Aligning Interests
Addressing Management and Stakeholder Incentives During Microfinance Institution Transformations
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Addressing Management and Stakeholder Incentives During Microfinance Institution Transformations

By Calmeadow and The Center for Financial Inclusion
# Table of Contents

**Foreword**

**Preface**

**Part 1: Why Aligning Interests Matters for MFI Transformations**
- A Cautionary Tale
- The Aligning Interests Research Project
- Microfinance Institutions Transform
- Defining Success in Transformation
- Transformation in Other Industries

**Part 2. The Challenges of Aligning Interests**
- Paradigm Clash
- Interests by Stakeholder Group
- What’s at Stake?
- Control and Preservation of Mission
- Building a Strong Institutional Team

**Part 3. Emerging Good Practice and Recommendations**
- Equity Participation
- Severance Packages
- Aligning Interests for Board Directors
- Employee Share Ownership Plans (ESOPs) and Profit Sharing
- Incorporating the Alignment of Interests into Practice – Processes, Norms and Next Steps

**Selected Bibliography**

**About the Sponsors**

**About the Authors**

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

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

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

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

– Richard Rosenberg
CGAP
Preface

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

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

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

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

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

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

– Ira W. Lieberman
Elisabeth Rhyne
Brian Busch
Stephanie Dolan

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

A Cautionary Tale

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

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

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

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

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

The Aligning Interests Research Project

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

¹ This description and the other extended descriptions in this paper are excerpted from case studies found in the annexes to this paper. The full case for Génesis Empresarial can be found in Annex 1.
terms of institutions not transformed or transformed in an unsatisfactory manner, is not easy to see, but it may be quite significant.

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

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

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

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

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

In the course of our research, a second key objective arose—to begin developing some consensus about tools for aligning interests. These tools are of two types: first, recommendations on how to incorporate discussions about personal interests into the decision-making process during transformation negotiations and, second, creating a common understanding about acceptable means of compensating or rewarding key stakeholders, such as general managers, to increase their alignment with the long-term success of the institution.
This document intends to start an industry-wide discussion about the proper treatment of interests for key stakeholders in MFIs during transformations (and to some extent mergers). We aim to:

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

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

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

The tentative recommendations in the final section can only be seen as a start. However, we come away from this exercise with at least two recommendations that stand out as applicable in many circumstances. First, organizations undergoing transformations need to address personal interests in their deliberations in a fair and transparent way. This is our most fundamental recommendation. Second, we believe that third-party independent advisors can be helpful in providing the objectivity to assist an organization in working through these sensitive issues. That said, and as the subsequent discussion will show, there is no “one size fits all” solution.

**Microfinance Institutions Transform**

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

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

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

² Please note, not all of the cases have been included in some print versions of this document; they are available electronically at: www.centerforfinancialinclusion.org.
Aligning Interests

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

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

Transformation in Other Industries

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

The niche industry of halfway houses and prisoner rehabilitation organizations in the United States and Europe, often referred to as community corrections, began life as a diverse group of NGOs devoted to the social goal of prisoner reintegration into society. In time, these NGOs realized they could operate on a financially sustainable, or even profitable, basis. The whole industry underwent a transformation,
resulting in a range of players from NGOs to profitable companies (see box).³

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

**Community Corrections**

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

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

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

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

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


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**Part 2. The Challenges of Aligning Interests**

**Paradigm Clash**

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

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

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

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

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

• Preservation of the use of non-profit assets for social purpose. Licensing authorities give the NGO board the duty of upholding social purpose through their stewardship of the net worth of the organization. If the board decides to redirect these resources to private individuals, the government, as guardian of social purpose and granter of tax benefits, may have something to say.

• Control of the institution is determined on the basis of shares of ownership and is subject to change when shares are bought and sold (though shareholders’ agreements and different classes of shares can modify “plain vanilla” arrangements).

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

4 The recent international financial crisis has cast a harsh light on executive compensation and employee incentives at many large for-profit companies, especially financial firms. Popular outrage against exorbitant incentive packages may result in stricter limits and oversight for firms. For a more thorough discussion on executive compensation, see Karen Dillon, “The Coming Battle over Executive Pay,” Harvard Business Review 87, no. 9 (September 2009): 98-103.
are interested in the social mission, others are not. If the investors are new to microfinance, they may not understand, or respect the validity of, the restrictions of the non-profit framework.

