

**Regulatory Impact Assessment in Microfinance:
A Theoretical Framework and Its Application to Uganda**

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Declaration

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Abstract

This thesis develops a public interest methodology for assessing the impact of regulatory reforms in microfinance, applies this methodology to the case study of Uganda and explains the results by analysing the political economy of policy change. It thus combines public and private interest approaches in assessing microfinance regulation.

Firstly, the study develops a methodology for regulatory impact assessment based on the public interest theory of regulation. The first step is an analysis of market failures as the main rationale for regulation. Regulatory objectives are then defined with reference to these market failures. Finally, a variety of quantitative and qualitative impact indicators are identified to measure the benefits of regulation with reference to the achievement of the regulatory objectives while also considering the costs. Secondly, the thesis applies this rationale-objectives-indicators approach to the new legal framework for microfinance deposit-taking institutions (MDIs) in Uganda using similar, but unregulated microfinance institutions as a control group. The results show that the MDI regime's generally positive impact was only achieved at substantial cost to the regulator and regulated institutions and is skewed towards safety and soundness and systemic stability without adequate consideration of other objectives such as consumer protection and access. Thirdly, the thesis explains the degree to which public interest objectives were achieved by analysing the political economy of regulatory change. It shows that the three stakeholder groups with the best knowledge of microfinance regulation and whose interests were most closely aligned with the public interest objectives – the Central Bank (Bank of Uganda), the MDI candidates, and donor agencies – were also those who had the strongest influence on the policy change process.

The thesis concludes that its unique contribution is to develop a thorough methodology for assessing regulatory impact in microfinance. The methodology is used to measure the strengths and weaknesses of the MDI regime in Uganda, while the political economy analysis explains why these strengths and weaknesses arose.

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LIST OF ABBREVIATIONS

AMFIU	Association of Microfinance Institutions of Uganda
AML/CFT	Anti-money laundering and combating financing of terrorism
BCBS	Basel Committee on Banking Supervision
BoU	Bank of Uganda
CAMELS	Capital, asset quality, management, earnings, liquidity and market sensitivity
CBA	Cost-benefit analysis
CG	Control group
CGAP	Consultative Group to Assist the Poor
CMF	Commercial Microfinance Ltd.
CRB	Credit Reference Bureau
DFID	Department for International Development
EIU	Economist Intelligence Unit
FINCA	Foundation for International Community Assistance
Fn	Footnote
FSA	Financial Services Authority
FSAP	Financial Sector Assessment Program
FSD	Financial System Development Project/Programme
FSDU	Financial Sector Deepening Project Uganda
FY	Financial year
GDP	Gross domestic product
GNI	Gross national income
GoU	Government of Uganda
GTZ	Gesellschaft für Technische Zusammenarbeit
IADB	Inter-American Development Bank
IMF	International Monetary Fund
KfW	Kreditanstalt für Wiederaufbau
LIF	Loan insurance fund
MDI	Microfinance deposit-taking institution
MDIA	Microfinance Deposit-Taking Institutions Act
MED-Net	Micro Enterprise Development Network
MFI	Microfinance institution

MIS	Management information system
MIX	Microfinance Information eXchange
MoFPED	Ministry of Finance, Planning and Economic Development
MOP	Microfinance Outreach Plan
MP	Member of Parliament
NBFI	Non-bank financial institution
NERA	National Economic Research Associates
NGO	Non-government organisation
NRM	National Resistance Movement
OECD	Organisation for Economic Co-operation and Development
PEAP	Poverty Eradication Action Plan
PMT	Performance Monitoring Tool
PRIDE	Promotion of Rural Initiatives and Development Enterprises
REG.	Regulation (paragraph in implementing regulations)
RIA	Regulatory impact assessment
ROA	Return on assets
ROI	Rationale-objectives-indicators
SACCO	Savings and credit co-operative
SBEF	Superintendencia de Bancos y Entidades Financieras
SEC.	Section (paragraph in law)
SIDA	Swedish International Development Cooperation Agency
SOMED	Support Organisation for Micro Enterprises Development
SPEED	Support for Private Enterprise Expansion and Development
TG	Treatment group
TSC	Transformation Steering Committee
UFT	Uganda Finance Trust Ltd.
UGAFODE	Uganda Agency for Development Ltd.
UML	Uganda Microfinance Ltd.
UMU	Uganda Microfinance Union
USAID	United States Agency for International Development
USh	Ugandan Shilling
UWESO	Uganda Women's Efforts to Save Orphans
UWFT	Uganda Women's Finance Trust
WWB	Women's World Banking

CHAPTER 1 – INTRODUCTION

Over the last 10 to 15 years, an increasing number of countries have been reforming their microfinance regulatory frameworks. In the majority of cases the preferred approach has been to introduce a special microfinance window – a microfinance law. Despite substantial practical experience in many countries with regulating microfinance under specialised laws, there has been little systematic analysis of whether the promulgation of these laws has been worth the effort. What has the impact been? Have the costs of regulating microfinance institutions (*MFI*s) been justified by the benefits for their clients and the general public? At the same time, *regulatory impact assessment* (*RIA*) as a method to measure the success of all types of regulatory reforms has grown in popularity both amongst policymakers and researchers. These developments together – the growth in specific legal frameworks for microfinance and new research on regulatory impact assessment – provide a unique opportunity to develop and test an *RIA* methodology specifically tailored to microfinance.

The public interest methodology developed in the first part of the thesis (Chapter 2) allows for the assessment of regulatory impact with reference to its effectiveness and efficiency in alleviating market failures. As a test case for its usefulness, the second part of the thesis applies the methodology to the case of Uganda, where a new legal framework for *microfinance deposit-taking institutions* (*MDI*s) was promulgated in 2003. The focus of the analysis is the impact of the *MDI* law on newly licensed *MDI*s and their customers (Chapters 3 to 5). A separate chapter estimates the costs incurred by the regulator and the regulated institutions and discusses whether they were justified by the benefits (Chapter 6). The following chapter explains the findings from the regulatory impact assessment with reference to the political economy of policy change processes (Chapter 7).

This introductory chapter first provides a short overview of the literature dealing with microfinance regulation and regulatory impact assessment and its relevance for my own research. The second section explains the reasons for choosing

Uganda as the main country case. After a section on the main research methodologies, the final part leads the reader through the main structure of the thesis.

1.1. Relevance and Related Research

One may wonder – and this view is still common especially among smaller microfinance institutions – why do we need to regulate microfinance? Isn't microfinance about providing small loans in a flexible manner to poor people? Wouldn't it be best to do this without the heavy burden of formal sector regulation? This section introduces the current discourse about regulating microfinance and positions the main themes of the thesis and their relevance within current developments in microfinance. It then reviews some of the related research of significance for the topic of the thesis and sets the ground for the definition of the research questions.

Access to financial services – savings accounts, loans, money transfers, insurance services, etc. – is still limited in developing countries. The main rationale for this study is that if access matters, microfinance matters, and if microfinance matters, regulation and its impact matters. In many Sub-Saharan African countries, only a small minority of the population is currently served by the formal or semiformal sector.¹ In 2006, the fraction of the adult population using formal financial institutions in Uganda was estimated at 18%, while 62% did not even have access to informal financial institutions (Steadman Group 2007, vii). Yet access to financial services matters. A growing body of literature shows a correlation between financial sector development, long-run economic growth, and poverty reduction.² Microfinance – defined as the provision of basic financial services to poor people – obviously plays an important role in increasing access as it is mostly targeted at

¹ According to Ledgerwood (1999, 97), “*semiformal institutions* are those that are formal in the sense of being registered entities subject to all relevant general laws, including commercial law, but informal insofar as they are, with few exceptions, not under bank regulation and supervision.”

² Work in this area includes Honohan (2004) and Beck, Demirgüç-Kunt and Levine (2004), who argue that economic development follows from financial development. Levine (2005) summarises the empirical evidence on finance and growth.

the financially excluded.³ As a result, microfinance is increasingly seen as an important instrument in the efforts by governments and international donor agencies to promote economic growth and alleviate poverty.

What is understood by microfinance has undergone substantial change since the term was first used in the 1990s. Most experts now agree that microfinance:

- Is more than just microlending, i.e., refers to a variety of basic financial services with access to savings facilities being at least as important as to loans
- Can be provided by a variety of financial institutions ranging from fully-fledged commercial banks to small community-based organisations
- Works best if it is operated on commercial principles and regarded as an integral part of the overall financial sector

The last point had initially been subject to some controversy between advocates of the *poverty approach* and those of the *self-sustainability approach* (Morduch 2000; Schreiner 2002). It is now widely accepted that the scarcity of subsidies by governments and donors on the one hand and the huge unmet demand for financial services (often called *outreach gap*) on the other, calls for the careful use of subsidies by focusing on institutions which have at least medium-term prospects of becoming self-sustainable (in others words profitable). A “hard” budget constraint for MFIs is also important as otherwise their incentives would be distorted (Morduch 2000, 623-24).

The changes in thinking about microfinance listed above have inevitably led to increased interest in microfinance regulation – defined as rules backed by the coercive power of law which are employed to control and direct the behaviour of microfinance institutions.⁴ Firstly, if microfinance is more than just microlending

³ Whether microfinance helps lift poor people out of poverty is still subject to controversy due to the scarcity of reliable research on the topic. For a recent overview see Rosenberg (2010), who concludes that microfinance definitely helps to smooth consumption, which can be an important benefit for poor people.

⁴ Unless mentioned otherwise, I will use the term regulation in a generic sense encompassing regulation in the narrow sense (establishment of rules of behaviour, which can again be broken down into the parent law or act and its statutory regulations), supervision (observing compliance with the rules) and enforcement (ensuring that the rules are obeyed).

– and there are strong arguments in favour of MFIs providing retail savings services – it is generally argued that MFIs⁵ that take deposits from the public should be prudentially regulated (Christen, Lyman, and Rosenberg 2003). Clients – and even very poor clients – demand savings services and clearly benefit from them (Devine 2002; Rutherford 2005). MFIs often want to go into the savings business as an alternative and reliable source of funding, which leaves the funding decisions in the hands of the institution and allows them to reap economies of scope between the provision of loans and savings services (Vogel, Gomez, and Fitzgerald 2000).⁶ Secondly, if microfinance can, and should, be provided by a variety of institutions, the question arises of how to facilitate the provision of microfinance by formal sector institutions such as banks or regulated MFIs. Thirdly and similarly, if a more commercial orientation of microfinance is needed to close the still enormous outreach gap, this is usually seen as being easiest to achieve in a formal sector environment (Christen and Rosenberg 2000, 2).

The strong interest in microfinance regulation has coincided with reform initiatives to the regulatory framework for microfinance in numerous countries. At least 57 countries recognise MFIs as a separate institutional type under the regulation of the main regulatory authority (CGAP 2009, 8), and more than half of the African countries have introduced a microfinance-specific law (MIX and CGAP 2008, Figure 3).⁷ Microfinance regulation is often associated with introducing a special law which caters for the licensing of a special institutional type, such as the MDI in Uganda. While the regulatory framework for microfinance can be reformed in ways other than by introducing a new law (e.g., by amending existing banking laws or issuing microfinance-specific regulations under a banking law), the promulgation of a new law constitutes the clearest change in how microfinance is

⁵ The term MFI in itself is confusing, as it is sometimes understood to only refer to not-for-profit non-governmental organisations (*NGOs*) which are not part of the formal financial sector. I use it (if not stated otherwise) as a generic term for all types of formal and semiformal institutions targeting poor customers.

⁶ Whether small deposits constitute a cheap source of funding depends on the country context and has been subject to much debate (Richardson and Hirschland 2005).

⁷ In their paper titled “The Rush to Regulate,” Christen and Rosenberg (2000) cautioned against the proliferation of special microfinance laws, yet without much success.

treated and thus makes it easier to measure regulatory impact. For this reason, this thesis focuses on the introduction of a special microfinance law.

The following section briefly reviews related research on microfinance regulation in general, RIA in general, RIA in microfinance in particular, and the political economy of regulatory change in microfinance.

- Since the early 1990s, a large number of papers on microfinance regulation have been published, mostly by donor agencies, international financial institutions such as the World Bank, and microfinance research centres, with very few articles in academic journals.⁸ The literature is mostly descriptive in nature rather than analytic. Whenever publications include normative statements, these statements are mainly based on theoretical considerations, anecdotal evidence, and common sense rather than rigorous empirical research. An example is CGAP's *Guiding Principles on Regulation and Supervision of Microfinance*, which were formally adopted by CGAP's 29 member donor agencies, and have become widely accepted industry standards (Christen, Lyman, and Rosenberg 2003).⁹
- *Regulatory impact assessment (RIA)* has recently attracted increasing attention from policy-makers and researchers alike.¹⁰ *Ex ante* regulatory appraisals are now mandatory for many legislative initiatives in OECD countries, but their use in developing countries has also been spreading (Kirkpatrick, Parker, and Zhang 2004). A recent monograph has reviewed international experience with conducting RIAs (Kirkpatrick and Parker 2007).
- Few publications deal explicitly with RIA in microfinance; the four following are an important point of reference for this thesis. Fernando (2004) provides

⁸ The reference library of CGAP's Microfinance Regulation and Supervision Resource Center provides a good overview of the literature. See <http://tinyurl.com/yc2fbbd>, accessed 26 January 2010. Kirkpatrick and Maimbo (2002), Hardy, Holden and Propenko (2003), and Arun (2005) are articles in academic journals, yet none are based on field research.

⁹ CGAP is a resource centre and standard setter in microfinance hosted by the World Bank and funded by more than 30 bi- and multilateral donors and private foundations. CGAP is currently revising the guidelines by drawing on the increasing empirical evidence on what works and what doesn't in microfinance regulation.

¹⁰ Kirkpatrick (2001) distinguishes two types of RIA, viz., *regulatory appraisal ex ante* and *regulatory assessment ex post*.

an interesting review of the experience of newly regulated MFIs around the globe, where he uses the MFIs' expectations as the main benchmark to measure impact. A recent PhD thesis on Zambia has assessed the expected impact of proposed regulatory changes in microfinance, yet without developing a rigorous theoretical framework that would allow for clear comparability of different options (Chiumya 2006). Two studies have specifically looked at Uganda. As part of his PhD research, Okumu (2007) looked at the implications of the MDI law in Uganda, but with a narrow focus on measuring expected impact on two indicators for outreach and sustainability.¹¹ Finally, Obara, Mukasa, and Staschen (2007) have recently conducted a donor-financed study on the (early) impact of the MDI Act in Uganda. All four publications fail to define a clear benchmark against which to measure regulatory impact, typically assuming that any changes in the market observed can be attributed to regulation.¹²

- While the political economy of regulatory change is a well-known topic in political science, it is not a prominent topic in microfinance regulation and usually is at best mentioned as a side-issue. A notable exception is a recent PhD thesis, which draws on research in institutional economics to study the emergence of microfinance regulation in three Central American countries (García Cabello 2007).¹³

From this short literature review it becomes obvious that to date no thorough methodology has been developed to **assess and explain** the impact of regulatory reforms in microfinance.¹⁴ In this thesis, the assessment will be conducted by ana-

¹¹ The main evidence provided by Okumu's thesis is a survey conducted among 31 MFIs asking them about their **expectations** with regard to becoming regulated, rather than looking at actual impact figures, and an analysis of the likely impact of the MDI law, without actually measuring it.

¹² A similar case is a comparative study of seven countries' experience with microfinance regulation by Meagher et al. (2006).

¹³ Another exception is the USAID Legal & Regulatory Reform for Access to Finance Policy & Programming Tool by Druschel (2005b), which includes an analysis of conditions for reform (such as capacity of the regulator, existence of an influential public or private advocate).

¹⁴ An alternative approach is to use statistical methods to measure regulatory impact across countries. Two recent papers have done so by drawing on the extensive database on MFIs' performance worldwide, which was collected by the Microfinance Information eXchange (*MIX*) and others (Cull, Demirgüç-Kunt, and Morduch 2009a, 2009b).

lysing the impact of the new MDI regime¹⁵ with reference to a *public interest benchmark*, which is derived from an analysis of market failures in microfinance, and by making use of *impact indicators*. After having assessed the impact in the specific Ugandan case with the use of the RIA methodology, I explain its strengths and weaknesses with reference to the political economy of regulatory change.

This thesis is guided by one main and three secondary research questions:

Main Research Question: How can the impact of regulatory reforms in microfinance best be assessed?

Secondary Research Question 1: What has been the impact of Uganda's new MDI regime?

Secondary Research Question 2: What costs has the MDI regime created, both for the regulator and for the regulated institutions?

Secondary Research Question 3: To what extent can the impact of the MDI regime as measured against the public interest benchmark be explained by the political economy of regulatory change?

Section 1.3 discusses how these research questions will be tackled. Before doing so, the following section introduces Uganda as the main case study of the thesis.

1.2. Choice of Uganda as the Single Case Study

Because of its overall positive experience, microfinance in Uganda has increasingly drawn attention from governments, donor agencies, experts, and practitioners from numerous other countries. One of the areas of greatest interest is microfinance regulation and supervision, with Uganda becoming a showcase for the collaborative development of a legislative framework. (Braun and Hannig 2006, 453)

The main contribution of this thesis is the development of a theoretical framework for assessing regulatory impact in microfinance. To test the usefulness of this

¹⁵ Here and henceforth I use the term regime synonymously with regulatory framework. It refers to legal provisions for MDIs (the law and its implementing regulations) – the legal framework – and the supervisory practice.

framework, it has to be applied to a specific case or cases. The thesis uses the single case of Uganda, and one might ask “Why only a single case? Why Uganda?”

The Single Case Study Approach

Case study research examines contemporary events making use of quantitative and qualitative evidence.¹⁶ Focusing on a single case has both advantages and disadvantages. The main advantage of a single case study approach as opposed to a comparative study of a few (or even many) cases is the richness of data available. A single case allows analysis of the complex impact of regulatory change and drawing of causal inferences on the basis of a wide range of observations. Many of the contextual variables such as the maturity of the microfinance sector, the relative strength of different interest groups in the legislative process, and the responsiveness of clients and MFIs to regulatory change are highly country-specific and likely to be important determinants of regulatory impact. A comparative study of more than one country’s experience with regulatory change would have to control for these explanatory variables. It also would not allow analysis of each case to the same degree of detail, as the collection of relevant data from a multitude of different sources would be an overwhelmingly time-consuming exercise. In sum, a single country case allows for a deeper analysis and the consideration of a broader range of variables with relevance to the impact of microfinance regulation.

One of the challenges of a single case study is to generalise the results to a wider population as many of the observations are inevitably based on inferences from the specific case. Yet even in single case study research it is still possible to undertake what Yin (2008, 10) describes as *generalisation to theoretical propositions*. These propositions are based on an understanding of the causality between certain design elements of the regulatory regime or of the political process and their regulatory impact. In contrast to a purely quantitative survey technique, the case study approach allows better understanding of these kinds of causality. In

¹⁶ A good recent overview on case study research, and the one this section draws on, can be found in Gerring (2007a).

other words, it answers “how” and “why” questions, while the survey looks at the “who”, “what”, “where”, “how many”, and “how much” (Yin 2008, Figure 1.1).

Uganda as a Crucial Case

There are three main reasons why Uganda is a good choice to test the theoretical framework for assessing regulatory impact.

Firstly, Uganda can be regarded as a *crucial case* in the sense that the conditions there were such that a positive impact of the microfinance law was *most likely* in comparison to other countries which have introduced a special law for microfinance (Gerring 2007b). Such a “disconfirmatory (most-likely) crucial case” makes use of the central Popperian insight that it is easier to disconfirm an inference than to confirm it (Gerring 2007a, 120). While theory would predict a positive impact, negative (or neutral) outcomes permit the conclusion that in other countries with less favourable conditions a negative impact is even more likely. It is to be expected that the question of whether my theoretical prediction (that the law would have a positive impact on the achievement of regulatory objectives) can be confirmed or not is a matter of degree with some observations being confirmatory and others disconfirmatory (*ibid.*).

The conditions in Uganda show many characteristics which make it a most-likely success case:¹⁷

- From early beginnings in 1996, Uganda has gone through a planned and intentional approach of adopting a special law for microfinance. The reform process is regarded as one of the most strategic among those countries that have introduced a special microfinance law.
- The stakeholders most important for the success of the regime (such as Bank of Uganda as the Central Bank, Ministry of Finance, donor agencies, and most mature MFIs) were heavily involved in the design process of the law. Donor support was mostly complementary with some supporting policy-makers and

¹⁷ These will be discussed in more depth in subsequent chapters.

others the industry. The main drivers of effective microfinance regulation in Uganda have been described as “shared stakeholder vision, skilled human resources, and intensive stakeholder collaboration” (Goodwin-Groen, Bruett, and Latortue 2004).

- At the time the MDI Act was promulgated, Uganda had five mature MFIs which had the potential to qualify for a licence under the law, and who jointly provided the majority of microloans among unregulated MFIs. It was therefore assumed that the sector was mature enough to warrant a special law for microfinance.

A recent report on microfinance in Africa summarises the Ugandan case as follows:

In Uganda, the Central Bank showed understanding about the issues at play in the domain of microfinance and sought to create an environment where the range of entities delivering microfinance could flourish. Donors joined hands and provided coherence in their support. (WWB 2009, 116)

Another advantage of choosing Uganda as the case study is the unique timing. The new law and its regulations were introduced in the middle of the research period spanning 2001 to 2008. It includes the time period during which the four candidates for an MDI licence (initially there were five, but one dropped out later) prepared their applications, were issued with a licence and gained their first experience with being regulated and supervised by the Central Bank. While it can be argued that long-term regulatory impact only really shows after some more years of having been regulated, the risk of conducting an RIA at a later stage is that it is more difficult to isolate the impact of regulatory change from other confounding effects (discussed in Section 1.3 below). Institutional change clearly attributable to regulation is expected to be most significant in the run-up to the license. Having data for the four MFIs that received licences as well as other, comparable MFIs which remained outside the formal financial sector for several years after the introduction of the law, allows for the use of the difference-in-differences approach, which will be discussed in the following section.

A final reason for choosing Uganda as the case study is my own intimate knowledge of the sector. I lived for almost two years in Uganda and have been travelling there regularly for the last 10 years. I have therefore followed the development of the microfinance sector over a long period and established crucial personal links with key actors in the sector, facilitating access to information and people (see also Section 1.4, “Role as ‘Participant Observer’”).

While this thesis is clearly a single case study, it does not abstain from making reference to other countries’ experience with regulating microfinance whenever it is of interest to understanding the Ugandan case.¹⁸

1.3. Empirical Methodology

How is it possible to prove the impact of regulatory change without knowing what would have happened in the absence of any regulatory change? How can you confidently attribute changes in the sector to the fact that legislation has changed while a myriad of other things changed at the same time? How do you assess whether regulatory impact has been beneficial or detrimental? These, and similar questions, point to some of the methodological challenges in conducting an impact study of regulatory changes in microfinance. The proposed theoretical framework for assessing regulatory impact has to give an answer to two basic questions:

- Which benchmark do you use to decide whether the observed changes have been beneficial or detrimental?
- Which of the changes observed in the *microfinance market* (defined as the place where sellers and buyers of microfinance services meet) and in the *microfinance industry* (the MFIs) can be identified as effects of the regulatory change (the introduction of the microfinance law)?

The following two sections will answer these questions in turn.

¹⁸ In the last eight years I have worked in a number of countries on microfinance regulation reform initiatives. In particular, I have been closely involved in the Kenyan debate since 2004 (which was also the year when I moved to Kenya).

The Public Interest Benchmark

How do you measure *success* and *failure* and not simply *impact*? In some cases, this is obvious (e.g., if the quality of the governance structure of MFIs has improved, this is in everybody's interest). In other cases, one would need a benchmark against which to measure the impact on certain variables in order to decide whether regulation had a positive or negative impact (e.g., if the regulation increases the profitability of MFIs, this is good for the institutions, but could also be a sign of regulated institutions benefitting from high barriers to entry). The approach of this study is to analyse a variety of *impact indicators* which can be linked to the achievement of *regulatory objectives*. These objectives, in turn, have been derived from an analysis of market failures and the potential harm these could cause to market participants. This approach draws on neoclassical welfare economics and is in line with the *public interest approach* to financial regulation. I will therefore refer to it as the *public interest benchmark*.¹⁹ Chapter 2 describes in detail the development of the public interest benchmark and identification of *impact indicators* as the main theoretical framework for assessing regulatory impact in microfinance.

Isolating Regulatory Impact from Other Exogenous Changes

The lack of a counterfactual – what the world would have looked like without the policy change – is a well-known problem in empirical research designs. The objective is to isolate the impact of the main causal variable – in this case the introduction of the MDI law (when looking at the microfinance sector as a whole) or the issuing of a licence (when looking at individual institutions). I will also refer to this as the *treatment*. This thesis makes use of statistical methods that are widely used in econometrics, even though the limited availability of quantitative data did not allow for the use of formal regression analysis. Yet according to King, Keohane, and Verba (1994, 4), the “logic of inference” used in quantitative research can and should also be used in qualitative research. I use the same termi-

¹⁹ For a summary of the public interest approach to financial regulation see Goodhart et al. (1998, Ch. 1) and Barth, Caprio Jr. and Levine (2006, Ch. 2.A.1.).

nology and thinking, which is also helpful for discussing impact when looking at changes in data which do not allow for formal regression analysis or at qualitative evidence.

The main goal of the empirical methodology is to produce valid inferences about the regulatory impact of introducing a special law for microfinance. The introduction of a new piece of legislation is the main exogenous source of variation (also called the *causal* or *explanatory variable*). It can be regarded as a vector of regulatory provisions specified in the new microfinance law and of changes in supervisory practices. The *outcome variable* or *dependent variable* is a vector of dependent variables which can be used as impact indicators for the achievement of regulatory objectives. The counterfactual is not the *status quo* before the treatment, but the likely development of the sector without the introduction of the law.

It is interesting to contrast the approach taken here with that of Chiumya (2006) used in her similar study on the regulation of microfinance in Zambia. Chiumya compares two options, the first being “do nothing” and the second the introduction of (proposed) microfinance regulations. She uses the *status quo* as the main reference for option 1 and regards any future positive changes as a benefit, even if regulations have remained the same:

The main benefit of maintaining the status quo is that the industry would grow with the establishment of more MFIs, as has happened since liberalisation [of the Zambian financial sector], and flourish, as has happened in other parts of the world where microfinance remains unregulated. (ibid., 212)

Benefits of option 2 are measured with reference to the reasons for regulating microfinance as stated by Central Bank officials (ibid., 214). One problem with this approach is that the two options do not use the same benchmark, and therefore the benefits of each cannot easily be compared. In this thesis, the benefit of the introduction of a new legal framework (Chiumya’s option 2) is measured against the (hypothetical) do nothing option (Chiumya’s option 1). Any changes which would have occurred anyway are not regarded as a benefit of option 1. This is the baseline scenario, which has by definition a zero benefit.

There are two basic methods of identifying regulatory impact: the difference-in-difference approach and the concept of structural breaks. I will look at *structural breaks* first, which is a less demanding method in terms of data availability as time series data is only needed for the Treatment Group, i.e., the MFIs granted a licence under the new law. A structural break is an unexpected shift in the data (such as a sudden jump in customer numbers) which cannot be explained by any exogenous variable other than the treatment. As long as I can claim with some confidence that the most important change during the observation period has indeed been the introduction of the new regime, I can make use of the concept of structural breaks. In other words, I am only interested in *incremental changes* or those changes that go beyond good business practice (e.g., not the new software system, which would have been bought anyway, but only those new modules which were needed as a result of reporting requirements under the new law). The concept of structural breaks can be used for quantitative and qualitative observations.²⁰

An alternative – and one that is much better able to deal with other exogenous changes – is to use the *difference-in-differences approach*. The introduction of the microfinance regime can be regarded as a *natural experiment* or *quasi-experiment* (Meyer 1995). Unlike a laboratory experiment, the investigator does not have control over the observations (there is no manipulated treatment) and is not able to randomly choose treatment and control cases. Yet similarly to laboratory experiments, two different groups are compared (the treatment group and the control group), which are ideally similar in all respects but one, the causal factor of interest. In my case, this causal factor of interest is the changes in the regulatory regime for microfinance. The difference-in-differences approach looks at one of the outcome variables, takes its difference for the treatment group before and after the treatment and subtracts from this the same difference for the control group. Assuming that both treatment and control groups were subject to parallel trends before the treatment, the difference-in-differences can be interpreted as the regulatory impact, as the approach controls for all those changes in explanatory vari-

²⁰ A qualitative example would be changes in senior management that can clearly be attributed to the treatment.

ables that affect the treatment group and the control group equally. Difference-in-differences estimates are likely to be most informative when one compares outcomes just before and just after the policy change, as in the longer term too many other factors will alter and confound the policy change effect (Duflo 2002, 17).

The dynamic comparison between the treatment group and one or more different control groups is subject to three potential biases, viz., selection bias, omitted variable bias, and endogeneity bias. These will be briefly introduced here, but have to be analysed in the specific country context. Firstly, *selection bias* occurs if the rule for selection of cases for the treatment and control group is not random, but correlated with any of the dependent variables. Typically MFIs self-select into one of the groups unless there are exogenous reasons for some MFIs getting licensed and others not. In microfinance regulation, the MFIs applying for a licence under a new law will typically be the most mature institutions (with maturity being measured by dependent variables such as total assets, operational efficiency, portfolio quality, etc.). In cases with only a few observations, it is best to carefully select the cases in the control group while keeping potential selection bias in mind (King, Keohane, and Verba 1994, 124-28). It should be made up of MFIs that are as similar as possible to those in the treatment group, with the exception that they decided not to get regulated. If MFIs in the treatment group were stronger than those in the control group even before the treatment, there is a risk of overestimating the impact of the law.

Another potential bias occurs if any of the MFIs in the control group are already taking preparatory steps to get licensed in the near future. In such as case, the explanatory variable would also affect the control group, though to a lesser extent than the treatment group. This type of *shadow regulation* leads to a potential underestimation of regulatory impact.

Secondly, it is important to consider in each case the influence of explanatory variables other than the causal effect of the law, if these do not affect the treatment group and the control group in the same manner. This is what is referred to as *omitted variable bias*. The difference-in-differences approach is the best way to

reduce the risk of omitted variable bias. A residual bias could still be present if, for example, the legal environment for MFIs in the control group also changed during the same period, or if donor funding was targeted at MFIs in the treatment group (e.g., in the form of support for transforming into regulated MFIs). In the latter case, the research design is likely to overestimate regulatory impact.

Thirdly, problems of *endogeneity bias* arise if the direction of causality between explanatory and dependent variables is not clear. Such endogeneity problems are widespread in political economy models and bear the risks of “confounding the effects of the policy on economic outcomes and the effect that economic outcomes have on the adoption of the policy itself” (Pagano and Volpin 2001, 517). This would be the case if the question of whether to be regulated or not depended on the performance of the MFI rather than vice versa (i.e., the performance depending on regulation).

In conclusion, this section has shown that RIA in microfinance is plagued by numerous methodological challenges. However, it has also shown how to use a clearly defined benchmark and statistical methods borrowed from econometrics to generate reliable results.

1.4. Data Collection Methods

An impact assessment is only as good as the quality of the data it draws on. Data collection can be a tedious process. If one is lucky, there is a central performance data repository for the microfinance industry accessible to researchers (like the MIX Market on a global level).²¹ As far as qualitative data are concerned, good access to key stakeholders in the debate is essential as most discussions are held behind closed doors. The case study of Uganda makes use of various sources of information. This section briefly describes my data collection methods, and discusses my role as an active participant in the regulatory change process and what implications this has for collecting and analysing data.

²¹ See <http://www.mixmarket.org> (accessed 29 January 2010), which also has country-level data, but which is often not sufficient for an RIA.

Collection of Quantitative and Qualitative Data

Most of the primary data for the thesis were collected from February 2000 to October 2001, when I was living and working in Uganda, and during eight subsequent visits as a consultant between January 2002 and August 2007. I also undertook three dedicated research visits (four weeks in November/December 2002, one week in October 2004 and one week in July 2008).

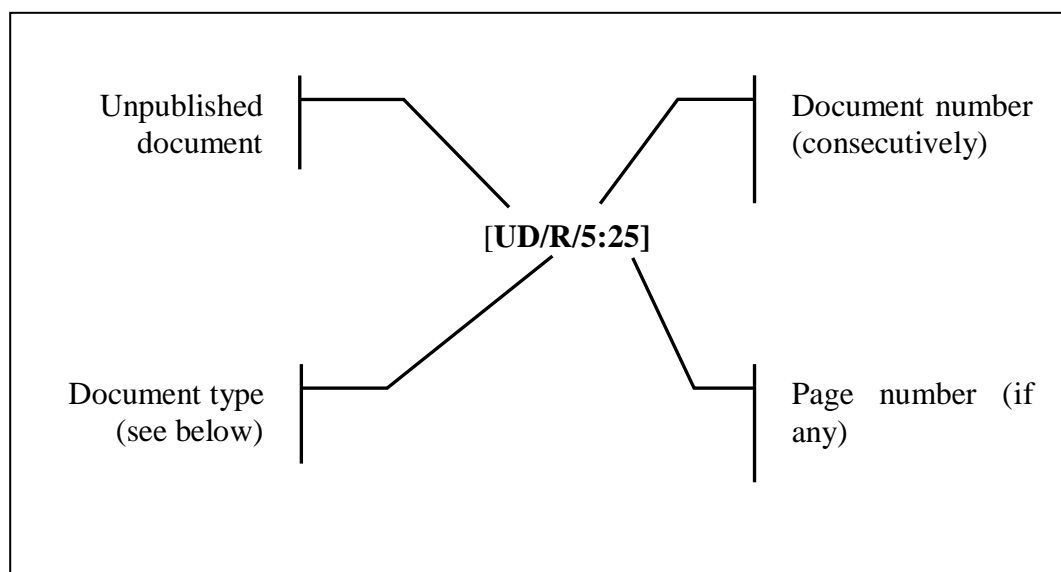
The data can broadly be divided into quantitative and qualitative data. On the qualitative side, my personal knowledge of the most important stakeholders in the regulatory debate and active participation in the design process of the legal framework helped me to gather important documents such as:

- Various versions of the draft MDI Bill and its draft implementing regulations
- Internal minutes and memos from the Central Bank (Bank of Uganda or *BoU*)
- Minutes of stakeholder meetings
- Supervision and examination procedures used by BoU
- Transformation²² plans of MDI candidates
- Studies on the Ugandan microfinance sector in general and on regulatory issues in particular

In addition, the study draws on my own personal notes from internal and public meetings and on publicly available documents such as newspaper articles, studies on the Ugandan microfinance sector in general and on regulatory issues in particular, and the minutes of the Parliamentary debate (a key source for the analysis in Chapter 7).

Appendix 1 lists all unpublished documents used for this study. It uses a simple code as follows:

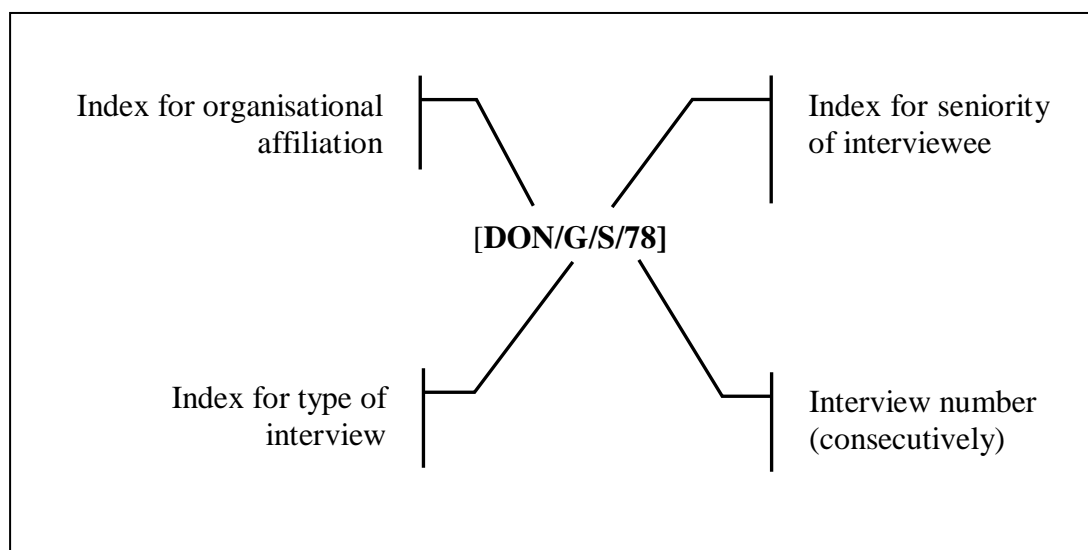
²² Transformation “refers to the institutional process whereby an NGO microfinance provider or a microfinance project creates or converts into a share-capital company and becomes licensed as a regulated financial institution” (Ledgerwood and White 2006, xxviii).

Figure 1.1: Coding System for Unpublished Documents**Index for document type:**

<i>C</i>	<i>Correspondence</i>	<i>E</i>	<i>Email</i>	<i>L</i>	<i>Legal document</i>
<i>M</i>	<i>Minutes</i>	<i>R</i>	<i>Report</i>		

These documents were supplemented by interviews with a wide range of senior members from various stakeholder groups: Members of Parliament (*MPs*), officials in the Ministry of Finance, Planning and Economic Development (*MoFPED* or simply Ministry of Finance), BoU officials, MFI senior members of staff, representatives of the Association of Microfinance Institutions of Uganda (*AMFIU*), consultants working on microfinance, donor representatives, and journalists. I did not conduct interviews with clients or potential clients as none were directly involved in the debate about microfinance regulation.²³ Overall, 76 people were interviewed (some of them more than once). I conducted 40 in-depth semi-structured interviews, but also collected information during roundtables in which I participated and held a few group interviews. For reasons of confidentiality, a coding system is used that indicates the broad organisational affiliation, the type of interview (acknowledging the difference between individual interviews and, for example, round table discussions where I was one of the facilitators), the seniority of the interviewed person (except for Members of Parliament), and the date of the interview (Figure 1.2).

²³ Chiumya (2006) conducted focus group discussions with MFI clients. It is not clear from her thesis how helpful their responses were.

Figure 1.2: Coding System for Interviews

<i>Index for organisational affiliation:</i>	<i>Index for type of interview:</i>	<i>Index for seniority of interviewee:</i>
<i>BOU</i> Bank of Uganda	<i>G</i> Group interview	<i>C</i> CEO, MD, head of organisation or relevant division
<i>CB</i> Commercial bank	<i>I</i> Individual interview	<i>O</i> Other (lower rank)
<i>CI</i> Credit institution	<i>R</i> Roundtable discussion	<i>S</i> Senior management/staff
<i>CON</i> Consultant		
<i>DON</i> Donor agency/international financial institution		
<i>MDI</i> Microfinance deposit-taking institution		
<i>MFI</i> Microfinance institution		
<i>MOF</i> Ministry of Finance		
<i>MOT</i> Ministry of Tourism, Trade and Industry		
<i>MP</i> Member of Parliament		
<i>SUP</i> Microfinance support organisation/industry association		

Some of the in-depth interviews were recorded, while others were not because of the confidentiality of information collected.²⁴ The most interesting and open discussions were often held in corridors in BoU or over a drink after work rather than in a formal interview setting. In such cases, I took notes only after the conversation (see also the following section below). I tried not to abuse the confidence of the people who entrusted me with insider information or shared their personal views with me by keeping all the information collected during these informal talks anonymous. As is always the case with interview evidence, I have to consider the respondents' incentives to respond strategically in order to shed a better light on their own role, to attract more donor funding, to conceal certain issues they are not proud of, etc. An important factor in this regard is my own role as an insider in the regulatory reform process, which I will discuss below.

²⁴ Maimbo (2001, 122) had a similar experience with Bank of Zambia officials not being willing to have their voices recorded. He eventually abandoned the idea of taping his interviews in order to yield satisfactory results.

As regards quantitative data, these are first and foremost performance data of MFIs. The only relevant survey on the customer level has been FinScope Uganda, a comprehensive study on the demand for financial services (Steadman Group 2007). As the repeat cycle of the survey has not yet been completed, it only provides a snapshot for the year 2006. There is a general lack of reliable performance data on the microfinance sector in Uganda; especially for the pre-2003 period (although some of the data go back as far as 1998). The approach followed is to make use of all data sources available, convert them into local currency (if required), clean the data (remove obvious false data), and adjust where necessary (e.g., for inflation). In each case, the reliability of data (e.g., self-reported data versus audited financial statements) has to be considered with the best approach being to use the most reliable data as the main source and fill any gaps with data from other sources. Although data collection analysis did not, in all cases, result in a sufficient number of observations to make use of statistical methods of analysis, other forms of analysis are possible, as shown below. Section 4.1 of this thesis provides a detailed discussion of these issues in the Ugandan case.

Role as “Participant Observer”

The objectivity and reliability of interview evidence depends partially on the respondents’ perception of the interviewer. The analysis of interview data could therefore be biased if interviewees respond strategically. Because of my professional work in Uganda, I can be described as an insider, often even an active participant in the regulatory game.²⁵ Over the years, I have worked for different clients in Uganda, while also pursuing my PhD studies. This led, at times, to confusion among my interviewees who had difficulties understanding whether I was talking to them as a donor representative, a consultant or as a researcher. My position as an insider and colleague (and sometimes even friend) of a respondent was a mixed blessing. It helped getting direct access to the main actors but the downside was that I might not always have been seen as an impartial observer and re-

²⁵ For the better part of 2000 and 2001, I was employed full-time by a donor-supported project called GTZ/SIDA Financial System Development Project (*FSD Project*) with offices based in Bank of Uganda. I also continued working as a short-term consultant for the same project until June 2005.

searcher, but as a donor representative or even staff member of the Central Bank with respective vested interests.²⁶ It is important to keep this potential research bias in mind. Where possible, any information collected through interviews was verified with references to other primary or secondary sources.

It is interesting to note the similarities between some of my methods for collecting data and the method of *participant observation* often used by anthropologists. Jorgensen (1989, 16) describes this as a method where

the researcher participates and observes in everyday life situations. Every effort must be made to minimize the extent to which the researcher disrupts and otherwise intrudes as an alien, or nonparticipant, in the situations studied. Taking the role of a participant provides the researcher with a means of conducting fairly unobtrusive observations.

While I did not plan to take on this role from the outset, as I did not even know that I would undertake my PhD studies in this specific field when I was still living in Uganda, my role turned more and more into that of a participant observer. In particular after I had left Uganda and started my studies in London, during subsequent visits I much more deliberately took advantage of my role as an insider. The following data collection methods I used have also been described by Jorgensen as being part of the methodology of participant observation:

- I took advantage of my insider position in the Ugandan microfinance community in general and as someone being based at the Central Bank in particular by “observing while participating” (ibid., 82).
- The role I performed was well within my range of expertise, in fact I was not playing a role, as my research interest was often only secondary to my role as international expert.
- I used a combination of unfocused observation (mainly before I started working on my PhD), more focused observations and in-depth interviews to collect

²⁶ It is interesting to look at two similar PhD theses analysing banking regulation and microfinance regulation in Zambia, respectively. Both Maimbo (2002, Ch. 4.6.2) and Chiumya (2006, Ch. 4.6.2) mention a potential conflict of interest between being, in their cases, central bank employees and at the same time researchers, but they do not see this as an important limitation of their research results.

data. In all cases, I took notes either directly after the meetings or, in the case of interviews, during the meetings. I also recorded some of the stakeholder meetings and actively collected secondary sources with relevance to my research topic.

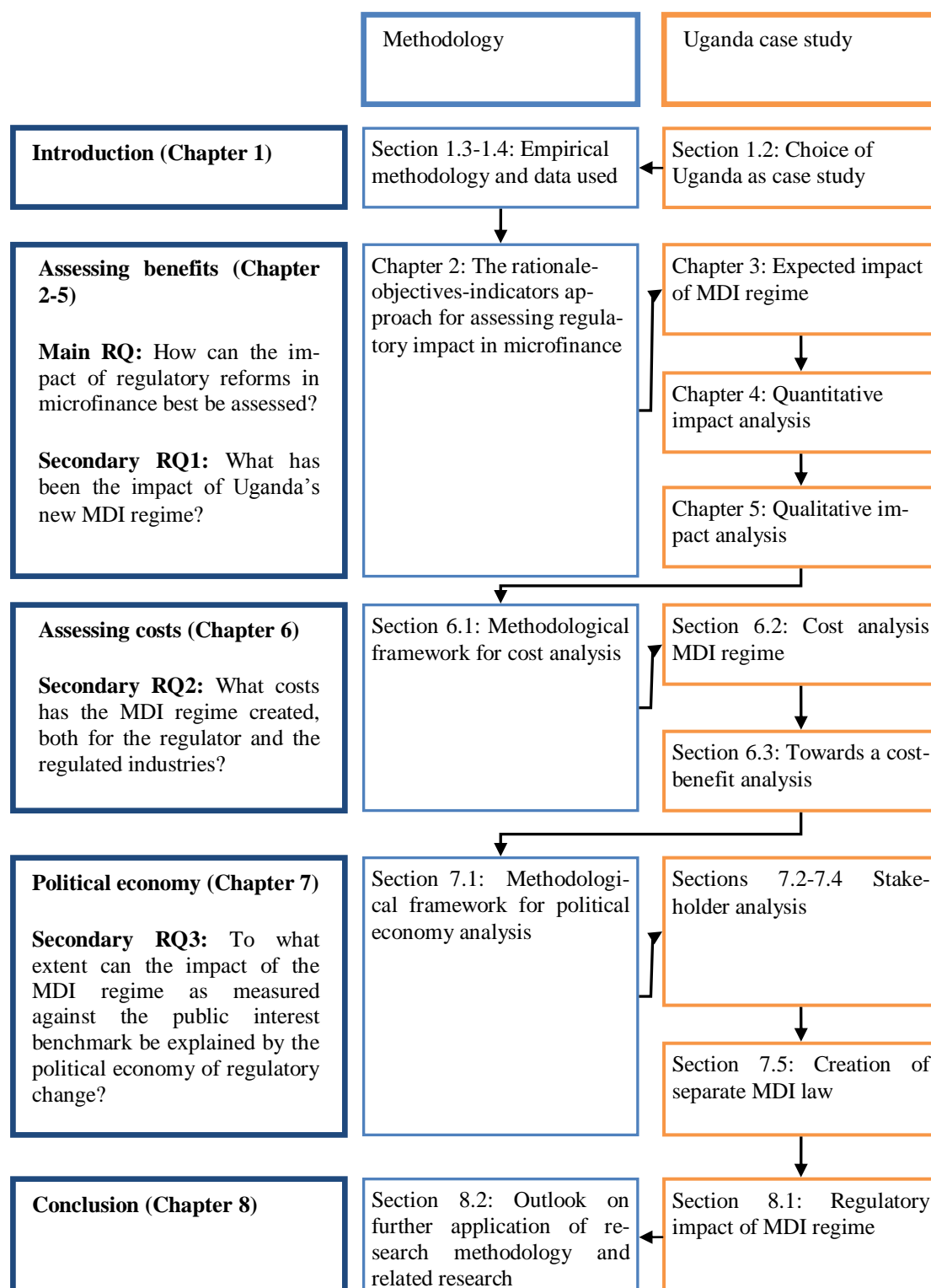
- During the visits after 2001, i.e., after I had started my PhD, I played a mixed role as participant observer and researcher. Some people were aware that I was working on my PhD (especially those I conducted interviews with), but for most of them my main role was still that of an international expert.

One of the advantages of having been something like a participant observer in Uganda is that it allows me to critically analyse all the information collected (both interview evidence and documents), as I often know the provider of the information personally and am able to better judge their specific position and interests.

1.5. Structure of the Argument

The thesis is organised around the four research questions. They are answered making use of various theoretical approaches. This section introduces the main structure and the theories used to answer the research questions and how they are linked to each other. Figure 1.3 depicts the main structure of the thesis.

Figure 1.3: Structure of Thesis



This thesis draws on the widely-used public interest theory of banking regulation and applies it to the specific case of microfinance regulation. To develop this public interest benchmark into a RIA methodology, it introduces the *rationale-objectives-indicators approach* (discussed in **Chapter 2** below) and also proposes a methodology estimating the costs of regulation. Regulatory impact is defined as observed changes in the sector that can be clearly identified (i.e., attributed to regulation) and are measured and rated against the public interest benchmark. I show that financial markets are subject to failure and therefore can produce suboptimal outcomes – the rationale for regulation. Five regulatory objectives are defined that are either targeted at reducing market failures or – to the extent that they cannot be removed altogether – mitigating their adverse consequences. As the final step, the rationale-objectives-indicators (*ROI*) approach identifies a detailed list of (quantitative and qualitative) impact indicators that can be used to measure the achievement of regulatory objectives. This approach, which is well grounded in the public interest theory of regulation, is the proposed response to the Main Research Question, viz., how the impact of regulatory reforms in microfinance can best be assessed.

Chapter 3 introduces the new legal framework for microfinance deposit-taking institutions in Uganda and thereby leads to the empirical part of the thesis and represents the first step in the RIA. It provides background information on Uganda's financial sector in general and microfinance sector in particular, and explains the general approach to regulating microfinance. The last section lists the most salient elements of the MDI Act and its implementing regulations with a view to deriving hypotheses about its expected impact on any of the regulatory objectives.

The following two chapters answer the Secondary Research Question 1 – what the impact of Uganda's MDI regime has been – by applying the ROI approach developed in Chapter 2 to the case study of Uganda. The analysis is in two parts: analysing quantitative indicators measuring the performance of MFIs (**Chapter 4**) and qualitative indicators following the approach of *process tracing* (**Chapter 5**). The outcome of this analysis is twofold: a better understanding of the usefulness

of the ROI approach, which develops the public interest benchmark into a RIA methodology, and a detailed account of regulatory impact as assessed with this methodology.

Regulation is not a free good. Its costs must be proportional to the benefits of having alleviated market failures and protected customers from their negative consequences. Whereas Chapter 2 develops a methodology to measure the *benefits* of regulation, **Chapter 6** focuses on the *costs* incurred by its introduction to make the RIA methodology complete. The first part introduces the methodology of cost analysis and various cost categories, drawing on insights from cost-benefit analysis. The second applies the methodology to the Ugandan case and provides estimates for major costs incurred by the Central Bank and MDIs, thereby answering the Secondary Research Question 2. The chapter concludes by putting the costs into relation to the benefits measured in previous chapters.

The final step in this study is to assess the importance of political economy factors in explaining the findings from the regulatory impact assessment. **Chapter 7** conducts a detailed stakeholder analysis for the six most important stakeholder groups in the policy-making process. It makes use of private interest theories on policy change and uses insights from the analysis of the presidential system and electoral laws in Uganda. The outcome is a better understanding of why the introduction of the MDI regime led to the regulatory impact as assessed in previous chapters and of the incentives and constraints of the different stakeholders (Secondary Research Question 3).

Chapter 8 concludes the thesis by summarising the main results from the Uganda case study and revisiting the ROI approach and its usefulness for similar studies. A final section looks at possible directions for future research, which would complement the results of this thesis.

CHAPTER 2 – DEVELOPING THE PUBLIC INTEREST THEORY OF REGULATION INTO A RIA METHODOLOGY FOR MICROFINANCE

The statesman who should attempt to direct private people in what manner they ought to employ their capitals, would not only load himself with a most unnecessary attention, but assume an authority which could safely be trusted, not only to no single person, but to no council or senate whatever, and which would nowhere be so dangerous as in the hands of a man who had folly and presumption enough to fancy himself fit to exercise it. Smith, Adam. 1999. *The Wealth of Nations*. London: Penguin, Book IV, Chapter II, p. 33

At least since Adam Smith the role of government in directing market participants how to invest and – in the same vein – how to run their businesses has been subject to questioning by economists. In the public interest view, financial regulation should only be imposed if there is an obvious economic rationale for it. Moreover, regulatory impact needs to be measured against a benchmark with a clear causal link to the rationale for regulation.

This chapter develops a methodology henceforth referred to as the *rationale-objectives-indicators approach*, which can be used to assess regulatory impact in microfinance in Uganda and elsewhere and thus answers the Main Research Question.²⁷ The first step in developing this approach is to define a *public interest benchmark for microfinance regulation*. The point of reference for this is neoclassical welfare economics, which defines the conditions for allocative efficiency in financial markets. Market inefficiencies constitute the main **rationale** for regulating MFIs. **Regulatory objectives** can be defined with reference to these market inefficiencies. As a direct measurement of regulatory impact with reference to the public interest benchmark is not possible, a variety of **impact indicators** will be defined with a clear causal link to the regulatory objectives. In contrast to Chiumya (2006), the RIA methodology clearly distinguishes between rationale,

²⁷ Similar approaches of describing the rationale, objectives, and indicators of financial regulation – albeit from a policy-makers perspective – are Llewellyn (1995a), Falkena et al. (2001), Carmichael and Pomerleano (2002, Table 2.2) and the “Lens to View Financial Policy and New Legislation” prepared by the consultancy firm Genesis Analytics for FinMark Trust (Genesis Analytics 2004; Bester et al. 2005a, 2005b).

objectives, and reasons of regulation (with the latter being the private interest explanation of why in practice regulation has been introduced, which is discussed in Chapter 7). While the framework should be generally applicable to countries that have introduced a special law for microfinance, it is also easily flexible enough to be of use for other regulatory reform initiatives in microfinance.

2.1. Market Failures in Banking as Economic Rationale

Financial institutions are much more heavily regulated than almost all other sectors in the economy (Benston 1998, 13). Why is this? What is special about financial markets in general and microfinance markets in particular? The *public interest approach* is commonly used to define the main rationale for regulating financial institutions. It assumes that the market will generally produce the best results unless the existence of market failures keeps Adam Smith's invisible hand from working towards market efficiency. If markets fail, the government can play a positive role in improving social welfare by acting in the best interest of the public. This view has dominated economic writing on banking regulation during much of the twentieth century (Barth, Caprio Jr., and Levine 2006, 21). It explains why markets for financial services are different from other product markets and why they therefore have to be regulated more heavily. Unlike Barth et al. (ibid.), who seem to have been surprised to realise that their empirical results were not consistent with the public interest view,²⁸ and Chiumya (2006, 230), who rejects the public interest view of regulation for the microfinance sector in Zambia, this thesis does not expect to observe that governments are acting purely in the interest of the public. Instead, it uses the public interest perspective as a normative benchmark in the regulatory impact assessment, as it defines what should, in principle, be observed in a regulatory system that maximises social welfare.²⁹

²⁸ They say: "Indeed, it was only after the initial stages of our research, when we found that the public interest view did not seem consistent with the data, that we considered alternative views" (Barth, Caprio Jr., and Levine 2006, 21).

²⁹ The *Theory of the Second Best*, discussed in Section 2.3 below, explains the limits of achieving this first best optimum.

The need for regulating banks is well founded in the economic literature³⁰ and so this section only briefly summarises the main rationale for regulating financial services. The focus here is on bank regulation; the following section discusses whether microfinance is fundamentally different or whether the same rationale for regulating banks also applies to MFIs.

There is general agreement among economists that there is a need for external oversight of banks, as the market for financial services suffers from market failures; even free banking proponents such as Benston, Kaufman and Dowd do not dispute that there are market failures in banking (Benston and Kaufman 1996; Dowd 1996; Benston 1998). The First General Theorem of Welfare Economics states that if markets are complete and producers and consumers are price-takers, a competitive general equilibrium is Pareto efficient.³¹ In other words, unfettered market forces lead to allocative efficiency and a social welfare optimum. The theory of market failure studies the assumptions which have to be met for the three conditions of the theorem to hold. The first, and probably most important assumption, is that there are no transaction costs involved in setting up markets, establishing equilibrium prices and concluding financial contracts between buyers and sellers of financial services (see, for example, Ulph and Ulph 1975, 358). Secondly, if one takes into account intertemporal allocation and uncertainty, the theorem only holds if there are markets for all commodities traded at any period in the future and for all possible states of the world. A final assumption is that buyers and sellers in the market are so numerous that they individually cannot influence prices; in other words they are price-takers. Greenwald and Stiglitz (1986, 259) conclude: “The theorem is an achievement because it identifies what in retrospect has turned out to be the single set of circumstances under which the economy is Pareto efficient.” If any of these assumptions is not met, the *laissez faire* solution does not necessarily lead to a Pareto efficient allocation.

³⁰ Llewellyn (1999) and Goodhart et al. (1998, Ch. 1) provide a good overview of the arguments.

³¹ After a paper by Arrow and Debreu (1954), this is also called the Arrow-Debreu General Equilibrium (Ledyard 1987).

In the economic literature on banking regulation, three main reasons are identified why the First Theorem of Welfare Economics might not hold and therefore allocative efficiency is not achieved: imperfect competition, information problems, and externalities (Barth, Caprio Jr., and Levine 2006, 22). The following section describes these three possible justifications for government intervention and their relevance in financial markets.

Imperfect Competition

Various forms of competition problems can be distinguished such as a monopoly or oligopoly, which both lead to non-efficient outcomes. One exception with relevance for banking is an oligopoly with two or only a few firms, where markets are not competitive, but *contestable*. Contestable markets are markets with, among other characteristics, no barriers to entry and absolutely costless exit (which implies no sunk costs), and perfect information on prices. In such a case, market players are not price-takers, but still price their goods at marginal cost and at average cost as otherwise new players would enter the market (Baumol 1982). Another Pareto inefficient market situation is the *natural monopoly*, i.e., the case of increasing returns to scale in production where the only efficient solution is a monopoly where the single firm's price equals its marginal costs.

It is generally believed that natural monopolies do not play a role in financial markets (see, for example, Llewellyn 1986, 11; Goodhart 1996). Dowd (1992) critically analyses a number of theoretical arguments and empirical studies and cannot find any evidence that banking is a natural monopoly. However, monopoly power can be an outcome of regulation rather than a justification for introducing regulation as many types of regulatory requirements typically increase barriers to entry and thus reduce competition in the market (Benston 1998, 79). The lack of competitiveness in the financial industry can therefore be regarded as an example of *iatrogenesis* (illness induced by treatment) rather than a reason for regulating

the industry (Goodhart et al. 1998, 2). There is empirical evidence that barriers to entry have indeed caused adverse effects on competition in the financial sector.³²

Information Problems

A second potential market failure can result from information problems in the financial services industry. Both in the lending and deposit business asymmetric information is common. Let us first look at information problems between the providers of funds (depositors and creditors) and the bank. One of the very reasons for the emergence of financial institutions is that they have better information about investment opportunities and the risk-profile of potential borrowers than individual clients, which is why they are also referred to as “delegated monitors” (Diamond 1984). Information collection is costly and depositors lack the incentive to collect a sufficient amount of information, as the activity of monitoring a bank has the character of a public good. For the individual depositor, the cost of controlling the use of her funds turns out to be prohibitively high (see, for example, Dewatripont and Tirole 1994, 33-34). A distinction can be made between retail and wholesale depositors with wholesale depositors suffering to a lesser degree from information problems (Llewellyn 1995c). The party receiving funds – in this case the bank – acts as agent on behalf of its depositors (principals). The agent is the better informed party in the transaction and can behave opportunistically (Williamson 1985, 64-67) by taking *hidden actions* (the problem of *moral hazard*). Debt financing increases a bank’s incentive to undertake excessively risky investments (Green and Talmor 1986). Information constraints render it difficult for depositors to hold the management accountable for its performance as it is hard to know whether the inability to pay back deposits is because of “shirking,” or due to some adverse effects outside the control of the institution. As a result of these information problems, the market solution will have a socially suboptimal level of

³² See, for example, a recent inquiry into competition in retail banking undertaken by the EU Commission in 2007, which concluded that entry barriers might indeed be one of the reasons for observed anti-competitive behaviour (<http://tinyurl.com/y9v8dtm>, accessed 1 February 2010). Another example is the UK inquiry into home collected credit as described in Porteous (2009a, sidebar B).

information collection. In addition, a regulator can monitor depository institutions on behalf of individual depositors more cheaply and more effectively.

The lending business of banks is likewise subject to information problems. In this case, it is the customer who receives the funds and holds superior information about the use of the funds (*hidden knowledge*). The bank bears the risk of non-repayment either due to the inability of the borrower to pay back or due to *hidden actions* – for the bank it is difficult to tell which of the two applies. Repeated interactions with the same customer allow banks to build credit histories and to reduce their information disadvantage vis-à-vis their borrowers. As superior information about customers increases the bank's franchise value (defined as the present value of future profits), banks will typically try not to share private information about their customers with other lenders (unless they are forced to do so by regulation). As Stiglitz and Weiss (1981) demonstrated in their seminal paper, with imperfect information the interest rate charged on loans can also have important incentive effects on borrowers so that lenders choose to charge a rate below the market-clearing rate. The result of this is credit rationing, which can be widely observed in financial markets around the world.

Externalities

The final reason for the market outcome not to be Pareto efficient is the existence of *externalities* (Greenwald and Stiglitz 1986). They occur when one party's behaviour imposes costs (negative externality) or creates benefits (positive externality) that are reflected in another party's utility or production function, but are not mediated through the price mechanism.³³ In a pure market solution, the equilibrium would lead to a misallocation of resources. In financial markets, two forms of negative externalities can be distinguished, viz., bank runs and contagion. According to a seminal paper by Diamond and Dybvig (1983), banks' transformation of illiquid assets into liquid liabilities is both the main rationale for their existence

³³ According to the Coase Theorem, a Pareto efficient allocation can still be achieved even when externalities exist as long as property rights have been clearly assigned. In such a situation, private bargaining between the party causing the externality and the affected party leads to Pareto efficiency (Coase 1960). Yet the restrictive assumptions of clearly assigned property rights and zero transaction costs are unrealistic in the case of financial markets.

and the reason for their susceptibility to *bank runs*. A random shock can be sufficient to trigger a bank run, as depositors act rationally if they rush to withdraw their deposits as soon as other depositors start to do the same. In the “bank run equilibrium,” even healthy institutions can collapse as they have to “fire-sale” their assets (in particular bank loans) at a high discount, which causes borrowers to terminate productive investment and thus creates high economic costs. In a world with information constraints where depositors cannot clearly establish the solvency of a bank, runs are essentially self-fulfilling prophecies.

In addition to the risk of a run on an individual bank’s deposits, in which externalities exist among different groups of depositors, problems in one financial institution can easily spread to other, solvent firms. The negative external effect of one failing institution on others is called *contagion* or *systemic risk*. *Bank panics* are the outcome. An important distinction is the transmission mechanism of systemic risk: contagion can spread through the credit channel (also referred to as “pure” systemic risk) and/or through the information channel (i.e., information-based systemic risk) (Jacklin and Bhattacharya 1988). The former occurs if banks are highly interconnected (e.g., through the interbank market or the payment system). The latter can, for example, be triggered by a general loss of trust in the banking sector, or in a world with imperfect information even by the similarity of a bank’s name with that of a failed institution (Schoenmaker 1996, 4). As could be observed during the recent global financial crisis, system-wide bank panics can create high costs for the economy.

Various empirical studies have been undertaken looking at the incidence and seriousness of system-wide crises. The main evidence from these studies can be summarised as follows:

- Systemic banking crises have occurred frequently in history and have resulted in serious social costs. A World Bank database lists 117 episodes of systemic banking crises (defined as much or all of bank capital being exhausted) between 1970 and 2002. Costs in some countries were close to or above 50% of GDP (Caprio and Klingebiel 2003). Hoggarth and Saporta (2001) of the Bank

of England estimate that the cumulative output losses during crisis periods were in the range of 15 to 20% of GDP.

- Information asymmetries play an important role in determining the seriousness of contagion. Providing depositors with better information can help to stop bank panics (Park 1991; Schumacher 2000).
- While failing banks were generally weaker than those that survived, on occasion even healthy banks were subject to runs.
- Information-based runs were more important than runs spreading through the credit channel (Bhattacharya, Boot, and Thakor 1998).

In summary, negative external effects can lead to runs on banks. This on its own can cause social costs (depending on whether the bank was solvent before the crisis started or not). Even more serious is the risk of contagion, which can affect solvent and insolvent banks alike and often has far reaching economic consequences. Contagion is a “low-probability-high-seriousness” risk (Llewellyn 1999, 16): even if it occurs only infrequently, it can have serious social costs.

2.2. Market Failures in Microfinance

Microfinance institutions are different from conventional banks. Their particular clientele in the lower end of the financial markets requires them to adapt their products and services. But does this mean that the main rationale for regulating banks – the existence of market failures as listed above – does not apply to MFIs? The focus of this section is on what is different in microfinance.

Imperfect Competition

The same arguments apply as in banking: the provision of microfinance services does not show the characteristics of a natural monopoly. However, there is a risk that new regulations increase barriers to entry and thus the market power of regulated institutions. What is special in microfinance is that regulated deposit-taking MFIs in their lending business typically compete with unregulated credit-only MFIs and even informal lenders. The main impact of regulation on competition is

therefore likely to be restricted to new entry barriers in the deposit-taking business.³⁴ Porteous (2009a, 14) concludes that

Regulators need to evaluate whether the requirements for entry to a particular regulated market (e.g., credit as distinguished from deposit taking) are unduly onerous for that particular activity so as to constitute an unnecessary barrier to entry which protects incumbents.³⁵

A different concern is if MFIs enjoy what Ray (1998, 544) describes as a “local monopoly” as the only or one of only a few providers of financial services in their geographical location. As microfinance is about serving customers that either previously had no access to financial services or only from informal sources, remote rural markets in particular are likely to be shallow. Besley (1994, 43) describes village moneylenders as the “archetypal monopolists because of their ability to exploit local knowledge” and sees good reasons for rural lenders to enjoy market power. Hardy, Holden, and Prokopenko (2002, 14) confirm this view when saying:

An MFI may enjoy considerable local market power, especially if it operates in a remote area and sunk costs are high, and its goals could be perverted into maximizing profits at the expense of (poor) clients.

Both the importance of local knowledge and high sunk costs make it likely that financial markets in remote rural areas are not contestable either. The result can be monopoly pricing and a lack of incentives to operate efficiently:

Because MFIs’ . . . interest rates are set not by the free market forces of supply and demand, but rather by monopolistic or oligopolistic institutions, there is a grave danger that inefficiencies and delinquencies can flourish, but remain hidden under “appropriate interest rates.” (Gibbons and Meehan 2000, 8)

The seriousness of this problem will depend on the specific country situation and in particular on the degree of saturation of rural financial markets and the extent

³⁴ They might even compete with semiformal and informal microfinance services in the savings business depending on the strictness of the regime regarding unregulated deposit-taking.

³⁵ Empirical studies on Bolivia (Vogelsang 2003) and Uganda (McIntosh, Janvry, and Sadoulet 2005) confirm that fierce competition can also create problems. Porteous (2009a) therefore argues for “healthy competition.” Yet instead of restricting competition these examples rather point to the need of protecting customers (see below).

of competition from informal providers. If competition regulation is chosen as a remedy, it should apply to the relevant market where competition problems occur, which can stretch beyond the regulated financial sector and also include semiformal institutions (e.g., credit-only MFIs).

In conclusion, market power can become a potential problem in microfinance if regulation increases barriers to entry, but it is likely to be restricted to the regulated activity (typically microfinance deposit-taking). A special characteristic of microfinance markets is that they are likely to be less competitive and contestable than conventional banking markets with MFIs enjoying local monopolies in specific geographical locations. Regulation can be a potential answer to this. Therefore regulation can both be a cause of and a cure for competition problems.

Information Problems

Looking at information problems in the deposit business first, all the arguments advanced above in favour of having a specialised regulator also apply to deposit-taking MFIs. The information problems are likely to be even more severe: "Most holders of bank debt have only a faint idea of the bank's real solvency. This **holds especially for small depositors**" (Dewatripont and Tirole 1994, 218. Emphasis added). The typical retail depositor of an MFI is likely to be smaller, less educated, more likely to be illiterate, and have less experience with assessing the financial position of a financial institution than a saver with a conventional bank, thereby incurring in relation to the savings amount substantially higher costs in choosing an MFI and monitoring its behaviour. It can be concluded that the information asymmetry between an MFI and its depositors tends to be greater than in conventional banking.³⁶

There are two specific characteristics of microfinance with relevance for the discussion about information problems. Firstly, quite a number of MFIs do not offer retail savings, but are purely financed by donor contributions (grants, loans),

³⁶ Goodhart et al. (1998, 103) maintain that the financial experience and sophistication of the general public are weaker in developing countries than in developed countries and thus the information problems are more serious.

commercial borrowing, self-financing and (more rarely) equity financing. They are referred to as credit-only MFIs. Borrowing a term from the UK Financial Services Authority (*FSA*), these “wholesale-only deposit-takers” (*FSA* 2001b) are in a much better position to monitor the use of their funds. Secondly, a specific characteristic of many MFIs is that they make use of *compulsory savings* as a precondition for accessing loans. These can be regarded as “cash collateral” as they are closely linked to the loan contract (Christen, Lyman, and Rosenberg 2003, 17).³⁷ Information problems are different as clients are net-borrowers most of the time, at least as long as compulsory savings are restricted to a certain percentage of the overall loan amount (i.e., do not accumulate over time) and are refunded upon repayment of the loan.³⁸ Their behaviour is likely to be similar to those of borrowers (see below on information problems in the lending business).³⁹ It can be concluded that MFIs that do not take retail deposits or only take compulsory savings that do not accumulate over time and are repaid upon termination of the loan contract are not subject to serious information problems in the deposit-business, while customers entrusting retail deposits with MFIs are likely to face even more serious information problems than bank clients. The general consensus is that only retail deposit-taking triggers the need for regulating MFIs (Christen, Lyman, and Rosenberg 2003, 14-16).

In the microlending business, MFIs are subject to even more serious information asymmetries than conventional banks. The small size of loans and the informality of many of the businesses financed through them make it very difficult and expensive for creditors to assess the borrower’s repayment capacity *ex ante* (Ledgerwood 1999, Ch. 5). The same is true for monitoring the use of funds after the loan has been granted. Given that money is fungible, the cost of controlling the use of borrowed funds in comparison to the much smaller loan amounts is likely

³⁷ Interestingly, in Uganda and Kenya this kind of savings is referred to as “loan insurance fund”.

³⁸ This has been referred to as the “net-borrower concept.” It assumes that clients are allowed to offset savings amounts against outstanding loan payments.

³⁹ A third special group of savings in addition to wholesale deposits and compulsory savings are savings from members in co-operative financial institutions, which are again subject to different information problems (see Cuevas and Fischer 2006, Ch. 2). However, this thesis does not cover the co-operative sector.

to be prohibitively high. Typical instruments for enforcing loan repayments, in particular the use of collateral and litigation, are either non-existent (traditional bank collateral) or too expensive and/or slow to use (taking legal action).

However, the success of microfinance has been based on innovative lending technologies, which have helped to deal with information problems and reduce credit risk. Most MFIs make use of collateral substitutes such as peer pressure in joint-liability lending or increasing loan amounts/decreasing interest rates for consecutive loans as very effective ways to reduce the problem of hidden actions by borrowers. Nontraditional collateral such as a TV, a fridge or other movable items are also in wide use (Balkenhol and Schütte 2001). Peer pressure in joint-liability lending can play an additional role in substituting for perfect information.⁴⁰ Using repayment rates as an indicator of how successful MFIs deal with information problems, the repayment performance in microfinance has often been at least as good as in conventional banking.⁴¹ Credit rationing, however, is a widespread phenomenon particularly in rural credit markets, one reason for which can be incentive effects of the interest rate as described in the Stiglitz/Weiss model.⁴² It can be concluded that information problems are even more severe in microlending than in conventional banking. They have contributed to credit rationing, but not to weaker repayment discipline. The very success of microfinance can be attributed to MFIs having found innovative ways to address the potentially acute hidden action problems.

