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Abstract

This paper examines the financial system reforms in the context of financial sector deepening, and strategy for financial sector development and inclusion in Uganda. Results suggest that the indicators of financial sector development are largely as they were in 1996 and that the actual gains from financial inclusion strategies are small. Evidence suggests a weak link between financial deepening and financial usage by firms and households. It finds the acclaimed success (by policy makers and stakeholders) in achieving financial inclusion somewhat exaggerated because their assessment relies in large part on the number of financial and mobile money accounts. The paper concludes that measurement of financial inclusion needs to go beyond looking at account numbers to understanding what is done with those account. It also recommends the subordination of financial inclusion policy to the needs of firms and households (—the type that is modelled to fit the local context) and more consideration of behavioural constraints in financial inclusion programmes.

JEL Classification: D14, G2, G3, D53, N27, O55.

Key words: Financial System Reforms, Financial Deepening, Financial Inclusion, Informal Financial Systems, Mobile Money, Political Economy of Financial Reforms, Sub-Saharan Africa, Uganda.

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Table of Contents

1	Introduction	1
2	Financial sector/ system reforms	2
2.1	Reform context	2
2.2	Inclusive financial system reform process	5
2.3	The political economy of financial reform in Uganda	8
3	Unveiling ambiguity	11
4	Supply of financial services	15
4.1	Account penetration	15
4.2	Mobile account penetration	16
4.3	Financial (supply) system in Uganda	17
4.4	The banking sector and credit institutions (Tier I & II)	18
4.5	The microfinance sector (Tier III & IV)	22
4.5.1	Overview	22
4.5.2	Tier III: Micro Deposit-Taking Institutions	23
4.5.3	Tier IV sector	27
5	Demand for financial services	30
5.1	Financing businesses	30
5.2	Selected access indicators for MDIs	32
5.3	Selected trend in financial services usage, including savings	35
6	Conclusion and implication for policy	37
	References	38

List of Tables

Table 1. Registered Commercial Banks as of March 2007 and 2017	19
Table 2. Registered credit institutions as at 31/12/2006	20
Table 3. Financial intermediation across countries, 2003	21
Table 4. MFI outreach: Top countries (credit clients as a percentage of population)	23
Table 5. List of Microfinance Deposit Taking Institutions in Uganda, Dec 2017	26
Table 5. Selected indicators of MDI outreach	26
Table 7. Legal Frameworks for Financial Service Providers in Tier IV	30
Table 8. Source of finance for business start-up	31
Table 9. Major problems in setting up a business	31
Table 10. Source of finance for expanding business	32
Table 11. Selected Indicators of the eight Largest Ugandan MFIs (31 Dec 2005)	32
Table 12. Interest rates and other charges on loans	34
Table 15. Types of collateral demanded by financial institutions	34
Table 14. Savings mechanism used by households in Uganda, 2016/17	35
Table 15. Mechanism for receiving money by households in Uganda, 2016/17	36

List of figures

Figure 1. Account penetration across Africa countries, 2011 and 2014	16
Figure 2. Mobile money account penetration across countries in Africa, 2014	17
Figure 3. Policy Impact on Access	33

1 Introduction

Over the past ten years, governments around the world have embraced financial inclusion as an objective for the financial sector and as a key to achieving inclusive pro-poor, equitable development. To this end, the G-20 agreed in 2008 to pursue a financial inclusion agenda, and in 2010, it established the Global Partnership for Financial Inclusion to carry the agenda forward. The Alliance for Financial Inclusion (AFI)—founded in 2008 as a peer exchange body for regulators from developing countries—spearheaded the Maya Declaration process through which governments announce specific financial inclusion commitments. As a result of these global initiatives, and the growing challenges of poverty and unemployment, the Uganda Government has pursued wide ranging financial inclusion reforms and strategies to improve financial depth and the use of formal financial services such as loans, savings, payment services, and other related services. Yet, whether these efforts have resulted in increased access to affordable financial services remains a contested question.

Evidence suggests that while Uganda's financial services (banks, capital markets, microfinance, corporate finance, risk sharing and insurance, etc) have expanded both in quantity and depth over the last two decades, finance has not been inclusive—raising doubts about the effectiveness of the policy reforms aimed at delivering financial inclusion and strategies adopted for the financial sector. This paper explores the reason behind this financial inclusion gap by examining past and current policies and financial system reforms intended to foster financial inclusion.

It attempts to evaluate the connection between the various initiatives to promote financial inclusion and some of the indicators of financial inclusion—with a view to unveil potential ambiguities in the policy discussions or strategies and financial inclusion outcomes. It looks at the strategies to achieving financial inclusion, which have often focused on financial depth, or expansion of the financial system—driven by financial/technology innovation, and the dilemmas that have been encountered in the process. It asks whether the inclusion gap could be a result of insufficient innovation in the business model, inadequate use of existing and new potential channels for reaching the poor, or ambiguities surrounding the strategies supposed to deliver financial inclusion.

In what follows, Section 2 looks at financial sector (system) reforms. Section 3 focuses on the strategies that have been tried over the years to foster financial inclusion and the ambiguities that stand on the way of the national efforts to achieve financial inclusion. Section 4 and 5 address the supply and demand side of financial services, and Section 6 concludes with recommendations.

2 Financial sector/ system reforms

2.1 Reform context

Uganda economic policy until early-1990s was inward-looking and emphasized the role of the state. Active government's involvement in economic management was perceived to be the only way to address problem of underdevelopment and to eradicate poverty. Governments held a dominant share of the financial sector and used state-controlled financial institutions to improve financial outreach to rural areas. Subsidised credit was distributed extensively under various credit schemes such as the Rural Farmers Scheme, under the Uganda Commercial Bank (UCB) and the Cooperative Credit Scheme, under the Co-operative Bank, without considering the viability of those extended bank branches in rural areas or the sustainability of the programmes.

Other schemes that benefited from the extended branch network included "Entandikwa" Credit Scheme, which was implemented through local governments and NGOs; and a number of smallholder credit programmes under the Ministry of Agriculture such as the Agricultural Development Project (ADP), Southwest Region Agricultural Rehabilitation Project (SWRARP), Progressive Farmers Loan Scheme, Rehabilitation of Production Enterprises scheme, Smallholder Cotton Rehabilitation Project (SCRIP), Cotton Sub-Sector Development Project (CSDP) and Livestock Services Project (LSP), among others.

Yet the expectation that these programmes would provide the rural poor with easier access to credit often proved to be unfounded. Formal credit reached less than 15 per cent of the farmers. Most of these schemes were characterized by high transaction costs and huge loan losses making little progress towards self-sustainability.

On seizing power in 1986, Museveni's government spearheaded a wide-ranging economic recovery and reforms program that begun in 1987 under the guise of the so-called "Washington Consensus". Financial sector reform was part of a wider reform (structural adjustment policy package), which prescribed a return to fiscal discipline and reorientation of public expenditures; tax reform; trade and financial liberalization; unified and competitive exchange rates; openness to direct foreign investment, privatization and minimal state intervention in the economy; deregulation; secure property rights; and flexible labour markets. Reforms in the financial sector were implemented within the framework of the Bank of Uganda Act of 1993 and the Financial Institutions Act amendment of 1993, which

- Established a legal basis for the independence of Bank of Uganda, thereby bringing to an end, the discretion of politicians in monetizing fiscal deficits and also restrained fiscal dominance in credit extension to the government.
- Conferred to Bank of Uganda, wide-ranging powers over the financial sector with overall responsibility for supervising financial institutions and to serve as an independent regulator and sole monetary authority.
- Introduced institutional reforms including new laws and regulations governing the financial sector.
- Liberalized interest and exchange rates, as well as the capital account — removing restrictions on capital transfers and strengthening competition in the financial sector.
- Scaled back government ownership in financial institutions.
- Reduced the corporate tax rate, and allowed new financial products and services to emerge including legalizing foreign exchange deposits.
- Reduced excessive prudential requirements imposed on banks (for example, it reduced minimum reserve requirements from 10 to 7% for time deposits and from 10 to 8% for savings deposits).

The strengthening of the banking supervision function of Bank of Uganda and adoption of strict banking legislation led to the closure of several commercial banks (some of which were state-owned) while other insolvent banks, which managed to restructure their business were re-capitalized. Non-performing assets were taken

over by a newly established state-owned, *Non-Performing Asset Recovery Trust*, which by 2003 had recovered over 40 percent of non-performing assets

The role of financial sector reforms in restoring macroeconomic stability is widely recognized, but it was also disruptive for the livelihoods of majority of people whose access to formal financial services were temporary or permanently interrupted by the closure of several commercial banks. The collapse of the Cooperative Bank in 1999 and the sale of state-owned Uganda Commercial Bank Limited (UCBL) eroded public confidence in the whole financial system resulting in a low savings rate and a lack of financial depth. The variance between the weighted lending rates and the annual yield on the Treasury bill remained very high, reflecting the high risks involved in lending to the private sector. Credit to private sector dwindled as commercial banks exercise more caution in dealing with the private sector.

By all measures, government interventions did not enhance access to financial services for the broad population, but benefited the politically well-connected classes with cheap loans, and reform did little to correct it. It became clear that reaching the poor and the underserved not only required financial sector reform but inclusive financial system reform that takes the needs of the firm and households into account.

