INSTITUTIONAL METAMORPHOSIS:

Transformation of Microfinance NGOs into

Regulated Financial Institutions

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<tr>
<td>ACEP</td>
<td>Alliance de Crédit et d'Epargne pour la Production</td>
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<tr>
<td>ACLEDA</td>
<td>Association of Cambodian Local Economic Development Agencies</td>
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<td>ACP</td>
<td>Acción Comunitaria del Perú</td>
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<tr>
<td>ADEMI</td>
<td>Association for the Development of Microenterprises</td>
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<tr>
<td>AfDB</td>
<td>African Development Bank</td>
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<tr>
<td>AMPES</td>
<td>Asociación de Medianos y Pequeños Empresarios Salvadoreños</td>
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<tr>
<td>ATM</td>
<td>Automatic Teller Machine</td>
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<tr>
<td>BCIE</td>
<td>Banco Centroamericano de Integración Económica</td>
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<tr>
<td>BSP</td>
<td>Bangko Sentral ng Philipinas</td>
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<td>CAF</td>
<td>Corporación Andina de Fomento</td>
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<td>CARD</td>
<td>Center for Agriculture and Rural Development</td>
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<td>CBK</td>
<td>Central Bank of Kenya</td>
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<tr>
<td>CDC</td>
<td>Commonwealth Development Corporation</td>
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<tr>
<td>CGAP</td>
<td>Consultative Group to Assist the Poorest</td>
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<td>CIDA</td>
<td>Canadian International Development Agency</td>
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<td>CMACs</td>
<td>Cajas Municipales de Ahorro y Credito</td>
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<tr>
<td>COFIDE</td>
<td>Corporación Financiera de Desarrollo</td>
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<tr>
<td>DFID</td>
<td>Department for International Development</td>
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<tr>
<td>DRDAP</td>
<td>Dutch Rural Development Assistance Program</td>
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<tr>
<td>EDCS</td>
<td>Ecumenical Development Cooperative Society</td>
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<tr>
<td>EDPYME</td>
<td>Entidad de Desarrollo para la Pequeña y Microempresa</td>
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<tr>
<td>ESOP</td>
<td>Employee Stock Ownership Plan</td>
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<tr>
<td>FMO</td>
<td>Nederlandse Financierings-Mutschappij Voor Ontwikkelingslanden</td>
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<tr>
<td>IDB</td>
<td>Inter-American Development Bank</td>
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<tr>
<td>IAF</td>
<td>Inter-America Foundation</td>
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<tr>
<td>IBL</td>
<td>International Bank of Luxembourg</td>
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<tr>
<td>IFC</td>
<td>International Finance Corporation</td>
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<td>IMI</td>
<td>Internationale Micro Investitionen AG</td>
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<td>IPC</td>
<td>Internationale Projekt Consult</td>
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<td>GTZ</td>
<td>Deutsche Gesellschaft für Technische Zusammenarbeit</td>
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<tr>
<td>KfW</td>
<td>Kreditanstalt für Wiederaufbau</td>
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<td>K-REP</td>
<td>Kenya Rural Enterprise Program</td>
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<td>KHL</td>
<td>K-Rep Holdings Limited</td>
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<td>LMS</td>
<td>Loans Monitoring System</td>
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<td>LPDF</td>
<td>Landless Peoples’ Development Fund</td>
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<td>MFI</td>
<td>Microfinance Institution</td>
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<td>MFRI</td>
<td>Microfinance Research and Innovations</td>
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<td>MIS</td>
<td>Management Information System</td>
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<td>NBFI</td>
<td>Non-Bank Financial Institution</td>
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<td>NGO</td>
<td>Non-Governmental Organization</td>
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<td>NORAD</td>
<td>Norwegian Agency for Development</td>
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<tr>
<td>PDIC</td>
<td>Philippine Depositors’ Insurance Corporation</td>
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<td>PFF</td>
<td>Private Financial Fund</td>
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<tr>
<td>PKSF</td>
<td>Palli Karma Sahayak Foundation</td>
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<tr>
<td>Abbreviation</td>
<td>Full Form</td>
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<tr>
<td>PRODEM</td>
<td>Fundación para la Promocion y Desarrollo de la Microempresa</td>
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<tr>
<td>PSIC</td>
<td>Private Sector Initiatives Corporation</td>
</tr>
<tr>
<td>ROSCAs</td>
<td>Rotating Savings and Credit Associations</td>
</tr>
<tr>
<td>SACCO</td>
<td>Savings and Credit Cooperative</td>
</tr>
<tr>
<td>SBS</td>
<td>Superintendencia de Bancos y Seguros</td>
</tr>
<tr>
<td>SEC</td>
<td>Securities and Exchange Commission</td>
</tr>
<tr>
<td>SME</td>
<td>Small and Microenterprise</td>
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<tr>
<td>USAID</td>
<td>United States Agency for International Development</td>
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- **Mibanco (Peru)** – special recognition to Manuel Montoya, Executive Director and CEO

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Finally, we thank the members of the MicroFinance Network for supporting this research.
Metamorphose: To change in form; transform

-- Webster’s New World Dictionary

Transformation. Transformation is a marvelous thing. I am thinking especially of the transformation of butterflies. Though wonderful to watch, transformation from larva to pupa or from pupa to butterfly is not a particularly pleasant process for the subject involved. There comes for every caterpillar a difficult moment when he begins to feel pervaded by an odd sense of discomfort. It is a tight feeling – here about the neck and elsewhere, and then an unbearable itch. Of course he has molted a few times before but that is nothing in comparison to the tickle and urge that he feels now...

...One wiggle, another wiggle – and zip the skin bursts down the back, and he gradually gets out of it working with shoulders and hips like a person getting out of a sausage dress...(T)he bared surface, now hard and glistening, is the pupa, a swathed-baby-like thing hanging from the twig – a very beautiful chrysalis with golden knobs and plate-armor wing cases...

After, say, two or three weeks something begins to happen. The pupa hangs quite motionless, but you notice one day that through the wing cases, which are many times smaller than the wings of the future perfect insect – you notice that through the hornlike texture of each wing case you can see in miniature the pattern of the future wing, the lovely flush of the ground color, a dark margin, a rudimentary eyespot. Another day or two – and the final transformation occurs. The pupa splits as the caterpillar had split – it is really a last glorified molt, and the butterfly creeps out – and in its turn hangs down from the twig to dry. She is not handsome at first. She is very damp and bedraggled. But those limp implements of hers that she has disengaged gradually dry, distend, the veins branch and harden – and in 20 minutes or so she is ready to fly...

-- Vladimir Nabokov from “Nabokov’s Butterflies”
PREFACE

The transformation of microfinance non-governmental organizations (NGOs) into privately owned, regulated financial institutions is a concept that has been evolving since the late 1980’s when microfinance experts first considered the transformation of the NGO PRODEM\(^1\) into a commercial bank, BancoSolidario S.A. (BancoSol). Key players in this transition, CALMEADOW and ACCION International, viewed the creation of BancoSol as a pilot project, which if successful could be replicated, thereby initiating a new era of commercial microfinance. As the pioneer, the PRODEM/BancoSol transformation has provided both inspiration and guidance to a number of MFIs seeking entry into the formal financial system.

PRODEM was created in 1986 as a joint venture between Bolivian business leaders and ACCION International, a U.S.-based NGO. Its lending operations grew rapidly and by 1989, the growth rate of PRODEM’s portfolio began to exceed the available donor funds. Donor funds that took a year to acquire were disbursed in three weeks. By year-end 1991, PRODEM employed over 116 staff in four main offices and seven branch offices, and was serving over 22,000 active clients with an outstanding loan book of $4.5 million. Unable to offer its clients savings services and restricted from accessing the commercial funds needed to fund its expansion, PRODEM’s leadership decided to pursue a commercial bank license.

PRODEM was well positioned to act as the transformation pilot, not only because of its financial viability but also because it had board members with influential commercial contacts that were willing to put their reputations on the line. At the time, it was considered politically risky to promote the concept of commercial microfinance, which could be interpreted as lending to the poor at usurious interest rates. On February 2, 1992, BancoSol opened its doors, becoming the first commercial bank in the world dedicated exclusively to serving the microenterprise market.

Today, BancoSol has over 80,000 active clients, representing one-third of all clients in the Bolivian banking system, and a loan portfolio of over $75 million. As of December 31, 1998, its portfolio at risk (over 30 days) was 2.3 percent, significantly better than any other Bolivian bank. Nearly all loans are made to solidarity groups with an average of four borrowers per group. After demonstrating sustained growth and profitability, BancoSol listed on the Bolivian stock exchange in 1997, setting a precedent for the microfinance industry. A year prior to this listing, BancoSol paid dividends based on end of year profits, which have increased from $0.48 to $0.63 per share over 1996-98. All shares are privately held, partly by Bolivian individuals and institutions, and partly by international entities, such as ProFund and ACCION International. The founding NGO, PRODEM, continues to hold 20 percent of BancoSol’s shares.

Since the founding of BancoSol seven years ago, PRODEM has become a leading organization in rural lending, disproving the assumption that rural lending could not be cost effective. As of year-end 1998, PRODEM’s financial self-sufficiency ratio\(^2\) was 108 percent. It had 47,130 active clients and a loan portfolio of over $24 million. Operating today in rural and urban areas, PRODEM provides both joint liability and individual loans. As an NGO, however, PRODEM is

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\(^1\) Fundacion para la Promocion y Desarrollo de la Microempresa

\(^2\) Financial self-sufficiency = (financial income) / (operating expenses + financial expenses + loan loss provisions + inflation adjustment on equity)
again facing many of the same constraints that it did in the early 1990’s prior to the creation of BancoSol. It is now in the process of initiating a second transformation, this time into a non-bank financial intermediary, or Private Financial Fund (PFF).

As the first NGO-to-bank transformation, the PRODEM/BancoSol story highlights three defining components of the transformation process. While each of these components is intricately linked, they do represent distinct phases in an organization’s transformation process:

**Licensing.** The regulatory laws that governed the financial system at the time of PRODEM’s transformation were designed around traditional banks and traditional methods of operation, and were thus not directly applicable to PRODEM’s operations. As the first microfinance institution to pursue a commercial bank license, PRODEM had to invest significant time and effort in educating the bank regulators about microfinance and in preparing necessary documentation, including multiple feasibility studies.

**Raising equity.** The process of raising equity was perhaps the most difficult part of BancoSol’s creation, since commercial microfinance was a new concept. Minimum capital requirements for starting a commercial bank in Bolivia at the time of PRODEM’s transformation were $3.2 million. In pursuing investors for the new financial institution, PRODEM sought a mix of international and local investors. Approximately $2.5 million of PRODEM’s loan book was sold to BancoSol in exchange for shares, resulting in an initial 18.1 percent ownership stake in the new bank. International institutions funded an additional 29.2 percent of the capital. Bolivian private investors funded the remainder, 52.7 percent.

**Operational transition.** Transformation required significant investments in staff training and systems development. New accounting and passbook savings software programs were installed. With the goal of filling as many bank positions as possible with former PRODEM staff, seminars and training sessions were scheduled to introduce banking principles. In addition, new employees were hired from the banking sector. Despite the staff training and seminars, the process of merging the commercial with the former NGO culture was difficult.

Using the PRODEM/BancoSol story as a backdrop, this publication summarizes the findings and lessons learned from other microfinance NGOs that have created privately owned, regulated MFIs. The findings in the first part are largely derived from three case studies detailed in the second part of the publication. The Network selected three institutions for this study, K-Rep (Kenya), ACP/Mibanco (Peru) and CARD Rural Bank (Philippines), because of their geographic and programmatic diversity, in addition to their differing approaches to transformation.

This research was selected by Network members to promote the financial systems approach\(^3\) to microfinance among policy makers, donors and practitioners. Transformation is presented as one approach, which in conjunction with others – such as, the involvement of traditional banks in microfinance - moves microfinance toward commercialization (the development of profit-oriented microfinance institutions). The transformed NGOs are pioneers; their experiences have already begun to change the landscape of microfinance. By sharing the transformation experiences of these institutions, the Network aims to shorten the learning curve for other transforming NGOs.

This document will be useful to any microfinance NGO contemplating institutional transformation. Certain elements, such as discussions on investor identification and board

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\(^3\) The financial systems approach applies market-driven principles used by formal financial institutions to the provision of financial services to the poor, as defined in Otero and Rhyne, eds., 1994.
development, will be helpful to the direct creation of a new private microfinance institution. The
publication will benefit donors and technical support agencies working to encourage MFI s to
move toward sustainability and institutional permanence. The findings can also be used to
educate regulators for whom microfinance is new or unfamiliar.

This document illustrates a range of transformation models and highlights the common issues
specific to the transformation process. It does not rule out alternative options to institutional
transformation. As other microfinance NGOs transform and newly transformed institutions
mature, undoubtedly more lessons will emerge, adding to and revising the findings presented in
this paper.
1. INTRODUCTION

The transformation concept was born over a decade ago out of a desire to increase significantly the number of clients that have access to microfinancial services in the world, increase institutional efficiencies and reduce donor dependency. In this document, the word “transformation” is used generically to reflect the institutional process of change that occurs when microfinance non-governmental organizations (NGOs) create or spin off regulated microfinance institutions (MFIs). While other forms of institutional transformation are feasible, such as transformation from a public to a privately owned MFI, this document solely addresses the issues specific to an NGO’s transformation to a regulated commercial MFI, the most prevalent form in the microfinance arena today.

Historical Perspective

In the 1970s, a few commercial banks, such as Bank Dagang Bali in Indonesia, targeted the microenterprise market. Most traditional banks, however, considered the poor “unbankable.” They did not believe that the poor could repay or that targeting the microenterprise sector could be profitable. In the mid-1970s, a number of non-governmental organizations (NGOs) began targeting microenterprises in their development efforts. ACCION International began solidarity lending to microentrepreneurs with an affiliate in Brazil in 1973. Three years later, Dr. Muhammad Yunus started a research project in Bangladesh, which by 1983 led to the creation of Grameen Bank. In the late 1970s, USAID’s PISCES project documented the existence of many smaller microfinance efforts in Africa, Asia and Latin America. As information became available, microfinance practitioners learned from each other and improved their lending methodologies.

By the early 1980’s, several ACCION affiliates and other microfinance NGO programs had developed successful microlending methodologies, characterized by low delinquency, cost recovery, customer satisfaction and increasing demand. At the time, ACCION’s largest affiliates reached only around 5,000 clients. Grameen Bank, on the other hand, had grown rapidly in terms of client outreach and loan portfolio size but was not able to cover its operating costs with operating revenues. ACCION International believed that the transformation of microfinance NGOs into regulated financial institutions was the only way that their small yet sustainable affiliates could gain access to the funds that would be required to expand significantly their outreach.

In 1989, CALMEADOW and ACCION International began exploring the creation of a regulated, commercial microfinance institution that would act as a demonstration model to encourage further private sector investment in microfinance and establish credibility with the formal financial sector. With this objective, they supported the transformation of PRODEM’s profitable urban lending operations, creating BancoSol in 1992. These institutions developed a vision that later was shared by microfinance practitioners, donors, and technical support agencies.

Simultaneously, the German consulting firm Internationale Projekt Consult (IPC) was contributing to the commercialization of microfinance through its market orientation and commitment to efficiency. After several disappointments in its attempts to create efficient public
banks, IPC began experimenting with different forms of corporate governance in search of the ideal mix of social commitment and commercial orientation. IPC believed that microentrepreneurs could be more efficiently served by involving the private sector in the ownership and governance of MFIs. The consulting firm approached this objective in two ways: by encouraging traditional financial institutions to downscale (target lower income markets) and by supporting the transformation of two of its NGO clients, AMPES in El Salvador and Pro-Credito in Bolivia into Financiera Calpiá and Caja Los Andes, respectively.

The combined institutional objectives of transformation from the visionaries’ perspectives were as follows:

1) to gain access to commercial sources of funds;
2) to mobilize savings and expand financial services to microentrepreneurs;
3) to increase operational efficiencies through enhanced systems, controls, and transparency in reporting that would result from links to regulators and other banking expertise.

Prior to the creation of BancoSol, the transformation planners visited Grameen Bank to learn how its methodology had been successful at “massification”- providing wide scale financial services to poor entrepreneurs. They studied Grameen’s systems and processes for handling a high volume of loans and looked for ways to improve PRODEM’s operational efficiency.

The BancoSol planners recognized that the creation of a financial intermediary would require the addition of micro-savings services, a technical area in which they had little experience. While Bank Rakyat Indonesia (BRI), a government-owned commercial bank, had been successfully collecting savings from the poor in Indonesia through its Unit Desa System since 1986, its lessons were not well known until 1990. The planners visited BRI’s Unit Desa just prior to the creation of BancoSol to study how to integrate effectively savings and lending into a microfinance institution (MFI) and develop its capacity to handle fiduciary responsibilities. While at that time savings mobilization was seen primarily as a means of increasing the funds available for lending to microentrepreneurs, microfinance practitioners have begun to recognize the intrinsic value of adding savings services for the poor.

By the mid-1990s, NGO transformation became an important microfinance strategy. ACCION International, for example, promoted the transformation concept among its affiliates by using the BancoSol demonstration model and encouraging the NGOs to specialize in financial services and scale up their microenterprise lending activities in preparation for eventual financial intermediation. The articulation of the goals of transformation, combined with BancoSol’s success and its use as a demonstration model by other MFIs, caused a paradigm shift within the industry. The historically exclusive focus on credit was expanded to include a wider range of financial services, encompassing both credit and savings. The evolution of this thinking marked the beginning of an era in which microfinance began to be guided by market driven principles, known as the “financial systems approach” to microfinance.4

Throughout the 1990s, microfinance NGOs have worked to reach the scale necessary to achieve operational self-sufficiency and to overcome donor dependence. As such, several of the multi-purpose NGOs with successful microfinance pilot projects narrowed their focus to work exclusively on microfinance, including ACP in Peru and CARD NGO in the Philippines. An increasing number of NGOs are now demonstrating their ability to cover operational costs with the income earned from their loan books. Simultaneously, the limits of donor funds have become

4 Otero and Rhyne, 1994.
evident. Donor agency budgets are shrinking, and microfinance institutions’ funding needs are growing as their portfolios begin to experience exponential growth. These factors have led increasing numbers of microfinance practitioners to consider options for commercialization and entry into the formal financial sector.

Transformation is just one component of a broader movement toward the commercialization and integration of microfinance into the formal financial sector. The transformation phase of the microfinance industry’s evolution has been essential to this movement because it has allowed MFIs to reach critical mass in terms of business operations and outreach, and to demonstrate financial viability and profitability. The transformation phenomenon has already attracted attention from the commercial world and caused donors to change policies in preparation for a burgeoning microfinance industry based on market principles. Throughout the 1990s, transformation has been closing the gap in the provision of services to microentrepreneurs and opening access to financial services that had long been denied to the poor. MFIs tend to lend at rates substantially lower than moneylenders and somewhat higher than traditional banks. Competition from transformed MFIs has caused banks to attempt to reach further down to lower income sectors and microenterprises. If the microfinance NGO transformations of the 1990s continue to demonstrate the levels of success and profitability to which they aspire, access to commercial sources of funds, including equity from private investors, will likely increase over the next decade.

The Transformation Process

The creation of privately owned, regulated MFIs is defined by two distinct events: the granting of a license by the central bank and the introduction of ownership through stock issuance. A third, more evolutionary phase of the transformation process is characterized by a multitude of organizational development changes.

Integration into formal financial system: the licensing process. The licensing process typically proceeds in one of two ways. MFIs either select an appropriate institutional structure from current banking legislation or work with the supervisory agency to enact special regulatory legislation for institutions providing microfinance services, such as defining a category for non-bank financial institutions. Both routes require significant investments in regulator education and need to be carefully considered in light of the current political and economic environment.

Ownership and governance: implications of stock issuance. By definition, NGOs have no owners; they are typically capitalized with grants and donations. With transformation, the new MFI’s capital base expands from donated equity and retained earnings to include share capital, creating an ownership base of individuals or entities seeking some form of return. Initially, this start-up capital is largely provided by the founding NGO, as all or a portion of their loan book is exchanged for shares in the new institution. In addition to the founding NGO, new owners typically include some combination of international development funds, employee stock ownership programs, and, in some cases, local private investors. A board is usually formed by representatives of the new shareholders, establishing a link between ownership and governance.

Organizational development. The granting of a license and the issuance of stock characterize the initial transformation process. The creation of a new institution, however, is a more lengthy process. From the addition of new systems and human resources to changes in organizational culture and funding relations, organizational development evolves over time. A process of change occurs both within the founding NGO, as it redirects its vision and institutional mission,
and within the newly created institution, as it establishes itself within the country’s financial system.

The Transformation Landscape

Currently, there are approximately 7,000 NGOs that provide microfinance services to low-income entrepreneurs throughout the world. While many offer these services at market rates, few can access capital markets as regulated financial institutions can. Regulatory policies in most countries also prevent unlicensed organizations from mobilizing deposits. As such, a number of NGOs are gradually reaching the limits of their expansion capacity and are considering transformation into regulated financial institutions. The transformation vision suggests that by becoming formal financial institutions, NGOs can increase their credibility in the eyes of the potential clients, the local government and central bank, and the rest of the formal financial sector. In many cases, the transforming NGO’s motivation is to access broader sources of capital, including deposits, and to increase significantly the scale of their operations. While they understand that the licensing process will result in government regulation and start-up costs, they anticipate that the long-term benefits will exceed the costs.

Transformation, however, is not appropriate for all microfinance NGOs. In some countries, the regulatory or economic environment is not conducive to transformation. Strict usury laws, onerous tax burdens, or inappropriate provisioning requirements may present significant constraints to an MFI’s profitability. Over the next decade, many microfinance NGOs will review their institution’s long-term objectives and determine whether institutional transformation lies on their critical path. Several profitable MFIs operating in supportive environments will decide that transformation is the only way to continue their natural growth rate and begin preparing for their impending transition. Others will determine that transformation is not appropriate given their current internal or external limitations and will direct strategic planning efforts in alternative directions. Likewise, some organizations may not be compelled to expand outreach or offer savings; as such, the potential benefits of transformation may appear less tangible. Unfortunately, most of this strategic soul searching will be conducted with few historical examples to guide the process.

Of the 7,000 NGOs providing microfinance services to poor entrepreneurs throughout the world, only a minute percentage have initiated transformation into privately owned, regulated MFIs. Table 1 captures basic information on eight of the transformed MFIs referenced in this document. As evident from the table, NGO transformation is not limited to a certain type of lending methodology, or determined by a certain outreach level or portfolio size. It is, however, initiated only by those institutions that have achieved cost recovery in their operations and have made a commitment to expand outreach.
Table 1: Statistics for MFIs at the Time of Transformation

<table>
<thead>
<tr>
<th>NGO name</th>
<th>PRODEM</th>
<th>Corposol6</th>
<th>AMPES</th>
<th>PRO-CREDITO</th>
<th>CARD</th>
<th>ADEMI</th>
<th>ACP</th>
<th>K-Rep</th>
</tr>
</thead>
<tbody>
<tr>
<td>New financial institution</td>
<td>BancoSol</td>
<td>Finansol</td>
<td>Financiera Calpiá</td>
<td>Caja Los Andes</td>
<td>CARD Rural Bank</td>
<td>Banco-ADEMI</td>
<td>Mibanco</td>
<td>K-Rep Bank</td>
</tr>
<tr>
<td>Date of transformation**</td>
<td>Feb ’92</td>
<td>Oct ’93</td>
<td>Jul ’95</td>
<td>Sept ’97</td>
<td>Jan ’98</td>
<td>May ’98</td>
<td>Sept ’99</td>
<td></td>
</tr>
<tr>
<td>Country</td>
<td>Bolivia</td>
<td>Colombia</td>
<td>El Salvador</td>
<td>Bolivia</td>
<td>Philippines</td>
<td>Dominican Republic</td>
<td>Peru</td>
<td>Kenya</td>
</tr>
<tr>
<td>Transformed institutional structure</td>
<td>Commercial bank</td>
<td>Commercial Finance Company</td>
<td>Financiera6 (Finance Company)</td>
<td>Rural bank</td>
<td>Commercial development bank</td>
<td>Commercial bank</td>
<td>Commercial bank</td>
<td></td>
</tr>
<tr>
<td>Lending methodology</td>
<td>Solidarity groups</td>
<td>Individual loans &amp; solidarity groups</td>
<td>Individual loans</td>
<td>Individual loans &amp; solidarity groups</td>
<td>Grameen Bank replicant</td>
<td>Individual loans</td>
<td>Individual loans &amp; solidarity groups</td>
<td>Solidarity groups</td>
</tr>
<tr>
<td>No. of active borrowers of NGO at transformation</td>
<td>22,743 (12/31/91)</td>
<td>32,022* (12/31/93)</td>
<td>7,769</td>
<td>12,662</td>
<td>10,868</td>
<td>18,000</td>
<td>32,000</td>
<td>13,201 (12/31/98)</td>
</tr>
<tr>
<td>Value of outstanding loan book at transformation</td>
<td>$4.5 million (12/31/91)</td>
<td>$11 million* (12/31/93)</td>
<td>$4.4 million</td>
<td>$4.2 million</td>
<td>$1.7 million</td>
<td>$30.3 million</td>
<td>$14 million</td>
<td>$3.3 million (12/31/98)</td>
</tr>
</tbody>
</table>


* reflects aggregate for Corposol

**refers to date of official opening/operation as a formal financial institution

Transformation is a relatively new phenomenon. Of the eight presented, four have received their bank license only in the last two years. As such, these recently transformed MFIs are still transitioning between NGO and formal financial institution at an operational level, and in some cases, at organizational and financial levels as well. (In CARD’s case, for example, the NGO branches will be transferred to the new bank structure over a period of a couple of years.) While it is too early to evaluate the overall financial health of most of the above institutions, Table 2 highlights key indicators of the four MFIs referenced in this study that have at least four years of experience behind them.

5 The statistics presented are from Corposol’s creation of Finansol, rather than FINAMERICA, the new institution established in the restructuring of Finansol.

6 A financiera is a type of commercial finance company prevalent in Latin America.

7 The Private Financial Fund (PFF) category, a type of commercial finance company, was established in Bolivia by Executive Decree in April 1995. PFFs are allowed to provide money transfers, to offer foreign exchange services, to receive savings and time deposits, and to contract obligations with second-tier institutions. They are restricted from offering checking accounts, foreign trade operations, equity investments, and security placements.
Table 2: Current Statistics of Transformed MFIs

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<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>76,216</td>
<td>81,500</td>
<td>27,876</td>
<td>32,482</td>
<td>24,629</td>
<td>29,101</td>
<td>9,601</td>
<td>9,800</td>
</tr>
<tr>
<td>Gross loan book (in US$ million)</td>
<td>$63</td>
<td>$75</td>
<td>$20.4</td>
<td>$28.6</td>
<td>$18.8</td>
<td>$22.2</td>
<td>$9.1</td>
<td>$13.4</td>
</tr>
<tr>
<td>Value of savings (in US$ million)</td>
<td>$46</td>
<td>$54</td>
<td>$8.64</td>
<td>$10.5</td>
<td>$1.4</td>
<td>$2.8</td>
<td>$6.3</td>
<td>$8.4</td>
</tr>
<tr>
<td>Av. outstanding loan balance</td>
<td>$827</td>
<td>$920</td>
<td>$732</td>
<td>$880</td>
<td>$763</td>
<td>$763</td>
<td>$948</td>
<td>$1,367</td>
</tr>
<tr>
<td>ROA (Net income / Average assets)</td>
<td>4.0%</td>
<td>5.2%</td>
<td>5.1%</td>
<td>4.5%</td>
<td>6.4%</td>
<td>4.8%</td>
<td>-20.4%</td>
<td>0.6%</td>
</tr>
<tr>
<td>ROE (Net income / Average equity)</td>
<td>30%</td>
<td>37%</td>
<td>37%</td>
<td>27%</td>
<td>25%</td>
<td>15%</td>
<td>-64.9%</td>
<td>2.6%</td>
</tr>
</tbody>
</table>


Of these four institutions, three have been successfully integrated into the formal financial system. They have significantly expanded client outreach, while maintaining strong portfolio quality and retaining their focus on their target market. In addition, they have gained recognition by improving operating efficiencies and have demonstrated that microfinance can be profitable. In contrast, the fourth MFI, Finansol, experienced a major crisis in 1995-96 that caused a severe deterioration of portfolio quality and led to the bankruptcy and dissolution of the founding NGO, Corplosol. With the support of both private and non-profit sectors, Finansol was restructured into what is now FINAMERICA, S.A. Its integration into the Colombian financial system was not smooth in the beginning, but now appears solid. As detailed in Chapter 7, the Finansol history highlights the challenges inherent in the transformation process.

Other NGO transformations are on the horizon, including the following:

**BRAC (Bangladesh)** – Seven years after BRAC first submitted its application, the Central Bank of Bangladesh approved BRAC’s bank license in early 1999. The newly approved BRAC Bank Limited is in the process of finalizing the details of the structural, financial and operational transformation of its financial services division.

**PRODEM (Bolivia)** – PRODEM is now undergoing a second transformation. It recently established a Private Financial Fund (PFF) to absorb all its lending activities, and the remaining NGO will focus on business development services. The PFF structure will allow PRODEM to offer savings services and accommodate its rapid rate of financial growth.

**ACLEDA (Cambodia)** – The Association of Cambodian Local Economic Development Agencies (ACLEDA) is an independent NGO established in 1993, funded primarily by the ILO and UNDP. The NGO provides both solidarity and individual loans. ACLEDA’s plans to create a commercial bank have been slowed in the past few years due to civil war in Cambodia but are now moving forward. ACLEDA plans to transform sometime in the next few years assuming the current political movement threatening to impose interest rate ceilings on microloans is unsuccessful.
PRIDE Tanzania – PRIDE Tanzania was established in 1993 with initial funding from the Norwegian Agency for Development (NORAD). The NGO has recently begun to plan its transformation to a bank, a process that is estimated to take two years.

Table 3 highlights key outreach and self-sufficiency indicators of these NGOs.

Table 3: Current Statistics for MFI Transformations on the Horizon

<table>
<thead>
<tr>
<th></th>
<th>BRAC - Bangladesh</th>
<th>PRODEM - Bolivia</th>
<th>ACLEDA – Cambodia</th>
<th>PRIDE Tanzania</th>
</tr>
</thead>
<tbody>
<tr>
<td>No. of active borrowers</td>
<td>Dec ‘97</td>
<td>Dec ‘98</td>
<td>Dec ‘97</td>
<td>Dec ‘98</td>
</tr>
<tr>
<td></td>
<td>1,719,016</td>
<td>2,003,789</td>
<td>36,000</td>
<td>47,130</td>
</tr>
<tr>
<td>Gross loan book (in US$ million)</td>
<td>$94.7</td>
<td>$107.1</td>
<td>$18.6</td>
<td>$24.0</td>
</tr>
<tr>
<td>Av. outstanding loan balance</td>
<td>$55</td>
<td>$53</td>
<td>$517</td>
<td>$509</td>
</tr>
<tr>
<td>Operational Self-Sufficiency*</td>
<td>142.3%</td>
<td>125.1%</td>
<td>113.1%</td>
<td>75%</td>
</tr>
</tbody>
</table>


*Operational self-sufficiency = operating income/total operating expense

Overview of Document

Despite the lack of a significant number of transformation experiences, this document attempts to highlight the general costs, benefits and key issues involved in creating a formal financial institution. It is comprised of two parts:

Part I: Global Experience in Microfinance Transformation identifies the key challenges faced by transforming microfinance NGOs. The section draws from three primary case studies presented in Part II, as well as from the transformation experiences of PRODEM/BancoSol and PROCREDITO/Caja de Ahorro y Prestamo Los Andes in Bolivia, ADEMI/BancoADEMI in the Dominican Republic, Servicio Crediticio de AMPES/Financiera Calpiá in El Salvador, and Corposol/Finansol in Colombia. While these institutional transformations took different paths, each resulted in the creation of a privately owned, regulated financial institution by an NGO. Part I concludes with future challenges to the field of microfinance in achieving the intended objectives of transformation.