Externalities

This section considers the question of whether the likelihood of runs and contagion in the microfinance sector differs from that in the conventional banking sector. Looking first at the risk of a run on an individual MFI, its probability depends

⁴⁰ According to Besley and Coate (1995) group lending can have both a positive (a group member steps in for defaulter) and negative (entire group defaults if single group member does not repay) effect on repayment rates.

⁴¹ In 2008, the 1,084 MFIs reporting to the MicroBanking Bulletin had an average portfolio at risk (payments overdue 30 days or more) of 3.1% (MIX 2009).

⁴² Cull, Demirgüç-Kunt, and Morduch (2009b) find that loan delinquency rates indeed increase with interest rates, at least for individual loans.

on the ability of depositors to assess the health of an MFI without having to rely on signals received from other depositors. As mentioned above, information problems in the deposit business tend to be more severe in microfinance than in conventional banking. At the same time, rumours about (perceived or real) problems of MFIs might spread more quickly as MFIs typically serve locally confined, closely knit-communities, which rely more on social information sharing than on publicly available financial data. The likelihood of an unjustified run on a solvent institution is therefore higher than in conventional banking as customers are less able to assess the financial performance of an MFI and at the same time are more prone to herding behaviour. Spencer (2000, 214) confirms this view when comparing small and large depositors' ability to monitor banks' performance:

[In a laissez-faire banking system] large professional investors might be able to look after their deposits, but this would leave a mass of small depositors with little knowledge or understanding of the situation, free riding on the activity of others. Small depositors would thus be prone to rumour and herding behaviour and liable to cause a run on the bank.

A second particularity originates from the fact that microfinance clients usually do not have much experience with entrusting their savings with an MFI (or with financial institutions generally) and are therefore more likely to "run" on an MFI. Game theory tells us that the time horizon matters (Mailath and Samuelson 2006). Entrusting savings with an MFI can be regarded as a *repeated game*, where the strategy to "cooperate" in all periods (i.e., to trust the institution) is only superior if the number of periods is great enough. With a shorter time horizon, saving with an MFI is more like the classical *prisoners' dilemma* with the dominant strategy for everybody being to withdraw their savings. In other words, the susceptibility to contagion declines with experience of participating in the financial sector.

A third distinctive feature of an MFI relates to the relative large size of its liquidity risk, which means that even moderate withdrawals by clients can lead to its collapse. There are four main reasons why liquidity risk is high. First, most MFIs have only limited access to emergency liquidity support. Second, in a segmented market, an MFI might also not have the option to cover its liquidity demand by transferring funds from other regions (Besley 1994). Third, the fire-sale of assets

is even more costly than for conventional banks. An MFI's most important asset is the loan portfolio, whose value depends to a great degree on specialised knowledge about the clients and is therefore difficult to sell to a third party. Fourth, an MFI cannot easily stop lending as a strategy to respond to a liquidity shortage, as the clients' willingness to repay existing loans usually depends on them having access to future loans. A strategy of no new loans could easily wipe out an MFI's existing loan portfolio (Christen and Rosenberg 2000).⁴³

To sum up, in comparison to conventional banking, runs on MFIs are more likely because depositors monitor MFIs less, and are more susceptible to a loss of trust irrespective of whether triggered by alleged or real problems. Even moderate withdrawals can bring down an MFI as liquidity risk tends to be greater than for conventional banks.

Looking at contagion, some microfinance experts are of the view that it is not of much concern for MFIs (Wright 2000, n. 3; IADB 2001, 29; Trigo Loubière, Devaney, and Rhyne 2004, 30). Their argument is based on the assumption that in most countries the microfinance sector, in terms of its assets, constitutes only a small portion of the overall financial sector and is quite isolated from mainstream banking. According to this view, an event would only qualify as 'systemic' if it affects "a substantial portion of the financial system" (Group of Ten 2001, 126). However, if one defines systemic risk simply as contagion among financial institutions, it does not necessarily have to affect the entire financial section, but can also occur on a sub-sector level.⁴⁴ In the following, I will refer to this special type of systemic risk as *sectoral risk*. Simply disregarding contagion because of its typically minor importance in terms of total assets ignores the fact that a sectoral crisis among MFIs can have serious implications for a high share of overall depositors. CGAP's Consensus Guidelines concur with this view:

⁴³ Bond and Rai (2009, 185) describe in a formal model that credit-only MFIs could also be affected by *borrower runs*: "If borrowers expect that others will default, and so loans will no longer be available in the future, then they will default as well." Yet in contrast to depositor runs, clients would not lose any money.

⁴⁴ Similarly, Schumacher (2000, 264) describes the "tequila-crisis" in Argentina in 1994 as "a bank-specific form of contagion," i.e., a run of depositors on banks which had similarities with previously suspended banks.

Wherever depository microfinance reaches significant scale in a particular region or country, systemic risk issues must be taken into consideration . . . The failure of a licensed MFI with relatively small assets but huge numbers of customers could be contagious for other MFIs. (Christen, Lyman, and Rosenberg 2003, 4)

Pure systemic risk spreading through the credit channel is less prominent in microfinance as long as the interbank market and linkages through the payment system are still quite insignificant (often MFIs have closer links to banks than to other MFIs). As regards information-based contagion, the same arguments from game theory apply as explained above: trusting savings with an MFI is like a repeated game where the susceptibility to contagion reduces over time. Vogel et al. (2000, Fn 5) conclude:

Depositors who would use microenterprise finance intermediaries [read: MFIs] might well be new to such intermediaries if not to depositing in general. It is thus plausible that the failure of a single microenterprise finance intermediary might lead depositors to desert other microenterprise finance intermediaries en masse, possibly producing a collapse in a country's entire microenterprise finance system.

Contagion through the information channel might even be possible among credit-only MFIs, as a slump in repayment performance in one MFI leading to its closure can have negative external effects on other MFIs and lead to a *credit crunch* in the microfinance sector: "The failure of a credit-only MFI can cause 'unzipping' or repayment failure in other MFIs" (Mudenda 2002, 55).⁴⁵ Such a systemic crisis in the lending business can also be triggered by a debtors' revolt as described by Rhyne (2001, Ch. 6) in the case of Bolivia in 1999/2000. A general credit crunch for microborrowers could also be caused by negative experience of one or a few financial institutions' leading to a policy of *redlining*. According to Goodhart (1989, 240):

⁴⁵ South Africa offers an example of negative spillover effects of bank failures on credit-only MFIs. The closure of two banks in early 2002, which were both heavily involved in microlending, had a knock-on effect on other microlenders, which were not prudentially regulated (Bezuidenhout 2004, 119-20).

Economic history is replete with occasions when the failure of a bank (or banks) which had become over-extended to a certain class of borrower is followed by a refusal of banks, and other intermediaries, to extend further credit to members of that class.

Yet contagion among credit-only MFIs does not hurt clients at least in the short-term, as they do not lose any savings. They could, however, potentially suffer from losing access to microloans if a considerable part of the market breaks down.

The overall impact of microfinance sectoral risk on social welfare can be substantial as microfinance clients often represent a substantial part of the total.⁴⁶ The same arguments apply as for runs on MFIs (clients having no alternative access except informal sources and savings having a higher marginal utility), but a sectoral crisis would obviously have even more serious consequences for the poor.

Two relatively recent incidents from Uganda and some international evidence can shed some light on the importance of negative external effects in microfinance. In 1999, FINCA Uganda went through a crisis when Co-operative Bank failed, where FINCA held 30% of its cash and cash equivalents and its customers held 80% of their savings. Gibbons and Meehan (2000, n. 13) report:

“When the Co-Op Bank closed, the clients’ first instinct was that FINCA Uganda was also ‘closed.’ However, FINCA Uganda got out and spoke to their clients, reinforcing that it was business as usual. . . . They were able to disburse all subsequent loans, thus maintaining the confidence of their clients.”

This constitutes a case of contagion through the credit channel from a commercial bank to an MFI and at the same time points to the risk of contagion through the information channel. The second case is the storming of the offices of the Ugandan MFI Front Page Microfinance by angry clients in early December 2007.⁴⁷ It was followed by runs on other MFIs and led to a general loss of trust in MFIs.⁴⁸

⁴⁶ The share of clients served by MFIs obviously depends very much on the specific country under consideration. The argument here is that simply disregarding contagion in microfinance because of its minor importance in terms of total assets ignores that a sectoral crisis among MFIs can have serious implications for a high number of clients.

⁴⁷ See Porteous (2010, Box B) for a more detailed account.

⁴⁸ Joseph Olanyo, “Bank of Uganda disowns microfinance institutions amid customer protests,” *Daily Monitor* (Kampala), 24 December 2007.

This event was triggered by one MFI – which was not authorised to mobilise savings – being unable to meet its customers’ demands for withdrawals. CGAP’s Kate McKee considered the effect of the global financial crisis in 2008/09 and concluded in an interview: “Recent isolated deposit runs at a few well-run, financially solid microfinance banks give us pause and remind us that deposit behavior can be as much about rumors and confidence as ratios and capital.”⁴⁹

Table 2.1: Market Failures in Conventional Banking and in Microfinance

	<i>Conventional Banking</i>	<i>What is different in microfinance?</i>
Imperfect Competition	More an outcome of, than a justification for, regulation; banking not regarded as natural monopoly	Barriers to entry only a problem for regulated activity (e.g., deposit taking), while regulated MFIs still compete with unregulated MFIs in other activities (e.g., lending). Risk of local monopoly in remote, rural markets
Information Problems in Deposit Business	Retail depositors lack incentive to sufficiently monitor the utilisation of their funds; banks have incentive to undertake excessively risky investments; information problems can lead to problems of hidden action, but are less pronounced for wholesale depositors	More severe because of small size of deposits, lower financial literacy of depositors; less of a problem for credit-only MFIs and MFIs only taking compulsory savings
Information Problems in Lending Business	Information constraints make it difficult to choose most creditworthy borrowers <i>ex ante</i> (hidden knowledge) and to prevent hidden actions <i>ex post</i> ; incentive effects of interest rate can lead to credit rationing	More severe because of small size of loans, lack of documentation; collateral substitutes quite effective in addressing hidden action problems
Externalities	Negative externalities can trigger bank runs (which might even affect solvent institutions) and cause contagion on a system-wide level; runs and contagion can potentially create high social costs	Risk of runs and contagion in microfinance likely to be higher, in particular information based contagion (and possibly even among borrowers); systemic risk most likely on sub-sector level (i.e., among MFIs)

⁴⁹ “Behind the Headlines: The Credit Crunch and Microfinance – One Potential Scenario: An interview with CGAP expert Kate McKee,” *CGAP Portfolio Dec. '08-Jan. '09*, 15 December 2008. Available from <http://dev.cgap.org/p/site/c/template.rc/1.26.4507>, accessed 8 October 2009.

Table 2.1 above summarises the three market failures discussed in this section and compares their relevance in the cases of conventional banking and microfinance. A general observation is that the differences are mostly a matter of degree: types of financial institutions are not fundamentally different, but the significance of market failures in each **does** differ.

This section has shown that not all the conditions for Pareto efficiency described in the First Welfare Theorem are fulfilled. The existence of market failures in microfinance are the main rationale for regulating MFIs. Most of the inefficiencies are more severe for deposit-taking MFIs than for credit-only MFIs. What the specific role of regulation can be in alleviating these market failures and which objectives regulation should follow is the subject of the following section.

2.3. Public Interest Objectives

Now that a clear rationale has been established for regulating microfinance based on the existence of market failures, the question arises what precise form such regulation should take. An intriguingly simple answer would be that regulatory measures are best targeted at removing market constraints and moving the economy towards the optimum as defined by the First Welfare Theorem. Unfortunately, a first best optimum can only be achieved in a world without market failures. It is technically impossible to correct all market failures at a reasonable price and a first best optimum is therefore utopian. The *Theory of the Second Best* recognises that the best one can achieve is a second best solution, which maximises social welfare given the persistence of certain market failures that cannot be eliminated (Bohm 1987). Yet as soon as one acknowledges the existence of *residual market failures*, the world will end up in a different equilibrium and the attainment of the other conditions for a first-best optimum are no longer necessarily desirable (Lipsey and Lancaster 1956, 11). Sometimes, the introduction of regulations in one area can create new market inefficiencies elsewhere. These negative external effects or *spillover effects* can be substantial: according to Benston (1998, 51), the negative externalities of government-provided deposit insurance (used as a regulatory measure to reduce the risk of a run and contagion) are one of the

main reasons for regulating financial institutions in the first place. Carmichael and Pomerleano (2002, 22), who derive regulatory measures from an analysis of market failures, have to admit that “this very general appreciation of why financial regulation matters, however, offers little guidance as to exactly what should be regulated or what precise form that regulation should take.”

Acknowledging that not all regulatory measures and outcomes can be assessed with reference to their direct impact on alleviating market failures, an intermediate step in the ROI approach is to define *public interest objectives*. While the rationale explains why regulation is necessary, the objectives of regulation are needed to explain what outcome regulation is trying to secure (Llewellyn 1999, 8). They are either directly related to the main market failures introduced above or targeted at alleviating negative consequences of market failures. Acknowledging that it is not possible to reach a state of the world without any market inefficiencies, these objectives can be used to assess whether a particular reform was welfare improving or not. Clearly defined and precisely delineated objectives can provide guidance for regulators, and, at the same time, increase their accountability (Goodhart et al. 1998, 156-57).⁵⁰ In this case of an *ex post* regulatory impact assessment, regulatory objectives are not used to guide the regulatory design process, but to provide a benchmark for measuring the impact of microfinance regulation.

Before discussing the regulatory objectives in detail, it is important to note that financial regulation enforced by the rule of law is not necessarily the answer to each of the identified market failures. At times, private market solutions can be available that successfully reconcile conflicting interests of various market participants and help to alleviate market failures. For instance, banks and MFIs have found innovative ways to respond to information problems in the lending business such as collateral security and a thorough analysis of the repayment capacity of borrowers for banks, while MFIs make use of collateral substitutes and joint liability lending. Government regulation is only needed to the extent that these pri-

⁵⁰ Compare the approach of the FSA (2000a, Ch. 2), which has taken its statutory objectives as a starting point to develop its operating framework.

vate market solutions are not sufficient in leading to allocative efficiency in the market.

The following sections introduce five public interest objectives for microfinance regulation. The first four belong to the standard canon of objectives in banking regulation (see, for example, Llewellyn 1995b, 4; Goodhart 2001, 154), while the fifth has only recently received more attention and is of particular relevance in microfinance. These objectives are frequently in conflict (Llewellyn 1995a, 6) – something I will return to in Section 2.4 below. Each objective is related to one or more of the market failures described above by being targeted at alleviating market failures, counteracting their negative consequences, or protecting market participants against their negative consequences.

Promote the Safety and Soundness of MFIs

What is it that makes MFIs – and for that matter financial institutions in general – different from other, non-financial firms, so that regulation is required to secure their safety and soundness? Two of the market failures listed above have potentially a negative impact on the safety and soundness of MFIs. Information problems in the deposit business can lead to a less than optimal degree of monitoring by depositors and incentives for MFIs to undertake excessively risky investments, even more so than for conventional banks. Likewise, information problems in the lending business can affect the ability of borrowers to repay their loans. Even though MFIs have found innovative and successful ways to reduce credit risk, repayment rates can quickly deteriorate and wipe out their capital.⁵¹ Negative external effects among different groups of depositors and even borrowers can potentially lead to runs on otherwise healthy MFIs. Finally, spillover effects of regulation in other areas such as moral hazard caused by deposit insurance can increase market inefficiencies (e.g., by clients having even less of an incentive to monitor

⁵¹ A number of reasons for the higher vulnerability of MFIs can be distinguished, most importantly a high covariance risk leading to a high volatility of repayment rates (borrowers are often concentrated in one geographical area and undertake similar economic activities), and the fact that the loan portfolio typically represents by far the single largest asset position on the balance sheet.

MFIs) and make the objective of promoting the safety and soundness of MFIs even more important.

Credit-only MFIs are only subject to information problems in the lending business and negative external effects that could potentially cause *borrower runs* (Bond and Rai 2009). The big difference between credit-only and deposit-taking MFIs is that the collapse of a single deposit-taking MFI can cause serious harm for its customers, while the collapse of a single credit-only MFI is not a big problem as long as customers have access to alternative lenders (discussed in more detail below).

Regulation targeted at the safety and soundness of financial institutions is referred to as *prudential regulation* (Goodhart et al. 1998, 5). Even in the absence of systemic concerns (discussed in the next section), prudential regulation of MFIs taking retail deposits from the public is necessary because of information asymmetries and externalities. Regulation can be targeted at alleviating information asymmetries or – as they cannot be eliminated altogether – establish other measures that reduce the risk of MFIs failing. As it is not possible for the government to enforce a minimum of bank monitoring by their customers, it is argued that the government has to monitor the banks on their behalf (e.g., by charging an external supervisory authority with this task). For instance, Carmichael and Pomerleano (2002, 27) argue that “prudential regulation overcomes the asymmetric information market failure in part by substituting the judgment of a regulator for that of the regulated financial institutions and their customers.” By doing so, a specialised regulatory agency is also able to reap economies of scale in monitoring financial institutions. The incentive to undertake excessively risky investments can also be lessened by monitoring, as well as by prescribing higher capital requirements for financial institutions (Campbell, Chan, and Marino 1992). The objective is not to establish a *zero failure regime*, but to alleviate the risk of institutional failure due to market failures.⁵² Credit-only MFIs do not require prudential regulation unless one is concerned about systemic risk, which will be discussed below. However, credit reference services collecting negative (only defaults) and/or posi-

⁵² The FSA (2003b) refers to this as the “non-zero failure” regime.

tive (complete payment history) information can potentially help to alleviate information problems in the lending business and thus lead to a deepening of credit markets.

The objective of safety and soundness of MFIs is closely related to the second regulatory objective, the prevention of systemic risk, as the failure of a single MFI can be contagious and affect the whole sector.

Guard against Systemic Risk

This objective is directly linked to one of the market failures: negative externalities cause systemic risk (system-wide or on a sub-sector level) with potentially high social costs. This is a serious problem for deposit-taking MFIs, but can also affect credit-only MFIs in the case of a sector-wide credit crunch. Such a credit crunch can be triggered by the closure of any other lender operating in a similar market. It causes social costs if borrowers cannot easily switch to other, similar sources of funds. As regards MFIs only mobilising compulsory savings, the same arguments apply as for credit-only MFIs as long as clients are net-borrowers with the institution.

One strategy would be to alleviate the market failure itself, e.g., by improving transparency, so that clients are better able to distinguish between idiosyncratic risk and system-wide crises. This would reduce their incentive to inflict negative external costs on otherwise healthy MFIs. However, as information is costly, information asymmetries will never be eliminated altogether so that residual market failures call for external regulation. The type of regulation targeted at reducing systemic risk is referred to as *systemic regulation*. The analysis of externalities in microfinance suggests that its main focus should be on systemic risk among deposit-taking MFIs on a sub-sector level, where the risk is highest. Contagion among credit-only MFIs can become a matter of concern if it has a serious impact on access to loans for certain groups of borrowers, which will be discussed below.

Establish a Competitive Market

The third objective is also clearly linked to one of the market failures, in this case the lack of a competitive market. As explained above, competition can be a problem if an MFI either enjoys a local monopoly in a specific location, or if regulation sets high barriers to entry, which create monopoly rents for regulated institutions. The first problem of the local monopoly is not only linked to deposit-taking business, but can also affect credit-only MFIs in their lending business. Attracting a sufficient number of players by subsidising the fixed costs of setting up an MFI and developing credibility and trust can reduce competition problems. If local monopolies in a particular area persist, regulation can potentially play a role in shielding customers against the negative consequences of a lack of competition.⁵³

The second problem of high entry barriers is caused by regulation itself and thus calls for a regulatory framework that considers its impact on competition in the market. Market entry barriers are typically much higher for deposit-taking MFIs than for credit-only MFIs as there is a greater need to regulate deposit-taking MFIs to mitigate any of the other market failures. Regulation targeted at reducing anti-competitive behaviour is called *competition regulation*.

Protect Consumers

The fourth objective is to protect consumers against negative effects of residual market failures or newly created market inefficiencies caused by spillover effects from regulatory interventions in other areas. Unlike the previous three objectives, this objective does not directly target market failures or the negative impact they have on market participants' actions. Instead, it assumes that the market for retail financial services, even if regulated, does not achieve a first best optimum, and that regulation can play a role in protecting consumers against any existing market failures. Unsafe or unsound financial institutions, runs, contagion, and non-competitive pricing can all create costs for MFI clients. The proposition here is

⁵³ Porteous (2009a) lists a number of remedies, one of them being the promotion of credit bureaus to reduce information problems.

that even if MFIs are subject to systemic, prudential and competition regulation, consumers can still suffer from negative consequences of residual market failures.

Many things can go wrong for microfinance clients, chief among them the loss of savings deposited with an MFI. As explained earlier, information asymmetries are more serious and the risk of runs and contagion is higher. Local monopolies give MFIs market power, which they can use to the detriment of their clients (e.g., by making use of unethical loan collection methods or opaque pricing). Consumers can also be exploited if there is too much competition (Porteous 2009b, 1).⁵⁴ Moreover, there are several reasons why typical microfinance customers are particularly vulnerable. Firstly, they cannot diversify their risk to the same extent as better-off customers as their options are limited (Collins et al. 2009). Secondly, it could be that the closure of an MFI leaves customers without any other option than to revert to informal sources, which on average are more risky than regulated depository institutions. Finally, microfinance clients can ill afford to lose any of their savings as their marginal utility of each monetary unit is higher than for better-off customers. This means that the closure of one MFI and loss of depositors' money has a more severe effect on social welfare than a comparable crisis in the conventional banking sector.

Regulation targeted at consumer protection is referred to as *conduct of business regulation* or *market conduct regulation*. Its focus is not on institutions or the financial sector as a whole (as it is the case for the three preceding objectives), but on the clients of these institutions. Consumer protection issues can arise both for clients of credit-only MFIs and of deposit-taking MFIs. This is why conduct of business regulation should ideally be targeted at activities, irrespective of the type of institution conducting these activities.

Improve Access

One of the premises of microfinance in general and of this thesis in particular is that access matters. This fifth and final objective is not part of the usual canon in

⁵⁴ See Brix and McKee (2010, Box 3) for a comprehensive list of typical consumer protection concerns in microfinance.

banking regulation, even though its importance has been recognised in several consultancy reports. Why do we need to include access as one of the public interest objectives of regulation? First, access is a serious problem in many developing countries and microfinance can play a strong role in improving access. There is evidence that improved access has a positive impact on economic growth (see Section 1.1).

Various reasons can be identified why people do not have access to the formal financial sector. They can be broadly divided into those caused by market failures and those by regulation:

- The main **market inefficiencies** leading to financial exclusion are the existence of transaction costs driving up the cost of serving poor people and information problems between financial institutions and their customers. The latter can lead to credit-rationing in line with the Stiglitz/Weiss model (Stiglitz and Weiss 1981). In some cases financial service providers misperceive the risks and costs of serving the poor and financially excluded (Benston 1998, 50), or they do not appropriately adapt their lending technologies and savings facilities to profitably serve this market.⁵⁵ External effects can cause systemic risk and lead to the exclusion of groups of borrowers (“redlining”) or potential savers from the formal and semiformal financial sector.⁵⁶
- **Regulation** itself can lead to increased financial exclusion if, for example, interest rate limits are set below (lending rate) or above (deposit rate) the market clearing rate. Regulation could also be prejudiced in favour of traditional banks and set high entry barriers for MFIs as the main providers of services to the financially excluded (one of the main reasons for advocating a special legal framework for microfinance). Customer due diligence requirements as part of anti-money laundering and financing of terrorism (*AML/CFT*) measures can

⁵⁵ Karlan and Mullainathan (2009) find some evidence that the lack of innovations in standard lending methodologies of MFIs has been one of the reasons for lack of access.

⁵⁶ I follow Honohan and Beck (2007, Box 4.1), who acknowledge the importance of access to informal finance, but also stress the superiority of formal finance: “The real effectiveness of formal finance lies in its ability to provide a wider range of services at a larger scale and offer a pooling of risks that cannot be attained by the informal sector.”

prove to be a major bottleneck for poor customers (De Koker and Isern 2009). A major concern is that the introduction of a special law for microfinance itself can have a negative impact on access as it typically goes hand in hand with the commercialisation of MFIs. It is possible that a regulatory framework could score highly on the preceding four regulatory objectives – but at the cost of fewer customers having access. In particular, many authors are concerned about a trade-off between the twin objectives of reaching out to the poor **and** being sustainable (cf., for example, Rhyne 1998; Morduch 2000; Schreiner 2002; Sinha et al. 2003).

In addition, some people (in particular the destitute and extreme poor) are excluded as they are beyond the reach of the market, which Porteous (2005) describes as the “natural limit” for reaching people with financial services. Removing market inefficiencies will not help to integrate these in the financial sector.

Access does not only refer to access to loans, but also to savings facilities and other financial services (although the focus of this thesis is on savings and loans). There has been a long-running debate about whether savings facilities are possibly more important for the welfare of poor customers than loans (Rutherford 2005), which goes back to Vogel’s often-cited article “Savings Mobilization: The Forgotten Half of Rural Finance” (1984). The access objective is therefore relevant for both credit-only and deposit-taking MFIs.

Looking at the literature on banking and microfinance regulation, Falkena et al. (2001) subsume improving access under the broader consumer protection objective. However I will treat it as a separate objective as it is not only about protecting consumers against potential damage, but also about increasing the overall efficiency of the economy by bringing as many people as possible into the formal financial sector.⁵⁷ A number of recent papers explicitly recognise the importance of considering access when regulating microfinance. One case is USAID’s *Legal*

⁵⁷ Porteous (2005) argues that there is no public case for increasing access unless one assumes that access has *merit good* qualities. This thesis argues that the efficiency gains and positive welfare effects for individuals having access to finance make the access objective worthwhile even on the basis of individual consumer preferences.

and Regulatory Frameworks for Access to Finance policy and programming toolkit, which is based on the assumption that the main goal of regulatory reform initiatives is to increase access (Druschel 2005b, 2005a). Porteous (2010, 2) stresses that the core question of prudential regulation in microfinance “remains how to protect poor people’s savings, *and* their access to formal savings (emphasis in original).” In a position paper on regulation of microfinance services, the World Savings Banks Institute mentions access as one of three objectives:

Any regulatory and supervisory measures applicable to microfinance activities should have, as a triple objective, to support the enlargement of access to finance, to guarantee a level playing field between all microfinance providers and to equally protect all consumers. (World Savings Banks Institute 2008, 7)

Lack of access – often also referred to as financial exclusion – has only recently attracted the interest of policy-makers around the world, and not only in developing countries. Some countries have chosen voluntary charters and codes of practice as the preferred strategy to improve access.⁵⁸ Others have introduced specific legislation aimed at increasing access to financial services.⁵⁹ The FSA was one of the first regulators to conduct thorough research on this topic (Kempson et al. 2000) and as a result introduced access-enhancing measures (McCarthy 2005).

The character of the access objective could be described as *market enhancing*. The main argument in favour of including access as one of the regulatory objectives is that the economy does not only depend on how efficiently people are served by financial institutions, but also on how many people are served. I will refer to any regulatory measures directly targeted at improving access as *access enhancing regulation*.

A number of other objectives have been proposed in the literature. In particular, these are social objectives (e.g., lending quotas for disadvantaged sections of the

⁵⁸ For instance, South Africa’s major banks, insurance companies, brokers, and exchanges agreed on a “Financial Sector Charter” in 2003, which sets a number of access targets. The charter is available at http://www.banking.org.za/documents/2003/OCTOBER/charter_final.pdf, accessed 19 February 2008.

⁵⁹ Interesting examples from industrialised countries according to Kempson (2006) are the Community Reinvestment Act in the United States (1997), the Law on Exclusion in France (1998), the Basic Banking Act in Belgium (2003), and a separate law in Canada (2001).

population or specific sectors of the economy) and what has been called the “public safety” objective (Genesis Analytics 2004, 12) targeted at a reduction of financial crime.⁶⁰ The ROI approach developed here focuses on market efficiency as the rationale for regulation. Social objectives are not founded in an analysis of market failures⁶¹ and the same is true for the public safety objective. The rationale for imposing AML/CFT rules is not market failures, but the government’s responsibility to prevent financial crime (Oxera 2006, 12). The public safety objective and social objectives are therefore not included in the public interest benchmark used in this thesis.

Table 2.2: Regulatory Objectives for Microfinance

	<i>Reason for including objective</i>	<i>Type and scope of regulation</i>
Promote safety and soundness of MFIs	Information problems in deposit and lending business and negative externalities affect safety and soundness	<i>Prudential regulation</i> only required for deposit-taking MFIs
Guard against systemic risk	Systemic risk (sectoral risk) caused by negative externalities both among deposit-taking MFIs and – to a lesser extent – among credit-only MFIs	<i>Systemic regulation</i> mostly for deposit-taking MFIs, but potentially also for credit-only MFIs
Establish a competitive market	Market barriers introduced by regulation and local monopolies in unsaturated markets	<i>Competition regulation</i> considering local monopolies in lending and deposit-taking and newly created entry barriers
Protect consumers	Residual and newly created market failures hurting loan and savings clients	<i>Conduct of business regulation</i> for all types of financial institutions
Improve access	Transaction costs, information problems, and externalities as well as regulation itself leading to lack of access	<i>Access enhancing regulation</i> for all types of financial institutions

The five public interest objectives summarised in Table 2.2, and derived from an analysis of market failures in the provision of microfinance services, can be used as a benchmark to analyse the impact of a special microfinance law. The ROI approach has to go one step further by defining indicators that can be used to measure the attainment of each of these five objectives.

⁶⁰ One of the four statutory objectives of the FSA is the reduction in financial crime (SEC. 6, Financial Services and Markets Act 2000).

⁶¹ Carmichael and Pomerleano (2002, 34) refer to the dismal experience with using regulation for social objectives.

2.4. Impact Indicators

While the higher level **objectives** defined above indicate the directions in which a strategy should aim, they say nothing about the amount which it would be appropriate to achieve. As a result, it may be difficult to judge whether a proposed strategy is successful, or whether more could be achieved. More quantified objectives can be specified in terms of a series of **indicators**, which can be either general or specific, and which can be used also to identify problems. (emphasis added)

*Approaches to Urban Transport Strategy Development*⁶²

A common problem with the use of objectives for assessing the impact of a policy (or strategy as in the example above) is that there is no simple method for measuring the achievement of objectives. What is a satisfactory level of achievement? How do we weigh different objectives against each other? How do we measure an objective such as systemic stability or consumer protection? The RIA methodology is only complete if it not only defines the rationale and objectives of microfinance regulation (the public interest benchmark), but also identifies indicators for measuring regulatory success – referred to as *impact indicators*.

A problem arises if some of the high-level objectives are too broad, unmeasurable and unmanageable. In such a case it is necessary to define intermediate goals and targets that are more operational and manageable. These targets are reasonably closely related to an objective, although they are not objectives in themselves (i.e., not necessarily desired in their own right). Achieving the targets is therefore a reasonable proxy for an objective. (Falkena et al. 2001, 41)

What Falkena et al. refer to as targets from a policy-maker's perspective, corresponds to indicators from that of an analyst assessing regulatory impact. The identification of impact indicators in this study draws on the related discussion about how to identify the optimal mix of regulatory measures.⁶³ A number of authors have drawn up lists linking various regulatory measures with regulatory objectives (Herring and Santomero 1999, Figure 1; Falkena et al. 2001, Table 4.1; Carmichael and Pomerleano 2002, Table 2.2).

⁶² Knowledgebase on Sustainable Urban Land Use and Transport (<http://tinyurl.com/yj4r5nq>, accessed 5 February 2010).

⁶³ There is a good degree of overlap between impact indicators and regulatory measures. The degree of compliance with regulatory measures can at the same time be used to measure the attainment of regulatory objectives.

Challenges in Identifying Impact Indicators

Identifying impact indicators with clear causal links to the regulatory objectives can be a challenge. The following discusses some of the problems and how they can be dealt with, followed by a categorisation of impact indicators.

First, none of the five regulatory objectives can be measured by a single indicator (in the same way that no legal framework uses a single regulatory measure to achieve any of its objectives). A **multitude of indicators** is required to determine the overall regulatory impact. Each indicator is assigned to the objective with which it has the clearest link, whilst recognising that any indicator may well be relevant to more than one objective.

Second, there is the problem of **attributing changes to regulation**. Data availability permitting, the two main strategies to identify regulatory impact is to look at structural breaks (assuming that these were caused by regulation and not by some other exogenous change) and – even better – to use the difference-in-differences method. In particular for the analysis of qualitative impact indicators, I will at times have to use my intimate knowledge of the MDI applicants to decide whether expenses would have been incurred even without regulation (*good business costs*) or can be identified as effects of regulation. In a few other cases, it is straightforward to identify changes as effects of the introduction of the legal framework for MDIs (e.g., in the case of the MDI Act requiring the establishment of a credit registry or the contribution of MDIs to a deposit insurance fund).

Third, the analysis also has to consider what constitutes a satisfactory degree of achieving regulatory objectives. By doing so, it has to take into account **competition and complementarity among regulatory objectives** (Bester et al. 2005a, 13). Because of this, a policy-maker will not be able to maximise each objective separately to achieve the social optimum. It is important to note that none of the objectives can be achieved to their fullest extent because of increasing marginal cost in attaining them. Table 2.3 below summarises some of the trade-offs (competition) and supportive relationships (complementarity) among objectives.

Table 2.3: Trade-offs/Supportive Relationships among Regulatory Objectives

	<i>Safety and Soundness</i>	<i>Reduction in Systemic Risk</i>	<i>Competitive Market</i>	<i>Consumer Protection</i>	<i>Access</i>	Trade-offs
<i>Safety & Soundness</i>		No obvious trade-off	Competition may reduce incentives for borrowers to repay and increase pressures to lend or borrow recklessly	No obvious trade-off	Strict safety and soundness rules increase barriers to entry and reduce access	
<i>Reduction in Systemic Risk</i>	Safe and sound institutions are an important defence against a systemic crisis		High competition may compromise safety and soundness and thus increase systemic risk	No obvious trade-off	An important defence against systemic risk are safety and soundness rules, which in turn may reduce access	
<i>Competitive Market</i>	Healthy competition may lead to more efficient and innovative MFIs	No obvious relationship		High competition can lead to reckless lending and overindebtedness of customers	A competitive market limits the scope for cross-subsidies favouring the poor	
<i>Consumer Protection</i>	Both ways: Safety and soundness rules protect consumers / information disclosure protects MFIs against consumers choosing wrong product	Lower systemic risk means lower risk for consumers to lose funds in failing MFIs	Competition increases incentives for MFIs to offer better, more secure and transparent services		Consumer protection measures may limit innovation in instruments to promote access	
<i>Access</i>	In the long term only safe and sound MFIs will be able to serve a growing number of customers	A systemic crisis would have grave consequences for access	Competition increases pressure for MFIs to explore new market niches	Consumer protection measures may increase trust by the unbanked to use formal financial institutions		
Supportive Relationships						

Source: Adapted from (Genesis Analytics 2004, Table 3)

Interestingly, objectives can be both in competition with each other and complementary at the same time. If this is the case, it means that there is an optimal degree of achievement of a regulatory objective, which is not found by maximising it. For instance, too much competition can lead to reckless lending, while too little

competition does not provide MFIs with sufficient incentives to offer a good service. Porteous (2009a, 1) therefore argues instead for “healthy forms of competition.”

If it were possible to measure the social benefits of each objective in monetary terms, the optimum combination of indicators would be the one where the marginal benefit of one more dollar spent on achieving any one of the objectives is the same for all objectives. However, as it is impossible to express all the benefits in monetary terms, trade-offs among objectives can only be resolved through value judgements.⁶⁴ In other words, it is ultimately a public policy decision how these trade-offs are valued (Llewellyn 1995a, 207). The indicators introduced here allow me to examine progress with regard to any of the five objectives and to point out trade-offs among them. Yet they do not offer any final answers on whether the outcome is a social welfare optimum or not. This depends on how the observer values each of the objectives.

The importance of properly identifying impact indicators can be demonstrated with reference to the regulatory impact assessment for Zambia conducted by Chiumya (2006). This RIA does not even discuss which indicators can best be used to measure regulatory success. For example, the study uses the case of a single MFI, which was regulated by the Central Bank and still failed due to poor performance, as sufficient proof that even the proposed microfinance regulations would not achieve the objective of protecting depositors, which seems quite far-fetched (ibid., 215).⁶⁵

Each of the impact indicators can be categorised with reference to one of the following three dimensions:

⁶⁴ Compare a similar conclusion by Schreiner (2002, 592) in an article assessing the social benefits of microfinance: “The social costs and benefits of microfinance will never be measured perfectly, so most public-policy choices will turn on judgements that, because they cannot be proven, must be argued.”

⁶⁵ Such reasoning shows a preference for a *zero failure regime* as the failure of a single MFI (and even one regulated under a different legal framework) is used as a sufficient evidence that the central bank is in general not able to protect depositors’ funds.

Indicators measuring market outcomes versus institutional change: an important distinction can be made between indicators directly measuring market outcomes and those indirectly measuring regulatory impact by looking at institutional change triggered by regulatory provisions.⁶⁶ Typically, regulatory provisions, if effective, lead to institutional changes, which in turn can be measured by changes in outcome variables such as financial performance indicators of MFIs, number of customers served, etc. These are referred to as indicators measuring *market outcomes* or *direct indicators*. Ideally, all benefits of regulation would be directly measured by changes in market outcomes variables, which reflect the market response to institutional changes. However, changes caused by regulation do not, in all cases, immediately translate into market outcomes. For instance, it is quite difficult to measure the reduction of systemic risk by looking at market outcomes like the number of systemic crises because “a lack of disasters may be due to a fortuitous conjuncture, rather than to the effects of the supervisors” (Goodhart et al. 1998, 67). A better indicator would be institutional changes such as mitigating systemic risk by the setting up of a deposit insurance system. Many of the objectives are targeted at preventing something from happening, which means

that success is measured by an *absence* of unwanted events, for example, (multiple) financial failures and by customer losses and complaints. But are these outcomes, whether success in the form of absence of failure and complaints, or failures, due to luck and conjuncture or to the efforts of supervisors? (Goodhart 2001, 154, emphasis in original)

In such cases *institutional changes* are the better indicator.⁶⁷ The term institution is used here in the wide sense as defined by North (1990, 4): “Institutions include any form of constraint that human beings devise to shape human interaction.” It includes changes in *systems* (e.g., the introduction of an ombudsman service or the setting up of a deposit insurance fund) and *processes* (e.g., new procedures for

⁶⁶ Oxera (2006) uses a similar distinction to assess the benefits of financial regulation: direct measurement of improvements in market outcomes and indirect measurement using proxy metrics.

⁶⁷ See a similar distinction used by the World Bank (2006a, 26), which defines institutional indicators (as opposed to outcome indicators) as “institutional and structural data related to the financial sector . . . providing more fundamental measures of the markets, laws, infrastructure and environment.”

conflict resolution or the use of different accounting standards).⁶⁸ These institutional changes can be used as proxies for future developments as they eventually – but not immediately and not in a deterministic manner – lead to changes in market outcomes. They are also referred to as *indirect indicators* or *proxy indicators*. Oxera (2006, 23) refers to this as indirect measurement in contrast to the direct measurement of market outcomes:

Indirect measurement seeks to quantify improvements in the mechanisms, somewhere along the process, by which regulation delivers better market outcomes. This requires identification of the complete set of causal links between the direct impact of the regulation and the desired market outcomes, and validating that these links hold in practice. If valid, measures of improvements in the intermediate mechanisms are suitable proxies and can be used to infer the ultimate benefits of improved market outcomes.

For example, if disclosure requirements are used as a proxy for consumer protection, it is essential to verify that financial institutions have actually improved their disclosure policies (the question of enforcement) **and** that there is a causal link between better disclosure and better choice by customers. In some instances it will be difficult to identify or predict the causal links between institutional change and market outcomes in the specific case of Uganda. In such instances, reference will be made to empirical studies from other countries or theoretical studies on the same issue.

Quantitative versus qualitative indicators: A general distinction can be made between quantitative and qualitative indicators. Quantitative indicators mainly use performance data of the treatment and control groups. Qualitative indicators are based on evidence from interviews and the analysis of primary and secondary sources. Indirect measures of institutional change are always qualitative, while direct measures of market outcomes can be quantitative or qualitative. Only the combination of both, quantitative and qualitative evidence, allows me to draw a complete picture of regulatory impact. In some cases it is obvious how to rate the values of the indicator (e.g., a higher number of borrowers is obviously good for

⁶⁸ It is important to stress that institutional changes are not changes in laws and regulations, as these are my main explanatory variables in the analysis. Institutional changes measure real-world changes caused by legal reform and thus depend on the degree of enforcement of, and compliance with, regulation.

improving access). In other cases and in particular for qualitative indicators, the assessment is more contentious (e.g., who is regarded as a good owner?). In such cases the main reference will again be secondary sources such as empirical studies on the same issue (e.g., on the performance of MFIs with different ownership structures) or theoretical studies (e.g., on the incentive effects of capital adequacy requirements).

Indicators measuring impact on MDIs versus on consumers: A final distinction can be made between benefits of regulatory reform for the sector as a whole, for financial institutions, and for consumers (Oxera 2006, 7). The vast majority of indicators measure the impact of the new legal framework on the institutional/MDI level (indicators for the first three objectives – safety and soundness, systemic stability, and competition). While there is a strong overlap between the benefits of regulation for MFIs and the benefits measured by the ROI approach, they are not identical. Rhyne (2002, 3) summarises the main benefits for MFIs of becoming regulated as follows:

- Greater access to sources of funds for both equity and debt, especially commercial sources
- Ability to achieve growth and quantitative outreach goals: to serve more people
- Improved, more professional operations through meeting higher standards of control and reporting
- Greater ability to offer products beyond microcredit, especially savings and transfers.
- Enhanced legitimacy in the financial sector and with clients.

All of these benefits are also of relevance for the achievement of one or the other of the five regulatory objectives. A few indicators assess the wider impact on the financial sector, especially on competition and systemic stability, and some look at the direct impact on consumers (e.g., indicators looking at product offerings and customer satisfaction). Changes in access can best be measured by looking at

the type and number of products sold, which is again data most easily collected on the institutional level. It is assumed that improvements on the sector-wide level and institutional level ultimately also increase social welfare by benefiting clients in form of lower prices, better services, and lower counterparty risks.⁶⁹

Main Impact Indicators for Each Regulatory Objective

Table 2.4 below summarises the main areas covered by various indicators broken down by the five regulatory objectives. It distinguishes between direct indicators measuring market outcomes and indirect measures making use of proxies describing institutional changes. A much more detailed list of indicators can be found in Appendix 2, which was used for the case study below (see Chapters 4 and 5). Both tables provide generic lists of impact indicators, which have to be adapted according to the data available in the specific country case. At this point, the main interest is to describe the general approach of using indicators to measure regulatory impact.

⁶⁹ With a lack of competition there is, however, a risk of MFIs appropriating all consumer surplus (Oxera 2006, Fn 3).

Table 2.4: Regulatory Impact Indicators

Objective 1: to promote the safety and soundness of MFIs	
MARKET OUTCOME: performance indicators MFIs	INSTITUTIONAL CHANGE: operational changes of MFIs and supervisory processes
<ul style="list-style-type: none"> • Profitability ratios • Capital ratios • Liquidity ratios • Portfolio quality ratios • Incidences of loss of savings 	<ul style="list-style-type: none"> • Ownership, governance and operations: board and management composition; MIS; internal controls; external audit • On- and off-site procedures: frequency of visits; early detection of problems; independence of regulator • Corrective actions / problem resolution • Bankruptcy procedures • Credit information sharing
Objective 2: to guard against systemic risk	
MARKET OUTCOME: frequency and severity of sectoral crises	INSTITUTIONAL CHANGE: measures aimed at reducing the probability of runs and contagion
<ul style="list-style-type: none"> • Overall deposit base of financial institutions • Incidences of crises spreading from one financial institution to another • Trust in MFIs and confidence in safety of deposits 	<ul style="list-style-type: none"> • Safety and soundness of MFIs: see Objective 1 • Deposit insurance system • Access to short-term liquidity support
Objective 3: to establish a competitive market	
MARKET OUTCOME: competitiveness indicators	INSTITUTIONAL CHANGE: measures targeted at promoting competition (or minimising regulation's negative impact on competition)
<ul style="list-style-type: none"> • Market growth: growth in customers, products and geographical reach • Efficiency and productivity ratios • Interest rate spreads • Structure-related competition measures: concentration ratio; Herfindahl-Hirschman Index; dominant player(s) • Customer responsiveness: customer service; product range; responsiveness to customer demands; branding • Perceptions about competition: perceptions by clients and financial institutions • Customer satisfaction 	<ul style="list-style-type: none"> • Barriers to entry: licensing conditions and procedures; minimum capital requirements; MFIs' perceptions about barriers to entry • Foreign participation • Credit information sharing • Role of regulatory authority in ensuring competitive financial market: role of financial regulator or competition regulator

Objective 4: to protect consumers	
MARKET OUTCOME: frequency and resolution of consumer grievances	INSTITUTIONAL CHANGE: consumer protection regime
<ul style="list-style-type: none"> • Incidences of consumer grievances: types and frequency (e.g., mis-selling, unethical treatment, etc.) • Resolution of consumer grievances: to whom have customers turned? Have problems been resolved? How? • Perceptions about consumer protection: customer satisfaction and MFIs' self-evaluation • Loss of depositors' money 	<ul style="list-style-type: none"> • Preventive measures: interest rate limits; limits on range of products; limits on outsourcing; minimum disclosure requirements; codes of professional conduct; data privacy; competency standards; etc. • Customer redress mechanisms: consumer agency; alternative dispute resolution schemes; small claim procedures; compensation schemes • Consumer empowerment: statutory role for consumer education • Transparency / disclosure requirements
Objective 5: to improve access	
MARKET OUTCOME: access indicators	INSTITUTIONAL CHANGE: regulatory measures targeted at improving access
<ul style="list-style-type: none"> • Breadth of access: number of clients; numbers of various financial products sold; volumes for various products; ; new versus repeat clients • Depth of access: poverty of clients measured by average loan size, rural versus urban clients, composition of loan portfolio • Length of access: safety and soundness of MFIs • Scope of access: number of types of financial contracts supplied • Quality of access: studies on customer perception/satisfaction, impact, and social performance • Affordability of access: reduction in interest rates/portfolio yields; transaction costs for customers 	<ul style="list-style-type: none"> • Role of regulatory authority in ensuring improved access: access as statutory or expressly stated objective; importance of access in regulatory decisions • Changes in MFI's policies: loan policies; vision/mission; target group identification; code of conduct/ethics; etc. • Regulatory requirements impacting on MFI's policies: composition of board (social versus purely commercial investors); loan size limit; credit information sharing; single shareholder limit; etc. • Credit information sharing

The following summarises briefly the main strategy for identifying impact **indicators** for measuring each of the five regulatory objectives. The focus of the analysis will always be on **changes** in any of these indicators, and not on their absolute level.

Objective 1 – to promote the safety and soundness of MFIs – can best be measured with reference to quantitative indicators, in particular performance indicators of MFIs. Depending on the availability of a good control group with sufficient data, the difference-in-differences approach controls for changes in non-

regulatory factors. Regulation is likely to have an impact – even if not always clear – on main market outcome variables such as profitability, portfolio quality, capital, and liquidity ratios. Better performance is first and foremost good for the MFIs. In a competitive market part of the benefits will be passed on to consumers. However, if the benefits to firms are only due to higher monopoly rents, MFIs might be safer and sounder, but the regulatory impact will score poorly under the competition and access objective.

In particular for cases of relatively recent regulatory changes (such as Uganda), it might be that the impact is not yet showing strongly in the data. Institutional changes brought about by regulation are valuable indicators for the future performance of MFIs. This is particularly true for ownership and governance changes.⁷⁰ The proposed indicators assess institutional changes in MFIs themselves or in supervisory practices. Corrective actions and bankruptcy procedures only become relevant if the institution's performance is unsatisfactory, but they are then of great importance for protecting customers from unwarranted losses. Credit information sharing is one way of lowering credit risks by improving information on repayment probabilities (Jappelli and Pagano 2005).

Objective 2 – to guard against systemic risk – is much more difficult to measure directly. As systemic crises occur only very rarely – but when they do, typically have grave consequences for the sector – the number of systemic events is not the best measure for the magnitude of the risk. Still, it might be possible to study the incidence of crises spreading from one financial institution to another, even if these did not lead to sector-wide crises. While direct indicators of systemic risk are difficult to identify, a number of indirect indicators can be used to assess the probability of future systemic events. According to Carmichael (2004, 107), the best defence against contagion is sound financial institutions (and macroeconomic stability, which lies outside the reach of financial regulation). This means that all indicators for Objective 1 can be used as proxy indicators for Objective 2.

⁷⁰ The following sources look at ownership and governance issues of MFIs: Campion and Frankiewicz (1999), Otero and Chu (2002), Lapenu and Pierret (2005), and Ledgerwood and White (2006, Ch. 7). Mersland and Strøm (2008) challenge the conventional view that shareholder owned firms show superior performance.

Another indicator is an (implicit or explicit) deposit insurance system, which should reduce depositors' incentives to run on an MFI in the first place and protect them against loss of deposits during systemic crises.⁷¹ Short-term liquidity support (as far as it can be identified as regulatory impact) such as a lender-of-last-resort facility or better access to the interbank-market can be used as another proxy indicator as it reduces the risk of contagion through the credit channel.

Objective 3 – to establish a competitive market – can be directly measured by looking at indicators for market saturation such as number and volume of loans/savings accounts, and number of branches. It will be important to define the relevant market, as this might not necessarily be restricted to the regulated micro-finance market, but could also include part of the unregulated market offering similar services (the question of *substitutability*). Competition problems might be restricted to a confined geographical area (the problem of local monopolies). Increasing competition puts pressure on institutions to increase their productivity and efficiency of operations, reduce lending rates, increase deposit rates, offer products which are better suited to a diverse clientele, improve customer service – in short to make use of product and process innovations to be at least as good and cheap as the competition.⁷² Structure-related measures such as the concentration ratio or the Herfindahl-Hirshman Index can be used to assess market concentration (Porteous 2009a). These market indicators can be complemented by perceptions of both clients and financial institutions regarding competition in the micro-finance market and customer satisfaction as an indicator for customers' perception about client responsiveness.

A number of institutional changes brought about by regulation can be used as indirect measures of competition. The main – and potentially harmful – impact on competition can be increased barriers to entry. These can be analysed by reviewing licensing conditions and procedures. In addition, MFIs themselves and other informed stakeholders can be asked about their perceptions concerning barriers to

⁷¹ See Barth, Caprio Jr. and Levine (2006, Appendix 1 and 2, Section 8 respectively) for a list of indicators measuring deposit protection schemes.

⁷² A lack of competition does not necessarily show in higher than average profits, as these could also be dissipated in higher administrative costs (Hardy, Holden, and Prokopenko 2002, 14).

entry. The openness to foreign participation in the microfinance sector either through equity investments in MFIs or through wholly foreign-owned subsidiaries can be a sign of a more competitive market.⁷³ Credit information sharing typically increases competition through more transparency in the market. And finally a regulatory authority, which could either be the financial regulator or a separate competition regulator, can have the statutory role of creating a competitive financial sector.

Objective 4 – to protect consumers – is targeted at the consumer level and the way financial institutions do business with consumers. Prudential and systemic regulation certainly have a positive impact on the consumer protection objective, but conduct of business regulation complements these by protecting against any residual market failures. Conduct of business regulation for microfinance can be measured with reference to the three core consumer protection principles—transparency, fair treatment, and effective recourse (Brix and McKee 2010, Box 1). Direct indicators for the consumer protection objective look at changes in the number and type of consumer grievances and the redress mechanisms employed. Grievances can be caused by mis-selling (such as selling misleadingly, fraudulently, or in violation of laws or regulations), and unprofessional or unethical treatment of customers (FSA 2003a). If there is no central authority in charge of receiving consumer complaints, it is likely to be difficult to get any comprehensive statistics about incidences and resolution of consumer grievances. In addition to hard evidence about consumer grievances, perceptions by customers as well as MFIs can be used as supporting evidence. If customer satisfaction surveys are available, they can also be used as another indicator, as can self-evaluations of MFIs regarding their dealings with customers. Unsatisfactory conduct of business is one reason consumer protection issues arise, the other one being the failure of an institution where clients hold funds, leading to loss of savings (Llewellyn 1999, 10). The indicator should be whether depositors have been protected against losses which they could not realistically have prevented by exercising due care in selecting the depository institution.

⁷³ Demirgüç-Kunt, Beck and Honohan (2008, 77-84) discuss the positive effect of foreign banks on access and competition.

If the number of customer grievances is low, it does not necessarily mean that there were not any problems, but it could also be that customer protection measures have only been rarely “tested” and not much can be said about their effectiveness. In such a case, changes in the consumer protection regime can be used as proxy indicators for the consumer protection objective.⁷⁴ Any statutory provisions specifically dealing with consumer protection will be of interest. A regulatory change can bring new institutions under an existing consumer protection regime (this is typically the case if MFIs are brought into the formal financial sector and enjoy the same consumer protection rules as banks), or can create new consumer protection regulations altogether. Regulatory measures in this area can be preventive (e.g., interest rate limits, prohibition on high risk products, limits on outsourcing of core banking activities to agents, restrictions on offering tied products, minimum requirements for disclosure and sales practices, data privacy rules, codes of professional conduct, minimum training and competency standards for staff, etc.) or protective. Protective measures include remedial measures, which offer recourse to consumers if they have been aggrieved. Such remedial measures could be redress through a consumer protection agency (general or specific for banking), alternative dispute resolution such as an ombudsman or another neutral third party, recourse through the judiciary (including small claims procedures), and compensation schemes (such as deposit insurance or other payout rules in cases of liquidation). Consumer protection rules can only be effective if consumers have the capacity to process information offered to them (in other words, to make an **informed** choice) and make use of available dispute resolution mechanisms. Consumer empowerment and financial capability therefore play an important role in protecting consumers (Miller et al. 2009).

Objective 5 – to improve access – can potentially be one of the main benefits of regulation. For measuring the direct impact of regulation on access I will look at a variety of access indicators. Access has various dimensions. Following Schreiner (2002), one can distinguish depth, breadth, scope and length of access. For all these dimensions I will define specific indicators.

⁷⁴ See World Bank (2009) for a diagnostic tool of consumer protection and financial literacy.

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- *Breadth of access* can be measured by the number of clients reached, volume and number of various financial products sold. A breakdown of client numbers by repeat clients versus new clients helps to answer the question whether new client groups have been reached.⁷⁵
 - *Depth of access* refers to reaching poorer clients. It is assumed that an additional dollar income has a higher weight if it benefits a poor person rather than a rich one.⁷⁶ The most commonly used proxy for measuring depth of access is loan size.⁷⁷ Similar indicators can be used for the savings business of MFIs assuming that there is a correlation between savers' poverty level and their savings amount. If there is a premium for rural outreach, as rural areas typically have the least access to finance, another indicator could be the geographical reach of financial services.
 - *Length of access* measures the self-sustainability of institutions as a precondition for their long-term survival. The bottom line should be that an MFI is safe and sound, which is measured by the first regulatory objective. Thus indicators listed under this objective will also be indicators for length of access.
 - *Scope of access* is defined as “the number of types of financial contracts supplied” (Schreiner 2002, 596). If the regulatory change allows MFIs for the first time to introduce savings services, this should lead to a substantial increase in scope of access. Indicators for scope look at the range of products offered and their characteristics (such as individual versus group loans, flexibility of repayment schedules, tenor, and loan amounts, costs, collateral requirements for loans; minimum balance requirements, interest paid, restrictions on withdrawals for savings and transaction accounts, etc.).⁷⁸

⁷⁵ The *access frontier approach* developed by Porteous (2005) is useful for measuring current and future access to financial services.

⁷⁶ In other words, I do not use the Kaldor-Hicks efficiency criterion according to which losers could in theory be compensated by winners.

⁷⁷ For a discussion of the usefulness of this indicator, see Christen (2001). Despite its limitations, it is still widely used to measure outreach (Cull, Demirgüç-Kunt, and Morduch 2009a; Mersland and Strøm 2010).

⁷⁸ The World Bank (2006d; 2006c) distinguishes between access and usage with access being defined as “access to and the *possibility* of utilizing financial services (emphasis in original).” Most of the indicators I am using for access look at what they call usage, while some of the indica-

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- *Quality of access*, finally, looks at customer perceptions of and satisfaction with the supply of products. These could be covered in customer surveys (such as FinScope studies), social performance, or impact studies.⁷⁹

There is the possibility that regulation has substitution effects in the semi-formal sector so that access indicators in the formal sector improve, but at the same time deteriorate in the semi-formal sector. This happens if the regulatory change leads to stricter overall regulation (or better enforcement of existing regulation) thereby making it more difficult for customers to access (beneficial) financial services from unregulated MFIs.⁸⁰ This should be considered if measuring overall changes in access.⁸¹

Especially in countries where the regulatory change has only been recently introduced, it might not yet be possible to see much change in access indicators. Proxy indicators for future access can be used as additional information. The access objective could be enshrined as one of the statutory objectives for the regulator. Even if this is not done, it would be interesting to know whether the regulatory authority considers access to be an important objective. Looking at MFIs, some of the changes in policies such as loan policies (e.g., loan size limit), mission and vision, code of conduct and ethics, and target group identification can be used as indicators for the access objective – if it is possible to establish a clear causal link to regulation. Moreover, some of the regulatory measures can have a direct impact on access such as, for example, if the regulator insists on bringing more purely commercial investors on board (a potentially negative impact), sets strict loan size limits, or requires credit information sharing (potentially positive impact).⁸² Fi-

tors for scope of access measure access (unless I look at the characteristics of products actually sold).

⁷⁹ See <http://www.finscope.co.za> for FinScope studies on financial perceptions and <http://www.microfinancegateway.org/p/site/m/template.rc/1.11.48260> on the concept of social performance (both accessed 11 May 2009).

⁸⁰ Wright and Mutesasira (2002) are even concerned about overall access deteriorating by regulation driving semiformal MFIs out of the market.

⁸¹ If this happens, the difference-in-differences approach will overstate the impact of the regulatory change.

⁸² Galindo and Miller (2001) have looked at the impact of credit registries on access. The World Bank (2006b) in its research on Financial Sector Development Indicators has found a positive

nally, the permission for financial institutions to make use of retail agents and technologies (such as mobile phones) to deliver financial services outside traditional bank branches – *branchless banking* – can have a potentially huge impact on improving access (Lyman, Pickens, and Porteous 2008).

Conclusion

This chapter has introduced a unique methodology for assessing the regulatory impact in microfinance that is firmly based on an analysis of market failures in microfinance. The main assumption is that regulation is supposed to aim at improving social welfare. Similar studies have suffered from a lack of a clear benchmark in the analysis. The ROI approach does not only include such a benchmark – the public interest benchmark – but also suggests a methodology of how to assess progress with respect to the benchmark by making use of impact indicators.

From the analysis of the main market failures in microfinance it becomes clear that the difference between microfinance and conventional banking is not as stark as one might think. The list of the main market failures is the same – imperfect competition, information problems, and externalities – only their significance differs. Thus the basic rationale for regulating microfinance and the regulatory objectives are quite similar to that of banks. Regulatory objectives are based on the premise that regulation can either alleviate market failures or – to the extent that residual market failures continue to exist – shield consumers against their negative consequences. One important addition to the usual canon of regulatory objectives is the access objective, as both theoretical considerations and empirical evidence show that access continues to be a serious problem even in a market-based financial system.

The rationale and objectives together constitute the public interest benchmark for the analysis of regulatory impact. In a second best world, this public interest benchmark is not a fixed target. The main assessment criterion is whether regula-

correlation between its depth of credit information index and private credit extended (as percentage of GDP).

tion has led to progress with reference to each of the five public interest objectives. Impact indicators that either measure changes in market outcomes or institutional changes are used to assess the impact of the regulatory reform on achieving these regulatory objectives. After having answered the Main Research Question of how to assess the impact of regulatory reforms in microfinance, the following three chapters make use of the RIA methodology to assess the introduction of the MDI regime in Uganda.

CHAPTER 3 – THE MAIN CHARACTERISTICS OF THE MDI REGIME AND ITS EXPECTED IMPACT ON THE REGULATORY OBJECTIVES

Ugandan microfinance has reached a critical point in its development. Either it will evolve into a dynamic market that is fully integrated into the national financial system, and provides a wide range of financial services to most of the population, or it will remain a successful, but marginal, development niche.

Goodwin-Groen, Ruth, Till Bruett, and Alexia Latortue. 2004. *Uganda Microfinance Sector Effectiveness Review*. Washington, DC: CGAP, p. iv

This thesis uses Uganda as a case study for assessing regulatory impact in microfinance. Uganda was at a crossroads in microfinance when the first licence under the new MDI Act was issued in 2004. This chapter provides the background information about the Ugandan banking and microfinance sector that is required to understand how the development of a special microfinance law fits into the broader financial sector developments. It explains the general approach the MDI Act takes in regulating microfinance and provides a broad analysis of the legal framework for MDIs by conducting an exegesis of the legal texts. The objective is to identify the most salient features of the MDI regime and deduce some hypotheses about its likely impact, which can then be tested empirically in subsequent chapters with the use of the ROI approach. The main points of reference are the regulatory objectives developed in the previous chapter and relevant literature on analysing legal frameworks for microfinance.

3.1. Overview of Uganda's Banking and Microfinance Sector

Uganda's microfinance sector has to be seen in the context of the wider economic, social, and political environment in Uganda. It would go beyond the scope of this thesis to discuss this wider context in detail. Instead, this section only discusses the main characteristics of the financial sector with relevance to microfinance regulation. In particular, it looks at the development of the financial sector and its regulation in general, and gives a short overview of the microfinance sector and how it has evolved from its early days in the 1980s. A more detailed analysis of

the political system and its relevance for microfinance regulation in Uganda will be provided in Chapter 7.

General Financial Sector Development

The main laws governing the financial sector in Uganda and of interest for this study are the Bank of Uganda Act (Cap. 51) (*BoU Act*) as the central bank law, the Financial Institutions Act (Cap. 54) (*FIA*) as the law governing banks and non-bank financial institutions (*NBFI*), and the new Microfinance Deposit-Taking Institutions Act (2004) (*MDIA*). According to SEC. 4 (2)(j) of the Bank of Uganda Act, BoU is the supervisor and regulator of all financial institutions. Savings and credit co-operatives (*SACCOs*) are regulated under a separate law, the Uganda Co-operative Societies Statute (Cap. 112). The Commissioner for Co-operative Development within the Ministry of Tourism, Trade and Industry (*MTTI*) is responsible for supervising and inspecting SACCOs. The main regulatory requirements under the SACCO law are the submission of audited annual accounts and the maintenance of minimum capital corresponding to at least a third of subscribed capital, which are, however, in at least 25% of cases not enforced (Tier 4 Technical Working Subcommittee 2005, Ch. 3.5.1). The co-operative sector in Uganda has had its own challenges and will only be discussed in this study in as far as its development is affected by the introduction of the MDI regime.

Like many other African countries, Uganda's banking sector has gone through a phase of financial liberalisation accompanied by regulatory and institutional reform. After a protracted civil war, in 1986 the National Resistance Movement (*NRM*) under Yoweri Museveni came into power and a year later launched the Economic Recovery Programme. In 1993, a revised central bank law (Bank of Uganda Act, CAP. 51) and a new law for banks and non-bank financial institutions (Financial Institutions Statute, CAP. 54) were introduced. Nonetheless, the banking sector experienced a phase of distress when four private local banks, which together held 12.1% of the Ugandan banking system deposits, were closed in 1998/99 (Brownbridge 2002).⁸³ Between 1994 and 1998 half of the banking

⁸³ More on the 1998/99 banking crisis can be found in Lawyer (2000) and Mpuga (2002).

system faced solvency problems (Caprio and Klingebiel 2003). The closure of these banks was at least partly blamed on an inappropriate legal environment and the weakness of the Department of Bank Supervision in BoU (Lawyer 2000, 10). Among them was the Cooperative Bank, which only the year before had opened six microfinance agencies targeting the microenterprise sector (USAID et al. 1998, 45).⁸⁴ Part of the response by the regulator to the 1998/99 crisis was to put a moratorium on any new bank licences, which was only lifted in 2005. The closure of these banks had a serious impact on confidence in the banking sector and in the safety of deposits (World Bank and IMF 2005, 13).

In 2001, a struggling state-owned bank, Uganda Commercial Bank, which was not only the biggest bank by assets but also had the largest branch network, was successfully sold to Stanbic Bank of South Africa (Clarke, Cull, and Fuchs 2009). Subsequently, further reforms in banking regulation have been introduced by revising the financial institutions law with the aim of bringing it in line with the Basel Core Principles for Effective Banking Supervision (now called the Financial Institutions Act 2004).

The report of a joint World Bank-IMF mission at the end of 2004 as part of the Financial Sector Assessment Program (*FSAP*) concludes:

The banking system is sound but continues to play a limited role in supporting economic development. Financial intermediation continues to be low. . . . While the banking system is healthy, it is still small, faces relatively high costs, and offers a limited array of products. (World Bank and IMF 2005, 6)

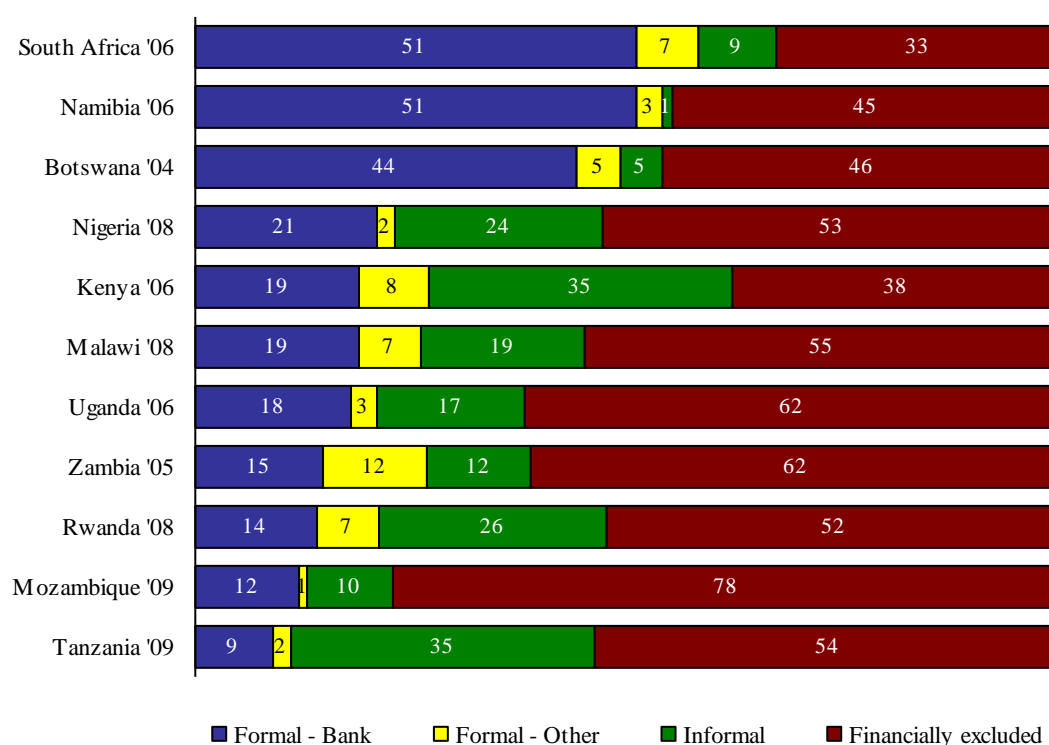
The *FSAP* report sees the shift to a risk-based approach as an important step:

“There has been a major change of emphasis in the supervisory processes from compliance with regulation to identifying the risks faced by financial institutions and assessing the capacity of the institutions to manage those risks. . . . It is already evident that although this process is just beginning, Uganda is already further down the road than most other African countries.” (ibid., 36)

⁸⁴ The microfinance agencies were later taken over by a newly founded credit institution, Commercial Microfinance Ltd. (CMF), while the rest of the bank was dissolved.

Looking at the wider legal environment for banking, important reform steps are still outstanding. In particular, the Bankruptcy Act is outdated and an Insolvency Act is still lacking.⁸⁵ Effective contract enforcement is hampered by inefficiency, inadequate skills and corruption in the court system (IMF 2003, 33). The Official Receivers Department lacks resources and staff and is subject to political interference. While a Commercial Court was set up in 1999, it lacks resources and well-trained staff (World Bank and IMF 2005, 19).

Figure 3.1: Access Strands in Sub-Saharan Africa



Source: FinScope Surveys (conducted in years closest to 2006), FinMark Trust (<http://www.finmark.org.za>, accessed 9 February 2010)

Most of the financial development indicators for Uganda have historically been quite weak, but recently have been improving. Access to financial services is low, but on a comparable level with the neighbouring countries, Kenya and Tanzania. Figure 3.1 above summarises the results from FinScope surveys in a number of countries in Sub-Saharan Africa. It shows that in 2006 62% of Ugandans were still financially excluded, i.e., did not have access to any formal, semi-formal or

⁸⁵ An Insolvency Bill has been drafted (Suruma 2008), but not yet introduced to Parliament by end 2009.

informal financial services. Only 18% had access to formal financial institutions (Steadman Group 2007).

However, recent growth figures have been impressive, with private credit by commercial banks having grown by 56.7% in FY 2007/08 (BoU 2008a, 35) and 40.1% between March 2008 and March 2009 (MoFPED 2009, 27-28).⁸⁶ Total deposits increased during the same period by 25.5% despite the onset of the global financial crisis. Savings rates used to be among the lowest in the world at 5.9% of GDP in 2005 (Pelrine and Kabatalya 2005, 1), but have recently increased to about 10% (Suruma 2007).

The number of branches fell drastically from a high in the 1970s, but has recently been growing and finally reached the 1970s level again in 2008. By April 2009 seven new banks had been licensed after the lifting of the moratorium, which increased the total to 21. In April 2009 the number of branches stood at 325 (MoFPED 2009, 26-27). This figure corresponds to 1.9 branches per 100,000 adults, which is a slightly better ratio than Tanzania (1.8), but less than half of Kenya's figure of 4.0 (CGAP 2009, Table S1). Spreads and overhead costs are higher than in comparable countries (World Bank 2006d), but recently have been coming down.⁸⁷ Agricultural finance remains one of the major challenges in the sector (Meyer, Roberts, and Mugume 2004).

The Microfinance Sector in Uganda

This section gives a brief overview of the microfinance sector in Uganda from its emergence in the 1980s to the present day. The focus is on information needed for understanding the regulatory impact assessment described in subsequent chapters. Apart from SACCOs, which have their own specific history in Uganda and are not part of this thesis, and informal financial services like *Rotating* or *Accumulating Savings and Credit Associations*, the first specialised MFIs emerged in the mid-1980s with Uganda Women's Finance Trust (*UWFT*) being founded in 1984 and

⁸⁶ The financial year in Uganda runs from July to June.

⁸⁷ The spread between the lending rate and the time deposit rate decreased from 11.94% in 2004 to 8.38% in 2008 (BoU 2008a, 30).

Centenary Rural Development Trust starting operations in 1986 (the latter transformed into Centenary Rural Development Bank in 1993). Many more specialised microfinance NGOs started their lending operations in the mid-1990s.⁸⁸ In 1996, the Association of Microfinance Institutions of Uganda (*AMFIU*) was founded as a membership network for the microfinance industry representing all types of financial institutions offering microfinance.

