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SOCIAL FINANCE INSTITUTIONS

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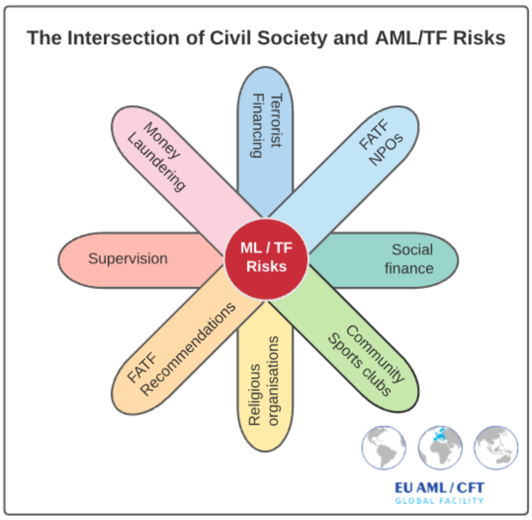
Introduction

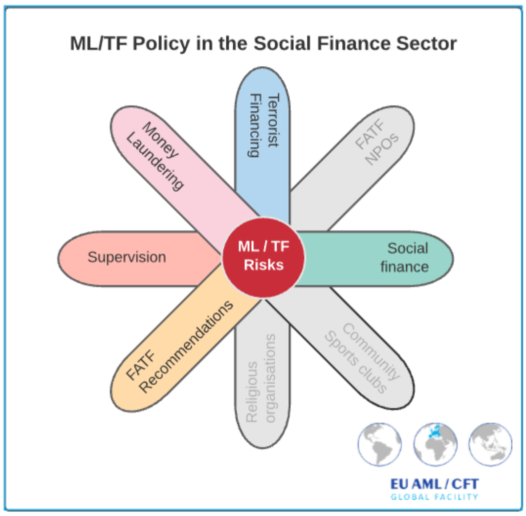
This paper has been produced by the EU Global Facility on AML/CFT. The overall objective of the EU Global Facility is to provide support to partner countries to put in place effective AML/CFT frameworks in compliance with the AML/CFT international standards, notably EU recommendations on AML/CFT, UNSCRs and FAFT recommendations.

The project also aims to encourage co-operation between financial, justice actors at national, regional and international levels. The project comprises of a global facility, structured technical assistance and equipment, working closely with partner countries for demand driven tailored support.

The intersection of civil society with ML/TF Risks

This paper forms part of ongoing research by the EU Global Facility examining the intersection of civil society and ML/TF risks. This aims to expand from the FATF Recommendation 8 (R8) focus on NPOs and terrorist financing to encompass other forms of civil society and organised financial crime[1].





In 2021, the EU Global Facility commissioned research into what we have termed the **'social finance sector'**. This refers to financial institutions whose objectives are primarily, although not necessarily exclusively, social rather than commercial. It includes legal types which meet the broad definition of civil society as non-governmental, non-profit making organisations, but which do not meet the narrower definition of NPO in FATF, which excludes what may be termed 'self-interest' organisations.

The concern is that these organisations fall between two stalls: they are treated neither as full financial institutions nor full-NPOs within the FATF architecture. The ML or TF risk profile may consequently be left unassessed, and the policy, legal, regulatory and supervisory framework varies between jurisdictions and may not always be risk-based, targeted, appropriate or adequate.

This paper explores the different forms of social finance, identifying a sector notable for its diversity and complexity. It examines the range of regulatory responses to the sector, and the specific challenges

1. Other published research focusses on FATF NPOs and ML; and community sports clubs and TF/ML.

faced by global standard setters such as the Financial Action Task Force as they seek to protect financial integrity and encourage financial inclusion.

Social Finance Institutions – applying a risk-based approach to a complex ecosystem

In January 2023, Netflix released Bank of Dave. The heart-warming film is based on the struggles of David Fishwick to obtain a banking licence for a new community bank to help local businesses in a working-class town in the North of England. The film sets up Dave as a community hero, battling against 'fat-cat' bankers focused solely on bonuses and profits.

