A Case Study in Transformation

THE CREATION OF UGANDA MICROFINANCE LIMITED

VICTORIA WHITE
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By Victoria White
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Ms. White is a co-author of Institutional Metamorphosis: Transformation of Microfinance NGOs into Regulated Financial Institution, a contributing author to Commercialization of Microfinance: Balancing Business and Development and a co-author of the forthcoming Transforming Microfinance Institutions: Providing Full Financial Services to the Poor. She holds an M.A. degree from the Johns Hopkins University School of Advanced International Studies (SAIS) and a B.A. from Wellesley College.
Introduction

On June 30, 2005, Uganda Microfinance Union (UMU) received official notice from the Bank of Uganda (BoU) that Uganda Microfinance Limited (UML) had been licensed as a microfinance deposit-taking institution (MDI). Long anticipated, this notification marked the realization of a long-term vision that motivated two aspiring entrepreneurs to launch UMU in August 1997, as well as the culmination of three years of intensive preparation, planning, and negotiation.

From UMU’s initial days, the founders were clear about their vision for the organization—to offer quality financial services to microentrepreneurs and low-income people living in Uganda. When presented with the opportunity to change institutional form and come under the supervision of the BoU to offer even more services (in particular savings), as well as to access broader sources of funding (equity capital and public deposits) and thus expand operations further, UMU’s founders did not hesitate. In early 2002, UMU embarked on transforming to an MDI through restructuring operations, formalizing policies and procedures, hiring new staff and investing in staff training, upgrading systems, redesigning products, and negotiating and renegotiating with investors.

In early 2002, before officially launching preparations for transformation, UMU operated out of a small, four-room house. The senior management team included two executive directors and a head office manager, the latter tasked with branch operations, human resources, and new product development. The staff complement totaled 120, most of whom knew each other personally. The organization served just over 10,000 active borrowers and approximately 20,000 savers out of nine service centers, and relied on a completely paper-based, manual accounting and account-tracking system. Portfolio quality was excellent, and the organization had experienced no known cases of fraud.
By June 2005, UMU no longer resembled the organization it had been just three years earlier. It had long since shifted premises to a 14-room, two-floor professional building. A core group of external investors, none of whom had been involved in the initial transformation planning, had been assembled to finance and lead the new MDI going forward. The senior management team had been expanded to include eight department heads, each managing fully staffed departments, including operations, credit, internal audit, human resources, finance and administration, information technology, research and development, and marketing. The organization’s geographic presence had grown from nine to 20 service centers (including branches and agencies or sub-branches), staffed by a total complement of 330. Client outreach had more than tripled to 91,000 savers and 36,000 active borrowers. The manual management information system (MIS) had been replaced by a sophisticated banking software, and formalized policies and procedures manuals had been developed for all operational activities. At the same time, however, portfolio quality had deteriorated and incidents of fraud had been detected at some of the branches.

These transition years were both challenging and defining for UMU—reflecting in many ways the traditional evolution from an entrepreneurial start-up, dependent on the visionary drive of a few key leaders, to a professional organization with systems and procedures led by a core management team and professional board. Significant improvements in standardization and overall professionalization had been made, yet transformation also challenged the corporate culture of the institution, previously defined by flexible operating procedures, informal communication patterns, and close-knit personal relations. Substantial investment in both financial and human resources had been made, and had tested the organization’s leadership and independence throughout years of complex investor negotiations. Although it is still too soon to reflect on the full impact of transformation, this monograph tells the story of these years preparing for licensing as a regulated deposit-taking institution. It highlights the unique aspects of UMU’s transformation process, including the operational, structural,
and financial challenges it faced as it evolved from a young entrepreneurial NGO to one of the first licensed MDIs in Uganda.

From Boston to Busiika

In September 1996, two students from Brandeis University’s Institute of Sustainable International Development in the United States discovered they shared a similar passion—to create a full service financial institution for microentrepreneurs and low-income people. Having both worked in Africa and seen microfinance in operation in the African context, they also shared a dream of creating a new kind of microfinance institution, one that from the beginning would seek to become a leading commercial entity, offering both loans and savings services to traditionally unbanked communities. Charles Nalyaali, a Ugandan bank examiner on study leave from the Bank of Uganda, and Rodney Schuster, an American entrepreneur with small business development experience in West Africa, spent their first year at Brandeis jointly developing a business plan for this dream. The then Governor of the Bank of Uganda, Mr. C. N. Kikonyogo, was an early supporter of the initiative. As quoted in a speech in June 1997, “Following a recent Seminar at Brandeis University in the USA where I was invited to present a paper…, I reached an understanding with that University to jointly carry out an experiment on micro-finance programs in Luwero district.”1 This experiment became known as the Uganda Microfinance Union, launched by the two friends with an initial start-up grant of US$32,000 from the BoU.

Uganda Microfinance Union was incorporated on July 21, 1997, as a company limited by guarantee2 and registered as a nongovernmental

1Speech by Mr. C.N. Kikonyogo, Governor, Bank of Uganda on the Opening of the Co-operative Bank’s First Microenterprise Agency Office, June 1997. Nakivubo, Uganda.
2“A company limited by guarantee is an alternative type of incorporation used primarily for nonprofit organizations that require corporate status. A guarantee company does not have share capital, but has members who are guarantors instead of shareholders. The guarantors provide an undertaking to contribute a nominal amount toward the winding up of the company in the event of a shortfall upon cessation of business. It cannot distribute its profits to its members, and is therefore eligible to apply for charitable status if necessary.” (Company Registration Online Web site http://www.companyregistrations.co.uk/companies-limited-by-guarantee.asp)
organization (NGO). The company’s initial board was composed of six directors, including its two founders, two Ugandan businessmen, a central banker, and a human rights activist. The original vision of the institution was “to offer quality financial services to micro-entrepreneurs and low-income people (female or male) living in the rural, peri-urban, and urban areas in the Republic of Uganda.” (UMU 2001 End of Year Report). With the goal of serving marginalized communities, UMU began operations in the small township of Busiika, Charles’ hometown located in Luwero district, approximately 22 miles from the capital city Kampala. After less than a month of additional research and planning, UMU’s first loan was disbursed on August 11, 1997. During those initial months, Charles played the role of finance manager, systems manager, and client mobilizer; Rodney served as the commercial manager, loan officer, and collections officer. Their first employee, who served as the sole teller, was also hired at this time, someone who remains an employee of the company today.

These initial start-up days were not easy ones. Funding, both to cover operating costs and to finance the loan portfolio, was limited, leading Charles and Rodney to forgo their own salaries for some of this time. The initial start-up grant from the BoU was fully utilized within three months, and efforts to seek additional funding from the formal financial system were unsuccessful. In March 1998, however, the BoU granted UMU a loan of 40 million Uganda shillings (approximately US$35,000 at the time), repayable over five years. To secure this loan, the directors had to execute promissory notes in favor of the BoU to the extent of the loan balance.

