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Financial Services Associations In Uganda

A Mid-Term Review

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1. Summary and Recommendation

1.1 Summary

- The seven FSAs currently in operation are entirely shareholder/owner-used and managed, membership-based organisations

- The Project Management Unit supported by DFID is based in Masaka town, with FSAs in Kingo, Bukunde, Kibinge, Lakaya, Butenga, Katovu and Kisseka providing essentially a loan service to predominantly poor, rural communities.

- Of the seven FSAs, five are operating relatively well in terms of financial performance, and governance and management criteria. Two are in clear need of further, strong technical support from the Project Management Unit (PMU) in terms of both financial management and governance issues.

- DFID should continue to support the PMU until the end of the current project, while exploring avenues for eventual exit leaving the FSAs with an adequate and appropriate supervisory system. These include tieing FSAs to a formal commercial bank (considered difficult to achieve for existing FSAs) and a self-financing apex body.

- The PMU should (and is) urgently undertake the development of an apex (AFSA – Association of FSAs) which can ensure close supervision of the FSAs. Role, functions, sanctions, and the funding of AFSA will need to be developed and agreed by the FSAs and DFID. The BOU should also be kept informed.

- The PMU should also concentrate its remaining technical assistance in assisting all FSAs (but especially Kingo and Bukunde) with additional, intensive training, particularly in dealing with arrears (and the governance issues that surround that), and Board and management governance and management issues. These include stricter controls on Board elections, Board and management borrowing, and independence of Management/Board relationships.

1.2 Recommendation

It is recommended that DFID renews the FSA International contract from end May 2000 for the duration of the project (end 2000) and continues to support the PMU for the remainder of this period. (See Appendix 10 for a full set of Review recommendations).

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2. Introduction

In October 1998, DFID initiated a programme of support for seven Financial Services Associations (FSAs) in Uganda. The purpose was to provide rural financial services to a wider proportion of the poorer population. The outputs were:

- Social acceptability of Village Bank (VB) concept tested
- Legal & regulatory framework that legitimise VBs as financial services providers
- Viable institutional framework for effective operation of VB concept in Uganda
- VB concept financially viable for commercial link banks and for VBs themselves
- Economic viability of VB concept shown at household, business & local economy levels.

Initially a two-year project, the mid-term review was undertaken at the end of the first year pilot phase (which, following contractual difficulties, was in April 2000). The intention was to establish progress of the FSAs and to decide how DFID should most sensibly and responsibly continue to support, or withdraw from, the project.

Terms of Reference for the review and outline question guidelines are attached as Appendix 1.

The review was conducted over a period of three days from March 28th – 30th, 2000 by: Anthony Way (DFID), Graham Wright (***MicroSave***), Leonard Mutesasira (***MicroSave***) and Henry Sempangi (***MicroSave***). Anthony Way and Graham Wright visited all FSAs except Katovu and Leonard Mutesasira and Henry Sempangi reviewed Lukaya, Kibinge and Bukunda in detail.

Caveat: given the relatively brief nature of the review, the review team did not have time to examine all FSAs in exhaustive detail. One recommendation is to have an in depth study of both Kenyan and Ugandan FSAs later in the year.

3. Rural Financial Services - Background and Theory

3.1 The Problem in Perspective

Extension of financial services into remote rural areas is notoriously difficult, and there are few examples of successful attempts to do so. CIDR's Caisse Villegoises (notably in Pays Dogon[1]) are the most commonly cited of these, but even they took over a decade of intensive foreign-lead technical assistance to establish. In Uganda, despite the clear demand (COWI Consult[2], 2000 and UNDP-PSDP[3], 2000 studies) few attempts have been made to bring financial services to remote areas. These include the UCA/UNDP "Village Banks" (now "Village Savings and Credit Institutions") and a few isolated community-based organisations supported by the Development Finance Department of the Bank of Uganda. Few have shown credible promise.

3.2 The FSA initiative

It is in this context that DFID's pilot-test of Financial Service Associations (FSAs) should be seen. If successful, the FSAs are intended to be the building blocks for a network of institutions that offer financial services where no traditional Grameen Bank/FINCA-inspired system will ever reach. FSAs seek to do this through business-oriented membership-based organisations. Given the history of traditional Credit Unions/Savings and Credit Cooperatives, it would not be unreasonable to view these

[1] See for example **Chao-Beroff**, Rene, "The Constraints and Challenges Associated with Developing sustainable Microfinance Systems in Disadvantaged Rural Areas in Africa", *mimeo for UNCDF*, March 1999.
[2] "Market Needs Assessment for Rural Financial Services to Households and Agricultural Sub-Sectors"
[3] "District Resource Endowment Profile Studies"

attempts with a degree of scepticism. Many of the problems associated with Credit Unions/Savings and Credit Cooperatives arise (*inter alia*[4]) from their ownership and governance systems (see Appendix 2). However, in an attempt to address these issues, the FSAs differ in significant ways from traditional Credit Unions/Savings and Credit Cooperatives (and thus most of the "Village Banks" above) as outlined in Appendix 3.

3.3 Report Findings

The main findings of the report have been divided into two main sections. Broad brush governance, management and finance issues covering all the FSAs are in Sections 4 -5. Individual FSA findings are in Appendix 9.

4. General

FSAs have faced a difficult initial period. They serve relatively remote communities, have encountered discontinuity in Project Management Unit (PMU) support, link bank closures and the BoU's radio and newspaper advertisements warning against community-based organisations. Thus, although the review disclosed a number of areas that need considerable tightening and change, FSAs have performed remarkably well. It is a tribute to those who have worked so hard to ensure that they have done so. Furthermore, they continue to grow and make steps (with varying degrees of surety and success) towards long term sustainability[5].

It should also be noted that, despite the relatively simple nature of the FSA concept, each FSA visited has its own unique governance/management challenges. Given the relatively new nature of these institutions, and thus the limited capacity of Boards/Management to resolve them, the problems present special challenges to the Boards and particularly the PMU (usually the arbiter of disputes and the source of guidance). This observation re-emphasises the need for a strong apex or centralised ownership structure.

A brief summary of the diverse ownership/governance issues facing the six FSAs visited by the team is below:

FSA	**Summary of Key Governance Issues**
Bukunda	• Purchase of Ush. 1.9 million plot of land without consulting members • Many Board and all staff have loans in arrears • Very high (70%) arrears/delinquency rate • Poorly/non-functioning Board and Audit Committee (*a new Audit Cmmtt. appointed April 2000)*
Butenga	• High turnover in Audit Committee • No business plan *(business plan now developed – April 2000)*
Kibinge	• High level of "roll-over" borrowing by the Chairman • Possibly risk of "capture" by educated, erudite elite on the basis that they want to create a sound, disciplined, high quality financial institution
Kingo	• Conflict between Board and (two) previous Managers • Conflict within Board over increasing members from outside Kingo • Dominant Chairman seeking to extend his term *(now expected to step down – April 2000)* • No General Meeting for 16 months and no attempts to keep members informed • Many Board members with loans in arrears
Kisseka	• Previous (founder) Chairman and wife delinquent • Under-trained management and Board • Business plan not implemented by Board
Lukaya	• Board/staff (all borrowers) seeking to reduce loan interest rate without consulting members • Risk of "capture" by those members with loans (which are being regularly "rolled over" with few and

[4] Other typical reasons include failure to implement a functioning basic accounting system and failure to collect loans. The latter presents particular problems for community-based organisations where it is often difficult to take firm action against defaulting neighbours, friends and relatives.
[5] Financial sustainability is almost secured from the outset by virtue of the model – the issue for FSAs is above all institutional/managerial sustainability.

	small repayments being made)
All	• Inappropriate ownership structure • Boards/Audit Committees require additional training and checklists to guide their work • Management needs training (on technical issues and the importance of professional conduct) • Dependent on PMU for "guidance" and supervision

5. Specific Issues

5.1 Ownership

5.1.1 Ownership Structure

The ownership structure of FSAs remains ambiguous. Only 4 of the 7 pilot FSAs have been registered at all (most as companies limited by shares, others as companies limited by guarantee). The Bank of Uganda seems to be committed to allowing "Membership-Based Organisations" (MBOs) to mobilise deposits and to be supervised by an (as yet unspecified) umbrella organisation. It is possible that the FSAs will have to (re-)register as co-operatives to allow them to continue their operations. This would have two consequences:-

1. The current system that varies voting rights with shareholding will have to be replaced with a more traditional "one person, one vote" system. (This seems unlikely to cause too much problem – most FSAs are using simple show of hands at the General Meetings to make decisions and, in one case, is seeking to implement the "one person one vote" system anyway. However some [notably Kingo and Bukunda] do value the FSA system of votes by shareholding).

2. Although the emphasis is on shareholding as a long term investment, the FSAs will be allowed to intermediate the savings they collect from their members. (This is a concern for weaker FSAs, which are struggling to collect their outstanding loans. It will be essential to ensure that their portfolio management capacity is significantly strengthened before this option is exercised. On the other hand, it will allow the FSAs to start offering improved savings services without reference to shareholding or the current deduction of the 3% fee and to increase the amount of capital available for lending[6]).

5.1.2 Acting As Agencies for a Bank?

A possible solution could be a formal sector bank or Microfinance Deposit-taking Institution (BoU's tier 3) taking controlling interests in the existing FSAs and thus providing them with important governance/supervision support. However, discussions with members suggest this is an unlikely outcome. Members take pride and interest in their FSA (the General Meetings seem to attract high [40-80%] levels of attendance) and are particularly pleased by the community-based nature of the institutions. An external agency buying a controlling interest in an FSA could meet considerable resistance. (The only exception to this could be failing FSAs in need of re-capitalising, and thus inherently unattractive to a bank). The only way such a type of ownership structure might be effected is if a bank or MDI took a controlling and guiding interest in the institution from the outset – an idea that might be worth pilot-testing (or learning about attempts to follow this model in Kenya).

[6] This is an important matter – under the present structure FSAs are still not providing a balanced set of financial services (i.e. high quality loans and savings services). There is a clear need for the FSAs to look at developing savings products that are responsive to the needs of the poorer members of the community.

5.2 Supervision

5.2.1 The Need for, and Role of, the Apex

In the short term, the umbrella organisation referred to in the BoU's Policy Statement is unlikely to have the capacity or have the time to spend carrying out meaningful supervision of small rural MBOs. **It is therefore important that an FSA-specific PMU remains in place or that an apex organisation is created as soon as possible.** The PMU would be required to continue its current roles: *supervision/quality control, training, advocacy, information exchange, centralised purchasing etc.* In addition, the PMU should be asked to develop the building blocks for further strengthening and replication: *formalised training manuals and refinement of the system including improvements to the governance systems, experimentation with improved products (especially savings) and approaches to loan portfolio management.*

If an apex is the preferred option, it would be required to fulfil the usual apex roles: supervision/quality control, training, intermediating excess liquidity between FSAs, advocacy, information exchange, centralised purchasing etc. Some of these give rise to conflicts of interest but, in the absence of a credible alternative, these should be accepted and managed. One means of achieving might be to finance the apex through shareholding within the member FSAs. This would create incentives for the apex to provide high-quality training and technical assistance as well as provide effective supervision/quality control to ensure good returns on the shares it owns in each FSA. The apex should also have the power to call Extraordinary General Meetings to address key issues as they arise, and possibly (subject to the legal framework) be given a substantial level of voting rights.

At present, FSA International[7] envisages the apex's role in the short term in a much more modest form, with no staff and limited responsibilities (procuring stationery, exchanging information etc.). However, the PMU accepts that, as a critical mass of FSAs is established, this role could be expanded and conducted on a self-financing basis (see Appendix 4). This larger role is needed quickly to allow some opportunity for the PMU either to transform into or be absorbed by the AFSA, or a period of "parallel run".

5.3 Governance Issues

5.3.1 Overall

Overall the governance of most FSAs (with the clear and notable exceptions of Bukunda and Kingo) is remarkable for its transparency. There is a clear sense that members are aware of the dealings of "their FSA" and their interest and involvement in it is notable, as is the committed and regular involvement of the Boards and Audit Committees. The ability of the FSA model to generate this type of effective governance in membership/community-based organisations is commendable. It is crucial that this committed behaviour to governance structures continue into the long term.

Nevertheless, effective supervision remains essential. For this to work effectively, the supervisory agency requires real powers - i.e. the ability to impose sanctions on FSAs that are not meeting performance and governance criteria. Furthermore, the striking variety of issues that beset even these seven FSAs highlights one of the dilemmas facing all attempts to established membership/community-based institutions. It is complex, time-consuming and subject to the vagaries of human nature and society. One option might be for DFID/another donor to finance a bank or MDI to study options for using the best operational practices of FSAs (performance related remuneration, simple accounting system etc.) as a basis for agency (or sub-agency) outreach from a formal sector organisation that fully owns (and thus controls/supervises) the FSA.