The microfinance sector can be broadly divided into three sub-sectors according to their legal status:

- Formal financial institutions offering microfinance as a (or the main) line of business, and being licensed either as a commercial bank or a credit institution under the FIA, or MDIs licensed under the new MDI Act
- Semi-formal financial institutions being registered as SACCOs, NGOs and/or companies limited by guarantee or shares⁸⁹ and
- Informal financial institutions

In 1999, BoU issued a Policy Statement in which the “tiered approach” was defined for the first time [UD/R/5]. This tiered concept, even though it is not a legal categorisation, has since been accepted as the main categorisation of the microfinance industry in Uganda.

- Tier 1: Commercial banks licensed under the FIA
- Tier 2: Credit institutions licensed under the FIA. Credit institutions are restricted to a more limited list of financial services and businesses than commercial banks. Among others, they are not permitted to offer demand deposits withdrawable by cheque and foreign exchange facilities, and they do not participate in the interbank clearing system (Second Schedule to the FIA)

⁸⁸ Among others these are FINCA Uganda in 1992, Feed the Children (now PEARL Microfinance) in 1994, UWESO (now Success Microfinance), UGAFODE and FAULU in 1995, PRIDE and FOCCAS in 1996, and UMU and MED-Net in 1997.

⁸⁹ Many of these semi-formal MFIs are registered both as an NGO and a company limited by guarantee.

- Tier 3: This is the newly created tier for microfinance deposit-taking institutions licensed under the MDI Act – the topic of this study⁹⁰
- Tier 4: All financial institutions involved in microfinance which do not qualify as Tier 1, 2 or 3. In general, the Tier 4 category is understood to include all member-based savings and credit associations (SACCOs), microfinance NGOs and companies (which I refer to as credit-only MFIs) and any other MFI incorporated under a Ugandan law.⁹¹

Tiers 1 to 3 fall into the category of formal financial institutions, while Tier 4 institutions are semi-formal. For ease of reference, all Tier 4 MFIs, which are registered as NGOs and/or companies, will be referred to as *non-SACCO Tier 4 institutions*. Table 3.1 summarises available information on the number of MFIs in each tier.

Table 3.1: Number of MFIs in Different Tiers

<i>Year</i>	<i>Tier 1</i>	<i>Tier 2</i>	<i>Tier 3</i>	<i>Non-SACCO Tier 4</i>	<i>SACCO Tier 4</i>
Mid-2006	1	1	4	181	767
End-2008	2	0	3	n/a	1,383

Source: MoFPED (2006) and AMFIU (2009). 2006 figures for SACCOs are numbers of outlets.

It is generally assumed that Tier 1 includes Centenary Bank (previously called Centenary Rural Development Bank) as the only bank specialising in microfinance, Tier 2 Commercial Microfinance Ltd. (CMF), and Tier 3 the four MDIs licensed since promulgation of the Act.⁹² In 2008, CMF was bought by Global

⁹⁰ There was some confusion about the correct long form of the acronym MDI. For a long time, the draft MDI Bill was referred to as the Micro Deposit-Taking Institutions Bill (without “Finance”), which was later changed into Micro Finance Deposit-Taking Institutions Act. I will use the latter term with microfinance in one word, as it is nowadays common practice.

⁹¹ It is obvious that Tier 4 is something like a default category or “dumping ground” [MOT/I/C/32]. The original BoU Policy Statement only included “very small member-based organisations” in Tier 4. In practice, however, all SACCOs irrespective of their size are regarded as Tier 4 MFIs. Community based organisations are sometimes also included in this category, even if they are not registered under any of the relevant laws.

⁹² Sometimes, e.g., by the Tier 4 Technical Working Subcommittee (2005) and MoFPED (2006), Post Bank Uganda is also referred to as a Tier 2 MFI. It is, however, not included here as Post

Trust Bank and one of the MDIs (UML) by Equity Bank Kenya. Both have since joined Tier 1 and become commercial banks, with only Equity Bank continuing to offer microfinance services.⁹³ It is difficult to get reliable data on the number of MFIs in Tier 4. A recent survey found 792 Tier 4 MFIs with 905 “active outlets” (i.e., stand-alone institutions or branches of an institution), of which 767 are SACCO and 181 non-SACCO outlets (MoFPED 2006, 5). By October 2008, the number of SACCOs had increased to almost 1,400 (AMFIU and Friends Consult 2009, 7).⁹⁴

The Introduction of a Special Microfinance Law

The main policy change analysed in this thesis is the introduction of the legal framework for MDIs. This section summarises the main stages in developing this new regime, while Chapter 7 below provides a much more detailed discussion of the roles played by the various stakeholders in this process.⁹⁵ The first discussions about creating a separate legal framework for microfinance were held in 1995/96, and led to the publication of a comprehensive report including an appendix with a three page draft microfinance institutions law [UD/R/1]. This was mostly an initiative of microfinance practitioners. The Central Bank responded by articulating its own perspective on the regulation of the microfinance industry at an AMFIU workshop in December 1997 [UD/R/3]. Soon after, the *National Microfinance Forum* was founded, chaired by the Ministry of Finance. According to an active participant in these early days [DON/I/C/66], two conferences held in Kampala [UD/R/4] and Nairobi (USAID et al. 1998), respectively, in May 1998 had a strong influence on shaping the debate, as they included dedicated sessions on microfinance regulation. The conference was attended by Ugandan players from BoU, the Ministry of Finance, and MFIs who later on played a key role in driving

Bank is not active in the retail microfinance market, but only offers wholesale loans to MFIs under its linkage banking programme [UD/R/6].

⁹³ FAULU, a Tier 4 MFI, was granted a credit institution license in March 2009 and thus graduated to Tier 2. It has since been renamed Opportunity Uganda Ltd.

⁹⁴ Their assessment is probably based on an earlier Tier 4 survey conducted by MoFPED, which is not publicly available and counted a smaller number of Tier 4 MFIs.

⁹⁵ Braun and Hannig (2006) offer a good summary on the design of the MDI Act.

the regulatory agenda. Later in 1998, the National Microfinance Forum published a comprehensive report on microfinance with one chapter dedicated to the “Policy, Legal, and Regulatory Framework” [UD/R/66].

In 1999, BoU took over the initiative from practitioners and started drafting a “Micro-Finance Bill” [UD/L/2]. The drafting process was guided by BoU’s “Policy Statement on MFI Regulation” (henceforth *BoU Policy*) which it had developed with the assistance of the new GTZ-supported Financial System Development Project (*FSD Project*) and was finalised in March 1999 [UD/R/5]. The Policy Statement sets out the general tiered structure introduced above and was later approved by the Ugandan Cabinet.⁹⁶ BoU finalised a first complete draft of the MDI Bill in October 2000 and forwarded it to the Ministry of Finance. The final MDI Bill had 78 pages and was passed by Parliament in November 2002, assented to by the President in April 2003 and came into force on 1st July, 2003. In a parallel process, BoU started drafting the implementing regulations under the MDI Act in 2001. It took until 15th October, 2004, for the full set of regulations to be issued, covering licensing, liquidity and funds management, capital adequacy, asset quality, and reporting regulations.⁹⁷

Subsequently, BoU granted four MDI licences: FINCA Uganda Ltd. (*FINCA*) in October 2004, PRIDE Uganda Ltd. (*PRIDE*) and Uganda Microfinance Ltd. (*UML*) in June 2005 and Uganda Finance Trust Ltd. (*UFT*) in October 2005.⁹⁸ To this day, these are still the only MDIs to have received a licence, and their number

⁹⁶ It was not possible to verify what the exact content of the Cabinet Memorandum was. According to [UD/C/60], the Policy Statement on the Regulation of Microfinance Business was contained in Cabinet Minute No. 247 (CT 2000) dated 21 June 2000.

⁹⁷ The five sets of regulations were published as Statutory Instruments 2004 No. 61 to 65, 15th October 2004.

⁹⁸ Some of the MFI changed their names when they transformed from NGOs into companies. UML used to be called Uganda Microfinance Union (*UMU*), while UFT was Uganda Women’s Finance Trust (*UWFT*). For a while, UFT used the acronym U-Trust, while in 2008 it changed its brand name into Finance Trust. I will use UFT throughout this thesis as this is the name of the regulated entity.

has subsequently reduced to three since UML became Equity Bank Uganda at the end of 2008.⁹⁹

With this background information it is possible to take a closer look at the regulatory framework for MDIs, first by looking at the general regulatory approach (3.2) and then by an analysis of its main provisions (3.3).

3.2. The Regulatory Approach for MDIs

Before looking at individual regulatory provisions in the following section, this section describes the broad approach for regulating MDIs in Uganda by categorising it according to a number of criteria such as institutional versus functional regulation, demarcation of various regulatory windows (tiers), and the institutional structure of regulation. Both this and the following section do not try to exhaustively discuss all characteristics of the MDI regime, but to summarise its most salient features with a view to deriving some hypotheses about the expected regulatory impact and some initial observations from the analysis of the legal texts. The hypotheses will later be tested empirically and the observations substantiated.¹⁰⁰

Institutional versus Functional Regulation

The regulatory regime for microfinance follows a tiered structure as explained above, which “reflects the concept of **microfinance as a line of business**. . . . The tiered approach incorporates the fact that it may be necessary to regulate different intermediaries in a different manner” (Kalyango 2005, emphasis added). The concept of *microfinance as a line of business*, as it is known in Uganda, or as a *function* or *activity*, as it is known otherwise, means that microfinance can be conducted by all four tiers under various institutional forms and under different laws. Microfinance is regarded as a product line with specific characteristics that can be offered by various types of financial institutions. Before analysing the implemen-

⁹⁹ Equity Bank Uganda was licensed by Bank of Uganda on 20 December 2008, which coincides with the end of the observation period of this thesis.

¹⁰⁰ Compare the similar approach used by Okumu (2007, 6.4.2), who hypothesises about the likely impact of the law on outreach and sustainability before testing his hypotheses empirically.

tation of the functional approach, I will briefly summarise the discussion regarding an institutional versus functional approach in the banking literature (see, for example, Llewellyn 1995a, 211-213; Merton 1995; Merton and Bodie 1995; Goodhart et al. 1998, Ch. 8; Carmichael and Pomerleano 2002, 37-48).

The functional approach to financial regulation has gained in popularity as the dividing lines between institutional types such as banks and insurance companies have become increasingly blurred. A functional approach is the best way to ensure competitive neutrality. To ensure a *level playing field* and prevent *regulatory arbitrage* (i.e., financial institutions taking advantage of less strict regulatory requirements for the same type of risk), the same function should be regulated in the same or at least similar way, no matter by which type of institution it is conducted. The World Savings Banks Institute summarises this as the principle “same business, same risks, same rules” (2008, 6).

The discussion about functional versus institutional regulation has important implications for the overall design of the regulatory regime. A purely functional regime would argue for an all encompassing “financial institutions law” rather than a separate banking law, insurance law, building societies law, etc. Under this broad law, microfinance could be defined as one activity. Wide parts of the law would be the same for all financial institutions regardless of the products being offered, while specific risks related to specific functions could be subject to additional provisions. The Financial Services and Markets Act (2000) in the UK is an example of such a broad law. However, a purely functional approach is not ideal as it would ignore the contribution of individual functions to the overall risk profile of an institution.¹⁰¹ Goodhart et al. (1998, 144) argue that the institutional approach is important “when considering prudential issues, which must necessarily focus on institutions because, after all, it is institutions and not functions that become insolvent.” They recommend a matrix approach where “institutions need to be regulated on a functional basis for conduct of business purposes and on an institutional basis for prudential reasons” (ibid., 145). Looking at special regula-

¹⁰¹ The aggregate risk of a financial institution is not simply the sum of the risk of its various activities, but depends on correlations of the individual risk factors.

tory adjustments needed for microfinance, most experts agree that the necessary adjustments required for accommodating microfinance should apply, no matter what type of institution is conducting microfinance (Vogel, Gomez, and Fitzgerald 2000, 6; Christen, Lyman, and Rosenberg 2003, 18; Jansson, Rosales, and Westley 2004, 27).

In Uganda, when the *Financial Institutions Statute* (FIS) was introduced in 1993, it broadened the coverage from the previous banking law by also covering credit institutions and building societies. The revision of the FIS 1993, the FIA 2004, which was drafted at about the same time as the MDI Bill, covers an even broader range of institutional types.¹⁰² Nevertheless policy-makers decided to introduce a separate law for deposit-taking MFIs while at the same time advocating for a functional (tiered) approach with the effect that deposit-taking microfinance activities became regulated under two different laws, the FIA (commercial banks and credit institutions) and the MDI Act.¹⁰³ The tiered concept should allow microfinance business to be conducted under different institutional forms – from a commercial bank in Tier 1 to an NGO or SACCO in Tier 4 [UD/R/5]. In practice, the combination of a functional regulation of microfinance with the introduction of a special microfinance law led to considerable confusion in drafting the Bill. The first version of the Bill was titled “Micro-finance Bill” and was supposed to apply to banks and credit institutions conducting microfinance business as well as MDIs [UD/L/2]. It soon became clear that the new law would define ownership and governance requirements which were different from what was prescribed under the FIS so that banks and credit institutions were finally excluded from its ambit.¹⁰⁴ The outcome in Uganda is a mix of institutional regulation for microfi-

¹⁰² According to the definition of “financial institution” in SEC. 3 of the Act, these are commercial banks, merchant banks, mortgage banks, the Post Office Savings Bank, credit institutions, building societies, acceptance houses, discount houses, finance houses, or any other institution classified by the Central Bank as a financial institution.

¹⁰³ Section 7.5 discusses the reasons for this decision.

¹⁰⁴ The only other reminiscence of this early debate in addition to SEC. 4 (1) is the preamble of the MDI Act, which reads: “An Act to provide for the licensing, regulation and supervision of **micro-finance business** in Uganda” (emphasis added). Kenya encountered very similar problems when it drafted her Microfinance Bill. An earlier version of the Kenyan Bill from 2005 included the following definition: “‘institution’ means deposit-taking microfinance business licensed under this Act.”

nance – after all, MDIs are a new institutional type – and some minor changes to the existing legal framework for formal financial institutions (the FIA), which follow a functional approach.¹⁰⁵ In fact, the only change for Tiers 1 and 2 can be found in the *Financial Institutions (Credit Classification and Provisioning) Regulations (2005)* under the FIA, which requires financial institutions to segregate “micro finance loans” (which are not further defined) in the books and subject them to the credit classification and provisioning requirements under the MDI Act. Even though *microfinance business* is defined in the FIA, the term is not used again anywhere else in the law. In conclusion, whilst the Central Bank and the FSD Project from the beginning marketed the changes in microfinance regulation in Uganda as a functional approach (i.e., microfinance as a line of business) (Hannig and Katimbo-Mugwanya 2000, 12 and 17), by far the most important regulatory change was the introduction of a new institutional type – the MDI.

Regulating Microfinance under Two Different Laws

Uganda follows a functional approach under two different laws. According to the functional approach, deposit-taking microfinance business should be regulated in the same way regardless of the tier the institution is in. The main risk of regulating microfinance under two different laws is that they differ not only with regard to provisions which have intentionally being kept different in order to cater for the specific **institutional** characteristics of MDIs (as institutions exclusively offering microfinance business), but also with regard to other provisions simply because they are stipulated in two different laws. A detailed comparison of both laws – the FIA and the MDI Act – goes beyond the scope of this thesis, yet a few observations can illustrate the challenge of creating a level playing field for microfinance in this situation.

- The FIA and the MDIA differ considerably, not only in terms of length (38,870 versus 18,810 words including the schedules), but also in terms of structure. One reason for these differences is that the FIA covers a wider range

¹⁰⁵ The focus of the debate about microfinance regulation was really on Tier 3, with very little attention paid to regulatory changes applicable to Tier 1 and 2.

of financial services and institutional types, some of which require specific regulatory provisions (e.g., requirements for foreign exchange business, which are not needed for MDIs as they are not permitted to lend or take deposits in foreign exchange). However, a comparison of the laws shows that the main reason for the difference in length is that the FIA prescribes more detail than the MDIA.¹⁰⁶ One would expect those parts of the law which apply to an institution to be identical or at least very similar no matter what kind of functions it is performing. Yet this is often not the case.¹⁰⁷

- Another problem arises if both laws do not use the same defined terms, but essentially mean the same. While the FIA defines MDI in the same way as the MDIA, i.e., with reference to the defined term *microfinance business*, the definition of *microfinance business* is not the same in both. MDIs are exempted from the FIA (SEC. 2 (3) FIA), yet a careful reading of both laws would conclude that an MDI as defined in the FIA is not the same as an MDI licensed under the MDIA.¹⁰⁸
- A final problem of having two laws can occur on the level of implementing regulations. Regulations are issued under the authority of a law. Some of the rules prescribed in regulations should apply to all financial institutions regardless of whether they are licensed under the FIA or the MDIA. A good example is the *Financial Institutions (Credit Reference Bureaus) Regulations (2005)*.¹⁰⁹ These regulations (*CRB Regulations*) also apply to MDIs (REG. 4 (b)). Yet the CRB Regulations have not been issued under the MDIA, but only under the FIA. This leads to a situation where MDIs are required to follow regula-

¹⁰⁶ Good examples are the sections dealing with the deposit protection fund, which are much more detailed in the FIA (SEC. 108-110) than the MDIA (SEC. 80), and the sections on offences (SEC. 66 MDIA and SEC. 126 FIA).

¹⁰⁷ Examples of unjustifiable differences between both laws are: some of the requirements for liquidation in the FIA (SEC. 99 (2) and (4)) are missing in the MDIA; the duties of a liquidator of an MDI (SEC. 73) differ considerably from the duties prescribed in the FIA (SEC. 100); the Deposit Protection Fund under the MDIA shall compensate depositors in the case of insolvency of an MDI (SEC. 80 (2)), while in the FIA the payment is triggered by the closure of a financial institution (SEC. 111).

¹⁰⁸ Other examples are the definitions of *affiliate* (includes a wider range of relatives in the FIA), of *liquid assets* (SEC. 17 MDIA), or of a person disqualified from being a director (SEC. 23 MDIA).

¹⁰⁹ Statutory Instruments No. 2005 No. 59, 1st July 2005.

tions issued under a law which they are explicitly exempted from. A similar example is the Anti-Money Laundering Guidelines (2002) issued under the FIA, but which, according to Circular EDS.B.66 dated 14 July 2006 also apply to MDIs.¹¹⁰

It can be concluded that the decision to introduce a special microfinance law in Uganda inevitably led to the creation of a new institutional form and issues of competitive neutrality between various tiers conducting microfinance under two different laws.

Demarcation of Various Tiers

With separate institutional types or *tiers* conducting microfinance business, a crucial question is how to draw the line between the respective tiers in a way that minimises the risk of regulatory arbitrage and creates legal certainty (Staschen 2003, Ch. 2.2.2). The general approach in Uganda is that only Tiers 1 to 3 are prudentially regulated by BoU and permitted to solicit and take deposits from the public. According to the *BoU Policy* from 1999, credit-only MFIs belong to Tier 4 and do not come under BoU's purview [UD/R/5]. The MDI Act does indeed not cover credit-only MFIs.¹¹¹ Tier 4 MFIs are allowed to take compulsory savings as long as they do not use these funds for lending, i.e., do not intermediate them.¹¹² Thus the *lower boundary* of the MDI window is crossed once an MFI takes deposits (regardless of whether they are intermediated or not) or intermediates compulsory savings. This is in line with the public interest benchmark of this thesis, as compulsory savings alone – often referred to as loan insurance fund (*LIF*) in Uganda – do not trigger the same market failures as deposit-taking from the pub-

¹¹⁰ A better solution was found regarding the credit classification and provisioning rules for microloan portfolios of Tier 1 and 2 institutions, as the implementing regulations under the FIA refer to the MDI Asset Quality Regulations rather than vice versa.

¹¹¹ Soliciting deposits qualifies as *microfinance business* under the definition of the law and therefore triggers the licensing requirement. A strict reading of the FIA would, however, require credit-only MFIs to be licensed under the FIA. Financial institution business is defined as any of the businesses listed in SEC. 3 of the FIA, one of them being lending or extending credit. According to SEC. 4 (1) financial institution business can only be conducted by licensed institutions.

¹¹² SEC. 2 of the MDI Act exempts from the definition of deposit “a sum of money which is paid as security for a loan granted or promised at a future date to be granted to the person making the payment, except that such sum or interest on it shall not be lent on.”

lic. At this point it is important to stress that the new MDI regime did not impose any new restrictions on Tier 4 MFIs.¹¹³ Even before the MDI Act was introduced, unregulated institutions were not allowed to accept deposits without a licence under the FIS 1993 and later the FIA 2004.

The lower boundary of the law lacks clarity with regard to SACCOs. While the intention was to exclude SACCOs – in the initial *BoU Policy* only small SACCOs, but later on all SACCOs – from the purview of the law, the MDI Act ended up being ambiguous on this. SACCOs are clearly taking deposits according to the definition of the MDI Act and should therefore fall under the definition of microfinance business, which in turn triggers the requirement to have a valid licence from BoU authorising them to conduct microfinance business (SEC. 4 (1) MDIA). However, BoU **itself** has argued that SEC. 3 of the Act exempts SACCOs [UD/C/7]: “This Act shall apply only to microfinance deposit-taking institutions” despite the fact that MDIs are defined as institutions conducting microfinance business – and SACCOs fall under this definition, so the Act should also apply to them. So far none of the SACCOs taking deposits from members only have been required to apply for an MDI licence and the current practice of exempting SACCOs from the MDI Act has not yet been challenged in court. Thus the MDI Act acknowledges lower risks of MFIs only taking compulsory savings or no savings at all by excluding these institutions from the purview of the law, while being ambiguous with regard to the coverage of SACCOs.

Following the current practice of excluding SACCOs from the purview of the law and considering that SACCOs are subject to much less oversight by the Registrar of Co-operatives, there is a risk of the SACCO structure being used to avoid the stringent regulatory requirements under the MDI Act. SACCOs are permitted to collect deposits, even though from members only. As membership contributions can be minimal and all clients can easily be declared members, this creates a serious risk of regulatory arbitrage (Terberger 2006, 56). This analysis suggests that

¹¹³ In contrast to MDIs, Tier 4 MFIs are not subject to any other restriction of how to treat compulsory savings except that they cannot use them for lending. There is no restriction on the amount of savings (e.g., as a percentage of the loan amount), and compulsory savings could even be used as security for accessing bank loans (and thereby be put at risk).

Tier 4 institutions may choose the SACCO structure in order to be able to mobilise deposits without having to comply with the much stricter rules under the MDI regime.

The *upper boundary* of the MDI window is not as important as the lower boundary as the differences between the prudentially regulated Tiers 1 to 3 are much less pronounced than between Tier 3 and Tier 4. The general approach is that all three tiers can conduct *microfinance business* as defined in the law, but Tier 3 specialises in microfinance, while Tiers 1 and 2 can perform many other functions. The defining elements of microfinance business are deposit-taking (and this is not restricted to microdeposits) and lending from such deposits (or any other activity prescribed by the Central Bank).¹¹⁴ The lending activity is defined with reference to the typical target group of microloans and the use of collateral substitutes, yet it does not rule out the provision of traditional retail loans or even corporate loans. Any financial institution which does at least some microlending would fall under this definition and, according to SEC. 4 (1) of the MDI Act, would need a BoU licence authorising it to conduct microfinance business. One such licence is obviously the MDI licence. As there is no provision for financial institutions to be authorised under the FIA to conduct microfinance business, this suggests that even Tier 1 and 2 institutions would need an MDI licence if they conduct microfinance business as defined in the MDI Act.¹¹⁵ This interpretation is certainly not in line with the intention of the lawmakers and is not current practice in Uganda. It can be concluded that flaws in clearly setting apart Tier 3 from Tiers 1 and 2 have created legal risk as to the applicability of the law.

¹¹⁴ The definition of “microfinance business” actually includes three elements, the third being “transacting such other activities as may . . . be prescribed by the Central Bank.” The sub-sections are connected by semicolons, which suggest an *or*. This is confusing as the first two elements seem to be connected by an “and” (acceptance of deposits *and* employing such deposits).

¹¹⁵ As mentioned before, *microfinance business* is also defined under the FIA, albeit differently. However, microfinance business is not listed as one of the activities under financial institution business and each licence has to specify the type of financial institution business an institution can transact (SEC. 4 (3)(a)). The unclear wording of SEC. 4 (1) could be due to the earlier approach of also regulating microfinance business conducted by Tier 1 and 2 under this law (see Section 7.5 below).

Several other provisions demarcate the MDI window from the higher tiers regulated under the FIA. Most importantly, MDIs are subject to:

- More limitations on the types of activities they can engage in (SEC. 19)
- Stricter capital adequacy requirements (SEC. 16)
- A loan size limit (SEC. 18 (1)(a))
- A stricter single-shareholder limit (SEC. 21)
- Lower minimum capital requirements (SEC. 15)
- No requirement to set up board committees

Some of the requirements are stricter and others more lenient than under the FIA and will be discussed in more detail in the following section.

Institutional Structure of MDI Regulation

A crucial aspect of a microfinance regime is the *allocation of roles* in regulating and supervising microfinance, i.e., the *institutional structure* of the MDI regime.¹¹⁶ Five types of regulation have been defined above in line with the five regulatory objectives, viz., prudential, systemic, competition, conduct of business, and access enhancing regulation (see Table 2.2).

While all of these dimensions of regulation should be addressed in a regulatory regime, this does not need to be done by a single institution. In fact, there can be potential conflicts of interest between different roles. Prudential regulation is focused on the solvency of financial institutions, conduct of business regulation on consumer interests, and systemic regulation on the stability of the financial system as a whole. While there is certainly some overlap regarding the type of regulatory provisions used in all these cases, they will never be exactly the same (e.g., the

¹¹⁶ See Goodhart et al. (1998, Ch. 8) and Llewellyn (2004) for a summary of the discussion about financial supervisory structures.

systemic regulator being more concerned with large institutions and the conduct of business regulator more with institutions reaching many poor customers).¹¹⁷

While the focus of this study is on the new MDI regime, some of the regulatory provisions can also be found in other laws and regulations such as general consumer protection or competition legislation. The five roles in MDI regulation are allocated as follows:

- The Central Bank is clearly in charge of *prudential regulation and supervision*. In addition to BoU's general role in regulating and supervising financial institutions according to the BoU Act, SEC. 55 of the MDI Act establishes BoU as the supervisory authority for MDIs and SEC. 56 provides it with the power to inspect and collect information.
- The laws and regulations do not clearly define systemic risk or financial stability, let alone BoU's role in maintaining financial stability.¹¹⁸ However, looking at regulatory instruments, the Central Bank plays the most important role in *systemic regulation*, as it is in charge of setting up the MDI Deposit Protection Fund and making regulations on payment systems issues.
- Uganda does not have an institution clearly in charge of *conduct of business regulation*. Consumer protection is not among the mandates or roles of the BoU and there is no stand-alone consumer protection law or statutory consumer protection agency.¹¹⁹ Some specific sections of the MDI Act, however, can be seen as directly aiming at, or at least contributing to, the protection of consumers, while BoU's general role in prudential and systemic regulation also contributes to the consumer protection objective.

¹¹⁷ The Basel Core Principles, for example, recommend: "It is important to draw a clear distinction between this systemic protection (or safety net) role and day-to-day supervision of solvent institutions" (BCBS 2006a, 7).

¹¹⁸ Oosterloo and de Haan (2003, Tables 1 and 2) find that only one in 28 countries has an official legal definition of financial stability or systemic risk, but in all cases the central bank is responsible for maintaining financial stability.

¹¹⁹ In 2002, the Uganda Consumers' Protection Association drafted a Consumer Protection Bill, which was, however, never introduced into Parliament.

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- Uganda does not have a general framework for *competition regulation* (Kibera 2006). There is a draft Competition Bill from 2004, but no progress has been made on it since. BoU does not have a specific mandate to look into competition in the financial sector.
 - Finally, none of the relevant laws allocates the role of *access enhancing regulation* to any specific institution. BoU does not have a specific role in improving access. This is not surprising as most other countries do not explicitly acknowledge access as one of their regulatory objectives (see “Improve Access” in Section 2.3). The Government of Uganda (*GoU*) regards the passage of the MDI Act itself as a measure to increase access (GoU 2004, 46).

It can be concluded that the Central Bank, BoU, is an integrated regulator in the sense that it is the single systemic, prudential, and conduct of business regulator for MDIs. As Uganda is a small country, it can be argued that an integrated regulator brings necessary economies of scale and scope, without becoming excessively powerful (Llewellyn 2004).¹²⁰ The main emphasis of the MDI regime is clearly on prudential and systemic regulation. The lack of a clear consumer protection mandate either by the BoU or by a specialised consumer protection agency could have a negative impact on the attainment of the consumer protection objective. The same applies to the lack of competition and access enhancing regulation.

Hypothesis 1: The strong focus on prudential and systemic issues without adequate consideration for conduct of business issues and without any provisions specifically targeting competition and access leads to the predominance of the safety and soundness and systemic stability objectives.

This hypothesis can be tested by measuring the success of the MDI regime in attaining various regulatory objectives.

¹²⁰ This risk of being too powerful is even lower as Uganda has separate regulators for capital markets and the insurance industry.

Delegation of Rule-Making Authority

A final criterion for categorising a regulatory approach is the *levels of rule-making* and the degree of *delegation of rule-making power* to a lower administrative body. With regard to statutory regulation, several levels of legal commands can be distinguished, which differ in terms of their rule-making process and thus the democratic accountability they have, their legal bindingness, and the flexibility to be altered (Staschen 2003, 4). The most important distinction is between primary legislation (legal acts in Uganda) and secondary legislation (in Uganda referred to as regulations). In Uganda, as in most democratic regimes, the former is subject to the full parliamentary law-making process, while the latter can be promulgated by a subordinate administrative body (e.g., by the Minister of Finance or the Central Bank). There are also other subordinate levels of rule-making such as guidelines and circulars.

For a regulatory regime to be effective it is important that some of the rule-making power is delegated to the regulator (typically the central bank or a separate supervisory authority for prudential regulation).¹²¹ The regime must be flexible enough to respond to changes in the financial sector, yet still ensure sufficient accountability of the regulator to the government. Rule-making by specialised agencies has the advantage of more expertise, distance from government and a longer-term perspective (Ogus 1994, 105-6). It is ultimately a political question how far this delegation goes.¹²²

Assessing the Ugandan case on the basis of these considerations, the MDI Act clearly confers broad regulatory powers on the Minister of Finance and the Central Bank. The Central Bank has a general rule-making authority under SEC. 89 of the MDI Act, which permits BoU to make regulations and issue notices and directions. In most cases, the Act defines standards, but leaves it to the Central Bank to set the specific rules. Only a few quantitative rules such as the minimum and on-

¹²¹ See Huber and Shipan (2006) on the tension between the necessity to delegate and the potential problems associated with delegation.

¹²² One of the criteria for assessing compliance with the Basel Core Principles is whether “the law empowers the supervisor to set prudential rules (without changing laws)” (BCBS 2006b, 8).

going capital adequacy requirement and a single shareholding limit are included in the parent law, but even some of these figures can be changed without going through a lengthy process of amending the law.¹²³ It can be concluded that the MDI Act has transferred extensive powers to BoU to define specific rules under the general guidance given by the law.

Hypothesis 2: The high degree of delegation of rule-making power provides the Central Bank with ample opportunity to shape the regulatory and supervisory framework according to its own interests.

The empirical analysis of the role of the Bank of Uganda in implementing the MDI regime will provide more evidence on this (see Section 7.3).

3.3. Main Provisions of the Legal Framework for MDIs

Following the approach for measuring regulatory impact with reference to the public interest benchmark, a text-based analysis of the legal framework for MDIs is only interesting in as far as it allows hypothesising about the likely impact of the MDI Act and its implementing regulations on the five regulatory objectives. Instead of striving for completeness, this analysis focuses on a few salient features of the legal framework, which can be used to derive such hypotheses. Chapters 4 and 5 below will test these hypotheses empirically and look at some of the regulatory provisions in more detail in as far as they can be used to explain the observed impact. This section follows closely the broad categorisation of regulatory measures used by Barth, Caprio, and Levine (2006, Appendix 1). It uses the Financial Institutions Act as an important point of reference as this was the only option MFIs had for becoming a licensed financial intermediary before the MDI Act was introduced. Appendix 3 includes a more detailed list of regulatory provisions assessed on the basis of prudential regulations for microfinance and with reference to the alternative of being regulated under the FIA.¹²⁴

¹²³ Appendix 3 lists some of the details on this.

¹²⁴ The Ugandan country profile at the Microfinance Regulation and Supervision Resource Center (<http://tinyurl.com/y88e67d>, accessed 1 February 2010) summarises the main elements of the legal and regulatory environment.

Licensing

The MDI regime puts a strong emphasis on a thorough **licensing process**. Minimum capital requirements of Ugandan Shilling (*USh*) 500 million are one-eighth those of commercial banks, but still half the amount for credit institutions.¹²⁵ Considering necessary economies of scale and the high costs of setting up sound systems and processes for conducting deposit-taking microfinance business, minimum capital is unlikely to constitute a serious hurdle for any applicant except for those that are likely not to have the capacity to provide deposit-taking microfinance services anyway (Ledgerwood and White 2006, 171).¹²⁶ A more serious challenge could be that applicants for an MDI licence are not permitted to provide part of their minimum capital in the form of the net present value of the existing loan portfolio, as Jansson (1997, Ch. 3.1.2) recommends and as is, for example, current practice for microfinance banks in Pakistan.

Other licensing requirements such as provisions on ownership, management, governance and financial strength of the institution are likely to constitute a steeper hurdle for applicants. All applicants have to provide a comprehensive feasibility study with, among other requirements, financial projections for the next three years, which is likely to be easier for existing MFIs than for start-up operations to comply with. The application includes a detailed questionnaire on the security of the proposed premises. Separate rules apply for opening new places of business, changing their location or even hours of business. In all these cases separate approval by the Central Bank is required.¹²⁷ It can be concluded from this analysis that the main regulatory hurdle is likely not to be the minimum capital requirement, but the detailed information requirements as part of the licence application.

¹²⁵ Comparing India, Nigeria, Philippines and Uganda, Porteous (2010, 11) makes a similar observation in all four countries: “The difference in minimum capital required for Tiers 1 and 2 is extreme, while the difference is less marked between Tiers 2 and 3.”

¹²⁶ A simple calculation can illustrate this: assuming that an MFI needs at least 20,000 clients in order to break even and has an average loan size of US\$500,000 (which is about US\$450 and typical for a regulated MFI in Uganda), its loan portfolio amounts to US\$10 billion. A minimum paid-up capital of US\$500 million would only correspond to 5% of the outstanding loan portfolio and thus not be in compliance with the capital ratios explained below.

¹²⁷ By way of comparison, 49 out of 139 countries surveyed by CGAP’s Financial Access Team in 2009 do not require branch approval by the supervisor (<http://www.cgap.org/p/site/c/template.rc/1.11.103336>, accessed 19 November 2009).

There is a risk that these favour existing MFIs over start-up operations, as compliance is easier for the former. The fact that none of the existing MDIs has been a start-up operation seems to support this hypothesis, although proof (or otherwise) will not be possible until a start-up company applies for an MDI licence.

The MDI Act lacks clarity with regard to the question of whether MDIs can use agents (such as retail stores) to transact microfinance business on their behalf, i.e., can conduct *branchless banking* (Lyman, Ivatury, and Staschen 2006). As *microfinance business* as defined in the law can only be conducted by licensed institutions, clarification is needed as to exactly which activities would trigger the licensing requirement.¹²⁸ While the MDI Act itself refers to branches, agencies, and offices without defining the latter two, the Form MDI 100 (Monthly Statement on Asset and Liabilities), which is Schedule 2 of the Reporting Regulations, defines agency as “a part-time office [that] is located in a place which supports a fully-fledged branch [and] offers a limited range of facilities.” This suggests that agencies are not subject to the onerous branching regulations (it is not a branch after all), but still need approval by BoU and are not agents in the sense of third parties acting on behalf of the MDI as principal. Third-party retail agents seem not to be allowed to conduct microfinance business outside licensed places of business, which, if it were permitted, would have the potential to increase access by reducing costs of service delivery. This puts MDIs at a disadvantage compared to unregulated MFIs.

MDIs are also subject to **ownership requirements** with potentially considerable impact on licensing and ongoing operations. The most important provision in this regard is a 30% shareholding limit for a person or a group of related persons. A “reputable financial institution” or “reputable public company” can apply to the Central Bank for exemption from the 30% limit. The advantage of such a single shareholding limit is a diversified ownership structure with checks and balances among different shareholders (Lauer 2008, 4). Another advantage could be that in

¹²⁸ See the discussion in Fn 114 above. A strict reading would suggest that deposit-taking alone would trigger the licensing requirement and can only be done by an MDI at its head office and branches.

the case of a transformation from an NGO, the founding NGO with its weak governance structure due to a lack of owners with a direct economic interest at stake, would not be allowed to become a majority owner of the MDI. However, exactly this can be seen as a serious concern by a founding NGO that is interested in preserving the social mission of the institution (*ibid.*). It can be a challenge for the NGO to find other suitable shareholders that not only comply with the ownership requirements set by the regulation but also share the mission of the NGO (Ledgerwood and White 2006, Ch. 7). The possible exemption by BoU for a “reputable public company” defined as “a company that is financially strong, whose ownership is widely distributed [and] is of good public standing” (SEC. 2 MDIA) opens up some leeway for higher shareholding in certain cases. Commercial banks and credit institutions are subject to a more relaxed shareholding limit of 49% and a similar exemption may be applied for a *reputable financial institution* or *reputable public company*. It is not obvious why Tier 3 should have to follow stricter ownership diversification requirements than Tiers 1 and 2.

Hypothesis 3: The shareholding limit leads to a welcome diversification of MDI ownership with a positive impact on safety and soundness, but also bears the risk of diluting the ownership of founding NGOs as the guarantors of the social mission, unless they can take advantage of the exemption provided for in the law.

Ongoing Operations

Capital ratios are key instruments of prudential regulations, as they align the incentives of bank owners with depositors and other creditors, act as a risk buffer to absorb unexpected losses, and counteract incentives for excessive risk-taking behaviour.¹²⁹ Most regulatory regimes for microfinance still follow the standard computation of a *risk-weighted capital adequacy ratio* set by the 1988 Basel Capital Accord (BCBS 1988), also referred to as *Basel I*, at times with higher ratios than the 8% suggested there.¹³⁰ A number of arguments have been brought for-

¹²⁹ There is, however, mixed empirical evidence on the last point (Barth, Caprio Jr., and Levine 2006, 52-55).

¹³⁰ Examples are 15% risk-weighted capital adequacy ratio for Microfinance Banks in Pakistan, 12% for Deposit-taking Microfinance Institutions in Kenya and Micro Financing Institutions in

ward why capital adequacy standards for microfinance should be more conservative than for banks (Christen, Lyman, and Rosenberg 2003, 19-20):

- MFI loan portfolios tend to be more volatile and deteriorate more quickly in times of crisis
- a given level of delinquency decapitalises an MFI more quickly than a bank because of higher costs per unit lent
- MFIs often do not have a long track record and are growing fast
- some supervisory tools like capital calls do not work well with MFIs

The legal framework for MDIs in Uganda also follows the general Basel 1 approach of risk-weighted assets, yet prescribes a 15% core capital adequacy ratio (Basel I suggests 4% for this) and a 20% total capital adequacy ratio, and authorises the Central Bank to determine higher (or presumably also lower) ratios for individual institutions. The definition of core capital and total capital follows a simplified version of Basel I and risk weights also differ slightly from Basel I with some being stricter and some more relaxed (see Appendix 3 for details). The capital adequacy ratio of 20% for MDIs is therefore clearly at the top end of the spectrum. It is also much higher than that required of commercial banks and credit institutions, which have to comply with a 12% total capital adequacy ratio and 8% core capital adequacy ratio. Capital adequacy rules are often not a binding constraint for newly regulated institutions, which are only beginning to leverage their equity to the same extent as banks by getting better access to bank loans and – often for the first time – access to client deposits. But in the medium to long term, MDIs like all other financial institutions, have an incentive to increase their leverage as this increases the return on equity and therefore directly benefits current (and also potential future) shareholders. Furthermore, a high capital adequacy ratio implies that less funding is available for the MDI's main income-generating activity, viz., its loan portfolio, and commercial equity is more expensive than debt capital.

Ethiopia, or 10% for Savings and Loan Companies and Rural and Community Banks in Ghana (data from country profiles at <http://www.microfinanceregulationcenter.org>, accessed 11 June 2009).

Hypothesis 4: The stringent capital requirements have a positive impact on the safety and soundness of MDIs, but at the same time reduce the amount of funding available for lending (a negative impact on access), make the MDI less attractive to investors due to lower returns (a negative impact on access and competition assuming that fewer MDIs are set up), and lead to higher costs as equity is more expensive than debt capital.

Another regulatory measure frequently used to reduce the risk of financial institutions is to restrict the range of **permissible activities**. It is common practice in microfinance regulation to impose more limitations on permitted activities than for conventional banks. One reason is to contain risk exposure, assuming that MFIs do not have the capacity to undertake some high risk business activities such as operating current accounts or engaging in foreign trade financing (BCBS 2010, 14).¹³¹ The MDI Act includes a list of prohibited transactions similar to the FIA and in line with international practice (Barth, Caprio Jr., and Levine 2006, Figure 3.2), but also a few others. In particular, MDIs cannot open and operate “demand cheque accounts” (i.e., current accounts), take deposits and lend in foreign exchange, intermediate “loan insurance funds” (compulsory savings), or deal in derivatives. All these activities are only prohibited as long as the Central Bank has not explicitly approved them. Banks and credit institutions have been authorised to conduct mortgage banking, MDIs not.¹³² The one prohibition whose rationale is not immediately obvious and which could potentially create high costs because of MDIs having to hold idle cash, is the prohibition on intermediating the loan insurance fund. While it is indeed not recommended for unregulated MFIs to intermediate compulsory savings, as these would be put at risk, an MDI is prudentially regulated precisely to mitigate this type of credit risk.¹³³ Instead, the legislator seems to have taken the view that LIF is not a deposit altogether, but a collateral substitute, which should not be touched as long as the loan is still outstanding.

¹³¹ Barth, Caprio, and Levine (2006, 216) warn that too many restrictions on bank activities can actually increase the risk of a crisis as financial institutions cannot sufficiently diversify their income streams.

¹³² BoU Circular EDS.B.66 dated 2 October 2006 reproduced in BoU (2007, 88-89).

¹³³ Moreover, the risk weights used to compute the capital adequacy ratio take account of the additional risk of using LIF for lending as opposed to holding the funds in liquid assets.

It can be concluded that the range of prohibited activities takes into consideration the limited expertise of many MFIs in conducting high risk activities, yet that the prohibition on intermediating compulsory savings makes its use as cash collateral expensive.

MDIs are subject to detailed **external auditing** standards very similar to commercial banks and credit institutions.¹³⁴ The Central Bank has the power to make ample use of external auditors in verifying information, receiving communication about irregularities, and getting a second opinion about any issues arising.

Good **governance** of MFIs is generally regarded as essential for the safety and soundness objective (Campion and Frankiewicz 1999; Lapenu and Pierret 2005). There is a broad consensus that more independent boards are more effective in achieving sustainability (empirically confirmed by Hartarska 2005). The fact that the board of an MDI must be headed by a non-executive director should guarantee a minimum level of independence, and the fit and proper test for directors, the board's professionalism. As far as board committees and **management** positions of MDIs are concerned, the MDI Act allows for a leaner structure than the FIA, taking into account the smaller size of MDIs. No board committees are required by law and the only management positions specified are those of the finance manager and an internal auditor, with the latter reporting directly to the board to guarantee his/her independence.

Another area of regulatory provisions targeted at the safety and soundness of MDIs are **liquidity and diversification** requirements. While the FIA stipulates an exposure limit of 25% of total capital, MDIs are subject to a limit for the aggregate outstanding loan amount of 1% of core capital for individual borrowers and 5% for group borrowers, respectively. In banking laws such diversification requirements are typically used to limit credit concentration. "In microfinance, loan concentration limits are not likely to constrain normal operations, due to the small

¹³⁴ There are some minor differences such as the time limit for external auditors (four years for commercial banks/credit institutions, three years for MDIs) and the maximum period for submission of audit report to BoU (three months for commercial banks/credit institutions, four months for MDIs). It is difficult to say whether these differences are the result of a conscious decision to treat institutions differently or not.

size of microloans. Nevertheless, loan concentration limits are needed to prevent MFIs from making larger loans beyond their core competence” (Trigo Loubière, Devaney, and Rhyne 2004, 37). In other words, they are used to delineate micro-finance from conventional banking and prevent regulatory arbitrage (see “Demarcation of Various Tiers” in the previous section). Their main thrust is therefore the access objective rather than the safety and soundness objective. Apart from this loan size limit, the legal framework does not include any other regulatory provisions directly targeted at preventing *mission drift* – defined as MFIs changing their target market to better-off customers.¹³⁵ A different question is whether this limit will be a constraint, which depends on the amount of capital held by MDIs.

As far as liquidity requirements are concerned, the Liquidity and Funds Management Regulations set only one statutory ratio, which is a minimum liquidity ratio of 15% of deposit liabilities. By way of comparison, the FIA requires commercial banks and credit institutions to comply with a liquidity ratio of 20% and to undertake a maturity analysis on a monthly basis (Financial Institutions Liquidity Regulations). The latter is not a statutory requirement for MDIs. Unlike commercial banks, MDIs are not subject to any reserve requirement with the Central Bank.¹³⁶ It is not obvious why MDIs are subject to less stringent requirements than financial institutions regulated under the FIA, as having sufficient liquidity at all times is equally important for them (Brom 2009) and MDIs do not have access to short-term liquidity support in the same way that commercial banks do. First, MDIs do not benefit from the lender of last resort facility run by the Central Bank called *Bank of Uganda Standing Facility*.¹³⁷ Second, MFIs typically do not have access to liquidity facilities (e.g., through the interbank market) in the same way as banks and might have to rely on overdrafts instead.

¹³⁵ While the definition of microfinance business in the law (SEC. 2 MDIA) refers to “the provision of short term loans [defined as period of repayment below two years] to small or micro enterprises and low-income households, usually characterized by the use of collateral substitutes, such as group guarantees or compulsory savings,” it also allows the provision of other loans.

¹³⁶ Banks are subject to a reserve requirement ratio, which, according to BoU (2008a, 26) stood in 2007 at 9.5% of total deposit liabilities, part of which has to be held in an account with BoU. MDIs do not hold accounts with BoU.

¹³⁷ BoU Circulars EDO.1.11 dated 2 August 2006 and EDO.1.11.1 dated 11 September 2006 describe the conditions for the LLR.

Access to emergency liquidity support for solvent, but illiquid institutions is one of the two most important instruments to reduce systemic risk, the other being a **depositor protection scheme**. The MDI Act requires BoU to set up an MDI Deposit Protection Fund, which it only did in 2009 and MDIs only started funding at the beginning of 2010 (with no seed funding yet provided by BoU).¹³⁸ The details of this Fund are very similar to the existing Deposit Protection Fund under the FIA, as both prescribe an annual contribution of 0.2% of average weighted deposit liabilities in the previous year, the option of a risk-adjusted contribution for high risk institutions, and a coverage limit of USh3 million or US\$1,500 [BOU/I/S/118]. Once this fund is fully operational, it should have a strong positive effect on the reduction of systemic risk as the majority of deposits will be covered (the average savings amount for the four MDIs in 2008 was just over USh120,000). The deposit protection scheme will, however, also increase moral hazard and reduce monitoring by depositors. Deposit protection constitutes a key element in consumer protection. It can be concluded that the lack of a lender of last resort and low statutory liquidity ratio increase systemic or at least sectoral risk, which should, however, be alleviated by the recent introduction of a deposit protection fund for MDIs.

In addition, a few sections of the law oblige MDIs to treat their customers fairly, and thus also contribute to the **consumer protection** objective. In particular, conduct of business “in a manner detrimental to the interests of its depositors and customers” and deception of the “general public in respect of its financial condition, ownership, management, operations or other facts material to its business” can lead to the revocation of the licence (SEC. 12 (1)(g) and (i)). A person who invites clients to make deposits without having the authority to collect deposits will be prosecuted (SEC. 87).

The most important asset category of an MFI is its loan portfolio. Adequate **provisioning** requirements are therefore of greatest importance for the safety and soundness of MDIs. Due to the short-term nature, typically higher frequency of

¹³⁸ The Micro Finance Deposit-Taking Institutions (Establishment of the MDI Deposit Protection Fund) Instrument, Statutory Instruments 2009 No. 26, 29th May 2009.

instalment payments, and lack of conventional collateral in microlending, most experts agree that provisioning rules, once a loan is delinquent, should be more conservative than for commercial banking portfolios (see, for example, Christen, Lyman, and Rosenberg 2003, 21). The regulations under the MDI Act impose more conservative provisioning requirements on an MDI than the regulations under the FIA. Table 3.2 below summarises the credit classifications and provisioning requirements based on the number of days principal or interest payments have been overdue.

Table 3.2: Loan Classification and Provisioning

Category	All three tiers	Commercial bank and credit institution		MDI and microfinance portfolio of commercial bank/credit institution		
	Accrual of interest	Days overdue	Specific Provisions	Days overdue	Specific provisions	Provisioning for restructured credit facility
Normal	yes	<30	0%	< 8	0%	0%
Watch	yes	30-89	0%	8-29	0%	5%
Substandard	no	90-189	20%	30-59	25%	50%
Doubtful	no	180-364	50%	60-89	50%	75%
Loss	no	>=365	100%	>=90	100%	100%

Source: REG. 9 and 10, MDI Asset Quality Regulations, and REG. 10 and 11, Financial Institutions Credit Classification and Provisioning Regulations

In general, the classification is simpler for an MDI than for a commercial bank or credit institution, as the latter uses other objective and also subjective criteria, while the MDI classification uses the delay in payments as the single (objective) criterion. REG. 6 (2) of the Asset Quality Regulations expressively states that the security held on a credit facility does not play a role in determining its performance. As the Loan Insurance Fund is treated as cash collateral, provisions are built on the outstanding amount net of LIF.¹³⁹ In addition, MDIs are subject to stricter provisioning rules for restructured credit facilities. Finally, all three tiers have to

¹³⁹ According to BoU's *Instructions for Filling Form MDI 100*, which are part of the Reporting Regulations, compulsory savings (used synonymously with LIF) "are considered part of the loan product rather than savings product since they are tied to receipt of loans."

maintain general provisions amounting to 1% of outstanding loans. As mentioned above, financial institutions regulated under the FIA have to subject their “micro finance loans” to the stricter credit classification and provisioning requirements under the MDI Act. As this term has not been further defined in the regulations, commercial banks and credit institutions have an incentive not to classify loans as microloans to minimise their provisioning requirements. As a result, MDIs are likely to incur substantially higher provisioning expenses than Tier 1 and 2 institutions, but also have better portfolio quality.

Accounting and information disclosure requirements can increase the accuracy of financial information and protect customers against not having sufficient information about the terms and conditions of financial contracts. The only disclosure requirements to the public are a list of MDIs published by the Central Bank and the audited accounts together with the auditor’s report published by the MDIs. Both publications have to be done on an annual basis in a “newspaper circulating in the whole of Uganda” (SEC. 14 and 52). The reporting requirements for MDIs to the Central Bank are much more detailed (see Table 3.3 below). As can be seen, MDIs have to report more frequently than commercial banks and credit institutions on issues such as capital adequacy and portfolio quality. However, they do not have to report on credit concentration and large exposures, which are not of much concern in microfinance (especially with the loan size limit being in place). In addition to these regular reporting requirements, certain incidences require immediate reporting by the directors and external auditors. Overall, these reporting requirements help BoU to track the performance of MDIs, but can also create substantial costs for operating in rural areas with weak infrastructure (Okumu 2007, 169).

Table 3.3: Reporting Requirements

<i>MDIs</i>		<i>Commercial banks and credit institutions</i>	
Annually	Audited financial statements	Annually	Audited financial statements
Monthly	Capital adequacy	Quarterly	Capital adequacy
	Assets and liabilities		Credit concentration and large exposures
	Income and expense		Large non-performing loans and bad debts
	Portfolio quality		Credit classification and provisioning
	Provision for bad debts		Credit facilities extended to insiders
	Loans extended to insiders	Monthly	Maturity analysis
Weekly	Liquidity	Weekly	Liquidity

Source: SEC. 49, 51, and 57 MDI Act and MDI Reporting Regulations

Finally, MDIs (as well as commercial banks and credit institutions under SEC. 78 FIA) have to report non-performing loans to a credit reference bureau. BoU later decided not to run the credit reference bureau itself and not to use only negative information (as envisaged in the MDI Act), but to license private credit reference bureaux and include positive information (CRB Regulations). The first credit reference bureau for Tiers 1 to 3, CompuScan CRB Ltd., was licensed in 2008 and started operations in 2009. Such a credit registry – once fully operational – helps to reduce credit risk, can be used by the regulator as additional source of information, and also allows customers to build a credit history, which improves their access to loans (Powell et al. 2004). It can also have a positive impact on competition through the reduction of switching costs, as it makes a borrower's track record accessible to other lenders (Porteous 2009a). A problem with the current set-up is that Tier 4 institutions are not subject to a reporting requirement and information can only be disseminated to other regulated financial institutions (REG. 19 CRB Regulations), which reduces the effectiveness of credit reporting in improving the safety and soundness of MDIs and competition and access in microfinance.

It can be concluded that the focus of accounting and information disclosure requirements is on satisfying the regulator's need to receive comprehensive, timely,

and accurate information, while the legal framework for MDIs says very little about disclosure to the public. The recent establishment of the first credit reference bureau will have an important impact on reducing information problems.

Corrective Actions and Exit

The effectiveness of a regulatory regime is not only determined by prudential standards, but also by **sanctions, corrective actions** and – as a measure of last resort – the **exit** of the market. Sanctions for non-compliance with regulatory provisions are mentioned in various sections throughout the MDI Act – not unlike in the FIA. As regards remedial measures in cases of breaches of any of the provisions under the law, two types of corrective actions are possible. First, there are discretionary measures, which depend on the judgement of the Central Bank and are not limited to specific circumstances.¹⁴⁰ Second, in cases of capital deficiency the Central Bank has to take clearly specified *prompt corrective actions*, which take precedence over any discretionary corrective actions. The law prescribes a gradual series of responses depending on the level of capital deficiency. Such prompt corrective actions have been discussed in the literature as a way to prevent regulatory forbearance and deal with time consistency problems. The downside of such an approach is that there might be cases where the central bank has strong evidence suggesting a different response that would be more suitable (Goodhart et al. 1998, 55-57). The MDI Act does not allow the Central Bank to override the stipulated pre-commitment. If corrective actions do not lead to sufficient improvements, the Central Bank enjoys wide-reaching powers to take over the management of an MDI, place it under receivership, and even liquidate it. All these provisions can be seen as primarily targeted at only allowing healthy and well-run institutions to operate. The safety and soundness objective is therefore of principal concern.

In conclusion, Tier 3 is subject to various regulatory provisions which are more conservative than similar provisions for Tiers 1 and 2, without at the same time

¹⁴⁰ SEC. 58 includes a catch all phrase: “impose any other sanctions as the Central Bank may deem appropriate in the circumstances.”

benefiting much from a relaxation of regulatory requirements in other areas (except first and foremost the lower minimum capital requirement), thereby confirming concerns that the regulation of MDIs under a separate law leads to issues of competitive neutrality. The more limited range of activities is only one of these restrictions, others being higher capital adequacy ratios, the prohibition on using LIF for lending, stricter provisioning requirements, the loan size limit, and a lower single shareholding limit. In other areas such as corrective actions, external auditing, and accounting the provisions under the FIA and MDI Act are very similar. The risk is that these kinds of limitations render the MDI structure unattractive in comparison to licences as Tier 1 or 2 institutions, which also allow the conduct of microfinance business (and much more), and lead to a situation where “MDIs have to compete with other formal banks [and credit institutions] on an unlevel playing field” (Terberger 2006, 56).

Hypothesis 5: In many areas stricter regulations for MDIs in comparison to commercial banks and credit institutions put them at an unfair disadvantage and make the MDI structure unattractive.

Conclusion

A text-based analysis of the legal framework for MDIs provides essential direction for the empirical analysis of regulatory impact and allows for a preliminary assessment of Secondary Research Question 1, namely what the impact of Uganda’s MDI regime has been. By looking at some of the initial observations and hypotheses derived from the analysis in this chapter, a picture emerges of a regulatory framework with a strong emphasis on prudential and systemic regulation supported by a regulatory authority that has all the necessary instruments at its disposal to collect information about the sector and enforce regulatory provisions (Hypotheses 1 and 2). The requirements for MDIs are similar to those that apply to commercial banks and credit institutions regulated under the FIA except for some – mostly more restrictive – requirements specifically tailored to those risks perceived to be higher in microfinance. This, and the lack of harmonisation between the two laws governing the formal financial sector, raises issues of com-

petitive neutrality between the FIA and MDI Act with the risk of rendering the MDI structure less attractive (Hypotheses 4 and 5). The main barriers to entry for transforming MFIs are likely not to be minimum capital requirements, but stringent licensing criteria in other areas, approval rules for branching and a single ownership limit forcing the founder-NGOs to give up control and find suitable investors with a suitable mission (Hypothesis 3). Less mature MFIs lacking the capacity to become an MDI might instead disguise their deposit-taking activities under the SACCO structure, which is hardly regulated at all. As far as clients are concerned, the recent introductions of deposit insurance and credit reference systems for MDIs will provide them with enhanced deposit security and the chance to build a positive credit history. Consumer protection is one of the weakest points of the MDI regime as disclosure rules and effective redress mechanisms hardly exist at all.

CHAPTER 4 – QUANTITATIVE ANALYSIS OF THE REGULATORY IMPACT: CHANGES IN MARKET OUTCOMES

It is time for micro-finance institutions to swallow a bitter pill. A new micro-finance law will finally hold them accountable to stringent standards, similar to those faced by commercial banks.

“Tough game for micro-finance,” *Monitor* (Kampala), 22 July 2003

This and the following chapter assess how bitter the pill was that MFIs had to swallow when they came under the MDI regime. Both chapters apply the ROI approach from Chapter 2 to the introduction of the MDI Act and its regulations. They test the validity and usefulness of the approach (Main Research Question) and assess the benefit of regulation as measured against the public interest benchmark. The five hypotheses from the previous chapter will be an important point of reference in the empirical analysis.

This chapter looks at a first set of indicators, which have a number of characteristics in common. They are quantitative indicators, which can be analysed with statistical methods, measure the performance of MFIs and are therefore also referred to as *performance indicators*, are consequently collected on the institutional level, and measure market outcomes. These quantitative outcome variables have been collected for the four MFIs that were licensed as MDIs (the Treatment Group) and, where possible, for control groups, which allows for isolating the regulatory impact from any other exogenous changes occurring during the same period. This analysis is kept separate from the analysis of qualitative impact indicators as the methods of analysis differ.

Changes in performance indicators of MFIs are the most obvious way to measure regulatory impact in the absence of client level data. In an ideal world, the causal effect of the legal framework for MDIs would show as significant changes of performance indicators and allow for simple statements like “regulation has led to an increase in customers” or “regulation pushed down the profitability of MFIs.” This chapter seeks to identify such findings for the case of Uganda. However, such a quantitative impact analysis suffers from a legion of methodological prob-

lems (see Section 4.1), chief among them the lack of sufficient data, so that it can only be a first step in a microfinance RIA. Moreover, performance indicators of MFIs in the Treatment Group (*TG*) and Control Groups (*CGs*) are only useful for measuring the safety and soundness objective and access objective. Qualitative impact indicators will be covered in Chapter 5, which will complement the analysis of performance indicators by bringing together evidence from sources of information other than performance indicators of MFIs. Section 4.2 discusses the expected results for each of the performance indicators on the basis of the analysis of the legal framework for MDIs and empirical evidence from other countries, and then presents and interprets the results from Uganda.

4.1. Choice, Preparation, and Use of Data from Ugandan MFIs

The quality of a quantitative impact measurement depends to a large extent on the availability and quality of data. This section picks up from the discussion about empirical methodology in Section 1.3 and turns to the specific case of Uganda. As a first step, it discusses the selection of control groups to be used in a formal difference-in-differences analysis or as a point of reference for the identification of regulatory effects. Second, it reviews the availability and preparation of data for the treatment and control groups. Finally, it introduces the statistical methods used in the analysis.

Selection of Control Groups

As mentioned in the introductory chapter (Section 1.3), one of the challenges of RIA is to identify the effects of the introduction of the legal framework for MDIs by controlling for any other exogenous changes occurring during the observation period. The best approach to achieve this is the difference-in-differences method, which can, however, be subject to various biases. While the choice of Treatment Group MFIs is straightforward, the selection of control groups needs to be discussed in more detail. This study makes use of two different control groups, which differ with regard to their similarity to the Treatment Group and are therefore kept separate. Control Group 1 (*CG1*) comprises financial institutions regulated under the Financial Institutions Act and predominantly offering microfi-

nance services. Control Group 2 (CG2) includes the most mature MFIs in Uganda, which are not (yet) licensed by the Central Bank. The difference-in-differences analysis requires the TG and CGs to be similar except for the main explanatory variable, which is regulation under the MDI Act.

To avoid selection bias, members of the two Control Groups have to be chosen based on objective criteria **before** the passage of the law and be as similar as possible to the Treatment Group. The choice of MFIs for CG1 is straightforward, as only two regulated financial institutions have been active in microfinance, namely Centenary Bank (*Centenary*) in Tier 1 and Commercial Microfinance Ltd. (*CMF*) in Tier 2. Both institutions are similar to the TG in as far as they serve more or less the same market, even though, judging by average loan size, Centenary Bank's customers in particular appear to be on average better-off than those of the MFIs in the TG. Both Centenary and CMF have been regulated and supervised by BoU under the FIA for many years. The treatment (the regulation under the MDI regime) makes MDIs in fact **more similar** to CG1 by also bringing them under the purview of BoU, even if regulated under a different law. The main limitations of using CG1 as a control group are the limited availability of data, in particular for CMF in recent years, and the fact that both institutions have been subject to their own regulatory change through the introduction of a revised Financial Institutions Act in 2004. In addition, since 2005 commercial banks' and credit institutions' microfinance portfolios are subject to the same (stricter) asset classification and provisioning requirements as MDIs, even though in the case of Centenary Bank this only applies to a small share of its overall portfolio.¹⁴¹ Finally, CMF started its operations with a very poor performance (a negative ROA of -30% in 2000, its first year of operations), took until 2003 to reach profitability and has been making losses again since 2006.¹⁴² The poor performance of CMF since inception has been of concern to the Central Bank and is more to do with idiosyn-

¹⁴¹ Centenary Bank classified only 13.7% of its loan portfolio as microfinance as of June 2008 [CB/I/C/104].

¹⁴² Industry insiders report that the licensing of CMF was very much a political decision, which should not have been taken in the first place [DON/I/C/11] and [BOU/I/C/18].

cratic factors rather than being typical for the development of a regulated MFI.¹⁴³ Because of all these limitations, CG1 (or in some cases Centenary Bank alone) will only be included as one of the control groups if it adds value to the analysis. If it is included, it is assumed that regulatory changes through the revision of the FIA had a lower impact than the change from being unregulated to being regulated under the MDI Act.

The better control group is Control Group 2 (CG2), as MDIs before transformation were indeed very similar to other mature credit-only MFIs. The selection of MFIs to be included in CG2 is more complicated as the potential group is much bigger. The strategy was to include all non-SACCO MFIs with a reasonable number of clients (at least 10,000). Thus CG2 includes the most mature MFIs in Uganda that are not (yet) licensed by the Central Bank. These are BRAC Uganda Microfinance Program (BRAC), Faulu Uganda Ltd. (FAULU), Hofokam Ltd. (HOFOKAM), Micro Enterprise Development Network (MED-Net), and Uganda Agency for Development Ltd. (UGAFODE). Of these, BRAC began its operations only in 2006 so it is only included in cases where it adds value to look at post-treatment years only. FAULU is the best choice when looking for a perfect match between Tier 4 and Tier 3 as it was the only other MFI included in the initial group of five transformation candidates and thus also eligible for considerable funding from various donors. In December 2004, FAULU even submitted a letter to the Bank of Uganda indicating its intention to apply for an MDI licence, but after Opportunity International bought a majority stake in it, the new owners decided not to pursue the MDI licence any further. Eventually FAULU transformed in December 2008 – not to an MDI, but to a credit institution regulated under the FIA. Similar to the *matching method*, FAULU is therefore used in a few cases as the match with a similar “propensity score” of being in the Treatment Group as any of the institutions actually in the Treatment Group (Pearl 2009, Ch. 11.3.5).

¹⁴³ The two MicroRate reports provide a good summary of CMF’s challenges during its early years: [UD/R/13 and 14]. In 2002 CMF was technically insolvent and had to attract new capital to continue operating [CI/C/19] After having been bought by Global Trust Bank and a phase of heavy restructuring, the new bank completely changed its focus and turned to corporate rather than microfinance clients: Bernard Busuulwa, “Global Trust now in corporate banking,” *East African* (Nairobi), 23 November 2009.

MED-Net went through a serious crisis in 2006, during which it had to write off 90% of its loan portfolio until it was finally bailed out by World Vision International [UD/R/12]. However, dismissing it and other Tier 4 MFIs that went through a crisis (or even closed down like FOCCAS and SOMED, see below) as “outliers” would clearly introduce a selection bias. One of the reasons for crises in Tier 4 (and the non-occurrence of crises in Tier 3) could be exactly what the analysis is trying to measure – regulation. While FOCCAS and SOMED had to be excluded due to lack of data, MED-Net will, in general, be included. In some cases, a comparison of the TG with CG2 both with and without MED-Net can show how much of the observed impact can be attributed to the crisis of MED-Net.

There are no reliable statistics on the sector listing all MFIs in Tier 4, yet the information available suggests that all mature non-SACCO MFIs should be included in CG2 except for the following:

- **FOCCAS** was until 2005 one of the biggest Tier 4 MFIs in Uganda, with more than 16,000 clients and a loan portfolio of more than US\$1 million.¹⁴⁴ However, it went into receivership in July 2006 when it defaulted on a loan from Nile Bank. The latest available data is from 2005 so it cannot be included in the Control Group.
- **SOMED** is the second MFI that has closed down (in December 2007) amidst accusations of embezzlement and fraud.¹⁴⁵ In this case, it was not possible to get any performance data over the observation period. Both FOCCAS and SOMED are included in CG2 if the only information needed is that they were making losses and depleting their capital (as this is all I know about them).
- **PEARL Microfinance** (formerly Feed the Children) had in 2005 more than 14,000 borrowers and a loan portfolio of US\$1.4 million (Obara, Mukasa, and Staschen 2007). These figures suggest that it would have been good to include it. Unfortunately, in July 2008 the board of PEARL decided “not to participate in this research.”

¹⁴⁴ Performance Monitoring Tool (*PMT*) data from July 2005.

¹⁴⁵ “Quack MFIs may throw economy into chaos,” *Monitor* (Kampala), 3 January 2008.

- Another well-established MFI that could not be included is **Success Microfinance Services Ltd.** (formerly UWESO), as all attempts to get performance data were unsuccessful. According to a rating report from April 2007, Success had in early 2007 a loan portfolio of about US\$1.1 million and almost 15,000 active borrowers [UD/R/11].

Even with careful selection of the MFIs to be included in CG2, **residual biases** in the estimation are hard to avoid (see Section 1.3):

- The four MFIs in the TG were clearly the strongest Tier 4 MFIs in Uganda, thus causing a problem of **selection bias** in comparison to CG2.¹⁴⁶ This could lead to a potential overestimation of regulatory impact. Another **selection bias** in the opposite direction is caused by the fact that all MFIs in CG2 had at least medium-term plans to transform and were thus preparing for being regulated under the MDI Act. This type of *shadow regulation* leads to a potential underestimation of regulatory impact.
- The substantial donor support to transformation candidates can lead to **omitted variable bias**, as MFIs in the CGs (except for FAULU as the best match) did not benefit from this to the same degree. It was not possible to control for this as no reliable data is available for donor support to the MFIs in the CGs.¹⁴⁷
- **Endogeneity bias** in the sense of reverse causality (the performance of MFIs determines whether MFIs are regulated and not vice versa) can lead to an overestimation of regulatory impact, as it is likely that those MFIs that apply for a licence are those that will benefit most from being regulated. Performance indicators as measured in this chapter can be regarded as *confounding*

¹⁴⁶ Cull, Demirgüç-Kunt, and Morduch (2009a, 26) look at 245 MFIs around the globe and are confronted with the same problem: “Strong patterns emerge from the supervisory data indicating that its assignment [the assignment of prudential supervision] is non-random. Specifically, supervision tends to be more stringent for commercially oriented MFIs, non-NGOs that collect deposits from the public, lend to individuals (rather than groups), make larger loans, have proportionately fewer female customers, and have a higher share of staff concentrated in the head office (and thus fewer staff with contact with clients in the field).” To deal with this selection bias, they use instrumental variables.

¹⁴⁷ Donor support to transforming MFIs will be discussed as part of the *compliance costs* in Section 6.2.

variables as they correlate both with the explanatory variable (the better the performance is, the more likely it is for MFIs to be licensed as an MDI) and the dependent variable.

All three effects are summarised in Table 4.1 below and should be considered on a case by case basis.

Table 4.1: Problems of Bias in Research Design

	<i>Significance of problem</i>	<i>Direction of bias in measuring regulatory impact</i>
Selection Bias	No selection problem for the TG (full census); CGs only similar, not equal; “maturity” as selection criterion for cases in Control Groups also one of the dependent variables to be measured	Upward bias in comparison with CG2
	CG2 subject to “shadow regulation”	Downward bias in comparison with CG2
Omitted Variable Bias	Exogenous influences only affecting Control Groups: change of law for CG1; substantial donor support for the TG	Upward bias in comparison with CG1 and CG2
Endogeneity Bias	Performance indicators of MFIs in the TG are not only a function of being regulated, but whether to be regulated is also a function of how well an MFI performs (reverse causality)	Upward bias in comparison with CG2

A final issue is the wider impact of the legal framework for MDIs, which is likely to have changed the competitive landscape in Uganda’s microfinance sector. In other words, the Control Groups are not completely unaffected by the treatment. One hypothesis could be that the commercialisation of the MDIs leads to a deterioration in the position of Tier 4 MFIs due to changes in the competitive landscape and donors favouring MDI candidates over other MFIs. Any difference-in-differences analysis between the TG and CG2 would then overestimate the impact of the law on the TG. Such an **indirect impact** of the MDI regime cannot be captured by the quantitative analysis. I will, however, consider it in the section on impact indicators below.

In cases where the availability of data is much better for the TG than for the CGs, the analysis of *structural breaks* can be an alternative to the difference-in-differences analysis.

Choice and Preparation of Data

This thesis makes use of a variety of data sources. **Incompleteness of data** is a serious challenge. Not surprisingly, it was difficult to get good data for all three groups for the entire observation period (which should ideally start a few years before the treatment), but sometimes even data for the Treatment Group alone is incomplete. Comparing groups of MFIs with varying group membership due to non-availability of data for some of the members can only generate an unbiased estimation if all members in the group are quite similar. One strategy in such cases of missing data for some years is to start by looking at individual MFIs **before** aggregating them into groups. In some cases (e.g., for gross loan portfolio which has been growing continuously over the years, but where data for one or two years were missing) missing data points could be estimated by conducting a trend regression.¹⁴⁸

Apart from the availability of data, the **reliability of data** is obviously of great importance for the quality of the results. It was not possible to draw on a single data source. A crucial (and often challenging) assumption is that the same definition of variables is used for all cases and years. One way to achieve this was to use, whenever possible, raw financial and performance data and calculate the ratios from this. The general approach was to follow the hierarchy of data sources described below, which starts from the most reliable source and complements this with other (often less reliable) sources to fill any remaining gaps.