Part II: Case Studies, presents the three transformation case studies, conducted between September 1998 and January 1999, as well as brief summaries of the four additional case studies referenced in this document. The MicroFinance Network selected the principal three microfinance institutions for their geographical diversity as well as their unique approach to institutional transformation:

K-Rep (Kenya) – K-Rep’s transformation is characterized by the involvement of large, reputable public institutions with complex legal requirements in a difficult regulatory environment.

CARD (Philippines) – CARD’s transformation from NGO to rural bank was motivated by its original mission to create a bank owned and managed by its clients. The transformation is occurring one branch at a time.
ACP/Mibanco (Peru) – The challenge issued by President Fujimori convinced ACP to transform into a commercial bank, rather than an alternative financial structure, such as a *financiera* or EDPYME.

While the transformation process differed significantly among these three organizations, the format for each case study is similar. The case studies open with a discussion of the history leading to transformation. They then provide details of the organizational, financial, and operational aspects of the transformation. Each case study concludes with a summary of the MFI’s preliminary results, remaining aspirations and future challenges.
PART I:

GLOBAL EXPERIENCE IN

MICROFINANCE TRANSFORMATION
2. OBJECTIVES IN TRANSFORMATION

In general, the NGOs that have created privately owned MFIs to date have achieved their principal objectives. Their common objectives include: access to commercial capital, the ability to mobilize local savings, expanded outreach, and improved customer service. However, from the microfinance industry’s perspective, transformation has not yet yielded all the benefits anticipated by the transformation visionaries. To date, transformation has attracted only a small amount of “pure” private sector investment, which has resulted in lower levels of commercialization and integration into the formal financial sector than anticipated. This section summarizes the short-term impacts that transformation has had on MFIs from the perspective of the institution and the industry.

2.1 The Institutional Perspective

For MFIs that adhere to the financial systems approach to microenterprise development, transformation into a formal financial institution is a natural progression. For MFIs that began more as international development projects, transformation may be a way to expand outreach and increase development impact. Regardless of the origins of the microfinance institution, given an amenable regulatory environment, transformation into a formal financial institution can offer many benefits not available to unregulated non-governmental organizations.

Access to Commercial Capital

While many microfinance NGOs offer loans at market rates and are approaching profitability, few are able to access capital markets as needed for loan portfolio expansion at a reasonable cost. Benefits of this access include: the ability to source capital more rapidly, increased leverage, and diversified funding sources.

Reduction in capital shortage risk: Transformation may be the only viable alternative for an MFI to continue its rate of growth. While donor funds may be sufficient for initial start-up capitalization needs, MFIs tend to grow quickly and require greater and more rapid access to sources of loan capital. Due to the unique nature of microlending, a temporary lack of access to adequate loan capital could result in the institution’s demise. In microlending, borrower repayment is typically not tied to collateral but to the borrower’s expectation that a good repayment record will lead to continued access to loans. Rumors that the MFI might not keep that implied promise can lead to a rapid decline in client repayment, as borrowers protect against their own impending capital shortage. An MFI’s ability to quickly access capital from other financial institutions or from the discount window at the central bank can reduce the risk of a liquidity shortfall, which can lead to an institutional crisis.

Leverage: As unregulated microfinance institutions, NGOs in general have not been successful at leveraging their equity base. Even those NGOs that have accessed commercial funds are rarely able to leverage more than $1.00 or $1.50 for each dollar of equity, a serious impediment to MFIs experiencing rapid growth. Without some form of guaranty facility, commercial banks are

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8 Pure private sector investment refers to capital from private individuals, corporations, investment funds and financial institutions who focus strictly on their return on investment.
reluctant to lend amounts much greater than the net worth of the unregulated MFI. As a regulated financial institution, however, the MFI is subject to on-going supervision by a regulatory authority, providing depositors, commercial investors and other banks a greater sense of security. As such, the MFI has the potential to leverage its equity up to 11 times, the limit prescribed by the Basle Convention, the international capital adequacy standard for regulated financial institutions.\(^\text{10}\) For every dollar of equity, the regulated MFI can fund $12 of assets.\(^\text{11}\) Having obtained a banking license in 1992 with $5 million in capital, BancoSol was able to draw deposits from a wide variety of sources to fund a loan book of $30 million by mid-1994. Today, with a capital base of $13.4 million, BancoSol has a microloan portfolio of $75 million, representing a significant increase in leverage, yet still significantly below the Basle limit.

**Chart 1:** Comparison of Equity to Gross Loan Book at BancoSol

![Chart](image)

**Diversified Funding Sources:** Linked to the leverage discussion above, diversification of funding sources is another key element of increased access to capital. Regulated MFIs can access diverse funding sources, including deposits from microenterprise clients and larger commercial investors, interbank loans, central bank credit facilities and international capital markets. Each of these funding sources carries a different cost and term length, allowing the MFI greater flexibility in asset liability management. Transformation also allows MFIs to diversify funding sources away from donors that have inconsistent policies or place inordinate burdens on them, for example, in terms of reporting or impact assessment. Furthermore, expanded financing options can permit MFIs to reduce their exposure to foreign exchange rate risk.

\(^\text{10}\)The Basle Convention requires an institution’s equity be no less than 8% of its risk-weighted assets.

\(^\text{11}\)The 1:12 ratio of capital to assets does not represent an absolute ceiling, due to the range in risk weightings among different categories of assets, e.g., loans to government (0%), retail mortgages (50%), as prescribed by the Basle Convention. As such, the ceiling that is consistent with maintaining the 8% capital adequacy ratio will ultimately depend on the institution’s mix of assets.
**Ability to Attract Savers**

Regulatory policies in most countries wisely prevent non-profit, unregulated organizations from collecting local savings. In many countries, only by becoming registered as a formal financial institution can an MFI gain access to this most stable capital base, voluntary local savings deposits.\(^{12}\)

The ability to mobilize local savings is a significant advantage to microfinance institutions for several reasons. Savings mobilization can increase the number of clients served, improve customer satisfaction, improve loan repayment, stabilize sources of funds, and improve governance of the MFI.

*More clients served:* MFIs can reach more clients by offering savings services. Experience has demonstrated that low-income people can and do save, and that they will entrust their savings to formal financial institutions if they are provided security, convenience, liquidity, and positive rates of return.\(^{13}\) Transforming MFIs have the benefit of a base of loan clients from which to begin marketing savings services. While microentrepreneurs may not always need a loan, they usually desire access to a savings account. Furthermore, many people dislike or fear becoming indebted and prefer self-financing, which can be facilitated by access to savings services. Table 4 demonstrates BancoSol’s increasing ability to attract client savings from 1994 to 1998.

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>CDs&lt;$50,000</td>
<td>3.4</td>
<td>6.3</td>
<td>9.8</td>
<td>288%</td>
</tr>
<tr>
<td>Savings Accounts</td>
<td>2.2</td>
<td>4.7</td>
<td>7.8</td>
<td>355%</td>
</tr>
<tr>
<td>TOTAL</td>
<td>5.6</td>
<td>11.0</td>
<td>17.6</td>
<td>314%</td>
</tr>
</tbody>
</table>

*Source: ACCION International (1998)*

*Customer satisfaction:* MFIs can better serve clients by offering savings products, specifically designed to suit their needs. Potential benefits to clients include: i) liquidity; ii) savings for investment and interest earnings; iii) savings for consumption purposes not usually eligible for loans by MFIs, since they do not generate an income stream; iv) lower transaction costs by increasing geographical access and convenience to savings products; v) replacement or supplement to credit; vi) increased access to credit through use of savings as security or down payment on a loan; and vii) confidence that their savings are secure.

*Improved loan repayment:* Clients can use their accumulated savings to make loan payments as necessary to cover periods of low income. In addition, clients can use their deposits to secure loans, allowing them to leverage their assets and increasing their level of commitment to repayment. Both of these measures can improve loan repayment.

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\(^{12}\) A number of unregulated microfinance programs require compulsory savings from clients as part of their methodology. These savings are used by the program as a loan insurance fund, as a way to mitigate default risk. Clients typically do not have access to these savings until they leave the program. As such, compulsory savings represent a component of the loan guarantee and are distinct from voluntary savings.

\(^{13}\) Robinson, 1994a.
*Stabilize sources of funds:* Over the long term, mobilizing savings can build a more dependable source of capital funds for MFIs, reducing the need for external funds and offering stability in times of crisis. In fact, low-income earners tend to increase savings in sound financial institutions in times of crisis to guard against potential future income shortages. During the recent financial crisis in Asia, the Unit Desa Unit of the Bank Rakyat Indonesia (BRI), experienced a 209 percent increase in deposits from 7.7 billion Rupiah at the end of June 1997 (a month before the crisis began) to 16.1 billion Rupiah at the end of 1998. This was primarily because as a public institution, BRI was considered the safest haven for deposits in Indonesia.

*Improved governance:* Savings mobilization can improve the governance of a microfinance institution since it heightens the board and management’s client orientation and requires a higher level of supervision and oversight. This can build local ownership and commitment to the success of the institution, as clients gain confidence in and establish a closer relationship with the MFI.

Transforming MFIs must weigh the benefits of savings mobilization against the costs. The development of savings products is expensive and complex, requiring higher levels of liquidity and risk management skills, as well as an understanding of the local economy. The addition of savings products is often more difficult than the addition of loan products. It requires the development of new policies and procedures, additional regulation and security, staff training and evaluation, management information system changes, promotional materials and marketing. It is often more efficient for microfinance institutions to mobilize savings only after achieving a scale sufficient to offer savings products cost effectively.

The impact of savings mobilization on an MFI cannot be overstated. In the few cases of transformed MFIs in this study, savings mobilization tends to increase the size of an MFI rapidly. The addition of savings products usually leads to an increase in loan sizes, as borrowers leverage their savings to access larger loans. The culture of the MFI changes, requiring bank managers and staff to become more familiar with local markets and to shift from the social service perspective typical of an NGO to a customer service orientation appropriate for a financial intermediary. While there are relatively few MFIs that mobilize savings to date, those that do often serve far more clients through their savings products than their loan products. The most impressive example is BRI’s Unit Desa, which serves almost nine times as many clients with its savings services as with its lending operations.14

**Expanded Outreach**

In harmony with the social mission to provide financial services to large numbers of low-income clients who are not served by the traditional banking sector, many MFIs consider transformation a way to expand outreach to the target market. By providing increased access to cheaper sources of funds, transformation enables the MFI to increase market penetration, open new branches, and increase its loan portfolio. Additionally, by offering new products, the transformed MFI can expand its client base and more fully serve its existing clientele. Caja Los Andes expanded outreach from 12,662 to 32,482 clients and increased its outstanding loan portfolio from $4.2 million to $28.6 million from the time of its transformation on July 10, 1995 to end of December 1998. Likewise, over 1992 to 1998, BancoSol increased its number of active borrowers from 26,200 to 81,500 and expanded its outstanding loan book from $8.8 million to $75 million.

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14 BRI reported 21.7 million savings clients and 2.5 million loan clients as of December 31, 1998.
Improved Customer Service

The benefits of transformation do not rest only with the microfinance institution. For NGOs founded on the vision of providing quality service to significant numbers of low-income entrepreneurs, one of the most convincing reasons for transformation is improved customer service. By offering savings, for example, a microfinance institution provides the most fragile sectors of society with a financial service that is often more critical than credit. While all indigenous forms of savings have some advantages, none provides the combination of security and positive rates of return that formal sector institutions can offer – and that poor savers appreciate.15

2.2 The Industry Perspective

Leading microfinance visionaries, practitioners, donors, technical assistance providers and researchers have espoused beliefs that transformation would lead to increased commercialization and integration of MFIs into the formal financial sector. This vision implies not only increased access to capital markets, but also the transfer of ownership to private investors with strong vested interests.

Access to Capital Markets

The experience of BancoSol demonstrates that transformation can in fact lead to increased access to capital markets. Table 5 shows the evolution of BancoSol’s access to capital markets from 1994 to 1998.

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<thead>
<tr>
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</thead>
<tbody>
<tr>
<td>CDs&gt;$50,000</td>
<td>25.5</td>
<td>29.6</td>
<td>34.4</td>
</tr>
<tr>
<td>Interbank</td>
<td>5.5</td>
<td>5.2</td>
<td>3.6</td>
</tr>
<tr>
<td>Med-Term Credit Lines</td>
<td>0.0</td>
<td>1.5</td>
<td>9.0</td>
</tr>
<tr>
<td>Bonds</td>
<td>0.0</td>
<td>2.0</td>
<td>3.0</td>
</tr>
<tr>
<td>TOTAL</td>
<td>31.0</td>
<td>38.3</td>
<td>50.0</td>
</tr>
</tbody>
</table>

Source: ACCION International (1998)

While transformation has opened the doors to capital markets for transformed MFIs, many continue to seek long-term funds from donors or other public sources of funds at below market rates. As a result of transformation, BancoADEMI was able to access cheap sources of funds from the Inter-American Development Bank and the Technical Secretariat of the Presidency (at 1 percent and 8.5 percent per annum, respectively).

Organizations need to carefully assess their country’s funding environment, since transformation to a regulated financial institution may preclude an MFI’s access to certain funding sources. In Bangladesh, for example, the Palli Karma Sahayak Foundation (PKSF), a government-funded foundation, was created in 1990 to provide loans exclusively to NGOs engaged in microcredit. In 1997, it received a loan of $100 million from the World Bank for this purpose, and is currently funding hundreds of microfinance NGOs in Bangladesh, which potentially acts as a disincentive

for MFIs to transform. In Peru, on the other hand, the Corporacion Financiera de Desarrollo (COFIDE), a second-tier financial institution, can only provide funding to regulated entities, precluding lending to microfinance NGOs. NGOs considering transformation must confirm that as a regulated MFI, the institution will have adequate access to funding sources to support the anticipated growth in the loan portfolio. While becoming a regulated entity may allow access to savings deposits, it takes years to develop a deposit base that can replace the need for external financing.

**Private Sector Ownership**

The involvement of private investors can enhance the internal control and governance of the MFI, since the owners are concerned with capital preservation and investment returns. Unfortunately, transformation has only attracted a small amount of private sector ownership to date. Nonetheless, all of the transformed NGOs in this study involve some form of private sector investment. Private sector ownership of these MFIs is comprised of individual and corporate investors, and employee stock ownership plans. However, despite the addition of private sector investors in transformed MFIs, public development agencies and non-profit organizations remain the largest investors in most transformed MFIs. Table 6 in Chapter 3 lists the shareholder breakdown of transformed MFIs.

Specialized equity funds, such as ProFund or ACCION’s Gateway Fund, are not pure private investors, yet they play an important role in the transition toward increased commercial investment in microfinance. While primarily capitalized by the public sector, these funds are managed and treated as private commercial money. If successful, these funds will demonstrate that investing in MFIs is viable and will divest their holdings to pure private investors.

**Improved Governance and Accountability**

With the involvement of new owners/investors, transformation usually requires a revision of the governance structure. This revision allows the MFI to renew the board’s commitment to the institutional mission and to reinforce its long-term strategic plans. The NGO board often chooses the owner mix with the desired board member characteristics in mind, while balancing the commercial and social objectives. Regulatory requirements can also influence the strength of the governance and internal control structures.

The industry has not yet realized the ultimate levels of governance and accountability. The shortcomings appear to be linked in part to the MFIs’ difficulties in balancing the social and commercial objectives through its ownership mix. In other industries, commercial objectives are best served by “pure” private investor representatives on the board. Because of their financial stake in the MFI, private investors could bring to the board a heightened interest in detecting early signs of problems and identifying potential opportunities. To date, the lack of private ownership in transformed MFIs keeps the microfinance industry from determining whether increased private sector representation would lead to improvements in governance and accountability. However, the low level of private ownership in MFIs implies a potential reduction in individual accountability, as well as an imbalance of the social and commercial objectives represented on the board.

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16 An exception is the specialized strategic venture capital fund, Internationale Micro Investitionen AG (IMI), which was initiated with 51% ownership by the German private consulting firm, IPC. However, IPC has limited capital to maintain this ownership percentage over time. The public investors are more likely to supply additional capital, which will thereby reduce the percentage of private ownership in the IMI fund.
Specialized equity funds help compensate for the lack of private sector representation on MFI boards, as they tend to have a strong interest in overseeing both the commercial and social objectives. These funds make an important contribution to the governance of microfinance institutions by linking technical advice and ownership. This unique link ensures that the providers of influential advice have a financial stake in the MFIs they are advising. However, these funds currently represent only minority ownership positions in the transformed MFIs.

NGO investors tend to place a heavier emphasis on the fulfillment of the social mission than the commercial objective, in line with their original reason for engaging in microfinance. The Corposol/Finansol crisis, as described in the textbox, offers one example of the governance limitations of controlling ownership by the former NGO, particularly when the NGO is a majority shareholder and there remains a strong operational link between the NGO and the new bank.

**The Finansol/Corposol Crisis**
Within a few years of purchasing the new finance company, Finansol, the Corposol holding company had increased its equity ownership to 71%, leaving minority shareholders. While Finansol had its own board, Corposol, as the majority shareholder, named most of the board members and played a dominant role in the new finance company’s leadership. As the financial intermediary of the Corposol group, Finansol was tasked with funding the group’s expansion plans to numerous related and unrelated sectors. A lack of separation at operational, financial and governance levels between the institutions led to inadequate management and inappropriate financial supervision, weakening oversight by owners, board members and bank supervisors. By early 1997, Corposol was bankrupt and Finansol was recapitalized and renamed FINAMERICA S.A.

NGOs can fulfill their governance role if they apply high professional standards and technical expertise to analyze and interpret the MFI’s financial evolution. NGO board members should be prepared for the increased time commitment required to successfully oversee a regulated MFI.

Public development agencies have played an important role in supporting transformation and filling the gap from the lack of pure private investors in microfinance institutions. Nonetheless, Financiera Calpiá, and to a lesser degree Los Andes, experienced some difficulties with the involvement of public development agency investors. The representatives of these public investors can change frequently, requiring constant training and learning for new board members, which slow the board’s decision-making process. By involving public development agencies in its ownership mix, K-Rep exposed itself to complex legal discussions, which slowed the transformation process. Los Andes and Calpiá are in the process of restructuring ownership and reducing public ownership in an attempt to strike a better balance of social and profit orientation in its owners.¹⁷

¹⁷ Refer to Campion and Frankiewicz (1999), *Guidelines for the Effective Governance of Microfinance Institutions*, for guidance on how to improve the effectiveness of board participation.
3. Key Issues in Transformation

The following section highlights the key issues in transformation using the three-part framework presented in the introduction: integration into the formal financial system, ownership and governance, and organizational development. The section draws primarily from the three principal case studies, using other examples of transformation for comparative purposes or to provide additional illustration. Where possible, lessons learned in each of these key areas are identified. However, the lessons and analysis in this section are limited by the small sample size of NGO transformations and the fact that, in most cases, transformation is recent.

3.1 Integration into the Formal Financial System

An MFI’s entrance into the formal financial system begins with a review of the country’s political and economic environment, as well as an in-depth understanding of the regulatory framework.

Political and Economic Environment

A microfinance institution’s analysis of its transformation options must be considered within the context of the country’s overall political and economic environment. Such contextual considerations play a determinant role in the implementation and timing of the transformation process. In an unstable political or economic climate, a microfinance NGO considering transformation may find that integration into the formal financial sector has more disadvantages than advantages. When weighing the pros and cons, microfinance institutions must first determine whether the anticipated benefits associated with transformation can in fact be achieved in the current political and economic environment. In addition, because the transformation process can take a number of years, institutions must attempt to evaluate these contextual considerations over a multi-year time horizon. As such, a transforming MFI should be aware of the long-term implications of integration into the formal financial system.

Key Contextual Considerations

The following section highlights some key political and economic issues microfinance organizations need to consider as they assess both options for and timing of their transformation:

- **Stability of the political climate**: A country’s overall political stability can significantly influence a transforming MFI’s ability to attract and maintain access to investment capital. Political instability can lead to arbitrary changes in monetary policy, such as to statutory reserve requirements, foreign exchange holding policies, or directed lending mandates (e.g., a sudden requirement to lend a certain percentage of the loan portfolio to the agricultural sector). Unstable political environments may also magnify competing political agendas among government officials, including bank regulators, creating significant delays in license processing. In such climates, a transforming microfinance institution’s fate may become inextricably linked to the future of one particular political party.

- **Macroeconomic trends**: MFIs looking to transform into regulated financial institutions must take into consideration general macroeconomic trends in both their country and their
Such trends would include the level of inflation, currency stability, unemployment and the general health of the financial sector and the economy. While microfinance NGOs must also consider these trends in their growth plans, licensed MFIs, subject to the supervision of the regulatory authorities and responding to profit seeking shareholders, must be particularly aware of how these factors affect their bottom line.

- **Characteristics of the financial system:** Transforming MFIs need to be aware of the full range of players in their country’s financial system. As a regulated financial institution, an MFI enters into a new competitive environment. While other microfinance NGOs remain competitors for market niche on the lending side, the transformed institution’s entrance into deposit mobilization may bring it into competition with other regulated financial institutions. In addition, the banking laws and regulatory environment play a key role in attracting investors, particularly as they affect the rights of shareholders. If the regulatory environment is in flux or unfavorable, the MFI may have difficulty raising equity capital.

- **Current policy environment for microfinance:** The government’s support for and understanding of microfinance, as demonstrated by the country’s general policy environment for microfinance, plays a significant role in determining the timing of transformation. As demonstrated in the textbox below, the Philippine government’s shift away from directed credit initiatives encouraged CARD to pursue integration in the formal financial system. In a country where interest rates are limited by usury laws or where government-directed credit programs are prevalent, an MFI’s ability to charge adequate interest rates to cover costs and provide a return for investors may be limited. The extent to which legal contracts are enforceable and sanctions for default, fraud or theft are applied also influences a microfinance institution’s ability to manage its loan portfolio quality.

**Government Support for Microfinance in the Philippines**

Liberalization of the financial sector in the Philippines in the early 1990’s was accompanied by a reexamination of the government’s role in supporting small-scale enterprise lending. By early 1996, the government’s understanding and support for market-oriented, as opposed to government-directed, credit initiatives had increased significantly. The government, through such bodies as the National Credit Council and the Supervision and Examination Sector of the Central Bank, also actively participated in the *Microfinance Standards Initiative*, a multi-sectoral coalition formed to develop and promote standards for microfinance operations. In sum, the critical role played by microfinance service providers was beginning to gain acceptance and support among policy makers, encouraging NGOs such as CARD, to take a closer look at options for entrance into the formal financial sector.

- **Political nature of superintendent:** In many countries, the superintendent of banks is either a political appointee, or reports to the President. While the independence of bank regulators is often cited as a critical ingredient of a stable financial system, the political nature of the superintendent’s position can limit the level of independence. In countries where the government specifically targets the microenterprise sector in its plans to promote economic growth, the bank superintendent often acts as the link between the government’s political agenda and the regulators’ work. This was the case in Peru with Mibanco, as explained below.
Institutional Metamorphosis

Political Challenge in the Creation of Mibanco

In Peru, the Fujimori administration played a critical role in expediting Mibanco’s regulatory approval. In July 1996, the President announced plans to create a microfinance bank, as part of the government’s strategy to promote economic growth by targeting the microenterprise sector. Meanwhile ACP, an ACCION International affiliate, had been contemplating an eventual transformation into a regulated, for-profit financial institution since 1985, and had received approval to establish a non-bank financial institution in 1996. The President’s announcement spurred ACP to reexamine its transformation plans. The presidential committee, created to oversee the development of the bank, initiated dialogue with ACCION International, which eventually led to an agreement to pursue the transformation of ACP into a microfinance bank. By November, 1997, the Bank Superintendent approved a feasibility study outlining the transformation and on May 4, 1998, Mibanco began operations as the first commercial bank dedicated to microfinance in Peru.

Implications of Integration into the Formal Financial System

Transformation of an NGO into a formal bank exposes the MFI to many factors and influences of the local political economy. As NGOs, microfinance organizations are isolated or at least partially protected from the shocks and regulatory decrees that often characterize the formal banking system. While some countries have begun to include provisions for microfinance NGOs in their regulatory frameworks (Uganda, Ghana, South Africa, Cambodia), most NGOs have evolved outside of any regulatory restrictions, allowing them to operate with relatively few constraints in terms of geographic location, methodology, cost structure, and growth rate. By choosing to transform into a regulated financial institution, however, microfinance institutions could lose this independence, as their operations become closely linked to the overall stability of the banking system. For example, the Central Bank of Kenya (CBK) was slow to process applications for new bank licenses, including K-Rep’s application, due to problems within the financial sector. The CBK was under scrutiny for its ability to provide adequate supervision to the existing financial institutions in Kenya. As a result, the CBK delayed approval of K-Rep’s application for a banking license and increased minimum capital requirements from $3.5 million to $6.8 million, forcing K-Rep to revise the capital structure of the proposed bank. Similarly, the textbox above describes the recent implications on Financiera Calpiá of being a part of the formal financial system in El Salvador.

Regulatory Framework

The decision to transform into a regulated financial institution is heavily influenced by the country’s regulatory environment. Transforming MFIs need to examine carefully the pros and
cons of each regulatory category before selecting the institutional type best suited to their operations. This process represents the beginning of a long-term relationship that must be carefully built with regulators through a variety of exchanges, including visits, discussions, letters, and information sharing.

**Examining Options**

As a precursor to developing a solid business plan and applying for a license to become a formal financial institution, the MFI must become familiar with the regulatory requirements and types of formal financial institutions permitted under the country’s banking laws. The three principal NGOs examined in this study pioneered NGO to bank transformation in their countries. Following the precedent set by PRODEM’s creation of BancoSol in 1992, each became the first microfinance NGO in their respective country to attain a banking license. CARD Rural Bank is legally registered as a rural bank; Mibanco and K-Rep are both commercial banks.

All three MFIs researched alternatives before deciding on their respective bank structure. K-Rep decided to create a commercial bank after ruling out the cooperative structure for fear of over-regulation and after the CBK eliminated the non-bank financial institution (NBFI) option. While the thrift bank structure would have allowed CARD the same level of flexibility to maintain their methodology and products, the NGO selected the rural bank structure because of the lower capital requirements. Similarly, ACP seriously considered transforming into a financiera due to its lower capital and reporting requirements, until the EDPYME became an option with even lower capital requirements and microfinance orientation. In the end, however, a challenge issued by President Fujimori caused ACP to transform into a commercial bank, Mibanco.

Each of the three principal NGOs sought to establish a regulated financial intermediary within the country’s existing regulatory framework, as opposed to lobbying regulators to create a new financial institution category. The German development agency Deutsche Gesellschaft für Technische Zusammenarbeit (GTZ) contracted IPC to work with the central bank in Bolivia to create a new type of commercial finance company geared toward microfinance, the Private Financial Fund (PFF). Once developed, Pro-Credito, an IPC affiliate, applied for a license and became the first microfinance NGO to transform into a PFF.

**Exchanges with Regulators**

The three principal institutions of this study all assumed primary responsibility for orienting the local banking superintendency about the particular characteristics of microfinance and its role in the larger financial sector. This orientation ranged from extensive one-on-one dialogues, to the hosting of local policy workshops, to organizing and accompanying regulators to examine field operations of successful MFIs both nationally and internationally. In the process of orienting the regulators, these MFIs applied three tactics: they used BancoSol as a demonstration model; they held on-going relationship-building discussions; and they educated regulators on the norms of microfinance while learning about traditional bank regulations.

*BancoSol as a demonstration model:* As the first microfinance NGO to bank transformation, the PRODEM/BancoSol experience has proved instrumental to the education of bank regulators around the world. K-Rep, CARD and Mibanco all benefited from the BancoSol demonstration model. Central Bank regulators from Kenya and the Philippines visited Bolivia at key points during the application processes of these institutions. In the Kenya case, two of K-Rep’s board members accompanied Kenyan regulators to Bolivia to see first hand BancoSol’s success in serving microentrepreneurs as a commercial bank.
On-going discussions: The amount of time and effort involved in educating and dialoguing with regulators should not be underestimated, particularly for the first NGO in a country to seek a license. In all three cases, regulatory approval was contingent upon approval of a formal business plan and a visit by regulators to review the MFI’s operations. While both CARD and Mibanco experienced a relatively short time delay (approximately six months) between the submission of their banking license application and its approval, both organizations dedicated many years to regulatory dialogue and education prior to submitting the application. Likewise, while K-Rep only submitted its application to the Central Bank of Kenya (CBK) in August 1998, dialogue with the CBK around the possibility of transformation began as early as 1995. While the CBK is not responsible for many of the delays, K-Rep’s changing transformation plans required on-going discussions with regulators to maintain the relationship and to understand changing regulatory requirements.

Mutual education: In many cases, the standard regulatory framework for financial institutions is not appropriate for the supervision of microfinance institutions. Through on-going discussions, MFIs can simultaneously learn about the standard regulatory requirements of the country and educate the regulators on the norms of microfinance. A superintendent’s principal goal is to protect the financial system from unsound practices by deposit taking institutions. From a traditional bank examiner’s perspective, many of the characteristics of microfinance - unsecured loans, limited financial statement analysis, transactions occurring outside formal bank premises - are considered unsound. The transforming MFI is tasked with convincing the regulators of the soundness of their practices or making the necessary changes to comply with regulatory requirements. Common issues include non-secured lending restrictions, reporting, loan loss provisioning requirements, loan documentation, and branch location. For example, the security of the proposed bank’s location was just one of the many issues raised by the Central Bank of Kenya (CBK) that K-Rep had to overcome to secure its bank license. K-Rep successfully convinced the regulators of the importance of conducting operations in low-income areas due to the proximity to its clients. However, K-Rep Bank did have to comply with the CBK’s security standards, which were much higher than those of the NGO.

After approval of the license, the initial regulatory examination often provides the first test of this new relationship, and serves an important educational role for both regulators and employees of the new formal financial institution. Approval of the license is only the beginning of the relationship with the regulators. The supervisory process, from monthly report submissions to annual on-site bank examinations, requires an on-going investment in time and effort by the MFI. Likewise, the regulators need to invest time and resources with the MFIs. Their ability to assume additional responsibility, however, is often limited by funding constraints and an already overstretched supervisory staff. While the costs of supervision are typically absorbed by the financial institution through annual dues, newly transformed MFIs may initially be hard-pressed to carry the full cost of both educating regulators and funding supervisory expenses. These expenses need to be taken into consideration in any transformation process.

3.2 Ownership and Governance

Once the MFI decides to transform into a privately owned institution, it must determine the desired composition of its new board, which usually comprises its owner-investors. In most cases, the NGO board will develop the proposed institution’s mission and use it as a guide in seeking potential owners and board members. Potential owners review the capitalization and asset-liability transfer strategies before reaching their investment decision. Therefore, the roles of

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ownership and governance, as well as capitalization and asset-liability strategies, are simultaneous related considerations.

Institutional Mission

The NGO board is usually charged with the responsibility of revising the current or developing a new mission for the proposed institution. Boards of transforming NGOs are often concerned with ensuring that the new microfinance institution retains the social mission. Transforming NGOs attempt to strike the desired balance between commercial and social objectives in the development of the new board and by selecting owners. A well-defined mission statement can help guide the board through the selection process. Boards can also add clauses to the new institution’s bylaws that ensure a commitment to the target sector, for example, by requiring that the MFI’s borrowers represent the microenterprise sector. This can be measured by loan size, or by the clients’ profits or accumulated assets.