The huge gap created by the retreating state from provision of financial services and the closure of major banks gave rise to the emergence of new generation of finance, the microfinance. The microfinance entered the scene to fill the vacuum left by a 'retreating state' and pursue credit-based development interventions. However, they operated under very difficult policy environment. While banks were regulated and therefore perceived as safe, microfinance did not have this seal of approval. They were not legally able to accept deposits unless registered as a financial institution.

With increased commitment to the implementation of Poverty Eradication Action Plan, government came to acknowledge the important role that microfinance could play in alleviating poverty, and made effort to press microfinance industry to augment its outreach. The administration of microfinance sector into the regulatory regime gave rise to a third tier of financial services industry: the Micro Deposit Taking Institution (MDI) regulated under the MDI Act 2003. In next section, we trace the process that delivered the MDI framework to fully understand the reform drivers.

2.2 Inclusive financial system reform process

One of the most important developments in the history of Uganda financial services is the extension of formal finance frontier under the Bank of Uganda regulatory mandate to include non-bank financial institutions—The Microfinance Deposit Taking Institutions through the Microfinance Deposit Taking Institutions Act 2003 (the MDI Act). The origin of the MDI Act can be traced to the informal discussion that began in 1996 between different stakeholders—microfinance institutions (MFIs), policy makers, and Bank of Uganda (BoU)—all with somewhat differing interests and goals.

A growing number of MFIs requested for a regulatory framework for microfinance that would allow them to broaden their funding base and increase their business and services to clients. MFIs taking compulsory savings were experiencing pressure and increasing demand from their customers to provide small voluntary deposit facilities. Undoubtedly, a number of MFIs went out of their way to take deposits from the public for on-lending purposes (which was illegal for them to do). At the time, microfinance began to appear on the political agenda as a potentially effective mechanism for poverty alleviation. Policy makers argued in favour of a legal framework for microfinance operations. They viewed such a framework as an enabler for a better access to credit for the poor at low-interest rates. The central bank—following a prudential view—also saw the importance of bringing the activities of a section of the microfinance industry under a legal regime. The Bank of Uganda was aware that the microfinance business was growing, and that some services provided by MFIs apparently took place in a regulatory void.

Government took the lead in the microfinance policy debate, and discussion proceeded in a more formal arrangement—a committee formed for this purpose in 1998, which later on became the microfinance forum. Some stakeholders perceived regulation as a way to promote MFIs and hence improve access to financial services for the poor, while others, saw it as a way to enable strong (financially sound) MFIs to mobilize deposits.

The Bank of Uganda was reluctant at first to take on a supervisory/ regulatory role (involving non-bank financial institutions, which it viewed as falling outside its mandate), given the complexities of the issues and the lack of clarity and consensus on a number of issues. However, it seemed there was increasing pressure from

some quarters, for them to take on the project work and draw a law to license and regulate the MFIs. Cautious in its approach, the Bank of Uganda, tried by all means to balance the competing interests before coming up with a draft a law. This helped in two ways. First, it helped to build consensus among stakeholders on how to deal explicitly with the microfinance sector. Second, because this was a gray area, there was need, first to build internal capacity within Bank of Uganda before proceeding with the drafting of the law.

The Bank began by drafting a policy statement on microfinance as an initial step to first clarify the guiding principles (such as the tiered approach to management of microfinance) and standards for microfinance regulation—which it accomplished with inputs of various stakeholders: government representatives, microfinance practitioners, and some donors. Discussions also focused on minimum capital for MFIs, the definition of microfinance as a “line of business (rather than a product only offered by a specific type of institution), and the role of SACCOs, which were not to be covered by microfinance legislation.

After the policy was approved by cabinet in July 1999 as the Government Policy on MFI Regulation, the drafting of the MDI legislation began—based on the already established consensus on principles and standards—with the Bank of Uganda Supervision Department taking the lead in this process. Cognizance of the supervisory role the Bank of Uganda would assume in future (of microfinance), the Bank board approved the establishment of a Microfinance Unit, and placed it under the Non-Bank Financial Institutions Department—in recognition that microfinance is a nonbank financial service.

Staff training became a top priority after the creation of the new unit—using both on-the-job training provided by international experts, and international microfinance training programs. With these trainings, the Bank was able to build high skill base in field of microfinance in a comparatively short time and therefore was in a position to lead the consultations with stakeholders on the microfinance legislation most effectively. The drafting of microfinance legislation for Tier III institutions (MDI Bill)

took into account the specific nature of the microfinance business and upheld the principles of the new FIA 2004 that was at the time being discussed in parliament.¹

In January 2002 the MDI Bill was complete, and tabled in Parliament, having been approved by the cabinet in September 2001. The microfinance forum (MFF), Bank of Uganda and Association of Microfinance Institutions of Uganda (AMFIU) organised events to sensitize Members of Parliament (MPs) on the Bill before the bill reached the floor of parliament for discussion (and to lobby them to support the bill). This meeting also served to provide a forum for interaction between MPs and microfinance practitioners. Debates during these events centred on the following issues:

- How the new law would promote smaller MFIs, especially in rural and remote areas. Because MPs perceived the MDI Bill as an instrument to promote microfinance, one of the major concerns was the minimum capital requirement of 700 million Uganda shillings, which was felt to be too high to enable small MFIs to come under regulation of the Bank of Uganda.
- Interest rates on microloans and terms. The MPs argued that poor people could not afford to pay high interest rates, and loans were too short term to facilitate productive investment. Some of the MPs insisted that the MDI Bill address these issues.

It became clear that the law and the policy framework would not affect Tier IV institutions as long as those institutions abstained from mobilizing deposits from the public. The legislation would enable stronger MFIs to offer additional financial products and services. Parliament passed (with few amendments) in November 2002, coming into force in July 2003. The still-persisting concerns of some MPs were addressed by the following motion:

It is hereby resolved that the Cabinet undertakes to bring to the August House within six months a Bill regulating the activities of Community-Based Financial Institutions referred to as Tier IV in the Report of the Committee on Finance,

¹ Members of the drafting team (task force) of the new legislation were of the view that converting MFIs into deposit-taking intermediaries could be achieved with lower transactions costs by amending the draft Financial Institutions bill rather than creating a new legislation. However, it already been determined at political level to have a separate law for this purpose.

Planning and Economic Development guaranteeing affordable interest rates and reasonable period of repayment to the borrowers.

In this context, the MFF commissioned AMFIU to prepare a proposal to regulate MFIs not covered by the MDI Act. In March 2003, AMFIU conducted a study to analyze the existing legal and institutional framework for Tier IV MFIs. Discussions on whether to non-prudentially regulate credit-only MFIs to ensure sound business practices and transparency are still ongoing.

Tier IV

Government is in advanced stages of establishing a law that will pave way for the formation of an autonomous institution that will license, regulate and supervise Tier 4 Microfinance Institutions. The proposed legislation, the Tier IV Microfinance Institutions Act, will supervise microfinance institutions that are in the category of Tier IV of which SACCOs and Microfinance institutions MFIs (non-MDIs) are part. The law will enable the application of prudential standards to microfinance institutions in order to safeguard the depositors' funds.

2.3 The political economy of financial reform in Uganda

Provision of affordable financial services to the rural population in less developed countries has been at the core of public policies. Direct interventions in rural finance through special credit programs, subsidised interest and other government policies was widespread until the late-to early-1980s when the system was dismantled by the World Bank–IMF's 'engineered' structural adjustment policies. For one thing, under increasing political competition, credit programme is being more deeply integrated into the national political agenda.

If for many years credit was aimed at addressing issues central to development and poverty eradication, in recent years it has become tethered to a political agenda. Agricultural credit programs in less developed countries can be used for political purposes because of government-controlled supply; and concessionary interest rates can be used as patronage for politically influential groups, and disbursement of cheap money under guise of development objectives.

Within Uganda's political context, direct distribution of cheap money through Rural Farmers Scheme, the "Entandikwa" Credit Scheme, "bonna bagaggawale" (prosperity for all), and the current government strategy of Group Lending Programme for SACCOs and community savings and credit groups such as village savings and loan associations and nigina groups and a few influential groups and individuals by the state-controlled Microfinance Support Centre Limited (MSCL) clearly shows the presence of political influence in credit allocation, with implications for financial inclusion. Having a Minister of State for Microfinance confirms the centrality of microfinance finance in the life of Uganda's politics.

In 2001, government (a presidential statement) announced that it would inject USD 5,000 in each of the 5,000 parishes in Uganda (US\$ 25 million in total). This intervention created a lot of discomfort within the microfinance community, who argued that such cash disbursements would undermine the sector. In response, the key stakeholders in the Ugandan Microfinance industry represented in the Microfinance Forum (MFF) came up with an alternative plan titled "*Expanding the Outreach of Sustainable Microfinance in Uganda*" that focused on increasing the outreach using private MFIs.