5.3.2 Division between Board and Management

The division between Board and Management is essentially non-existent (see below). With the exception of Kingo, in all FSAs visited they worked closely together and seemed to support each other on all matters. On the other hand, Boards were not perceived to be intrusive by Management who continued in their everyday work without hindrance. Boards generally have a clear enough vision of the future of their FSA, but two FSAs (Butenga and Kisseka) have no formal business or five year plan. (In others, the business plan was simply a few projections, out of date, inaccurate and not referred to.)

[7] The private consulting company that is managing the pilot-test and the PMU.

However, in Kingo there is a history of conflict between Board and Management, and both are now almost entirely controlled by the Chairman. **The FSAs' Memorandum and Articles of Association need to define clearly the responsibilities of the Board, those of Management and those decisions that must be referred to the General Meeting.** Boards should be given training on the nature of their responsibilities and checklists to assist them. These checklists could also form the basis of a Board performance appraisal system. The division of responsibilities, training and checklists should be amended over time as the size of the FSA increases.

5.3.3 Regularity of Board Meetings

This close working relationship arises both from the small locality from which members are drawn and the regularity of Board/Credit Committee meetings. Typically, the Board (with the exception of the Chairman) meets as the Credit Committee on a weekly basis, generally coinciding with the Audit Committee's weekly accounts review. Thus the Board, Audit Committee and Management meet weekly in this manner, in addition to their monthly review of the FSAs accounts/audit reports, loan portfolio and the growth of the FSA. Most FSA Boards seem to be meeting according to the above schedule and are thoroughly committed to the institution – a commendable involvement. However, where the Board and Audit Committee lose interest or are inadequately proactive, the FSA can quickly deteriorate, as the examples of Bukunda and Kingo illustrate.

5.3.4 Board Remuneration

The Board members are remunerated for the time they spend on the FSA based on the monthly results of the FSA. This results in a typical monthly payment of Ush. 4,000 – Ush.6,000 or Ush. 400 – Ush.600 per hour spent on FSA, depending on the results. This system also means that if the FSA grows and becomes more profitable, so the Board members (and staff whose salary is also directly linked to monthly profitability) receive increased remuneration. In principle the system is good, and provides fine incentives for active Board involvement. However, linking remuneration to performance provides another reason for extending the maximum consecutive tenure of the Board members to three to possibly even five years[8] – this term would allow them to reap the benefits of hard work to expand and develop the FSA (see below). Furthermore, linking remuneration directly to profitability of the institution can potentially set up conflict between the staff and Board (or between the staff/Board and members) as the profitability of the FSA (and thus the remuneration levels) climb. Even at the current modest levels of operations/profitability, the Manager and Cashier receive salaries equivalent to a Primary School teacher – successful FSAs can reasonably be expected to double that with 2-3 years of operation.

5.3.5 Board Rotation

The FSA system recommends that the Board is re-elected annually at the Annual General Meeting for a maximum of two terms. This re-election requirement provides an important opportunity for the members to drop non-performing Board members – and in several FSAs this opportunity had been used effectively. In others (notably Kingo and possibly Kibinge) it could prove an invaluable mechanism to remove dominant Board members – typically the Chairman. However, in these two cited cases, the Chairmen are aware of the provision for FSAs to change their Memorandum/Articles to allow for increased consecutive terms and are moving to do this. Conversely, many FSA Boards (including Kisseka and Kibinge) and members worry that the maximum of a two year term will result in too frequent changes of Boards, thus losing precious institutional memory and trained resources. There is also a risk that the rural communities, where FSAs have the greatest role to play, will have too few numerate/business-minded members capable of serving on the Boards. Finally, in most FSAs there remains a lack of understanding of the importance of staggered rotation of Board members to retain and transmit institutional memory and trained capacity: this should be addressed.

5.3.6 The Board's Relationship with the General Meeting

Members are fully aware of their rights as shareholders. They are aware they have the authority to change management, all the committees and even establish interest rates. These rights were reportedly

[8] One Board member in Kisseka noted that Board members start by formulating a five year plan and have not time to implement it before they are barred from standing for election again. On the other hand, as the Chairman at Kingo demonstrates, it is important to rotate Board members to ensure that particularly erudite and dominant individuals do not "capture" the organisation.

exercised during the last Annual General Meeting in all the FSAs. There were reports among some clients in Bukunda FSA that the Annual General Meeting was manipulated by the chairman who did not give a fair opportunity to those with dissenting views to express them. Similar concerns have been raised about the General Meetings at Kingo**. It may be that the PMU or apex organisation should take a more proactive – though perhaps not chairing - role in the General Meetings.**

In several FSAs the Boards underestimate the importance of involving the General Meetings in key decisions. In one FSA (Bukunda) the Board had decided to invest Ush. 1.9 million in an (untitled) plot of land without reference to the General Meeting[9]. In another (Lukaya), the Board had decided to lower interest rates from 12% to 10%, despite a serious shortage of capital in the FSA and many members applying for loans that were being turned down for want of cash to meet the demand. Closer inspection of the Lukaya loan ledger cards suggested that many of the members who were receiving loans were rolling them over (i.e. receiving another, often larger loan the same day they made the last and often disproportionately large repayment of the previous one)[10]. In the case of Lukaya there was a suspicion that the Board were taking this decision in their own interests rather than that of the FSA (see below). Similarly, in Kingo, the Chairman and other Board members are aggressively pushing for a reduction in interest rates – not least of all since they are regular (if not high quality – many are in arrears) borrowers**. It is essential that all members be made aware of the implications of reducing the interest rates charged on loans** (see Appendix 6 for an illustrative calculation) and the importance of using the interest rate to balance the supply of and demand for capital funds within the FSA. The PMU could also play an important role in analysing the real costs of borrowing from the growing competition (FINCA, UWFT, Med-Net etc.) which is often cited by those who wish to lower interest rates.

5.3.7 Board and Staff Borrowing

In many FSAs all Board members and both staff members were borrowing from the FSA and had outstanding loans. In one (Kibinge), the influential Chairman had easily the largest loans, the two most recent being Ush. 2 million and Ush. 3 million, the latter of which appears to have exceeded the maximum of 15% of loanable funds stipulated in the Memorandum and Articles of Association. These situations could lead to profound conflicts of interest when setting loan interest rates as the situation in Lukaya illustrates. In several FSAs (particularly Bukunda and Kingo) Board members and/or staff had arrears/delinquent loans and thus were experiencing difficulties with (or perhaps not concentrating sufficiently on) collecting overdue loan payments. Not surprisingly, Bukunda and Kingo have the worst arrears/delinquency rates of all the FSAs.

The FSAs should give serious consideration to insisting that:

1) staff cannot borrow from the institution (with the exception of taking an advance against salary subject to a maximum of [for example] the average of their previous three months' salary payments),
2) less than 50% of Board/Audit Committee members can borrow from the FSA at any one time,
3) Board/Audit Committee members with loans in arrears of more than 1 month should automatically be disqualified from holding office and ineligible to stand for re-election for another one year after the loan is fully repaid,
4) The names of all those with delinquent loans are posted on the FSA notice board.

These provisions are likely to increase the commitment of staff and Board members to collect loans and reduce the risk of "capture" of capital by the Board. They are also likely to reduce the incentives to lower the interest rates below market rates. However, they may also make it even more difficult for the FSA to recruit appropriately qualified Board/Audit Committee members.

5.3.8 Audit Committee

Most Audit Committees seemed to be meeting regularly and to have a reasonable understanding of their function. In most FSAs there was evidence that the Audit Committees had indeed been working. Despite this, **there is a clear and pressing need for additional training and perhaps some simple checklists**

[9] The purchase looks gratuitous since there is not formal title to the land and the FSA's office is being rented for only Ush. 20,000 a month.
[10] See Appendix 5 for a random selection of active loan accounts from Lukaya.

to guide the Audit Committees in their work. The close working relationship between Board, Audit Committee and Management makes the laudable idea of having the Audit Committee report independently to the General Meetings hard to implement effectively. Indeed, several Audit Committee members noted that they presented their report after clearing it with the Board.

5.3.9 General Meeting

The attendance at the General Meetings seems to have been remarkably high – shareholders remain genuinely interested in their FSAs. Kibinge has a clever system of "Zonal Representatives" (elected from each village) charged with mobilising members to attend General Meetings[11], while others use letters and microphones mounted on boda-boda bicycles. Given the expense of publicising and holding General Meetings they seem to be held less often than quarterly as prescribed by the FSA system. Six monthly General Meetings seem to be typical and this is probably adequate. However, Kingo and Bukunda have a problem in this respect – no General Meeting has been held for 16 months and no systematic attempts have been made to communicate with the members. In most FSAs, all important decisions are made by the General Meetings including setting interest rates, dividend distribution, the creation of loan insurance fund and share protection funds and so on.

The information presented at the General Meetings seems to be adequate – although in some cases shareholders have actually demanded additional details. In order to maintain transparency, a useful substitute for General Meetings that the FSAs could consider is the posting of simple monthly financial statements and graphs[12] (and possibly Audit Committee narrative thereon) on the FSA office notice board. This would necessitate a brief training for members on how to interpret these financial statements but this would be a worthwhile investment.

5.3.10 Influence of Project Management Unit

Although there is a substantial improvement in the understanding that the FSAs are owned by their members[13], the Project Management Unit (PMU) is still seen as the source of most (if not all) technical knowledge. The influence of the PMU can be seen in the almost 100% adherence to the standardised FSA model; the creation of the share protection fund in every FSA last year; the suspension of issuing loans in Bukunda (even though the Board do not believe that this is a useful policy) and so on[14]. The PMU is seen as an invaluable source of supervision (a function that is absolutely essential) and assistance with some of the more complex functions (preparing the business plan etc.). DFID should note this in discussions about future support.

Occasionally the PMU has raised expectations unnecessarily – particularly with regards to the level of capital/transport support likely to be provided by DFID (although this may have been misinterpretation by the FSAs). Irrespective of how this has occurred, the PMU must transmit appropriate and accurate messages about DFID's intentions. Other examples include the support for the first Manager of the Kingo FSA by PMU in the face of growing discontent from both the Board and the community (although much of this discontent may well have been fermented by the Chairman).

This is the community development specialist's dilemma: how to ensure maximum participation from the community that owns the organisation while ensuring that they do not make decisions that may destroy it. The result inevitably is 'guided participation'. This compromise is a necessity for the effective development of the FSAs – supervision with "teeth" is essential.

5.4 Management

5.4.1 Management Team

All FSA management teams consisted of a Manager and a Cashier.

[11] These representatives might also be used to chase recalcitrant loanees.
[12] Membership growth and # of shares growth; Total loan portfolio outstanding, arrears (1 and 2 months) and delinquent; Income and Expenditure etc.
[13] By comparison to the results reported by Research International in early 1999.
[14] Extract from Kingo 1998 AGM Minutes: "PMU said that their role was to put right the Board where it goes wrong".

5.4.2 Training

All FSA managements have had training only from the PMU. This has been occasional because of the irregular absence of overseas TA and the short amount of time the PMU can spend on training. All managements saw the need for additional external training: at least two (including Kisseka) are almost entirely self-taught. All demonstrated methodical recording (albeit with a number of inaccuracies noted by the PMU auditor) but none (except perhaps Kibinge) had developmental skills to help grow the organisation or to challenge Boards on lending and repayment policies. Kibinge noted that a bye-law was needed to allow re-election of the management team, given the paucity of accounting skills amongst the members.

5.4.3 Pay

All managements are paid by performance of monthly income. Most are assisted by Board members in collecting loans and following up on late-payers which has a direct impact on their remuneration. Kibinge Board does not assist in this way.

5.4.4 Relationship with Boards

Mirroring the Governance issues raised in 5.3.2 above, the closeness of the working relationship effectively precludes any real independence of Management from Board. The overwhelming view was that everything had to be passed before and approved by the Board before any reports could go to shareholders. No management team appeared even to foresee any reason (problem) why, for example, they might need an external overseer such as the PMU or AFSA. Only Kibinge noted that the audit committee could call an AGM. The Business Plan for Kingo stated that the Manager had power to veto all loans. The Chairman and Board were unaware of this.

5.4.5 Relationships between Manager and Cashier

It was notable that in almost all the FSAs interviewed, the Manager was by far the dominant personality. To effect independence of thought and confidence of action, the PMU should give consideration to specific Cashier training in order to strengthen the sense of identity and role importance of the Cashiers.

5.4.6 Supervision.

All management teams saw the need for external supervision. This was perceived much more in the light of correcting mistakes rather than righting any malpractice. None had given any consideration as to how AFSA would be funded or what its full remit would be.

5.4.7 Role of the PMU

The PMU's role was perceived to be of real importance, performing its training, auditing and advisory role. Reliance on the PMU was high and showed no sign of reduction over the life time of the project. Kibinge and Butende noted that their FSAs could continue alone, but they would welcome an AFSA. The ability to operate alone over the medium term and beyond is questionable for any of the FSAs.

