

# Financial Inclusion and Regulatory Policy: The Case of Ghana's Informal and Semiformal Financial Institutions

## *Fletcher School Leadership Program in Financial Inclusion: Ghana Policy Memo*

There is some consensus that a broad-based financial sector can contribute to economic development and poverty alleviation (United Nations, 2005). Access to financial services provides people with the opportunity to manage their risks, broaden their menu of choices, and smooth their consumption patterns. This promotes development, thereby contributing to poverty reduction. This raises concern for a country such as Ghana, which has a fairly well-diversified banking and financial system, and yet relatively low financial inclusion. The FinScope Ghana survey of 2010 (FinMark Trust, 2010) indicates that only 56 percent of the adult population is financially served and 44 percent is financially excluded. Among the financially served, as much as 15 percent is served only by informal financial institutions.

Thus, the central bank's financial inclusion efforts, including the creation of rural and community banks, as well as savings and loan companies to help promote financial access for the rural folk and urban poor, have positively impacted access to financial services. Nevertheless, much still remains to be done. The proliferation of a new layer of financial intermediaries below rural and community banks and savings and loans companies, which are enjoying growing patronage, is evidence that financial access remains a challenge.

### PROBLEM STATEMENT

The recent emergence of a new wave of unregulated informal and semiformal financial intermediaries, comprising individual Susu collectors,<sup>1</sup> Susu companies,

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money lenders, financial NGOs, and financial service companies, which are ostensibly catering to the financial service needs of the lower echelons of the financial pyramid, presents both opportunities and challenges.

While the FinScope survey indicates an important role for informal financial services providers in financial service delivery to the poor and the marginalized, operations of such individuals and entities often pose a number of risks to patrons. These risks, if not addressed, can threaten confidence in the financial system. Apart from occasional reports of companies going bust or proprietors running away with depositors' funds, there are concerns that such providers are levying usurious lending rates and/or using unorthodox lending and recovery practices, which creates a sense of insecurity among operators and patrons.

This policy memo explores ways of achieving a cost-effective system of supervision that promotes the orderly growth and integration of such intermediaries into the formal financial system while protecting patrons from fraud and other malfeasance.

## ANALYSIS

*Statistics on providers in this space.* The Ghana Cooperative Susu Collectors Association (GCSCA) boasts a membership exceeding 1,500 collectors country-wide. This number excludes a number of freelance collectors that are not affiliated with the GCSCA. Information available from the Ghana Police Service identifies 160 individuals, enterprises, and companies licensed to carry on money-lending operations. While the numbers of Susu companies and financial service providers are less certain, they probably number about 50 such entities. In terms of deposit mobilization, it is estimated that they intermediate about GH¢50-60 million (equivalent to US\$30-40 million), which is significant, given the segment of the market covered.

*Variety of institutions in this space.* There are a variety of players in this intermediary space. They range from individual Susu collectors and money lenders, Susu companies, financial services providers (or mini savings and loan companies), and financial NGOs, most of which are companies limited by guarantee. The variety of institutions calls for a tiered approach to regulation and supervision. Tiered regulation implies that regulation should be differentiated and suited to each particular segment of this mixed market.

*Criticality of their role in increasing access to financial services.* Although Ghana has witnessed an expansion in the bank branch network over the last few years, from under 400 in 2005 to over 700 at the end of June 2011, these remain concentrated in the major cities and urban centers and relatively wealthier southern parts of the country. In addition, their flashy swinging glass doors and suit-clad staff remain intimidating to both the urban and rural poor. Informal financial intermediaries like those being described remain attractive, and sometimes are the only ones available in some localities. Introducing some formality into their operations and

recognizing their status and role can enhance confidence in them as intermediaries, and thereby expand access to financial services.