With a year of operations under its belt, UMU began a number of fruitful discussions with the donor community. In late 1998, Novib

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3 Initial board members included Rodney Schuster, Charles Nalyaali, Ronald Kasibante (former Managing Director of Shell, Uganda), Willie Patrick Ogule (Group Secretary and Head of Legal Services of dfcu), Joannita Babumba (Principal Banking Officer of the Bank of Uganda), and Taaka Awori (human and children rights activist, as well as Program Advisor, UK Department for International Development). By 2001, the latter two were no longer active board members.
(Oxfam Netherlands) provided a sizable grant of approximately US$300,000 to support both the capitalization of the loan portfolio and operating costs. In 1999, an additional US$500,000 grant was secured from the United States Agency for International Development (USAID) Private Enterprise Support Training and Organization Development (PRESTO) project, $400,000 of which was for the loan portfolio and the remaining $100,000 for fixed assets. In addition, in late 1999, UMU received a second loan from the BoU for 100 million Uganda shillings (approximately US$66,000 at the time) repayable over one year. By late 2000, the small research project, started with a minimal $32,000 in 1997, had amassed a capital base of over 1.2 billion Uganda shillings (approximately US$700,000).

During this time, UMU was experimenting with solidarity group lending (groups of five borrowers), much smaller groups than were currently the norm among microfinance institutions in Uganda, most of which were using village banking methodologies with groups of 25 to 30 borrowers. With the motivation of “doing things differently,” Charles and Rodney sought to create a different kind of institutional culture at UMU. The tag line of “quality, innovation and flexibility” was born during this time, in reflection of the kind of staff, services, and products they anticipated offering. The “UMU way” was defined as Microfinance with a Difference.

Growth of Operations

Since reaching their 100th client in September 1997, UMU grew steadily and became one of the largest MFIs operating in Uganda.

As illustrated in Table 1, UMU registered exponential growth as the organization moved quickly to open branches throughout the country. In 2001, the organization posted its first profit of approximately US$40,000, achieving self-sufficiency after only four years of operations.
Table 1: Growth of UMU’s Credit Operations

<table>
<thead>
<tr>
<th>Year End</th>
<th>Number of active loan clients</th>
<th>Outstanding portfolio ($US 000)</th>
<th>Number of service centers&lt;sup&gt;a&lt;/sup&gt;</th>
</tr>
</thead>
<tbody>
<tr>
<td>1997</td>
<td>421</td>
<td>33</td>
<td>1</td>
</tr>
<tr>
<td>1998</td>
<td>1,098</td>
<td>93</td>
<td>1</td>
</tr>
<tr>
<td>1999</td>
<td>1,762</td>
<td>184</td>
<td>2</td>
</tr>
<tr>
<td>2000</td>
<td>7,598</td>
<td>683</td>
<td>5</td>
</tr>
<tr>
<td>2001</td>
<td>10,417</td>
<td>1,652</td>
<td>7</td>
</tr>
<tr>
<td>2002</td>
<td>20,598</td>
<td>3,872</td>
<td>11</td>
</tr>
<tr>
<td>2003</td>
<td>28,625</td>
<td>6,342</td>
<td>14</td>
</tr>
<tr>
<td>2004</td>
<td>36,864</td>
<td>10,576</td>
<td>15</td>
</tr>
<tr>
<td>August 1, 2005 (UML)&lt;sup&gt;b&lt;/sup&gt;</td>
<td>27,700</td>
<td>10,700</td>
<td>18</td>
</tr>
<tr>
<td>2005 (UML)</td>
<td>31,145</td>
<td>11,313</td>
<td>20</td>
</tr>
</tbody>
</table>

<sup>a</sup> Includes branches and agencies (sub-branches).

Source: UMU internal documents

While the combination of a burgeoning private sector and a relatively shallow financial system in the late 1990s created significant demand for microfinance services in Uganda, UMU’s particular operating strategy also helped encourage rapid market penetration.

Broad market perspective. From its opening days, UMU’s goal has been to provide a range of financial service to eligible unbanked members of the community, and ultimately even attract clients away from banks by offering better and more efficient service. As such, UMU’s target market has included both self-employed microentrepreneurs and salaried workers.

Investment in research and development. The organization’s wider perception of target market spurred a significant amount of product development work within UMU’s research and development department. Early on, UMU made responding to client needs a top priority, most noticeably demonstrated by the resources, both human and financial, that the organization directed to research and
development efforts. In fact, the research and development function preceded the creation of both the human resources and internal audit departments.

*Range of products and services.* Unlike other MFIs operating in Uganda at the time, UMU was never a one-product organization. The organization started operations by offering a range of credit products and today offers microenterprise working capital loans (both group and individual), various loan products for salaried employees, a home improvement loan, a school fees loan, and a small and medium enterprise loan.

*Consolidating Resources*

Similar to other MFIs in Uganda, UMU’s lending methodology included a compulsory savings component, mandated at 20 percent of the loan size for some of its products. The organization also offered its members the choice to save above the minimum required, which many did, despite both minimal interest rates and monthly account maintenance fees. By early 2002, UMU’s savings portfolio had already reached over 2 billion Uganda shillings (approximately US$ 1.2 million), tripling to 6 billion Uganda shillings (approximately US$ 3.5 million) by mid-2005, indicating an active demand among clients for savings services and increasing public confidence in UMU. As an NGO, however, UMU was prohibited from intermediating these deposits, requiring the institution to maintain at all times an equivalent balance at corresponding banks. In addition, while the BoU specifically prohibited non-licensed institutions from mobilizing savings from the public, the regulations at the time were less clear about member-based organizations. Because all UMU clients paid a membership fee to access services, all clients were considered “members” of the Union, and as such, the additional voluntary savings that were accepted by UMU were technically not being mobilized from the public. Once the MDI Act was passed on July 1, 2003, however, the BoU was much clearer in its guidance—MFIs that were mobilizing deposits either had to apply for a license and comply with the requirements of the MDI Act within 24 months from the
commencement of the Act or wind up business within six months.

With growth in the loan portfolio continuing at a rapid pace, UMU’s funding needs became more and more urgent. While the organization had historically relied on a combination of loans from local commercial banks and international lenders to finance its loan portfolio, these sources were relatively expensive. In addition, by year end 2004, UMU was already leveraging its capital base by almost 3:1, a leverage ratio for an NGO that made some lenders uncomfortable. Having achieved self-sufficiency a few years earlier, raising additional capital from donations was also unlikely, limiting the institution’s equity growth to the rate at which it could capitalize its retained earnings. Managing growth within the confines of the NGO structure was proving to be a challenge.

In addition to funding constraints, UMU’s relative slowdown in borrower growth since 2004 was largely attributable to management’s increased focus on transformation. The investor negotiation process, explained in more detail below, consumed a great deal of senior management’s time, leaving less time to support mid-level managers in their growth targets. Around this same time, UMU’s portfolio at risk (PAR) began to creep upward. (Until mid-2003, UMU’s PAR had never risen above 3 percent.) Furthermore, UMU had expanded its offerings of individual loan products, which resulted in increased demands on middle management. Combined with a corresponding rise in the incidence of fraud, the quality of the portfolio began to deteriorate. By late 2004, PAR greater than 30 days exceeded 5 percent, increasing to as high as 9 percent by June 2005.

