# BANK OF UGANDA

**Remarks by Prof. Emmanuel Tumusiime-Mutebile,**
**Governor, Bank of Uganda,**
**At the National Microfinance Conference, 2015**

***The Effect of Regulation on Financial Inclusion***

**Thursday January 29, 2015**
**Africana Hotel, Kampala**

Good morning, ladies and gentlemen,

My intention this morning is to outline the regulatory approach which we have adopted in Uganda with regard to the promotion of financial inclusion and then to discuss the results of that approach. I will start by expounding the principles which guide the regulatory approach.

The key principle which guides our regulatory approach to the promotion of financial inclusion is that financial regulations cannot force financial institutions to provide customers with financial services when this is not profitable for them to do so. The main cause of financial exclusion is the difficulty in serving the financially excluded in a commercially viable manner. These difficulties arise because the costs of serving the financially excluded are high, especially in rural areas, whereas the income which can be generated from the poor is low. Consequently financial exclusion can only be reduced through innovations which can lower the cost of providing financial services or which can create new financial services which are both wanted by and affordable to the poor.

In a market economy, the institutions best placed to generate these innovations are in the private sector; institutions which have the incentives and expertise to do so. The rapid growth of mobile banking in East Africa is a phenomenon which has been driven by private sector initiatives. Private sector banks and telecommunications companies, driven by the profit motive, have utilised new technologies to create new markets and have thus brought financial services to millions of people who previously had no access to these services.

In these circumstances, what is the appropriate role of financial regulation? The primary objective of financial regulation is prudential; it is to protect the savings of ordinary citizens from reckless or abusive management of financial institutions, and to preserve the stability of the financial system. To the extent that ordinary citizens have greater confidence in the safety of their deposits in financial institutions, prudential regulation can contribute to the deepening of the financial system.

Inevitably, however, there are often tradeoffs to be considered when innovations are proposed by the private sector which have the potential to promote financial inclusion. The approach which we have adopted in Uganda is to avoid placing regulatory restrictions on innovations in the financial sector provided that these innovations do not conflict with the primary objectives of prudential regulation. In some cases, this has meant that innovations have had to be designed to incorporate safeguards to protect the public's savings, as is the case with mobile banking, which I will discuss later. In other cases, such as with small informal financial

institutions, we have to recognise that it is not practically possible to provide effective prudential regulation.

I would like now to highlight four innovations in the Ugandan financial markets which are relevant for financial inclusion and explain the regulatory approach that we have adopted to them.

**Deposit taking microfinance institutions**

The first innovation I want to discuss is the establishment of microfinance institutions (MFIs), which began in Uganda in the 1990s. Initially these were not-for-profit institutions which relied mainly on donor funding and did not take deposits. At around the turn of the millennium, Uganda, along with many other countries, took the view that at least some of the MFIs should be allowed to accept deposits, both because their customers would benefit from access to deposit facilities and because MFIs could grow more rapidly and be more sustainable if they could mobilise deposits. Therefore, specific legislation was introduced in 2003 to allow MFIs to take deposits. To provide safeguards for the deposits, the legislation imposed prudential regulations on Microfinance Deposit Taking Institutions (MDIs) and brought them under the regulatory aegis of the Bank of Uganda. However the prudential regulations were specifically designed to take account of the fact that MDIs are generally much smaller than commercial banks and have a very different business model. For example the minimum start up capital requirement for a deposit taking microfinance institution is much lower than that of a bank. For an MDI the minimum capital is Shs 500 million, whereas for a commercial bank it is Shs 25 billion. In 2010, the coverage of the Deposit Protection Fund was extended to include the deposits of MDIs.

**Table 1 MDIs and number of accounts with MDIs in Uganda**

| | 2006 | 2010 | 2014 |
|---|---|---|---|
| | | | |
| Number of MDIs | 4 | 3 | 3 |
| Total number of MDI accounts | 152,448 | 458,033 | 776,179 |

Source: Bank of Uganda

It is fair to say that the growth of the MDIs has not been as rapid as originally hoped. Although the number of deposit accounts with MDIs has increased five fold since 2006, as shown in table 1, it is still small in comparison with the number of deposits accounts held in commercial banks; commercial banks held more than five times as many deposit accounts as

MDIs in 2014. As such MDIs have only made a relatively modest contribution to reducing financial exclusion over the past decade. It appears that the business model of MDIs, which involves a high volume of small loans and deposits, has not always been successful in Uganda, possibly because the operating costs have been too high. Several of the MDIs which were licensed in the 2000s have since been converted into commercial banks.

**Mobile banking**

Mobile banking was first introduced in Uganda in 2009. The business model involves a partnership between a mobile phone operator and a commercial bank. The services offered have so far been restricted to basic retail payments and money storage services; money can be transferred from one customer to another and it can also be stored in a customer's virtual account.