5.4.8 Relationships with link banks.

In general, FSAs had little or no effective relationship with their respective banks. As can be understood, there was considerable scepticism shown by a number of management teams about the formal banking sector. Several had lost money and had suffered a drop-off in new shareholders when the commercial banks were closed down.

5.5 Membership

5.5.1 Those Who Join

In the wealth ranking exercises used to explore these issues, the clients were typically subdivided into 4 categories – rich, upper middle, lower middle, poor. Most members described themselves as upper and lower middle, and believed most members are in this category[15]. The Boards and Audit Committees are usually predominantly upper middle. The majority of members of the FSA are in this category because many require business loans, some are looking for a return on their shares and almost all are unable/cannot afford the transport to transact in Masaka banks and need somewhere to keep their money safely.

The upper middle members have the largest fraction of shareholding in order to expand their businesses and are looking for working capital to do that. They buy more shares to get bigger loans. The lower middle is interested in a safe place to keep money as savings. They will not buy shares because they are too illiquid to be used in case of emergencies

Within the membership, the upper middle members seem to secure the majority of loans since they have the business opportunities to invest. Lower middle members usually borrow only for school fees and farming activities. Conversely, the upper middle members do not save much because they need the money for investment as they strive to become rich. The upper middle believe savings are "stupid money" because it could be used to produce more money. The upper middle store money after harvest but only for a short time – about a month. The lower middle save a lot because, when selling an asset such as a goat, the surplus money needs to be stored safely. The rich do not save in an FSA: they only require safekeeping for money overnight while in transit to Masaka town.

An examination of gender within the FSAs suggests that 60-75% of members are men and the majority of loans are made to men. Clients explained this in terms of the fact that the household budgets are run by men.

There was a remarkable level of satisfaction with the FSA and its services amongst the members, the only real area of dissatisfaction/contention being the loan interest rate.

5.5.2 Those Who Do Not Join

There are few rich FSA members because they despise it and believe that it may be closed any time. In addition, they can afford to take their money to Masaka and have alternative investment options. Finally, the rich are not shareholders because the amounts that they want to borrow are too large for the FSA to provide.

The poor and destitute rarely join FSAs because they fear both taking loans because of debt servicing pressure and the potential consequences in case of failure, and loss of property in case of failure to repay and being summoned to court. Furthermore, the price per share is so high (as high as Ush. 8,000) that it excludes the poorest who cannot afford such an amount when living day by day. Related to the above is that loans are tied to shares and so the poor cannot access loans which they might need because they have no (or too few) shares. Some people who can afford to buy shares stay out for fear of failing to get a guarantor when they need to get a loan - these are "the people of bad character".

Some people fear membership and accessing loans because of concerns of being unable to service them and stress this would bring on their lives. Many non-members cited the high interest rates on loans as a reason not to join, and several of these noted these rates were being charged on "our own money". Others were "watching and waiting" to see how the FSAs developed.

Other reasons for not joining were as follows:

- I think the FSA has not done a good job mobilising us through seminars and training.
- I did not join because I had rumours that BoU will soon close the bank.
- I feared because I cannot cash the shares when I need cash.

[15] A finding that confirms the results of Research International's review in 1999.

- The dividends are very low. It is better to buy things like chickens because they yield a better return than FSA shares.
- The banks belongs to the "mzungu". He usurped the power from the "owners" and even declared that the chairperson cannot be changed. I am afraid I do not know what is going to happen next. How can someone who did not invest money take over the FSA?
- Some people fear because of the experience of the past with Cooperative Union in which people lost money to political appointees after the government took over 60% of the ownership from the people.

5.6 Financial Services

5.6.1 Loans - Instalments

The loans (with monthly repayment instalments) are considered inappropriate for farmers who find monthly payments difficult. Most would prefer balloon payments, which correspond to the harvesting cycle. However, some members were afraid of balloon payment, fearing that they will fail to come up with the lump sum in case of crop failure. These members preferred smaller monthly payments. International experience suggests that these latter members are right and the FSAs should not move to balloon-based repayments**. Board members in particular should set a good example by regular repayment instalments.**

Clearly, monthly payments were feasible for traders (indeed, it is surprising that more did not opt for the weekly repayment instalment system). Traders, particularly in Lukaya, complained of a drain in working capital if they were to repay all their loans without refinancing. This has lead to "rolling over" last repayments (see Appendix 5). Unfortunately, in Lukaya at least, this practice has been combined with that of making only small nominal repayment instalments for the first two months and then "rolling over" a very large proportion of the loan into the next one. This practice (particularly when combined with increasingly larger loans each cycle) results in **increased levels of indebtedness of members and exposure for the FSA.**

The varying perceptions and needs outlined above (as well as a relaxed attitude towards loan repayment) are reflected in the repayment patterns in the loan ledgers, which show a very varied pattern of repayment. It is essential that FSAs restore the discipline of regular repayments.

5.6.2 Loans - Interest

Interest rates are perceived to be too high and capable of crippling the borrower. This is made worse by large fines and penalties. As with all borrowers, loanees prefer lower interest rates. Whether reductions in interest rates would make a substantial difference to the repayment sums is uncertain (see analysis in Appendix 6). If the instalments really are too large to manage from household budgets, extending loan durations and thus reducing monthly instalments is probably the best option (see below). It should be noted that many defaulters clearly had the capacity to repay but were choosing not to. The interest rate charged is unlikely to be the determining factor.

5.6.3 Loans - Duration

In all FSAs apart from Kibinge the loan term of four months was deemed too short and is currently being extended to an optional six month term. While this may better suit farmers and reduce instalment size, lengthening loan duration presents the additional problem of reducing the capital available to the members. In many of the FSAs, despite high interest rates, there is a chronic shortage of loan capital (resulting in Kingo, Kibinge and others dipping into the savings deposited with them in order to meet demand for loans). Extending the loan duration would mean that this capital was out with certain members for a longer period of time, thus further reducing the availability of this money. Of course, improving the regularity and discipline of repayment instalments would increase the availability of capital to lend.

5.6.4 Savings

Members can save up to ten times their share capital at the FSA but, thereafter, any balance above this amount is charged at the rate of 3% of the amount deposited. This charge is designed to cover the cost of making the transaction and of taking the savings deposited (in excess of the insured maximum cash-on site at the FSA – currently at Ush. 2 million) to the "link bank" in Masaka. This charge seems excessive since (given the limited level of transactions per day – on average around 20) the only marginal cost of offering this service is the cost of taking the money to Masaka – approximately Ush. 2,000 for the round trip. The other justification for the charge may be to reduce the number of high value, over-night safe-keeping transactions by traders placing large amounts in the FSA in the afternoon and withdrawing them the following morning, thus creating many liquidity management headaches for the FSAs.

Savings services are generally under used. The link to share holding and the 3% charge is probably significantly reducing the level of savings mobilised from members and dissuading many potential members from joining. This is an area of important potential (both for the FSAs and for their members/potential members) that requires more careful analysis and product development. The PMU should request assistance to look at options for improving savings services by:

- careful research into member and potential members' needs;
- de-linking savings balances from the value of share owned;
- reducing the 3% charge;
- employing other systems/charges/regulations to manage highly volatile high value accounts;
- negotiating with the link bank for improve interest on the FSAs' accounts;
- making provision for the FSAs with high quality loan portfolios to on-lend a limited percentage of savings mobilised (subject to the legislation) etc.

This will require a careful process of product development, but could result in significant increases in membership, savings mobilisation and demand for loans.

Finally it is important to note that (as of December 31, 1999 – see Appendix 7) all FSAs with the exceptions of Kingo and Butenga have cash balances in excess of the Ush. 2 million maximum stipulated and insured. FSAs should adhere to policy or examine the need for amending the policy and increasing the level of insurance cover.

5.7 Accounting Systems

Overall, the FSAs' accounting systems, which combine a General Ledger and Cash book with "Personal Ledger Cards" that record individual member's shares, savings and loan activities, is notable for its simplicity and effectiveness. It is a clearly appropriate system for such small CBOs. The requirement for weekly Audit Committee reviews and a trial balance every 2-3 days, if carried out effectively, should be sufficient to ensure the prompt and accurate recording of transactions.

The importance of an involved and committed Audit Committee is noted above, and where this has not been the case (e.g. Bukunda) the accounts can soon fall into a state of imbalance and inaccuracy. Bukunda was Ush. 435,500 (cash) short, and no explanation was forthcoming for this. This requires prompt and thorough investigation by the PMU.

Probably as a result of the limited staffing of the FSAs, in some cases the Managers authorise payments to themselves. These expenses should be authorised by the Board or Audit Committee.

5.8 Loan Portfolio Management

Loans outstanding have grown quickly as the FSAs have developed and members have bought more shares. The quality of loan portfolios varies greatly in each of the FSAs, but there is an overall problem with arrears and a growing hard core of delinquency.

	Sept 1998	**% of Principle/ Interest**	**Dec 1998**	**% of Principle/ Interest**	**Dec 1999**	**% of Principle/ Interest**
Principal/Interest outstanding	34,379,940	100%	45,393,856	100%	126,012,789	100%
Total Balance loans in arrears	4,205,080	12%	11,833,996	26%	28,508,480	23%
Loans in arrears up to 1 month.	2,731,120	8%	5,552,655	12%	10,202,685	8%
Loans in arrears up to 2 months	1,245,610	4%	5,144,126	11%	7,802,310	6%

Delinquent loans	228,350	1%	1,137,215	3%	10,503,485	8%

However, these figures vary substantially between the FSAs (as of December 1999 Kibinge has an arrears rate of 27% and a delinquency rate (> 3 months over due) of 4%, Bukunda has an arrears rate of 53% and a delinquency rate of 39%). Furthermore almost all FSAs have a history of distinctly variable arrears and delinquency rates, reflecting the problems that almost all CBOs have with instilling the discipline of regular repayment within the membership.

Nonetheless, in most FSAs (the clear exceptions being Bukunda and possibly Kingo where collection efforts seem to be selective) there are serious efforts underway to collect loans, including the initiation of court cases. Several FSAs have loan tracking calendars on the walls and are clearly following their loan portfolio.

The individual FSAs do not have a copy of the lending guidelines, which are said to be available at the PMU. It is essential that the Boards and Management of the FSA s are fully conversant with these important guidelines and therefore copies should be sent to each FSA.

As noted above in many instances, the staff are borrowing from the FSA (and often then taking advances against salary on top of these loans). This is clearly undesirable both in terms of over-indebtedness of these individuals and in terms of governance. The prevalence of Board members taking loans (and in many cases failing to repay on time/in a disciplined manner) and Lukaya's problem with "rolling over" loans (which may well mask a more profound problem within its portfolio) is noted above under Governance.

In one FSA (Kibinge), members are only permitted to borrow three times their share capital which has two possibe beneficial effects.

1) It increases the FSA's loan security level
2) It increases the amount of capital available to the FSA. On the other hand, the same FSA was not using a graduated system requiring members to pay off small loans before progressing to take larger ones. The size of loan was left entirely to the Credit Committee, which risks favouritism. Kibinge may do well to grant larger loans on the basis of credit history. Indeed, as part of the effort to encourage prompt and disciplined repayment, all FSAs should pay increased attention to credit history in deciding loan size.

5.9 Growth

Despite their short-comings and the BoU's advertisements against such "village banks", the FSAs are still growing by almost all measures. The most obvious is the new shareholders buying stakes in the FSAs and the on-going purchase of shares.

	Sept 1998	Dec 1998	Dec 1999
Total Current Shareholders	1,262	1,466	2,091
Total Shares this Month	4,566	5,973	11,603
New Shareholders this Month	108	87	55
New Shares Bought this Month	938	499	513

Dis-aggregating this table reveals that this growth varies substantially between FSAs according to the policy of the Board (Kingo: growth above all – Kibinge: limited growth a focus on "quality members") and according to FSA's history. However, note too that many shares are purchased to allow access to larger loans rather than as investments. See above for loan portfolio growth.

Despite the lack of emphasis on and interest in savings mobilisation (as above), there has been a steady growth in net savings and high level of deposit and withdrawal activities, suggesting the service is used primarily for safe-keeping savings for short time periods. The growth in these accounts in the face of relatively adverse terms and conditions (through the link to equity and the 3% fee) also suggests that there is large latent demand for savings products at the FSAs.

Savings	**Sept 1998**	**Dec 1998**	**Dec 1999**
Balance last month	9,950,400	7,318,386	17,746,501
Deposit this month	14,224,950	9,668,700	23,855,735
Withdrawals this month	(13,725,050)	(8,339,450)	(20,417,400)
Balance this month.	10,450,300	8,425,886	21,184,836

Above all, despite the problems with their loan portfolios, the FSAs remain profitable: unsurprising, given their high monthly interest rates and basis for calculating expenses. However, if appropriate provisioning was made for the potential bad debts resulting from loans in arrears or delinquent, this profit would disappear. The Loan Insurance Funds in each FSA (giving a combined total of less than Ush. 700,000) remain too small to provide any significant cover against the potential loan losses, and it is the shares/savings balances of loanees and (ideally) their co-guarantors that should provide the security for the portfolio.