- MIX Market data was used as the main source (<http://www.mixmarket.org>). The Microfinance Information eXchange (*MIX*) provided me with a data extraction for Uganda in June 2008. In July 2009, the MIX Market website was relaunched, and now presents some of the MFI data in a different way.¹⁴⁹ Any changes in data treatment have been included and the initial data extraction has been complemented with more recent data available on the website. There

¹⁴⁸ This is not possible for variables that do not exhibit a clear trend. Depending on the overall trend observed in the available data, I assume linear or exponential growth. In some cases the best estimation will be the average of prior and subsequent year data.

¹⁴⁹ Details of the changes in data treatment can be found at <http://www.mixmarket.org/data-differences>, accessed 2 September 2009.

are three reasons for using the MIX as the main source. The first is reliability. The data collected by the MIX goes through a comprehensive review process, is double checked against source documents such as ratings and audits, and standardised according to International Financial Reporting Standards.¹⁵⁰ The ultimate objective of the MIX is to provide data which is easily comparable across institutions and countries. The second reason is practicality, as it is the most comprehensive data set available. Thirdly, it is *the* standard industry source for performance data of MFIs, and is also widely used in academic research.

- For the majority of MFIs I had access to copies of their audited financial statements (often also available through the MIX Market website), annual reports, or directors' reports. These data have been verified by external auditors and should therefore be at least to some degree (with the possible exception of portfolio quality, which in microfinance is difficult to verify for an external auditor) an accurate reflection of the institution's financial performance. These data are used to fill gaps in MIX Market data and, in a few cases, to verify outliers in the data.
- Data from publicly available rating reports was used as another source, which often draws on audited financial statements.
- Some indicators (in particular access data) are not tracked by the MIX and cannot be compiled from data in the audited financial statements. In these cases, data from the Performance Monitoring Tool (*PMT*) was used instead.¹⁵¹ All MFIs from the sample use it except those in CG1 and BRAC. PMT reports are not publicly available, but it was possible to get many either directly from the MFIs or from AMFIU. Data is not verified as AMFIU lacks the capacity to cross-check PMTs with any other data source [SUP/I/S/110].

¹⁵⁰ See <http://www.mixmarket.org/faq/Reliability-of-data>, accessed 2 September 2009.

¹⁵¹ The PMT was developed by Ugandan donor agencies in cooperation with the Association of Microfinance Institutions of Uganda (*AMFIU*). It has evolved into the industry standard for MFIs reporting to their funders and to AMFIU. It is a protected Excel-Workbook, into which MFIs enter raw data. Ratios are automatically calculated from these.

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- Finally, self-reported data (collected through email or during interviews) and data collected as part of the Friends Consult study (Obara, Mukasa, and Staschen 2007) fill any remaining gaps. In both cases, data have not been verified by a third party.

It has to be stressed that even after this careful selection of the best available data source, data might in some cases not reflect the true state of the MFI. This is particularly true for institutions in CG2 and in the TG before transformation, as for these MFIs the Management Information System (*MIS*) often did not or still does not have (in the case of CG2) the capacity to produce accurate results.¹⁵²

The result of this data collection effort is probably the most comprehensive database of microfinance performance data available for Uganda with more than two thousand observations for 11 MFIs for the period 1997 to 2008 (with more comprehensive data for more recent years). Before starting with data processing, some final steps were required:

- **Data cleaning:** Any data entries which are either outliers or appear not to make economic sense have been verified. If they could not be confirmed and if there seemed to be a strong likelihood that they were false, they were removed from the dataset. Yet in many cases it was possible to either verify them or replace them with more probable data from another data source.
- **Periodisation of data:** All data except that from the PMT is only available on an annual basis, so that the analysis had to be restricted to annual data. In a few cases the financial year does not coincide with the calendar year. This is particularly true for earlier years, as by now all MFIs in the sample except for HOFOKAM have switched to calendar years. Due to lack of data to adjust for different financial years, all data for financial years ending in June, August, or September are treated as end of year data. For reporting periods longer than 12 months (i.e., cases where MFIs changed their financial year), flow data has been adjusted to make them comparable to other years.

¹⁵² One former CEO of a transformation candidate is reported as saying: “The high-tech MIS software exposed many inaccuracies in portfolio quality and volumes previously reported. The true picture was always ‘less’” [UD/M/75]

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- **Inflation adjustment:** For the difference-in-differences analysis, an adjustment of data for inflation was not required as inflation affects all differences in the same way. Ratios were not adjusted either if inflation cancelled itself out. In all other cases (and in particular for the graphical presentation of absolute values in charts), data is given in 2000 prices.¹⁵³
 - **Currency:** All data is given in local currency (Ugandan Shilling, USh). The reason is that all MFIs from the sample mostly operate in the domestic market (except for Tier 1 and 2 they are not even allowed to conduct foreign exchange business) so the local currency is most relevant for them. The exchange rate to the US\$ was relatively stable for the period 2001 to 2008 with an average of US\$1,775 to the US\$.
 - **Weighting:** When looking at averages for groups, indicators have to be weighted. The general approach is to weight them using the respective denominator (e.g., number of borrowers as weight for average loan balance per borrower or assets as weight for return on assets). Using weights in this manner assumes that a policy-maker puts a higher weight on the impact a large (large defined as total assets, number of borrowers, gross loan portfolio, etc.) institution has than a small institution (cf. Rosenberg, Gonzalez, and Narain 2009, 4).
 - **Treatment date:** The four MDIs were licensed within a period of one year – FINCA in October 2004, PRIDE and UML in June 2005 and finally UFT in October 2005. However, the licensing date is not necessarily the date where the treatment begins to show. Institutional changes such as ownership and governance structure started for all four MFIs much earlier (roughly in 2002).¹⁵⁴ The biggest change brought about by the actual granting of the licence was that MDIs started sending regular reports to BoU, being regularly inspected by BoU, and were allowed to solicit deposits from the public. For

¹⁵³ For this I have used the consumer price index of the IMF World Economic Outlook Database, April 2009.

¹⁵⁴ By December 2002, FINCA, UML and PRIDE had all hired transformation managers or received external assistance to help them with the transformation process. UFT and FAULU started their preparations for transformation around the same time.

this reason the licensing date will be used as treatment dates for all dependent variables which have been directly affected by the issuing of the licence (e.g., operating expense ratio, any indicators describing the savings business). For other indicators, it can be assumed that the treatment started as early as 2002 and took full effect in 2005 with a lot of noise during this period as the process of preparing for the licence typically varies from institution to institution. Using a different year for FINCA would introduce a distinction, which cannot be justified by differences in the actual change processes of the four transformation candidates, which in reality proceeded in parallel.¹⁵⁵

Statistical Methods

The limited number of observations (four MFIs in the TG, two in CG1 and five in CG2, with an observation period running from 1998 to 2008 with generally much better data for the years after 2001) did not allow for the production of any useful results by conducting a formal regression analysis (see Appendix 4 for a description of how such a formal difference-in-differences analysis might look). In some cases, introducing a dummy variable for missing values for certain years and certain MFIs showed that the fact of whether or not certain values are available is more important for the observed results than regulation as the main explanatory variable. Simple t-tests showed that the Treatment and Control Groups were significantly different in relevant characteristics (e.g., size, profitability, number of customers, etc.) even **before** treatment. Furthermore, the statistical power was not sufficient to detect reasonable departures from the null hypothesis, which is that the value for the respective dependent variable is significantly different for the Treatment and Control Groups. This is mainly due to the small sample size and the often small size of the treatment effect. As will be shown below, treatment effects are at times ambiguous and short- and long-term effects differ.

¹⁵⁵ In other words, regarding the years 2002 to 2004 as pre-treatment dates and using them for my difference-in-differences analysis is likely to introduce a bias in the estimation. Ideally, I would have included a gap in the data and compared the period before 2002 with the period after 2005. Unfortunately, data for the pre-2002 period is very patchy thus precluding this approach.

The graphical presentation of the results using simple Excel charts proved much more useful. It obviously does not solve the problem of lack of similarity and missing variables (the latter being a reason for the time axis often only including a few years). Yet it is a much better tool when looking at the development of individual MFIs in the Treatment and Control Groups, as many of the charts include graphs for individual MFIs rather than group aggregates. As can be seen, the assumption of parallel trends within groups often does not hold. Instead, a more detailed analysis of individual MFIs based on other sources of information can explain much of the variation among MDIs. The charts also nicely visualise structural breaks. The focus will be on a comparison between the Treatment Group and Control Group 2 (as the better control group), with Control Group 1 only being used if it provides additional evidence.

In some cases it is not clear what overall effect the regulation has had and is continuing to have, i.e., whether it leads to a reduction or an increase in the value of the specific variable. Alternatives to simple reductions or increases of values that will be considered below are the changes in dispersion measured by analysing the variance of a variable; the variable fluctuating within a certain range of values; and a change in growth rates from before to after licensing.

4.2. Results from Analysis of Performance Indicators

The impact of regulation is transmitted through various channels, and ultimately reveals itself in changes in performance indicators for the MFIs in the Treatment Group. These channels will in the following be referred to as *impact channels*. The performance of MFIs is typically measured by a multitude of indicators in the areas of profitability, capital adequacy, portfolio quality, access, efficiency, and liquidity. I have analysed more than 40 different performance indicators in these six areas. This section summarises the results with reference to a smaller selection of 13 indicators.¹⁵⁶ The analysis is focused on those variables with a sufficient number of observations and with strong “priors”, i.e., with a clear expectation of

¹⁵⁶ A similar list of indicators is used by the MIX Market and the PMT. For the definition of performance indicators used in this study see Appendix 5.

what effect will be observed. There is a partial overlap between indicators in the six areas and the regulatory objectives. Profitability, capital adequacy, portfolio quality, and liquidity are clearly indicators for the safety and soundness of MFIs. Access is the one regulatory objective which can be directly measured by access indicators. Efficiency is an indicator for competition, but is also an important determinant for the safety and soundness and access objective. For each performance indicator, a first step is to hypothesise how its values are likely to change with the onset of regulation. A point of reference for this is the analysis of the MDI regime in the previous chapter and similar research in other countries.¹⁵⁷ A second step is to present the results from the analysis. Finally, the results are interpreted with reference to their relevance for achieving regulatory objectives and, if applicable, also with reference to the hypotheses of the previous chapter. A detailed summary of the results presented below and the analysis of some additional performance indicators can be found in Appendix 6.

Profitability

Profitability is a core objective of commercially oriented MFIs and also of central importance to regulators. The legal framework for MDIs does not specify a benchmark for profitability, but BoU monitors one of the profitability indicators, return on assets (*ROA*), as part of its off-site surveillance. Low or negative return on assets is used as one of the alerts during BoU's quarterly off-site analysis of MDIs' overall financial condition [UD/R/10: 12].¹⁵⁸ Thus regulation, if effective, should ensure that MDIs achieve at least a minimum level of profitability larger than zero.

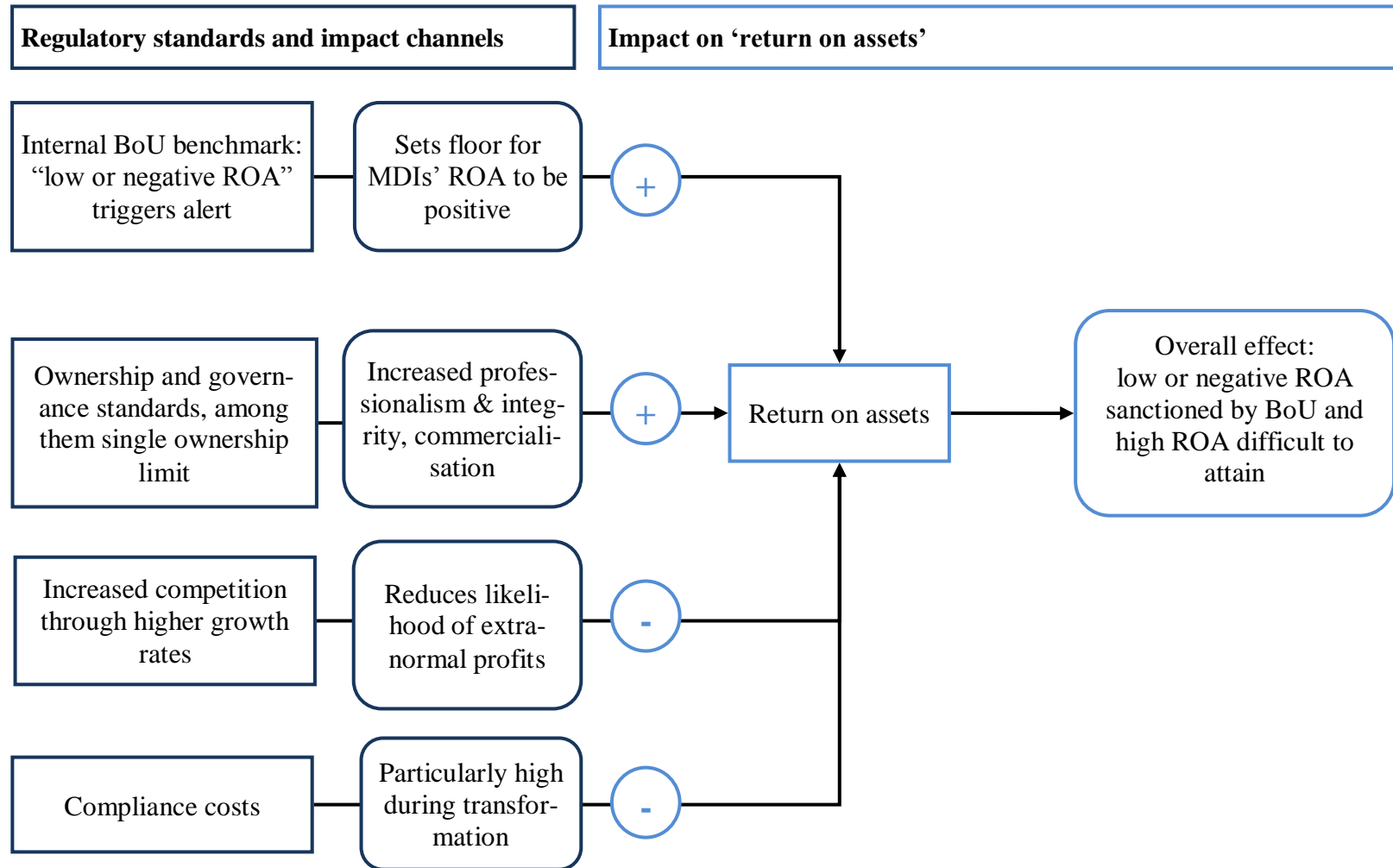
The MDI Act includes a number of regulatory provisions with a likely impact on profitability:

¹⁵⁷ Of particular interest are the results from a recent series of research papers published by the World Bank Development Research Group, Finance and Private Sector Team, drawing on the comprehensive global database by the MIX (Cull, Demirgüç-Kunt, and Morduch 2009a, 2009b).

¹⁵⁸ Unlike, for example, low liquidity or high portfolio risk, a negative ROA cannot be easily countered by imposing corrective actions. Instead, the supervisor would focus on the causes of low returns.

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- Ownership and governance standards including fit and proper requirements for directors and officers should have a positive effect on the professionalism and integrity of the people running the institution. The single shareholding limit of 30% (unless exempted from this by BoU) forces the institution to bring new investors on board, who should be more interested in a positive financial return than the founding NGO. This impact channel will henceforth be summarised under the term *commercialisation*.
 - A more indirect impact channel is possible changes in the competitive landscape caused by higher growth rates of Treatment Group MFIs (whether this is the case will be discussed below under “Access”) which make it more difficult for MFIs to earn extra-normal profits than in former times (McIntosh, Janvry, and Sadoulet 2005). The MDI Act does not erect any new barriers to entry, but rather makes it easier for MFIs to get licensed (in comparison to the previous option of a licence under the FIA) by introducing a new prudential tier especially tailored to microfinance. Tier 4 institutions can continue operating without any changes in their legal environment and will continue competing in the lending business with newly regulated MDIs.
 - Another impact channel is costs of regulatory compliance. These are likely to be highest during the transformation process, when an institution has to adapt its systems and processes according to the requirements of the MDI licensing regime. In addition to these one-off costs, reporting and compliance generate ongoing costs, which will depress profitability (see Section 6.2 below). This is confirmed by Cull, Demirgüç-Kunt, and Morduch (2009a, 17), who find that “the additional costs of complying with prudential supervision are associated with reduced financial self-sufficiency” (as an alternative measure of profitability).
 - Finally, the change of asset classification and provisioning rules (more on this below under “Portfolio Quality”) can lead to a drop in reported profitability around the transformation date. For example, UFT in 2005 was profitable in its operations, but because of stricter provisioning rules and write-off policies had to report a loss [UD/R/18].

Figure 4.1: Impact Channels for Return on Assets



The overall expected effect of all these impact channels on profitability is undetermined (see Figure 4.1 above), as some impacts have a positive effect on profitability, others a negative. Other cross-country studies could not determine a specific effect of regulation on profitability (Hartarska and Nadolnyak 2007; Merstrand and Øystein Strøm 2009). Yet what one would expect to observe is trimming on both ends of the extreme: neither negative nor very low profitability, which would lead to sanctions by BoU, nor exceptionally high profitability rates, as competition has been increasing.

Figure 4.2: Return on Assets for Treatment Group

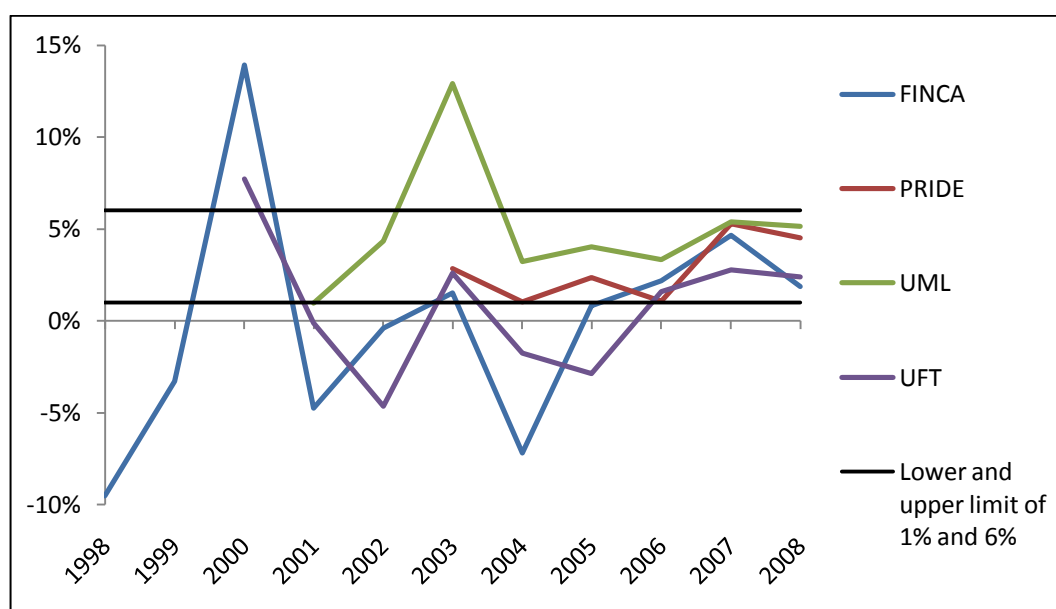


Figure 4.2 above shows the development of ROA for the four institutions in the Treatment Group. After quite a mixed performance in the years just before licensing, the amplitude has reduced considerably since. All values after 2005 lie within a range of 1% to 6%. The mean for the TG (weighted by average assets) dipped in 2004 and since then has been somewhere between 1.5% and 4.8%. This compares to a global average for MFIs in the MIX database for the years 2001 to 2004 of 2.8% (Gonzalez and Rosenberg 2006). This reduction in dispersion can also be shown by looking at the average variance for the Treatment Group, which dropped from 0.3% in the years 2000 to 2004 to 0.04% for 2005 to 2008. All four MFIs experienced a considerable drop in profitability in the year 2004 with two of

them making losses as a result. This can be explained by high transformation expenses and stricter provisioning and write-off rules, especially as a similar drop in profitability could not be observed in any of the MFIs in the Control Groups. Control Group 2 did not experience a similar reduction in dispersion over the same period. Three of the five MFIs made a loss during the period 2006 to 2008, while two MFIs, which are not part of the sample due to lack of data (FOCCAS and SOMED), even went bankrupt. Interestingly, ROA values higher than 6% did not occur for any MFI in the control groups after 2004 either, which is an indication for a more competitive environment precluding MFIs in all tiers from earning substantial monopoly rents.

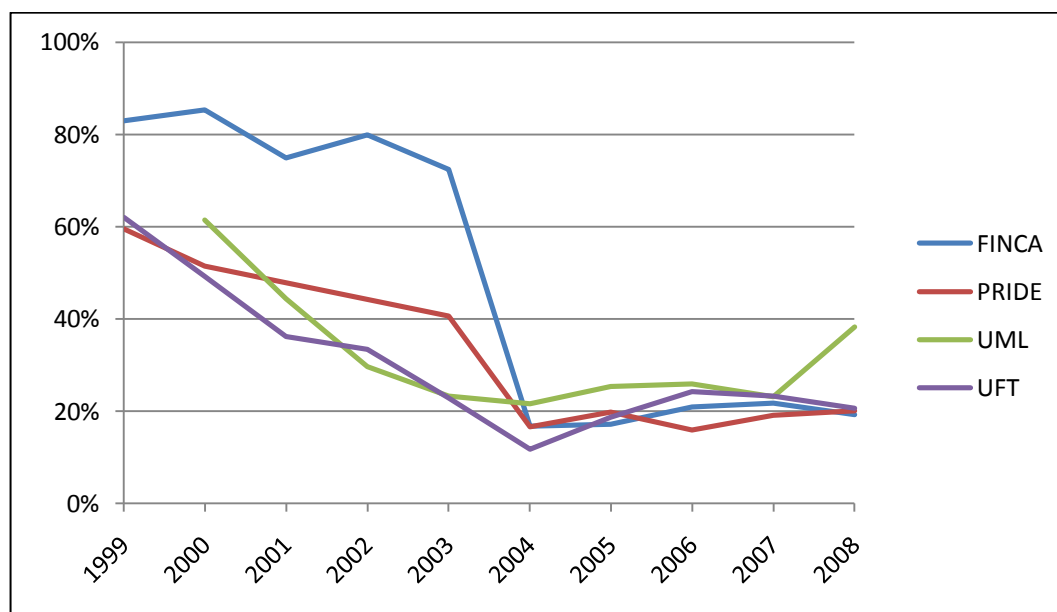
In sum, a clear change between before and after treatment years can only be observed for the Treatment Group. The fact that in all years after 2005 all MDIs have had a positive ROA of 1% or higher, while many MFIs in CG2 went through a crisis during the same period supports the hypothesis that regulation had a positive impact on the safety and soundness of MDIs. The absence of any extra-normal profits in the years since 2004 is an indication for a more competitive microfinance market.

Capital

Risk-weighted capital adequacy requirements are among the few performance benchmarks directly mentioned in the MDI Act. Capital deficiencies lead to clearly specified prompt corrective actions by the Central Bank with the ultimate sanction of revoking an MDI's licence. Thus the Central Bank keeps a close eye on the two capital ratios (core and total capital to risk weighted assets, respectively). The expected observation is that MDIs' capital ratios remain above these specified minimum levels. However, there are also some pressures at work that may bring capital ratios down from very high pre-licensing levels. Typically, credit-only MFIs (the TG before licensing and CG2) are mainly financed by donors and have few options to leverage their capital leading to high capital ratios (low leverage ratios). This changes with regulation. First, MDIs can tap into client deposits as a new source of funding. Second, external oversight increases the trust

in them and thus facilitates access to bank loans (Obara, Mukasa, and Staschen 2007, 38-39). Third, the change to a more commercially oriented shareholding structure will increase the pressure on MDIs to make use of their full earning potential by increasing their leverage ratio (Ledgerwood 1999, 224).¹⁵⁹ Taking both effects together – minimum statutory levels to be observed by regulated MDIs and pressures to reduce capital ratios – should lead to capital ratios lying within a relatively narrow range above the specified minimum. On top of this, capital injections by new shareholders will, at least temporarily, push up capital ratios. Finally, while the capital to assets ratio can be deliberately reduced by leveraging the equity capital (increasing the denominator), it can also drop due to depletion of capital (decrease of the numerator). The latter is a sign of crisis rather than of the successful employment of the full earning potential of capital.

Figure 4.3: Capital to Assets Ratio for Treatment Group



There are not sufficient data available on risk-weighted capital ratios for MFIs in Uganda to use in this study. Instead, Figure 4.3 shows a simple capital to assets ratio. It has been falling for all four MFIs in the Treatment Group from a high of

¹⁵⁹ The Transformation Manager of one MFI described the challenge between high start up capital and sufficient return on equity as follows: “We want to create from the beginning a very solid capital base [of US\$4 million], but at the same time we are aware that in order to attract the investors we are looking for we also need to have attractive returns, which means high enough leverage” [CON/I/S/28].

more than 60% in 1999 to between 12 and 22% in 2004.¹⁶⁰ The decrease in values started well before the treatment year and can therefore be only partly identified as an effect of the regulatory change. It can also be seen as a shift away from donor funding towards more commercial sources of finance. In particular, as early as 2001 commercial banks started to lend to the strongest MFIs (among them all four MDI applicants) not only against 100% cash guarantee (which they had been doing for a while), but also against the MFI's loan portfolio (Ledgerwood and Musana 2002, 11). Furthermore, some of the MDI candidates had already been accepting voluntary deposits even before getting licensed.¹⁶¹ Together this drove capital to assets ratios down over the pre-licensing years until they came close to – and in one case even fell below – the new statutory minimum of 15% risk-weighted assets. In the years after licensing all values lay in the range between 15 and 30% with the exception of UML in 2008, which increased its share capital by US\$ 14.15 billion through the issue of new shares after it had been acquired by Equity Bank Kenya.¹⁶²

A look at the Control Groups allows controlling for other external factors which might have caused this particular development. The difference-in-differences analysis confirms the general observation: most MFIs in CG2 have been able to reduce their capital to assets ratio even without being regulated. Yet in contrast to the TG MFIs, some of the unregulated Tier 4 MFIs have depleted all their capital (MED-Net, which had negative capital for the years 2006 and 2007, and SOMED and FOCCAS, which are not included in the dataset). FAULU shows a development very similar to MDIs in the pre-treatment years (which confirms the view that it is the “best match”), but experienced unsustainably low capital levels in 2006 (when it was still unregulated). One can also look at changes of the variance

¹⁶⁰ The statutory minimum of 15% risk-weighted asset ratio corresponds to an actually lower capital to assets ratio as some assets – but only a few – carry a risk weight of below 100%. Only UFT once fell below the statutory limit at the end of 2004 [UD/R/16].

¹⁶¹ Voluntary deposit taking by unregulated institutions was also not permitted under the Financial Institutions Act, let alone the MDI Act. However, BoU only started strictly enforcing this with the advent of the MDI Act.

¹⁶² Strictly speaking UML ceased to exist just before the end of the year. On December 20, 2008, BoU issued a licence to Equity Bank Uganda. However, as the institution was still regulated as an MDI until this date, UML is included in the Treatment Group in 2008.

in the years before (2000 to 2004) and after treatment (2005 to 2008) as a measure of dispersion. The mean of variance for the TG reduced from 3.9% before to 0.2% after treatment. For CG1 it remained at a low level (0.1% before and after), while it increased considerably for CG2 from 1.9% to 9.7% in post-treatment years (or from 1.6% to 1.9% without MED-Net). Thus regulation has been successful in reducing the variation of capital ratios over time.

It can be concluded that the reduction of capital to assets ratios from very high levels cannot be attributed to regulation alone, although it certainly helped to get even better (and cheaper) access to bank loans and allows for the mobilisation of voluntary savings. The legal framework for MDIs has, however, been successful in ensuring a minimum level of capital that is sufficient to absorb future losses. Capital adequacy rules can be seen as a core measure of prudential regulation targeted at the safety and soundness of financial institutions. The drawback of, by international standards, high capital adequacy ratios is that they constrain growth, increase costs, and make MDIs less attractive for investors – something difficult to prove without a counterfactual (see Hypothesis 4). On the basis of the available information it is not possible to say whether the capital adequacy ratio is binding, i.e. that MDIs would have reduced their capital to assets ratios even further if they did not have to comply with the statutory limit.

Portfolio Quality

Regulatory provisions on portfolio quality also have a direct impact on the safety and soundness of MDIs. The MDI Asset Quality Regulations set clear rules on how to treat non-performing credit facilities (including write-off and non-accrual policies). The Ugandan standard ratio for tracking portfolio quality is portfolio at risk >30 days (PAR_{30}), which includes the value of outstanding loans with payments past due for thirty days or more. The provisioning requirements for Ugandan MDIs are listed above in Table 3.2 and are more conservative than for conventional banking and also the internal policies of many of the MDI applicants. As a result, any portfolio problems have a more immediate effect on MDIs' profitability. The Central Bank monitors portfolio quality as part of its off-site surveil-

lance by looking at the PAR₃₀ figure and figures approaching or exceeding 5% trigger an alert [UD/R/10: 12]. As a result, portfolio quality should stay within reasonable limits as the MDI would otherwise incur high provisioning expenses or be subjected to remedial measures by the Central Bank.

The following impact channels of regulation on PAR values can be distinguished. A short-term deterioration in portfolio quality can be caused by the transformation process itself, which absorbs much of the attention of staff [MDI/R/C/116]. One of the MFIs preparing for transformation explained its increase in PAR₃₀ values as follows:

Management believes that a decline in staff morale, attributed to uncertainty surrounding the transformation process, is the chief underlying factor. Two branch managers have resigned, and the front-line staff are not confident that they will retain their jobs in the more rigorous regulated environment. [UD/R/18]

As part of the licence preparation, all MDI applicants introduced a new software system. The difficult process of data migration can lead to some disruption in operations and higher PAR values, as confirmed by one MDI [UD/R/16]. Many MDIs also introduced individual loans and other new loan products (more on this below), which often did not perform well.

While these are reasons for *real* deterioration in portfolio quality, some of the *observed* changes might actually be caused by changes in measurement of portfolio quality:

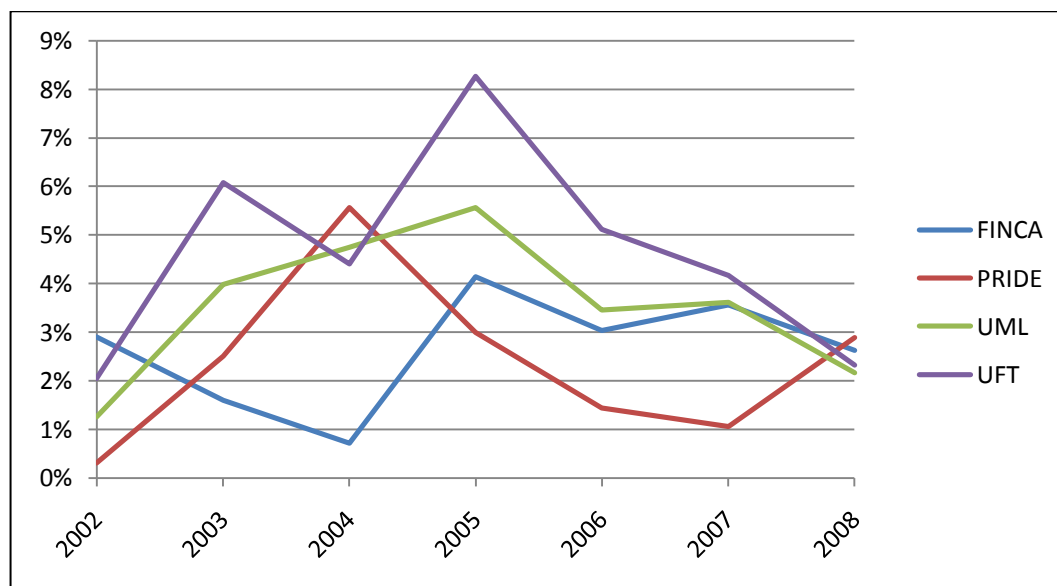
- As most unregulated MFIs used less strict provisioning rules before getting licensed [UD/M/61], one effect of the law was higher PAR₃₀ values due to a reclassification of loans. This was, for example, the case for one MDI applicant, which had to set aside US\$448 million in loan loss reserves to meet the more conservative general and specific provisioning requirements [UD/R/15].
- Similarly, some MFIs followed in pre-licensing times a less rigorous write-off policy than required under the MDI regulations [UD/R/16 and UD/R/18]. Ac-

ording to the MDI Asset Quality Regulations, loans classified as a loss have to be written-off within six months.

- All transforming MFIs upgraded their MIS. There is evidence that in some cases the new MIS exposed previous repayment problems which had been underestimated [UD/R/15].
- The shift from group to individual lending, which will be discussed below under “Access,” often goes hand in hand with higher PAR₃₀ values because portfolio problems in group lending are often resolved within the group and thus do not appear in the MFI’s accounts [UD/R/16].¹⁶³

The aggregate effect of all these changes in *observed* PAR₃₀ values should be an upward bias on PAR₃₀ figures. The first three points listed above should lead to a sudden increase of PAR₃₀ values around or before (MIS upgrades were part of the institutional changes undertaken in preparation of licensing) the licensing date. The fourth point – the change from group to individual lending – is an ongoing process which varies from MDI to MDI.

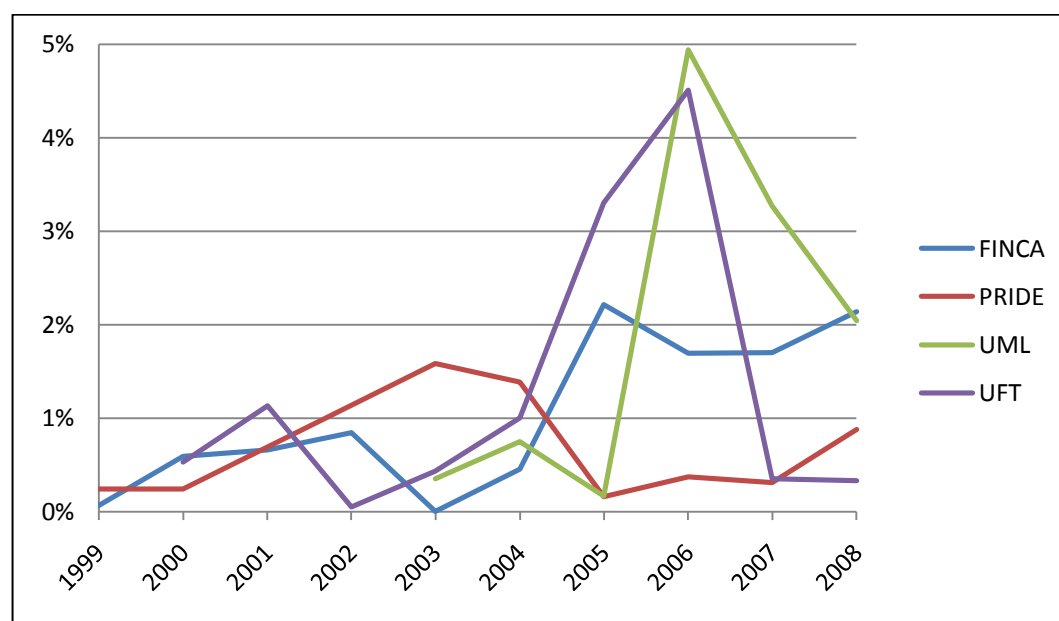
Figure 4.4: Portfolio at Risk > 30 Days for Treatment Group



¹⁶³ A final effect leading to **lower** observed PAR₃₀ values was caused by two of the new MDIs – UML and PRIDE – assuming upon licensing only those loans from their founding NGO which were current or less than 30 days past due [UD/R/19]. However, this effect does not show in the figures, as the temporary improvement had already passed by the end of the year.

Figure 4.4 confirms the expectations regarding the development of PAR₃₀ figures. All four MDIs went through a slump in repayment performance in the year of licensing (FINCA in 2004, the others in 2005).¹⁶⁴ This can be attributed to a *real* temporary deterioration of portfolio quality due to the disruption of day-to-day operations by the transformation process, and to changes in *observed* PAR₃₀ values as discussed above. As expected, the longer-term trend is very positive with all values coming down substantially and in 2008 lying in a narrow range between 2.2 and 2.9%. As far as write-offs are concerned, Figure 4.5 below shows the extent to which some of the MDI applicants cleaned up their loan portfolio as a result of the new rules imposed by the regulation and real repayment problems over the transformation period. The peak in write-offs for UFT and UML in 2006 coincides with much better PAR₃₀ figures in the same year.

Figure 4.5: Write-off Ratio for Treatment Group



Comparing treatment with control group values, the PAR₃₀ values for the four MFIs in the Treatment Group have been by far the most stable. All MFIs in the Control Groups (except for the relatively new BRAC) have gone through phases with PAR₃₀ values above 10%, even if at different times. This suggests that the

¹⁶⁴ PAR value peaked for UML in June 2005 at 9.2% [UD/R/15] and for UFT in March 2006 at 10.9% [UD/R/99].

good portfolio performance of MDIs in recent years can be attributed to the success of the new legal framework for MDIs.

It can be concluded that being licensed as an MDI led to a temporary increase in PAR₃₀ values, but also to a longer-term positive impact on portfolio quality and thus on the safety and soundness objective. Part of the temporary spike in PAR₃₀ values can be attributed to changes in measurement of portfolio quality, but part was also likely to have been caused by a real deterioration of repayment performance.

Access to Loans

Various dimensions of access can be analysed with reference to performance indicators of MFIs. At the same time, access is one of the regulatory objectives, and will therefore be discussed in more detail in the following chapter. A number of indicators on the institutional level can be used to measure breadth, depth, scope and affordability of access. The analysis of access indicators is split in two. This section starts by looking at indicators for access to loans.

Better access to finance is the main driver for increasing the *number of borrowers* served by MDIs.¹⁶⁵ International cross-country studies show that regulation has a positive impact on the number of borrowers: “A closer examination of data also supports the hypothesis that most institutions have experienced strong growth in the number of borrowers after transformation” (Fernando 2004, 23). Hartarska and Nadolnyak (2007) find that regulation as such does not affect outreach, but access to savings does. This would argue for an indirect effect of regulation on number of borrowers through better access to finance.

An opposing force stems from the increasing commercialisation of MFIs, which often goes hand in hand with a shift to larger and fewer loans (Christen 2001).

¹⁶⁵ Counting the number of borrowers leads to an underestimation of the impact of increasing number of loans. For example, the number of loans could double, but the number of borrowers remains constant simply by two loans being issued to each borrower instead of one. No improvement would be measured with the variable I am using, although the increase in number of loans is likely to have had a positive impact on access. Unfortunately the data on number of loans was not sufficient and I therefore had to restrict the analysis to number of borrowers.

Changes in the number of borrowers should therefore be seen in combination with changes in *average loan sizes*. Other reasons for slower growth in number of borrowers could be increased concerns about portfolio quality as described above leading to a more cautious growth strategy, and the preoccupation of staff with transformation [UD/E/39]. Similar to portfolio at risk figures, *observed* changes should be greater than *real* changes as MDI applicants cleaned up their data as part of the MIS upgrade and thereby eliminated duplicates and inactive clients from their books [UD/M/20].

Figure 4.6: Number of Borrowers for Treatment Group, FAULU and BRAC

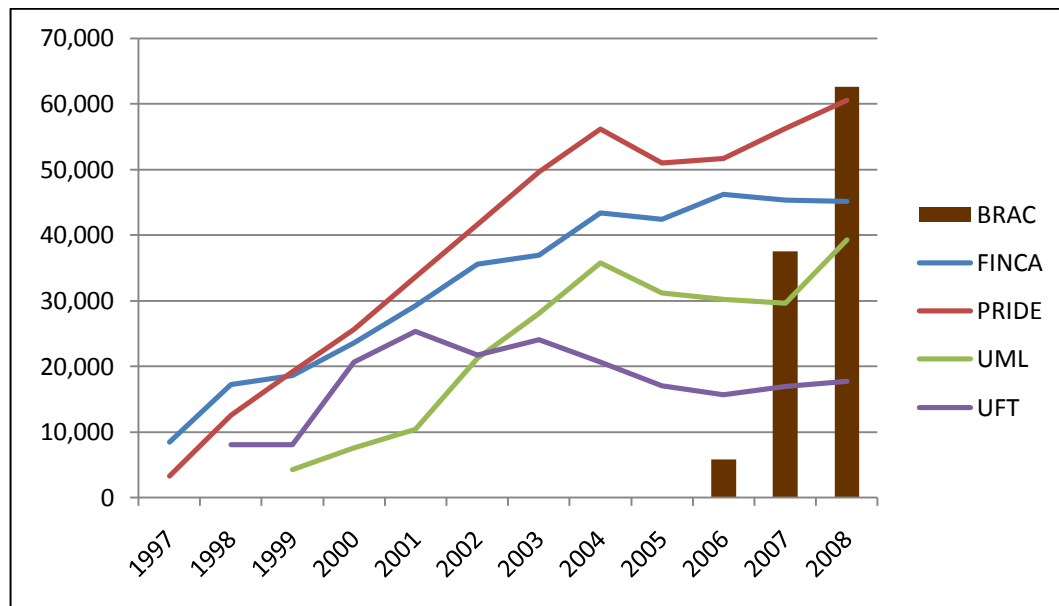


Figure 4.6 illustrates changes in the number of borrowers served by the TG MFIs and by BRAC for comparison. As can be seen, progress for the TG has been rather limited. There is quite a consistent development for three of the four MFIs in the Treatment Group with all three experiencing growing numbers of borrowers over many years prior to being licensed and reaching a local maximum in 2003 (UFT) or 2004 (PRIDE and UML), respectively. After a structural break in values it has either taken them years to reach the same level again (PRIDE three years, UML four years) or they had not yet exceeded pre-licensing levels by the end of 2008 (UFT). The only exception is FINCA, which grew quite consistently, even if modestly, until 2006 with a slight drop in loan clients in 2005 and again after

2006. In the years 2000 to 2004, the combined increase in borrower numbers for the four MFIs in the TG was on average 19,636 per year or 19.1% (compound annual growth rate), while this number dropped to 7,035 in the years 2005 to 2008 or 4.7% (although UML added almost 10,000 in 2008). By comparison, Gonzalez and Rosenberg (2006) look at a global database of about 2,600 MFIs and find that the average growth rate is 16% for profitable MFIs, which means that MDIs compare poorly in post-licensing years. Only the Treatment Group and FAULU experienced such a drop in loan clients in 2004/05. BRAC, by comparison, grew its number of borrowers from zero to 62,600 in only four years (also included in the figure above).¹⁶⁶ It now has more borrowers than any of the MDIs, which proves that funding constraints are not necessarily a reason for low growth in client numbers. Comparing actual with projected figures used by the MDI candidates in their licence applications, it is obvious that the applicants themselves expected more growth in the number of loan clients. On average, the aggregate figure for loan clients in 2006 was 30% lower than predicted.¹⁶⁷

UML was a clear outlier in 2008, when it put an end to a three year long decline in its number of borrowers, and increased the number by 33% in 2008 alone with even higher growth rates in 2009. Part of the reason could be a reduction in lending rates from 3-4% per month to 2%, more flexible collateral requirements, and a surge in funding available from savings (see below). More in-depth research would be required to establish exactly what caused this sudden rise in numbers, but a change of business strategy after the acquisition by Equity Bank Kenya has certainly played the main role in this.¹⁶⁸

In sum, since the Ugandan MDIs experienced a structural break in numbers of borrowers around the licensing year, which cannot be equally observed among

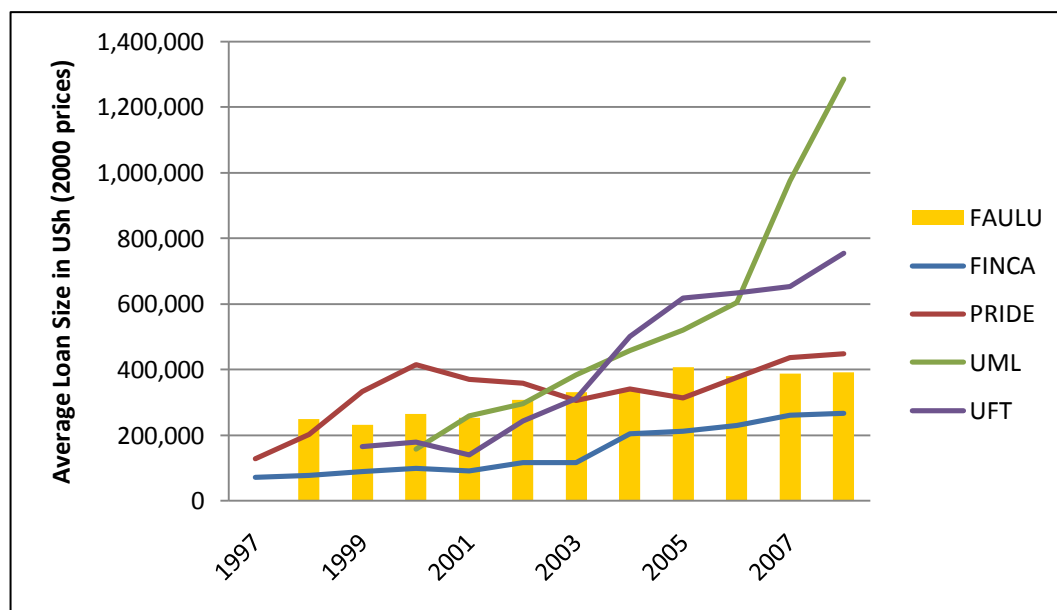
¹⁶⁶ By September 2009, the number had risen to 92,000 borrowers (<http://www.brac.net/index.php?nid=16#Uganda>, accessed 23 February 2010).

¹⁶⁷ The detailed figures are the following (the length of the projection period varies): UFT -53% in 2006; UML -35% in 2008; PRIDE -11% in 2007, FINCA -14% in 2008.

¹⁶⁸ There are some indications that this was a high-risk strategy as Equity Bank Uganda reportedly made an operating loss of about US\$9.7 billion (almost US\$5 million) in 2009, which compares to a profit before tax of US\$6.5 billion the year before. See Washington Gikunju, "Equity Bank profits grow to Sh5.3 billion," *Business Daily* (Nairobi), 19 February 2010.

Control Group MFIs, the impact of regulation on breadth of access seems clearly to have been negative – an issue that requires further investigation. Looking at these figures alone, it is not possible to say how much of the drop in numbers around the licensing date was due to data cleanup and how much to fewer loans being advanced.

Figure 4.7: Average Loan Size for Treatment Group and FAULU



To understand why loan client numbers decreased around the treatment date and growth rates have slowed since, and to get an indication of depth of access, it is informative to look at changes in *average loan size* (Figure 4.7).¹⁶⁹ The following can be observed for the four MDIs:

- FINCA, which is the only MFI in the Treatment Group showing moderate growth in number of borrowers throughout the observation period, is also the MFI with the lowest growth rates in loan size and by far the lowest absolute figure at the end of 2008.¹⁷⁰ No impact of regulation can be observed.

¹⁶⁹ The graphs in Figure 4.7 actually underestimate the growth in average loan sizes as measured by amounts actually paid out because MFIs in the Treatment Group have been reducing compulsory savings (more on this below), which allows them to pay out larger amounts (and keep less as compulsory savings) for the same average loan size [UD/E/24].

¹⁷⁰ The average loan size only jumped once: by 77% between 2003 and 2004, which coincided with the year of licensing. It can be explained by the introduction of individual loans and issuing of larger group loans [UD/R/100].

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- In 2005, PRIDE experienced a precipitous drop in both values, which can be explained by its acute lack of funding caused by disintermediating its compulsory savings, and its efforts to bring down high PAR₃₀ values [UD/M/20]. The disintermediation of savings was not really triggered by the MDI Act, but by stronger enforcement of existing rules on deposit-taking by unregulated institutions. It has since experienced moderate growth in average loan sizes not much different from pre-licensing figures.
 - UFT (2003-05) and UML (2006-08) both experienced huge jumps in average loan size in post-licensing years. For UFT, the number of borrowers dropped by about 30% during the same period, while UML managed to both grow its number of borrowers by 32% and its average loan size by 32% in 2008. This was only possible because it grew its loan portfolio by 82% in the same year.¹⁷¹ One explanation could be that both MFIs deliberately switched to larger loans with UFT being constrained in funding and thus having to decrease its number of borrowers, while UML received a boost in funding from its new owners, Equity Bank Kenya.

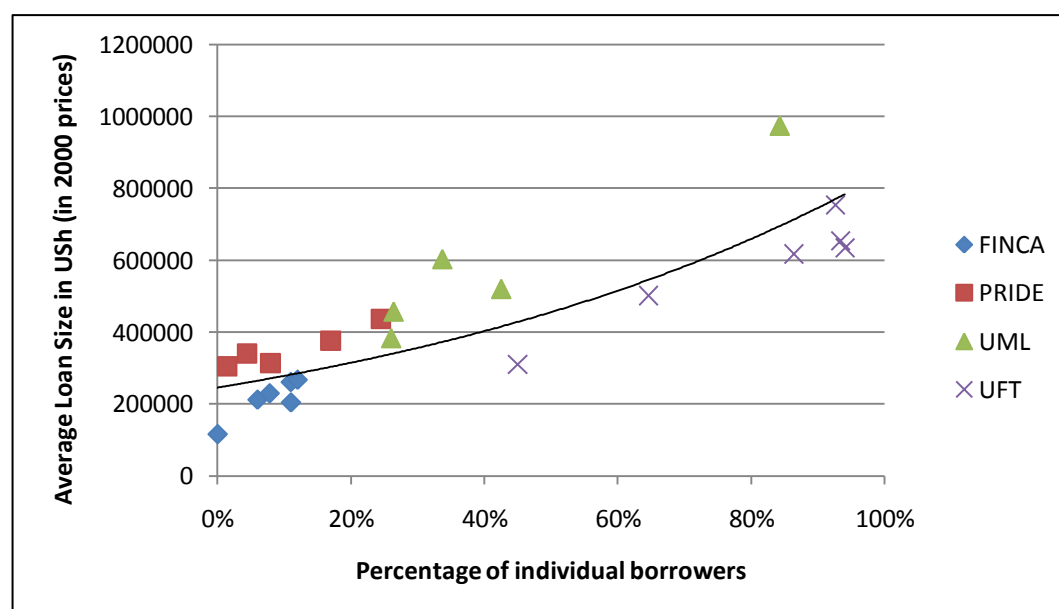
Using the categorisation for target market peer groups used by the MicroBanking Bulletin (MIX 2008, 34), which is based on average loan sizes/GNI per capita, in 2008 FINCA and PRIDE fell into the “broad” category, UFT in the “high end” category and UML the “small business” category. All MFIs in CG2 fell in the “broad” category (as did TG MFIs before transformation) and both MFIs in CG1 in the “small business category.” It can be concluded that for two of the four MDIs, regulation has led to a marked increase in average loan size.

The question is whether this is sufficient evidence for *mission drift* and thus a negative impact on depth of access. Cull, Demirgüç-Kunt, and Morduch (2009b, 8) conclude from their recent analysis of the global MIX database: “On average, commercial microfinance banks make loans that are about four times larger than loans from NGOs, suggesting that they tend to serve a substantially better-off group of borrowers.” This assumes that average loan size is a good enough meas-

¹⁷¹ All figures have been adjusted for inflation.

ure for depth of outreach. Yet an increase in average loan size might have other reasons. One potential explanation is that microfinance has been successful in that it helped poor customers to become more successful and demand larger loans. Another explanation is that the MFI has won additional customers with higher loan demands as a deliberate strategy of cross-subsidising poorer customers.¹⁷² Neither of these would constitute mission drift (Armendáriz and Szafarz 2009, 2). A much better indicator is therefore changes in number of loans broken down by loan sizes. Unfortunately, it was not possible to obtain this kind of information.

Figure 4.8: Share of Individual Borrowers versus Average Loan Size



In all cases, average loan sizes have been increasing over time and the data represents the years 2003 to 2007 for PRIDE and UML and 2003 to 2008 for FINCA and UFT

Instead, it can be useful to look at the correlation between the share of individual borrowers and average loan size, which appears to be quite strong (see scatter plot in Figure 4.8 above). It can therefore be assumed that one of the drivers for increasing loan sizes has been a shift to individual loans, which are typically larger with more traditional collateral requirements. In a letter to BoU, MDIs gave the following reason for the shift to individual loans:

¹⁷² This would be in line with the statement of the CEO of one MDI that they have only “widened their scope” by continuing to offer the same pro-poor products, but adding some new products targeting better-off customers [MDI/R/C/115].

The restriction of not allowing MDI [sic!] to use LIF to off set defaulting members arrears by default means killing the group lending methodology. This is mainly because MDIs have been using such transfers or set offs to enforce discipline in the groups as well as recovery. Doing away with the group lending methodology leaves no other option through which the poor can access credit other than as individuals. We all know that under the individual loan methodology formal collateral with sufficient value is a must. The very thing the poor do not have. [UD/C/64]

This would imply that a) the shift to individual lending is caused by regulation (because of the prohibition on intermediating compulsory savings), b) this shift is inevitable, and c) that it goes hand in hand with serving better off clients. As can also be seen from the scatter plot, the shift has been most pronounced for UML and UFT, while FINCA did not reduce its share of group borrowers at all and PRIDE experienced a more moderate decrease in the share of group borrowers than all MFIs in CG2 (between 2004 and 2008) “Killing” the group lending methodology is therefore definitely too strong a term. Also, there is mixed empirical evidence from Uganda and elsewhere as to whether group lending is correlated with better outreach to poor clients.¹⁷³

One potential explanation for these observations is that the increase in average loan size is most pronounced for the two MDIs which had to comply with the 30% shareholding limit and diversify their ownership structure (UML and UFT), thereby changing to a more profit-oriented shareholding structure. In Kenya, the Chairman of the local microfinance association expressed a similar concern with regard to the 25% shareholding limit applicable to deposit-taking MFIs: “Bringing in new shareholders who don’t share the vision of the current owners merely because you need to fulfil the law on deposits could change the orientation of the business as it becomes more about making profits than poverty alleviation.”¹⁷⁴ Both UML and UFT have substantial shareholding by private investors and social investment funds, while the two MDIs that enjoy an exemption from the single shareholding limit have much lower average loan sizes and are fully owned by

¹⁷³ (Okumu 2007, 201) finds in his study on Uganda that the group-based delivery mechanism compared to the individual lending methodology is negative related to outreach. He also provides a good overview about related research (ibid., Chapter 4.2.8.3).

¹⁷⁴ Geoffrey Irungu, “Deposit-taking rules restrict small lenders,” *Business Daily* (Nairobi), 22 February 2010.

non-commercial investors (an international NGO and the Government of Uganda, respectively).¹⁷⁵ Ownership thus seems to be an important determinant for the share of group borrowers and the average size of loans, thus supporting Hypothesis 3 that the 30% shareholding limit increases the risk of mission drift.

If the hypothesis holds that the change to a more profit-oriented shareholding structure pushed up average loan sizes as larger loans are more profitable, this strategy only paid off for UML, which had the highest ROA of all MDIs for post-licensing years (4.47% on average between 2005 to 2008). This compares to the lowest value for UFT (0.96%), even though it had among the highest average loan sizes over this period. Using a global database of about 2,600 MFIs, Gonzalez and Rosenberg (2006) find a very weak relationship between loan size as percent of GNI per capita and ROA and a low slope of the curve. Using panel data on 53 Ugandan MFIs (mature and less mature Tier 4 MFIs) over a six year period (2000 to 2005), Okumu (2007, 200) finds a significant negative relationship between average loan size and sustainability (measured by operational self-sufficiency). Increasing average loan size thus seems not to be a sufficient strategy to increase profitability and thus safety and soundness.

An alternative explanation for the increase in average loan size could be that strict portfolio quality regulations might have led to a slowdown in customer growth. Combined with better availability of funding, the easiest way to grow the loan portfolio without compromising portfolio quality was to issue larger loans, which, again, could best be done by issuing more individual loans. The following quote summarising the experience of one MDI at the end of 2005 confirms this view:

Gross portfolio ended the year at 13.4 billion, up 12.8%. . . . However, the company experienced a precipitous decline in borrowing clients – from 20,440 to 17,052, with the [among the four MDIs] biggest decline in group loans (over 50%). The company has not articulated a clear strategy vis-à-vis group loans, and loan officers are following the easiest path to portfolio growth: ever-larger individual loans. [UD/R/19]

¹⁷⁵ See Section 5.1 for a discussion of the shareholding structure of MDIs.

Data cleanup is not mentioned by this report as one of the reasons for the drop in number of borrowers.

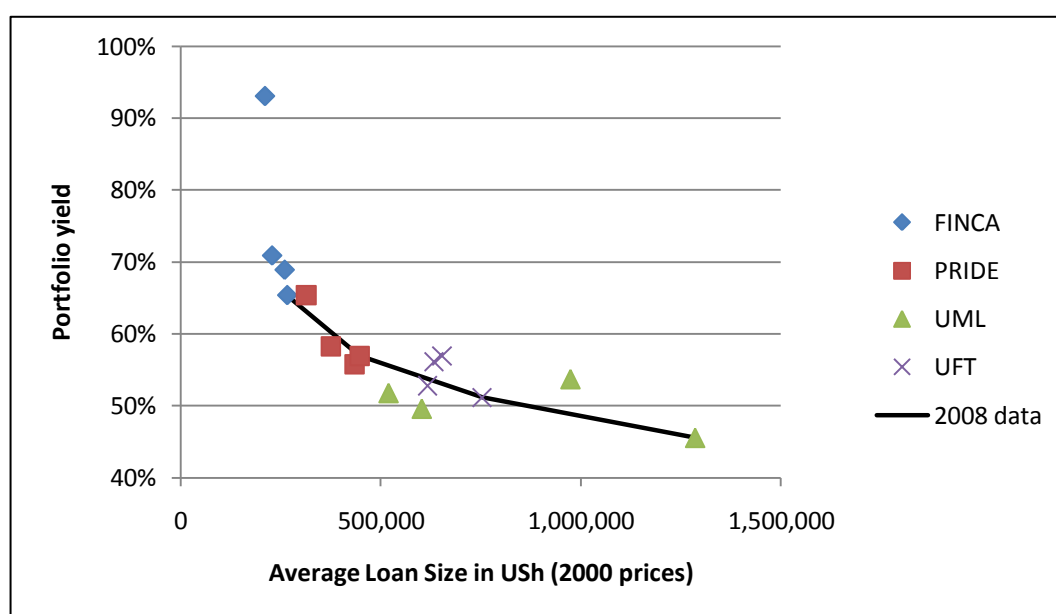
The following conclusions can be drawn from this analysis. Regulation had a negative impact on the number of clients having access to loans. While improved access to finance did indeed allow all MDIs to substantially grow their loan portfolio, it did not lead to a similar increase in number of borrowers served. There are different possible explanations for what pushed up average loan sizes so that the number of borrowers did not grow much and the relative importance of each of these cannot be established without more detailed research.

- The easiest way for MDIs to grow their portfolio and at the same time achieve or maintain excellent portfolio quality was to increase average loan size. Regulation played a role in this to the extent that good portfolio quality became much more important.
- The prohibition on making use of compulsory savings to offset arrears by defaulting group members rendered the group lending methodology much less attractive. So did the prohibition on intermediating LIF. Individual loans as the alternative have on average higher loan sizes.
- Changes in the ownership structure triggered by the ownership limit of 30% led to a commercialisation of two of the four MDIs, which subsequently switched to a higher share of individual lending and much larger average loan sizes. This pressure to go upmarket could best be resisted by the MDI fully owned by an international NGO with a clear focus on the double bottom line.

It is an open question whether the shift to a higher share of individual and larger loans actually led to mission drift and had a negative impact on depth of access. Armendáriz and Szafarz (2009) discuss the thin line between cross-subsidisation (which is good) and mission drift (which is bad) and how difficult it is to empirically tell them apart. The only indication for this is that the MDIs themselves claim not to be able to serve the same poor customers with individual loans.

Finally, *portfolio yield* can be used as a proxy indicator for cost of borrowing with affordability being an important determinant for access. Various impact channels are at work when looking at portfolio yields. The CEO of FINCA lists three main channels that increase the pressure to lower rates: transparency through disclosure requirements, increasing competition, and improved efficiency caused by more commercial operations [MDI/R/C/115].¹⁷⁶ In addition, lower cost of funding could bring down rates, while compliance costs would push them up. The overall effect is indeterminate. Cull, Demirgüç-Kunt, and Morduch (2009b, 8f) conclude from their empirical analysis of the MIX database that interest rates of unregulated NGOs are about double those charged by commercial microfinance banks, which leads to the expectation of falling rates after licensing.

Figure 4.9: Average Loan Size versus Portfolio Yield for TG



In all cases, average loan sizes have been increasing over time and the data represents the years 2005 to 2008

Looking at the results from Uganda, the average portfolio yield for the TG (weighted by gross loan portfolio) in 2008 at 52% was only slightly lower than in 2003, when it stood at 54%, and experienced higher values in the interim (a

¹⁷⁶ Isern and Abrams (2008, 48) show the empirical relationship between portfolio yield and expense ratios.

maximum of 63% in 2005).¹⁷⁷ In 2008, portfolio yields for MDIs ranged between 46 and 66%. Not surprisingly, the MDI with the highest value is the one with the lowest average loan size, and vice versa (see the connecting line in Figure 4.9). This could be an indication that interest rates are to a great degree determined by the size of loans.¹⁷⁸ The relationship between average loan size and portfolio yields had not been that close in earlier years, which could be an indication for increasing competition that does not allow for huge price differences for similarly sized loans. Overall, portfolio yields are still extremely high in comparison to other Sub-Saharan African countries with a weighted average yield of 23.9% in 2006 (Rosenberg, Gonzalez, and Narain 2009, 9). The MDI regime has so far not had any positive impact on the affordability of access and any reductions in portfolio yield have been mainly driven by increasing average loan sizes. The reason for the lack of price reductions could be that the microfinance market has not yet reached the consolidation phase, during which MFIs start to compete on price (Porteous 2006). Furthermore, supervisory costs can put pressure on the profitability of MDIs (Cull, Demirgüç-Kunt, and Morduch 2009a), which makes it difficult for them to reduce interest rates.

Access to Savings

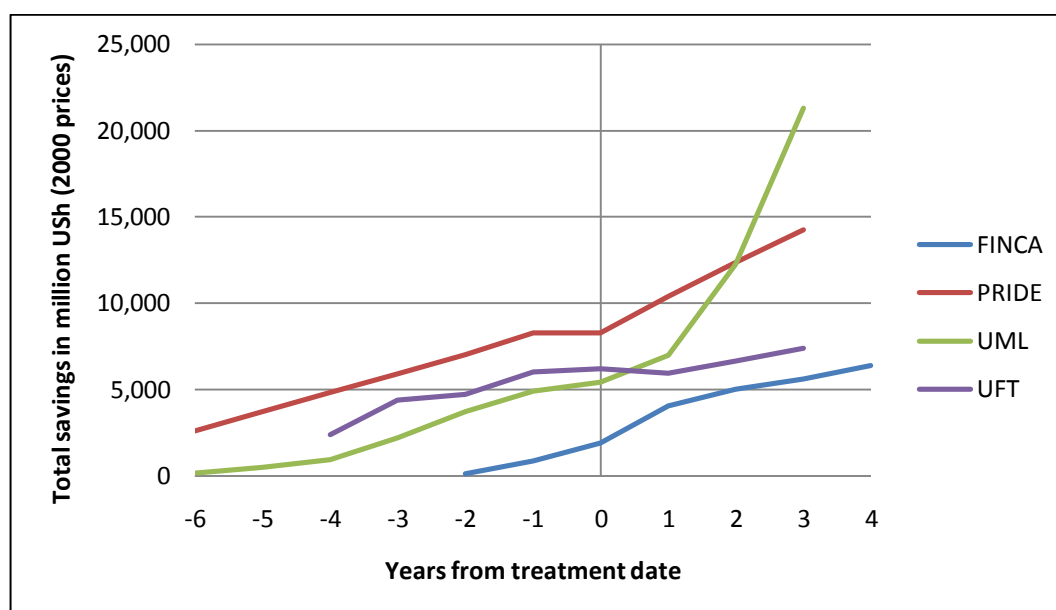
On the savings side, one would expect to see a much more pronounced change than on the lending side. Being regulated and supervised institutions, MDIs are for the first time permitted to go into voluntary deposit-taking. This is the single most important difference between MFIs in Tiers 1 to 3 and those in Tier 4. In addition, increased safety and soundness of MDIs should encourage depositors to entrust their savings to the MDI, especially once the deposit insurance system for MDIs is fully operational and widely understood. Even if some MFIs had already started taking voluntary savings before, without getting a licence the Central Bank might not have allowed them to continue taking or even growing voluntary savings

¹⁷⁷ In the case of UFT, average loan sizes **and** portfolio yields have increased over the years without any increase in profitability, which is a clear sign of inefficient operations (see below).

¹⁷⁸ Waterfield has established similar relationships between annual effective interest rate and initial average loan size for various regions, with the Southern Africa region showing the weakest relationship. See slideshow “Why We Need Transparent Pricing in Microfinance” at <http://www.mftransparency.org>, accessed 5 December 2009.

much longer. There is a clear impact expected of the regulation on the *amount of savings* mobilised and the *number of savers* served. The former is not so much important from an access perspective, but more as it constitutes an additional source of funding portfolio growth (Hartarska and Nadolnyak 2007, 1217).¹⁷⁹ Ledgerwood (2006, 174) confirms that transformed institutions increasingly rely on deposits as a funding source, while Jansson (2003, 6-7) observed in the case of Bolivia that the growth in savings volumes was slow in the first years after transformation, only to win traction a few years later.

Figure 4.10: Total Savings for Treatment Group



Looking at total savings (compulsory and voluntary), the growth in savings has been moderate except for UML in the last two years. The chart above (Figure 4.10) uses the years before and after treatment (2004 for FINCA, 2005 for the others) as its timeline as the permission to mobilise savings is clearly linked to the licence. It shows for three of the four MDIs a more or less constant gradient before and after licensing, which implies decreasing growth rates, but similar growth in absolute numbers. The combined savings growth for the TG was US\$4.58 billion per year before licensing and has since increased to

¹⁷⁹ According to SEC. 19 (h) MDIA, MDIs are not permitted to intermedate the loan insurance fund. This is why it would be better to look at the increase in voluntary savings. However, I have much more detailed data on total savings.

US\$8.46 billion per year. These are still modest figures compared to Centenary Bank, which added US\$25.47 billion per year in the same period (2005 to 2008). At the end of 2008, Centenary was holding almost four and a half times the amount of savings of all MDIs combined. The upsurge for UML in 2007 and 2008 (when it was still regulated as an MDI and not yet subject to any regulatory changes) suggests that savings mobilisation is not mainly a regulatory issue, but depends more on following the right savings mobilisation strategy.

In line with the slow growth of overall savings, deposits as a source of funding for the lending business of MDIs measured by the *savings to loans ratio* turned out to be less important than one would expect. For all TG MFIs except for FINCA (which as an NGO did not hold any client savings in its own name) savings financed a similar or even higher (UFT) share of the gross loan portfolio before licensing – when voluntary savings business was in theory not even allowed – than it did in 2008. In 2008 only between 42% and 55% of the loan portfolio was financed by savings. As a comparison, the deposit to loan ratio of nine transformed Latin American MFIs in 2003 stood at 65%.¹⁸⁰ This stands in stark contrast to Centenary, which consistently held more savings than it needed to finance its loan portfolio – so much so that it is a declared objective of the bank to decrease this ratio.

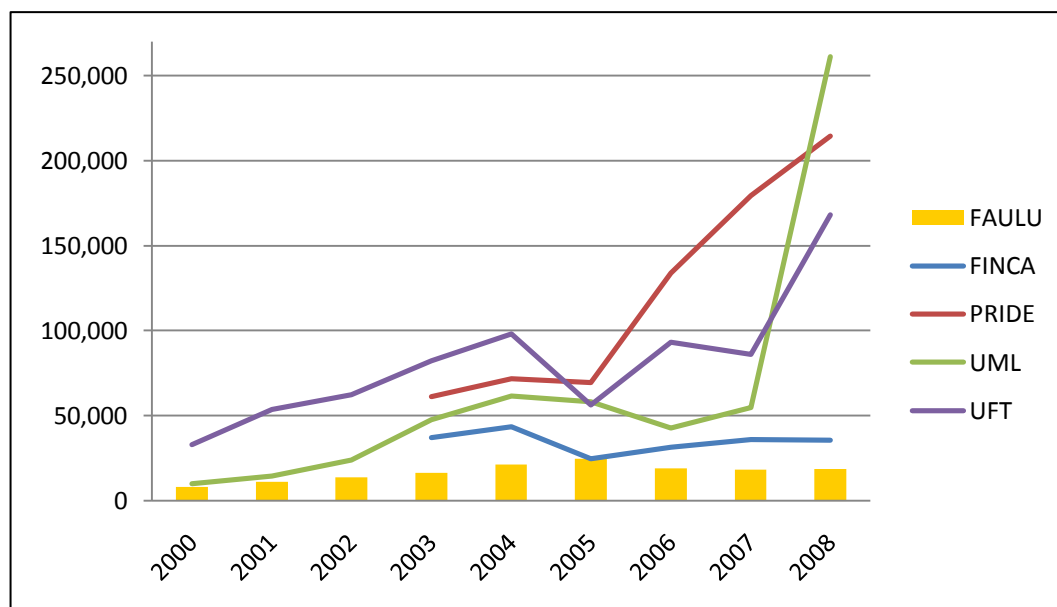
One can only speculate what the reasons for the slow savings growth are. The high cost of, and therefore slowness in, opening new branches, which are needed to be close enough to potential customers could be one. Another reason, which is not a regulatory issue, could be that turning a credit-only MFI into a deposit-taking institution requires profound cultural and institutional changes (Christen, Srinivasan, and Voorhies 2005), so that it could still be too early to judge the impact of the MDI regime on savings.

A final observation regards the shift from mainly offering compulsory savings to also offering voluntary savings products: the ratio of compulsory savings as a

¹⁸⁰ Weighted average calculated from Fernando (2004, table 6), all data except for one MFI (2000) from 2003.

percentage of total savings has come down from 68% in 2004 to 23% in 2008. One of the drivers behind this is likely to be the prohibition on intermediating compulsory savings, which have to be held in liquid assets with a low return. This shift can be regarded as a positive regulatory impact on “scope of access,” as voluntary savings facilities represent a new product category.

Figure 4.11: Number of Savers for Treatment Group and FAULU



To measure the breadth of access to savings products, the *number of savers* is the best known indicator. Similarly to the lending business, the number of savers (compulsory and voluntary) experienced a more or less dramatic drop for all MDIs in 2005 (Figure 4.11). Yet apart from FINCA, all MDIs have added substantial numbers of new savers since. UML has more than quadrupled its numbers since it was bought by Equity Bank Kenya in 2008. FINCA has not yet recovered from the steep drop in 2005, while UFT and PRIDE have experienced impressive growth rates since 2005.¹⁸¹ The temporary drop in numbers could again be attributed to data cleanup as part of the licensing process as well as to the preoccupation of management with working on the transformation at the expense of manag-

¹⁸¹ The drop of numbers for FINCA should be read with some caution as it only shows in the data from the MIX Market, which are used here, while PMT figures show much higher numbers for all years. A comparison with the projections from the MDI Business Plans gives the following results for 2006: PRIDE +99% (higher than projections), UFT -17% [UD/R/33], and UML -34% [UD/R/32].

ing the day-to-day business. The rise in the years since is an indication that MDIs have been able to reach new customers. All MDIs except FINCA now have a multiple in the number of savers as they have in borrowers (between 3.5 and 9.5 times), which indicates that they have been much more successful in increasing outreach with savings products than with loans. The huge difference in the success of attracting savers between FINCA (which still has more borrowers than savers) and UML in the year 2008 cannot be explained by regulation. It has mainly to do with UML's new savings mobilisation strategy, which abolished minimum opening and operating balances, account maintenance and ledger fees, and streamlined the account opening process,¹⁸² made all the easier (and more efficient) by Equity Bank's decision post-acquisition to change the MIS to bring all branches online. All of these changes could have been implemented by UML (or any of the other MDIs) before, as they are not subject to restrictions under the MDI legislation. One can conclude that regulation was a necessary condition to boost the number of savers, but whether this was done successfully depended to a large extent on MDIs implementing the right savings mobilisation strategy. UML is a case in point, as its fortunes only changed after it had been bought by Equity Bank (and while it was still regulated as an MDI).

