

SACCOs/CREDIT UNIONS REGULATION AND SUPERVISION

TECHNICAL NOTE

1. Introduction

This document has been drafted for the African Confederation of Cooperative Savings and Credit Associations (ACCOSCA) and has been funded by the International Fund for Agricultural Development (IFAD) through the 'Improving Rural financial Inclusion through Cooperatives' programme (IRFITCO). It is aimed at providing guidance on the nature and scope of best practice in SACCO regulation and supervision and with particular emphasis on the IRFITCO project countries of Malawi, Tanzania and Ethiopia.

The note highlights the justification for SACCO regulation as well as outlining the preparations necessary for successful implementation of a SACCO regulatory system. It also deals with the roles of key stakeholders, the nature and importance of regulatory reports and analysis in the implementation of the process. In addition, it outlines the administrative actions necessary to enforce compliance with regulations.

Finally, it provides an opinion on the regulation of other financial services provided within the SACCO sector such as the Central Finance Facility (CFF), Stabilization Funds, SACCO housing funds and SACCO insurance funds.

2. Key Definitions

- a. SACCOs/Credit Unions. Savings and Credit Cooperatives are financial cooperatives owned and governed by members through a set of their own bylaws which normally enshrine cooperative structure and principles. They are established to mobilize member savings and to provide loans to them at affordable rates. SACCOs also provide other investment vehicles for members' excess liquid funds at competitive interest rates. These services abide by over-riding national laws where these apply. SACCOs are also referred to as Credit Unions in many countries such as in Canada, Ghana, Ireland, U.S.A. and Sierra Leone.
- b. SACCO Regulation and Supervision. This refers to an oversight role provided by government in order to ensure the safety and soundness of SACCOs. The structures and methods used vary from country to country. The tendency increasingly is for the central bank of a state to act as the SACCO regulator, especially for large SACCOs. However in other jurisdictions, independent institutions have been created by acts of parliament as regulators while in other countries, a government department has served that purpose. The later case may include a Registrar or a Commissioner of Cooperatives.
- c. Prudential Regulation and Non-Prudential Regulation. In general, the forms of regulation are classified as prudential or non-prudential. Prudential regulations refer to mandatory financial standards set by law for periodic reporting to the regulator. These may be included in the primary Act (Proclamation) or regulations relating to SACCOs. More often they are specified in regulations or directives issued by the regulator. SACCOs are obliged at a minimum to meet these standards or face specified sanctions for non-compliance. The common areas usually covered include capital adequacy, risk management, loan loss provisioning, and earning performance, among others and are perceived to be the areas that bear the greatest risk in the SACCO operations.

Non prudential regulations refers mainly to non-financial standards set out in the SACCO act or in the regulations. They include consumer protection laws, Labour laws, anti-money laundering regulations, fitness and probity rules for SACCO board of directors and key personnel, complaint handling procedures among others. These regulations are mostly non-measurable in quantitative terms.

- d. Tiered Regulation and Supervision. Tiered regulation refers to the standards expected and levels of supervision that are exercised variably in a system. It usually refers to the method whereby the intensity of the scrutiny in supervision and the standards expected from a SACCO is related to the significance of risk that it presents to the financial system. It is premised on the likelihood that the failure of a larger SACCO would provide most serious damage to the movement. Newer and often smaller SACCOS are given a lighter supervisory burden in order to enable them grow and cope with a lighter bureaucratic workload given that they pose a very low risk of systemic damage to the sector and to the overall financial sector stability. In many cases, tiered regulation and supervision involves a division of the regulatory authorities between the larger and smaller societies. Kenya, Uganda and South Africa operate a two tier system for large and small SACCOS. Tanzania, The Gambia, Ghana, Malawi, Lesotho and Ireland are examples of countries which have one central system of regulation. A two or more tiered system has the advantage of giving smaller SACCOS the opportunity to graduate to the next tier within a given timescale. A centralized system can be said to ensure that all SACCOS grow together under the one standard regulatory regime and therefore eliminates any regulatory arbitrage.