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

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

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

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

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

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

5 Grant agreements sometimes include clauses about the perpetual use of the grant money, stipulating that it forever serve its initial social purpose and not become private wealth.
wanted, effectively financed out of NGO resources and eliminated the NGO as a voice in governance.


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

**Interests by Stakeholder Group**

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

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

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

In many cases an NGO’s general manager has spent years building the MFI. He or she may have created, fostered, and spent innumerable hours anguish over the institution and deriving enormous satisfaction from watching it grow. Staff and clients have become close friends. The general manager may see the MFI as a life’s calling or a source of esteem among the local community. Typically, managers enjoy great decision-making freedom. In addition, the manager receives a salary and has a strong degree of job stability, even though the salary may not be adequate reimbursement for the trials and tribulations of building a microfinance NGO from the ground up. If the manager is lucky, there is a pension.

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

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

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

The personal interests of board directors are broadly
similar to those of senior managers, though there are some differences. The most important difference is, of course, that directors do not earn their living from the organization. While they may receive sitting fees or travel reimbursement, their main compensations are intangible. The alignment of interests for directors may be about issues such as control, power, participation, image, and status, rather than financial compensation.

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

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

**Investors.** As the prospective owners of a for-profit MFI, investors’ interests lie with the future growth and profitability of the institution and, if socially motivated, with the future achievement of social goals. Their interests are to ensure a top-performing management team and effective governance structure. If they come from the private sector, they are accustomed to ensuring that they get the right team, with the right motivations, by structuring incentive-based compensation packages. Also, investors want to make sure that they can accommodate succession.

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**Do incentives need aligning for clients?**

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

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

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

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

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

transformations. The more poverty-oriented networks remain uncomfortable with some of the commercial forms of incentives discussed in Part 3. However, more than one interviewee from a microfinance network mentioned that poorly aligned interests have caused transformations to fail and talented, experienced managers to leave MFIs. Such experiences, among other factors, may cause networks to grow more open to incentives than they have been in the past. In fact, one microfinance network indicated that, following transformation, it has begun to introduce incentives for management and directors tied to the growth in equity valuation of the MFI.

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

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

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

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

Until recently, most networks have hesitated to engage in explicit consideration of personal interests during transformations. The more poverty-oriented networks remain uncomfortable with some of the commercial forms of incentives discussed in Part 3. However, more than one interviewee from a microfinance network mentioned that poorly aligned interests have caused transformations to fail and talented, experienced managers to leave MFIs. Such experiences, among other factors, may cause networks to grow more open to incentives than they have been in the past. In fact, one microfinance network indicated that, following transformation, it has begun to introduce incentives for management and directors tied to the growth in equity valuation of the MFI.

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

**What’s at Stake?**

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

**Control and Preservation of Mission**

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

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

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

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

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

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

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

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

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

A complicating factor is that it is not easy to distinguish between a drive to preserve the mission and a drive to preserve personal influence. One of the most effective ways to preserve mission is, of course, to maintain the same people in guiding positions in the organization. The very human tendency, however, is that these same people may become so identified with the institution or its mission that they come to see maintaining their influence as the best or only path to preserving mission.

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

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

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

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

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

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

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

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

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

In a typical MFI transformation, the founding NGO ends up owning a large bloc of shares of the transformed MFI, even if not a controlling share. For the purpose of preserving mission it seems advisable that the NGO remain as a prominent shareholder. The NGO’s ownership will ensure that the focus on the social mission enters into strategic decisions.
at the board level, even though many prominent microfinance investors are also committed to the social mission of microfinance. Incorporating the social aims of the MFI into the mission statement at transformation, as FIE did, is advisable to help ensure continuity of the double bottom line. Finally, continuity of ownership is another important reason for the NGO to maintain a significant stake. Many international equity investors expect to seek an exit in the medium term, perhaps three to seven years. A significant shareholding percentage by the NGO ensures that one shareholder will remain with the MFI for the long-term and maintain the cultural heart of the institution.