While an MFI’s average loan size may increase following transformation, this may or may not imply mission drift. Increases in average loan sizes can be due to entrance into new markets, including the targeting of small businesses, and/or growth of active clients’ loan size requirements. In two of the three principal cases of this study, K-Rep and CARD, average loan sizes actually decreased over the year of their transformation. Even MFIs that have shown an increase in average loan size since transformation may have continued to expand their outreach to the microenterprise sector. For example, over time Financiera Calpiá’s average loan balance has gradually increased from $593 (Dec. ‘93) to $895 (Dec. ’98). However, the number of Calpiá’s outstanding loans under $500 has consistently remained around 50 percent of the portfolio overtime.19 This implies that Calpiá has maintained its commitment to serving the microenterprise sector in El Salvador.

Board Formation

Spending time and energy up front to ensure a strong board that will develop an appropriate vision for the MFI is one of the most important investments an MFI can make for its long-term survival. An MFI should not assume that its current board has the necessary skills and financial backing to guide it through the transformation process, or to lead it as a regulated financial institution. While there is no formula for board formation, ideally the board consists of members with a diverse set of skills, including private business, financial sector and legal or regulatory expertise. As such, it is likely that the board will either need training and/or member replacement to ensure that the necessary skills are present.20 In addition, with the creation of an ownership base, the shareholders will have to be taken into consideration in new board formation in most cases.

Board member selection: The link between ownership and board representation is a key difference between governance structures of NGOs and those of many privately owned financial institutions. Board members of NGOs are usually selected for their community connections or respected technical expertise. While these attributes are certainly relevant for a regulated financial institution, a bank board also typically includes representatives of the institution’s key investors - individuals who have a financial stake in the future of the organization. Additionally, the banking superintendency will often require that a certain number of board members have formal financial management experience. Hence the need to create a board whose members

19 Based on data from 1993-97 provided by Financiera Calpiá to the Economics Institute.
20 Campion and Frankiewicz, 1999.
collectively offer the desired technical and leadership expertise is a consideration in the selection of investors in a transforming MFI.

**NGO board member overlap:** In the cases examined, new boards were created for the regulated financial institution, composed of former NGO board members as well as new individuals. The prevalence of former NGO board members ranged from 2/8 on K-Rep Bank’s board to 3/7 on CARD Rural Bank’s board to 5/9 on Mibanco’s board. This representation also reflects the range of NGO ownership, 32.5, 44 and 60 percent, respectively, as discussed in **Ownership Options** below. In addition, in each case, individuals with strong banking or financial skills were invited to join the new board, often as representatives of investors or as individuals with reputations for solid banking expertise.

**Client representation:** Only one of the cases studied includes borrowers on its board. Two of CARD Rural Bank’s seven board members are clients, both of whom have outstanding loans. These two members were elected to the board by the client membership, primarily for their strong leadership skills and demonstrated business success. As new board members, the ability to balance their own interests as net borrowers against the institution’s larger interests of outreach and sustainability has yet to be tested. The Central Bank of the Philippines imposes restrictions on loans to directors, officers, shareholders and related interests, which should help to minimize this potential conflict of interest.

**Employee representation:** Each of the cases examined include the managing director/president as a member of the new financial institution’s board. None of the cases, however, have incorporated other staff representation on their boards, due primarily to concerns regarding the sensitivity of information discussed at board meetings. In K-Rep’s case, the Kwa Multipurpose Cooperative Society, the savings and credit cooperative for staff, owns 10 percent of K-Rep Bank’s shares, but does not have board representation. Due to the frequent turnover of Kwa leaders, each of which is democratically elected, K-Rep Bank opted not to include Kwa representatives on the board. This also ensures that the three organs of the bank, the board, management and staff, function semi-independently of each other.

**Ownership Options**

**Table 6** identifies the breakdown in shareholders for the three principal cases studied as well as BancoSol, BancoADEMI, Caja Los Andes and Financiera Calpíá. (Finansol / FINAMERICA was not included in this table as ownership upon the creation of Finansol and currently at FINAMERICA are not comparable.) To facilitate comparison, the table distinguishes between seven different types of ownership: founding NGO, other NGOs, public development agency / donor, specialized equity fund (such as ProFund, IMI or ACCION’s Gateway), foreign private investor, local private investor, and employee stock ownership plan (ESOP). None of the institutions has any government ownership. For each institution, the ownership mix at transformation is presented in the left column, and the current ownership is presented in the right column. Minimum capital requirements for the license chosen by the MFI are also shown at the bottom of the table.

**NGO Ownership**

Each of the transformation cases involved the creation of a new privately owned, regulated financial institution by a non-profit NGO. In each case, the NGO, through various mechanisms,
Table 6: Ownership of Transformed MFIs, at transformation (left column) and today (right column)

<table>
<thead>
<tr>
<th></th>
<th>CARD</th>
<th>K-Rep</th>
<th>Mibanco</th>
<th>BancoSol</th>
<th>BancoADEMI</th>
<th>Caja Los Andes</th>
<th>Financiera Calpiá</th>
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</thead>
<tbody>
<tr>
<td>% founding NGO</td>
<td>100.0</td>
<td>44.2</td>
<td>32.5*</td>
<td>60.0</td>
<td>60.0</td>
<td>29</td>
<td>20</td>
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<tr>
<td>% other NGOs</td>
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<td>0</td>
<td>0</td>
<td>0</td>
<td>19</td>
<td>14</td>
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<tr>
<td>% public</td>
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<td>3.07</td>
<td>0</td>
<td>0</td>
<td>29</td>
<td>20</td>
</tr>
<tr>
<td>% specialized</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>26.0</td>
<td>26.0</td>
<td>0</td>
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</tr>
<tr>
<td>% foreign private</td>
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<td>0</td>
<td>26.8</td>
<td>26.8</td>
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<td>27</td>
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</tr>
<tr>
<td>% local private</td>
<td>0</td>
<td>0</td>
<td>33.1**</td>
<td>0</td>
<td>0</td>
<td>13.2</td>
<td>14</td>
</tr>
<tr>
<td>% ESOP</td>
<td>0</td>
<td>0</td>
<td>10.0</td>
<td>10.0</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Capital</td>
<td>$116,279</td>
<td>$6.8 million</td>
<td>$5.6 million</td>
<td>$3.2 million</td>
<td>$2.2 million</td>
<td>$1 million</td>
<td>$1 million</td>
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<td>requirement at</td>
<td>(Rural Bank)</td>
<td>(Commercial bank)</td>
<td>(Commercial Bank)</td>
<td>(Commercial Bank)</td>
<td>(Development Bank)***</td>
<td>(Private Financial Fund, PFF)</td>
<td>(Financiera)</td>
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<tr>
<td>transformation</td>
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</tbody>
</table>

† At December 31, 1992.

* K-Rep Holdings Ltd., a newly established holding company, will own 32.5 percent of K-Rep Bank rather than the NGO.

** Represents client ownership; currently held on deposit for future stock subscription.

*** BancoADEMI’s status as a Development Bank is temporary, until regulators approve the Savings and Credit Bank category later this year.
capitalized a sizable portion of the new financial institution, making it a part, or in one case full, owner of the new institution. In each of the cases, NGO ownership was considered vital to maintaining the founding vision of the regulated financial institution. As a shareholder with a certain number of board seats, the NGO can expect adequate influence over the future direction of the new institution.

Among these newly regulated financial institutions, the initial level of NGO ownership ranged from 32.5 percent at K-Rep, to 60 percent at Mibanco, to 100 percent at CARD, highlighting a significant range in levels of NGO ownership. It is important to note that while K-Rep had sufficient capital to meet the CBK’s minimum capital requirements to create the new bank, Kenyan law limits the amount that any person or institution, except banks and public companies, can own of a bank. Therefore, K-Rep was forced to seek outside investors and reach an acceptable shareholder agreement. The law governing rural banks in the Philippines allows 100 percent ownership by one party and given relatively low capital requirements to create a rural bank, CARD NGO was able to provide all of the original share capital. CARD NGO has since reduced its share ownership to approximately 44 percent.

The dominance of NGO ownership in all three cases raises questions about the nature of transformation. Since NGOs and private development agencies by definition have no owners, their ownership in the transformed financial institution does not represent personal equity. As discussed below, the NGO’s portion of paid-up capital typically comes from grants and accumulated capital. A dominance of NGO ownership can reduce the intended benefits from private ownership of increased accountability and access to additional sources of capital.

The NGO’s management of its new ownership stake is a critical issue. Many issues are less clear under NGO ownership, such as who will take responsibility for managing the investment and what role it will play. The new bank charter should clearly define the NGO’s intentions for disposing of this investment in the future, preferably with plans for eventual divestment. This issue should be addressed within the framework of the NGO’s future plans for income generation and asset accumulation. It should be clear how the NGO will use returns from the investment, especially if it will fund additional credit activities. The continuing role of the NGO is treated as a separate discussion below.

**Limited Local Private Ownership**

The initial amount of local private ownership in these new formal financial institutions is quite limited. K-Rep sought local investors, but the Kenyan banks were not interested initially because they were unfamiliar with microfinance. Only later, as the process advanced and K-Rep received support from reputable international entities such as the World Bank/IFC and positive media attention, did local banks express an interest. Unfortunately, at that point it was too late for their participation. In Peru, there was interest by other banks and insurance companies, but with the NGO taking 60 percent of the shares, the potential for private ownership was minimal. Hence,

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21 K-Rep presents an exception to this scenario, since it created a holding company, K-Rep Holdings, explicitly for the purpose of owning subsidiaries, including K-Rep Bank.

22 In the final stages of CBK negotiation, minimum capital requirements for commercial banks in Kenya were raised to 500 Ksh ($6.8 million as of August 1999). K-Rep Holding, Limited (KHL), the parent entity of the surviving NGO, provided the additional required capital, temporarily increasing its ownership holding to 49.75%. The CBK granted KHL a permanent waiver on the 25% ownership limitation, yet KHL offered all shareholders the option to increase their subscription so as to retain their respective original ownership percentage. All shareholders, except AfDB, Shorebank and Kwa, accepted this offer, leaving KHL with 32.5% ownership.
only two private commercial banks, Banco de Credito and Banco Wiese, comprise Mibanco’s local private ownership, each of which owns 6.6 percent of the bank. BancoSol is an exception, in that it had 25 percent local private investors at the end of 1992 and its shares are now sold on the Bolivian stock exchange, as described in the textbox. However, several of the local private owners did not have a long-term commitment to their investment and have since divested, reducing BancoSol’s local private ownership to only 10 percent at the end of 1998.

BancoSol Lists on the Bolivian Stock Exchange
In September 1997, BancoSol became the first microfinance institution to be listed on a national stock exchange and one of only 12 publicly traded companies on the Bolivian stock exchange. While the market for trading BancoSol shares has not been very active, the listing represents a significant step in commercializing microfinance. BancoSol first began preparing the market for public offering in 1997, when they issued their first dividends of $162,857 or $0.45 per share on 1996 earnings of $1.1 million.

The microfinance sector is just beginning to attract private capital. While public sector development funds are playing an active role in the sector, private investors are not convinced that such an investment makes sense. Except in a few isolated cases, returns within the microfinance industry have not yet been realized. Secondly, in most cases, there is no liquid market for the shares, limiting the investor to dividend returns and hindering their exit strategy. Thirdly, with most of the MFIs examined in this study, the founding NGO wanted to maintain majority ownership, leading private investors to question their own abilities to shape the long run vision of the organization. In sum, those regulated financial institutions which have been created by microfinance NGOs still do not appear ready for full private ownership; investors need to have confidence in the sector before risking large amounts of capital, and this confidence building requires time and demonstration of profitability.

ESOPs
As a vehicle for staff ownership, employee stock ownership programs (ESOPs) provide a mechanism for aligning employees’ goals with the goals of the company. In general, these programs offer employees the ability to benefit from the increase in value of the company, either directly as shareowners or indirectly through incentives tied to profitability. The mechanisms for doing this vary, based on the level of risk assumed by the employees and their actual ownership rights. In matching benefit programs, for example, the employer matches the employee’s contribution to purchase shares, thereby reducing the downside risk to the employee if there is a devaluation of the shares. In contrast, in leveraged stock distribution plans the employer typically provides the employee with an interest-free or low interest loan to purchase shares, a highly risky proposition on the downside. In phantom stock plans, employee incentives are paid and earned in relation to the share price. As such, the employee does not own any shares, but his/her incentive scheme payout relies on the earnings per share as the primary indicator of performance.

In three of the seven cases examined, an employee stock ownership program was designed to reward and acknowledge the contribution of staff and management’s service to the organization, ranging from 10 percent at K-Rep Bank to 22.7 percent at CARD Rural Bank. In both CARD and K-Rep, non-voting shares are made available to staff based on a combination of seniority and professional status.

In K-Rep’s case, eligible members must agree to purchase one right for every right awarded as a bonus. To facilitate this process, employees can borrow money to purchase shares at 9 percent
p.a. for five years. With initial funding from CGAP, the Kwa Multipurpose Cooperative Society, a credit and savings cooperative for K-Rep staff, will purchase and assign these initial rights to members. Shares can be sold at times and dates specified by Kwa. In case of death or permanent disability, shares can be cashed out.

In contrast, at CARD, eligible staff will be given shares. Staff will benefit from dividends, but will not be able to sell, transfer or convert the shares to cash. This differs from the *phantom stock plan* mentioned above, as shares are actually assigned to individuals. As such, CARD will not require staff to put any of their own funds at risk. At BancoADEMI, 20 percent of the shareholders control was relinquished to ADEMI employees by means of a special bonus based on accumulated severance and pension benefits. The case studies in Part II provide more detail on each particular ESOP.

The use of an ESOP conveys an important message to staff that they too can benefit in concrete ways from the transformation. In CARD’s case, the vision behind transformation was built on the ultimate goal of employee and client ownership. At K-Rep, the ESOP was specifically designed to reward and acknowledge the contribution of staff, management and board members’ service to K-Rep. In both cases, the transfer of shares to staff was designed as a bonus, an added benefit to supplement their salaries. This extra bonus becomes particularly important as staff begin to compare their new bank salaries, which are typically comparable to other NGOs, with the salaries of other bank employees. The ESOP can build employee loyalty and ownership, smoothing the transformation process and reducing the potential for staff turnover.

The element of risk in ESOPs can be particularly significant in transforming microfinance institutions. There is usually a great deal of pressure to participate in the program, yet no proven stream of earnings to aid staff in making informed decisions as the ESOP is typically launched in conjunction with the opening of the newly formed bank. Transforming MFIs need to be aware of this element of risk when launching an ESOP and ensure a balance between individual risk and salary stability. CARD and BancoADEMI both awarded shares to staff as a special bonus, essentially eliminating individual risk. At K-Rep, on the other hand, eligible staff are required to purchase one right for every right awarded, and are offered a loan to do so. K-Rep believes that the requirement for staff contributions ensures that members have an adequate sense of ownership and commitment to the ESOP.

**Client Ownership**

Among the case studies examined, CARD Bank was the only institution to incorporate client ownership into its initial share structure. CARD plans to offer preferred stock to borrower groups (individual clients will not be eligible) which meet certain eligibility criteria, and will allow clients to use their center fund contributions (composed primarily of clients’ compulsory savings) or cash to purchase the shares. To facilitate this process, the board recently voted to set aside approximately $190,000 in center fund contributions as a deposit for future stock subscription. Mibanco plans to sell shares to its clients as well. It has reserved $1 million of preferred stock to sell to interested clients sometime after the year 2000.

**Investor Characteristics**

In general, transforming microfinance institutions should seek investors who demonstrate the three C’s of continuity, commitment and credibility in the market place. Whether they are local or international, individual or institutional, these investors need to maintain a continuous commitment to the mission of the institution. At least a few of them should also be capable of providing additional capital contributions, if necessary. Ideally, investors should have a technical
understanding of microfinance. This, along with demonstrated performance in the financial sector, will build the credibility necessary to attract commercial sources of funds and regulatory support. Specialized equity funds, such as ProFund, IMI and ACCION’s Gateway, offer unique investor profiles since their primary purpose is to achieve a return on investment. Yet as representatives of development-oriented organizations, they are motivated by an institutional mission. These investors have the experienced staff and resources to allocate to performance monitoring and provide technical guidance when needed. While primarily funded by public investment, specialized equity funds offer an investment model from which microfinance could learn and evolve to include more pure private investment.

Currently, these investors are all foreign. Foreign investors are often less accessible, and the cost of their participation needs to be carefully weighed against the benefits of their participation. In addition, these investors often play a dual role as technical assistance provider and board representative. The board member of such an institution must be careful to balance his or her role with that of the technical assistance team, so as to protect the trust, and therefore effectiveness, of the technical assistance providers. Representatives from ACCION International carefully balanced the governance and technical assistance roles in their involvement with the creations of BancoSol and Mibanco.

While less likely to carry a personal agenda and often helpful in establishing an organization’s credibility, public development agencies, such as the International Finance Corporation (IFC) or the Inter-American Development Bank’s (IDB’s) Multilateral Investment Fund (MIF), may not have the same drive to oversee the investment that a personal investor would. In addition, representatives from public development agencies tend to rotate every few years. This limits the effectiveness of their governance contribution and requires continual investments in board training by the financial institution. As these limitations become known, public development agencies are increasingly moving away from direct investment in MFIs and are instead channeling resources through specialized funds, such as the IDB’s MIF invests in ProFund and USAID and CGAP invest in ACCION’s Gateway Fund. Regardless of investor type, the transforming MFI should seek investors with transparent motivations that collectively support the dual commercial and social missions.

**Capitalization**

The initial capitalization of a regulated financial institution is typically determined by two factors: the regulatory requirements in the country and the institution’s business plan. Minimum capital requirements for the three principal financial institutions examined in this study ranged from $161,000 (CARD Rural Bank) to $6.8 million (K-Rep Bank). In addition, growth projections among the institutions vary significantly. Within five years of acquiring a bank license, CARD and K-Rep anticipate outstanding loan books of $26 million and $35 million, respectively. In contrast, by the year 2000, only three years after acquiring a bank license, Mibanco anticipates an outstanding loan book of $200 million. These various growth plans and each country’s minimum capital requirements have led each of these organizations to very different capitalization strategies.

In NGO to bank transformations, the net assets of the NGO are typically transferred to the new regulated financial institution in exchange for some combination of debt and equity in the new institution. The variations among capitalization strategies primarily reflect differences in the transaction method and in the timing of the exchange. The transaction can either happen as a direct swap, as in the case of PRODEM/BancoSol, whereby the assets of the NGO were directly
sold to the bank in exchange for shares, or as a cash capitalization, as in the case of ACP/Mibanco and CARD, whereby the NGO provides the paid-up capital in cash. In this second scenario, the NGO either borrows the necessary funds for the paid-up capital requirements, paying off the loan as its own loan book comes due, or uses its own accumulated capital. The choice between initiating a direct swap of assets for shares, as opposed to capitalizing the new institution in cash is often a function of the regulatory requirements in the country. Providing the capital in cash is often viewed as preferable for preserving the integrity of the capital account.

The timing of this exchange of assets for debt or equity is another important factor in determining the capitalization strategy. CARD, for example, initiated a phased approach to transformation, which will allow for the gradual transfer of some assets and liabilities from the NGO to the bank on a branch by branch basis. Drawing from accumulated capital, the NGO provided initial capitalization to the bank. In addition, the loan books of the relevant NGO branches were transferred to the bank’s balance sheet in exchange for debt in the new institution. This process of gradually increasing capitalization as new NGO branches are transformed into bank branches and the gradual transfer of their respective loan books will continue for the next few years.

Asset and Liability Transfer Issues

The transfer of assets and liabilities from an NGO to a regulated financial institution raises a number of key issues. These include the following:

- **Debt/equity split**: The proportion of debt to equity is influenced by five primary factors: i) the minimum capital requirements in the country; ii) the maximum leverage ratio allowed by bank regulators; iii) the value of the NGO’s net assets; iv) regulatory limits to ownership; and v) to a certain degree the NGO’s ownership ambitions. Each of these variables is evident in the K-Rep case. The Central Bank of Kenya (CBK) restricts ownership by non-bank entities, which initially limited K-Rep Holdings to a maximum of 25 percent ownership. In the final stages of CBK negotiation, minimum capital requirements for commercial banks in Kenya were raised to US$6.8 million from US$3.5 million. K-Rep Holding, Limited (KHL), the parent entity of the surviving NGO, provided the additional required capital, temporarily increasing its ownership holding to 49.75 percent. The CBK granted KHL a permanent waiver on the 25 percent ownership limitation, yet KHL offered all shareholders the option to increase their subscription so as to retain their respective original ownership percentage. All shareholders, except AfDB and Shorebank, accepted this offer, leaving KHL with 32.5% ownership.

K-Rep Holdings provided this initial capitalization from the accumulated capital of the NGO. In addition, assets and liabilities of the NGO, which is now a division of KHL will be transferred to the nascent bank, K-Rep Ltd., and exchanged for convertible income notes that will serve as quasi-equity. This long-term debt resembles equity in that it does not have a fixed return and is only retired when the capital structure is changed, such as when the bank tenders shares to the public. The income notes earn returns only when dividends are declared, yet appreciate through retained earnings. This mechanism allows KHL automatic access to additional funds to maintain its ownership percentage if needed.

- **Valuation exercise**: Microfinance institutions that seek private investors need to determine the net value of the new institution. While this can be determined internally, it is typically done through a formal valuation of assets and liabilities by a reputable accounting firm.

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23 BancoSol exchanged shares based on the value of PRODEM’s loan book plus a 10 percent premium.
While time consuming and often disruptive to staff and management, this exercise is essential for building investor confidence.

- **Premiums**: In each case, the new financial institution gained instant access to the NGO’s client base. As compensation, some NGO to bank transfer strategies are structured to include a premium payment from the bank to the NGO. For example, Mibanco agreed to administer ACP’s existing loan book at no cost for the first year, and to pass on the interest revenue on all pre-existing loans until they came due. In addition, Mibanco paid ACP a premium of $1 million in cash for access to these clients. CARD Rural Bank is required to pass on half of all interest payments on all pre-existing loans to the NGO.

- **Lender negotiations**: NGOs that have sourced funds from commercial or other lenders need to negotiate carefully either a transfer of this liability to the bank or some other arrangement which will allow the NGO to continue to pay off the debt with resources from the bank.

- **Donor negotiations**: A large portion of an NGO’s capital base typically comes from donor contributions. Funded by taxpayers, these development agency resources are typically restricted to non-profit organizations with social objectives. When the NGO creates a for-profit financial institution, the transfer of these assets can raise concern among donors. In Bolivia, for example, PRODEM hoped to transfer a significant portion of its loan book, largely funded by USAID, to BancoSol in exchange for shares. Only after complex negotiations did USAID approve the transfer, based on the notion that USAID funds donated to PRODEM were no longer classified as U.S. government funds since they had been lent once and repaid. Despite donors’ support for commercialization of MFIs, most donor agencies do not yet have written policies and procedures to address the issue.

- **Capital transfer to private individuals**: In a number of NGO transformations, donor funds have been used to capitalize individual shareholdings. While in some cases, shares in the new financial institution were sold to private individuals, in others, the shares were simply transferred to board members, managers or staff of the former NGO. This raises ethical questions as to the fairness of transferring share capital partly accumulated with taxpayer money to a few well-placed individuals. Donors that have supported the subsidized transfer of shares to private individuals argue that funding individual share ownership helps foster enhanced levels of governance and accountability. CGAP, for example, provided funds to facilitate the creation of an ESOP for K-Rep employees. CGAP views this support as an important contribution to moving microfinance forward and hopes that K-Rep’s ESOP will encourage higher levels of staff commitment and productivity, providing a demonstration model to other MFIs in the future. On the other hand, such transfers could be viewed as contradictory to the non-distribution constraint (no dividends on NGO equity) typically applied to non-profit equity bases or public funds.

### 3.3 Organizational Development

Identifying investors, establishing a board, and transferring assets and liabilities represent only the beginning of the transformation process. A range of organizational development changes must also be addressed, which is an evolutionary process that requires time and effort. A new mission must be identified for the founding NGO. Furthermore, the leadership of the new regulated financial institution must communicate its vision to employees and clients, generating enthusiasm without creating unrealistic expectations. Systems must be put in place, and new staff hired and trained. While many of the organizational development decisions can be made prior to
receipt of the bank license, most of the organizational transformation occurs after regulatory approval.

**Continuing Role of Founding NGO**

A critical issue for NGOs that create regulated financial intermediaries is the role of the founding NGO. One option is for the NGO to cease all lending activities, and operate solely as a trust for the NGO’s investment in the regulated financial institution. This is the case for both Fundación Calpiá and Caja Los Andes. In addition, while still in the transformation planning stages, ACLEDA in Cambodia is also pursuing this route. Because the capital markets in Cambodia are relatively underdeveloped, ACLEDA Trust, which will be the main shareholder in ACLEDA Bank, has been created to access soft capital and on-lend it to the bank at commercial rates. The National Bank of Cambodia has specifically indicated that they do not want ACLEDA Trust to have any operating activities or financial activities outside of its relationship as shareholder in and lender to the Bank.

For NGOs that do continue in an operational capacity, a variety of options are possible. This section examines two options as adapted by the range of institutions examined in this study.

1) **Continue with lending activities in different markets: The PRODEM/BancoSol case**

Upon the creation of BancoSol, the directors of PRODEM decided to continue as a microfinance NGO, but to operate in different geographic areas. Based on the assumption that it was not cost-effective to provide credit in rural areas, PRODEM initially retained all rural and semi-rural branches, transferring its profitable urban-based field offices to BancoSol in exchange for share capital. With the installment of the new executive director, PRODEM refocused its mission on two activities: (1) developing a sustainable model of rural lending in Bolivia, and (2) developing new, non-core financial services, such as pension plans and insurance schemes, for the microenterprise sector. Shortly after the launch of BancoSol, an additional office was transferred to BancoSol, in exchange for a combination of shares and cash, raising its ownership stake to approximately 30 percent of BancoSol. Subsequently in 1994, four more branches were sold to BancoSol for cash. While located in secondary cities, these branches had achieved profitability, dispelling the assumption that rural or semi-rural microfinance lending could not be commercially viable.

PRODEM’s own success at developing a sustainable model of rural microfinance lending, combined with a shift in strategy at BancoSol to grow through deeper rather than wider penetration of their current market, led to a discontinuation of this branch transfer strategy in late 1994. PRODEM’s outreach increased throughout the rural and semi-rural areas, as well as in some of the semi-urban markets. Without the on-going source of capital provided by the sale of branches, however, PRODEM needed to identify an alternative funding strategy. In addition, PRODEM and BancoSol soon found themselves in competition for the same clients, a situation greatly complicated by the ownership and governance ties between the two organizations. A merger between the two organizations was temporarily considered, but PRODEM ultimately decided to pursue a separate PFF license and in late 1998 sold half its BancoSol shares.

The PRODEM and BancoSol story highlights the complications that can arise when the founding NGO’s role post transformation is not distinct from that of the new financial institution’s. As the single largest shareholder in BancoSol, PRODEM had a vested interest in the success of the new institution. This interest was compromised when the two institutions began competing for market

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[24 Berenbach and Churchill, 1997.](#)
share, impeding PRODEM’s ability to serve an unbiased governance role. This issue will be resolved in the coming months when PRODEM sells its remaining BancoSol shares, thereby surrendering its role on BancoSol’s board of directors.

2) Cease lending activities and focus on business development services: The ACP case

In Peru, ACP has ceded all lending activities to the new microfinance bank, Mibanco. In fact, it was explicit in the design of Mibanco that the two institutions must be separate in order to avoid the problems experienced by Corposol/Finansol. For this reason, the transformation entailed a full transfer of the microlending operations from ACP to Mibanco. ACP plans to continue providing technical assistance and business development services to microentrepreneurs. It intends to develop its own client market in addition to targeting Mibanco clients.

Due to its phased approach to transformation, whereby the NGO transfers branches to the rural bank over a period of a few years, CARD NGO has not yet surrendered all lending activities to CARD Bank. Branches will continue to operate under the CARD NGO through the year 2002. CARD’s lending and savings operations will continue to be housed under two organizations, requiring an overlap in senior management between the bank and the NGO. In addition, CARD NGO will continue to own a significant portion of CARD Rural Bank for the next few years. Once all lending activity is transferred to CARD Rural Bank, CARD NGO will focus solely on training and research. Training will be targeted at other NGOs, MFIs, and cooperatives, as well as for staff and clients. Research activities will include impact, means testing, product development and market surveys.

**Hybrid:** In Kenya, K-Rep Development Agency, the NGO, intends to follow a hybrid of these two models. K-Rep Development Agency will assume responsibility for most research and consultancy services through its Microfinance Research and Innovations Department, which will act as the incubator of new product ideas, including new savings and loan products as well as business development services. In its savings and lending activities, the NGO will attempt to reach lower income individuals than currently comprise K-Rep Bank’s clientele. The NGO activities will not compete with K-Rep Bank, but may indirectly support its development. For example, the NGO is developing a rural savings model in which groups of savers are linked and their funds are jointly placed in a commercial bank account, which could be a K-Rep Bank account. If profitable and successful, pilot projects can be spun off into new for-profit institutions under the K-Rep Holding umbrella. Once K-Rep Bank matures, however, it is assumed that it will undertake its own research activities to avoid dependence on the NGO for innovation and new product development.

While it is still very early in each of the above NGO/bank relationships, the extent to which transformation ultimately encourages commercialization will be largely dependent on the new financial institution’s ability to gain complete independence from the NGO. This includes eliminating dependence on the NGO for such core functions as product development and market research. True commercialization of the sector will occur when a financial institution becomes not only independent of donor funding, but also independent of donor-dependent NGOs for key development functions.

**Organizational Culture**

Organizational culture is a system of shared beliefs and values that develops within an organization and guides the behavior of its stakeholders. It is created by the leadership of the organization, often articulated in the organization’s mission statement, and shaped and sustained by the organizational structure, policies and procedures, and the relationships among staff and
between staff and management. When a non-profit NGO transforms into a privately owned, regulated financial institution, each of these influential factors can change, thereby altering the MFI’s organizational culture.

The degree to which transformation affects the organizational culture of an institution is largely influenced by changes in management and communication styles. In Mibanco’s case, the strategic plan called for a mix of NGO and bank managers in the management hierarchy. The institutional structure was revised to accommodate the transformation from an NGO to a bank. The addition of traditional banking professionals with strong personalities in key management positions led to changes in communication patterns among staff (more hierarchical and formal) and in methodology (based more on traditional banking methods). These changes temporarily lowered employee morale and customer satisfaction. The board quickly recognized and corrected the imbalance by shifting management positions so that former NGO staff would hold positions involving close contact with branch staff and clients.

In contrast, CARD has not experienced a significant change in organizational culture. From both an accounting and organizational chart perspective, CARD is composed of two distinct entities, a bank and an NGO. However, when viewed from an operational perspective, CARD is one organization. This distinction is important as it underlies CARD’s ability to implement successfully a phased approach to transformation. Bank and NGO staff do not see themselves as working for two separate organizations. The interconnectedness between the NGO and the bank, from the operations’ level to the board, has helped shape this perception. In addition, CARD did not hire a cadre of traditional bankers when launching CARD Rural Bank, opting instead to train current staff in their new responsibilities.

