



# Aligning Interests

Addressing Management and  
Stakeholder Incentives During  
Microfinance Institution  
Transformations

**CALMEADOW**  
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**CENTER FOR  
FINANCIAL INCLUSION**  
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Microfinance Institution  
Transformations

By Calmeadow and  
The Center for Financial Inclusion



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## Foreword

**M**ore and more microfinance operations are migrating out of not-for-profit associations (like NGOs) and into for-profit companies (like banks). Similar transformations have occurred in other industries that began with pro bono efforts but went on to mobilize commercial capital. These transformations create important challenges. Some of the challenges inherent in migrating to for-profit microfinance have been discussed widely—for instance, the question of maintaining a social mission when for-profit investors enter the scene.

This useful and timely paper opens a dialogue about another transformation challenge that occurs often but has received little attention so far. Moving a microfinance operation into a new for-profit structure can make the managers and directors of the old not-for-profit NGO worse off individually rather than better off. If angels have been running the NGO, there will be no problem—they will cheerfully ignore consequences for themselves and resolutely pursue whatever is best for the microfinance operation and its clients. But quite a few non-profit MFIs are run not by angels but by humans, and humans have a poor record when it comes to enthusiastically supporting changes that affect them negatively.

The authors present examples of such transformation problems, and of various tools to compensate managers, directors, and staff so that the success of the transformation will make them better off rather than worse off. The paper analyzes the ethical and practical issues involved, and takes a strong first step in the direction of articulating good practice guidelines for structuring incentives.

I think this paper does a fine job of flagging and analyzing the problem. But the authors recognize that a lot more work needs to be done before an industry consensus can emerge about appropriate ways to manage incentive conflicts when MFIs commercialize. The working group that supported this paper is mounting a series of regional workshops to explore the subject, and is considering a database to inventory compensation and incentive arrangements in transformations around the world. I hope that many members of the microfinance industry will engage in moving this discussion forward.

– Richard Rosenberg  
CGAP



## Preface

The idea for this paper arose from the experience of microfinance investors reflecting on failed NGO transformations. Over the years, a number of investors have tried to invest in institutions that were in the midst of undergoing the process of transformation from an NGO to a regulated MFI, only to find the potential transaction unwind due to an inability of the stakeholders to adequately align their interests. Alex Silva, founding partner of Omatrix Inc. and president of the Calmeadow Foundation, and Deborah Drake, vice president of Investing in Inclusive Finance at The Center for Financial Inclusion at ACCION International, provided the vision for this paper from the start. Calmeadow and the Center for Financial Inclusion at ACCION International are co-sponsors of this project.

Once we had broadly outlined the topic that later evolved into this project, the core project team (Ira W. Lieberman, the Project Coordinator, along with Brian Busch and Stephanie Dolan) set out to interview a wide range of players, both within and beyond the microfinance industry. While we could not have hoped to include in the paper all the valuable anecdotes and important insights gained through those conversations, we want to sincerely thank all those who took the time to share their thoughts with us; Annex 1 of this document contains a list of those who contributed.

To delve deeper into specific instances, with the hope of better understanding the interrelated issues and subtleties that have an impact on stakeholder interests, we commissioned eight case studies on specific institutions from different regions. The cases were extraordinarily well done and we are grateful to Mohini Bhatia, now with the IFC, Modibo Camara, Alfredo Bello, and Tom Keleher of A2F Consulting, and José Ruisanchez for their work producing the cases. Please note, not all of the cases have been included in some print versions of this document; they are available electronically at: [www.centerforfinancialinclusion.org](http://www.centerforfinancialinclusion.org).

In mid-May 2009, a working group of respected industry professionals met to discuss the first draft of this paper, the issues raised and the preliminary conclusions. The comments received from this group were invaluable and brought to the forefront the complexities of the issue. While we have tried to do justice to their insight, ultimately this paper can only hope to start the discussion on the proper alignment of interests, not conclude it. The members of that working group are listed in Annex 1; in particular we'd like to thank Rich Rosenberg of CGAP for his review of a later draft in detail and Gary Mulhair of Global Partnerships for his insight into other social enterprises that have faced NGO transformation and misaligned interests in the past.

Finally, we would like to express our gratitude to Joan Hall, who edited several iterations of this document, for the pointed, insightful feedback she provided.

We view this paper as the start of what we hope will become an important dialogue and educational process for the industry as a whole on an extremely sensitive topic. We also hope that the reader will find this paper as stimulating as we did in drafting it. Of course, any mistakes are those of the authors alone.

– Ira W. Lieberman  
Elisabeth Rhyne  
Brian Busch  
Stephanie Dolan



## Part 1: Why Aligning Interests Matters for MFI Transformations

### A Cautionary Tale

**I**n 1999, *Fundación Génesis Empresarial*, a successful Guatemalan microfinance non-governmental organization (NGO), sought to transform into a for-profit, regulated entity so it could increase its outreach to the large underserved microenterprise market throughout Guatemala. Regulators had made it clear that they would not approve a banking license for Génesis. A merger was therefore proposed with BancaSol, a bank whose owners had intended to build an institution for the poor but had fallen short of that goal. Most stakeholders, including Génesis' chairman and prospective investors, agreed that the two institutions were a nearly perfect "fit": the bank had a full license, advanced information systems, a healthy—if small—loan portfolio, and experience managing cash transactions. Most importantly, it had savings deposits. Génesis, for its part, had a large base of microentrepreneur clients together with the staff and credit methodologies to serve them. It seemed to be a win-win prospect.

*But this view turned out to be premature. The issue of who would manage the new bank proved critically important. There was an understanding among prospective investors that BancaSol would choose a general manager with banking experience. The NGO's general manager, with 20 years of microfinance experience, was offered a mid-level management position. He viewed the position, not entirely inaccurately, as a demotion. It required him to give up prestige, autonomy, and various perks.*

*The investors and directors did not consider the transformation from the general manager's perspective, nor did they realize at the time how negative the deal appeared to him. He was offered neither the opportunity to purchase shares in the new bank nor other financial or intangible incentives that might have made the merger more attractive to him. As one investor noted, "We didn't even think about the general manager's personal interests. We didn't think we needed to."*

*The merger negotiations gradually bogged down as the NGO's general manager repeatedly maneuvered to reopen issues that had ostensibly already been resolved. After two years without resolution, the investor group withdrew, and the merger fell apart.*

*Since then, Génesis has tried three more times to transform into a bank. The regulators continue to resist. Its growth has slowed significantly, and it cannot offer savings or other new products. Its general manager signed on with a competitor. At one level, Génesis remains a success story, an early innovator serving poor clients and a prominent national player. Yet its full potential has not been realized.<sup>1</sup>*

### The Aligning Interests Research Project

The case of Génesis is not unique. There are numerous examples of transforming microfinance institutions (MFIs) in which the alignment or misalignment between the personal interests of key decision makers and the long-term interests of the institution affected the ultimate outcome and future of the organization. Yet to date there has been little formal analysis or discussion of this issue. Without open discussion on how to treat personal interests, the issue is too often relegated to whispered conversations in back rooms. The resulting cost, in

<sup>1</sup> This description and the other extended descriptions in this paper are excerpted from case studies found in the annexes to this paper. The full case for Génesis Empresarial can be found in Annex 2.

terms of institutions not transformed or transformed in an unsatisfactory manner, is not easy to see, but it may be quite significant.

Transformation of MFIs from non-profits with indistinct ownership to commercial entities with clear ownership and governance has been occurring ever since the first transformation in 1992—that of the Bolivian NGO PRODEM into the formidable BancoSol, the first private commercial bank devoted exclusively to microfinance. The drive to reach more clients, the need to broaden product offerings to attract them, and regulatory changes will continue to push MFIs toward transformation. Even for for-profit MFIs, opportunities for mergers and second round transformations (i.e., from privately held to publically listed, or from finance company to commercial bank) will continue to appear, raising some of the same issues we analyze here.

The road to transformation can often be bumpy. Any number of variables can complicate the transformation process, from the regulatory environment, to information technology challenges, to the needs of investors and NGO management. Not all attempted transformations are successful, and, as in the case of Génesis, some that could be beneficial never take place.

In this paper, our focus on aligning interests speaks to the human elements at play during the decision making about the future of transforming MFIs. The people involved in the transforming MFI—general managers, board members, staff, and even clients—have a personal stake in the outcome of the transformation. Those individuals may have the power to derail the process and may try to do so if they perceive the outcome as not in their best interests. Their concerns are not only financial. Other concerns include personal status, public recognition, social mission, desire for control, and still other motivations. It is important for all participants in the decision-making process, including prospective investors sitting around the negotiating table, to acknowledge the existence of such issues and to find ways to align the interests of the key decision makers with the long-run good of the organization and its mission. On their own, properly aligned interests cannot make a transfor-

mation succeed. Misaligned interests, however, can cause it to fail.

The Aligning Interests Research Project began with one clear objective—to spur the microfinance industry to discuss this potential stumbling block for MFIs undergoing transformation. We investigated five case studies in depth and compared them with brief examples from other cases. The cases focus not only on the interests of the decision makers, especially the general manager, but also on those of board members and staff. Most are cases of non-profit to for-profit transformation, although we also consider mergers and acquisitions. In addition to Génesis, the cases include ACLEDA Bank in Cambodia, FIE in Bolivia, UMU of Uganda, and Partner MFI in Bosnia. The cases should not be viewed as prescriptive, but rather as specific, illuminating examples. We use them to draw lessons and spark reflection. They vary according to the manner and success with which they address the issue of aligning interests. In addition, interviews with numerous people from across the microfinance industry (MFI managers, investors, and networks) and in the private sector beyond microfinance (private equity firms, professional compensation firms, and venture capitalists) have informed this paper.

During the research for this paper, we heard a strong desire for more open and thoughtful discourse on this topic. The subject of the alignment of interests appears to be a valid, even vital, concern for many of those involved in transformations. Although personal interests are a very difficult topic to address openly, the microfinance industry needs to develop the means to do so, both at an industry level and in individual cases.

In the course of our research, a second key objective arose—to begin developing some consensus about tools for aligning interests. These tools are of two types: first, recommendations on how to incorporate discussions about personal interests into the decision-making process during transformation negotiations and, second, creating a common understanding about acceptable means of compensating or rewarding key stakeholders, such as general managers, to increase their alignment with the long-term success of the institution.

This document intends to start an industry-wide discussion about the proper treatment of interests for key stakeholders in MFIs during transformations (and to some extent mergers). We aim to:

- situate this paper relative to larger issues for the industry and transforming MFIs;
- define the challenge of aligning interests, within the context of transformation from non-profit to for-profit operating paradigms;
- use examples and cases from actual industry experience; and
- propose some tentative solutions to these issues in the form of suggested “good practices” and areas that require further industry collaboration.

We also note that other social enterprises and industries with double-bottom-line objectives (social and financial) have faced and overcome this same dilemma. The problem is not intractable, nor is microfinance different in principle from other socially driven industries when considering the alignment of incentives.

The paper is divided into three main sections: (1) this introduction, which explains the issue and situates it in the context of the transformation of MFIs; (2) an analysis of the non-profit to for-profit transition and of the interests of various stakeholders, especially the key decision makers, as illustrated by the case studies; and (3) potential solutions and good practices, as well as next steps for the industry in addressing this issue. The bibliography, list of persons interviewed, and extended case studies are found in the annexes.<sup>2</sup>

The tentative recommendations in the final section can only be seen as a start. However, we come away from this exercise with at least two recommendations that stand out as applicable in many circumstances. First, organizations undergoing transformations need to address personal interests in their deliberations in a fair and transparent way. This is our most fundamental recommendation. Second, we believe that third-party independent advisors can be helpful in providing the objectivity to assist an organization

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<sup>2</sup> Please note, not all of the cases have been included in some print versions of this document; they are available electronically at: <http://resources.centerforfinancialinclusion.org>.

in working through these sensitive issues. That said, and as the subsequent discussion will show, there is no “one size fits all” solution.

### **Microfinance Institutions Transform**

*Why Transform?* Microfinance industry practitioners refer to “transformation” as the change from non-profit to for-profit status. When BancoSol opened its doors, becoming the first microfinance NGO-to-bank transformation, it became a demonstration model for the industry, introducing the concept of transformation among MFIs.

Microfinance NGOs transform because, as regulated financial institutions, they can advance their scale, growth potential, and product range. Transformation brings institutions into the formal financial sector, where they can leverage capital from local and international markets through outside investors—from large commercial lenders to specialized equity funds to local and international private investors. Transformation helps set the institution up for longer-term financing, increasing its credibility in the eyes of potential investors. Although access to capital is one of the principal motives for transformation into a for-profit entity, NGOs undertake this process for many additional reasons, including the following:

- **Expand financial services, especially savings, to clients:** In order to provide savings services and get access to low-cost, stable customer deposits for funding, NGOs must become regulated financial institutions.
- **Increase scale:** With enhanced access to funding, institutions can scale up their operations and expand outreach.
- **Gain legitimacy:** As regulated institutions, MFIs increase their credibility in the eyes of government policymakers, debt and equity investors, existing and potential new clients, and the formal financial sector.
- **Increase efficiency:** To comply with regulatory requirements, transformed institutions typically enhance back-office systems, controls, and transparency in reporting, which lead to more efficient operations.
- **Conform to new legislation:** In some countries with new microfinance regulations, transforma-

tions are mandated by rules requiring that all MFI NGOs become regulated.

- **Enable formal ownership:** While NGOs have boards of directors, they do not have owners. Transformed institutions become shareholding institutions in which owners have a vested interest. In some cases, managers, staff, and even clients of the original NGO may acquire stakes in the new institution.
- **Improve governance:** Regulators require licensed financial institutions to appoint a “fit and proper” board, and often, additional board committees are introduced, such as risk management, compensation and audit committees.

### Defining Success in Transformation

Before examining private interests, it will be helpful to anchor our discussion by starting with a very broad, “public interest” perspective. We need a frame of reference for judging whether the interests of various stakeholders are in line with the long-run good of the institution and the clients it serves. A simple decision rule might be this: *The transformation is successful if the introduction of a for-profit framework maximizes the ability of the MFI to achieve its mission.* It is difficult to see any reasons for transformation not derived from the mission of the transforming institution (with the possible exception of regulatory requirements). A successful transformation assists the new institution in achieving the strategic and tactical goals listed previously in service of its mission.

Clients are at the heart of all MFI missions. To be more specific, we measure the success of a transformation by whether it maximizes the MFI’s long run potential to bring high-quality services to as many of the people it seeks to reach as possible. The introduction of a profit motive into the mix should serve this goal, by allowing the MFI to achieve specific objectives, like access to finance, regulatory recognition, wider product range, etc. Complex tradeoffs will undoubtedly appear, such as whether to reach *more* clients or to reach *poorer* ones. Such tradeoffs make the evaluation of success in any given instance open to a range of opinion.

Added to this equation is the question of the future of the *original* NGO and its mission. Transformations leave behind the founding NGO, which typically becomes a

shareholder of the new financial institution. The NGO can then move in one of several directions. In some cases, the NGO continues to operate in microfinance. PRODEM in Bolivia turned its focus to rural areas after spinning off BancoSol. This option is not generally recommended as it sets up a potentially conflictive relationship between the new MFI and the original NGO. The NGO may focus on other social issues, using dividends from the transformed MFI to finance these new activities. Such is the case for the founding NGO of Compartamos Banco, which continues to operate health and nutrition programs. Finally, as with ACLEDA, the founding NGO can cease to operate, functioning only as a shareholder. In any case, the future role of the NGO is an important part of the outcome to be judged in evaluating the success of a transformation.

Personal interests will be aligned when the plan for the transformation causes the key players to embrace decisions that are in the long-run interests of the institution, as just defined. They are more likely to do so if they see these decisions as good for, or at least acceptable to, themselves.

### Transformation in Other Industries

“Transformation,” as used here, seems to be a term unique to microfinance. However, organizations in other industries also cross the line from non-profit to for-profit, and for many of the same reasons. Some do it to attract new resources in order to achieve much larger scale, to capitalize personally on the value of what they have created, or both. For example, some bio-tech firms have sprung from non-profit research projects or non-profit institutes, such as the National Institute of Health in the United States. The researchers behind the discoveries generally turn to the for-profit world to commercialize their new products.

The niche industry of halfway houses and prisoner rehabilitation organizations in the United States and Europe, often referred to as community corrections, began life as a diverse group of NGOs devoted to the social goal of prisoner reintegration into society. In time, these NGOs realized they could operate on a financially sustainable, or even profitable, basis.

The whole industry underwent a transformation, resulting in a range of players from NGOs to profitable companies (see box).<sup>3</sup>

Non-profit hospitals go through a similar transformation when they are sold to for-profit hospital groups. In these cases, individuals often receive incentives in line with those of the for-profit buyer, and standard metrics have been developed to monitor the social performance of the hospital after the transaction. The bio-tech and health care industries have developed standard practices concerning the types of incentives organizations considered appropriate.

## Part 2. The Challenges of Aligning Interests

### Paradigm Clash

What makes aligning interests in MFI transformations awkward at best is the bright line between non-profit and for-profit operating frameworks. While the differences between non-profits and for-profits may be obvious, we find it useful to state them now. When an NGO begins life within the non-profit framework, everyone involved accepts, implicitly or explicitly, non-profit ground rules. This

### Community Corrections

Today, “Community Corrections” encompasses a wide variety of for-profit and non-profit treatment agencies, providing mandated counseling services to offenders on probation. These services can include counseling related to sex offenses, substance abuse, domestic violence, impulse control, anger management, and life skills training.<sup>1</sup> The goal of the industry is to help a convicted offender reenter society. Clients range from minor offenders to victims of severe substance abuse and mental illness. Over time, corrections officials, looking for better, cheaper alternatives to customary inmate reintegration, turned to private Community Corrections organizations.

As public-sector funds were increasingly directed to private Community Corrections agencies, some NGOs realized that they could standardize their services for specific segments of the inmate population, achieve significant scale, and operate in a profitable manner. Their motivations echo the drive for scale, outreach, and additional products in microfinance transformations. In a sense, the whole Community Corrections industry ‘transformed’ over the course of a ten- to fifteen-year period. Many players became for-profits, while others decided to remain as NGOs, often choosing to work with the most difficult populations such as the mentally ill.

The most pertinent aspect for this paper of the Community Corrections experience is that the industry as a whole achieved consensus on the ethics of for-profit agencies providing social services. There was an increased focus on accountability through contractual provisions and monitoring. The industry also developed common definitions for certain treatments. Transparent surveys emerged, such as the DASIS Report for substance-abuse-treatment providers, which explicitly compare for-profit and non-profit agencies.<sup>2</sup> Competitive bidding for government contracts became standard in order to assure fair and transparent transactions. Contractual and legal precedents to punish abuses evolved as well.

With these provisions in place to assure quality of service, industry observers reported feeling more comfortable with commercial treatment agencies.<sup>3</sup> Incentive compensation, among both for-profit and non-profit agencies, became more widely accepted. Incentive packages in the form of consulting contracts became acceptable for exiting NGO managers when their organizations transformed into for-profits or were acquired by commercial agencies.

<sup>1</sup> Karol Lucken, “Privatizing Discretion: ‘Rehabilitating’ Treatment in Community Corrections,” *Crime and Delinquency* 43, no. 3 (1997).

<sup>2</sup> The DASIS Report, 2003, <http://www.oas.samhsa.gov/2k4/owners/owners.htm>.

<sup>3</sup> Carole McCarthy and others, “Privatising Community Corrections,” Center for Applied Psychology and Criminology, Bond University, Australia, February 2000.

<sup>3</sup> “Community Corrections,” The John Howard Society of Alberta, 1998, <http://www.johnhoward.ab.ca/PUB/C29.htm>.; See also Center for Community Corrections, <http://www.centerforcommunitycorrections.org>.

“everybody” includes the government that granted a license for the NGO to operate, the funders who supplied the NGO with cash, and the employees who accepted their terms of employment. For example:

- The government grants a non-profit license in recognition of the social purpose of the NGO, agreeing for that reason to forgo taxes. In return, it stipulates in law that, while the NGO may generate profits, it cannot distribute them for the benefit of private parties without losing that status and incurring taxation.
- When funders provide grants or soft loans, they do so with the understanding that their aid will support the NGO’s social purpose. In addition, funders may request specific restrictions on the use of their funds.
- Senior managers accept terms of employment that rarely include performance-based compensation and never include ownership rights.
- Directors recognize that their role brings with it no direct financial interest in the organization, even if they are compensated for their time in meetings. They serve as custodians of the social purpose, with a fiduciary duty to manage financial resources prudently.

In the for-profit paradigm, several essential differences prevail, especially for regulated financial institutions:

- The for-profit is free to earn and use profits as it wishes, to plow back into the company, reward shareholders or create incentives for staff, as long as it fulfills its tax obligations (and, for a financial institution, as long as it remains solvent).<sup>4</sup>
- Control of the institution is determined on the basis of shares of ownership and is subject to change when shares are bought and sold (though shareholders’ agreements and different classes of shares can modify “plain vanilla” arrangements).
- The governance of the institution is charged

<sup>4</sup> The recent international financial crisis has cast a harsh light on executive compensation and employee incentives at many large for-profit companies, especially financial firms. Popular outrage against exorbitant incentive packages may result in stricter limits and oversight for firms. For a more thorough discussion on executive compensation, see Karen Dillon, “The Coming Battle over Executive Pay,” *Harvard Business Review* 87, no. 9 (September 2009): 98-103.

with upholding shareholder interests, specifically financial interests, thus introducing a new fundamental purpose to the organization. No social purpose is present, unless by agreement of all parties.

- Regulated financial institutions face additional considerations, such as rules governing ownership and “fit and proper” criteria for senior management and board members.

Use of for-profit frameworks has allowed transformed microfinance institutions to deliver more services to more people than they could have done as non-profits. Nevertheless, the line between the two frameworks, embedded in law in most or all countries, protects the interests of the state to tax profitable activities, society to assure that non-profits put social purpose ahead of other concerns, and of funders to determine how their donations are used. Most of us support the broad public purpose behind the distinction between non-profit and for-profit frameworks. Upholding this distinction is a necessary part of building an active non-profit sector that pursues multiple social goals. Nevertheless, the distinction is sometimes uncomfortable for transforming microfinance institutions.

There is nothing inherently unethical about either operating framework, but the transition from one to the other creates problems. These problems arise from three sources:

- **Preservation of the use of non-profit assets for social purpose.** Licensing authorities give the NGO board the duty of upholding social purpose through their stewardship of the net worth of the organization. If the board decides to redirect these resources to private individuals, the government, as guardian of social purpose and granter of tax benefits, may have something to say.
- **Prior agreement.** The fact that all parties have agreed to one set of ground rules makes it difficult and potentially questionable from an ethical perspective to change those rules without the assent of all. As just mentioned, this issue applies especially to the use of the organization’s net worth.
- **New perspectives.** The for-profit framework brings in a new group of stakeholders—the investors. While many investors in microfinance

are interested in the social mission, others are not. If the investors are new to microfinance, they may not understand, or respect the validity of, the restrictions of the non-profit framework.

Specialized microfinance investors may be better prepared to bridge between the two frameworks than investors operating in, say, venture capital. The managers and directors of MFIs who make the critical decision to transform may not be familiar with practices within the for-profit framework. The stage is set for some confusion during negotiations at best, and at worst people operating at cross-purposes.