**Building a Strong Institutional Team**

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

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

Shortly after the transformations of both BancoSol in Bolivia and MiBanco in Peru, two early microfinance transformations, the boards of directors of each institution asked the incumbent CEOs to step down. Both CEOs had been the entrepreneurial leaders of their original NGOs. Industry professionals who have seen many transformations acknowledge that the individual who builds the institution as an NGO may not be the right person to take the institution to the next level. Different skills, particularly banking skills, are required. This transition may also mark a classic shift from the need for a dynamic start-up entrepreneur to the professional manager needed by a more established business.

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

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

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

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

**Equity Participation**

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

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

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

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

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

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

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

- Managers are given a payment by the NGO, which they then use to buy shares.
- NGO resources are explicitly allocated to pay for a grant of shares, or a discounted purchase price, for managers.
- NGO resources are not explicitly allocated for managements’ granted or discounted shares, but

7 Note that if the NGO retains an ownership stake for its original portfolio contribution, say 20 to 30 percent, then the original board and management would direct or indirect influence over some 30 to 40 percent of shares, forming a strong voting bloc.
in fact the “cost” of the award comes out of the NGOs’ shareholdings, not the new investors’ share.

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

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

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

In short, ethical and legal issues arise if the NGO’s resources, rather than those earned by the for-profit, are the real source of the benefit offered to managers. This means that backward-looking bonuses in recognition of past contributions are more problematic than forward-looking ones (options to purchase or be granted shares based on future earnings). Nearly all those interviewed viewed purchase at full price as the optimal solution at the time of transformation, and also supported the earning of additional shares over time through performance-based agreements. Very few in the industry recommend free granting of shares to managers at transformation, though many are willing to consider reduced price or partially subsidized share acquisition.

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

**Severance Packages**

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

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18 Aligning Interests
is acceptable. The “smell test” is, unfortunately, rather imprecise, and there is a question as to which industry to use when benchmarking the severance payment—should one look to other NGOs or to for-profit commercial actors.

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

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

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

**Aligning Interests for Board Directors**

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

The approach to aligning interests for NGO board directors is quite similar to that for top managers. The preferred solution is that if board members wish to invest they should use their personal capital. Resulting shareholding percentages will vary greatly, due mainly to relative wealth or ability to invest, but those we spoke to suggested that board directors’ shares should be modest, a few percent at most. Preferential pricing mechanisms or restricted share grants with long-term vesting can also be options, subject to the same concerns noted above.

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

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

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

In order to bring many or all staff into an incentive program, several prominent and successful MFIs have implemented variations of employee share ownership plans (ESOPs). An ESOP is a plan, in the form of a trust, through which employees can buy stock in the company that employs them. ESOPs are widely used in high-income countries. Millions of
MFIs can use the ESOP model to increase employee support for transformation. ESOPs can be restricted to senior management, but in this paper we look at two examples where ESOPs were created for all employees as part of transformation strategies: ACLEDA in Cambodia and K-Rep in Kenya.

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

- The staff received no preferential pricing nor do they receive any shares as part of their compensation. Each employee can choose whether to purchase shares and nearly all of the roughly 6,000 employees currently do.
- In order to make it easier for staff to purchase, given their limited resources, they are given a long time frame for making purchases. ASA has the right to purchase up to 19 percent of the total equity of ACLEDA with each new rights issue or capital call. Clearly, the employees do not have the same access to capital to purchase shares as the international investors do. Therefore the NGO may purchase the shares on ASA’s behalf and then return them to ASA over time as the individual employees purchase shares.
- Typically, shares are allocated based on seniority of position and length of employment, but in ASA’s case, all staff have equal rights to purchase shares.
- Every six months, a day-long open exchange takes place within ASA, setting a general price peg for any share exchanges in the following months. By providing an exchange, ASA also provides liquidity for employees wishing to sell shares or leave the bank.
- ASA members vote for the two representatives who represent ASA’s holding on ACLEDA’s board.