**Planning and Managing the Transformation**

Given UMU’s desire to accept and intermediate deposits from the public, both for purposes of expanding its funding sources and offering clients a needed service, transformation to a regulated deposit-taking institution was a logical step. Based on its experience and because Uganda has few banking outlets,
especially in close proximity to low-income households, UMU believed the demand for savings services would be quite high, particularly outside Kampala. In addition, because Ugandan capital markets are not well-developed, deposits represented the best source of local funding for the loan portfolio for the longer term.

UMU also saw transformation as a means of acquiring greater legitimacy in the marketplace—among clients, staff, local supporters, funders, and creditors. Transformation would require the organization to upgrade its systems and processes, to standardize its operations throughout its branch network, and to improve its reporting and controls. In addition, transformation would mean the injection of new investor capital, thus facilitating UMU’s ability to raise additional funding from other commercial sources. Finally, the presumed gains from central bank oversight and professional governance from board members with their own capital at stake were viewed as important benefits as well.

**Transformation Options**

The decision to transform was ultimately spurred by the evolution of events occurring at the regulatory level and the corresponding timeline of donors. The process of developing a regulatory and supervisory framework for microfinance in Uganda had started as early as April 1996, and in July 1999, the BoU policy statement on microfinance regulation and supervision was passed by the cabinet, creating separate tiers for different financial institutional types. Tier 1 consists of commercial banks. Tier 2 consists of credit institutions that can take deposits but are not permitted to perform all operations and services that banks are allowed. Tier 3 consists of microfinance institutions regulated by the BoU that can accept deposits. Tier 4 consists of non-deposit taking institutions such as credit-only NGOs.

Within this policy framework, the new MDI legislation was developed to specifically respond to the special characteristics of microfinance. Minimum capital was set at a modest level (500 million Uganda shillings, approximately US$276,000), though balanced by a relatively
conservative minimum capital adequacy ratio of 20 percent (total capital to risk-weighted assets). The legislation expects the primary services of an MDI to be short-term loans (up to two years) to microentrepreneurs, and savings and time deposits from the public, although it is acceptable for MDIs to have some loans of longer duration, provided that short-term loans remain the core of the business. Special permission is required for an MDI to engage in payment services, international money transfers, and other services. MDIs are prohibited from a range of activities, including current accounts and foreign exchange operations. In the short to medium term, however, UMU felt the legislation would provide the institution room to offer all its current products (provided it obtained permission on payments and transfers) and to aggressively develop new savings products as well.4

The BoU followed a relatively transparent and participatory process in drafting and circulating the new microfinance legislation and the corresponding regulations. UMU, along with other transforming MFIs in Uganda, was an active participant in the numerous forums and discussion groups held to vet the overall strategy and approach to regulating microfinance operations. In addition, UMU’s Chief Executive Officer himself was a former BoU examiner, and thus well versed in the general procedures and expectations of the BoU. Although continual delays in the publishing of the final regulations did add some confusion to the process, the path toward transformation for UMU initially appeared to be relatively straightforward.

Managing and Funding the Transformation

As early as 2001, UMU began discussions with various donors to explore accessing financial and technical support for the transformation process. As part of a larger donor effort to support the microfinance industry, a number of donors included funds in their projects to finance technical assistance and anticipated capital expenditures to prepare MFIs for licensing. The donors included

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4 MDIs or “tier 3 institutions” can move up to tier 2 or tier 1 licenses as they mature.
USAID, through its Support for Private Expansion and Enterprise Development (SPEED) Project; the European Union, through the Support to Feasible Financial Institutions and Capacity-building Efforts (SUFFICE) Programme; and DFID, through its Financial Sector Deepening Uganda (FSDU) Programme. The SPEED Project, for example, conducted a competitive tender to select institutions for assistance based on interest, potential for success, and current and projected financial performance, with the aim of selecting three institutions for significant financial support in the transformation process. In what was ultimately a pivotal point in the institution’s evolution, UMU was one of the three institutions selected for this assistance, making it eligible for substantial technical and financial support for transformation.

As a starting point, the SPEED project jointly contracted ACCION International and Shorebank Advisory Services, two US-based organizations, to conduct due diligence of UMU and to develop a preliminary transformation plan for the institution. This exercise was carried out in October 2001; at its conclusion a detailed transformation plan was agreed on by the institution and funders. This plan included a total of 111 activities that needed to be completed prior to licensing. Key areas included strategic and business plan development, credit methodology refinement, financial management upgrading, improvements in governance, human resources capacity building, development of an investor relations function, MIS upgrading, savings product development, and ultimately submission of the application to BoU.

Responsibility for these activities was primarily allocated to UMU and a newly appointed in-house transformation manager, seconded from ACCION, with additional support provided by other ACCION staff, Shorebank staff, and MicroSave\(^5\) staff in key technical areas. The transformation manager was contracted for one year beginning in April 2002, and was tasked with ensuring completion of these 111 activities.

\(^5\) MicroSave is a Nairobi-based project that promotes the development of a market-led and client responsive approach to delivering financial services among MFIs. See www.microsave.org for more information.
activities. Funding for the transformation manager and numerous short-term technical assistance missions was provided by the SPEED Project, for a total of just over US$450,000. In total, this funding supported approximately 500 days of external technical support to UMU over a period of 18 months. With the departure of the transformation manager in June 2003, ACCION International continued to support additional short-term missions to the organization and in 2004 installed a resident adviser to work closely with the organization on product development.

Donor funds were also provided to facilitate capital improvements and computerization. In addition to its support for technical assistance, the SPEED project provided $125,000 for capital improvements, such as branch upgrades and signage. Support was provided by FSDU in the amount of 125,000 British pounds (approximately US$200,000) and the SUFFICE project in the amount of 65 million Uganda shillings (approximately US$35,000) for MIS upgrades.

UMU received external support for transformation totaling just over US$1 million. Transformation costs for microfinance institutions generally range from US$700,000 to US$1.5 million, including the costs of infrastructure upgrades, MIS and technical support.

During the transformation planning period, external and internal transformation committees were organized and met on a consistent basis. The external committee included representatives from the primary funders, UMU board members, members of senior management, and the transformation manager. The internal transformation committee included one board representative, members of senior management, a representative from the staff, and again, the transformation manager. These meetings served as useful benchmarking sessions for tracking completion of the various activities in the transformation plan, an exercise that ultimately took three years to complete. The meetings were also important for discussing strategic issues that arose during the transformation process and, even more important, for building buy-in to transformation. While staff in general supported UMU’s plans to transform, a key agenda
topic in these meetings was agreeing on communication strategies for the range of changes being introduced within the organization. Transformation implied a significant change in UMU staff requirements, and care was taken from the beginning to ensure staff were aware of and in support of the changes taking place. One of the critical information dissemination tools was Transformation News, a monthly newsletter that was sent to all staff that documented the key activities under way in preparation for licensing. In addition, the transformation manager provided monthly updates in the monthly branch manager meetings and was a participating member in senior staff meetings.