*The clash of paradigms is illustrated in the case of the Uganda Microfinance Union (UMU). Two talented and committed general managers built a microfinance NGO from the ground up (see the full case in Annex 6). The two managers launched UMU as a Master's degree project when both were in graduate school, using \$32,000 from a local bank as start-up funds. They received little or no salary at first, and personally backed some of the NGO's early debt. Starting small, over the next few years they attracted increasing amounts of grant and debt funding from donors including USAID, UNHCR, Hivos, NOVIB, and the Ford Foundation. UMU served 36,000 borrowers with a loan portfolio of more than \$16.6 million when the founders decided to transform it, following new Ugandan regulations that allow transformed MFIs to take deposits.*

*As investor negotiations began, the two founders, plus two original local board members, asked for a significant ownership percentage in the new organization. They wanted enough to gain a right to a board seat (approximately 14 percent for each founder). According to people interviewed for this paper, the managers felt they deserved a significant stake in recognition of their sweat equity contribution over the years. In effect they asked, "Is it fair for new investors to capture all of the value without compensating the team that built it?" In addition, they argued that a significant equity stake would motivate them to maintain the MFI's solid performance and growth. Moreover, a large shareholding would allow them to maintain some control over the transformed MFI, just as they had almost total control over the NGO. But neither manager had the capital to purchase the desired stake.*

*Involved in the negotiations were some of UMU's original donors, ACCION International (as transformation*

*coordinator and a prospective investor), and potential new investors. Some donors were concerned about whether it was acceptable to turn over donor resources intended to serve social needs, and the reinvested earnings generated by those donations, to a for-profit entity.<sup>5</sup> This issue was easily resolved, however, as it was clear that a) the new MFI would continue pursuing the original purpose, b) donated capital and its proceeds would remain in the equity base of the institution, and c) that the value of the shares corresponding to the NGO's contribution to the new MFI would continue to benefit the NGO. However, when it came to compensating the founder/managers, discomfort arose, because the non-profit paradigm under which UMU began did not allow for private gains. Investors and donors felt uncomfortable with the idea of granting such a large ownership stake to the two managers, despite their undisputed contribution to building a successful MFI.*

*As an alternative to granting an equity stake up front, the investor group suggested making equity part of the ongoing compensation of the managers, who would build up their stake gradually through future performance. In contrast, the managers felt they deserved a significant equity stake right away, in recognition of their past sweat equity contributions. Differences of view about the size of their stake continued as well, and negotiations spiraled into frustration.*

*At this point, the two founder/managers recruited a different group of investors, led by a venture capital company new to the microfinance market, Aureos Capital's East Africa Fund. Aureos was interested in providing a \$1 million equity stake and additional debt capital for the transformation, but wanted to structure a quick exit. The new group of investors, it seems, was relatively less concerned about the non-profit origins of UMU and, in effect, treated the founder/managers much as they would treat the founding entrepreneurs of the other businesses they invested in. They granted the founders the stake they wanted, effectively financed out of NGO resources and eliminated the NGO as a voice in governance.*

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<sup>5</sup> Grant agreements sometimes include clauses about the perpetual use of the grant money, stipulating that it forever serve its initial social purpose and not become private wealth.

*In August 2005, Uganda Microfinance Union transformed into Uganda Microfinance Limited (UML), a regulated microfinance institution. In 2008, Aureos Capital led the UML shareholder group in a sale of the institution to Equity Bank of Kenya.*

Clearly, the UMU case illustrates the gap between the rules of the game for non-profit and for-profit entities, and the absence of an effective bridge between them. It also illustrates the nature of the problem that arises with no industry standard practices to turn to.

### **Interests by Stakeholder Group**

We turn now to look at the concerns of major groups of stakeholders during transformations, beginning with the key decision makers in the NGO: the general manager and board members.

**General Managers.** The general manager (the NGO's CEO) is usually the most important decision-maker in the transformation process and may even be the person who initiates a transformation. At the very least, as in the Genesis case, the general manager occupies a critical position from which to influence the outcome. For a transformation to succeed, it is extremely helpful if the general manager supports the path the transformation takes.

What factors motivate managers of NGOs? Several things come to mind: love of the institution and commitment to its mission; personal prestige, recognition and status; financial security and other perks. In addition, managers want to be treated in a way that they perceive as fair, given their past—and prospective—contributions to the institution. All these factors, singly or in combination, influence a manager's willingness to proceed with a transformation.

In many cases an NGO's general manager has spent years building the MFI. He or she may have created, fostered, and spent innumerable hours anguishing over the institution and deriving enormous satisfaction from watching it grow. Staff and clients have become close friends. The general manager may see the MFI as a life's calling or a source of esteem among the local community. Typically, managers enjoy great decision-making freedom. In addition, the manager receives a salary and has a strong degree of

job stability, even though the salary may not be adequate reimbursement for the trials and tribulations of building a microfinance NGO from the ground up. If the manager is lucky, there is a pension.

With the commercialization of microfinance, transformed NGOs have become profitable institutions that reward their shareholders, in some cases very well. Managers of microfinance NGOs are increasingly alive to this possibility (sometimes unrealistically so). In other cases, a manager may focus on the fact that a number of transformations have led to the replacement of the original CEO. All of these considerations will influence a manager's decision-making process during a transformation.

**NGO Directors.** The members of the board of directors of the NGO are also important stakeholders. In a transformation, NGO directors often confront the prospect of yielding power to the new directors governing the transformed MFI and elected by the shareholders. Yet, the NGO board makes the ultimate decision about whether the transformation will proceed. Recognizing that the transformation creates difficult personal choices for NGO directors, and, perhaps, offering them appropriate incentives, will help move the transformation forward.

Sometimes directors are among the founders of NGOs, and, in several prominent cases, the chair of the board is the driving force behind the creation of the NGO. These directors may feel a deep commitment to the mission of the organization and may enjoy prestige and personal satisfaction from leading a successful organization. Other directors may have similar motivations, though less intensely. For example, non-founding directors, who may have signed on as a favor to a founder or representative of a friendly organization, may feel committed to the organization yet hesitant to challenge a passionate manager or fellow director. In every context, dedicated board members and management often feel a strong sense of ownership. In all cases, directors have a legal duty of loyalty to the organization and its social purpose.

The personal interests of board directors are broadly similar to those of senior managers, though there are some differences. The most important difference is, of course, that directors do not earn their living

from the organization. While they may receive sitting fees or travel reimbursement, their main compensations are intangible. The alignment of interests for directors may be about issues such as control, power, participation, image, and status, rather than financial compensation.

A final consideration, which applies to both directors and managers of NGO MFIs, is their probable lack of experience with equity investing and related commercial practices compared to the new investors around the table. They may be less adept at defending their interests or creating innovative solutions for all parties.

**Staff.** While staff are not usually decision makers during a transformation, their attitudes and behavior will influence the success of the new institution, so it is important to consider their interests. Successful transformation requires the support of the majority of the staff of the NGO, most of whom move to the new MFI. This support is not a foregone conclusion. Staff concerns during transformation may include job security, especially in a merger or when new specialized staff is brought in, the preservation of the mission and corporate culture of the organization, and their own compensation and career advancement. When BancoSol transformed, many of the staff of the NGO resisted the idea of becoming a bank; their esprit d'corps had been built around viewing banks as the problem. The clash of corporate cultures that BancoSol experienced after transformation alerted other transforming NGOs to the importance of getting staff buy-in during the transformation process. There are many ways to do so, such as focused communications or training, as in the case with ACLEDA's transformation. In this paper we focus on ownership and financial compensation through employee stock ownership programs (ESOPs).

**Investors.** As the prospective owners of a for-profit MFI, investors' interests lie with the future growth and profitability of the institution and, if socially motivated, with the future achievement of social goals. Their interests are to ensure a top-performing management team and effective governance structure. If they come from the private sector, they are accustomed to ensuring that they get the right

team, with the right motivations, by structuring incentive-based compensation packages. Also, investors want to make sure that they can accommodate succession, either through voluntary retirement or by replacing existing managers. Finally, investors have to make sure that the price they pay for their stake will give them good prospects for a solid return on investment.

### Do incentives need aligning for clients?

Client interests must be considered in any effort to align interests in a MFI transformation. Benefitting clients is, after all, the heart of the social purpose of all microfinance NGOs. However, views differ widely on how client interests are best served.

Proponents of client ownership argue that ownership gives clients a voice in decisions that directly affect them, such as product pricing. Moreover, it allows clients to benefit financially from the profits of the MFI, just as investors do. Certain specialized MFIs, such as the Grameen Bank in Bangladesh, as well as credit unions, involve clients as owners.

Some transformations have been structured to incorporate clients as owners, often through an association that becomes a shareholder. This has occurred several times in India, where NGOs cannot be owners of for-profit institutions. Skeptics argue that such structures may provide only an illusion of client alignment, ultimately masking management control. They also point to the questionable benefit of using client savings to fund the shareholding, thereby reducing client access to those funds.

The standard commercial perspective is that client interests are best served through their role as customers. It is clear that institutions only grow and prosper by attracting and retaining satisfied customers. Commercially-oriented institutions tend to focus on aligning the interests of management with those of customers (e.g. through targeted incentives for reaching more customers), rather than vice versa. In this approach, clients benefit financially only if the MFI reduces prices.

Client ownership deserves fuller treatment than can be provided within the scope of this paper. One last note is that in considering the alignment of client interests, it is important to consider all clients, over time, rather than specific clients. Specific clients may have competing interests, as in the case of credit unions where savers and borrowers view interests quite differently.

In the case of transforming MFIs, most of the investors are likely to be institutions, including the original NGO. If the investor is an equity fund it is likely that its negotiators receive some performance-based compensation, which aligns their interests with the long run interests of the fund. On the other hand, negotiators for NGOs, networks and public-sector investors (international financial institutions) are unlikely to receive variable compensation. While the compensation of the investor negotiators is not directly relevant, we mention it to highlight the variety of perspectives that may meet around the negotiating table. Those who receive performance-based pay themselves may have different views about its appropriateness for MFI managers than those who do not.

While management, the board, and investors are the critical players in transformation and the alignment of interests, other stakeholders also play an important role.

**Networks.** In microfinance networks with affiliated MFIs around the world, such as ACCION, FINCA, ProCredit, and Opportunity International, the management of the network has a strong say, or at least a guiding role, in their affiliates' transformations. This often stems from the networks' role as board members and/or investors in their subsidiaries or affiliates. The networks have a strong interest in both the social and financial success of the institution and, in most cases, are interested in maintaining their influence, or even a controlling role, in the governance of the institution.

Network organizations have tended to develop one specific approach to transformation and carry that approach to as many of their affiliates as possible. Most networks are non-profit organizations (the largest exception being ProCredit). However, the networks that have engaged in transformations have often created for-profit equity funds or other investment vehicles to facilitate their participation in transformed MFIs. One example is ACCION Investments.

Until recently, most networks have hesitated to engage in explicit consideration of personal interests during transformations. The more poverty-oriented networks remain uncomfortable with some of the commercial forms of incentives discussed in Part 3.

However, more than one interviewee from a microfinance network mentioned that poorly aligned interests have caused transformations to fail and talented, experienced managers to leave MFIs. Such experiences, among other factors, may cause networks to grow more open to incentives than they have been in the past. In fact, one microfinance network indicated that, following transformation, it has begun to introduce incentives for management and directors tied to the growth in equity valuation of the MFI.

**Donors.** Often, much of an MFI's funding has come from a variety of donor institutions in the form of grants or soft loans during its growth stages. Some donor funds implicitly serve as a portion of the MFI's core capital. Before transformation, the NGO MFI may need donor approval to allow its grants to serve as the equity for the newly commercialized company, at least if the grant agreement is still in force. Donors have generally sought to be as cooperative as possible because transformations end donor-dependence, leveraging the initial donation. In most cases approval has not been difficult to secure, although the legalities associated with each case have sometimes been very confusing.

**Lenders.** Most commercial lenders prefer to lend to MFIs after transformation. However, lenders representing public institutions (such as the IFC, KfW, or FMO), or microfinance investment vehicles, may lend to transforming NGOs through quasi-equity, such as convertible debentures that convert to equity at time of transformation. In this case the loan agreement is written to protect the lender's rights as the transformation proceeds, including stipulations around minimum capital requirements, portfolio quality, conversion rights and conversion price, and so on. Due to these considerations, the lender plays an important role with the transforming NGO, but, unless the lender converts to a shareholder, probably little role in direct negotiation of incentives.

**Regulators.** Banking regulators must approve the new MFI's license, and, as part of the licensing process, investors and management will also need to be approved. Regulations define ownership possibilities. In Bosnia, as in the Partner case, regulations limit the percentage of a regulated MFI that can be owned by the Foundation. In India, NGOs cannot own shares in financial institutions.

## What's at Stake?

Now that we have reviewed the interests of various stakeholders seated around the negotiating table, let us examine some of the issues they may be talking about. All are asking the same questions. Who will control the new MFI? Will the new MFI serve the mission? How will profits be allocated? Who are the right people to operate the new MFI? How will we be recognized for what we have created? It is to these questions that we now turn.

## Control and Preservation of Mission

Transformation requires change in ownership and governance, which creates change in control and power. The decision makers in the original NGO are often asked to reduce their degree of control. Even if they are willing to cede control to new players, they may be concerned to ensure that the new players will be as dedicated to the organization's mission as they are.

Shares in corporations can be bought or sold at any time, and there is both an expectation that ownership will change and a mechanism for change. Not so in an NGO, where there are no owners. Control emerges in an NGO from the interplay of powerful and energetic individuals or institutions. Real control is more often *de facto* rather than *de jure*, as the literature on microfinance governance has observed. For example, in *Principles and Practices of Microfinance Governance*, the authors note that the governance process may fail if power concentrates either in a strong executive whose decisions meet a "rubber stamp" approval from directors or in directors who take on a very operational role.<sup>6</sup> Corporate governance is of course also vulnerable to management domination and board meddling, but the more rigorous governance requirements that accompany for-profit structures, and especially regulated financial institutions, are designed to avoid or minimize such problems.

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<sup>6</sup> Maria Otero, Rachel Rock, and Sonia Saltzman, "Principles and Practices of Microfinance Governance," Development Alternatives, Inc., August 1998, <http://www.gdrc.org/icm/govern/govern.pdf>.

Moreover, it is quite common for control of NGOs to be static, with the same people in charge for long periods of time. In many cases, NGOs develop governance practices that provide reasonable oversight under normal conditions, as long as no sweeping changes rearrange the traditional power centers within the institution. The point here is that NGO decision makers may be used to many years in which they enjoy a great deal of personal control. The changes brought about by transformation threaten to disrupt this comfortable position.

The managers of both Genesis and UMU enjoyed almost total control of the MFIs prior to the transformation and knew that the transformation would force them to sacrifice some control. In the Genesis case, no incentives were provided and the transformation failed; in the UMU case, the first group of investors provided insufficient incentives (in the eyes of the founders), so a second group was found who would offer what the founders desired.

*The case of Partner, an MFI in Bosnia-Herzegovina, illustrates how important control can be. Partner, established by Mercy Corps in 1997, has quickly become one of the leading MFIs in Bosnia (Please see full case in Annex 4). It has shown outstanding growth in spite of increased competition, with steady return on equity and solid asset quality. A close-knit group of key managers, led by a charismatic director, propelled Partner to deserved recognition among peers. In this case the management team is the real power center of the institution, much more than the board of directors or Mercy Corps. The management exercises effective control almost as if it were the majority owner.*

*Partner's current stakeholders wish to transform it into a for-profit financial institution in order to mobilize deposits. The new regulatory environment, adopted in 2006, requires microcredit organizations like Partner to transform first into microcredit foundations. After this, they may opt to transform into a for-profit company with the foundation as the main shareholder. Only after transforming can the company apply for a license to take deposits.*

*At the end of this two-step process, the following challenges will appear. The law stipulates that the foundation should have the majority share. Mercy*

*Corps, management and employees would all buy minority shares. As a non-profit, the foundation will not be organized by ownership percentages. Management and employees expect to buy shares in the new entity, possibly at a discounted price, with final shareholding around 10 percent. Mercy Corps will have a similar 10-15 percent. The contrast of management's future minority position with its current de facto control has dramatically slowed the transformation process, as it does not appear attractive to management. One partial solution apparently under consideration is for the CEO of Partner NGO to remain as head of the foundation (the real seat of control), instead of heading the for-profit.*

Because the for-profit framework does not usually incorporate social purpose, and because it introduces financial goals as the new central purpose, there is always a question in transformation about how the organization's mission will carry forward in the new institution. Even if the general mission to serve low income people is solidly accepted as the core of the business model, potential tradeoffs between financial and social goals are likely to surface in decisions ranging from dividend policy to product pricing. Preserving the mission is often one of the critical concerns of board members, managers and institutional stakeholders like founding NGOs and networks.

In many transformations, the NGO receives a controlling share of the total equity. This serves the dual purpose of capturing the original donor resources within the NGO's asset sheet and ensuring that the MFI maintains a focus on its social mission. The NGO may not want to lose control over the transformed MFI because of the assets it has invested to build the NGO or due to a fear of mission drift, as in the case of FIE described below. It could be a loss of prestige or purpose, or a worry that the NGO may not be able to take advantage of future profits. When aligning interests for transformation, it is important that investors and donors understand the reasons behind the NGO's concerns, so that they can give them genuine consideration.

A complicating factor is that it is not easy to distinguish between a drive to preserve the mission and a

drive to preserve personal influence. One of the most effective ways to preserve mission is, of course, to maintain the same people in guiding positions in the organization. The very human tendency, however, is that these same people may become so identified with the institution or its mission that they come to see maintaining their influence as the best or only path to preserving mission.

*The case of the Centro de Fomento a Iniciativas Economicas (FIE) illustrates how a Bolivian NGO chose to maintain majority control of the new MFI in order to preserve the mission (Please see full case in Annex 5). Shortly after the transformation of BancoSol, the government of Bolivia introduced the option for microfinance NGOs to convert to a non-bank financial form called a Fondo Financiero Privado (FFP). Because it was less daunting for the NGO to jump to an FFP than to a commercial bank, FIE decided to form an FFP.*

*The central issue expressed in FIE's transformation was how to ensure that the new institution would continue to serve its clientele of low-income entrepreneurs. FIE feared that the dedication to serving the poor might erode under a new structure that demanded profitability. In internal debates prior to the transformation, FIE investigated ways to preserve its mission and maintain control over the FFP, deciding upon the following measures:*

- *The mission statement of the FFP remained congruent with that of FIE the NGO.*
- *There was a long and careful search for potential shareholders who would gladly accept FIE's mission. Several potential investors were excluded when it became evident that their commitment to serving low-income persons was subordinate to the pursuit of return on investment.*
- *The team of executives and staff who had successfully operated FIE as an NGO was the same team who started the FFP. The institution chose not to bring in executive talent from banks.*
- *Payment of dividends was used not only as compensation to the shareholders for their risk but also as a way of enabling FIE NGO to accumulate the means to buy the shares of its partners in case a disagreement developed with regard to the mission.*

- *Despite the prospective investors' stated commitment to the mission, the NGO insisted on maintaining majority control.*

*FIE NGO's solution to keep majority control of the FFP has worked well to date. But some observers have asked whether the arrangement is in FIE's long-run best interests, given that the NGO has a limited ability to generate growth capital without diluting its stake (i.e., only through dividends from the FFP). BancoSol and Caja Los Andes, FIE's main competitors, have both become commercial banks, leaving FIE in a somewhat less competitive position. A number of merger opportunities have arisen over the years, eventually rejected over control/mission concerns. In 2009, FIE's shareholders began exploring a holding company as an option that would widen the ownership base and bring in additional capital without altering the mission or the ultimate location of control.*

Most NGO managers and directors who seek control over the transformed MFI genuinely want to ensure that the MFI continues to serve the poor. Their presence on the board as an owner helps maintain the mission. Many of the individuals interviewed for this project noted that they liked to see the founding NGO remain a significant shareholder, especially given the many challenges facing the MFI after transformation. The presence of the NGO as a shareholder can help maintain the stability of the institution.

It is interesting to compare the outcomes of the FIE and UMU/UML examples. FIE continues as an independent financial institution, while UML's new owners sold the institution to a strategic partner, Equity Bank. UML is rapidly becoming the first regional operation of Equity Bank outside Kenya. It is not easy to determine which outcome is better from a mission-related perspective, given the impressive accomplishments and capabilities of Equity Bank and its commitment to serving low income people. What is clear is that FIE NGO has played an important role in guiding decisions at FIE and keeping it from dramatic change, while this did not occur in UML—the structure of the transformation left the original NGO without any influence.

At the extreme, there is a possibility that a controlling NGO shareholder may oppose any actions that would cause it to lose control. Some MFIs have demonstrated astounding growth, which requires existing shareholders to increase capital themselves or be willing to be diluted by other investors who add the needed capital. In the first few years, the NGO may have the resources to meet capital demands, for example by converting debt to equity. However, if growth continues, the NGO may not be able to keep up with capital needs. In such instances, a NGO may be tempted to restrict growth in order to maintain control of the MFI.

*To continue the story of FIE, we note that the MFI has rejected several merger opportunities that would have resulted in the loss of NGO control. At least one potential merger proposed an intriguing complement to FIE's existing operation. The opportunity in question was a proposed merger with PRODEM. After the founding of BancoSol, PRODEM had successfully reinvented itself as a prominent rural microfinance player. At the time of the proposed merger, FIE's main client base was primarily urban. Thus the merger planned to combine two complementary institutions, giving the merged MFI a much larger client base and both rural and urban growth prospects. The merger discussions did not progress far. FIE's decision makers decided fairly quickly not to pursue the merger. FIE NGO did not want to sacrifice control over its operation, even with the potential benefits. Of course, other factors were at play as well; a merger of two institutions is difficult under the best circumstances. We raise this example to illustrate that NGOs, as organizations, also may have interests that must be considered as part of the transformation process.*

In a typical MFI transformation, the founding NGO ends up owning a large bloc of shares of the transformed MFI, even if not a controlling share. For the purpose of preserving mission it seems advisable that the NGO remain as a prominent shareholder. The NGO's ownership will ensure that the focus on the social mission enters into strategic decisions at the board level, even though many prominent microfinance investors are also committed to the social mission of microfinance. Incorporating the

social aims of the MFI into the mission statement at transformation, as FIE did, is advisable to help ensure continuity of the double bottom line. Finally, continuity of ownership is another important reason for the NGO to maintain a significant stake. Many international equity investors expect to seek an exit in the medium term, perhaps three to seven years. A significant shareholding percentage by the NGO ensures that one shareholder will remain with the MFI for the long-term and maintain the cultural heart of the institution.

### **Building a Strong Institutional Team**

Equity investors of all types often say that the management team is the most important factor in deciding to invest in any business, and investors in microfinance institutions are no different. The ability of the management team to carry the institution forward to its full potential is a paramount concern. If the management team is strong, investors will have a compelling interest to keep the team in place and ensure that they stay with the institution in the future. As discussed in Part 3, this need has led to the offer of various forms of performance-based compensation, such as stock options. In the UMU example, the first investor group proposed this kind of compensation to motivate the top managers to stay committed to the institution over the medium term.

This question is complicated by the fact that as an institution transitions from NGO to regulated financial institution, and as it then continues to grow, management skills must evolve with the institution. It is necessary, though often not pleasant, to take a hard look at a manager's ability to continue to lead a very different institution post-transformation. Even the best NGOs may need new talent, and in most countries banking laws require a CEO with banking experience.

Shortly after the transformations of both BancoSol in Bolivia and MiBanco in Peru, two early microfinance transformations, the boards of directors of each institution asked the incumbent CEOs to step down. Both CEOs had been the entrepreneurial leaders of their original NGOs. Industry professionals who have seen many transformations acknowledge

that the individual who builds the institution as an NGO may not be the right person to take the institution to the next level. Different skills, particularly banking skills, are required. This transition may also mark a classic shift from the need for a dynamic start-up entrepreneur to the professional manager needed by a more established business.

If a manager needs replacing, and this is not done in a transparent manner with the appropriate incentives, it can affect the entire transformation process, as shown in the Genesis case. In such cases, the board of the transformed MFI may begin to look for any mistake or excuse to dismiss the manager. Such a dismissal can be traumatic for both the manager and the institution and could jeopardize the MFI's performance. Sometimes the board members and investors suspect, but aren't sure, that the general manager lacks the ability to lead the regulated institution. In this case, the new board might set clearly outlined one-year performance goals at the time of transformation, accompanied by the appropriate incentives.

*ACLEDA in Cambodia demonstrates that in certain cases the NGO managers can continue to manage the regulated institution. The management team wanted the opportunity to run the new bank, although team members were fully aware of their own lack of experience. The limited number of developed banks in Cambodia at the time and the lack of a pool of experienced individuals from which to recruit a new manager influenced the board to keep the management team and invest in training for them (Please see full case in Annex 3).*

## **Part 3. Emerging Good Practice and Recommendations**

The alignment of interests can be improved when the governance process includes clear, fair and transparent consideration of the interests of all stakeholders involved. Decision makers can offer specific and appropriate incentives so that the decisions they collectively make are in the best interests of the institution and its clients. We now turn to some of the most important tools available for aligning interests.