	Sept 1998	**Dec 1998**	**Dec 1999**
Gross Income	3,293,100	4,128,625	7,100,163
Salaries	799,340	846,610	1,065,950
BOD allowances	156,450	154,870	520,150
Operating expenses	718,550	629,850	657,400
Net Income	1,618,760	2,497,295	4,856,663

(See Appendix 8 for the detailed accounts and portfolio status of each of the FSAs and some graphs of these, and Appendix 9 for more detailed comments on Lukaya, Kibinge and Bukunda FSAs.)

APPENDIX 1

BRITISH PARTNERSHIP FOR ENTERPRISE DEVELOPMENT

END OF PILOT PHASE REVIEW OF THE FSA PROJECT

1. Introduction

FSA is a two year project funded by DFID, which provides support to the seven established FSAs in rural parts of Uganda based in Masaka district. The project has been operational since October 1998. It aims to assist FSAs with managerial and technical assistance through provision of FSA International Ltd management services in the PMU in Masaka.

The project was originally managed by Pride Africa with TA by FSA Intl., but both were transferred to FSA International on 15th July 1999.

FSA International has therefore been managing the project for the last eight months. It should be noted, however, that contractual difficulties have prevented the company from been present in Uganda at the times they would have wished. The original project end - October 1999 - was extended to the end of December 2000 as a result.

2. FSAs

FSAs are NGO MFIs which are owned and governed by the shareholders who live in the local communities. They elect a Board from the shareholder population. Full ownership and governance are therefore in the hands of the users of each FSA. FSAs also offer a deposit service which can be accessed five days a week, lending on their equity. The Bank of Uganda granted an exemption from existing banking regulations to allow this pilot project to go ahead.

FSA Intl. has been undertaking training with FSAs (as well as, since July 1999, managing the project) to assist them to manage their own businesses. A key set of criteria was agreed to which FSAs must conform and report on. If unable to do so, discussions would be required as to the best way forward for them, which would include FSA Intl's input. These criteria included:

- Management capacity, particularly the ability of personnel to train new recruits to the FSA and to manage it on an ongoing basis:
- Governance capacity, especially the workings of the Boards, election processes and so on;
- The growth ability and rate of each FSA;
- FSAs' financial viability in terms of income asset ratio and capital adequacy; FSAs' operational and financial controls, in particular repayment rates and bad debt levels, and the efficiency of internal audits.

3. Purpose of this Review.

The key purpose of this mid term Review, undertaken at the end of the FSA Intl contract, is to assess the progress of the FSAs towards managerial and financial sustainability. If satisfactory, DFID will continue to fund FSA Intl.'s managerial inputs for a further year. Most important is the issue of future ownership and governance of the FSAs.

Following the Review, the Review team will assess the current state of the FSAs and will make recommendations as to the best way forward. FSAs will be informed of the decisions taken and, on the basis of these, will need to discuss how their own individual operation should go forward.

4. Terms of Reference

The Review Team will, therefore:

Examine the records of all seven FSAs to assess:
- levels of financial sustainability
- financial management record keeping
- minutes and processes of elected Boards and shareholder meetings
- progress against developed business plans.

The Team will also visit the PMU to
examine staffing capacity, IT and records management
interview the FSA Intl field manager.

In addition, the Team will visit all seven FSAs in order to make a fuller asessment of their current status. The Team will:
- interview key Board members (names and numbers to be developed in the workplan)
- interview selected user-shareholders to assess FSA activities from the client side
- examine each FSA's office management and staffing capacity.

The Team will discuss with Centenary Bank and others possible future partners the options for linking the FSAs into the formal banking system.

The Team will also confirm with the Bank of Uganda the likelihood of a continuing waiver to allow FSAs to continue to develop.

5. Outputs

A report, not more than 15 pages long plus annexes, which covers qualitative and quantitative issues arising from the above examinations.
A clear recommendation as to whether DFID should continue funding FSA Intl's input for a further year or whether to recommend closure of the FSAs.

6. Timing/Resources

The Review will take place between March 28 and April 6, 2000, with three days being spent in Masaka with the FSAs, and the remaining time for assessing the records of all seven FSAs.

DFID will provide one staff member and three existing sub-contractors for this Review.

BRITISH PARTNERSHIP FOR ENTERPRISE DEVELOPMENT

END OF PILOT PHASE REVIEW OF THE FSA PROJECT

Guideline Questions for Use in the Field

Four key areas of operations will be reviewed and evaluated, these will include.

- *Management capacity, particularly the ability of personnel to train new recruits to the FSA and to manage it on an ongoing basis*

Draft report-writing responsibility: AW

- Does the Board participate in setting performance targets and monitoring progress toward them? (AW)
- Are the roles and responsibilities of the Board and management clearly defined so as to prevent inappropriate intrusion by the board into operational details? (AW)
- Are staff recruited and trained to ensure the appropriate skills? (For example, do credit staff have good communication skills, a basic knowledge of credit, and good business sense?) (AW)
- How does the FSA manage staff turnover? (AW)
- Are incentive systems designed to hold staff accountable and to reward them for good performance? (AW)
- As greater operational scale is reached, is compensation becoming more competitive with market rates? (AW)
- Is staff training a serious priority for the institution? What percentage of the total budget does staff training g represent? (AW)
- Are performance evaluations of staff and board based on mutually developed and agreed upon objectives? (AW)
- Is there evidence of regular and effective internal audit activity? (AW)
- What role has the Project Management Unit played? (AW)
- Are FSAs able to manage their own affairs without the support of the PMU? If not what are the key areas requiring on-going support? (AW)
- What options have the FSAs considered for managing the usual apex functions: supervision, intermediation, training etc. (AW)
- How has the FSA progressed against its business plan? (AW/HS)
- How has the “link bank” concept operated? What was the consequence (if any) of the closure of the Co-operative and Greenland Banks? (AW)

- *Governance capacity, especially the workings of the Boards, election processes and so on*

Draft report-writing responsibility: GW/LM

- Does the Board provide vision and policy leadership, if so how? (GW)
- Does the Board ensure that the institution’s financial resources are prudently managed by monitoring investment and operating performance? (GW)
- Does the Board provide ongoing guidance and advice to the manager? (GW)
- Do Board members provide expertise in such key areas as banking, law, and accounting? (GW)
- What are the provisions for rotation of the Board ? Are these effective? (GW)
- How often are Members’ General Meetings held? How well are they attended? (GW)
- Are appropriate reports provided to the different levels of users (Board, management, and members**)** within the organization? (GW)
- What efforts are made by the FSA to engage all its members in the GM process? (GW/LM)
- Have local elites/community leaders captured the FSA? (LM)
- Are members aware of the value of their shares? Are members aware of their rights as shareholders (including access to financial services, to sell shares, attend and vote in General Meetings etc.)? (LM)
- What efforts are made by the FSAs to ensure clear and transparent:-
    1. Financial results
    2. Decision making processes for its members (GW/LM)

- *The growth and susainability and rate of each FSA*

Draft report-writing responsibility: HS/GW

- ➢ Is there a dear pattern of significant growth and increasing profitability? (HS)
- ➢ Is reliable information available for assessing the institution's current financial position, including trends in its performance indicators? (HS)
- ➢ Are budgets and cash flow projections prepared and reviewed regularly?(HS)
- ➢ Does the institution conduct periodic analysis comparing projected with actual performance (variance analysis)? (HS).
- ➢ Do financial statements present an accurate picture of the institution? (For example, are loan loss reserves sufficient to cover projected defaults, are assets valued conservatively, and are non-performing loans regularly written off). (HS).
- ➢ Do key staffs have good financial management skills? (HS)
- ➢ Assess financial sustainability on the basis of the PEARLS indicators/benchmarks (HS)

- *FSAs' financial viability in terms of income asset ratio and capital adequacy; FSAs' operational and financial controls, in particular repayment rates and bad debt levels, and the efficiency of internal audits*

Draft report-writing responsibility: HS/LM

- ➢ Assess financial sustainability on the basis of the PEARLS indicators/benchmarks (see Appendix 1) (HS)
- ➢ Are the credit and savings products appropriate for the market segments that the institution seeks to reach? (LM)
- ➢ Within a village who joins and who does not join FSAs? (quick wealth ranking) (LM)
- ➢ What are the barriers to joining an FSA?(LM)
- ➢ Within the FSA who access loans and who does not? (quick wealth ranking) (LM)
- ➢ Is there a high rate of client satisfaction and retention?(LM)
- ➢ Who are the most common defaulter? And what is the attitude of members towards loan default? (LM)
- ➢ Are the members aware of any Board members with loans in arrears? (LM)
- ➢ Are there any Board members with loans in arrears? (HS)
- ➢ How good is portfolio quality, as measured by the default rate and portfolio at risk? (HS)
- ➢ Are clear and appropriate credit policies and procedures in place?(HS)
- ➢ Does the institution monitor loan officer productivity (such as the number of active clients per loan officer)?(HS)
- ➢ Are the accounting systems clear, documented and effective? (HS)
- ➢ Does the management information system produce accurate, timely, and comprehensive reports for accounting and loan tracking? (HS)
- ➢ Is there a formal, comprehensive system of internal controls in place to prevent corruption and the misuse of funds? (HS)
- ➢ Is there evidence of regular and effective internal audit activity? (AW)
- ➢ Is a formal audit performed by a reputable accounting firm each fiscal year? (AW)

APPENDIX 2

Overview and Rationale
Ownership and Governance Issues Facing Traditional Credit Unions
Adapted from
Balkenhol, Bernd, "Introduction: Background And Issues" in **Balkenhol,** Bernd (ed.), "Credit Unions And The Poverty Challenge", *International Labour Organisation*, Geneva, 1999, and
Branch, Brian and Christopher Baker, "Credit Unions: Overcoming Governance Problems – What does It Take?", *Inter-American Development Bank*, 1998.

Why the Interest in Credit Unions?
Credit unions would seem to be an appropriate organisational form for providing financial services, since they:-

- have close links to the local community or target group;
- are not profit – maximizers (although should clearly be aiming at sustainability);
- may be one of the few ways of extending financial services to remote rural areas on a sustainable basis; and
- have performed this function successfully in many countries which are today industrialised nations.

Three Significant Principles:
There are three principles of co-operative organisation that are of particular significance to their performance:

Identity principle (or solidarity principle)
The *identity principle* (or solidarity principle) refers to the fact that the members of the co-operative are clients and owners. This self-contained structure is a prerequisite for:

- the application of a simple, cheap and effective credit technology, namely peer monitoring; and
- conforming to regulatory requirements in many countries.

Thus the difference between credit unions and most other financial institutions is that their owners are their clients. This has two implications:

(1) The governance system of credit unions must respond to two sets of owners/clients: the net borrowers and the net savers. Credit unions not only face the separation of ownership and decision making but also contradictions in the interests or objectives of the two subsets of owners.
(2) For most financial institutions, the owners, represented at the Board of Directors are primarily interested in the profitability of the institution. In credit unions dominated by net borrowers, many of the owners and Board members are not primarily interested in the financial viability and profitability of the credit union. The combination of borrower dominated credit unions operating in an environment that lacks clear governance rules, provides temptation for improper manipulation of credit granting by volunteer Directors.

Nominal capital principle (redeemable equity capital)
The *nominal capital principle* (redeemable equity capital) means that the equity capital of the co-operative members is really only shareholders' loan as it can, in principle, be reclaimed at any time and is repayable at nominal value. Thus in practice, the distinction between shareholdings and deposits is frequently blurred. This situation:

- obliges the credit union to maintain a comparatively high volume of liquid reserves;
- to build up internal reserves (retained earnings); and
- provides little incentive to buy more share capital than is required to leverage loans since profits from the credit union do not enhance the value of the shares, which can only be redeemed at nominal value.

Furthermore, many credit unions were originally set up with intention to provide access to cheap credit, which meant that they also have to pay lower interest rates on deposits and thus attract fewer deposits.

Equality principle (“one person-one vote”)

The *equality principle* (“one person-one vote”), which implies that voting rights are not proportionate to the volume of capital invested, undermines control rights that normally go hand in hand with equity capital. As the number of members, i.e. the size of credit union, increases, this disincentive is magnified, which in effect rules out the supervisory function of relatively large, active investors (shareholders) typical of limited liability companies. The “one member- one vote” principle has two results:

- the management of a “co-operative” has a large degree of autonomy from owners, i.e. the ordinary members; and
- management is therefore in a stronger position to pursue its own interests or what it considers to be interest of credit union, as opposed to the interest of its members.

And the Resulting Governance Problems:

Thus from the three principles outlined above two major problems in governance arise.

Principal-Agent problem

One is the *principal-agent problem*; the elected Directors and contracted management’s’ interest may diverge from the interest of the members. Individual owners do not necessarily posses the required managerial skills and technical knowledge. This may require that one or a small number of professionals make the critical management decisions.