The film culminates with the issuance of a banking licence to the 'Bank of Dave', the first new bank licence issued in the United Kingdom in 150 years. But the film, which describes itself as 'true(ish)', doesn't tell the real story. Burnley Savings and Loans, the real organisation set up by Dave Fishwick, issues loans to individuals and businesses in the community, and donates its profits to charity. But it has never received a banking licence from the banking supervisors, and is not a bank[2]. Indeed, as Fishwick himself says, if he were to use the word 'bank' or 'deposit' in relation to Burnley Savings and Loan, he could go to prison[3].

So, is the real villain a regulatory system which prevents people like Dave from developing innovative community-focussed, public benefit financial services? And are regulations designed to protect against fraud, abuse and insolvency in commercial financial institutions appropriate for grass-roots, community focussed financial vehicles?

Lending money, not making money

There is no single agreed term for financial institutions whose objectives are primarily social rather than commercial. In this essay we use the term 'social finance institutions'. However, it is important to note that this is not a widely-accepted term, and there is no agreed definition.

Regardless, social finance institutions are ubiquitous, varied and ancient (Japanese tanomishi have existed since at least the 14th Century).

There are various motivations for the evolution of social finance institutions. Perhaps the most important is financial inclusion. Complex regulations, commercial pressures or aversion to risk can lead to a lack of financial services from commercial financial institutions for significant parts of a community. Social finance institutions are developed to provide access to financial services to businesses and individuals which may otherwise be unavailable.

A linked but separate driver is the development agenda. Social finance institutions may be established as a means for alleviating poverty or for aims related to economic development. These are sometimes targeted at marginalised groups, particularly women.

A third agenda is ideological or political. The aim is to keep financial services within the ownership and control of the community, to prevent financial or other exploitation of communities by outside groups.

Some academics also note a social role, with social finance institutions facilitating community bonding, improving the social status of members, combatting isolation amongst immigrant groups and encouraging saving.

2. https://www.burnleysavingsandloans.co.uk/about/
3. https://www.theguardian.com/money/2012/jul/06/bank-of-dave-small-business-finance-dave-fishwick

Understanding a complex ecosystem

The ecosystem of non-commercial financial services is complex, varied and constantly evolving. Furthermore, definitions, legal forms and practices are blurred, and are applied in different ways in different jurisdictions.

Certain archetypes are identified below, which follow a broad progression from grass roots informal entities, through grass roots formal entities to top-down intervention. But these archetypes are offered with a strong caveat – these terms are not universally agreed nor clearly defined. Real world social finance institutions may not fit neatly into any of the categories, or may display features of multiple types.

Membership savings and loan clubs

Membership-based savings and loans clubs are grass-roots, informal financial entities. Typically, they comprise a group of individuals who agree to save and borrow funds together. Membership is by invitation, and is usually based on a village or small community. These are typically grass roots organisations, although development agencies sometimes seek to stimulate their formation in specific countries.

Academics have noted two particular forms: ROSCA and ASCA.

ROSCA are Rotating Savings and Credit Associations. These are membership-based time limited savings and loan institutions. Each member pays an agreed amount into a pot each week, with one member receiving the pot until all have had a turn (hence, 'rotating'). There are varied mechanisms for selecting the member that receives any given pot.

ASCAs are Accumulation Savings and Credit Associations. These are also membership-based, time limited institutions, but they typically appoint a manager from amongst the membership to oversee loans for interest made from the members' deposits. At the end of the designated time period loans are recalled and any surplus distributed.