## Equity Participation

Among the industry participants we interviewed, share ownership was the solution recommended most often to align interests of the top management with that of investors and the long run good of the business. In the for-profit world, equity stakes for top managers have become nearly universal.

Equity participation is desirable because it provides the general manager with a potential payoff directly linked to the future success of the MFI. Many investors want to see managers buy equity in order to demonstrate their commitment to the future of the institution, to “have some skin in the game.” Share ownership provides both a carrot in long-term value appreciation and a short-term stick for poor decisions that damage the MFI. With prospects for share appreciation over time, ownership complements annual performance-based bonuses focused on short-term achievements.

The ownership percentages that general managers have received in the past demonstrate quite a wide range. However, through conversations with a variety of investors and technical assistance providers, we conclude that amounts generally fall between 3 and 5 percent of total equity for CEOs, with a pool of 1 to 3 percent available to other executive managers, and maximum total management ownership in the range of 5 to 10 percent. Data from other industries indicates that management and director ownership generally does not exceed 15 percent, especially for public companies as corporate-governance watchdog groups will report to institutional investors when the total ownership of managers and directors exceeds this 15 percent threshold. On the other hand, in mid-sized venture capital-backed companies, management may own 20 to 30 percent of total equity. With such high shareholding, managers are generally required to both meet ambitious growth goals and invest some of their own money into the company.<sup>7</sup> One interviewee noted that equity participation must provide a significant potential payoff relative to the manager’s base salary in order to truly influence behavior.

<sup>7</sup> Note that if the NGO retains an ownership stake for its original portfolio contribution, say 20 to 30 percent, then the original board and management would direct or indirect influence over some 30 to 40 percent of shares, forming a strong voting bloc.

In several early MFI transformations, managers did not necessarily want to own equity in the new MFI. They viewed this as too risky and were not comfortable with the concept of employee ownership, which was then the exception. However, given the success enjoyed by some of the leading commercial MFIs in recent years, managers may no longer have the same hesitations. There are some concerns for managers and other employees regarding share ownership, such as the fact that it may reduce liquidity and over-concentrate an individual’s personal financial portfolio. In this section, we assume that equity participation is desired by the top managers as a way to align interests and examine several questions about appropriate and effective ways to structure such participation.

Most observers agree that some paths to management equity participation are legitimate and appropriate for use in transforming MFIs. These include:

- Managers purchase shares at the time of transformation, paying the same price as other investors. An example of this was the purchase of shares by several members of Compartamos’ management and board when the NGO first created a SOFOL (finance company) in 2000.
- Managers earn shares over time based on strong performance in the new MFI and paid out of the earnings of the for-profit MFI.

However, some practices are less clearly acceptable from an ethical, and sometimes legal, perspective. Opinions differ widely regarding such practices, although even if all negotiating parties consider them ethically acceptable, they may be prohibited by non-profit law. These include:

- Managers are given a payment by the NGO, which they then use to buy shares.
- NGO resources are explicitly allocated to pay for a grant of shares, or a discounted purchase price, for managers.
- NGO resources are not explicitly allocated for managements’ granted or discounted shares, but in fact the “cost” of the award comes out of the NGOs’ shareholdings, not the new investors’ share.

These latter situations arise for several reasons, all of which were present in the UMU case. UMU managers used the concept of sweat equity to argue that they deserved to receive shares as recognition for their contributions to creating the MFI, especially given that their salaries had been minimal—even at times non-existent—during the start-up years. If private investors, who had not been present from the start, were about to benefit from the value that they (the founder/managers) had created in UMU, shouldn't they benefit, too? It is easy to see why many observers sympathized with their argument and acknowledged the value of their contributions. Nevertheless, the inconvenient fact was that they had agreed to operate under the rules governing non-profits; donors gave funding and governments gave tax exemptions only because they expected that those rules would be followed.

Even if fairly priced shares are available to them, NGO managers and other founders commonly lack the resources to purchase those shares. This is particularly true for managers who have been working for years in non-profit positions, as in the case of UMU. The managers have forgone the opportunity to earn greater wealth by choosing to work in MFIs. Only those who have chosen a for-profit path, or who come from independent wealth, have the resources to buy shares at full price.

A number of MFIs have employed favorable pricing mechanisms to assist management to purchase shares, while tying the acquisition of the shares to performance over time through a vesting schedule, negotiated in advance. The award of shares can be tied to specific financial and social goals. Vesting refers to the period in which the employee earns a stock grant or during which share options become available to the employee for conversion. A typical vesting period is five years, with the employee earning one fifth of the total number of shares available to him or her each year. Any variation on the same theme is possible. For example, a portion of the shares might vest immediately, with the rest vesting over three to five years. The value of this approach from an ethical point of view is that the incentive is financed from the earnings of the for-profit. The value from an interest alignment point of view is that it is based on future, not past, performance. In short, ethical and legal issues arise if the NGO's resources, rather than those earned by the for-profit, are the real source of the benefit offered to managers.

This means that backward-looking bonuses in recognition of past contributions are more problematic than forward-looking ones (options to purchase or be granted shares based on future earnings). Nearly all those interviewed viewed purchase at full price as the optimal solution at the time of transformation, and also supported the earning of additional shares over time through performance-based agreements. Very few in the industry recommend free granting of shares to managers at transformation, though many are willing to consider reduced price or partially subsidized share acquisition.

With this range of viewpoints it is not surprising that we see a very broad range of practices. Terms for managers or employees vary greatly, from a token payment to nearly full price. In the case of Partner, the management team expects to acquire an equity stake on favorable pricing terms. One prominent investor in India noted that he considers share grants or favorable pricing mechanisms as an acceptable means to overcome the manager's lack of capital to purchase shares.

### **Severance Packages**

In cases where a new general manager is needed, NGOs have provided severance payments to exiting managers. Several industry professionals interviewed mentioned instances of such payments. A severance payment is a lump-sum payment made when an organization terminates the employment of a staff member or manager. The size of the severance payment usually increases as a function of both the time the manager has spent with the institution and the perception of her contribution during those years. Use of severance payments for departures is often mandated by labor laws. Guidelines vary, but most severance payments involve some multiple of monthly or annual salary, often based on years of service. If the board of directors choose to augment the legal minimum, it is providing what might be termed a recognition package or "golden parachute." Beyond the minimum severance amount, however, there is no guidance other than the "smell test"—that is, the informal norms among industry participants—to determine how large a severance payment is acceptable. The "smell test" is, unfortunately, rather imprecise, and there is a question as to which industry to use when benchmarking the severance

payment—should one look to other NGOs or to for-profit commercial actors.

In the Community Corrections NGOs mentioned earlier, there were several instances in which a for-profit business acquiring a non-profit offered a manager a consulting contract which required very little of the former manager. Such contracts were understood as compensation for stepping out of a managerial role or leaving the institution entirely.

If it were deemed acceptable for exiting managers to receive some type of compensation for leaving the MFI, perhaps managers, directors, and investors would be more inclined to participate in frank and transparent discussions about the management needs of the institution, thereby easing the transformation process. Unfortunately, the fact that non-profit rules forbid private benefit will continue to make this avenue a problematic one.

One last note on severance payments is that they have also been used in cases where the manager is not really leaving, but rather is transitioning from the non-profit to the for-profit, as a way to provide capital for share purchase. In at least one instance, an MFI's manager received a sizable severance package and then purchased an equity stake in the transformed institution. Such a practice is essentially another version of the problematic situation described above in which NGO resources are used to provide bonuses to managers.

### ***Aligning Interests for Board Directors***

As noted above, the board members of transforming NGOs may have much the same interests as the general manager, with the exception that they are not employed by the organization, making their dependence on the organization generally less. There are, however, cases where NGO board members played an active and critical role in the MFI and feel entitled to a significant equity stake at transformation.

The approach to aligning interests for NGO board directors is quite similar to that for top managers. The preferred solution is that if board members wish to invest they should use their personal capital. Resulting shareholding percentages will vary greatly,

due mainly to relative wealth or ability to invest, but those we spoke to suggested that board directors' shares should be modest, a few percent at most. Preferential pricing mechanisms or restricted share grants with long-term vesting can also be options, subject to the same concerns noted above.

Post-transformation, some institutions choose to introduce board-director compensation. The general experience in the microfinance industry is that most NGOs do not compensate their directors. By contrast, most commercial firms do. Compensation for directors in the private sector (beyond microfinance) generally includes an annual retainer and/or fees for attending board and committee meetings. The heads of key committees, such as audit or compensation committees, may receive additional compensation. In addition, in many commercial companies directors receive stock options and/or restricted stock grants. The latter is less common.

Among commercial MFIs, most board director compensation is modest and based on meeting attendance. We do not have hard data on whether or not the practice of compensating board members is widely applied or on the amounts involved. In our interviews, the few anecdotal numbers cited were between \$500 and \$1,000 dollars per meeting, essentially compensating members for time spent, much as if they were professional consultants. Annual retainers or stipends were not common. Greater transparency and disclosure about board member stipends would help increase the level of professionalization of corporate governance among MFIs and spare directors some indignity.

### ***Employee Share Ownership Plans (ESOPs) and Profit Sharing***

In order to bring many or all staff into an incentive program, several prominent and successful MFIs have implemented variations of employee share ownership plans (ESOPs). An ESOP is a plan, in the form of a trust, through which employees can buy stock in the company that employs them. ESOPs are widely used in high-income countries. Millions of employees in the United States take part in ESOPs, and nearly all Japanese firms with a stock market listing have an ESOP in place. Share ownership

provides financial incentives to employees through dividends and share appreciation, giving participants a stronger stake in the institution's success. ESOPs also provide a voice for employees in governance. In most cases, employees aggregate their voting rights to elect board representatives.

MFIs can use the ESOP model to increase employee support for transformation. ESOPs can be restricted to senior management, but in this paper we look at two examples where ESOPs were created for all employees as part of transformation strategies: ACLEDA in Cambodia and K-Rep in Kenya.

*From its earliest days as a project and then NGO, ACLEDA had a very participatory management structure. Thus it was natural that the idea of employee participation and ownership figured in the transformation discussion. After much internal consultation, the employees approved the transformation, and the ACLEDA Staff Association (ASA) was established. ASA is structured as an investment company that allows all staff, regardless of rank and title, to own equity shares in ACLEDA Bank. ASA operates as follows, with several features that distinguish it from a standard ESOP:*

- *The staff received no preferential pricing nor do they receive any shares as part of their compensation. Each employee can choose whether to purchase shares and nearly all of the roughly 6,000 employees currently do.*
- *In order to make it easier for staff to purchase, given their limited resources, they are given a long time frame for making purchases. ASA has the right to purchase up to 19 percent of the total equity of ACLEDA with each new rights issue or capital call. Clearly, the employees do not have the same access to capital to purchase shares as the international investors do. Therefore the NGO may purchase the shares on ASA's behalf and then return them to ASA over time as the individual employees purchase shares.*
- *Typically, shares are allocated based on seniority of position and length of employment, but in ASA's case, all staff have equal rights to purchase shares.*

- *Every six months, a day-long open exchange takes place within ASA, setting a general price peg for any share exchanges in the following months. By providing an exchange, ASA also provides liquidity for employees wishing to sell shares or leave the bank.*
- *ASA members vote for the two representatives who represent ASA's holding on ACLEDA's board.*

*ASA is not subsidized by donor capital or the NGO, nor is it rewarded as compensation for sweat equity. Employees participate on a voluntary basis and assume the same risks, rights, responsibilities, and potential financial gains as other shareholders.*

*Managers viewed the invitation for employees to participate in the new institution as an important statement about the value the organization placed on staff, and ASA became a tangible manifestation of the staff's long-time sense of ownership. ACLEDA designed ASA to give all employees equal recognition for their contributions to the organization's evolution. ACLEDA had already decided that employees would ultimately vote on whether to transform. Managers felt it important that staff understand that they would become real owners of the bank. Management hoped that the employees' participation in the plan would ease the transition, create support for the new company, and enhance employee productivity. Following its transformation, ACLEDA enjoyed a period of dramatic growth in outreach with strong financial results.*

*K-Rep is our second example. K-Rep began in 1984 as a multipurpose enterprise development program. From 1990 on, K-Rep focused on microlending, although it retained a broad interest in enterprise development, which the NGO revived after spinning microlending off to the new K-Rep Bank. K-Rep NGO was to remain active after the formation of the bank, and some employees stayed with the NGO while others moved to the bank. Uncertainty over job security and the future of the two K-Rep institutions led to unease, exacerbated by a culture clash between better paid new-hires from the banking community and long term employees of the NGO.<sup>8</sup> K-Rep's management dealt with this problem in a number of ways, one of which was to establish an ESOP pro-*

<sup>8</sup> John Nyerere and others, "The Case of K-Rep—Nairobi, Kenya," The World Bank, 2004.

*gram available to both bank and NGO employees. The ESOP was established as the Kwa Multipurpose Cooperative Society. Administered by an external professional administrator, the Kwa financed share purchases for employees using funding provided by a CGAP grant. It maintains liquidity for employees leaving K-Rep by purchasing shares from them.*

Despite these two examples, the experience with ESOPs in microfinance is still rather scant. The use of stock as a reward or incentive is not common in the developing world, and some observers commented that ESOPs are not an effective incentive to boost operational performance, because the benefit is not well understood or appreciated by employees, and because it is not directly linked to individual employee's performance of their own jobs. Moreover, in some countries no legal framework for ESOPs exists, requiring creative design to craft structures that perform the function of ESOPs using available legal structures. One approach has been to establish employee associations that imitate the trust structure.<sup>9</sup>

A second problem is that shares in privately-held microfinance institutions are rarely traded. The illiquidity of shares and resulting lack of reference prices can complicate the ESOP. One solution is to maintain a liquidity pool within the ESOP so that employees can access the capital held in those shares during an emergency or so that exiting employees can liquidate their holdings, as ACLEDA does. If the institution or its investors have not sold any shares recently, the MFI will have to determine on its own what the shares are worth.

Several investors speculated about other ways to address illiquidity, including pre-negotiated share buy-back from managers according to vesting schedules for meeting future performance goals, or designing equity-like instruments that provide cash payments pegged to the value of the institution's equity. The illiquidity of shares affects all owners (including investors and managers who own shares), which clearly aligns all shareholders in a common desire for increased liquidity. Another option to provide

employees with liquidity without having to sell their shares is to create "leveraged" ESOPs that allow employees to borrow from their company, using the shares as collateral. If the employee defaults, the company recovers the shares, a low-risk lending strategy for the company.<sup>10</sup>

ESOPs require significant planning and incur continuous expenses to administer. For these reasons, several individuals interviewed for this project indicated that they would prefer profit-sharing schemes or non-voting shares. While profit-sharing mechanisms do not require financial input from employees or confer governance rights and responsibilities, they can offer a strong financial incentive. Profit-sharing plans either distribute cash at year-end (taxable) or defer funds in an employee account, accessible to the employee only under pre-established conditions. The latter option may not be taxed or not taxed until the employee withdraws the funds.

Share ownership by management and employees, especially through restricted stock grants or options that vest over time, is often referred to as "golden handcuffs." It binds the employee to the institution for the medium to long term. That connection is not always positive. If the value of the MFI declines and the shares are worth less, they may become a negative incentive. Also, if there is not a liquidity event (some type of sale that allows shareholders to sell their holding) in a reasonable period of time (for example, within five years) after share restrictions are lifted, or a way for employees or management to sell some of their shares, the options may play a negative role as the time of holding increases. For instance, K-Rep's original plan was to list the Bank's stock on a public exchange within a few years. Since that did not occur, the value of the Kwa ESOP diminished over time, and became concentrated in a few senior employees.

The opposite was true for Equity Bank and Compartamos, which were able to benefit their employees through public listings. Many of Equity Bank's employees and clients became shareholders as the bank was restructuring from a savings bank to a commercial bank. By listing, Equity Bank increased the value of these shares, and gave these

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<sup>9</sup> David M. Binns and Ronald J. Gilbert, "The Role of Employee Stock Ownership Plans in the Restructuring and Privatization of State-Owned Financial Institutions," presentation to a World Bank conference on state bank restructuring, 2004.

<sup>10</sup> Ibid.

small shareholders a way to exit if they chose. In the case of Compartamos, the senior management team purchased shares when Compartamos converted to a finance company. When Compartamos listed on the Mexican stock exchange and sold of shares through a secondary offering, the management team was able to realize a significant gain.

Employees with limited experience in stock ownership may not recognize the risk involved. Clear explanations are needed that what goes up may come down. Employees are well advised, from a risk diversification point of view, not to hold most of their financial assets in the same institution that provides their daily living.

### ***Incorporating the Alignment of Interests into Practice – Processes, Norms and Next Steps***

The argument is gaining ground in some circles that drawing too rigid a line between non-profit and for-profit has a number of negative consequences.<sup>11</sup> Certainly, as we have seen, it complicates MFI transformations. Socially responsible investing is one attempt to chart a middle path. Community Corrections, hospitals, biotech firms, and now microfinance have all faced the challenge of creating double-bottom-line institutions. Solutions to the problem of personal interests in these situations require the creation of norms that are viewed as ethical by all stakeholders and fit within the law. These norms are stated openly and embodied in agreements. They are applied by third parties with an objective point of view who implicitly represent the ethical standards of the industry or community. We look now at processes for addressing these issues, first in individual MFIs and then in the microfinance industry.

**Individual MFIs.** While the cases presented in this paper are only specific instances of an issue that manifests itself in many different ways, they do show that the alignment of interests has not been addressed in a clear and transparent way. Ideally, the key decision makers will develop a forum to openly discuss their, and others', interests.

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<sup>11</sup> Dan Pallotta, *Uncharitable: How Restraints on Nonprofits Undermine Their Potential* (Medford: Tufts University Press, 2008).

The transformation process differs for each MFI, and that is why we do not recommend any single recipe for alignment. However, we do make some process recommendations for working toward alignment before, during and after transformation.

As we discussed in the earlier sections of the paper, many of the headaches and heartaches associated with transformation result from the terms of implicit and explicit agreements surrounding the creation of the original NGO. Some of these could be avoided if the possibility of transformation is anticipated at the time an NGO MFI is formed. In the past, most NGOs began without any thought of transformation, but as far back as 1992, there are cases where transformation was anticipated from the start, making the subsequent process somewhat easier. Procredit, the Bolivian NGO that spawned Caja Los Andes FFP, was created with the intent to transform into a regulated financial institution. There are a number of other cases since then. Today, any start-up NGO should consider whether transformation might be a part of its future, and, if so, its founding agreements should anticipate the possibility as much as possible—the NGO equivalent of a prenuptial agreement. No NGO by-laws or employment agreement can anticipate and resolve every future possibility, but it is possible to specify broad processes through which incentive issues may be resolved. For instance:

- Founding documents, funding agreements, or employee contracts can address whether “sweat equity” rewards for service to the NGO are prohibited or permitted; if permitted, formulas can be established, or at least processes can be specified. For example, they might require review of incentive awards or share prices by independent experts with no financial stake in the outcome.
- Frameworks can be specified under which founding organizations or individuals may gain an ownership stake in the institution upon transformation.
- Money provided to NGOs by founding organizations can take the form of long term loans, making it easier for a founder to withdraw funds from the NGO and move them to the regulated institution.

Provisions such as the granting of recognition for sweat equity, which may be ethically questionable if granted in retrospect, become more acceptable precisely because all parties to the institution have explicitly agreed to them from the first. And these issues tend to be easier to agree on at the beginning, when the NGO's business has not yet developed a large commercial value. Nevertheless, care must be taken in developing any of these provisions to ensure that they are in keeping with local law. Founders will also need to ensure that such provisions will not pre-empt or discourage investors from becoming involved at a later date.

Company valuation is often the fulcrum around which transformation negotiations with investors take place. The valuation of the existing MFI and the new company looks backwards to incorporate past accomplishments and forward to anticipate future prospects. Thus, it seems natural that discussions about aligning personal interests will be closely linked to valuation discussions.

One of the most promising methods for bringing greater transparency to this process may be the use of third-party advisors. MFIs and investors sometimes hire advisors to perform a valuation of the MFI, reasoning that a third party without a personal stake in the valuation will provide an objective and fair result. This same principle could apply to the alignment of interests at transformation. As different from valuation, however, the third party in this case would not provide an independent opinion based on accepted analytic methods. Rather, an objective third party could lend transparency to the process and guide the conversations, operating much like a mediator. The advisor would hear from all sides and then bring knowledge of good practices to bear in crafting a proposed framework. The advisor could function as a representative of the public interest.

Some of the advisory service organizations working in microfinance, such as those that help MFIs raise debt and equity, may already be doing some of this work informally and could, perhaps, be in a position to help spread good practices. To maximize objectivity and acceptance by all parties, the advisor should be selected by all the negotiating

parties and paid out of pre-launch costs, in the same way pre-launch legal costs are shared by incoming investors.

Once transformation takes place, the new MFI's board takes responsibility for management and employee compensation as well as its own compensation, the latter a delicate self-policing role, with the oversight of shareholders. Typically, the board appoints a compensation committee to take responsibility for this function. The compensation committee works closely with management to align compensation including annual bonuses as well as stock or option awards with specific corporate goals and objectives.

**The Microfinance Industry.** Practices that help align personal and institutional interests need support from the microfinance industry as a whole. Industry agreement that it is appropriate and even necessary to address personal interests will help bring the issue out of the closet and into the negotiating room, where it can be addressed in a more mature and constructive way. Recognized practices can provide both direction and legitimacy, making it easier for those negotiating transformations to increase the transparency of their own processes and reach better results. It is important for professional advisors to build up expertise in this area so that they will be recognized as experts, raising their acceptance by all parties in the negotiating process.

A major problem is the gap in information available to the microfinance industry on compensation. The microfinance industry lags behind other parts of the financial sector, and other sectors generally, in providing comparable data for developing industry norms. In sectors as diverse as banking, private equity, and bio-technology, industry compensation surveys benchmark compensation for CEOs, COOs, CFOs, and other senior positions. For example, in bio-tech such surveys include the chief scientific officer and/or the chief medical officer. Benchmarks are provided by size of institution, geographic area, whether the institution is privately or publicly held, and other factors. The compensation surveys are very similar to the MFI operational benchmarking of the MicroBanking Bulletin, and they operate as the Bulletin does on an anonymous, peer-group basis,

protecting the confidentiality of company-specific information. Board compensation committees use these surveys or professional compensation firms to prepare packages for their own companies or hire compensation experts periodically to tailor packages based on survey results. The compensation firm is well-placed to provide objective input to support negotiations among the MFI board, management and investors. One microfinance investor group indicated that it hires local firms to do a compensation study so that the group understands local market practices before offering salaries and incentives.

Compensation benchmarking would be difficult for the microfinance industry, with MFIs operating across the globe in regions and countries, each with its own currency, labor market, and compensation norms. However, it could be feasible to begin with transformed and commercialized MFIs, which are both limited in number and linked into international networks of investors. Information sharing could be carried out through the Microfinance Information Exchange (MIX) and its MicroBanking Bulletin, initially with grant support. If its value to the industry were demonstrated, MFIs could be asked to report as they do to the Bulletin, on a confidential basis and paying their fair share for access to the survey data.

At the same time, we recognize that compensation practices in the mainstream financial sector are undergoing significant rethinking in the wake of the financial crisis. Nothing in this paper or in the views of those we interviewed suggests any support for excessive compensation or rewards for excessive risk-taking.

More generally, a next step for the industry is to document the types and relative amounts of incentives currently offered to stakeholders. It is our hope that as discussion grows, benchmarks will emerge along with industry consensus.

This paper has presented the topic of the alignment of interests and some of the subtleties of the issues involved. It does not attempt to conclude the discussion, only to begin it and frame it. While many specific aspects mentioned in the paper require more discussion and research, two clear tasks for the industry stand out:

- The industry as a whole must continue to discuss the issue of aligning interests. Only if MFIs, investors, advisors, and observers share their experience can we develop common norms. Continued assessment of experience will increase understanding of how best to incorporate the alignment of interests into transformation and governance processes. It will also increase consensus regarding what incentives constitute fair and ethical remuneration.
- Further research must examine the legal, accounting, and regulatory implications of the concepts presented herein. MFIs take serious risks if they address such interests without a full analysis of legal and regulatory requirements. We hope that future research and dialogue will continue to expand the clear and practical options for MFIs confronting the need to align interests.

