

# Transforming NGO MFIs: Critical Ownership Issues to Consider

A significant proportion of microfinance institutions (MFIs) in developing countries operate either as nongovernmental organizations (NGOs) or as projects run by international NGOs. Many of these NGO MFIs plan to “transform” into a for-profit company—often, a regulated financial institution. The microfinance sector is, in many ways, at the threshold of knowledge and experience regarding this type of transformation.<sup>1</sup> A key component of the transformation of an NGO MFI into a company—the establishment of ownership—presents issues for the NGO as well as the founders and funders of both the NGO and the newly established institution. These issues include the following:

- Legal limits on an NGO’s ownership of the transformed institution, which may have consequences for mission and governance
- Legal restrictions affecting the ability of the NGO MFI to contribute its assets to the transformed institution
- Effective transfer of liabilities
- Limitations related to the NGO’s grant funding
- Issuance of shares to management, employees, and other stakeholders
- Future divestiture by initial shareholders

This paper provides insights and guidance for those who plan to carry out a transformation.<sup>2</sup> Thus the paper’s discussion of issues is likely more detailed and technical than most general readers will care to wade through. At the same time, this is not a “how to” manual nor does it identify right and wrong answers.<sup>3</sup> Such an approach would not be feasible, primarily because of the different scenarios transforming institutions will face depending on local law and regulation. Although this paper touches on matters that have raised difficult ethical and “double bottom line” issues in recent transformations and post-transformation sales of shares, it does not deal with these issues in depth because they have already been discussed in various publications.<sup>4</sup>

NGO founders and funders should consider the topics addressed in this paper long before beginning a transformation. Early planning and consultation with local counsel will help them avoid pitfalls that may

make a transformation unnecessarily costly, difficult, and sometimes unworkable.

## Introduction

In most cases of transformation, NGO MFIs have two primary objectives: (i) to provide clients with a range of financial services beyond credit,<sup>5</sup> including savings and transfer services,<sup>6</sup> and (ii) to increase access to capital, whether through commercial borrowings (which remain inaccessible for many NGO MFIs today), deposits, raising equity, or all three. (See Box 1.)

### Box 1. Why Transform?

NGOs transform for various reasons:

- to offer financial services beyond lending
- to access capital
- to comply with new legislation requiring or permitting transformation
- to gain legitimacy
- to enable employees, clients, and other stakeholders to become owners

Increasingly, transformations are triggered by legislative change.<sup>7</sup> Sometimes the change requires NGO MFIs to transform. In other cases, new legislation or regulations provide new institutional options for engaging in microfinance activities. Several NGO MFIs have transformed into regulated financial institutions in an effort to gain legitimacy in the eyes of investors, commercial lenders, and other financial institutions and policy makers. In a few cases, NGO MFIs have transformed specifically to enable employees or clients to become owners.

In some transformations, NGOs bring in outside investors,<sup>8</sup> usually to access new capital or specific expertise and technical assistance (TA). (In several completed transformations, a TA provider had been working with the NGO for years and was a catalyst for transformation.) However, not all NGOs want to bring in outside investors. Some prefer to have complete control over the transformed institution. This is most common with international NGOs (INGOs) that have transformed their local projects or locally established NGOs into local companies.

Typically, these transformations are driven by legislative changes or the desire to provide new services. (Rarely is the demand for capital a motivating factor for INGOs.) In fact, many INGOs that already have gone through one transformation plan to transform all of their local operations as part of an institutional design approach.<sup>9</sup> For similar reasons, several local NGOs have declined to bring in outside owners. It is important to note that in several cases, where an NGO considered transforming into a regulated financial institution, NGO senior management—fearing the loss of their jobs—opposed the transformation and prevented it from taking place. Ultimately, however, the path taken by the NGO may be determined by local law. For instance, in some countries, an NGO is permitted to be the sole or majority owner of a financial institution while, in others, the NGO may be required to have outside investors and even reduce its ownership interest below 50 percent.

## From Ownerless to Owned: Understanding the Implications

In microfinance lexicon, “transformation” is a catch-all term that refers to a variety of transactions in which a microfinance business is transferred from one institution to another. But for purposes of this paper, the term “transformation” refers specifically to the transfer by an *ownerless* NGO of all or a part its microfinance business to a for-profit company: a new or preexisting legal entity *with owners* who exercise rights proportional to their ownership interests.<sup>10</sup>

A generic transaction could be described as follows: an NGO transfers its loan portfolio and other assets, liabilities, and employees to a new company (Newco) in exchange for shares of Newco or payment (cash, debt, or a combination thereof). The NGO is the sole shareholder, majority shareholder, or a minority shareholder of Newco. (Variations on the generic structure are identified in Box 2.) Other owners of Newco may include the following:

- NGO founders (e.g., an INGO or individual founders)
- NGO board members or trustees
- Newco board members (who may also have been board members of the NGO)

### Box 2. Transformation Iterations

Variations on an NGO establishing Newco as a subsidiary and selling or transferring its microfinance business to Newco in exchange for shares include the following:

- NGO acquires an existing company or regulated financial institution and transfers all or a portion of its business (its portfolio, other assets, liabilities, and employees) (India BWDA Finance Limited)
- NGO “merges” with one or more NGOs; they transfer their collective portfolio to Newco or to an existing company or regulated financial institution (Bolivian Eco Futuro)
- NGO MFI does not transfer portfolio; instead, as each loan is repaid, the transformed institution makes a new loan (i.e., client list is transferred but not loans) (Peru MiBanco)
  - Other assets and liabilities may be transferred in one or several steps
  - employees may be transferred up front or after Newco has taken over all or part of the portfolio
- NGO transfers branches to Newco on branch-by-branch basis (e.g., Philippine CARD NGO and CARD Bank)
- NGO MFI continues to engage in microfinance activities alongside Newco (e.g., K-Rep and K-Rep Bank; CARD NGO, and CARD Bank)
- NGO is reorganized from an ownerless company limited by guarantee into a company with shareholders (FINCA Uganda)

- NGO management (even if not Newco management)
- Newco management (often formerly NGO management)
- NGO employees
- Newco employees (typically, some but not all of the former NGO employees)
- Newco clients (formerly NGO clients)
- technical advisers
- unaffiliated outside investors (e.g., international financial institutions and local and foreign private investors)
- government bodies

It is essential that those discussing the possibility of a transformation be aware of the significant differences between an ownerless NGO and a company with owners. Volumes have been written on how to define an NGO. (NGOs go by many different names: association, foundation, not-for-profit corporation, company limited by guarantee, public benefit

company, etc.) For purposes of this paper, an NGO has the following attributes: it has no owners, cannot distribute profits, is not part of the state, and has voluntary membership.

Although there is variation across countries, usually the governing body of an NGO includes a general assembly that meets annually and/or a board of directors that is appointed by the members or the founders (and, in some cases, is self-perpetuating) and assumes a governance role between annual meetings. A primary role of the governing body is to ensure that management pursues the objective of the NGO, which in the case of an NGO MFI, is typically to provide low-income and poor people with access to financial services.

In contrast, a company is formed by individuals and legal entities that invest equity in the company and then generally determine its direction through exercising voting rights at annual and special meetings. (Companies also can have owners who have no voting rights. See Box 3 for a description of different types of ownership interests in a share company.) Depending on local law, the owners of a company may be entitled or required to elect a governing board that is responsible for ensuring the executive management runs the business in accordance with the wishes of the owners. The company's constituent documents (certificate of incorporation or articles of incorporation and company bylaws) may specify which shareholders—typically determined by percentage shareholding—have the right to appoint or vote for one or more board members.

Unless there are restrictions on transferability of shares (or participations), ownership may change over time. Generally, owners are interested in ensuring the company generates a profit and in receiving dividends (or at least realizing a gain on the sale of their shares). There may be social investors who may have other interests that equal or exceed their interests in profit making, although this factor is not guaranteed to result in an institution pursuing the NGO's mission and prioritizing the clients' interests.

### Box 3. Different Types of Ownership Interests

Owners of a share company can hold different types of interest, including common shares, preferred shares, and convertible preferred shares.

- **Common shares** carry voting rights and have the most upside and downside. The owners of common stock are entitled to receive dividends if everyone else (including preferred shareholders and creditors) has been paid.
- **Preferred shares** pay an annual fixed income and have priority over common shares in the payment of dividends and in the return of capital in the event of bankruptcy. Preferred shares may or may not carry voting rights, although these rights typically would pertain only to certain events, such as a new share issuance. Sometimes voting rights are triggered only when preferred dividends are in arrears.
- **Convertible preferred shares** are preferred shares that provide the holder with the right, on a specified date, to convert into common shares.

## Factors That May Interfere with the NGO Retaining Control over the Transformed Institution

In most transformations, the NGO has (at least in the initial stage) retained, or wanted to retain, control over the transformed institution—as sole shareholder or otherwise. In several transformations, one or more of the legal restrictions discussed below have interfered with the NGO's original intent of being the sole shareholder or the controlling shareholder.

**1. Maximum Ownership Limitations.** Many countries limit the percentage of shares that an individual or entity may own in a regulated financial institution.<sup>11</sup> One-third of the 143 countries in a 2007 survey set a maximum percentage for bank ownership (Caprio, Levine, and Barth 2007).<sup>12</sup> It is likely that a country applying a maximum ownership limit with respect to banks would also apply such ownership limits to depository MFIs, if such a legal category exists.<sup>13</sup> This maximum usually applies to the aggregate holding of any group of related persons. For legal entities, this typically would include all entities that are tied by significant ownership or control. Often, these restrictions apply only to owners who are not themselves regulated financial institutions.<sup>14</sup>

The rationale for these limits is usually a belief that governance of financial intermediaries with diverse ownership will have more checks and balances and consequently will be safer. Another potential benefit of diverse ownership relates to the ability of owners to satisfy capital calls. (In both cases, these benefits will turn on the specific qualities, experience, and financial situation of the owners. Additional owners with little experience and knowledge or with insubstantial liquid assets may not, in fact, benefit the company.) However, maximum ownership limits can be problematic for an NGO that wants to protect the social mission of the Newco or that cannot find interested investors that share its commitment to the same mission. More than one INGO has negotiated with regulators for a specific exemption from the maximum ownership limit based on the NGO's track record as a successful owner of financial institutions (e.g., FINCA Uganda). However, this is not easy and is likely to depend on the success of the financial institutions owned by the NGO.