These forms of social finance are extremely common, appearing in societies across the world. Examples include:

Gam'eya	Egypt
Equb	Ethiopia
Xitique	Mozambique
Susus, Tontines	Western Africa and the Caribbean
Likelambas	Democratic Republic of Congo
Chama	Kenya
Tanomoshiko	Japan
Arisan	Indonesia
Committees	India and Pakistan
Tanda	Latin America
Pandeiros	Brazil
Juntas, quiniela or panderos	Peru
C.A.R. Ţigănesc/Roata	Romania
Gün	Turkiye
Menage' or menodge	Scotland

Many of these organisations are 'intermediate' or 'pre-cooperative' groups, evolving organically from peasant societies as they seek to align with commercial markets.[4] A key feature is their informal and unregulated nature, based on simple rules, time-limits, internal transparency and trust. Loans are guaranteed through community bonds, rather than collateral. Few such unregulated clubs are covered by government insurance schemes. They are usually separate from the formal financial system and associated supervisory bodies and regulations.

Neither are they usually considered 'not-for-profit' organisations, as 'profits' or 'surpluses' are shared between the members, depending on the form. They are not normally regulated as NPOs, and do not meet the FATF definition of NPO.

However, these models can evolve, and more complex models bring formality and regulation. For example, in South Africa, Stokvels are regulated by the National Stokvel Association of South Africa (NASASA), a self-regulatory organisation approved by the Prudential Authority.

In India, chit funds provide another example. Chit funds are a popular form of ROSCA. Since 1982, organised chit funds have been required to register, and they are currently regulated as Miscellaneous Non-Banking Companies (MNBCs).

In Kenya, a longer-term form of chama exists through which members buy shares in an investment pool through regular payments. Funds are loaned to members, with interest paid, making these an ASCA. Most chama remain unregulated. But some have grown and become Savings and Credit Cooperatives regulated under the 'Cooperative Societies Act' (see next section).

Accurate global data on membership-based savings and loans clubs is elusive, as many are unregulated, and no common definition of the form exists. A sense of the vast scale can be obtained from data from individual countries. Table 1 provides some selected data on membership-based savings and loans clubs.

Table 1: Savings and loans clubs (selected countries)

Country	Form	Number	Assets (US$)	Members	Date
Kenya[5]	Chama	300,000	$3.4 billion		2012
Mexico[6]	Tanda			31% of population	2010
South Africa	Stokvel	800,000	$28bn	Half the adult population	

4. Geertz, Clifford (1956). The Rotating Credit Association: a middle rung in development. Cambridge, Massachusetts, United States: Massachusetts Institute of Technology, Center for International Studies

5 "Capital Business » First handbook to guide chamas out". Capitalfm.co.ke. 2012-11-29.

6 Fundary. "Tandas And The Informal Economy of Mexico

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Cooperative financial institutions

As grass roots, membership-based savings and loans clubs grow, they may evolve into cooperative financial institutions. The section above gives the example of chama in Kenya becoming Savings and Credit Cooperatives.

Cooperative financial institutions share many features with membership-based savings and loans clubs. They are also typically grass-roots organisations, membership based, and also predominantly offer savings and loans. However, there are some important differences. Typically, they have a broader membership, a more formalised structure and do not rely on 'social bonds' in the place of collateral. In this respect, they start to look more like traditional banks.

At the most informal level, self-help groups (commonly abbreviated SHG) are an example of informal cooperative financial institutions common in South Asia. Like ASCAs, they consist of a small group of individuals within a community who make regular savings contributions, from which small loans are made. Like ASCA, they primarily rely on solidarity bonds rather than regulations or collateral. However, they can be distinguished from ASCAs in two important ways:

First, whilst members may be the primary recipient of loans, they can be offered to non-members in the community. Secondly, they do have collateral. The Reserve Bank of India requires commercial banks to offer collateral-free low interest loans to SHGs. The 'SHG Linkages Programme' run by the National Agricultural and Development Bank of India facilitates this, with millions of SHGs benefitting. Many SHGs are also philanthropic, making donations to needy individuals in the community.

One of the best known forms of cooperative financial institution is the credit union. In the United Kingdom, credit unions emerged in the 1960s, building on a long tradition of 'friendly societies' but echoing practices brought by immigrant groups from the Caribbean and Ireland. These were formally regulated by the Credit Unions Act in 1979, and are now subject to dual regulation from the Financial Conduct Authority (FCA), who register credit unions and The Prudential Regulation Authority (PRA), who authorise credit unions.

