesale loans are max. 500m – too little		Already addressed
MFIs masquerading to be banks. BoU doesn't do anything. "king has been quiet for too long		Already addressed
LIF is hurting us as MDI. Why take it? It's just cost on balance sheet. If they keep it with banks they have hold 20% capital against it. UML has developed some products not using LIF. Do microleasing and salary-based lending.		Already addressed
Provisioning: more stringent.	Table 2	Already addressed

ISSUE	ADDRESSED-SECTION	REMARKS
Fishing in the same lake, why not provision the same way as banks		
Focus on better off: Premises were changed, clients didn't like that; poor people feel uncomfortable with fancy banking halls		Not a common experience with other MDIs. Also, the view is not supported by the fact that number of savers, mainly the poor (by virtue of low average savings) has grown rapidly
Reporting not a problem, can report at the click of the mouse Disfavouring elements in law/regulations: provisioning; follow own standards or those in the regulations? SACCOs taking deposits	n/a	Agreed
Interest rates are generally not going down among MDIs	Figure 2	Agreed. Interest rates have not come down but savings account charges have.