Regulation Not a Panacea for SACCO Troubles

In the last century, we have witnessed rapid technological innovation. At one time, the list of basic human needs began with food, clothing, shelter, and ended with education, health, and sanitation.

However, in the information age, two new items have been added to the list: the Internet and financial access. The mobile phone revolution in East Africa brought Internet access to the masses, but unfortunately, financial access is still far from ubiquitous. Formal financial services reach less than one-fifth of the population in Uganda, and informal sector financial services only increase this to around half the population at best. In other words, half the country is unable to reap the savings in good times and borrowing in times of need. In fact, those who have access through informal institutions and arrangements are likely being exploited, cheated, or offered grossly inefficient services.

SACCOs in Uganda (like ROSCAs in Latin American countries) are savings and credit cooperatives that have emerged to fill this gap. Cooperative savings arrangements and microfinance initiatives have achieved significant success and generally a clean reputation in otherwise corruption-ridden countries such as Bangladesh and Indonesia. I questioned why this was not the case in Uganda after reading Nathan Were’s commentary in the *Daily Monitor* on October 2, 2012. His article was titled “Rural finances: Raising questions about the state of Uganda’s rural financial system.”[[1]](#footnote-1) Were’s article addresses the dismal state of governance in Uganda’s savings cooperatives. Including these organisations in the regulatory ambit of financial regulatory authorities in Uganda would be the solution, he concluded.

I beg to differ. To answer the question why SACCOs in Uganda are in a state of disarray, let’s go back to the features of credit cooperatives, which make them successful in other countries.

First of all, any SACCO or collective saving and lending arrangement is only as strong as its relationships with members. The basis of collective savings programs is to leverage “social capital” for ensuring that members keep their commitments and behave ethically. (Social capital means the influence that people in a community have over each other’s behaviour due to their social relationships.)

Savers and borrowers prefer to keep their commitments because they value their reputation among this particular group. They behave ethically because their relationship with the community or their reputation is *too valuable to lose,* even for money!

Conversely, if they don’t adhere to their commitments, other members in the group will generally be able to talk them into doing so. Therefore, at a minimum, members need to play a crucial role in the governance of the SACCO by effectively exercising this social capital.

What, then, leads to the creation and maintenance of strong social ties among group members? To ensure that social capital works, the formation, size, and composition of the member group are all critical.

Ideally, groups should be *self-selected.* In that case, all participants would be selected unanimously and share common underlying ties, such as being from the same village or working at the same place, etc. This way, any prospective members who have a history of default in that community or are considered untrustworthy get weeded out before they even join. This makes the group more close-knit and possibly more reliable to begin with. While group selection for most SACCOs in Uganda is based on such a common bond, that criterion isn’t always painstakingly enforced, and exceptions are common.

Second, collective savings programs generally work well in small groups of women. A small group size makes governance less cumbersome, makes behaviour (or misbehaviour) of members more visible to other members, and therefore creates greater accountability.

For example, if a member who generally commands more influence within the group is misusing this influence to embezzle funds, this person’s actions become evident easily and early. The other members discuss such transgressions in person, often during their meetings. The threat of public shaming acts as an effective deterrent for such embezzlement in small, close-knit groups. In large groups, such behaviour becomes known only when it’s too late, and the relationships between members are too loose to be valuable anyway.

Today, many SACCOs are missing out on this self-governing mechanism because they’re required by law to have a minimum of 30 members.[[2]](#footnote-2) That number, in my opinion, is too large to form any meaningful social capital within the group, and I think the basis for this law needs a second look.

The commentary in the *Daily Monitor* suggested that lack of regulation is the cause of improper governance. However, if a SACCO is ill-governed, it points to a breakdown of the social capital within the group, which is unlikely to be rectified through external regulation. Regulating inefficient financial institutions doesn’t make them efficient if they’re inherently designed for failure (e.g., large groups in which members don’t trust or know each other well). Rather, it creates a false picture that the regulatory authorities are endorsing the business that these institutions are engaging in and the way they conduct it.

I recognise that given the structure and sizes of Ugandan SACCOs, there is a place for regulation. Regulatory guidelines can be a great resource for SACCOs to implement best practices and good accounting standards as well as be protected by some form of insolvency framework. However, I am sceptical about the assertion that regulation of SACCOs by the appropriate government authorities would solve the problem of mismanagement altogether. While there may be benefits to regulation of SACCOs, regulation itself is certainly not adequate.

First, just as markets fail, regulations can fail as well. This was amply highlighted by the microfinance crisis in the central-bank-regulated microfinance sector in Andhra Pradesh, India. The state passed new, inadequately thought-through regulation for microfinance institutions. In the aftermath, microfinance institutions in Andhra began to face large-scale defaults, which eventually led to the bankruptcy of the largest microfinance institution in the country. Clearly, regulation is not enough and, in fact, improperly implemented regulation may do more harm than good.

In my opinion, the “government-should-do-something” rhetoric no longer works. Regulating every single financial institution of every size and volume isn’t practical as the economy incurs significant costs for such regulation. Instead of regulating institutions that are too large to be efficient, regulators can weed them out by letting them dissolve.

An interesting characteristic of SACCOs in Uganda is that many of them have been created as development institutions, as conduits to channel financial support from the state to the grassroots level. As such, their failure could adversely affect the reach and effectiveness of state-led development programs. An alternative approach then could be to encourage these groups to downsize to the optimal size at which micro-savings and micro-lending can effectively self-regulate. Yet another option is to encourage these groups to transform themselves into credit institutions, which are already regulated under the current framework.

It is important to acknowledge that failure of even small SACCOs could undermine the confidence in the cooperative savings system in Uganda. This is where the heavily promoted financial literacy efforts in Uganda will bear fruit.

People need to heighten their financial awareness, exercise caution, and ask sound questions when they join SACCOs. Why would they want to hand over their savings to a group that’s too large for them to know and trust each member well? Yes, SACCO members often have no alternatives, but they’re still advised to avoid group-based financing services they don’t fully understand. When such questioning begins to happen on a large scale at the grassroots level, SACCOs will be forced to pay heed and self-regulate the size and formation of their groups.

Financial literacy initiatives implemented by BOU can go a long way to encourage people to ask these questions and make informed financial decisions. Moreover, in the event of failure of a SACCO, people would be aware of their rights as members.

In summary, in their current form and scale, SACCOs won’t work efficiently due to their large size, and people shouldn’t be encouraged to join them. Those that exist with an inefficient size and structure for developmental reasons should be gradually divided into sub-groups of smaller sizes or transformed into larger, already regulated institutions.

Government regulation of SACCOs is a suboptimal solution. Instead, effective implementation of social capital through small, self-selected groups, proactive financial literacy efforts, and raising caution among members of SACCOs are ways to ensure effective governance of these groups.

*Note: A previous version of this article was originally published on October 16, 2012 in* The Daily Monitor*, a national newspaper in Uganda.*

1. *Daily Monitor*. October 2, 2012.“Raising Questions about the state of Uganda’s rural financial system” Nathan Were.

([http://www.monitor.co.ug/Business/Prosper/Raising+questions+about+the+state+of+Uganda+s+rural/-/688616/1522316/-/lomc7b/-/index.html](http://www.monitor.co.ug/Business/Prosper/Raising%2Bquestions%2Babout%2Bthe%2Bstate%2Bof%2BUganda%2Bs%2Brural/-/688616/1522316/-/lomc7b/-/index.html)) [↑](#footnote-ref-1)
2. Uganda Cooperative Savings and Credit Union Ltd. website (<http://www.ucscu.co.ug/>) [↑](#footnote-ref-2)