**Operational Transformation: Upgrading and Systemizing**

Operationally, the most challenging aspects of the transformation process were the comprehensive formalization, systemization, and documentation of policies and procedures at UMU. Before preparing for transformation, very few of UMU’s procedures were formally documented, and as mentioned, the MIS was largely manual. As a demonstration of their commitment to flexibility, the organization prided itself on not requiring wholesale standardization of all policies and procedures, and encouraged staff to think creatively. As such, the dissemination of policies and procedures occurred primarily through on-the-job training, passed down from head office to branch managers and from branch managers to senior staff who then advised more junior staff. With transformation, however, UMU recognized it would need to systemize and standardize most of its operating procedures.

**Human Resources Management**

When UMU first began preparing for transformation, its senior management team consisted of the Chief Executive Officer, the Executive Director, and a head office manager, who was tasked with branch oversight, human resources, and product development. The absence of a second tier of senior managers at head office made sense for UMU as a young, start-up NGO. However, with over 20,000
members and more than 10,000 loans when it began the transformation process, UMU needed to reinforce and expand its management team. Thus, one of the more urgent initial tasks was to recruit a number of senior managers, including a Chief Financial Officer, a Chief Internal Auditor, a Human Resources manager, and an Information Technology manager. These positions were filled over a 6- to 12-month period, resulting in a very different organizational structure and senior management team. In addition, in early 2004, UMU created a Head of Credit position, reporting directly to the Chief Executive Officer, and staffed for the first two years by an individual seconded from ACCION International. The Head of Credit is responsible for overseeing credit operations in the organization, including maintaining strong portfolio quality, ensuring adherence to policies and procedures, and managing the collections team.

Significant effort was also made to create a series of in-house training courses, including general staff orientation as well as courses on delinquency management, credit analysis for individual loans, and customer service, among others. Throughout the transformation process, UMU remained committed to retaining all staff, building capacity through training and other measures. (With the launch of Uganda Microfinance Limited, all UMU staff and their benefits were transferred to the new organization.)

The overall performance management system, including compensation and staff incentive schemes, was also overhauled during this period. Before transformation, UMU’s incentive scheme was limited to annual performance raises, subjectively determined by a staff member’s supervisor. The organization was wary of implementing any incentive scheme based on individual performance, fearing the rise of negative competition among staff. At the time, this also reflected the overall operating environment at UMU. For example, loan officers were not individually responsible for specific clients—they were jointly served by all branch staff. As such, branch performance was considered the main indicator of staff performance. With the increase in client numbers, weakening portfolio quality, and an increase in incidents of fraud, UML decided to begin tracking performance by loan officer,
and thus shifted to individual-based incentive schemes, though branch performance is still a component. Incentives for loan officers are based on number of loans disbursed, portfolio growth, and portfolio quality. Branch manager incentives include these same parameters, plus compliance with reporting requirements and operating policies, as well as branch profitability. Back-office staff including accountants, cashiers, and support staff, such as customer care officers, receive incentives based on the profitability of the branch.

Financial Management

Before transformation, UMU’s finance function was staffed by a senior accountant assisted by a few junior accountants, and was primarily tasked with preparing financial statements and monitoring liquidity at the branches. The overall financial management function at UMU underwent significant upgrading during the transformation process. This included recruiting a Chief Financial Officer and a Treasurer, developing and documenting key financial management policies and procedures, developing appropriate financial management tools including a liquidity management model and the tools and procedures for an institutional budgeting process, developing a long-term financial projection model, and launching an internal audit department. An Asset and Liability Management Committee (ALCO) was established to meet on a monthly basis to review critical risk categories in UMU’s financial position. Branch managers and senior management were trained to use a branch-level budget tool, developed to assist with the annual budget process.

Additionally, UMU’s financial statement preparation was significantly upgraded to adhere to appropriate accounting principals and to respond to BoU reporting requirements. The upgrading included changing the organization’s chart of accounts, introducing cost center financial reporting at the branches (for example, allocating fixed asset depreciation and loan loss provisioning to each branch), introducing accrual accounting (as appropriate), conducting monthly budget to actual analysis, and developing a new series of reports to be submitted to the BoU.
UMU recognized that a key factor in the organization’s successful MDI application would be the effectiveness of its tracking systems and the accuracy and timeliness of its reporting. UMU’s manual account management system, built primarily with ledger cards (yellow for loans, and pink for savings) and a separate centrally based automated accounting package (Solomon IV) faced limitations in efficiency, consolidation of data, and trend analysis. It was clear the system would be insufficient to respond to the reporting and tracking requirements of a regulated MDI. Moreover, the BoU specifically required MDIs to have an acceptable, automated MIS to ensure accurate and timely reporting. The process of conceptualizing and implementing a new MIS was thus a critical component of the transformation process.

UMU initiated its system selection process by conducting an in-house needs assessment. Based on this exercise, seven systems were evaluated, three of which were short-listed for further consideration. UMU ultimately selected Bankers’ Realm, a holistic banking software developed by the Kenya-based firm Craft Silicon and installed in a number of MFIs and smaller banks in Eastern Africa. The selection was based on a general analysis of the system’s capacity, commitments of timely and regionally based support, and a relatively competitive price.

The conversion from a totally manual system—characterized by ledger cards, ledger keepers, waste sheets, and tedious month-end balancing—to an automated, computerized one was not easy. The first branch to go “live” was UMU’s newest urban branch, opened in August 2002, and computerized in October of the same year. The computerization of all UMU branches took over two years to complete and was challenged by data migration hurdles, a lack of proper version control, an understaffed IT department, delays by the supplier in responding to customization requests, and challenges linked to data consolidation. While some issues were due to UMU’s own staffing constraints, bugs in the system and the supplier’s overstretched project management abilities at the time contributed to the delays in system
implementation. These issues have become even more urgent with licensing and the need to submit timely and accurate reports to the BoU, requiring UML to invest in a separate report writing solution.

**Internal Controls and Audit**

While UMU’s original manual policies and procedures had been designed with internal controls in mind, the organization recognized that the level of internal controls needed for a primarily credit organization were quite different from those needed for an organization mobilizing and intermediating savings from the public. UMU also recognized that the opportunities for fraud and error were likely to increase substantially during the transition period from a manual system to an automated MIS. At the start of the transformation process, however, UMU lacked a formal Internal Audit department, and did not have an internal auditor on staff. The transformation planning exercise helped to identify weak spots and develop checks and balances to ensure that UMU’s internal controls were adapted to the new system and expanded to account for new risks (for example, risks associated with money transfers or raising of deposits from individuals).

The large portfolio of responsibilities implied that the internal auditor, once hired, would require dedicated and trained staff. UMU also needed a detailed Internal Audit manual that documented various audit policies and procedures, as well as the distinct UMU internal audit methodology. A consultant working with internal staff developed a manual that incorporated internal control systems, risk methodology, personnel qualifications, audit methodology, audit responsibilities, audit reporting requirements, standards for each audit, and a variety of audit tools. UMU created an internal audit department and hired a Chief Internal Auditor as well as three internal auditors.

**Product Mix and Branch Operations**

The transformation process encouraged UMU to introduce greater standardization into its policies and procedures, as well as to refine its
product offerings further by introducing new loan products and undertaking significant research on developing appropriate savings products.