*Problems brought up in the past: Sudden collapse/disappearance, undue risk to patrons, “illegality,” etc.* There have been a number of incidences of the sudden collapse and disappearance of Susu companies and financial service providers, often with catchy headlines in the print media that imply inaction or negligence on the part of the Bank of Ghana, the institution entrusted with regulation of deposit and credit-granting activities. Within a space of one month, three such incidences were reported in one region, involving about GH¢150,000 of savings. Shortly after, another case was reported in the Afienuya area (Accra region), where a collector bolted with GH¢74,000 of depositors’ funds. These incidences arise principally because of imprudent use of mobilized resources and reflect a lack of expertise on the part of the collectors. These developments not only cost patrons their hard-earned savings, but also hurt confidence in the wider financial system.

*Past response of the central bank.* In the past, the Bank of Ghana took the position that these institutions were insignificant relative to the wider financial sector and therefore did not pose any risks to the financial system. In addition, regulating such small-scale operators was thought to be costly and a waste of scarce supervisory resources. However, as the spate of reported collapses increased and the headlines became rampant, the bank moved in 2008 to close down a number of operations countrywide. This attracted some public outcry, including from political figures. The bank responded to this by relaxing its stance and began to look at ways of installing a cost-effective system of regulation and supervision.

*Rationale for regulation.* Regulation is necessary not only to restrict entry exclusively to competent persons and entities, but also to ensure orderly exit. It is also appropriate that regulations address permissible activities and the appropriate level of capital for operations and risk mitigation. Regulations should also put in place a system of prudential reporting to the regulator to ensure adequate data for analysis and policymaking. That way, sanity could be restored to the sector in a cost-effective way while allowing innovation for financial inclusion. Regulations should seek to provide a transition path from informality to formality, thus allowing bigger operators to incorporate or register a business name while still allowing individuals to operate as Susu collectors or money lenders, provided they associate with an umbrella association for purposes of sharing best practices and collating data on operations.

*Proportionality principle.* The challenge that arises is one of proportionality; how to ensure that regulation and supervision are not so burdensome as to drive operators underground or kill initiatives, or so demanding of regulatory resources as to outweigh the benefits of extending regulatory oversight to the sector. The solution can be found in a system of “tiered regulation,” whereby the bigger and systemically important operators are subject to direct regulation and supervision by the Bank of Ghana, while the smaller ones are subject to indirect supervision through self-regulatory umbrella associations. The central bank could also promote the forma-

tion of umbrella associations for the different types of institutions to serve as a platform for information exchange, good practice dissemination, and the exertion of some form of peer pressure on their membership to ensure good conduct.

## OPTIONS FOR REGULATION

1. *Maintain the status quo.* This is always a default option—let things stay as they are. The risk is that we have to live with the occasional failures and the bad press for the central bank. It will also deny the central bank access to good data and information on the contribution of that sector to financial intermediation. As a nation, we could lose the benefit of actually harnessing the potential of these operators to achieve and expand financial inclusion.

2. *Close down all such “illegal” operations.* The central bank is vested with power to “police” the financial system and can therefore order the immediate closure of operations that it determines to be “illegal” or “unauthorized.” Indeed, this has been done before (in 2008) and it resulted in a public outcry, including complaints from politicians who thought the central bank was unnecessarily high-handed in its treatment of their constituents. That option may therefore not be appropriate, especially as we approach another election year in 2012. Besides, without continuous monitoring and closures, such institutions resurface after a while and therefore defeat the whole exercise. This option also eliminates the potential benefit of expanding financial inclusion through the services that these institutions provide.

3. *Establish a tiered system of regulation.* A third policy choice is to put in place a system of regulation and supervision commensurate with the risks posed by these institutions and operators. This approach avoids the backlash associated with doing nothing and/or outright closure of institutions, although it comes with challenges. It also allows a nurturing of these institutions as instruments for financial inclusion, while also providing a transition route to both formality and upgrading into the formal sector. Given the variety in the size, scope, and mode of operations of the players, designing a suitable regulatory system is challenging. The solution is to divide institutions into those that can be directly supervised by the central bank and those that should be supervised indirectly through self-regulating umbrella associations.