**2. Regulatory Approval of Significant Owners.** Local law may require regulatory approval of any acquisition that would result in an individual or legal entity, together with related parties (including companies that are controlled, controlling, or subject to common control), owning a "significant interest." Approval is typically based on a "fit and proper" standard, which may include an assessment of the potential owner's financial condition and trustworthiness. This may pose problems for NGOs that do not have "deep pockets," something few NGOs have.

**3. Restrictions on Foreign Ownership.** Some countries—for instance, Ethiopia—restrict foreign ownership of financial institutions, although this is less prevalent than it was two decades ago. For INGOs, this would prevent direct ownership altogether. Depending on the particular law, it might be possible to own indirectly, through a local subsidiary. Alternatively, local persons could be owners and the INGO could exercise rights through either (i) a loan agreement with Newco, pursuant to which Newco would make certain affirmative and negative covenants or (ii) a side agreement with the owners, although the enforceability of such an agreement would depend on local law.

**4. Initial Minimum Capital Requirement.** Often, a regulated financial institution is subject to an initial minimum capital requirement. The owners typically must deposit the initial minimum capital or a portion thereof into an account of the central bank on receipt of a license or, in some countries, when submitting the license application. In some countries, the entire requirement must be satisfied with cash; in other countries, a portion of the requirement may be satisfied with noncash items, such as a loan portfolio. Requiring an all-cash initial capital contribution or restricting the noncash portion can cause hardships for NGO MFIs that are short on cash.<sup>15</sup> If the NGO cannot fund the minimum required amount on its own, then it may have to raise funds through outside investors.

An NGO with a sizable loan portfolio could face the inverse problem if the NGO is subject to a maximum legal ownership percentage and sufficient funding cannot be raised from outside investors. That is, if the NGO were to contribute 100 percent of its loan portfolio as capital, it might not be able to raise sufficient capital from outside investors to keep the NGO's ownership percentage below the legal limit. In this case, the NGO might consider selling the portfolio to the transformed institution, either for cash, for a loan, or for convertible notes, as was the case with the K-Rep transformation in Kenya. K-Rep convertible notes were treated as capital reserves by the Central Bank of Kenya.

**5. Minority Shareholder Rights.** Some countries give minority shareholders statutory rights that may not be contracted away in an agreement among shareholders. In this situation, even if the NGO has majority ownership, certain matters may require approval by the minority owners. Rights regarding appointment of members to the board of directors are particularly important.

**6. NGO Post-Transformation Activities.** In almost all countries, an NGO must be engaged in a public-benefit activity. Often, this requirement would not be satisfied solely by virtue of the NGO owning a company, even if such company is engaged in the same activities that would satisfy the charitable activities requirement for NGOs. Some countries' laws may absolutely prohibit an NGO from owning,

in whole or in part, a for-profit entity or from having that ownership be its primary activity. If an NGO is prohibited from owning shares in a for-profit company, then it may be able to structure the transformation transaction so that the NGO receives cash instead of shares. If the NGO dissolves, then in many countries, its assets must be either distributed to another nonprofit (often, it must be another nonprofit that engages in similar activities) or turned over to the state.

Sometimes, the law is not clear: In the case of Georgia, the new microfinance law required all foundations and other nonprofits to cease engaging in microfinance by December 31, 2007. The various NGO MFIs had different interpretations of the law and whether it prohibited any future NGO involvement in microfinance. Some interpreted it to mean that the NGO could retain ownership in the transformed institution; others interpreted it to mean that the NGO was not permitted to hold shares in an MFI. In contrast, the new Bosnian regulations applicable to microcredit organizations include the unusual requirement that, on transformation, the NGO MFI must initially hold at least a 51 percent interest in the transformed institution. The regulations also specifically require an NGO MFI that transfers assets to a for-profit company to continue to engage in microcredit activities post-transformation.

In fact, many NGOs post-transformation have provided business development or other nonfinancial support services for microentrepreneurs and the poor. If the NGO continues microlending and other financial services (which some have done post-transformation), then it may ultimately be competing against the new company it created. In some such cases, the NGO or the transformed institution have agreed not to compete (e.g., they divide geographical areas). Such an arrangement may raise issues under competition law in some countries. In other transformations, the NGO has pursued new geographic regions or new clientele who had not been served by the NGO before the transformation. (See Box 4 for a description of two such arrangements.)

#### **Box 4. NGOs Engaged in Microfinance Post-Transformation**

The first microfinance transformation on record occurred in 1992, when the Bolivian NGO Promoción y Desarrollo de la Microempresa (PRODEM) created the commercial bank Banco Solidario, S.A., or BancoSol. PRODEM transferred only its already profitable branches to BancoSol. The two institutions agreed that, on an ongoing basis, the NGO would develop new markets and transfer its new branches and clients to BancoSol once they became profitable. However, the initial arrangement resulted in a falling out between the two institutions. PRODEM developed a rural portfolio but transferred it to a finance company (Prodem FFP) that the NGO established in 1999. Postscript: Today, Prodem FFP is the third largest MFI in Bolivia, serving more than 250,000 clients through 90 rural and urban branches. Currently, more than 600 Prodem employees are also shareholders.

In contrast, the Philippine NGO CARD has an ongoing arrangement with CARD Bank (established in 1997, 11 years after the establishment of the NGO). Since the transformation, the NGO has continued to open new branches. When a branch is financially sustainable, it is absorbed (subject to regulatory approval) by CARD Bank.

### **Restrictions on NGO's Capital Contribution of Loan Portfolio and Other Assets**

Establishing ownership in the transformed institution involves a capital contribution by each owner. An owner's percentage interest and corresponding voting rights depends on the amount of capital contributed. (Voting rights also depend on the type of shares held; as described in Box 3, preferred shares generally do not carry voting rights.) Often, the NGO's capital contribution is comprised, in whole or in part, of the loan portfolio and the NGO's other assets.

**1. Transferring the Loan Portfolio.** The NGO should be sure it understands the law governing the exchange of a loan portfolio for shares. In many countries, local law does not permit the transfer of a loan portfolio in exchange for shares, because of perceived risks associated with the collection of the loans.<sup>16</sup> As noted earlier in "Factors That May Interfere with the NGO



Retaining Control over the Transformed Institution—Initial Minimum Capital Requirement,” even in the absence of such a prohibition, an NGO that intends to contribute its entire loan portfolio as capital may face limits on whether any or all of it could be used to satisfy the initial minimum capital requirement.

Some countries have no limit on how much capital may be contributed in-kind (whether a loan portfolio or other asset), but they may require that the in-kind contribution be accompanied by an expert’s valuation. Occasionally, the expert must meet certain objective criteria established by regulation or must be on a regulator’s list of approved experts. An expert valuation can be very costly.<sup>17</sup>

On more than one occasion, an NGO has decided against transferring its portfolio and instead structured the transaction as a transfer of clientele: as each loan was repaid to the NGO, the client received the follow-on loan from the transformed institution. This approach has consequences on the already complicated process of transferring employees over to the new institution. (The transition doesn’t take long if the NGO is making short-term loans; however, Asian MFIs and an increasing number of other MFIs make many loans of a year or longer.)

There are two possible solutions: the NGO could retain some or all of its employees to service the loans and transfer them when all of the loans are repaid or it could transfer the employees to Newco and have them service the loans for a fee or as secondees.<sup>18</sup> In at least one case—the transformation of the Peruvian NGO, ACP, to MiBanco—MiBanco administered ACP’s loan portfolio at no cost. In fact, MiBanco paid the NGO \$1 million for access to ACP’s client base.

Structuring the transaction as a transfer of clientele requires the shareholder(s) of the transformed institution to fund the minimum capital requirement with cash. If the NGO does not have sufficient resources to fund its portion of the capital, it will need the other shareholders to agree that it may pay in capital as the loans are repaid. This may affect the price at which the NGO will purchase shares. If the microloans are short term, this should not be a significant issue.

In those countries that prohibit the exchange of a loan portfolio for shares, the NGO may be permitted to *sell* the portfolio to the transformed institution for cash or some other consideration besides shares. (Alternatively, it could transfer its list of borrowers, as described earlier). However, the NGO should determine the tax consequences of such a sale.<sup>19</sup>

The transfer of a loan portfolio to a regulated institution may introduce additional requirements aside from those already discussed. Perhaps most important, the transaction may require the approval of the financial regulator. When the Peruvian NGO ACP transformed into MiBanco, the Banking Superintendency approved the transaction but only performing loans were permitted to be transferred.<sup>20</sup> Delinquent loans were required to remain with the NGO.

**2. Regulatory Treatment of Loan Portfolio.** Even if local law permits the transfer of a loan portfolio in exchange for shares, if Newco is a bank, it will be important to establish whether the loan portfolio would qualify for purposes of regulatory capital, also referred to as tier 1 capital or core capital.<sup>21</sup> (As noted earlier, 57 out of 143 countries surveyed permit initial or subsequent capital injections to be made with assets other than cash or government securities (Caprio, Levine, and Barth 2007). The 57 include most industrialized countries, such as the United States. If a loan portfolio does *not* qualify as core capital, then the NGO must determine how the loan portfolio will be transferred (which may depend, in part, on the tax treatment of a sale versus exchange of assets for shares) and what additional funds it will need to raise to meet the initial capital requirements.

**3. Transferring Other Assets.** Most often, for regulatory reasons, initial discussions regarding transformation of an NGO and the transfer of the NGO’s assets focus on the loan portfolio. However, a transformation usually involves the transfer by the NGO of some or all of its other assets, including fixed assets (computers, desks, chairs) and intangibles, such as lending methods, and reputation of the NGO. The agreed value of intangible assets can be the subject of protracted negotiations when outside investors are involved.

As noted in “The Long Term—Ownership and Mission—Asset-Stripping and Expert Evaluations” on page 16, when an MFI is valued as a business (i.e., in its entirety, as opposed to its component parts), there are three different methods of valuation: multiple of net assets, discounted cash flow, and multiple of net earnings.<sup>22</sup> With the first method, often book value is used with a premium or discount applied. According to a recent survey of the members of the Council of Microfinance Equity Funds, this method is the most common starting point; but it has its disadvantages, including its focus on past performance as opposed to future possibilities.