**Loans.** In recognition of increasing demand for individual loan products, both from its current client base and the anticipated new target market after licensing, UMU made the strategic decision to focus on improving its individual working capital loan product, known as the microcorporate product. Prior to product reengineering, UMU relied primarily on formal collateral such as car logbooks (the document used for vehicle registration in Uganda) and land titles, in its underwriting of individual loans, an approach that limited its market to clients at the higher end of the target population. With input from ACCION’s technical staff, UMU redesigned its approach to place greater emphasis on the client’s cash flow rather than on the value of the collateral. This new approach, although requiring significantly more investment in loan officer training, allowed loan officers to reach a wider market and to provide clients with loans tailored more to their specific working capital needs.

Using this refined individual loan as a base, UMU developed a new home improvement loan product. Similar to the microcorporate product, the home improvement loan product assesses capacity to repay through an analysis of the client’s cash flow, with some additional examination of construction plans and budgets and certain guarantee requirements.

**Savings.** Over the three years of transformation preparation, UMU invested significant time and resources in designing new savings products to be launched as soon as its license was granted. Working closely with MicroSave, the UMU research and development department conducted numerous focus groups with clients to better understand their savings behavior and needs. While UMU historically offered its members the option of saving more than the compulsory amount, the fee and interest rate structure did not encourage significant savings mobilization. With the goal of offering clients a range of products appropriate to their savings needs, once licensed, UML
launched an aggressive savings mobilization campaign, promoting two principal savings products—ordinary savings and time deposits. The ordinary savings product includes three tiers of interest based on minimum account balances and charges no transaction fees, except for a monthly account fee. UML also offers time deposits for terms of 91, 182, and 365 days, each with increasing rates of interest. Though still too soon to evaluate the success of these products, UML expects savings to be a significant source of funding in the future.

Unlike many of the MFIs operating in Uganda, which frequently meet clients in informal community venues, UMU, from day one, had formal banking halls, tellers, safes, and security, with all client transactions occurring in the branches. Loans are disbursed and repayments are accepted at the teller windows. The introduction of voluntary savings services in UML, however, has increased the volume of transactions, requiring changes in back office operations and the refurbishing of some banking halls.

The launch of savings operations also required a more formal and professional marketing strategy. As part of preparing for transformation, UMU added and has slowly started to staff a Marketing Department, tasked with overall product development, branding, and customer service. One of the most important image management strategies has been UML efforts to upgrade its branch “look” by doing the following:

- Redesigning the logo—UMU NGO’s logo was a three-dimensional blue diamond, with the organization’s name (in blue and red) and the two words, “trust” and “work” inscribed inside (see top portion of Figure 1). This logo had been drafted by the founders in the initial days and was meant to convey a trustworthy, reliable organization. With competition increasing and the organization aiming for a more professional look, the decision was made to redesign the logo for UML to portray a clean, professional look, while retaining the blue and red color theme (see bottom portion of Figure1).
Figure 1. The Evolution of Uganda Microfinance Union’s Logo

Uganda Microfinance Union Logo

Source: UML Marketing Department

- Relocating “hidden” branches—To try to encourage greater brand recognition, UML has relocated some of its branches to higher traffic locations.

- Differentiating “hot spots” from “cold spots” in branches—Within its branches, UML distinguishes between high traffic areas, better for placing UML publicity materials, and “cold spots” better for general administration or operations communication materials.
• Adding customer service agents—Each branch is now staffed with a customer service agent, available to answer any client questions or advise clients on UML’s products and services.

**Structural Transformation: Creating UML and Attracting Investors**

In addition to the multitude of operational changes required to comply with BoU MDI regulations, UMU also needed to transform into or create a new for-profit company, capitalized with a minimum of 500 million Uganda shillings (approximately US$ 276,000) and owned by BoU-approved investors, none of whom could own more than 30 percent of the organization. The MDI Act and accompanying regulations also provide specific requirements for the composition and duties of the board of directors in line with sound corporate governance practices. The BoU made clear there would be a rigorous investigation of prospective owners. They expressed particular concern that owners be able to provide the "deep pockets" necessary to supply the MDI with additional capital if required. In connection with this, the BoU expressed some skepticism that local NGOs would have the financial resources to be significant owners of MDIs.

*Creation of UML*

In anticipation of transformation, the UMU board took steps in early 2002 to incorporate a private company limited by shares, known as Uganda Microfinance (MDI) Limited. A shell company at the beginning, the entity was launched with negligible paid-in capital but with authorized share capital of 4 billion Uganda shillings (US$2.3 million at the time). The initial subscribers included Uganda Microfinance Union (the NGO), the four board members, and UMU staff. At the time of licensing, UMU planned to transfer the NGO’s business to the MDI (selling the NGO’s net assets in exchange for debt and equity in the MDI), thereby launching a new company with a solid business practice already in place. The NGO itself was envisioned to cease operations and to just be an investor in the new entity. As it turned out, the structural transformation of UMU, and in particular the
formation of the investor group, proved to be one of the most challenging aspects of the transformation process.

**Attracting Investors**

UMU’s initial vision for UML’s ownership group, as articulated in the transformation plan, included a diverse group of investors, including the founding directors, the NGO itself, UML staff through an employee share ownership program, local private investors, and some international investors including various technical partners, multilaterals, and socially responsible investment funds. Over the course of three years, the types of investors involved, the anticipated ownership role of the NGO and the founding directors, and the structure of the MDI’s overall capital base changed significantly (see Table 2).

**Table 2 Ownership Structure of UML**

*(percent of shares)*

<table>
<thead>
<tr>
<th></th>
<th>Initial proposal</th>
<th>Structure at licensing (August 2005)</th>
<th>Current structure (at time of writing)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Local private investors and directors</td>
<td>10</td>
<td>99.99</td>
<td>40</td>
</tr>
<tr>
<td>UMU NGO</td>
<td>25</td>
<td>&lt;1</td>
<td>&lt;1</td>
</tr>
<tr>
<td>Staff</td>
<td>10</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Technical partners</td>
<td>20</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Multilaterals and bilaterals</td>
<td>20</td>
<td>0</td>
<td>30</td>
</tr>
<tr>
<td>Socially responsible investors</td>
<td>15</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Commercial funds</td>
<td>0</td>
<td>0</td>
<td>30</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>100</strong></td>
<td><strong>100</strong></td>
<td><strong>100</strong></td>
</tr>
</tbody>
</table>

*Source: Uganda Microfinance Union Transformation Plan and Author*

The investor negotiation process was not easy. It involved numerous starts and stops, a range of different players, and consumed significant time for all involved.
**Investor Negotiations: Round One**

Early in the transformation process, a few local private companies were approached as potential investors in UML. While UMU’s projected returns were impressive, these private investors were ultimately deterred by what they perceived to be an illiquid market for the shares. Although a viable exit strategy remained an important issue for all prospective investors, international investors, and particularly those seeking both social and financial returns, were easier to attract. At the time of transformation, UMU was already borrowing from a number of international funders including Triodos and Novib, who also sought equity investments in the sector. In addition, UMU had established technical assistance relationships with organizations that also had investment arms, such as ACCION International with ACCION Investments in Microfinance and Shorebank Advisory Services with its Shorecap Fund. The organization’s first prospective investors meeting, held on July 16, 2002, thus included five international institutional investors: Novib, Triodos, ACCION Investments in Microfinance, Shorecap, and the East African Development Bank, the first four already partners of UMU.