Self-regulatory organisations also exist for credit unions. In Bangladesh, The Cooperative Credit Union League of Bangladesh supports and encourages the formation of credit unions, advises on best practices, provides training, and offers accounting and auditing services. Similarly, in Sierra Leone, the National Cooperative and Credit Union Association (NaCCUA-SL) is a registered cooperative which registers, verifies and supports credit union and requires those registered credit unions to have an annual audit.

Credit unions also exist in the United States and Canada as not-for-profit, cooperative tax-exempt organisations. These are closer to banks than the smaller savings and loans clubs seen in other parts of the world, as reflected in their size (see table 2) and the complexity of their regulation. Credit unions are regulated, advised and insured, by the National Credit Union Administration, and have a higher insurance ratio and a higher equity capital ratio than U.S. banks.

In 2021, the World Council of Credit Unions (WOCCU) had 87,914 members serving 393 million members in 118 countries with $3.48 trillion in assets.[8]

7 According to the Credit Union National Association
8 https://www.woccu.org/documents/2021_Statistical_Report

Table 2: Credit Unions (selected countries)

Country	Form	Number	Assets (US$)	Members	Date
Bangladesh	Credit unions (affiliated)	628	$100m	335,212	2012
Sierra Leone[9]	Credit Unions (registered)	23	$510m	11,363	2021
United Kingdom[10]	Credit Unions (registered)	c. 400	$4.1bn	1.2 million (since 1964)	2022
United States[11]	Credit Unions	5,099	$1,840bn	100m+	2020

The US model of credit union fits at the most formal end of the scale, being reliant on collateral, regulation and statutory insurance rather than on a community bond. Elsewhere in the world, similar entities are more commonly known as ‘cooperative banks’, ‘land development banks’ (South Asia) or ‘building societies’ (UK and Commonwealth). Cooperative banks in Islamic societies have evolved as a means of offering finance whilst avoiding the charging of interest (for example, Bank Rakyat in Malysia). They are often regulated both as formal financial institutions and as cooperatives. These banks can grow into major financial institutions – Crédit Agricole in France has 52 million members and is considered a ‘systemically important bank’ in the global financial sector by the Financial Stability Board.

Microfinance

‘Microfinance institutions’, sometimes called ‘MFIs’, are the stars of social finance. ‘Microfinance’ is a broad term encompassing a range of institutions defined by their development aims, focus on poverty and small sums. Microfinance institutions may offer a range of services, including credit, savings, deposit accounts, insurance and even payment systems. These are not grass roots organisations, but services are offered or facilitated by established NGOs, development agencies or commercial financial institutions

Whilst microfinance entities have existed in Europe for centuries, the modern understanding of the term is shaped by developments in Bangladesh in the 1970s and 1980s, where a pioneering model of microcredit was developed. Entities like BRAC, ASA and Grameen Bank became global leaders, and Grameen Bank founder Muhammad Yunus was awarded the Nobel Peace Prize for his work on microfinance in 2006. By 2019, the Microfinance Barometer (2019)[12] estimated that 139.9 million borrowers benefited from the services of MFIs, with an estimated credit portfolio of $124.1 billion.

BRAC, ASA and Grameen all started as non-profit entities. However, modern MFIs may or may not be non-profit organisations. Grameen itself became a corporate entity in 2002; another major MFI NPO is PRODEM in Bolivia, which became the commercial BancoSol in 1986.

9 https://www.naccuasl.org/
10 www.findyourcreditunion.co.uk
11 National Credit Union Administration figures
12 https://www.convergences.org/en/119115/

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Structurally, MFIs can be classified as wholesale or retail. Wholesale MFIs are entities which raise and disperse capital for microfinance. They may also stimulate or operate a network of retail MFIs for dispersing and managing individual loans. They may be non-profit, government or commercial. Examples include the CDFI Fund in the United States, a government agency which funds over 1000 MFIs throughout the country. These entities are regulated by banking supervisors, and, depending on their status, as NPOs.