To assess the depth of access in the savings business of MDIs, Gonzalez and Meyer (2009) recommend looking at a ratio of *average savings per saver to average loan size*. A value below 100% suggests that an MFI has "been able to design and mobilize voluntary deposits with instruments that match the needs of individuals as poor or even poorer than their borrowers" (ibid., 12). The legal framework for MDIs does not include any provision directly aimed at the type of depositor to be reached, which means that MDIs are not confined to offering microsavings. Similar to the empirical results obtained by Gonzalez and Meyer, who looked at more than 1000 MFIs in 104 countries, all MDIs had in all years very low values mostly below 40%, with FINCA being the only MDI in the 60 to 80% range (but also being the MDI with by far the lowest average loan sizes). No ob-

¹⁸² Edris Kisambira, "Equity Bank Opens 800 Accounts Daily," *Daily Monitor* (Kampala), 8 April 2009 and Aggrey Nshakanabo, "Equity Bank Uganda Opens 1,200 Accounts Daily," *East African Business Week* (Kampala), 20 July 2009.

vious change can be observed after treatment. The values for both Control Groups lie in the same range. An interesting case is UML in 2008, which experienced a sharp drop in values from 23% to 6.3% while at the same time experiencing a strong increase in average loan size. This was due to the removal of minimum account balances as noted above. It can therefore be concluded that depth of access is not a regulatory issue, but rather a business decision by individual institutions.

In sum, regulation had in general a positive impact on savings, even if savings volumes are still growing slowly. This is partly due to low average savings amounts, but could also be a sign of how difficult the process is of changing from a credit-only to a deposit-taking institution. MDIs have still been much more successful in reaching new customers through savings than through loans. Regulation is a necessary condition for this, but has to be complemented by the right savings mobilisation strategy.

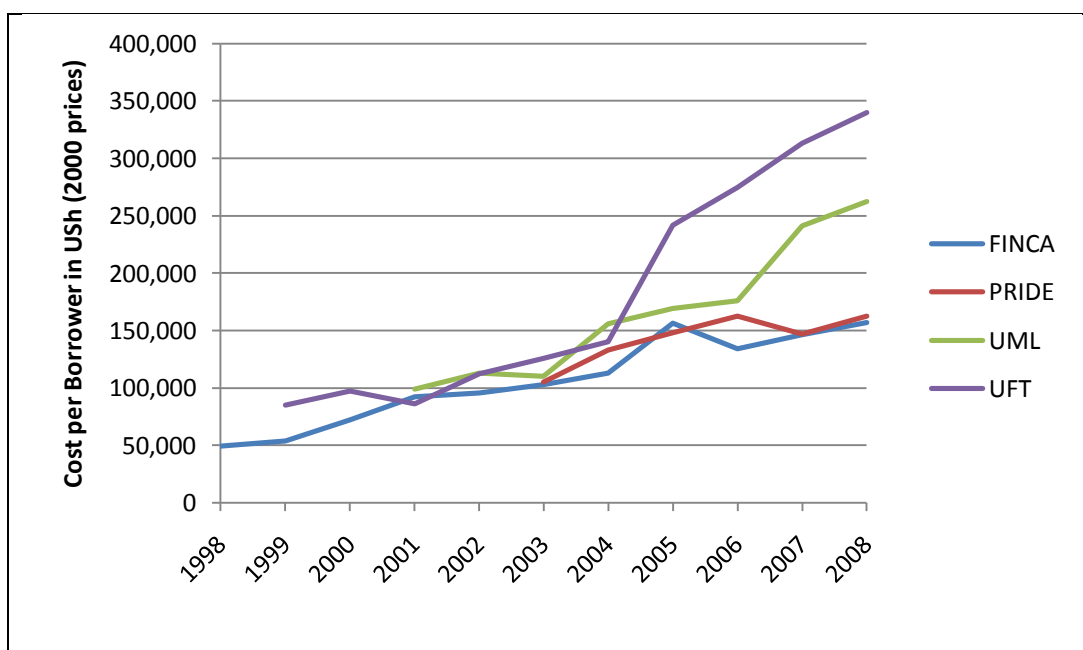
Efficiency

Efficiency is not directly related to any of the regulatory objectives, but plays an important indirect role for the safety and soundness and access objectives. It is also a measure of competition in the sector. Portfolio yields crucially depend on the efficiency of operations, typically measured by the *operating expense ratio*, defined as operating expense as a percentage of loan value. Growth of the institution leading to larger loan sizes, improved governance, more profit-oriented ownership, and more competition can all be caused by regulation and should lead to increased efficiency of operations. An effect in the opposite direction is compliance costs, which can push up the operating expense ratio. Cull, Demirgüç-Kunt, and Morduch (2009a, 10) conclude from their cross-country analysis that “profit-oriented microfinance institutions absorb the cost of supervision by curtailing outreach to market segments that tend to be more costly per dollar lent.” The main strategy to achieve this is to increase the average loan size, which shows in a lower operating expense ratio. The same authors find that the ratio is highest for the median NGO (26%), lower for non-bank financial institutions (16%) – MDIs

would fall in this category – and lowest for banks (12%) (Cull, Demirgüç-Kunt, and Morduch 2009b, 9). For the TG, the mean of the same ratio was 41% in 2003, reached a local maximum of 45% in 2005 (which could be due to high transformation costs), and has since come down to 37% in 2008. The range between different MDIs is huge with the lowest value being 24% and the highest 67% – all being very high values by international standards.

As with portfolio yield, there is a similar strong correlation between average loan size and operating expense ratio. One explanation could be that MDIs have indeed increased their average loan sizes to cover additional costs of being supervised (as suggested by Cull, Demirgüç-Kunt, and Morduch). This is a problematic strategy from a public interest perspective, as depth of access is likely to suffer.

Figure 4.12: Cost per Borrower for Treatment Group



A look at *cost per borrower* as another indicator for efficiency improvements supports the argument that efficiency improvements have been mainly driven by increasing loan sizes, as the efficiency of the core business of lending has been decreasing (see Figure 4.12).¹⁸³ Comparing average loan sizes and cost per borrower ratios, there is a strong correlation between the two for all four MFIs in the

¹⁸³ There are other potential explanations for this such as an increase in multiple loans to the same customer (the ratio measures cost per borrower, not cost per loan).

Treatment Group. It can be concluded that MDIs have experienced only modest improvements in operating efficiency after a temporary deterioration around the treatment date. The most likely reason for any improvement at all is increasing average loan sizes, which also explains similar observations for portfolio yield.

Liquidity

The last impact area to be examined is liquidity – again an important indicator for the safety and soundness objective. As part of its offsite surveillance, BoU monitors the MDIs' liquidity positions looking at the statutory limit for the liquidity ratio (minimum 15% liquid assets net of LIF as percent of deposit liabilities), the liquid ratio (liquid assets to total assets), and two lending ratios (advances to deposits, and advances to deposits and borrowings) [UD/R/10: 9-10]. One would expect to observe that liquidity levels remain above the statutory minimum, but not too much as holding idle cash reduces the earning potential of the MDI. The statutory limit is not likely to be a constraint for newly licensed MDIs which have not yet started mobilising substantial deposits. Unfortunately, it was not possible to get sufficient data for testing compliance with the liquidity ratio.¹⁸⁴ The liquid ratio does not show a clear trend and has been quite volatile for all MDIs.

Conclusion

This chapter has made use of quantitative performance indicators to measure regulatory impact. As could be shown, the ROI approach is demanding with regard to the availability of data and good control groups. A formal regression analysis cannot be conducted if the number of observations is small, treatment and control groups are heterogeneous, sufficiently similar control groups lacking, and the impact of regulation on the respective variable is not clear. Instead, the graphical presentation of results in line charts can visualise the development of treatment group variables before and after licensing and a comparison of these observations with the development of control group variables is useful in identifying regulatory

¹⁸⁴ At least one MDI did not initially comply with the statutory minimum as it had a negative liquidity ratio of -28% at the end of 2004, which improved to 7.3% as of 31 March 2005 [UD/R/16].

impact. In some cases, comparison with a “best match” (such as FAULU in the case of Uganda) is the best strategy to clearly identify regulatory effects. Scatter plots can visualise correlations between two dependent variables and changes in variance give an indication of the impact of regulation on the dispersion of values. For each performance indicator, the empirical analysis should be preceded by an analysis of the expected impact on the basis of a legal analysis of the regulatory regime (such as the analysis in Section 3.3). Important observations are that many dependent variables are affected by regulation through various impact channels, which at times may have opposing effects on the variable leading to an ambiguous overall effect, and that short-term impact can differ from medium- to long-term impact. Overall, the quantitative analysis of performance indicators is best used for assessing regulatory impact on the safety and soundness and access objectives.

As far as the empirical results from Uganda are concerned, the following Table 4.2 summarises the results. The story of the effects of regulation as it emerges from this analysis is as follows. The regulatory impact of the MDI regime shows most in improvements of the safety and soundness of MDIs measured by indicators such as profitability, capital, and portfolio quality, which supports Hypothesis 1. The dispersion of profitability and capital ratios has reduced substantially and they are now within a reasonable range above the statutory minimum requirements. Portfolio quality for all four MDIs went through a temporary slump in the licensing year, which was partly caused by changes in measurement of portfolio quality, but also partly by the lack of attention to repayment performance during the demanding process of transformation. In the following years, portfolio quality clearly improved to reach excellent values for all MDIs in 2008.

Performance indicators could also be used to measure depth, breadth, and affordability of access. The two MDIs with the biggest change in ownership towards more profit-oriented shareholders (which was at least partly triggered by the strict shareholding limit) have experienced a strong increase in average loan sizes. Possible reasons for this are a clear shift from group to individual lending triggered by commercialisation and restrictions on the use of compulsory savings (which were popular as part of the group lending technology) and strict portfolio

requirements making it easiest to grow the loan portfolio by issuing fewer and increasingly large loans. There is not sufficient evidence to prove whether or not this has also led to mission drift. The number of borrowers dropped around the treatment date and remained depressed for all four MDIs, only picking up again for two of the four at the end of the observation period. It is still too early to say whether regulation will lead to lower growth rates in number of borrowers in the long term. Lending rates (proxied by portfolio yields) have hardly come down, not least because of increasing costs per borrower, and are closely correlated with average loan sizes. On the savings side, a similar drop in the number of savers occurred during licensing, which however was more than made good in subsequent years. All MDIs except one have been successful in reaching large numbers of small savers.

Table 4.2: Impact of the MDI Regime on Performance Indicators

<i>Impact Area</i>	<i>Observation</i>
Profitability	Temporary drop in profitability around treatment date, but after licensing in range between 1% and 6% due to higher competition and regulator's attention to minimum return on assets
Capital	After licensing almost all values in a range of 15% to 30% capital to assets ratio
Portfolio Quality	Higher PAR ₃₀ values around treatment date, which were at least partly caused by accounting changes, followed by a peak in write-offs for two of the MDIs. Longer-term trend positive with almost all PAR ₃₀ values below 5% since 2006
Breadth of access	Drop in number of loan clients around treatment date with slower growth in subsequent years. Temporary drop in number of savers around treatment date with strong growth in subsequent years for all MDIs except FINCA
Depth of access	Surge in average loan sizes for two of the four MDIs, driven by a higher share of individual loans. All MDIs showing low values for average deposits per depositor as percentage of average loan balance per borrower
Affordability of access	Hardly any reduction in portfolio yield in comparison to 2003. Portfolio yields closely related to average loan size
Scope of access	Higher share of individual loans and voluntary savings
Efficiency	Positive impact on operating expense ratio mainly driven by larger average loan sizes, while cost per borrower increased in tandem with increasing loan sizes

However, it is important to bear in mind that this interpretation of the results is often based on limited quantitative evidence, which lies in the nature of drawing broad conclusions from a small sample size. In particular, the strength of various

impact channels and at times also the direction of causality are not clear from looking at outcome variables alone. In the following chapter, I will broaden my evidence base and use results from the analysis of other sources and interviews to corroborate the results presented so far.

CHAPTER 5 – QUALITATIVE ANALYSIS OF REGULATORY IMPACT: PROCESS TRACING

Process tracing is akin to detective work. The maid said this; the butler said that; and the suspect was seen at the scene of the crime on Tuesday, just prior to the murder. Each of these facts is relevant to the central hypothesis – that Jones killed Smith – but they are not directly comparable to one another.

Gerring, John. 2007. *Case Study Research: Principles and Practices*. Cambridge: Cambridge University Press, p. 173

This chapter does what Gerring describes as *process tracing*. It brings together many pieces of information from different sources, which have one thing in common: they provide evidence about the achievement of one or more of the five regulatory objectives. After the legal analysis in Chapter 3 and the quantitative analysis of performance indicators in Chapter 4, this is the third step in the application of the RIA methodology developed in Chapter 2 to the case study of Uganda. It again makes use of the indicators developed according to the ROI approach, but this time drawing on qualitative indicators. These complement the quantitative analysis of MFI performance indicators in the previous chapter by providing a deeper understanding of causal mechanisms and also assessing the other regulatory objectives not yet covered. The main sources of information for the impact indicators discussed here are interviews and documents describing the institutional change of MDIs and changes in the microfinance market. As explained in Section 2.4, regulatory impact often cannot be measured directly. This chapter looks at *market outcomes* other than changes in performance indicators, and at *institutional changes* caused by regulation as proxy indicators for regulatory impact in each of the five areas (cf. Table 2.4). The analysis of institutional changes can provide additional evidence for future regulatory impact as the introduction of the new legal framework has been quite recent and its full impact can therefore not be gauged by looking at market outcomes alone. The results from the previous chapter and this chapter together provide a comprehensive assess-

ment of the regulatory impact in microfinance as measured against the public interest benchmark.

The chapter is broken down by the five regulatory objectives. As the objectives are not independent of each other, but subject to trade-offs and supportive relationships (see Table 2.3), some indicators cannot be unambiguously assigned to a single objective. In such cases, they will be discussed under the objective with which they have the clearest causal relationship. The focus will again be on changes directly affecting MDIs, but I will also look at changes in the relationship between MDIs and their customers, MDIs and the regulator, and the impact on the wider financial sector. Appendix 7 summarises the results in all five areas.

5.1. Safety and Soundness

The safety and soundness objective is the one which can most easily be measured by looking at *market outcomes*. Many of the performance indicators discussed in the previous chapter provide information about changes in this area. The main conclusion was that regulation has been successful in maintaining minimum levels of capital and profitability, and in achieving, at least in the medium term, good portfolio quality. All these are strong indications that the regulation is achieving its safety and soundness objective. That MDIs improved their performance over the years is confirmed by their BoU ratings. BoU routinely awards two ratings based on its risk-based on-site examinations, a composite risk rating and a CAMELS rating. The results for 2006 to 2008 are summarised in Table 5.1.

Table 5.1: Development of Bank of Uganda Ratings of MDIs

	<i>Composite risk rating</i>		<i>CAMELS rating</i>		
	high	moderate	unsatisfactory	fair	satisfactory
2006	4	0	1	3	0
2007	0	4	0	0	4
2008	0	4	0	0	4

Source: (BoU 2007, 2008b, 2009b)

Supervisory structure and the supervisor's capacity are important determinants for the effectiveness of regulation and its impact on safety and soundness of

MDIs. The MDI Supervision Unit (a separate unit within the NBFID Department) is, with eight staff, well equipped to perform its task of both on and off-site supervision (Terberger 2006, 55). In 2005, supervision staff attended a specialised five-day training course on Risk-Based Supervision of MDIs conducted by two well-known experts in this field from ACCION International. According to ACCION's course completion report, the trainers were very impressed with the participants from BoU, and the participants saw this course as highly relevant for their work [UD/R/27].

Institutional and operational changes caused by regulation can give an indication of future developments. Chief among these are changes in ownership and governance structures and operations of MDIs. The *supervisory practice* of BoU gives a clear indication of regulatory impact on **governance**:

- **Diversified shareholding structure:** The shareholding limit of 30% has helped to create a diversified shareholding structure with checks and balances for two of the four MDIs. UFT has a more diversified shareholding structure with substantial shareholding by the founding NGO, social investors, its founders and employees. UML is jointly owned by its founders and social investors. However, FINCA is still fully owned by FINCA International and PRIDE is 100% government-owned.¹⁸⁵ In line with its proclaimed policy to withdraw from direct delivery of credit, the Government had three years to divest itself of its ownership of PRIDE – a time limit that was eventually not enforced [UD/M/17]. This is in line with experience from other countries, which shows that transformed NGOs lack significant purely private risk capital investments (Fernando 2004, 7-14).
- **Board composition:** As one of the licensing requirements, the Central Bank conducted thorough fit and proper tests on directors and evaluated the skill composition of the board. Corporate governance was identified as one of the

¹⁸⁵ BoU exempted FINCA International from the shareholding limit as a “reputable public company” according to SEC. 21 (3) MDIA. PRIDE is a special case, as it is fully owned by the Government of Uganda and therefore not owned by a “person” as defined in the MDIA.

main problem areas. In the case of PRIDE, BoU fired the whole board due to some (unspecified) governance issues (Obara, Mukasa, and Staschen 2007, 24). Another critical issue before licensing was the undue influence of founder-members of the NGOs, which was alleviated through the 30% ownership limit forcing MFIs to attract international investors and establish a more diversified board composition in two of the four cases [MDI/I/S/112]. The fit and proper test also allowed management to more easily replace founder members lacking adequate skills [UD/M/75].¹⁸⁶ FINCA is the one institution with a clear majority of directors representing its single owner (three out of five) and thus with few checks and balances.

- **Board committees:** Reportedly BoU insists on MDIs having an asset liability management, audit, risk management and human resource committee and a Treasurer, even though none of this is required by law [MDI/I/S/112]. This would be in line with Hypothesis 2 stating that the Central Bank has powers to shape the regulatory framework according to its own interests.
- **Internal audit:** BoU in several cases asked for changes when it deemed that the independence of an MDI's internal audit function was compromised [BOU/G/O/105].

As a result, BoU is perceived as being strict as far as enforcement of good governance rules for MDIs is concerned. It has sufficient powers to intervene early and stipulate corrective actions, and it has made use of them, thereby supporting Hypothesis 2.

As regards **management** changes, BoU equally made use of its powers by requiring one MDI to change its CEO [BOU/G/O/105], others to hire senior managers with banking experience, or to hire a well qualified internal auditor (Obara, Mukasa, and Staschen 2007, 25). MDI senior managers acknowledge the positive role BoU played in bringing quality staff with minimum education levels and adequate

¹⁸⁶ Obara, Mukasa and Staschen (2007, 24) provide an overview on how the board composition of the four MDIs changed after transformation.

levels of experience to the institution [MD/I/S/112] – in the words of one former CEO of an MDI: “external pressure helped things to happen” [MFI/I/C/103]. A sign of the high qualification of management is that MDIs are subject to poaching from commercial banks and have had to respond to this by paying higher salaries, performance-based bonuses, and offering training and clear career paths for their employees [MDI/I/S/102]. As a comparison, over the same period some of the unregulated Tier 4 MFIs suffered from serious management problems leading either to a crisis (MED-Net) or to the liquidation of the institution (FOCCAS, SOMED).

The MDI law also had a positive impact on the quality of **information systems**. All four MDIs upgraded their MIS in the course of transformation. This alone does not necessarily constitute a regulatory impact as some unregulated MFIs also upgraded their systems in the same period. Yet all MDIs explicitly mentioned the stringent reporting requirements as one of the main reasons for having to upgrade (PRIDE) or change (UML, UFT, FINCA) their MIS. The Central Bank reports that the minimum standards for the MIS as set out in SEC. 13 (1) of the MDI Licensing Regulations were a challenge for the applicants. In two cases, BoU requested changes to the MIS as it was not satisfied with the capabilities of the system in use [BOU/G/O/105].

Once the **Credit Reference Bureau** is fully operational, it is expected to have a positive impact on the quality of loan portfolios and thus on the safety and soundness objective.

Finally, an analysis of supervisory processes and practices can help to determine how the supervisory agency monitors the safety and soundness of MDIs and how it responds if problems arise. The extensive **reporting requirements** (see Table 3.3) are supposed to ensure that the Central Bank receives timely and meaningful information about the financial state of the industry. BoU asserts that in the beginning some of the reports were delayed due to the initial MIS problems [BOU/G/O/105]. Without having access to any of the inspection reports, it is dif-

difficult to judge their accuracy, but according to BoU, inaccurate reporting has so far not been a major area of concern and has improved through recent MIS upgrades.

The effectiveness of supervision hinges on the timeliness of corrective actions. Reporting alone without a sophisticated early warning system does often not allow for early detection of risk areas. A thorough analysis of risk management systems during **on-site inspections** plays a crucial role in this. It is also used to verify the accuracy of off-site reports. BoU distinguishes between comprehensive on-site examinations and follow-up examinations, the latter being undertaken to confirm that MDIs have complied with previous recommendations. The following pattern was observed over recent years:

Table 5.2: Frequency of MDI Examinations

	<i>On-site examinations</i>	<i>Follow-up examinations</i>
2006	4	2
2007	1	3
2008	3	0

Source: (BoU 2007; Obara, Mukasa, and Staschen 2007; BoU 2008b, 2009b). 2008 includes all three MDIs registered at the end of the year, as UML had already converted into a commercial bank

The express objective of BoU is to go once a year on-site plus conduct follow-up examinations, if required – a demanding target which it has not been able to meet in all years. In addition, BoU visited all newly licensed branches in 2006 and afterwards revisited those which were classified as high risk. The main risk areas BoU identified during these examinations were operational risk (banking operations, MIS, fraud, malpractices, delivery of products) and corporate governance [BOU/G/O/105]. In response to this, BoU imposed the described corrective actions in the areas of MIS, management, and board composition. Other instruments it used were to prohibit the payment of bonuses and in one case, the issuing of a Memorandum of Understanding with one of the MDIs detailing the steps required to improve performance (ibid.). The one MDI which was rated unsatisfactory in

2006 was subjected to mandatory prompt corrective measures as detailed in the MDI Act in case of capital depletion (BoU 2007, 7).

Interviews with industry experts confirmed that the MDI regulation has had a positive impact on safety and soundness. According to a former CEO of one MDI, “reinforcement from an external supervisor” by telling MDIs what to do and how to change has even helped them in becoming more profitable [MFI/I/C/113]. It can be concluded that BoU has followed a close hand-holding approach with frequent use of corrective actions, which has been successful in guaranteeing the safety and soundness of MDIs. This validates the analysis of the legal framework for MDIs in Section 3.3, which concluded that the focus of the regime is on prudential regulations concerned with the safety and soundness of MDIs (Hypothesis 1). It also confirms international experience from other countries that “transformation has, in line with the expectations, brought significant improvement in governance and institutional sustainability” (Fernando 2004, 13). The MDI candidates were all perceived as being strong, well-managed institutions, yet BoU supervision “exposed the real weaknesses (governance, management and operational) in some institutions which were otherwise considered strong and profitable” (Obara, Mukasa, and Staschen 2007, 46). Regulation led to real improvements in all these areas.

5.2. Systemic Risk

The size of systemic risk is notoriously difficult to measure. Systemic risk is to a great extent determined by the amount of deposit-taking from the public and the quality of safeguards shielding financial institutions from depositor runs. The more important clients’ savings are as a source of funding for an MDI, the higher the risk of it being negatively affected by sudden withdrawals of deposits. In theory, the introduction of the MDI regime should have increased systemic risk as it allowed MFIs for the first time to (legally) solicit savings from the public, even if regulation stipulated certain safeguards against systemic risk at the same time. In practice, many unregulated MFIs were (and still are) taking deposits without be-

ing subject to prudential regulation so it can be assumed that systemic risk existed even before.

As has been shown in Section 4.2, the onset of voluntary deposit-taking has led to increased savings amounts in Tier 3, even though the overall deposit base of MDIs can still be considered as being small and therefore liquidity risk as relatively low, albeit growing.¹⁸⁷ Whether this will also lead to substantial increases in systemic risk depends on the effectiveness of the safety net put in place and other market characteristics such as clients' trust in MDIs and their ability to distinguish systemic events from more limited crises only affecting single institutions or institutions different from MDIs. This section looks at the different channels through which systemic risk can spread and assesses the likelihood of contagion for each. As no systemic crisis has yet occurred in Tier 3, the likelihood of future crises can only be assessed with reference to proxy indicators.

So far there are no inter-MDI linkages so that **contagion through the credit channel** currently is not an issue among MDIs. However, as the negative impact of bank failures on MFIs during the 1998/99 banking crisis showed (see "Externalities" in Section 2.2), MDIs can potentially suffer from contagion through the credit channel if one of their partner banks fails. This risk is likely to have been reduced since MDIs no longer keep all their savings with banks (as they had to), but use them for lending.

Contagion through the information channel is likely to be the more serious problem for MDIs, in particular as many clients are clients of more than one MDI so that bad news is likely to spread quickly [BOU/G/O/105]. Four different impact indicators can be used to gauge MDIs' susceptibility to runs. Firstly, there could be negative information about MDIs leading to contagion. One such case occurred in May 2008 when a newspaper article claimed that PRIDE was for sale.¹⁸⁸ This

¹⁸⁷ In 2008, the ratio of total savings to total assets for the four MDIs was between 27.7% and 38.2% (for comparison, the same ratio for Centenary is 77.7%).

¹⁸⁸ Jeff Mbanga, "Pride Microfinance Limited is on sale," *Weekly Observer* (Kampala), 22 May 2008.

false information led to higher than normal withdrawals by primarily large value savers [MDI/I/S/97], which shows that negative (or perceived negative) information can cause sudden deposit withdrawals from an MDI, particularly in the absence of deposit insurance.

Secondly, MDIs could be susceptible to contagion from Tier 4. There are a number of indications that this risk of contagion is low despite numerous examples of MFIs in Tier 4 failing.¹⁸⁹ The analysis of performance indicators of Tier 3 and 4 MFIs (the TG and CG2) does not show any obvious spill-over effects from the unregulated to the regulated sector. Most practitioners interviewed are of the view that Tier 3 was not negatively affected by the closure of MFIs in Tier 4. The risk of information-based runs is much lower if clients can differentiate between the tiers. Senior managers from several MDIs think that clients do indeed understand the difference between an MDI and a Tier 4 MFI (at least if they have been banking with the MDI for some time) and this is why MDIs were not affected by the crisis in Tier 4 [MDI/I/S/97, MDI/I/S.102, MFI/I/C/109]. A senior manager of another MDI thinks that there was not enough sensitisation of the public in the beginning, but that the publicity about the crisis in Tier 4 helped customers to see the difference between the two [MDI/I/S/112]. However, there are also numerous public statements by politicians and newspaper articles that prove the lack of understanding of the difference between various tiers. It is likely that existing MDI customers are better at differentiating the two than new customers or customers of Tier 4 MFIs.

A third impact indicator is incidences of contagion within Tier 4, which can be used as a proxy for the likelihood of contagion within Tier 3.¹⁹⁰ While several Tier

¹⁸⁹ There have been numerous newspaper reports every year about “fake MFIs” disappearing with public deposits, most of them having registered as SACCOs. Some of the names of the MFIs having closed in recent years are (with year of closure in parentheses) FOCCAS (2006), COWE (2006), Support Uganda Finance (2007), Front Page Microfinance (2007), SOMED (2008), Key Business Microfinance (2008), Visa Finance Bank (2009), and Triple Pride Self-Help (2009).

¹⁹⁰ Obviously the risk of contagion in Tier 4 is not exactly the same. On the one hand, Tier 4 MFIs are not prudentially regulated and therefore contagion risk could be higher. On the other, the risk could be lower as customers of MDIs are likely to be better informed about their MFIs and thus “run” earlier.

4 MFIs have been affected by a run, this interestingly has **not** led to contagion within Tier 4.¹⁹¹ It seems that clients were able to distinguish good from bad risks. The CEO of a more mature Tier 4 MFI believes that his organisation has not been too much affected by the crisis as customers know exactly why a specific MFI collapses [MFI/I/C/115]. Furthermore, despite the high failure rates, which have also been well publicised in the media, the demand for savings facilities seems to be unabated. Without further research on the client level it is impossible to establish whether this points to a general ignorance of customers about the risk they are taking or to a conscious decision as risks are still perceived to be lower than alternative savings options in the informal sector.¹⁹² Whatever the reason, the demand for savings seems to be high even if, on average, a certain share of savings is lost.

Finally, the degree to which clients trust MDIs can be used as an impact indicator. Not least as a result of regulation, increased confidence and trust of clients in MDIs “because of BoU being one of the highest regarded institutions” mitigates systemic risk [MDI/I/S/112 and similarly SUP/I/C/106]. Even though the banking sector went through a crisis in the late 1990s, customers seem to have forgotten about this and show a general trust in the safety of deposits with banks and MDIs [BOU/G/O/105]. This is in line with the argument that trusting savings with an MFI is like a repeated game where the susceptibility to contagion reduces over time.

In addition to the above analysis of market outcomes, the following *institutional changes*, which can be directly linked to regulation, determine the future likelihood of systemic crises:

- **Safety net:** A deposit insurance system is currently being set up, which is likely to become the single most important deterrent against runs and conta-

¹⁹¹ These were runs on customer deposits, as MFIs were illegally taking deposits or accepting member deposits under the guise of being a SACCO, which they could subsequently not pay back. See, for example: Amlan Tumusiime, “Hoima locals demand microfinance refund,” *New Vision* (Kampala), 8 October 2007; Herbert Ssemugo, “Clients storm Front Page,” *New Vision* (Kampala), 3 December 2007.

¹⁹² The average loss of savings in Uganda is lower among semi-formal Tier 4 institutions than in the informal sector (Wright and Mutesasira 2002).

gion once it has been sufficiently funded and MDI customers know about and trust it. The high coverage limit of USh3 million/US\$1,500 will practically eliminate the risk of losing any deposits for most savers. While there is no lender of last resort facility provided by the Central Bank, which could prevent a liquidity crisis turning into a solvency crisis, at least to a certain degree MDIs can stem more than usual withdrawals by making use of widely used negotiated lines of credit with commercial banks, which have to be honoured even in a crisis situation as they have been paid upfront [BOU/G/O/105].¹⁹³

- **Safety and soundness of MDIs:** as explained above, regulation has a positive impact on the safety and soundness of MDIs, which can be regarded as a very important defence against contagion (see “Main Impact Indicators” in Section 2.4).
- **Liquidity management:** MDIs are subject to lower statutory liquidity requirements than commercial banks/credit institutions (see Section 3.3), which makes them more vulnerable to liquidity crises.
- **Disclosure policy by BoU:** BoU has started to publish a list of licensed financial institutions on a quarterly basis and stating publicly that it does not regulate SACCOs or any other MFI that is not a commercial bank, credit institution or MDI, thereby stressing the dividing line between regulated and unregulated MFIs.

From the evidence gathered here it can be argued that most indicators suggest that MDIs are not prone to runs and contagion. Increasing savings amounts will push up the risk in the future, which, however, will be countered by increasing trust in MDIs and an effective deposit protection system.

¹⁹³ The last point is obviously not a regulatory impact, but a private sector response to manage MDIs’ liquidity demand. Available data is not sufficient to assess whether these lines of credit would be able to stem a fully-fledged run.

5.3. Competition

Barriers to entry created by regulation and local monopolies are the two main market failures with relevance for competition, one caused by regulation and the other potentially cured by it (see Section 2.2). This section looks first at institutional changes leading to changes in competition before analysing market outcomes as indicators for competition.

With regard to *institutional changes*, the leading question is “Which elements of the MDI regime had a direct or indirect influence on the competition landscape in microfinance?” Unlike for the previous two objectives – safety and soundness, and systemic stability – the regulatory regime for MDIs does not include any provisions directly targeted at the competition objective. There is no **statutory role** prescribed for the Central Bank in watching over the competitiveness of the financial sector. And the Central Bank – judging from the interview statements of a senior officer – also does not see a need to monitor competition issues: “The Central Bank insists that all institutions must be safe and sound. The financial sector is liberalised. We have nothing to do with looking at competition” [BOU/G/O/105]. This conforms to a growing consensus that the prudential and systemic regulator indeed should not also be in charge of competition regulation in banking (and by extension in microfinance), as this could otherwise create potential conflicts of interest between its various roles (Biggar and Heimler 2005). However, Uganda does not have either a competition law or a national competition authority.¹⁹⁴ Competition in the financial sector has therefore not yet received the attention it deserves and falls under no specific institution’s authority.

The main institutional change with relevance for competition apart from the introduction of a new deposit-taking tier, which will be discussed below, has been the recent establishment of a **credit reference system**. As discussed in Section 3.3, its main impact on competition is through the reduction of switching costs for bor-

¹⁹⁴ A Competition Bill was first drafted as far back as 2004, but has never been introduced to Parliament.

rowers. BoU's expectations are high: "Competition between lenders will now thrive offering immense benefit to the borrower and the overall level of credit default in the financial system will reduce, which should help to reduce the interest rates charged on loans" (BoU 2009b, 3). It remains to be seen whether the newly established Credit Reference Bureau alone will be sufficient to make competition thrive. The causality also runs in the opposite direction: the more competition among microfinance lenders, the more important it is to use credit information systems to curb problems of over-indebtedness.

Potential competition problems can arise for the following three reasons:

- The legal framework for MDIs creates new barriers to entry.
- Competition in the market is distorted by subsidised Government programmes.
- Insufficient competition and contestability are a problem in specific geographical markets (local monopolies).

The second reason is not a market failure, but a "government failure," and has therefore not been discussed before.

The problem of creating new **barriers to entry** can be ruled out, as the MDI regime has, if anything, lowered barriers to entry. None of the existing MFIs in Tier 4 were forced to come under the stricter regulatory regime for MDIs, thus no new barriers to entry were created. On the contrary, the threshold for becoming a deposit-taking institution was lowered by the introduction of a lower tier. Some observers have claimed that the MDI law had a negative impact on non-SACCO Tier 4 institutions, as they had to stop illegal deposit-taking.¹⁹⁵ Yet even before the MDI Act was introduced, deposit-taking from the public was strictly reserved for

¹⁹⁵ Okumu (2007, 206) claims that "one of the major impacts of the MDI Act was that MFIs had to stop illegal deposit-taking: Some of the institutions which were hitherto mobilising public deposits or savings for intermediation have had to change their legal status, stop taking deposits or savings for intermediation or close down."

licensed financial institutions.¹⁹⁶ There are some indications that BoU has started to enforce the ban on deposit-taking by unregulated institutions more strictly by handing over cases to the police and security agencies (BoU 2007, 7-8). However, this would not be an impact of legal changes, but a case of enforcing existing regulations more strictly.

The second point – **market distortion** by subsidised Government programmes – is a reality. According to newspaper reports, as part of the “Prosperity for All” programme US\$262 billion (about US\$135 million) was set aside in early 2009 for subsidised microloans channelled through SACCOs.¹⁹⁷ It would be far-fetched to claim that this is mainly a regulatory impact, but there is certainly some link between the Government’s support for SACCOs and its unfulfilled (even if unrealistic) expectations with regard to MDIs (discussed in more detail in Section 7.2). Reportedly, the subsidised programme “has not had a significant impact on the profitability or operations of regulated institutions to date” (EIU 2009, 37) – something that could easily change once it is fully implemented, given its high finance volume. Furthermore, MFIs can offer savings products under the guise of being SACCOs and without being subject to much regulation and thus at lower costs. Some of the MDIs have strongly criticised this type of regulatory arbitrage as being unfair competition [MDI/R/C/115 and 116 and MDI/R/S/117].¹⁹⁸

Finally, regulation can lead to changes in the **market structure** with an effect on competition. A first step is to define the *relevant market*, which is a key concept in competition analysis. According to Carlton, it “comprises all those products whose presence constrains the price of a particular product to a particular level” (2007, 161). Important is the concept of *substitutability*, which analyses whether

¹⁹⁶ For example, when COWE was asked by BoU to cease deposit-taking without having a licence, the point of reference was SEC. 4 (1) of the FIA, and not the MDI Act. See Sylvia Juuko, “BOU warns MFIs on deposits,” *New Vision* (Kampala), 29 September 2006.

¹⁹⁷ See Josephine Maseruka and David Muwanga, “Sh262b set for low interest loans,” *New Vision* (Kampala), 3 February 2009.

¹⁹⁸ The following quote from a newspaper article is a good example: “Before we opened accounts, you told us that although this was a SACCO (savings and credit cooperative organisation) you operate like any other bank where one can deposit and withdraw money any time, but now you don’t allow us to withdraw our money’ a customer lamented.” See Tumusiime (Fn 191).

customers are prepared to substitute other products for the product in question. The relevant market is not confined to the product offerings of the four MDIs and it is therefore not possible to follow a difference-in-differences strategy comparing changes in competitive practices for the Treatment and Control Groups. Instead, my analysis focuses on the analysis of changes in the competitive environment for microfinance products, which can be clearly identified as effects of the introduction of the MDI regime.

On the credit side, there is a high substitutability of various microcredit products offered by institutions in all four tiers. The addition of the new tier has, if anything, led to a temporary slowdown in the growth of number of loans provided by MDIs without any measurable impact on the other tiers. On the savings side, however, the four MDIs are now for the first time permitted to offer deposit accounts and thus compete with credit institutions and commercial banks. Thus the relevant market has grown and so has competition in the supply of savings products.

However, the relevant market is not only determined by the set of products, but also by its geographic reach: “Finer analysis may show that there remain distinct niches of the credit market which are not subject to pricing pressures across them, qualifying them as distinct markets” (Porteous 2009a). This is what has earlier been referred to as *local monopolies*. There is some evidence that competition was seen in urban centres outside Kampala as early as 2003 (Kaffu and Mutesasira 2003, 2). A detailed map of geographical locations of MFI/MDI branches is only available for the years before the introduction of the law and shows a clear lack of service points in the north east of the country. Yet the steady increase in the total number of branches of the four MDI applicants/MDIs from 71 in 2003 to 103 at the end of 2008 can be used as evidence that MDIs are now reaching more remote areas and that this reduces the risk of any one branch enjoying a local monopoly. The growth in branches of these four institutions has been roughly the same for the pre- and post-licensing period, so there is no evidence that the relatively strict

branching regulations have slowed down branch openings.¹⁹⁹ This is confirmed by the assessment of practitioners, who believe that the pressure to become profitable and increasing competition is pushing MDIs to expand in rural areas [MFI/I/C/113].

Figure 5.1: Market Share Centenary Bank



Concentration can be another issue when looking at market structures.²⁰⁰ Centenary has remained the dominant player both in the lending and savings business. Figure 5.1 shows the market share of Centenary Bank (measured as a percentage of the combined group of Centenary Bank and the MDI applicants/MDIs). With regard to number of borrowers, its market share is still increasing and now stands at 36%. The MDI Act has so far had a positive impact on competition as Centenary's market share in the savings business has dropped from a high of almost 70%

¹⁹⁹ It is also roughly in line with growth in number of branches among CG1 over the same period (from 26 to 44), while the growth of branches/offices in CG2 was driven by the emergence of BRAC, which went from zero to 64 offices within three years. No information is available about the geographical distribution of branches.

²⁰⁰ Unfortunately, structure-related measures such as the Herfindahl-Hirschman Index (*HHI*) or the concentration ratio cannot be computed without sufficient data about the relevant market, which includes at least part of Tier 4.

to a more moderate level of 52%. Both figures indicate the strong, but not dominant position of Centenary.

There is some evidence that the recent lifting of the moratorium on new bank licenses will have a much stronger impact on competition than the new legal framework for MDIs. By mid-2009, BoU had licensed an additional seven banks, bringing the total number to 22 and increasing the number of branches from 194 in December 2007 to 325 at the end of April 2009 (MoFPED 2009, 27). While this policy decision led to a noticeable increase in the number of players in the market and to a widening of their footprint, none of the MDIs is a new player. The expectation by the Central Bank is that the increased number of players will force down interest rates [BOU/G/O/105].

According to the '*structure-conduct-performance*' paradigm developed by industrial economists in the neo-classical tradition, the market structure as measured above largely determines the competitive conduct of firms and clients, which in turn influences the institutions' performance (Cook et al. 2003). The **competitive conduct** of MFIs had been subject to change for many years prior to the introduction of the MDI Act. This is well documented in a number of studies on competition in the financial sector in Uganda covering the period before 2005 (Wright and Rippey 2003; Hauner and Peiris 2005; McIntosh, Janvry, and Sadoulet 2005; Obara 2005; Porteous 2006). Kaffu and Mutesasira (2003) analysed the 2001 to 2003 period and found that competition had intensified substantially, not due to changes in regulation, but simply because of the Ugandan microfinance market moving from the take off phase into the consolidation phase (Porteous 2006, Table 3). No similar in-depth research is available for the period after the introduction of the MDI regime. Instead, the perceptions of practitioners are used as supporting evidence, some of which are listed in Table 5.3 below.

There is a consensus among practitioners that competition has increased. There is increased advertising by MDIs and as a result customers are more aware of the products provided by different MDIs [UD/M/83] and more satisfied with the ser-

vice provided.²⁰¹ Most practitioners are of the view that customers look first at the quality of service and at product features, and only then at the interest rate charged, although the latter is slowly becoming more important.²⁰² Changes in product features will be discussed in more detail under the access objective below. It can be concluded that there are clear signs for a continuing increase of competitive pressures in the microfinance sector, which started long before the introduction of the MDI Act. While these cannot necessarily be identified as effects of regulation, it can at least be said that the regulatory change has not curtailed competition.

Table 5.3: Perceptions of Practitioners About Competition

<i>Issue</i>	<i>Perception</i>	<i>Source</i>
Responsiveness to customer demand	“On the ground, you really have to do your thing right to retain your customers. . . . Customers have a choice”	MFI/I/C/95
	“We listen more to our customers, serving more of their needs, giving customers what they want”	MFI/I/C/113
Competitive pressure on interest rates	“Price is a distant thing”	MFI/I/C/95
	Borrowers are more interested in service and speed of service than in price. Even banking customers come to MDIs and are prepared to pay more interest to get a loan quicker	MDI/I/S/97 and MFI/I/C/103
	Pressure on prices and on charging interest on the declining balance is definitely there; have reduced rates for loans >US\$5 million	MDI/I/S/98

A final indicator for the extent of competition is the **performance** of MDIs, which was analysed in the previous chapter. The following indicators for increased competition could be observed: none of the MDIs earned extraordinary profits after being licensed (nor did any of the MFIs in the Control Groups), but some did before. Portfolio yields post-treatment are closely correlated with average loan size, an indication that the market does not allow for huge price differences for similarly sized loans. Too much competition can also lead to over-indebtedness

²⁰¹ Walter Wafula, “Banking battle nurtures customer content,” *Daily Monitor* (Kampala), 14 July 2009.

²⁰² This is in line with results from two other studies concluding that clients’ first concern is product-related and service-related factors, and only then the price of loans (Kaffu and Mutesasira 2003; Porteous 2006).

(McIntosh and Wydick 2005), especially in the absence of a credit information system (Luoto, McIntosh, and Wydick 2007). Looking at the portfolio at risk figures analysed above, this has not yet happened. These observations confirm the general analysis of the market structure and competitive conduct.

In conclusion, the new legal framework for MDIs did not create any new barriers to entry. Most indicators point to an increase in competition, but not to unhealthy levels. The main risks are the lack of a competition watchdog for the financial sector, and the distortion in the market caused by subsidised Government programmes, with the latter potentially being prompted by unrealistic expectations with regard to the impact of the MDI Act.

5.4. Consumer Protection

There are a few similarities between competition and consumer protection. Both are policy issues with relevance far beyond the financial sector. They might be covered under a dedicated law, but could also be ruled by specific provisions governing the financial sector. And they might be under the purview of a specialised regulatory body or the financial regulator. In the Ugandan case, another similarity is that both competition and consumer protection have not been high on the agenda of policy-makers. The impact of the MDI regime on consumer protection appears to be more of a by-product of other issues being the focus of attention such as, in particular, the safety and soundness of MDIs. This section looks first at *institutional changes* and then at market outcomes as indicators for the achievement of the consumer protection objective.

A first step is to look at **statutory roles** in conduct of business regulation. Uganda does not have a dedicated consumer protection regime, nor an umbrella consumer protection body.²⁰³ There is no market conduct regulator for the financial sector and the Central Bank does not have a statutory role in consumer protection. Therefore conduct of business regulation can only be assessed by looking at the

²⁰³ The Uganda Consumers' Protection Association helped to draft a Consumer Protection Bill in 2002, which however never made it into Parliament.

few sections of the law with direct relevance for consumer protection and the broader impact of the regulatory change on how financial institutions interact with their customers.²⁰⁴ The leading questions are whether new consumer protection issues have arisen as a result of the regulatory change and how the treatment of customers has changed in comparison to a counterfactual world in which customers would still do business with unregulated MFIs.

A few provisions of the law can be identified, which have a direct impact on consumer protection (see Appendix 3 for more details). The most important of these is the **deposit protection** scheme, which is directly targeted at the main vulnerability of customers, the risk of losing their savings. With the authorisation of MDIs to solicit deposits from the public, the issue of depositor protection has gained in importance. However, once the deposit protection fund is fully operational, clients will clearly be better off.

The information disclosure requirements targeted at increasing **transparency** in the market are minimal: the Central Bank publishes annually a list of MDIs and the MDIs publish their audited annual accounts. Even though this is more than Tier 4 MFIs have to do, the regulatory impact is likely to be weak. CGAP's Financial Access Report 2009 (CGAP 2009) identifies five regulatory provisions in the area of disclosure which are most often applied as part of a financial consumer protection regime: Uganda does not make use of any of these. In particular, it does not have any disclosure requirements for issues such as loan rates, account fees, and change in terms unfavourable to account holders (CGAP 2009, 70). MDIs are not prohibited from charging a "flat" interest rate on the initial outstanding loan amount, instead of using the more appropriate declining balance.²⁰⁵ The Central Bank has recently started publishing a schedule of MDI charges on a quarterly basis in newspapers and since 2009 also on its website (as it had already been

²⁰⁴ There are other laws with relevance for consumer protection such as those dealing with general consumer rights, contracting, access to the court system, etc. They are not part of the analysis as the focus here – as always – is on incremental changes caused by the MDI Act.

²⁰⁵ Establishing compulsory disclosure of effective interest rates and prohibition on charging flat interest rates are among the recommendations given by the consultants, who drafted the MDI Supervision Manual [UD/R/30].

doing for a while for banks and credit institutions). This is a detailed table with 50 rows for different categories of charges, one of them being interest rates. As there is no uniform formula for calculating interest rates, some of them are weekly, some monthly, and some annual rates (often broken down by different products in the notes to the table).²⁰⁶ It is doubtful that this will substantially increase price transparency – even officials at BoU are not sure how effective it is [BOU/G/O/105]. It can be concluded that there is a startling absence of effective information disclosure rules.

Finally, one section of the law lists conduct of business detrimental to the interests of customers as one of the potential triggers for revocation of licence. This **fair treatment** rule could potentially be a powerful instrument, and it leaves the Central Bank wide discretion in interpreting it. The third leg of an effective consumer protection regime in addition to transparency and fair treatment rules are **effective redress** mechanisms (Brix and McKee 2010, Box 1). There are no specific rules for MDIs on this (or for financial institutions in general). The introduction of the MDI Act has therefore not led to any change with regard to redress, which means that MDI customers are confined to making use of the judicial process.

Finally, the effectiveness of all consumer protection rules depends on the financial literacy or **financial capability** of customers, which has been defined by the OECD as

the combination of consumers'/investors' understanding of financial products and concepts and their ability and confidence to appreciate financial risks and opportunities, to make informed choices, to know where to go for help, and to take other effective actions to improve their financial well-being. (Miller et al. 2009, 2)

This, again, is an area without much involvement by the Central Bank or any other Government authority. BoU clearly regards consumer education as impor-

²⁰⁶ A recent example of this table can be found at <http://tinyurl.com/yc6bvnh>, accessed 18 February 2010. BoU does not include interest rate charges among the information published for commercial banks.

tant, but not part of its mandate. Its main activity has been to inform consumers about the difference between SACCOs and MDIs [BOU/G/O/105].

In all these areas – transparency, fair treatment, redress, and financial capability – **non-regulatory alternatives** can complement statutory rules. Asimwe (2007) reports on various initiatives in the areas of transparency, customer education and complaint handling, which have been taken on by AMFIU and are supported by various donor agencies. Most of them are still at an early stage, and lack any central coordination mechanism or common understanding about terms and instruments (e.g., the difference between marketing and financial literacy campaigns [UD/R/25]).²⁰⁷ While these non-regulatory alternatives can play an important role, there is also general agreement that self-regulatory initiatives and industry standards are not sufficient:

If coverage is broad enough, if policies and practices are well-targeted, and if credible sanctions exist for wrongdoing, industry standards might help create an interim framework for some basic protections prior to regulation. These are three big ifs. (Brix and McKee 2010, 21, emphasis in original)

It can be concluded that specific conduct of business regulations are almost non-existent except for some minimal disclosure requirements and a non-specific clause about detrimental conduct of business as a possible reason for revoking a licence. Many of the non-regulatory alternatives are still in their infancy. Even if taking into account the general maxim that conduct of business regulations should be proportional to the risk in order not to restrict access, the existing rules seem insufficient as they do not even include the “basic consumer protection package” as described by Brix and McKee (2010, Box 5). The impact of the new law has therefore been minimal. The risk of losing depositor funds, however, is well catered for under the recently established deposit protection scheme.

²⁰⁷ Among these initiatives is the establishment of a Performance Monitoring System for benchmarking of AMFIU members, which was still not fully operational in 2008 although work on it had started as far back as 2003 [SUP/I/O/63 and SUP/I/S/110], and the development of a Consumer Code of Practice for AMFIU members.

The **complementarity of different regulatory objectives** can be regarded as a more indirect impact on consumer protection (see Table 2.3). Both safety and soundness rules and the impact of the legal framework on systemic risk are complementary to the consumer protection objective, as they lower the risk of customers losing their funds. Growing competition, as observed in Uganda, increases incentives for MDIs to offer more secure and better-suited financial products in a more transparent manner. However, too much competition could lead to reckless lending and over-indebtedness of customers.

A look at *market outcomes* can shed some more light on the question of whether MDI clients have been sufficiently protected. Most importantly, none of the MDIs to date have gone bankrupt which could have led to the loss of depositors' money. No data is available about the number of **consumer complaints** and how they have been handled, as there is no central authority in charge of this. Both BoU and AMFIU report that they have received complaints from customers, but neither has a formal process for dealing with them and BoU neither has the capacity nor the authority to follow up on them [BOU/G/O/105 and SUP/I/O/111]. Bank of Uganda makes use of the complaint letters it receives to find out about illegal activities in the unregulated market segments. Experience shows that when customers lose any savings in Tier 4 MFIs, they turn to the police as they do not know where else to go.²⁰⁸ As all this is only anecdotal evidence, it is not possible to say whether customer grievances have actually increased or decreased for the MFIs that graduated from Tier 4 to Tier 3.

More research on the client level would be required to find out about changes in the fair treatment of customers and their understanding of the terms and conditions of various financial products. Some results from the FinScope survey on demand for financial services provide a snapshot of some customer perceptions in the year 2006.²⁰⁹ Responses can be broken down by customer groups (customers

²⁰⁸ See, for example, Ssempogo (Fn 191 above).

²⁰⁹ Special thanks go to FinMark Trust for commissioning the market research firm Eighty20, which conducted some further analysis on the survey results on my behalf. The details of the survey design and major results are summarised in Steadman Group (2007).

of Treatment Group MFIs and non-SACCO Tier 4 institutions).²¹⁰ Table 5.4 summarises the most interesting results.

Table 5.4: Perceptions of Various Types of Financial Institutions (2006)

<i>Views by respondents who are loan clients</i>	<i>of</i>	<i>Treatment Group</i>	<i>Non-SACCO Tier 4 MFIs</i>
	<i>on</i>	<i>Tier 1-3</i>	<i>Tier 4 MFIs</i>
They are financially strong		79%	32%
They are trustworthy		51%	45%
They require saving with them to get a loan		80%	33%
They force me to keep a minimum balance		69%	28%
They have minimal requirements with which I must comply		56%	13%
I understand how they work		39%	54%
I understand how their interest rates work		25%	47%
They charge low interest on loans		30%	26%
I am currently satisfied with their services and products		41%	51%

Source: Analysis of FinScope Uganda database by Eighty20

It is important to note that clients of non-SACCO Tier 4 MFIs and TG MFIs have self-selected into their respective groups, which means that they are not the same. Clients of MDIs are much more convinced about the financial strength of their institution than clients of Tier 4 institutions; they trust them slightly more, but they understand less about how they work and how their interest rate works than the customers of Tier 4 institutions understand about their MFIs. This confirms the general view that MDIs have been successful in building an image of financial solidity, but lack transparency about their operations. Some of the results are also contradictory, as compulsory savings and minimum balance requirements (which

²¹⁰ It was not possible to get responses from clients of CG2 MFIs only, but only for all non-SACCO Tier 4 MFIs. Also, respondents were asked about perceptions regarding formal financial institutions (Tier 1-3), semi-formal financial institutions (Tier 4 including SACCOs) and informal groups. Therefore it is not possible to differentiate views **on** the TG and CG1 (but between views **by clients of** the TG and CG1). Respondents having products with more than one MFI were excluded, so that views by the TG clients on Tier 1-3 are most likely to refer to their experience with one of the TG MFIs.

could be the same thing) seem to be much more widespread among MDIs, but still many more MDIs clients than clients in Tier 4 think that requirements are minimal. One reason could be that Tier 4 MFIs impose other, further requirements on their loans than MDIs.

Breaking down the analysis further, a general pattern emerges that perceptions differ widely depending on whether a respondent is actually a (loan) client of the institution s/he is asked about. For example, 51% of MDI clients think that regulated financial institutions are trustworthy, while only 17% of non-SACCO Tier 4 clients hold the same view. An impressive 79% of TG clients believe in the safety and soundness of regulated financial institutions, but only 36% of non-SACCO Tier 4 clients. Transparency is still lacking, with 54% of TG clients thinking that regulated financial institutions have many hidden charges, while only 26% of TG clients think the same of Tier 4 institutions.

While it is not possible to clearly identify any of these results as effects of regulation, they show two things: firstly, transparency is still a serious problem, with MDI clients giving MDIs even worse ratings than Tier 4 clients do their institutions. Secondly, MDIs and other regulated institutions have not been able to create trust and understanding about what they do among non-clients. These results confirm the general results from the analysis of consumer protection indicators that clients of MDIs are best protected through BoU's strong focus on the safety and soundness and systemic stability objectives, while little else is provided for in the MDI regime that is specifically targeted at conduct of business. The recent introduction of a deposit protection system has all but eliminated concerns about depositor protection, while transparency and information disclosure is hardly better than for unregulated Tier 4 MFIs.

5.5. Access

The last regulatory objective to be analysed is the access objective. The section again starts by looking at *institutional changes* before moving on to *market out-*

come measures on financial access. One of the explicit objectives of BoU according to its Policy Statement on Microfinance Regulation was to improve access:

As access to financial services is crucial for economic development and poverty reduction, one of the priority tasks of BOU is to foster conditions and to create mechanisms to encourage financial intermediation and to make it possible to bring broad sectors of the population into the financial system. [UD/R/5]

This was confirmed in interviews with the Central Bank, even though BoU officials also stressed that the Central Bank shares its function to increase access with the Ministry of Finance, and that BoU's role is not articulated anywhere, and thus not statutory [BOU/G/O/105].

The MDI Act itself and its regulations do not include any provisions directly targeted at improving access, but there is a long list of potential **supporting relationships and trade-offs** between the access objective and the other four (see Table 2.3). From the analysis of the other objectives it can be concluded that the strict safety and sound rules should have a positive impact on length of access, but could have a negative impact on breadth and depth of access. The increase in competition can have a positive impact on quality of access (Demirgüç-Kunt, Beck, and Honohan 2008, 156-57), but at the same time limit the scope for cross-subsidisation at the expense of poorer customers (McIntosh and Wydick 2005). In addition to these broad relationships between regulatory objectives, some **individual regulatory provisions** have a specific – even if not direct – effect on access:

- The loan size limit could be regarded as a measure to prevent MDIs issuing ever larger loans and thus to ensure depth of access. However, it is probably first and foremost a measure to prevent regulatory arbitrage and – given the size of core capital of MDIs, to which it is linked – is not a binding constraint in any of the cases.²¹¹

²¹¹ FINCA, the MDI holding the lowest amount of capital (end of 2008 US\$6.159 billion), could theoretically issue individual loans up to an amount of US\$61 million. This is about 30 times higher than the highest average loan amount of the four MDIs.

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- The credit reference bureau, once fully operational, could have a positive impact on access by establishing good credit records for borrowers (Demirgüç-Kunt, Beck, and Honohan 2008, 153-54; CGAP 2009, 30). However, the fact that it does not include information sharing with Tier 4 MFIs might compromise its effectiveness.²¹²
 - The stringent capital adequacy regulations reduce the amount of funding available for lending with a negative impact on access (Hypothesis 4). The same is true for the prohibition on intermediating compulsory savings.
 - Furthermore, restrictions on the use of retail agents to conduct branchless microfinance business on behalf of an MDI preclude MDIs – other than Tier 4 MFIs – from using alternative delivery channels as a cost-efficient way to increase rural outreach. However, BoU has recently shown some flexibility in this regard by allowing mobile branches and permitting the opening of agencies, which do not take deposits, but can disburse loans and accept instalment payments. This has helped to push financial services beyond urban centres [BOU/G/O/105].
 - As was shown in Section 4.2, commercialisation triggered by shareholding limits and strict portfolio quality rules can push up average loan size with a negative effect on breadth and depth of access.

The last point is corroborated by some of the interview evidence. The only MDI 100% owned by an international NGO was the most successful in keeping its average loan size down. FINCA's CEO admits that management felt pressurised to move to high-income clients to increase profitability, yet the board (which is dominated by FINCA International as an NGO with a clear mandate to serve the poor) resisted by setting strict loan size limits [UD/M/78]. The board also expressed its unease with the introduction of business loans and thus reportedly plays a crucial role in preventing mission drift [MDI/I/S/102]. As a result, FINCA has by far the lowest average loan size. In another case, Opportunity International

²¹² According to the Finscope results from 2006, only 8% of MDI clients also use Tier 4 institutions, but 48% use informal financial groups (Steadman Group 2007, 11).

as the majority owner of FAULU does not allow more than 20% of the volume of the loan portfolio to be composed of loans of USh3 million or more [MFI/I/C/95]. One of the CEOs of the MDIs concludes that “mission depends on choice, not on regulation” [MDI/I/C/99]. The analysis here suggests that regulation plays at least an indirect role, as the two MDIs were forced by regulation to attract more commercial investors to comply with the 30% ownership limit.

A broader impact of the MDI regime could be **substitution effects with Tier 4**. On the lending side, Tier 4 MFIs have not been subject to any regulatory changes. As the growth in customer numbers in Tier 3 took a hit after licensing, it is unlikely that Tier 4 lost substantial numbers of customers to Tier 3. The picture is different on the savings side, as BoU started to enforce the ban on deposit-taking by non-SACCO Tier 4 MFIs more strictly. This, however, cannot be regarded as an impact of the MDI regime, but as an overdue tightening of enforcement.

The previous chapter has already looked closely at *market outcomes* for access by analysing performance indicators of MDIs (and the Control Groups). In addition to the observations there with regard to breadth and depth of access, a closer look at changes in product offerings can shed some light on **scope of access**. All MDIs have introduced both new loan and savings products. Among others, they now offer loans with higher loan amounts and longer maturity [MDI/I/S/98], salary loans [MDI/I/S/97], and corporate accounts for suppliers and schools [MDI/I/S/102]. On the savings side, voluntary savings accounts are obviously new products on offer. However, the development is only unique to Tier 3 on the savings side, while other non-SACCO Tier 4 institutions have also increased their range of loan products [MFI/I/C/103], which is a general sign of a maturing market.

It is interesting to juxtapose the results from the analysis of performance indicators with perceptions of interviewees, as they are summarised in the table below. Many of these statements come to a more negative assessment of regulatory impact than the quantitative analysis.

Table 5.5: Interview Responses on Access (Interviews in July 2008)

<i>Access dimension</i>	<i>Access as measured by performance indicators</i>	<i>Interview statements</i>	<i>Source</i>
Breadth of access: loans	Depressed growth except for two MDIs in last year	“One of the challenges the regulation has created for MDIs is that they could not expand as fast they would have loved as they cannot intermediate LIF”	SUP/I/C/106
Breadth of access: savings	After temporary slowdown growth in numbers of savers during transformation increasing for three of the four MDIs	“Many of the MDIs did not get as many deposits as they expected to. And that’s the main thing that was luring them [to become regulated]. Because once they get deposits, they get a very cheap source of leverage because they are paying almost nothing on deposits”	BOU/G/O/105
Depth of access: loans	Strong shift to larger average loan size for two of the four MDIs coupled with increasing share of individual loans	“The focus of MDIs has shifted to servicing pretty much the lower end of the commercial banking market with the exception of FINCA. . . . They [UFT and UML] are now more profit-driven than mission-driven”	MFI/I/C/95
		“I think you can hardly see the difference between MDIs and banks”	MFI/I/C/103
		“The MDIs have done a wonderful job by moving into the ‘missing middle.’ They have expanded and fine-tuned their mission. There is always need for institutions like BRAC doing original microfinance. The MDIs have gone into the market of not so poor – poor, but not so poor.”	SUP/I/C/106
		“The moment an MDI tastes that profit that comes from one big loan, it doesn’t want to go back.”	BOU/G/O/105

One reason for the relatively negative assessment could be the choice of benchmark. For example, in 2006 only 2% of Ugandans had an account with one of the MDIs (Steadman Group 2007, vii), while the number of savers had grown by 45% in comparison to the previous year. Neither figure is very convincing on its own. Instead, the difference-in-differences analysis can provide a more sensible benchmark. The annual growth rates for number of savers in MDIs increased from 21% (2003-04) to 30% (2005-07), while it dropped from 46% to -20% for Control Group 2 for the same periods. As regards depth of access, most observers are of the view that MDIs have indeed moved upmarket, lured by higher profits from

serving better-off customers. This cannot be confirmed on the basis of available performance indicators.

Finally, it is essential to consider that it is still early days for assessing the success of the MDI regime in boosting savings mobilisation. Access is probably the objective where the short-term impact of the law differs most from its long-term impact. In 2004, Robinson clearly stressed the risk of high growth rates in the first years after transformation because of their potentially negative impact on safety and soundness:

New MDIs . . . need to go slow in the first few years. MDIs will need to keep their portfolio quality high and learn to manage savings, individual loans, intermediation, and rapid growth in the number of savers. . . . Most MDIs should not open for public savings for at least a year after being licensed and in some cases even longer. Therefore in the next few years the annual increase in numbers of loans and savings accounts is not a good indicator to use. The successful MDIs will be the ones that take as much time as necessary to build the management, knowledge, skills, and corporate culture needed for mobilizing savings from the public and intermediating these savings effectively and profitably. [UD/R/29]

The large loss of Equity Bank Uganda in 2009, when it was growing both its savings and loan portfolio quickly (see Fn 168), seem to confirm her appeal for a slow growth strategy after licensing.

In conclusion, while access was expressly one of BoU's initial objectives in microfinance regulation, the MDI regime does not include any direct measures targeted at improving it. Nevertheless, many of the regulatory provisions have an indirect impact – positive or negative – on one or several of the different dimensions of access. It is not possible to identify any substitution effects between Tier 4 and Tier 3 that can be directly linked to regulation. There seems to be a general feeling among practitioners and the Central Bank that MDIs have moved upmarket as slightly better off customers are easier and more profitable to serve – something the performance data cannot confirm. If some of the growth figures are lower than expected, it has to be stressed that MDIs probably had good reasons for growing their number of borrowers and savers slowly after having just gone

through a radical institutional change process. If one regards access to savings facilities as at least as important as to loans, the overall impact of the MDI regime can be regarded as positive.

Conclusion

Qualitative impact indicators, which measure market outcomes and institutional changes with a clear causal link to the introduction of the MDI regime, are a useful tool to complement the purely quantitative impact assessment of the previous chapter. In the tradition of detective work, they bring together evidence from a variety of sources giving an indication of the achievement of all five public interest objectives. As was shown in this chapter, the advantage of including qualitative indicators is that they allow for a more refined assessment of regulatory impact by also considering changes in systems and processes that have not yet led to a clearly observable impact on market outcomes. While the safety and soundness and access objective can also be assessed by analysing performance indicators (see Chapter 4), the other objectives are mostly targeted at preventing something from happening (such as customer grievances, systemic crises, or MFIs enjoying monopoly power) and can therefore best be assessed by indicators measuring institutional changes. As can be seen from the list in Appendix 7, qualitative indicators are very diverse. Of particular interest are those looking at corrective actions by the Central Bank as these can be clearly identified with regulation. Secondary sources such as studies about the impact of regulatory provisions from other countries (e.g., on credit reference services or deposit insurance systems) or surveys on the client level (such as the FinScope survey) can complement the picture of regulatory impact.

Looking at the results from the case study, the new MDI regime has both been praised as a model for how to set-up a tiered legal framework for microfinance, and criticised for being overly restrictive and having failed to attract a larger number of applicants and substantially increase access for poor people. The regulatory

impact assessment conducted here allows for a more balanced assessment of its success.

The overall impact of the MDI regime on each of the five regulatory objectives (see Secondary Research Question 1) is summarised below, taking into account the results from the analysis of performance indicators in Chapter 4 and the more qualitative assessment of other indicators in this chapter.

- **Safety and soundness** of MDIs has clearly improved. This is shown in improved performance indicators on profitability, capital, and portfolio quality after a temporary deterioration of profitability and portfolio quality during transformation. The regulator keeps a close eye on the quality of MDIs' governance, management, and systems reducing the likelihood of future crises. Regular on-site examinations are only one example of the regulator's close-touch approach.
- Quantifying **systemic risk** will always remain an elusive goal. Yet there are some indications that systemic risk on the sectoral or system-wide level has not increased to dangerous levels due to the (still) relatively low deposit-base of MDIs and little indication of contagious effects caused by the crisis in Tier 4. The newly established deposit insurance fund, increased trust in MDIs, and positive achievements in the area of safety and soundness are the best defence against systemic crises.
- **Competition** regulation in the microfinance market is all but nonexistent. The general impact of the new law on competition has been positive, as it did not create new barriers to entry, but removed some of the existing barriers by introducing a lower tier. Competition has increased in the savings business in particular, while most practitioners believe that customers have in general become more demanding as they have more choice. The absence of extraordinary profits earned by MDIs seems to confirm this view. The current implementation of a credit reference system will increase competition further. An area of concern is the Government's efforts to increase access through the roll-out of massive subsidised credit programmes.

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- The MDI regime includes only a few sections directly targeted at **consumer protection**. For depositor protection the most important is the coverage provided by the deposit protection fund. While achievements in the areas of safety and soundness, systemic stability, and increased (but not unhealthy) competition are very much in the interest of consumers, they are not sufficient. The lack of more comprehensive rules on transparency and fair treatment of customers and effective consumer complaint and recourse mechanisms are among the most negative points of the MDI regime. Customers' understanding about "how MDIs work" is limited, but they generally believe in their financial soundness.
 - Increasing **access** was one of the expressed goals in the introduction of the MDI Act. Some of the regulatory provisions are restricting MDIs' efforts to increase access – such as limitations on using agents and the prohibition on intermediating compulsory savings. Ignoring short-term negative impact, outreach indicators suggest that the new legal framework has been quite successful in improving access to savings facilities for poor people, but has led to a slow-down in the number of loans and a marked increase in average loan sizes for all but one MDI. The evidence is not sufficient to prove whether this has been a sign of mission drift. The quality and length of access has improved through increased competition and improvement in the safety and soundness of institutions.

These findings support Hypothesis 1, as the clearest positive impact can be measured on the first two objectives. There are signs that competition and access have increased despite the absence of specific competition and access enhancing regulation. The structural change of introducing a new regulated tier with lower barriers to entry, but still being authorised to mobilise deposits, has been sufficient to generate some positive results with regard to these two objectives. The one area without much progress (except for increased safety of deposits) is consumer protection.

One of the reasons for choosing Uganda as the main case for this study was that it represents the *disconfirmatory (most-likely) crucial case*. The assessment of regulatory impact with reference to the public interest objectives of microfinance regulation could not refute the hypothesis that the introduction of the new legal framework has had a positive impact on social welfare. The two remaining tasks are to look at the costs of achieving this positive impact (Chapter 6) and to analyse the political economy of regulatory change as a way to explain regulatory impact (Chapter 7).

CHAPTER 6 – THE COST OF REGULATION

A successful CBA might be rather like an impressionist painting – much less detailed than a photograph but much more recognisable than an abstract image would be.

Alfon, Isaac, and Peter Andrews. 1999. *Cost-Benefit Analysis in Financial Regulation: How to Do It and How It Adds Value, Occasional Paper Series No. 3*. London: The Financial Services Authority, p. 25

While the ROI approach developed in Chapter 2 allows for the measurement of benefits of regulation – i.e., changes in the achievement of regulatory objectives – it does not make specific reference to the additional costs caused by regulation (Secondary Research Question 2). Regulation is not a free good. It changes market outcomes by force and by doing so incurs costs for the regulator, regulated institutions, and the wider economy. Most, but not all, of these costs are reflected in the measurement of benefits discussed in previous chapters. Furthermore, it is useful to spell them out clearly to better understand regulatory impact. Thus the cost analysis will be added as a final step of the RIA methodology in microfinance. The chapter begins with a discussion of methods of measuring costs, which draws on insights from cost-benefit analysis. Section 6.2 applies the proposed method of cost analysis to the case study and estimates major costs incurred by the Central Bank and MDIs due to the MDI regime. The final section compares some of the cost elements with the benefits as deduced from the public interest analysis. It does this not only for the MDI regime, but also by comparing the cost-benefit ratio for MDIs with that of commercial banks and credit institutions.

6.1. Measurement Methods and Cost Elements

The previous chapters have measured the success of the regulatory framework for MDIs with reference to the public interest benchmark. *Benefits* have been defined as progress with regard to the achievement of any of the five regulatory objectives. Negative progress (e.g., an increase in systemic risk) could also be described as *disbenefit* and the overall impact as *net-benefit*. The costs of regulation

have not yet been explicitly discussed. Imposing regulatory measures can only be justified in as far as the costs created by regulation do not exceed the net-benefits of alleviating market failures or better protecting customers against the adverse consequences of any residual market failures. Goodhart et al. (1998, Ch. 4) refer to this as *proportionality*. As regulation is not supplied through a market mechanism, information about how much regulation consumers demand is lost. Regulation is treated by both consumers and regulators as a free good and the result is a tendency towards overregulation (ibid.). Llewellyn (1999, 52) concludes: “In the final analysis, it is a question of balancing the benefits of a higher degree of achievement of objectives (*effectiveness*) and the costs that may go with this pursuit (*efficiency*).”