This first investor meeting was the kick-off gathering for what became a complex and ultimately inconclusive negotiation process between the four founding directors of UMU and the four international investors, Novib, Triodos, ACCION Investments, and Shorecap. A series of investor meetings was held in late 2002, the second of which was also attended by AfriCap Microfinance Fund, a socially responsible investment fund for regulated MFIs in Africa) and throughout 2003. In addition, a due diligence exercise was carried out in April 2003 jointly by representatives of each of the international investors. Discussions throughout this period focused on the terms of the investment, including the amount of capital, percentage ownership, investor rights, exit strategies, and governance implications. Although agreement was achieved among the investors on most of these topics, two issues proved to be significant stumbling blocks for all parties involved—the mechanism for facilitating ownership for the founding directors and the valuation of the NGO’s net assets.
Ownership for the founding directors. For any start-up company that decides to sell shares to external investors, the issue of founder compensation is likely to arise. The technology world, for example, is full of stories of entrepreneurs who were compensated for their initial efforts by receiving shares on favorable terms to reflect the value they had added and will continue to add to the company. This concept of “sweat equity,” however, is difficult to apply when start-up and ongoing capital is composed of public money, granted by donors for charitable purpose, and retained earnings, a portion of which has been earned from these grant funds. Historically, some transformed MFIs have compensated the founders and leaders through preferential terms on shares they purchase in the new company or, in a few cases, through granted bonus packages to facilitate share purchase. Determining what is appropriate compensation and how such benefits should be funded can become particularly difficult negotiating points.

In UMU’s case, the directors argued that their role in building UMU from the ground up provided the rationale for them to acquire shares on preferential terms. The legitimacy of such a claim was generally acknowledged, though one investor emphasized the importance of structuring such an agreement to provide incentive for longer-term commitment of the founders and continuing management performance. It was also argued that the directors should make a contribution of their own funds to the degree possible. The relatively high starting capital (at the time, estimated to be approximately US$3 million—based on capital adequacy requirements, not minimum capital), however, made this a difficult proposition in light of the founders’ desire to hold a stake significant enough to ensure board representation and ongoing influence. A myriad of alternatives was considered to facilitate ownership by the founders, such as a loan facility from the NGO, discounted shares, and stock options based on future performance of the MDI, none of which, however, was ultimately acceptable to all parties.

NGO valuation. A second stumbling block in the negotiations was the process for valuing the NGO itself. As with many previous NGO transformations, the assumption among this initial group of investors
(including UMU’s representatives) was that the NGO would sell its net assets to the new company in exchange for debt and equity in the new company. Although there was general agreement on the percentage ownership for the NGO (at the time, it was assumed it would range between 10 and 25 percent), the approach to valuing the worth of the NGO holding, and thus the value of how much debt the NGO would receive, differed significantly among the parties. The founders of UMU initially argued that the organization’s positive reputation in the market, its existing client base, its demonstrated profitability, and, perhaps most important, its even more profitable projections, justified a value in excess of the NGO’s book value, a view also supported by a few of the external investors. Other external investors, however, incorporated more conservative profitability assumptions as well as a discount rate that reflected what was perceived to be a relatively illiquid market for MFI shares and relatively high country risk, resulting in a value for the NGO below its book value.

While the valuation process in any industry ultimately requires just as much negotiation as calculation, one of the more challenging factors in this negotiation process was that the founders of the NGO were representing both the NGO and themselves as individual investors in UML. The many differences of view between the various parties on how best to facilitate share ownership for the founders and how to value the NGO proved too difficult to overcome. Throughout 2003, various proposals were put forward to address these two issues, none of which were ultimately acceptable to the parties involved. In early September 2003, Triodos withdrew from the investor group, citing differing views on the issue of directors’ shares and the discount rate being applied to the NGO. Six days later, a similar statement was issued by Novib.

With the withdrawal of Triodos and Novib from the prospective investor group, the group was narrowed to the founders, ACCION Investments, and Shorecap. Throughout 2004, ACCION Investments and Shorecap continued to negotiate with the UMU founders. Various proposals on each side were put forward and each ultimately rejected by the other side. Negotiations appeared to be at a deadlock.
Investor Negotiations: Round Two
With the breakdown in discussions with ACCION Investments and Shorecap, UMU began exploring other investment partners, including Aureos East Africa Fund, a Nairobi-based investment fund capitalized by NorFund, CDC (the UK government's instrument for investing in the private sector in developing economies), and others. By late 2004, a separate agreement had been reached between UMU’s founding directors and Aureos, outlining a significantly different ownership and capital structure. This structure included a very small amount of common equity and a significant portion of preferred shares. The founders would own 40 percent of the common shares (none would individually own more than the 30 percent limit), with the remaining 60 percent to be held by Aureos and others. Aureos also agreed to place a convertible loan with UMU NGO to be converted into perpetual preferred shares in the MDI once a license was granted, and in addition, offered a term loan to UML once licensed. The NGO’s value would be nominally reflected in the face value of perpetual preferred shares issued to the NGO. These shares would carry a predetermined rate of return and would ensure a steady income stream for the NGO. The NGO itself would cease microfinance operating activities but in the future was anticipated to offer various grants to the community out of the stream of dividends from the preferred shares.

This new proposal was a creative one. It established different tranches of investors and thereby addressed many of UMU’s founders’ previous concerns. The smaller amount of common equity allowed the founders to obtain a significant stake in the common equity for a minimal investment. The preferred shares were envisioned to provide a home for the NGO’s capital and a significant source of funding for UML, yet would not place UML in violation of the 30 percent maximum ownership restriction, because this was applicable to core capital only (which does not include preferred shares). It also would mean the NGO would not have a governance role in the MDI. The issue of valuation for the NGO was to be encapsulated in the rate of return of the preferred shares rather than the amount of investment (that is, the book value of the transfer).
This new agreement was presented to ACCION Investments and Shorecap for consideration in late 2004. Despite significant efforts on both sides to find a mutually agreeable deal, both investors ultimately declined to participate, citing concerns about the variation in economic and political rights among the parties. In early 2005, a Shareholder Agreement was signed between the four founding UMU directors and Aureos. Soon thereafter, Aureos invested US$960,000 in a convertible loan with UMU, portions of which were anticipated to be converted into both common and preferred shares in UML, ensuring Aureos a 30 percent holding in the new MDI. The remaining 30 percent of the company was offered to Norfund, which would also invest a similar amount in a similar combination of debt, common equity, and preferred shares. After three years of negotiation, the investor negotiation process appeared to be concluded.