Thanks to the microfinance outreach programme (MOP), which by its timely response to the presidential statement, succeeded in halting government's initial plan to disburse the cash. It was surprising why non-sustainable institutions would benefit from substantial funding. MOP has been responsible for (i) capacity building; (ii) reduction of market imperfections, especially in remote rural areas; (iii) improved linkages and co-operation between MFIs at district level; (iv) employment of financial extension workers as a contact point for clients and MFIs; and (v) consolidation of the government credit schemes. The Microfinance Outreach Plan was implemented through two components: (1) The Microfinance Capacity Building Unit (MCBU) at the MoFPED that was supported by IFAD and the EU offered grants to rural MFIs for the opening of new branches, providing computers, etc.

The MCBU together with AMFIU was also engaged in the development of a legal framework for Tier IV MFIs — thereby supported by GTZ. (2) The Microfinance Support Centre Limited (MSCL) is a public agency that initially, channelled USD 21 million provided by the AfDB (African Development Bank) as loans at preferential terms to rural NGOs and SACCOs.

To prevent the government from directly intervening in the microfinance sector, the MFF elaborated the Microfinance Outreach Plan that focuses on working with private MFIs instead of direct government interventions. However, since its inscription the MOP has been a controversial initiative mainly because channelling of loans at preferential terms is a core element of the plan.

In October 2003, the President directed the transfer of the microfinance unit from the Office of the Prime Minister to the Ministry of Finance, which became responsible for the overall coordination of government policies with regards to microfinance. Microfinance is under the direct responsibility of the Minister of State for Micro Finance who coordinates with other relevant Government agencies, including the MTTI, the BoU, the Microfinance Outreach Plan (MOP) and the Microfinance Support Centre Limited (MSCL) (see below).²

Following an appeal of the President to use existing SACCOs and to found new ones for speeding up rural outreach, in 2006 through MSCL cheap money was distributed to SACCOs all over the country.

Later in 2006 the concept “bonna bagaggawale” (prosperity for all) was mooted. It originated from the NRM manifesto during the election campaign and forms the basis for the governments new Economic Development Strategy. As part of this strategy, the Ugandan government was planning to increase poor people’s access to rural financial services through channelling financial support (capacity building grants and loan funds for on-lending) and technical support to SACCOs through the state-owned Post Bank Uganda (PBU). In addition to opening 63 new district level branches and acting as a wholesale lender and provider of accounting and IT services to SACCOs, the plan proposed the passing of a new Bill to create PBU as an apex body for the regulation and supervision of SACCOs.

Further, the plan proposed to set an interest rate cap on funds on lent to SACCOs through PBU. Cabinet approved the plan in September 2006. The intention of the Ugandan government is to subsume at least elements of the large microfinance funding programs of the World Bank/IFAD, AfDB and the EC under “bonna bagaggawale”.³

² A chart of the government responsibilities for microfinance can be found in the Annex.

³ The sums involved are as follows: IFAD/World Bank \$18m, AfDB \$ 21m, EU € 6.2m. Further there are smaller programs of German KfW and other bilateral agencies that may also be submitted to the plan.

The bonna baggalawe-scheme, was officially launched by the President on February 20, 2007. However, donors through the MoFPED continued to press upon government to have in place a legal framework for licensing and supervision of SACCOs and Tier IV MFIs. They advocated for minimum standards and criteria for SACCOs for receiving the (still subsidized) loans for on-lending, putting in place the principle of "saving first", restricting Post Bank Uganda's (PBU's) role as wholesale lender, training for those 17 districts, where they have already branches plus the other 17 districts, where there are no regulated MFIs at all and a drastic downsizing of the whole scheme (there were conflicting figures about the size of the scheme). The scheme had many issues that contradicted good microfinance practices (such as creation of new SACCOs in 589 sub counties where no SACCOs existed by then). However, it seems that a number of issues that were of major concerns have since been resolved. But political interference into microfinance has not gone away, and remains a threat to development of microfinance industry in Uganda. As it stands, only time will tell, what the future holds for Uganda's microfinance industry

3 Unveiling ambiguity

Financial inclusion is firmly placed on the agenda of most governments as a key policy priority for poverty reduction. Over the past two decades, Uganda government has pursued a strategy of financial inclusion (—access by enterprises and households to affordable and appropriate formal financial services that meet the needs of enterprises and households and the use of formal financial services such as loans, savings, payment services, and other related services) as the linchpin of its strategy to address the problem of unemployment and poverty and to sustain economic growth. These underlying policy goals resulted in initiatives, which include

- (i) measures that target financial depth (relaxing borrowing constraints) or expansion of the financial system, driven by policy reforms and financial innovation;

-
- (ii) policies in favour of government direct interventions in rural finance through special credit programs, financial and technical support to intermediaries and subsidised interest;
 - (iii) policies that set an interest rate cap on funds on lent to intermediaries (e.g. SACCOs, village association, etc) at preferential terms;
 - (iv) promoting financial (technology) innovations that can bring costs down and broaden outreach, and by ensuring that systems are in place to protect consumers (i.e. policy emphasising depositor's protection); and
 - (v) promoting financial literacy and financial services data and measurement, and ensuring that regulatory and supervisory capacity adequately covers the institutions (financial providers) that provide financial solutions at the different levels of the financial system.

For the last twenty years, policies on financial inclusion have often focused on financial depth as a way to improve access and use of financial services. However, the contribution of financial deepening in achieving financial inclusion is ambiguous.

The view that financial deepening spurs financial service usage lacks firm empirical support (Demirgüç-Kunt and Klapper 2012; and World Bank, 2012). While Ugandan financial services (banks, capital markets, microfinance, corporate finance, risk sharing and insurance) have expanded both in quantity and depth over the years, evidence suggests that finance has not been inclusive. For instance, in 2014, only 27.8 percent of adults in Uganda had an account with a formal financial institution (Otchere 2016; Demirgüç-Kunt and Klapper 2012), which is a half the world's average of about 50% (Demirgüç-Kunt and Klapper, 2012), and only 15.7 percent received a loan from a formal financial institution (Otchere 2016; Demirgüç-Kunt and Klapper 2012).

There is also no clear evidence that having account is positively associated with financial usage. Having an account per se does not guarantee usage of financial services; this is further supported by the records of dormant accounts in commercial and MDIs and accounts facing closure every day. Account holding (without considering its usage) is not a good indicator of financial inclusion. The premise that financial inclusion becomes more feasible when financial system is deeper or better

capitalized, with good pricing and competitiveness does not hold water. Implementation ambiguity thus mirrors policy ambiguity.

Direct government involvement in an effort to increase (rural) outreach disregards behavioural constraints on financial inclusion, which have undermined past efforts to deliver financial inclusion. If for many years financial policy was aimed at addressing issues central to development and poverty eradication, in more recent years it has become tethered to political goals and interest. It seems that most lessons learnt on past credit programmes have been forgotten. When you have cheap money being thrown around through bonna baggalawe-scheme and now, probably, indefinitely with billion of shillings flowing to SACCOs and groups, there is a clear mismatch in expectations from what policy makers actually think they should be able to get from the outreach drive by playing double standards (distributing cheap money with one hand and regulating activities of the industry with another hand. Further, some state-owned commercial banks (such as UCBL) failed due to government action undermining their solvency.

The premise that financial intermediation for the poor cannot achieve scale because the regulatory framework does not provide space for appropriate (savings-based) business models is unfounded. Inability to mobilise savings is not because of availability of space for appropriate business model or lack of it, but because the savings enablers that are needed for actors to be able to deliver savings-oriented inclusive financial services are not available. We instead are faced with disabler such as withholding tax on interest income and persistently high inflation that discourage financial savings.

There is also a growing debate about the ambiguity surrounding the actual impact that mobile money transfer service and other financial innovations have had on households, firms and societies especially the poor (Ayoki, 2009). According to government statistics, the proportion of the financially excluded in Uganda fell from 30 percent in 2009 to 15 percent in 2013, largely driven by the phenomenal increase in the usage of mobile money services (Republic of Uganda, 2014). It suggests that, mobile banking – a service that allows customers to operate their accounts through their mobile devices – has increased significantly with the increasing number of mobile phone users. The number of registered users of mobile money financial

services rose to 14.24 million people as at December 2013 (Republic of Uganda, 2014).

While these developments cannot be discounted, evidence suggests that it is not simply having a mobile money account, availability of mobile money services, holding an account at a financial institution or expanding services outreach that matters, but also what you do with that account (Ayoki, 2009). In the case of credit, financial innovation in risk sharing mechanisms and payments systems that fosters insurability and bankability of the poor and small actors such as smallholder farmers must be considered (Ayoki, 2009).

Some authors e.g. (Ayoki, 2009) question the ability of mobile money service providers such as Airtel Money, MTN Mobile Money, M-PESA and others to deliver financial inclusion through access to poor people; especially how this can be achieved in a business model...” The combined cost of sending and withdrawing Shs300,000 through Airtel is Shs7,000, which is more than a return fare on public transport, from Entebbe to Kampala. Can mobile money provide affordable finance to the poor? As the Nobel Laureate Paul Krugman aptly notes, “it is hard to think of any major recent financial innovations that actually aided society” (The New York Times, 2009 cited by Mention and Torkkeli, 2014 and Ayoki, 2009). Critics argue that recent financial innovations were not aiming at the “enhancement of the ability of the financial sector to perform its social function” (Joseph Stiglitz, cited by The Economist, February 2012 and Ayoki, 2009), but rather embraced “opaque pricing including billing tricks and traps ... that encourages unsafe lending practices” (Pew Charitable Trusts, 2009, cited by Lerner and Tufano, 2011 and Ayoki, 2009). Volcker (New York Post, December 13, 2009 cited by Ayoki, 2009) also stated that ATM was the only financial innovation he can think of that has improved society.