However, the cost of regulation has implicitly played an important role in the assessment of benefits in previous chapters. Costs change the behaviour of market participants and thus the achievement of regulatory objectives. Market participants will try to avoid regulatory costs resulting in a different market equilibrium. Assuming sufficiently competitive markets, any residual costs for MDIs will show in price changes and if they cannot be passed on to clients, they will lead to lower profits. When benefits of regulation are measured by looking at *market outcomes*, costs incurred on the institutional and consumer levels are automatically taken into account. For example, strict provisioning requirements make it more expensive to serve high-risk borrowers and thereby have a negative impact on access (and a positive on safety and soundness). Oxera (2006, 13), which proposes a similar framework for assessing the benefits of regulation to the one used in this thesis, concludes:

It is inevitable that, in many cases, the measured improvements in market outcomes do not reflect gross benefits, but benefits net of costs. In other words, the benefits measurement exercise cannot be carried out in isolation from an assessment of regulatory costs.

It is still useful to look at costs separately for two main reasons. Firstly, some of the costs did not have an impact on the market outcomes measured above and have therefore so far been all but ignored. These are all expenses not borne by

either consumers or MDIs (and therefore not showing in changes in market outcomes) such as donor funding, government subsidies and costs borne by the Central Bank.²¹³ Secondly, spelling out the size of different cost categories provides more information on the question of which regulatory provisions created high costs and thus led to lower net-benefits. Before introducing the approach taken here to measure various cost categories of MDI regulation, I will look at some of the theoretical and empirical literature on cost-benefit analysis in financial regulation.

Insights from Literature on Cost-Benefit Analysis

A *cost-benefit analysis (CBA)* is a tool widely used to measure costs and benefits of regulation.²¹⁴ Regulatory impact assessment is sometimes used synonymously with cost-benefit analysis:²¹⁵ this thesis, however, uses RIA as the term for the broad appraisal of the effects of regulation making use of quantitative and qualitative methods (the topic of the whole thesis), while CBA is the specific method of quantifying costs and benefits in monetary terms (the topic of this chapter) (cf. Arcuri 2007, 2). A review of the theoretical and empirical literature on CBA helps to better understand the methodological challenges in quantifying costs and benefits and the main methods used.

CBA's particular appeal lies in its ostensibly simple and value-free decision criterion: choose the one alternative with the highest net-benefit. However, the cost-benefit principle has also been subject to strong criticism as it is not as simple, objective, and free of any value judgement as one might think.²¹⁶ The following discusses the two main methodological problems in conducting a CBA.

²¹³ The last cost category is net of any fees Bank of Uganda charges MDIs such as licensing fees.

²¹⁴ Radaelli (2004) looks at the experience with CBA in OECD countries and in the European Union, Cecot et al. (2008) review the EU and US experience, and Kirkpatrick, Parker and Zhang (2004) have conducted a survey on its use in developing countries.

²¹⁵ One example is Kirkpatrick (2001, 3), who defines it as "a method for assessing the positive and negative impacts (benefits and costs) of existing or potential regulatory measures."

²¹⁶ See, for example, Lave (1996), Frank (2001) and Heinzerling and Ackerman (2002). For a recent defence of CBA see Hahn (2005).

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- **Monetisation:** A CBA tries to translate all relevant changes caused by the regulatory reform into monetary terms. This is not an easy task and has been one of the main points of criticism. There are issues with “pricing the priceless,” i.e., goods which do not have a readily available market price. Assigning a value to cost categories is less problematic – at least if direct market transactions are involved – than evaluating benefits.²¹⁷ A related problem is the determination of the “present discounted value” of costs and benefits. As costs are often incurred immediately, while benefits might only materialise at a later point, the choice of an appropriate discount rate is of great relevance for the overall net-benefit.
 - **Indifference to distributional issues:** A CBA is not necessarily value-free, as it takes the current distribution of wealth as given and does not distinguish between who wins and who loses – a dollar is a dollar and is worth the same for everyone. Accordingly, a social net-benefit is not the same as a Pareto improvement, even though – theoretically – the winners could compensate the losers and everyone would be better off (the so-called Kaldor-Hicks potential compensation test). Yet if this compensation is not actually paid, a reform project with a net-benefit might be politically undesirable if it benefits the rich at the expense of the poor. Possible solutions to this are to accompany a CBA with an analysis of distributional effects (as the FSA does) or to introduce distributional weights for different costs and benefits depending on who is affected (HM Treasury 2003, Appendix 5).

Despite these methodological challenges, CBA is increasingly being used as an analytical tool in financial services regulation both by policy-makers and researchers. The following provides a short overview of a few empirical studies with a view to assessing how these challenges can be overcome in practice. In general, three broad cost categories are distinguished: *institutional costs* as the

²¹⁷ Appendix 2 of the Green Book by the UK HM Treasury (2003) lists the most common methodologies used for valuing non-market impacts. However, many of these methodologies have been criticised for not being very reliable. See, for example, Sen (2001, 109-111) for a critique of the widely used willingness to pay approach.

expenditures of regulatory bodies, *compliance costs* as incurred by financial institutions to comply with regulatory requirements, and *structural costs* (also called *dead-weight costs* or *indirect costs*) as a result of market failures.

Only a small number of **academic studies** have looked at costs and benefits in financial services regulation.²¹⁸ All of them focus on institutional and compliance costs, which are easiest to measure, and most found that compliance costs are at least a small multiple of institutional costs. Franks, Schaefer and Staunton (1998) estimate that the ratio of incremental compliance costs to institutional costs is 4:1. While it is difficult enough to estimate incremental costs of complying with financial regulations – the above-mentioned study did, for example, not include the (incremental) costs of minimum capital requirements – none of the studies has tried to come up with a figure for structural costs, not least because the benchmark for these costs is a hypothetical state of the world without any market failures.²¹⁹ Nor have any of the papers mentioned tried to quantify benefits. Empirical studies on benefits have been limited to the analysis of certain elements of a regulatory regime.²²⁰ Goodhart (2001, 157) expresses his general scepticism about quantifying benefits:

The economic benefits of regulation lie in the prevention of disaster. But how do you measure this? Without the assistance of such regulation, what is the increase in the probability of disaster, and what would be the cost of disaster if such befell? . . . The benefits are, for most practical purposes, simply not measurable.

As regards practical applications of CBAs, the UK's Financial Services Authority is a leader in this field.²²¹ While this thesis is about an *ex post* evaluation, the FSA has conducted both *ex ante* and *ex post* CBAs. Some interesting examples are the

²¹⁸ See, for example, Lomax (1987, 198-99), Goodhart (1988) and Franks, Schaefer and Staunton (1998).

²¹⁹ Bannock (2002) speculates about the same 4:1 ratio as a rule of thumb for the ratio between compliance costs and structural costs, but without offering convincing arguments for this.

²²⁰ Oxera (2006, Ch. 4) lists a number of studies which have tried to measure the benefits of regulation, yet most of them require survey evidence on the customer level.

²²¹ SECTION 155 of the UK Financial Services and Markets Act 2000 requires the FSA to conduct a cost-benefit analysis each time new rules are proposed.

ex ante CBAs on planned changes in the areas of mortgage advice (FSA 1999), anti-money laundering (PricewaterhouseCoopers 2003), and regulation of electronic money issuers (FSA 2001a, Ch. 14). The latter is of particular interest as it is a CBA on the introduction of a **new regulatory framework for a special category of financial institutions** (in this case electronic money issuers) and therefore similar to the case discussed in this thesis. Predicting the number of new players entering the market as a result of the introduction of the new regulatory regime is considered one of the major uncertainties of this CBA. All three examples focus on quantifying institutional and compliance costs, and simply list potential impacts on changes in the market structure (structural costs) and categories of benefits without trying to quantify either of them.

The FSA's experience is also interesting because it conducted a comprehensive review of its experience with conducting CBAs in 2005/06. As part of this review, it commissioned studies looking at its methodology in conducting CBAs (NERA 2004), calculating an estimate of the administrative burdens caused by FSA regulation (Real Assurance Risk Management 2006), and developing a framework for the assessment of benefits of regulation (Oxera 2006).²²² One of the conclusions from this comprehensive review states:

It is difficult to get an accurate picture of the costs to firms of regulation. This is partly because of the way rules are aligned with existing business processes, and partly because firms have not felt the need to separately identify the costs associated with regulation. We are also conscious that the one-off costs associated with change can be very important in large areas of regulation. (FSA 2006, 11)

One can therefore conclude from the experience so far with conducting CBAs on financial regulation that:

²²² In addition, Europe Economics (2003) published a comprehensive study of compliance costs in the UK financial services industry. This study uses as counterfactual a hypothetical state with no specific financial services regulation, but just the general legal framework common to all UK firms, and without any changes in the portfolio of products offered (the last point excludes structural costs from the analysis). Deloitte (2006) undertook another study on compliance costs in a few sub-sectors of the financial sector in the UK.

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- No-one has tried yet to monetise the **benefits** of a broad regulatory change such as the introduction of a new class of licence. The study by Oxera (2006, Ch 4) suggests methods of measuring benefits similar to the usage of impact indicators used in this thesis, but does not envisage that benefits will or can be expressed in monetary terms.
 - **Structural costs** have not been quantified either in any of these cases. The most any of these studies did was provide a list of the potential effects regulation may have on the market structure.
 - Finally, all empirical studies have focussed on **compliance costs**, with some of them also looking at institutional costs. The main challenge in this regard is to identify incremental costs caused by regulation.

Proposed Method for Cost Analysis

A number of recent policy documents stress the importance of CBAs for microfinance regulation yet without providing any details about the methodology to be used.²²³ This section develops a methodology for measuring the **cost of regulation**. The approach of this thesis is to start with the analysis of benefits as measured by the achievement of regulatory objectives. While it has taken a broader view than Goodhart on the economic benefits of regulation by not only looking at the “prevention of disaster”, but also including positive achievements such as consumer protection and access, it concurs with Goodhart by not trying to monetise benefits. In line with the experience of other empirical studies, the monetisation of benefits would only be possible when conducting a comprehensive customer survey that would allow the establishment of a monetary value for such different benefits as a reduction of systemic risk, an increase in the safety of deposits, or better treatment of MDI clients. Such a survey would be beyond the scope of this

²²³ See, for example, World Savings Banks Institute (2008, 7), CDG Task Force on Access to Financial Services (2009, 21), and Porteous (2010).

thesis. For this reason the topic of this chapter is the cost of regulation – a simple **cost analysis**, and not cost-benefit analysis.²²⁴

In response to the methodological problems listed above, the following approach to the analysis of costs in *microfinance* regulation is suggested here:

- **Monetisation:** while it is possible to collect relevant data on institutional costs for the central bank and on compliance costs for MFIs, structural costs will always remain elusive (see below). Cost categories that cannot be quantified will be discussed qualitatively.²²⁵ The objective is not to derive a figure for the net social benefit of regulatory change, but to list major cost categories and their range so that an informed judgement is possible as to whether the benefits of regulation have been worth the costs. The issue of determining the appropriate discount rate will not occur as the analysis is limited to the computation of current costs.
- **Indifference to distributional issues:** the only costs, which can be easily measured, are costs borne by MDIs and by the regulator. While it is assumed that MDIs will pass on at least part of the costs to their clients, it is not possible to measure the exact allocation of costs across various market participants. Distributional issues arise if the main regulatory burden rests with those clients that can least afford it. However, it can be assumed that regulatory costs discriminating against the poor show as changes in the benefits of regulation. For example, higher costs imposed on poor customers leads to lower ratings under the access objective (especially under depth of access). Similarly, the customer protection objective considers the specific characteristics of poor clients.

²²⁴ In cases where benefits cannot be quantified it has been suggested that a cost-effectiveness analysis is conducted instead. However, this method assumes that there is either a pre-determined budget (if one maximises the output) or a pre-specified linear goal (if one minimises the costs) in financial regulation, neither of which is the case here (Alfon and Andrews 1999, Fn 6).

²²⁵ Jacobs (2006, 34) refers to a CBA, “in which quantitative and qualitative metrics are combined and presented systematically,” as *soft CBA*.

The cost analysis will be used as an *ex post* evaluation tool of the regulatory reform undertaken in Uganda. Similar to the benefit analysis with the help of the ROI approach in preceding chapters, it can only measure the costs of the specific “policy package” chosen, but not of any alternative policy packages, as this would be a highly speculative exercise.²²⁶ The objective is to point to individual policy components of the regulation that have created particularly high costs. Where possible, the analysis draws on similar cost data from other countries.

In the same way as for the benefit analysis, the **benchmark** in the analysis of costs is a world without policy change, also called the *do nothing option*. Choosing the right counterfactual of how much expenditure would have been required in the absence of regulatory change is “notoriously difficult” (NERA 2004, 27). NERA proposes as one option the state of the market before the regulation came into effect (*ibid.*, 28). This, however, would assume constant expenditure over time, which is not very realistic in such a dynamic sector as the microfinance sector in Uganda.²²⁷ Instead, the opportunity costs of the do nothing option should be considered assuming, for example, that a looming crisis might have broken out. While such opportunity costs are difficult to quantify, it is important to mention them, as a simple comparison with the *status quo ex ante* would lead to an overestimation of costs.

The **measurement of costs** should be restricted to *incremental costs*, which exclude *good business costs* – defined as costs that would have been incurred even without any regulatory changes (which is not the same as without any regulation). One risk is that the regulated industry has an incentive to blame as much expenditure as possible on regulation and claim all the benefits achieved for itself (Goodhart et al. 1998, 65). Furthermore, financial institutions, and also the regulatory authority, might use the opportunity provided by the debate about regulatory reform to review their procedures on a much broader scale than required by the

²²⁶ By contrast, the quality of an *ex ante* regulatory appraisal depends to a large degree on the choice of relevant policy options to be compared (Sen 2001).

²²⁷ The other option NERA (2004, 28) proposes is to make use of independent assessments how the market might otherwise have developed. However, these are rarely available.

regulations (Alfon and Andrews 1999). Both effects lead to another upward bias in the cost measurement that one should be aware of. As far as compliance costs are concerned, one way to identify incremental costs is to compare costs incurred by MDIs with costs incurred by institutions in Control Group 2.

Similar to the benefit analysis, where the short-term impact differs from the long-term, a general distinction can be made between one-off costs – referred to as *start-up costs* – and *ongoing costs*. Looking at institutional costs, start-up costs incurred for designing the new legal framework and implementing it are not of much relevance in the long term, even though they might be the focus of attention in the short term. In retrospect, start-up costs are sunk costs. Their analysis is mostly of interest to draw lessons for similar interventions elsewhere, but not for future adjustment of the legal framework.²²⁸ For MFIs, the start-up costs are the costs of transforming (if indeed they do) and licensing. High start-up costs create high barriers to entry and can therefore lead to high structural costs.

The cost analysis will look at the following main cost elements in the three cost categories introduced above:

Institutional costs: the measurement of institutional costs (sometimes also called *direct costs* as the costs incurred by the regulator) is relatively straightforward as long as the regulatory body (in Uganda the Central Bank) is willing to share the information. Start-up costs include the time spent by central bank staff on the design of the regulatory framework, technical assistance received by the central bank (including training costs for central bank staff),²²⁹ and costs for upgrading the system (e.g., for processing off-site reports) in order for the supervisor to process increased flows of information. Ongoing costs will be composed of staff expenses, additional costs for on-site inspections, and running costs of the of-

²²⁸ In a similar vein, NERA (2004, iv) suggests that *ex post* CBAs are most valuable for the FSA if similar interventions are proposed in other areas, and ongoing costs are high relative to sunk costs.

²²⁹ Even though these technical assistance costs are often paid for by international donors and thus do not constitute monetary costs for the local economy, they are not without opportunity costs assuming that donor funding is scarce.

face.²³⁰ Unless institutional costs are passed on to regulated institutions, they do not lead to changes in market outcomes measured in the benefit analysis.

From a theoretical point of view, delegating the task of monitoring the behaviour of financial institutions to a specialised agency – in the Ugandan case the Central Bank – can bring efficiency gains, as the duplication of monitoring activities by a large number of small depositors can be reduced and the regulator is able to acquire expertise and take advantage of economies of scale (see Section 2.1). Thus increased institutional costs could be offset by lower monitoring costs by depositors, which will show as benefits for customers.²³¹

Compliance costs: these are the incremental costs incurred by regulated financial institutions. In the same way as institutional costs, compliance costs can be divided into start-up and ongoing costs. A number of arguments can be brought forward why compliance costs tend to be higher for MFIs than for conventional banks (Cull, Demirgüç-Kunt, and Morduch 2009a, 2-3). Firstly, the start-up costs for becoming licensed are mostly fixed costs, which are particularly high for small financial institutions which have never been regulated before. Secondly, reporting costs for many small transactions are higher. Thirdly, small institutions face higher ongoing compliance costs as they do not benefit from economies of scale (see also Europe Economics 2003). Furthermore, Elliehausen and Lowrey (2000) conducted a study on the implementation of the Truth in Savings Act in the US and found that start-up compliance costs were insensitive to the extent of changes required. This implies that overall costs can be reduced by making fewer, but more substantial, changes. According to this, the introduction of a new law can be seen as a less costly strategy than gradual changes to the existing legal framework.

Start-up costs include expenses for consultations in the design phase of the new regime and transformation costs. The latter include, among others, expenses for

²³⁰ It will obviously be difficult to allocate certain overhead costs such as office space (especially if the office building is owned by the central bank), but it is important to get an idea of the general order of costs.

²³¹ This could, for example, show in increased trust by customers in MDIs (as compared to unregulated MFIs), but also in higher usage figures as the transaction costs for customers are lowered.

drafting a transformation plan, hiring a transformation manager, legal advice, staff time spent on implementing necessary changes, and costs of changes to the business processes (e.g., upgrading of the MIS). After completion of this adjustment process, costs typically come down again (Europe Economics 2003, vi). Ongoing compliance costs comprise the financial costs of complying with various prudential requirements such as reporting, capital, liquidity, management and governance arrangements. The challenge of identifying only incremental costs is most pronounced in the case of ongoing compliance costs. MDIs have adjusted their structure and operations over the years to minimise compliance costs. Incremental changes caused by regulation can best be measured with the methods of difference-in-differences analysis and structural breaks as used for the benefit analysis. If no time series data on costs is available, it is all but impossible to identify the costs caused by institutional changes in areas such as management and governance. The analysis should therefore focus on those cost categories that can clearly be identified as impact of regulation, such as costs of reporting (the time staff spend on preparing and submitting reports to BoU) and on-site examinations (time spent on preparing on-site visits and attending meetings with the inspectors). Compliance costs – unless covered by subsidies from a third party – will lead to changes in market outcomes and thus be reflected in the measurement of net-benefits.

Structural costs: these are the costs of market distortions caused by regulation. They are sometimes also referred to as *indirect costs*. The ROI approach used in the benefit analysis measures precisely these changes by looking at changes in the prevalence of market failures. Regulation is supposed to alleviate market failures – measured as one of the main benefits of regulation with the help of impact indicators introduced in the previous section. However, regulation can also create distortions elsewhere. Examples for these newly created inefficiencies or structural costs are changes in the efficiency of competition, limitations on product

offerings, and increased moral hazard created by the safety net.²³² All these are already implicitly covered under the benefit analysis as they have a negative impact on the achievement of regulatory objectives. Therefore structural costs are measured as benefits or disbenefits rather than as a separate cost category.

The social net-benefit of the regulatory change can be calculated as the benefit measured by the degree of achievement of regulatory objectives (which reflects the costs incurred by consumers and financial institutions) minus any costs borne by a third party, i.e., borne by neither consumers nor MDIs. In the same way as the weighting of various benefits is ultimately a political decision (e.g., how to trade-off access against safety and soundness), the final judgement about the regulatory impact will depend on how much one values the achievement of certain benefits and whether one thinks it was worth the cost.

6.2. Cost Analysis of the MDI Regime

This section applies the proposed method of a cost analysis to the specific case study of Uganda. It looks at institutional costs incurred by the Central Bank in setting up the MDI Regime (*start-up costs*) and in running it (*ongoing costs*), and at costs for the MDI applicants to get licensed (*start-up costs*) and to operate under the MDI regime (*ongoing costs*). The main sources for measuring costs are primary data provided by the MDIs themselves, by donor agencies, and the Central Bank. The details of the cost calculations can be found in Appendix 8.

It is surprising how little information there is on the cost of microfinance regulation from similar studies. Chiumya (2006, Fn 155) simply includes a footnote in her cost-benefit analysis on microfinance regulation in Zambia stating that “the benefits and costs were not quantifiable due to the fact that values were subjective and the non-availability of data.” Okumu (2007, Ch. 6.33) in his study on the MDI

²³² Some Latin American MFIs mentioned as a negative impact of regulation “a loss in ability to experiment with unconventional ideas, particularly those involving products or markets that have not yet proved their viability” (Rhyne 2002, 4).

regime in Uganda includes a section on economic costs of regulating MFIs, but only gives a single monetary figure, which is the licensing fee to be paid to BoU.

Institutional Costs

The *start-up costs* for the Central Bank were spread out over many years from the first discussions about introducing a special legal framework for microfinance in 1998 to the final implementation of the regulatory framework for MDIs in 2004/05.²³³ It is not possible to quantify all these costs, but based on available data at least some rough estimates can be provided. The **time** BoU staff, mostly from the NBFi Department, the Executive Director Supervision and the Legal Officer/Assistant Legal Counsel, spent during these years on devising the MDI regime constitutes an important cost category. The intensity of involvement varied over time, but included issues such as drafting the first Bill (before October 2000), participating in an *Internal Project Team on Supervision and Regulation of Tier 3* set up jointly by Bank of Uganda and the GTZ/SIDA-funded Financial System Development Project (*FSD Project*), drafting the implementing regulations (issued in October 2004), and developing on- and off-site supervision procedures. The Internal Project Team had eight members from BoU and three FSD Project staff, and met regularly every few weeks over a period of more than a year (until submission of the Bill to Parliament in January 2002). The best cost estimate is to look at the costs of running the *Microfinance Unit*, which BoU established in early 1999 as part of the NBFi Department (i.e., more than five years before the first licence was granted). Between 1999 and 2004, staff salaries and allowances for the Unit are estimated as US\$500,000 (here and in the following, all costs are expressed in 2008 prices for ease of comparison). Adding administrative costs for running the Unit and allocated salary expenses for the Director of the NBFi Department, and the Executive Director Supervision (who were both closely in-

²³³ In contrast to Obara, Mukasa and Staschen (2007, 44), salaries and allowances of the Members of Parliament paid for the time they were considering the Bill are not included. MPs are paid for their role as legislators. Having more bills to consider does not lead to an increase in costs of running Parliament, but rather to a delay in passing legislation – with the MDI Bill being a good example of this.

volved with designing the legal framework) the overall amount for running the MDI Unit was probably in the range of US\$1 million. This should be a conservative estimate as it does not include salary expenses for the Legal Officer, who was the main drafting person of the law and regulations.

There is limited information on additional **capital expenditure** in the preparation of BoU's new responsibilities. In 2005, BoU implemented a *Bank Supervision Application* [UD/R/30]. Yet it seems to be purely a coincidence that it was procured at the same time as BoU started supervising MDIs, as its implementation was part of an initiative by the East and Southern Africa Banking Supervisors Group to improve banking supervision in the region. Therefore its costs cannot be regarded as incremental costs of the MDI regulation. Otherwise BoU uses standard software packages such as Excel and Access to monitor MDI's performance, which were available even before BoU started supervising MDIs. As the number of institutions supervised by the NBF department almost doubled, it is reasonable to assume an additional capital expenditure for desktop and laptop computers and one more vehicle, of US\$200,000. Thus overall start-up costs for BoU would be in the range of US\$1.2 million.

Part of the institutional set-up cost was borne by **donor agencies providing technical assistance**. The main assistance to BoU was provided by GTZ and SIDA through the FSD Project. Based on available project documents, an educated guess is that overall assistance to BoU for establishing the MDI framework has amounted to at least US\$3 million. This includes project staff time spent on this activity, various consultancy assignments (e.g., on drafting the MDI Supervision Manual in 2005), an exposure visit for a group of policy-makers (including three BoU staff), regulators, and practitioners to India and Indonesia in 2001 and a five day training course for BoU staff on risk-based supervision of MDIs in 2005. Other donor agencies concentrated on supporting MFIs (Terberger 2006, Table 2.4), and are therefore not included in the estimate. The overall estimate for start-up institutional costs is therefore US\$4.2 million.

The risk-based approach as described in the MDI Supervision Manual and, more generally, in BoU's Policy Paper on Risk-Based Supervision²³⁴ aims at reducing *ongoing costs*: "Risk-based supervision saves regulatory resources because it focuses them on areas of highest risk and usually requires substantially less transaction testing" [UD/R/10: 4]. According to information provided by BoU, US\$700,000 was budgeted for running the MDI Division in financial year 2008/09. This figure includes salaries and allowances, an allotment for the time of the Executive Director Supervision, and the share of overhead costs which could be assigned to the MDI Division, and costs for on-site examinations (mainly daily allowances and transport). It corresponds to 1.3% of the general and administration costs of BoU in the same year (BoU 2009a, 84). Additional costs could potentially arise if the Central Bank becomes the receiver of a closed MDI, but this has not happened yet.²³⁵ On the revenue side, application and licensing fees and income from penalties and fines are negligible in comparison to these costs (below 1% of costs).

Overall supervision costs correspond to about 0.5% of total assets of the four MDIs in 2008. As a comparison, Christen and Rosenberg (2000, 6) estimate that supervision costs in microfinance could be as high as 1 to 5% of assets supervised, while it is typically in the range of 0.1% for commercial banks.

Compliance Costs

This section looks at the incremental costs imposed on MDIs as a result of the new legal framework. *Start-up costs* are comprised of the costs for consultations in the design phase of the regulatory framework and for setting up an MDI or transforming an existing MFI into an MDI. It was not possible to quantify the former due to lack of data. As regards the latter, all four MDIs previously operated as microfinance NGOs, thus the transformation costs correspond to their

²³⁴ Approved by BoU's Monetary and Credit Policy Committee on 11 November 2002.

²³⁵ In contrast to receivership, the cost of a management take-over by BoU would have to be borne by the MDI (see SEC. 65 MDIA).

start-up costs. Most of the data available is either on transformation funding or on self-reported transformation expenses.

All MDI candidates received substantial **donor funding** for transformation. This funding can be regarded as the lower limit for start-up compliance costs as it was explicitly provided for covering incremental costs of transformation. The main funders of transformation expenses came together in early 2005 and founded a Transformation Steering Committee (*TSC*) to coordinate donor funding for pre-licensing transformation support and post-licensing compliance support. They hired a *Transformation and Consolidation Consultant* in charge of supporting transformation activities of various donors. As a measure to coordinate funding and create a level playing field, in 2004 the Transformation Steering Committee set a ceiling for total donor support to each of the MDI candidates. While it was not possible to get reliable data on overall funding provided, the ceiling provides an estimate for transformation costs. A basic funding amount of US\$400,000 mainly for upgrading the MIS plus an additional US\$50,000 for each branch translates into a funding ceiling between US\$750,000 and 1.8 million (Terberger 2006, 29). Self-reported transformation funding, however, is much lower, one reason being slow disbursements by some of the donors and possible omission of some funding sources in the self-reported data. Table 6.1 below summarises the possible funding ceiling and actual funding provided as listed in the Friends Consult study (Obara, Mukasa, and Staschen 2007).²³⁶

Assuming that part of the costs of transformation are also borne by the institutions themselves, as some donors only provided matching grants for 50% of the real expenses and none of the funding makes provision for the opportunity costs of staff time spent on transformation-related work, the economic costs of transformation are likely to be even higher. The Transformation and Consolidation Consultant confirms that the cost of US\$50,000 to upgrade a branch for transformation and US\$400,000 for a core MIS were indeed good estimates of the economic

²³⁶ Assuming that most of the funding was provided in 2004 or earlier and that most of the costs were incurred in local currency, the value of US\$1 million in 2004 prices in local currency equals almost US\$1.5 million in 2008 prices.

costs and thinks that total transformation costs per institution of US\$1.2 million are probably even slightly on the low side (which would be US\$1.8 million in 2008 prices) [UD/E/42].

Table 6.1: Transformation Funding (in US\$ at the time costs were incurred)

	<i>FINCA</i>	<i>PRIDE</i>	<i>UMU/ UML</i>	<i>UWFT/ UFT</i>	<i>Average per MDI</i>	<i>Average in 2008 prices</i>
Funding ceiling as per formula agreed by TSC	750,000	1,800,000	1,400,000	1,450,000	1,350,000	2,000,000
Transformation support according to Friends Study	473,000	735,000	912,000	826,000	736,500	1,300,000

Source: Own calculations and Obara, Mukasa, and Staschen (2007, Appendix V). FINCA also received funding from the FINCA Regional Office and FINCA International [UD/E/39], which is not included in the figure. According to interviews in 2008, PRIDE did not receive part of its funding [MDI/I/S/97], so that transformation support only amounted to US\$365,000.

UFT and PRIDE provided a more detailed breakdown of their real expenses. For UWFT/UFT, costs add up to about US\$1.4 million (2008 prices) without considering the opportunity costs of staff that were involved in preparing the transformation plan and in implementing necessary institutional changes; more than half of the money was spent on upgrading the MIS and about a quarter on upgrading branches [UD/E/36]. PRIDE lists total expenses of around US\$1.5 million [UD/E/37]. The two single largest items on the list are branch renovation costs, at over half, and legal costs at a quarter of total costs.²³⁷

Transformation can also potentially have considerable tax implications depending on how the transfer of assets is treated under taxation rules and whether the MFI was previously exempted from paying corporate taxes (Lauer 2008). Only PRIDE provided some information on this by listing US\$41,000 as tax expenses related to transformation issues [UD/E/37] – expenses that do not carry much weight com-

²³⁷ PRIDE (and also FINCA) did not install a new software system as part of the transformation (which is typically the single most expensive item on the list), but simply upgraded their existing systems at the time of transformation.

pared to the overall costs. The loss of charitable status by all four transforming MFIs due to their transformation into for-profit companies (required under SEC. 2 of the MDI Act) is not regarded as a regulatory impact because even before transformation it had become increasingly difficult for MFIs to argue for tax exemption once they had become profitable. Application and licensing fees could be considered an additional expenditure, but at US\$820 per MDI were negligible. It can be concluded that transformation costs were probably in the range of US\$1.8 million per MDI with some variation depending on the number of branches.

For comparison, a few figures are available from other countries (with the year when the expenses were incurred in parenthesis): in Peru, Mibanco spent an extraordinarily high amount of US\$1.5 million (1998) on a new MIS prior to being licensed (Campion, Dunn, and Arbuckle 2001, 17); US\$700,000 (2000) is an estimate for transformation costs into a Private Financial Fund in Bolivia (Wiedmaier-Pfister, Pastor, and Salinas 2001); and in Kenya, to get a deposit-taking licence under the Microfinance Act, MFIs have to spend about US\$400,000 on software upgrades and US\$800,000 (2010) on “documentation required in meeting the conditions for licensing.”²³⁸

Considering that a large part of the start-up compliance costs was covered by donor assistance and that they amortise over the years, the more important cost category from the perspective of MDIs is *ongoing compliance costs*. The challenge to identify only incremental costs – which grows with the numbers of years having passed since licensing – has been discussed in the previous section. Without time series data on costs for the four transforming institutions (let alone the Control Groups), the analysis has to focus on the few cost categories with a clear causal link to regulation.

As with the start-up compliance costs, part of the ongoing compliance costs were initially subsidised by donors. These subsidies can give an indication of the lower limit of incremental compliance costs due to strict eligibility requirements (fund-

²³⁸ See Irungu (Fn 174 above).

ing for general capacity building and ordinary operating expenses were explicitly excluded). According to this, compliance expenses were on average US\$120,000 per MDI or 1% of their average outstanding loan portfolio for 2005. UFT is the only MDI that provided a detailed breakdown of ongoing compliance costs, which amount to US\$212,300 for the year 2008 (or 2.1% of average gross loan portfolio). It did not, however, include important cost categories such as reporting, staffing in the compliance function, and hiring additional staff required by BoU regulations as UFT regarded it as “not easy to attach a monetary value.” Evidence from Bolivia suggests that the costs of reporting alone can be substantial – up to 5% of portfolio in the first year of operations, and about 1% in the following years (Christen and Rosenberg 2000, 6). In addition, MDIs have to pay a notional annual license fee of about US\$600.

Recently, additional ongoing compliance costs were imposed by MDIs having to contribute to the deposit-protection fund and report to the Credit Reference Bureau.²³⁹ For 2008, the contribution would have been (MDIs only started contributing in 2010) US\$15,200 each. Estimates on the costs of reporting to the CRB vary. On the lower end is an estimate by the operator of the CRB, who thinks one-off costs for MDIs might have been in the range of US\$30,000 (to make system changes required to capture the correct data fields and to automate the extracts and supply of data to the bureau) [UD/E/40]. At the upper end is an estimate by one of the MDIs of US\$120,000 as a “conservative budget” for implementing necessary institutional changes [MDI/I/S/112]. No data are yet available for ongoing costs.²⁴⁰

The table below provides an indication of the major costs of the MDI regime.

²³⁹ The highest single costs in the UK are regulatory fees and banks’ contributions to the deposit-protection fund (FSA 2006, 17).

²⁴⁰ Donors have heavily subsidised the start-up costs of the CRB with KfW paying for financial institutions’ costs to issue identification documents (“financial cards”) and to install all equipment required by Compuscan (the company operating the CRB) and the World Bank covering 50% of the “support fee” financial institutions have to pay to Compuscan [UD/E/40].

Table 6.2: Estimated Costs of MDI Regime (in US\$ and 2008 prices)

<i>Cost category</i>	<i>Estimate</i>	<i>Reference</i>
Start-up institutional costs of BoU (1999 to 2004) borne by BoU	1.2 million	170% of running MDI Division in FY 2008/09 or 300% of running the NBFID Department in 2002
Start-up institutional costs of BoU borne by FSD (1998 to 2005)	3 million	20% of overall budget of FSD Project for 1998 to 2005
Ongoing institutional costs (annually)	700,000	0.5% of total assets of supervised institutions 1.3% of general and administration costs of BoU
Start-up compliance costs	1.8 million per MDI	25% of average gross loan portfolio in 2005
Ongoing compliance costs (annually per MDI)	135,000 to 230,000 per MDI	1-2% of MDIs' average gross loan portfolio

Source: Own calculations

These figures should be read with due care as they are mostly based on self-reported, and at times contradictory information, and it is methodologically incredibly difficult to identify regulatory impact. There are many sound arguments for not even trying to compute these cost figures as the assumptions are often heroic. In particular, the opportunity costs of not doing anything could have been huge because of a looming crisis brought about by deposit-taking activities of unregulated MFIs, which overstates the cost of regulation. Another upward bias could be caused by not only measuring incremental, but also “good business” costs. How large these biases are is impossible to determine. However, the attempt to measure these costs – however imperfect – is still worth the effort as it allows for a better understanding of the main cost drivers of the regulatory framework and how they compare to the benefits measured in previous chapters, which is the topic of the following section.

6.3. Towards a Cost-Benefit Analysis

Keeping all the limitations of the foregoing cost analysis in mind, this section draws a few cautious conclusions on the overall net-benefit of the legal framework for MDIs. It first looks at individual cost categories and their relevance for

the overall benefit of the MDI regime, before comparing the MDI regime more broadly to the alternative of being licensed under the Financial Institutions Act.

Comparing Costs and Benefits

Institutional costs are not reflected in the assessment of benefits, as they are borne by either the Central Bank or donors and thus do not have a direct impact on the achievement of regulatory objectives. They therefore have to be taken into consideration when assessing the overall net-benefit of the MDI regime.

The high **start-up costs for BoU** were mainly driven by the length of the legal design process, extensive consultations with the industry and Government (in particular the Ministries of Finance and Justice), and the costs incurred in relation to the specialised support provided by donors. In particular the latter – there are some indications that the total expenses caused by the FSD Project were a multiple of the costs incurred by BoU itself – show the heavy dependence on donor subsidies for creating this law. This leads to the broader question of different modes of aid delivery and whether alternatives (e.g., direct financial support to Bank of Uganda for the specific task of developing the MDI law instead of making use of relatively costly expatriate staff) might have been cheaper and similarly effective. A discussion of this would be beyond the scope of this thesis (on donor effectiveness in Uganda, see Goodwin-Groen, Bruett, and Latortue 2004). What can be said, however, is that the Central Bank received substantial technical assistance, without which the law might have never been introduced (Terberger 2006, 55). It also has to be noted that branch inspections can accelerate supervisory costs: they were compulsory for all newly licensed branches and any classified as high risk continue to receive visits from BoU staff. Requiring branch approval (still widespread in developing countries) is correlated with lower branch penetration and thus a negative impact on access (CGAP 2009, 42).

As regards **ongoing institutional costs** of supervising MDIs, these seem to be reasonable and compare favourably to other countries. One reason could be the relatively comprehensive reporting requirements and the risk-based approach in

supervision, both of which reduce the need and scope of relatively expensive on-site inspections. These costs, however, would certainly increase in a crisis situation.

The effect of compliance costs – unless covered by donor subsidies – is already reflected in the measurement of regulatory benefits as they have a direct impact on the achievement of regulatory objectives. For example, compliance costs lead to lower profitability, which is one of the main measures for the safety and soundness objective. They can also have a negative impact on access, if high compliance costs are passed on to customers and therefore make financial services less affordable.

The **transformation costs for MDIs** have been substantial and heavily subsidised by donor agencies. Without this support, these costs would probably have constituted a serious hurdle for potential MDI applicants. This is seen as one of the reasons why no other MFI applied for an MDI licence after the initial round of applications [MFI/I/C/103]. It can be concluded from the analysis and confirmed by interview evidence that some of the cost categories were particularly burdensome.

First and foremost, branch licensing turned out to be very onerous. One MDI suffered most as only 11 out of its 21 branches were authorised to mobilise savings at the time of licensing [MDI/I/C/99]. It took more than 20 months to receive clearance from BoU for the remaining branches – a period during which almost half of the MDI’s branches could not open new savings accounts [UD/R/41]. Some of the practitioners complained that branch licensing requirements go beyond what is spelled out in the regulations (Schedule 3, MDI Licensing Regulations): “Many of the things you won’t find them in black ink in the Regulations or in the Act, but when the Central Bank officials come [to inspect]” [MDI/I/S/97 and similarly MDI/I/S/102]. While it was not possible to establish the typical cost of transforming a branch – estimates vary between US\$25,000 according to UFT’s list of transformation expenses and US\$250,000 according to the Finance Manager of

another MDI [MDI/I/S/112]²⁴¹ – most observers agree that they added substantially to overall transformation costs. It is at least doubtful whether these costs were justified by the improved safety and soundness of MDIs, especially in light of the trend in higher income countries towards regimes without any branch approval (CGAP 2009, 42).

The second major cost item on the list was for the upgrade or replacement of the MIS. This was mostly triggered by the reporting requirements to BoU, which some practitioners perceive as being too frequent and too detailed [MDI/I/S/112], and the need to add new modules for handling voluntary savings, identifying clients, and generating reports to the CRB [MDI/I/S/97]. The establishment of a credit reference system, launch of voluntary savings products and timely and frequent reporting to BoU have all been listed as important indicators for the positive impact of the MDI regime so that the benefits might justify the one-off costs for upgrading the systems. Finally, there could have been a general cost inflation caused by the availability of donor funding (similar to the possible cost inflation in the start-up institutional costs). In the words of one senior manager: “Because the MDI Bill got us some money we could hire some really expensive consultants – so it became more expensive than it would have been without donor funding” [MDI/I/C/27].

As regards *ongoing compliance costs*, these are noteworthy, yet seem to be within reasonable limits. They are likely to be in the range between 1 to 2% of their gross loan portfolio – costs that can be realistically covered through improvements in efficiency and reduction in costs of funding. Some of the costs, however, have also been avoided through changes in operations so that they do not show in the cost analysis, but might show in lower benefits. Examples of these are the shift to individual lending triggered by restrictions on the use of LIF and a general trend to larger average loan sizes due to changes in the shareholder composition.

²⁴¹ Other estimates for the renovation of an MDI branch to comply with BoU standards are US\$34,000 [CON/I/S/28], US\$50,000 [UD/E/42], and US\$100,000 [SUP/I/C/106].

Comparing Tiers 1, 2, and 3

The main counterfactual of the analysis so far has been a world without any regulatory changes. An alternative benchmark could be the costs and benefits of transforming into a commercial bank or credit institution, as these were the only options for MFIs to become regulated before the promulgation of the MDI Act. Another reason for using this second benchmark is that it transpired that the legal provisions for Tier 1 and 2 were actually the main point of reference for most practitioners during the interviews. This section will not try to conduct a thorough comparative analysis or provide an exhaustive list of costs and benefits of different tiers (which could be the topic of a separate thesis), but to highlight some of the main differences and commonalities between Tiers 1 and 2 on one side and Tier 3 on the other. Section 3.3 already made use of this benchmark when comparing the main provisions of the FI Act with the MDI Act.

There is a general sense among practitioners and even officers in Bank of Uganda that the legal framework in Uganda discriminates against Tier 3 on many accounts without at the same time offering sufficient advantages over Tier 1 (and sometimes also over Tier 2). The conclusions from the legal analysis in Section 3.3 support the argument that the MDI Act did not succeed in creating a level playing field for different types of financial institutions conducting microfinance.

From a cost-benefit perspective, commercial banks benefit from being able to offer a wider range of products. Foreign exchange business and current accounts, in particular, are important product offerings to attract high value savers [CD/I/C/104] and benefit from more income streams [MDI/I/C/99]. The minimum capital, which used to be the major hurdle in getting a banking licence, is becoming less of a hindrance. In 2008, all four MDIs had sufficient capital to comply with the US\$4 billion capital requirement for commercial banks. An officer in BoU comments:

And now they are seeing one of the main restrictions is capital. They actually have reserves that give them the capital of a commercial bank. And then when they look at the Financial Institutions Act, there are so many other activities they can do, so they want to jump up. [BOU/G/O/105]

A particular concern of MFIs is the risk of mission drift through ownership dilution, which is easier to avert if regulated under the FIA with its 49% single shareholding limit than under the MDI Act (30% limit). This was one of the main reasons why FAULU applied for a Tier 2 licence [MFI/I/C/95]. MDIs had hoped to benefit from more relaxed provisions in some areas such as branching and governance, which, however, did not materialise as BoU applies similar standards to commercial banks (see Section 5.1). A senior manager of one MDI summarised his experience with MDI supervision:

Inspectors come with the same commercial banking mentality and do not always recognise the differences between microfinance and commercial banking for example regarding underwriting criteria for loans, when they want to see a chattel mortgage as security. Inspectors are stricter with MDIs than with banks. [MDI/I/S/112]

While it is doubtful that inspectors are stricter with MDIs than with banks, at least they seem not to be more lenient in areas where they could take into consideration the smaller size and historically more informal character of MFIs (as was initially envisaged under the MDI Act).

Some MDIs also complain that they have to comply with stricter (and thus more costly) provisioning requirements, while Tiers 1 and 2 are free to define what part of their loan portfolio is considered microfinance [MDI/R/C/116]. The potential costs of the restrictions on the use of LIF have been discussed earlier. These restrictions do not apply to financial institutions licensed under the FIA. Finally, there is a clear pecking order with regard to the reputation of different tiers with Tier 1 clearly at the top: “What seems to last longest and what is most appreciated is the word bank” [MFI/I/C/113]. While this is not necessarily a regulatory issue, it certainly has implications for the cost-benefit analysis.

The evidence presented here seems to suggest that the costs of being regulated as a commercial bank would not have been much different, but the benefits could be considerably higher, thus supporting Hypothesis 5 that MDIs are put at an unfair disadvantage and are perceived as unattractive in comparison to Tiers 1 and 2. Not surprisingly, the three remaining MDIs have at least medium-term plans to convert into commercial banks. The institutional start-up costs of introducing a few essential changes to the FIA would have definitely been much lower. I agree with Terberger (2006, 57) when she concludes:

If the MDI-Act produces some incentives for MDIs to transform into commercial banks, this should not per se be criticised. At least the MDI-Act fulfilled the predominant aim of creating an entrance door for MFIs into the formal financial system. What can be questioned, however, is whether there would have been less costly ways to produce similar results, because a separate law plus a separate supervision unit are very resource demanding activities for a handful of institutions.

Most microfinance practitioners and senior officers in the Central Bank are of the view that Tier 3 is still needed as it allows for easier graduation to Tiers 2 and 1, even if it has become an “endangered species” [MFI/I/S/112]. Porteous (2010, 12) concludes that “at best, the MDI Act may have created a temporary stepping stone towards higher status for the first four institutions alone.”

Braun and Hannig (2006, Fn 7), who worked with the FSD Programme and advised BoU on the design of the MDI Act, report in a footnote that:

It should be noted that members of the task force [the BoU Internal Project Team being set up to draft the MDI Bill] were of the opinion that converting MFIs into deposit-taking intermediaries could have been achieved with lower transaction costs by amending the draft Financial Institutions bill rather than creating new legislation. However, this political decision had already been made.

Why this “political decision” was taken will be subject to the political economy analysis in Section 7.5. What can be concluded here is that the costs of becoming an MDI are perceived to be not much lower than those of transforming into a credit institution or even a commercial bank. The successful operation of Centen-

ary Bank under Tier 1 and recent licensing of FAULU as Tier 2 prove that it is indeed possible to successfully offer microfinance services under the FIA and even transform from Tier 4 straight into Tier 2 (this would also have been possible before the MDI Act was introduced).

Conclusion

The cost analysis as the final element of the RIA methodology can shed more light on major costs incurred due to regulatory change. It makes use of insights from the method of cost-benefit-analysis. While the costs incurred by market participants such as MFIs and customers lead to changes in behaviour and are therefore already reflected in the benefit analysis, information about their magnitude can help to detect major cost drivers (such as branching and MIS in the case of Uganda), which can then be compared to their benefits (even if the latter cannot be quantified). The cost analysis also takes into account costs incurred by third parties, which reduce the overall net-benefit of regulation. A general conclusion is that an accurate cost analysis is often difficult to conduct, but that even a rough estimate of costs incurred by different actors (in particular the regulator and the regulated institutions) can add value to the regulatory impact assessment.

The case study shows that the success of the Ugandan reform process in reaching public interest objectives of microfinance regulation is at least partly due to substantial donor support, which was not taken into consideration in the benefit analysis of previous chapters. This chapter has tried to separate the costs and benefits of the MDI regime by looking at various expenses incurred on behalf of the regulator and the regulated institutions in setting up and running the regime. Despite all the methodological challenges in conducting a rigorous cost analysis, it has produced a few interesting new insights. In particular, it could be shown that the set-up costs were mostly covered by donor funding, which, if taken into account, substantially reduces the net benefit of the policy reform, while the running costs are borne to a much higher degree by the regulator and regulated institutions. The main drivers of start-up compliance costs were MIS upgrades and

branch licensing requirements, with the former being the price for the strong positive impact on safety and soundness, whilst the costs of the latter are difficult to justify by their benefits.

The cost-benefit analysis takes an interesting twist when comparing the cost-benefit ratios of different tiers authorised to conduct deposit-taking microfinance business. Even a broad comparison of regulatory provisions under the MDI Act and under the Financial Institutions Act provides a number of indications that MDIs are unfairly discriminated against. The approach of this thesis – assessing regulatory impact with reference to the public interest benchmark – does not allow a final judgement on this. Yet one wonders why the alternative of amending the Financial Institutions Statute/Act to cater for microfinance was not more seriously discussed. This and other questions of the political economy of regulatory change will be discussed in the following chapter.

CHAPTER 7 – THE IMPACT EXPLAINED: THE POLITICAL ECONOMY OF REGULATORY CHANGE

Regulation has provided and still provides benefits to governments, legislators, and regulated financial institutions. That is the principal reason financial-service regulation was enacted and is continued, although it is generally detrimental to most consumers.

Benston, George J. 1998. *Regulating Financial Markets: A Critique and Some Proposals*. London: The Institute of Economic Affairs, p. 18

Benston's view seems to be diametrically opposed to the public interest perspective. If regulation is supposed to serve the interest of the public, it should first and foremost **benefit** consumers, not be detrimental to them. From a public interest perspective, benefits to the government, legislators and regulated financial institutions are only relevant in as far as they advance social welfare. But would it not be naïve to assume that the rationale and objectives of the public interest benchmark are also what directed various stakeholders in the implementation of the new regulatory framework? Could there have been other, **private** interests guiding them?

Previous chapters have assessed regulatory impact by taking the legal framework for MDIs as given. The rationale-objectives-indicators approach developed in Chapter 2 is an assessment methodology that does not ask **why** the legal framework for MDIs was designed the way it was. The result has been an assessment of progress of the MDI regime with regard to the achievement of five public interest objectives. This chapter moves beyond this potentially limited perspective of assessing impact with reference to the *normative* public interest benchmark by looking at the *reasons* for regulation, i.e., “why regulation in practice takes place” (Llewellyn 1999, 8). Such a *positive* assessment acknowledges that the reasons can be quite different from the rationale and objectives. It explains why certain elements of the MDI regime have been successful in advancing the interests of the public and others not so much, by analysing the *policy change process* that led to the promulgation of the new regime. With the help of political economy theories it is possible to explain both the achievements and shortcomings of the MDI regime

(Secondary Research Question 3). A general assumption is that policy-makers and other stakeholders in the policy arena are guided by their personal, *private* interests, which only partially overlap with the interests of the public. The chapter also recognises that the political system shapes these private interests. Its ultimate goal is to better understand the underlying causes of the regulatory impact as measured in previous chapters.

The first section introduces a simple methodology for analysing the political economy of regulatory change and then applies this methodology to the Ugandan case. The analysis is broken down into six different stakeholder groups. For each of these groups, I will discuss why it was interested in microfinance regulation, what its interests were, how much it knew about the topic, and what influence it had on the policy change process. A final section analyses the decision to introduce a special microfinance law from a private interest perspective.

7.1. Methodology for the Political Economy Analysis

Two contrasting views on regulation are recognised: the *public interest view* which assumes that regulation is sought to alleviate market imperfections and serve the interest of the public, and the *private interest view* which treats regulation as a commodity like any other, produced according to the laws of supply and demand in the market for policy reforms (see, for example, Barth, Caprio Jr., and Levine 2006, Ch. 2.A). In their pure forms neither does the reality of regulatory change in Uganda much justice. Instead, the public interest view is a useful **benchmark** in assessing the impact of regulation – how successful it has been in improving social welfare – but it does not have much value in predicting how policy changes in practice. “A serious problem with any version of the public interest theory is that the theory contains no linkage or mechanism by which a perception of the public interest is translated into legislative action” (Posner 1974, 340). The private interest view can be used to understand why the interest of the public has not necessarily gained the upper hand. It can explain shortcomings of the legal framework and highlight conditions under which a regulatory reform process is

most likely to be successful or fail. It is to the merit of private interest theories of regulation that they stress that if private interests prevail, the regulatory outcome can actually be inferior to a state of the world without any regulation:

The Chicago School of economic analysis [as one branch of private interest theories] has entered a powerful *prima facie* case *against* regulation, whether of financial services or elsewhere. The case for regulation is *not* self-sufficient and requires more careful construction than it is sometimes given. (Goodhart 1989, 202, emphasis in original)

Private interest theories are much more eclectic than the public interest view of regulation introduced in Chapter 2. There are numerous ways to analyse policy change processes and many different theories could be subsumed under the broad heading of private interest theories.²⁴² This chapter uses the even broader term of *political economy theories* as the generic term for theories that assume that stakeholders act in line with their private interests and that policy change is formed not only by the interests of these stakeholders, but also occurs within an existing *political system*. Political economy is defined as the field of study looking at the relationship between the state and the economy. A thorough political economy analysis of regulatory change in microfinance could be the topic of a separate thesis.²⁴³ The approach of this chapter is more modest: it does not try to develop a model of its own for how to assess policy change, but instead uses some simple assumptions about the behaviour of policy-makers and a common terminology for categorising their private interests to assess the likely role they played in the policy change process. It also draws on insights from similar research on the political economy of regulatory change. The usefulness of this methodology is tested by contrasting the predicted role of various stakeholders with the empirical evidence from Uganda.

²⁴² Grindle and Thomas (1991, Ch. 2) offer a comprehensive review of theories explaining policy change in developing countries.

²⁴³ One example for such a thesis is García Cabello (2007), who used several theories of institutional change to explain the evolution of microfinance regulation in three Central American countries.

Political Economy Theories

The main reference for the analysis is private interest theories on regulatory change and theories about the system of government and electoral system. Some common elements of **private interest theories** will be used in this chapter. Firstly, in comparison to normative theories such as the public interest approach, private interest theories are more descriptive in character. They generally abstain from setting any normative objectives at the outset, and focus on individual preferences instead. This is why they are also referred to as *positive theories*. Secondly, private interest theories use insights from microeconomics and apply them to decision-making processes in politics and administration, which is why the private interest view is also often referred to as the *economic theory of regulation*. A common assumption is that individuals try to maximise their personal utility. This utility is often equated with wealth, but other elements like altruism or the desire to further the public interest could also enter the utility function. In a way, the public interest perspective is but one possible form of the private interest perspective. Its insights can thus be relevant for analysing the behaviour of policy-makers to the extent that the regulatory objectives identified on the basis of welfare economics correspond with their private interests (Joskow and Rose 1989, 1456). A third common element that distinguishes the private interest from the public interest perspective is that proponents are more sceptical about the role the government can play in curing market failures – they preach “politics without romance” (Buchanan 1984).

A number of different schools or branches of private interest theories exist, such as the *Chicago School* with Stigler and Peltzman (Stigler 1971; Peltzman 1976) as early protagonists, or the public choice theory which has Niskanen and Buchanan as its best known advocates (Niskanen 1973; Buchanan 1984; Niskanen 1994). The following will not try to summarise these theories, as this would go too far. Instead, I will draw on some of their insights in explaining the expected interests of various actors in the policy change process.

One distinction that can be made is between those private interest theories focusing on individuals and those on groups as the main unit of analysis. The focus here will be on the latter, which are often also referred to as *interest group theories*. Regulatory developments are seen as products of relationships between different groups, with one of them being the state (Baldwin and Cave 1999, 21). With a focus on individuals it would be much more difficult to draw general conclusions about the policy change process.

One of the limitations of most private interest theories is that they often do not explicitly look at characteristics of the political systems involved and how they influence the legislative design process and subsequent implementation of the law. This is the reason why the private interest analysis will be complemented by an analysis of the **political system**. Politics does not happen inside a “black box,” but crucially depends on the political environment of the respective country. Many different issues could be considered in this regard such as the legal tradition,²⁴⁴ electoral system, and system of government (parliamentary versus presidential systems).²⁴⁵ I will only look at the latter two as those aspects that are most informative for the analysis of the voting behaviour in parliament and of the relationship between the executive and the legislature. The most basic distinction is between *presidential* and *parliamentarian systems* (see, for example, Linz 1994) and *proportional representation* and *plurality voting systems*. The focus in the analysis will be on presidential systems and plurality voting systems as this is what is found in Uganda.

The Method of Stakeholder Analysis

Stakeholder analysis can be seen as a practical application of interest group theories – the term “stake” is generally defined as having an interest in the matter. It is not a theory as such, but rather an analytical tool which will be used as the main

²⁴⁴ La Porta et al. (1997) and Ergungor (2004) show that the *legal tradition* of each country is an important determinant for its financial system structure.

²⁴⁵ Grindle and Thomas (1991, Figure 8.1) subsume these issues under “the context of policy choice.”

method for structuring the analysis. By way of stakeholder analysis, the positions of various stakeholders and their respective influences in the policy-making process will be defined with reference to their private interests and the political system they are operating in.²⁴⁶

In conducting a stakeholder analysis, three issues have to be considered:

Choice of relevant stakeholder groups: excluding important actors can lead to distorted results, while including too many renders the tool impractical and makes it more difficult to generalise from the specific case. A stakeholder could be a branch of government (the executive), an organisation (the Ministry of Finance), or even a small sub-group within an organisation (a specific department in the ministry). Wolfe and Putler (2002, 65) criticise what they call the “primacy of role in stakeholder definition”, i.e., the fact that most of the literature defines stakeholders by the role they play in society without paying too much attention to individuals in groups. Yet it might well be that individuals from different organisations share more interests than individuals within the same organisation. Role-based stakeholder groups are important if members of the groups are mainly motivated by a collective self-interest which is specific to the organisation. Only then can homogeneity of the organisation as a single stakeholder be rightly assumed. Sometimes individuals in groups can play an extremely important role depending not only on their position within an organisation (which is easy to establish), but also on personal characteristics such as charisma, negotiating skills, political connections, etc.²⁴⁷

Role-based stakeholder groups will be the main unit of analysis. As long as it can be assumed that the affiliation with an organisation determines an individual’s interests, it is possible to draw some general conclusions with relevance for similar debates in other countries. The potential role of individual “champions” within any of the stakeholder groups, and any indications about the heterogeneity of

²⁴⁶ Many practical guides are available for conducting a stakeholder analysis, e.g., Crosby (1991), ODA (1995), Schmeer (2000), and Varvasovszky and Brugha (2000).

²⁴⁷ Compare the literature on “personalisation of politics” (Jeffries 1990; 1991).

groups will also be discussed, if these are considered to be important for the behaviour of a specific group.

Changes of stakeholder interests over time: stakeholder interests are not static, but can be actively changed through rhetoric and persuasion: “Decision makers may alter their perspectives on what constitute preferred or viable policy options in response to experience, study, values, ideology, institutional affiliation, and professional training” (Grindle and Thomas 1991, 19). Furthermore, each decision affects the fallback position for the next, which can lead to time-consistency problems: what seemed to be in everyone’s interest at an earlier point might now be resisted by some as they see the opportunity of improving upon it (Stiglitz 1998, 11). The collection of evidence over a long period (from 2000 to 2008) allows me to take such dynamic changes into consideration.

A priori attribution of goals: a potential risk with an *ex post* stakeholder analysis is that the goals of stakeholders are derived from an analysis of their actual behaviour. Doing so would be a mere tautology as everything could be explained with regard to the specific country case, but no generalisable conclusions could be drawn (Ogus 1994, 74; Geddes 1995, 85). Instead, goals must be attributed a priori with reference to “*definite material interests* rather than indeterminate psychological rewards” (Rubin 1991, 17, emphasis added). The goal of increasing personal wealth is always more easily attributed than some non-financial utility such as altruism or ideological behaviour. The discussion of each stakeholder group’s interest will therefore start with defining the role that it is expected it will play in the policy making process before looking at the individual Ugandan case. Any deviations of observed from expected behaviour can then be explained with reference to the specific evidence collected for the Ugandan case.

Each stakeholder group can be categorised according to a number of criteria, which allow the definition of its expected role in the policy change process. Firstly, the involvement of different stakeholders obviously depends on their *interest* in the topic, which in turn depends on the expectations associated with the

reform. Secondly, having an interest in a matter does not necessarily imply having *influence*. The power of stakeholders to influence the policy-making process can depend on the stakeholder group's statutory role, but also on the quantity of resources it has and its ability to mobilise them (Schmeer 2000). Other factors determining the effectiveness of influencing policies are group size (the smaller, the more effective),²⁴⁸ the size of the stake in the issue, the homogeneity of the group (a fact which tends to favour producer interests at the expense of less homogenous consumer groups) and the uncertainty of expected benefits (assuming risk-averse behaviour) (Noll and Owen 1983, 41-46). Thirdly, the level of knowledge or *expertise* about the topic is an important determinant, as a stakeholder group with high interest and high influence, but lack of understanding is more likely to have a (from a public interest perspective) negative impact on the outcome.

As a way to determine who will be attracted to a specific policy issue, one can look at its *salience* and *complexity* (Gormley 1986; Ringquist, Worsham, and Eisner 2003). "A highly salient issue is one that affects a large number of people in a significant way" (Gormley 1986, 598). Complexity refers to the technical complexity of an issue. If an issue has high salience and low complexity, it is of interest to political elites. Conversely, if it has low salience, but is highly complex, bureaucratic actors with expert knowledge are likely to play a much stronger role. Gormley (*ibid.*, 600) classifies banking regulation in the US as a high complexity and low salience issue. Microfinance regulation as a new, emerging field can also be regarded as highly complex with the result that effective consumer participation is difficult to achieve and politicians are likely to have to rely on expert advice. Unlike banking regulation, however, microfinance regulation is typically a topic of high salience because of the large share of the population without any alternative financial access and the strong appeal for the government to market it as a poverty alleviation tool. If this is the case, the government is likely to be very interested in the topic, but at the same time would have to rely on expert advice due to its high complexity.

²⁴⁸ According to Olson's seminal work on "The Logic of Collective Action," small groups are more likely to be successful in lobbying for policies than large ones (Olson 1965).

The following three sections look at the role of various stakeholder groups in bringing about regulatory change in microfinance. Llewellyn (1995b) distinguishes only three key stakeholders (consumers, regulated institutions, and regulators), while Black (2003) provides us with a list of around 50 different actors having influence on financial services regulation in the case of the UK. Here only six (role-based) stakeholder groups with a strong interest in regulatory change will be looked at in depth, for each of which it is possible to identify material interest *a priori*: the legislature, the executive, the Central Bank, MFIs planning to transform (called *transformation candidates*), donor agencies, and consumers. These could certainly be broken down further (I will also briefly look at non-SACCO Tier 4 MFIs, regulated MFIs and commercial banks),²⁴⁹ yet for the purpose of explaining regulatory impact in Uganda, this level of disaggregation will in general be sufficient.

7.2. The Role of the Legislature and Executive

Both branches of government play central roles in preparing and passing legislation. Before analysing their specific roles in microfinance regulation, some characteristics of the Ugandan presidential and electoral system will be introduced in as far as they explain the legislative process. Of interest for this thesis is the *status quo* in the years 2001 to 2003 when the MDI Bill was discussed by Cabinet and Parliament and finally assented to by President Museveni. The Ugandan political system as enshrined in its 1995 Constitution boasts all the characteristics of a “**pure**” **presidential regime** (Shugart and Haggard 2001, 65). According to the Constitution the cabinet is accountable to the president (Art. 117); the president can remove ministers from office (ART. 116) and can veto bills, while his veto can only be overruled by a two-third supermajority in parliament (ART. 91).

One potential problem of a presidential system is that the *separation of power* between the legislature (the National Assembly) and the executive (the president

²⁴⁹ Bell (2003) and Obara, Mukasa and Staschen (2007) define the microfinance association AMFIU as a separate stakeholder. However, as AMFIU represented the interests of its members (MFIs from all four tiers), it is not distinguished as a separate actor.

and his cabinet ministers) leads to the risk of political gridlock except for the case of *unity of purpose* between both branches of government, which is defined as both pursuing similar political objectives (Shugart and Carey 1992, 32-34). One determinant for the likelihood of political gridlock is the president's formal law-making powers – if these are low, gridlock is more likely. Using an index developed by Shugart and Haggard (2001), the Ugandan president enjoys only low powers in law-making with an index value of two on a scale from zero to eight. In particular, the president only enjoys a *package veto* and not an *item veto* (where certain sections of a bill can be rejected and the rest be promulgated into law), which means he can only “defend the status quo against attempts by the legislative majority to change it” (ibid., 72). In practice, however, President Museveni has used his package veto as if it were an item veto by rejecting bills and at the same time giving Parliament clear guidance as to what he wants to have changed and thereby forcing it to consult with him closely.²⁵⁰

However, political stalemate can still be averted despite low formal powers in law-making if there is unity of purpose. Unity of purpose is most likely to occur when both branches – the executive and the legislature – are dominated by the same partisan group, as was the case in Uganda with the Movement enjoying a strong majority in Parliament throughout the relevant period. In particular, a *party-centred electoral formula* increases the likelihood of unity of purpose. Uganda, during the period of study of this thesis, was following the “movement” or “no-party” system, according to which all Ugandans by birth were members of the National Resistance Movement (*NRM* – or just *Movement*), while the activities of political parties were subject to severe restrictions. Candidates were nominated based on the “individual merit” principle (Ugandan Constitution SECTION 70 (1) (d)). This would argue for a *candidate-centred electoral formula*. In practice, however, it was well known to the electorate whether candidates were “movemen-

²⁵⁰ One such case was the Financial Institutions Bill (Bill No. 6 of 2002), which Museveni refused to sign in July 2003. In a letter to the MPs, he listed the two provisions of the Bill he wanted to have changed and clearly stated how he wanted them to be changed. Parliament consulted about these provisions with the President and came to a compromise on one, while leaving the other one unchanged after having received consent from the President.

tists” or “multipartists,” and the executive, and especially the President, had a number of instruments at their disposal to put pressure on candidates:

Ugandan elections are formally fought on a non-partisan basis. Nevertheless, the fear of having to run, in practice, against the informal pressures and without the financial support of the Movement, can be a further powerful reason for an MP to comply with directives coming from above. (Carbone 2001, 173)

Not unlike a normal party, the Movement tried not to have more than one candidate in any given constituency. According to the Uganda expert Nelson Kasfir, it is not the Movement as an organization that decides on nominations, but the inner circle around Museveni [UD/E/85]. Even after having being elected, Movement MPs had strong incentives to toe the line of the Movement in general and the President in particular. Typical ways of rewarding ‘appropriate’ voting behaviour were appointment as a minister,²⁵¹ business opportunities, overseas travel (Carbone 2001, 174), and nomination at the next parliamentary elections. It is therefore more appropriate to talk of a *party-centred* (or better *movement-centred*) *electoral formula*, which favours unity of purpose, and with the NRM resembling a traditional party in all but name.²⁵²

The one element of Uganda’s electoral system that does not promote unity of purpose is the incongruence between the President’s nationwide constituency and the single-seat constituencies for parliamentary elections. In a “first past the post” electoral formula, MPs are mainly concerned about the well-being of their constituency, whereas the President must appeal to the whole nation in order to maximise his votes in presidential elections (Moe and Caldwell 1994, 175). The result can be a *common pool problem*: legislators have an incentive to spend more money on “distributive policies” (i.e., projects whose benefits are concentrated in their constituency) than the president. Such policies are funded from the general

²⁵¹ Unlike in other parliamentary systems, in Uganda ministers can also be chosen from among MPs.

²⁵² Carbone (2001, 72) confirms this view when he says: “Its formal camouflage as a public arrangement can hardly disguise the fact that the Movement is a full-fledged organisation aimed at the conquest and retention of state power by a specific and partisan group (this, incidentally, would be a party’s legitimate goal in a multiparty polity).”

budget, while the benefits accrue to a geographically restricted area (Weingast, Shepsle, and Johnsen 1981). Another index by Shugart and Haggard (2001, Table 3.3) measures the likelihood of separation of purpose. On this index, Uganda scores 1 on a scale from 0 (high unity) to 8 (high separation of purpose).²⁵³

In conclusion, the analysis of the Ugandan political system in place at the time when the MDI Bill was passed shows that the President had relatively weak legislative powers, but that the electoral system favoured unity of purpose between the legislature and executive. The dominance of the Movement system increased the likelihood of a unity of purpose even further: “The institutional features promoting separation of purpose can be overridden if a single dominant party exists that can control elections at all levels” (Shugart and Haggard 2001, 95). As a result, the likelihood of political gridlock in passing new legislation and of Movement MPs pursuing their own agenda at the expense of the president can be regarded as low. There is a risk, however, that because of the incongruence of constituencies MPs support *pork barrel policies* favouring their own constituencies as long as this does not diminish their chances of being nominated in the next parliamentary election. This section has looked at how characteristics of the political system influence the balance of power between the executive and the legislature. The following sections discuss the legislature and executive in turn.

The Legislature

The Parliament of Uganda has a strong **influence** on the law-making process because of its role in initiating (together with the Government), debating, amending, and ultimately passing bills. It enjoys one of the two “veto gates” (Shugart and Haggard 2001, 70) in law-making (with the president holding the other one). A more complex issue is what the **interest** of the legislature in microfinance regulation probably was. In the Stigler/Peltzman model, politicians promote regulation to be rewarded with votes (by the consumers) and money (by the producers). The

²⁵³ 0 points each for concurrent electoral cycle, no staggering of assembly elections, and a party-centred electoral formula and 1 point for moderately incongruent constituencies.

regulated industry, as the producers, is interested in economic rents to be earned from barriers to entry (Stigler 1971; Peltzman 1976). As explained in Section 5.3, the new law lowered the entry barriers rather than raising them. Furthermore, it is unlikely that the microfinance industry could provide substantial financial support to MPs as most MFIs that would potentially benefit from microfinance regulation were still small players. Thus the interest of parliamentarians in microfinance regulation mostly depended on whether they could use it to increase their chances of re-election. The Movement-centred electoral formula provided the Movement MPs (holding the majority in Parliament) with a strong incentive to toe the line of the NRM Government. At the same time, they were interested in promoting policies that would increase their popularity among their constituents. Which one of the two – following the Government’s line or pursuing policies in the interest of their constituency – prevailed will be discussed in the empirical analysis below.

How can microfinance regulation be used as a topic to increase the chances of re-election? It is a “structural issue” in the sense that it establishes a new structure by which policies are carried out, and therefore does not have much appeal to the broad electorate (Moe and Caldwell 1994, 175). Yet if microfinance regulation is sold to the electorate as an instrument to alleviate poverty – and the majority of voters are the poor – it has much broader public appeal. In other words, a complex topic has to be reduced to a simple message. This is why microfinance regulation is regarded as a topic of high salience. At the same time, there is a risk that the high complexity of the issue and a lack of **knowledge** among MPs could lead to misunderstandings about what regulation is for and which objectives could be pursued by regulating the industry. There are numerous examples from around the world of politicians regarding microfinance as an instrument for providing subsidised funds to poor people. Any inherent trade-offs among different objectives (e.g., low interest rates undermining the sustainability and thus outreach of MFIs) are either not fully understood because of the lack of knowledge of how microfinance works, or simply brushed aside as they are much more difficult to sell to the electorate. Furthermore, the incongruence of the constituencies leads to a common

pool problem, where MPs do not hesitate to promote subsidies for their own constituency without considering the broader impact on the federal budget.

Looking at the empirical evidence in Uganda, the debate in Parliament offers some insights into the balance of power between the Government and Parliament. On the first day of the Second Reading in Parliament there was a standoff between the Ministry of Finance as the initiator of the Bill and some vocal MPs, which threatened to return the Bill to the Cabinet (Parliament of Uganda 2002). The proposed motion by Hon. Awori (an outspoken opposition MP of the Uganda People's Congress) to throw the Bill out was, however, never voted upon as the Speaker of the House adjourned the debate until the following day. When the House reconvened the next day, a compromise had been found and the Bill was passed with only minor amendments. Unity of purpose between the executive and the legislature prevailed. At the same time, the House passed a new motion proposed by Hon. Awori to the effect that the Cabinet should present a new bill for regulating Tier 4 MFIs within six months. This can be interpreted as a sign that the Movement Government was successful in mobilising its majority in Parliament to pass the Bill, but only at the cost of being confronted with a motion, which was clearly not in its interest. The MPs were flexing their muscles, but ultimately gave in.