**Submitting the Application**

With the planned upgrades in operations largely in place and investor negotiations seemingly concluded, UMU was ready to submit its application for MDI status. In anticipation of receiving UMU’s application, the BoU scheduled a pre-inspection visit to UMU in August 2004. The purpose of this visit was to conduct a preliminary risk assessment of the organization. In particular, the examiners focused on the strategic, credit, and operational risks inherent in UMU’s operations, concluding that while risk was high in each of these categories, the institution’s risk management was generally acceptable. With time running out on the deadline by which all MFIs needed to transform or cease savings operations (July 1, 2005), UMU assembled the necessary documentation and submitted its application for an MDI license to the BoU on December 17, 2004. The formal approval by the BoU, received approximately six months later on June 30, 2005, cleared the way for the final component of the transformation process—the launch of UML.
Financial Transformation: Launching the MDI

With license in hand, the final step in UMU’s transformation was the formal transfer of the NGO’s assets and liabilities to the new entity. After years of profound institutional change, accompanied by complex investor negotiations, this final step was assumed to be a relatively straightforward exercise. A number of critical regulatory factors, however, presented a final set of hurdles that, while eventually overcome, served to redefine UML’s final capital structure. This section starts by highlighting the more critical regulatory implications of becoming an MDI, explores the method by which the assets and liabilities of the NGO were ultimately transferred to the new MDI to respond to these requirements, and notes the corresponding implications for UML’s board formation.

Regulatory Implications

As a licensed MDI, UML is mandated to adhere to various regulatory and fiscal requirements that significantly impact the organization’s financial structure.

Core capital. UML must maintain core capital equal to no less than 500 million Uganda shillings (approximately US$276,000). In the regulations, core capital is defined as shareholder equity “in the form of issued and fully paid-up shares including disclosed non distributive reserves approved by the Central Bank, share premiums, less any unconsolidated investment in financial companies, less provisions for loan portfolio or expenses, less accumulated and current losses.” (Bank of Uganda, Capital Adequacy Regulations, 2004) It does not include the value of any preferred shares, a key distinction in UML’s final capital structure.

Capital adequacy. The funding structure for UMU the NGO was primarily limited to subsidized short- and long-term debt and donated grant capital. Liabilities, which at the end of 2001 were about 1.25
times capital, were primarily composed of compulsory savings and various concessional funding, the latter being mostly long-term loans from Novib and Triodos. By 2004, this leverage had increased to over three times capital and the capital adequacy ratio (total capital to risk-weighted assets) hovered between 25 and 30 percent. As an MDI, UML needs to maintain core capital at no less than 15 percent of risk-weighted assets and total capital at no less than 20 percent of risk-weighted assets. Total capital includes core capital as well as supplementary, or Tier 2 capital (using Basle capital accord definitions), defined as subordinated debt up to 50 percent of core capital, revaluation reserves on premises, and voluntary general provisions at not less than 1 percent of current loan portfolio.

Ownership restrictions. As an MDI, the portion of common shares any one investor can own is limited to 30 percent of the total. Exemptions, however, can be obtained from this restriction for wholly owned subsidiaries of banks already licensed under Uganda’s Financial Institutions Statute or “reputable financial institutions.”

Liquidity ratio. As an MDI, UML will need to ensure its liquid assets equal or exceed 15 percent of total deposit liabilities, defined as the total of savings and time deposits. Compliance is monitored through the submission of weekly liquidity reports and thus requires UML to maintain strong liquidity management. For purposes of this requirement, liquid assets include cash, balances with the central bank, balances with other banks licensed to accept deposits by the central bank, and treasury bills and securities issued by the Ugandan government.

Compulsory savings. As previously mentioned, once the MDI Act was passed, MFIs that were mobilizing deposits either had to apply for a license and comply with the Act’s requirements within twenty-four months or wind up business within six months. This included being able to demonstrate that all compulsory savings (also known as loan

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insurance funds) pledged as security for a loan agreement were both unencumbered and managed in a separate account. Thus, such funds cannot be on-lent and must be managed quite distinctly from voluntary savings.

Provisions. UMU’s prior provisioning policy was significantly less conservative than that required by the BoU (see Table 3). In preparation for transformation, UMU converted its policy to be in line with the BOU’s requirements. This policy change coincided with an increase in delinquency in the loan portfolio, resulting in significantly higher provisioning expenses than the organization had previously incurred.

**Table 3  MDI Provisioning Requirement**

<table>
<thead>
<tr>
<th>Time</th>
<th>Regular</th>
<th>Rescheduled</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current</td>
<td>1</td>
<td>5</td>
</tr>
<tr>
<td>31-60 days</td>
<td>25</td>
<td>50</td>
</tr>
<tr>
<td>61-90 days</td>
<td>50</td>
<td>75</td>
</tr>
<tr>
<td>91-180 days</td>
<td>75</td>
<td>100</td>
</tr>
<tr>
<td>&gt;180 days</td>
<td>100</td>
<td>100</td>
</tr>
</tbody>
</table>

*Source: Bank of Uganda, MDI Act (2003), Asset Quality Regulations, 2004*

Tax requirements. As a for-profit company, UML is liable for corporate income tax on its profits. Currently set at 30 percent, this represents a significant change for an organization that was tax exempt for its first seven years of operations.

Transfer of Assets and Liabilities

Given the decision that UMU NGO would cease microfinance operations and remain an investor in UML, UMU’s directors decided to transfer all assets and liabilities to UML, with one exception. Loans with installments more than 30 days past due as of July 31, 2005, which totaled approximately 2 billion Uganda shillings (US$1.1 million), remained on the NGO’s books. The balance, totaling 30 billion Uganda shillings (US$17 million), less approximately 24
billion Uganda shillings (US$13 million) in liabilities, was sold to UML in exchange for shares in the new institution.

The original decision to offer the NGO preferred shares in UML as opposed to common shares in exchange for its net assets was made in response to the BoU ownership limitation. Because the NGO’s net assets, valued at approximately 6 billion Uganda shillings (or US$3.4 million), were significant at the time of transformation, exchanging this value for common shares would have either swamped the share contributions from the other parties, violating the 30 percent limit, or required the other parties to inject significantly more capital than the organization needed simply to realign percentage ownership. By exchanging irredeemable preferred shares for this value, the NGO’s net worth would be injected in the MDI without affecting the ownership structure, because preferred shares are not included in 30 percent ownership calculation. After submitting its application, however, the BoU clarified that in accordance with its regulations, preferred shares—even irredeemable ones—are likewise not eligible for inclusion in the minimum capital calculation. The proposed capital structure therefore would not satisfy the capital requirements of the BoU, given their growing asset base.

This created a conundrum for UMU: if it converted the NGO’s net worth to common shares, it would violate the ownership limitation. Even if only a portion of the NGO’s net worth was converted to common shares, the founders were actively seeking a solution that would not install the NGO, which itself had no owners, as a significant owner of the MDI. (Because the founders of the NGO were all themselves becoming owners of the MDI, the NGO itself was not represented by a separate interest group seeking a separate stake in the new entity.) Likewise, if the NGO’s net worth was converted to preferred shares, the remaining core capital composed of the founder’s own contributions would be insufficient to ensure adherence to capital adequacy requirements. The third option, renegotiating with the external investors to have them increase their committed contributions, would add significant time delays to the process and was thus not considered a viable option.
A solution was ultimately found in the creation of a premium account—the NGO could purchase a minimal amount of common shares, but at a premium. The value of this “premium” would be reflected in a premium account. This premium is included in the core capital calculation, yet does not affect the ownership structure, which is determined solely by the number of common shares held by each party. As such, UMU NGO is an investor in UML, but not a relevant owner (ownership of common shares is less than 1 percent). Its value has been converted into a premium share account in the MDI’s core capital, as well as into preferred shares.