Policy makers have maintained a narrow view of the savings dynamics and how to promote savings culture and investment. The passion for financial savings and technology innovation has overshadowed alternative traditional systems such as saving in livestock or other forms of assets. The failure to achieve financial inclusion in certain communities reminds us of the importance of knowing and understanding firms and households’ needs in designing and delivering innovations—the type that are modelled to fit the local context. After all, what is truly inclusive about diverting people away from their less costly traditional system of holding savings in assets e.g.

cattle, which earn them higher return to a non-interest or low return yielding, more costly savings account in financial institution?

The idea that introducing a tiered regulatory framework for deposit-taking institutions would trigger significant growth of pro-poor access to finance through appropriate business models has some merit. After the transformation of four Ugandan NGOs into MDIs in 2004, there was a strong growth on the supply side (17% growth in number of borrowers in 2005) with a significant increase in the number of small loans below USD 110. The MDI's outstanding loan portfolio between 2004 and 2006 rose by 25.9%. On the demand side, there was a significant growth of savings accounts with 41% in 2005, which shows that the poor have a strong demand for accessible and safe savings facilities. Total deposits at MDIs rose from USh 11.7 billion in 2004 to 23.230 billion in December 2006 (98% increase).

What remains a challenge is how to get financial service providers at different levels of the financial system to provide affordable financial services or funding in a manner that is consistent with inclusive business model. Apart from high cost of services (e.g. credit), evidence suggests that scale of financial intermediation is constrained by high regulatory compliance cost. All the MDIs maintained unimpaired paid-up capital above the statutory capital requirements of Shs. 500 million and complied with the minimum core capital-to-risk-weighted-assets ratio requirement of 15 percent. MDIs' paid up capital increased by 1.6 percent; from Shs. 13.4 billion to Shs. 13.6 billion between June 2013 and March 2014. All MDIs complied with the statutory liquidity requirements during FY2013/14. The regulatory compliance means that if you have to reserve Shs500 million and another 15% in deposit insurance plus the liquidity requirements, those additional costs are passed through in how MDIs set interest rates for loans.

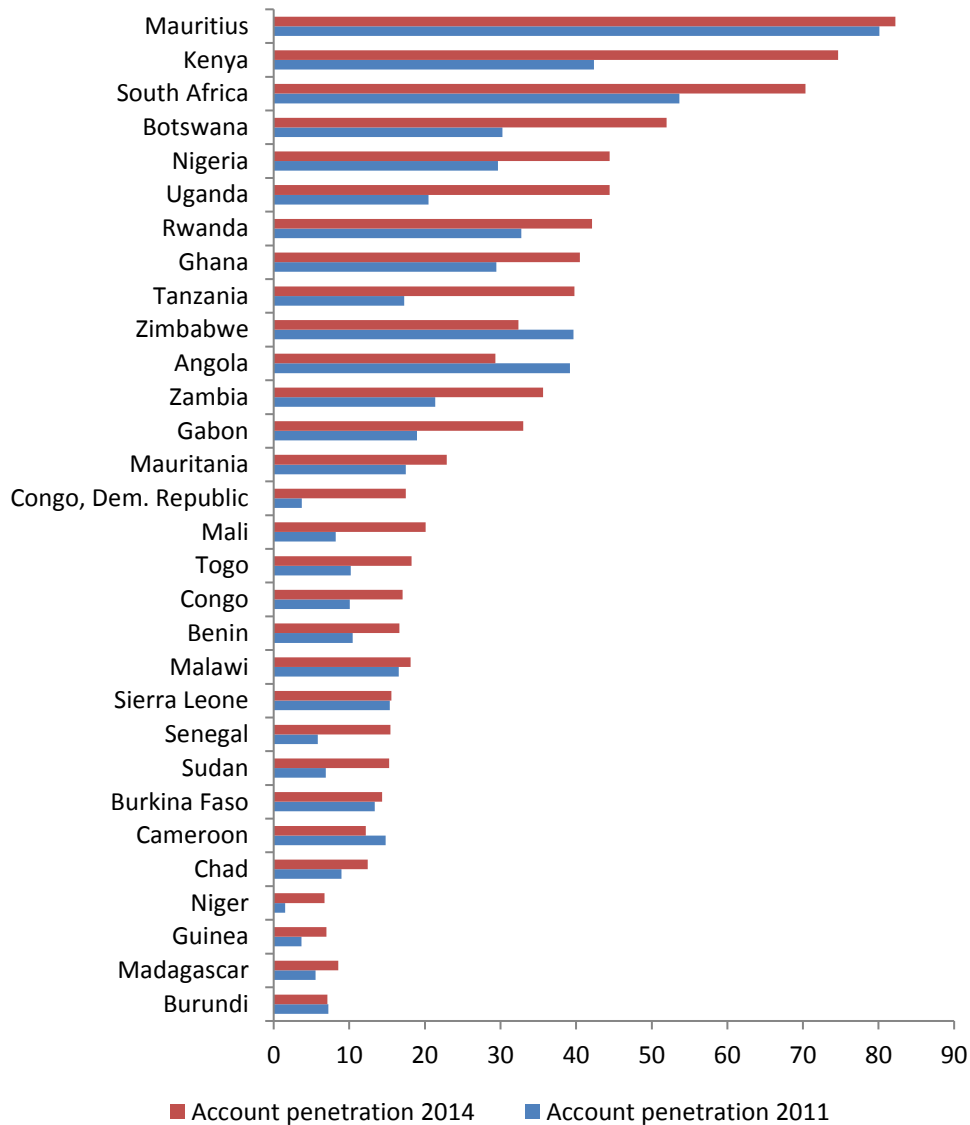
4 Supply of financial services

4.1 Account penetration

Figure 1 shows the wide disparity in account penetration across African countries, with adult population having an account in formal financial institution ranging from 82 percent in Mauritius to 7 percent in Burundi. The financial inclusion gaps mirror

country-specific financial frictions, which have a differential impact across countries. The challenge is to provide a correct diagnosis of those problems, and the prescriptions to alleviate them.

Figure 1. Account penetration across Africa countries, 2011 and 2014



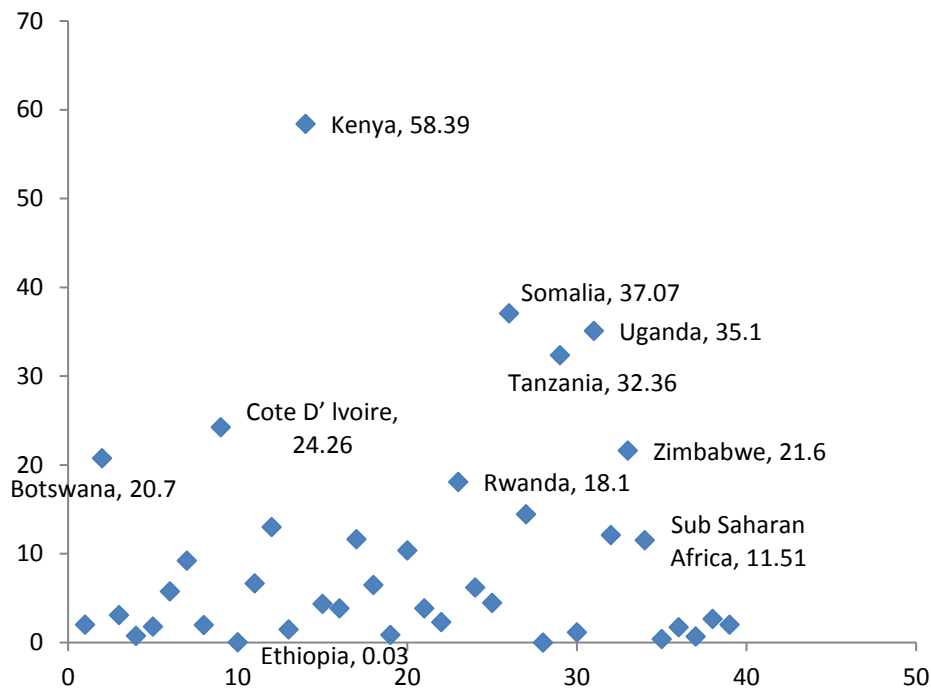
Source: Global Findex, 2011 and 2014

4.2 Mobile account penetration

Figure 2 also shows enormous variation in the share of population with mobile money accounts across Africa, ranging from about 60 percent in Kenya to less than

0.5 percent in Ethiopia. Uganda, Tanzania, and Somalia have a population share with mobile money accounts of more than 30%. On the other extreme, there are many African countries e.g. Ethiopia, where mobile money accounts have extremely low outreach.