Retail MFIs are the client facing institutions responsible for distributing, managing and collecting the individual loans. The range from formal and regulated institutions (like the Community Development Financial Institutions, which may take a variety of forms) though to the informal and unregulated (such as ‘solidarity lending groups,’ which are informal small groups prevalent in developing economies who mutually obtain and repay loans ‘guaranteed’ through social bonds).

Various models exist for connecting the two parts of the system. Some MFIs combine the wholesale and retail aspects. For example, ASA in Bangladesh reported in 2013 that it had 2,933 branches, each run by six people.

In other systems, intermediaries provide the link. Grameen Bank developed a system of grouping eight ‘solidarity groups’ known as ‘centres’. In Francophone Africa, CVECA (Caisse Villageoise d'Epargne et de Crédit Autogérée, or self-reliant village savings and credit banks) are described as intermediaries between the informal and formal banking sector. They are community-run banks in rural areas with fewer than 250 clients which network to form regional federations.

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Financing MFIs

The mix of commercial and non-profit features is also observed in the sources of seed and operational capital for MFIs. This includes:

- Self-financing: The Association for Social Advancement, a Bangladeshi NPO and MFI, is entirely self-financing[13].
- Charitable donations from development budgets: BRAC receives funding from international aid agencies and private foundations.
- Charitable donations from commercial entities: In 2010, Bank of America established a $10m grant fund to leverage microloans to small businesses via non-profit financial institutions.
- Government grants: in India, the National Bank for Agriculture and Rural Development funds thousands of rural self-help groups through 500 banks.
- Commercial financing. CVECA in Mali access refinancing through the Banque Nationale de Developpement Agricole, the rural central bank.

Commercial MFIs

A wide range of commercial MFIs operating for profit exist. They are excluded from our definition of 'social finance institutions' are they not primarily established for a social purpose. They include:

- Formal banking institutions offering microfinance products, including state banks, agricultural banks, development banks and retail banks. Examples include the National Bank for Agriculture and Rural Development (NABARD), India and the BRI-UD unit within Bank Rakyat Indonesia.
- Informal financial services providers, such as payday lenders and pawnbrokers.
- Purchase loan companies, such as Klarna, Afterpay or Affirm, which offer small loans for purchases at high interest rates.

The commercialisation of microfinance has been criticised by Muhammad Yunus, amongst others.

13 https://asa.org.bd/AboutUs/UniqueFeatures

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Applying a risk-based approach

As noted above, the primary goal of social finance is to increase financial inclusion. This is a goal supported by the Financial Action Task Force, which states that financial inclusion and AML/CFT are mutually supportive and complementary objectives. In 2013 FATF published guidance on the topic of financial inclusion, subsequently updated in 2017[14].

'Social finance' entities are, from a systemic and AML/CFT perspective, low risk. Studies of financial crime associated with membership-based savings and loans clubs note small frauds and embezzlement, particularly in unregulated institutions[15]. In ACMAs, typical crimes include mismanagement, embezzlement by fund managers, or collusion with defaulting creditors. The most serious frauds are 'chain-mail' style pyramid schemes, which have been noted in India[16], Nigeria, and amongst immigrant communities in the United States[17]. But abuse in the regulated sector is far less common. In the United Kingdom, the Prudential Regulation Authority website published two cases where it used its enforcement powers relating to credit unions, neither of which related to criminal activity. And FATF's guidance notes assessments from Sri Lanka, Nigeria, Malawi and Tanzania that found micro-finance and/or community lending products to be low risk from an AML/CFT perspective[18]. Social finance therefore seems ideally suited to benefit from the application of FATF's risk-based approach.