The principal-agent problem arises when those who make decisions (the agents) are not the owners who bear the consequences of those decisions (the principals). The decision-makers’ (agents’) interests may differ from those of the owners (principals). Therefore the decision-makers may take actions in their own interests that differ from the interests of the owners.

Where there are a large number of owners, such as in a credit union, it is costly for all members to frequently monitor the decision-makers. Most of the individual owners do not have the qualifications or information upon which to oversee managerial actions. It is efficient for them to delegate decision oversight to protect their interests – therefore the owners vote for representatives to serve on the Board of Directors.

In theory, the principal agent problem is controlled by checks and balances of decision-making and decision-monitoring. However, in practice, governance problems occur when the rules of decision-making and decision-monitoring are not clearly specified and carried out. Where problems arise in credit unions, they are often due to:

(1) *One-person-one vote*

Board members of companies limited by shares or banks often assume their position in governance because they have large shares of the ownership in the institutions. The credit union Board member has less at risk in absolute terms than a comparable bank or limited company Director if he or she makes a mistake.

Credit union Directors are elected from the general membership on a one-person-one vote basis. The democratic one-person-one-vote governance process of credit unions has evolved and been maintained over the years to make the credit unions responsive to all of their owners. When Directors become unresponsive, members elect new Directors at the Annual General Meeting of membership. Yet, Directors do not necessarily represent those with the largest portion of the savings or shares of the credit union. A small group, (the Directors), which may have little at risk make decisions that affect the larger group of membership.

(2) Unqualified personnel in decision oversight

The democratic election of Directors is a problem when the individuals elected fail to have the proper credentials and expertise to make sound judgements. The ability of Directors to fulfil their role as a monitor or control depends upon their business and management skills.

As credit unions become larger, they engage in more sophisticated operations and officials enjoy less personal familiarity with loan applicants so volunteer credit committee operations are less effective. As they become larger, credit unions generate sufficient income to hire professional staff and involve volunteers less in operational matters. Decision-making is carried out by professional staff with specialised expertise. Volunteer owner/representatives are called upon for decision-monitoring and oversight. Once the credit union achieves a scale that allows it to hire professional staff, it needs to separate decision-making and decision-monitoring functions clearly. It is inevitably the success and the sharpness with which this transition from heavy volunteer dependence to the separation of decision-making and decision-control, that affect the governance of the larger credit union (see (3) below).

(3) Lack of clear rules of decision-making v. decision-monitoring roles
Many co-operative laws and credit union bylaws do not make a clear distinction between Director oversight responsibilities and management operational responsibilities. Overlapping authorities for operational decisions and the lack of clear guidelines where one group's authority ends and another's begins can produce operational sluggishness. As a result, many decisions must be reviewed by all groups, and it becomes difficult to reach a consensus which pleases all parties.

(4) Paying management a competitive salary
Governance difficulties can compound problems of poor management, low wages and administrative inefficiencies. Administrative and management competence requires that staff be competitively remunerated. Many credit union members tend to have low to moderate levels of income. Salaries that are competitive with those paid by other financial institutions are often criticised by members who compare credit union staff salaries to their own. Directors may see credit union staff salaries in excess of their own earnings, particularly when the Directors are dominated by lower salary level professionals.

Experience has shown that credit unions can obtain higher profits by paying higher wages in order to attract, motivate and retain better-qualified personnel. With such management, credit unions can demonstrate better financial results, which then more than pay for the increased wage costs. Credit unions also benefit from incentives that partly tie managerial remuneration to the financial results.

(5) *Failure of Boards to exercise fiduciary responsibility*
Where credit union ownership is diffused among a large number of members, governance problems may take a form that is the opposite to that of excessive operational interference by Directors. For example, driven by the needs for economies of scale, some credit unions operate with more than 10,000 members. With ownership spread over such a large group, few individuals carry out the responsibilities of monitoring the performance of the credit union by attending the annual General Assembly or of monitoring their representatives elected to the Board of Directors.

With limited overview or attention from the membership, the Board and managers, as well as the Supervision Committee, may collude to protect one another's interests at the expense of the institution. Managers may arrange for high salaries for themselves and Directors may arrange for insider loans for themselves and their friends. The problem occurs where internal controls are weak or not enforced and bylaws or regulations provide weak control of insider dealing.

Solutions to the Principle-Agent Problem:
The resolution of these issues depends upon clear specification and enforcement of the institutional rules, which define the roles, and responsibilities of the actors involved in the governance of the credit union: decision-making and decision-monitoring.

Recommendations to overcome these problems:
1. Bylaws should establish criteria for who is qualified to assume a position as a Director.
2. The chartering bylaw requirements need to define the decision oversight role of the Directors.
3. Bylaws should set out the appropriate functions of the Supervisory/Audit Committee.
4. Credit decisions need to be made on technical risk analysis criteria by technical staff with appropriate preparation[16].

[16] The Credit Committee in many countries has evolved from an elected volunteer committee to a technical committee made up of credit union loan officers and employees with specialized skills. The manager approves small loans, and the technical committee approves larger loans within size parameters and policies approved by the Board of Directors. The Board of

5. The credit union bylaws need to establish clearly the fiscal responsibility of Directors serving on the Board and their responsibility for monitoring the decisions of the credit unions[17]. These should be amended over time as the size of the credit union increases.
6. Credit union bylaws need to establish controls on insider (Board and staff) loans and ethical codes of behaviour to avoid conflicts of interest.
7. Bylaws should provide for staggered rotation of Board members.
8. Consideration should be given to increasing the voting rights of members with many shares (subject to a maximum in order to avoid undue influence).
9. Check-lists can be developed for Board members to assist them in their monitoring duties.

Problem of Borrowers Dominating Boards
The second problem is the *tendency of borrowers to dominate the Boards* of credit unions.

Savings to get credit
Many credit unions were originally established with a mission, which was social or focused upon providing cheap credit to borrowers. In many traditional credit unions, interest rates and access to savings are not adequate for attracting popular savings. Members place money in these low-yield share/deposit accounts in credit unions not for savings purposes but for the purpose of providing collateral for their loans. People join such credit unions largely to get access to loans, rather than to deposit their savings. The majority of these members are net borrowers, those who are waiting their turn for loans or those who have invested their shares to receive a loan in the past and now hold dormant share accounts. Such traditional credit unions are forced to ration loans by queuing applicants for loans, disbursing only a portion of the loan requested and rationing loans to a low multiple of what a member has in shares.

Manipulating cheap credit
Governance problems become manifested in excessive and improper manipulation of the credit-granting procedures by volunteer Directors. Members may actively seek election to the Board of Directors or Credit Committee by promising loans to friends and supporters after the election. Candidates promise supporters that they will receive preferential treatment, side-stepping the credit rationing process for loans. They may also promise supporters that the credit union will be lenient with them in loan approval or collection. Once elected, the new Directors act to fulfil these promises and interfere in loan granting and collection.

Cheap credit and institutional viability
Net borrowers will demand low loan rates, low transaction costs and lax prudential discipline, while net savers will demand high deposit rates and strong prudential disciplines to protect their savings. Therefore, although the net savers have strong incentives to see the viability of the institution strengthened with profitability and solvency, the net borrowers' short term incentives favour conditions which adversely affect the financial viability of the credit union.

Solutions to the Problem of Borrowers Dominating Boards:
The resolution of these issues requires that balanced and updated services be provided which will tend to attract not only borrowers but also savers to credit unions. The presence of net savers on Boards will lead to a more effective pressure upon credit union management and Directors for the implementation of proper financial management and prudent governance that will protect the interests of savers and help ensure the long run sustainability of the credit union. IN order to increase the number of net savers on Boards and to address some of the problems arising from the manipulation of cheap credit, credit unions can place restrictions upon loans to those who serve on Boards.

The governance distortions caused by borrower domination can be brought into balance via service reorientation, including aggressive deposit mobilisation and limitation of external credit. Credit unions

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Directors then considers loans to credit union Directors and staff (if allowed) and loans that exceed the sizes which are approved by the technical credit committee or manager.

[17] The Board of Directors is held accountable to the General Assembly and membership for the results of the credit union. Removal of Board members should be specified in bylaws for failure to meet their responsibility, for mismanagement or for legal improprieties.

characterised by market-rate accessible savings deposits as the principal source of funds and by high levels of savings mobilisation tend to be more balanced and effective financial intermediaries. These credit unions attract net savers as well as net borrowers. The threat of withdrawal of deposits (as a result of lack of confidence in the management of the credit union) would eliminate the base of funds for the credit union. This in turn would force the Directorship and management to operate on sounder principles of adequate capital reserves, loan loss provisions, and liquidity reserves which protect the savings of the members.

Recommendations to overcome these problems:

1. Credit unions need to offer attractive services for both net savers and net borrowers in order to operate as a balanced financial intermediary.
2. Credit unions should set interest rates on their savings and loan products that balance supply and demand – this will generally mean higher interest rates on both loan and savings products.
3. External credit, particularly subsidised, should be avoided by credit unions and donors[18].
4. Instead credit unions should seek to make profits that should then be partially distributed by dividends and partially added to the equity, thus increasing the value of share capital – this will encourage entrepreneurial investment in the credit union and thus its equity base.
5. Limit the times of year when shares can be redeemed or encourage a secondary market for them within the community.
6. Restrict the provision of loans to staff and Board members.

[18] Experience has shown that external credit programs often weaken incentives to mobilize deposits and thus reinforce a borrower-dominated governance structure with poor prudential discipline and weak loan recovery.

APPENDIX 3
Key Differences Between Traditional SACCOs/CUs and FSAs

	SACCOs/Credit Unions	Financial Service Associations
Ownership Structure	Registered under the Co-operative Act.	Registered under the Companies Act as companies limited by shares.
Profit Orientation	Non-profit but aiming at sustainability.	Run explicitly as a profit-making business.
Share Sale/ Valuation	Shares can sometimes be redeemed, but only at their nominal value, and often only with (delayed) Board approval. Shareholders wishing to leave often simply net their shares off against their loans.	Shares can be sold at their market value (which in turn depends on the balance sheet of the FSA). Initially FSAs agree to buy back their shares from shareholders who wish to sell them during one specific window period (usually after the annual audit). However, overtime it is hoped/likely that a secondary market will be created.
Dividends	Generally low/nominal in nature – due to the non-profit orientation of most co-operatives.	Generally much higher than for co-operatives because of the business orientation of FSAs.
General Meetings	Typically only Annually and very occasionally Extraordinary General Meetings held.	Annual plus Quarterly General Meetings required to maximise the involvement of and information for the members.
Voting Rights	One person one vote.	Depends on number of shares held to a pre-set maximum (often 10 votes per person). This is designed to encourage more active governance/oversight from individuals with larger numbers of shares.
Board Rotation	Usually on a three year basis – Board members are elected to serve for three years at a time.	Directors are usually (re-) elected on an annual basis with maximum tenure of two years.
Board Remuneration	Directors usually serve on a voluntary basis.	Directors are often remunerated on the basis of profits made by the FSA. This is designed to ensure greater involvement and participation by Board members.
Management Reporting	Management reports to the Board.	Management reports to the Board but is primarily responsible to the General Meeting.
Management/ Staff Remuneration	Generally fixed salaries – sometimes even voluntary.	Generally directly related to the profitability of the FSA – thus providing important performance incentives.
Interest Rates on Savings and Credit	Generally low (if any) interest paid on savings and low interest on loans – resulting in members primarily saving to borrow at the low-interest rates. This also results in the co-operatives having to ration the (cheap) loans: either in amount or by making members take turns to access credit.	Generally low (if any) interest on savings and high interest on loans (ideally to balance the supply of and demand for loan capital through the interest rate). This interest rate structure is designed to encourage individuals to save through buying shares in the FSA. Shares will offer the investor a high rate of return and provide the FSA with a relatively stable source of capital.

APPENDIX 4

Subject: Regulator or Franchiser

Date: November 23,1998

As we know, The FSA model requires a clear settlement of the supervision issue and the sustainability of the model depends upon some form of internalising the supervision costs as initial costs are generally negligible and the unit FSA covers internal costs within 3 months after lending starts.

Following an intensive reflection on this issue, I believe that self-regulation is perhaps not the optimal solution. Apart from limited success through self-regulation and the problem of non-compliance by recalcitrant members, the incentives of the regulator in monitoring the FSAs and the incentives of the FSAs in complying is not clear. We need clear incentive and ownership arrangements to ensure that quality control is done for commercial rather than purely "regulatory " purposes. I have found the solution in the franchising model where a franchiser provides the package, training, and supervision for a fee and sometimes for equity position in the franchisee's business and the franchisee agrees to maintain standards and respect the brand name. In the case of the FSAs, the optimal solution of this problem is in the creation of a "franchisee-owned franchiser", or the AFSA. This is similar to the "third party arrangement" in the literature on MFI regulation and has some similarities to how BRI regulates the Unit Desas or how the federation of the municipal banks regulate the retail municipal banks (although in these cases the franchisees do not own the franchiser). The Superintendecy of the financial institutions would then only supervises one institution namely AFSA which would itself become an MFI. AFSA is therefore the FSA of the FSAs. Biff Steel in his recent visit to one FSA reminded me that the rural banks in Ghana are also following a similar route for creating an apex MFI.