Figure 2. Mobile money account penetration across countries in Africa, 2014



Source: Otchere (2016) based on data from Demirgüç-Kunt and Klapper (2012)

4.3 Financial (supply) system in Uganda

The Financial Institutions Act (FIA) 2004 introduced a tiered approach to the regulation of financial services and in the development of inclusive financial systems where different types of financial institutions can tailor their services to the needs of poor clients. The tiered approach to the regulation of microfinance services that was adopted in the policy statement of the Bank of Uganda in July 1999 (Bank of Uganda, 1999) classifies institutions that provide microfinance services into four categories or tiers, namely:

-
- Tier I: Commercial banks with a fully fledged banking license. A few commercial banks are engaged in microfinance, notably Centenary Rural Development Bank Ltd (CERUDEB);
 - Tier II: Credit institutions. There is only one institution under this category i.e. Commercial Microfinance Ltd (CMFL) that is currently involved in microfinance services;
 - Tier III: Microfinance deposit-taking institutions (MDIs);
 - Tier IV: All other – MFIs, including NGOs, savings and credit cooperatives (SACCOs), financial services associations (FSAs) and other community-based organisations whose core activity is to provide financial services to their members.

While Tier I and II classified institutions are regulated under the Financial Institutions Act (FIA) 2004; Tier III institutions are regulated under the Micro Deposit Taking Institution Act 2003. Institutions under Tiers I, II and III (formal financial sector) are supervised by the Bank of Uganda (BoU) (see Figure 1). However, the institutions under Tier IV (informal financial sector) are neither regulated by law nor supervised by the BoU.

4.4 The banking sector and credit institutions (Tier I & II)

In contrast to commercial banks (Tier I), credit institutions (Tier II) can take deposits and give loans but are restrained from FOREX operations. The credit institutions operate almost exclusively in Kampala, with the exception of PostBank Uganda Ltd (PBU), which offers savings and credit services up-country and has 21 branches.⁴ Commercial Micro-finance Ltd provides microfinance services through six branches focusing on urban areas. The Microfinance Deposit-Taking Institution Act of 2003 allows MDIs to mobilise (and lend out) deposits – under the supervision of the BoU. The MDI Act incorporates most key principles of modern banking supervision, while taking into account the specific and unique features of MFIs. So far, four Ugandan MFIs have been licensed as MDIs.

⁴ Until November 2005 when BoU granted a license for lending operations, PBU was a savings-only institution.

Uganda's financial services industry remains dominated by the banking sector. In March 2007, Uganda's banking sector consisted of 15 commercial banks, 12 of which are foreign-owned. The number has since grown to 24 (Table 1).

Table 1. Registered Commercial Banks as of March 2007 and 2017

Licensed Commercial Banks as at March 31, 2007			Licensed Commercial Banks as at	
Name of Bank	Ownership	Number of branches	March 31, 2017	
1	Bank of Africa (Fr. Allied Bank Intl)	Foreign	5	ABC Capital Bank Limited
2	Bank of Baroda (U) Ltd	Foreign	6	Barclays Bank of Uganda Limited
3	Barclays Bank (U) Ltd	Foreign	8	Bank of Baroda
4	Cairo Bank	Foreign	1	Bank of Africa Uganda Ltd
5	Centenary Rural Dev. Bank	Local	25	Bank of India (Uganda) Ltd
6	Citi Bank	Foreign	1	Cairo International Bank Ltd
7	Crane Bank	Local	15	Commercial Bank of Africa (Uganda)
8	Diamond Trust Bank	Foreign	1	Centenary Rural Development Bank
9	DFCU Bank	Foreign	7	Citibank Uganda Ltd
10	National Bank of Commerce	Foreign	2	DFCU Bank
11	Nile Bank Ltd	Foreign	7	Diamond Trust Bank Uganda
12	Orient Bank Ltd.	Local	7	Ecobank Uganda Limited
13	Stanbic Bank	Foreign	63	Equity Bank Uganda Ltd
14	Standard Chartered Bank	Foreign	6	Exim Bank (Uganda) Ltd
15	Tropical Bank	Foreign	3	Finance Trust Bank Ltd
16				Guaranty Trust Bank (Uganda)
17				Housing Finance Bank Ltd
18				KCB Bank Uganda Limited
19				NC Bank Uganda Limited
20				Orient Bank Ltd
21				Stanbic Bank Uganda Ltd
22				Standard Chartered Bank Uganda
23				Tropical Bank Ltd
24				United Bank for Africa Uganda Ltd

In 2005, foreign-owned banks together held 84% of total assets, with the two biggest banks, Stanbic Bank and Standard Chartered, holding a market share of about 52% and 55%, of total assets and total deposits respectively (www.bou.or.ug).

Having acquired the formerly state-owned Uganda Commercial Bank Limited (UCBL) in 2002, Stanbic Bank is the largest bank in Uganda and with 63 branches holds the largest branch network in the country. Stanbic Bank is a subsidiary of the Standard Bank Group, one of Africa's leading banking and financial services groups. Following the acquisition of UCBL, Stanbic's strategy shifted from providing basically

corporate banking to that of providing a wide range of wholesale and retail banking products and services. In terms of its branch network, CERUDEB that is owned by the local Catholic Church is the second bank with 25 outlets nationwide. DFCU (Development Finance Corporation Uganda) which is the market leader in leasing has a particular potential to serve small enterprises. Besides 7 commercial banking branches of DFCU Bank, DFCU-Leasing has 5 branches located in Kampala and 4 in other towns. The rest of the banks with the exception of Crane Bank have six or fewer branches with a high concentration in Kampala.

In addition to the commercial banks, there are 4 credit institutions (from 7 in 2007) licensed by BoU, all locally owned (one owned by the government). In contrast to commercial banks credit Institutions can take deposits and give loans but are restrained from FOREX operations. The credit institutions operate almost exclusively in Kampala, with the exception of PostBank Uganda Ltd. (PBU), which offers savings and credit services up-country and has 21 branches.⁵ CMFL provides microfinance services through 6 branches focusing on urban areas.

Table 2. Registered credit institutions as at 31/12/2006

Licensed credit institutions as at March 31, 2006	Ownership	Number of Branches	Licensed credit institutions as at March 31, 2017
1. Housing Finance Company (U) Ltd	Local	2	Mercantile Credit Bank
2. Commercial Micro Finance Ltd. (CMFL)	Local	6	PostBank Uganda Ltd
3. Mercantile Finance Co.Ltd	Local	1	Opportunity Bank Uganda Ltd
4. Capital Finance Corporation Ltd.	Local	2	Top Finance Bank Uganda Ltd
5. Stanhope Finance Co. Ltd.	Local	0	
6. Imperial Investments Finance Co.Ltd.	Local	0	
7. PostBank Uganda (PBU)	Local	21	
Total		32	

Although there are only one commercial bank and one credit institution that specialize in microlending on the retail level, some of the banks have started to experiment with technology innovations to explore the “mass savings market”. On the lending side, most commercial banks in the near future will abstain from directly serving poorer clients. Some of them have, however, started to lend to top MFIs, especially those that are regulated under the MDI Act.

⁵ Until November 2005 when BoU granted a license for lending operations PBU was a savings-only institution.

In addition to commercial banks and credit institutions the formal financial sector comprises over 80 FOREX bureaus, 20 insurance companies, and 4 licensed Microfinance Deposit-taking Institutions (MDIs) described below.

There were about 219 formal service outlets in the country in 2007, comprising all the branches of commercial banks, credit institutions and MDIs combined. With 75 districts in the country, there are, on average, two formal finance outlets per district serving a population of about a half million people.

Uganda's financial system is still very shallow. The government has a target to increase in financial depth (measured by M3/GDP) from the current level of about 20 per cent to 29 per cent of GDP by 2013/14. Savings are picking up, but the volume of private sector credit is still very low compared to neighbouring countries (see Table 3). Agricultural finance is almost non-existent, and rural outreach of financial services is weak. Only a small proportion of the population has access to formal financial services. The majority of the poor has no savings accounts, does not have access to loans from formal financial institutions and has no insurance policies. Instead, many rely on informal services – ranging from the most traditional (saving in boxes at home) to a cooperative system (see Table 3).

Table 3. Financial intermediation across countries, 2003
(percent)

Country	Private Credit/GDP	Bank Deposits/GDP	Loan/Deposit Ratio	Overhead Costs
(1) Uganda	7.0	19.6	42.1	7.9
(2) Tanzania	6.8	22.2	40.9	7.0
(3) Kenya	22.6	42.9	60.1	6.1
(4) Sub-Saharan Africa	19.1	31.3	74.2	6.1
(5) Low-Income Countries	15.0	30.7	70.0	5.9

Source: Terberger, 2006.

In order to create a sound framework for the orderly development of the financial sector, the Government has strived to strengthen the regulatory and supervisory responsibilities of BoU with the enactment of a new FIA in April 2004. The FIA 2004 incorporates most key features of modern banking legislation, including an extensive focus on corporate governance issues, provisions for prompt corrective action and improved transparency and disclosure.

The Capital Market Authority (CMA) was established in 1996 and charged with promoting and developing an orderly, fair, and efficient capital market. The market is supported by a well-designed law, but remains a small market with low capitalization.⁶ Given the low volume of trade liquidity the way forward is for both investors and listed firms in Uganda to have access to more developed markets that offer superior infrastructure, liquidity and depth. The investments already made toward regional integration and the establishment of the East African Regional Stock Exchange will allow partner governments to enhance the efficiency and liquidity of the regional market. But this will be fully realised when a functioning regional exchange in the EAC (East African Community) is created (The World Bank, 2007). The limited market for bonds has hindered further developments in the corporate bond market. Today, there are only five corporate bond issues.