3. Why Regulate SACCOS

SACCOS are financial institutions that collect and manage funds from their members. In the case of Banks, insurance companies and microfinance institutions, they are regulated in the interests of the public and their customers. When SACCOS are seen to be regulated in a similar manner then public confidence in the reliability of their business is increased. Third party oversight of their operations also act as an incentive for management to operate to high standards. As a result, it will raise the confidence of members and potential members in the safety and soundness of their societies.

SACCOS are often perceived to have weak governance, weak accounting systems, lower management skills and little technology. In fact, governance generally has tended to be an area of weakness in their operations, particularly in new and smaller societies. Regulation should ensure that weak areas and systems are identified and dealt with by the implementation and monitoring of set standards.

A failure in smaller SACCOS cannot generally be said to be a systemic threat to a national financial framework. However the damage done to the confidence of the public in the movement as a whole can be significant if a large SACCO fails with significant losses. In addition, if a series of small failures becomes known, a similar level of damage will be inflicted on the reputation of the sector. Consequently SACCOS should be required to report on their capital adequacy, liquidity, profitability, and other key operations to demonstrate their ongoing health and stability levels.

Proper regulations ensure that SACCOS are run within set policies and recognized sound financial parameters. These critical standards and policies include such matters as credit policy, risk management policy, liquidity policy, finance and disaster management policies, human resource and administration policies, dividends and reserve policies among others. These policies are designed to ensure a more secure and well-structured SACCOS.

Key elements of SACCO-wide safety and soundness encompasses several layers including loan protection insurance (or 'credit life'), deposit protection insurance, the system of audit, regulation and supervision, stabilization (for SACCOs in financial distress) and a resolution mechanism for SACCOs that are not viable. The delivery of these different forms of protection spans the regulator, the apex association and the SACCOs. However the relevant standards should be articulated by the regulator (or apex in the case of self-regulation, although this is now less common).

4. Role of Government in SACCO Regulation and Supervision

The role of the government is to provide a conducive policy and legal environment for SACCOs to do their business by enacting relevant laws and regulations. Of utmost importance to the government and regulator is the protection of members' deposits, and relatedly the financial safety and soundness of the SACCO. The World Council of Credit Union (WOCCU) has produced a model law (Model Credit Union Act 2015) which is comprehensive and can be referred to in developing a dedicated SACCO Act. Having a separate SACCO Act ensures that SACCOs get the requisite status of distinct type of cooperative that should not be overseen in the same way as other cooperatives, while at the same time protecting the cooperative ethos and not-for-profit nature which makes them different from other financial service providers.

In developing the system of regulation and supervision, the government takes into account both internal and external factors that pose a threat to the SACCO sector, potentially emanating from poor governance, economic conditions, the finance and business environment, politics, technological situation, credit risks and other factors therein. It then develops a legal and regulatory framework to protect the SACCO business and members' funds. In doing this, the government shall ensure that all stakeholders are adequately consulted in coming up with such laws and regulations. Equally, the government has the responsibility to review and amend the Act and related regulations as necessary and for the better supervision and growth of the sector.

5. The Regulator's Constitution and Organization

Ideally the SACCO regulator should be created through an Act of parliament and made as an autonomous and independent government Agency, equipped with the necessary powers and resources to carry out its designated role. Its functions and powers should be outlined in the Act. This is not always the case, and there are many variants on how it is mandated and resourced. However, to operate effectively, the regulatory agency must at least be staffed by capable personnel and supplied with an adequate budget to fulfil its role.

Successful regulation depends upon a crucial couple of powers and processes to function adequately. Firstly, the regulator must operate a sound supervisory unit that must be effective. It is of little use to enact the Act and regulations without having the ability to monitor their implementation. Secondly, it must possess the power to sanction those that do not adhere to the process. Remedial and corrective measures available to the regulatory body will be an important element in ensuring compliance.

To operate in a cost effective and useful way it is usual to operate two interdependent supervisory systems. The first is the off-site system whereby regular returns are submitted to the regulator by all

SACCOs in a predetermined format. These are then analyzed by the off-site unit in the regulator's office to establish the financial status of each SACCO.

The second is on-site inspection by supervisory staff. These inspections can include the evaluation of factors such as the fitness and probity of top management and the routine administrative effectiveness of the SACCO as well as in-depth checks on its financial records. These visits may take place on a routine basis or in response to concerns raised by an off-site inspection (the process, usually referred to as a risk based supervision approach, is addressed in greater detail in the part of this note which deals with preparations for regulation).