An analysis of the parliamentary debate of the Bill, public statements of MPs during round table discussions, and interviews with other experts in the sector provides the following picture. MPs' main **interest** was to sell the MDI Bill as an initiative of direct benefit to their constituents in rural areas, "especially at village level where most of us derive our powers" (Hon. Awori in Parliament of Uganda 2002). Firstly, they assumed that the benefit would be greater if the coverage of the law was wider, i.e., not only covering MDIs, but also non-SACCO Tier 4 MFIs. Hon. Kazoora, an "independent Movementist,"²⁵⁴ expressed this concern when saying "How are we going to explain this kind of thing? That we passed a law for the big people when the voters down there have nothing; when they got a

²⁵⁴ Victor Karamagi, "The Buffalo' goes on rampage," *Monitor* (Kampala), 20 July 2005.

raw deal?” (Parliament of Uganda 2002). Secondly, MPs’ expectations were that the Bill would prevent exploitation of people by taking advantage of their ignorance (e.g., by seizing their property in case of default), reduce interest rates,²⁵⁵ and help with expansion into rural areas [MP/R/41]. Thirdly, at least some of them saw microfinance as a tool to channel Government funds to the poor; they wanted to be able “to tell their constituents that they brought money to their village” [BOU/I/C/18] – an objective quite different from that of the public interest view of financial regulation.²⁵⁶ This also confirms the common pool problem with MPs focusing on the narrow interests of their constituency without sufficiently taking into account the effects on the national budget. Finally, quite a number of MPs were personally involved in nurturing or even running MFIs in their constituencies. A senior officer at BoU thinks that “they wanted all MFIs to be covered under the law as they see regulation as a guarantee that nobody runs away with the money and they see a promotional role of the government to be fulfilled by regulating NGOs” [BOU/I/S/5]. From various public statements one gets the impression that regulation by BoU was seen as a substitute for lack of capacity on the part of the MFIs.²⁵⁷ The personal involvement – at times even financially – can also explain why the debate in Parliament was so much focussed on the minimum capital requirement (notwithstanding the fact that many of the other regulatory provisions are much more difficult to comply with), as it was a figure MPs could directly relate to and assess whether they would be able to provide this amount of money: “MPs look at their own pocket” [BOU/I/O/6].

Most of these statements show a lack of **knowledge** amongst MPs as to what the proposed law was for: “It was taken for granted that people understood what this

²⁵⁵ The perceived exploitative interest rates charged by MFIs were raised time and time again during all information exchange events with MPs (Ledgerwood, Burand, and Braun 2002).

²⁵⁶ Hon. Awori said during the Parliamentary debate: “We are looking at these MFIs as a way, as conduits of financial resources to the rural area” (Parliament of Uganda 2002).

²⁵⁷ E.g., Hon. Banyenzaki’s statement: “When you leave such organisations unregulated . . . then you are creating problems. . . . We expect that we are going to get relief . . . by being covered by a law. If we are left unregulated, I wonder how we are going to proceed” (Parliament of Uganda 2002).

thing meant until it went to Parliament” [SUP/I/C/25].²⁵⁸ The objectives they seem to have pursued in regulating microfinance often run counter to the public interest objectives. Some close observers, however, believe that MPs knew better, but chose the arguments easiest understood by their electorate: “MPs in private, in meetings understand the approach of microfinance regulation, but then they will always say differently in public. That’s demagoguery” [DON/I/C/10].

Considering this evidence one wonders why more substantial amendments to the Bill were not proposed during the Bill’s second reading, with the increase of the maximum shareholding limit from 20 to 30% being the most substantial one.²⁵⁹ This can be explained by the twin objectives of MPs to follow the Government’s line and promote policies directly benefiting their constituency. What they said was not necessarily what they did. It was rational (even if opportunistic) behaviour to publicly criticise the bill and vote in favour of the motion as this was perceived as supporting their electorate, but yet still pass the Bill in order not to put at risk their future prospects for promotion within the NRM.²⁶⁰

It can be concluded that MPs publicly pronounced strong interests in microfinance regulation, which however often ran counter to the public interest objectives. They used the topic to enhance their reputation with their electorate, but did not make as much use as they could have of their strong legislative powers as they did not want to upset their crucial relationships with the ruling NRM. Their overall impact on the legal outcome was minimal.

²⁵⁸ The inability of Hon. Awori to draft a motion which would show that he had understood the proposed tiered structure is but one indication for this. In its initial version, the motion was asking Cabinet to come up with a bill “on regulation of community-based financial institutions referred to as Tier IV of Micro-Deposit Institutions.”

²⁵⁹ Only three notable changes to the Bill were adopted with only of them likely to have had a substantial impact: the minimum capital was reduced from US\$700 million to US\$500 million (irrelevant as all potential candidates had a multiple of the amount of capital); the single ownership limit was raised from 20 to 30% (reducing the regulatory burden, even though the rationale for this given by the Parliamentary Committee was that 20% “would limit core investments” in MDIs [UD/R/43] and not to reduce the risk of mission drift); and approval rules for amending the Schedules (e.g., the definition of “currency points”) of the Bill became stricter (potentially problematic as flexibility is required to keep the real value of any monetary amounts mentioned in the law constant).

²⁶⁰ As the voting in Parliament was by acclamation, it is not possible to compare MPs’ statements during the debate with their voting behaviour.

The Executive

The executive is not a monolithic bloc, but comprised of the President, the Cabinet – with the Minister of Finance typically playing the most important role – and the Government bureaucracy (in particular in the Ministry of Finance). Since ministers are appointed (with approval of the Parliament) and can be dismissed by the President, and senior positions in the Ministry can only be occupied with approval of the Minister, the President is likely to have played the most important role in defining the overall policy direction. His dominant role in the NRM contributed significantly to this. The **interest** of the President in the topic of microfinance regulation should have been similar to the interest of the legislature²⁶¹ with the important difference that the President had to appeal to the broader national constituency. The interest of the Minister was to follow the President's line, and that of his staff to improve their prospect for advancement in the Ministry.

It is worth looking more closely at the official Government of Uganda policy with regard to microfinance as an indication of its interest in the topic and how it evolved over time. There was a well-documented Government position on the role of microfinance and at the time when the MDI regime was designed, Uganda had a comprehensive planning framework for economic and social policies. The most important documents in this regard were the Poverty Eradication Action Plan (*PEAP*) in its various versions (1997, 2000 and 2004), which was the Ugandan national planning framework; the Medium-Term Competitive Strategy for the Private Sector (2000 to 2005); and the Plan for Modernisation of Agriculture (2000). All of these documents recognised the role of microfinance for economic development. They proclaimed the withdrawal of the Government from direct delivery of credit and the restriction of the Government's role to the provision of a legal and regulatory framework for MFIs – the MDI Act – and capacity building initiatives in microfinance (GoU 2000, n. 24; MoFPED 2001, 17-19; GoU 2002,

²⁶¹ In fact, many private interest models such as the Stigler/Peltzman model do not distinguish between different branches of government.

20-21). All this seems to be in line with the public interest perspective on microfinance regulation.

However, Government support for microfinance had also been a double-edged sword. In 1994, GoU started the *Entandikwa* credit scheme, into which it sunk several million US Dollars.²⁶² It suffered from low repayment rates as loans were perceived as free Government handouts, high operational costs, lack of institutional sustainability, and use of funds for trade rather than investment [UD/R/1: 6]. More recently as part of the NRM election manifesto of 2006, the Government launched the *Bonna Baggagawale* or *Prosperity for All* scheme, which among other points, advocates the creation of a SACCO in each of Uganda's 1,020 sub-counties. The Government was not satisfied with the results achieved through the introduction of the MDI Act and was looking for alternative ways to improve access to finance in rural areas in particular (MoFPED 2009, 38). As part of the new scheme, GoU set aside US\$135 million for low-interest loans to be disbursed to SACCOs.²⁶³ The scheme has been criticised for its bias towards SACCOs over MFIs, its focus on creating new SACCOs rather than building the capacity of existing ones, and the lack of capacity of the Post Bank (as the main intermediary) to disburse the funds.²⁶⁴ Interest rates for on-lending subsidised Government funds are capped. From this short review of Government policies it can be concluded that there was a substantial gap between the official Government policies with relevance for microfinance, which were mostly in line with a public interest perspective, and various subsidised Government schemes leading to distortions in the market and unfair competition for commercial operators (see Section 5.3). A recent study on the microfinance sector in Africa uses Uganda as an example for a reversal in government policy-making and concludes:

²⁶² The Government through the Ministry of Gender, Labour and Social Development disbursed US\$9.924 billion, which included US\$624 million administrative costs (MoFPED 2003). In 2003, some US\$9 billion were still outstanding and will probably never be recovered. According to [UD/R/66], the total Entandikwa Credit Scheme fund was US\$9,920,000.

²⁶³ Maseruka/Muwanga (Fn 197).

²⁶⁴ Madina Tebajjukira, "Post Bank cannot handle poverty funds," *New Vision* (Kampala), 19 November 2007 and Joseph Olanyo, "Prosperity Funds tilt to regional players," *Monitor* (Kampala), 19 November 2007.

In an odd twist for Uganda, after years of working to develop the capacity to deliver services to lower-income markets, government actions could impede the sector from reaching the next phase of high penetration of the microfinance market which could improve the lives of millions of the country's poor. (WWB 2009, 86)

While the interest of the executive seems therefore at least ambiguous, its **influence** according to its statutory role in law-making was substantial. First, the executive, represented through cabinet and the appropriate ministries, had the right to initiate new legislation. It was in charge of drafting bills (or at least closely participated in the drafting process), discussing them among its cabinet members, introducing them to parliament and defending them in committee and in plenary. The President's most important role was derived from his power to veto bills. As regards the executive's **knowledge** of microfinance regulation, one can expect that the Ministry had some expert staff, while the Minister and President are typically more dependent on expert advice.

Looking at empirical evidence for the role the executive played in Uganda, it is quite clear that the Government, in the words of a BoU officer, "took a back seat" [BOU/I/O/91]. The Ministry of Finance lacked the **expertise** and capacity to be fully involved in the design process of the law (ibid.). Donors wanted the Ministry to engage and successfully lobbied for it to chair the Microfinance Forum [MDI/I/C/24], but this did not change the fact that all information came from BoU and the GTZ-supported FSD Project [MDI/I/C/27]. Quite a number of Government representatives did not share the basic premise of the law that better outreach can best be achieved by MFIs operating on commercial principles [MOF/I/S/12]. Cabinet members including the State Minister for Finance²⁶⁵ and the Vice-President²⁶⁶ were quoted as publicly lobbying for interest rate ceilings, even if this was against official Government policy. According to newspaper articles, President Museveni said that Government "had decided to eliminate middlemen because they caused unnecessary delays"²⁶⁷ and advised residents to only use MFIs

²⁶⁵ "Loan control," *New Vision* (Kampala), 24 October 2003.

²⁶⁶ "VP roots for new micro-finance law," *New Vision* (Kampala), 1 October 2003.

²⁶⁷ "Museveni gives farmers microfinance," *New Vision* (Kampala), 6 April 2006

in which the Government has a stake.²⁶⁸ All these public statements contradict not only official Government policy, but also the public interest objectives of microfinance and many of the provisions in the MDI Act.

According to the analysis of the political system, the Government had sufficient powers to introduce changes to the Bill such as interest rate restrictions. With a high unity of purpose between the executive and the legislature, the President could have used his powers to implement many of the proclaimed policies (including direct credit delivery by the Government, which did not happen) or to veto the Bill. Instead, there are some indications that he was a strong supporter of the Bill. Some close observers suspect that the President was directly involved with solving the looming stalemate in Parliament and put pressure on Movement MPs by questioning their future role in the Movement [SUP/I/O/16]. It is also well-known that the President is very close with the Governor of the Central Bank, which led to a coalition of the President, BoU and the Cabinet on one side and a (at least temporarily) rebellious Parliament on the other.²⁶⁹

There seems to be a huge discrepancy between Museveni's public statements and his behind-the-scenes support for BoU's policy. Similarly, the State Minister of Finance strongly supported the Bill when it was read in Parliament (not surprisingly as his Ministry had been in charge of developing it). In the end, the executive followed the Central Bank's and donors' line. One can only speculate about the reasons for this discrepancy. One possible explanation – and one similar to the interest analysis of the legislature – is that the Government's public pronouncements had a lot of populist appeal to its electorate, whilst it knew full well that if the suggested policies actually became law it would significantly hurt the microfinance sector. Moreover, the President had to consider broader political issues such as the country's relationship with major international supporters such as the World Bank and IMF [UD/E/90], which he probably did not want to put at risk because

²⁶⁸ "Arrest owners of thieving banks, says Museveni," *Monitor* (Kampala), 8 April 2008

²⁶⁹ According to the IMF Advisor to BoU at the time, it was the Governor who recommended the President not to sign the Financial Institutions Bill half a year later [DON/I/C/2].

of this.²⁷⁰ The Cabinet and its ministries followed the President's line because of his role in appointing and dismissing ministers.

After the Bill had been passed, the Government again publicly advocated for policies diametrically opposed to the needs of a sustainable microfinance sector such as the Prosperity for All scheme described above. The official justification was frustration with the slow progress of the formal financial sector in expanding outreach and the perceived high cost of credit. Obara, Mukasa, and Staschen (2007, 13) list the expectations of the Government with regard to microfinance regulation and conclude that none of them was met. From the above analysis, however, one could also conclude that the Government was very well aware that it had exaggerated expectations with regard to the impact of the law, but could not easily explain to its electorate that it should be more patient. A donor representative explains the policy shift as follows:

Someone has to be blamed for the failure of microCREDIT to reach constituents (I use that term advisedly) throughout the whole country; while the failure of MFIs to penetrate remote areas with little economic or financial activity may be reasonably explained in technical terms, it cannot in political terms, given the promises that have been made (for the last 2 elections). [UD/E/90]

The predominance of political rather than operational and technical considerations explains the failure of these policy shifts. In each case, a lot of publicity in announcing these allegedly pro-poor policy shifts was followed by slow and often disappointing implementation. It can be concluded that the executive and, in particular, the President, played a supporting role in passing the MDI Bill despite numerous public pronouncements advocating opposing policies. This can be explained by the President's tendency to publicly support populist policies to maximise votes, while at the same time his awareness of the effect these policies would have on the sector and his Government's relationship with international financial institutions led him to act contrarily to his publicly stated views. Not surprisingly,

²⁷⁰ Reportedly US\$25 million World Bank money was at stake because one of the conditions under the Second Poverty Reduction Support Credit was the passage of the MDI Act [DON/I/S/15 and MDI/I/C/27]. As the project document is not publicly available, this could not be verified.

many of the populist policies have suffered – maybe even deliberately – from weak implementation whilst the MDI Bill became law.

7.3. The Role of the Regulator and Regulated Institutions

The two stakeholder groups typically most involved in the design process of a microfinance law are the regulator and the regulated institutions – in the Ugandan case, Bank of Uganda and the four (initially five) transformation candidates. Many of the private interest theories on regulation focus on the relationship between the regulator and regulated institutions. Insights from these theories will be used to analyse the role of these stakeholder groups in the regulatory game.

The Central Bank

The Bank of Uganda did not have a statutory role in initiating and drafting legislation, but was certainly the authority with the strongest **expertise** in financial regulation. Due to the complexity of the topic, the executive had to draw on *technical advisors* (Grindle and Thomas 1991, 97-99) the best of which were to be found in the Central Bank and among donor staff (discussed below). These technocrats can take on an active role as integral actors in policy-making, become catalysts for institutional change (Williams 2002) and thus have substantial **influence** on the policy-making process. The Bolivian experience with microfinance regulation shows that a strong technical approach (in contrast to a more political approach) during the design phase can have a positive impact on the quality of the regulatory framework.²⁷¹ Furthermore, BoU is the main authority in charge of implementing financial sector legislation. The extent of its power crucially depends on the degree to which the law delegates regulatory authority, in particular the authority to make regulations, issue licences, mandate corrective actions and close financial institutions, which in turn lead to issues of accountability. In theory, the regulator

²⁷¹ The advantages of such a technical approach are: “There was not much room for the often misleading romanticism or political opportunism that usually surrounds policies for helping the poor. Rather, the SBEF [as the supervisory authority] focused on building a modern regulatory framework that would enable access to financial services by all sectors of the population (rich, poor, urban, and rural)” (Gomez, Tabares, and Vogel 2000, 28).

should be accountable to the government for achieving the public interest objectives – what Ogus (1994, 117) refers to as *substantive accountability*. This, however, is only possible if the law includes clearly defined regulatory objectives, which are operational in the sense that a measurement of success is possible.²⁷² A lack of accountability can increase the risk of the regulator pursuing private interests that diverge from the public interest objectives.

The *professional expertise and training* of Central Bank staff can at the same time form their interests (Grindle and Thomas 1991, 35-36). As the majority of staff are typically financial economists or accountants, they were likely to have a general understanding of the economic underpinnings of financial regulation, which although by itself is not sufficient to ensure that they follow a public interest perspective, is an important pre-requisite for doing so and their professional background renders it more likely that they did so. There is the risk that Central Bank employees as a self-selected group of people favour regulatory solutions to economic problems rather than trusting the “invisible hand” of market forces. This could lead to a bias towards overregulation. A second bias, which is also related to their professional background, stems from their professional experience with regulating and supervising conventional banks without knowing much about microfinance. As this is what supervisors were most familiar with, they could have been biased towards traditional banking regulation.²⁷³ Expertise thus determines interests **and** influence.

What are the typical **interests** of a central bank in microfinance regulation? The *theory of bureaucracy* as one of the private interest theories looks specifically at the principal-agent relationship between the legislators and the government bureaucracy. Like other private interest theories, it assumes that bureaucrats (like central bank staff) maximise their utility subject to certain constraints.

²⁷² Goodhart (2001) shows that this is not the case for the FSA’s statutory objectives.

²⁷³ In the Philippines in 1999 the examination practices of the Central Bank were based on traditional banking practices and constituted the major hurdle for MFIs (Gomez, Fitzgerald, and Vogel 2000). García Cabello (2007, 166) observed a “banking orientation” to microfinance supervision in three Central American countries.

Among the several variables that may enter the bureaucrat's motives are salary, perquisites of the office, public reputation, power, patronage, output of the bureau, ease of making changes, and ease of managing the bureau. All except the last two are a positive function of the total budget of the bureau during the bureaucrat's tenure. (Niskanen 1973, 22)

What this meant exactly in the case of Bank of Uganda staff depends on the composition of their utility function. It could manifest itself in an interest in expanding their regulatory functions or the scope of institutions under their purview if this might lead to an increase in perquisites and the prestige of their job. The interest in defending their public reputation could also lead to a very cautious approach towards microfinance regulation.

The interests of BoU could also be influenced by the typical time-consistency problem of *regulatory forbearance* (see, for example, Kane 1989; Goodhart et al. 1998, 52-59). One can show that, in the private interest perspective, it is often better for regulators' career interests to cover up the real extent of problems in the financial sector for as long as possible.²⁷⁴ Regulators could also be under political pressure to delay corrective actions. This creates potentially huge costs for the taxpayer (as was the case in the U.S. Savings and Loans crisis) especially as de-capitalised financial institutions have an incentive to invest in increasingly speculative projects (Boot and Thakor 1993). The use of *prompt corrective actions* as in the case of capital deficiency in Uganda can help to deal with these time-consistency problems (Benston 1998, 106-8).

Regulatory capture, defined as regulated firms gaining considerable power over the regulatory agency, is a central ingredient of many private interest theories.²⁷⁵ Regulatory capture can lead to socially sub-optimal shifts towards higher producer surplus at the expense of consumer surplus (Parker and Kirkpatrick 2002, 6). However, Goodhart (1989, 210) points out that a degree of regulatory capture is inevitable as voluntary cooperation is a precondition for any regulatory frame-

²⁷⁴ Boot and Thakor (1993) have developed a model in which the interest of a regulator in building up its reputation leads to a closure policy which is more lax than in the social optimum.

²⁷⁵ For an early critique of the hypothesis of regulatory capture, see Posner (1974, 342).

work to work. Furthermore, practitioner-involvement in the regulatory process ensures that the expertise of the regulated institutions is utilised and that “ownership” in the regulatory system is established (Llewellyn 1995c, 15-16). According to this, capture only becomes an issue if regulated firms influence the regulatory outcome in a way that compromises the effectiveness of the legal framework by, for example, regulators establishing an unduly liberal regulatory regime and/or using lax enforcement. One potential reason for BoU to be captured by the industry was the pressure to issue more licences. The risk of regulatory capture also increases if staff in the Central Bank see the regulated industry as an attractive future employer.

Finally, financial regulators typically “face asymmetric rewards and punishment” (Benston 1998, 91): they are easily blamed for any crisis occurring in the sector, while overly strict and costly regulatory requirements do not cause the same kind of criticism. The result might again be a tendency towards *overregulation* (Goodhart et al. 1998, Ch. 4). Which of the two incentives – being lax due to regulatory capture or being strict so as not to be blamed for any problems in the industry – prevails has to be explored empirically.

A comparison of these interests derived from theory with the empirical evidence in Uganda underlines the importance of private interests in policy formation. In line with the analysis above, the following could be observed in Uganda:

- Because of its **expertise**, the Government relied heavily on BoU (supported by donors) in drafting the Bill; the Central Bank also played a very active role in most of the information exchange events with the industry and legislature. As a result of this, the final Bill clearly bears BoU’s signature.²⁷⁶ As the main drafting authority BoU tried to assign itself strong discretionary powers in licensing, supervising and closing of MDIs. These were partly trimmed by Parliament,²⁷⁷ but still the degree of delegation is substantial (see Hypothesis 2).

²⁷⁶ Unlike many other developing countries, the MDI Bill was drafted by BoU’s own legal staff with assistance from external consultants, and not vice versa.

²⁷⁷ See Fn 259 above.

However, the accountability of BoU to its principal, the legislature, is rather weak. The law itself does not include clear objectives of regulation against which performance could be judged, and BoU has allegedly failed to report regularly to Parliament [UD/R/92].²⁷⁸ This increases the room for the Central Bank to pursue its own objectives.

- Looking at the *theory of bureaucracy*, BoU staff have on various occasions expressed reservations about increasing their mandate by taking on the responsibility of regulating even more MFIs than the few that qualified for an MDI licence [SUP/I/C/76 and BOU/I/O/6]. This can be seen as a sign that public reputation and ease of managing the bureau feature more prominently in BoU's utility function than elements such as power and output. Capacity constraints on the part of BoU can also play a role in this.
- *Regulatory forbearance* has not been an issue so far, as none of the MDIs has gone through a serious crisis.
- The initial trigger to introduce a special microfinance law was the looming crisis among unregulated MFIs, which increasingly ventured into illegal deposit-taking.²⁷⁹ Reportedly the Executive Director Supervision at the time was close to asking the Governor to intervene [BOU/I/C/18].
- Given the strong influence by BoU in the design phase, it is not surprising that the focus of the MDI regime is clearly on the safety and soundness and systemic stability objectives (Hypothesis 1). According to BoU, access and other "social objectives" are not among its primary objectives: "What is most important is the MDI's profitability and being run in a sound manner although it can still pursue the social objectives" [UD/M/91]. There could be various potential reasons for this as listed above: the asymmetric rewards and punish-

²⁷⁸ Earlier drafts of the Bill included a "Memorandum" defining objectives of the law, which was later deleted. BoU has to report annually to the Minister of Finance (SEC. 50 Bank of Uganda Act). According to SEC. 155 of the Constitution, Parliament is authorised to scrutinise the budgets of all Government institutions including Bank of Uganda, but BoU has not complied with this provision.

²⁷⁹ The role of crisis in setting agendas for policy reform is discussed in Grindle and Thomas (1991, Ch. 4).

ment system, the professional predisposition, and the relatively recent experience with the banking crisis in Uganda.²⁸⁰ BoU officers openly admit that they are deliberately strict on licensing.²⁸¹

- Even after the law was passed, BoU tended to interpret the law in the strictest possible way. This supports Hypothesis 2 which contends that it has ample opportunity to shape the regulatory and supervisory framework in its own interests, which are to err on the side of caution. In particular, BoU did not allow a transition period for NGO ownership dilution, changed its mind with regard to the commencement date of the law, and did not allow intermediation of compulsory savings (LIF). While none of these legal interpretations were wrong, they led to considerable confusion and high legal risk as earlier pronouncements had been different or unclear to say the least.
- One of the main complaints by practitioners (and one I have already referred to under “Comparing Tiers 1, 2, and 3” in Section 6.3) is that BoU’s approach to supervising MDIs very much reflects the formative influence of regulating commercial banks. This is in line with the proposition that the staff’s professional background led to a bias towards traditional banking regulation. Substantial training of key players in BoU in the special characteristics of micro-finance has probably helped to mitigate this bias.
- Finally, while the Central Bank had to cooperate with potential candidates for an MDI licence and be more flexible with regard to the single ownership limit by granting exemptions as otherwise too few MFIs would have been able to qualify [BOU/I/C/18], to talk of *regulatory capture* would go too far. If anything, some of the MFIs already taking deposits were captured by BoU as their only options were to either get licensed or to disintermediate their savings (see the following stakeholder group). Many practitioners, and also some donors,

²⁸⁰ “The Act was crafted with the hindsight of a failing banking sector, so it was made more stringent than the Banking Act” [UD/M/75].

²⁸¹ “Some of the MFIs will find licensing very onerous and rigorous. We expect systems, we expect procedures, we expect everything to be streamlined. It’s important to be strict. It’s better not to license them if they are weak as entry is very important” [BOU/I/O/14].

complained that BoU was not (or not any longer) consulting the industry sufficiently [UD/M/81].²⁸²

A final observation is that the MDI Bill, once its first draft had been finalised, only changed gradually and to a limited extent. One could term this the *path dependence* of legal drafting. It would be easy to illustrate by an analysis of how the MDI Bill evolved over time that, in fact, much of the discussed (and often even conceded to) criticism did not lead to any changes in the Bill. One outcome is a number of ambiguities in the law such as, for example, whether banks, credit institutions and SACCOs are covered or not (see Section 3.2). One explanation would be that this is due to carelessness or limited capacity of the legal drafting team. An alternative is that giving in to proposed changes could have been perceived as weakness, admitting mistakes, or even as a sign of regulatory capture.

It can be concluded that the expertise and influence of BoU, coupled with incentives to err on the side of caution, have led to a strong focus on the first two public interest objectives without much consideration for the others. This supports Hypothesis 1.

Transformation Candidates

A fourth key stakeholder group in the regulatory process were MDI candidates. They should have clearly had the strongest **interest** among all MFIs in initiating the required regulatory adaptations – assuming that they regarded the existing legal environment as being inappropriate for microfinance. Four main objectives are generally recognised why MFIs might want to become regulated (Fernando 2004, 3-6):

- To have access to diversified funding sources such as deposits, capital market funds, commercial borrowing, and equity²⁸³

²⁸² Stiglitz (1998) has looked at the role of secrecy in policy change processes. As reasons for secrecy he mentions the fear of stakeholders to expose policy mistakes or weaknesses, which could undermine their position.

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- To be able to offer a diversified set of products, in particular savings products, but also (depending on restrictions under the current legal regime) loans, insurance products, money transfer services etc.
 - To improve their public image by coming under the supervision of a regulatory authority and
 - To bring in investors with a financial stake in the MFI, thereby establishing a “sustainable ownership structure” (Gomez, Tabares, and Vogel 2000)²⁸⁴

The ability to mobilise retail deposits is typically the most pressing motivation to become regulated. While MFIs want to minimise the compliance costs of regulation and are therefore in favour of a lax regulatory environment, they also do not want to set the standards too low as otherwise the reputation of the sector could suffer. Economic rents from barriers to entry in line with the Stigler/Peltzman model probably did not play a role in Uganda as MDIs continue to compete with unregulated MFIs except for their savings business, in which they compete with Tiers 1 and 2. Transformation candidates definitely had a high degree of **knowledge** about microfinance, but were new to the world of financial regulation.

However, transformation might have also met resistance by some MFIs, and here it is worth looking at the different stakeholders **within** an MFI, in particular singling out the board and the MFI’s staff.²⁸⁵ All MDI candidates transformed from NGOs to shareholding companies. The boards of microfinance NGOs were dominated by founders and promoters of the MFI such as local dignitaries or benefactors who wanted to make a difference by improving access to finance for the poor. Over time, many of the NGO founders had invested considerable “sweat equity”

²⁸³ Some unregulated MFIs had already used some of these funding sources (e.g., bond issues, commercial borrowing, equity investments), but it is generally much easier to gain access once regulated.

²⁸⁴ In many countries, including Uganda, this is possible without regulatory changes by transforming from an NGO into a company. In Bolivia this was one of the main motivations for MFIs to lobby for regulation (Gomez, Fitzgerald, and Vogel 2000). Moussa (2007) reports that in Egypt (at least until 2009) only NGOs and banks were permitted to conduct microfinance.

²⁸⁵ Lieberman et al. (2009, 10-12) provide a more detailed list of stakeholders for a transforming MFI and a detailed account of the discussions between UMU’s founders and potential investors.

in their institution. Similar experience from other countries shows that founders and promoters wanted to be financially rewarded for their efforts in nurturing the MFI when the NGO's net worth was converted into equity of the newly licensed institution (Lauer 2008, 7-9) – which should make them strong supporters of transformation. Yet they are also typically a guarantor for the MFI to remain true to its original mission and run the risk of losing their board seat if they do not fulfil the fit and proper requirements for regulated MFIs, which could reduce their enthusiasm for transformation. As regards the MFI's staff, the management and other employees could see transformation both as an opportunity and a threat. On the positive side, transformation might increase job security, salaries, and prestige for staff. However, some staff members might also be concerned about losing their job if they did not have the required skill sets for a formal financial institution, or about institutional change (e.g., a more hierarchical and formal communication style between management and staff), and thus resist formalisation (Campion and White 1999, 35).

As mentioned before, interest does not necessarily lead to **influence** and no regulator can successfully regulate an industry without at least a minimum degree of *regulatory capture* to be sure that the regulatory framework is relevant. In addition, if donor agencies provide financial and technical support to transformation candidates, this can both increase their interest in transformation and their influence if donors lobby on their behalf. If there are only a relatively small number of transformation candidates, Olson's *theory of collective action* shows that they are likely to be very effective in their lobbying. Furthermore, an industry association for MFIs such as AMFIU could have played a strong role as lobbying and advocacy is one of the core activities of microfinance associations (Gross and Brütrup 2003).

The empirical evidence from Uganda confirms that the **interest** of applicants in becoming regulated was broadly in line with the material interests defined above. In the case of UMU, White (2006, 13-15) lists funding constraints, the risk of operating in a grey zone by taking voluntary deposits without being regulated, and

the desire to gain greater legitimacy as the main reasons for transformation. Obara, Mukasa, and Staschen (2007, 14) add to this list that transformation was seen as a “further opportunity to improve on corporate governance, systems and management practices.” One of the issues was that donor funding was drying up so that MFIs were under pressure to become sustainable and tap other sources of funding [MDI/I/C/7]. Three of the four transforming MFIs were already taking voluntary deposits before getting licensed, which left them with no choice but to get regulated, as refunding the deposits to the clients would not have been a realistic option: “We never wanted to stay outside because of what we were already doing” [MDI/I/C/24].

Moreover, as mentioned under “Compliance Costs” in Section 6.2, all transformation candidates benefited from substantial donor support, which certainly had a positive impact on their interest in becoming regulated. Nevertheless, in retrospect many newly licensed MDIs admitted that they had underestimated the challenges of becoming an MDI particularly with regard to time commitment, costs, and required cultural and institutional changes [UD/M/75 and UD/M/79]. In 2005, MDIs complained in a letter to BoU about the rigidity of the MDI regime:

Rigid standards will only limit growth and outreach. If standards applied to commercial banks continue to be applied to MFIs [i.e., MDIs], there is no doubt that the very reasons why commercial banks are not opening branches especially in rural areas will apply to MDIs. [UD/C/64]

This clearly shows their interest in reducing compliance costs – and as was shown in Section 6.2, justifiably so.

The interests of founders and promoters sitting on the board of transformation candidates were indeed a mixture of fear that they might not pass the fit and proper test [UD/M/75] and personal financial interests.²⁸⁶ However, in none of the cases did the fears outweigh the positive expectations with regard to transformation so that none of the boards voted against transformation.

²⁸⁶ “What is there for us?” was among the questions posed by board members of one transforming MFI as a sign of financial interests cropping up [MDI/I/C/24].

As regards the transformation candidates' **influence** on the policy-making process, it can be observed that it was probably only second to that of BoU. They were quick to learn about financial regulation and argue their points. A number of factors favoured the power of transformation candidates as a stakeholder group such as its relatively small size, its homogenous interests, the effective use of AMFIU and the Lobby Sub-Committee of the Microfinance Forum for lobbying, and the often close relationship between senior management of MFIs and BoU's staff.²⁸⁷ They successfully pushed through a few essential changes such as a relaxation of the strict shareholding limits by inclusion of an exemption clause and higher loan size limits for group loans. A few other changes were rejected.

It can be concluded that the small group of leading MFIs planning to transform under the upcoming law had both strong interest and influence in shaping the law. Their small size and close relationship was certainly helpful in making their voice heard.

7.4. The Role of Other Stakeholders

Two other stakeholder groups had high stakes in the issue - donors and consumers. This section looks at these two and concludes by briefly discussing other stakeholder groups.

Donor Agencies

In many cases, regulatory reforms in microfinance were initiated and closely guided by donor agencies. In the case of Uganda, the MDI Act would probably have never seen the light of day without the substantial assistance by donors (see Chapter 6). Support by donors can take various forms, e.g., high level budget support, financial support for specific projects, or technical assistance to the regulator or regulated institutions. It can be targeted at the policy, institutional or client level. Of interest here is technical and financial assistance provided for the spe-

²⁸⁷ Two of the CEOs of the transformation candidates and one of the transformation managers were former staff of the BoU, having previously worked in its Supervision Function.

cific purpose of facilitating regulatory change in microfinance with the FSD Project financed by GTZ and SIDA being the main contributor.²⁸⁸

According to the private interest view, donor staff maximise their utility function, into which the following (non-exhaustive) list of objectives could enter:

- To achieve project goals as their performance is measured with reference to these
- To improve their reputation by achieving outcomes which are highly visible (even if these do not necessarily have the strongest impact)
- To take steps which improve their career prospects
- To be recognised as the lead agency in their field of operation
- To follow the predominant ideology of their government with regard to development aid²⁸⁹ or current “fashions” (microfinance certainly being one of them)
- To disburse allocated funding within the allotted time period
- To provide advice according to their personal professional background (which can vary, for example, depending on whether they come from a common law or civil law country)

According to this, **interests** can vary substantially from one donor project to another. Wright (2000, 5) claims that “donors, defensive and risk averse by nature, would hate to be associated with poor people losing their savings, and therefore seek the most conservative approach.” However, donor projects also often include quantitative targets with regard to access to financial services, which are not likely to be met if they pursue the most conservative approach. There are numerous ex-

²⁸⁸ Certainly donors use other channels to influence policy-making such as dissemination of best practices or international conferences. Yet for the stakeholder analysis, local donor projects are most relevant.

²⁸⁹ Schraeder (2002) distinguishes various donor countries’ programmes in the field of democracy promotion according to their “principal foreign policy thrust,” which could be security interests, economic interests, or humanitarian interests.

amples of donors actually lobbying for a relaxation of regulatory provisions. Which of their interests prevailed has to be assessed in the empirical analysis.²⁹⁰

As regards **expertise**, donors constituted the second group of technical advisors to the Government besides the Central Bank. The degree of knowledge about microfinance varies substantially depending on the main mode of aid delivery favoured by the specific donor. GTZ typically makes use of long-term expatriate staff with highly specialised knowledge about the specific field the project is operating in.²⁹¹ The availability of *champions* who are experts in their fields is important for the influence donors have on the policy change process.²⁹² This means that – probably even more so than for the other stakeholder groups – the character, professional background, and personal views of individuals matter.

The **influence** depends to a great extent on the resources donors bring to the table, as funding commitments can be used as an effective instrument to exercise power. The homogeneity of the group is also important in this regard, which crucially depends on how serious donors are about coordinating their efforts:

A lack of coordination amongst donors can be confusing to government, notably the central bank or banking supervisory authority. Since microfinance is relatively new to many countries, there is uncertainty as to how the sector should be regulated and supervised. Different donors may push for different solutions, taking the experience of different countries as their model. (Wright 2001, 1)

A lack of coordination certainly reduces the effectiveness of donor policies.

Turning to empirical evidence, Uganda has been praised for its high degree of “sectoral strategic coordination” (Wright 2001) and its ability to attract a number

²⁹⁰ A special case is where a donor has provided funds to an MFI (equity or loan) and is therefore interested in the supervisor taking over the responsibility of monitoring its investment. In Bolivia, exactly this happened, but the superintendency refused to accept this task as it did not see the regulation and supervision of NGOs as being part of its mandate (Gomez, Tabares, and Vogel 2000).

²⁹¹ The CGAP Donor Peer Review in Microfinance awarded GTZ high marks for “Excellent in-house financial sector expertise” (Duflos, Helms, and Latortue 2004, 11).

²⁹² Goodwin-Groen, Bruett and Latortue (2004, 9) talk about “microfinance champions” in Uganda as “technically skilled advocates.”

of microfinance champions, who are internationally known experts in their field (Goodwin-Groen, Bruett, and Latortue 2004). The development and passage of the MDI Act is regarded as a very positive collaborative effort (*ibid.*, 6). The two donor projects most involved in the design and implementation of the MDI regime were the FSD Project supporting Bank of Uganda and the SPEED Project supporting transforming candidates, which had excellent working relationships. The small number of players and their substantial funding (see Section 6.2) guaranteed that their voice was heard. It is therefore not surprising that donors had substantial **influence** on the process. The funding provided by them also helped to familiarise key personnel in the Central Bank with microfinance by sending them on training courses and organising exposure visits to other countries with a longer experience of regulating microfinance.

As regards their **interests**, the experts most closely involved had a good understanding of the public interest arguments for regulation and a background in microfinance. The project planning document of the FSD Project explicitly referred to an increase in access to loans and savings as one of the overall goals of the project [UD/R/101]. A general tendency to choose a conservative approach to regulation could not be observed. Donors supported the microfinance industry in its lobbying efforts to exempt compulsory savings and credit-only MFIs from the purview of the microfinance law,²⁹³ while at the same time arguing for strict licensing requirements for MDIs with reference to the limited capacity of the Central Bank [UD/C/65]. The one issue where private interests of donors might have led them to support a policy not in the best interest of the public was the early decision to promulgate a separate law rather than integrating microfinance under the Financial Institutions Act. To this day, this is a bone of contention, and will be discussed in more detail in Section 7.5. From a private interest perspective, the visibility of having a separate law is much higher and might therefore be the preferred approach for a donor agency (and perhaps also for the government) as they have

²⁹³ For example, representatives from several donor projects and the World Bank sent numerous letters to the Executive Director Supervision, Bank of Uganda, explaining the special characteristics of microfinance and why credit-only MFIs and MFIs only accepting (and not intermediating) compulsory savings should not come under the new law: [UD/C/68, 69, 96, 97, 98].

‘something to show’ for the money. Just amending an existing banking law is a much less visible exercise and a harder sell to their constituency, i.e., the government back home.

It can be concluded that donors as a stakeholder group had a strong influence not only on the law, but also in setting financial incentives for MFIs to transform, and mostly followed public interest objectives including a clear target to increase access (with the possible exception that donors were biased in favour of having a separate law).²⁹⁴

Consumers

The final stakeholder group are consumers of microfinance services, which should have had a strong **interest** in the reform as the ultimate beneficiaries. If the regulatory regime serves the public interest, it also serves the interests of consumers (which include current and potential future users of financial services). Even more, their interests should theoretically be identical with public interests as measured in this thesis.²⁹⁵ In practice, though, consumers are likely to lack the **expertise** to fully understand the economic rationale for regulation and thus be in favour of regulations such as below-market interest rates, which are beneficial in the short-term, but undermine the sustainability of the sector in the long term.²⁹⁶ According to Stiglitz (1998, 14), complex policies in political discourse are subject to a “simplicity constraint”. An entire field of economics – behavioural economics – is devoted to the question of why consumers do not always act in their own best economic interest.²⁹⁷ Moreover, individual consumers can gain at the

²⁹⁴ This is confirmed by the list of expectations of donors with regards to the MDI Regime, which is broadly in line with public interest objectives (Obara, Mukasa, and Staschen 2007, 14).

²⁹⁵ The public interest is defined with reference to the social welfare, which is the sum of the welfare of all individuals in a society.

²⁹⁶ There are numerous examples of consumer advocacy bodies lobbying for lower interest rates for poor borrowers such as the *Model Law for Consumer Protection in Africa*, SEC. 10, developed by Consumers International Regional Office for Africa (<http://tinyurl.com/yfaodk3>, accessed 15 January 2010).

²⁹⁷ One observation, for example, is called *hyperbolic discounting*, which describes the observation of extreme discounting of the future relative to the present. As a result, length of access is not considered as important as it should be from a public interest perspective.

expense of others. Thus the interests of consumers as a group are not necessarily the same as the sum of the interests of individuals.

There is certainly still a good degree of overlap between consumer interests and the public interest objectives: consumer protection and, in particular, deposit protection and increasing access are likely to feature prominently in their utility functions. As far as consumers' influence is concerned, they typically neither have sufficient resources to engage in lobbying, nor can they easily mobilise the few resources they have to defend their own interests successfully due to the large size of the group and associated free-riding problems (Olson 1965). These problems can lead to the paradoxical situation that consumers are the stakeholder group with the strongest stake in microfinance regulation yet with the weakest representation in the regulatory debate.

However, consumer interests might still be considered in the policy-making process and consumer protection agencies could play a role in raising their concerns. Also, even if consumers in most cases (and also in Uganda) do not have any statutory role in rule-making,²⁹⁸ they could still have a considerable **passive** influence. As voters they are the ultimate principals in the political system and thus the legislators have a strong incentive to consider their (perceived) interests in policy-making. Moreover, the management of MFIs must take into account the response of its customers when changes in the regulatory environment are implemented in order not to end up losing business.

In Uganda, direct consumer representation in the policy-making process did not happen as although a consumer protection agency did exist, it was not involved in the discussions about the MDI law. The general understanding was that MFIs and MDIs should represent consumer interests [DON/I/S/15], and that it would be asking too much of consumers to understand the difference between regulated and unregulated MFIs. However, at least one former CEO of a transformation candi-

²⁹⁸ This is different in the UK, where the law (the Financial Services and Market Act, 2000) stipulates the establishment of a consumer panel, which has the right to make "representations" to be regarded by the FSA (see <http://www.fs-cp.org.uk>, accessed 15 January 2010).

date admits that clients were not sufficiently consulted, as MFIs just claimed to know what they want, but never asked them [CON/I/S/94]. Just looking at the type of misinformation conveyed in the media about who is covered under the MDI Act and what the law is for, it was indeed difficult for the average customer to understand what this law is about.²⁹⁹ It can be concluded that consumer interests were only indirectly represented through MFIs (to a limited extent) and their political representatives in the Parliament (to a larger extent), yet with the latter arguing for the perceived interests of consumers (such as subsidised interest loans), and not necessarily the public interests.

Other Stakeholders

There are several other stakeholder groups with a potential role in the policy-making process. On the practitioners' side, these are other **non-SACCO Tier 4 MFIs** that do not have immediate plans to transform, **regulated MFIs** (i.e., Centenary Bank and CMF) and **commercial banks** (even if not providing microfinance services). All these played a marginal role in the Ugandan case. Non-SACCO Tier 4 MFIs probably had the highest interest among this group because of either having medium-term plans to transform (e.g., MED-Net, UGAFODE, FOCCAS) or because they wanted to avoid becoming regulated. The former group followed the discussions and hoped to learn from the transformation lessons learned by early pioneers (Obara, Mukasa, and Staschen 2007, 14), but was much less involved than the transformation candidates. The latter should have had a strong interest in lobbying against any regulatory provision which would not allow them to continue operating in the same way (e.g., the prohibition on using compulsory savings without becoming regulated). However, neither had much influence on the debate not least because of their diversity and lack of resources (none of them received comparable amounts of donor funding). What is striking about this group of MFIs is that they had very little understanding about what it means to get an MDI licence. In 2003, Okumu (2007, 206) interviewed 31 MFIs (among them the four MDI candidates) – 13 thought they would meet all the re-

²⁹⁹ There are numerous examples for this from local newspapers – too many to list here.

quirements and be licensed immediately upon the law coming into force, 17 that they would register later and only one said it would never meet the requirements.

Two MFIs were already regulated, viz., Centenary Bank and CMF. While they could have seen the emergence of new competitors as a threat to their unique position in the sector and as leading to the dissipation of the rents they enjoyed because of market entry barriers, they did not play an active role in the debate about the MDI law. They participated in some of the meetings, but did not lobby for any specific changes to the Bill. This is even more surprising as they were also affected through changes in the asset quality regulations for banks and credit institutions applicable to their microfinance portfolio. Possible explanations for this lack of interest are that the rents from barriers to entry were low even before, as they were already competing with unregulated MFIs in their lending business; that they saw themselves operating in a different market (which was partly true at least for Centenary with much larger average loan sizes); that they were not aware of the planned changes to their asset quality regulations; or that donor agencies were not actively engaging them because of traditional reservations against working with commercial banks. Finally, banks that did not offer microfinance services were even less involved as none of them had any serious interest in entering the microfinance market (except for wholesale lending to MFIs).

Table 7.1 below briefly summarises the stakeholder interests, their level of knowledge of microfinance regulation, and their influence on the outcome. While all stakeholder groups had a high interest in the topic – this was the main criterion for choosing them – only three had a strong influence on the outcome: Bank of Uganda, the transformation candidates, and donor agencies. These happen to be those stakeholders with the highest knowledge of the topic. This concurrence can be seen as one of the success factors of the MDI regime: those with the highest expertise were at the same time those with the highest influence on the outcome. The only downside is that Bank of Uganda’s interests are skewed towards over-regulation and traditional bank regulation, which explains many of the observations of the regulatory impact assessment in Chapters 4 and 5.

Table 7.1: Stakeholder Analysis of the Policy Change Process in Uganda

<i>Stakeholder Group</i>	<i>Interests in Reform</i>	<i>Level of Knowledge</i>	<i>Influence on Outcome</i>
Legislature	High: topic of high salience as it can be used to gain votes and because of MPs' personal involvement in running MFIs	Low: objectives run counter to public interest objectives	Low: held veto gate and could have shaped legislation through amending Bill, but did not make full use of its powers and instead followed Government line
Executive	High: topic of high salience to the Government; Ministers have strong interests to follow President's line	Low to medium: some knowledge about topic in MoFPED	Low: President held veto gate, but depended on support from donors; Government chaired MFF and defended Bill in Parliament
Bank of Uganda	High: responsibility for safety and soundness of financial sector and looming crisis because of unregulated deposit-taking	High: experts on financial regulation with increasing knowledge about microfinance	High: drafted law and regulations and led stakeholder consultations; biased towards overregulation and traditional banking regulation
Transformation candidates	High: see strong advantages in being regulated and majority was already taking deposits	High: experts on microfinance with increasing knowledge about regulation	High: close relationship with BoU; BoU depended to certain degree on their cooperation; small, homogeneous group
Donor Agencies	High: among the initiators of regulatory reform; performance measured with reference to project goals; interest in high visibility of results	High: relevant donor projects led by microfinance "champions"	High: small group of donors closely involved in designing regime and assisting with implementation; could make use of funding conditionalities
Consumers	High: similar (but not identical) to public interest	Low: highly complex topic; unclear public messages in the media; free-rider problems in lobbying	Low: interests not directly represented, but only through MFIs and political representatives

7.5. Private Interest Explanations for Having a Separate Law

This final section looks at the debate about whether it was worthwhile having a separate law or whether it would have been better to integrate microfinance under the existing Financial Institutions Act. One of the most fundamental criticisms of the MDI law is that a lot of effort was devoted to setting up this special legal framework for microfinance with only four institutions qualifying for a licence

under the new law, one of which has already converted into a commercial bank and the three remaining having at least medium-term plans to graduate to a higher tier – something I have already alluded to in Section 6.3. The Friends Consult study from 2007 concludes:

If MDIs turn into banks and mature Tier 4 institutions continue to seek transformation into Tier 1 or 2, Uganda might soon have a redundant law called the MDI Act 2003. This would be a culmination of needless legislation. (Obara, Mukasa, and Staschen 2007, 42)

This, again, supports Hypothesis 5 that the MDI structure is not attractive in comparison to being regulated under the FIA. While Chapter 6 showed that promulgating a special microfinance law created high costs and that the cost-benefit ratio of the MDI Act seems not to compare favourably with the FIA, this section analyses the possible reasons for setting up a special law from a private interest perspective.

No rigorous *ex ante* impact assessment – as for example recommended by Porteous (2010) – was conducted to decide whether the expected benefits of a special new legal window would be justified by its costs or whether alternative approaches might have been preferable. During the earliest discussions about microfinance regulation in 1996, it was suggested that MFIs be brought under the general Financial Institutions Statute by classifying them as a new type of “financial institution” as defined in SEC. 2 of FIS (1993) [UD/R/1]. Only later, when Bank of Uganda drafted the *Policy Statement on Microfinance Regulation*, did the approach change, and BoU argued that the mismatches between standard regulatory frameworks for banks and MFIs made it necessary to regulate MFIs under a separate law [UD/R/4, UD/R/44, UD/R/63]. The rationale was, according to one close observer at the time, “to put microfinance on a different template from commercial banking” [SUP/I/C/25]. This rationale did not, in the end, hold water considering how similar both laws turned out to be and numerous complaints by practitioners that the MDI Act is at least as strict as the Financial Institutions Act (see Section 6.3). Quite a number of industry experts have concluded that it would

have been better to integrate microfinance under an all-encompassing Financial Institutions Act [e.g., DON/I/C/11, DON/I/S/15].

One reason for a separate law was obviously the initial expectation that the two laws would be much more different [MDI/I/C/7]. Also, while the concurrent revision of the FIS seems to have offered a perfect opportunity to integrate microfinance under this law, it was initially planned to finalise it much earlier than the MDI Act [BOU/I/O/1]. Apart from these more practical reasons, the strongest arguments in favour of having a separate law can be found in a political economy analysis of stakeholders' interests:

- As mentioned above, both for the Government and for donors, the higher visibility of a special law is easier to sell to their principals (the voters and the superiors/government in the donor's home country, respectively). Jansson (2004, 18) looks at the experience in Latin America and bemoans that the creation of new institutional types "can sometimes be a high profile response to a problem that could better be solved by a more modest regulatory approach."
- Bank of Uganda and also the commercial banks were not in favour of turning microfinance into a "back-door method for entering banking business," i.e., wanted to keep a clear dividing line between them – something that certainly clashes with the approach of regulating microfinance as a function rather than institutional type [BOU/I/C/18].³⁰⁰
- MFIs themselves were initially strongly opposed to coming under the FIS/FIA, as they did not want to be perceived as banks – this changed later once they realised how similar the regulatory provisions were to the banking regulations [CON/I/S/94] and they became used to the idea of becoming a bank.

³⁰⁰ According to the CGAP expert, Lyman, the main argument for proliferation of specialised microfinance laws worldwide is that banks did not want MFIs to be incorporated under the mainstream banking legislation: "The banks would have made such a fuss . . . that they could have stopped things dead in their tracks" [UD/E/87].

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- The most important argument, however, is that a separate law has forced everyone to think hard what the best regulatory provisions for microfinance are and to what extent they should differ from commercial banking (Obara, Mukasa, and Staschen 2007, 42). The transformation manager of one of the MFIs concludes: “I think just by nature of the intellectual capital that has gone into thinking through what is the best regulatory structure for microfinance institutions it does make sense to have a Tier 3” [CON/I/S/28].

Only the last point is convincing from a public interest perspective. The World Bank financial sector expert in Uganda at the time concludes:

While I would agree that in principle it would be clearest (and most consistent with an inclusive financial systems approach) to have one law covering all licensed/supervised tiers, from a practical-technical-historical perspective, I think that the process of preparing a separate law to bring MDIs into a system is **strategically desirable** in most African countries in order to get the central bank authorities to **really focus on and understand the special aspects of microfinance**. Even with such special treatment, there is a **tendency to treat them just as mini-commercial banks** in terms of supervision requirements. . . . Once central banks have had some experience dealing with MFIs as licensed entities, it would be appropriate at a subsequent time to review financial sector legislation and integrate them. [UD/E/86, emphasis added]

Another interesting aspect is that the parliamentary debate would certainly have been quite different if MPs had to vote on the amendment of the FIS to allow for inclusion of microfinance instead of the creation of a new law. The point of reference would have been Tiers 1 and 2, and not Tier 4, and therefore it would have been much more obvious that the regulatory change would lead to a **lowering** of barriers to entry for microfinance. The debate about legislating for only a very few MDIs would not have occurred (indeed there might not have been much debate about microfinance at all as the sections in the Financial Institutions Bill specifically targeted at microfinance would have been few).

It can be concluded that the question of having a separate law or not cannot only be discussed with reference to what is theoretically the best or most elegant solution, which makes it difficult to find arguments for having two different laws

regulating deposit-taking microfinance business (see Section 3.2). The political economy of how to achieve the best possible regulatory outcome also needs to be considered. The MDI Act has been described as being overly cautious, but the inclusion of microfinance under the general financial institutions law could have led to even more banking-style provisions for microfinance. These political economy arguments can easily be at least as important as more technical arguments for one or the other approach.

Conclusion

This chapter showed that a political economy analysis of regulatory change constitutes an essential complement to the public interest perspective of the ROI approach developed in Chapter 2. It moves beyond just measuring impact by exploring the reasons why the regulatory intervention took the form it did and is therefore essential for understanding regulatory change processes and learning from them for similar initiatives elsewhere. The instrument of the stakeholder analysis is useful to structure the analysis, while the three characteristics of interest, knowledge, and influence can give an indication of the role played by each stakeholder group.

The basic assumptions of the political economy perspective are that policy change processes are driven by the personal interests of policy-makers, which only partially overlap with the interests of the public, and are conditioned by the legal environment of the country, in particular by its system of government and electoral laws. While some of the policy-makers might know of the rationale and objectives of financial regulation based on an analysis of market imperfections – the benchmark used in this thesis – this is not necessarily what drives the process. This chapter has distinguished six key stakeholder groups involved in introducing the MDI regime in Uganda and identified their material interests, knowledge of microfinance regulation, and influence in the regulatory debate.

The relative success of the MDI regime in achieving the five public interest objectives should not be taken for granted, but can be explained by the influence of the

Central Bank, a few closely involved donor agencies, and the transformation candidates, which were all knowledgeable about microfinance regulation and pursued objectives broadly in line with the public interest objectives. The regulator, in particular, played a central role in developing the MDI regime as it was the most knowledgeable Government organisation and at the same time had a strong self-interest in regulating the microfinance sector. A bias towards the safety and soundness objective can be clearly identified as an effect of its private interests. The legislature and executive, which at times followed diametrically opposed objectives, did not make use of its broad powers in law-making. This can be explained by the tacit approval of the MDI Law by the executive and a legislature that did not challenge the political hegemony of the ruling party. The lack of consumers' voice in the debate is a possible explanation for the relative weakness of consumer protection rules.

The last section looked at the question of introducing a separate law rather than integrating MFIs under the general Financial Institutions Act as an example of how private interests influence policy decisions. It has shown that what seems to be superior from a public interest perspective might in fact not be the better approach if private interests are taken into account. The main arguments for having a separate law are political economy arguments, even though an all-inclusive financial institutions law seems theoretically to be the preferred approach.

CHAPTER 8 – CONCLUSION

The main motivation for conducting this study was that despite numerous regulatory reform initiatives in microfinance, there has been little systematic research on assessing their impact. There is a general consensus that the outreach gap is still enormous and that the integration of microfinance into the formal financial sector can help to bridge it, yet evidence is still lacking on what role the promulgation of special microfinance laws can play in this. A review of the relevant literature confirmed that what is missing most with regard to RIAs in microfinance is a rigorous methodology that provides clear guidance on how to identify impact and measures impact against a widely accepted benchmark.

This study has developed such a methodology to assess regulatory impact in microfinance. To test its usefulness and validity, it has applied it to the case of Uganda, where a special microfinance law was introduced in 2003, and made use of political economy theories to explain the observed impact. The result is twofold (see Figure 1.3): a systematic methodology for the assessment of regulatory impact in microfinance that can be widely used for the assessment of similar regulatory reforms and an in-depth assessment of the MDI regime in Uganda.

This concluding chapter summarises the main results in both areas. It first summarises the main findings from the case study on Uganda as a practical application of the RIA approach, and then revisits the ROI approach developed in Chapter 2 and discusses its usefulness for similar studies and how it can be complemented by related research on regulatory impact assessment.

8.1. Results from the Application of the RIA Approach in Uganda

Uganda was chosen as the case study of this thesis as the “disconfirmatory (most-likely) crucial case” due to a unique combination of conducive conditions, which included, among others:

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- A committed central bank, motivated to regulate the microfinance sector by a looming crisis among unregulated deposit-taking MFIs
 - Strong interest from key donor agencies providing targeted and complementary support
 - A sufficient (if limited) number of mature MFIs

Overall, the impact of the MDI regime on the public interest objectives of microfinance regulation was rated a success, which means that the “(most-likely) crucial case” confirmed the general assumption that the introduction of a special microfinance law can have a positive impact on social welfare. The contribution of the empirical part of this thesis is the analysis and explanation of the impact of the new legal framework on each of five public interest objectives, while making special reference to the costs of achieving the observed impact (Secondary Research Questions 1 to 3).

This section will not repeat the detailed results of the RIA in Chapters 4 to 6 and the political economy analysis in Chapter 7, but instead discusses the most interesting results and draws some conclusions on a more general level for regulating microfinance.

The Five Public Interest Objectives

The positive impact of the MDI regime was most pronounced on the public interest objectives *safety and soundness* and *systemic stability*, thus providing strong supporting evidence for Hypothesis 1. If anything, the MDI regime is overly conservative in pursuing these two objectives at the risk of creating unnecessarily high costs and achieving lower than possible growth rates in access figures. Evidence supporting this conclusion includes:

- A strict shareholding limit of 30% forcing transforming MFIs to dilute their ownership and take on more commercially oriented shareholders, thereby increasing the risk of mission drift (Hypothesis 3)

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- By international standards strict capital adequacy rules leading to higher costs and lower outreach (Hypothesis 4)
 - Few advantages to, but many more restrictions of, the MDI structure in comparison to being regulated under the Financial Institutions Act (Hypothesis 5)
 - High costs of transformation amounting to an estimated US\$1.8 million per institution
 - High costs of branch licensing with requirements imposed by the Central Bank being stricter than required by law
 - A prohibition on intermediating compulsory savings

A number of reasons for the bias towards safety and soundness have been given, chief among them the prominent role of the Central Bank in both designing the legal framework and implementing it. In the design phase, the political principals (the executive and the legislature) relied strongly on the technical expertise of the Central Bank in financial regulation. Post-enactment, the Central Bank has enjoyed considerable leeway in interpreting the MDI Act and issuing implementing regulations under the law (Hypothesis 2). A central bank like Bank of Uganda is subject to two biases towards overregulation. Firstly, the professional expertise and training of central bank staff renders it more likely that they favour regulatory solutions to economic problems and that they use their commercial banking lens in regulating microfinance. Secondly, the central bank is subject to an asymmetric reward and punishment system (being blamed for institutional failures, but not equally rewarded for improving access). It can be concluded that central banks (or supervisory authorities more generally) are likely to play a prominent role in the regulatory reform process because of their outstanding expertise and interest in financial regulation. While this ensures a general understanding of public interest arguments for regulating microfinance, it bears the risk of a bias towards overregulation.

Despite this bias towards two of the five public interest objectives and an almost complete absence of regulatory provision directly targeting any of the other regu-

latory objectives, the MDI regime still had a positive impact on two of the other objectives, viz., increasing competition and access. This is because the introduction of the new legal framework **reduced** barriers to entry by introducing a new, lower tier without stipulating new limitations for the operations of unregulated MFIs. High transformation costs, which could have prevented MFIs from fulfilling the strict licensing criteria, were mostly covered by donor grants and thus did not constitute a serious hurdle. The main qualification of the positive impact on access is the temporary drop in the number of borrowers around the licensing date and slower growth since then. This could be linked to strict portfolio quality regulations and a trend to issue much larger loans among those MFIs that had to take other, more commercial investors on board. Whether this constituted *mission drift*, i.e., a departure from serving the typical microfinance clientele, is not possible to say conclusively on the basis of available data. Affordability of access (measured by portfolio yield) is another area without any positive impact, which is in line with other studies showing that supervisory costs can lead to interest rate increases and that price competition only starts in the consolidation phase of microfinance markets, which Uganda might not yet have reached.

An interesting lesson from the Ugandan experience is that the introduction of a lower tier – as long as it does not lead to the tightening of existing regulations, but simply lowers the hurdle for MFIs to enter the deposit-taking business – is likely to have a positive impact on competition and access to savings services.³⁰¹ Furthermore, if transformation costs are as high as they were in Uganda, it is unlikely that many MFIs will be able to afford these costs without substantial donor support. Finally, those MFIs that were able to retain 100% shareholding in the transformed institution were best able to preserve their mission, as stated by Hypothe-

³⁰¹ A possible exception would be if one of the newly licensed MFIs takes on a dominant position in the market on the strength of being regulated.

sis 3. However, it could not be observed that a diversified shareholding structure increased the safety and soundness of the other two MDIs.³⁰²

The one public interest objective, for which hardly any improvement could be observed, was consumer protection. The main impact of the MDI regime in this regard was through increased deposit safety. Apart from this, rules on disclosure, fair treatment of customers, and recourse mechanisms are all but non-existent. This is even more of a problem in the light of recent research that underlines the importance of private monitoring – including reliable information disclosure and only limited deposit insurance coverage – as a strategy to regulate banks (Barth, Caprio Jr., and Levine 2006, 310). It can be explained by the absence of a consumer voice in the regulatory debate and the strong influence of the MDI candidates on shaping the regulatory regime with only limited interests in increasing the transparency of their operations.

The Political Economy of Regulatory Change

What is striking about the Ugandan case is that the interests that prevailed were those of the stakeholders which were best informed about microfinance regulation (the Central Bank, donor agencies, and transformation candidates), while those with the highest statutory power (the executive and legislature) and views that differed most from the public interest view did not have a formative influence on the MDI regime. The complexity of the topic made it necessary for the Government to be advised by technical experts such as the Central Bank and donor agencies, thus ensuring that their voice was heard. However, the analysis of the debate in Parliament and public statements by legislators and Government representatives illustrate how their political self-interests could easily have derailed the law-making process. The eventual outcome of this debate was not at all obvious, but can be explained with reference to elements of the political system (the presidential system in Uganda and its election rules) and the private interests of various

³⁰² It could be, however, that in a crisis situation the MDIs with a more diversified shareholding structure are better able to inject fresh capital than the two MDIs fully owned by an international NGO and the Government, respectively.

stakeholders involved in the policy-making process. In particular, it could be shown that it was in the interest of the executive, and especially the President, to support the MDI Bill while the legislature succumbed to the hegemony of the ruling National Resistance Movement. The analysis suggests that it was a deliberate decision by the Government not to obstruct the law-making process as it was well aware that the conflicting policies it publicly supported, such as interest rate restrictions and microfinance delivery by government-owned MFIs, would hurt the microfinance sector and strain its relationship with international financial institutions such as the World Bank and IMF. More generally, an important determinant of the final outcome of such a legislative process is the relative strength of various stakeholders and their interests in and knowledge of microfinance regulation. Initially the regulator's knowledge of microfinance and the MFIs' of regulation is typically limited. The donor agencies invested heavily in a mutual learning process, which was necessary in order for the Central Bank to understand the specific characteristics of microfinance (e.g., the use of collateral substitutes such as compulsory savings, which do not necessarily require prudential regulation) and for the transformation candidates to know what to expect from becoming regulated. However, potential opposition from the legislature was underestimated for a long time so that the MDI Bill was almost thrown out of Parliament and was only saved by a last minute compromise. One lesson from this experience is the importance of studying the political system and interests and influence of various stakeholders early on in the proceedings in order to avoid unexpected turns in the legislative process.

Another insight from the political economy analysis is that regulatory impact can be transmitted through the wider political system with far-reaching consequences – something all too easily ignored when conducting a regulatory impact assessment. In Uganda, the unrealistic expectations of the Government with regard to the impact of the law on bridging the outreach gap led it to announce a strategy of subsidised credit, relying on the creation of numerous SACCOs in rural areas.³⁰³

³⁰³ This strategy has up until now not yet been fully implemented, which supports the view that public announcement and political actions can differ deliberately.

While it is difficult to blame the MDI regime for this kind of distortionary policy, the Ugandan experience clearly shows that it is important to manage the expectations of various stakeholders and consider the risks of unfulfilled expectations among government representatives.

The Approach of Introducing a Special Law

This thesis did not compare alternative regulatory approaches such as regulating microfinance under a separate law or integrating it under an all-encompassing financial institutions law, as its main benchmark was a world without any regulatory change. Nevertheless, a side-product of the regulatory impact assessment are a number of observations about the drawbacks of introducing a special law and hypotheses about the likely impact of alternatives approaches. The most interesting alternative would have been the integration of microfinance under the Financial Institutions Act.

- Firstly, the regulation of deposit-taking microfinance business under two different laws created numerous practical problems with regard to delineating various tiers and harmonising regulatory provisions and terms used in both laws. It definitely would have been easier to harmonise provisions applying to microfinance as a specific line of business, if it had been regulated under a single law. It also transpired that the differences between microfinance and commercial banking regulation are not as stark as most stakeholders initially thought they would be.
- Secondly, the introduction of a separate law invariably leads to the creation of a new institutional type (even if the MDI regime was supposed to be a functional approach) with the risk that it will be perceived as inferior to a fully-fledged commercial bank (as is the case in Uganda).
- Thirdly, and relatedly, a new law leads to the fragmentation of the regulatory regime and higher start-up institutional costs (the sum of costs borne by the Central Bank and donor agencies supporting the Central Bank in Uganda were estimated at more than US\$4 million). It is questionable whether the Central

Bank would have been able to meet these costs without the substantial donor support it received over the years. This is even more of a problem if the new institutional form lacks appeal due to an unfavourable cost-benefit ratio in comparison to the alternative of being regulated under the existing banking law.

- Fourthly, one wonders whether the introduction of a new tier (combined with substantial donor support for applicants under this tier) sends an unwanted signal that microfinance is best provided by this new institutional type, while commercial banks and credit institutions might have had even better potential for boosting the microfinance sector (if they had received the same attention and financial support as MDI candidates). All MDIs admit that transformation has been a costly and painful organisational change process. Despite all the support and attention to the four MDIs, each of their market shares is still dwarfed by that of Centenary Bank (Centenary had, in 2008, 57% of the **combined** number of MDI borrowers and 107% of the combined number of MDI savers). There was only minimal effort by the Central Bank and donor agencies to involve commercial banks as potential providers of microfinance.
- Finally, the best regulatory approach cannot be discussed in isolation from the political economy of regulatory change. Despite all the evidence suggesting the integration of microfinance under the FIA would have been the better approach, the promulgation of a special law might have been the only way to warrant that the peculiarities of microfinance were sufficiently taken into account.

I will return to this when discussing directions for future research below.

One conclusion from the Ugandan case is that the introduction of a special law requires long-term financial and time commitment from a number of key stakeholders – it is better to think twice before pursuing this regulatory approach.³⁰⁴

³⁰⁴ There are numerous examples, e.g., from Tanzania and Kenya (and of course Uganda), where donor agencies set over-ambitious time targets for the reform of the legal framework.

Start-up institutional and compliance costs can be prohibitively high if not subsidised by donor agencies. These subsidies are not reflected in the benefit analysis according to the ROI approach and therefore reduce the overall net-benefit of the policy change.

8.2. Concluding Comments on the RIA Methodology

The main contribution of this thesis is the development of an RIA methodology rooted in welfare economics. The approach is deductive in the sense that it takes the public interest theory of regulation as its starting point and advances the theory by conducting empirical work (cf. Parker and Kirkpatrick 2002). This section summarises the principal advantages of the ROI approach developed in this thesis and its usefulness for similar research elsewhere, and concludes by outlining some directions for future research on RIA in microfinance.

The Main Advantages of the Rationale-Objectives-Indicators Approach

Most similar research on assessing regulatory impact in microfinance has suffered from the lack of a coherent theoretical framework. In particular, studies have used different benchmarks when comparing several regulatory options, or have simply assumed that all observable changes can be identified as the impact of regulatory change (implicitly assuming that the counterfactual would be a static world without any changes, e.g., Chiumya 2006). Other studies have only looked at the costs of regulation without attempting any – not even qualitative – assessment of its benefits. The ROI approach used in this study is a more rigorous methodology offering a solution to the limitations of previous RIAs:

- It proposes a consistent and widely accepted benchmark for different types of regulatory interventions, which is firmly rooted in economic theory and assumes that regulation is only needed to alleviate market imperfections or to protect against their negative consequences.
- It focuses on the assessment of benefits defined as the achievement of regulatory objectives. Costs – unless borne by a third party whose expenses do not

lead to changes in the microfinance market (e.g., the central bank, government or donor agencies, but not MFIs and their customers) – are reflected in the measurement of benefits. A separate cost analysis such as the one conducted in Chapter 6 should still be part of the overall assessment as it can highlight the magnitude of different cost categories and add information about those borne by third parties.

- The analysis makes use of quantitative and qualitative data recognising that some benefits are difficult to quantify (let alone monetise), but that this does not mean that they are less important. Some of the qualitative data from interviews in particular, also allows for establishing causality, which is often a challenge when analysing quantitative data such as performance indicators.
- A key challenge in conducting an RIA is to isolate regulatory impact from changes caused by other exogenous variables – the identification problem. The methodology used here borrows from the logic of inference used in quantitative research. The two main approaches are to look at difference-in-differences between MFIs affected by regulatory change (the Treatment Group) and other similar MFIs (the Control Group(s)), and to analyse structural breaks. Both approaches were useful, even for the analysis of qualitative indicators (e.g., comparing organisational changes of treatment and control group MFIs).
- Finally, the use of a multitude of indicators for each of the regulatory objectives recognises the complex web of impact channels triggered by regulatory change and can help to disentangle it, even though some of these channels might not be immediately obvious (such as the increase in average loan size triggered by strict portfolio quality regulations). The combination of indicators measuring changes in market outcomes with others looking at institutional changes allows for the estimation of future impact, especially in cases where regulatory impact does not yet show in changes in market outcomes.

There has been a long-running debate between proponents of the public and private interest views of regulation. For example, Chiumya (2006, 230) concludes from her RIA study: “The public interest view of regulation did not hold for the

microfinance sector in Zambia.” This study has moved beyond this dichotomy and acknowledges that neither view in its pure form reflects the reality. Instead, the public interest view plays a central role as a benchmark for what regulation is supposed to achieve. Ultimately, regulation has to be judged with reference to its impact on advancing the interests of the public – on increasing social welfare. The private interest view, however, assumes in a realistic way that policy changes are driven by individuals, and groups of individuals, who pursue their own private interests. These private interests do often overlap with public interest objectives, but not always. One could say that the private interest theory is the generic theory with public interests being but one possible realisation of private interests.

Complementing the assessment according to the ROI approach with a political economy analysis such as the one in Chapter 7 makes it possible to explain the achievements and shortcomings in attaining regulatory objectives with reference to the political process and private interests of various stakeholder groups involved in the regulatory debate. The political economy analysis thus moves beyond a simple assessment of regulatory impact and explores the underlying reasons. While the political economy of regulatory change differs from one country to another (and even from one regulatory reform initiative to another), the approach employed in the thesis is to identify the main stakeholder groups and define their respective material interests, knowledge of the topic, and influence in policy-making. By doing so, similarities across different reform initiatives can be identified. For example, a bias towards overregulation, as in Uganda, can likely be observed for all regulators.