4.5 The microfinance sector (Tier III & IV)

4.5.1 Overview

Microfinance can be offered by a wide range of institutions ranging from formal (institutions licensed and prudentially supervised by the country's banking authorities, e.g. banks and licensed non-bank financial institutions) to semi-formal (registered with and officially recognized by some public authority but not prudentially supervised by the banking authorities) to informal (not registered with or officially recognized by any government authority).

Uganda experienced a proliferation of microfinance institutions (MFIs) during the 1990s. In 1990, it was estimated that MFIs were providing loans to an estimated 50,000 clients. In 2005, a survey undertaken by DFID Financial Sector Deepening Project established that a total of 801,813 clients were served by MFIs. Given that the clients of these institutions are typically very poor women with no collateral and that legal enforcement of these loans is almost impossible, Ugandan MFIs typically

⁶ Currently there are nine listings on the Uganda Securities Exchange: The local listings include Stanbic Bank, Uganda Clays Limited, British American Tobacco Limited, Bank of Baroda Uganda, DFCU Group and New Vision Printing and Publishing Limited. The cross-border listed companies are East African Breweries, Kenya Airways and Jubilee Holdings Limited.

employ a lending technology based on joint-liability groups combined with compulsory savings to ensure timely repayment. A number of the larger MFIs (and all MDIs) also now offer individual loans.

Aggregate data on microfinance are scanty and unreliable. However, recent studies indicate that very small percentage of the Ugandan population (0.9 per cent) is utilising microfinance services. This ratio represents only 2.4 per cent of the population estimated to be living below the poverty line (Ayoki, 2006).

Table 4. MFI outreach: Top countries (credit clients as a percentage of population)

Country	%	Country	%
Bangladesh	13.1	Senegal	1.6
Indonesia	6.7	Nepal	1.5
Thailand	6.5	Mali	1.5
Sri Lanka	4.3	Niger	1.4
Vietnam	4.3	Honduras	1.2
Cambodia	3.0	El Salvador	1.2
Malawi	2.6	Nicaragua	1.1
Togo	2.4	India	1.1
Gambia, The	1.7	Bolivia	1.1
Benin	1.7	Ethiopia	0.9

Source: Based on Daley-Harris, 2003.

The current trend is reflected in the heavy concentration of MFIs in and around Kampala and a few major towns with limited geographical outreach – what some people refer to as the 'Kampala–Mbarara microfinance highway'. High operational costs experienced by MFIs and the influence of high treasury bill interest rates have made these MFIs maintain high interest rates on loans, ranging from 22–48 per cent per annum and 2–5 per cent per month.

4.5.2 Tier III: Micro Deposit-Taking Institutions

As mentioned early already, the class of tier III financial institutions was created under the Microfinance Deposit-Taking Act (MDI Act) in 2003. The MDI Act allows sound and sustainable MFIs to mobilize deposits and thus are under the supervisory arm of the Bank of Uganda. The MDI Act incorporates most key principles of modern banking supervision and at the same time it takes into account the specific and unique features of MFIs. By 2006, four Ugandan MFIs have been licensed as MDIs:

FINCA Uganda, *Pride Microfinance Limited (PML)*, *Uganda Microfinance Limited (UML)*, and *Uganda Finance Trust (U-Trust)*.

FINCA Uganda (FU)

At the time of licensing in November 2004, FU had over 48,000 clients and a portfolio of 10.5 billion Uganda shillings (about US\$5.8 million), making it the second largest MFI by clients and third by portfolio. By December 2005, FU had a total of 46,267 active borrowers and 20,947 savings clients with an outstanding loan portfolio of Ush 11.4 billion. As Ugandan affiliate of FINCA International (FI), FU's strategy and management are largely influenced by the head office in Washington, DC. One of FI's main aspirations in transforming FU was that the company remains under its control. The MDI Act limits ownership by any one person to 30 percent. The law does, however, allow an exemption in the case of a reputable financial institution. FI was able to demonstrate to the Bank of Uganda that it met this requirement, and accordingly the license was granted with FI effectively owning 100 percent of the shares of FU. FI undertook initial steps to reduce its ownership over a five-year period.

As of December 2015, FU's asset base stood at Ush128.51 billion, with shareholders' equity of Ush 42.67 billion. It operates 27 inter-linked branches nationwide (as of March 2015). In Tanzania, 43% of FINCA transactions occur on mobile phones.

Pride Microfinance Limited (PML)

PRIDE Uganda began as a Ugandan government project with funding from the bilateral Norwegian Aid. In 2002, PRIDE acquired an NGO status, and assumed all of the project's assets and liabilities. Then, in 2004, in anticipation of transformation, a share company called Pride Microfinance Ltd (PML), majority-owned by the NGO but with additional investors, was formed and the assets and liabilities of the NGO transferred to it. However, prior to licensing, questions were raised by both stakeholders and government as to the procedures followed in the creation of PML, and ultimately the full ownership of the company reverted to the government of Uganda. The question of ownership of PML was resolved, at least on an interim basis. At the time of its licensing in June 2005, PML had 51,500 clients and 18.4

billion Uganda Shillings (US\$10.2 billion) in portfolio, ranking first in clients and second in portfolio. By 31 December 2005, the number had grown to 69,314 active borrowers and 21,822 savings clients, with outstanding loan portfolio of US\$ 20.37 billion.

Uganda Microfinance Limited (UML)

At the time of acquiring MDI license in June 2005, UML was the largest MFI in the country by portfolio (20.7 billion Uganda shillings, or US\$11.5 million) and the third largest by borrowers (35,000). By 31 December 2005, UML's number of active borrowers had decreased to 30,738 though the outstanding loan portfolio remained stable at US\$ 20.35 billion. UML made remarkable progress in growing the number of savings accounts, with 81,027 depositors by 31 December 2005. The UML was previously as an NGO known as Uganda Microfinance Union (UMU) – created in 1997 – until it acquired an MDI license in 2005, transforming itself into Uganda Microfinance Limited (UML), a microfinance deposit taking institution regulated by Bank of Uganda. UML from the very beginning had a clear strategic vision to provide a broad range microfinance services to the poor on a sustainable basis. With this vision UML was one of the lead supporters of the project to introduce a new microfinance legislation to enable strong institutions to mobilize savings. Before its acquisition in April 2008, UML offered a broad range of credit and savings products including loans for salaried employees, home improvement loans, etc. In April 2008, Equity Bank Kenya Limited successfully acquired Uganda Microfinance Limited (UML).

Uganda Finance Trust (U-Trust)

Although its parent Uganda Women's Finance Trust was the oldest MFI in Uganda, U-Trust was the last of the four MDIs to acquire MDI license in October 2005. Its portfolio of 12.2 billion Uganda shillings (US\$6.8 million) ranked third among the four, and its borrower base of 20,100 ranked fourth. However, UWFT had been actively mobilizing savings deposits from the public for years, accumulating 4.4 billion Uganda shillings in savings from 72,000 depositors, far more than its competitors. By 31 December 2005, the number of depositors had grown to 78,707, with 17,052 active borrowers.

On 11th November 2013, *Finance Trust Bank* was granted a commercial banking licence as a Tier 1 Financial institution, taking over the business of *Uganda Finance Trust Limited* (MDI). Over time, new MDIs have been licensed (Table 5)

Table 5. List of Microfinance Deposit Taking Institutions in Uganda, December 2017

MDIs	Date granted MDI License
(1) Entrepreneurs Financial Centre (EFC) Uganda Limited	17th November, 2014
(2) FINCA Uganda Limited	November 2004
(3) Pride Microfinance Limited	June 2005
(4) UGAFODE Microfinance Limited	October 2011
(5) YAKO Microfinance Limited	September 2015

Source: Goto (1989) based on United Nations trade statistics.

Outreach indicators of MDIs

Table 6 summarizes selected outreach indicators of MDIs. In 2005 there has been a strong growth on the lending side. More impressive however is the growth of savings accounts with 41% in 2005 which indicates that the poor have a strong demand for accessible and safe savings facilities. Women take the lion's share of smaller loans and have a much stronger demand for savings services than men. In March 2007, 8252 cooperative societies had been registered with the Registrar of Co-operatives, 2800 of which are SACCOs. Another 1263 cooperatives are on probation – awaiting registration. Of the 2800 SACCOs, 172 are being mentored by Uganda Cooperative Alliance (UCA).

Table 6. Selected indicators of MDI outreach

	Total	Women	Change	Growth
Credit				
No. of loan clients, 31st Dec 2005*	145,120	55.6%	+	17%
No. of loans < 200,000 (USD 110) Jan -Dec 2005	65,773	64%	+	12%
No. of loans >3,000,000 (USD 1700) Jan-Dec 2005	1,568	38.3%	-	8.5%
Active loan clients chin rural branches by Dec 2005	100,902		-	13%
Av. disbursed loan amount, Jan-Dec 05	667,318		+	13%
Savings				
No of clients with savings, Jan- Dec 2005	248932	70%+	+	41%
Av. amount per savings, Dec 2005	120,031	116,735		
* 77% of clients received loans as members of groups				

4.5.3 Tier IV sector

SACCOs

For over 20 years, the cooperative movement in Uganda has been neglected by government and donor agencies because of mismanagement and political influence. Over a decade after the collapse of cooperatives, government thought of reviving cooperatives. A high-level task force (chaired by the deputy speaker of parliament) was created to spearhead the revival of cooperatives, particularly SACCOs. Even then, the government strategy has been too focused on increasing the number of SACCOs without sufficiently taking into account the demand side and the capacity of these institutions.