AFSA would be a limited company owned by the FSAs. Its capital would be majority owned by the FSAs but public and private investors would be welcomed to buy shares. No single shareholder could have more than 10% of votes. The FSAs would swap 10% of their shares for shares in AFSA and would agree to pay 10% of their monthly income as fee in exchange for services from AFSA which would, *inter alia*, include regular training and supervision. AFSA would be to promote, train, and supervise the FSAs and eventually act as the wholesaler of funds and a clearing house. The FSA would be interested in the AFSA as a collective investment with a view of investing in all future FSAs as well as creating their own bank in the medium term. AFSA would supervise the FSAs because it is a part owner and it wants to maintain franchise standards.

The above concept has been preliminarily discussed and has received acceptance from two FSA AGMs.

In addition once AFSA is established, the present field supervisors should receive a mandate from AFSA as the franchiser to continue their work and they should eventually be employed and paid by AFSA once its resource base has grown to a sufficient level. This would allow transfer the true ownership of the project to the FSA and the supervisors would report to AFSA as well as reporting to PMU. The FSAs would elect a board and an audit committee for AFSA. The Board would be initially an unpaid job and would become paid once AFSA has the resources for this purpose.

It seems to me that the correct donor strategy, in all the countries where FSAa would be implemented, should be to promote the AFSA as a potential MFI/franchiser with the difference that is owned by retail intermediaries one level below. I see my own task as promoting this system. For the remainder of the Uganda project, it could be rational to consider AFSA as the implementing agency. The project would build up AFSA's promotion, supervision, and financial capacity. It would also establish a revolving equity fund that would perpetually create FSAs. I am confident that with the remaining funds in the project, we can make great strides in this direction.

The FSAs are extremely interested in creating the AFSA. They agree in giving 10% of part of their own equity in exchange of AFSA's equity and pay regular fees for training and supervision as well as for establishing an FSA promotion fund. Following established MFO model (eg in BRI Indonesia), one AFSA officer could comfortably supervise 10 FSAs. We therefore would need only one full time employed AFSA staff for this purpose for the remainder of the project (if we are doing only 10 FSAs). The FSAs themselves would also provide human resources for further promotion and supervision of the FSAs.

<u>AFSA Cost and Financing Estimates</u>:

Board	initially voluntary
1 field supervisor	Sh. 1.2 million/month
1 secretary	Sh. 300,000/month
office cost	Sh. 200,000/month
transport	Sh. 500,000/ month
vehicle	provided by the project
TA	provided by the project
Total	Sh. 2.2 million/ month

Fees from 7 FSAs	Sh. 350,000/month (rising to 700,000/ month by end 1999)
Fees from 10 FSAs	Sh. 1 million/month by end 1999
Shortfall	Sh. 1.2 million/month
Project Contribution	Sh. 1.2 million/month
Total	Sh. 2.2 million/month

I have taken the absolute minimum to the bone for the above costing. If AFSA decides to keep a second field officer the cost would obviously be doubled. With one officer only, AFSA should be 50% self-sufficient by the end of the project. Clearly, the more FSAs are created, the stronger would AFSA become. It would also have an additional income coming from dividends that it would receive from its FSA shares. By the end of the project, AFSA should be in a position to justify a major expansion of the FSA programme for Uganda with itself as the implementing agency.

Year-end meetings of FSA reveal that the second year Board can be very solid and one observes a true take-over of the institution by the shareholders. Supervision of the FSAs that are more than 1 year old is actually considerably reduced. Patience undertakes fewer visits of the FSAs that are more than one year old and she has passed them to Jennifer who is a light follow-up. Once the shareholders understand the consequence of arrears, the rate goes down sharply as the institution becomes much more careful in its lending activities. The first year is the real challenge of institution-building in these institutions while year 2 the growth takes-off (almost a quadrupling of the volume of transactions). I therefore have some inclination to suggest that perhaps we should have an open mind about the number of FSAs and in view of the experience open the way for the number of the FSAs to be eventually increased so as to give AFSA greater income.

Ahmad Jazayeri

			Appendix 5									
Lukaya	**Branch**											
Abdul Karim	**Nampagi**	**(018)**	**Chairman**									
Shares		54,500		84,500		144,000						
	Loan 1		Loan 2		Loan 3							
Loan	01/21/1998	150,000	02/05/1998	300,000	08/20/1999	430,000						
Repay 1	02/05/1998	-150,000	08/11/1998	-4,000		-44,500						
Repay 2			03/23/1999	-23,400								
Repay 3			03/23/1999	-5,000								
Repay 4			03/23/1999	-5,600								
Repay 5			04/21/1999	-21,950								
Repay 6			05/12/1999	-37,700								
Repay 7			08/20/1999	-202,350								
Repay 8												
Ms. Annet	**Nyaqnzi**	**(020)**	**Ex-Board Member**									
Shares		56,000		74,000		112,000						
	Loan 1		Loan 2		Loan 3							
Loan	08/10/1998	200,000	12/30/1998	300,000	01/10/2000	500,000						
Repay 1	09/11/1998	-38,750	02/01/1999	-27,500	02/10/2000	-102,500						
Repay 2	10/06/1998	-46,250	03/03/1999	-36,500	03/10/2000	-117,500						
Repay 3	11/09/1998	-53,750	03/31/1999	-8,000								
Repay 4	12/08/1998	-61,250	04/06/1999	-37,500								
Repay 5			04/30/1999	-17,000								
Repay 6			05/05/1999	-37,500								
Repay 7			05/31/1999	-27,000								
			06/02/1999	-26,500								
			06/04/1999	-10,000								
			10/11/1999	-15,000								
			12/20/1999	-43,000								
			12/20/1999	-14,500								

Emmanual Ssewgendo		**(067)**	**Shareholder**									
Shares		28,500		54,000		78,000		104,000				
	Loan 1		Loan 2		Loan 3		Loan 4					
Loan	12/23/1998	100,000	02/24/1999	200,000	06/04/1999	300,000	09/28/1999	300,000				
Repay 1	01/21/1999	-28,350	03/23/1999	-58,700	07/06/1999	-12,000	11/12/1999	-30,000				
Repay 2	01/21/1999	-20,000	05/14/1999	-66,700	07/13/1999	-23,000	11/29/1999	-30,000				
Repay 3	02/23/1999	-51,650	05/25/1999	-74,600	09/08/1999	-88,000	02/01/2000	-70,300				
Repay 4					09/22/1999	-90,000						
Repay 5					09/28/1999	-87,000						
Repay 6												
Repay 7												
Ibrahim Kasiga		**(043)**	**Shareholder**									
Shares		27,000		27,000		27,000		75,000		126,000		126,000
	Loan 1		Loan 2		Loan 3		Loan 4		Loan 5		Loan 6	
Loan	06/23/1998	100,000	09/11/1998	100,000	09/25/1998	100,000	12/23/1998	300,000	06/01/1999	500,000	11/19/1999	400,000
Repay 1	07/21/1998	-26,700	09/14/1998	-55,000	11/03/1998	-3,350	01/22/1999	-5,000	11/19/1999	-500,000		
Repay 2	08/18/1998	-16,650	09/23/1998	-45,000	11/11/1998	-16,025	01/25/1999	-15,000				
Repay 3	08/20/1998	-10,000			11/27/1998	-23,150	01/27/1999	-7,000				
Repay 4	09/04/1998	-6,000			12/21/1998	-57,475	01/28/1999	-4,250				
Repay 5	09/04/1998	-6,900					03/02/1999	-20,000				
Repay 6	09/07/1998	-37,550					03/10/1999	-6,700				
Repay 7							03/10/1999	-10,000				
Repay 8							04/14/1999	-20,000				
Repay 9							04/30/1999	-7,500				
Repay 10							05/31/1999	-204,550				
Repay 11												
Ahmad Ssemakula		**(070)**	**Shareholder**									
Shares		25,000		52,500		64,500		150,000				
	Loan 1		Loan 2		Loan 3		Loan 4					
Loan	04/14/1998	100,000	07/22/1998	200,000	12/01/1998	300,000	05/28/1999	600,000				

Repay 1	05/19/1998	-23,250	08/24/1998	-10,000	12/31/1998	-5,000	07/30/1999	-30,400				
Repay 2	05/22/1998	-3,450	08/26/1998	-28,750	01/04/1999	-20,000	10/12/1999	-26,400				
Repay 3	06/16/1998	-33,350	09/22/1998	-7,500	01/15/1999	-2,500	11/26/1999	-97,200				
Repay 4	07/14/1998	-39,950	09/25/1998	-38,750	01/29/1999	-36,500	01/03/2000	-46,480				
Repay 5			10/19/1998	-15,000	02/26/1999	-26,000						
Repay 6			10/27/1998	-18,800	04/23/1999	-13,000						
			11/02/1998	-19,950	05/21/1999	-90,000						
			11/24/1998	-61,250	05/26/1999	-50,000						
					05/27/1999	-20,000						
					05/28/1999	-20,000						
					05/28/1999	-17,000						

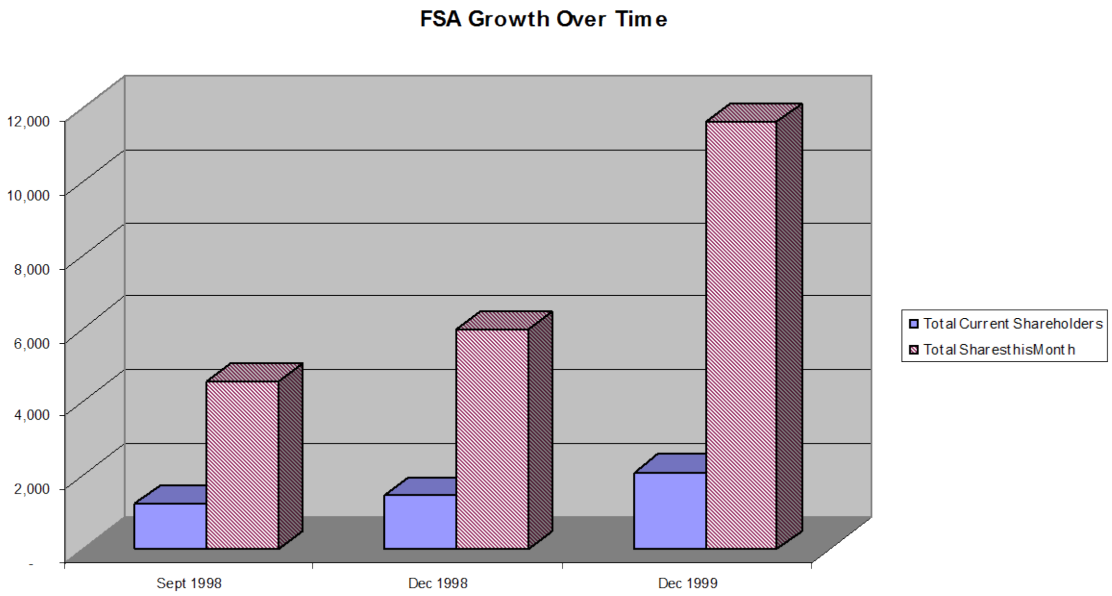
APPENDIX 6

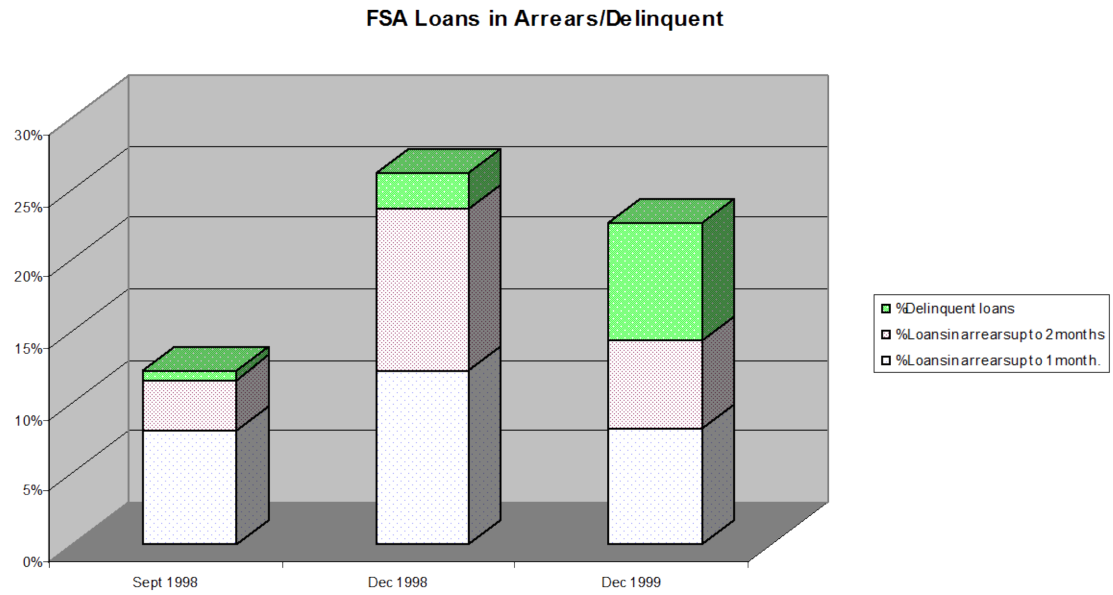
Implications of Lukaya Dropping the Interest Rate			
(based on December 31, 1999 Figures)			
	Ush.		Ush.
Implications for the Institution			
Loanable Capital	15,351,000		
Monthly Interest Set at:	12%		10%
Annual Interest Income	1,842,120		1,535,100
Annual Expenses	(546,000)		(546,000)
Net Profit	1,296,120		989,100
Difference	**307,020**		
Difference as percentage of Net Profit	31.0%		
For Individual Loanees			
Typical Average Loan	200,000		
Monthly Repayment (3 month loan)	90,667		86,667
Difference	**4,000**		
Difference as percentage of Repayment	4.6%		