The past-due loan portfolio that remained with the NGO continues to be monitored and recovered by UML staff. In exchange for this service, UML receives 10 percent of the value of any loans recovered with 90 percent staying with the NGO. It is assumed that in the future UMU NGO will invest these amounts in UML. Whether these funds will be invested in common or preferred shares will depend on the capital requirements of the organization at the time. (Such a transfer will probably be accomplished whenever the amounts become sizable enough to warrant the transaction, estimated to be approximately 500 million Uganda shillings {approximately US$ 276,000}.)

On the liability side, all external loans and other liabilities were also directly transferred to UML, pending no objection from the lenders. The transfer of client savings, however, was complicated by regulatory hurdles. As previously mentioned, the BoU requires compulsory savings to be both unencumbered and managed in a separate account. In UMU’s case, clients maintained their savings, both compulsory and voluntary, in their own savings accounts. Compulsory and voluntary savings were not separately accounted for in UMU’s system. Thus, UMU was unable to separate the compulsory from the voluntary savings to meet the BoU’s requirement that they be unencumbered and separately managed. Therefore the entire value of UMU NGO’s savings was transferred to UML as voluntary savings, and clients were informed of the transfer and change through an advertisement placed in the newspaper. Given the relatively short-term nature of UML’s
loans and the likelihood that most clients were unaware of the implications of this change, this did not create as significant a risk exposure for UML as was initially feared. In the future, all new loans issued by UML that require compulsory savings will be managed in accordance with BoU guidelines.

Another variable in this transfer exercise was whether the asset transfer between the two companies would raise a tax liability for UML. The Uganda Revenue Authority ultimately issued a waiver for this transfer, agreeing with the argument posed by UMU that the sale of assets was occasioned by a change in legislation, with which the NGO was trying to comply and that there would be no new benefit to the organization.

**Equity Assignment and Board Formation**

On August 1, 2005, UML was officially launched with total assets of 29.9 billion Uganda shillings (US$16.8 million), financed by 23.7 billion Uganda shillings (US$13.3 million) in debt and 6.4 billion Uganda shillings (US$3.5 million) in equity. This equity base was composed of 500 million Uganda shillings (US$276,000) of common shares contributed personally by the four founders. The sale of the NGO’s net assets contributed another 6 billion Uganda shillings (US$3.4 million) to UML’s total capital base, split between a premium share account (4 billion Uganda shillings, or US$2.2 million) and preferred shares (2 billion Uganda shillings, or US$1.1 million). As such, UML’s core capital totaled 4.5 billion Uganda shillings (US$2.5 million) and total capital totaled 6.4 billion Uganda shillings (US$3.7 million), well above the minimum required and enough to satisfy capital adequacy requirements of 20 percent of risk-weighted assets.

Since the launch, and following formal confirmation of the Uganda Revenue Authority’s tax waiver on the net asset transfer, Aureos converted a portion of its convertible loan by purchasing 30 percent of UML’s common shares (from the founders) and purchasing additional preferred shares. In December 2005, Norfund injected an equivalent amount to Aureos in convertible
debt. Shortly thereafter, in April 2006, this debt was converted into common and preferred shares for an ownership stake of 30 percent. This purchase completed the first round of UML investors.

**Governance**

The board of UML is currently composed of investor representatives. As of the time of writing, the UML board included three of the four founding directors of UMU, and two representatives from Aureos, one of whom also represented Norfund’s holding. The organization plans to add other independent directors.

With only a minimal holding of common shares, the NGO will not be represented at the governance level. UMU’s founders have agreed that UMU NGO will cease its microfinance and related business activities (after collecting on the non-performing UMU loans) and will essentially remain a shell company, concerned initially with the performance of the MDI. The NGO’s investment in UML, however, is anticipated to generate an income stream, which may be reinvested back in UML or distributed through grants to other community development projects. Should the NGO undertake development or other activities in the future, no financial services activities will be included.

**UML and the Future**

As of the time of writing, UML had been operating for ten months. Although licensed, it has only just completed the transfer of assets, solidified its investor group, and continues to upgrade its systems and processes to BoU standards. Although much was accomplished during the three years of preparation and negotiation, UML as a new operating entity is still establishing itself, particularly in the eyes of the regulators and investors—its new stakeholders. UML anticipates some immediate challenges.

*Maintaining strong portfolio quality.* When UMU first began planning for transformation in late 2001, its PAR greater than 30 days was approximately 1 percent. Just before transformation in mid-2005, this
indicator was close to 10 percent, indicating a decrease in the quality of the portfolio. While the decision to leave all loans with installments past due more than 30 days with the NGO certainly improved the impression of portfolio quality for UML, portfolio quality continues to be a challenge. Over the last few years, some of the urban market areas in Uganda have become saturated with microlenders—it is not unusual for clients to have multiple loans with multiple institutions. Although efforts are under way to develop a credit reference bureau in Uganda, it is not yet functioning. At the same time, the growth of UMU’s operations over the last few years stretched both its management and systems. If UML is to continue its aggressive growth rate and maintain profitability, PAR will need to be maintained at a level less than 5 percent.

**Balancing entrepreneurial spirit with ongoing professionalization.** Transformation of UMU to a regulated MDI places the organization under the spotlight of BoU regulators and profit-seeking investors. While UMU has always prided itself on its entrepreneurial spirit, the flexibility and innovation that defines this spirit needs to be continuously balanced with ensuring sufficient standardization and well-managed growth. The opening of new branches now has to be approved by the BoU and key performance ratios need to be maintained at all times. In addition, the new board, composed of both direct investors and (eventually) independent directors, introduces external parties to UML’s governance structure, and each has specific operating and performance expectations.

**Mobilizing savings.** UML’s long-term financial projections show a considerable reliance on public deposits to fund the projected growth in the loan portfolio. With just ten months of new marketing efforts, it is still too soon to evaluate the success of UML’s new savings products. The institution’s ability to shift its market perception from primarily a microlender to also providing a safe place for savings will determine the success rate of its savings efforts. This will be further challenged by the fact that the other newly licensed MDIs—FINCA Uganda Limited, PRIDE Microfinance Limited, and Uganda Finance Trust Limited—are embarking on the same efforts.
Incorporating staff ownership. UML remains committed to bringing in staff as owners. The current intention is to make 7.5 percent of the company available for employee share ownership, although details of this plan are still being finalized.

Maintaining good relations with the BoU. As an innovative start-up NGO, initially funded by a special facility from the BoU and led by two entrepreneurs, one of whom was a former BoU staff member, UMU started its operations with positive BoU relations. Ongoing system challenges and the relatively complex capital structure of UML, however, have led to some strains in this relationship. As one of the first MDIs to be licensed, UML will undoubtedly be under close surveillance by the BoU and will need to ensure it maintains good standing.
References


Uganda Microfinance Union Business Plan 2003-2008, Uganda Microfinance Union, Kampala, Uganda

UMU 2001 End of Year Report, Uganda Microfinance Union, Kampala, Uganda.