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## About the Sponsors

### **Calmeadow Foundation**

Calmeadow is a registered Canadian not-for-profit charity celebrating over twenty years of experience in microfinance. Our goal is to enable the self-employed poor in developing countries to strengthen their enterprises and achieve improved standards of living for themselves and their families. Our strategy is to ensure ready access to sustainable and affordable financial services. Based in Toronto and with an operating base in Costa Rica, Calmeadow has focused its efforts on mobilizing and managing capital for direct investment in developing microfinance institutions in Latin America and Africa since 1996. Our earlier experience gained in a broad range of microfinance program initiatives convinced us that the most likely route to significant development of the global microfinance sector would require engaging local commercial financial institutions.

### **The Center for Financial Inclusion at ACCION International**

The Center for Financial Inclusion at ACCION International is an action research center that works on behalf of the microfinance industry as a whole, serving as a bridge to leverage private-sector interest in microfinance. In collaboration with nonprofits, commercial banks, technology firms, regulators, universities, and many others, the Center works to bring the best minds and expertise to bear on challenges facing the industry as a whole. Using tools such as convening, coalition building, research, information dissemination, training and piloting, the Center is dedicated to the proposition that low-income people deserve high-quality, regulated financial services, and that those services are best provided through sustainable, commercial programs that incorporate social purpose. The Center seeks to connect the microfinance community with the major drivers of the global economy—e.g. capital markets and technology—and harness their capabilities to address the financial needs of poor people. By bringing these elements together, the Center for Financial Inclusion serves as a bridge between today's microfinance and a future of economic opportunity for all.

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Ms. Rhyne is the managing director of the Center for Financial Inclusion. As senior vice president of ACCION International since 2000, Ms. Rhyne was responsible for ACCION's initial entry into Africa and India. She directed the organization's research efforts to develop new financial products and managed ACCION's publications and educational activities. Recognized as a leading thinker and writer in the field of microfinance, Ms. Rhyne has published numerous articles and four books on the topic, including *Microfinance for Bankers and Investors: Understanding the Opportunities and Challenges of the Market at the Bottom of the Pyramid* (McGraw-Hill, 2009) and *Mainstreaming Microfinance: How Lending to the Poor Began, Grew and Came of Age in Bolivia* (Kumarian Press, 2001). She was also co-editor of *The New World of Microenterprise Finance* (Kumarian, 1994), which provided the introduction to microfinance for many of the field's current professionals. Ms. Rhyne's experience includes eight years of residence in Africa (Kenya and Mozambique) and independent consulting on microfinance policy and operations for governments, international organizations, and microfinance institutions.

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Mr. Lieberman is the president and CEO of LIPAM International, Inc., an advisory firm that assists governments, international financial institutions, not-for-profit institutions and for-profit companies in emerging market countries. Mr. Lieberman created the CGAP Secretariat and was its CEO from June 1995 through June 1999. He presently serves as chairman of the Advisory Board of ELF, an emergency liquidity facility for MFIs in Latin America. He is also on the Board and Investment Committee of the Calvert Foundation, and is the chair of the Board of Directors of Fintech Africa, a technical assistance facility serving AfriCap (a microfinance equity fund for Africa) investees. Finally, he is on the Advisory Board of the Council of Microfinance Equity Funds (CMEF).

### ***Brian Busch***

Mr. Busch is currently an investment officer with Omrix Inc., a microfinance fund manager and financial consultancy located in San José, Costa Rica. In that capacity, Mr. Busch works with MFIs throughout Latin America and the Caribbean via two technical assistance facilities, the Risk Management Facility for Microfinance and the Caribbean Technical Support Facility. Both programs are designed to strengthen the institutional capacity to assess and manage risk at partner MFIs. In addition, he provides financial analysis and support to the Emergency Liquidity Facility, a debt fund designed to assist MFIs facing a liquidity crunch due to man-made or natural disasters. Prior to working with Omrix, Mr. Busch worked with ACCION International and the Council of Microfinance Equity Funds, co-authoring the 2006 study “The Growth of Commercial Microfinance 2004–2006”. Mr. Busch earned a BS in finance and a BA in philosophy from Boston College.

### ***Stephanie Dolan***

Ms. Dolan currently works at the Center for Financial Inclusion at ACCION International. As part of the Investing in Inclusive Finance team at the Center, she coordinates the Council of Microfinance Equity Funds (CMEF), working closely with members and other actors on research and projects to advance equity financing of MFIs, including the Microfinance Banana Skins publication. She is also engaged in transformation initiatives and facilitates investment readiness training courses, most recently in Lagos, Nigeria. She plays a key role in the organization of ACCION-hosted conferences, including Microfinance Cracking the Capital Markets, as well as other events in India and Central America. Before joining ACCION, Ms. Dolan worked as an analyst in Morgan Stanley’s Credit Research and Risk Management Division. Ms. Dolan holds a BA in political science and history from Dartmouth College.

## Annex 1 - List of Interviews

### *Roundtable Participants*

Lauren Burnhill	-	One Planet Ventures, USA
Paul DiLeo	-	Grassroots Capital, USA
Modibo Kamara	-	A2F, USA
Elissa McCarter	-	CHF International, USA
Gary Mulhair	-	Global Partnerships, USA
Rich Rosenberg	-	CGAP, USA
Damian von Stauffenberg	-	MicroRate, USA

### *List of Interviews*

Fouad Abdelmoumni	-	Al Amana, Morocco
Femke Bos	-	Triodos Bank, the Netherlands
Phil Broughton	-	FINCA International, USA
Edgar Búcaro	-	Génesis Empresarial, Guatemala
Deborah Burand	-	U of Michigan Law School, USA
Vincent Burgi	-	Individual Investor, Switzerland
Carlos Castello	-	ACCION International, USA
Luis Castillo	-	Apoyo Integral, El Salvador
Jill Chen	-	Grameen Foundation, USA
Paul Christensen	-	Kellogg University, USA
Michael Chu	-	Harvard Business School, USA
Heather Clark	-	Independent Consultant
Pam Eser	-	United Nations
Enrique Ferraro	-	ACCION Investments in Microfinance, USA
John Fischer	-	ACCION Investments in Microfinance, USA
Sean Foote	-	Labrador Ventures, USA
Erik Geurts	-	TripleJump, the Netherlands
Anna Gincherman	-	Women's World Banking
Philip Goodeve	-	FINCA International, USA
Diego Gúzman	-	ACCION International, Colombia
Steve Halstedt	-	Centennial Ventures, USA
Miguel Herrera	-	ACCION Investments in Microfinance, USA
Mona Kachhwaha	-	Bellwether Fund, India
Valerie Kindt	-	ACCION Internacional, USA
Peter Kooi	-	ACLEDA Bank, Cambodia

Brian Kuwik	-	ACCION International, USA
Melissa Lumpkin	-	ACCION International, USA
Leonor Melo de Velasco	-	FMM Popayán, Colombia
Venky Natarajan	-	Lok Capital, India
Juan Niemann	-	Génesis Empresarial, Guatemala
Francisco “Pancho” Otero	-	IPM, Bolivia
Viswanatha Prasad	-	Bellwether Fund, India
Steve Rasmussen	-	CGAP, USA
José Ruisanchez	-	Independent Consultant, USA
Eric Savage	-	Unitus Capital, India
Mark van Doesburgh	-	TripleJump, the Netherlands
Ken Vander Weele	-	Opportunity Internacional, USA
Philip Vassilou	-	Legatum, Dubai, United Arab Emerites
Juan Vega	-	PROMIFIN, Nicaragua
Victoria White	-	ACCION International, USA

## **Annex 2 - The Case of Génesis Empresarial, Guatemala - Why Aligning Incentives Matters to MFIs**

When the proposed merger between Génesis and BancaSol failed, several of the potential investors who had worked for over two years on the deal found themselves at a loss; they wondered why this merger, with so much to gain for both institutions, had ultimately failed. The deal seemed like an almost perfect match and had gained wide support from all sides early on. The MFI, Génesis Empresarial, a non-profit foundation, had designed a credit product and operational model that aptly addressed the needs of the large, underserved population of microentrepreneurs in Guatemala. At the time of the proposed merger, Génesis had exceptional potential to grow and greatly expand the number of clients served. However, directors and managers could see that their NGO status limited their ability to finance future growth and limited the products they could offer to clients, such as much-demanded voluntary savings.

Separately, a group of wealthy business owners had created the bank, BancaSol, out of a genuine desire to expand banking services to the poor (even the bank's name, after BancoSol in Bolivia, demonstrated the commitment). However, after several failed attempts to enter the microfinance segment, even trying to directly copy the methodologies of other successful MFIs, the bank had settled in a fairly conservative niche, financing consumer loans for salaried employees. BancaSol brought to the negotiating table a full bank license and regulatory approval, but lacked spectacular growth possibilities or a model to achieve its original mission. BancaSol knew that its license would prove most valuable to Génesis in the merger, since national banking regulators had plainly indicated that they would not approve a new banking license for Génesis.

Thus the directors of both entities envisioned merging the two institutions: BancaSol planned to provide the banking license and its portfolio, and Génesis intended to contribute its loan portfolio, lending methodology, and growth potential (vision). Several international investors knowledgeable in microfinance, such as ProFund, planned to contribute additional capital, lend credibility to the new vision of the institution, and help ensure the focus on the mission of serving microentrepreneurs. For the involved parties, the proposed merger offered many advantages: greater regulation fit the natural progression of the MFI's mission and vision; the merger (as opposed to granting a new license) fit the needs of the banking regulators; new growth potential fit the needs of the BancaSol's directors; and most importantly, expanded outreach, new products and services, and potentially lower-cost loans served the needs of the microentrepreneur clients of the MFI.

In the years since the failed merger, Génesis has tried three more times (all unsuccessful at present) to transform on its own into a bank. The NGO status and reliance only on reinvested loan returns continues to limit growth and leverage potential (the NGO has not received donations in years). Without greater regulation Génesis cannot offer additional products to clients. Outside competition, especially from commercial banks, has increased, even drawing away the MFI's general manager who had worked nearly 20 years with the MFI. Génesis remains a success story to this day, an early innovator serving poor clients and a prominent national player; yet it has fallen behind its regional peer group and has lost ground to national competitors as it continues to strive for transformation and the potential it offers.

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This case was prepared by Alex Silva and Brian Busch.

## Background

Génesis was founded in the late 1980s as the combined effort of bilateral aid donations, a local NGO, and a microfinance network and technical assistance (TA) provider. The credit program remained a part of the founding NGO for nearly a decade, at which point the program was converted into a separate NGO providing microcredit and business training to clients. Broad outreach has always been a part of the mission, although Génesis continues to serve mainly female clients. The TA provider played a critically important role in Génesis' success. Initially a resident advisor, operating as another high level manager, worked with the MFI full-time to develop the basic lending methodologies. Later, teams of consultants re-engineered various business and credit processes. In addition, the TA provider linked Génesis to a regional network of well-performing MFIs, who shared amongst themselves best practices and field experience.

Not long after Génesis separated from the original NGO, managers and directors realized that over the course of the coming years increasing growth would soon exhaust the capital base and either force higher leverage ratios or lower growth (in line with credit returns), since soliciting significant amounts of donations seemed unfeasible. Four years after the creation of Génesis as a stand-alone NGO, the number of clients had nearly doubled. Although the loan portfolio grew at a significantly slower rate, capital grew still slower. The capital-to-asset ratio, already well below the ratio for financially self-sufficient MFIs that same year, according to the *MicroBanking Bulletin*, began to decline.<sup>1</sup> Managers and directors looked to transformation in order to offer voluntary savings deposits to clients, a new product that they believed would increase the efficacy of the MFI in terms of meeting all of the clients' financial needs, and provide a large pool of relatively stable, low-cost funds. Additionally, a banking license would provide access to other sources of on-lending funds helping to greatly expand outreach.

High levels of fragmentation characterized the banking sector in Guatemala at the time when Génesis

<sup>1</sup> *MicroBanking Bulletin*, <http://www.mixmbb.org>.

first considered transformation. Many smaller, regional banks served different market niches; often, wealthy businessmen from a given industry or economic sector had created these banks for a variety of reasons. A group of sugar industry magnates created BancaSol in an effort to genuinely address the needs of individuals excluded from the formal financial system. However, the bank found itself in a small but relatively safe niche making small consumer loans to low-level salaried employees, mainly employees of the founders' companies, in a situation similar to the "company store" of many remote mining towns of the past. Also, a number of smaller banks had failed over the past years, and the banking authorities were trying to remedy the situation by pushing for consolidation among the smaller banks.

BancaSol had a relatively small loan portfolio relative even to Génesis and operated out of only four offices, compared to the MFI's 43 'business centers.' In spite of reduced potential, the bank had a full license and regulatory approval from the national authorities, advanced information systems to track and analyze loans, a relatively healthy loan portfolio, and experience managing cash transactions and the accompanying risks. Génesis, although a highly specialized lender that understood the needs of its target market, did not manage cash transactions; instead the NGO relied on local banks to disburse loans, collect cash payments and accepted the accompanying costs. Above all else, BancaSol had proved itself adept at collecting and managing savings deposits from the public, which made it an ideal partner for Génesis.

## A Microfinance Bank

When the idea to merge Génesis and BancaSol arose, the MFI's managers and directors had already spent considerable amounts of time considering transformation and had discussed their options with the TA provider. The TA provider could provide access to specialized microfinance investors who could add to the professionalism of the institutional governance and (more importantly) understood the nature of microfinance. Given the national banking regulators' reluctance to approve a new banking license, the idea of a merger of equals with a fully licensed bank gained quick interest, since it resolved the

licensing issue and in addition would shorten the period to develop and implement savings products for microentrepreneurs.

To form the new bank, BancaSol planned to buy Génesis' loan portfolio and assume its liabilities. Génesis anticipated using the proceeds to buy shares of BancaSol but would maintain apart its business training and advisory services for clients. A group of four international investors planned to supply new funds, bringing the equity base up to US \$10 million. In the end, each of the key parties expected to receive similar stakes: BancaSol and the international investors would own roughly 30% each, Génesis would own approximately 40% (revised up from 30% originally), and board seats would be distributed accordingly. Additional provisions meant to protect the microfinance mission included limiting any single party to owning more than 40% of the total equity and requiring a 75% supermajority to make any changes concerning the institutional mission.

The mission statement of the new bank would mandate that the newly formed institution maintain at least 50% of its loan portfolio in the microfinance niche. However, the microfinance market offered significantly higher growth potential in general, and the bank's founders had a genuine desire to provide a social service to the unbanked. For these reasons, more than one of the international investors, all of whom had years of experience with transformed and non-profit MFIs, mentioned feeling very secure about the mission of the new bank and confident that the new MFI would expand the reach of Génesis's services to many more microentrepreneurs.

The parties formed an "in principle" agreement in 2000. The agreement, however, left out many of the details, such as the organizational chart of the new bank and the timeline for implementation. Thus, the parties agreed to two additional points: 1) a committee with key members representing the different parties would convene in order to negotiate the details of integrating the operations and setting deadlines for the merger, and 2) the committee would hire an independent financial firm to perform a valuation. Present on the committee from Génesis were the president and vice president of the advisory board,

and the general manager of the MFI to, in his words, "help answer technical questions."

## Key Issues for the Transformation Committee

Génesis realized it must sacrifice some measure of control over the institution in order to make the merger work. Control is a delicate issue; it touches not only the mission and the social impact of the MFI, but also the primary motivations of founders and long term managers. In this case, the general manager and many directors felt personally attached to the institution. All had invested much time and hard work in its creation, and the general manager especially derived not only his financial livelihood but also a sense of power and respect from his position in the MFI. However, in the NGO's capacity as a "public good," one generally expects that founders and managers will sacrifice control when it serves the best interests of the institution and its clients. The "in principle" agreement made it very clear that the key decision-makers from the NGO felt that the proposed merger did indeed serve the best interests of the poor clients Génesis served.

In spite of Génesis' potential and past success, the MFIs managers, directors, and even the international investors had to overcome BancaSol's doubts about its operational capacity. As one international investor said, "We had to spend a lot of time with BancaSol's board, gaining their trust and helping them to understand microfinance and its potential." In spite of these efforts, shreds of BancaSol's skepticism remained and manifested themselves at times at the negotiation table, especially when the committee discussed the new bank's organizational chart.

BancaSol's board seemed to find some justification for its skepticism in the valuation performed by the independent consulting firm. Both Génesis and the international investors acknowledge that, as one international investor put it "In retrospect, the valuation of Génesis was low. When the consultants looked at the MFI as if it were a bank, it looked weak; the portfolio looked questionable. They didn't understand, or just undervalued, the unique nature of the microfinance operation." Given the benefits of hindsight, a low valuation for

the MFI should not have surprised those involved. At the time only a few MFIs were operating as regulated institutions in the region and even fewer transactions involving the equity of such MFIs had taken place to establish market multiples of earnings or book value. In fact, not until several years later did the industry in general come unhinged from the 1.0x book value peg.

In spite of the apparently low valuation delivered by the consultants, negotiations proceeded. Génesis' president, supported by the international investors, tried to push beyond the issue, as he said "I didn't think [the low valuation] was that big of an issue. It was a question of some money versus the mission and growth of the institution." He also noted that several of Génesis' other directors, including the vice president, worked in the banking sector, as had the general manager prior to joining Génesis. While these individuals probably understood the unique financial and operational strengths of Génesis better than the board of BancaSol, they proved less willing to let the low valuation slide for the sake of making the merger work. In fact, as the general manager said, "The low valuation had implications for the governance of the new institution, and the governance structure would determine the management. We wanted Génesis to take the lead in the new institution... A majority (51% or greater) ownership would have been better."

The original valuation would have given Génesis an ownership stake of roughly 30%, equal to the other key parties. However, given the low valuation, BancaSol and the international investors decided to make a concession and increased the NGO's proposed ownership to 40%. But the investors, as minority investors, made very clear that they would not accept either the bank or the NGO owning more than 40%, in order to protect their rights as shareholders. On top of this concession, the TA provider would invest as part of the group of international investors. By combining Génesis' participation and that of the TA provider, the total shareholding would be greater than 51%, total control of the new institution. Given the TA provider's long history working with the NGO, there could be no doubt about its commitment to the social mission of serving the poor, thus it seems the issue of control went beyond just protecting the mission.

The general manager's quote above notes other important issues the merger committee had to address. Beyond operational issues such as how and when to integrate the information systems of the two institutions, the issue of who would manage the new bank, for example, proved critically important. Génesis' President noted that "During the committee meetings, we worked on the organizational chart for the new bank, but we didn't put any names on it. It was understood that BancaSol wanted to choose the general manager. We didn't talk of Génesis' general manager becoming the general manager of the new bank, even though he wanted to be the general manager. We didn't realize until later how important this issue was."

Génesis' general manager had spent over 15 years working at the MFI after working both with the central bank and other small- and medium-enterprise finance institutions. As one international investor mentioned, "It was clear that [Génesis' general manager] would not be the new bank's general manager. He didn't have the right experience to manage a bank and there were operational problems with the NGO that he had not overcome." Another international investor offered the opinion that "...he was simply not the right person to manage the new bank. At some point he was told he would not be the general manager but rather the manager of the micro-finance operation (a division manager); that was a problem." The manager himself instead expressed a greater degree of openness to the matter, "If the board had asked me to step down, I would have done it if it was in the best interest of the institution and the clients." But, when asked about his view of his qualifications and desire to be the general manager, he responded, with an air of vindication: "The proof is in my current position; I'm managing the micro-finance division of a commercial bank with a large microfinance portfolio."

In addition to the organizational chart, cultural issues plagued the negotiations. As one international investor noted, "there was some distrust between Génesis and BancaSol, but the presence of the international investors lent credibility to the process." Génesis' president felt the culture clash during the negotiations between the foundation and the bank.

Both the president and the general manager mentioned feeling that the BancaSol team viewed the deal more as an acquisition of Génesis rather than a genuine merger of equals. However, Génesis's president quickly added that he did not feel that any of these issues (the valuation, the organizational chart, or the culture clash) would prove insurmountable. One international investor agreed, "At each meeting of the committee, the NGO's president made strong statements about his desire to see the deal through, to negotiate and overcome the differences, for the advantages that the merger offered. Only the opinion of the president carried more weight than the opinion of the general manager." With the president's strong support, the process would move forward, though slowly.

## A Vision Crumbles

Armed with the "in principle" agreement, the committee charged with negotiating the details of the proposed merger began meeting regularly, oftentimes with one or more of the international investors present. Merging two organizations, especially those with unique operations and systems, is a long and arduous task in the best of circumstances. The committee needed to analyze and make key decisions and set a timeline for key deliverables for the implementation. However, the merger negotiations for the new bank actually moved in reverse and stretched on for more than two years.

As noted before, the committee viewed the organizational chart as a key factor in the success of the new bank, and therefore it received early attention from the committee. In order to truly realize the high hopes of all parties, the new bank needed to best use the human resources and experience of both Génesis and BancaSol by getting key people in the right places. Génesis' president seemed to accept the bank's insistence on naming a new general manager as a simple fact, although he understood that the MFI's current general manager wanted to run the new bank as well.

If the president viewed a general manager named by BancaSol as a sacrifice, he viewed it as a limited and necessary sacrifice to achieve more important ends

for the institution and the mission. As for the international investors, they did not perceive BancaSol's position as unreasonable, given the experience and past performance of the MFI's general manager, Génesis' primary candidate for any senior management position. However, as these discussions progressed and it became clear that Génesis' general manager would not be the new bank's general manager, the issue of mission drift was brought back into the discussion, often by the general manager. As one international investor noted, "we had a signed deal (the 'in principle' agreement) and yet some committee members were still discussing mission drift."

Mission drift is a critical issue for any MFI considering transformation. However, in this case, all the parties agreed that Génesis' mission of providing financial services to an increasing number of the entrepreneurial poor was adequately protected and embodied in the new bank. Génesis' directors, especially the president, remained confident that the agreement reached with BancaSol and the natural evolution of the market opportunities ensured the social impact of the MFI and expanded outreach. In addition, the presence of international investors who specialized in microfinance reinforced the mission through their commitment to social returns, and by limiting the ownership and therefore control of any other parties that might argue for a more commercial focus. In hindsight, it seems only Génesis' general manager would consistently bring up the topic of mission drift as the negotiations progressed. These discussions about the mission would take up considerable amounts of time and to a greater or lesser degree distract from other critical issues.

The merger negotiations continued for the most part, largely pushed by the president of the NGO. However, the president's other business interests took a drastic turn for the worse during the negotiations which forced his attention from the deal. Thus Génesis' vice president and the general manager took on larger roles in the negotiations. The vice president in particular did not support the merger as much as the president. The vice president worked for another bank, potentially a competitor of the new bank, but more importantly remained hung up on the valuation, initially low but adjusted up. As one investor

mentioned, “after the president was forced to attend to his own affairs, the negotiations became progressively less productive.” The MFI’s other directors, perceived as strongly in favor of the merger, did not want to stand up to a strong general manager in their capacity as volunteer directors of a NGO. As the same investor noted, “[the other directors] were on board just to try and do something good. They were not prepared to fight with the manager over the issue.”

Génesis’ representatives at the negotiating table also periodically raised the issue of valuation, apparently still unsatisfied with the proposed ownership structure and fully aware that the international investors would not accept an increased participation for the NGO. After two years of negotiations, the MFI’s committee representatives felt that the situation justified revaluing the proposed ownership structure of the new bank. While the MFI had grown faster than the bank over the years of negotiations and now offered an even larger loan portfolio relative to the bank, the international investors understood that a new valuation would drag the process out much longer and interpreted the gesture as an indication that Génesis preferred not to continue with the proposed deal.