*Direct regulation of bigger players.* In order to maximize efficiency in the use of supervisory resources, it is appropriate to focus supervisors’ attention on the bigger players in this space. The collection of data on balance sheet size, loan portfolio, and other key parameters will assist in stratifying all players by size and scale of operations. Based on this, those that meet a minimum threshold can be subject to direct supervision through rules and guidelines that define minimum capital requirements, permissible activities, governance structure, and prudential reporting, among others. A dedicated unit within the Banking Supervision Department that is staffed with suitably qualified individuals could be made responsible for their oversight.

*Indirect regulation: Promotion of self-regulating umbrella organizations.* For small players, such as the individual Susu collectors dotted all over the country, direct regulation and supervision may be burdensome and not cost-effective. The obvious option would be to encourage all such operators to belong to an umbrella association that establishes some minimum operating norms for compliance by all members, with the approval of Bank of Ghana. Such an association already exists for Susu collectors, and extending the same to money lenders or financial service providers below the threshold would be appropriate. The rationale is to provide a forum for members to learn good practice and for the regulator to interact with the widely dispersed members through the leadership of the association. The umbrella associations could be supported with capacity-building for their leadership and members, recognition, and also access to non-lending funds, as incentives to get individual operators to take interest in belonging to these associations.

### RECOMMENDATION

The third option, which is to establish a tiered system of regulation, appears to be the best choice under the circumstances, as it is supportive of financial inclusion, provides for an orderly operation and development of the sector, and affords the Bank of Ghana the opportunity to discharge its mandate in a cost-effective manner.

### IMPLEMENTATION PROCESS

Initially, a unit dedicated to the supervision of microfinance institutions, manned by ten staff, was set up within the banking supervision function. This was followed by the development of rules and guidelines and licensing requirements, which were discussed with all stakeholders before being finalized for adoption and implementation.

The draft rules and guidelines were first discussed with top management in the Bank of Ghana and the board of directors, and then presented at stakeholder meetings in Accra and Kumasi, to which operators in the microfinance space were invited. Staff of the Bank of Ghana also made presentations to umbrella associations separately, and aspects of the guidelines were clarified. After the stakeholder meetings, the guidelines were finalized and published in mid-July 2011, followed by a transition period of six months in which all operators were required to either complete or start the licensing process, otherwise their operations would be deemed illegal and subject to outright closure.

For the purposes of the regulation and supervision, microfinance activity was divided into four tiers:

- Tier 1 comprises savings and loans companies, finance houses, and rural and community banks; these are already regulated under the Banking Act of 2004
- Tier 2 comprises Susu companies and other entities engaged in financial services that involve deposit-taking, credit extension, or both

- Tier 3 comprises money lenders (who are not deposit-taking) and financial NGOs, which are companies limited by guarantee and non-deposit taking
- Tier 4 includes all individual Susu collectors and individual money lenders, as well as individuals trading with a business name but not incorporated; this category will be regulated through an umbrella organization, such as the Ghana Cooperative Susu Collectors Association

Subsequent to the publication of the rules and guidelines, the Bank of Ghana has received support from Responsible Finance, a German initiative, to build the capacity of umbrella organizations and enable the Bank of Ghana to achieve its supervisory objectives in the microfinance sector.

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1. Susu is a traditional methodology of savings with several variants, the most common of which is where an individual known in the community collects periodic savings from other individuals on the understanding that the total savings will be returned at the end of the specified period, less a commission of a day's savings. In other variants, people may agree to contribute a specified amount and give the total to one member of the group, repeating same by rotation till every member is served and the cycle begun again. In this memo we refer to the first type, where individuals, business enterprises, and companies undertake this activity using the methodology.

## References

FinMark Trust, *FinScope Ghana*, 2010

United Nations, *Building Inclusive Financial Systems*, 2006.