Usefulness of the RIA Methodology for Other Studies

While the RIA methodology employed in this study has certainly been helpful in assessing the impact of the MDI regime, it also has its limitations. This section looks at some of these limitations and suggests possible applications of the methodology for other regulatory impact assessments. The major challenge in making use of the ROI approach is to define sound indicators and collect sufficient (in

terms of number of MFIs and length of the observation period) and reliable data. With regard to the empirical analysis of performance indicators, the typically limited number of observations for a single country and the challenge of identifying a control group similar enough to the treatment group are likely to make it impossible to conduct formal regression analysis. For some variables (in particular those that are affected by one-off transformation costs or by accounting changes through transformation), the short-term effect of regulation differs from its long-term impact. Moreover, regulatory impact transmitted through various impact channels can have an ambiguous overall effect on some of the dependent variables (e.g., on return on assets as shown in Figure 4.1). A simple test for increases or reductions in values is therefore often not sufficient. Finally, the analysis can be subject to a number of biases (see, for the Ugandan case, Table 4.1), which have to be taken into consideration.

Instead of a formal regression analysis, alternative empirical methods can be used such as those applied in this study. The results can be graphically presented in line charts (to show structural breaks) or scatter plots (to visualise the correlation of two dependent variables). In cases where individual MFIs within the treatment group do not show parallel trends, it is better to look at each institution individually (in particular in cases where regulatory treatment differs across institutions as it was the case with the single ownership limit for MDIs). Control group MFIs can be used to verify whether the observed changes can be clearly identified as regulatory impact. Finally, the calculation of changes in absolute values or growth rates between the pre- and post-licensing period are evidence for regulatory impact, as can be the reduction or increase in the variance of values. The quantitative analysis alone will often not be sufficient to identify regulatory impact. Complementary to this is the use of qualitative data from various sources, including interview evidence and other primary and secondary sources such as internal documents, newspaper articles and any available studies (including customer surveys) with relevance for the assessment of regulatory objectives. According to the approach of process tracing, all information that provides evidence about the achievement of any of the regulatory objectives is relevant. The result is a much more refined

picture of various impact channels and regulatory impact than would be possible with the analysis of only performance indicators.

The ROI approach can be used for a wide range of studies. It is valuable for both *ex ante* and *ex post* RIAs, and it is in no way restricted to the analysis of such a profound change as the introduction of a new law, but could also be used for minor regulatory reforms. While the rationale for regulation – alleviating market imperfections or their negative consequences – is always the same, the composition and seriousness of market imperfections varies from one case to another. As a consequence, public interest objectives and indicators must be defined for each specific case.

Ex ante RIAs will be of particular interest to policy-makers, who ponder over a regulatory reform initiative. Several issues have to be considered when assessing future policy changes rather than past reforms:

- Typically more than one option will be compared with the do nothing option. The choice of the most relevant options is obviously of great importance for the quality of the RIA. The final criterion is to choose the alternative with the highest net-benefit.³⁰⁵
- The public discussion of an *ex ante* RIA by stipulating a consultation period (as in the case of the FSA) can increase the public accountability of the regulator, but could also increase the risk of regulatory capture.
- The weighting of the different public interest objectives is ultimately a political decision and should be represented as such. The RIA can help to point out trade-offs and complementarities among various objectives (cf. Table 2.3).
- The estimation of future impact is even more challenging than the measurement of past impact. An *ex ante* RIA is therefore likely to be less accurate than an *ex post* RIA (which could be one reason why academic research has focused on the *ex post* assessment).

³⁰⁵ Sen (2001, 105) emphasises that “cost-benefit analysis does need maximization, but not completeness or optimization.”

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- Supervisory capacity needed to implement regulatory changes plays an important role in assessing the desirability of different options.

One lesson from the case study is that it would have been desirable to conduct an *ex ante* regulatory appraisal of different options, which might have shown the superiority of alternative approaches such as integrating microfinance under the general banking law. Regardless of whether an *ex ante* RIA has been conducted or not, the quality of an *ex post* RIA can certainly be improved if relevant data for measuring regulatory impact is collected right from the start.³⁰⁶

Directions for Further Research

This final section outlines some ideas for related research that would be complementary to the RIA methodology used in this thesis. This study raised two major questions with regard to the Ugandan case, which could not be answered by using the ROI approach developed in Chapter 2 and on the basis of the available data.

The first is the question of alternative regulatory approaches, and in particular, whether the integration of microfinance under the Financial Institutions Act would have been more successful in reaching regulatory objectives. While Sections 6.3 and 7.5 offered some information about the cost-benefit ratio of different tiers and analysed the decision to introduce a special law from a political economy perspective, respectively, they could not provide a final answer. As it is unlikely that a country would follow both approaches at the same time – introducing a special microfinance law **and** integrating microfinance under the general banking law – a comparison would either have to look at two different (but preferably otherwise similar) countries or estimate the likely impact of one of the options while observing the other. An alternative could be a cross-country study drawing on the comprehensive database of the MIX, looking at numerous countries and using statisti-

³⁰⁶ NERA (2004, 26) points out that *ex post* assessments can also be used to improve future *ex ante* analyses by testing the accuracy of impact estimates.

cal methods to identify the impact of different regulatory approaches.³⁰⁷ The evidence collected here would seem to suggest that the revision of the Financial Institutions Act with the aim of including deposit-taking MFIs in its coverage, combined with a similar concerted effort to raise the profile of microfinance (with the same political attention and donor support, but a stronger focus on incentivising commercial banks to provide microfinance) would have generated even better results. In particular, the institutional costs would have been lower and the chances of attracting mainstream banks into microfinance better.

The second question without a satisfactory answer is whether regulation led to mission drift among the newly licensed MFIs. The main indication for this is increasing average loan sizes (in particular for two of the four MDIs). However, it could be shown that while average loan size is still a widely used indicator for mission drift, it is not a good one (Armendáriz and Szafarz 2009). A more in-depth study of some transforming MFIs would be needed such as, for example, a comparison of FINCA, as the only MDI fully owned by its founding NGO and the one with by far the lowest average loan size, with UML/Equity Bank, which experienced the strongest growth in average loan size. Such a study would require privileged access to detailed institutional and performance data and could look at better indicators for mission drift such as changes in the loan portfolio broken down by loan size, social profile of customers, product details and lending technology. Key research questions would be whether UML experienced mission drift, whether there is a clear causal link between regulation and mission drift, and what mechanisms led to differences in impact across institutions.

Two other areas for further research would be to look at the longer-term impact of the law and to conduct a more in-depth study on supervisory practice, as both these areas are shortcomings of the study in hand. The analysis of performance indicators in particular, showed that the short-term impact of the law was different from its longer-term impact. Many of the indicators have only recently changed

³⁰⁷ This would be similar to the recent studies by Cull, Demirgüç-Kunt, and Morduch (2009a; 2009b), but with a focus on regulatory approaches. One challenge would be to meaningfully categorise different regulatory approaches, as a multitude of variants can be found around the world.

their trend and it would be interesting to see how they develop in the future. Also, the study mostly relied on an analysis of legal requirements and perceptions of practitioners in analysing supervisory practice. A detailed study on how supervisory practice differs between commercial banking and microfinance and how different regulatory requirements are implemented in practice, could decide whether the complaint is justified that supervisors “come with a commercial banking mentality” and ask for more than is prescribed in law.

There is an obvious trade-off between the depth and breadth of studies on regulatory impact. Both types of studies – single case studies and cross-country studies – are needed. The comparative advantage of a single case study such as this thesis is the depth of analysis, which gives a detailed account of the mechanisms through which regulation works. Cross-country studies in the vein of the recent effort by the World Bank to understand the development and impact of microfinance (Cull, Demirgüç-Kunt, and Morduch 2009b) can complement such case studies and provide further evidence about regulatory impact.

It can be concluded that this thesis offers a foundation stone upon which further research can be built. It has demonstrated the usefulness of a rigorous RIA methodology grounded in the public interest theory of regulation for assessing regulatory change by applying it to the case of Uganda. It thus contributes to the growing literature on regulatory impact assessment, and also provides important insights for the future regulation of microfinance.

APPENDICES

APPENDIX 1: CODING OF UNPUBLISHED DOCUMENTS

<i>Code</i>	<i>Author</i>	<i>Title or Topic (in parentheses if untitled)</i>	<i>Date</i>
UD/R/1	Microenterprise Finance Task Force, Financial Sector Development Working Group, National Forum on Strategic Management for Investment and Export Growth	Uganda's Micro-Enterprise Finance: Urgent Need for Reform (Issues and recommendations on the reform agenda) (Draft)	October 1996
UD/L/2	Bank of Uganda	Micro-finance Bill 1999 (MFA 1999). Draft	1999
UD/R/3	Bank of Uganda	An outline of the presentation at the AMFIU Workshop 4-5 December 1997 at Hotel Equatoria. Theme for the presentation: Prudential standards for micro finance institutions in Uganda: the Bank of Uganda perspective	1997
UD/R/4	National Technical Committee for Coordination of Micro Financing Initiatives	Proceedings of the Uganda Workshop on the National Policy and Strategic Framework for Micro and Rural Finance held at Equatoria Hotel, Kampala, Uganda, May 05 – 08, 1998	1998
UD/R/5	Bank of Uganda	BoU Policy Statement on Micro-Finance Regulation	31 March 1999
UD/R/6	Post Bank Uganda	Postbank: Mid-Term Review	November 2008
UD/C/7	Legal Officer, Bank of Uganda	Memorandum to FSD Project. Re: Comments/Questions by Stefan Staschen on the Micro Deposit Taking Institutions Bill, 2001	14 September 2001
UD/R/8	Bank of Uganda	Reform of Deposit Insurance in Uganda: Key Elements of a Continuous Improvement Process	18 August 2006
UD/E/9	Titus Mulindwa, Bank of Uganda	(Coverage of member-based institutions under MDI Act)	15 June 2009
UD/R/10	International Consulting Consortium Inc.	MDI Supervision Manual	2005
UD/R/11	Planet Rating	GIRAFE Rating : Success Microfinance Services Ltd., Uganda	April 2007
UD/R/12	MicroRate	MicroRating International: MED-Net, Uganda	September 2007
UD/R/13	MicroRate	Commercial Microfinance Limited, Uganda	December 2003
UD/R/14	MicroRate	Commercial Microfinance Limited, Uganda	June 2005

<i>Code</i>	<i>Author</i>	<i>Title or Topic (in parentheses if untitled)</i>	<i>Date</i>
UD/R/15	FSDU	Quarterly Report to the Transformation Steering Committee, 2 nd Quarter 2005 (through 31 July)	2005
UD/R/16	FSDU	Quarterly Report to the Transformation Steering Committee, 1 st Quarter 2005 (through 30 April)	2005
UD/M/17	FSDU	Transformation Steering Committee	4 August 2005
UD/R/18	FSDU	Quarterly Report to the Transformation Steering Committee, Period: 3rd Quarter 2005	2005
UD/R/19	FSDU	Quarterly Report to the Transformation Steering Committee, Period: 4th Quarter 2005	2006
UD/M/20	FSDU	Transformation Steering Committee	4 October 2005
UD/M/21	FSDU	Transformation Steering Committee	22 March 2006
UD/R/22	FSDU	Quarterly Report to the Transformation Steering Committee, Period: Quarter 2, 2006	2006
UD/R/23	FSDU	Quarterly Report to the Transformation Steering Committee, Period: Quarter 3, 2006	2006
UD/E/24	Richard Rosenberg, CGAP	(Comments on draft chapter 5 of PhD thesis)	22 September 2009
UD/R/25	Karen Losse, GTZ	Back to Office Report: Financial Capability Uganda. Kampala, 17-20 November 2008	7 January 2009
UD/R/26	Ministry of Finance, Planning and Economic Development	Strategic Plan for Expanding the Outreach and Capacity of Sustainable Microfinance in Uganda	October 2003
UD/R/27	ACCION	Course Completion Report: Summary Report for Course on Risk Based Supervision of Microfinance Deposit Taking Institutions	April 2005
UD/E/28	Godwin Kihuguru, Operations Manager FAULU	(FAULU's experience with banking crisis in 1998/99 and systemic risk)	13 February 2004
UD/R/29	Marguerite Robinson	Mid-term review of GTZ/SIDA Financial System Development Programme Phase II	2004
UD/R/30	International Consulting Consortium Inc.	Consultancy on Risk-based Supervision of Microfinance Deposit-taking Institutions: Final Report	4 July 2005

<i>Code</i>	<i>Author</i>	<i>Title or Topic (in parentheses if untitled)</i>	<i>Date</i>
UD/C/31	Budget Officer NBFID Department, Bank of Uganda	Memorandum to Acting Executive Director Supervision: Budget Estimates for NBFID Dept. for Financial Year 2002/03	3 May 2002
UD/R/32	Uganda Microfinance Union	Uganda Microfinance Union Business Plan 2002 – 2008	June 2002
UD/R/33	Uganda Finance Trust Ltd.	Three Year Strategic and Operational Plan through December 2006	(2004)
UD/R/34	FINCA Uganda	Formalisation of FINCA Uganda: Options and Implications (2 volumes)	(2001)
UD/L/35	MOP, FSDU, FSD, Rural SPEED	Transformation Steering Committee: Letter of Mutual Understanding	4 August 2005
UD/E/36	Mathias Katamba, CEO UFT	(Costs of Transformation and Compliance)	10 September 2008
UD/E/37	Gerald Kikambi, Financial Controller PRIDE	(Costs of Transformation)	31 July 2008
UD/M/38	FSDU	Transformation Steering Committee	8 February 2005
UD/E/39	Deborah Burand, former Transformation Specialist, FINCA International	(Transformation Costs FINCA Uganda)	25 November 2009
UD/E/40	Mike Malan, Managing Director, Compuscan CRB Ltd. Uganda	(Compliance costs for CRB participation)	25 November 2009
UD/R/41	FSDU	Quarterly Report to the Transformation Steering Committee, Period: Quarter 1, 2007	2007
UD/E/42	Lloyd Stevens, former DFID Transformation and Consolidation Consultant	(Donor Funding for Transformation)	30 November 2009
UD/R/43	Committee on Finance, Planning and Economic Development	Report on the Micro-Deposit Taking Institutions Bill, 2002	14 November 2002
UD/R/44	Bank of Uganda	Report on the Meeting between the Ministry of Finance, Bank of Uganda and Parliamentary Sessional Committee on Finance, Planning and Economic Development	31 October 2002
UD/R/45	Henry Kibirge, Executive Director Supervision, Bank of Uganda	MFI Regulation in Uganda	(1998)
UD/L/46	Bank of Uganda	Microfinance Act, 2000. Draft	31 October 2000

<i>Code</i>	<i>Author</i>	<i>Title or Topic (in parentheses if untitled)</i>	<i>Date</i>
UD/M/47	David Kalyango, Bank of Uganda	Proceedings of the Consultative Meeting with the Select Committee on the Draft Micro Finance Bill 2000	21 December 2000
UD/M/48	David Kalyango, Bank of Uganda	Minutes of the Meeting of the Internal Project Team (IPT) held on 18 th December 2000	2 January 2001
UD/M/49	David Kalyango, Bank of Uganda	Minutes of the Meeting of the IPT held on 7 th February 2001	20 February 2001
UD/C/50	Stefan Staschen, FSD	Memorandum to Legal Officer, BOU	5 February 2001
UD/E/51	Andrea Bohnstedt, FINCA Uganda	(Comments by FINCA Uganda and FINCA International on Micro-finance Bill)	9 February 2001
UD/C/52	Lobby Sub-Committee of the Microfinance Forum	Comments to the MFI Act 2000 (sent to BoU)	26 March 2001
UD/C/53	Legal Officer, Bank of Uganda	Memorandum to Executive Director Supervision. Re: Comments on the Draft Bill for Regulating and Supervising Microfinance in Uganda	10 April 2001
UD/R/54	BoU/GTZ FSD Project	Microfinance Operations of FINCA Uganda: Conclusions for Regulatory principles and Supervisory Practices. Presentation at the Microfinance Forum	11 April 2001
UD/R/55	Bank of Uganda	Policy Paper: Risk-Based Supervision	2002
UD/L/56	Bank of Uganda	Micro Deposit-Taking Institutions Bill, 2001. Draft	6 June 2001
UD/C/57	Executive Director Supervision, Bank of Uganda	Letter to Ag. First Parliamentary Counsel, Ministry of Justice and Constitutional Affairs. Re: Micro Deposit-Taking Institutions Bill, 2001	12 June 2001
UD/R/58	Internal Project Team, Bank of Uganda	Framework for Risk-Based Supervision of MDIs	various versions 2001 and 2002 (final version reproduced in Ledgerwood and White 2006, Appendix 2B)
UD/C/59	Legal Office, Bank of Uganda	Memorandum to Alfred Hannig, FSD. Re: Definition of Microfinance Business	13 September 2001
UC/C/60	Executive Director Supervision, Bank of Uganda	Letter to State Minister of Finance (General Duties). Re: Micro Deposit Taking Institutions Bill, 2001	26 September 2001

<i>Code</i>	<i>Author</i>	<i>Title or Topic (in parentheses if untitled)</i>	<i>Date</i>
UD/M/61	Augustine Mwanja, Bank of Uganda	Minutes of the Meeting of the Committee on Design of Reporting Formats and Performance Benchmarks for MDIs	30 November 2001
UD/R/62	Stefan Staschen	Report on Short-Term Assignment to GTZ/BoU Financial System Development Project, 28/01 to 05/02/02	5 March 2002
UD/R/63	Bank of Uganda	Whether the Micro-Deposit Institution's Bill, No. 1 of 2002, should be merged with the Financial Institutions Bill, No. 6 of 2002, since the MDI Bill seems to be a replica of the FIB 2002?	2002
UD/C/64	AMFIU	Emerging Issues in the Implementation of the MDI Act and Regulations (Draft of a letter by AMFIU to be sent to BoU)	25 October 2005
UD/C/65	William Steel, Lead Specialist, World Bank	Letter to Executive Director Supervision, Bank of Uganda: Comments on Draft Paper on MFI Regulation in Uganda	June 1998
UD/R/66	National Technical Committee for Coordination of Micro Financing Initiatives, MoFPED	Draft Report on Co-ordination of Micro Financing Initiative	September 1998
UD/R/67	Bank of Uganda	Proposals for BoU Policy Statement on MFI Regulation – Draft	26 October 1998
UD/C/68	William Steel, Lead Specialist, World Bank	Letter to Katimbo Mugwanya, Executive Director Supervision, Bank of Uganda. Re: BOU Policy Statement on Micro Finance Regulation	21 January 1999
UD/C/69	Alfred Hannig, GTZ Germany	Telefax to Katimbo Mugwanya, Executive Director Supervision, Bank of Uganda. Re: BOU Policy Proposals on Microfinance Regulation	11 January 1999
UD/R/70	Edward Katimbo Mugwanya, Executive Director Supervision, Bank of Uganda	Regulation and Supervision of Microfinance Business: A Case for Uganda. Paper presented at the Dialogue Seminar at Nile Hotel International Conference Centre	25/26 February 1999
UD/R/71	Research Department, Bank of Uganda	Comments On Bank of Uganda Policy Statement on Microfinance Regulation, 28 February 1999	12 March 1999
UD/R/72	Bank of Uganda	BoU Policy Statement on Micro-Finance Regulation – Draft	4 January 1999
UD/C/73	William Steel, Lead Specialist, World Bank	Letter to Katimbo Mugwanya, Executive Director Supervision, Bank of Uganda. Re: Comments on Micro-Finance Legislation	2 November 1999

<i>Code</i>	<i>Author</i>	<i>Title or Topic (in parentheses if untitled)</i>	<i>Date</i>
UD/C/74	Microfinance Practitioners	Letter to Bank of Uganda. Re: Regulation and Supervision of the MicroFinance in Uganda: The Practitioners' Views	November 1999
UD/M/75	Friends Consult	Interview with Peter Okaulo, Executive Director UGAFODE	27 June 2007
UD/M/76	Friends Consult	Interview with Saliya Kanathigoda, Programme Advisor GTZ	3 July 2007
UD/C/77	William Steel, Lead Specialist, World Bank	Letter to Katimbo Mugwanya, Executive Director Supervision, Bank of Uganda. Re: BOU Policy Statement on Micro-Finance Regulation	20 May 1999
UD/M/78	Friends Consult	Interview with Fabian Kasi, Managing Director FINCA	27 June 2007
UD/M/79	Friends Consult	Interview with Mathias Katamba, CEO UFT	27 June 2007
UD/M/80	Friends Consult	Interview with Wilson Kabanda, CEO Uganda Co-operative Savings and Credit Union	29 June 2007
UD/M/81	Friends Consult	Interview with David Baguma, Executive Director AMFIU	29 June 2007
UD/M/82	Friends Consult	Interview with Helton Achaye, Programme Administrator Microfinance Outreach Plan	9 July 2007
UD/M/83	Friends Consult	Survey of MDI Clients and Potential Clients, Masaka & Iganga	(June/July 2007)
UD/E/84	Godwin Kihuguru, Operations Manager FAULU	(Systemic crises through bank closures in Uganda)	13 February 2004
UD/E/85	Nelson M. Kasfir, Professor at Dartmouth College	(Nominations for Parliamentary elections in Uganda)	3 July 2005
UD/E/86	William Steel, Senior Adviser, World Bank	One Act or Many?	26 July 2005
UD/E/87	Timothy Lyman, Senior Policy Advisor, CGAP	(Political economy and specialised microfinance laws)	15 August 2008
UD/E/88	John Giles, Managing Director, Centenary Bank	(Deposit mobilisation by MDIs)	19 September 2008
UD/E/89	Titus Mulindwa, Asst. Legal Counsel, Bank of Uganda	(Interpretation of contentious issues in the MDI Act)	15 June 2009
UD/E/90	Senior staff of donor agency	(Email to colleagues from other donor agencies on Interest Rate Caps)	30 November 2006

<i>Code</i>	<i>Author</i>	<i>Title or Topic (in parentheses if untitled)</i>	<i>Date</i>
UD/M/91	Irene Mwoyogwona, Bank of Uganda	(Minutes of a meeting between practitioners and BoU: Reactions of practitioners on the Director's presentation)	4 February 2002
UD/R/92	Sessional Committee on Finance, Planning and Economic Development	Report on the Policy Statements of the Ministry of Finance, Planning and Economic Development, Office of the Auditor General and The Autonomous Bodies for FY 2007/08	2008
UD/E/93	Lloyd Stevens, DFID Transformation and Consolidation Consultant	(Transition periods in MDI Act)	6 May 2005
UD/E/94	Transformation Manager of one of the MDI candidates	(Practical experience with transformation)	6 September 2006
UD/M/95	FSDU	Transformation Steering Committee	10 May 2005
UD/C/96	Anne Ritchie, Director, Center for Microfinance	Letter to Katimbo Mugwanya, Executive Director Supervision, Bank of Uganda. Re: Collateralized Savings	10 December 1999
UD/C/97	Anne Ritchie, Director, Center for Microfinance	Letter to Katimbo Mugwanya, Executive Director Supervision, Bank of Uganda. Re: Ownership and Governance of Microfinance Institutions	10 November 1999
UD/C/98	William Steel, Lead Specialist, World Bank	Letter to Katimbo Mugwanya, Executive Director Supervision, Bank of Uganda. Re: Comments on Draft Proposal for BOU Policy Statement on Microfinance Regulation	19 November 1998
UD/R/99	FSDU	Quarterly Report to the Transformation Steering Committee, 1st Quarter 2006 (through 31 March)	2006
UD/R/100	MicroRate	Rating Report of Finca Uganda Limited	August 2004
UD/R/101	GTZ	Angebot zur Durchführung des Vorhabens Finanzsystementwicklung	2001

APPENDIX 2: INDICATORS FOR MEASURING REGULATORY IMPACT

Objective 1: To Promote the Safety and Soundness of MFIs		
<i>Market Outcomes</i>		
<i>Impact indicator</i>	<i>What does the indicator measure?</i>	<i>Definition / criteria to look at</i>
Return on assets	Overall financial performance	(Net operating income, less taxes) / period average assets
Return on equity		(Net operating income, less taxes) / period average equity
Operational self-sufficiency		Financial revenue (total) / (financial expense + loan loss provision expense + operating expense)
Financial self-sufficiency		Financial revenue (total) / (financial expense + loan loss provision expense + operating expense + adjustment for inflation + adjustment for subsidised funding)
PAR > 30 days	Credit risk	Value of all loans outstanding with one or more instalments of principal past due more than 30 days
Loan loss reserve ratio		Loan loss reserve / gross loan portfolio
Write-off ratio		Write offs for the 12-month period / period average gross loan portfolio
Risk coverage ratio		Loan loss reserve / PAR > 30 days
Financial expense ratio	Access to cheap sources of finance	Financial expense / average total assets
Capital / asset ratio	Risk cushion	Total equity / total assets
Debt / equity ratio		Total liabilities / total equity
Liquid ratio	Liquidity risk	(Cash and near cash + deposits in banks + short term investments) / total assets
Loss of savings	Materiality of crystallised risks	Loss in savings in formal versus semi-formal and informal financial institutions

<i>Institutional Change</i>		
<i>Impact indicator</i>	<i>What does the indicator measure?</i>	<i>Definition / criteria to look at</i>
Ownership	Ownership, governance and management as main determinants of long-term viability	Type of owners, liability provisions, “deep pockets”
Board composition and roles		Complementarity and relevance of skills on board; changes in job description; board committees
Management composition		Qualification of senior management
MIS	Accuracy and timeliness of provision of data for management, board and supervisor	Quality of software systems; quality of reports for management and directors
Accounting standards		Quality of standards
Reporting		Standards, accuracy and timeliness
External audit		Specific requirements for external audits and qualification of audit firms
Internal audit	Internal control and fraud prevention	Dedicated function; reporting; internal audit manual
Independence and capacity of supervisory authority	Risk of political interference	Appointment of senior management; legal liability of officers; precedents of withstanding political interference; number of staff and specialised skills / training
Off-site surveillance	Early detection of problems	Assessment of off-site reports; early warning system
On-site inspections	Detection of problems and high risk areas	Number and qualification of supervisors; frequency of inspections; supervision manual
Corrective actions and problem resolution	Containing risks and early resolution of problems	Corrective (mandatory) actions; authority to make exceptions to these actions; civil and penal sanctions; cease and desist-type orders
Insolvency	Orderly closure of problem institutions	Authority to appoint and supervise receiver / liquidator, to revoke the licence
Credit information sharing	Improves quality of borrower selection	Reduction of credit risk

Objective 2: To Guard Against Systemic Risk		
<i>Market Outcomes</i>		
<i>Impact indicator</i>	<i>What does the indicator measure?</i>	<i>Definition / criteria to look at</i>
Crises spreading from one MFI (or other type of financial institution) to another MFI	Occurrence of systemic events	Unwarranted financial loss triggered by contagious events
Precedents of depositor protection during previous crises	Past experience in the banking sector as an indicator for response to potential crises	Loss of depositor funds
Trust in MFIs	Reduces susceptibility to runs / contagion	Perceptions by clients
<i>Institutional Change</i>		
Safety and soundness of MFIs	Strength of defence against systemic crises	See indicator for Objective 1
Deposit insurance system	Magnitude of incentive to run on an MFI	Set-up of the system: funding, limits, management of insurance fund etc. ³⁰⁸ If not explicit, implicit deposit insurance based on previous experience with Government's crisis handling
Lender of last resort	Magnitude of risk of illiquidity as a trigger for systemic crises	Conditions for access: only solvent, but illiquid banks? Penalty rates? Length of support
Access to short-term liquidity support		Supervisory authority's role as lender of last resort; access to interbank market; overdraft facilities and credit lines (if they can be attributed to regulation)

³⁰⁸ More details in Barth, Caprio Jr., and Levine (2006, 324-26).

Objective 3: To Establish a Competitive Market		
<i>Market Outcomes</i>		
<i>Impact indicator</i>	<i>What does the indicator measure?</i>	<i>Definition / criteria to look at</i>
Development of lending and deposit rates	Extent to which competition has exerted downward pressure on interest rates	Lending rate or effective cost of borrowing or portfolio yield (if lending rates not available) versus deposit rates
Operating expense ratio	Extent to which competition has created pressure to increase efficiency and productivity	Operating expense / average total assets
Operating expense / loan portfolio		Operating expense / period average gross loan portfolio
Cost per borrower		Operating expense / period average number of active borrowers
Borrowers per staff member		Number of active borrowers / number of personnel
Product growth	Extent of competition	See Market Outcomes under Objective 5
Customer growth		See Market Outcomes under Objective 5
Number and location of MFI branches or other customer service points		Regional spread
Product range	Improvements as signs for extent of competition	Number and characteristics of products
Customer service		Rules and procedures for customer service
Responsiveness to consumer demands		Rules and procedures for market research, product development
Level of innovation		Innovative products, methods, and processes
Customer satisfaction		Perceived changes in customer service and product offerings
Structure-related measures	Market dominance of single or few players	Concentration ratio and / or Herfindahl-Hirschman Index

<i>Institutional Change</i>		
<i>Impact indicator</i>	<i>What does the indicator measure?</i>	<i>Definition / criteria to look at</i>
Barriers to entry	Competitiveness and contestability	Restrictiveness of regulatory requirements (gap analysis)
Foreign participation	Openness to foreign players increases competition	Limits on foreign ownership
Competition policy	Measures to counteract market concentration	Monitoring and promotion of competition in financial market
Credit information sharing	Increased lending and lower costs through better information	International evidence for positive impact of credit information sharing on competition; interest rates tailored to individual borrower's credit risk

Objective 4: To Protect Consumers		
<i>Market Outcomes</i>		
<i>Impact indicator</i>	<i>What does the indicator measure?</i>	<i>Definition / criteria to look at</i>
Customer satisfaction	Direct measure of consumer protection	See Market Outcomes, Objective 3
Customer grievances		Number of complaints and other evidence for customer grievances
Customer grievances redressal		Resolution of customer grievances
Loss of savings	Materiality of crystallised risks	See Market Outcomes, Objective 1
Customer understanding about operations of MFIs	Indicator for transparency in the market	Perceptions expressed in customer surveys
<i>Institutional Change</i>		
Professional and ethical treatment of customers	Statutory customer protection rules	Rules on treatment of customers; collection procedures; seizure of collateral
Information disclosure and transparency	Enabling informed choice	Statutory requirements for information disclosure by MFIs (e.g., APR; cost of credit; details of loan contract)
Customer education		Regulatory requirements for MFIs and initiatives by regulator
Marketing and sales		Prohibition on deceptive marketing and sales practices, and predatory lending; cooling off period
Customer knowledge and awareness		Comprehension of financial products
Prohibitive measures	Outright prohibitions can protect consumers	Interest rate limits; limits on range of products; limits on outsourcing etc.
Entry qualifications, training and competency standards	Professionalism of staff in dealing with customers	Fit and proper rules; human resource standards; min. qualifications of officers
Dispute resolution	Effectiveness of compensating aggrieved customers	Effective measures for handling customer complaints and for securing redress (e.g., banking ombudsman)
Deposit insurance system	Safety of customer deposits	See Institutional Change under Objective 2
Data privacy and security	Safety of customer data	Data protection measures of CRB

Objective 5: To Improve Access		
<i>Market Outcomes</i>		
<i>Impact indicator</i>	<i>What does the indicator measure?</i>	<i>Definition / criteria to look at</i>
Number of active borrowers	Indicator for breadth of access	Number of individuals who currently have an outstanding loan balance with the MFI
Number of new / repeat borrowers		Number of borrowers broken down by new versus repeat borrowers
Gross loan portfolio		Outstanding principal for all loans (current, delinquent and restructured loans)
Number of savers		Total number of individuals who currently have funds on deposit with an MFI, which the MFI is liable to repay
Total savings		Deposits from the general public and members that are not maintained as a condition for accessing a current or future loan
Average loan balance per borrower		Indicators for depth of access
Av. loan balance per borrower / GNI per capita	Average loan balance per borrower / GNI per capita	
Composition of loan portfolio	Breakdown of loan sizes; percentage of clients living below the national poverty line	
Average savings balance per saver	Voluntary savings / number of voluntary savers	
Av. savings balance per saver / GNI per capita	Average savings balance per saver / GNI per capita	
Composition of savings portfolio	Breakdown by size of savings accounts	
Geographical reach	Financial contracts broken down by region / rural versus urban branches	
Safety and soundness of MFI	Indicator for length of access	See Objective 1
Portfolio yield	Affordability of access	Interest and fee income from loans / average gross loan portfolio
Product range	Indicator for scope of access	For loans: individual versus group loans, flexibility of repayment schedules and loan amounts, costs (price costs and transaction costs), collateral requirements; for savings: minimum balance requirements, interest paid, restrictions on withdrawals, etc.

<i>Impact indicator</i>	<i>What does the indicator measure?</i>	<i>Definition / criteria to look at</i>
Current usage	Indicator for bottlenecks in reaching more poor customers	Reasons for not using formal or semi-formal institution
Customer satisfaction		See Market Outcomes, Objective 3
<i>Institutional Change</i>		
Role of regulatory authority in ensuring improved access		Statutory role of regulatory authority to consider access in regulatory and supervisory practice
Interest of regulatory authority in access		Self-perception of regulatory authority regarding its role in access
Loan policies	Policy changes with impact on access	Eligibility criteria; target group identification; collateral requirements; loan size limits; loan approval time; frequency of meetings; credit manual
Savings policies		Minimum balances; KYC; charges
Number and location of MFI branches or other customer service points		See Market Outcomes, Objective 3
Board composition		Representation of double bottom line investors
Mission / vision		Mission, vision, code of conduct / ethics
Regulatory measures impacting on MFIs' policies		Indirect effects of regulations on access
Credit information sharing	Positive impact of information sharing on access	Reduction of asymmetric information problems

This list draws, among others, on FSA(2000b), Falkena et al. (2001, tables 2.1, 2.2, 2.3, 4.1), Genesis Analytics (2004, table 4), and Barth, Caprio Jr., and Levine (2006, Appendix 1)

APPENDIX 3: MAIN REGULATORY PROVISIONS OF THE LEGAL FRAMEWORK FOR MDIS

This table summarises the major regulatory measures and gives the legal reference. In the third column of the table, the regulatory provisions are assessed on the basis of existing knowledge about prudential regulations for microfinance and with reference to the alternative of being regulated in the FIA. The last column indicates which of the five regulatory objectives the regulatory provision is mainly directed at.

<i>Regulatory measure</i>	<i>Legal reference</i>	<i>Assessment</i>	<i>Regulatory objective</i>
Licensing Process and Approval of Branches			
Minimum paid-up capital of US\$500 million (expressed in currency points)	SEC. 15 and First Schedule. Minister of Finance with approval of Parliament can change min. capital (SEC. 15 (3)) or definition of currency points (Sec. 90 (1)). Licensing regulations: REG. 12 (1)(a) only allows cash as evidence for capital shown on the opening balance sheet; REG. 8 (1)(e) requires 75% of the paid-up capital to be held in a time deposit account with a commercial bank until the licence is approved	Commercial banks need to provide eight times this amount, but credit institutions only twice the amount. Major hurdle likely to be not the amount of capital, but the requirement to provide it in cash.	S&S
Licensing application including, among others, a feasibility study with detailed financial projections and minimum qualification requirements for directors and substantial shareholders, detailed information on security of premises	SEC. 7 and Licensing Regulations	Strict and detailed licensing criteria being easier to comply with for existing MFIs than for start-up operations	S&S
Approval of new branches and changes of location and opening hours of branches with the public interest being one of the criteria the Central Bank looks at	SEC. 81 and Schedule 3 Licensing Regulations	Close oversight by the Central Bank on branching with onerous approval requirements	S&S, COM and ACC

<i>Regulatory measure</i>	<i>Legal reference</i>	<i>Assessment</i>	<i>Regulatory objective</i>
Ownership			
30% shareholding limit with possible exemption (with approval by BoU) for “reputable financial institution” or “reputable public company” with the latter being defined as “a company that is financially strong, whose ownership is widely distributed, is of good public standing and meets such other requirements as may be prescribed by the Central Bank.”	SEC. 21 and definition of terms in SEC. 2 SEC. 18 (1) and (2) FIA	Ownership diversification improves governance structure, but shareholding limit can also be a serious hurdle for transforming NGOs. No level playing field with commercial banks and credit institutions (49%)	S&S, ACC
Fit and proper test for substantial shareholders (>10% of shares)	SEC. 21 (4) and Second Schedule. Minister of Finance can change definition of fit and proper (SEC. 90 (2))	Substantial shareholders are checked for professional and moral suitability and “deep pockets”	S&S
Capital			
20% total and 15% core risk-weighted capital adequacy requirement or any other ratio as determined by the Central Bank. Central Bank can define categories of assets included in the computation of the ratio. The risk weights are slightly different from Basel I, with some of them being stricter (there is no 50% risk weight for mortgage backed loans, which therefore attract a 100% weight as all other loans), and some less strict (claims on all banks attract a 20% weight irrespective of whether they are inside the OECD or not).	SEC. 16, definition of terms in SEC. 2, and risk weights in Schedule 1, Capital Adequacy Regulations SEC. 27 (1) FIA	High ratios in comparison to other countries and to credit institutions and commercial banks (which also use different weights) with positive effect on safety and soundness and possibly negative effect on access	S&S
Activities			
Similar restrictions as under the FIA plus no foreign exchange business, current accounts, intermediation of LIF, dealing in derivatives unless authorised by the Central Bank. The Central Bank can issue regulations on the operations and permitted usages of a LIF, but has not done so yet.	SEC. 19 and SEC. 89 (3)(g)	Restrictions limit MDIs’ risk exposure to high risk activities. The prohibition on intermediating LIF can potentially create high costs	S&S

<i>Regulatory measure</i>	<i>Legal reference</i>	<i>Assessment</i>	<i>Regulatory objective</i>
Restriction of advancing loans to insiders (directors, staff members, related firms) in excess of 1% limit of core capital except on non-preferential terms.	SEC. 18 (1)(c)	Provision seems to be meaningless as even insiders would fall under the 1% of core capital limit stipulated in sub-section (1)(a).	S&S
External Auditing			
Detailed rules on duties of external auditors, which among others set minimum qualification requirements for audit firms; give the Central Bank the right to appoint an audit firm; specify a time limit for audit firms of three years; describe auditors' duties (including the at least quarterly verification of reports to BoU and reporting, meetings with BoU, and their duty to report to BoU any evidence of irregularities or illegal acts); prescribe content and frequency of audit reports (annually); and clarify their liability for negligence (yes, but with mandatory insurance cover) and acts committed in good faith (none).	SEC. 29 to 45	Similar provisions as for commercial bank and credit institution. Substantial authority for BoU to make use of external auditor in monitoring performance	S&S
Internal Management and Governance			
Board of Directors with five members headed by a non-executive director, meeting at least four times per year. Directors must pass fit and proper test. Responsibilities and duties of the board are clearly spelled out.	SEC. 22 to 26	Certain degree of independence of board guaranteed. No requirement to set up specific board committees such as audit committee and ALCO.	S&S
Finance manager and internal auditor with the latter reporting directly to the board	SEC. 27 and 28, respectively	Mandatory positions with clearly specified duties. Finance manager takes the role of ALCO under the FIA, internal auditor with comprehensive duties similar to Audit Committee	S&S

<i>Regulatory measure</i>	<i>Legal reference</i>	<i>Assessment</i>	<i>Regulatory objective</i>
Liquidity & Diversification			
Loan size limit of 1% of core capital for individual and 5% of core capital for group borrowers, respectively	SEC. 18 (1)(a) SEC 31 (1) FIA and “Limits on Credit Concentration and Large Exposures” Regulations	Provision mainly targeted at MDIs keeping to their original mission of providing microloans as it is much lower than the 25% prescribed under the FIA	ACC
Liquidity ratio of 15% and comprehensive liquidity management policy. Central Bank also tracks advances to deposits ratio. Regulations specify role of the board and management in liquidity management and require all MDIs to have a comprehensive liquidity and funds management policy. The “Policy Statement of the Bank of Uganda on Prudential Aspects of Liquidity of Micro Finance Deposit-taking Institutions” provides MDIs with guidance in this area.	SEC. 17 and Liquidity and Funds Management Regulations Financial Institutions Liquidity Regulations	MDIs are subject to less stringent liquidity and fund management regulations than commercial banks and credit institutions (20% liquidity ratio) and do not have a statutory reserve requirement	S&S
Consumer Protection			
MDI Act provides for the establishment of an MDI Deposit Protection Fund	SEC. 80	MDI Deposit Protection Fund is presently been set up	SYS and CP
Sanctions for conducting business in a manner detrimental to the interests of depositors / customers, and for soliciting deposits without having a licence	SEC. 12 (1) (g) and (i); SEC. 87	A few provisions directly address the interests of clients in proper conduct of the MDI and only entrusting regulated MDIs with their savings	CP

<i>Regulatory measure</i>	<i>Legal reference</i>	<i>Assessment</i>	<i>Regulatory objective</i>
Provisioning			
Provisioning requirements and non-accrual of interest on non-performing loans. Provisioning net of LIF. LIF is also considered when classifying a credit facility as “well-secured” (one of the precondition for restructuring a credit facility). Loans classified as a loss have to written-off within 6 months	SEC. 43 and Asset Quality Regulations	Simpler (only based on days overdue) and more conservative provisioning schedule than for commercial banks and credit institutions, but the latter have to use the same schedule for their microloan portfolio	S&S
Accounting / Information Disclosure			
Non-accrual of interest for non-performing loans including reversal of previously accrued interest	SEC. 43 (b) and REG. 8 Asset Quality Regulations	Non-accrual policy ensures that account reflect the true value of loan portfolio	S&S
Use of international accounting standards	SEC. 48	MDIs follow international standards in accounting	S&S
Publication of list of MDIs (by BoU) and of audited accounts (by MDIs) in newspaper of wide circulation	SEC. 14 and 52	Disclosure requirements for MDIs limited to annual publication of audited accounts	CP
Regular reporting requirements to BoU	SEC. 49, 51, 57 and Reporting Regulations	Comprehensive and frequent reporting requirements to the Central Bank	S&S
Reporting requirements in special cases: Directors have to report cases of misconduct or payment problems; the external auditor reports irregularities or illegal committed by directors or the MDI	SEC. 25 (2) and SEC. 35 (b)	Special responsibility of directors and auditors to alert Central Bank about problems	S&S
Reporting requirements to credit reference bureau	SEC. 46 and CRB Regulations SEC. 78 FIA	Positive effect on portfolio quality, but at substantially high costs. Substantial part of the market (Tier 4) not covered	S&S, COM, ACC

<i>Regulatory measure</i>	<i>Legal reference</i>	<i>Assessment</i>	<i>Regulatory objective</i>
Sanctions / corrective actions / exit			
Sanctions for various offences in form of a fine and / or imprisonment to be imposed on officers, directors, the MDI, or a person conducting microfinance business (as defined in the Act) without having a licence	SEC. 4 (2) (microfinance business without licence); SEC. 88 and various other sections (MDI, its directors, officers, and employees)	The law defines a wide range of offences and specifies maximum fines and / or periods of imprisonment	S&S
Corrective actions at the discretion of the Central Bank with personal liability on members of the management in case of regulatory breaches	SEC. 58 and separate parts in the implementing regulations	BoU has wide discretionary powers to impose corrective actions on MDIs	
Prompt corrective actions for capital depletion with graduate response depending on capital deficiency	SEC. 59	BoU is bound by clear rules	S&S
Management take-over, receivership and liquidation. Management take-over automatically leads to closure after 120 days if prudential standards are still not complied with	SEC. 60 to 79	Far-reaching powers for BoU to take over management and close an MDI	S&S

If only section is mentioned as legal reference, it refers to the MDI Act. The last column refers to the objective on which the regulatory provisions are likely to have the strongest impact: S&S- safety and soundness; SYS- reduction of systemic risk; COM- competition; CP- consumer protection; ACC- access.

APPENDIX 4: DIFFERENCE-IN-DIFFERENCES ANALYSIS

Before conducting a difference-in-differences analysis, a simple t-test can be used to assess whether the dependent variables in the Treatment and Control Groups were not significantly different at baseline, and an analysis of statistical power to determine whether the number of observations is sufficient to make accurate statistical calculations. For those dependent variables (i.e., observed performance variables), for which the answer is yes to both questions, a formal regression analysis can be conducted. The difference-in-differences approach is a simple panel-data method that allows comparing group means for the Treatment Group, which is exposed to the explanatory variable, and for a Control Group, which is not (Angrist and Krueger 1999, 1296). The advantage of the approach is that it controls for unobservable characteristics that are time-invariant for the individual MFIs because these cancel each other out in the equation.

The equation can be written as follows:

Y is one of the performance measures (dependent variables) for MFI i in year t . α is the intercept showing the average value of the dependent variable for MFI i at time zero. D_i is a dummy variable taking the value 1 if the MFI is in the Treatment Group and 0 if it is in the Control Group. T_t is the time dummy variable taking the value 1 in post-treatment periods and 0 in pre-treatment years. And ε is the error term. β is the interaction term between the two variables with γ being the coefficient of interest. Depending on the availability of sufficient observations and a sufficiently similar Control Group, various dependent variables can be regressed on whether the MFI was in the Treatment Group or not and whether we look at a period before or after treatment.

The null hypothesis is $H_0: \gamma = 0$. The analysis would test whether the respective coefficient is significantly different from zero. If it is, the impact of the treatment on the Treatment Group is significantly different from the impact on the Control Group.

APPENDIX 5: PERFORMANCE INDICATORS USED FOR QUANTITATIVE ANALYSIS

The performance indicators in bold are those discussed in the main text. The additional indicators are also included in Appendix 6.

<i>Indicator</i>	<i>Definition</i>
<i>Profitability</i>	
Return on assets (%)	Profit (loss) from operations after tax/ average assets
Return on equity (%)	Profit (loss) from operations after tax/ average equity
Debt to equity ratio (%)	Total liabilities / total equity
<i>Capital ratios</i>	
Capital/ asset ratio (%)	Total equity/ total assets
<i>Portfolio quality</i>	
PAR > 30 days / gross portfolio (%)	Value of outstanding loan balance with payments past due > 30 days (end of period)/ value of outstanding loans (end of period)
Write-off ratio (%)	Write-offs for the 12 month period / average gross loan portfolio
Risk coverage ratio (%)	Loan loss reserve/ PAR > 30 days
<i>Access</i>	
Number of borrowers	Number of active loan clients (end of period)
Average loan size	Gross Loan Portfolio / Number of Active Borrowers (end of year)
Share of small loans (%)	Number of loans with a disbursed loan amount < US\$ 200,000 / number of loans
Share of group borrowers (%)	Number of active borrowers receiving loans as members of a group / number of active borrowers (end of period)
Portfolio yield (%)	Interest and fee income from loans / average gross loan portfolio
Total savings	Total short-term deposits (end of period)
Savings to loans ratio (%)	Total savings / gross loan portfolio (end of period)
Number of savers	Total number of clients with savings (end of period)

Average savings per saver	Total savings / number of savers (end of period)
Average savings per saver to average loan size (%)	(Total savings / number of savers) / (gross loan portfolio / number of active borrowers)
<i>Efficiency</i>	
Operating expense ratio (%)	Operating expense / average gross loan portfolio
Financial expense ratio (%)	Financial expense / average total assets
Cost per borrower	Operating expense / average number of active borrowers
<i>Liquidity</i>	
Liquidity ratio (%)	Liquid assets net of LIF / deposit liabilities
Liquid ratio (%)	(Cash and near cash + deposits in banks + short term investments) / total assets

APPENDIX 6: RESULTS FROM ANALYSIS OF PERFORMANCE INDICATORS

<i>Impact Area</i>	<i>Indicators</i>	<i>Impact channels</i>	<i>Observation</i>	<i>Interpretation</i>
Profitability	Return on Assets	<ul style="list-style-type: none"> • BoU monitors profitability • Changes in ownership and governance structure, in particular 30% shareholding limit, lead to commercialisation and stronger focus on profitability • Increased competition reduces monopoly rents • Compliance costs, particularly high during transformation, reduce profitability 	<ul style="list-style-type: none"> • Drop in profitability in 2004 (no similar observation in CGs) • After treatment amplitude of observations decreased to range between 1% and 6% • CGs: Centenary all years within same range of 1 to 6%; a number of MFIs in CG2 has gone through phases of losses 	<ul style="list-style-type: none"> • Transformation expenses and stricter accounting rules temporarily depressed profitability • Regulation successful in keeping MDIs from making a loss • Higher competition keeps MDIs from earning monopoly rent
Profitability	Return on equity and debt to equity ratio (leverage ratio)	<ul style="list-style-type: none"> • Same as for ROA • In addition, more commercial investors putting pressure on MDIs to increase leverage • 30% shareholding limit bringing in new capital and decreasing leverage 	<ul style="list-style-type: none"> • No clear relationship between ROA, ROE, and debt to equity ratio 	<ul style="list-style-type: none"> • Idiosyncratic developments more important for debt to equity ratio (capital injection by Equity Bank Kenya in UML in 2008 and by FINCA International into FINCA)

<i>Impact Area</i>	<i>Indicators</i>	<i>Impact channels</i>	<i>Observation</i>	<i>Interpretation</i>
Capital	Capital to asset ratio	<ul style="list-style-type: none"> • Risk-weighted capital adequacy requirements as key regulatory provisions prescribing minimum • Regulation improves access to debt financing (loans and savings) and facilitates higher leverage • Ownership and governance changes increase pressure to leverage capital further • Confounding effects: Capital injections can push up capital/asset ratio; crises can lead unsustainably low capital levels 	<ul style="list-style-type: none"> • Ratios for MDIs have come down considerably for some years before licensing and stayed below 30% and above statutory minimum since (except for higher value for UML in 2008 after issuing new shares) • CG1 had consistently low ratio between 13 and 16% • CG2 have reduced ratio over the years, with some of them depleting all their capital (MED-Net, FOCCAS, SOMED) 	<ul style="list-style-type: none"> • Access to loan funds improved even before licensing • Regulation was successful in keeping capital ratio within sound range between 15% and 30% and reducing variation of ratios • Control Groups confirm that regulation is successful in maintaining minimum levels of capital (lower statutory minimum for CG1), but not needed to bring down capital ratios from very high levels
Portfolio Quality	Portfolio at risk ratio, write-off ratio and risk coverage ratio	<ul style="list-style-type: none"> • No statutory limits for any of these ratios, but BoU monitors PAR₃₀ and risk coverage ratio • Alerts are a decreasing risk coverage ratio and PAR₃₀ approaching or exceeding 5% • Regulation specifies strict asset classification and provisioning and write-off rules leading to clearly specified expenses • Management absorption by transformation process, change of MIS, and introduction of new products can lead to lower portfolio quality • Changes in observed PAR₃₀ values through more accurate and more conservative accounting and shift to individual lending 	<ul style="list-style-type: none"> • All MFIs in the TG observed spike in PAR₃₀ ratios around treatment year • Longer-term trend positive with most values below 5% since 2006 (weighted average 2.4% in 2008) • Both CG1 and CG2 experienced several years with PAR₃₀ ratios above 5% throughout the observation period (with serious repayment crisis of Centenary in 2003 and MED-Net in 2006) • High expenses for write-offs around or just after licensing • Risk coverage ratio fluctuating, but within reasonable range 	<ul style="list-style-type: none"> • Combination of real deterioration of portfolio quality during transformation and accounting changes leading to further deterioration of PAR₃₀ ratio shown on the books • MDI regulation successful in guaranteeing good portfolio quality in the longer term (and more successful than FIA)

<i>Impact Area</i>	<i>Indicators</i>	<i>Impact channels</i>	<i>Observation</i>	<i>Interpretation</i>
Breadth of access: loans	Number of borrowers	<ul style="list-style-type: none"> • If access to finance has restricted portfolio growth, regulation can lower this hurdle • Commercialisation leading to shift in policy to serve fewer borrowers with larger loans • Increased concern with portfolio quality can lead to slowdown in growth • Preoccupation of staff with transformation can lead to temporary drop in numbers 	<ul style="list-style-type: none"> • Except for FINCA, drop in number of borrowers served around licensing date and after licensing growth rate lower than before • No similar drop for CGs • Very strong growth for Centenary and BRAC throughout 	<ul style="list-style-type: none"> • Breadth of access has been negatively affected by regulation as portfolio growth is mainly due to growth in average loan sizes (see below) without similar growth in number of borrowers
Depth of access: loans	Average loan size, share of small loans and group borrowers in portfolio	<ul style="list-style-type: none"> • Commercialisation and/or strict portfolio quality regulations leading to shift in policy to serve fewer borrowers with larger loans • Larger loans are expected to be more profitable • Strict portfolio quality requirements easier to comply with by issuing fewer and larger loans 	<ul style="list-style-type: none"> • UMLs average loan size has surged in 2007 and in 2008; UFT's in 2003 to 2005 and again in 2008 • Compound annual growth rate for average loan size: Increase for the TG from 11% to 20% (pre-licensing versus post-licensing), increase for Centenary from 4% to 15% • Share of loans < US\$200,000 decreasing across the board, lowest for UFT and UML • Strong correlation between share of group borrowers and average loan size • Loan size limit in the MDI Act not binding 	<ul style="list-style-type: none"> • The two MDIs with a diversified shareholding structure including more commercial investors had the strongest shift towards larger loans • This goes hand in hand with a shift to individual lending, at least partially triggered by restrictions to use LIF. It is not possible to prove whether this has also led to mission drift • MDIs with larger average loan size are not more profitable, which is in line with other empirical evidence • Portfolio quality rules could also have caused the increase in average loan sizes

<i>Impact Area</i>	<i>Indicators</i>	<i>Impact channels</i>	<i>Observation</i>	<i>Interpretation</i>
Affordability of access	Portfolio yield in combination with operating expense ratio and financial expense ratio	<ul style="list-style-type: none"> • Changes in efficiency (see below) lead to changes in cost-covering interest rate and thus yields • Better transparency in theory improves comparability of interest rates and thereby the market power of the clients, but Ugandan regime rather weak on transparency • Credit reference system allows MDIs to reduce risk premium charged for low risk borrowers, but not yet operational (as of end 2008) • Higher growth rates can lead to market saturation (at least in certain markets) and thus competitive pressure to reduce rates • Improved portfolio quality leads to higher portfolio yields (everything else equal and using gross portfolio as denominator) 	<ul style="list-style-type: none"> • Overall, operating costs ratio and financial expense ratio have come down • Operating expense ratio as percentage of gross loan portfolio fell by 4.3 percentage points ('04-'08) for the TG, but portfolio yield has hardly come down (exception is FINCA with a drop of 30 percentage points in portfolio yield since 2003 starting from a very high level of 96%) • Similar observation for CG2, while CG1 experienced drop in portfolio yield and unchanged operating expense ratio • There is an increasingly strong (negative) correlation between portfolio yield and average loan size 	<ul style="list-style-type: none"> • Reduced costs (operating and financial expenses) did not lead to a similar reduction in portfolio yields, • The close relationship between average loan size and portfolio yield in 2008 is an indication for increasing competition • The correlation between loan sizes and portfolio yields suggests that any reductions in portfolio yield have mainly been driven by loan size increases, and not by increases in productivity
Breadth of access: savings	Total savings and savings to loans ratio	<ul style="list-style-type: none"> • Regulation allows MDIs for the first time to offer savings services in excess of compulsory savings, which should lead to increase in savings • Regulation increases safety and soundness and therefore encourage savers to entrust their money with MDIs • Savings important as an additional source of funding for portfolio growth 	<ul style="list-style-type: none"> • Moderate savings growth after treatment, but not as high as for Centenary • Two of four MDIs exceeded their expectations • Strong growth of savings for UML preceded its transformation into a commercial bank • Savings did not grow in importance as a source of funding portfolio growth 	<ul style="list-style-type: none"> • Positive impact of regulation on savings mobilisation, but not very strong • UML experience suggest that savings mobilisation strategy is more important than regulatory issues • It could still be too early to observe the long-term trend in savings growth

<i>Impact Area</i>	<i>Indicators</i>	<i>Impact channels</i>	<i>Observation</i>	<i>Interpretation</i>
Scope of access: savings	Compulsory savings to total savings	<ul style="list-style-type: none"> • The ratio should decrease as compulsory savings constitute idle cash 	<ul style="list-style-type: none"> • Ratio has come down considerably from 68% in 2004 to 23% in 2008 • Even before licensing, all except one MDI candidate had already been mobilising savings in excess of compulsory savings 	<ul style="list-style-type: none"> • Regulation creates strong incentive to reduce compulsory savings, as they cannot be intermediated
Breadth of access: savings	Number of savers	<ul style="list-style-type: none"> • Regulation allows MDIs for the first time to offer savings services in excess of compulsory savings, which should lead to increase in savings • Before licensing, number of savers was in theory linked to number of borrowers (only compulsory savings permitted), but now clients can be savers only 	<ul style="list-style-type: none"> • Temporary drop in numbers around treatment date, but increase for all MDIs except FINCA since • Dramatic growth for UML in 2008 • FAULU shows similar drop, but no increase afterwards 	<ul style="list-style-type: none"> • Positive impact of regulation after temporary drop in numbers, even though still much lower growth in numbers of savers than for Centenary • Regulation necessary condition for growth, but UML shows that the right savings mobilisation strategy also plays an important role
Depth of access: savings	Average deposits per depositor and average deposits per depositor as percentage of average loan balance per borrower	<ul style="list-style-type: none"> • No direct regulatory impact • Indirect impact through commercial pressure to turn to high value savers as a cheaper source of funding 	<ul style="list-style-type: none"> • 3 out of 4 MDIs keep average savings per saver at low pre-licensing levels or bring it back to this level • All MDIs show low figures for average deposits per depositor to average loan balance per borrower for all years • Same observation for CGs • Interesting case of UML in 2008: Steep drop in ratio, even though average loan size also increased in 2008 • FINCA has the highest value due to a combination of relatively small loans and large savings 	<ul style="list-style-type: none"> • Depositors likely to be poorer or at least as poor as borrowers • No regulatory impact observable • Main reason for lower value for UML in 2008 change in savings mobilisation strategy (e.g., removal of min. balance) and not regulatory issues
Depth of access: geographic spread	Branches	<ul style="list-style-type: none"> • Branch licensing requirement makes branching out more expensive • But some donors offered specific support for branch openings • Better access to funding makes it easier to branch out 	<ul style="list-style-type: none"> • Similar growth rate as before licensing, but higher than growth in number of borrowers 	<ul style="list-style-type: none"> • Branch licensing requirement has not slowed down branch network expansion • Other than commercial reasons might have played role in increasing branch network

<i>Impact Area</i>	<i>Indicators</i>	<i>Impact channels</i>	<i>Observation</i>	<i>Interpretation</i>
Efficiency	Operating expense ratio and costs per borrower	<ul style="list-style-type: none"> • Improved management, ownership and governance structure should lead to commercialisation and more efficient operations • Larger loan sizes reduce operating expenses, but increase cost per borrower • Compliance costs exert upward pressure 	<ul style="list-style-type: none"> • Except for UFT, all MDIs have lowered their operating expense ratio since licensing • FINCA has by far the highest operating expense ratio, UML the lowest (negative correlation with average loan size) • Costs per borrower have increased since licensing, strongest for UFT and UML 	<ul style="list-style-type: none"> • Cost-reducing impact channels outweigh increased cost of compliance • Increased average loan sizes helped to increase efficiency, but at the expense of depth of access • Costs per borrower have also been driven by changes in average loan size
Liquidity	Liquid ratio	<ul style="list-style-type: none"> • Close monitoring of liquidity ratios and liquidity management as part of BoU's offsite surveillance • Statutory minimum of 15% for liquid assets to deposit liabilities • Commercialisation increases pressure to hold less excess liquidity 	<ul style="list-style-type: none"> • No data on liquidity ratio • Liquid ratio does not show a clear trend and has been quite volatile 	<ul style="list-style-type: none"> • Insufficient data to draw conclusion

**APPENDIX 7: ANALYSIS OF IMPACT INDICATORS FOR THE
MDI REGIME**

<i>Indicator</i>	<i>Observation</i>
<i>Safety and Soundness</i>	
Performance indicators on profitability, capital, portfolio quality	Positive impact except for temporary deterioration in portfolio quality (which could also be caused by better recording of portfolio quality) and profitability.
Supervisory capacity	Well-equipped and well-trained specialised BoU Unit in charge of on- and off-site supervision of MDIs
Governance	BoU used its power to prescribe changes in composition of board of directors and in internal audit function; positive influence of shareholding limit on diversification in two of four cases
Management	BoU prescribed changes in senior management in several cases; positive development confirmed by MDI management and by the fact that competitors poach staff from MDIs
Information systems	Gradual improvement of MIS, in at least two cases prescribed by BoU; all MDIs upgraded MIS to meet reporting requirements
Reporting	Comprehensive reporting to BoU with some delays in submission in early days
On-site examinations	Regular (even if not necessarily annual) on-site examinations with corrective actions and follow-up visits to check compliance
<i>Systemic Risk</i>	
Deposit-base of MDIs	Increasing due to the permission to mobilise voluntary savings, but still relatively low
Contagion through credit channel	Contagion risk through credit channel low as no credit links among MDIs and not all client savings are held with commercial banks any longer
Susceptibility to runs	No run or contagion, but one case of high deposit withdrawals triggered by newspaper article, and likelihood of negative news spreading quickly through overlap in clientele of MDIs
Susceptibility to contagion from crisis in Tier 4	Clients can increasingly tell difference between tiers and crisis did not spill over to Tier 3
Runs and contagion in Tier 4	Several runs on Tier 4 MFIs, but no spill-over effect to Tier 3
Deposit insurance system	Will be single most important deterrent against runs/contagion, once fully operational
Lender of last resort facility	Does not exist, but negotiated lines of credit a partial substitute
Safe and sound institutions	Best defence against contagion
Trust	Trust in institutions supervised by the Central Bank has increased since last banking crisis in late 1990s

<i>Indicator</i>	<i>Observation</i>
<i>Competition</i>	
Allocation of statutory roles in competition policy	The Central Bank does not have competition as one of its objectives and there is neither a competition law nor competition authority
Credit reference system	Will reduce switching costs and thus the prevalence of local monopolies once fully operational, but no impact so far
Licensing regulations creating new barriers to entry	Barriers to entry lowered, as a new lower tier was created, while other tiers remained unchanged
Subsidised Government programmes	“Prosperity for All” creates unfair competition through subsidised interest rates and might have been prompted by unfulfilled expectations with regard to MDIs
Unfair competition from SACCOs	Problem of regulatory arbitrage by MFIs mobilising deposits under the disguise of the SACCO structure
Relevant credit and savings market	Higher growth on savings side, slower growth on credit side
Market dominance	Mitigation of strong dominance of Centenary Bank in number of savings accounts
Market structure	Increasing penetration of underserved areas through branch expansion in all tiers, yet stronger impact of lifting of moratorium on new bank licences (not an impact of MDI regime)
Competitive conduct	Practitioners perceive increase in competition and are more responsive to customer demands
Performance of MDIs	No extraordinary profits any longer; portfolio yield closely correlated with average loan size; no observable problems of over-indebtedness
<i>Consumer Protection</i>	
Allocation of statutory roles in consumer protection	The Central Bank does not have consumer protection as one of its objectives and there is neither a consumer protection law nor an umbrella consumer protection body
Deposit insurance system	The recently established explicit deposit insurance system will have a positive impact on the safety of deposits
Transparency	Only minor measures to increase transparency (publishing of charges, declaring publicly who is authorised to take deposits)
Fair treatment of customers	General clause mentioning conduct of business detrimental to the interests of customers as one reason for revocation of licence
Redress	No formal recourse mechanisms
Financial capability	No involvement of any Government authority
Non-regulatory alternatives	A few, yet not well-coordinated activities by various players
Safety and soundness, systemic stability, and competition objectives	Strong focus on safety and soundness and systemic risk also has positive impact on consumer protection. so has increasing competition

<i>Indicator</i>	<i>Observation</i>
Incidences of complaints	Only anecdotal evidence suggesting that clients resort to the police or, in a few cases, send complaints to BOU and AMFIU without formalised follow-up
Customer perception	Customers believe in MDIs' safety and soundness, but do not know much about how they work and what they charge
<i>Access</i>	
Statutory role in increasing access	BoU sees passage of MDI Act as important contribution to increase access, but access is not a statutory role
Other regulatory objectives	Most of the other regulatory objectives have either a supporting or conflicting relationship with the access objective
Regulatory provisions with potential impact on access	Restrictions on use of branchless banking, high capital adequacy requirements, prohibition to intermediate LIF, single shareholder limit have potentially negative impact; loan size limit is ineffective; CRB can improve access
Substitution effect with Tier 4	MDI regime did not create any new barriers for Tier 4; enforcement of prohibition to take deposits became stricter, but not due to MDI Act
Length of access	Clear improvement through strong focus on safety and soundness and systemic stability objectives
Breadth of access	Negative impact on number of loans (at least temporarily), positive impact on savings
Depth of access	Negative impact on lending side, but degree of shift to larger loans depends on ownership composition; positive on savings side
Scope of access	Growing number of loan and savings products (with only the latter being clearly caused by regulation). Individual loans and voluntary savings more prevalent

APPENDIX 8: COST OF MDI REGIME

This appendix summarises the main calculations for estimating institutional and direct costs of the MDI regime. All prices are expressed in US Dollars in 2008 prices unless mentioned otherwise, which allows for easier comparison with other countries. To convert costs incurred in earlier years into 2008 prices, their Ugandan Shilling equivalent in the respective year was first adjusted for inflation (using the consumer price index in Uganda) to get figures for 2008 in local currency and then converted into US Dollars by using the average exchange rate for 2008. Such a calculation takes into account the substantial appreciation of the real value of the Ugandan Shilling against the US Dollar (inflation reduced the value of the Ugandan shilling by more than 50% between 2002 and 2008, but the nominal exchange rate against the dollar appreciated slightly).

A. INSTITUTIONAL COSTS BANK OF UGANDA

A.1 Start-up costs: US\$4.2 million

Staff expenses (salaries and allowances) for the Microfinance Unit from 1999 to 2004: **US\$500,000**

This is based on the following available data: The budget for staff salaries and allowances alone in the financial year 2008/09 was US\$312,000. The actual staff costs for the financial year 2001/02 for the entire NBFI Department, which is also in charge of supervising non-bank financial institutions, were about US\$79,000 (no separate figure was available for the MDI Unit). It is assumed that initially a third of the costs can be allotted to the MDI Unit and that costs increased linearly over the years. All figures have been converted into US Dollars at 2008 prices.

Administrative costs for running the Unit and **allocated salary expenses** for the Director NBFI, and the Executive Director Supervision: **US\$500,000**

This is based on the breakdown of costs for the MDI Unit (approved budget for 2008/09). According to this, staff and salary expenses are almost exactly half of overall administrative costs when including supervision costs (and all four MDIs had pre-licensing inspections), costs for the Executive Director Supervision and overhead costs.

Capital expenditure in financial year 2002/03: US\$200,000

The NBFi department had budgeted for a US\$150,000 (2008 prices) capital expenditure in the financial year 2002/03 for additional desktop and laptop computers and one extra vehicle to cope with the increased workload caused by its responsibility to supervise MDIs [UD/C/31]. Assuming that additional costs in 2003/04 were lower (no data available), overall costs are assumed to be US\$200,000.

Sum of start-up costs borne by BoU: US\$1.2 million

Technical assistance provided for designing MDI regime: US\$3 million

The FSD Project did not track expenses according to activities. The overall programme budget for the first two project phases (June 1998 to May 2005) was above US\$15 million in 2008 prices. A conservative estimate is that 20% of this was spent on supporting BoU to develop the MDI regime, which was among the four main activities of the project the one which got most attention.

A.2 Ongoing costs: US\$700,000 per year

Running cost of MDI Division: US\$700,000

This is based on the approved budget for financial year 2008/09 and may have, according to BoU, a margin of error of +/- 5%. It does not include capital expenditures. Half of it is made up of staff salaries and allowances.

Income from application and licensing fees, penalties, and fines: negligible

Application fees were US\$500,000 each, while the annual licensing fee is US\$1 million. In 2008, this came to US\$4 million or about US\$2,300. Other income comes from fines and penalties paid by MDIs. However, the combined income for BoU (not only from MDIs, but from all regulated financial institutions) from fines, penalties and hire of bullion vans was only US\$10 million in FY 07/08 (this was the only information obtainable).

B. COMPLIANCE COSTS MDIs

B.1 Start-up costs: US\$1.8 million per MDI

Reported costs for UWFT/UFT: US\$1.4 million

<i>Item</i>	<i>Cost in US\$ at the time they occurred</i>
Developing a transformation plan	Not easy to attach a monetary value
Opportunity costs staff	Not easy to attach a monetary value
Expenses for transformation manager	104,000
Legal advice on transformation	50,000
Upgrading of MIS	500,000
Costs of attracting investors	25,000
Costs of upgrading branches	253,000
Total transformation costs	932,000

Source: [UD/E/36]

For FINCA and UMU/UML, only budget estimates for transformation costs are available. UMU in 2002 estimated a budget for the MIS alone for the period 2002 to 2008 of US\$914,390, which, however, includes substantial costs for branch expansion most likely not (or not only) caused by regulation [UD/R/32: table 9]. FINCA in its “Formalisation Report” from 2001 drew up a detailed budget for transformation of US\$1.9 million [UD/R/34: annex 5]. This budget is broken down in expenditure for external consultants (14%), technical assistance provided by FINCA International (31%), costs of additional staff to be hired by FINCA Uganda (38%) and capital expenditure (16%). The latter does not include any expenses for an MIS upgrade. Again,

all of these expenses (including the 2001 budget from FINCA) would be about 50% higher in 2008 prices.

Reported costs for PRIDE: US\$1.5 million

<i>Item</i>	<i>Cost in US\$ at the time they occurred</i>
Transformation consultants	48,000
Working on Policy Manuals	48,000
Salary survey & review, Tax consultancy	63,000
Marketing, changing logo, Road signs	53,000
IT Consultancy	14,000
Legal costs	249,000
Taxes related to transformation issues	41,000
Branch renovation costs	523,000
Total transformation costs	1,040,000

Source: [UD/E/37]

B.2 Compliance costs: Min. US\$135,000 per MDI per year, but could also be double the amount

Compliance expenses according to MOP funding request: US\$120,000 per MDI

In 2005, the Microfinance Outreach Plan (*MOP*) provided funding to the tune of US\$184,000 to the four MDIs, which was equivalent to 50% of the funding requested by the MDIs to support them with compliance expenses [UD/M/38]. These expenses therefore added up to on average US\$92,000 per MDI for the year 2005 (US\$120,000 in 2008 prices). It was not possible to verify whether all these expenses were caused by recurring compliance costs, or whether part of it was also spent on start-up compliance costs.

Reported costs for compliance expenses of UFT

The items in this table were provided by the author for UFT to complete.

<i>Item</i>	<i>Cost in US\$ in 2008</i>
Recurring system costs (as annualised expenditure figure which amortises any large but infrequent costs incurred)	80,000
Costs of training clearly attributable to BoU regulation and supervision	25,000
Additional costs of hiring senior management which passes BoU fit and proper rules (i.e., salary increases)	10,500
Costs of additional insurance cover (e.g., for cash in transit)	70,000
Costs of changes in ownership and governance structure (e.g., costs of setting up board committees and having regular meetings, imputed costs of holding more capital, etc.)	26,800
Reporting costs (staff and system costs of submitting report to BoU)	Not easy to attach a monetary value
Staffing costs of compliance function (salary costs and associated salary costs [such as pension contributions] plus allocated overhead add-on)	
Costs of hiring additional staff (e.g., internal auditor, finance manager, dedicated customer care officers, cashiers, etc. – but only in as far as required in law and regulation or requested by BoU)	
Total reported compliance costs	212,300

Source: [UD/E/36]

Contribution Deposit Protection Fund: US\$15,200

MDIs only started contributing to the Fund in 2010, but the hypothetical contribution in 2008 would have corresponded to 0.2% of the total deposit liabilities of the MDI in the previous year (SEC. 10 (3) Establishment of the MDI Deposit Protection Fund Instrument), and could have been higher for high risk MDIs (SEC. 11).

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