The main regulatory concern of the BOU has been to safeguard customers' virtual money which they purchase, with cash, from mobile money agents. The BOU has only allowed mobile money operations when this is done in partnership with a supervised commercial bank. Mobile money operators have to hold, in an escrow account in their partner commercial bank, the equivalent in value of all the mobile money that they have sold to their customers. This means that the mobile phone operators, which are not licensed financial institutions, cannot themselves intermediate the funds that they have mobilised through the sale of mobile money. Customers who purchase mobile money have a similar level of protection as that which is afforded to depositors in a commercial bank. The BOU has also issued mobile money guidelines in 2013. The guidelines stipulate an approval process for all agents who wish to engage in the provision of mobile money services and the roles and responsibilities of all parties involved. They also stipulate the safeguards to protect customers, such as the requirement that customers' PIN numbers must be used to authenticate all transactions.

As can be seen in table 2, the growth in mobile banking has been phenomenal. The number of registered mobile money customers exceeds half of the total population of Uganda, although this number may include some people who are registered with more than one operator. In terms of extending access to financial services, mobile banking has made a much larger contribution than any other recent innovation. The regular FINSCOPE surveys reveal that the share of the population with access to formal financial services increased from 28 percent in 2009 to 54 percent in 2014 and that almost all of this increase was due to access to mobile banking. However, although the growth of mobile banking amongst the previously financially excluded has been impressive, we should also bear in mind that the range of financial services available through mobile banking is very narrow; as I have already noted it is restricted to basic payment transactions and storage of money.

**Table 2 Mobile Banking Data: 2009-2014**

| | 2009 | 2012 | 2014 |
|---|---|---|---|
| | | | |
| Registered customers (millions) | 0.55 | 8.9 | 18.5 |
| Number of transactions (millions) | 2.8 | 242 | 496 |
| Value of transactions (billions of Shillings) | 133 | 11,663 | 24,050 |

Source: Bank of Uganda

**Agent banking**

Although the number of deposit accounts held in commercial banks in Uganda has grown rapidly, tripling since 2005, commercial banks only serve 20 percent of the adult population, according the 2013 FINSCOPE survey. The provision of banking services involves substantial fixed costs, which is an obstacle to expanding services to the unbanked, especially in rural areas. As such, an expansion of banking services requires new business models which can deliver services at much lower costs.

One such model is agent banking. Agents are normally people with small businesses, who are contracted by the banks to undertake transactions on their behalf, such as collecting deposits, facilitating customer withdrawals and making payments, for a fee. The advantage for the bank is that it can avoid the heavy expenses involved in setting up a bank branch. Agent banking is restricted under the existing banking laws, hence we are currently in the process of amending the Financial Institutions Act to permit the use of authorised agents by banks, with safeguards for bank customers.

**Savings and Credit Cooperatives**

There are currently approximately 2,000 savings and credit cooperatives in Uganda. These are mutual associations whose members make deposits in, and can access loans from, their SACCO. Although there are a handful of quite large SACCOs, whose members comprise employees of large organisations, the vast majority are very small. SACCOs undoubtedly play an important role in extending financial services to the unbanked. The 2013 FINSCOPE survey revealed that 622,000 adults, about four percent of the adult population, held accounts in SACCOs in 2013, a fivefold increase since 2009. Although SACCOs are registered with a public agency – the Registrar of Cooperatives – they are not subject to any prudential regulation, and hence there are no safeguards for members' savings.

The dilemma for regulatory policy is that effective prudential regulation of a very large number of small, informal financial institutions, such as the SACCOs, is not feasible. It is far too costly for any regulator to supervise effectively any more than a tiny fraction of the existing SACCOs. Consequently the approach we have adopted at the BOU is to try and encourage some of the larger SACCOs, which have hundreds or even thousands of members, to graduate to the status of Microfinance Deposit Taking Institutions (MDIs), and thus become subject to the MDI Act. To facilitate this, the MDI Act is being amended to make it more compatible with the organisational structure of SACCOs, for example, by allowing institutions which are not limited liability companies to be licensed as MDIs. The remaining SACCOs may eventually be brought under the umbrella of an apex body, but it will clearly not be possible for this body to provide the same degree of regulatory safeguards to the savings held in SACCOs as that afforded to deposits in banks and MDIs.

**Conclusion**

Uganda has made some progress towards greater financial inclusion over the last 10 years. The most important contribution has been made by the rapid spread of mobile banking, although the range of services offered is still quite narrow. However, commercial banks should be able to harness new technologies, especially through the use of smart phones, to provide a wider range of services through mobile banking in the future. We also hope that the graduation of some of the larger SACCOs into Microfinance Deposit Taking Institutions and the adoption of agent banking by the commercial banks will also boost financial inclusion. The priority objective of financial regulation will continue to be ensuring the safety of customers' deposits.