## Transferring Liabilities

In general, a transforming NGO MFI needs to be alert to whether an asset transfer or a change in legal form would violate any of its preexisting 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 the loans 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.

If the loan was formally secured by the loan portfolio, then the NGO will not be able to transfer the assets unless the company receiving those assets also assumes the loan. The lenders may insist on adjustments to the transformation structure before they will approve the assignment of their loan to the transformed institution. These negotiations may be time-consuming and costly for both sides. At least one lender has incurred substantial legal fees in working through and negotiating the terms of a transformation.

Occasionally a lender may be willing to convert the debt into equity in the transformed institution, as FINCA International did in Ecuador. In a few other transformations, FINCA converted the debt owed by its local NGO into subordinated debt, making it easier to borrow from other sources.

A further complication occurs if a transformed MFI starts to take deposits. At that point, the unsecured loans transferred by the NGO to the transformed MFI are likely to be legally subordinated to depositors’ claims. In the event of problems, the unsecured loan will be paid only after all deposits have been paid.

When the NGO negotiates its original loan agreement, it should try to include a provision permitting it to transfer the loan (i.e., to assign rights and delegate responsibilities) to a successor company under defined circumstances.

## NGO-Related Parties as Owners

Many NGOs and outside investors are interested in providing management, employees, and occasionally board members and trustees with an opportunity to be owners in the transformed institution. The reasons may be both to reward people for building the institution and to align the interests of the transformed institution and its management. In some transformations, management, board members, and occasionally employees of the NGO have claimed a *right* to ownership in the transformed institution based on the argument that their work built the successful MFI undergoing transformation. In general, providing employees, management, and occasionally board members or trustees of the NGO with ownership is more complicated than bringing in “outside” owners that have no connection or affiliation with the NGO, especially if the individuals do not pay market value for the shares.

**1. The NGO as “Grantor” of an Ownership Interest in the Transformed Institution.** Insiders may purchase shares (either at the general offer price or at a discount) or receive them without having to pay 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 private investor may fund the issuance of shares to the individuals.

The granting by the NGO of shares to individuals raises the question of whether public-purpose donations are providing private gains. Under most countries’ laws, the NGO and its operations are

intended to benefit the public and thus enjoy tax-exempt status and receive donations that sometimes have tax preferences themselves. If the NGO, on transformation, awards shares to individuals without receiving fair market value, this gifting appears to be a contradiction of the basic principle of a nonprofit. Furthermore, if the NGO or its donors enjoy tax benefits, such a gifting would involve a transfer of public assets (i.e., the foregone tax revenue) to private individuals. As discussed in “Use of Grant Funds,” page 12, if the NGO received a grant from a tax-exempt donor or received one or more grants intended to benefit the public (regardless of the tax status of the NGO), the awarding of shares without requiring payment of fair market value would also involve the transfer to private individuals of grant funds intended to benefit the poor and low income.

Aside from whether local law would permit the granting of shares by an NGO to private individuals, the basic fact—the compensation (through the granting of shares) of former NGO management, employees, board members, or trustees over and above the compensation they had agreed to before the transformation—poses a contentious ethical question. However, this type of reward is becoming increasingly common as more private investors—who are accustomed to such rewards—come on to the scene as participants in NGO MFI transformations. (See discussion of awarding of shares by parties other than the NGO in “Management and Board Members.”)

The statements here should not be interpreted to mean that an NGO may not use performance-based compensation for its employees. An employment agreement that constitutes an arm’s length transaction and provides that the employee may be awarded shares as compensation for future performance should not necessarily present problems,<sup>23</sup> although it will turn entirely on local law. Anyone considering this route should seek tax counsel. Of course, the devil is in the details: the most important factor in determining the legal permissibility of such an agreement probably should be whether the agreement was negotiated at arm’s length, especially where senior managers are involved.

**2. Management and Board Members.** Issuing shares in a transformed MFI to former NGO managers and board members has sometimes led to protracted and divisive negotiations, even when the shares are paid for by the individuals. (In some cases, the transformation has not gone forward because an agreement could not be reached.) Such negotiations were said to have added a year to one transformation process. In theory, one would specify up front—for instance, on establishing the NGO MFI or in an employment contract—the ownership interest to which management would be entitled in the event of a transformation. However, if the NGO were to gift the shares to the individuals, this could present a serious issue for the tax-exempt status of the NGO MFI and for the NGO’s tax-exempt donors as well.

Whether management, a board member, or a trustee is purchasing or being granted shares, entering into such an arrangement post-fact presents a clear conflict of interest issue: that is, the individual being awarded shares is on both sides of the transaction. How can such a purchase or grant be done on an arm’s length basis? Who should represent the NGO’s interests, if not its managers and board? There are a few possibilities: an institutional founder such as an INGO, donors, or lenders. However, in many cases, INGOs and donors have “moved on” to other projects and may not be in touch with the NGO or informed about its developments.<sup>24</sup> For INGOs and donors who would want to be involved in the discussions regarding the issuance of shares to management, the board, or trustees, they will need to consider how their participation could be ensured. Even if the donor has not “moved on,” the typical grant agreement does not address this type of situation and would not provide the donor with clear legal standing to object to a proposed sale or grant to insiders of shares in the transformed institution.

The problems presented by the transfer of an NGO’s assets to private individuals would not necessarily prevent others (for instance, outside investors who are interested in rewarding management and high-performing employees) from funding the grant of shares or other bonus compensation. In fact, various donors have been involved in providing direct funding for the purchase by employees and clients of shares in transformed institutions. However, the same problem



would exist if outside investors provided the funding and considered such compensation a part of the total value of the MFI, thus reducing the shares or funds received by the NGO.<sup>25</sup>

**3. Employees.** For some NGOs, one of the benefits of a transformation is the possibility of offering employees ownership in Newco. And the awarding of shares to NGO nonmanagement employees is less controversial than the awarding of shares to management and board members because nonmanagement employees typically do not control the transformation process nor determine whether and how many shares will be awarded to whom.<sup>26</sup>

Employees of a transforming NGO MFI have become owners of the transformed institution either through the direct purchase or grant of stock or an employee stock ownership plan (ESOP). Typically, shares are awarded or allocated for purchase to employees based on objective factors, such as length of time employed and seniority. In some transformations, only employees being transferred to the new institution were brought in as owners.<sup>27</sup> In a number of transformations, the NGO or donors have provided funds for the employees' purchase of shares or have funded an ESOP; in others, the employees have had to self-finance their purchase of shares, either at full price or at a discount.

While there has been much discussion recently of MFI transformations and ESOPs, they are in fact not common in MFI transformations.<sup>28</sup> (See Box 5 for a brief description of three different ESOPs.) First, many developing countries have no convenient legal framework for ESOPs.<sup>29</sup> Second, some NGOs

have decided against bringing employees in as shareholders out of concern about blurring the lines among governance, management, and employees. In general, this concern reflects a more Anglo-American perspective on governance. In fact, such risk may be minimal: if shares are owned directly, it is unlikely that employees will influence governance much unless they (i) hold a significant number of shares in the aggregate and (ii) organize themselves and their voting. If employees own only nonvoting shares, their ownership is purely a profit-sharing plan and does not affect governance of the institution. Even if employees hold shares through an ESOP, whether this translates into a role in governance depends on the specifics of the ESOP. For instance, the K-Rep ESOP holds a 10 percent interest in the bank but is not represented on the board even though all other investors with at least 10 percent are represented.

**4. Clients.** In a few transformations—SHARE Microfin (India), SKS (India), CARD (the Philippines)—the NGO has brought in clients as owners. (In the case of CARD, described in Box 6 on page 10, clients hold nonvoting preferred shares.) In some instances, the NGO issued shares to clients in exchange for their savings. (See Box 7 on page 11 for a description of the SHARE Microfin transformation.) Some have queried whether investing savings in an illiquid asset is an advisable use of clients' limited funds, especially given the greater risk of loss when compared to the alternative: a deposit in a savings account.

Recently, in India, some NGO MFIs have had clients hold shares in the NBFC—either directly or through mutual benefit trusts—allegedly without the clients' knowledge. It appears that, in some instances, this may have been done to sidestep a provision in the income tax law stating that a charitable organization loses its tax-exempt status if it makes an equity investment in a for-profit private sector company (although there is an exemption for scheduled banks and cooperative banks).

### Box 5. Transformations and ESOPs

In the case of K-Rep, the NGO set aside 10 percent of the bank shares for purchase by the ESOP, Kwa Cooperative. A CGAP grant financed both the establishment of the cooperative and the initial purchase of shares. Shares were allocated to employees depending on seniority and their time with K-Rep. However, it was structured as a matching grant: one share was granted for each share purchased. In contrast, Banco ADEMI and CARD Rural Bank awarded shares to staff. Staff of Banco ADEMI hold 20 percent through an ESOP and have a seat on the Board. CARD assigned preferred nonvoting shares to staff.

## Corporate Governance

The term "governance" refers to a system of checks and balances put in place to ensure that decision-making power is properly distributed among management and the governing body and that the resources of an organization are managed well. A key aspect of good corporate governance, whether for an NGO or a company, is the active involvement of the board of

### Box 6. CARD Bank and Client Ownership

CARD Rural Bank is an example of a transformation that involved the issuance of both common and preferred shares. The founder of the Philippine NGO CARD Inc. set out to create a bank owned and managed by landless rural women. The objective was to have members of the NGO own 75 percent of the bank and have the NGO own the balance. (Because of the low minimum capital requirements applicable to rural banks, CARD did not need to raise equity from outside investors.) As part of the transformation transaction, the NGO board set aside P7.5 million (approximately \$250,000 in 1997) of clients' "center fund savings"—mainly compulsory savings as well as penalties and interest income—to be used by qualified members to purchase their shares. Members were permitted to purchase only as part of a group that met certain requirements.