As mentioned earlier, to this day Génesis has not transformed into a regulated institution because the national regulatory authorities refuse to grant the institution a banking license. The MFI therefore cannot offer savings deposits to clients and has seen its growth taper off slightly in recent years, arguably because the capital base and leverage are now limiting factors. Some years after the merger negotiations, Génesis’ general manager left the institution to manage the microfinance division of a larger commercial bank. A regional bank group eventually acquired BancaSol, for a considerable premium, which may have led to speculation from the MFI side that the bank never fully committed to the deal, once the directors realized the institution’s potential value. However, that criticism does not take into account the potential growth of the merged microfinance bank.

## Conclusions

A number of factors contributed to the failure of the merger, which appeared very beneficial to those involved and would have offered Génesis a solution to its growth constraints and opened up a new product category for its clients, thereby fulfilling the institutional mission. The original valuation appeared low, even to those outside the MFI, and created some lingering resentment during the negotiations. The culture clash between the two institutions represented a significant challenge for the proposed institution. Génesis’ other directors, as volunteers with charitable personal motivations, did not want to stand up to a strong general manager over key decisions. Finally and perhaps most importantly, the position and motivations of Génesis’ general manager must be considered.

As noted above, Génesis had long before joined a regional network of MFIs organized by the TA provider it was working with. In fact, Génesis had recently held the rotating “chairman” post of the network at the time the negotiations took place. Through this network the MFI’s general manager had close contact with other MFI managers, two in particular whose boards had recently forced them to step down only a short time after their institutions had transformed into banks. Génesis’ general manager recounted the leadership changes at those other institutions with apathy and one of the investors noted, “... Génesis’ general manager was definitely in touch with the other managers, two vivid examples of how the process could go very wrong for him personally.” This is not to say that the general manager had a gloomy outlook from the beginning, far from it. Instead, as the same investor said, “... he saw his friends lose their income, their means to provide for their families. For these guys, running an MFI is a calling, their passion, but it’s also a source of income.” At first, the general manager, it seems, supported the merger whole-heartedly, determined to overcome the pitfalls of his colleagues.

In the general manager’s own words, “I had a severance payment as a part of my employment contract, so money was not an issue. If the directors had asked me to step down and it was in the best interests of

the institution, I would have.” However, the general manager was not asked to resign, instead he was asked to accept what could plausibly be viewed as a demotion, from general manager to manager of the microcredit division. Nor would he be let go, paid his severance, and then potentially rehired by the new bank. Both investors and the MFI’s president acknowledge that they did not discuss the general manager’s personal compensation. Even though the salary may have been similar or even a bit better, the general manager would clearly be giving up a prestigious, powerful position for a less visible, subordinate post. In addition, one investor noted that the NGO covered many of the general manager’s expenses, such as transportation, and provided other generous perks. It appears unlikely that similar perks would have accompanied the position with the new bank.

Nor was the general manager offered the opportunity to purchase shares in the new bank or any type of incentive compensation in the form of options or share grants in the future. He says that he advocated for an employee stock-option program that would reward a larger base of employees, himself included, for positive institutional performance. The general manager did not receive an opportunity to share in the future growth of the institution nor was rewarded for his “sweat equity” contribution over nearly 20 years. Finally, not one person involved had contemplated

making the NGO’s general manager something like a “managing director” or putting him in a prestigious, directorial role that would make good use of his experience and commitment and play to his ego for the sake of the deal. While these options all have pros and cons debatable far beyond this case, the investors and Génesis’ directors acknowledge their fault of not considering the general manager’s personal incentives during the merger talks.

Multiple conversations with those involved point to, but cannot confirm, what at least one involved party concluded: that a failure to consider the MFI’s general manager’s incentives was the single factor that destroyed the new bank merger talks. However, those conversations, with the benefit of hindsight, do point to this issue as a key factor that, had it been fully considered and addressed directly, could have resulted in a different outcome, given the general manager’s importance to the MFI. As one international investor put it:

*The general manager kept talking about mission drift, about the valuation, even when I felt the issues were decided and concluded. Looking back I wonder how often those discussions were more of an excuse, an excuse not to go forward with the merger just because the manager wasn’t going to get what he personally wanted; what he felt he deserved. If we had been more conscious of his interests, there’s a chance we could have avoided that.*

**Table 1 - Key Figures for Génesis<sup>1</sup>**

<b>Génesis Empresarial</b>	<b>1999</b>	<b>2000</b>	<b>2001</b>	<b>2002</b>	<b>2003</b>	<b>2004</b>	<b>2005</b>	<b>2006</b>	<b>2007</b>	<b>2008</b>
Number of active borrowers	24,896	25,217	31,096	35,452	32,939	42,492	55,184	66,144	77,941	82,719
Debt to equity ratio	1.96	2.1	2.67	2.97		3.53	4.07	5.07	4.93	3.95
Gross loan portfolio to total assets (%)	93.18	93.93	93.64	93.85	89.60	91.94	91.74	93.43	92.51	93.23
Loan portfolio, gross (in USD)	9,945,692	11,154,948	13,184,006	16,633,008	17,734,557	25,802,847	31,963,877	41,266,345	45,450,381	42,958,814
Average loan balance borrower per borrower / GNI per capita (in USD) (%)	23.36	25.57	25.54	28.09	30.94	31.46	27.85	27.73	23.80	21.20
Operational self sufficiency (%)	106.26	105.59	111.66	111.10	N.A.	112.48	103.75	99.64	109.96	111.12
Return on assets (%)	1.65	1.40	2.83	2.88	N.A.	3.21	0.29	-0.48	2.05	2.44
Return on equity (%)	5.18	4.24	9.57	11.04	N.A.	13.76	1.38	-2.67	12.31	13.20
Operating expense / loan portfolio (%)	11.85	13.78	14.63	16.16	N.A.	17.59	17.66	19.35	19.35	22.70
Loan loss rate (%)	N.A.	N.A.	N.A.	N.A.	N.A.	1.53	2.10	2.66	3.52	2.76
Portfolio at risk > 30 days (%)	7.60	7.70	10.67	11.97	N.A.	5.51	10.40	4.89	3.74	N.A.
Risk coverage (%)	102.50	122.84	75.50	66.81	N.A.	29.07	28.85	61.38	80.17	N.A.

<sup>1</sup> Microfinance Information Exchange, <http://www.mixmarket.org>.



## Annex 3 - Aligning Incentives in a Successful Transformation – The Case of ACLEDA Bank Plc.

*ACLEDA Bank's vision is to be Cambodia's leading commercial bank, providing superior financial services to all segments of the community.*

- ACLEDA Bank's Vision Statement

*One of the biggest mistakes donors make in the field of microfinance is to assume there is a recipe... [for] a successful institution... That thinking is wrong. It's really about the people behind the institution, not the recipe. By following a recipe, donors lose out on the idea that it all starts with people with ideals.<sup>1</sup>*

- Marilou van Goldstein Brouwer, Triodos Bank

### Introduction

Since December 31, 2000, ACLEDA Bank has grown at an incredible pace, bringing a range of financial services to microentrepreneurs in nearly all provinces in Cambodia. As of December 2007, the amount of total savings grew at a cumulative average annual rate of 137%, and the loan portfolio increased over 50% per year. Both the total shareholders' equity and the number of active borrowers more than tripled. By that same date, the number of savers had reached nearly 250,000—a dramatic increase given the fact that ACLEDA could not accept deposits until after it transformed into a bank in late 2000. Although the microfinance industry is accustomed to high growth, ACLEDA's performance remains particularly impressive.

Only ACLEDA's ambition “*to be Cambodia's leading commercial bank,*” embodied in the institution's vision statement, can overshadow the MFI's growth. One cannot understate the boldness of such an aspiration, given the gulf that normally separates microlenders from their much larger commercial-banking cousins. However, this vision proves even more ambitious when considering Cambodia's well-known history of political and economic turmoil. The country has faced a succession of bloody political coups and civil wars, which brought the destruction of governmental institutions, the violation of human rights, and the flight of hundreds of thousands of Cambodians across the border and around the world.

Citizens and foreigners alike held a deep mistrust for the war-torn country's financial sector. In the 1970s, the Khmer Rouge destroyed the banking system and outlawed currency, trade, and private property. Vietnamese rule in the 1980s resulted in extreme dependence on foreign aid and witnessed periods of hyperinflation. Cambodian attempts to regulate the banking sector in the 1990s resulted in bank failures and liquidations, revoked licenses, and allegations of money laundering. Even by 2000, the country's ill-functioning financial markets lacked commercial lending options and domestic investors. The deep-seated suspicion of the banking system underscores ACLEDA's ambition when the institution chose to apply for a specialized banking license in 2000, with the ultimate goal of achieving commercial-bank status.

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This case was prepared by Stephanie Dolan and Brian Busch.

<sup>1</sup> Heather Clark, *When there was no Money: Building ACLEDA Bank in Cambodia's Evolving Financial Sector* (New York: Springer, 2006), p 135-36.

By transforming into a licensed bank, ACLEDA took a fundamental step on the road towards achieving its current success. The institution's expansion into savings products opened up a new, high-demand service for existing and new clients, offering a stable, low-cost source of funds to grow the loan portfolio. This ultimately spurred other decisions that would dramatically increase the bank's visibility, both with new client segments and in new provinces. However, securing a banking license from regulators is only one of a myriad of steps in a long and difficult transformation process. In structuring ACLEDA's transformation plan, the organization's directors and management carefully weighed the interests, values, and concerns of managers, employees, and new investors, with a view to crafting a transformation that best aligned the interests of key stakeholders with the needs of the organization.

## Institutional Background

### Country Background

When the Khmer Rouge seized power in Cambodia in 1975, they destroyed national ministries and public institutions, declared literacy and the arts to be capital crimes, targeted thousands of citizens for execution, and forcibly relocated many more to rural areas throughout the country. When the Vietnamese invaded the country in 1979, two million Cambodians, or 21% of the country's population, had been executed or had died of starvation or illness during the Khmer Rouge's four years in power. Failed attempts to get the economy back on track did little to alleviate poverty and instead contributed to ten more years of civil war and emigration. During the 1980s, 370,000 people fled to Thailand and another 250,000 escaped to other parts of the world.<sup>2</sup> When the United Nation's peacekeeping mission arrived in Cambodia in 1990, it entered with the daunting objective of demobilizing 150,000 soldiers, repatriating 370,000 refugees, and resettling 170,000 displaced persons.<sup>3</sup>

In 1992, in the midst of this war-torn environment, ACLEDA got its start in a Thai refugee camp. Its humble origins went on to play a pivotal role in the organization's decisions regarding institutional di-

rection, and are crucial in understanding how incentives were effectively aligned during the transformation process.

### Genesis of Organizational Values

ACLEDA began as a development project with the aim of promoting economic rehabilitation and effecting "immediate impact" in Cambodia. The International Labor Organization and Care International recruited the organization's future leadership and staff from refugee camps on the Thai-Cambodian border, where many of them had lived in exile for years. Although initially targeting demobilized soldiers, the project quickly grew to include refugees, widows, displaced persons, and other victims of war.

As the project's primary delivery channels, Local Economic Development Agencies (LEDAs) would provide business development services, vocational training, and small loans in five of Cambodia's twenty provinces. Although the agencies enjoyed relative autonomy, ACLEDA's hires shared *key values of trust, honesty, and transparency*, largely resulting from the staff's personal experiences as refugees and victims of persecution. These values and the staff's commitment to the LEDAs' social mission were reinforced by the dangerous operating environment, which included armed robberies, warring political factions, sporadic violence, and the proliferation of landmines. As Heather Clark points out, ACLEDA's corporate culture stemmed from determination, trust, and equal treatment, because "the *drive to work together* was the only option when so many had lost so much already."<sup>4</sup>

The agencies' relative autonomy instilled a *sense of ownership* at all levels and laid the foundation for similar employee sentiment within ACLEDA in the future. The organization's governance structure reinforced this attitude: with the LEDAs largely autonomous, ACLEDA (Association of Cambodian Local Economic Development Agencies) acted as an overarching organization that coordinated the agencies' efforts and facilitated the exchange of knowledge and experience. Each branch manager held a seat in ACLEDA's General Assembly, the key decision-making body. All staff had an equal say

<sup>2</sup> Ibid, 21.

<sup>3</sup> Ibid, 21-22.

<sup>4</sup> Ibid, 33.

in organizational decisions and all members voted on each issue, from the appointment of directors to the strategic path of the organization. In this way, ACLEDA's traditional values of consensus and commitment were formalized through institutional governance, and staff were empowered with a feeling of ownership.

At the same time, healthy management practices became embedded, as leadership was made accountable for both branch-by-branch and organization-wide performance and operated through *consensus, cooperation, and compromise*, rather than placing power in the hands of a select few.

An organization-wide commitment to professional development, regardless of rank, deepened the staff's sense of ownership in the institution. As In Channy explained, "ACLEDA's priority is not seniority, but capacity first, then knowledge and skill. Everyone has to learn, to improve all the time... the learning never stops".<sup>5</sup> A *learning culture* had been embraced by ACLEDA from the beginning, with the organization choosing to provide extensive training to employees, rather than establish an inner circle of managers with the potential to abuse the system. Staff development was seen as part of fulfilling the organization's purpose; management realized that increasing institutional capacity through trainings and workshops created greater opportunities for future organizational growth. This policy reinforced the staff's loyalty to the institution, and, later, created buy-in among the employees for ACLEDA's transformation.

### **Strategic Response to Crisis**

In 1996, a critical event occurred that would shape ACLEDA's future: the organization experienced a liquidity crisis as demand for its services grew more rapidly than it could access capital. This crisis prompted ACLEDA to address three strategic challenges:

1. it had to choose between providing business development services *or* credit products for micro and small enterprise; it could not continue to provide both;

2. it had to become a sustainable organization, which would entail streamlined operations, higher interest rates, and, most importantly, funding from outside investors; it could not remain dependent on donor funding;
3. it required a more centralized organization to improve internal efficiencies, manage performance, control risk, and attract investors; as a maturing organization, it could not operate as effectively on its previous branch-by-branch basis.

The General Assembly responded by deciding to unify the local agencies into a single organization and to focus on microfinance. As ACLEDA directed its attention to becoming a dedicated microfinance provider, it built a structure that supported and cultivated this objective, strengthening its risk management systems, reporting and accounting practices, MIS, and internal audit procedures. As a result of these upgrades, and with the receipt of outside funding from KfW, USAID, and Sida, ACLEDA witnessed spectacular portfolio growth and operational improvements between 1996 and 2000. By year end 1999, the organization's portfolio had grown to \$13.7 million, five times the size of its 1996 portfolio.<sup>6</sup>

## **The Transformation Process**

### **Strategic Benefits of Transformation**

After the 1996 liquidity crisis, ACLEDA managers could see that demand for credit outpaced the NGO's ability to secure additional funding. Early growth had been financed primarily by donor funds, but donors became more reluctant to provide such generous grants as the organization achieved financial sustainability. As a result, managers began to seek out alternative sources of funding in order to fuel portfolio and organizational growth, focusing on the recruitment of outside investors and the mobilization of savings. Because NGOs were not allowed to accept investments or offer savings deposits, ACLEDA's managers, directors, and technical advisors were left with just one option: transform into a fully-regulated bank.

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<sup>5</sup> Ibid, 38.

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<sup>6</sup> Ibid, 202.

In addition to providing enhanced access to capital, transformation offered significant benefits from both a legal and governance perspective. The legal and regulatory framework for banks was much better defined than for NGOs. Moreover, transformation promised to institutionalize good governance practices at an organization that had faced conflict of interest issues in the past.

### **Challenges of Transformation**

While ACLEDA recognized numerous advantages to transformation, it realized that these potential benefits also posed new risks to the institution. While foreign investors could provide much-needed improvements in institutional governance, members of the NGO worried about mission drift and wondered how investors would balance the social goals of ACLEDA with their desire for a return on investment.

Moreover, by becoming a regulated institution, the organization would expose itself to a government with a history of interference—and even control—in the banking industry. National regulators had planned to institute a new series of laws and regulations for the country’s budding microfinance industry (the legislation, however, was not enacted until just months before ACLEDA’s conversion was complete). Equally concerning, the Cambodian legal system failed to provide basic protection for investors and lenders. It failed to lay out rules for corporate governance or define relationships between shareholders, directors, managers, and third parties. Furthermore, as the existing legal framework did not address liens or secured financial transactions, contracts were not backed by credible guarantees. Finally, the land law was unclear, and the contract law was outdated. Many laws were subject to interpretation by local courts, and court rulings were often subjective—and influenced by personal relationships and bribes.

These are only a few examples of the adverse enabling environment that management, technical advisors, and new investors had to navigate in order to complete the transformation. In structuring and documenting an investment, ACLEDA had to take into account the foreign shareholders’ desire to protect themselves against the political, legal, and eco-

nomics risks associated with investing in Cambodia, and to build in provisions and mechanisms to mitigate these risks.

### **Timeline and Overview**

In 1997, ACLEDA began iterative rounds of feasibility studies to analyze the institutional effects of transformation. As the studies began to generate positive results, ACLEDA launched a series of workshops to prepare staff and management on the process and implications of transformation, analyze past industry experiences, and address staff’s questions. These workshops allowed staff to recognize the benefits that transformation would bring to ACLEDA’s operations, its clients, and to the employees themselves. When the General Assembly met in February 1999 to vote on ACLEDA’s 5-year strategic plan, 98% voted in favor of transformation, effectively voting themselves out of power and relinquishing control of the institution to a board of external directors.

Detailed negotiations with investors began soon thereafter and continued until September 2000, when the final shareholder agreements were signed with investors and a specialized banking license was awarded by the National Bank of Cambodia. Six investors were brought into ACLEDA Bank—four international investors (Triodos, FMO, DEG, and the IFC) and two local investors (ACLEDA NGO and the ACLEDA Staff Association). ACLEDA Bank purchased the NGO’s operations, including staff, equipment, and all assets and liabilities, for nearly \$13.3 million; in exchange, the NGO received nearly \$1.8 million in shares and a subordinated loan of \$11.5 million. The Bank’s Board included nine directors, elected by the shareholders, with the NGO holding three seats, the ACLEDA Staff Association (ASA) holding two, and the international investors each holding one.

### **Key Factors for Aligning Incentives**

From 1997 through much of 2000, managers, directors, and their technical partners worked furiously to address countless issues arising from transformation, ranging from investor worries to government approvals to staff concerns. In spite of these challenges, the team never lost its drive and desire to

pursue transformation. In hindsight, five key factors emerged that contributed to the effective alignment of stakeholders' incentives and ACLEDA's comparatively "smooth" transformation process:

1. the inclusive nature of the transformation process;
2. the quality of management and staff;
3. the creation of the ACLEDA Staff Association (ASA);
4. the future role of the NGO; and
5. the attitudes of key managers and directors.

### ***Inclusive Nature of the Transformation Process***

When the General Assembly approved ACLEDA's decision to pursue transformation in 1999, the vote marked a culmination of more than two years of management initiatives to educate all levels of staff on the implications of transformation. ACLEDA knew that the ultimate decision for the organization's strategic path would lie in the hands of its employees, through a vote by the General Assembly. Recognizing the staff's sense of ownership and institutional pride, the champions of transformation set out to build internal understanding, support, and consensus for the transition.

As part of this effort, ACLEDA launched an intensive education effort, targeted to all staff, from loan officers through senior management. In the two-year period leading up to transformation, ACLEDA held 6,187 days of workshop training for employees, allowing for open dialogue between management, technical advisors, and staff to discuss the motives for transformation, clarify the process, and explain the new roles and responsibilities for employees.<sup>7</sup> The inclusive format of the workshops provided a forum for employees to ask questions and raise doubts, while also offering management and TA providers an opportunity to respond to these concerns. The time, funds, and effort that were devoted to this initiative were not merely a pragmatic concession towards achieving a majority vote in favor of transformation; rather, they are indicative of ACLEDA's deep, strategic decision to accommodate the genuine, but intangible, sense of ownership among the staff.

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<sup>7</sup> Ibid, 185.

### ***Quality of Management and Staff***

ACLEDA's institutional culture had long centered on learning and opportunities for staff, from the vault attendants to the branch managers, and proved to play a critical role during the transformation process. Not only was staff education engrained in the institutional culture, but it served a more practical purpose: by encouraging employees to grow professionally, as the institution grew in size and complexity, ACLEDA actually stemmed attrition to competing microfinance practitioners and banks. The organization's dedication to professional development proved particularly important during the transformation period, as it reinforced the staff's sense of ownership in the institution and created buy-in among the employees for transformation.

Rather than look outside the institution for new management for the transformed institution, ACLEDA's directors and investors chose to invest heavily in training for existing managers and staff. They reached this decision after much discussion, as they examined the pros and cons of keeping NGO staff on board; while the original staff was needed to initiate the transformation, the NGO employees were not bankers and had no experience running a regulated institution, particularly one growing so rapidly in a volatile environment. Ultimately, in keeping with their past focus on professional development, ACLEDA chose to offer all NGO employees a fair chance to transition to the new institution. The organization solicited grants from the UNDP and USAID to fund consultant visits, fellowships to visit other institutions, and training sessions for all levels of staff. This was an expensive and time-consuming endeavor, amounting to more than \$1.2 million and years of staff time. However, ACLEDA viewed it as an essential part of the process: qualified staff were a rare commodity in Cambodia, so it made sense to harness the experience of their existing staff, rather than replace them. Moreover, given the low supply of experienced bankers in the country, it would have been costly and difficult to recruit or import the type of talented professionals necessary to run the new institution. Finally, by providing additional training and opportunities to employees, ACLEDA offered a powerful incentive for employees to be committed to the transformation.

## **Creation of ASA**

The creation of the ACLEDA Staff Association (ASA) is one of the most tangible incentives of the transformation process. Senior management considered its organization's greatest asset to be its staff and believed that employees should be invited to hold a stake in the new institution. With this in mind, they established ASA, an investment company that allows all staff, regardless of rank and title, to own equity shares in ACLEDA Bank.

ASA is organized as a trust, holding the employees' shares in the MFI, aggregating the voting rights and governance responsibilities through two elected Board Directors, and distributing vouchers for dividends and other profits to staff. In setting up ASA, management was determined that participation be on the same basis as other investors, so as not to "devalue the psychological value" of ownership.<sup>8</sup> As such, ASA is not offered preferential pricing, nor is it subsidized by donor capital or the NGO, or rewarded as compensation for sweat equity. Employees participate on a voluntary basis and, as such, assume all the same risks, rights, responsibilities, and possible financial upside as other shareholders.

Managers and directors of ACLEDA were keenly aware of the employees' lack of capital to buy shares on the same terms as international investors. To address this issue, ASA may continuously buy shares in ACLEDA Bank at any time following a capital call, and can hold up to 19% of the Bank's total equity. This mechanism allows the 6,000 employees who participate in ASA to save and invest small amounts over time as they cannot match the occasional but large investments of the international investors. Every six months, a day-long open exchange takes place within ASA, setting a general price peg for any share exchanges in the following months. By acting as an internal exchange for ACLEDA's illiquid shares, ASA also provides liquidity for employees wishing to sell shares or leave the bank by acting as an internal exchange.

Managers viewed the invitation for employees to participate in the new institution through ASA as an

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<sup>8</sup> Peter Kooi (director, ACLEDA Bank, Plc.), in discussion with the authors, January 13, 2009.

important statement about the value that the organization placed on staff. ACLEDA designed ASA to be open to all staff so that all employees received equal treatment and recognition for their individual contribution to the organization's evolution. Moreover, ASA became the physical manifestation of the staff's long-time sense of ownership. As Peter Kooi, Director of ACLEDA Bank, explained, "Making the employees actual owners of the bank was only natural given their history with the institution. As they would ultimately vote on the fate of the transformation, we felt it important that they understand that they would become real owners of the bank." Beyond this, management recognized ASA's practical benefits, hoping that the employees' participation in the plan would raise their economic stake in the operation and effectively align their interests with those of the new institution to ease the transition, create support for the new company, and enhance employee productivity. Proper alignment of interests among this key stakeholder base was crucial to the institution's successful transformation.

## **Role of the NGO**

Management and investors worked together to determine a role for ACLEDA NGO that would best serve the new institution's goal of becoming a strong, efficient commercial bank. Keeping in mind both the Bank's needs and the past experiences of other transformed MFIs, particularly BancoSol in Bolivia, it was decided that the NGO would take on a new, supportive role, ceasing operations and turning over its entire credit operation to ACLEDA Bank. Champions of the transformation pursued this decision in order to prevent future competition between the Bank and the NGO. This also avoided a "culture clash" between Bank and NGO employees, keeping in mind management's promise to NGO staff not to "leave behind" any of the organization's employees during the transition to a regulated institution.

