Consumer Protection and Code of Conduct for Unregulated Microfinance Organizations – the Role of Regional and National Norms in the Case of Uganda

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Public demand for sufficient regulation of microfinance organizations (MFO) increases at present times – not only in the context of growing micro-savings business since beginning of the new century, but also towards the background of the international discussion about suicidal acts of several smallholder farmers in Andhra Pradesh (India), who found themselves trapped in excessive debts to microfinance organization that predominantly focused on credit-only business. How can could or should such a regulation look like? Prudential regulation and supervision of organizations with lending-only business usually exceeds the capacities of governmental authorities as well as of MFOs. MFOs in those countries that inflict governmental surveillance to MFOs (e.g. in Tajikistan) seriously complain about the efforts and costs related to the fulfillment of such norms. Which role can bookkeeping and accounting standards on national as well on regional level play in this context? Will increased market transparency and self-inflicted rules for the microfinance industry contribute to financial services quality assurance and improved consumer protection?

Regulation of MFO – a balancing act

Regulating microfinance institutions aims to assure the protection of depositors' savings as well as at the systemic stability of a financial system on the whole. Assuring public trust into the (micro) financial system is the direct intended impact of prudential regulation and supervision. According to CGAP (2003) regulation and bank supervision is considered to be prudential as soon as the financially sound condition of licensed financial intermediaries is being externally steered by legal and regulatory norms to actively prevent possible destabilizing risks and the potential loss of small holders' deposits. The essential rational for prudential regulation is therefore to keep supervision and regulatory action as comprehensive as necessary (systemic stability) but in the same way as minimal as possible (cost efficiency and quality assurance). Amongst practitioners and scientist there is no dispute about the assumption that prudential regulation of credit-only financial intermediaries would in no way correspond to the second criterion of cost effectiveness.

However, exactly this assumption – stipulating that a complete part of the microfinance industry is exempted from systemic control and supervision – appears to be a main factor for the Andhra Pradesh tragedy, leading to lack of trust if not even mistrust into the microfinance industry. It seems that MFOs, which do not refinance themselves from their client deposits ("warm debts") but predominantly from equity investments, bonds and selling of shares on capital markets ("cold debts"), appear to be

Implications of over-regulation in Tajikistan and Uganda

The National Bank of Tajikistan licenses financial services of savings mobilizing Microfinance Deposit Organizations (MDOs – corporate company), as well as for those MFOs that run credit-only business under the umbrella of non-commercial funds. The regulating authority demands detailed accountability from all kinds of MFOs on a ten days or monthly basis. The amount of work time to be dedicated to such administrative accountability by loan officers, accountants and portfolio managers – as the MFO's cost units – is enormous! Thus, regulation becomes a cost driving factor for financial products and subsequently towards the client.

In 2003 the Bank of Uganda established a regulatory window for deposit mobilizing microfinance organizations. At that time, the microfinance sector encompassed a multitude of unregulated MFOs that followed several models, e.g. NGO/Grameen model, the cooperative-model etc. the regulating authority aimed to integrate the leading MFOs into the supervised regulatory framework. However, after adoption of the so called "MDI-act" only four MFOs transformed to Micro-Deposit Institutions (MDIs). The obvious low demand most probably rested on the so called phenomenon of "regulative arbitrage", according to that an MFO preferred to remain in the unregulated market segment (tier 4) due to considerable cost advantages compared to the new MDI-window (cost-implications for transformed MDIs over-extended available capacities of most of the MFOs).

Implications of under-regulation in Uganda

On the contrary to prudential regulation of credit-only MFOs in Tajikistan, more than 2000 unregulated savings and credit cooperatives (SACCOs) intermediate member shares and savings in Uganda. The unregulated nature of SACCOs imposes a high risk on members; but in the same way those institutions are often the only alternative to community-based Accumulating Savings and Credit Associations (ASCAs) in most parts of the country. Statistics about the population's access to financial services unfortunately show a decrease from 10% (2006) to 7% (2009) in the cooperatives market segment, probably indicating declining trust into SACCOs by the population. Some of possible reasons for that development may be frequent media reporting about embezzlement of savers' assets, mismanagement and corruption in SACCOs and subsequent closure by governmental organs.

forced to scarify the company mission's social aspect to follow values that are far more focused on business economics and investors' return.

The debate of the last months showed that not only MFOs often lose sight of their social mandates but even the actual target group can become significantly threatened through immoral behavior of MFO staff (e.g. loan officers) and lack of consumer protection (O. Schmidt 2010). The economic pressure perceived by some unregulated and growth oriented MFOs – to find foreign equity investment and get access to capital markets – appears to make the necessity of non-prudential regulation or self-imposed quality standards in the context of the credit business and consumer protection again even more relevant.

Regional and national norms for microfinance business

In analogy to e.g. a "code of conduct" on consumer protection regional or country-wide standards on bookkeeping and accounting in combination with sector transparency could be considered as a promise on professional ethics and quality assurance given by MFOs themselves. Unregulated MFOs (e.g. SACCOs) obligate themselves towards their relevant apex organizations to adhere to established norms and thus assure the implementation of qualitative minimum standards of microfinance business. Reference shall be made here to two projects in Uganda, results of which feed into each other to establish a normative framework as well as sector transparency and benchmarking for the unregulated segment of the Ugandan microfinance sector:

(i) **Regional cooperative data services center (DSC) for SACCOs**

Only very few of the approximately 2000[1] financial cooperatives with full credit and deposit business in Uganda have been able to develop into sound member-based financial intermediaries. Most of them do not prevail over sufficient capacities to implement international minimum good practice of microfinance. The economic position of a SACCO in most of the cases remains totally unknown to management and board of directors. This often is a negative consequence of the necessity to manage and administer complex credit and savings portfolios – often aldo including external refinance provided by the government – on the foundation of a manual, paper-based bookkeeping system.