Effective leadership and management are essential to the transformation process. Because transformation can take a long time, both what is communicated about the change and how it is communicated to staff are critical. By emphasizing the twin goals of better client service and organizational sustainability, management can provide concrete reasons for the transformation. The challenge for a leader is to keep staff informed of anticipated changes and to generate enthusiasm for these changes, without excessively raising expectations or causing fear among staff. This is a delicate balancing act. If change is oversold, unmet staff expectations may lead to low employee morale in the future. On the other hand, if not enough information is communicated to staff, unfounded fears around job uncertainties may mount. This is particularly hard when the timing of the transformation is delayed by outside interests. In K-Rep’s case, for example, management has assured staff that the transformation will not have a significant impact on their jobs. While this has allayed employee fears, K-Rep had only a few months from bank license to opening for which to prepare staff for the many operational changes and new tasks that are required of a regulated, deposit-collecting institution.

**Human Resources**

The set of skills required from staff changes as NGOs transform into regulated financial institutions. Whether an organization chooses to hire traditional bankers, to initiate an intensive training program for its own staff, or to apply a combination of the two, MFIs need to be aware of the significant amount of time and money required to prepare staff for the transformation. At PRODEM, for example, the executive director prioritized building staff capacity and invested heavily in preparing the NGO’s employees for the transition, determined that NGO staff would fill as many bank positions as possible. Seminars and training sessions, which focused on the technical aspects of banking as well as on the cultural differences between an NGO and a bank, were held for all staff levels. BancoSol’s early success is largely attributed to this emphasis on
cultural integration and to the effectiveness of these trainings in smoothing the transition. At Mibanco over $180,000 was spent on training in one year preparing employees for the transformation. This included training on the new computer system, as well as special training for loan officers on a new loan review process, loan sales and collections. Both K-Rep and CARD contracted outside service providers to conduct introductory courses on traditional banking for their staff.

An NGO’s transformation from a microcredit program to a financial intermediary implies significant change in responsibilities among all staff levels. This section examines the impact of transformation on loan officers, middle and senior managers.

**From Credit Officers to Financial Service Marketers**

The additional training needed to educate and train staff on bank procedures should not be underestimated. Initial training needs to focus on building employee commitment for the transformation and on how staff should communicate the transformation to clients. This includes reviewing upcoming operational changes and ensuring staff are prepared to articulate the future vision of the new regulated financial institution to clients.

With transformation comes a shift in loan officers’ responsibilities and the MFI’s approach to expanding outreach. In a microfinance NGO, most field staff focus on the provision of loans to clients beneficiaries. For those MFIs that become deposit-taking institutions, the MFI must also sell its clients on its financial strength and build their trust in its ability to manage their savings. Transforming NGOs need to train employees to handle this level of financial service marketing. Employees will need to understand the typical concerns clients have about saving in a formal financial institution and how to overcome them. In addition, as new loan products are introduced, such as individual loans, loan officers may require a different set of tools to analyze the creditworthiness of their borrowers. For example, loan officers may need to be trained in basic cash flow and balance sheet analysis.

**Importance of Grooming Middle Management**

Transformed microfinance institutions tend to expand rapidly, leading to an increase in new branch openings and therefore increased demand for branch managers. In most MFIs, branch managers are typically drawn from the pool of loan officers. While loan officers tend to have strong interpersonal and analytical skills, few have the ability to effectively manage staff or operate profit centers. One of the key challenges faced by transforming microfinance institutions is to develop a management training or grooming program that will adequately supply a quickly expanding middle management team.

**Increased Responsibilities of Senior Management**

The responsibilities of senior management increase significantly with transformation to a regulated financial institution. Organizations need to establish the right balance between hiring bankers for certain key banking functions and training their own staff to assume these functions. The goal should be to create an institutional culture with the right mix of the two cultures, adequate to provide the security of a formal bank while catering to the microenterprise market. Traditional bankers are appropriate for new positions that require traditional banking expertise, such as Investment or Treasury Officer. Existing staff, however, are often better suited for positions that require an in-depth understanding of microfinance and directly oversee branch level personnel, such as Operations or Business Manager.
Client Transitioning

Responding to client needs is one of the principal reasons for transformation. Transformation into a regulated financial institution allows an MFI to expand its market, offer its clients a broader range of products and services, and in some cases, even offer its clients a stake in the ownership of the bank. While each of these benefits may be clear to the management and staff of the organization, the clients’ perception of the transformation process will depend on the organization’s ability to effectively market these changes. The word “bank” often has negative connotations for people who have been excluded from the formal financial system due to lack of traditional collateral requirements or insufficient minimum balances. An NGO’s announcement that it plans to create a bank may fuel concerns that the organization will shift target markets or that customer service will deteriorate.

MFIs considering transformation need to involve their clients in the transformation process from the beginning. This involvement may include focus groups to collect input on the transformation process, or workshops to explain the potential impact of transformation. In CARD’s case, for example, clients have been informed from their initial membership with CARD about CARD’s intention to become a bank. In addition, training sessions have been scheduled to explain to clients the benefits and risks of purchasing share capital in the bank. Mibanco officially communicated the transformation to clients through a written letter mailed to each customer, verbally by employees, and through posters that described Mibanco’s mission statement and commitment to serve microentrepreneurs. In addition, radio and newspaper advertisements announced the transformation publicly and aimed to attract new clients.

Finally, clients need to see tangible benefits of the transformation soon after the bank is opened. Depending upon how the transformation is communicated, expectations can be high. Clients often expect greater efficiency, a broader selection of products, and improved customer service. At the same time, the newly formed bank is trying to launch a new computer system, implement new procedures, and schedule additional training for staff and management. The better prepared an institution is for the operational side of transformation, the easier it will be to meet the clients’ expectations. If, however, the initial transformation process is not well managed, clients may associate transformation with poor customer service, a potential precursor to client desertion.

3.4 Future Challenges

Using three principal case studies and a handful of other experiences, this paper offers some initial insights into the transformation process. The findings, however, are limited by the number of institutions that have experienced transformation and the short time frame from which to extract lessons. As more MFIs demonstrate profitability and microfinance becomes more commercialized, the barriers to entry into the formal financial sector will likely decline, facilitating other NGO transformations and more private sector ownership of MFIs. However, NGO transformation is likely to be just one phase in the evolution of the development of commercial MFIs. Fewer new microfinance NGOs are being created today, as donors have shifted their funding strategies away from start-ups. Furthermore, not all microfinance NGOs will develop to the level of scale and capacity necessary to justify transformation. New models for approaching commercialization still need to be explored. This final section identifies key challenges / next steps in the commercialization of microfinance.

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25 The UNDP’s MicroStart program is an exception to this trend.
**Time and information.** The future commercialization of the microfinance sector depends on two important elements: time and information. Access to commercial sources of funds will naturally increase as MFIs mature and demonstrate to capital markets their long-term viability as regulated for-profit institutions. In addition, the industry needs standard methods of rating and disseminating information on the financial health of MFIs. BancoSol recently received a positive rating by Standard and Poor, which is the first time a microfinance institution has been rated by an internationally accepted rating agency. With greater transparency, the microfinance industry can educate regulators and formal financiers so that they will better understand how to participate in the development of sustainable MFIs.

**New models for transformation.** New models or strategies for approaching transformation need further study and piloting. For example, the incorporation of a microfinance NGO into a new subsidiary of a bank is one model worth consideration. This option would reduce the time and money spent to acquire a bank license and allow the bank to achieve scale quickly. Change from one type of formal financial institution into another type is an alternative form of institutional transformation that merits study. One model is that of Financiera Calpiá, which is considering transforming from a *financiera* into a bank, due to changing capital requirements in El Salvador. Another is that of the *Alliance de Crédit et d’Epargne pour la Production* (ACEP), a credit union in Senegal that is currently researching its transformation into a bank.

**Direct creation of regulated commercial MFIs.** As the demonstration model takes effect, pure private investors may prefer to create their own regulated entities, rather than become minority owners of MFIs primarily owned by the founding NGO. This option would bring with it the benefits of improved governance and accountability currently lacking in microfinance NGOs and many transformed MFIs that are primarily owned and controlled by NGOs and public development agencies. MicroCredit Nationale in Haiti, which officially opened in the summer of 1999, is one example of this model. It is 40 percent owned by the largest commercial bank in Haiti, Unibank, 10 percent owned by IMI, with the balance owned by public development agencies. Other hybrids of this concept are being developed around the world, further indicating the potential for this evolution. For example, BanGente, a new MFI created in Venezuela in 1998 by a conglomerate of NGOs, also began directly as a regulated, for-profit financial institution.

**Long-term commitment.** Microfinance, however, remains a tough market, requiring long-term oriented, knowledgeable investors. While many traditional banks have attempted to enter the microfinance sector, several have already left to focus on consumer credit as a means of reaching low-income individuals. Few traditional banks have had the long-term commitment to or understanding of microenterprise lending necessary to achieve the economies of scale that lead to profitability. Time and education will help traditional banks and regulators learn how to participate successfully in microenterprise development.

**Exit strategies.** To encourage more private sector investment in MFIs, NGOs and public investors, particularly donors, must concern themselves more with developing appropriate exit strategies. First, the microfinance industry needs to identify and understand the profile of its potential private investors. Then, more transitional mechanisms, including debt and equity instruments, need to be available to attract those investors. Specialized equity funds could encourage private sector investment by creating opportunities for smaller investors to participate.

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26 Private Sector Initiatives Corporation (PSIC) is one organization working toward this goal by developing a rating agency for microfinance institutions. In addition, the MicroBanking Bulletin, managed by Calmeadow, provides a tool for making comparisons between one MFI and others within a region or peer group.
in the fund. The technical expertise of these fund managers could build the confidence necessary to encourage smaller investors to experiment with microfinance.

**Donor roles.** While donors have been and continue to be imperative in the development of the microfinance industry, they now have to be careful to avoid roles that could potentially impede the commercialization of microfinance. They too can play a role in weaning MFIs off free funds and encouraging increased access to commercial funds. Some donors, for example, are considering ways to provide convertible debt, such as through specialized equity funds. Donors can also encourage microfinance transformation and commercialization by supporting the development of prudential regulation and supervision by central bank authorities in the many developing countries where it is lacking. Likewise, they can continue to support the development of rating agencies and credit bureaus that collect the information necessary to encourage more commercial investment in the sector. Donor funds should also support research on new products and methodologies to provide financial services to even poorer sectors of the economy in a sustainable manner.

**Technical expertise.** Given that the microfinance industry is not yet fully developed, the direct creation of microfinance institutions still requires the involvement of technical experts. In the case of MicroCredit Nationale, IPC provided the technical assistance with donor support from the German development agency, Kreditanstalt für Wiederaufbau (KfW). It is currently difficult, however, to identify donor funds to support technical assistance to private microfinance institutions. While donors purport a desire for projects to be sustainable, there is still a preference for providing funds to NGOs. Yet many of these new private MFIs will have to compete directly with microfinance NGOs and transformed institutions that received years of donor supported technical assistance. Additional donor assistance is needed to create a level playing field for the next generation of MFIs and to move the microfinance industry forward upon its path towards commercialization.

This paper provides a framework from which a more detailed list of transformation issues and considerations could be categorized. MFIs contemplating institutional transformation should not limit their thinking to the models presented in this paper. Alternative and innovative approaches would benefit the microfinance field as a whole. More experience may uncover a preferred framework or refine the assertions made in this document.
PART II:

CASE STUDIES

You will ask – what is the feeling of hatching? Oh, no doubt, there is a rush of panic to the head, a thrill of breathless and strange sensation, but then the eyes see, in a flow of sunshine, the butterfly sees the world, the large and awful face of the gasping entomologist.

-- Vladimir Nabokov, from “Nabokov’s Butterflies”
4. THE CREATION OF K-REP BANK

“The creation of K-Rep Bank is not an end in itself, but one of the means by which K-Rep fulfills its on-going mission.”

-- Kimanthi Mutua, Managing Director, K-Rep Bank

On March 26, 1999, K-Rep received its commercial bank license, paving the way for an anticipated September 1999 bank opening. Throughout its 15 year history, K-Rep’s founding board and managing director have provided key visionary guidance and maintained a spirit of innovation that has led K-Rep to become one of the leading microfinance institutions in Africa. Using a modified Grameen Bank lending methodology, K-Rep extends credit to microentrepreneurs in urban and rural towns throughout Kenya. As of December 1998, K-Rep had 13,000 active clients and an outstanding loan book of over US$3.8 million. K-Rep has five branches and 16 service points, and employs over 100 staff in its lending operations.

K-Rep Bank’s regulatory approval was facilitated by the lobbying efforts of its board and its demonstrated success in microlending. In identifying investors, K-Rep turned to large reputable institutions that were willing to take a risk, not only on the institution but on the Kenyan financial and regulatory environment. However, by including public institutional investors, K-Rep exposed itself to costly and complex legal bureaucracy that delayed the process by two years.

Throughout the transformation process, K-Rep’s mission “to empower low income people, promote their participation in the development process and enhance their quality of life” has remained unchanged. The creation of the bank is seen as a means to achieving the original mission, rather than an end in itself. The surviving NGO is now charged with continuing to explore and identify new institutions, systems and methods of fulfilling the same mission.

4.1 Background

K-Rep has been a microfinance pioneer in Kenya, providing training and on-lending to microfinance NGOs, as well as developing its own microlending program. Following a period of both high delinquency and client desertion in the mid 1990’s, K-Rep has recently begun to expand its outreach again.

Development of a Credit Methodology

In 1984, the Kenya Rural Enterprise Programme (K-REP) was launched as a project of World Education Incorporated, a U.S.-based private voluntary organization, to establish and expand microenterprises in the informal sector. In 1987, the project was incorporated as Werep Limited, a company limited by guarantee with no share capital. In its first few years of operation, the K-Rep project acted as a wholesaler for microenterprise development NGOs, providing grants, training and technical assistance to other NGOs. During 1984-94, the project received over $14 million from USAID, much of which was on-lent or granted to other NGOs for their microenterprise development projects.
After a series of technical exchange visits to other MFIs worldwide, K-Rep introduced a group based lending approach among its partner NGOs, and in September 1990 launched its own lending program, known as *Juhudi*. Modeled after the Grameen Bank and modified to the Kenyan environment, *Juhudi* is based on co-guaranties of peer groups of 5-7 members (called *watanos*) within larger groups of 5-6 *watanos* (known as a *kiwas*). These groups receive an initial two months of training on group dynamics and the methodology, with initial emphasis on the importance of savings. Savings are collected and loans are disbursed at weekly meetings, with two members of each *watano* eligible for loans in the first month, two more in the second month and the rest the following month. Each member pays a membership fee and buys a passbook for a combined total of $3.70 upon registration. Each borrower also pays 1.5 percent of the loan amount to cover the loan application fee (1 percent) plus loan insurance (0.5 percent). All member savings are compiled in a group savings account at a formal bank, with the credit officer and two members as co-signers. Client savings serve as an additional guaranty against loan default, but are withdrawn only as a last resort.

In 1991, in an effort to expand outreach, K-Rep began targeting the pre-existing indigenous rotating savings and credit schemes (ROSCAs) primarily located in rural areas, and created a new scheme known as *Chikolas*. Lending to *Chikolas* was initially a highly cost-effective method of increasing outreach since only one check would be issued to each group which was then responsible for allocation to individual members. In 1994 and 1995, however, repayment rates fell to 90 percent due to the lack of group cohesiveness among the larger *Chikolas*. As a result, K-Rep changed many features of the scheme and began disbursing loans to individual members within the group and moving *Chikolas* toward smaller group formation and weekly repayment in line with the *Juhudi* lending approach.

**Growth in K-Rep’s Operations**

In December 1991, Werep Limited changed its name to Kenya Rural Enterprise Programme (K-Rep) Ltd. In 1993, K-Rep registered with the NGO board, to comply with the NGO Co-ordination Act of 1990. This solidified K-Rep’s move from a project toward institutionalization and self-sufficiency. In 1994, K-Rep ceased all wholesale lending to NGOs due to increasing arrears and merged the administration of the *Juhudi* and *Chikola* lending methodologies.

During 1990-95, K-Rep expanded operations from one branch to 5 area and 11 field offices. In the mid-1990s, average loan sizes began to increase rapidly as credit officers found it easier to expand their portfolio by managing larger loans. (See Chart 2 for average loan sizes for 1991-98.) Rapid expansion through larger loan sizes resulted in increasing delinquency and desertion rates, as many clients were uncomfortable co-guarantying large loans. In addition, credit officers were not able to manage their portfolios well and provide the necessary client follow up in this period of rapid growth. Despite increased profits in 1996, management feared rapid growth would hide deterioration of the loan portfolio, and therefore slowed lending in 1997 until they could identify the root of the problems. This, in addition to several write-offs of the old NGO loans, decreased the outstanding loan portfolio by 7.7 percent in 1997. **Table 7** lists K-Rep’s outstanding loan portfolio from 1991-98.

In January 1998, K-Rep embarked upon a path leading employees “Back to Basics.” Under this program, K-Rep re-trained all the credit officers on its original philosophy, fundamental

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27 Unlike Grameen, K-Rep offices are based primarily in mid-sized towns rather than in rural areas and do not incorporate the 16 lifestyle decisions that Grameen borrowers commit to improve their futures.

28 Based on an exchange rate of 58 Kenyan shillings to the US dollar as of January 1999.
Institutional Metamorphosis

K-Rep implemented new internal control instruments, which increased management’s supervision of credit officers, as well as the amount and frequency of loan delinquency tracking. K-Rep also lowered the maximum initial loan size from $431 to $238, reduced the rate at which subsequent loans could increase and shortened loan terms. These changes were implemented in an attempt to return to a focus on the original target population and to make the loan products less attractive to wealthier entrepreneurs. As a result, the average loan size decreased from 33,600 Ksh ($529) in 1997 to 24,800 Ksh ($394) at the end of 1998 and the average term shortened from 12 to 9 months.

In the past, K-Rep required a collateral guaranty in savings equivalent to 10 percent of each Chikola loan and 20 percent of each Juhudi loan. In January 1998, K-Rep changed this guaranty for new clients to 5 percent of the loan amount, incrementally increasing to 20 percent for loans of $862 and higher. These changes help clients gradually adjust to the practice of weekly deposits and are considered more realistic targets for the clients. By the end of October 1998, total member savings had risen to over $1.37 million.

Table 7: K-Rep Outreach Figures

<table>
<thead>
<tr>
<th>Year</th>
<th>Number of Active Loan Clients</th>
<th>Outstanding Loan Portfolio (US$)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1991</td>
<td>1,253</td>
<td>$580,607</td>
</tr>
<tr>
<td>1992</td>
<td>2,852</td>
<td>$982,991</td>
</tr>
<tr>
<td>1993</td>
<td>4,331</td>
<td>$1,087,100</td>
</tr>
<tr>
<td>1994</td>
<td>5,149</td>
<td>$3,514,797</td>
</tr>
<tr>
<td>1995</td>
<td>11,137</td>
<td>$4,601,441</td>
</tr>
<tr>
<td>1996</td>
<td>12,885</td>
<td>$4,534,323</td>
</tr>
<tr>
<td>1997</td>
<td>10,956</td>
<td>$3,622,043</td>
</tr>
<tr>
<td>Nov. 1998</td>
<td>13,150</td>
<td>$3,816,639</td>
</tr>
</tbody>
</table>

29 First loans must now be paid within six months and subsequent loans within one year.
By the end of November 1998, K-Rep’s “Back to Basics” crusade had proven fruitful, resulting in a rapid turnaround of delinquency rates, bringing arrears over one day past due down from 20.9 percent in 1997 to 9.7 percent. The number of active borrowers had risen from 11,000 to 13,150, and K-Rep’s portfolio at risk (over 30 days past due) was 8.8 percent, much lower than the 30.0 percent average experienced by traditional banks in Kenya.

4.2 Transformation Plans

K-Rep considered a variety of transformation options before deciding to create a commercial bank. Difficulties in reaching a shareholder agreement, followed by political and economic factors, slowed the transformation process. Over five years passed from initial discussion of transformation to receipt of the K-Rep Bank license.

Rationale

K-Rep’s decision to pursue a bank license was influenced by a number of factors. The NGO structure prevented K-Rep from seeking outside investors and limited the potential benefits of private ownership. Secondly, the cross-subsidization of the non-financial services by the lending operations was impeding the expansion of K-Rep’s lending activities. Likewise, management acknowledged that the energy and focus required to oversee adequately the microlending program was overshadowing the potential for new product development and expansion of the non-financial activities of the NGO. Hence, K-Rep NGO began to consider options for separating its Financial Services Division from its Non-Financial Services Division, the first step in the organization’s institutional transformation. (See Annex 4.1 for the organigram of the K-Rep NGO structure prior to transformation and Annex 4.2 for the organigram of K-Rep Bank.)

On January 28, 1994 K-Rep’s board voted in favor of transforming the NGO’s Financial Services Division into a regulated financial institution. With transformation, K-Rep hoped to achieve four principal goals:

1. Gain access to additional sources of capital, particularly from client savings, thereby greatly expanding the availability of loans to the target population.
2. Right the moral wrong of client savings being on-lent to wealthier formal bank clients and poor treatment of K-Rep clients by the traditional banks.
3. Provide additional financial services, including savings and current accounts, to microentrepreneurs as well as other low-income populations.
4. Move K-Rep’s Financial Services Division toward institutional permanence through improved governance and increased profitability.

Transformation Options

K-Rep considered several options before deciding to transform into a commercial bank. In 1994, Non-Bank Financial Institutions (NBFI) had lower capital and liquidity requirements than commercial banks and permitted similar services, except for current accounts. However, in 1995, the Central Bank of Kenya (CBK) increased the capital requirements from approximately $646,000 to $1.34 million, the same level required of commercial banks. This caused 95 percent of pre-existing NBFI to convert to commercial banks by June 1997.

31 An additional 4,149 members held savings but no loans at the end of November 1998.
32 Carpenter, Mutua, and Oketch, 1997.
increased capital requirements for both banks and NBFIs to approximately $3.5 million and subsequently increased them again to $6.8 million in January 1999.

The cooperative structure also did not present a viable alternative. The Commissioner of Cooperatives in Kenya heavily regulates cooperatives and K-Rep feared excessive exposure to government influence. Specialty financial institutions, such as mortgage financing or life insurance, were not an option for K-Rep. In sum, K-Rep decided to pursue a commercial bank structure as a result of the changes affecting NBFIs and because the commercial bank provided the widest range of opportunities for the future.

**Business Plans**

In 1994, K-Rep wrote the first concept paper on its plans to create a formal financial institution. The Ford Foundation granted K-Rep $129,000 for the development of a feasibility study in 1995. To conduct the study, K-Rep contracted one of its board members with experience in crafting complex financial arrangements for new ventures. In addition, K-Rep assembled a six-person advisory team, including the former head of supervision of the central bank, two experienced bankers, and a former senior executive of a major accounting firm, as well as the K-Rep board chair and managing director.

The team drafted several versions of the business plan before presenting a final version in March 1996 to potential investors and later to the CBK. The final business plan projected pre-tax profits between 35 and 45 percent over the first five years of the bank’s operations. The plan included a sensitivity analysis of K-Rep Bank’s projected profitability, using three variables: i) a 25 percent increase in staff salaries; ii) a decrease in the lending rate from 35 to 29 percent per annum; and iii) a drop in loan repayments to 80 percent and an increase in the loan loss rate to 10 percent. The analysis concluded that neither individually nor together would these factors result in an absolute loss to the bank.

**Political and Economic Environment**

With Kenya’s transition to a market economy in 1990, the financial system underwent significant reform, resulting in lower inflation, more independence from the government, and regulatory changes to meet international banking standards. In 1991, interest rate controls were abolished. Foreign exchange was also deregulated in 1993. In the mid-1990’s, several new rules were introduced aimed at protective regulation of the banking sector, raising the standards for minimum capital requirements, management quality, and the overall financial condition of formal financial institutions.

While the Ministry of Finance has the final authority to license banks, the CBK is technically responsible for the approval or rejection of new bank applications. Initially, the CBK indicated that no favorable treatment would be given; a microfinance bank would be subject to the same rules and regulations of any commercial bank. Hence, K-Rep began working to educate the authorities of the central bank shortly after the board agreed to the initial idea of transformation. In January 1995, two of K-Rep’s board members took two high-level central bank authorities33 to Bolivia to study BancoSol’s success in serving microentrepreneurs as a commercial bank. The visit convinced the CBK officials that microfinance could be done profitably as a formal bank, and commissioned an in-house study to learn more about microfinance.

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33 K-Rep’s Managing Director (Kimanthi Mutua) and the board member that worked on the business plan (Harry Mugwanga) accompanied the Central Bank’s Deputy Governor and the Director of Bank Supervision.
K-Rep did not specifically request any waivers or exceptions, as the board wanted K-Rep Bank to be respected as an integral part of the financial sector. K-Rep appreciated the fact that the central bank would prevent less serious players from entering the formal microfinance arena, yet knew that certain regulatory adjustments would have to be made to allow K-Rep to reach its full potential. To address this issue, K-Rep board members and senior management held numerous discussions with regulators, and sent literature and other information on microfinance’s unique characteristics.

Over time, K-Rep successfully influenced the regulators in their interpretation of how to apply traditional bank regulatory practices to a microfinance bank. Initially, the CBK was wary of approving branches in low-income, potentially dangerous areas. K-Rep explained that those were the neighborhoods of their target clientele and being located there facilitated access to increased markets. K-Rep also convinced the CBK that group guaranties acted as a successful collateral substitute. The regulators agreed to risk weight K-Rep loans according to their performance for loans up to amounts of $4,310. Loans over this amount would be rated on the basis of their collateral, as is done traditionally.

In June 1996, K-Rep was ready to apply for the bank license and the CBK indicated their willingness to consider K-Rep’s application. Finalizing arrangements with investors, however, took an additional two years, delaying formal submission of the application until August 1998.

The application process required a full disclosure of the bank’s proposed capital structure, shareholders, board members, and curriculum vitae of senior management. The CBK indicated that the license would be issued within three months but before the three months ended, five small banks were placed under the CBK’s management due to lack of liquidity. This was followed by another financial scare in which the fourth largest bank, the National Bank of Kenya, experienced a run on the bank and nearly collapsed in December 1998. It received $34.5 million in government support but may require more to keep it solvent in the near future. The CBK fell under scrutiny as its ability to provide adequate supervision to the existing financial institutions was questioned. Because of this situation, the central bank became preoccupied with efforts to stabilize the financial market, giving zero priority to new applications. K-Rep’s application was therefore placed on hold until the situation improved.

In January 1999, the central bank designed more stringent regulations, including an increase in the required minimum paid up capital from Ksh 200 to 500 million ($3.5 million to $6.8 million). This rule will be applied gradually to existing banks, but takes immediate effect for new applicants, such as K-Rep. The CBK informed K-Rep of the new regulations and asked for a revised proposal of the capital structure. Concerned about the time it would take to re-negotiate a revised capital structure with all shareholders, K-Rep proposed a temporary ownership structure that would result in K-Rep holding more than 25 percent. This proposal was first declined on January 26, 1999, with a requirement that K-Rep normalize the shareholding structure (i.e. ensure that no shareholder owns more than 25 percent). Upon further negotiation, however, the proposal was accepted on the basis that as an NGO, K-Rep is not owned by individuals and therefore qualifies as a public venture. Additionally, the CBK demanded that K-Rep increase the representation from the Kenyan financial sector at the board level.

After complying with the two new requirements, K-Rep’s patient lobbying and investment in working with the regulators finally paid off. In March 1999, K-Rep received a commercial bank license.

4.3 The Transformation Process

The transformation of K-Rep’s Financial Services Division into a commercial bank required organizational, financial and operational changes.

Organizational Transformation

This section describes K-Rep’s organizational transformation, which involved the creation of new legal entities, including a holding company, an NGO and a consulting firm, in addition to the bank. Investor selection and regulatory requirements guided the formation of the new bank’s governance structure, which resulted in a board heavily represented by bankers.

Creation of K-Rep Group

In preparing for the transformation, K-Rep reformed its organizational structure, creating the K-Rep Group, a conglomeration of for-profit and non-profit organizations. These organizations include K-Rep Holdings, Ltd. (KHL), K-Rep Bank, K-Rep Development Agency (the NGO) and K-Rep Consulting Services, as presented in the diagram below.

**Chart 3: Structure of the K-Rep Group**

![Diagram of K-Rep Group](chart.png)

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**K-Rep Holdings Limited (KHL)**

Kenyan banking law limits any non-commercial bank shareholder to a maximum of 25 percent ownership. Originally K-Rep had intended to be majority shareholder with over 51 percent ownership of the bank, but this restriction forced K-Rep to redesign its structure and identify potential investors for the nascent bank, despite the fact that K-Rep had more than sufficient accumulated capital to meet the minimum capital requirements.

The Kenyan Banking Act does not recognize an NGO as a corporate entity (when it is registered under the NGO Act and not under the registrar of companies). Recognition as a corporate entity is required to create a corporate bank. Fortunately, K-Rep’s original registration as a company limited by guarantee was still valid, which helped to clarify the issue of ownership and liability.
K-Rep’s subsequent registration as an NGO did not invalidate the original license. Therefore, K-Rep decided to use the original registration to create K-Rep Holdings Ltd. (KHL), which will be the vision holder for the K-Rep Group. The K-Rep Bank, K-Rep Development Agency (the NGO) and K-Rep Consulting Services are its first holdings. The former K-Rep NGO board now acts as the board for the holding company and NGO, simultaneously responsible for overseeing its investment in K-Rep Bank and the activities of the NGO.

Creation of K-Rep Limited (The Nascent Bank)

In March 1997, K-Rep Ltd., the nascent bank, was officially registered as a subsidiary of K-Rep Holdings Ltd. K-Rep originally planned to acquire the bank license, incorporate the bank and then transfer assets. However, K-Rep’s legal counsel advised that this would result in a large tax on the sale of the assets. Instead, legal counsel suggested the creation of a for-profit company, K-Rep Limited, a subsidiary of K-Rep Holdings, to later become K-Rep Bank Ltd. upon acquisition of the bank license. The transfer of assets from one KHL subsidiary to another would avoid tax consequences.

The K-Rep Bank headquarters will be based out of a new building, currently under construction, that will also house K-Rep’s largest branch, in the Kawangware section of Nairobi. The new building will cost K-Rep approximately $700,000. K-Rep Bank will convert the NGO’s five area offices into bank branches. The 16 field offices will become “service points” continuing to utilize credit officers to expand outreach throughout the country. However, the service offices will not offer cashiering services but will instead use the Post Savings Bank for these functions.

All clients and the entire loan portfolio will transfer to the bank. This will mean a transfer of approximately 15,000 clients representing a loan portfolio of over $4 million. The bank will issue new loan contracts and passbooks, replacing the former NGO documents.

K-Rep Development Agency

K-Rep spun off the assets, liabilities and activities of the NGO’s Financial Service Division to form the new K-Rep Bank. K-Rep’s Non-Financial Service Division remains with the NGO, now called K-Rep Development Agency. K-Rep Development Agency will continue the small and microenterprise activities of the Non-Financial Services Division under its Microfinance Research and Innovations (MFRI) Department. The MFRI Department is the incubator for new product ideas that, if profitable and successful, can be spun off into new for-profit institutions under the K-Rep Holdings umbrella. Currently, the MFRI Department is pilot testing the following microfinance services:

- Financial Service Associations (FSAs) which are user owned, managed and financed savings and credit schemes;
- health care financing and insurance for the poor;
- microloans for small holder dairy farms;
- low-cost housing finance;
- rural savings mobilization in which rural communities pool savings to access higher returns, such as through Kenyan treasury bills;

35 In the future, KHL hopes to establish other for-profit subsidiaries committed to the same mission of providing financial services to low-income individuals.
MFRI will conduct market research and attempt to identify and develop sustainable products and services suitable for the microenterprise and low-income sectors. While K-Rep Bank may benefit from some of the findings of the research in the future, the MFRI Department’s agenda is not tied to the bank’s long-term objectives. The NGO will share its findings with any interested parties and help to implement successful product lines in development organizations. Donors have agreed to continue their support of the NGO with the understanding that its services are valuable resources for microenterprise development in Africa.

