

# NGO MFI Transformations: Ownership Issues

More and more nonprofit microfinance institutions (NGO MFIs) are transforming into for-profit companies, including regulated financial institutions. Transformations are typically driven by one or more of the following factors: an MFI's need for capital, its desire to offer services that may be limited to regulated financial institutions (such as savings), and new legislation or regulation requiring or permitting transformation.

Transformations raise a host of issues that NGOs and their founders and funders need to address. The complicated issues involved in switching from an ownerless entity to an entity with owners often are not well understood before the transformation process is initiated. This brief reviews seven areas in which those embarking on a transformation should research and seek legal counsel's advice. These areas and others are discussed in depth in Lauer (2008).

**1. Factors that may interfere with an NGO retaining control over the transformed institution.** Legal requirements may leave an NGO with less ownership and control than it wants. The law may prescribe a maximum percentage of ownership. Significant owners (e.g., those owning 10 percent or more of the voting shares) may be subject to prior approval by the financial regulator. There may be restrictions on foreign ownership of companies. The initial minimum capital requirement may be too high for the NGO to meet. In addition, minority shareholders may have statutory rights to veto or influence voting on specific issues.

**2. Restrictions on an NGO's capital contribution of loan portfolio and other assets.** Local law may prohibit an NGO from selling its loan portfolio or exchanging it for shares. Even if the loan portfolio may be contributed as capital, regulations may not recognize it as "tier 1" capital for capital adequacy purposes. And finally, other assets—such as employee contracts and intangibles—may be difficult to transfer or value.

**3. Transferring liabilities.** An asset transfer by an NGO to the transformed institution may be subject to the NGO's pre-existing debt agreements or other contractual obligations. An NGO MFI that has outstanding borrowings must review whether these liabilities will be assigned to and assumed by the new company or stay with the NGO. Although typically debt may stay with the NGO if the lenders agree, few lenders will want to be in the position in which they can look only to the NGO for repayment after it has transferred its loan portfolio—the principal source and guarantee of repayment—to another entity.

**4. NGO-related parties as owners.** Many transforming NGOs as well as outside investors have expressed an interest in providing management, employees, and occasionally board members and trustees with an opportunity to be owners in the transformed institution. Insiders may purchase shares (either at the general offer price or at a discount) or receive shares without having to pay for the shares themselves in one of the following ways: the NGO may grant shares to individuals; the NGO may negotiate a grant from a donor to fund the individuals' purchase of shares in the transformed institution; a third party investing in the transformed entity may fund the issuance of shares to the individuals, typically in order to retain those in key management positions.

The granting by the NGO of shares to individuals raises ethical and sometimes legal questions as to whether public-purpose donations are providing private gains. Whether management, a board member, or a trustee

is purchasing or being granted shares, entering into such an arrangement presents a clear conflict of interest issue that the NGO must address: that is, the individual being awarded shares is on both sides of the transaction.

**5. Corporate governance.** The main difference between NGO governance and company governance is that a company is controlled by owners who have an incentive to protect their private financial interests, while an NGO has no owners and depends on the social motivation of its governing body. The Board of Directors has an important role to play in determining how the new for-profit institution will grow, be profitable, and manage its risk while preserving its vision. The board structure is key to ensuring the right balance between holding management accountable and enabling management to retain its independence and flexibility.

Aside from relying on the board, it is possible to have an agreement among shareholders that includes a statement on the mission of the company and also addresses issues regarding general operations. However, shareholder agreements are not enforceable in all countries.

**6. Use of grant funds.** In general, grant funding for NGO MFIs is meant to benefit poor and low-income people by supporting the development of institutions that offer formal financial services to such people. Until recently, most donors did not contemplate the possibility of an NGO transforming into a for-profit company, so their policies and grant

agreements did not address a situation in which the grantee would transfer its assets to a company with private owners. Today, most donors support the position that the primary purpose of the grant funds is to increase the poor's access to financial services and that if the funds are used to create a sustainable institution (i.e., the transformed institution) that is able to serve more of them by mobilizing savings and other capital, then the funds have accomplished their purpose. This is *not* to imply that donors are in favor of uncompensated transfer of assets from the NGO to private parties; rather, in most donor-approved transformations, the NGO receives shares or other value in exchange for its transfer of assets to the new institution. Careful attention must be paid to the pricing of those shares, to avoid unfair transfer of the NGO's assets, including grant funds, to private parties.

**7. The long term: Ownership and mission.** Will anyone ensure that the original mission is pursued once the NGO no longer has control over the new entity? Will there be remaining shareholders with an equally strong interest in pursuing the original mission? These are significant and difficult questions, the answers to which will depend on the composition of shareholders and how that composition is permitted or not permitted to change.

## Resource

Lauer, Kate. 2008. "Transforming NGO MFIs: Critical Ownership Issues to Consider." Occasional Paper 13. Washington, D.C.: CGAP, May.