*Based on description in Campion and White (1999).*

NGO client members (as well as staff) were issued preferred shares instead of common shares. Campion and White (1999) attribute this decision to two factors: (i) holders of common shares would have been required to be present for the annual meeting, which would be a very high burden for many and (ii) common shares are a riskier investment than preferred shares. (According to the Campion and White paper, bank management believed that members' input would be taken into account through the NGO's meetings.) The shares owned by NGO members and staff are nontransferable and are assigned to another member or staff on departure or death of the holder. In essence, the members' and staff's shareholdings represent a form of profit-sharing plan.

directors. The board must provide proper guidance to management regarding the strategic direction for the institution and oversee management's effort to move in this direction. 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.<sup>30</sup>

If the NGO is not the sole owner, it will no longer have control of the board unless the minority shareholders cede control (or are otherwise inactive) or the constituent documents of the transformed institution provide that the NGO will control the board. If the NGO is a minority shareholder, it will have to adjust to a more limited role in determining the direction of the company. Even if the NGO is the sole owner, it will have to adjust to new measures of accountability, especially if it becomes subject to regulatory oversight or supervision. The change in accountability is significant and requires listening to and accommodating new stakeholders' interests.

**1. Board of Directors.** The Board of Directors plays an important role in determining how the new for-profit institution will grow, be profitable, manage its risk, and at the same time, preserve 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. The main aspects include the size

and composition of the board as well as members' terms.<sup>31</sup> How many board seats should there be (the number may be limited, both in minimum and maximum, by law) and how will they be selected/elected? What will the different shareholders' voting rights be? Do minority shareholders have a statutory right to elect a director? Will there be independent directors (i.e., individuals who don't themselves have an ownership interest and aren't tied to any of the owners)?<sup>32</sup> Individual board members and/or senior management may be subject to the approval of the regulator, based on objective or subjective factors. "Fit and proper" standards commonly address trustworthiness (primarily, absence of a criminal record or involvement in failed financial institutions) and professional experience in finance.

In addition, an NGO has to consider legal requirements regarding the board's powers, residency/nationality, and matters requiring approval by more than a simple majority.

**2. Shareholders' Agreements.** 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. A shareholders' agreement can provide for the post-transformation relationship among shareholders, including governance matters, such as supermajority approval, board representation, preemptive rights, and transfer restrictions.<sup>33</sup>

### Box 7. SHARE Microfin and Client Ownership

In 1999, after 10 years of operating as a nonprofit, the Society for Helping and Awakening Rural Poor Through Education (SHARE) completed the first transformation in India of an NGO into a nonbank finance company (NBFC): SHARE Microfin Limited. On transformation, 99 percent of the paid-up capital of \$1.2 million was contributed by over 26,000 poor women clients via the conversion of their compulsory savings into shares. For three consecutive years, clients received an annual dividend of 10 percent on the shares. In 2005, SHARE Microfin was required to return clients' savings. In part to effect this, the shares held by clients and by mutual benefit trusts (which held the shares on behalf of clients) were purchased by staff and other individuals known to staff (but not involved in the NGO's activities) as well as the NGO promoters at a

premium of 50 percent. Because of the requirement that SHARE Microfin return all clients' savings as well as other factors affecting its financial situation, the institution faced a severe liquidity crisis.

In May 2007, a Dubai-based privately owned finance firm, Legatum Capital, purchased a majority interest in the NBFC for \$25 million (Rs100 125 crore).<sup>\*</sup> Staff sold 18 percent of their shares to Legatum; the balance of the Legatum investment constituted a fresh injection of capital (i.e., the purchase of newly issued shares). Today, SHARE Microfin is owned by Legatum (65%), Aavishkaar Goodwell (5%), the NGO promoters (5%), and approximately 3,100 other staff members and other individuals (25%).

<sup>\*</sup>Source: SHARE Microfin Limited. The Legatum investment constituted the second major investment by a foreign investor in an Indian MFI.

- Typically, most matters are subject to majority approval. The agreement can specify that certain matters will be subject to supermajority approval or veto rights. These could include appointment and removal of senior management, material transactions (including material borrowings), dividends, and related party transactions. Any change to the provisions specifying supermajority approval also should be subject to supermajority vote.
- The shareholders' agreement typically would specify the number of board seats, the number of directors appointed by each shareholder, and how this will change if an owner's equity stake changes, committee membership, and whether there will be independent board members and, if so, how they will be selected.
- Preemptive rights of any new share issuance (i.e., capital increase) entitle shareholders that are party to the agreement to purchase their respective allocations (determined by their percentage ownership) of any new share issuance and are intended to prevent dilution of initial shareholders.
- To preserve the relative ownership and control existing on transformation, shareholders may agree to include transfer restrictions applicable in the first few years post-transformation. Thereafter, owners may have a right of first offer or right of first refusal.

However, in some countries, shareholders' agreements are unenforceable. In other countries, the law governing companies subjects certain matters to approval by minority shareholders or prohibits a requirement of unanimous approval for certain matters. These provisions usually cannot be overridden by a private shareholders' agreement.

**3. Arm's Length Transactions.** Dealings between the NGO and the transformed institution should be at arm's length, whether or not the NGO is the sole shareholder. Regulations already may require arm's length transactions between related parties. A classic example of what can happen when a parent and subsidiary fail to deal with each other on an arm's length basis occurred in the transformation of Colombian NGO Corposol into the finance company Finansol. Although Corposol transferred to Finansol a loan portfolio of over 25,000 borrowers of excellent quality, a proven methodology, and operational profitability, Finansol's financial position deteriorated rapidly due to, in large part, the flawed relationship between the two entities.<sup>34</sup> Finansol's statutes mandated that majority control of its board remain with Corposol. The two organizations used this control to side-step requirements applicable to regulated financial institutions.<sup>35</sup> By the time the bank supervisor became aware of the situation, loan collection had deteriorated to the point where Corposol was insolvent and could be rescued only by converting into equity its unpayable debt to a government wholesale fund.

Perhaps one of the increasingly common (and problematic) examples of inappropriate decision making by an NGO that controls its transformed entity is the NGO's resistance to raising new equity capital for the transformed institution out of fear of losing control.

## Use of Grant Funds

In general, grant funding provided to nonprofit institutions engaged in microfinance is intended to benefit poor and low-income people by supporting the development of institutions that provide them with access to formal financial services. Grants may provide non earmarked core support or may be directed to loan capital, TA, infrastructure (e.g., management information systems), or legal and other support services. The intent of these grants—whether they come from a bilateral donor, multilateral donor, or a private foundation—is not to benefit private owners of microfinance companies.<sup>36</sup> However, a transformation of an NGO into a for-profit company may effectively involve the transfer by the NGO to the new company of grant funds although the NGO—if it negotiates well and knows its own value—should receive fair market value for its assets, including those assets built out of grants. The permissibility of such a transfer depends on the following factors:

- the specifics of the transformation transaction
- the terms of the grant agreement (in particular, the stated purpose of the grant) and whether the grant agreement has expired
- the identity of the grantor
- local law

**1. Historical Treatment of Grant Funds in Transformations.** Until recently, donors did not contemplate the possibility of an NGO transforming into a for-profit company, so their policies did not address a situation in which the grantee would transfer its assets to a company with private owners. Thus, the treatment of grant funds in NGO MFI transformations depends largely on the particular donor, although many donors themselves have not been consistent in their approach. The lack of consistency reflects (i) an evolution in donors' internal discussions over time, (ii) inconsistent approaches of donors' various field offices because of the absence of a policy articulated

by headquarters as well as the particular convictions of grant officers, and (iii) the department from which the microfinance program originates (e.g., private sector development, rural development, etc.).

Today, most donors feel the primary purpose of grant funds is to increase the poor's access to financial services and that if funds are used to create a sustainable institution (i.e., the transformed institution) that is able to serve more of the poor, then the funds have accomplished their purpose. This is *not* to imply that donors favor 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. Even so, some NGOs have viewed the funds as restricted post-transformation and have taken steps to ensure grant-sourced funds are effectively kept by the NGO (e.g., Mercy Corps' interest in XAC Bank). Some donors require grant funds for loan capital either to remain with the NGO or to "stay in the country"—which typically means that the NGO must, on transformation, own a percentage of the company equal to the grant funds divided by the total initial capital of the transformed institution and be required to retain such ownership position indefinitely (e.g., the Ugandan Women's Finance Trust transformation).<sup>37</sup> Other donors place no restrictions on NGOs in transformation.

**2. The Transformation Transaction.** Typically, the NGO transfers its assets in exchange for cash, debt, or shares. If the NGO is the sole owner of the new MFI, then the benefit of the grants has not been transferred to private individuals. If there is more than one owner, but the NGO retains ownership of assets equivalent to the aggregate value of the grants received, then there should be no issue. Even if the NGO transfers all of its assets, if they are properly valued and the NGO receives shares of equivalent value, then the NGO effectively retains the benefit of the grants, which it will presumably continue to use for some public purpose. In this last case, the other owners of the transformed institution will reap the future benefits (in the form of dividends) of the microfinance business that was developed with the assistance of the grants, but this should not present any legal problem nor an objection on principle *if the assets (tangible and intangible) were properly valued on transfer.*

Some argue that transformed MFIs often have been undervalued because of their own lack of experience and lack of understanding of the sector among consultants performing valuations.<sup>38</sup> On the other hand, determining a “fair market valuation” is thorny in situations where there are in fact no truly commercial funders who are willing to invest because the sector is perceived as too new and risky. The absence of a standard objective valuation method for MFIs creates particularly serious conflict-of-interest issues if the NGO principals who are negotiating the price of the NGO’s assets stand to gain personally from the transformation.

**3. The Grant Agreement.** The confusion about the proper resting place of grant funds in the case of a transformation is largely a result of the absence—until recently—of provisions in grant agreements specifying who would own what on transformation donor grant agreements. This is because most donors did not anticipate that NGO MFIs would transform into for-profit companies and therefore did not plan for it. Ideally, each donor should be clear about its view on treatment of grant funds and grant-sourced funds post-transformation, and each grant agreement should be specific about ownership and restriction of such funds on transformation. Some donors have started adding general language that would apply to a transformation in their grant agreements.

Grant agreements usually contain conditions for the use of the grant over a specified term. If a grant is ongoing (i.e., it has not been fully disbursed or it has been fully disbursed but the term of the agreement has not yet expired), then the grantor can enforce the terms of the agreement and ensure the grant is being used according to its stated purpose. If the grantor is a tax-exempt entity, the grantor is legally obliged to ensure the grant funds are being used for the stated purpose. Tax-exempt donors may have made grants to NGO MFIs with the understanding that the grantee would be prohibited under the law of the MFI’s country from distributing funds or other assets to individuals, or using them for other nonpublic purposes, and that local regulators would enforce this.

