

Regulation is not the panacea we are looking for to cure ills of savings co-operatives

LSE alumna Prajakta Kharkar Nigam argues that education, not regulation, is what is needed for savings and credit co-operatives to be successful. This post draws upon research Prajakta pursued as part of her Masters' thesis on microcredit contracts, titled 'Cash-flow constraints: Impact on borrowers facing frequent repayment obligations' and later as a research assistant at LSE STICERD.

The 21st century has witnessed rapid technological innovation. There was a time when the list of basic human needs began with food, clothing and shelter and stopped at education, health and sanitation. However, in the information age, two new items should be added to the list – the internet and financial access.



The mobile phone revolution in East Africa brought internet access to the masses but, unfortunately, the level of 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 benefits of saving in good times and borrowing in times of need. In fact those who have some 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 co-operatives which emerged to fill this gap. Co-operative savings arrangements and microfinance initiatives have achieved significant success and generally a clean reputation in otherwise corruption-ridden countries like Bangladesh and Indonesia. Reading the commentary published in the Daily Monitor on 2 October 2012, "Rural finances: Raising questions about the state of Uganda's rural financial system"^[1] by Nathan Were, made me question why is this not the case in Uganda?

To answer that we need to go back to the basics. What made collective savings schemes successful in other countries where they first thrived? Any SACCO or collective savings and lending arrangement is only as strong as the relationships between its members. The basis of

collective savings programmes is effective exercise of social capital to ensure that members keep to their commitments and behave ethically. Social capital means the influence that people in a community have over each other's behaviour due to their relationships. Savers and borrowers prefer to keep to their commitments because they value their reputation among this particular group. They behave ethically because the relationship with the community or their reputation is "too valuable to lose", even for money! Conversely, if they do not adhere to their commitments, other members in the group will be able to talk them into doing so. Therefore, at a minimum, members need to be playing 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? In ensuring that social capital works, the formation, size and composition of the member group are critical. First of all, groups should ideally be "self-selected" where all participants are selected unanimously and share some common underlying ties such as being from the same village or working at the same place. This way, any prospective members who have a history of default in that community or are generally considered less trustworthy are weeded out at the outset. This makes the group more closely knit and possibly more ethical to begin with. In principle, for most SACCOs in Uganda, while group selection is based on such a common bond, it is not always self-selection. Even the common bond criterion is not always painstakingly enforced and exceptions are common.

Secondly, collective savings schemes generally work well in small groups of women. Small size of groups 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, her actions become evident easily and early. The other members can discuss this in person or during their periodic meetings. Usually, 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 is too late and the relationships between members are too diluted to be valuable anyway. Today, many SACCOs are missing out on this self-governing mechanism because they are by law required to have a minimum of 30 members^[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 the lack of regulation is the cause of improper governance and that regulation of SACCOs by the appropriate government authorities would solve the problem. I am sceptical. First, we should not forget that just as there are market failures, there can be regulatory failures as well. This was amply highlighted by the crisis in the central bank-regulated microfinance sector in Andhra Pradesh, India. In my opinion, the "government should do something" rhetoric no longer works. Regulating every single financial institution of every size and volume is not practical as there are significant costs of such regulation to the economy. Regulating inefficient financial institutions does not make them efficient, if they are inherently designed for failure (eg: large groups where members hardly trust or know each other well). On the other hand, it creates a false illusion that the regulatory authorities are endorsing the business that these institutions do and the way they do it. Instead of regulating them, institutions which are working at a scale that brings diseconomies should be allowed to get weeded out by letting them fail. Alternatively, they should be encouraged to downgrade to the optimal size at which micro savings and micro lending work well and the system effectively self regulates. Yet another alternative is to encourage them to transform themselves into credit institutions which are regulated.

Well, but then do we let the members of such inefficient SACCOs suffer when they are allowed to fail? I believe that would not be necessary if financial literacy efforts are driven forward in a big way. People need to have heightened financial awareness and need to exercise caution when joining such groups. They need to ask sound questions when they join SACCOs. Why would I want to hand over my savings to a group which is too large for me to know and trust each member well? I understand that SACCO members often have no alternatives, however, they should still

avoid group-based financing services which they do not 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 can go a long way in encouraging the common man to ask these questions and to make informed financial decisions.

In summary, in their current form and scale, SACCOs will not work efficiently due to their large size; people should not be encouraged to join them. Nevertheless, regulation of SACCOs by the government is a sub-optimal solution. Instead, effective implementation of social capital through small, self-selected groups, proactive financial literacy efforts and raising caution among members of SACCOs are some ways towards effective governance of SACCOs.

[1]

<http://www.monitor.co.ug/Business/Prosper/Raising+questions+about+the+state+of+Uganda+s+rura>

[2] <http://www.ucscu.co.ug/>

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