The bank and the NGO will function as two completely separate institutions, with 38 of the 160 existing employees remaining with the NGO, 110 going to the bank, two to the Holding Company and 10 to K-Rep Consulting Services. With few exceptions, those material and human resources located at the former K-Rep NGO headquarters will remain with the NGO. All the field office equipment and personnel will transfer to the bank. In 1998, K-Rep separated the accounting functions in preparation for the transition. In the future, the NGO may provide services to K-Rep Bank on a contractual basis but neither is under any obligation to work together.

K-Rep Consulting Services

K-Rep Consulting Services recently became the newest division of K-Rep Holdings. It provides fee-based training, institutional capacity building and advisory services on a cost-recovery basis to other organizations in the area of microenterprise development.

Board Formation

K-Rep NGO’s board is comprised of eight distinguished Kenyans with a variety of backgrounds who collectively offer strong political, academic and international connections, as well as development, community banking, accounting, and legal expertise. Most of the members have been reelected every year since inception. The NGO board meets quarterly and has been supportive of management initiatives. The board has been responsible primarily for overall policy setting while relying heavily on the Managing Director to oversee operations.

Table 8: K-Rep Bank Board Members

<table>
<thead>
<tr>
<th>Institution Represented</th>
<th>Professions Represented</th>
<th># Board Members</th>
</tr>
</thead>
<tbody>
<tr>
<td>K-Rep Holdings</td>
<td>Chair of K-Rep Holdings with former experience as Secretary of Foreign Affairs and Ambassador; Managing Director of K-Rep Bank and former Managing Director of K-Rep NGO with accounting background.</td>
<td>2</td>
</tr>
<tr>
<td>Shorebank</td>
<td>Community banking expert</td>
<td>1</td>
</tr>
<tr>
<td>IFC</td>
<td>Institutional board representative with experience in bank oversight</td>
<td>1</td>
</tr>
<tr>
<td>AfDB</td>
<td>Institutional board representative with experience in bank oversight</td>
<td>1</td>
</tr>
<tr>
<td>FMO and Triodos</td>
<td>Banker</td>
<td>1</td>
</tr>
<tr>
<td></td>
<td>External (non-shareholder) directors with high-level banking experience in Kenya.</td>
<td>2</td>
</tr>
</tbody>
</table>
The new K-Rep Bank board has more banking technical background and will be more directive, as board members’ liability will increase as the NGO becomes a bank and manages client deposits. Table 8 provides a list of the eight K-Rep Bank board members and their backgrounds.

One board seat is allotted for each institution or combination of institutions that holds 10 percent ownership. This agreement allows K-Rep Holdings two seats on the board, which will be held by the two main visionaries of the NGO board: the Chair, Mr. Bethuel Kiplagat; and the Managing Director, Kimanthi Mutua. Shorebank, IFC and AfDB will each appoint one representative to sit on the board. FMO and Triodos banks will have over 10 percent combined ownership so together will select a board member to jointly represent them. Kwa Multipurpose Cooperative Society, a savings and credit cooperative for K-Rep employees and board members, will not have a seat on the board, despite its 10 percent ownership. The Kwa shares were specially designed to avoid conflicts of interest between staff and the board. Two directors will be externally appointed to add unique perspectives by not representing any specific shareholder interests and to satisfy regulatory requests for local representation on the board.

There will be quarterly meetings for all the principal directors, with four members required to form a quorum. Other monthly meetings will be held with local representatives, for which each of the foreign institutions may appoint local alternates to the foreign directors. The most important matters will be reserved for the quarterly meetings with the principal directors as detailed in the bylaws. The bylaws were written in a manner that allows board members to veto a proposed action rather than require written consent of all board members for board decisions. This should greatly reduce bureaucratic delays in decision making.

Financial Transformation

K-Rep sought institutional investors that represented the desired combination of expertise, influence and commitment to its mission. The involvement of large public institutions with bureaucratic decision-making processes caused difficulties in reaching an acceptable shareholders’ agreement. To determine the final agreement, investors requested an external valuation of the assets and liabilities, conducted their own due diligence on the MFI and researched the regulatory implications.

Identifying Investors

K-Rep began by seeking potential investors within Kenya. Initially, the Kenyan banks were not interested, since traditional bankers did not understand or believe that microfinance could be profitable over time. Later, when the process was more advanced and K-Rep had received media attention for its microfinance bank, the Kenyan banks expressed interest in investing. At this point, however, K-Rep had already identified foreign investors.

In seeking investors, K-Rep focused on institutional rather than individual investors. K-Rep believed that institutional investors’ motivations were more transparent and that they would have a longer-term commitment to the investment. Nevertheless, K-Rep recognized that institutional investors might not have the same drive to oversee the investment that a personal investor would. The board attempted to address this by developing a detailed list of characteristics of institutional investors, including the following:

- share K-Rep’s vision and commitment to its social mission;

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36 Board members must have 20% collective representation to veto major transactions, such as entering into large contracts, large capital or unbudgeted expenditures, issuing shares, and acquiring subsidiaries.
• bring strong financial and commercial discipline to the bank;
• give the bank a good public image;
• have resources for additional future investments if necessary;
• protect K-Rep Bank from negative political interference;
• have clout to influence Kenyan authorities;
• be willing to divest some of their holdings when the bank goes public in five years.

K-Rep’s donors assisted the new bank with the identification of potential equity investors. Ford Foundation brought in Shorebank, and granted half the funds to cover Shorebank’s investment in K-Rep bank. USAID recommended the International Finance Corporation (IFC), which in turn facilitated the entry of the African Development Bank (AfDB) and the Netherlands Development Finance Company (FMO). The Department for International Development (DFID) suggested the Commonwealth Development Corporation (CDC), which decided not to invest because of the instability of the Kenyan banking sector.

K-Rep itself identified the Ecumenical Development Cooperative Society (EDCS), CALMEADOW and Triodos Bank. EDCS, an international cooperative society created by the World Council of Churches, decided not to invest for the same reason as the CDC. K-Rep’s rejection of the EDCS’s proposal to invest partially through debt instruments further discouraged their involvement. CALMEADOW, a Canadian microenterprise development support agency, was not able to mobilize investment funds in time, but might join as an investor in the near future.

Together, these institutions satisfied the desired combination of financial expertise and commitment to the social mission that K-Rep sought. Each institution added value to the organization:

Shorebank, a U.S-based commercial bank that provides commercial and development loans to small and microenterprises, offers a unique combination of commercial banking expertise and commitment to poverty alleviation through microlending.

International Finance Corporation (IFC), an independent member of the World Bank Group with projects in over 160 countries, brings financial expertise and political clout that has been a critical element in persuading the CBK to approve the bank license.

African Development Bank (AfDB), a multilateral development agency for Africa, provides access to funding sources and potential linkages to other countries and programs in the region. It also offers extensive expertise in organizing and governing financial institutions in Africa.

Kwa Multipurpose Cooperative Society, the K-Rep employee association, facilitates the ownership of K-Rep employees and board members and acts as a motivator for employee performance and commitment to the organization in the future.

Triodos Doen Bank, a Dutch private bank, brings long-term investment commitment and banking expertise to K-Rep Bank.

Netherlands Development Finance Company (FMO), a Dutch development bank that specializes in long-term finance to enterprises in developing countries, brings committed long-term funds and expertise in development and project financing.

Under the initial shareholder agreement, KHL was to hold 25 percent of the bank, the largest shareholding. Due to its strong development interest, Shorebank received the next largest
percentage of shares. This ensured three institutions with clear commitments to K-Rep’s social mission - KHL, Kwa and Shorebank - would control 53 percent of the shares. The rest of the shares were distributed based on the amount that each institution was willing to invest and the remaining available shares. Originally, the plan was for K-Rep Bank to be capitalized at $4.53 million representing 670,000 issued and fully paid shares with a conservative capital to assets ratio of about 56 percent. Given the changes in regulatory requirements, however, minimum paid-up capital will be Ksh 500 million or $6.76 million.37 KHL provided the additional required capital, temporarily increasing its ownership holding to 49.75 percent. The CBK granted KHL a permanent waiver on the 25 percent ownership limitation, yet KHL offered all shareholders the option to increase their subscription so as to retain their respective original ownership percentage. All shareholders, except AfDB and Shorebank, accepted this offer, leaving KHL with 32.5% ownership. Table 9 presents the shareholder breakdown as initially agreed, the breakdown at the time of licensing, and the current structure.

Table 9: K-Rep Bank Ltd. Shareholders

<table>
<thead>
<tr>
<th>Investor</th>
<th>Type of Institution</th>
<th>Original Structure</th>
<th>Licensed Structure</th>
<th>Revised Structure</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Ksh. '000</td>
<td>%</td>
<td>Ksh. '000</td>
<td>%</td>
</tr>
<tr>
<td>K-Rep Holdings Ltd.</td>
<td>83,750</td>
<td>25.0</td>
<td>248,750</td>
<td>49.75</td>
</tr>
<tr>
<td>Shorebank</td>
<td>60,300</td>
<td>18.0</td>
<td>60,300</td>
<td>12.06</td>
</tr>
<tr>
<td>IFC</td>
<td>33,500</td>
<td>10.0</td>
<td>33,500</td>
<td>6.70</td>
</tr>
<tr>
<td>AfDB</td>
<td>56,000</td>
<td>16.7</td>
<td>56,000</td>
<td>11.20</td>
</tr>
<tr>
<td>Kwa Multipurpose</td>
<td>56,000</td>
<td>16.7</td>
<td>56,000</td>
<td>11.20</td>
</tr>
<tr>
<td>Triodos Bank</td>
<td>28,700</td>
<td>8.6</td>
<td>28,700</td>
<td>5.74</td>
</tr>
<tr>
<td>FMO</td>
<td>16,750</td>
<td>5.0</td>
<td>16,750</td>
<td>3.35</td>
</tr>
<tr>
<td>TOTAL</td>
<td>335,000</td>
<td>100.0</td>
<td>500,000</td>
<td>100.0</td>
</tr>
</tbody>
</table>

The Employee Stock Ownership Plan (ESOP)

K-Rep’s ESOP was specifically designed to reward and acknowledge the contribution of staff, management and board members’ service to K-Rep. As a private company, K-Rep Bank cannot have more than 50 shareholders. The Kwa Multipurpose Cooperative Society provided a mechanism for employees to participate in the ownership of the bank.

Ten percent of the bank’s shares have been allocated to the ESOP, which Kwa will purchase with a $900,000 grant from CGAP. Of this grant, $676,000 will be used to purchase shares while the

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37 The revised total authorized share capital is approximately US$6.76 million for 1,000,000 shares at 500 Ksh or US$6.76 per share at the August 1999 exchange rate of 74 Ksh per US$1.
Institutional Metamorphosis

removal will cover administrative costs related to the creation of the ESOP. This will enable Kwa to acquire 100,000 shares of the bank at a par value of $6.76 per share.\textsuperscript{38}

Kwa will assign share rights\textsuperscript{39} to members based on a formula that rewards seniority and professional status. These rights entitle members to participate in the bank’s dividends in direct proportion to the rights held. Members will also benefit if the shares appreciate in value. Members are free to sell their rights to other Kwa members at times and dates specified by Kwa.\textsuperscript{40} In the case of death or permanent disability, shares can be cashed out. Kwa will arrange for an annual valuation of shares and charge a small brokerage fee for each transaction.

While the plan is strictly voluntary, most employees of the K-Rep Group plan to participate in the ESOP. To qualify for assigned rights, members must have been an employee or board member of the K-Rep Group for at least three consecutive years. This requirement limits ownership to those with a demonstrated commitment to the mission. Eligible members must agree to purchase one right for every right awarded as a bonus. This ensures that members have an adequate sense of ownership and commitment to the ESOP. To facilitate this process, employees can borrow from Kwa at 9 percent p.a. for five years. Members forfeit their rights if they leave K-Rep voluntarily before completing three years of service.

All employees of K-Rep Group institutions will be eligible for the initial stock offering, including employees that remain with the NGO. This policy helped to reduce tension concerning the division of employees between the bank, the holding company and the NGO. Of the initial 100,000 shares, 50,000 will be allotted up front to staff (25,000 as bonuses and 25,000 sold at the par value). The balance is retained in the Kwa treasury to be allocated over a five-year period as bonuses for current and future bank staff. Once the bank goes public, the holders of share rights will be able to convert them into individual shares and become direct owners of the bank, with full voting rights.

**Shareholder Agreement**

The transformation process was delayed by two years as a result of the difficulties in reaching an acceptable shareholder agreement. It took time to understand the needs and motivations of the various investors, especially those of the public investors. For example, the IFC and AfDB required specific provisions in the shareholder agreement ensuring that the investments of the bank would be in their targeted areas and countries of business. Additionally, the agreement was written so shareholders were not required to make a full commitment until the license was obtained. Yet, the regulators required documentation of the bylaws and the purchase agreement, which were items that the shareholders’ agreement implied would not be written until after the license was acquired. This “catch 22” caused many legal discussions, fees and a major delay in applying for the bank license. The issue was finally resolved when K-Rep negotiated with the central bank to accept its application papers (including a theoretical purchase agreement and by-laws) prior to the signing of all investors.

The shareholders convened to approve the initial agreement on June 3, 1997. The documents were drafted and sent to the various shareholders for signing. All but two were signed by the August 1997 deadline. Shorebank’s signed agreement arrived by the end of the year after some legal discussions. However, the African Development Bank’s agreement was not received by

\textsuperscript{38} Based on 74 Ksh:US$1, the exchange rate as of August 1999.

\textsuperscript{39} The Kwa share rights represent 1/100th of a K-Rep Bank share for a total of 6.7 million initial Kwa shares.

\textsuperscript{40} With the exception that no one member is allowed to own more than 5% of Kwa ESOP shares.
August 1998, the point at which the application for the license was submitted to the CBK. Due to legal hurdles and AfDB bureaucracy, selling the concept to AfDB officials took time. The IFC had to go through a similar process but had done so prior to coming to the negotiating table. In July 1999, K-Rep Bank made an addendum to the shareholder agreement to specify the new terms resulting from regulatory changes in capital requirements. The addendum allowed for the increased share capital, revised ownership and the appointment of two locally based directors.

Transfer of Assets and Liabilities

In preparing for the transformation, K-Rep ensured that the donors would allow the transfer of assets to the new bank. Shareholders subsequently required a formal valuation of all assets and liabilities to be transferred to K-Rep Bank. This assessment determined the amount of KHL’s combined debt and equity investment in K-Rep Bank.

Donor Support for Transformation

The donors posed no objections to the NGO’s transfer of assets previously funded by grants to K-Rep Bank. In fact, the donors were supportive of the transformation. USAID gave a grant to K-Rep explicitly to upgrade the MIS and for staff training. In addition to the funds given to Shorebank to purchase its shares and to K-Rep for the concept paper, Ford Foundation plans to lend K-Rep’s MFRI S1 million interest at 1 percent p.a. Interest is payable annually, and the principle is payable in three annual installments after a seven-year grace period. The MFRI will then on-lend the funds to K-Rep Bank at 7 percent, repayable over 10 years. DFID has created a guaranty fund with the Cooperative Bank of Kenya from which K-Rep can access an overdraft account for up to $862,000 at 13.5 percent annual interest.

Valuation of Assets and Liabilities

The shareholders ordered an external audit and valuation of all assets and liabilities to be transferred to K-Rep Bank. The assessment, conducted at the end of 1997, valued net assets at approximately $5.9 million as of December 31, 1997, and was used to transfer all the assets (including loan receivables) from the NGO’s Financial Services Division to the nascent bank, K-Rep Ltd. KHL exchanged net assets for shares and for convertible income notes that serve as quasi-equity in K-Rep Bank. This long-term debt instrument resembles equity in that it does not have a fixed return and is only retired when all shareholders agree to retire it or when it is converted into equity; it does not have a pre-determined term. The income notes generate returns only when dividends are declared, and appreciate through retained earnings. This mechanism allows K-Rep automatic access to additional funds to maintain its ownership percentage if needed.

The assets and outstanding liabilities continue to change. Assets have undoubtedly increased in value, with the addition of the new bank building and growth in the portfolio. As of November 1998, the liabilities to be transferred to the bank had lowered by 15 percent from $836,680 to approximately $722,750 and will most likely be reduced further by the time the official transfer takes place. Because of the delay, however, a revaluation of the assets and liabilities to be transferred to K-Rep Bank was conducted in June 1999 to determine the value of the business and the income notes, which are in addition to the net assets listed in Table 10.

41 Telephone interview with Mengistu Alemayehu, IFC Investment Officer, January 21, 1999.
### Table 10: K-Rep’s Financial Service Division
Assets and Liabilities, Dec. 31, 1997

<table>
<thead>
<tr>
<th>ASSETS</th>
<th>Amount US$</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>678,300</td>
</tr>
<tr>
<td>Loan Portfolio</td>
<td>3,820,000</td>
</tr>
<tr>
<td>Provisions</td>
<td>361,900</td>
</tr>
<tr>
<td>Fixed Assets</td>
<td>361,900</td>
</tr>
<tr>
<td>Other Debtors</td>
<td>357,400</td>
</tr>
<tr>
<td>Investments</td>
<td>1,116,200</td>
</tr>
<tr>
<td><strong>Total Assets</strong></td>
<td><strong>6,695,700</strong></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>LIABILITIES</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Trade Creditors</td>
<td>45,030</td>
</tr>
<tr>
<td>Other Creditors</td>
<td>428,325</td>
</tr>
<tr>
<td>Bank Overdraft</td>
<td>363,325</td>
</tr>
<tr>
<td><strong>Total Liabilities</strong></td>
<td><strong>836,680</strong></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>NET ASSETS</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>5,859,020</strong></td>
<td></td>
</tr>
</tbody>
</table>

### Regulatory Implications

In issuing bank licenses, the Banking Act requires the Central Bank of Kenya to assess the quality of management, the board of directors, the adequacy of the paid-up capital and the capital structure, earnings potential, and the needs of the geographic market. In addition to the initial regulatory requirements for obtaining a bank license, K-Rep Bank will have to adhere to a variety of on-going supervisory and monitoring requirements.

**Asset Quality** – The CBK has agreed that K-Rep’s group loans under $4,310 can be risk weighted according to performance rather than assigned the traditional risk weighting of zero for non-collateralized loans.

**Provisions** – K-Rep plans to retain its provisioning policy even though it is more stringent than regulatory requirements. **Table 11** compares CBK provisioning requirements to K-Rep’s policy. The central bank allows interest to accrue as normal for loans in arrears under 90 days, after which interest accrual is suspended.

### Table 11: K-Rep Loan Loss Provision Rates

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>1 to 60</td>
<td>0%</td>
<td>0% except in known doubtful cases</td>
</tr>
<tr>
<td>61 to 90</td>
<td>25%</td>
<td>0% except in known doubtful cases</td>
</tr>
<tr>
<td>91 to 120</td>
<td>50%</td>
<td>0% except in known doubtful cases</td>
</tr>
<tr>
<td>121 to 150</td>
<td>75%</td>
<td>0% except in known doubtful cases</td>
</tr>
<tr>
<td>151 to 180</td>
<td>100%</td>
<td>0% except in known doubtful cases</td>
</tr>
<tr>
<td>Over 180</td>
<td>100%</td>
<td>100% of loan value less suspended interest and value of realizable collateral or other guaranty</td>
</tr>
</tbody>
</table>
**Internal Auditor** – In accordance with the business plan, K-Rep Bank will have to create an Internal Audit Department and hire an internal auditor to perform operational and financial audits, as required by the CBK.

**External Audit** – Banks are required to contract CBK-approved external auditors to conduct an audit of financial statements at the end of each year and send the report to the central bank.

**Security** – The CBK provides a book of codes for a new bank to follow in setting up a security system, which will require K-Rep to add safes and security guards and modify existing branch buildings. K-Rep will need to improve security in the field branches and service points before it can convert all its area offices into branches.

*Table 12* presents additional regulatory requirements of the CBK that will apply to K-Rep Bank.

**Table 12: CBK Regulatory Requirements**

<table>
<thead>
<tr>
<th>Regulatory Requirement</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>Taxes</td>
<td>By becoming a bank, K-Rep’s annual net income will be subject to 30 percent corporate income tax.</td>
</tr>
<tr>
<td>Capital Adequacy</td>
<td>Kenya financial institutions must maintain a gearing ratio of 7.5 percent between their capital base and deposit liabilities and capital cannot fall below 8 percent of risk-adjusted assets.</td>
</tr>
<tr>
<td>Cash Ratio</td>
<td>The CBK requires that banks maintain cash balances with the central bank equal to 12 percent of their total assets with no interest payable.</td>
</tr>
<tr>
<td>Cash Reserve Requirements(^{42})</td>
<td>Paid-up capital and unimpaired reserves must equal 7.5 percent of risk weighted assets.</td>
</tr>
<tr>
<td>Liquidity Ratio</td>
<td>The CBK requires a bank to hold a minimum of 20 percent of customer deposits in liquid assets (cash, placements with other financial institutions, and treasury bills maturing in 90 days or less).</td>
</tr>
<tr>
<td>Financial Reporting</td>
<td>For off-site supervision, the CBK requires frequent reports to assess the health of the financial institution, including a monthly income statement and balance sheet due 15 days after the end of each month, and quarterly audited financial statements within three months of the end of each period.</td>
</tr>
<tr>
<td>On-site Examinations</td>
<td>The CBK will make periodic on-site evaluations of the bank’s operations, to check on adherence with regulatory requirements and procedures.</td>
</tr>
<tr>
<td>Deposit Protection</td>
<td>All banks are required to contribute 1.5 percent of each deposit account to the national deposit protection fund, which insures deposits up to $1,724.</td>
</tr>
<tr>
<td>Bank License Fees</td>
<td>In addition to the initial bank licensing fee, the bank must pay approximately $4,362 each year to keep the license active and $2,181 for each additional branch.</td>
</tr>
</tbody>
</table>

\(^{42}\) Carpenter, Mutua, and Oketch, 1997.
Institutional Metamorphosis

Operational Transformation

K-Rep waited to receive its bank license before investing heavily in the operational transformation, which management estimates will take 6 to 12 months to complete. While significant time and energy has been devoted to planning for the financial and organizational transformation of K-Rep, K-Rep’s greatest short-term challenge is to develop its institutional capacity to operate as a commercial bank. This includes MIS adjustments, staff changes, training, development of new products and processes, marketing, and client transitioning.

MIS: System and Reports

In preparing for the operational transformation, the greatest amount of time and money has been spent on an overhaul of the management information system (MIS). The former MIS suffered from two inter-related problems: accuracy and timeliness. In the past, K-Rep relied heavily on credit officers to track and record past due clients and arrears. This presented control issues as account information was primarily in the hands of one employee. Bank reconciliations were conducted regularly but there was a delay in obtaining the receipts from the banks.

By becoming a bank, K-Rep has to change its reporting format to respond to the requirements of the central bank, requests of the new board, and changing needs of staff and management. In June 1998, K-Rep organized a committee of 10 employees of various backgrounds to develop a system that would satisfy the organization’s MIS needs. The committee identified a software package “Bank 2000,” which was developed in India for cooperative banks that offered the best combination of features, flexibility, and local technical support. The three employees of the MIS Department met periodically with the committee to present alternatives for adapting the system and to note critiques, prior to implementing proposed adjustments.

It is anticipated that Bank 2000 will enhance reporting and summary accounting by improving accuracy, timeliness and simplicity. While the program is designed for traditional lending, it allows for easy adjustment of the coding, which the MIS department has customized for group lending. The new system is designed to record all types of individual and group loans, savings deposits, current accounts, overdrafts, interbank loans, reports to the central bank, ATM and telephone transactions, and foreign currency exchange. The savings programs are contained in the system, but have not yet been adapted to K-Rep’s needs. For example, it is not yet feasible to freeze savings that act as a loan guaranty.

The bank will demand more rigorous and timely reporting than formerly practiced by the NGO. In the past, most reporting was processed by back office operations and was delayed at least one week. As a bank, K-Rep must move to daily opening, closing and reporting to the central bank. In order to collect information from all branches and service points, K-Rep will need to install a wide area network. K-Rep has an agreement with Post Savings Bank, which has widespread branches for the collection of deposits and loan repayments and the daily balancing of accounts. Funds will then pass through the interbank clearinghouse at the end of each day for daily consolidation and central bank reporting. The bank has hired staff with treasury/dealer expertise to identify the best approach to this problem.

Staff Changes

Kimanthi Mutua, the Managing Director of KHL, will become the bank’s Managing Director. As Managing Director of K-Rep Bank, Mr. Mutua’s role is to maintain the institutional commitment to the current mission, culture and clientele. Thus far, Mr. Mutua has solicited the input of employees by forming working committees to determine future staffing and material needs of the
institution. This has further smoothed the transitional process and encouraged employee support for necessary changes.

All NGO employees transferring to K-Rep Bank have to apply formally for their new job and resign from their former position. This is simply a formality since most staff will retain their current position under the new legal entity. K-Rep Bank plans to add at least 10 new positions to the 110 existing employees to be transferred from the NGO plus fill nine open positions, for a total of 129 employees in the first year. The central bank requested that the General Manager and Treasury/Dealer both have strong banking background and technical expertise to fulfill their duties. K-Rep Bank has also hired experienced bank tellers to manage cash transactions and later train new tellers, some of whom may be former NGO employees. In the first year, K-Rep Bank will contract experts to temporarily fill the positions of Investments Manager and Marketing Officer until the positions are more fully developed. In addition, K-Rep Bank will hire an internal auditor to manage the new Internal Audit Department who will report to the Managing Director.

The 54 credit officers\footnote{There were 54 credit officers as of November 31, 1998.} will become “microfinance officers (MFOs),” marketing both savings and credit products. Each MFO will continue to handle between 250 and 300 clients each. They will have the additional responsibility of describing new savings products available through K-Rep Bank and be involved in overseeing the transfer of group savings accounts from other banks.

Ironically, by becoming a bank, one of K-Rep’s greatest challenges will be building client trust. Operating in a volatile banking environment in which clients have lost their life savings when banks have collapsed will be difficult. Clients will not only be providers of revenue but also the source of funds to fuel K-Rep Bank’s growth. This will have an impact on the institutional culture and staff who not long ago viewed clients primarily as beneficiaries. The new MFOs will now be in the business of selling trust and confidence in the institution in addition to selling savings and loan products.

In becoming a bank, K-Rep Bank will have to make efforts to maintain the same quality of staff as it enters into a phase of rapid growth. Management plans to be vigilant in ensuring that staff maintain their commitment to client service. As employees acquire a couple years of experience working at a formal bank and microfinance becomes more respected in the traditional banking sector, K-Rep Bank will have to compete with other banks for quality staff. K-Rep Bank plans to offer attractive compensation packages and other benefits to retain quality employees. At the same time, the bank looks forward to the opportunity to bring on new staff with fresh ideas.

The Kwa ESOP helps to build employee motivation, loyalty and commitment to the institution. K-Rep’s staff training helps to build understanding and commitment to the mission as well. K-Rep Bank will continue to screen new employees to make sure they have a suitable disposition and value system, especially in light of the prevalence of fraud and corruption in Kenya.

**Training**

In early 1998, K-Rep formed a training committee with managers of several departments to assess and plan for the future training needs of K-Rep bank employees. As a result of this assessment, K-Rep contracted the Kenyan College of Banking and Finance to conduct an introductory course on traditional banking, which began in November 1998. This is a one-week awareness training to prepare staff for the impending transition to a bank. All employees received
this training by the end of March 1999. Employees have found this training helpful in developing employee understanding of traditional bank approaches to customer service, management information, collateral guaranties and other legal aspects of formal banking. Most of all, it has “demystified” banking. However, employees have criticized the training for being overly general and not responsive enough to individual concerns, since the trainers were not familiar with K-Rep’s operations.

The next phase is operational training on specific job assignments, which will occur in the second and third quarters of 1999. Special training will be given to tellers, MFOs, branch managers, accountants and other administrative staff customized to their specific needs and areas of responsibility. These will be intensive training sessions lasting from 2-4 weeks. The MIS department is also developing its own one-week program to train staff on the new MIS system, which ultimately will be integrated into the operational training program for future staff. Together these trainings will take 4-6 weeks out of each employee’s time normally dedicated to their regular duties.

Processes
For the most part, K-Rep lending processes are standardized and documented, and will change little as result of the transition. However, with the addition of savings and other products, K-Rep will need to update its policies and procedures manuals. New policies and procedures have to be developed for teller functions, savings collection, personnel, investments, and interbank lending. Several of these must be developed and approved by the board before the bank can begin operations.

Marketing
K-Rep Bank will be the first microfinance bank dedicated to microentrepreneurs and other low-income Kenyans. K-Rep Bank is demonstrating its continued commitment to this sector by locating its headquarters office in Kawangware. K-Rep plans to get involved in the activities of this community, where its clients are located. For example, K-Rep Bank may support certain school activities, local theater or women’s groups. In addition, K-Rep plans to hire a public relations firm to announce publicly the bank’s opening. These activities will show K-Rep’s target clientele that it is not like other banks and remains committed to understanding and serving the needs of the poor.

Client Transitioning
K-Rep’s clients have anxiously awaited the opening of the bank for years. Credit officers and area office managers have communicated the impending transformation since 1995. In fact, clients believe that K-Rep is creating the bank as a direct response to their suggestions and complaints of poor treatment by traditional banks that manage their savings accounts and cash their loan checks. Many clients are anxious for the bank to open in anticipation of improved customer service, greater accessibility to branch locations, and hopes for individual loans and increased interest paid on savings.

All client groups will be required to hold a savings account with K-Rep Bank to have access to loans. The marketing officers will facilitate the transfer of client savings accounts from traditional banks to K-Rep Bank. As co-signatories on the existing client accounts, the marketing officers will supply one of the two signatures required to transfer the funds from each account.
Products
K-Rep Bank aims to provide its clients with the widest range of general banking services. In general, new products will be developed based on client demand.

Loans
Group Loans - The group loan products will not change as a result of the transformation to a commercial bank. K-Rep will continue to offer the same interest rates, at the same terms, to the same target population.

Individual Loans - In 1998, K-Rep began piloting individual loans. So far, most of these loans have been issued within the group structure, but are not co-guaranteed by group members. Once K-Rep is assured it has a successful methodology, individual loans will be offered on a wide scale to clients who have outgrown the group lending methodology. Existing group clients with at least three years of successful repayment experience with K-Rep are eligible for individual loan amounts over $4,310. The clients are charged the same interest rates as group loans, 35 percent annually on the declining balance, but must secure it with a traditional collateral guaranty such as a land title deed or other material asset. Additionally, K-Rep has begun to experiment with collateral-based individual lending with some new clients. As a bank, K-Rep plans to lower interest rates on secured loans to be more competitive with traditional banks.

Savings
In 1996, K-Rep conducted a study comprised of clients and non-clients within the target population to determine their interest in opening a savings account with K-Rep Bank. The majority of the respondents (91.7 percent of entrepreneurs and 86.4 percent of non-entrepreneurs) expressed their willingness to open an account. Their main motivations in order of importance were: 1) access to credit; 2) low minimum balance; 3) proximity; 4) good customer relations; 5) fast service; and 6) competitive interest rates.

Group Savings - From the opening of the bank, K-Rep will be prepared to open savings accounts. K-Rep estimates that it will receive approximately $500,000 of group savings transferred from traditional banks in the first year. In a given group, each individual will have his or her own account with all the group member accounts electronically linked to each other to cover group guarantees. Interest rates paid on savings will be aligned with those of other commercial banks, which currently pay 9 percent annually.