However, if the agreed grant term expires and the NGO subsequently distributes or uses assets

inappropriately, then the donor likely would not have a legal basis for reclaiming the funds.<sup>39</sup> (Many donors would not want to reclaim the funds for various reasons, including—with respect to U.S. foundations—tax requirements on meeting an annual minimum distribution level.) Notwithstanding this, there have been several instances in which donors, NGOs, and potential investors in transformations have insisted on incorporating mechanisms that would ring-fence any grant funds and prevent their transfer to private individuals.<sup>40</sup> (Ring-fencing refers to the practice of placing funds in a separate and isolated facility or otherwise limiting their use or exposure to risk.) The argument has been that retained earnings may end up in private hands but not the grant itself.

If the grant is made to a network with the intent that the funds be transferred to one or more NGOs in the network, then the network may try to reclaim the funds on transformation or at least assert an ownership interest in the transformed institution. For this reason and others, grant agreements should be explicit about the treatment of grant funds in a transformation.<sup>41</sup>

**4. The Identity of the Grantor.** The question of the rightful ownership and resting place post-transformation of an NGO’s grant funds triggers strong and varied reactions from the many camps involved.

**Bilateral Donors.** Perhaps the most heated discussion involves grants by a bilateral donor, because the recipient country expects the money to remain in country.

When NGO MFIs first started transforming, bilateral agencies debated whether their grant funds should be retained by the NGO.<sup>42</sup> This is easy to do when the NGO is the only owner of the transformed institution and continues to engage in microfinance or microfinance-related activities, but eventually there will be a problem if the NGO decides to sell all or part of its ownership interest. As MFIs started bringing in new owners, agencies began to hear complaints from various stakeholders, including government officials and citizens of the recipient country. The primary argument was that the grant funds belonged to the people of the recipient country and that it was a violation of the grant’s *intent* for the benefit to be

transferred to private owners.<sup>43</sup> Many voiced concern regarding the flow of funds out of the country because of foreign ownership in the transformed institution.<sup>44</sup>

Today, most bilateral aid agencies make it clear that repayment of grant funds on transformation is not required, and most do not impose conditions or restrictions on an NGO's transformation. However, some still argue that all grant funds should "stay with the NGO."<sup>45</sup> This is easier to do if the NGO continues operating, either engaging in microfinance or other activities, such as business development services. However, there will still be a problem if the NGO wishes to divest entirely or in part, as evidenced by the recent initial public offering (IPO) of shares of the Mexican Banco Compartamos. Compartamos funding sources included grants from various donors, including a bilateral (USAID). As a result of the IPO (which involved solely the sale of shares by the original shareholders), Compartamos shareholders realized huge profits—approximately \$300 million in total. Most of these profits accrued to shareholders who were themselves public-purpose not-for-profit institutions, but a third of the profits went to private individual investors.<sup>46</sup> Among other protestors were U.S. taxpayers.

**Local Government Donors and National Wholesale Funds.** The situation may become complicated and political when an MFI has received government funding. Specifically, the government may resist the transformation because of concerns regarding the appearance (or reality) of public funds benefiting private individuals. In addition, some government actors may resist losing control of an institution that it helped. This may be an even greater problem in socialist countries or countries that have a socialist agenda or orientation. For example, Agrocapital in Bolivia is a nonprofit rural lending foundation that commenced as a project of the government of Bolivia with the assistance of ACDI-VOCA. When Agrocapital initiated efforts to convert into a private finance company, the finance ministry and a part of the bank superintendency refused, stating that the capital of Agrocapital belonged to the public, notwithstanding that only a portion of the funding came from the government.

National wholesale funds (apexes) may have internal restrictions regarding the use of grant funds, or they may insert such restrictions into the grant agreements. Afghan MFIs that received grant funds from the apex MISFA have agreed, pursuant to negotiations with MISFA and the government, to return the grant funds received from MISFA in the event of a transformation to a for-profit company, and to include such a provision in their own articles of association.

**Private Tax-Exempt Donors.** The treatment of grants from private tax-exempt donors presents different problems. A U.S. tax-exempt foundation,<sup>47</sup> when making a grant to a foreign NGO, must be sure that under local law (i) the NGO is not permitted to distribute funds for the private benefit of its members or others and (ii) the NGO is required to transfer its distributable assets to another charity in the event of liquidation. A U.S. foundation may make a grant directly to a for-profit entity; however, it must ensure both that the grant-financed activities are for charitable purposes and that the benefit will be passed on to the charitable recipient and not inure to the owners of the company. In a transformation of a NGO grantee, the U.S. foundation will generally accept the transaction provided that the transformed entity continues serving poor and low-income clients.

**5. Local law.** Local law may prohibit the transfer of grant funds that is effected by a transformation, even if due consideration is paid. For example, a new Uzbek resolution provides that a microfinance organization is entitled to tax-exempt treatment with respect to funds received from a donor only if the funding agreement stipulates that the donated funds and interest income earned thereon remain the property of donor organization. In other countries, lawyers have suggested that grant funds received by NGOs—regardless of the source—are received "in trust" for the benefit of the people and, as such, may not be distributed to private individuals.



## The Long Term—Ownership and Mission

Will anyone ensure the NGO's original mission is pursued once the NGO no longer controls Newco? Will there be remaining shareholders with an equally strong interest in pursuing the original mission?<sup>48</sup>

**1. NGO Divestiture.** Many NGOs, including some INGOs, plan ultimately to divest. Some NGOs and INGOs may wish to divest: an INGO may have decided that microfinance will not be a part of the organization's core ongoing activities; the MFI simply may not be doing well. Occasionally, applicable law requires an NGO to divest itself of any stake in a transformation to a new for-profit institution. Even if the NGO doesn't plan to divest, future ownership and control can be unpredictable unless the initial investors all agree that their shares may not be sold (nor new shares issued) other than to each other. (See Box 8 regarding the surprising purchase of Prodem FFP by the Venezuelan development bank.) And if a transformed institution has multiple owners, the NGO's interest may be diluted as the institution brings in new shareholders to increase its capital base.<sup>49</sup> The transformed institution eventually may be owned by shareholders whose objectives differ significantly from those of the NGO's founders.<sup>50</sup> The starkest illustration of this occurs when there is a public offering of shares. See Box 9 for a description of the evolution of the shareholding of Banco Compartamos.

For some observers, this uncertainty regarding the future course of transformed MFIs raises serious questions about the direction of microfinance.

### Box 8. The Case of Prodem FFP

The Bolivian Prodem FFP was established in 1999 by the NGO PRODEM. In February 2008, the Venezuelan national development bank purchased a majority interest in Prodem FFP. (This transaction followed a year of negotiations between Prodem and another Venezuelan government-owned bank, Banco Industrial de Venezuela or BIV.) The purchase price was between 1.8 and 2.5 times book (depending on the identity of the seller), with employees being paid the higher price. Many expressed concern with the initial proposed purchase by BIV and of the risk the Venezuelan government would cause Prodem to charge below-market loans. The outcome remains uncertain.

### Box 9. Compartamos

Compartamos began as an NGO in 1990 and transformed into a limited-liability finance company (Financiera Compartamos S.A. de C.V. SOFOL) in 2001. At the time of transformation, the company had 18 owners: the NGO, ACCION Gateway Fund, ProFund, and 15 individual Mexican shareholders. In 2006, Financiera Compartamos converted into a joint stock company and received a license to operate as a commercial bank. In 2007, Banco Compartamos had an IPO of shares pursuant to which existing shareholders sold approximately 30 percent of their holdings. The new shareholders were primarily mainstream investors (i.e., international fund managers) and other commercial investors.

**2. Protecting the Mission.** One way to protect the mission is to include a statement in the transformed institution's constituent documents and/or in a shareholders' agreement and to require unanimous shareholder agreement for it to be changed. However, local law sometimes prohibits unanimous consent requirements, and some jurisdictions will not enforce shareholders' agreements at all.

Another approach is to require initial shareholders (who may be selected because of interest in the mission) to hold their shares for a specified period. Such transfer restrictions need to be clearly set forth in enforceable agreements, to avoid problems. (In the case of the Bolivian Eco Futuro—formed by the “merger” of four NGOs—one of the founding NGOs unexpectedly decided to sell its shares post-transformation.)

Or, instead of imposing an outright prohibition on the sale of shares, the founders of the transformed institution can agree to subject new owners to the approval of existing owners and provide the initial owners with a right of first refusal (i.e., if an owner finds a purchaser, the other owners are first given the right to purchase the shares on the same terms, and any new shares issued by the company are offered first to existing shareholders).<sup>51</sup> However, a right of first refusal may reduce the value of the shares because of the unpredictability of the transaction closing. The extent to which the value is reduced depends in part on the prescribed period during which the existing shareholders must act or lose their right to purchase the shares.

### 3. Asset-Stripping and Expert Valuations.

Asset stripping refers to a variety of schemes that inappropriately move assets from the NGO into private pockets.<sup>52</sup> This can happen if the NGO's business is transferred to a transformed institution with private shareholders at well below the business's likely market value, followed by a sale of the assets or the shares in the transformed institution at a higher value. (It will not be unusual for the business to become more valuable after the transformation than it was before, so the fact that assets or shares may eventually be sold for more—even far more—than their purchase price does not necessarily mean that illegitimate asset stripping has occurred.) To avoid asset stripping, it is essential that the NGO get a competent independent valuation. A recent survey of Council of Microfinance Equity Funds listed 10 qualitative valuation factors (in order of importance):<sup>53</sup>

- quality of senior management
- sophistication of the MFI's governance and board structure
- long-term planning and vision as indicated by a detailed business plan
- financial performance to date
- customer base and portfolio quality
- level of competition and the MFI's position in the marketplace
- regulatory environment and whether the MFI is able to offer a broad range of products (whether as a bank or otherwise)
- MFI's future capital requirements and existing sources of funds
- local political and macroeconomic factors
- currency risk

In the context of a transformation, some of these factors may change depending on how the transaction is structured. For instance, senior management may change (either voluntarily or because of legal requirements); the governance and board structure will likely change; the transformed institution may very likely offer products additional to those offered by the NGO.