While the NGO's redefined role was structured to avoid a number of potential long-term difficulties, it also was designed to actively meet the Bank's needs, allay investors' concerns, and address weaknesses distinct to the country's banking structure. The NGO's donor funds and reinvested earnings were turned into a 45% equity stake in the Bank, as well

as loans to the new institution. Because no commercial lending market existed in Cambodia at the time, the NGO acted as a small-scale commercial lending market, making “market rate” loans to the bank until it could attract debt from more diversified sources. The NGO also served as a counterparty for foreign exchange transactions, imitating the currency market that did not yet exist in Cambodia and taking on much of the foreign exchange risk. Finally, it provided liquidity to ASA and supplied the initial capital for ASA’s equity purchases, which the employees later paid back as a low-interest loan. It is important to note that these functions were designed and contractually regulated at the time of transformation. Given Cambodia’s nascent financial infrastructure at the time, the NGO’s functions in this capacity were imperative in supporting the Bank, providing comfort to the institution’s new investors and, ultimately, in facilitating a successful transformation.

### **Management Attitudes**

Throughout the transformation process, ACLEDA’s management demonstrated an extraordinary willingness to set aside their own feelings and to pursue the broader interests of the institution. As Heather Clark describes, “they did not try to control, they tried to enable”.<sup>9</sup> This is notable in any situation, but particularly remarkable given the Cambodian operating environment. At the time, many Cambodian businesses operated under the tenet that “the boss gets everything”; questions were not encouraged, and if they were asked, clear, comprehensive answers were rarely given. The decision-making process at most organizations was rarely as inclusive, or as well-communicated, as at ACLEDA. As illustrated by ACLEDA’s values of consensus, equality, trust, and employee ownership, the management team at this NGO worked to implement a very different corporate mentality.

The inherent fairness of ACLEDA’s key managers emerges as a critical determinant of the organization’s successful transformation. Like many NGOs, ACLEDA NGO was driven by a passionate management team. However, in some cases of institutional transition, conflicts of interest between the organizations’ leaders—founders, individuals, management,

<sup>9</sup> Clark, 133.

or boards—and the new institution and its investors have undermined, prolonged, and even derailed the process. These tensions can manifest themselves through a range of issues, from worries about mission drift under the direction of new shareholders, to concerns about management’s role in the new institution and job security. Other times, challenges may be even more intangible, such as a founder’s pride and passion for an institution that they created and shaped over the years, pouring their time, talent and emotion into it. In each of these cases, the question arises over how, or even if, incentives can be properly aligned to address or allay the parties’ concerns. By adhering to their organizational values, striving for the institution’s ultimate goals, and holding ACLEDA’s best interests at heart, management demonstrated inspired leadership that ultimately produced a remarkable alignment of the incentives of different stakeholders.

### **Conclusions**

Although each institution faces unique challenges and circumstances in preparing for and undergoing transformation, a few lessons can be gleaned from ACLEDA’s experience. Its efforts to align the interests of various stakeholders, from management to staff to investors, contributed to a comparatively smooth transition process and positioned the institution for future growth in both services and portfolio size.

Key take-aways from ACLEDA’s experience that could be applied to future transformations at other organizations include:

- **Facilitate an inclusive process.** Use workshops and open forums as a way to explain the implications of transformation to staff, provide employees with an opportunity to voice questions and concerns, and set realistic expectations for the post-transition period. It is important to allocate enough time for these programs, so that staff have adequate time to come up to speed on the process, familiarize themselves with their new roles and responsibilities, and grow accustomed to the idea of their NGO as a regulated bank. For example, ACLEDA launched its educational programs two years in advance. In this

way, the new institution can make staff feel valued by management and involved in the process, building good will and support for transformation at the same time.

- **Offer appropriate training for transitioning staff.** By providing educational opportunities for existing staff, institutions can shift old staff into new, often more complicated, roles, while still leveraging the staff's familiarity with and loyalty to the original organization. Moreover, by offering staff the opportunity to transition to the new institution, it can allay fears or hesitation about transformation and ease staff buy-in.
- **Provide financial incentives for future performance.** As a way to motivate staff on future performance, employees (either of all levels or solely management) can be invited to invest their own capital in the new institution. In doing so, staff would have a financial incentive to strive for growth and streamlined operations and could reinforce their commitment to the institution. An ESOP plan, similar in structure to ASA, could be created to facilitate this incentive. Importantly, in the case of ACLEDA, the institution chose to make this completely voluntary, making it forward-facing. ACLEDA did not subsidize the employees' stock purchases because it did not want participation in ASA to be seen as a reward for past sweat equity.
- **Ensure that the original organization's role supports the goals of the new institution.** During transformation, management should remain as focused as possible on setting up the new institution. In the case of ACLEDA, management was able to do this most effectively by ceasing NGO operations and relegating it to a secondary position. While NGOs can take on other roles such as providing services to the very poor, it is important for the NGO to assume a role that avoids the potential for future competition.
- **Have a strong, capable, cohesive management team.** Management should work well together, appeal to the organization's values and mission, and anticipate the challenges that the managers, staff, and institution will face. Moreover, management will be primarily responsible for communicating effectively and frequently about the decision-making process so that staff view transformation as an inclusive process and not a top-down decision.

- **Management must put the institution's best interests first.** In keeping the MFI's ultimate objectives in mind, management must be able to put institutional goals above all others, including personal interests. ACLEDA stands out as a case in which the management team truly prioritized their objectives and wholeheartedly pursued their organization's long-time dream.

The fact that all stakeholders involved in ACLEDA's transformation, from management to staff to donors to investors, were willing to compromise for the greater good of the institution facilitated the alignment of incentives and made possible the organization's ambitious transition from an NGO to a commercial bank.

**Table 1 - Key Figures for ACLEDA<sup>1</sup>**

<b>ACLEDA Bank Plc.</b>	<b>1999</b>	<b>2000</b>	<b>2001</b>	<b>2002</b>	<b>2003</b>	<b>2004</b>	<b>2005</b>	<b>2006</b>	<b>2007</b>	<b>2008</b>
Number of active borrowers	56,412	60,860	81,446	82,598	98,905	122,173	140,920	159,930	185,492	214,337
Debt to equity ratio	0.42	0.42	0.62	2.65	2.03	2.24	2.88	4.12	8.53	6.58
Gross loan portfolio to total assets (%)	86.04	74.76	76.69	86.69	84.11	78.45	80.72	71.00	66.60	67.04
Loan portfolio, gross (in USD)	13,719,210	16,667,328	20,967,416	26,846,703	40,572,670	65,981,228	99,994,807	158,463,941	315,073,995	464,477,809
Deposits (in USD)	N.A.	N.A.	N.A.	N.A.	13,160,685	31,640,359	61,901,125	123,149,783	344,533,315	487,802,546
Average loan balance borrower per borrower / GNI per capita (in USD) (%)	81.07	91.29	85.81	108.34	120.65	138.48	154.26	198.17	308.83	394.01
Operational self sufficiency (%)	146.00	138.03	107.18	110.33	127.54	118.09	126.15	129.35	126.13	132.72
Return on assets (%)	12.69	10.73	1.91	2.02	4.93	3.08	4.00	3.82	2.78	3.34
Return on equity (%)	17.83	15.27	2.92	5.35	18.55	9.74	14.35	17.80	20.96	27.57
Operating expense / loan portfolio (%)	24.15	23.90	27.59	24.30	22.67	21.95	18.89	16.89	14.28	13.66
Loan loss rate (%)	1.48	1.50	5.81	4.06	0.06	-0.34	-0.27	-0.15	-0.13	0.06
Portfolio at risk > 30 days (%)	6.06	5.62	4.46	1.75	0.57	0.77	0.57	0.49	0.13	0.82
Risk coverage (%)	48.43	66.95	92.55	123.72	288.57	205.81	267.08	243.32	813.17	136.30

<sup>1</sup> Microfinance Information Exchange, <http://www.mixmarket.org>.



## Annex 4 - The Case of PARTNER, BiH – Legal and Regulatory Hurdles to Aligning Interests

### Synopsis

Microfinance in Bosnia and Herzegovina (BiH), and the microfinance institution Partner in particular, on which this case study is based, is clearly a great success story to date, with an impressive and so far sustainable growth in customers, loans and capital.

Indeed, the success has been such that it could be argued that the original vision behind the industry in BiH, to significantly bridge the gap in access to finance for small and micro entrepreneurs after the devastating effects of the 1992-95 war, has been largely fulfilled.

Unfortunately, however, the next steps for the industry, leading to transformation of the MFIs into for-profit deposit-taking institutions, and the expected consolidation of the sector, are far from crystal clear in BiH.

The process set out in the law mandates that MFIs transform, yet creates unclear ownership and corporate governance structures, which has resulted in a *misalignment of interests between the vision of transforming MFIs and their management*; the forced transformation obliges management, who effectively control the institutions, to sacrifice control, or sense of ownership, but may not provide sufficient incentives to compensate the sacrifice.

*This misalignment appears to be the biggest barrier to the required consolidation of the microfinance industry in BiH.* There is therefore now a risk, likely to be accelerated by the ongoing global financial crisis, that the successful path of value creation of the industry over the last decade or more could be reversed.

### The Microfinance Sector in the Country

The story of the microfinance industry in Bosnia and Herzegovina is without a doubt one of great success. It is considered by many to be one of the most vibrant microfinance sectors globally. The industry emerged, quite literally, from the ashes of the 1992-95 war, with the heroic efforts of individuals, government and non-government organizations, as well as, increasingly, the private sector.<sup>1</sup> The destruction caused by the war, both in terms of physical damage as well as massive displacement of people, along with the previous significant dependence of the country on now largely uneconomic heavy industries, meant that new business models were key to economic recovery. Access to finance for small and micro entrepreneurs was seen by many as one of the (various) building blocks required for the eventual economic recovery of the country.

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This case was prepared by Alfredo Bello of A2F Consulting.

<sup>1</sup> This note does not intend to provide a comprehensive history or overview of the microfinance industry in BiH. The reader is however directed to Microfinance Information Exchange (MIX) ([www.themix.org](http://www.themix.org)) and to the related MixMarket ([www.mixmarket.org](http://www.mixmarket.org)) as a good starting point for this, and in particular to the recent joint publication with the Association of Microfinance Institutions in BiH (AMFI): “Bosnia and Herzegovina Microfinance Analysis and Benchmarking Report 2008”.

The industry has grown from zero after the war to now serving in aggregate over 380,000 clients, with a total loan portfolio of over EU550 million and a capital base of close to EU120 million.<sup>2</sup> The industry has evolved from being highly dependent on grants and soft loans for financial survival, to now being a dynamic and profitable business. Loan growth has been impressive, particularly in the last three or so years, enabling greater leverage of the operational infrastructure and good profitability. Return on equity (ROE) is a respectable 20% or so, despite the (also healthy) trend towards greater use of more commercial funding sources.

However, the growth in the industry has started to slow down in 2008, reflecting some market saturation from an increasingly competitive environment, as well as limitations of wholesale funding from the global financial crisis (more on the potential impact of the crisis later). The number of active borrowers served in aggregate by the industry is high in relation to the country's population of 4 million, indicating high penetration, as well as likely multiple borrowings by the customer base. In addition, the MFI industry does not work in isolation and represents only 6-7% of total lending in the financial sector, with some of the (30 or so) largely foreign-owned commercial banks in the country increasingly active in the same market as the MFIs.

It additionally has to be recognized that the country still presents significant structural challenges for small and micro entrepreneurs, which further restricts growth. The business environment is not the friendliest, with BiH ranking only 21 out of 25 countries of Eastern Europe and Central Asia in the 2009 World Bank rankings for ease of doing business.<sup>3</sup> The political structures that were put in place after the Dayton Agreement, with the two separate entities of the Bosnian Federation and Republic of Srpska, as well as the Breko district, also present their own challenges, in general adding a particularly complex political dimension to what might otherwise be fairly technical decisions related to the economy or to the

<sup>2</sup> Unless otherwise stated, industry data is at September 2008, aggregated from the 12 members of AMFI, which represent the vast majority of the sector in the country.

<sup>3</sup> *Doing Business 2009*, report by the World Bank, 2009, <http://www.doingbusiness.org/economyrankings>.

financial sector. With a relatively weak private sector, the public sector is large, representing close to 50% of GDP. Finally, the fixed exchange rate to the Euro from the currency board arrangements, while providing certain stability, brings its own economic challenges—in particular the risk of a weakening country competitive position as higher inflation is increasingly not matched by greater productivity increases.

## Consolidation is the Next Step for the Industry

To the credit of the players involved, it would appear that the original mission of providing “access to finance” to the unbanked has mostly been achieved in BiH. *Consolidation* of the market is clearly the next step for the industry. The relatively large number of MFIs in a small country and an increasingly saturated market, as well as a blurring of the mainly artificial market barriers with the larger, foreign-owned commercial banks, point to a period of ongoing increased competition. This should lead ultimately and naturally to a consolidation of the industry. This consolidation would take the form of mergers and acquisitions amongst the MFIs, as well as between commercial banks and MFIs.

Unfortunately, there are some important barriers to this natural process of consolidation. Because of the ownership and transformation processes set out in the law, there is a *misalignment of interests and incentives between the MFIs and management*; the latter effectively control the institutions, but are not owners of them. The explanation of this is set out in greater detail below, first in the context of Partner, without a doubt one of the leading and most successful MFIs in BiH, but then by looking at the implications of the findings in the context of the broader industry.

## Partner: A Clear Success Story so Far

The initial story of Partner is in some ways not uncommon for the industry in the country. It began operations in April 2007, set up by Mercy Corp, a US-based NGO. Mercy Corp had initially entered the country to help rebuild homes for citizens re-

turning to their shattered villages. They recognized, however, that they could support a more sustainable avenue to rehabilitation by creating a microfinance operation. Formally, Mercy Corps' European affiliate, Mercy Corps/Scottish European Aid, executed an agency agreement with the Local Initiatives Department of BiH's Foundation for Employment, Training, Demobilization, Reintegration and Public Works.

Mercy Corp hoped to create an organization that would service former front-line communities, therefore reaching populations most affected by the war. They initiated early activities in the Doboje region (on the border between the two entities) where they hired the current director, Senad Sinanović, as one of the very first employees. Mercy Corp believed in creating an organization that would be led and managed by local talent. They also focused on breaking down ethnic divisions. Thus, Partner was the first microcredit organization to lend in both entities of BiH while also sensitively providing clients with options as to which branch they could work with. It created an integrated multiethnic staff that, according to the 2005 business plan, "makes it a role model for what BiH can become."

Partner has since grown to be one of the top three microfinance institutions in the country. It has over 63,000 clients with a total loan portfolio of EU 95 million and a capital base of EU 21 million. It has 255 employees and operates from 44 field offices spread throughout the country. The bulk of this growth has been organic, although in June 2004 it also absorbed the operations of the significantly smaller BosVita based in Tuzla. The reported loan quality of Partner is one of the best in the country with a PAR >30 days of 1.1%, versus an average for the top 12 MFIs of 2.1%. It is also one of the most profitable, with an annualized reported ROE of 30% in the first three quarters of 2008, versus close to 20% for the industry.

An exceptionally strong and closely-knit management team appears to have been key to the success of Partner, without a doubt led from the very front and held together by its director. The core management

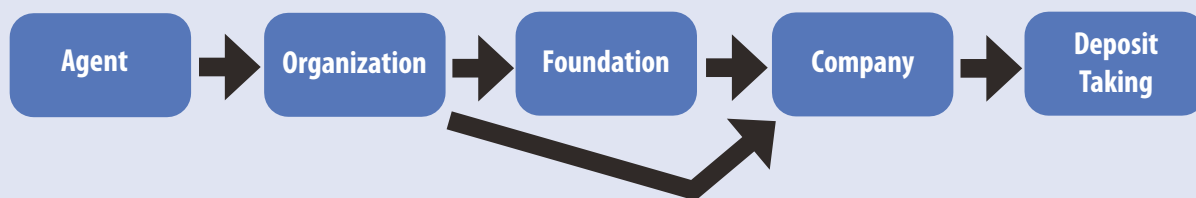
team has worked together throughout most of the history of the institution. Loyalty to the institution and to the team would appear to be very high. And they have undoubtedly been effective in ensuring the success to date of Partner. Others have also played an important role, in particular Mercy Corps, the board of directors, and various funders and donors throughout its short history. However, the key drivers for the success would appear to have been management, led by its director.

Looking forward, Partner's management recognizes that it operates in a competitive environment, and sees as a strategic priority the eventual transformation from its current status to a for-profit licensed deposit-taking institution. This is important, not just in order to diversify its funding structure with local deposits, but even more strategically to be able to offer a broader range of products to its existing and future customer base. The process will additionally broaden the options available to Partner as it expands its capital base.

## **An Unclear Transformation Path**

Unfortunately, however, the path for transformation to deposit-taking in BiH has not been straightforward and, to some extent, still has some uncertainties. The legal status of the participants has already undergone a number of changes as the legislation has evolved. Partner began life (in April 1997) as a humanitarian organization formally acting as agent to the Local Initiatives Department (LID) of BiH. In December 2000 it became registered as a micro credit organization in the Register of the Ministry of Social Affairs, Displaced Persons and Refugees of the Federation of BiH. In September 2006, a new law on micro credit organizations was introduced, according to which all micro credit organizations had to transform, first into micro credit foundations, after which they may then transform into a for-profit company with the foundation as the main shareholder. The company can be either a joint stock company or a limited liability company. There is a similar process in the Republic of Srpska, except that institutions are able to go from being an organization directly to a for-profit company status.

**Figure 1 - The (rather long) Path to Transformation in BiH**



Under the new law, the foundations and/or companies come under the supervision of the Banking Agencies in each of the two entities. However, they are not automatically entitled to take deposits. The Company will need to apply to the appropriate Banking Agency for the banking license. To date, no MFI has completed this process, and the likelihood of this being achievable is still far from certain.

### **The Reality of Ownership and Control**

Because of the unclear transformation path, there is also unfortunately a lack of clarity of ownership (both at Partner, and throughout the industry in BiH). Formally, once the transformation is completed as set out in the law, the owner of the company will be the foundation. However, the foundation does not itself have clear ownership, and its operation will ultimately depend on the decisions of its own board of directors. In accordance with the current law, the foundation must remain the majority owner of the company, and it is not in a position to distribute dividends, or to be sold. Therefore, although there would appear to be some clarity of ownership at the company level, the uncertainties will have remained at the foundation level.

In the case of Partner, although exact options and details are in the process of being evaluated, it is likely that at the time of transformation into a company, the capital structure will also be opened to Mercy Corp and to management and employees. It is most probable that: (i) Mercy Corp will become a shareholder on conversion of some existing outstanding debt into equity (itself originally donor funds obtained by Mercy Corp for microcredit), and (ii) management and employees will also be able to become shareholders, by taking over some of the debt conversion

of Mercy Corp. The price at which both of these entries of capital will take place is not yet determined. In the case of management and employees, current expectation is that their shareholding will require a contribution of capital (perhaps at a discounted price). The final shareholding of management and employees is expected to be in the order of 10%, with Mercy Corp having similarly in the order of 10-15%. The foundation will clearly remain majority owner.

Unfortunately, according to the existing legislation, these arrangements would not appear to best reflect the reality of control and management of Partner. In the absence of certainty or clarity, it is worth considering how control is currently exercised in Partner:

- **Management:** Partner would appear to be principally controlled by the management team, in particular under the tight leadership of its director. As has already been stated, the core team has worked together throughout most of the history of the institution, and loyalty to the institution and to the team would appear to be very high. Management takes all key strategic, risk management and operational decisions, even though the board of directors may then formally endorse them. Based on observations on the ground, it is clear that it is primarily management that exercises control of Partner.
- **Mercy Corp (Founder):** The role of Mercy Corp is important, and in particular one of its staff, Pamela Eser, was operationally involved at Partner in the early years. She has since continued a close and influential involvement with the institution as a member of its board of directors. Mercy Corp additionally retains a second seat on the board. However, Mercy Corp, at least for now, has been happy to leave the leadership and

effective control of the institution to the management of Partner.

- **Board of Directors:** The board of directors seems less critical to decision-making at Partner. Although the current chairman, Bahrija Tanovic, is one of the oldest board members, and is actively involved with Partner, it is not clear that the board in general would be disposed to go in a direction that was contrary to the management team. At the extreme, it would currently appear to be inconceivable for the board to replace the management team, whereas for the reverse to happen, or at least for individual board members to be gently encouraged out, might be feasible. Surely this is the best indicator of the reality of who controls Partner.

The analysis implies that the management has “majority” control of Partner (as a NGO, of course, it has no actual owners), while Mercy Corp and/or the board of director actually have far less control over decision and operations. This contrasts very sharply with the anticipated legal shareholding, where the foundation (itself with its own governance uncertainties) will have legal control, while management is expected to own some 10%. This disconnect between the reality of control and legal ownership (ultimately translating into incentives of management) has important implications for Partner, but perhaps even more significant, for the whole microfinance industry in BiH.<sup>4</sup>

## Negative Implications for the Industry

This unclear situation, where the *reality* is that management controls the institution, but where legal and economic ownership lies elsewhere, could have significant and severe consequences for the microfinance industry in BiH. At the extreme, it risks tainting the success of the industry to date.

<sup>4</sup> This far from ideal situation also goes to explain why the current expectation is that the director of Partner will probably remain as head of the foundation (the real seat of control), instead of formally heading the for-profit company once it is set up. In the absence of a significant personal financial gain, the director might continue his vision to improve the lives of his countrymen, but now with a slightly different development mission than the “access to finance” one which has already largely been achieved. But in the end, it seems that effective control will still be with him.

As has been set out earlier, the next step for the industry, as its mission to bridge the “access to finance” gap has largely been met, is to *consolidate* as a route for the strongest players to continue to grow, as a route for the weakest players to exit, and as a route for the artificial barriers between microfinance and commercial banking to dissipate.

*Unfortunately the biggest barrier to consolidation is the current unclear ownership structure in the industry.* If management had shareholdings that reflected more closely the reality of their level of control, there would be far greater incentives to “do the right thing and merge”. In the case of a merger, the management of the weaker institution today has everything to lose, but nothing to gain. As non-shareholders, they will lose control of their current MFI (with benefits not just of employment, but of status in the community), with no gain. Conversely, if they were *significant* shareholders (at least partly reflecting the reality of today’s control), then management would be motivated by financial gain to sell their institution to a stronger player before there is further erosion of value. They may lose their jobs, but at least they will have some capital left.

Determining what is the right shareholding level to adequately reflect the reality of this control and to trigger the required consolidation is clearly a highly sensitive and subjective one. However, it seems that the expected management ownership of 10%, when the management effectively controls the MFI, is not a sufficiently strong incentive to promote consolidation. At the end, this situation can only be corrected by careful and sensitive negotiations between the various participants (management, founders, funders, customers), with critical participation of the banking and legislative authorities, as well as no doubt some thoughtful but forceful mediation between the parties. Unfortunately, the complex political structures already referred to make this task particularly difficult and unlikely in BiH.

If the right structures are not put in place for the industry to naturally consolidate, there will be risk of the weaker institutions contaminating the broader industry. If the misalignment of interests of management with the vision of a shareholder-based

MFI structure is not resolved, exits or mergers will only be possible once an institution has reached a point of having zero or little value. This change of control will therefore only happen either because it has breached regulatory limits (i.e., the authorities are now in control), or—perhaps more likely under current market circumstances—because the providers of wholesale funds become more cautious (the funders are now in control). Unfortunately, as is being seen globally with the current financial crisis, the change under these circumstances from being a valuable institution to one needing extensive support can happen frighteningly quickly. It would be a great pity if the currently highly regarded Bosnian micro-finance sector were to end up having to go down this route because of a structural misalignment of management interests!