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

Some SACCOs have a strong growth potential which entails certain risks. International experience shows that large institutions with more than 10,000 members can no longer be effectively controlled by their members. Thus the need for prudential regulation by a specialized financial regulator becomes much more acute. The Co-operative Department in MTTI presumably cannot fulfill this role in its current capacity. Still, despite the weaknesses of the sector, the government, especially the Ministry of Finance, Planning and Development (MoFPED) expect these institutions to play an important role in the development of the rural financial sector – an issue that will be taken up later in the report.

NGO-type MFIs

The majority of these institutions are registered both as NGOs and as companies limited by guarantee. Most NGOs receive considerable support from donors and serve clients with fairly short-term loans with group guarantees and frequent

payment schedules. The interest rates and fees charged for small loans amounts to 36–80 per cent nominal annual effective interest rate, which in part is needed to cover high operating expenses. The number of Tier IV MFIs other than SACCOs is not exactly known, as neither the NGO Board nor the Registrar of Companies keeps separate records of institutions offering financial services to the poor.

Well-performing NGOs have a chance to access bank loans. These wholesale relationships permit banks to utilise their comparative advantage in mobilising savings, whereas the NGOs utilise their comparative advantage of making small loans with non-traditional collateral. Unfortunately, most of these institutions are assumed to be quite weak, only about a dozen is recognised as having potential to become important players in the financial market and eventually transform to micro-deposit-taking institutions in the future.

Moneylenders and money keepers

Moneylenders are quite different from the other Tier IV institutions as they are not incorporated, but mainly individuals lending money from their own sources and on their own account. Moneylenders can be found at all social levels, from the remote rural village to the parliament's floor. Legally, they operate under the Moneylenders Act 1952, but since there is no central registry for moneylenders, the exact size of the sector is unknown.

To reduce the risk of theft, or to be able to deny claims from family members, relatives and friends, many people use (business) people, whom they trust to keep money for them. In most cases, there is no documentation – no receipt or signature as proof of deposits. The deposits earn no interest and can be withdrawn at short notice. The money keepers maintain enough liquidity to service the claims of their depositors, but they may use the funds to finance their own business transactions or for lending.

CBOs⁷

There are other CBOs engaged in the microfinance business, which are or are not registered at district level. Exact numbers are hard to know, but it is estimated that

⁷Sometimes these are called SIDAs (sub-county integrated development associations).

there are more than 10,000 of these organisations are scattered across the country. There are different forms of organisations such as community-based village banks, FSAs,⁸ and savings and loan associations (SLAs).⁹ Some of these organisations are savings-based self-help groups but often they are created with the expectation of receiving external assistance.

Informal self-help groups/associations

Informal groups ('self-help' as they are sometimes called) are mechanisms to cope with daily problems in the community. ROSCAs and accumulating savings and credit association (ASCAs or non-ROSCAs) are good examples. They have been in existence for centuries. Prior to the monetisation of the rural economy, workplace and social associations dominated. Today, ROSCAs and ASCAs frequently offer assistance in savings and credit services. Some groups perform additional functions, such as the provision of basic health and accident insurance and emergency aid through mutual aid mechanisms.

Traditional systems

Traditional systems include saving money in wooden or metallic boxes at home, or in a belt made of cloth material tied around the waist (called *ekitamba* in Luganda, *omweko-omushumi* in Lukiga and *alid* in Luo – used especially by elderly women), or keeping money under the mattress, among other methods. This system also comprises holding financial savings in form of livestock and poultry.

Legal frameworks for financial service providers in tier IV

Table 7 shows the legislations applying to financial providers in tier IV. The law empowers Bank of Uganda to investigate such cases and to close down institutions doing banking business without holding a license. Yet it does neither have the capacity nor the necessary physical proximity to know about such illegal activities and to initiate the adequate investigations. Bank of Uganda typically sees its role as

⁸ FSAs are small locally managed MFIs that provide savings and loan services to their shareholders. The model was developed by Ahmad Jazayeri in Uganda and Tanzania as a means to provide financial services to low-income people. In 2003, FSAs in Southern Uganda had around 13,000 members.

⁹ CARE has created around 600 SLAs, with around 13,000 members in the Western Nile region.

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

Table 7. Legal Frameworks for Financial Service Providers in Tier IV

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

Source: Akampurira; Staschen (2003)

5 Demand for financial services

5.1 Financing businesses

According to the 2003 and 2016 household surveys conducted by the Uganda Bureau of Statistics, the first source of finance for starting a business in Uganda is own savings. The financial sector (SACCO, MDI, Commercial banks, and Local groups, all combined) account for a paltry 5 percent of overall startup capital for the enterprises (Table 8).

Table 8. Source of finance for business start-up
(percent)

Source	Rural (%)		Urban		Total	
	2003	2016	2003	2016	2003	2016
Own savings	92.7	75.4	89.7	82.6	92.4	77.8
Commercial Bank	5.3*	0.8	8.4*	1.6	5.6	1.1
SACCO	--	1.1	--	0.8	--	1.0
MDIs	--	0.5	--	1.0	--	0.6
Local Group	--	2.3	--	0.9	--	1.9
Other source	1.7	3.9	--	6.2	1.6	4.6
I didn't need any money	--	16.1	--	6.9	--	13.0
Total	100	100	100	100	100	100

Source: Uganda Bureau of Statistics (2003) and 2016

Notes: *Include loans from friends, relatives, money lenders, banks, or other financial institutions

Other sources include employer, landlord, NGO, Friend, Relative, credit union, Local money lender

Urban enterprises and households are more likely (than their rural counterparts) to access loans to finance their business start-up (10.5 percent in 2016/17 up from 8.6 percent in 2003). In rural areas 8.6 percent of households reported to have had access to loans in 2016/17 (up from 5 percent in 2003). Over 50 percent of households interviewed in the survey report start-up capital as the major problem in setting up enterprises.

Table 9. Major problems in setting up a business

Problems	Number	%	Number	%	Number	%
	('000) -Rural		('000) - Urban		('000) - Total	
None	223	14.0	18	10.8	241	13.7
Start-up capital	819	51.3	96	57.5	915	51.9
Obtaining skills	111	7.0	11	6.6	122	6.9
Accessing raw materials	131	8.2	7	4.2	138	7.8
Finding clients/ markets	175	11.0	26	15.6	201	11.4
Government regulations	27	1.7	2	1.2	29	1.6
Water, elect., transport	28	1.8	1	0.6	29	1.6
Others	51	3.2	4	2.4	55	3.1
Not stated*	31	1.9	2	1.2	33	1.9
Total	1,596	100	167	100	1,763	100

Source: Uganda Bureau of Statistics (2003)

*Some people stated unspecific problems.

On the source of finance for expanding business, the 2016/17 UNHS (Table 9) indicates that more than half of the enterprises (54%) relied on own savings for further expansion of business enterprises, and meet unexpected expenses (Table 10). This story is not very different from that of business start-ups, which reflects

natural tendency of financial institutions, including those supposed to serve the unbanked, to adopt a risk-adverse attitude, which adds to the common belief that most financial innovations are not there to deliver financial inclusion.

Table 10. Source of finance for expanding business (percent)

Source	Rural (%)		Urban		Total	
	2003	2016	2003	2016	2003	2016
Own savings	--	57.9	--	46.3	--	53.5
Commercial Bank	--	3.6	--	8.7	--	5.6
SACCO	--	4.8	--	3.7	--	4.4
MDIs	--	2.0	--	10.7	--	5.4
Local Group	--	17.9	--	11.7	--	15.5
Other source	--	13.8	--	18.9	--	15.7
Total	--	100	--	100	--	100

Source: Uganda Bureau of Statistics (2016)

Notes: Other sources include employer, landlord, NGO, Friend, Relative, credit union, Local money lender

5.2 Selected access indicators for MDIs

Table 11 provides data on the average loan size, the outstanding portfolio and the number of active borrowers and savers of the Ugandan MDIs and the largest tier IV institutions. There is clear indication that the MDIs serve by far larger numbers of clients than non-regulated institutions.