Other circumstances also can affect post-transformation share value. First, the buyer of a *controlling interest* would normally pay a premium. Second, liquidity—whether

there is a ready market for the company's shares—is also likely to influence the price. Third, social investors may be willing to pay more than others for shares of a company whose mission they want to support.

## Conclusion

Transformations—especially those involving the introduction of new owners and/or the establishment of a regulated financial institution (in particular, a depository institution)—have often required more time and been more costly and disruptive than planned. However, there has been significant upside to some transformations because they are permitted to offer additional services, access commercial capital, and work toward better governance. Some of this upside can be traced specifically to the introduction of outside owners, who may bring financial expertise, important connections to providers of capital, and the potential to contribute to effective governance. There are also risks, including in particular the possibility of mission drift.

The upsides and downsides are determined in large part by the selection of outside owners and their involvement in the governance of the institution, as determined by their type of ownership and their availability. (Outside owners who don't have voting rights have little if any say in the direction of the company.) For this reason and others, it is crucial that the NGO familiarize itself, well in advance of transforming, with the legal and financial considerations that may affect the NGO's selection of outside investors. Potential investors also will want to familiarize themselves with the limits they will be subject to before entering into negotiations. These issues can be especially complicated when more than one NGO is transferring assets to the new company.

Almost without exception, participants in past MFI transformations have encountered unexpected restrictions and problems, often with serious negative consequences. This paper has tried to flag the most important issues and pitfalls *related to ownership* as revealed by those experiences. We believe that careful investigation of these issues in the specific context of each future transformation will pay a big return in terms of smoother, quicker, less expensive, and more effective transactions.

## End notes

- 1 As of December 2007, there had been at least 84 such transformations in more than 30 countries. See Annex 1 for a chart of transformations. (This list does not include transformations from or into a cooperative or other similar type of member-owned organization.) Many of these transformations are considered simple because they do not involve outside investors.
- 2 See Annex 2 for a list of persons consulted. These people consist primarily of microfinance practitioners, founders and funders of MFIs (both those that transformed and those that did not), and other experts who have been involved with, advised on, or are otherwise familiar with NGO MFI transformations.
- 3 Ledgerwood and White (2006) is as close to a “how to” manual as one could ask for and is an excellent resource and guide for any institution considering transforming.
- 4 See Rosenberg (2007) for a discussion of the tensions between social and commercial objectives.
- 5 Approximately half of the transformed institutions are credit-only institutions. For example, in Peru, which has the highest number of transformations of any country (see Annex 3 for a list of transformations by country), nine of the 10 MFIs transformed into nondepository regulated institutions.
- 6 In most cases, engaging in these activities would necessitate being licensed and prudentially regulated and supervised by a financial regulator, such as the central bank or the ministry of finance. In contrast, in most countries, credit-only institutions either are not regulated or are subject to only minimal nonprudential regulations.
- 7 Of 11 transformations completed in 2007 (see Annex 1), seven were mandated by new legislation. All seven resulted in the establishment (at least initially) of for-profit institutions engaged in credit-only activities.
- 8 The process of selecting investors is crucial to the success of the transformed institution and the continued pursuit of the NGO’s social mission. However, because this topic has been covered by various papers and books, it is not discussed in this paper. For a detailed discussion, see Ledgerwood and White (2006).
- 9 At least one INGO has set up a wholly owned for-profit company and another has set up a nonprofit that, in each case, owns or will own all of the INGO’s MFI subsidiaries.
- 10 Although cooperatives and other member-owned institutions (e.g., credit unions, *mutuelles*) play an important role in microfinance in certain countries, transformations of such institutions are not addressed in this paper. The member-owners of such institutions typically have only one vote each regardless of the equity contributed. For this and other reasons, transformations involving these institutions present issues that are quite distinct from those associated with NGO transformations.
- 11 Rarely are owners of unregulated finance companies subject to maximum ownership limitations. Company law may require that there be more than one owner, but the ownership interest of new owners could be nominal and, in most cases, the requirement would not prohibit owners from being related or part of a group. In Kyrgyzstan, the MFI law allows certain institutions to own 100% of an MFI; however, the company law requires a joint stock company (JSC) to have at least one minority shareholder (who can be related to or in a control relationship with the majority shareholder) to hold at least one share.
- 12 Based on the survey, it appears that with exception of Canada, Luxembourg, and Norway, developed countries do not have bank ownership limitations.
- 13 For example, in Uganda, the maximum ownership requirements are 49% for banks and 30% for microfinance deposit-taking institutions.
- 14 In some countries, competition law also might place restrictions on the ownership by one financial institution of another financial institution or prevent the owner of one MFI from holding a significant interest in another MFI.
- 15 For example, if no more than 30% of the initial capital requirement of \$1 million may be contributed in noncash items and the loan portfolio is valued at \$600,000, then the NGO could contribute half of the portfolio as capital and would need to invest an additional \$700,000 in cash (if it were permitted to own 100%) or find investors to contribute all or part of that amount. If the NGO wished to have a majority interest, it would need to contribute at least \$200,001 in cash. In some cases, the NGO has borrowed funds to capitalize the new institution, although this often is prohibited by local law.
- 16 According to a 2007 survey of 143 countries, 57 countries permit the initial injection of capital or subsequent capital injections to be made with assets other than cash or government securities—i.e., possibly a loan portfolio (Caprio, Levine, and Barth 2007).
- 17 If the transformation involves bringing in new shareholders, it may be in the NGO’s best interest to hire a valuation expert to value the entire business as opposed to merely the loan portfolio. See O’Brien (2006) arguing that the absence of valuations has resulted in MFIs being sold at prices below what they should be commanding.
- 18 This paper does not address labor law issues that may arise in connection with the termination of employee contracts by the NGO and rehiring by the transformed institution.
- 19 A sale may be subject to a transaction tax while the exchange may be subject to a capital gains tax. A donation by the NGO of the loan portfolio (to avoid taxes on a sale or exchange), if permitted under local NGO law, may raise other issues: the transformed institution may have to pay income tax based on the value of the loan portfolio; if the NGO is tax exempt, the tax authorities may view the donation as violating the rules regarding private benefit.
- 20 The loans remained on ACP’s loan book until repaid, but MiBanco administered them at no cost. On each loan’s repayment, MiBanco would issue the new loan.
- 21 Bank regulators divide bank capital into two (and sometimes three) tiers for purposes of calculating a bank’s capital adequacy ratio. In all countries, Tier 1 capital (or core capital) consists of equity capital (issued and fully paid ordinary shares/common stock and noncumulative perpetual preferred stock, but excluding cumulative preferred stock) and disclosed reserves (i.e., retained profits minus accumulated losses). Tier 2 is supplementary capital. At least 50% of the capital adequacy requirement must be satisfied by Tier 1 capital. (Many countries follow the Basel requirement that a bank’s capital must be equal to or greater than 8% of the bank’s risk-weighted assets.)
- 22 See O’Brien (2006) for a discussion on valuing an MFI (as opposed to its components).
- 23 Such an arrangement may, for those in positions of management or control, ultimately create skewed incentives. For instance, a manager may be more inclined to run the NGO so that it has maximum value as opposed to considering institutional growth (and sustainability) as well as the benefits to its clients and potential clients. The arrangement could theoretically present the manager with a conflict of interest between her fiduciary duty to the organization and her personal financial interest.
- 24 In one recent transformation that is still under way, the INGO—which for years was not involved with the NGO it had helped found—was unaware of the transformation or the protracted negotiations between the NGO’s lenders and NGO management and board members regarding the issuance of shares to management and board members.
- 25 The perception (if not the reality) of the NGO being swindled would be hard to dispel if those receiving the bonuses were involved in negotiating the transaction on behalf of the NGO.
- 26 However, the awarding by the NGO of shares to employees who do not pay for the shares or pay below market value raises the same concern discussed in “Management and Board Members” (page 8) regarding the transfer to private individuals of assets intended to benefit the public.