## The Impact of the Global Financial Crisis

Unfortunately, there is a possibility, or a risk, that the ongoing global financial crisis will bring these issues to a head rather rapidly, and before appropriate structural solutions are put in place. Reported loan quality is beginning to show a negative trend, which is only likely to accelerate over the course of the next few months as the weaker economic climate affects the ability of borrowers to repay their loans. The problem will be further exacerbated if more constrained access to wholesale funding limits further lending by the MFIs, itself leading to a change in customer behavior and a reduction in *willingness* to repay.

On the positive side, MFIs in BiH in general have relatively high levels of capital adequacy, although the trend has been clearly downwards over the last few years. There is still a cushion to be able to weather the storm, hopefully for a while. However, it would be a pity for the industry if there were excessive loss in value before appropriate actions are taken to consolidate the industry and continue the historical path of value creation, for both the shareholders, and the BiH community at large.

## Key Lessons Learned

This case study highlights the potential for success of a participant, or indeed of the whole industry to—in a relatively short period of time—make significant inroads in bridging gaps in access to finance.

However, it also highlights the importance for an industry not just to be set up, but also to be able to then follow the natural evolutionary path of financial systems. At the heart of this, as is often the case, is the issue of ownership and corporate governance. It would appear that the main obstacle to the required consolidation of the industry in BiH is a misalignment of interests and incentives between the MFIs and management, who effectively control the institutions but who are not sufficiently large shareholders in them.

Unfortunately, the path for transformation set out for the industry in this country does not appear to have adequately taken these ownership and corporate governance issues sufficiently into consideration, or the natural evolution of MFI towards deposit-taking. There is therefore now a risk, likely to be accelerated by the ongoing global financial crisis, that the successful path of value creation of the industry over the last decade or more could be reversed because the next steps were not adequately thought through.

**Table 1 - Ease of Doing Business in BiH<sup>1</sup>**

<b>Eastern Europe and Central Asia</b>	<b>OVERALL: Ease of Doing Business</b>	Starting a Business	Construction Permits	Employing Workers	Registering Property	Getting Credit	Protecting Investors	Paying Taxes	Trading Across Borders	Enforcing Contracts	Closing a Business
Georgia	<b>1</b>	1	1	1	1	6	6	11	12	12	16
Estonia	<b>2</b>	4	2	25	6	12	10	3	1	10	5
Lithuania	<b>3</b>	14	5	20	2	12	15	6	3	3	1
Latvia	<b>4</b>	7	8	13	15	2	10	4	2	1	13
Azerbaijan	<b>5</b>	3	15	2	4	2	3	10	22	7	10
Armenia	<b>6</b>	11	3	5	3	6	15	19	19	17	4
Bulgaria	<b>7</b>	16	10	6	13	1	6	9	14	21	8
Romania	<b>8</b>	5	9	22	21	2	6	18	4	11	12
Slovenia	<b>9</b>	8	7	24	19	20	3	8	11	20	2
Turkey	<b>10</b>	9	11	21	8	18	10	7	7	8	20
Kyrgyz Republic	<b>11</b>	6	4	8	12	6	1	21	25	16	23
Kazakhstan	<b>12</b>	15	22	3	7	12	10	5	24	9	19
Macedonia, FYR	<b>13</b>	2	14	18	17	12	15	1	9	19	22
Poland	<b>14</b>	23	16	9	16	6	6	16	5	18	11
Belarus	<b>15</b>	18	6	4	5	22	20	25	17	2	7
Albania	<b>16</b>	12	20	15	14	2	2	17	10	22	25
Montenegro	<b>17</b>	19	19	14	22	12	5	15	15	25	3
Serbia	<b>18</b>	20	21	10	18	6	14	13	8	23	18
Moldova	<b>19</b>	17	16	17	11	20	20	12	18	4	14
Croatia	<b>20</b>	21	18	23	20	18	23	2	13	13	9
<b>Bosnia and Herzegovina</b>	<b>21</b>	<b>24</b>	<b>12</b>	<b>16</b>	<b>25</b>	<b>17</b>	<b>15</b>	<b>20</b>	<b>6</b>	<b>24</b>	<b>6</b>
Russian Federation	<b>22</b>	10	25	12	10	22	15	14	20	5	15
Uzbekistan	<b>21</b>	13	13	7	23	24	22	23	21	14	21
Ukraine	<b>24</b>	22	24	11	24	6	24	24	16	15	24
Tajikistan	<b>25</b>	25	23	19	9	25	25	22	23	6	17

<sup>1</sup> *Doing Business 2009*, report by the World Bank, 2009, <http://www.doingbusiness.org/economyrankings>.

**Table 2 - Key Figures for Partner<sup>1</sup>**

<b>Partner</b>	<b>2000</b>	<b>2001</b>	<b>2002</b>	<b>2003</b>	<b>2004</b>	<b>2005</b>	<b>2006</b>	<b>2007</b>	<b>2008</b>
Number of active borrowers	5,461	6,777	7,139	11,935	19,676	20,216	33,193	51,982	63,593
Debt to equity ratio	0.28	1.52	1.47	1.47	1.72	2.35	2.60	4.08	3.67
Gross loan portfolio to total assets (%)	93.58	92.77	92.11	89.84	92.05	89.71	91.01	92.59	90.02
Loan portfolio, gross (in USD)	4,626,586	6,003,261	9,949,773	15,909,650	30,461,751	34,192,252	59,241,273	117,393,155	128,485,584
Average loan balance borrower per borrower / GNI per capita (in USD) (%)	56.48	55.36	79.64	65.34	60.71	56.38	53.44	59.59	53.31
Operational self sufficiency (%)	147.51	149.23	144.04	167.77	177.49	123.31	143.89	132.69	141.12
Return on assets (%)	9.09	10.21	8.93	11.19	11.36	3.93	6.19	4.50	5.48
Return on equity (%)	11.88	18.13	22.24	27.63	29.85	11.88	21.66	20.04	26.62
Operating expense / loan portfolio (%)	16.05	17.75	17.68	15.10	12.16	10.33	9.81	8.00	7.83
Loan loss rate (%)	0.58	0.27	0.16	0.09	0.12	2.74	0.50	0.68	1.10
Portfolio at risk > 30 days (%)	0.80	0.21	0.32	0.56	0.59	1.22	0.85	0.63	1.60
Risk coverage (%)	431.05	1061.53	730.13	468.02	443.41	210.29	260.46	333.20	85.27

<sup>1</sup> Microfinance Information Exchange, <http://www.mixmarket.org>.

## Annex 5 - The Case of FIE's Transformation into FFP FIE

### Introduction

Five professional Bolivian women launched Centro de Fomento a Iniciativas Economicas (FIE, Center for the Fostering of Economic Initiatives) in La Paz in 1985.<sup>1</sup> FIE was organized as a private, non-profit association with the goal of making individual loans to credit-constrained microentrepreneurs, mainly small manufacturers, and also to provide them with training services. Shortly after FIE's founding, a handful of Bolivia's leading bankers and businessmen started PRODEM as a non-profit foundation to provide solidarity loans to microentrepreneurs.

The NGOs FIE and PRODEM went on to grow vigorously and to spawn or influence the creation of Bolivia's four leading for-profit and regulated microfinance institutions: Banco Sol, ProCredito/Los Andes Bank, FIE FFP and PRODEM FFP, in order of incorporation.<sup>2</sup> These and other regulated MFIs have provided access to quality and competitive financial services to hundreds of thousands of previously excluded poor Bolivians. They have also inspired many other similar initiatives and have helped spark the "microfinance revolution" throughout the developing world. Today, of the four leading for-profit MFIs, only the FFP FIE remains controlled by Bolivians.

This is an account of how FIE evolved from NGO to the for-profit and regulated FFP FIE. It presents the context and issues that influenced its transformation process and that can still spark a lively discussion among its founders and their colleagues. It relies on the views of the management of FIE as well as outsiders who both compete with and respect FIE.

### Original Context

In Bolivia, in 1985, decades of failed policy and weak management culminated in hyperinflation and economic collapse. The country's indicators for health, nutrition, and literacy were among the worst in the Western Hemisphere. A new and democratically elected government proceeded to quickly stabilize the economy, dismantling the state-owned enterprises upon which the old development model had rested since the Revolution of 1952. Crashing tin prices and a severe drought in the Andean Altiplano triggered a large migration from rural areas, and this, combined with rising dismissals of state employees, produced high urban unemployment. The new government introduced a market-based economic policy which lifted the traditional controls on wages, prices, tariffs, capital, and exchanges and ended the subsidized and directed credit which had distorted economic activity in years past. Under the new policy, the main responsibility for economic initiative was passed on to the private sector. Yet it took years for the reforms to trigger substantial long-term investment. Many at the lower echelons of society found, in their own enterprises, the only means to their daily sustenance. It is in this

This case was prepared by Jose Ruisánchez.

<sup>1</sup> Maria Elena Butron, Maria del Pilar Ramirez, Maria Victoria Rojas, Helga Salinas, and Pilar Velasco.

<sup>2</sup> FFP is the acronym for Fondo Financiero Privado (Private Financial Fund, in English), a non-bank financial institutional form regulated and supervised by Bolivia's Superintendency of Banks and Financial Entities. FFPs can take deposits from the public, make loans and provide remittances, collections, payments and other financial services. Unlike banks, they cannot engage in foreign trade and checking accounts, and their capital requirements are smaller.

challenging context that microenterprise surged in Bolivia, and with it a huge demand for credit.<sup>3</sup>

## In the Beginning

FIE's founders had worked together in a United Nations project, assisting political refugees who had fled Bolivia during past military dictatorships and were now returning home. This experience had given them a pretty good idea of what worked and didn't work, and they had all agreed on the importance of enterprise as a dignified way out of poverty. They knew that the traditional financial system, itself recovering from the recent crisis, favored doing business with formal companies and salaried employees. With the poor lacking access to financial services, or having to resort to informal and costly lenders, FIE's founders saw an opportunity and decided to pool their limited resources and start making loans.

FIE's initial operations were comprised of a mix of small loans to individuals, mostly artisans and small manufacturers, as well as a few loans to associations of producers. Trial and error favored the individual loans, on which FIE soon concentrated. An original condition for obtaining a loan was that the microentrepreneur had to take one or more training courses; this was gradually relaxed by FIE in recognition of the entrepreneurial capacity of its clients, as well as to remain competitive with other sources of microcredit, which did not ask for it. An early debate on whether loans ought to be individual (i.e., similar to the loans made by commercial banks to their clients) or group/solidarity was settled in favor of the former kind. In time, Bolivia's MFIs have followed FIE's lead, and the majority of credits are now made on an individual basis.

Aside from the founders' own resources, FIE's funding at its start was obtained in the form of donations from NGOs (such as Oxfam-America, Diakonia, and Catholic Relief Services), from local business firms (such as PRINTEX and Compañía Industrial de Tabacos), and from the Swiss Aid Agency, which

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<sup>3</sup> World Bank Economic Memorandum, The World Bank, 1990. Also Enrique Garcia (minister of planning and governor of Bolivia), statement at the annual meeting of the Inter-American Development Bank, 1991.

at the time was locally known as COTESU (Cooperación Técnica Suiza). Later, it was able to access InterAmerican Development Bank (IADB) financing, which contributed to growth and credibility.

A distinguishing factor of FIE's operations during this period was the fast growth in its loan portfolio. FIE's founders recall how they kept being surprised by the ever-growing demand for its loans among low-income entrepreneurs. Most encouraging was the absence of advertising and the low profile that FIE maintained as it concentrated on delivering its services. During this period, FIE made gradual and consistent progress toward covering its operating and financial costs. FIE saw its mission clearly as one of supporting microenterprise. Generating a surplus responded to the need to show an efficient administration and to attract funding for its growth. FIE realized that, in the medium-term, it could not rely on donations and soft loans to sustain rapid growth.

In 1992, the Bolivian microfinance sector was energized by the launching of Banco Sol, which resulted from the transformation of PRODEM Foundation into a for-profit bank dedicated exclusively to providing financial services to low-income clients. This transformation was to demonstrate that MFIs could be credit-worthy and sustainable and could meet the market test, i.e., generating both quality services to its clients as well as a good return to its shareholders. For FIE and the other microfinance NGOs, the writing was on the wall.

## To Transform or Not

The general case for becoming a regulated and for-profit entity was grounded on ease of access to funding with which to meet the ever-growing demand for credit by the microenterprises. This growth exceeded available donations, especially following the fall of the Berlin Wall in 1989 and a redirection of aid toward Central and Eastern Europe. Expansion of microcredit called for sustainable funding, which could only be attained by a regulated financial institution capable of taking deposits from the public and of eventually accessing the capital markets. Such an institution could provide diversified services to the poor, not just NGO-type credit.

There were many arguments against becoming a bank. Many a key practitioner of microcredit came from the left and had NGO in her/his professional DNA. In their view, banks were places where the poor traditionally got no welcome mat, much less a loan. The key to getting a loan was to have collateral, which the poor lacked. Besides, it might be all right for a bank to make money out of lending to companies and well-endowed clients, but make a profit from lending to the poor? Even if legal, it had to be some sort of sin. It was bound to look awful if a bank had to charge high interest rates to cover the cost of small loans. And if the bank became more efficient, wouldn't it pay higher dividends rather than lower the interest rate? Banks have been known to be aggressive and charge whatever interest rates they could get away with and to be ruthless in recovering loans. NGOs were different: they cared for the poor. Also, if poor borrowers defaulted and an NGO failed, it would never be as troubling to the country's financial system and its regulators as if a deposit-taking bank were to fail for similar reasons.

The debate on whether or not to transform the NGO into a for-profit bank had traveled from the board of PRODEM Foundation to the decision-making spheres of NGOs, multilateral and aid institutions, and private investors. Several of those entities declined to get involved in Banco Sol, and some of them counseled against running the risk. In one instance, it was mentioned that if the for-profit model of lending to the poor could be viable, someone in the developed world would have already invented it.

In the end, PRODEM Foundation, a group of Bolivian investors, international NGOs, and a sole multilateral development finance institution made up their minds and capitalized Banco Sol. As soon as its success became evident, the urge to compete and grow and become sustainable, just as Banco Sol did, became the central issue in all the other microfinance NGOs. Not to transform meant staying small and dependent on ever dwindling donations. If Banco Sol could do it, why not the others? FIE was not immune to this line of thought.

## **FIE's Transformation**

Around 1990, the Government of Bolivia obtained loans and advice from the multilateral development institutions in support of the reform of its financial sector. A new banking law and regulations were introduced seeking to modernize and strengthen the banking system. Out of this initiative came the introduction of the FFP-type of non-bank financial institution, which was intended to facilitate the transformation of the MFIs. While FFPs could take deposits from the public and were regulated and supervised by the Superintendency, they had fewer regulatory and capital requirements than banks. The jump from NGO to bank was much more daunting than to FFP.

The first FFP to gain a license was Caja Los Andes (CLA) in 1994. CLA transformed from ProCredito, an NGO which had come to life when one of the original founders had decided to leave FIE to pursue her own initiative. It took FIE until early-1998 to prepare for and gain its own license and start its operations as an FFP. FIE used this time to debate its transformation issues and ensure that it resolved them in a way that was reconciled with its values and that satisfied those who governed it. These issues were debated at great length by FIE's executives and assembly members, and a variety of alternative ways were carefully explored and evaluated. It was striking to contrast how swift had been the transformations of Banco Sol and CLA, with how FIE took its time, while continuing gradually to grow and improve its operations. Below are the main issues and how FIE managed them in its transformation from NGO to FFP FIE.

## **Preserving the Mission**

The central issue in FIE's transformation was how to ensure that, as FFP FIE, it would continue to serve low-income entrepreneurs who lacked access to the traditional financial system. FIE's main concern was that its for-profit's need to generate a profit, maintain financial sustainability, and achieve a good risk rating classification might erode its dedication to serving the poor. In its internal debates and planning, FIE's management and Board sought to preserve its traditional mission and to ensure that profit was the

means and service to the micrentrepreneur was the end as it transformed from NGO to FFP. This issue was addressed through the following measures:

- The mission statement of the FFP was and remains congruent with that of FIE. This issue is still discussed often at the board of directors of the FFP and in FIE's assembly. There appears to be no deviation from the mission or disagreement on it. There is, however, a recognition that partner harmony on this issue would have likely been lower if FFP FIE had not been as profitable as it has been over the years.
- There was a long and careful search for investment partners who, as potential shareholders, would gladly accept FIE's mission. During this search process, several candidates were excluded when it became evident that their commitment to serving low-income persons was subordinated to the pursuit of return on investment.
- The team of executives and staff who started the FFP FIE was the same team who had successfully operated FIE as an NGO for over 12 years prior to the creation of the FFP. Unlike some of the other transformations in Bolivia and elsewhere, there was no "contamination" with executive talent brought in from banks to ensure the profitability of the FFP.
- FIE kept majority control of the board and shares of the FFP. Eventually, FIE was satisfied with being the largest shareholder, but remained ready to regain majority control.
- FIE demonstrated and codified a willingness to consider buying back the shareholding of a partner who might not be satisfied with the mission of FFP FIE.

## Who Benefits?

Even when mission was favored over profit, there was a related question of who should benefit from any efficiency produced by the NGO's transformation to FFP. Greater growth and scale in the FFP were expected to generate economies and to afford better systems which would reduce costs. Similarly, the access to deposits and the capital markets was expected to lower financial cost. Should the resulting savings go to the client or to the FFP's share-

holders? And if competitors kept their rates high, should FFP FIE go along? Or should it lower the interest rate on its loans? This issue was addressed through the following measures:

- FIE formulated a clear policy that its objective in becoming an FFP was not to maximize profit but to increase its growth and improve its services to its microenterprise clients. This policy called for a balanced sharing of the gains from the transformation to FFP among the owners and the clients. This policy was communicated permanently to partners, managers and employees.
- Vigorous debates occurred at board and management levels on how to implement this policy. A recent example was when some of FIE's directors advocated lowering interest rates and a careful study was made comparing this with other alternatives and measuring the impact on client welfare. The conclusion was to leave interest rates on loans unchanged and instead open mini-branches in previously under-served areas, which saved time and transportation cost to the microentrepreneur who now could get her/his financial services much closer to home. A similar decision has taken FIE to expand its operations in rural areas.
- Payment of dividends became policy, not only as compensation to the shareholders for their risk, but also as a way of empowering FIE to accumulate the means to buy the shares of its partners in case a disagreement developed in regard to this policy. So far no such situation has arisen.
- Constant reinforcement of FIE's traditional culture of service exists among its executives, managers, and employees. This culture puts respect for the client on top.

## What Should the NGO do After the FFP was Launched?

As with all the other issues, this one was and continues to be debated at FIE. One benefit of being the third among the four MFI leaders to transform was to be able to observe what the competition did. This issue was addressed through the following measures:

- FIE stopped making loans and transferred all its operations to the FFP. In contrast with some other transformations, this measure prevented competition between the FFP and the NGO. It also facilitated the focusing of the FFP on providing financial services, and of FIE on providing oversight of the FFP.
- Initially, FIE kept providing training services to its clients. These services have been discontinued for some time. In part this was due to FIE's realization that clients often could teach FIE lessons on entrepreneurship. Also, early on, FIE and its fellow shareholders decided to limit dividends so as to facilitate the expansion of the FFP's financial services.
- In recent years, with greater dividends from the FFP, FIE the NGO has started supporting social projects in the communities where the FFP operates.
- FIE has developed the FIE Gran Poder joint venture in Argentina and invested in it (FFPs are limited to operating in Bolivia). The NGO keeps open to considering other opportunities to transfer FIE's microfinance know-how to other countries.

## To Be or Not to Be Bolivian

Among Bolivia's leading four MFIs, the FFP FIE is the only one which remains controlled by Bolivians (i.e. by the NGO FIE); the other three were originally started by Bolivians but today are either majority or effectively controlled by foreign investors. FIE is open to foreign investment, but feels a special pride in having retained its Bolivian control and essence. Over the years, this has been challenged and debated on several occasions when other MFIs have approached FIE and discussed either a merger or a buy-out. Although the debates have been intense, and the decisions have been close ones, FIE has resolved to keep its FFP Bolivian.

## The Incentives

The main incentive considered here is a program to facilitate the purchase of shares by the staff and/or the managers of the transformed MFI.

Along with Banco Sol (which started as a bank in 1992) and FFP Pro-Credito/Los Andes (1994), FFP FIE (1998) became a for-profit MFI without offering their managers and employees the opportunity to buy shares in their respective transformed institutions.<sup>4</sup>

In the case of FIE, the issue of providing share ownership incentives to the management and staff of the FFP was considered and discarded mainly because:

- One reason for the long time it took FIE to get the FFP license was a concern by the Superintendency that the FFP would be overly dependent on FIE, an NGO. In arranging the equity capital for the FFP, the Superintendency requested that FIE obtain as partners private investors who were "solventes" (i.e., with "deep pockets") and had a sensitivity to losses (somehow an NGO was viewed as not hurting in case of losses as much as a private investor) and a capacity to add more capital in case of need. While respected, FIE's managers and employees did not qualify as having deep pockets.
- As in many other countries worldwide, there was no tradition in Bolivia of employee and management share-ownership programs. The typical compensation to bankers is in the form of a bonus, which functions as a participation in the bank's profit.
- It was considered simpler not to mix the ownership role of the shareholder with the operating roles of the managers and staff.
- The paramount concern was to preserve the performance and model of FIE which had been developed as a non-profit NGO. FIE had done well as an NGO, and the idea was not to change what had worked well prior to the transformation.

This issue has been revisited from time to time, and there have been discussions on it at the board of the FFP FIE and at FIE's assembly. To date, no positive decision has been made, but as with the other

<sup>4</sup> Apparently, the first instance in which NGO MFI managers and employees were given a facility for buying shares in the new institution took place when PRODEM Foundation created PRODEM FFP in 2000. Banco Sol and some of its shareholders later arranged for facilitating share ownership by its managers. Pro-Credito/Los Andes does not disclose this kind of information.

issues, FIE's management and Board keep an open mind and are prepared to reopen the discussions if conditions so warrant.

## The Results

On the following page is a summary of FIE's performance for 1998, its first year as FFP, and 2007, the most recent year for which audited financial statements are available. Further below is information for 2008 comparing FIE's performance with those of other Bolivian regulated MFIs. FFP FIE has attained impressive growth in its operations and results, as evidenced in the second table.

FIE has maintained good profitability in spite of rising competition which has required that it lower the interest rate it charges on its loans to clients. This has resulted partly from lower administrative expenses as a percent of its loan portfolio.

## Conclusion

As this case demonstrates, the alignment of stakeholders' interests, primarily the interests of FIE NGO as an organization, played a significant role in FIE's decision to transform into a regulated FFP. In spite of having no guide to follow, FIE's directors and managers examined and discussed the interests of different stakeholders: the desire for the NGO to preserve the social mission, investors' interests in financial performance and the use of profits, and staff's feeling of ownership versus tradition within Bolivian organizations. Beyond any particular decision that FIE made, the most important lesson to be drawn from this case is that FIE explicitly considered these issues and found solutions that, at the time of transformation, fit with the culture of the institution and met the stakeholders' needs. The institution's continued growth and outreach demonstrate the success of the effort.

The case also raises some questions about the reasoning behind the decisions FIE made. For example, FIE invested large amounts of time and

energy into picking future investors that would accept the institution's social mission, such as CAF, Oikocredit, and COSUDE (of the Swiss government). However, FIE NGO remains the majority investor to this day, effectively controlling all key decisions made by the MFI more than 10 years after the transformation. The question that arises is why such redundancy is necessary, so many years after transformation? Also, as was mentioned when FIE's employees were considered as potential owners, other MFIs have encountered resistance from regulators to keep founding NGOs as majority owners because they may lack "deep pockets." Limited resources at FIE NGO could one day restrain the FFP's growth or force dilution of the NGO. Finally, the NGO's activities post-transformation also touch on the challenges that other successful NGOs have encountered with regards to the institutional identity of the NGO after transformation.