6. The SACCO Auditor's Role and Importance

Independent auditors play a vital role in the regulatory process. They are qualified professionals who have the most intimate knowledge of the SACCO as a result of their detailed work on the books and records. It is true that their main responsibility is to the SACCO members to whom they make their report. However the regulator can supply the auditor with a request for supplementary data needed to analyze a SACCO's performance for a financial year. It is the auditor who is most likely to produce accurate data for the regulator's purpose in the case of very small SACCOs. The regulator should supply the auditors with constant information on legal requirements and any changes to the system as a matter of practice.

7. Preparation for Implementation of Regulation and Supervision

When the SACCO laws and regulations are enacted three key organizations have a central role to play in their implementation. These are the regulator, the SACCOs themselves and the SACCO apex association (s) where one or more exists.

Preparations by the regulator will include;

- a) Informing the SACCOs and all other stakeholders of the commencement date for the new regulations.
- b) Preparing the sector for the new regulatory regime through sensitization and sharing the contents of the law and regulations with the groups affected by them. These groups will include the SACCOs, their apexes (federations, leagues or other associations) where these exist.
- c) Where possible copies of the SACCO Act and regulations or SACCO directives should be made available to all SACCOS by the regulator.
- d) Developing new model by laws which incorporate the new SACCO laws and regulatory requirements. These should be provided in hard copy to the SACCOS or alternatively they could be made available to them by means of digital access.
- e) Providing compliance template forms which will have to be returned on a regular basis and train SACCO staff on how to use them.
- f) Hire extra staff, where necessary, with the required skills especially in ICT or accounting,
- g) Allocating an adequate budget for the supervisory wing of the operation. Without a properly funded and qualified inspection staff, the regulation will be just a paper exercise and serve no good purpose.
- h) Training the regulator's own staff in all aspects of their new duties.

- i) Training the relevant inspection staff in up to date supervision practices including the risk based method of supervision.
- j) Setting up the inspection unit and deciding on how the data will be delivered for analysis. Where information technology is available for use, it will lighten the work burden greatly. Where manual reports are used the process will pose concerns around data accuracy and even document storage.
- k) Ensuring that the regulator's own staff are well versed in the new laws, regulations and the proposed regulatory regime.
- l) Inspection and supervision tends to be technical in nature and require skills in accounting and accounts analysis, law and the use of information technology. It will be essential that the relevant skills are present in sufficient numbers on the staff.
- m) Ensuring that the I.T. resources and systems, are sufficient to handle the expected workload.
- n) Where there is a transitional period involved in the process it will be essential that the regulator should take the SACCOs and their associated organizations, (like apexes) through the transitional provisions so that they can avail of the opportunity to prepare themselves to be compliant with the new standards.
- o) Publishing the details of the process in the media and use the various publicity outlets on a constant basis throughout the inception period to keep the public and the SACCO membership of the ongoing activities and progress in the area.

SACCO auditors should be kept up to date with all processes as they may well be involved as advisors at SACCO level. Other support organizations such as state promotional and advisory bodies should also be part of the process, where these play an active role in the life of the SACCOs.

Preparation by SACCOs

- a) Ensure that the board of directors and all affected officers and personnel are fully informed of the new laws/regulations, its benefits and implications for their SACCO.
- b) Ensure that all employees are fully trained in the requirements that the new regime will come with and create in their work.
- c) Make all the necessary policy changes to include the new requirements in the law and regulations. Such policies include the credit policy, capital requirement policy, liquidity policy, dividend policy, investment policy, external borrowings and governance policies.
- d) Amend the SACCO's by laws where required to bring them in line with the new laws and regulations.
- e) Appoint a staff member who will be responsible for compliance reporting and ensure compliance with the law and regulations in practice. Keep the function simple and effective.
- f) Hire extra staff, if required, with the necessary skills especially in ICT or accounting.
- g) Prepare the documents necessary for licensing, where this is required. These will consist of items such as the society's business plan, policies, details of its risk management framework, financial status, among others.
- h) Build the necessary minimum capital adequacy requirements, liquidity requirements and realign other ratios such as external borrowings, investments to the regulatory limits.
- i) Develop or acquire a basic ICT platform capable of generating and submitting compliance reports to the regulator.