			APPENDIX 7					
		Accounts as of 31st December 1999.						
			000s Ush.					
	Lukaya	**Bukunda**	**Kingo**	**Butenga**	**Kibinge**	**Katovu**	**Kisseka**	**Consolidated**
Profit and Loss Account.								
Income								
Interest From Loans	1,440	17,443	17,349	4,617	5,001	12,515	6,344	64,709
Other Income	9	618	958	126	76	591	701	3,079
Total Income	**1,449**	**18,061**	**18,307**	**4,743**	**5,077**	**13,106**	**7,045**	**67,788**
Expenses								
Operating Costs	546	13,550	9,115	1,654	2,166	5,695	6,487	39,213
Total Expenses:	**546**	**13,550**	**9,115**	**1,654**	**2,166**	**5,695**	**6,487**	**39,213**
Surplus / Deficit	**903**	**4,511**	**9,192**	**3,089**	**2,911**	**7,411**	**558**	**28,575**
Balance Sheet.								
Assets								
Loans to Shareholders	18,096	11,806	25,609	10,488	17,664	15,343	7,979	106,985
Bank	569	4,257	41		5,752			10,619
Cash	2,017	4,047	487	1,582	3,981	2,388	3,299	17,801
Total Assets.	**20,682**	**20,110**	**26,137**	**12,070**	**27,397**	**17,731**	**11,278**	**135,405**
Liabilities								
Savings	4,061	3,538	1,215	1,753	6,283	1,023	3,291	21,164
Loan Insurance Fund	1,260	959	1,372	735	1,238	682	556	6,802
Total Liabilities	**5,321**	**4,497**	**2,587**	**2,488**	**7,521**	**1,705**	**3,847**	**27,966**
Net Assets.	**15,361**	**15,613**	**23,550**	**9,582**	**19,876**	**16,026**	**7,431**	**107,439**
Capital and Reserves.								
Shares	14,039	11,102	14,358	6,493	14,907	8,615	5,473	74,987

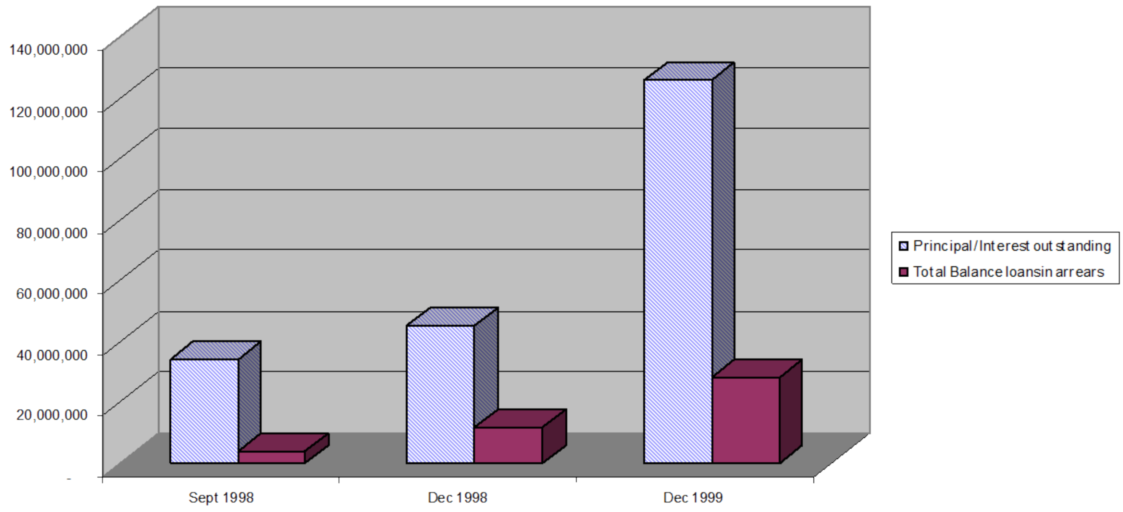
Share Protection Reserve	419				2,058		1,400	3,877
Retained Surplus	903	4,511	9,192	3,089	2,911	7,411	558	28,575
Total Capital:	**15,361**	**15,613**	**23,550**	**9,582**	**19,876**	**16,026**	**7,431**	**107,439**
Ratios	**Lukaya**	**Bukunda**	**Kingo**	**Butenga**	**Kibinge**	**Katovu**	**Kisseka**	**Consolidated**
Provisions: Total Loans Outstanding	9%	8%	5%	7%	19%	4%	25%	10%
Unencumbered Reserves & Retained								
Earnings /Total Assets	4%	22%	35%	26%	11%	42%	5%	21%
Net loans / Total assets	79%	54%	93%	81%	52%	83%	53%	71%
Shares and Deposits / Total Assets	88%	73%	60%	68%	77%	54%	78%	71%
Operating Expenses / Average Assets	3%	67%	35%	14%	8%	32%	58%	29%
Net Income / Average Assets	4%	22%	35%	26%	11%	42%	5%	21%
Liquidity reserve / withdrawable savings and deposits	50%	114%	40%	90%	63%	233%	100%	84%
Savings/Shares	29%	32%	8%	27%	42%	12%	60%	28%
Return on Shares	6%	41%	64%	48%	20%	86%	10%	38%
Expenses/Income	38%	75%	50%	35%	43%	43%	92%	58%

Appendix 8

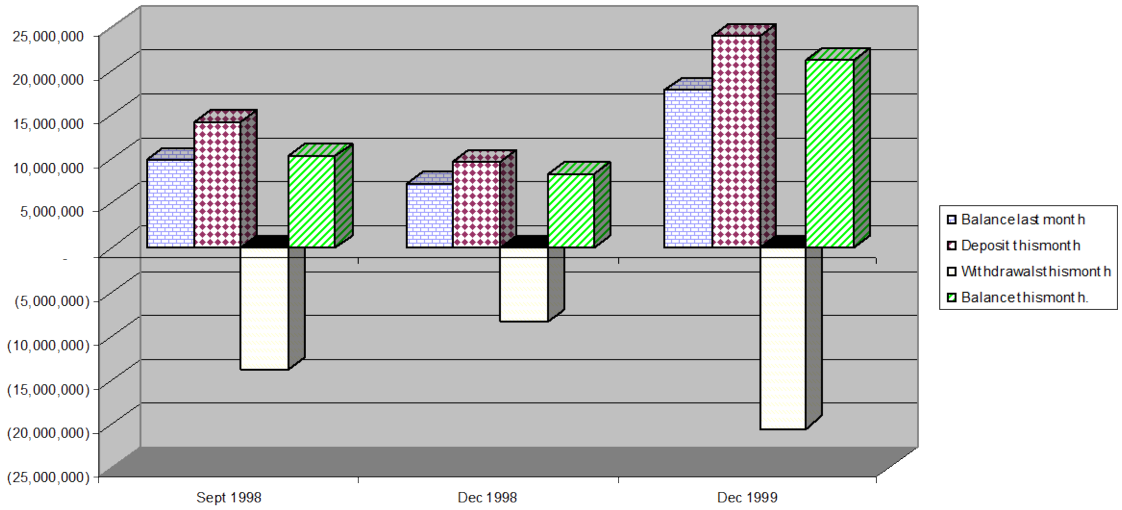

FSA Growth Over Time
12,000
10,000
8,000
6,000
4,000
2,000
-
Sept 1998
Dec 1998
Dec 1999
Total Current Shareholders
Total SharesthisMonth

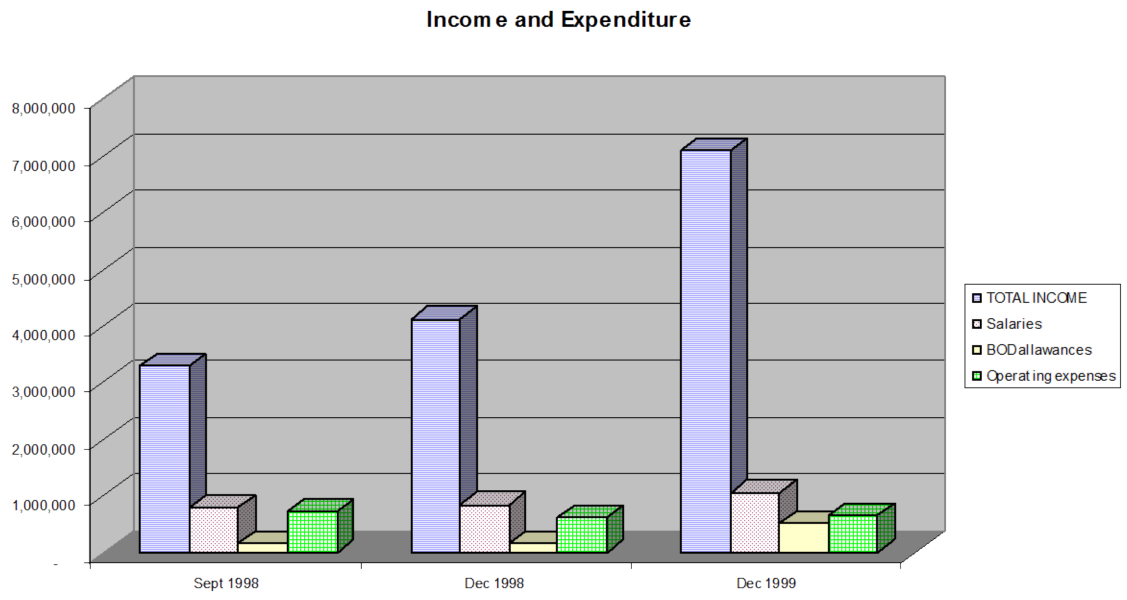

FSA Loans in Arrears/Delinquent
30%
25%
20%
15%
10%
5%
0%
Sept 1998
Dec 1998
Dec 1999
%Delinquent loans
%Loansinarrearsupto2months
%Loansinarrearsupto1month.

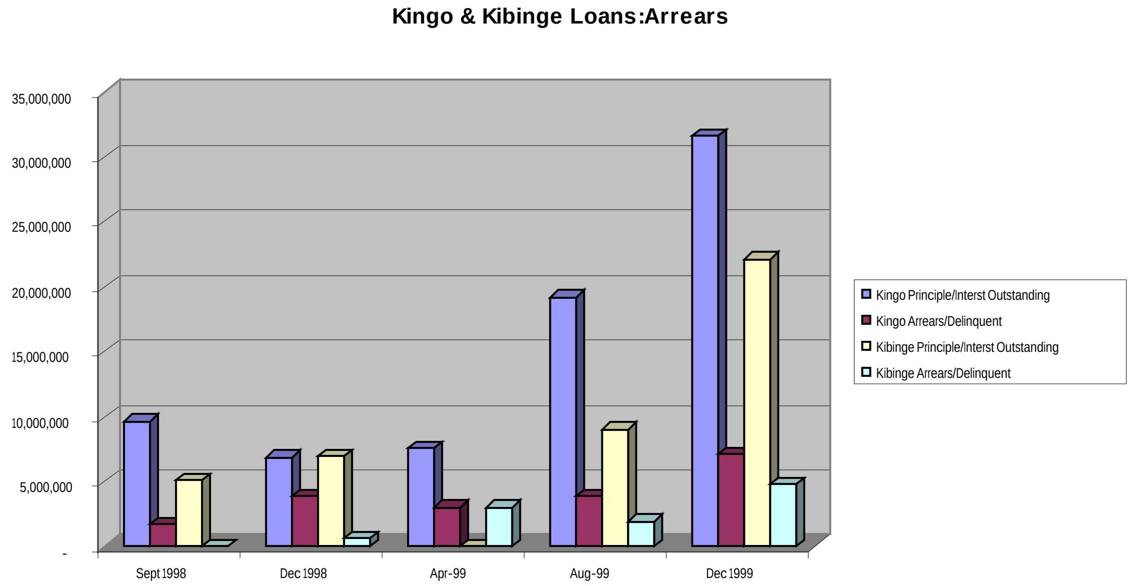
FSAs Arrears/Deliquent to Total Loans



Savings Account Activities




Income and Expenditure
8,000,000
7,000,000
6,000,000
5,000,000
4,000,000
3,000,000
2,000,000
1,000,000
-
Sept 1998
Dec 1998
Dec 1999
TOTAL INCOME
Salaries
BOD allawances
Operating expenses


Kingo & Kibinge Loans:Arrears
35,000,000
30,000,000
25,000,000
20,000,000
15,000,000
10,000,000
5,000,000
-
Sept 1998
Dec 1998
Apr-99
Aug-99
Dec 1999
Kingo Principle/Interst Outstanding
Kingo Arrears/Delinquent
Kibinge Principle/Interst Outstanding
Kibinge Arrears/Delinquent

APPENDIX 9

Summary on the review of the accounting systems and loan portfolio management of the FSAs at Masaka.