Individual Savings - Individuals will also be able to open personal savings accounts for voluntary savings. The exact terms of the personal savings accounts have not yet been determined, such as minimum balance and conditions for withdrawal. K-Rep plans to offer liquid, semi-liquid and term savings accounts. Liquid accounts will pay no interest on deposits but will allow the client to withdraw savings at any time. Semi-liquid accounts will require some advance notice of withdrawal. K-Rep will begin offering liquid and semi-liquid savings accounts sometime in the year 2000. Term savings accounts will act as time deposits in which clients can receive higher interest if they commit to investing for longer periods of time. Term accounts will offer 3, 6, 9, and 12-month terms and should be available in 3-4 years from the opening of K-Rep Bank.

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44 Based on a survey of 1,133 respondents, of which 815 were microentrepreneurs.
**Current and Overdraft Accounts**

By its fifth year, the bank hopes to begin offering current accounts. These accounts are more complex as they require full understanding and operations to handle check-clearing processes. At that point, K-Rep will begin pilot testing overdraft accounts, where customers will be allowed to write checks for more than the amount in their account and automatically activate a short-term loan for the amount of the negative balance.

**Other Products**

Bank checks – K-Rep must have the capability to issue bank or counter checks from the day the bank opens. Clients will be able to purchase a cashier’s check for a small fee.

ATMs – K-Rep plans to develop automatic teller machine (ATM) capabilities in its first year of operations. Management plans to link the bank with a consortium of other banks to offer widespread service at a low cost to the clients. This service will be especially important to offer outside of Nairobi to save on the cost of hiring cashiers.

**4.4 K-Rep Bank – Preliminary Results and Goals**

While it is extremely early to tell the impact of K-Rep’s transformation, there are a few initial indicators of K-Rep Bank’s progress towards its short and long-term objectives.

**Short Term Results**

**Institutional Perspective**

By becoming a bank, K-Rep will be able to achieve its four transformation objectives. Through new lines of credit and client savings, K-Rep Bank will have access to new sources of capital to fuel its growth. Secondly, it will no longer rely on other banks that do not lend to its clients to store their savings. Thirdly, by having access to additional sources of capital, K-Rep Bank will be able to expand outreach and offer additional services to its target population. Finally, K-Rep Bank will improve its long-term sustainability through an improved system of governance that will be less dependent on the Managing Director’s vision and guidance. Transformation will also bring increased access to legal protection and banking expertise.

**Staff Perspective**

In general, K-Rep Bank staff are supportive of the transformation and express feelings of pride and confidence when discussing the bank’s future. The staff view the transition as a chance for potential promotion and to experience new challenges. By becoming bank employees, K-Rep Bank staff will have more career opportunities both within and outside of the institution. They will also have the opportunity to become part owners of the bank through the Kwa Multipurpose Cooperative Society.

The greatest difficulty for staff is dealing with the uncertainty of how transformation will affect the nature of their jobs. At first, there was some confusion as to whether as bank officers their jobs would change, but now they understand that they will continue to work with clients in the field. K-Rep Bank management has been careful to reassure staff that their positions and individual duties will not change significantly as a result of the transformation.
Client Perspective

Clients are also very positive about the bank’s future potential. They expect the creation of K-Rep Bank will improve customer service. They hope to be able to do all their banking at K-Rep Bank, since it will be oriented specifically to the needs of the poor. This will reduce their transaction costs in terms of time and money spent conducting banking affairs. K-Rep Bank will need to convince not only existing but also potential clients that by becoming a bank, it will not become like other banks. Traditional banks do not have a good reputation with the target population. K-Rep Bank needs to distinguish itself from other banks, particularly those that have collapsed recently causing losses of client savings.

Competition

K-Rep is not concerned with competition in the short run. It estimates that its target market exceeds one million micro and small enterprises, of which only 4.5 percent are currently being served. This leaves room for growth and expansion before competition becomes a real issue in Kenya. K-Rep views itself as a pioneer, intentionally facilitating the entry of others into the sector.

Money lenders and traditional rotating savings and credit associations (ROSCAs) do not present real competition for K-Rep as their lending rates often exceed 25 percent monthly (300 percent annually). Savings and credit associations (SACCOs) offer more competitive rates than K-Rep but primarily extend consumer loans to salaried members rather than to entrepreneurs. The Kenyan government has a microcredit program in which it lends at 6 percent annual interest rates, but it does not have a wide outreach and suffers from high default rates.

In general, traditional banks in Kenya still don’t understand microlending and make few attempts to reach this market. In fact, in response to the weak banking environment, traditional banks have raised minimum deposit amounts and closed branches outside the cities. In that regard, K-Rep’s entry into the formal financial sector is well timed to fill a large and growing gap in the market. As K-Rep’s transformation becomes more visible, K-Rep anticipates that traditional banks will become interested as a result of the demonstration effect. K-Rep Bank’s earnings will become public information and as profits are reported, the sector will likely attract more players.

Five-Year Goals

In the business plan, K-Rep estimates that five years after acquiring the bank license the bank will increase its market share from approximately 2.5 to 12.5 percent of the total potential microenterprise market. K-Rep Bank plans to expand outreach to over 45,000 group loan clients with an outstanding loan portfolio of over $32 million in that time period. Individual loans will represent an additional 348 clients with an outstanding portfolio of over $2.9 million. They predict that compulsory savings (savings that act as loan guaranties) will increase to approximately $10 million and voluntary savings will increase to over $26 million.

K-Rep Bank anticipates interest income will increase at an average rate of 50 percent per year to over $13 million by the end of the fifth year of operations. K-Rep Bank projects that total revenue will increase to approximately $15.5 million while expenditures will only increase to $5.2 million, resulting in net profits of $10.3 million, in the fifth year. K-Rep used sensitivity analysis to ensure these estimates were realistic.

In five years, K-Rep Bank plans to go public, with all non-local shareholders selling a portion of their holdings on the Kenyan stock exchange. This will create the opportunity for the Kwa
members to divest their holdings at fair market rates or to trade in their Kwa shares for individual bank shares and become direct owners with full voting rights. K-Rep also hopes the public issue will create the opportunity to expand ownership participation, particularly to clients.

K-Rep’s projections are based on an ambitious assumption that the average group loan size will increase by 25 percent each year from $278 to $845 over five years. The business plan projects that the average individual loan size will increase by 25 percent per year, from $3,448 to $8,414 by year five. With K-Rep Development Agency’s focus on reaching down farther to poorer sectors of Kenyan society, it will be tempting for K-Rep Bank to leave this task to the NGO, allowing loan sizes to increase in its efforts to maximize profits. K-Rep Bank’s higher profile will inevitably attract viable customers who do not fit the target client profile, yet will be hard to turn away. It will be a challenge for K-Rep Bank to develop controls that will ensure a lasting commitment to the original target sector.
Annex 4.1: Organigram – K-REP NGO Prior to Transformation

Board of Directors

Managing Director

General Manager – Non-Financial Services Division (MFRI)

Manager Arifu Centre
Manager Training Department
Manager Research Department

Systems Admin.
Sr. Training Officer
Sr. Research Officer
Sr. Admin. Officer

Training Officer
Secretary
Support Staff

Research Officer
Research Assistants
Adm. Officer
Caretaker, Receptionist
Drivers, Messengers

Assistant Area Managers and Credit Officers

Area Accountant (assisted by Assistant Accountants)

Support Staff
(Secretaries, Messengers, and Clerks)
Annex 4.2: Organigram – K-Rep Bank

- Shareholders
- Audit & Finance Committee
- Chief Manager Audit
- Auditors
- Inspector
- Board of Directors
- Managing Director
- General Manager
- Chief Manager Credit
- Deputy Chief Operations
- Area Operations Managers
- Assistant Managers
- Microfinance Officers
- Area Office Secretaries
- Office Assistants
- Chief Manager Accounting
- Sr. Accountant
- Accountants
- Account Assistants
- Clerks
- Off Assts & Drivers
- Chief Manager Operations
- Administration Manager
- Security Officer
- Officers
- Tellers
- Clerks
- Chief Manager MIS
- Branch Operations Manager
- Technician
- Officers
- Clerks
- Data Clerks
- Chief Manager Treasury
- Exec. Asst.
- Off. Asst.
- Driver
- Manager General Credit
- Officers

Assets & Liabilities
5. THE CREATION OF CARD RURAL BANK

“Only by creating a vehicle for asset ownership, can we ensure that the poor will gain control over their own resources and over their own destiny.”

-- Mr. Jaime Aristotle B. Alip, Founding President, CARD Rural Bank

On September 1, 1997, CARD Rural Bank opened its doors in San Pablo City, becoming the first microfinance NGO in the Philippines to transform into a bank. This transformation was initiated approximately eight years after the Center for Agriculture and Rural Development, Inc. (CARD) first began lending operations, using a modified Grameen Bank methodology to extend credit to landless, rural poor women in the environs of San Pablo City. The transformation from NGO to bank has been gradual and continues today; NGO branches are transferred to the bank operations on a branch by branch basis, a process that will continue for the next few years. As of year end 1998, CARD Rural Bank had a loan book of $1.02 million, with total membership of 6,530, and has recently begun a savings mobilization campaign. CARD Inc., the NGO, continues to support 11 branches and as of year end 1998 had a loan book of $1.11 million, with total membership of 14,087. Together, CARD Inc. and CARD Rural Bank operate in five provinces of the Philippines and employ over 200 staff.

From the founding days of CARD’s operations, the vision of CARD has been to create a bank owned and managed by landless rural women. As such, the story of CARD’s transformation from an NGO to a rural bank reflects the realization of a long-term vision held by board directors, management, staff, and client members. CARD has already begun to sell CARD Rural Bank shares to qualified members and staff, to ensure the original goal of creating member ownership is achieved. The purpose of this case study is to document CARD’s gradual transformation process, from organizational, financial, and operational perspectives, and to identify key issues and challenges that have arisen from this process. The study also examines the history of CARD’s operations, its rationale for transformation, and identifies preliminary results from the transformation process.

5.1 Background

CARD’s board, management, staff and clients have all contributed to its growth. Led by a strong sense of mission, they nurtured CARD’s development into an operationally self-sufficient MFI.

CARD’s Founding Vision

CARD Inc. is a non-profit, non-governmental organization, founded in December 1986 by 15 rural development practitioners to improve the quality of life of poor Filipinos, particularly those in rural areas. The organization began formal operations in April 1988 with community training and livelihood assistance activities for landless coconut workers in San Pablo City. CARD organized the coconut workers into associations of 15-20 members each and trained them in

45 “Managed” refers both to the active role played by CARD clients in conducting weekly meetings and to board representation. Two representatives of CARD clients serve as board members.
project management and organizational development. Following the training, loans were provided to the associations, ranging from $45 to $227\textsuperscript{46} per borrower. Repayment schedules were determined by the groups themselves, and saving was optional. The project’s success, however, was limited. The majority of loans were not repaid on time and internal savings remained low.

Following a visit by the Chairman, Mr. Aristotle Alip, to Grameen Bank in Bangladesh, CARD decided to pilot test a modified\textsuperscript{47} Grameen Bank scheme in four villages in San Pablo City in January 1989. The results were positive; women were able to make successful credit investments and repay their loans regularly. Known as the Landless Peoples’ Development Fund (LPDF), this Grameen replication ultimately became a full-scale program in 1990. LPDF received funding from the Japanese, the Philippine Australian Community Assistance Program (PACAP) of the Australian Embassy, the Philippine Development Assistance Program (PDAP) of CIDA, and the Dutch Rural Development Assistance Program (DRDAP).

As early as the first year of the organization’s existence, \textit{CARD’s vision was to create a bank that would be owned, managed and controlled by its own members}. Guided by a five-member board, primarily composed of prominent community development leaders and practitioners, the project’s initial objectives were:

1. to provide banking services especially designed for landless rural workers by bringing bank services to community sites and minimizing transaction costs;
2. to provide loans to non-bankable projects with no collateral; and
3. to institutionalize and establish a non-stock, non-profit Landless People’s Bank that would be owned and controlled by the landless members.\textsuperscript{48}

These initial objectives have remained guiding principles for all of CARD’s management and staff. As a modified Grameen Bank replication, CARD was concerned with providing a financial service to the poorer segments of the community. Yet, even more importantly, CARD’s leadership was interested in empowering the poor landless women of the Philippines. Through majority share ownership in their own bank and representation on the bank’s board, CARD’s founders believe that landless, rural poor women can be empowered to change their lives. As such, the creation of CARD Bank in September 1997 did not reflect a major shift in philosophy or vision by the board or management, but the final realization of a seven-year dream.

\section*{Development and Growth of CARD’s operations}

During 1990-95, CARD refined its methodology and slowly began to expand its outreach beyond San Pablo City. In June 1990, a second branch was opened. Less than a year later, in March 1991, a third branch was opened in a second province, followed by additional branch openings in two island provinces a month later. By late 1995, CARD had opened eight branches in five provinces. Total active members grew from 307 at the end of 1990 to 1,711 at the end of 1993, and then increased to 4,240 at the end of 1995. The total outstanding loan balance was P9,669,498 (or $379,196 at 1995’s exchange rate). Portfolio at risk remained 0 percent.

\textsuperscript{46} Exchange rate at December 1988: US$1=22 pesos
\textsuperscript{47} Modifications included: more intensive training, management of collective funds done by center, not group; members selected on basis of housing and marketable assets, as opposed to land ownership; disbursement on a 2-3 schedule, as opposed to 2-2-1.
\textsuperscript{48} Gregorio, 1998, p.3.
During this time, CARD successfully weathered two challenges. The first occurred in 1994, when the Bay branch registered a repayment rate ranging from 83 to 86 percent due to one delinquent center. Management investigated and discovered the branch manager had “become too familiar with the members”\textsuperscript{49} and had overruled a technical officer’s\textsuperscript{50} recommendation not to issue a loan. The branch manager was removed from the post, and the branch was subjected to tight supervision. The repayment rate quickly improved. The second challenge faced by CARD was a liquidity crisis, which occurred in 1994-95 due to the delay of expected donor funds. As a demonstration of their commitment to CARD, the board, management and staff mobilized their own savings to ensure a continual flow of disbursements to members.

With five years of a successful track-record, CARD began to significantly scale up operations beginning in late 1995. Still using the group guaranty mechanism, new loan products such as the Multi-Purpose Loan, intended for members’ consumption and emergency needs (see Annex 5.1 – Table 19 for loan terms and structures), were introduced, expanding CARD’s loan products beyond enterprise loans and encouraging previously dormant clients to start borrowing again. In addition, significant branch expansion was undertaken in the five provinces where CARD already had a presence. Area offices, responsible for monitoring, auditing and supervising the local branch operations, were established in the island provinces of Mindoro, Masbate and Marinduque to facilitate decentralization of operations. In addition, incentives were introduced by including the number of quality members recruited in each technical officer’s evaluation and by attaching monetary rewards for performance.

By late 1997, at the time of transformation, CARD’s total members and outstanding loan book had grown significantly. Active members reached 10,868 at the end of 1997. The total number of active loans reached 15,786 (more than one-third of the members had more than one loan), and the outstanding loan book rose to $1,733,565, a 118 percent increase over year-end 1996 and a 357 percent increase over year-end 1995. By year-end 1998, active members totaled 20,617 and active loans reached 26,691, representing an outstanding portfolio of $2.1 million. Chart 4 demonstrates the growth in CARD’s outstanding loan portfolio over 1994-98.

\begin{center}
\textbf{Chart 4:} Growth in CARD’s Outstanding Loan Portfolio ($US)
\end{center}

\begin{figure}[h]
\centering
\includegraphics[width=0.5\textwidth]{chart4}
\caption{Growth in CARD’s Outstanding Loan Portfolio ($US)}
\end{figure}

In spite of rapid growth, CARD’s repayment rates have remained high, averaging 98/99 percent. In addition, the increased volume has led to significant improvement in administrative

\textsuperscript{49} Gregorio, 1998, p.25.
\textsuperscript{50} Loan officers at CARD are referred to as “technical officers.”
efficiency, falling from 69.5 percent at the end of 1995 to 36.8 percent at the end of 1997. Operational self-sufficiency for the consolidated CARD operations was also attained at the end of 1997; financial self-sufficiency is projected for 2000. Because of access to subsidized funding sources, the NGO has been able to realize profits, facilitating accumulation of retained earnings.

CARD’s Critical Success Factors

CARD’s success can primarily be attributed to four factors: a visionary management and board (particularly its founder and Chair, Mr. Alip), a commitment to staff development, strong credit discipline, and innovative product development. Of these four, guidance from a visionary board and management has been instrumental in ensuring CARD’s commitment to creating a bank owned and managed by landless rural women. As a pioneer in its phased conversion from an NGO to a rural bank, CARD has provided a demonstration model for other MFIs in the Philippines.

CARD has consistently placed a high priority on staff development and training. Prior to receiving a full time appointment, each technical officer undergoes the following: two-week exposure to CARD, three months on-the-job training, and a six-month probation period. Once employed, each technical officer receives an average of eight days of on-going training at the CARD training center. As front line staff, each technical officer serves as the primary contact point with the clients. Most are recent graduates from four-year colleges with no prior work experience, and many are recruited from the local area in which they work.

A third success factor is CARD’s strong credit discipline. Since inception, CARD has never written off a loan. A policy of “no-arrears,” whereby any level of delinquency is considered unacceptable, combined with the threat to borrowers of losing access to future loans, have contributed to CARD’s strong repayment rate. In addition, in 1995, CARD introduced enterprise inventories, ensuring that the value of members’ enterprises have grown by at least 25 percent of the original loan. As a modification to the Grameen Bank Model, CARD provides more intensive training on business management and credit discipline to the prospective borrowers.

Finally, CARD has demonstrated a commitment to product development based on member needs. Today, CARD offers five different loan products to accommodate a spectrum of investment opportunities with varying repayment terms and amounts, voluntary and compulsory savings, a members’ mutual fund which acts as an insurance fund in the event of death or injury, a pension plan, and emergency medical assistance. (Annex 5.1 provides an expanded description of CARD’s products.) CARD is currently studying the possibility of offering benefits similar to those given by the Philippines’ Medicare and the Social Security System. An actuarial assessment will soon be conducted of the Members’ Mutual Fund to determine which benefits are really affordable considering the future value of the fund.

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51 Administrative efficiency is defined as per CGAP assessment of CARD: administrative costs (excluding cost of funds and loan loss provisions) / average outstanding portfolio
52 Operational self-sufficiency is defined as per CGAP assessment of CARD: (financial income) / (operating expenses + financial expenses + loan loss provisions)
53 Financial self-sufficiency is defined as per CGAP assessment of CARD: (financial income) / (operating expenses + financial expenses + loan loss provisions + subsidized cost of funds adjustment + inflation adjustment on equity + in kind subsidies)
5.2 Rationale for Transformation

Because CARD’s vision from its founding days was to become a bank managed and owned by the landless rural poor, the question was not whether or not to transform, but when and how. CARD considered a variety of institutional options before deciding to create a rural bank.

Key Motivating Factors

Once the Landless People’s Fund Project started to show success, it became clear that CARD’s vision of creating a bank could become reality. A number of key factors came together in late 1995 and early 1996 that provided the impetus for CARD’s Board to pursue registration as a formal financial institution. These included: the liberalization of the Philippine banking sector; the impending pressure by government officials to legitimize CARD’s lending and savings operations; the need to actively pursue greater sources of loan capital; and the need to resolve key ownership issues.

Liberalization of Philippine Banking Sector

Since the early 1990’s, the Philippine financial sector has undergone significant reform. The New Rural Bank Act was approved in April 1992, governing the establishment and operation of rural banks. In June 1993, the New Central Bank Act was enacted, establishing the Bangko Sentral ng Pilipinas (BSP) as an independent central monetary authority to provide policy direction for the banking sector and to supervise and regulate bank operations. This Act paved the way for the restructuring of the Philippine financial system, liberalizing the establishment of local banks and deregulating the foreign exchange system in the country. A year later, in May 1994, the Foreign Banks Act was approved, facilitating the entry and widening the scope of operations of foreign banks in the Philippines. In February 1995, the Thrift Bank Act was approved, revising the regulation and operation of thrift banks, which include savings and mortgage banks, private development banks, and stock savings and loan associations.54

This liberalization of the financial sector was accompanied by a reexamination of the government’s role in supporting small-scale enterprise lending. Since the early 1990’s, the Philippine financial sector has witnessed a shift from government directed credit and guaranty programs and a re-orientation toward the provision of market-oriented credit by financial institutions. The critical role played by microfinance service providers has gained acceptance and support among policy makers. In 1993, the National Credit Council (NCC) was created to “provide a market-oriented financial and credit policy environment, to promote efficient financial markets, and help private microfinance institutions broaden and deepen their microfinancial services.”55 In August 1996, a two-year microfinance standards initiative was launched with initial funding from USAID to develop and promote standards for microfinance operations through surveys, regional awareness and advocacy forums. In sum, by early 1996, the government’s understanding and support for market-oriented microfinance initiatives had increased significantly since the early 1990’s, encouraging CARD to take a closer look at options for entrance into the formal financial sector.

Need to Legitimize Operations

As an NGO, CARD was not officially permitted to mobilize savings. Only organizations registered with the BSP, or with the Cooperative Development Authority (CDA) if a cooperative, can collect savings and deposits from the public. Nonetheless, CARD has mobilized both forced

54 Luang and Vasquez, 1997.
55 Philippine National Strategy for Microfinance.
and voluntary savings since it began operations. While in the early 1990’s, CARD’s loan and savings balances were not significant enough to attract much attention, by 1995/96, CARD’s operations were starting to raise questions among local government officials. As evident in Table 13, CARD’s rate of lending and savings mobilization increased significantly over 1995-97, attributable to the fact that CARD was satisfying a large unmet need. CARD was offering financial services for low-income individuals and entrepreneurs that were not available through the formal financial sector. The drop in savings in 1998 was due to the effect of the Asian economic crisis, as members withdrew their savings during a period of economic hardship.

### Table 13: CARD’s Growth in Loans and Savings (in nominal US$)56

<table>
<thead>
<tr>
<th></th>
<th>Dec 94</th>
<th>Dec 95</th>
<th>Dec 96</th>
<th>Dec 97</th>
<th>Dec 98</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Loans</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Growth rate</td>
<td>55%</td>
<td>110%</td>
<td>118%</td>
<td>22%</td>
<td></td>
</tr>
<tr>
<td><strong>Savings</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(Voluntary)</td>
<td>75,370</td>
<td>100,528</td>
<td>207,845</td>
<td>816,330</td>
<td>655,612</td>
</tr>
<tr>
<td>Growth rate</td>
<td>33%</td>
<td>107%</td>
<td>293%</td>
<td>-20%</td>
<td></td>
</tr>
</tbody>
</table>

Figures drawn from CGAP Appraisal, April 1998.

The value of the savings was reaching significant levels, representing 25 percent of the loan portfolio in December 1996, and climbing to 47 percent of the loan portfolio by December 1997. Operating outside the formal financial system’s regulatory framework, CARD’s members’ savings were not insured, and the rate of growth of both the loan book and the savings clearly showed that CARD was becoming more than just a small community lending operation. CARD was collecting large amounts of forced and voluntary savings without being subject to regulatory reserve requirements. By late 1997, CARD was offering four different types of loan products: regular project loans for investment in working capital, productive asset loans for investment in fixed assets, housing loans and multi-purpose loans for emergency or consumption purposes. Although CARD had received Presidential recognition in 1990, municipal leaders were starting to question the legality of CARD’s operations, particularly in light of its growing uninsured savings base. As such, pressure was increasing on CARD to seek registration as some form of formal financial institution.

### Need to Access Greater Sources of Loan Capital

As a private, nonprofit organization, CARD’s financing came primarily from concessional loans (including Grameen Trust, Catholic Relief Services, Department of Trade and Industry) and donated capital, both of which CARD realized were limited sources of funds. CARD projects it will reach 100,000 landless women by the end of 2002, which requires a funding strategy that can provide immediate access to a significantly larger pool of funds. Without a banking license, CARD had been unable to initiate any serious savings mobilization campaign. By transforming into a formal financial institution with a banking license, CARD would be able to attract savings from both members and non-members, as well as access other sources of capital, such as loans from the central bank and commercial debt.

As evident from Table 14, CARD’s projections through the year 2002 clearly rely on significant savings mobilization for future portfolio funding needs, which further encouraged CARD to

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initiate the process of transformation. These savings projections are extremely aggressive, particularly given the drop in savings CARD experienced between December 1997 and 1998 due to the Asian economic crisis. CARD Bank may have to rely on debt financing if its savings mobilization fall short of the projections.

**Table 14: CARD’s Loans and Savings Projections (US$57)**

<table>
<thead>
<tr>
<th></th>
<th>Dec ‘98 (actual)</th>
<th>Dec ‘99</th>
<th>Dec ‘00</th>
<th>Dec ‘01</th>
<th>Dec ‘02</th>
</tr>
</thead>
<tbody>
<tr>
<td>Loans</td>
<td>2.1 million</td>
<td>3.5 million</td>
<td>7.9 million</td>
<td>14.5 million</td>
<td>26.3 million</td>
</tr>
<tr>
<td>Savings (Voluntary)</td>
<td>0.6 million</td>
<td>2.3 million</td>
<td>5.3 million</td>
<td>11.9 million</td>
<td>24.6 million</td>
</tr>
<tr>
<td>Savings as % of Loans</td>
<td>31%</td>
<td>66%</td>
<td>67%</td>
<td>82%</td>
<td>93%</td>
</tr>
</tbody>
</table>

Figures drawn from CGAP Appraisal, April 1998.

**Providing an Ownership Structure for Members**

When CARD first began operations, the actual mechanism for transferring ownership to CARD’s clients was unknown. Members were involved in key strategy decisions through center meetings and informal discussions with technical officers, but did not own CARD. As an NGO, CARD Inc. has no owners; capital is composed of donated equity and retained earnings. The creation of CARD Bank, which will ultimately be 75 percent owned by members and 25 percent by the NGO, offers an institutional structure whereby members, through the group structure, will purchase shares in the organization. By using either the compulsory savings they have accumulated or cash, eligible groups may purchase shares in the bank. This is discussed further in the section on **Equity Assignment**.

**Institutional Options**

In January 1996, a discussion paper outlining the different institutional options for transformation was produced by the Executive Director and Chairman for review by CARD’s board. While the BSP was beginning to gain a deeper understanding of microfinance, through both international study tours of leading microfinance institutions in Bangladesh and Bolivia and greater dialogue with MFIs in the Philippines, it was clear that the BSP was not ready or willing to create a separate regulatory category for MFIs. Instead, CARD was encouraged to select from among the following pre-existing categories:

- **Cooperative:** Credit cooperatives, which provide loans only to their members, are licensed and regulated by the Cooperative Development Authority. For CARD, the principal drawback to pursuing a cooperative license was the significant time and expense that would have been required to redocument and restructure their operations to conform to the cooperative structure. For example, all centers would have to be reorganized and registered as cooperatives, a process that would have required a complete reorganization and retraining of all members.

- **Thrift or development bank:** The Thrift Bank Act, which was approved in February 1995, provides for the regulation and operation of thrift banks, which include savings and mortgage banks, private development banks, and stock savings and loan associations. Thrift banks

57 US$1 = P40 for projected years.
typically mobilize small savings and provide long and medium term financing. They can offer a greater range of services than a rural bank, but the paid-up capital requirements are higher, ranging from $1.5-$9.5 million\textsuperscript{58} depending on geographic location.

\textit{Savings and Loan Association:} As a savings and loan association, CARD would be restricted from providing savings and loans to non-registered members, which ultimately would have severely restricted deposit mobilization. In addition, in a savings and loan, staff must be drawn from the membership base, a requirement which CARD did not consider feasible.

\textit{Rural bank:} The New Rural Bank Act, approved in April 1992, governs the establishment and operation of rural banks. By definition, rural banks provide credit to farmers and merchants, or to cooperatives of farmers or merchants, in primarily rural areas. While CARD’s target market and methodology differ from a traditional rural bank’s, the type of lending is similar. Capital requirements for rural banks, ranging from $76,000 to $760,000 depending on the geographic location, are also lower than for other institutional structures. For example, the rural bank paid up capital requirements in San Pablo City must be at least $116,279. Branch openings in other locations will require additional capitalization. In addition, the New Rural Bank Act provides for a “tax holiday” for all rural banks by exempting them from gross receipt tax for five years from the license date. Rural banks are also exempted from paying the property registration fees and document stamps for property registrations valued at P100,000 (US$2,500) or less (less relevant for CARD’s landless membership.) Savings permitted include passbooks, checking account, time deposits, and inter-bank loans.

While either a rural bank or a thrift bank institutional structure would permit CARD the flexibility to maintain their own type of products and methodology, the rural bank structure offered significantly reduced capital requirements. As such, CARD’s board selected to pursue a rural bank license, and in May 1996 submitted an application to the Department of Rural Banks in the BSP. The application included a feasibility study composed of a survey of existing banks in the region, justification for granting the organization a license, financial statement highlights for the past several years, and cash flow projections. The feasibility study included only the four branches of the Laguna and Quezon areas, as the board decided to approach the transformation process through a phased approach. The remaining branches will be gradually incorporated into the bank structure based on CARD’s approved business plan, which projects establishing CARD Bank branches within the same five provinces covered by CARD NGO. (As of March 31, 1996, the operating self-sufficiency ratios for these initial four branches were 100, 96, 98, and 97 percent, respectively.) Six months later, in December 1996, three days before CARD’s 10\textsuperscript{th} anniversary, CARD received approval to open a rural bank and was given eight months to comply with the requirements of a rural bank license.

\textbf{5.3 Realizing a Dream: the Transformation Process}

The process of transforming CARD NGO into CARD Rural Bank consisted of three phases: organizational, financial, and operational transformation.

\textbf{Organizational Transformation}

CARD’s organizational transformation is characterized by an interconnectedness between the NGO and the bank, from the operational level to the governance structure.

\textsuperscript{58} Luang and Vasquez, 1997, p.37.
Board Formation

CARD’s board realized the need to create a separate and independent bank board. In particular, there was a need to incorporate greater banking expertise into the MFI’s leadership. A former Land Bank Vice-President and a microfinance specialist with the Department of Finance were both offered positions on the board. In line with CARD’s goal of creating a bank owned and managed by members, CARD wanted to include representatives of the client membership in the Bank’s board. As such, the membership recently selected two client members through a democratic voting process to join CARD Rural Bank’s Board, pending approval by the BSP. Board members are elected to serve two-year, renewable terms. Table 15 identifies the seven members and their affiliations.

Table 15: CARD Rural Bank Board Member Affiliations

<table>
<thead>
<tr>
<th>NAME OF MEMBER (BOARD POSITION)</th>
<th>AFFILIATION</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Mr. Jaime Aristotle Alip (Chairman)*</td>
<td>Former Assistant Secretary, Department of Agrarian Reform; Chairman, CARD Inc.</td>
</tr>
<tr>
<td>2. Ms. Dolores Torres (President)*</td>
<td>Chief Executive Officer, CARD Bank; Executive Director, CARD Inc.</td>
</tr>
<tr>
<td>3. Mr. Feliciano Matienzo*</td>
<td>President, KASAMA (Federation of Agrarian Beneficiaries)</td>
</tr>
<tr>
<td>4. Ms. Illuminada Cabigas</td>
<td>Consultant, Solid Bank; formerly Senior Vice President, Land Bank of the Philippines</td>
</tr>
<tr>
<td>5. Dr. Gilbert Llanto</td>
<td>Chief of Party, Credit Policy Improvement Program (CPIP), National Credit Council, Department of Finance</td>
</tr>
<tr>
<td>6. Ms. Agnes Gavanes**</td>
<td>CARD member since 1993</td>
</tr>
<tr>
<td>7. Ms. Araceli Suzara**</td>
<td>CARD member since 1993</td>
</tr>
</tbody>
</table>

* Also serve on CARD Inc. (the NGO) board.
** Pending approval by BSP.