**Table 1 - Key Figures for FFP FIE<sup>1</sup>**

FFP FIE	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
Number of depositors	121	218	440	1,039	7,277	19,310		77,622	130,258	207,692	250,041
Number of active borrowers	20,848	24,114	23,402	23,173	26,468	31,397	41,888	51,973	64,456	79,553	103,584
Debt to equity ratio	6.46	4.25	5.07	5.62	6.24	6.34	6.92	7.72	8.38	8.71	8.16
Loan portfolio, gross (in USD)	14,680,253	18,707,340	22,423,559	26,286,340	33,529,320	39,431,837	54,263,640	73,849,702	101,057,702	161,253,139	244,433,565
Deposits (in USD)	N.A.	N.A.	N.A.	N.A.	N.A.	19,379,589	23,188,499	32,697,855	55,845,361	100,482,605	161,706,659
Average loan balance borrower per borrower / GNI per capita (in USD)(%)	70.42	78.36	95.82	118.16	136.21	136.51	134.94	139.31	141.25	160.87	187.28
Operational self sufficiency (%)	123.42	108.19	109.72	109.73	123.99	124.60	125.94	122.89	115.37	117.20	115.82
Return on assets (%)	N.A.	1.60	1.65	1.53	3.50	3.10	3.12	2.66	1.86	1.79	2.04
Return on equity (%)	N.A.	9.71	9.36	9.69	24.36	22.63	23.94	22.29	16.90	17.17	19.12
Operating expense / loan portfolio (%)	N.A.	16.07	13.89	11.70	10.41	10.92	11.70	11.92	12.23	10.91	10.75
Loan loss rate (%)	N.A.	0.09	0.92	2.17	2.42	4.55	0.61	0.39	0.51	0.24	0.41
Portfolio at risk > 30 days (%)	1.50	5.40	6.30	7.25	5.98	5.10	3.83	2.40	2.00	1.21	1.03
Risk coverage (%)	63.02	101.51	114.39	119.29	115.72	88.91	181.61	146.30	262.97	424.16	489.68

<sup>1</sup> Microfinance Information Exchange, <http://www.mixmarket.org>.

**Table 2 - FIE Compared with the Other Regulated Bolivian MFIs<sup>1</sup>**

*As of December 31, 2008, in US\$ million*

	FIE	Banco Solidario	Caja Los Andes/ ProCredito*	PRODEM	Others*	MFIs	Banks*
Total Assets	295	393	472	317	239	1,716	6,281
Cash & T bonds	46	87	101	60	49	343	2,910
Net loan portfolio	242	292	341	241	175	1,291	2,933
Loans / Assets in %	82	74	72	76	73	75	47
Gross loan portfolio (GLP)	246	296	343	241	178	1,304	3,094
Number of borrowers	103,584	109,763	111,022	98,207	82,481	505,057	N.A.
Average loan in US\$	2,375	2,697	3,089	2,454	2,158	2,582	N.A.
Equity	31,658	28,547	50,914	31,750	31,658	174,527	355,886
Equity / Assets in %	10.70	7.3	10.80	10	13.20	10.20	5.30
Net Income	5,089	2,299	3,940	3,353	(159)	14,522	118,522
NI / Equity in %	16.10	8.10	7.70	10.60	Neg.	8.30	35.30
NI / Assets in %	1.70	0.60	0.80	1.10	Neg.	0.80	1.90
Administrative Expenses	22,628	29,332	34,573	32,321	18,818	137,672	233,292
Ad. Exp. / GLP in %	9.20	9.90	10.10	10.20	10.60	10.60	7.50

<sup>1</sup> Unaudited figures reported to ASOFIN (the association of regulated banks and FFPs dedicated to microfinance in Bolivia).

\* Caja Los Andes/ProCredito is now Banco Los Andes/ProCredito. "Others" includes Ecofuturo, Fortaleza, Fassil, and AgroCapital. "Banks" exclude Banco Sol and Banco Los Andes, which are included with the MFIs.



## Annex 6 - The Case of UMU, Uganda – Recognizing Founders & Managers

### Introduction

Uganda Microfinance Union (UMU) was founded by Charles Nalyaali and Rodney Shuster in 1997 with a US\$32,000 grant from the Bank of Uganda (BoU). Both were recent graduates of Brandeis University in Boston, Massachusetts, and did most of the business planning for UMU while still students. Mr. Nalyaali had previously worked as a bank examiner at the BoU and enlisted the early support from BoU's Governor for the project. The founders' vision was to create a sustainable financial institution to promote self-help among low-income people in Uganda. UMU received significant support in the subsequent years from ACCION, Novib (Oxfam Netherlands), and USAID to help it grow its loan portfolio. By the end of 2004, UMU had nearly 36,000 active borrowers and total assets in value of US\$16.6 million.

In 2003, the Ugandan Parliament passed the Micro Finance Deposit-Taking Institution (MDI) Act, which provided an opportunity for microfinance institutions to significantly expand the scope of their activities and also attract outside investors. UMU had been actively preparing for transformation since the introduction of the draft law in Parliament. The institution was interested in capturing deposits as a cost-efficient way to fund its rapidly expanding lending business. UMU understood that transformation would require a greater level of regulatory scrutiny and would involve system upgrades and additional investments, which ultimately would enhance the value of the institution. Its two founders, who were by that time senior managers, saw an opportunity to reap some financial rewards for their long hours toiled and their modest (and occasionally, foregone) salaries over the years.

### UML's Transformation Experience

The transformation of UMU from an NGO to a licensed MDI took about 3 years to complete. Exhibit 1 summarizes the entire structural evolution of the organization from NGO formation in 1997 to acquisition by a foreign bank in 2008. Three issues turned out to be key to the transformation process: (i) how to treat the capital grants given to the NGO, (ii) how to identify the right investors, and (iii) how to design a satisfactory exit clause for potential investors.

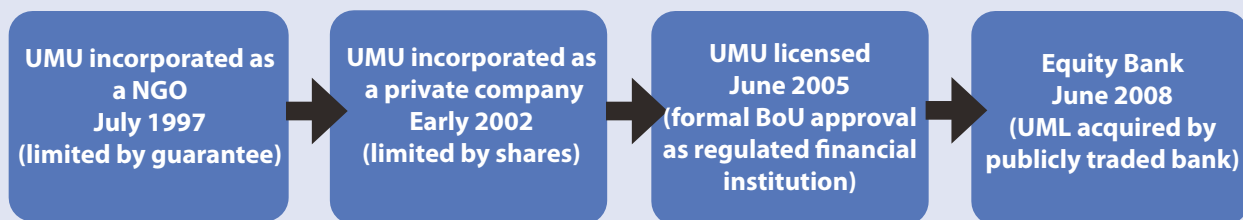
UMU's capital was constituted almost entirely with grant funding from donors and retained earnings. As mentioned earlier, the founders felt that they should be awarded equity stakes in the new institution as a reward for the years of work they put into building and developing UMU. They put their own reputation at stake to establish and grow the NGO, went without salaries at times, raised the donor funds themselves, and were personally responsible for much of the organization's debt. While some of UMU's donors, which included the BoU, Oxfam-Novib, USAID, UNHCR, the Ford Foundation and DFID, agreed in principle with the founders' argument, the question of how much of UMU's capital amounted to "sweat equity" became a source of disagreement.<sup>1</sup> Whereas the founders felt that the retained earnings were made possible (at least partly) because of their management performance, donors felt that these returns were generated by their capital grants and therefore belonged to the NGO. To make matters

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This case was prepared by Modibo Camara of A2F Consulting.

<sup>1</sup> UMU financial statements, 2004, <http://www.mixmarket.org>.

**Figure 1 - Structural Evolution – from NGO to Acquisition**



more complicated, Bank of Uganda expressed skepticism to having the NGO become the owner of the transformed institution.<sup>2</sup>

The first group of investors approached by UMU's founders included Triodos Bank, ACCION International, and Shorebank International. But as it turned out, these investors shared the position of the donors with respect to the treatment of retained earnings. Hence, they proposed that the founders bring their own funds to the table and that their future performance will be rewarded in line with UML's performance. Several ideas, including bonus packages, loans from the NGO, and limitations on when the founders could vest their shares were all discussed but ultimately rejected because of concerns associated with each. No agreement could be reached and negotiations eventually broke down. However, ACCION continued to provide most of the technical assistance required to upgrade UMU's systems and management tools. Most of this work was funded by USAID. The negotiations with the first investor group proved very difficult, and many involved were left with bitter, unpleasant feelings.

UMU founders then began exploring the interest of other potential investors, and ultimately concluded a deal with Aureos East Africa Fund and Norfund, backed by the Norwegian Agency for Development Cooperation (Norad). Aureos and Norfund were comfortable with an arrangement that enabled each of the founders to obtain 13.4% of UML's capital. The original donors that were uncomfortable with the situation acquiesced, presumably for the sake of the transformation and increased outreach. These shares

were however acquired with funds borrowed from local banks. Norfund was amenable to a longer time horizon, but not Aureos, which had a shorter time line, so UML as an organization needed to agree on a time period of five years to achieve liquidity.<sup>3</sup> The ownership interest of UMU, the founding NGO, in UML was primarily translated in preferential shares acquired at a premium of two times book value. It did not receive a board seat or any role in the governance of the transformed institution. All the NGO's assets were transferred to UML with exception of the loan portfolio overdue for more than 30 days. An agreement was made with UML to recover this portfolio in arrears for a 10% fee on the recovered amount.<sup>4</sup>

UML founders saw their shareholdings diluted only a year after the transformation, when UML's capital was increased and Aureos / Norfund's affiliate Micro Africa Limited acquired 20% of the ordinary shares. This brought the investor group's shareholding to about 67.99%. This change in ownership structure certainly facilitated the acquisition of UML just three years later by Equity Bank from Kenya, through a share swap for the equivalent of US\$25.5 million, i.e., at three times its book value. The purchase price represented only about 2.5% of Equity Bank's market value at that point, but it allowed Aureos and Norfund to make sizeable profits on their investment.

Not all the details of the deal have been disclosed. While Aureos and Norfund were allowed to immediately cash in on their stocks, the terms of the deal oblige both UMU founders to keep most of their

<sup>2</sup> Victoria White and Joanna Ledgerwood, *Transforming Microfinance Institutions: Providing Full Financial Services to the Poor* (Washington DC: World Bank, 2006), p. 454 and 470.

<sup>3</sup> Uganda Microfinance Ltd., <http://www.aureos.com/case-studies/africa/uganda-microfinance.php>.

<sup>4</sup> White and Ledgerwood, p 476.

**Table 1 - UML's Ownership Structure After Transformation<sup>1</sup>**

<b>Investor</b>	<b>Ordinary Shares (%)</b>	<b>Preference Shares (%)</b>	<b>Total Shareholding (%)</b>
<b>Rodney G. Schuster</b>	13.34	0	1.55
<b>Charles W. Nalyaali</b>	13.34	0	1.55
J.R.M. Kasibante	4.66	0	0.54
James Mugambi	2.00	0	0.23
Willie P. Ogule	6.66	0	0.77
<b>UMU</b>	0.02	52.63	46.51
<b>Aureos East Africa</b>	29.99	23.68	24.42
<b>Norfund</b>	29.99	23.68	24.42

<sup>1</sup> Audited financials, UML, 2007.

shareholding for a certain number of years. This arrangement of course makes the value of their investment vulnerable to the swings of the Nairobi stock market. Both founders are now employees of Equity Bank, with Mr. Nalyalaa still as CEO of UML. A conversion of the preferential shares held by UMU into common shares to be held by the NGO staff was under discussion at the time of the study.

## **UML's Performance Since Transformation**

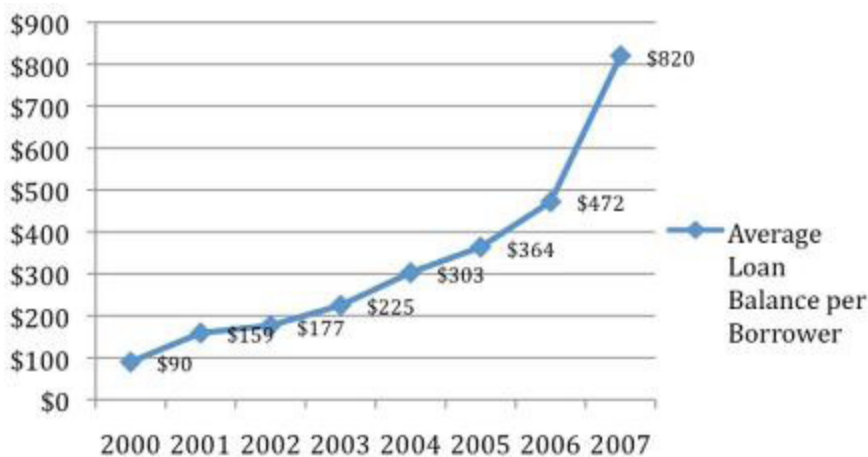
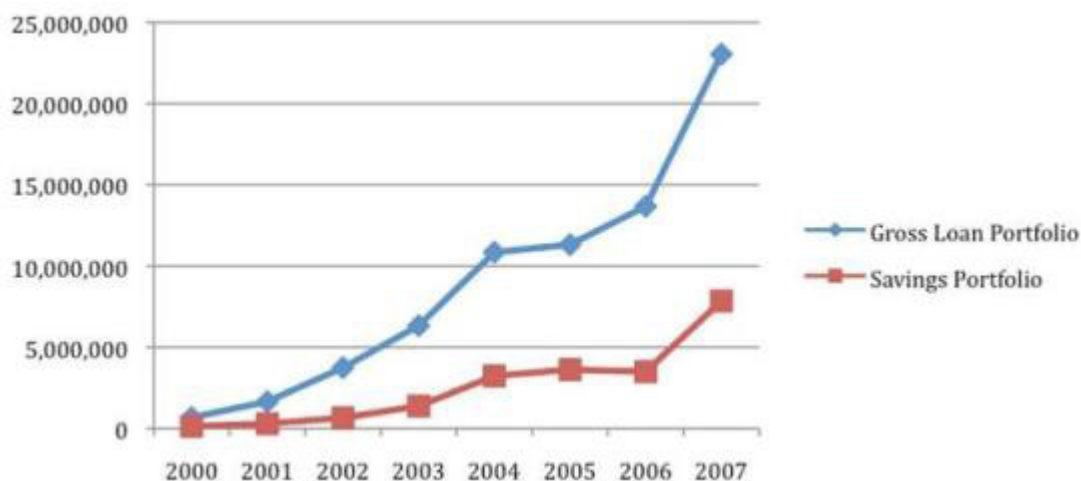
UMU has been growing strongly since its creation. This trend persisted after its transformation, apart from a slight slowdown in 2005 and 2006. A careful look at the growth numbers, however, shows a significant change in the business strategy. Whereas UMU grew primarily by expanding its outreach, the number of borrowers decreased steadily since transformation. A similar evolution was observable with the number of depositors. At the same time, however, a transition to mandatory voluntary deposits was taking place, making the assessment more difficult in this case. Interestingly, UML's loan portfolio, as well as the savings collected, grew significantly in the same period (see figure 2). This resulted from a sharp increase in the average loan size from US\$364 to US\$820.

In terms of financial performance, UML has consistently been one of the most profitable MFIs in Uganda (see figure 4). Like UMU, UML's returns have fluctuated but were consistently above the market average except for 2005. Net profit more than doubled in 2007 alone, compared to the previous year. Therefore, there was a tremendous amount of value created by the founders and managers of UML. They built an institution that investors considered worth nearly US\$4 million in 2005 and continued to build the value of UML to where it was bought by a publicly listed bank for US\$25.5 million just 3 years later in mid-2008. By that time, UML was clearly a leading microfinance institution in Uganda, operating profitably with 26 branches and 14 offices.

## **Did Governance Matter?**

A typical problem of NGOs like UMU is their "unclear ownership situation". UMU was founded by two entrepreneurs who had a vision, took risks and put years of efforts to establish a successful microfinance institution. At the same time, these founders lacked capital and approached donors to get the resources needed for turning their vision into reality. UMU was started with a grant of the BoU and depended heavily from donors for most of its funding. The initial failure of the founders, donors, and

**Figures 2 and 3 - Evolution of Key Outreach Indicators Since UML's Transformation**

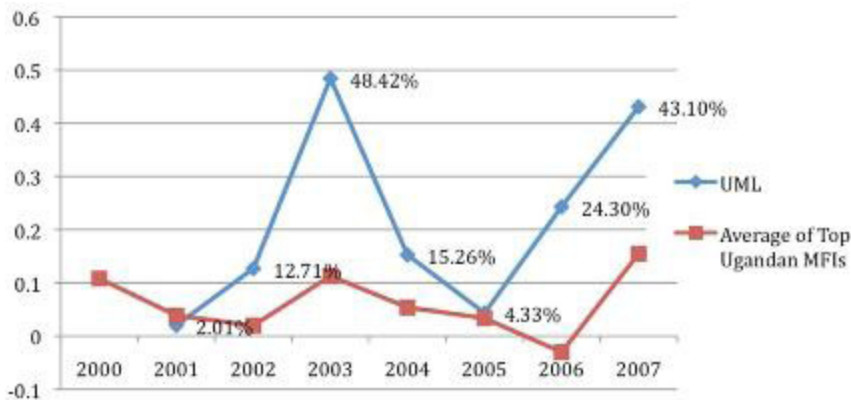


investors to agree on the value of the founders' sweat equity significantly slowed down the transformation process. The donors, likewise, failed to recognize that their "ownership rights" over UML were incomplete because they did not include control over the institution. None of the donors had a legal right to appoint or remove UML's founders from their position at the helm of the institution. None of the donors was also set-up to run the operations of the NGO. The ambiguity of control over the NGO, in this case, seems to have reinforced the founders' sense of ownership of the organization, and in the end they were able to acquire "de facto" its lending business at the price of their choice.

A second important insight of the UML case is that the post-transformation ownership structure mat-

ters, in particular the type of investors. Some fund managers, like Aureos, have a short-term investment perspective of up to five years. Their first objective is making a successful deal, rather than maximizing the development impact. It is therefore not surprising that UML actually reduced its outreach and went up-market under their watch, which helped double profits in 2007 compared to the previous year. It would appear that UML's founders ultimately accepted a disadvantaged position within their own organization that pushed them into a different segment market and eventually into the acquisition by Equity Bank. Not all the details of the deal were disclosed. But, Aureos and Norfund were apparently able to make sizeable profits on their investments in three years only. For their part, UML's founders find themselves now locked in a deal under which they

**Figure 4 - Evolution of UML's Return on Equity Compared to Rest of Sector**



have lost control of the institution they set up, but still have to remain to create value for Equity Bank with (again) significant uncertainty on the final value of their investment. The real loser was, however, the NGO, whose assets are now likely to be distributed to the staff. This was ironically what donors tried to avoid in the first place.

The key unanswered question remains whether these shifts in governance will affect UML's potential long-term contribution to improving access to finance in Uganda. In our view, the data available on The Mix Market does not allow a definitive answer to this at this stage. UML may have reduced its outreach, but its average loan in 2007 was still only about US\$820. Therefore it is still providing financial services to segments of the population who lack appropriate access to finance in Uganda. Its association with Equity Bank could also bring additional strength at scaling its activities, especially in deposit-taking where its performance has not been as strong since transformation. Equity Bank, after all, has downscaling and access to finance at the core of its business.

## Conclusions

The UML case is a good illustration of the basic ownership problems of NGO and how they affect the transformation process. Development finance institutions (usually bilateral and multilateral donors and investors) play a very important role as funders

and sometimes even initiators of microfinance ventures. But, DFIs are not set-up to own MFIs. Hence, DFIs have to pay significant attention to the governance structure of the MFIs they invest in. At the same time, they have to recognize that they are typically not in control of these MFIs with which they partner. They therefore have to be aware of possible misalignments of incentives which, if not properly managed, like in the case of UML, could lead to sub-optimal outcomes from their perspective. Founders in turn have to carefully assess the incentives of potential partners looking to invest in their institutions. While asset managers investing in microfinance now abound, it is important for MFIs seeking to transform to give preference to those investors who are interested in a long-term partnership and, if possible, an involvement at the operational level.

In addition, the UML case demonstrates the lack of benchmarks within the microfinance industry concerning the alignment of interests. The main difference between the two investor groups was not a denial of the founders' claim to some level of ownership of the soon-to-be transformed MFI, but instead a disagreement about how to recognize that claim in a transparent ethical and legal manner. Issues, such as whether or not the founders contributed their own capital to purchase shares, and what ownership stake could be purchased at transformation versus "earned" over time, ultimately broke up the first investor group.

**Table 2 - Uganda Microfinance Limited Financial Indicators (US\$)<sup>1</sup>**

	31/12/07	21/12/2006	31/12/05	31/12/04	31/12/03	31/12/02	31/12/01	31/12/00
<b>Exchange rate used for conversion (UGS/USD)</b>	1,690	1,740	1,819	1,732	1,937	1,730	1,727	1,767
<b>Balance sheet</b>								
Gross loan portfolio	2,3049,567*	1,368,1990*	11,325,366	10,850,560	6,333,673	3,750,105	1,654,795	680,384
Total assets	34,091,942	21,402,999	16,468,096	16,623,085	10,121,782	5,638,036	2,439,032	1,095,750
Savings	7,854,041*	3,500,300*	3,629,407	3,239,666	1,385,625	659,515	299,793	133,361
Total Equity	7,869,884	5,545,808	4,165,472	3,593,735	2,351,236	1,672,363	1,083,007	673,576
(* taken from audited financial statement)								
<b>Financing structure</b>								
Capital / Asset Ratio (%)	23.08	25.91	25.29	21.62	23.23	29.66	44.40	61.47
Deposits to loans (%)	31.89	18.48	32.05	29.86	21.88	17.59	18.12	19.60
Gross loan portfolio / total assets (%)	71.17	66.73	68.77	65.27	62.57	66.51	67.85	62.09
<b>Overall financial performance</b>								
Return on assets (%)	7.22	4.96	0.89	3.39	12.36	4.34	1.00	N.A.
Return on Equity (%)	43.10	24.30	4.33	15.26	48.42	12.71	2.01	N.A.
(* taken from audited financial statement)								
<b>Revenues</b>								
Financial revenue ratio (%)	32.58	38.27	37.96	42.06	43.32	35.55	36.35	N.A.
Profit margin (%)	-1.74	13.09	59.35	8.07	28.54	12.20	2.75	-10.11
<b>Expenses</b>								
Total expense ratio (%)	33.15	33.26	15.43	38.67	30.95	31.21	35.36	N.A.
Operating expense ratio (%)	22.29	24.11	9.97	26.66	22.24	26.95	32.54	N.A.
<b>Efficiency</b>								
Operating expense / loan portfolio (%)	32.09	35.66	14.88	41.49	34.76	40.27	49.25	N.A.
Cost per borrower	206.70	148.8	49.30	111.60	71.10	68.8	63.80	N.A.
<b>Productivity</b>								
Borrowers per staff member	75	99	96	111	114	117	92	92
Savers per staff member	138	141	180	192	193	133	128	118
<b>Risk</b>								
Portfolio at risk > 30 days ration (%)	3.40	3.46	5.57	4.75	3.98	1.25	N.A.	N.A.
Loan loss reserve ration (%)	2.67	2.71	3.39	5.16	3.32	1.52	1.54	1.46
Write off ratio (%)	3.33	5.19	N.A.	0.79	0.34	N.A.	N.A.	N.A.

<sup>1</sup> Microfinance Information Exchange, <http://www.mixmarket.org>.

**Table 3 - Outreach Indicators<sup>1</sup>**

	31/12/07	21/12/2006	31/12/05	31/12/04	31/12/03	31/12/02	31/12/01	31/12/00
<b>Number of personnel</b>	397	304	323	321	246	181	113	83
<b>Loans</b>								
Number of active borrowers	29,604	30,235	31,145	35,787	28,099	21,207	10,417	7,598
Average loan balance per borrower	\$820	\$472	\$364	\$303	\$225	\$177	\$159	\$90
Average loan balance per borrower / GNI per capita (%)	N.A.	157	130	121	98	77	66	34
<b>Saving</b>								
Number of savers	54,679	42,798	58,127	61,538	47,529	23,987	14,505	9,824
Average loan balance per saver	\$142	\$62	\$62	\$53	\$29	\$27	\$21	\$14
Average loan balance per saver / GNI per capita (%)	N.A.	21	22	21	13	12	9	5

<sup>1</sup> Microfinance Information Exchange, <http://www.mixmarket.org>.

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