Table 11. Selected Indicators of the eight Largest Ugandan MFIs (31 December 2005)

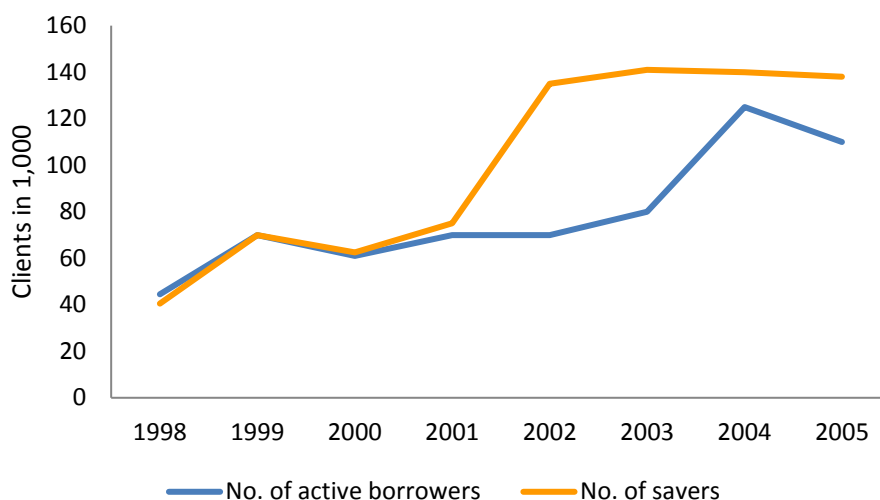
MFI	Tier	Average 1st loan	Current Av. loan size	Outstanding Portfolio	Nr of Active Borrowers	Total No of Savers*
FAULU Uganda Ltd.	4	590,880.00	422,803.0	6,153,904,178.0	11,909	24,813
FINCA Uganda (MDI) Ltd	3	215,000.00	456,000.0	11,400,000,000.0	46,267	20,947
FOCCAS Uganda	4	50,000.00	100,000.0	1,700,000,000.0	16,325	16,325
MED-Net	4	200,000.00	350,722.0	5,894,058,562.0	22,230	22,230
PRIDE Microfinance Ltd.	3	150,000.00	540,482.0	20,370,000,000.0	69,314	21,822
UGAFODE Ltd.	4	200,000.00	232,484.0	2,900,000,000.0	12,817	10,121
Uganda Finance Trust Ltd	3	375,000.00	784,339.0	13,375,000,000.0	17,052	78,707
Uganda Microfinance Union Ltd	3	200,000.00	500,000.0	20,353,645,794.0	30,738	81,027
Growth/Total			70%	82,146,608,534	226,652	275,992

Notes: MED-Net = Micro Enterprise Development Network; UGAFODE = Uganda Agency for Development

* Savings of most tier IV institutions are compulsory savings that are taken as collateral which is allowed for non-regulated institutions. Only FAULU, where the number of savers by far exceeds the number of borrowers is taking savings from non-borrowers. FAULU, however, is on its way to transform into an MDI which will "legalize" the savings.

Table 11 further shows a 70% growth in the average loan size compared to the average first loan which indicates that many clients have been for some time with the institution and have become eligible for larger loans. Figure 3 indicates that the beginning of the process of licensing MDIs in 2004 had a strong impact on savings mobilisation whereas on the lending side there was little impact.

Figure 3. Policy Impact on Access



Cost of finance

The interest rates reported by commercial banks in Kampala range from 22-25 percent per annum, compared to about 30 percent charged by credit institutions and over 35 percent charged by MDIs. The rates are far higher for moneylenders (72-480% per annum). Group loans normally seem to be more expensive than individual loans which may be due to the smaller loan volumes and the potential risks involved if no physical collateral is pledged.

Collateral requirements

Land is the preferred or even the only collateral accepted by commercial banks. However, most of the small borrowers and the rural poor in Uganda rarely hold the deeds to land. Also the rural people are sometimes reluctant to enter into self-binding contracts, such as a loan contract, for fear of losing their livelihood assets.

Table 12. Interest rates and other charges on loans

Banks and non-banks financial service providers	Interest per annum (%)			Application/ documentation fee	Commitment fee (% loan amount)	Insurance (% of total loan amount)
	Salary loans	Group loans	Individual/ business loans			
Commercial Banks	22-25	--	22-25	5,000 - 25,000	2	2
Credit Institutions	34.8	--	30	20,000 - 50,000	-	1.2-2
MDIs	36	48	48	30,000	-	1-2
Other MFIs (Non-MDIs)	24	36	30	1.25%	-	1 - 2
SACCOs	--	--	7-13	--	--	--
Money lenders	--	--	72 - 480	--	-	--

Most MDIs charge interest of 4% p.m. (on outstanding loan balance) for business/group loans, credit institutions charge flat interest of 2.5% p.m. (on original loan amount). Some institutions e.g. Centenary Rural Development Bank and Uganda Micro Finance Ltd (UML) offer "Home Improvements Loan" – at an interest of 22% p.a. (CERUDEB) to 48% p.a. (UML). Land is the common form of security.

In urban areas, most credit institutions prefer vehicles to land (as a form of collateral) especially for small loans (< US\$ 10 million) since transferring ownership is easier for vehicles than for land. Substitutes for land and other asset collateral that are acceptable to MDIs and MFIs are group guarantee mechanism combined with compulsory savings.

Loans granted on the basis of the client's savings represent a certain percentage of the accumulated deposits, and the savings account is fully or partially blocked during the loan period and can only be withdrawn when the loan is fully repaid.

Table 13. Types of collateral demanded by financial institutions

	<1000,000	1,000,000 – 10,000,000	Above 10,000,000
Commercial Banks	Land	Land	Land
Credit Institutions	Clients Savings Vehicle	Client's Savings, Vehicle or /and Land	Client's Savings/Land
MDIs	Group Guarantee, Client's Savings	Savings, Land	Land
SACCOs	Guarantor s, Client's Savings	Guarantor s (sureties), client's savings, land	-
Other MFIs	Group Guarantee, Client's (Compulsory) Savings	Vehicle	-
Money lenders	Vehicle Post Dated Check	Vehicle Post Dated Check	Vehicle

Given the value attached to land as collateral by Ugandan financial institutions, the potential to enhance access to finance through the strengthening of the secured lending framework remains a challenge.

Other costs of finance (other transaction costs)

Apart from interest rates, a major component of transaction costs is insurance (for loans and collateral particularly vehicles that can only be used as a collateral if comprehensively insured). All transfer costs or costs associated with registering the security are also borne by the borrower. Commercial banks charge an application or commitment fee or both (Table 12). In most cases, borrowers pay for land verification and valuation – a cost of about US\$ 140,000. In some banks, a penalty interest of 0.55 (or more) is charged per day for late repayment on the outstanding loan amount in arrears (up to a period, usually not more than 30 days).

5.3 Selected trend in financial services usage, including savings

Table 11 shows that only 8 percent of households (household enterprises) were using commercial banks as savings mechanisms by the time of the interview in 2016/17, majority (33%) keep money at home/secret place (informal system) and 16 percent save with village and loans associations (VSLAs).

Table 14. *Savings mechanism used by households in Uganda, 2016/17*
(percent)

	Commercial bank	SACCO	Home/secret place	VSLA	Mobile money	ROSCA	Other ^a	Not saving
Male	8.4	3.3	32.6	15.0	10.5	4.2	7.6	6.6
Female	8.4	3.2	32.6	15.9	9.5	6.5	5.1	9.6
Rural	4.9	3.0	35.5	17.8	7.8	4.8	5.9	8.3
Urban	16.8	3.7	25.9	10.0	15.0	6.5	7.3	7.7
Kampala	22.3	4.1	20.3	3.8	20.4	7.3	8.0	9.1
National	8.4	3.2	32.6	15.5	10.0	5.3	6.3	8.1

Savings and Credit Cooperatives (SACCOs). Village Savings and Loans Associations (VSLAs), Rotating Savings and Credit Associations (ROSCAs)

Use of commercial banks and mobile money are largely urban phenomena, with 22 percent of households in Kampala reporting using commercial banks and 20 percent using mobile money. This trend shows that having mobile account does not necessarily translate into usage of mobile money services, which suggests that mobile money account per se is not a good indicator for financial inclusion.

These findings are reinforced by the evidence in Table 15, where over 50 percent of the households reported having received money in cash form, and only 6.7 percent through mobile money services. Much smaller number (4.8 percent) received money through the banking channel – making banks the least used channel for money transfer, remittances and payments.

Table 15. Mechanism for receiving money by households in Uganda, 2016/17
(percent)

Main source of Income	Cash	In-Kind	Mobile money	Bank	Other ^a	Total
Subsistence Farming	53.4	41.7	3.6	0.7	0.7	100.0
Wage Employment Non-Agricultural	56.6	21.9	5.6	15.3	0.6	100.0
Enterprises	67.5	20.5	9.6	1.4	1.0	100.0
Remittances	32.0	48.1	17.0	1.1	1.8	100.0
Other	68.3	13.3	12.8	5.2	0.4	100.0
Total - Uganda	56.3	31.4	6.7	4.8	0.8	100.0

Source: Uganda Bureau of Statistics

^aOther includes SACCO, Western Union, Money Gram, Other money transfers

6 Conclusion and implication for policy

Evidence suggests a weak link between financial deepening and financial usage by firms and households. The acclaimed achievement in financial inclusion that relies on the face value of financial and mobile money accounts and aggregate usage is exaggerated as evidence suggested that the actual gains are small. Measurement of financial inclusion need to go beyond mere account numbers to what is done with that account. There is also need for the subordination of financial inclusion policy to the needs of firms and households—the type that is modelled to fit the local context—if we are to achieve equitable financial inclusion. Despite vigorous official denials in government, the increased generosity in distributing cheap money (through SACCOs and community groups) across the country is at least partly motivated by strategic and political reasons, with implications for financial inclusion and the development of the financial sector. More consideration of behavioural constraints in financial inclusion programmes is required.

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