As currently structured, the CARD NGO board and the CARD Bank board share three members. The Chair of the NGO board serves as the Chair of the bank board, the President of the NGO board, the Executive Director of CARD Inc., also serves as the President of CARD Rural Bank, and the Vice President of the NGO board also serves on the bank board. This overlap was considered important for ensuring that the vision of CARD Bank remain consistent with its original mandate to serve the landless poor of the Philippines. In addition, CARD felt this overlap would facilitate the phased approach to transformation, as many of CARD’s branches will remain under the NGO structure for the next few years.

The two client members of the board were elected by the membership, primarily due to their leadership abilities and demonstrated business success. Both of them have outstanding loans; one of them has the largest loan available at CARD, $2,907. As brand new board directors, their ability to balance their own interests as net borrowers against the institution’s larger interests of outreach and sustainability has yet to be tested. Elected by the membership, these directors serve as representatives of the members, which include shareholders, borrowers and savers, a diverse
group with competing interests. If the board director is a net borrower, will this influence her bias? A borrower bias among board members can lead to excessive downward pressure on interest rates and a focus on client services at the potential cost of institutional efficiency and profitability. In addition, if the member-director falls behind on her loan repayment, will the technical officer exercise the same amount of discipline as on any other delinquent client?

These types of governance questions are not unique to CARD. Credit unions, for example, have also struggled with these issues. Brian Branch and Chris Baker describe common governance issues found in credit unions, including: the principal-agent problem resulting from the misalignment of priorities between elected directors and contracted management; the dominance of net borrowers on the board; and diffuse ownership and the boards’ failure to exercise adequately its fiduciary responsibility. Branch and Baker suggest that well-defined roles and regulatory supervision help to resolve these issues but that they may not be enough. The challenge for CARD is to implement safeguards against such potential conflicts of interest. As a regulated financial institution, CARD now discloses to the Central Bank all loans to directors, officers, staff and other related interests. While the net-borrower issue is only relevant for two of CARD’s seven board directors (CARD prohibits loans to management and non-member directors), such disclosure may raise further questions by regulators.

**Bank Structure**

From an organizational perspective, CARD Rural Bank currently consists of a head office in San Pablo City and four former CARD Inc. branches plus one new branch, all of which are located in the Luzon and Quezon Provinces. Prior to transformation, CARD’s organizational structure included 13 branches (there are now 16) located in five separate provinces, three area offices that supported the branches located in the three island provinces, and a head office, which served as headquarters for all of CARD and provided support to the mainland Luzon and Quezon province branches. With transformation to a rural bank, CARD’s head office now serves as the first bank branch. An additional 11 CARD branches and the three area offices still remain under the CARD Inc. structure, but will gradually be incorporated into the bank structure as satellite offices and bank branches, respectively.

The transformation to CARD Rural Bank has primarily affected the head office structure; most processes and procedures remain the same at the branch level. The organigram for CARD Bank (see Annex 5.3) includes an Executive Director, an Associate Director, an Internal Auditor and five principal departments, including Training, Finance, Operations, Research and MIS. As currently staffed, there is one Operations Director for the Laguna/Quezon branches. Once the three island provinces are incorporated into the bank structure, an additional two operations directors will be identified (one for Mindoro/Marinduque and one for Masbate) from among CARD’s current area managers. While CARD has had an internal auditor since May 1995, this position was elevated in importance during the transformation process. In May 1998, two additional support staff were hired to assist with internal audit functions.

From the perspective of the organization chart and the accounting department, CARD is composed of two distinct entities, a bank and a NGO. However, when viewed from the perspective of operations and organizational culture, CARD is one organization. This distinction is important as it underlies CARD’s ability to successfully implement a phased approach to transformation. While some branches are housed under the bank and some under the NGO, a technical officer in a bank branch is following the same procedures as a technical officer in a

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60 Branch and Baker, 1998.
NGO branch. Likewise, a member linked to a bank branch has access to the same products and services as a member in a NGO branch. Similarly, the staff employed under the bank and under the NGO do not view themselves as working for two separate organizations. While this structure has potential to temporarily reduce transparency in the bank’s operations, CARD prefers this approach because it encourages a strong sense of team effort. This organizational culture is constantly reinforced by workshops and planning sessions, which do not distinguish between bank and NGO staff.

The Future of CARD NGO

Guided by the goal of creating a bank, CARD Inc.’s board members, senior management and staff have been singularly focused on preparing and planning for the future of CARD Rural Bank. Because of the interconnectedness between the NGO and the bank, the future role of CARD NGO has yet to be clearly articulated. As envisioned, all lending operations will eventually be housed under CARD Bank, and CARD Inc. will ultimately reduce its ownership in CARD Bank to 25 percent, with the shares transferring to the clients. As such, CARD Inc. will continue as an investor in CARD Bank and, through overlaps in board membership, continue to play an active role in the bank’s governance structure. It is anticipated that CARD Inc. will seek to professionalize its training and research units in order to continue to serve the bank, including staff and clients, as well as other MFIs in the area. Research activities will include impact, means testing, product development and market surveys. When necessary, and if resources are available, training centers will be established by CARD Inc.

The relationship between CARD Bank and CARD NGO will continue to evolve, raising questions about future ownership and governance. This interconnectedness between the NGO and the bank, from operations up through the board level, is considered critical for maintaining CARD’s vision to build a sustainable financial institution owned, managed and controlled by landless rural women. The senior management and board of CARD NGO were particularly concerned with maintaining their commitment to the poor women of the Philippines, and believed that the linkage with the NGO would help retain the rural bank’s target market. Though it is too soon to assess the success of this objective, average loan size at CARD has actually fallen since the creation of the bank ($80 vs. $72), largely due to the significant increase in number of first loans within the portfolio. As a proxy for reaching the poorer members of the community, this drop in average loan size suggests an on-going commitment to the same target market.

Financial Transformation

CARD’s financial transformation resulted in the creation of a structure that more closely resembles a credit union than a traditional bank. Since the majority of the bank’s equity will be assigned to client members with the balance remaining with the NGO, CARD’s transformation is unique among the case studies in its choice not to attract outside investors. This section discusses these issues as well as the transfer of net assets and regulatory implications.

Equity Assignment

Capital requirements for rural banks in the Philippines are prescribed based on geographic location and class of city or municipality. Located in San Pablo City, considered a “first-class” city, CARD Rural Bank required paid-up capital of P5,000,000 ($116,279) prior to licensing. While CARD ultimately plans to establish an ownership structure which will be 75 percent member owned and 25 percent NGO owned, the initial P5 million was invested by the NGO with funds from its accumulated capital, through an equity assignment process. To meet BSP’s ownership requirements, the board assigned P2 million to CARD, Inc. and the remaining P3
million to five founding senior managers. This assignment was accompanied by an agreement, which stipulated that these individuals would not maintain ownership rights over these funds, nor profit from any dividend pay-outs. In the event one of them leaves, the shares will be reassigned. Table 16 identifies the original shareholder breakdown.

As of December 1998, CARD Bank’s capital base had increased to P15,000,000 ($375,000), representing P10,000,000 ($250,000) of common and P5,000,000 ($125,000) of preferred stock. In addition, the board recently voted to set aside P7.5 million ($187,500) of clients’ center fund savings, primarily composed of compulsory savings, as deposit for stock subscription, to be used by qualified members to purchase shares in the bank. (This process is discussed in more detail in the section on Member Ownership.) A board member has also recently added an additional P100,000 to the deposit for stock subscription, bringing the total capital base to P22.6 million. CARD Inc, the NGO, has fully paid up its subscription of 50,000 shares of common stock for P5 million and an additional 25,000 of preferred stock for P5 million. As such, CARD Inc.’s stockholdings represent 44.25 percent of total paid-up capital of the bank.

Table 16: CARD Rural Bank Shareholder Breakdown

<table>
<thead>
<tr>
<th>Shareholder</th>
<th>Relationship to CARD Bank</th>
<th>NO. OF COMMON SHARES SUBSCRIBED</th>
<th>Amount Subscribed (in pesos)</th>
<th>Paid Up Amount (in pesos)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dolores Torres</td>
<td>Executive Director</td>
<td>15,000</td>
<td>1,500,000</td>
<td>700,000</td>
</tr>
<tr>
<td>Lorenza De Torres</td>
<td>Associate Director – Finance</td>
<td>15,000</td>
<td>1,500,000</td>
<td>700,000</td>
</tr>
<tr>
<td>Ancieta R. Alip</td>
<td>Director, Research</td>
<td>20,000</td>
<td>2,000,000</td>
<td>1,400,000</td>
</tr>
<tr>
<td>Aristeo A. Dequito</td>
<td>Area Manager, Region IV</td>
<td>2,000</td>
<td>200,000</td>
<td>100,000</td>
</tr>
<tr>
<td>Elma F. Buedad</td>
<td>Area Manager – Masbate</td>
<td>2,000</td>
<td>200,000</td>
<td>100,000</td>
</tr>
<tr>
<td>Card, Inc.</td>
<td>The NGO</td>
<td>20,000</td>
<td>2,000,000</td>
<td>2,000,000</td>
</tr>
<tr>
<td><strong>TOTAL</strong></td>
<td></td>
<td>74,000</td>
<td><strong>$185,000</strong></td>
<td><strong>$125,000</strong></td>
</tr>
</tbody>
</table>

These increases in CARD’s capital base precipitated from CARD’s expansion strategy. As mentioned above, CARD Bank currently includes only five branches, all of which are located in the BSP’s Region IV. It is anticipated, however, that the other CARD NGO branches, which are located in Region V, will be brought under the CARD Bank structure over the next two years. This branch expansion into Region V will require an increase in capitalization to P50,000,000 ($1.16 million), with P20,000,000 ($465,116) in paid up. In early 1999, CARD Bank submitted an application to the BSP to increase its capital stock to P50 million, in order to pursue the transformation of additional branches. CARD anticipates issuing an additional P5 million of common stock, and P30 million of preferred, for a total share capital base of P15 million ($348,837) of common and P35 million ($813,953) of preferred. Once this increase in capitalization has been approved, it is anticipated that the bank’s ownership will be as presented in Table 17.
Table 17: CARD Rural Bank’s Anticipated Ownership Composition

<table>
<thead>
<tr>
<th>Shareholder</th>
<th>Ownership</th>
</tr>
</thead>
<tbody>
<tr>
<td>Board of Directors of CARD Bank &amp; CARD NGO</td>
<td>17%</td>
</tr>
<tr>
<td>CARD NGO</td>
<td>45%</td>
</tr>
<tr>
<td>Selected management and staff</td>
<td>14%</td>
</tr>
<tr>
<td>Selected member borrowers</td>
<td>24%</td>
</tr>
<tr>
<td><strong>TOTAL</strong></td>
<td><strong>100%</strong></td>
</tr>
</tbody>
</table>

**Member Ownership**

Under the founding ownership structure, CARD Bank was 100 percent owned by the NGO. From the initial days of CARD’s existence, however, the organization planned to create a bank managed and owned by its members. Unlike many other NGO transformations, CARD’s transformation was motivated more out of a sense of social commitment to improve the lives of low-income women than to gain access to commercial sources of funds. As such, CARD’s funding strategy targets members as investors and savers. While CARD has access to outside sources of funds in the Philippines, the Bank has made the strategic choice to fuel its growth primarily from the savings and share capital of its own members. While BRI Unit Desa in Indonesia has demonstrated the potential for this level of savings mobilization, CARD’s ability to attract sufficient equity capital in addition to savings from its client members has yet to be tested.

The first board studies conducted of member ownership options indicated that common stock, which requires a vote, would not be the most appropriate investment vehicle for members, as it requires attendance at annual stockholder meetings. Due to the geographically dispersed nature of CARD’s client base, ensuring attendance by all shareholders would be difficult and expensive. Instead, CARD plans to offer preferred stock to groups at a value of P200/share. Management feels that the non-voting nature of the preferred stock will not compromise members’ input into CARD’s operations, as they are already active participants in CARD’s policies and procedures through the center meetings. In addition, preferred stock reduces the client members’ risk.

It is anticipated that the selling of shares to members will begin in 1999. Shares will only be available for purchase by the group, and groups may use either their center fund contribution (composed of compulsory savings, loan retention and penalties and interest income on the fund) or cash to purchase the shares. As of December 31, 1998, CARD members had a total of P26.5 million ($663,000) in center fund contributions (P16 million with CARD NGO and P10.5 million with CARD Bank), P7.5 million ($188,000) of which the board has recently approved as deposit available for stock subscription. These funds will be converted to share capital and assigned to eligible groups.

All CARD member groups, including those who are currently members of the NGO branches, are potentially eligible. To qualify, groups must have:

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61 As of year end 1998, BRI Unit Desa had 2.5 million borrowers with an outstanding loan book of US$456 million, and 22 million depositors with combined savings balances of US$1.6 billion.

62 CARD’s clients are organized into groups of five. While each client receives her own loan, the group is required to save regularly in a group account.
MicroFinance Network

- finished their fourth loan cycle;
- attained a record of 100 percent repayment rate for all CARD loans;
- achieved at least 95 percent attendance rate at group meetings for the past two years;
- managed successful on-going business;
- maintained a good record with CARD or with the center since becoming a recognized member;
- remained intact for the last two years (meaning no replacement, changes, or reorganization)

In addition, groups have to be recommended by their branch manager and a community leader, and be endorsed by the Associate Director or Executive Director. Once approved, shareholders will be issued a Certificate of Stock. All transfers must be made through the bank; to effect the transfer, the old stock certificate must be surrendered to the bank for cancellation before a new certificate is issued. The number of shares permitted per group purchase will be based on the indicators in Table 18.

Table 18: CARD’s Group Share Eligibility

<table>
<thead>
<tr>
<th>Indicators</th>
<th>9 years</th>
<th>8 years</th>
<th>7 years</th>
<th>6 years</th>
<th>5 years</th>
<th>4 years</th>
</tr>
</thead>
<tbody>
<tr>
<td>100% Repayment Rate</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>95% Attendance Rate</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Ongoing Project</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>No Bad Record</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Group Remains Intact</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>No. of Shares</td>
<td>35</td>
<td>30</td>
<td>25</td>
<td>20</td>
<td>15</td>
<td>10</td>
</tr>
</tbody>
</table>

Source: Guidelines for the Acquisition of Shares of Preferred Stock from CARD Bank by the Qualified Recognized Members.

Grameen Bank also offers its members the option of purchasing shares in the bank, though this share capital represents only a small portion of Grameen’s equity base. Similar to CARD, Grameen offers its members non-transferable preferred shares. In contrast to CARD, however, Grameen shares are available to all members; members may purchase shares as soon as they join Grameen and are not restricted by repayment or attendance rates. In addition, Grameen shares are only available for individual purchase, as opposed to group purchase.

Given CARD Bank’s relatively short track record, members will not have access to historical earnings information when making their share purchase decision. As such, a member’s choice may be influenced more by the pride associated with owning shares in a bank than by an understanding of future return on investment. While members have continuously been informed of CARD’s plans to transform into a bank, additional training for members will be conducted to explain the costs and benefits of owning shares. Topics will include: the terms and conditions to holding preferred stock, rights and privileges of shareholders, policies on dividend declaration, transfer guidelines and the risks associated with share ownership. The issuance of certificates of stock will begin once the proposed increase in capitalization is approved by the BSP.
Shares for Staff

To reward and acknowledge the contribution of staff’s service to the organization, CARD will assign shares to eligible staff. Staff with five years of service will be assigned 50 shares of preferred stock, and those with more than five years of service will be assigned up to a maximum of 350 shares. All staff shares will be preferred stock, valued at P200($5)/share. Staff will benefit from dividends, but will not be able to sell, transfer or convert the shares into cash. If they die or leave CARD, the shares are reassigned to another staff person. As such, this transfer mechanism reflects a form of profit sharing, as opposed to actual ownership. At CARD’s current staffing pattern, 21 staff are eligible for shares, for a total capital value of P490,000 ($11,395), or 2,450 shares. CARD NGO plans to purchase this stock using its own retained earnings, pending final approval by the BSP and the Philippine Securities and Exchange Commission.

Transforming without Attracting Outside Investors

Unlike other microfinance transformations, CARD’s transformation process did not involve raising equity from outside commercial or institutional interests. Because of the low capital requirements of Philippine rural banks, CARD did not need to attract outside investment to fulfill minimum capital requirements. Therefore, CARD has not spent time negotiating with a range of potential investors or diluted its equity base. Such negotiations often require the development and revision of numerous feasibility studies and revenue projections. In addition, the structuring of shareholders agreements and dividend policies can be a time-consuming activity. Instead, CARD produced only one feasibility study for the BSP using only four of its branches, and has the freedom to structure a member ownership policy according to its own eligibility criteria.

The flip side of this capital structure, however, is an equity base limited to members’ shares, staff shares, donated equity and retained earnings. This equity structure raises questions about its ultimate influence on management. CARD’s shareholders will primarily be composed of staff, senior management, some board members, and active clients located throughout five provinces. With over 20,000 active clients (year-end 1998), CARD’s client base has the potential to be diffused among a large number of people. Such a ownership structure may not exert the same amount of influence on management as, for example, a large investor concerned with realizing some form of profit. The level of accountability demanded by this geographically dispersed and diffuse ownership base may also be less. Finally, in case of a crisis, it is questionable that CARD’s clients will have sufficient resources to recapitalize the institution. Credit unions throughout the world have struggled with these same types of ownership issues, with mixed results.

Asset and Liability Transfer

As mentioned above, CARD Bank currently includes the five branches of Laguna and Quezon, four of which were originally formed under CARD NGO. The transfer of the four NGO branches to the bank occurred over a five-month period, starting with the San Pablo branch. At the August 25, 1997 board meeting, the board agreed that San Pablo’s outstanding loan balance ($114,181) and the outstanding Center Fund Savings balance ($30,467) would be transferred as a loan to CARD Bank according to a Deed of Assignment between CARD NGO and CARD Bank. The agreement requires CARD Bank to reimburse CARD NGO for the full amount of the principal, based on repayment dates determined by CARD NGO. In addition, CARD Bank is required to pay CARD NGO an amount equivalent to 50 percent of the total interest collected on the transferred loan book.
This interest payment, which appears on the financial statements as a donation from the bank to the NGO, was established to cover the salary costs of bank branch technical officers who continue to remain on the NGO’s books. Because most rural banks are only staffed by seven or eight people, CARD opted to retain the branch staff under the NGO to avoid unfavorable efficiency comparisons during the regulatory approval process. In fact, the application for the rural bank license presented a staffing pattern of only 13, including four principal officers, two junior officers, and seven junior staff. In reality, each CARD branch employs a branch manager, an assistant branch manager, approximately eight or nine technical officers, and a cook. (Most technical officers live at the branches.) In addition to principal and interest payments, CARD Bank has also made a one-time donation of P500,000 ($11,628) to CARD NGO in June 1998. It is anticipated, however, that once the bank structure has been formalized, all bank expenses will be charged directly to the bank.

CARD NGO continues to own most of the fixed assets. The NGO has leased four cars to CARD Bank for a term of five years, for which CARD Bank agrees to pay a monthly rent of P10,000 ($232) per car, and to maintain responsibility for the maintenance and repairs of the cars. In addition, CARD NGO has leased a portion of the commercial building to CARD Bank for a period of 20 years at a charge of P10,000 ($232) per month. Because CARD NGO and CARD Bank share the head office location, charges for water, electricity and telephone are covered by both in proportion to their consumption, while taxes are to be paid by CARD NGO.

Regulatory Implications

The BSP conducted its first examination of CARD Rural Bank in early 1999. The examination resulted in no major findings or exemptions, except for the lack of certain accounting procedures, which were immediately implemented. While the Rural Bank Department within the BSP has been supportive of CARD’s transformation, a number of regulatory issues remain pending. These include: CARD’s eligibility to access funds from the central bank discount window; the legal implications of collecting repayments and savings outside the principal bank branch (i.e. at center meetings); and a mutually acceptable loan loss provisioning policy. As a rural bank, CARD must also adhere to general and liquidity reserve requirements, and is now subject to a significant tax liability.

Access to Rediscount Window

To access the BSP’s rediscount window, a rural bank must ensure that 70 percent of the value of the borrowed funds is fully collateralized. Given CARD’s emphasis on character and cash-flow based lending, this requirement precludes the bank from accessing the discounted funds. Despite this obstacle, CARD’s management remains committed to maintaining its methodology, and has stated that they will not resort to requiring collateral from clients. Instead, CARD Bank is prepared to meet with the Governor of the BSP to present justification for a waiver. The BSP examiners found it difficult to dispute CARD’s non-collateralized lending procedures, given its 100 percent repayment rate.

Legal Implications of Center-Based Methodology

As a rural bank, CARD must adhere to policies and procedures governing the collection of funds. According to BSP regulations, deposit and repayment transactions must be conducted on bank premises. Most client transactions at CARD, however, occur outside the bank, in small center meetings, conducted in villages throughout the provinces. These center meetings are critical to CARD’s methodology and, according to CARD management and staff, are the primary reason for CARD’s high repayment rates.
During the BSP examination, one of the examiners observed a center meeting. He was impressed with the strong credit discipline of the member-borrowers, and agreed to submit a request for “information and favorable action” to the Governor’s Office. In addition, CARD Bank has submitted a letter to the Department of Rural Banks requesting written approval of their collection procedures. The request is currently being evaluated by the BSP.

**Loan Loss Provisioning**

Prior to creating the bank, CARD did not have a provisioning or reserve policy, as repayment rates have always been high, and no amount has been written off since inception, as CARD has been able to draw from the compulsory group savings for any unanticipated losses. As a rural bank, however, CARD was required to establish a general loan loss reserve equivalent to 2 percent of the total outstanding portfolio by April 1999. This reserve is in addition to mandatory reserves for any substandard or doubtful loans. According to CARD management, none of the bank’s portfolio will require additional provisioning. However, the BSP’s view of the risk of CARD’s non-collateralized portfolio has yet to be tested.

**Reserve Requirements**

As a rural bank, CARD must now adhere to BSP reserve requirements. These include reserves against deposits and liquidity. Rural banks are required to set aside regular reserves equivalent to 8 percent of demand deposits and NOW accounts, and 3 percent of savings and time deposits regardless of their maturity. The BSP also sets rural banks liquidity reserve ratios at 3 percent against demand deposits and 0 percent against time and savings deposits. Both liquidity and regular reserves may be maintained in the form of short-term market yielding government securities purchased directly from the BSP-Treasury Department. Because CARD is currently restricted from offering demand or NOW accounts, only the 3 percent reserve requirement and the 0 percent liquidity ratio apply. Within the next year, however, CARD intends to offer checking facilities, a move, which once approved, will further increase reserve requirements.

**Tax Implications**

As a rural bank, CARD is exempted from documentation, stamp tax and gross receipt tax, consisting of interest income, service fees, and deposit charges, for five years. However, they will still have to pay taxes equivalent to 35 percent of net income.

**Depositors’ Insurance**

Deposits of CARD Rural Bank’s clients are now insured up to a maximum of $2,325 by the Philippine Depositor’s Insurance Corporation (PDIC). Under this deposit insurance scheme, CARD Bank pays an amount equivalent to 0.001 percent of current deposit liabilities but not less than $6 on a bi-annual basis. For the period July to December 1998, CARD Bank paid a premium of $165.

**Operational Transformation**

CARD’s operational transformation required the overhaul of systems and infrastructure, as well as the retraining of employees.

**MIS: Systems and Reports**

Operationally, the most challenging aspect of the transformation was the computerization of CARD's loan tracking, savings and accounting systems. Prior to acquiring a bank license, CARD
had a manual system and used computers only to generate spreadsheet reports. This system was cumbersome for both the technical officers and head office. In late 1997, CARD Bank introduced a computerized loan tracking, savings and general ledger (G/L) system. All three modules were originally part of a computerized system called Ruralbanker; CARD, however, has replaced the loan tracking system with its own system designed in-house. While CARD still relies heavily on a manual system, the introduction of the loan tracking system has already improved efficiency at both the branch and head office levels.

The loan tracking system, known as Loan Monitoring System (LMS), has been installed at all 16 CARD branches. Designed in DOS, LMS is used by technical officers primarily to update center records (the system operates with exceptions posting) and to print expected repayment reports and receipts to be used at center meetings. All loans are tracked individually within the group guaranty structure. Information is sent via fax or email to head office on a weekly basis, and consolidated on a monthly basis for branch by branch analysis. The system still requires some development, and more frequent LMS training for technical officers.

The savings and general ledger (G/L) systems are installed only at the head office. The savings system tracks the bank's voluntary savings, as group compulsory savings are all tracked through the LMS. Basic financial statements are produced by the area offices on a branch by branch basis (in Excel spreadsheets) and are sent to the head office for consolidation into the G/L system. The three systems are currently not integrated and significant development and training is needed. To address these issues, CARD recently commissioned an MIS audit. A plan has been prepared to strengthen and improve the MIS and to ensure it can cope with the scaling up of CARD and CARD Bank operations.

The transformation to a rural bank has resulted in a significant increase in reporting requirements. While most of the required reports are still not relevant to CARD's operations, CARD submits over 30 weekly, monthly, quarterly, biannual and annual reports to the BSP. These include weekly liquidity reserve reports, monthly portfolio quality reports, quarterly income and expense reports, disclosure reports on loans to officers or employees, application for write-offs, and reports on dividends declared, among others.

**Human Resources**

CARD’s hiring requirements have changed little with the creation of CARD Rural Bank. As CARD continues to provide the same type of loan products, using the same methodology, technical officers and branch managers do not need different skills. All department directors in CARD Bank were part of the NGO staff, and technical officers are still recruited based on their level of commitment to community development, as opposed to their accounting or banking background. Instead of hiring individuals with formal banking expertise, CARD has elected to provide the necessary bank training to its staff. For example, all branch managers and senior management recently participated in a 10-day BSP Institute training course, which focused on the regulatory implications of a rural bank license. In addition, CARD relies on both the insights of its board members and the advice provided through technical assistance contracts with such organizations as the German Savings Bank.

Staff morale at CARD is high due to a strong commitment among staff to helping the poor and a competitive salary structure. Staff members express great pride in CARD’s transformation. The process of transformation and its impact on staff has been well managed. From the early days of

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63 Typical technical officers are recent graduates averaging 23 years old with 14 years of school.
the Landless People’s Development Fund, new hires have been informed of CARD’s intention to
create a bank. Frequent branch manager workshops are held to incorporate the views of staff in
strategic planning exercises and to provide a forum for voicing any concerns. In addition, most of
CARD’s staff are still employed by the NGO, a deliberate move by senior management to
maintain cohesion among CARD staff. CARD management has also been careful to ensure bank
and NGO staff receive equivalent benefits. For example, when CARD Rural Bank head office
staff were provided with uniforms, the rest of the staff were provided with a compensating
clothing allowance.

At the management level, significant overlap exists between the NGO and the bank. Several
senior managers, including the Executive Director and Finance Offer, hold positions in both
organizations. Because of CARD’s phased approach to transformation, this management overlap
will continue for the next few years.

Physical Infrastructure / Public Image

As a stipulation to receiving its banking license, CARD spent nearly $25,000 to upgrade its head
office facility to conform with banking security requirements. This included the construction of
vault facilities with time delay devices, the purchase of additional furniture and fixings for tellers,
and the hiring of security personnel to guard the bank 24 hours/day.

CARD has designed a new logo for CARD Rural Bank which portrays the structure of a house
with the silhouette of five people inside, representing the group of five which form the basis of
CARD’s lending. Eleven rays of sun project from the roof of the house, representing the 11
branches of CARD at the time of transformation. The name CARD Rural Bank, Inc. surrounds
the logo.

5.4 CARD Rural Bank – Preliminary Results and Future Plans

Recognizing that only a year has elapsed since CARD Rural Bank was officially opened, the next
section attempts to identify the preliminary results from the transformation process. In particular,
it examines the impact of transformation on CARD, its members, and the microfinance sector in
the Philippines. It concludes with a review of CARD’s future plans.

Impact on Institution

CARD’s transformation into a financial intermediary for poor, rural women implies expanded
access to funding sources, particularly from anticipated increases in member savings.

Establishment of a Financial Intermediary

As an NGO, CARD was not officially recognized as a full service financial intermediary. Prior to
receiving its rural bank license, CARD was not permitted to mobilize savings, nor was it
structured as a legal entity engaged in lending operations. While regulatory authorities turned a
blind eye on CARD’s activities, CARD’s recent growth in both loans and the center fund,
combined with their near 100 percent repayment rates, were quickly raising CARD’s profile in
the sector. As a regulated financial institution, CARD Rural Bank is now in a better position to
pursue its planned growth projection.

According to the recent strategic planning document, CARD anticipates reaching 100,000
landless rural women by the end of 2002. Projections indicate an outstanding loan balance of $25
million with 156,317 active loans, and an outstanding savings balance of $19 million by 2002.
Within this time period, CARD anticipates establishing a total of six CARD Bank branches, with approximately 35-40 sub-branches primarily in the same geographic locations. In addition, within this five-year time frame, CARD’s consolidated operational self sufficiency is projected to increase from 102 to 263 percent, and financial self-sufficiency from 81 to 213 percent.

**Access to Expanded Sources of Funds**

While the NGO was able to access soft loans from sources such as the People’s Credit and Finance Corporation (a government financed wholesale loan facility for MFIs) and Grameen Trust, CARD’s funding projections primarily rely on member savings. With a rural bank license, CARD now has the legal authority to mobilize savings. Since receiving a bank license, CARD has introduced a voluntary savings product for both members and non-members.

On the one-year anniversary of their opening, CARD Bank held a raffle as part of a savings mobilization campaign to attract both members and non-members. Qualified depositors were divided into those with minimum savings balances of P5,000 ($116) and those with minimum savings balances of greater than P10,000 ($232). Nine depositors qualified for the first level, and eight for the second. Over 100 new depositors were attracted by the raffle, and the San Pablo and Bay branches have seen an increase in savings since the raffle. CARD plans to hold the raffle every quarter.

As of August 31, 1998, a year after the CARD Bank was created, total savings represented $132,674, of which $101,424 represents deposits by the NGO with CARD Bank. As such, voluntary deposits by members and non-members total only $30,233. Currently, savings (including CARD NGO’s accounts) represent 28 percent of the total outstanding loan book. By 2002, CARD anticipates mobilizing a total of $23 million in savings, representing 98 percent of the projected total outstanding loan book. The shift from a microlending organization to a formal savings and loan institution is significant, and requires a significant change in perception among members as well as staff.

CARD anticipates that it will mobilize a significant portion of its deposits from the non-member community, including staff and management, local civic organizations, and other cooperatives which have received training at one time by CARD. CARD has recently qualified and applied for a license to offer current accounts. The organization is preparing the required systems and procedures to accommodate this new product, and recently sent one of its staff members for on the job training with the Land Bank of the Philippines. CARD Bank’s General Manager anticipates that current accounts will significantly increase CARD’s depositor base.

**Member Pride**

For CARD’s members, the transformation to a rural bank represents a shift from being a client to being an owner and manager. Informal conversations with clients revealed tremendous pride in CARD’s transformation. None of the members interviewed expressed concern over CARD’s transformation from an NGO to a bank. Instead, clients saw the transformation as extremely positive. Perceived benefits included access to depositor insurance and the opportunity to own a bank.