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

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

K-Rep is our second example. K-Rep began in 1984 as a multipurpose enterprise development program. From 1990 on, K-Rep focused on microlending, although it retained a broad interest in enterprise development, which the NGO revived after spinning microlending off to the new K-Rep Bank. K-Rep NGO was to remain active after the formation of the bank, and some employees stayed with the NGO while others moved to the bank. Uncertainty over job security and the future of the two K-Rep institutions led to unease, exacerbated by a culture clash between better paid new-hires from the banking community and long term employees of the NGO.\footnote{John Nyerere and others, “The Case of K-Rep—Nairobi, Kenya,” The World Bank, 2004.}
management dealt with this problem in a number of ways, one of which was to establish an ESOP program available to both bank and NGO employees. The ESOP was established as the Kwa Multipurpose Cooperative Society. Administered by an external professional administrator, the Kwa financed share purchases for employees using funding provided by a CGAP grant. It maintains liquidity for employees leaving K-Rep by purchasing shares from them.

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

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

Several investors speculated about other ways to address illiquidity, including pre-negotiated share buy-back from managers according to vesting schedules for meeting future performance goals, or designing equity-like instruments that provide cash payments pegged to the value of the institution’s equity. The illiquidity of shares affects all owners (including investors and managers who own shares), which clearly aligns all shareholders in a common desire for increased liquidity. Another option to provide employees with liquidity without having to sell their shares is to create “leveraged” ESOPs that allow employees to borrow from their company, using the shares as collateral. If the employee defaults, the company recovers the shares, a low-risk lending strategy for the company.

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

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

The opposite was true for Equity Bank and Compartamos, which were able to benefit their employees through public listings. Many of Equity Bank’s employees and clients became shareholders as the bank was restructuring from a savings bank.

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10 Ibid.
to a commercial bank. By listing, Equity Bank increased the value of these shares, and gave these small shareholders a way to exit if they chose. In the case of Compartamos, the senior management team purchased shares when Compartamos converted to a finance company. When Compartamos listed on the Mexican stock exchange and sold of shares through a secondary offering, the management team was able to realize a significant gain.

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

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

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

**Individual MFIs.** While the cases presented in this paper are only specific instances of an issue that manifests itself in many different ways, they do show that the alignment of interests has not been addressed in a clear and transparent way. Ideally, the key decision makers will develop a forum to openly discuss their, and others’, interests. The transformation process differs for each MFI, and that is why we do not recommend any single recipe for alignment. However, we do make some process recommendations for working toward alignment before, during and after transformation.

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

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

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Aligning Interests

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

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

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

Some of the advisory service organizations working in microfinance, such as those that help MFIs raise debt and equity, may already be doing some of this work informally and could, perhaps, be in a position to help spread good practices. To maximize objectivity and acceptance by all parties, the advisor should be selected by all the negotiating parties and paid out of pre-launch costs, in the same way pre-launch legal costs are shared by incoming investors.

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

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

A major problem is the gap in information available to the microfinance industry on compensation. The microfinance industry lags behind other parts of the financial sector, and other sectors generally, in providing comparable data for developing industry norms. In sectors as diverse as banking, private equity, and bio-technology, industry compensation surveys benchmark compensation for CEOs, COOs, CFOs, and other senior positions. For example, in bio-tech such surveys include the chief scientific officer and/or the chief medical officer. Benchmarks are provided by size of institution, geographic area, whether the institution is privately or publicly held, and other factors. The compensation surveys are very similar to the MFI operational benchmarking of the MicroBanking Bulletin, and they operate as the Bulletin does on an anonymous, peer-group basis,
protecting the confidentiality of company-specific information. Board compensation committees use these surveys or professional compensation firms to prepare packages for their own companies or hire compensation experts periodically to tailor packages based on survey results. The compensation firm is well-placed to provide objective input to support negotiations among the MFI board, management and investors. One microfinance investor group indicated that it hires local firms to do a compensation study so that the group understands local market practices before offering salaries and incentives.

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

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

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

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

- The industry as a whole must continue to discuss the issue of aligning interests. Only if MFIs, investors, advisors, and observers share their experience can we develop common norms. Continued assessment of experience will increase understanding of how best to incorporate the alignment of interests into transformation and governance processes. It will also increase consensus regarding what incentives constitute fair and ethical remuneration.