However, in practice FATF's measures may inhibit some kinds of social finance organisations. To understand why, consider FATF's own statement on financial inclusion. It states that its interest "is primarily driven by our objective of protecting the integrity of the global financial system." In practice, its goal is to increase the use of formal financial services and thereby the reach and the effectiveness of AML/CFT regimes. It sees informal financial services as "threats to the integrity of formal financial services, as due diligence inquiries fail when money trails disappear in the cash economy."

This reflects the 'top-down' perspective of FATF, which focusses on what formal financial institutions do. It measures 'financial inclusion' by the degree to which excluded individuals are 'raised-up' into the formal and regulated financial sector. So, as FATF's own guidance recognises that the greatest challenge to financial inclusion is the cost and complexity of accessing formal financial services, the remedies are focussed on reducing that complexity and cost, for example through simplified customer due diligence requirements in certain cases.

But it still requires formal, regulated entities to conduct that due diligence. A 'financial inclusion-first' approach would instead measure the degree to which financial vehicles and products 'reach down' to the financially excluded.

However, this approach may also help increase financial integrity. Informal social finance organisations act as a gateway to the formal financial sector: they are both a first step for many financially excluded people into the formal world of regulated financial services; and, as this paper explores, these entities are themselves proto-financial institutions, the first step in a process of growth and formalisation which leads to the regulated sector.

14 FATF (2013-2017), Anti-money laundering and terrorist financing measures and financial inclusion - With a supplement on customer due diligence, FATF, Paris Link

15 For example, a study from India found that 35% of subscribers failed to pay at least one contribution, with 24% defaulting after receiving the pot. Rao, Preethi; Buteau, Sharon (2018-05-04). "Modelling credit and savings behaviour of chit fund participants"

16 https://www.tribuneindia.com/news/nation/chit-fund-case-ed-attaches-assets-worth-rs-5-crore-of-west-bengal-based-journalist-382441

17 https://www.washingtonpost.com/business/2020/08/07/sou-sou-blessing-loom-illegal-pyramid-schemes/

18 FATF (2013-2017), Anti-money laundering and terrorist financing measures and financial inclusion - With a supplement on customer due diligence, FATF, Paris Link

A risk-based approach could therefore also consider the variety and reach of the financial ecosystem, and the proportionality of regulatory hurdles for certain kinds of informal financial institutions which may contribute to financial inclusion and financial integrity.

This paper reflects a range of regulatory responses to social finance institutions: they are unregulated, 'socially' regulated, self-regulated, statutorily regulated and even, in some cases, double-regulated[19]. The EU Global Facility on AML/CFT itself has been supporting innovative regulatory solutions for microfinance institutions with voluntary certification mechanisms to certify their compliance with AML/CFT standards which are based on community-led processes which can be officially assessed and endorsed[20].

FATF's risk-based approach and focus on financial exclusion is necessary and welcomed[21]. However, a risk-based approach could also encourage innovative regulatory measures which allow a complex financial ecosystem to flourish. This ecosystem would recognise that 'social finance' offers a unique service, and is categorically different from both financial institutions and NPOs, as currently understood within FATF standards. And it would embrace the grass-roots, membership-based organisations that offer unparalleled penetration into financially-excluded communities. Such an ecosystem would tackle both financial exclusion and bolster financial integrity by facilitating the entry of the financially excluded into the formal financial sector.

FATF states that financial inclusion and AML/CFT are mutually supportive and complementary objectives. But the diversity of the social finance sector and its role in facilitating the entry of the financially excluded into the formal financial sector is not well understood. Further research, at both the global and the national level, is necessary for the development of effective policies to combine the two objectives.

19 See, for example, building societies in the UK, which are regulated both as financial institutions and cooperatives.

20 https://www.global-amlcft.eu/tackling-dirty-money-while-supporting-financial-inclusion-an-innovation-in-regulation-of-microfinance/

21 As a side-note, they also contrast favourably with the approach of other standard setting bodies such as the Basel Committee, whose Core Principles incorporate the risk-based approach and the proportionality principle but make no reference to financial inclusion.

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