- 27 While typically an ESOP would be established for employees of the *transformed institution* (including, if applicable, employees who had worked for the NGO), in the case of K-Rep in Kenya, staff who were not transferred over to the transformed institution were permitted to become owners through the ESOP.
- 28 The following five transformed institutions have established ESOPs: Banco ADEMI (Dominican Republic), ACLEDA (Cambodia), Hattha Kaksekar (Cambodia), XAC Bank (Mongolia), K-Rep Bank (Kenya).
- 29 The handful of ESOPs formed in NGO MFI transformations have been structured in various ways: as trusts, cooperatives, and companies.
- 30 At least one country—Afghanistan—has the unusual legal situation in which a nonprofit is formed as a share company. However, the shareholders are owners in name only because they have no rights to receive dividends or sell their shares.
- 31 At least one transformation has been stalled because of a disagreement between the INGO founder and the executive director (together with the NGO board members) regarding the future composition of the board of the transformed institution. The NGO brought a legal claim and as of the publication of this paper, the matter remains unresolved and with the local courts.
- 32 In some countries, independent directors are required by law, especially for regulated institutions.
- 33 Much of this discussion draws on Cleary, Gottlieb, Steen, and Hamilton (2006).
- 34 See Inglesias and Castello (1997).
- 35 Specifically, Corposol, which was an NGO and not a regulated financial institution, kept a portion of the loans on its books. The two institutions developed a practice of shifting portfolios between themselves, including delinquent portfolios, hiding this practice from regulators and misrepresenting both institutions' financial positions.
- 36 This discussion does not apply to grants that have been made specifically to finance investments in transformed MFIs. For example, CGAP has funded the establishment of an ESOP as well as the purchase by the NGO, clients, and staff members of shares in transformed institutions. USAID has funded the purchase by a TA provider of shares in transformed MFIs in the belief that the TA provider would strengthen the institution through its involvement as owner and board member.
- 37 This requirement is reminiscent of what happened in the United States in the 1980s when the private sector began acquiring nonprofit healthcare institutions (which were laden with cash). In sum, the State Attorneys General and local communities began looking into these acquisitions and determined that the acquirers would have to facilitate the creation of spin-off "conversion" foundations that would hold the "equity" that had been contributed by government agencies and foundations (and generated by the nonprofits' tax exempt status) and such funds would be used to benefit the community. One example of such a foundation is the California Endowment, established after a for-profit acquired Blue Cross Blue Shield in California.
- 38 See O'Brien (2006).
- 39 An employee of a significant donor involved in many transformations of NGOs found it highly problematic that when grants were closed out there had not been an exchange of letters indicating that the NGO was entitled to keep the grant funds and other assets.
- 40 For instance, the Peruvian NGO ACP Inversiones y Desarrollo (ACP), which transformed in 1998 into the commercial bank MiBanco, was required to ensure the donated funds remained in a "like institution" even though most of the grants had expired by 1990. As of February 2008, when MiBanco announced its plans for an IPO, ACP remained the majority shareholder.
- 41 One significant INGO plans to require each affiliated MFI, before transformation, to trace its grant funding and verify that donors have no ongoing claims to those funds.
- 42 USAID initially argued—with respect to its microfinance activities in the Caucasus—that an NGO MFI's loan portfolio was a fixed asset, like a car, and the NGO had to approach the agency for disposition of the asset. In 2000, the USAID general counsel announced that after money was "recycled" once through the loan portfolio, it lost its identity and could not be recaptured. This does not mean, however, that USAID has not, since such announcement, required a transforming NGO to ring-fence the USAID grants.
- 43 In several instances, bilateral aid has been directed specifically to support the transformation process (e.g., to fund a transformation manager or to fund the technical steps of transformation), to capitalize the new institution or to fund the purchase of shares in the transformed institution by a network or TA provider. These grants are less problematic because they are made specifically to facilitate transformation.
- 44 This argument is more powerful with respect to grant agreements that provide that grant funds may not be transferred from a local NGO operation in a particular country to the NGO's international headquarters.
- 45 One agency has attempted to require that its grant funds become statutory capital of the transformed institution. Statutory capital cannot be distributed. Interestingly, in one transformation, it was the new investors who required ring-fencing of the grant funds because they did not want to be seen as benefiting from grants intended for the citizens of the country.
- 46 See Rosenberg (2007).
- 47 The illustration regarding a U.S. foundation and other references in this document to U.S. tax-exempt institutions reflects the reality that a large portion of transformations involve U.S. tax-exempt funders and founders.
- 48 The experience of Compartamos in Mexico suggests that having socially oriented nonprofit investors doesn't guarantee that poor people's interests will take priority. Despite the fact that Compartamos was controlled by a Mexican NGO, an INGO, and an international development finance institution, it funded much of its rapid growth by charging poor Mexican women interest rates that were much higher than its costs, even after it had access to other sources for this funding. See Rosenberg (2007).
- 49 This was the case with Mercy Corps and the Mongolian XAC Bank. Mercy Corps wished to retain a controlling interest in the bank out of concern about the future course of a commercial institution controlled by commercial institutions. Ultimately, as a result of the bank bringing in new shareholders, Mercy Corps' ownership was reduced significantly. Today, it no longer holds a controlling interest in the bank.
- 50 This risk of mission drift may introduce a tax complication for tax-exempt owners that bring in for-profit shareholders. At least one NGO has explored introducing language into the constituent documents of the transformed institution or into a shareholders' agreement stipulating that, in the event of a conflict between serving the poor (or the specified clientele) and maximizing profit, the former will prevail. Whether this type of solution works (as well as whether there is a problem to begin with) depends on the law of the country of the tax-exempt institution. In the United States, a tax-exempt entity may own an MFI that doesn't serve a charitable purpose as long as the business is not substantial in relation to the tax-exempt entity's activities. However, any income (i.e., dividends) received by the tax-exempt entity from the MFI may be taxable as unrelated business income.
- 51 Existing shareholders may also have preemptive rights to purchase shares under local law.
- 52 In some countries (e.g., Bosnia, where the concern has been expressed not only by regulators but also by bilateral aid agencies), there is heightened concern that transformed institutions will be effectively stripped of their assets by management or others controlling the institution. This is likely largely because of past experiences with privatization of state enterprises (in particular, in certain countries in Central and Eastern Europe and in certain NIS countries) that essentially amounted to theft by a few individuals of institutions built through the work of many.
- 53 See O'Brien (2006).

## Annex 1

### TRANSFORMED NGO MFIS (through December 2007)

Year	Number of Transformations in a year	Name of Transforming Institution or Project	INGO or Other International Founder, Network, or TA Provider <sup>a</sup>	Name of New Financial Institution	Type of Formal Financial Institution	Country
1992	1	Promoción y Desarrollo de la Microempresa (PRODEM)	ACCION International	BancoSol	Commercial Bank	Bolivia
1993	1	Corposol (dissolved in 1996)		Finansol (restructured and renamed FINAMERICA in 1997)	Commercial Finance Company	Colombia
1994	1	Women's World Banking Ghana	Women's World Banking (WWB) network	Mutual Assistance Susu Savings & Loan	Savings and Loan Company	Ghana
1995	2	Procredito	Internationale Projekt Consult GMBH (IPC) (TA provider)	Caja Los Andes	Finance Company (FFP)	Bolivia
		AMPES		Financiera Calpiá	Finance Company	El Salvador
1996	1	AzerCredit (project)	World Vision International (WVI)	WV AzerCredit LLC	NBFI	Azerbaijan
1997	3	SEPAR		EDPYME Confianza	RFI	Peru
		CARE Peru	CARE	EDPYME EDYFICAR	RFI	Peru
		CARD		CARD Rural Bank	Rural Bank	Philippines
1998	5	FIE		FIE Fundo Financiero Privado	FFP	Bolivia
		ADEMI		BancoADEMI	Development Bank	Dominican Republic
		ACP	ACCION International (TA provider)	MiBanco	Commercial Bank	Peru
		Habitat Arequipa Siglo XXI	Habitat	EDPYME Crear Arequipa	RFI	Peru
		Habitat Tacna Siglo XXI	Habitat	EDPYME Crear Tacna	RFI	Peru
1999	7	FEFAD		ProCredit Bank	Bank	Albania
		PRODEM (rural portfolio)		PRODEM Fundo Financiero Privado	FFP	Bolivia
		IDEPRO, CIDRE, FADES, and ANED		ECO Futuro Fundo Financiero Privado	FFP	Bolivia
		K-Rep	World Education	K-Rep Holdings (which owns K-Rep Bank)	Commercial bank	Kenya
		Micro-Start program	MicroStart	X.A.C. Ltd. Co.	NBFI	Mongolia

Year	Number of Transformations in a year	Name of Transforming Institution or Project	INGO or Other International Founder, Network, or TA Provider <sup>a</sup>	Name of New Financial Institution	Type of Formal Financial Institution	Country
		Nirdhan	Save the Children	Nirdhan Utthan Bank Ltd.	Development bank	Nepal
		Fundacion Intervida		EDPYME Raiz	RFI	Peru
2000	8	ACLEDA <sup>b</sup>		ACLEDA Bank Plc.	Commercial Bank <sup>c</sup>	Cambodia
		FUNADEH (Fundación Nacional para el Desarrollo de Honduras)		Financiera FINSOL	Private finance company	Honduras
		SHARE	WWB network	Share Microfin Ltd.	NBFC	India
		Moznosti	Opportunity International (OI)	Moznosti	Savings bank	Macedonia
		CHISPA	MEDA	Corporacion Nicaraguense Financiera, S.A. (Confia) (see 2005 for transformation to bank)	Licensed financiera	Nicaragua
		Centro de Estudios Sociales Solidaridad		EDPYME Solidaridad	RFI	Peru
		Habitat Crear Cusco Siglo XXI		EDPYME Crear Cusco	RFI	Peru
		World Vision	WVI	EDPYME Credivision	RFI	Peru
2001	8	BRAC Holding		BRAC Bank	Commercial bank	Bangladesh
		Ennathian Moulethan Tchonnetat (EMT) (project)		EMT	NBC licensed mf company	Cambodia
		Hattha Kakesekar		Hattha Kakesekar Ltd.	NBC licensed mf company	Cambodia
		Vision Fund (program)	WVI	VisionFund Cambodia	Company – Nacional Bank license in 2004	Cambodia
		Asociacion Programa Compartamos	ACCION International (TA provider)	Financiera Compartamos S.A. de C.V. SOFOL (see 2006 for transformation to bank)	Limited liability finance company	Mexico
		XAC and Goviin Ekhlel Co. [merger] <sup>d</sup>	Mercy Corps and others	XAC-GE Group, a holding company which owns XacBank Ltd.	Commercial bank	Mongolia
		DEPROSC		DEPROSC Development bank	Development bank	Nepal



Year	Number of Transformations in a year	Name of Transforming Institution or Project	INGO or Other International Founder, Network, or TA Provider <sup>a</sup>	Name of New Financial Institution	Type of Formal Financial Institution	Country
		Habitat Crear Trujillo Siglo XXI	Habitat	EDPYME Crear Trujillo	RFI	Peru
		KMBI, ASKI, TSKI, DSPI, RSPI; APPEND	OI	Opportunity Microfinance Bank	Thrift bank	Philippines
2002	6	Microcredit Montenegro	OI	Opportunity Bank Montenegro	Commercial bank	Montenegro
		Center for Self-Help Development (CSD)		Swalamaban Nikas Bank (SBB)	Development bank	Nepal
		Aga Khan Rural Support Program	Aga Khan	First Microfinance Bank	Microfinance bank	Pakistan
		ARDCI		Vision Bank	Rural bank	Philippines
		E Zobel Foundation (program)		Banco Ng Masa	Rural bank	Philippines
		La Asociación del Fondo del Instituto Nicaragüense de Desarrollo (FINDE)		FINDESA	Deposit-taking NBFi	Nicaragua
2003	3	Thaneakea Phum (project)	Catholic Relief Services (CRS)	Thaneakea Phum Camdodia	Licensed microfinance company <sup>e</sup>	Cambodia
		FINCA Kyrgyzstan (program)	FINCA International	FINCA Microcredit Company	Microcredit company	Kyrgyzstan
		ADOPEM	WWB network	Banco de Ahorro y Crédito ADOPEM	Savings and loan bank	Nicaragua
2004	8	CREDIT (project)	World Relief	CREDIT Microfinance Institution	Licensed microfinance company <sup>f</sup>	Cambodia
		FINCA Ecuador	FINCA International	FINCA Ecuador	Financiera (regulated financial institution)	Ecuador
		Financiera Calpia <sup>g</sup>	IPC (TA provider)	Banco ProCredit	Bank	El Salvador
		Sinapi Aba Trust	OI	OI Sinapi Aba S&L Ltd.	NBFI	Ghana
		Fondasyon Kole Zepol (Fonkoze)		Sevis Finansye Fonkoze (Fonkoze Financial Services)	NBFI	Haiti
		Bullock Cart Workers' Development Association (BWDA)		BWDA Finance Limited (BFL)	NBFC	India