Preparation by SACCO representative association(s) (Apex group)

SACCOS usually come together to act collaboratively for their common good. Generally, this takes the form of national apex bodies. However, in some countries there are a number of such bodies that act on behalf of different groups of such societies. They will be expected to:

- a) Review and analyze the law and regulations and receive feedback and reports from SACCOs on its impact or potential impact on the sector and make appropriate steps to lobby for amendments,
- b) Sensitize SACCOs on the new laws and regulations, its implications and its benefits to the members and the sector,
- c) Collect and keep SACCO statistics and in particular, that which shows how the regulation is impacting on SACCOs over the period,
- d) Support the sector through capacity building initiatives such as education and training, research and consultancy to the SACCO Board of directors, staff and members as required,
- e) Develop the Central Finance Facility (CFF) to support the SACCO liquidity requirements,
- f) Develop a risk management service/facility to support the SACCO risk management and insurance needs.

8. SACCO LICENCE APPLICATION PROCESS

In jurisdictions where SACCOs must apply for a license to operate as well as being registered with the Registrar of Cooperatives or similar mandated authority, additional preparation is required. The regulations shall provide for the commencement date upon which all SACCOs shall submit their applications for licensing. Only SACCOs which have been registered by either the registrar or the Commissioner for Cooperatives and have a valid registration certificate shall apply for a license from the regulator. In the case of Ethiopia, the regulator has assumed that the registration certificate shall be deemed to be the license certificate. In such a case, the registration process of a SACCO shall be and form part of the regulation and must be strictly observed as such. This is also the case for Sierra Leone.

The license application form shall be accompanied by all the supporting documents as provided for in the Act and regulations. This may include updated bylaws, a business plan, evidence of capital adequacy, liquidity adequacy, a list of the board of directors and senior management, a list of SACCO members, and any other as provided for in the regulations.

SACCO licensing is a legal process and therefore must be duly followed before issuing a license certificate. In countries where it is instituted, licensed SACCO members benefit from the deposit protection fund in case of a collapse and therefore a proper due diligence must be done on the licensing process.

The regulator may decline a SACCO a license where a SACCO fails to meet all the licensing requirements. In certain cases the denial may be due to the small size of the SACCO, making it difficult to provide for capital adequacy, liquidity, ICT and the so on. In such a case the SACCO may be advised to merge with the others.

Where a SACCO is permanently denied a license, such a SACCO shall be advised to immediately stop operating as a SACCO until such a time when they shall have met the full requirements for licensing and the application re-submitted for licensing and considered.

9. Commencement of SACCO Supervision

The issue of a license certificate marks the beginning of the life-long process of the SACCO's supervision. Prudential supervision is only applicable to SACCOs which have been licensed. This generally involves reviewing returns submitted by SACCOs, obtaining audit reports and appraising the financial health of the SACCO through ratio analysis. The most prevalent supervisory ratio framework for SACCOs worldwide is known as PEARLS. Beyond measures of profitability, the World Council of Credit Unions (WOCCU) developed this set financial ratios which have been consolidated into an evaluation program.¹ The objective of PEARLS ratios is to quantitatively assess key risk areas and to measure and monitor the financial health of SACCOs. By using these ratios on a regular basis, SACCOs can make business decisions which will help them move towards an ideal financial statement structured to produce 'healthy ratios' and withstand shocks, and also suit regulatory compliance checks, trend analysis and peer SACCO comparison. For effective supervision:

- a) SACCOs shall submit off-site reports to the regulator at such intervals as provided for in the Act and regulations. Such reports can be weekly reports, monthly reports, quarterly reports or yearly reports and include such reports such as capital adequacy report, liquidity report, investment report, earning report, loan loss provision report, insider loan report or as stipulated in the regulations or as directed by the regulator.
- b) The SACCO off-site reports may lead to a visit to a SACCO for on-site supervision. On-site supervision is triggered by the off-site reports (or may be routine for a certain scale of SACCO) and is meant to provide for further clarification on the operations of a SACCO. Reports are therefore mainly from offsite or onsite. It is the responsibility of the regulator to ensure that they get accurate reports from SACCOs so as to appraise the extent of compliance.
- c) Regulators are required to analyze both the off-site and on--site reports against set regulatory standards provided and make a report and recommendations.
- d) In a number of cases, most reports will be good reports and may not require further action. In some reports, it may require advisory recommendation from the regulator on how to further improve, maintain or control the SACCO in line with the set standards.
- e) In certain extreme cases, such as fraud, uncontrolled deterioration or erosion of capital, extreme decline of liquidity, deliberate governance challenges, investment in risky assets beyond the prescribed limits, the regulator may prescribe harsher measures in line with the law. These measures may be moderate to severe depending on the gravity of the situation and may incremental depending on the matter(s) arising or the trajectory of financial safety and soundness of the SACCO. These can include introducing loan ceilings, removal of the board of directors and/or management, recommend for the prosecution of the officers responsible for a loss where criminal law applies, stopping the SACCO from receiving further savings from members until the situation is corrected or cessation of issuing loans to members until the matter is corrected, taking over as statutory management of the SACCO until the matter is

¹ 2009, WOCCU, Richardson, D. C., PEARLS Monitoring System from file:///C:/Users/User/Downloads/pearls_monograph.pdf

stabilized, among other administrative sanctions. The challenge facing the regulator is to administer sanctions without seriously undermining the business model of the SACCO.

- f) As part of its supervisory role, regulators may suspend or cancel a license issued to a SACCO. This may happen in cases where a SACCO permanently and deliberately violates the provisions of the Act and regulations. In the case of cancellation, the SACCO shall be liquidated and the registrar of cooperatives shall be advised to de-register such SACCO accordingly.
- g) Implement consumer protection guidelines by developing a robust complaints handling mechanism or procedures that ensure that SACCOs conduct transparent, fair and ethical business with its members. Tanzania and Uganda have a very elaborate consumer protection chapters within their regulations.
- h) Role of external auditors. The regulator shall have a close working relationship with external auditors to ensure that all audit reports incorporate regulatory requirements and a summary of the regulatory ratios and standards at the end of the financial year.
- i) As a good regulatory practice and to ensure compliance with capital and liquidity adequacies, regulators are expected to ensure that all SACCO financial accounts are audited and approved before they hold their Annual General Meeting and issue payment of dividends to members. The reason is to authenticate the financial statements and ensure that there is adequate capital and liquidity before such dividends are paid.

10. Regulation of other SACCO funds such as the central finance facility (CFF), the SACCO stabilization fund, housing fund savings, insurance funds (risk management services)

Regulation and supervision is about safety of SACCO members' funds. In a number of instances, SACCO funds are invested or held at the national association in products such as the central finance facility, stabilization funds, housing fund savings, risk management funds or in other form of funds. Such funds must be subjected to prudential regulation and supervision for the sector to be fully secure. In countries such as Uganda and Ethiopia, the law allows any two SACCOs to have their own Central Finance Facility. In Kenya, Ghana, The Gambia and Malawi, the apex associations hold huge amounts of money in the form of such funds. It would be a negligence on the part of the regulator if such funds are not regulated and supervised.

In more advanced countries, such funds are sometimes registered as separate legal entities and therefore easier to regulate. In the case of most African countries, such funds are managed by the apex associations as products and services. In such situations, regulators shall develop the necessary regulations to provide oversight to the associations but with a focus to its financial services.

Regulation focuses on the association's financial instruments and financial services because these funds are not separate legal entities, have no capital of their own and their oversight policies are at the discretion of the board of the association.

Further, it should be noted that the national association of SACCOs are often registered as secondary SACCOs and therefore, the regulators are expected to issue directives clarifying that 'for the sake of these regulations', the SACCOs and the SACCO national associations shall be treated as one and the same thing. A directive issued as such would clarify and cure this without necessarily amending the law.

11. Conclusion

SACCOs must be regulated so that they can provide the necessary stability and confidence to the members, the stakeholders and the rest of the financial sector. This requires that the regulator, the SACCOs and the national association of SACCOs play their active roles effectively. Finally the regulator must focus on members' deposits, both at the SACCO and at the national association level to ensure a complete risk coverage and protection of the sector.