Lukaya FSA.

<u>Loan portfolio .</u>
Very good loan tracking and reporting system in place just a few issues noted:

- As at the end of Feb 2000, the delinquency rate was 6.5% and the percentage of loans that were in arrears accounted for 28% of the total outstanding loans.

- Both the cashier and Manager didn't have the documentation of the lending guidelines, I understand these are available at the PMU therefore copies should be sent to this branch.

- Authorization of loans, Loans to the manager and credit committee (Board) members are approved by a member of the Audit committee and in return the credit committee members approve the loans to the Audit committee members. It should be noted that all members of the Board are at the same time the credit committee members and all of them have received loans from the FSAs. Because none of them is independent there is an evident conflict of interest that has to be addressed. The easiest option is to deny the Manager access to loans since he gets a salary and he/ she will act as the independent person in all this.

- Management, the Board and so a number of other shareholders have been receiving a loan from the FSA the same day that they complete the old loans. This can be interpreted as a way of re-greening the last part of the loan and in most cases it was the biggest installment. It is also an indication that no time is allowed for the loan committee to approve the loans in essence the manager approves them and the committee endorses the already issued loans.

- A number of personal ledger cards lacked the photos, this was seen as a serious omission on the part of management because they may not have the identity of a defaulter in case he/ she disappears.

<u>Acting system.</u>
Good accounting systems in place, just three issues to note.

- On a number of occasions both the Manager and Cashier have received salary advances despite the fact that they had outstanding loans. This was seen as having two parallel loans from the FSA at the same time.

- Payments to the manager are authorized by himself, this may not provide sufficient control on such expenses. If possible these expenses should be approved by a member of the board.

- There is a functioning audit committee who visit the FSA at least once in a week, each issue that they raise is recorded in a minute book for PMU to take action. We suggest that the board should start getting involved in the audit issues and any anomaly noted should be acted upon whenever the board meets.

Kibinge FSA.

<u>Loan portfolio.</u>
Same loan tracking and reporting system as in Lukaya.

- Kibinge - Misanvu has a low delinquency rate of 4.4%, this was seen to be within control.

- Authorization of loans, Loans to the manager and credit committee (Board) members are approved by a member of the Audit committee and in return the credit committee members approve the loans to the Audit committee members. It should be noted that all members of the Board are at the same time the credit committee members and all of them have received loans from the FSAs. Because none of them is independent there is an evident conflict of interest that has to be addressed. The easiest option is to deny the Manager access to loans since he gets a salary and he/ she will act as the independent person in all this.

- Some of the loans to the Manager and the board chairman where more than what they were entitled when you compare the shares held with the amount of loans receive. This was seen, as a violation of lending guidelines that should be avoided. The last loan of Shs. 3,100,000/= received by the chairman of the board should be closely monitored by the PMU given the history of how the loans to the manager have been growing.

- A number of personal ledger cards lacked the photos, this was seen as a serious omission on the part of management because they may not have the identity of a defaulter in case he/ she disappears.

- The board at Kibinge had passed some resolutions that are slightly different from what is stipulated in the general guidelines issued by the PMU. The two issues that we came to our notice are:-
    - The ratio of value of shares held to loans should not exceed 1:3 this is differs from the 1:4 followed by the other FSAs.
    - They are not following the loan graduation system, they say that this is not favorable for the types of business there shareholders do. The credit committee determines the amount of loan to be given to a shareholder basing on their assessment of the client.

  These changes should be formally documented if agreeable to the PMU and they should be included in the lending guidelines for Kibinge.

<u>Accounting system.</u>
Good accounting systems in place, just two issues noted.

- On a number of occasions both the Manager and Cashier have received salary advances despite the fact that they had outstanding loans. This was seen as having two parallel loans from the FSA at the same time.

- Payments to the manager are authorized by himself, this may not provide sufficient control on such expenses. If possible these expenses should be approved by a member of the board.

Bukunda FSA

<u>Loan portfolio.</u>
Good loan tracking and reporting systems in place, however their operations are in a bad shape.

- The delinquency rate as at the end of February 2000 was 40% and of the delinquent loans 24% were over a year in arrears. This is a bad position and if not checked may affect the going concern of the FSA. Of the total outstanding loan portfolio, 54 % were in arrears.

- It was noted that the loan cards, personal ledgers and other records where not being checked by the Audit committee, further interview indicated that the Audit committee has not been very active. This is a big problem that has resulted into a number of problems facing Bukunda FSA.

- A number of clerical errors and erasing using pencil were noted on the clients personal ledgers, in the course of the review an error involving Shs. 100,000 to the chairman's personal ledger was corrected this transaction took place in June 1998. A savings deposit of Shs. 100,000/= had been recorded on the personal ledger as a saving and at the same time a loan to the Chairman, no one had noted this error since that time.

- Almost 80% of all the personal ledgers have no photos on them this is a big omission that should urgently be acted upon to avoid losing identity of the defaulters.

- A number of loans have been in arrears for along time, noted among them are the loans to the Chairman of the board, Manager, Cashier and her husband which have been outstanding for over a year now. This is a bad indication on part of the FSA, it becomes extremely difficult for such people to foster repayments from the other shareholders.

- A number of loans noted where the shares held are not enough for receiving the amount of loan issued to the client, this includes loans to all the people mentioned above. This is a violation of lending guidelines that should be stopped instantly.

- Personal ledgers not up to date some had not been updated for the last two months, Manager says that this happened because the cashier was on maternity leave. This is considered *s*trange since the FSA serves a maximum of 15 clients per day – thus leaving plenty of scope for the Manager to update the ledgers.

- Both the cashier and Manager didn't have the documentation of the lending guidelines, I understand these are available at the PMU therefore copies should be sent to this branch.

- Authorization of loans, Loans to the manager and credit committee (Board) members are approved by a member of the Audit committee and in return the credit committee members approve the loans to the Audit committee members. It should be noted that all members of the Board are at the same time the credit committee members and all of them have received loans from the FSAs. Because none of them is independent there is an evident conflict of interest that has to be addressed. The easiest option is to deny the Manager access to loans since he gets a salary and he/ she will act as the independent person in all this - this decision should be taken after assessing his integrity as will be seen under the review of the accounting systems.

Accounting Systems.

- Reconciliation of the cash in the safe and the general ledger indicated that there is a shortage of Shs. 435,550/=, the Manager and Cashier couldn't give any reason where this cash had gone. The general assessment of the review team is that this shortage has been building up over time since there was no audit to continuously check on the FSAs operations. Manager and Cashier should pay back the money and appropriate action should be taken by the PMU / Board.

- It was also noted that Bukunda FSA has been maintaining cash in the safe far above the insured value of two million shillings, at times the cash in the safe has gone as high as six million shillings. Management was advised to maintain cash in the safe within the insured limit to avoid losing the excess in case of anything.

- On a number of occasions both the Manager and Cashier have received salary advances despite the fact that they had outstanding loans. This was seen as having two parallel loans from the FSA at the same time.

- Payments to the manager are authorized by himself, this may not provide sufficient control on such expenses. If possible these expenses should be approved by a member of the board.

- During the year Management purchased a plot of land and a motor cycle, the review team did not see the approval from the general assembly. However they say that DFID promised to contribute 50% of the cost of the motorcycle, no written commitment from DFID could be produced by the FSA. As for the piece of land that costed Shs. 1,900,000/= it was seen to be an unnecessary expenditure given the fact that they pay Shs. 20,000/= per month for renting their current offices.

Appendix 10
Recommendations

Project Management/Development

1. It is important that an FSA-specific PMU remains in place or that an apex organisation is created as soon as possible (<u>if</u> DFID or other donors are interested in maintaining and developing the current 7 FSAs).
2. The PMU should be asked to develop the building blocks for further strengthening and replication: formalised training manuals and refinement of the system including improvements to the governance systems, experimentation with improved products (especially savings) and approaches loan portfolio management.
3. In the event that an apex is to be established, it should be financed through shareholding within the member FSAs, have the power to call Extraordinary General Meetings to address key issues as they arise and be given a substantial level of voting rights.
4. DFID or another creative donor to finance a bank or MDI to look at the options for using the best operational practices of FSAs as a basis for agency outreach from a formal sector bank or MDI that fully owns the FSA.
5. It is essential that the PMU transmit appropriate and accurate messages about DFID's intentions. These should be made as clear as possible by DFID to PMU and by PMU to the FSAs.
6. The FSAs should not be given external capital funding until they have a credible track record of solid performance of five plus years (if at all). When and if external funding is provided it should be provided on a loan basis from a commercial institution and not a donor.

Ownership

1. The ownership structure of the existing 7 FSAs must be regularised in a manner that conforms with the requirements of the requirements of the BoU Policy Statement for tier 4 Membership Based Organisations.

Governance

1. The FSAs' Memorandum and Articles of Association need to define clearly the responsibilities of the Board, those of Management and those decisions that must be referred to the General Meeting. Boards should be given training on the nature of their responsibilities and checklists to assist them. These checklists could also form the basis of a Board performance appraisal system. The division of responsibilities, training and checklists should be amended over time as the size of the FSA increases.
2. Board and Audit Committee members should be re-elected annually but for a maximum of three (not two as is currently the practice) consecutive years to allow for improved institutional memory and use of trained resources.
3. FSAs should initiate staggered Board/Audit Committee rotation to maintain institutional memory and allow training of new Board/Audit Committee members by their peers.
4. Systems for Board and Audit Committee evaluation should be put in place and the results publicised at the FSA.
5. Board members must consult the General Meetings on all major policy decisions – interest rates, large fixed asset acquisitions, remuneration etc.
6. General Meetings should be held every six months – as a minimum.
7. It is essential that all members be made aware of the implications of reducing the interest rates charged on loans and the importance of using the interest rate to balance the supply of and demand for capital funds within the FSA. The PMU/apex could also play an important role in analysing the real costs of borrowing from the growing competition (FINCA, UWFT, Med-Net etc.) which is often cited by those who wish to lower interest rates.
8. The FSAs should give serious consideration to insisting that:
    a) staff cannot borrow from the institution (with the exception of taking an advance against salaries subject to a maximum of [for example] the average of their previous three months' salary payments),
    b) less than 50% of Board/Audit Committee members can borrow from the FSA at any one time,

c) Board/Audit Committee members with loans in arrears of more than 1 month should automatically be disqualified from holding office and ineligible to stand for re-election for another one year after the loan is fully repaid,

d) The names of all those with delinquent loans are posted on the notice board of the FSA.

1. There is a clear and pressing need for additional training and perhaps some simple checklists to guide the Audit Committees in their work.
2. In order to maintain transparency, the FSAs should post simple monthly financial statements and graphs (and possibly Audit Committee narrative thereon) on the notice board in the FSA office. This would necessitate a brief training for members on how to interpret these financial statements.

Financial Services

1. The FSAs should insist on disciplined and regular (at a minimum monthly) loan repayment instalments and should not move to balloon-based repayments.
2. The PMU should request assistance to look at options for improving savings services.
3. FSAs should adhere to the policy governing keeping cash in the safe at the FSA office or examine the need for amending the policy and increasing the level of insurance cover.

Accounting Systems and Loan Portfolio Management

1. Copies of the lending guidelines should be sent to the FSAs.
2. Staff should not be permitted to take loans and advances against salaries (see Governance above).
3. Payments made to the Managers should be authorised by the Board or Audit Committee.
4. In order to increase the level of loan security, (particularly in FSAs with significant loan repayment problems) FSAs should insist on co-guarantors putting their shares/savings at risk to guarantee loans.
5. FSAs should make increased loan size dependent on credit history – as part of the incentive system to encourage prompt, disciplined repayment.
6. The PMU must conduct a thorough and immediate investigation into the missing Ush. 435,550 at Bukunda.