Year	Number of Transformations in a year	Name of Transforming Institution or Project	INGO or Other International Founder, Network, or TA Provider <sup>a</sup>	Name of New Financial Institution	Type of Formal Financial Institution	Country
		Rural Finance Program of Kosovo	ADIE International (project)	Kreditimi Rural I Kosovo (KRK)	LLC	Kosovo
		Ai-Ken, Ak-Peil Talas, Umai-Ene, Keremet-Kol, Ak-Maal Yug	Mercy Corps	Kompanion Financial Group	Microcredit company	Kyrgyzstan
		FINCA Uganda	FINCA	FINCA Uganda Ltd.	Micro deposit-taking FI	Uganda
2005	10	Caja Los Andes <sup>h</sup>	IPC	Banco ProCredito	Commercial bank	Bolivia
		Spandana		Spandana	NBFI	India
		SKS		SKS	NBFC	India
		Public Fund Asian Credit Fund	Mercy Corps	Asian Credit Fund LLP	Newly formed subsidiary of licensed institution	Kazakhstan
		Bai Tushum Financial Foundation	ACDI-VOCA	Bai Tushum and Partners	Microcredit company <sup>i</sup>	Kyrgyzstan
		Confia <sup>j</sup>		Banco ProCredit Nicaragua	Commercial bank	Nicaragua
		FORA Fund for Small Business Support	OI	FORUS Bank	Commercial bank	Russia
		RWMN	WWB network	RWMN NDCO	Non-banking deposit and credit organization	Russia
		ARC (program)	ARC	Finance Salone	LLC	Sierra Leone
		PRIDE Uganda	PRIDE network	PRIDE Microfinance Ltd.	Micro deposit-taking FI	Uganda
		Uganda Microfinance Union	ACCION International (TA provider)	Uganda Microfinance Ltd.	Micro deposit-taking FI	Uganda
		Uganda Women's Finance Trust	WWB network	Uganda Finance Trust Ltd. (U-Trust)	Micro deposit-taking FI	Uganda
2006	9	Aregak (program)	UMCOR	Aregak	Universal credit organization (closed JSC)	Armenia
		FINCA	FINCA International	FINCA Armenia	Universal credit organization	Armenia
		Horizon		Nor Horizon	Universal credit organization	Armenia
		AMEEN	CHF	AMEEN JSC	Financial service company	Lebanon
		Compartamos Financiera, S.A. de C.V. <sup>k</sup>		Banco Compartamos	Commercial bank	Mexico
		Agroinvest Foundation	WVI	Agroinvest LLC	NBFI	Montenegro

Year	Number of Transformations in a year	Name of Transforming Institution or Project	INGO or Other International Founder, Network, or TA Provider <sup>a</sup>	Name of New Financial Institution	Type of Formal Financial Institution	Country
		Capa Finance	WVI	Capa Finance	Nonbank microfinance company	Romania
		CHF International	CHF	Express Finance	JSC	Romania
		Opportunity Microcredit Romania (OMRO)	OI	Opportunity Microcredit Romania	Nonbank microfinance company	Romania
		Agroinvest (project)	WVI	Agroinvest LLC	LLC	Serbia
2007	11	Mikrofin	CARE	Mikrofin	Microcredit organization	Bosnia
		MiBospo	WWB network	MiBospo	Microcredit organization	Bosnia
		Lider	CHF	Lider	Microcredit organization	Bosnia
		Constanta	Save the Children	Constanta (JSC)	Licensed microfinance organization	Georgia
		Crystal Fund		Crystal (JSC)	Licensed microfinance organization	Georgia
		Small Business Development Fund	Oxfam GB	Lazika Capital (JSC)	Licensed microfinance organization	Georgia
		VisionFund Credo Foundation	WVI	Credo (LLC)	Licensed microfinance organization	Georgia
		Activists for Social Alternatives—Grama Vidiyal (ASA-GV)		Grama Vidiyal Microfinance Ltd.	NBFC	India
		Bandhan		Bandhan	NBFC	India
		BSS (registered public charity)		BSS	NBFC	India
		Kazakhstan Loan Fund	ACDI-VOCA	KazMicroFinance	LLC <sup>l</sup>	Kazakhstan
Total	84					35 countries

Note: NBFI = nonbank financial institution; RFI = regulated financial institution; NBFC = nonbank finance company

<sup>a</sup> In some instances, the founding INGO may not have been involved with the NGO at the time of transformation.

References to networks and TA providers include only those involved with the NGO at the time of transformation.

<sup>b</sup> Association of Cambodian Local Economic Development Agencies (established by UNDP and ILO).

<sup>c</sup> Initially licensed as specialized bank (with name ACLEDA Bank Limited); received commercial banking license in 2003.

<sup>d</sup> This transformation constitutes a “second stage” transformation: an already transformed NGO is changing into a regulated entity. This type of transformation is not counted for purposes of column 2.

<sup>e</sup> TPC became an LLC in 2002 and received its license in 2003.

<sup>f</sup> CREDIT became an LLC in 2003 and received its license in 2004.

<sup>g</sup> Second stage transformation.

<sup>h</sup> Second stage transformation.

<sup>i</sup> To be converted in a deposit-taking microfinance company or microfinance bank.

<sup>j</sup> Second stage transformation.

<sup>k</sup> Second stage transformation.

<sup>l</sup> Plans to become a bank in 2009.

Sources: Fernando (2003), updated by William Steel, further updated by Kate Lauer.

## Annex 2

### List of Persons Consulted

Jim Anderson, SME and Microfinance advisor, Mercy Corps	Tamar Lebanidze, board director, Constanta
Hay Assaad, head of Micro, Rural and Small Business Financial Services and E-Finance, International Finance Corporation	Lisa Lindsley, managing director, CtW Investment Group (former ACCION Gateway Fund manager)
Jay Banjade, associate director, Economic Opportunities Development Programs for Children, Save the Children	Cesar Lopez, vice president, International Operations, ACCION International
Caitlin Baron, director of Global Microfinance Initiative, Michael & Susan Dell Foundation	Elissa McCarter, director, Office of Development Finance, CHF (previously of Catholic Relief Services)
Deborah Burand, independent consultant	Dawn McGee, general counsel and transformation manager, Unitus
Tim Burgett, senior legal counsel, WVI	Jason Meikle, country director at FINCA Tanzania (formerly country director at FINCA Kyrgyzstan)
Mary Chaffin, general counsel, Mercy Corps	Patricia Mwangi, Financial Sector Deepening Trust—Tanzania (formerly of CGAP)
Sita Conklin, economic opportunities specialist, Save the Children	Jorge Noda, executive president, AgroCapital
Tamara Cook, program officer, Bill & Melinda Gates Foundation (formerly microfinance analyst at CGAP)	Viswanatha Prasad, managing director, Bellwether Microfinance Fund
Deborah Drake, vice president, Investment Policy & Analysis, ACCION International	Doug Rutzen, president and chief executive officer, International Center for Not-For-Profit Law
Sabina Dziurman, senior banker, European Bank for Reconstruction and Development	Rodney Schuster, co-founder Uganda Microfinance Union and Uganda Microfinance Limited
Pam Eser, director, Microenterprise and Economic Development, Mercy Corps	Beso Shengalia, general manager, Lazika Capital (formerly general manager of Small Business Development Fund)
Bill Farrand, senior technical adviser—Microfinance, Catholic Relief Services	Chris Shore, director, Microenterprise Development, WVI
Prabhu Gbate, independent consultant	Stacie Shrader, Russia country director, Opportunity International; chairman of the Board of Directors, FORA
Geeta Goel, grants officer, Michael & Susan Dell Foundation	Sanjay Sinha, managing director, M-CRIL
Bill Harrington, senior technical advisor—Microfinance, Catholic Relief Services	William Steel, independent consultant
Martin Holtmann, head, Microfinance Group, International Finance Corporation	Lloyd Stevens, vice president, Deutsche Bank
Jim Kaddaras, Developing World Markets	Thierry van Bastelaer, associate vice president, Economic Opportunities Development Programs for Children, Save the Children
Jean-Pierre Klumpp, chief operating officer, BlueOrchard	Gagik Vardanyan, executive director, MDF-Kamurj
Udaia Kumar, managing director, SHARE Microfin Ltd.	Victoria White, vice president, International Operations, ACCION International
Levan Lebanidze, executive director, Constanta	

## Annex 3

### Transformations by Country, through December 2007

Country	First Transformation	Last Transformation	Total (no.)
Albania	1999		1
Armenia	2006	2006	3
Azerbaijan	1996		1
Bangladesh	2001		1
Bolivia	1992	1999	5 plus 1 second-stage transformation <sup>a</sup> (2005)
Bosnia	2007	2007	3
Cambodia	2000	2004	6
Colombia	1993		1
Dominican Republic	1998		1
Ecuador	2004		1
El Salvador	1995		1 plus 1 second-stage transformation (2004)
Georgia	2007	2007	4
Ghana	1994	2004	2
Haiti	2004		1
Honduras	2000		1
India	2000	2007	7
Kazakhstan	2005	2007	2
Kenya	1999		1
Kosovo	2004		1
Kyrgyzstan	2003	2005	3
Lebanon	2006		1
Macedonia	2000		1
Mexico	2001	2001	1 plus 1 second-stage transformation (2006)
Mongolia	1999	2001	1 plus 1 second-stage transformation (2001)
Montenegro	2002	2006	2
Nepal	1999	2002	3
Nicaragua	2000	2003	3 plus 1 second-stage transformation (2004)
Pakistan	2002		1
Peru	1997	2001	10
Philippines	1997	2002	4
Romania	2006	2006	3
Russia	2005	2005	2
Serbia	2006		1
Sierra Leone	2005		1
Uganda	2004	2005	4
35 countries			84

<sup>a</sup> A second-stage transformation is the transformation of a for-profit company that had already transformed from an NGO into a bank.

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