- Further research must examine the legal, accounting, and regulatory implications of the concepts presented herein. MFIs take serious risks if they address such interests without a full analysis of legal and regulatory requirements. We hope that future research and dialogue will continue to expand the clear and practical options for MFIs confronting the need to align interests.
Selected Bibliography


About the Sponsors

Calmeadow Foundation

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

The Center for Financial Inclusion at ACCION International

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

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

Roundtable Participants

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

List of Interviews

Fouad Abdelmoumni - Al Amana, Morocco
Femke Bos - Triodos Bank, the Netherlands
Phil Broughton - FINCA International, USA
Edgar Búcaro - Génesis Empresarial, Guatemala
Deborah Burand - U of Michigan Law School, USA
Vincent Burgi - Individual Investor, Switzerland
Carlos Castello - ACCION International, USA
Luís Castillo - Apoyo Integral, El Salvador
Jill Chen - Grameen Foundation, USA
Paul Christensen - Kellogg University, USA
Michael Chu - Harvard Business School, USA
Heather Clark - Independent Consultant
Pam Eser - United Nations
Enrique Ferraro - ACCION Investments in Microfinance, USA
John Fischer - ACCION Investments in Microfinance, USA
Sean Foote - Labrador Ventures, USA
Erik Geurts - TripleJump, the Netherlands
Anna Gincherman - Women’s World Banking
Philip Goodeve - FINCA International, USA
Diego Gúzman - ACCION International, Colombia
Steve Halstedt - Centennial Ventures, USA
Miguel Herrera - ACCION Investments in Microfinance, USA
Mona Kachhwaha - Bellwether Fund, India
Valerie Kindt - ACCION Internacional, USA
Peter Kooi - ACLEDA Bank, Cambodia
<table>
<thead>
<tr>
<th>Name</th>
<th>Organization/Location</th>
</tr>
</thead>
<tbody>
<tr>
<td>Brian Kuwik</td>
<td>ACCION International, USA</td>
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<tr>
<td>Melissa Lumpkin</td>
<td>ACCION International, USA</td>
</tr>
<tr>
<td>Leonor Melo de Velasco</td>
<td>FMM Popayán, Colombia</td>
</tr>
<tr>
<td>Venky Natarajan</td>
<td>Lok Capital, India</td>
</tr>
<tr>
<td>Juan Niemann</td>
<td>Génesis Empresarial, Guatemala</td>
</tr>
<tr>
<td>Francisco “Pancho” Otero</td>
<td>IPM, Bolivia</td>
</tr>
<tr>
<td>Viswanatha Prasad</td>
<td>Bellwether Fund, India</td>
</tr>
<tr>
<td>Steve Rasmussen</td>
<td>CGAP, USA</td>
</tr>
<tr>
<td>José Ruisanchez</td>
<td>Independent Consultant, USA</td>
</tr>
<tr>
<td>Eric Savage</td>
<td>Unitus Capital, India</td>
</tr>
<tr>
<td>Mark van Doesburgh</td>
<td>TripleJump, the Netherlands</td>
</tr>
<tr>
<td>Ken Vander Weele</td>
<td>Opportunity Internacional, USA</td>
</tr>
<tr>
<td>Philip Vassilou</td>
<td>Legatum, Dubai, United Arab Emerites</td>
</tr>
<tr>
<td>Juan Vega</td>
<td>PROMIFIN, Nicaragua</td>
</tr>
<tr>
<td>Victoria White</td>
<td>ACCION International, USA</td>
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</tbody>
</table>
THE CENTER FOR FINANCIAL INCLUSION pursues the proposition that low-income people deserve high-quality financial services and that these services can best be provided through commercial models that incorporate social purpose. The Center works on behalf of the microfinance industry as a whole, serving as a bridge to leverage private sector interest in microfinance. In collaboration with others, the Center works to bring the best minds and expertise to bear on industry problems. We are outcomes-focused, setting specific goals and measures of accountability for real-world change.

www.centerforfinancialinclusion.org

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