The establishment of a regional Data Services Center for SACCOs provides an effective instrument against that lack of data to empower management and control of an MFO for better decision making and appropriate action; given that such centrally offered services are being accompanied by capacity building measures[2] amongst management and board of the MFO.

Adherence to cooperative sector standards ("good practice") would in its consequence lead to more service quality and transparency for the SACCO's members. The concept of a centralized service provider resembles the model of central banks (Zentalbanken) in the German Raiffeisen and Volksbanken system. The project is being implemented through the collaboration of Uganda Co-operative Alliance (UCA) and Deutsche Gesellschaft für Internationale Zusammenarbeit (GIZ) as a pilot approach in Uganda.

[1] See UBOS (2010): Report on Census of Microfinance Institutions in Uganda

[2] E.g. bookkeeping and accounting standards, financial and economic analysis, financial and business planning etc.

(ii) **National Performance Monitoring Tool (PMT)**

Since December 2009 the Association of Microfinance Organizations of Uganda (AMFIU) provides to its members the Performance Monitoring Tool (PMT) in a second, more client oriented version. MFOs use a platform-independent software tool to compare and verify internal accounting data. They have to provide compiled bookkeeping and accounting data to the association that will subsequently process data received and present a report about the economic situation including basic recommendations for improvement (ratios and indicators) to the MFO. At the same time data is being fed into a Performance Monitoring System (PMS) which is the basis for the sector's benchmarking database at AMFIU. Beginning of 2011 AMFIU received approximately 80 of ca. 300 expected PMT reports (27%). It is envisaged to regularly publish status reports about the microfinance sector in Uganda and to offer MFOs included in the system to compare their economic performance to other comparable competitors.

The concept of a national benchmarking system is being implemented through the collaboration between the Association of Microfinance Institutions of Uganda (AMFIU) and Deutsche Gesellschaft für Internationale Zusammenarbeit (GIZ). Publication of the first sector-wide benchmarking report is expected in the very close future.

Voluntary adoption of quality standards, market transparency and consumer protection

In those segments of financial systems that are exclusively non-prudentially or not at all regulated quality assurance and consumer protection starts already with the establishment of a code of conduct on bookkeeping, accounting and disclosure requirements for financial intermediaries. Responsible financial services rely on three major pillars as has been defined in the context of the 2009 MFW4A[3] conference „Promoting Financial Capability and Consumer Protection, A Step Forward towards Financial Inclusion in Africa“:

1. Regulation for consumer protection;
2. Self-regulation of the industry (e.g. code of conduct for MFO towards minimum bookkeeping and accounting quality standards);
3. Promotion of basic financial education and consumer awareness.

The microfinance industry itself shall be responsible for the establishment of high ethical and professional norms; the industry itself shall assure that financial intermediaries are treating their clients with due diligence and stewardship (Alliance for Financial Inclusion 2010). Economic entities of the civil society and governmental agencies bear a high potential of constructive and symbiotic collaboration to assure quality and trust within the microfinance sector as a whole.

The present article shall not be perceived as a general call for cost-intensive prudential regulation / supervision of the credit-only business of microfinance organizations, but plead for the establishment and proliferation of norms and ethical standards by a microfinance industry itself through the application of appropriate and acknowledged instruments. Assured quality standards and sector transparency, complemented by consumer protection and the promotion of financial literacy can build a supportive framework that may sustain regulation on consumer protection to even cost-reducing extends for governmental surveillance.

But how can such a normative (or professional ethic) implemented on a regional or national level? Which incentives have to be provided to assure that the normative is being obeyed by the market participants? As soon as state institutions recur to legal or regulative means to sustain the norm, one can hardly speak about self-regulation anymore, but more about delegated state supervision to an agency. Such kind of incentive might be considered as “negative”, since sanctioned, and thus may appear as counterproductive, e.g. for a members-based apex organization.

More positive potential might be identified through the commitment of members to self-regulation and the obedience of norms established by their apex body (e.g. through accreditation or quality certification by membership). However, the question about how to control proper obedience of standards and financing these allegedly called “privileges” (e.g. access to subsidized services etc.) indirectly places in the same way the issue of corruption on the agenda.

Immoral behavior of client advocates and loan officers as well as concealed excessive interest rates for micro loans can be challenged and mitigated also beyond state control and prudential regulation, e.g. through the establishment of institutional instruments like quality standards, sector transparency and consumer protection. Sector apex organizations do play an increasingly crucial role in that field.■

[3] MFW4A – Make Microfinance Work for Africa

Alliance for Financial Inclusion (2010): Consumer protection - Leveling the playing field in financial inclusion; Policy Note

CGAP (2003): Guiding principles on regulation and supervision of microfinance. Microfinance Consensus Guidelines

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http://www.amfiu.org.ug

http://www.mfw4a.org