**Microfinance Sector in the Philippines**

CARD is a pioneer in that it is the first microfinance NGO in the Philippines to create a regulated financial institution. As such, the organization is being closely watched by regulatory authorities and other MFIs interested in transformation. The raised expectations among the microfinance
community, as well as members, have placed CARD under a great deal of pressure to deliver a profitable member-owned bank. Whether CARD will serve as a demonstration model for other transforming MFIs is largely dependant on its ability to demonstrate a continued commitment to its target market while expanding outreach and maintaining portfolio quality and viability. The BSP’s first examination was viewed as a key hurdle in this process.

CARD’s entrance into the formal banking sector has not forced it into competition with other, better capitalized banks, primarily because those banks are not currently interested in lending in such small amounts to individuals with no collateral. CARD’s main competitors are the informal moneylenders. These moneylenders use the traditional “5-6” scheme, whereby clients borrow in increments of five pesos at the beginning of the period, and repay the equivalent of six pesos at the end of the term. While such loans have low transaction costs for the borrower, as no pre-training or group meetings are required, effective interest rates on these loans can run as high as 1,000 percent/year, significantly above CARD’s effective rates which range from 38-46 percent, depending on the loan product.

While other NGOs also operate within CARD’s target area, they do not pose a significant threat. An unwritten understanding exists between the MFIs not to intrude on each other’s geographic areas. However, given both CARD’s and other MFIs’ expansion plans over the next few years, this situation may change.
Annex 5.1: CARD’s Products

Training
CARD’s training aims to assist the members in acquiring skills for effective management, both of their centers and businesses. Prior to receiving loans, members are required to attend 24 hours of initial training, known as Continuous Group Training. The five-module training includes: Value Formation and Self-Group Awareness, Organizational Management, Project Management, Savings and Credit Management, and Commitment Building Ceremony. In addition, during center meetings, center leaders initiate discussion on a range of socio-economic topics, from gender sensitivity to bio-intensive gardening, using an educational development booklet developed by CARD, known as the Center Development Calendar.

Savings mobilization
Members are required to deposit P20 per week in the Center Fund, effective March 1999. An additional five percent of the value of their loan is retained. CARD has also encouraged voluntary savings of any amount.

Loans
CARD Bank offers five different types of loan products. Table 19 identifies their term and size.

Interest rates for all loans, except MPL, are 20 percent per annum, charged on an add-on basis, and amortized over the life of the loan. MPL loans carry an interest rate of five percent, charged up-front. All loans also require a four percent service fee, paid up front.

Table 19: CARD loan products

<table>
<thead>
<tr>
<th>Loan Product</th>
<th>Loan Ceiling / Range 1US$ = 43 Pesos</th>
<th>Maturity</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Regular Project Loan</td>
<td></td>
<td></td>
</tr>
<tr>
<td>• 1st cycle</td>
<td>• P2,000 or $47</td>
<td>• 25 weeks</td>
</tr>
<tr>
<td>• 2nd cycle</td>
<td>• maximum of P5,000 or $116</td>
<td>• 50 weeks</td>
</tr>
<tr>
<td>• 3rd cycle</td>
<td>• maximum of P10,000 or $233</td>
<td>• 25-50 weeks</td>
</tr>
<tr>
<td>• 4th cycle</td>
<td>• maximum of P20,000 or $465</td>
<td>• 25-50 weeks</td>
</tr>
<tr>
<td>2. Housing Loan</td>
<td></td>
<td></td>
</tr>
<tr>
<td>• 1st cycle</td>
<td>• max P10,000 or $233</td>
<td>• 50 weeks</td>
</tr>
<tr>
<td>• 2nd cycle</td>
<td>• max P20,000 or $465</td>
<td>• 50 weeks</td>
</tr>
<tr>
<td>3. Productive Asset Loan (PAL)</td>
<td>• P21,000 to max P50,000 or $488 to $1,163</td>
<td>• 25-50 weeks</td>
</tr>
<tr>
<td>4. Multi-Purpose Loan (MPL)</td>
<td>• max of P5,000 or $116</td>
<td>• 25 weeks</td>
</tr>
<tr>
<td>5. CARD Loan Acceleration Program (CLAP)</td>
<td>• max of P125,000 or $2,907</td>
<td>• 50-75 weeks</td>
</tr>
</tbody>
</table>
Annex 5.2: Organigram - CARD NGO
Annex 5.3: Organigram - CARD Rural Bank, October 1998

Board of Directors

Chief Executive Officer

Internal Auditor

Operations Manager

Operations Manager - San Pablo Branch
Bank Workers

Operations Manager - Bay Branch
Bank Workers

Operations Manager - Dolores Branch
Bank Workers

Operations Manager – Candelaria Branch
Bank Workers

Finance and Admin. Director

Finance and Admin. Manager

EDP Assistant

General Accounting Clerks

Bookkeepers

General Services
6. ACP’S TRANSFORMATION TO MIBANCO

“...el Perú profundo (the unknown Peru) began a long and sustained battle to integrate itself into formal life, a battle so gradual that its effects are only just beginning to be seen. We appear to be witnessing the most important rebellion against the status quo ever waged in the history of independent Peru.” — Hernando de Soto, The Other Path

Economic hardship, changing alternatives and political challenges characterized the transformation of the Peruvian NGO, Acción Communitaria del Perú (ACP), into the commercial bank Mibanco. While high inflation and instability dominated the 1980’s in Peru, the 1990’s witnessed positive changes in the regulatory and economic environment. As a result of liberalization in the financial sector, ACP was no longer limited by restrictive usury laws and was able to recapitalize quickly in an environment of little competition. Rapid growth and a supportive political and economic environment ultimately encouraged ACP to transform into a regulated financial institution. As of year-end 1998, Mibanco had 33,849 active clients and an outstanding loan book of over $12 million.

ACP’s transformation plans evolved with the changing regulatory and political environment. In 1994, ACP considered creating a fianciendra. This type of formal financial institution would allow them to collect savings deposits with lower minimum capital and fewer regulatory requirements than a commercial bank. In December 1994, the Peruvian Bank Superintendency created new legislation to facilitate the transformation of microfinance NGOs into regulated financial institutions, called EDPYMEs. This new option required even lower minimum capital but did not permit savings mobilization. ACP planned to transform into an EDPYME, because it would allow the MFI to become gradually accustomed to being regulated. Later the MFI could apply to become a fianciendra or bank when it was ready for the additional responsibilities of managing deposits. Before the EDPYME license was granted, however, a challenge issued by President Fujimori convinced ACP to create the first full-service microfinance bank in Peru, named Mibanco, “My Bank.”

6.1 Background

Acción Communitaria del Perú began operations as a non-profit NGO on January 13, 1969. It was started by a group of business people with the objective of creating development opportunities for low-income Peruvians. Until the 1980’s, ACP operated like many NGOs at that time, working on several aspects of community development, with projects such as community savings, housing construction, and community education.

In the early 1980’s, ACP developed its first long-term strategic plan focused on microenterprise development in response to a survey showing that access to credit and business training were the greatest needs of entrepreneurs. During 1982-98, ACP focused on providing these services to microentrepreneurs through a credit scheme, “Programa Progreso.” ACP targeted microentreprises in the capital city, Lima, which was experiencing astounding population growth
due to migration from rural areas of Peru.\textsuperscript{64} Over its 16-year history, Progreso experienced rapid growth that was temporarily stunted by economic and financial crisis in the mid-1980s.

**Interrupted Growth (1983-89)**

In 1983, ACP began its loan program. With the technical assistance of ACCION International, ACP (one of the oldest members of the ACCION network) began offering solidarity group loans and individual loans to enterprises with at least one year in business. These lending methods proved to be profitable over time.

ACP grew to become the largest microenterprise institution in Latin America in 1986. By the end of 1987, ACP’s Progreso project had reached a level of annual disbursements in excess of $5.8 million to 9,000 microentrepreneurs. Economic crisis and hyperinflation in 1988, however, nearly erased all of the progress made by Progreso. By the end of 1988, two of the four existing branches were closed, and the loan portfolio shrunk to $98,793. Economic policy and the resulting hyperinflation were not conducive to providing microcredit. During 1985-90, it was illegal to issue loans in foreign currencies. The usury rate was lowered to 32 percent in 1987 while inflation skyrocketed to over 7,000 percent. This forced ACP to reduce its total annual lending from $5.8 million in 1987 to only $700,000 in 1989. (See Table 20.)

<table>
<thead>
<tr>
<th>Year</th>
<th>Disbursed (US$)</th>
<th># of Borrowers</th>
</tr>
</thead>
<tbody>
<tr>
<td>1983</td>
<td>500,000</td>
<td>1,500</td>
</tr>
<tr>
<td>1984</td>
<td>900,000</td>
<td>2,700</td>
</tr>
<tr>
<td>1985</td>
<td>1,300,000</td>
<td>3,900</td>
</tr>
<tr>
<td>1986</td>
<td>4,700,000</td>
<td>13,800</td>
</tr>
<tr>
<td>1987</td>
<td>5,800,000</td>
<td>9,000</td>
</tr>
<tr>
<td>1988</td>
<td>1,500,000</td>
<td>6,000</td>
</tr>
<tr>
<td>1989</td>
<td>700,000</td>
<td>3,500</td>
</tr>
<tr>
<td>1990</td>
<td>1,700,000</td>
<td>3,000</td>
</tr>
<tr>
<td>1991</td>
<td>4,000,000</td>
<td>2,200</td>
</tr>
<tr>
<td>1992</td>
<td>5,000,000</td>
<td>2,500</td>
</tr>
<tr>
<td>1993</td>
<td>7,000,000</td>
<td>5,000</td>
</tr>
<tr>
<td>1994</td>
<td>16,000,000</td>
<td>9,600</td>
</tr>
<tr>
<td>1995</td>
<td>39,000,000</td>
<td>19,000</td>
</tr>
<tr>
<td>1996</td>
<td>58,683,000</td>
<td>26,766</td>
</tr>
<tr>
<td>1997</td>
<td>61,231,000</td>
<td>33,549</td>
</tr>
</tbody>
</table>

**Expansion of ACP (1990-98)**

Peru has long suffered from its mercantilist history, a residual effect of Spanish colonialism, which has resulted in an excessive and obstructive legal system as well as massive public and

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\textsuperscript{64} Hernando De Soto estimates that Lima’s population increased by 1,200 percent over the four decades prior to 1989.
private bureaucracies. Official approval to create a private enterprise was difficult if not impossible for the masses. However, rapid growth of the informal sector, particularly in Lima and other cities, have slowly moved Peru toward a market-based economy. With the installation of the Fujimori government in 1990, a series of structural changes were implemented to liberalize the financial sector and usury laws were abolished. The government targeted the microenterprise sector in its plans to promote economic growth. A separate microenterprise division was created at the Superintendency of Banks (SBS), further demonstrating the government’s commitment to the microenterprise sector.

Along with an improved regulatory environment, economic stability and lower inflation returned to Peru, allowing ACP to begin a second growth phase. This period was marked by ACP’s strong drive to increase the loan portfolio and accumulate equity to protect itself against possible future instability. By the end of 1995, ACP had reached an active loan portfolio of $6.8 million and 19,100 clients, charging an effective annual interest rate of 125 percent. Inflation came down from 7,650 percent in 1990 to just 10 percent in 1995 allowing ACP to quickly recapitalize and accumulate net equity of over $5.5 million by the end of 1995. ACP’s net income from lending operations exceeded $3.2 million in 1995 alone.

ACP has maintained a portfolio of high quality loans over time, with only five percent over seven days past due on average. Chart 5 tracks the percentage of portfolio at risk over 30 days past due. In 1984, ACP’s portfolio reached a rate of eight percent at risk, which is attributed to their learning curve in identifying the best lending methodology. In 1991, portfolio at risk peaked at 16 percent due to macroeconomic adjustment and in part, the cholera epidemic in Peru.

Chart 5: ACP’s Portfolio at Risk (1983-97)

Over 1997-98, ACP experienced a slower rate of recapitalization due to the negative impact of the “El Niño” weather phenomenon and the Asian economic crisis. By the end of 1997, ACP had an active loan portfolio of over $10 million and 28,902 clients. At the time of transformation, May 4, 1998, ACP had 32,000 clients and active loan portfolio over $14 million.

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6.2 Transformation Plans

In 1985, ACP first began to contemplate its eventual transformation into a regulated, for-profit financial institution. Institutional transformation was the only way to expand services to the large untapped market of microentrepreneurs in Peru. However, the macroeconomic crisis of the late 1980’s temporarily shelved the transformation project. Once economic stability returned in the 1990’s, ACP researched a variety of financial structures, including: the financiera, the EDPYME, and the commercial bank. Ultimately President Fujimori’s challenge to the private sector to create a bank for microentrepreneurs led ACP’s decision to revise its plans and create Mibanco, the first microfinance bank in Peru.

Rationale

Through transformation, ACP saw the potential to expand outreach to the many Peruvian microentrepreneurs who still lacked access to microfinance services. While there are no official statistics on microenterprises, an estimated sixty percent of the workforce in Peru is employed in the microenterprise sector. In 1998, ACP’s Executive Director, Manuel Montoya, estimated that of the 27 million inhabitants in Peru (seven million in Lima), the institution only reached approximately two percent of the market. The potential market in Lima alone, ACP’s target market, is approximately 600,000 microenterprises.

In the 1990’s, donor funds, which had been readily available for the start-up of microenterprise programs in the past, were drying up. Institutional transformation would allow the MFI access to new sources of capital, including $16 million of IDB funds being channeled through Corporación Financiera de Desarrollo (COFIDE), a second-tier financial institution which can only on-lend to formal microfinance institutions.

ACP’s board believed that being regulated would force the MFI to improve its financial transparency and accountability. They hoped that this would help uncover inefficiencies and improve cost-cutting measures. By becoming part of the formal financial system, the MFI would have to raise its standards, comparing itself now to other profitable banks rather than to other microfinance NGOs. Entrance into this arena would provide access to resources only available to the formal banking sector. Finally, ACP viewed transformation as a method by which it could institutionalize its commitment to self-sufficiency.

Financiera

In 1994, ACP explored the possibility of becoming a financiera. The minimum capital requirements of a financiera are $3 million, substantially less than the amount required to create a full-service bank. The limitations to becoming a financiera rather than a commercial bank in Peru are the inability to offer checking accounts, passbook savings, international transactions, and to create specialized businesses within the institution, such as insurance. The inability to offer passbook savings was the only long-term limitation to the financiera structure from ACP’s perspective, in terms of its desired future product offerings. The financiera structure would allow ACP to collect term deposits.

ACP contracted an economist to conduct a pre-feasibility study that presented a variety of options on how to approach transformation. This was followed by a survey of 850 clients at five different branches. The results were compiled in a feasibility profile that was discussed with the Bank Superintendency. This process took approximately six months. The financiera proposal was

never formally presented to the SBS due to changes in banking laws that presented a new transformation possibility, the EDPYME.

**EDPYME**

In December 1994, the SBS created new laws to encourage the transformation of NGOs into regulated financial entities, to be called *Entidades de Desarrollo para la Pequeña y Microempresa* (EDPYMEs) or Small Business and Microenterprise Development Institutions. The minimum capital required is only $256,000. However, at this level of capitalization, the EDPYMEs are not allowed to collect savings deposits in any form. By regulating EDPYMEs, the government developed a mechanism by which NGOs could be nurtured along a path that would help them to grow into fully regulated financial intermediaries. It also offers regulators the chance to become more familiar with microfinance methodologies before they become financial intermediaries.

Despite the fact that ACP had more than enough funds to meet the minimum capital requirements of any financial structure, ACP began to study the possibility of converting itself into an EDPYME in 1996. ACP preferred a cautious and gradual approach to transformation since it did not plan to mobilize savings deposits in the short-term. This option would allow ACP more time to become acquainted with regulatory requirements and implications before proceeding to higher levels of responsibility and regulatory exposure. Furthermore, the EDPYME option would allow access to additional bank funding and special rediscount credit facilities from the development bank not available to financieras. Three studies were conducted: a legal review, a feasibility study, and an operational plan. This process took 18 months and identified a few core potential investors. ACP, ProFund, and ACCION International combined efforts and funds to develop the studies and formally present their findings to the Superintendency. In October 1996, ACP’s proposal to establish an EDPYME was approved, but operations had not yet begun when a third possibility arose.

**The Peruvian Government’s Microfinance Challenge**

In a public address in July 1996, President Fujimori challenged the Peruvian formal financial sector to create a bank for microentrepreneurs. At first, the message was directed more to formal banks than to the NGO community. While the traditional banks were interested in microfinance, they preferred to reach the microenterprise sector through their existing institutions rather than to create a new specialized institution. The President, unsatisfied with this response, named a commission to oversee the development of a microfinance bank. The government’s objective was to create a competitive environment for microfinance institutions that would effectively serve microentrepreneurs on a large scale and at reasonable interest rates. He recognized that not only was microfinance economically profitable, but immensely socially profitable and therefore politically attractive.

The IDB offered a grant to the government to conduct a feasibility study. Fujimori’s administration acknowledged its lack of familiarity with microfinance and formed a technical committee of microfinance experts in the autumn 1996 to carry out the study of what he referred to as a “private sector initiative.” In February 1997, Fujimori attended the Micro Credit Summit in Washington, D.C. In an effort to gain public recognition and support, he announced his commitment to create a microfinance bank in Peru to the international microfinance community.
**ACCION International’s Involvement**

The presidential committee contacted ACCION International to explore the possibility of ACCION’s involvement. ACCION offered its technical assistance with the condition that the “private sector initiative” would be defined as 100 percent private sector ownership. ACCION promoted the concept of transforming an existing microfinance NGO into a formal financial institution. As the largest microfinance NGO in Peru contemplating transformation and a long-time affiliate of ACCION International, ACP was the obvious choice. ACCION International was already working with ACP on the possible creation of an EDPYME and renewed its participation in ACP’s transformation through its work on the creation of Mibanco. ACCION and ACP jointly submitted a concept paper to the presidential committee built on the transformation concept ACP had been developing.

ACP’s decision to follow the government’s plan of transformation was a calculated risk. While the government could offer support through the regulatory approval process and increased public awareness, there was legitimate concern that Mibanco would be confused for a public sector effort. Neither banks nor government institutions have positive reputations with the target clientele in Peru, low-income individuals and microentrepreneurs. By following the government’s plan, ACP was risking a negative perception by microentrepreneurs with whom it had worked so hard to develop good relations. All involved acknowledged that such confusion or misperception could potentially lead to asset quality problems. In negotiating the agreement, ACCION and ACP attempted to minimize the potential for future government intervention.

In April 1997, an agreement was reached with ACP, ACCION, and ProFund to pursue the transformation of ACP into a microfinance bank. The government agreed to help facilitate the process but to hold no direct equity in the new institution. By July 1997, private sector investors had been identified, including two formal Peruvian banks, Banco Wiese and Banco de Credito, and the partnership was announced publicly.

**The Creation of a Commercial Bank, Mibanco**

In July 1997, a new feasibility study was conducted on the possibility of transforming ACP into a multi-purpose bank to be named Mibanco. President Fujimori wanted a commercial bank that would target the microenterprise sector. For the services ACP planned to offer in the short-term, there were few advantages in becoming a bank. The bank structure would allow the institution to offer passbook savings accounts, a financial service that the institution hoped to provide its clients in the long run. However, banks are the most regulated type of institution and require the highest level of minimum capital, $5.6 million.

The feasibility study took approximately five months to develop. The proposed concept of transformation was to transfer the majority of the employees and lending operations into the new bank, while leaving a few employees with the NGO to work on the continued provision of technical assistance and business development services to microentrepreneurs. The objective was to find ways in which ACP and Mibanco could complement each other in their targeting of the microenterprise sector.

ACP believes that the provision of business development services, such as training, business information, and sub-sector development, can improve its investment in Mibanco by reducing the credit risk of the clients. ACP intends to develop its own client market in addition to targeting former Progreso borrowers. ACP would like to create promotion channels linked to Mibanco
branches, but no formal agreement currently exists detailing the nature of such potential collaboration.

Regulatory approval by the Peruvian Bank Superintendency consists of a two step process: 1) approval of the financial plan and board of directors, and 2) approval of the operational plan. The financial plan includes detailed financial history and projections along with information on investors and their ability to satisfy the minimum requirements. The operational plan explains how the business will operate, presents an organizational chart and details of the various levels of responsibility. For approval of the second step, the institution must have proof of its paid-in capital and be registered publicly.

The government’s involvement was decisive in expediting Mibanco’s regulatory approval. The Bank Superintendent facilitated the bank’s approval. The feasibility study presented to the SBS was approved in November 1997, thereby concluding the first step of the process. On May 4, 1998, Mibanco began operations as the first full-fledged commercial bank dedicated to microfinance in Peru.

6.3 Transformation Process

The final transformation process took one year, with most of the time spent discussing the organizational and financial aspects of the shareholders’ agreements necessary to create a bank. The majority of the operational transformation, however, occurred in just six months, from initial regulatory approval in November 1997 to Mibanco’s official opening in May 1998.

Organizational Transformation

ACP contracted a banking technical advisor to work with management to develop and implement a strategic plan, including an organizational framework and budget.

Mission

ACP’s old mission statement translates to “Our mission is to promote the development of low income people through high quality economic, social and cultural services, managed with a business focus.” The new Mibanco mission statement reads:

*We are a private bank made up of highly skilled individuals, committed to continued economic development of small and micro-enterprises. We are leaders at satisfying financial needs through innovative and efficient products and services. We know and value each client, supporting them in the pursuit of success. Mibanco….Tu banco*

Investor Identification

ACP’s board of directors identified and negotiated with potential investors in Mibanco. The resulting mix of investors comprises representatives from the private and non-profit sectors. Table 21 presents the five shareholders of the transformed institution, their percentage of ownership and primary motive for investing in Mibanco.

Together, the five investors subscribed $14 million of capital, of which $5.6 million represents the required paid-in capital. There is also a government-promoted plan that has been written into the bylaws to offer Mibanco shares to interested clients. The plan is to sell preferred stock of $1

million to client shareholders. This will take place after the year 2000, once the remainder of the stock is paid up. Mibanco has not yet determined the exact terms of this offering.

Other institutions, including other banks and insurance companies, wanted to invest in Mibanco but the new bank was already overcapitalized. Mibanco currently maintains a ratio of 2:1 debt to equity, a conservative gearing ratio that will permit additional leverage in the coming years.

**Table 21: Shareholders in Mibanco**

<table>
<thead>
<tr>
<th>Institutional Investor</th>
<th>Type of Institution</th>
<th>Ownership</th>
<th>Primary Motive(s)</th>
</tr>
</thead>
<tbody>
<tr>
<td>ACP</td>
<td>Microenterprise NGO</td>
<td>60.0 %</td>
<td>Microenterprise development</td>
</tr>
<tr>
<td>ProFund S.A</td>
<td>MFI Investment Fund</td>
<td>19.0 %</td>
<td>Microenterprise development and profitability</td>
</tr>
<tr>
<td>ACCION International’s Gateway Fund</td>
<td>MFI Support NGO</td>
<td>7.0 %</td>
<td>Microenterprise development and profitability</td>
</tr>
<tr>
<td>Banco de Credito</td>
<td>Commercial Bank</td>
<td>6.6 %</td>
<td>Learn about microfinance, profitability</td>
</tr>
<tr>
<td>Banco Wiese</td>
<td>Commercial Bank</td>
<td>6.6 %</td>
<td>Learn about microfinance, profitability</td>
</tr>
</tbody>
</table>

**Governance Structure**

Mibanco’s shares are designed so that each initial owner has at least one seat on the board. The ACP board members selected owners who would bring the desirable mix of banking and microfinance expertise into the bank’s leadership. The transition from an NGO into a commercial bank has resulted in a much more active and rigorous board. The board, which meets at least monthly, is responsible for overseeing the stability of the bank. **Table 22** provides a breakdown of the number and background of board members per investor institution.

**Table 22: Mibanco Board Members**

<table>
<thead>
<tr>
<th>Shareholder</th>
<th>Professions Represented</th>
<th># Board Members</th>
</tr>
</thead>
<tbody>
<tr>
<td>ACP</td>
<td>Two Businessmen, Banker, NGO Manager, Lawyer</td>
<td>5</td>
</tr>
<tr>
<td>ProFund</td>
<td>Investment Fund Manager</td>
<td>1</td>
</tr>
<tr>
<td>ACCION International</td>
<td>NGO Manager/Businessman</td>
<td>1</td>
</tr>
<tr>
<td>Banco de Credito</td>
<td>Banker</td>
<td>1</td>
</tr>
<tr>
<td>Banco Wiese</td>
<td>Banker</td>
<td>1</td>
</tr>
<tr>
<td><strong>TOTAL</strong></td>
<td></td>
<td><strong>9</strong></td>
</tr>
</tbody>
</table>

In recognition of Fujimori’s interest in supporting the creation of a microfinance bank, the President was invited to send one non-voting representative to participate in board meetings for Mibanco’s first two years in operation.

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68 Mibanco created four different classes of shares to enshrine the right of the original shareholders to be represented on the board. Some of the shares do not transfer this right to a new owner if sold.
There are a few potential conflicts of interest inherent in Mibanco’s board. The primary conflict lies in the fact that the former NGO, ACP, maintains majority control with its 60 percent ownership of Mibanco. Currently, five of the eight ACP board members are also Mibanco board members. Manuel Montoya, Director and CEO of Mibanco, anticipates that any possible conflict will be eliminated by defining ACP as a non-financial services institution and Mibanco as a financial institution. The SBS required $200,000 minimum equity to be provided by each director of Mibanco’s board of directors. For the directors representing ACP’s stake, ACP, not the individual, provided this equity. These board members hold no personal equity in either institution, thereby possibly reducing the intended benefits from private ownership of increased accountability, profitability and access to additional sources of capital.

The two private sector investors are the two largest commercial banks in Peru and, as competitors, represent a potential conflict of interest. Peru’s banking sector is highly concentrated with four banks holding 67 percent of the market share. Banco de Credito and Banco Wiese represent 27 percent and 17 percent respectively, for a combined total of 44 percent of the total market share. At this point, there is little conflict in having these two competitors sit on Mibanco’s board since their shares are small and the microfinance market is far from saturated. Currently, their board representatives provide unique insight into the formal financial sector in Peru. But competition will likely increase in the future and their investments in Mibanco represent a very small portion of their overall holdings. These factors could hinder the board members from providing adequate oversight and fulfilling their duty of loyalty to Mibanco.

ACCION International plays a unique function in Mibanco in its dual role as technical assistance provider and board member. Michael Chu, President and CEO of ACCION International, explains that the key to juggling simultaneously these potentially conflicting roles is to never use information acquired by the technical assistance team to erode the authority or responsibility of management. As co-owner and technical service contractor, ACCION balances the desire to maintain a well-informed board member with the importance of maintaining the rapport that the technical assistance team has built with management. ACCION has applied this same approach to managing its dual relationships with several of its affiliates in which its Gateway Fund holds equity, including BancoSol (Bolivia), FINAMERICA (Colombia), Funadeh (Honduras) and Compartamos (Mexico).

Financial Transformation

In conjunction with the organizational transformation, the investors considered the following financial aspects of the transformation: the transfer of assets and liabilities from ACP to Mibanco, the regulatory implications, and access to new sources of funds.

Transfer of Assets and Liabilities

Mibanco assumed ownership of ACP’s loan book as loans were renewed, which circumvented the need for an official transfer of the loan book. Mibanco agreed to administer ACP’s existing loan portfolio at no cost for the first year. The loan portfolio to be renewed by Mibanco was estimated at $10 million. The agreement stated that ACP would continue to receive the interest payments on all pre-existing loans until they came due. Since most ACP loans have 3-4 month terms, 80-90 percent of the portfolio had already been transferred to Mibanco by September 1998. The remaining loans were due by April 30, 1999, the end of Mibanco’s first year in operation.

Mibanco paid ACP a premium of $1 million in cash for access to ACP’s client base and $3,578,000 on credit for fixed assets. Table 23 details the categories of fixed assets valued and transferred to Mibanco in 1998. The transfer of fixed assets was based on an external valuation.
of the assets in 1998. Through a promissory note, Mibanco has agreed to pay ACP for the fixed assets at an annual interest rate of 19.5 percent to be paid off by August 2000.

Donor limitations on the transfer of assets did not present a problem, since ACP would retain control of $6 million, far exceeding the total grants of $1.8 million. The grants did have limitations on the use of the initial funds requiring that they remain in a like institution, but most had expired by 1990.

No liabilities were transferred in the transformation process. There were neither client savings nor debt for Mibanco to assume. However, one loan fund of $500,000 previously lent to ACP for its microlending operations by the Corporación Andina de Fomento (CAF) was redirected to Mibanco.

Table 23: Fixed Assets Transferred to Mibanco

<table>
<thead>
<tr>
<th>FIXED ASSETS</th>
<th>US$</th>
</tr>
</thead>
<tbody>
<tr>
<td>Buildings</td>
<td>2,414,000</td>
</tr>
<tr>
<td>Furniture</td>
<td>212,000</td>
</tr>
<tr>
<td>Computers</td>
<td>588,000</td>
</tr>
<tr>
<td>Intangibles</td>
<td>330,000</td>
</tr>
<tr>
<td>Other</td>
<td>34,000</td>
</tr>
<tr>
<td>TOTAL</td>
<td>3,578,000</td>
</tr>
</tbody>
</table>

Regulatory Implications

As a regulated financial institution, Mibanco is subject to many legal requirements that were not applicable to the NGO, ACP. Mibanco’s new regulatory requirements include: taxes, provisioning, reserves, reporting, security systems, and external and internal audits.

Taxes. As a bank, Mibanco must pay 30 percent tax on net income, whereas as an NGO, ACP was tax exempt. The tax rate would have been the same if ACP had transformed into a financiera. As an EDPYME, they would have been subject to 18 percent tax on total revenues, which would have been an even greater amount.

Provisioning. As a bank, Mibanco is subject to loan provisioning requirements. Table 24 presents minimum provisions as required by law, ACP’s former loan provisioning, and the new Mibanco provisions.

Table 24: Mibanco’s Loan Classification and Provisioning

<table>
<thead>
<tr>
<th>Loan Classification</th>
<th># DAYS PAST DUE</th>
<th>SBS Minimum Requirements 69</th>
<th>ACP Provisions</th>
<th>Mibanco Provisions</th>
</tr>
</thead>
<tbody>
<tr>
<td>Normal Loans</td>
<td>9 or less</td>
<td>0 %</td>
<td>0 %</td>
<td>0.6 %</td>
</tr>
<tr>
<td>Potential Problem Loans</td>
<td>9-30</td>
<td>3 %</td>
<td>5 %</td>
<td>5 %</td>
</tr>
<tr>
<td>Deficient Loans</td>
<td>31-60</td>
<td>30 %</td>
<td>25 %</td>
<td>50 %</td>
</tr>
<tr>
<td>Doubtful Loans</td>
<td>61-120</td>
<td>60 %</td>
<td>75 %</td>
<td>75 %</td>
</tr>
<tr>
<td>Lost Loans</td>
<td>120+</td>
<td>100 %</td>
<td>100 %</td>
<td>100 %</td>
</tr>
</tbody>
</table>

Not only is Mibanco’s provisioning stricter than it was under ACP but it is also more conservative than that required by the Superintendency. The required SBS minimum provisions presented above are those for loans without real guaranties, which represent the majority of Mibanco’s portfolio. This level of provisioning is the same as that required for consumer credit in Peru. With guaranties, provision requirements are much lower. Provisions are tax deductible with a maximum of one percent on normal loans (under nine days past due).

**Reserve Requirements.** Once Mibanco begins mobilizing client savings, it will have to keep 7 percent of its domestic-denominated deposits on reserve at the central bank and 20 percent of its international-denominated deposits, of which 13 percent is to be kept on reserve at the central bank and the remaining 7 percent can be kept in a bank account.

**Reporting.** As a microfinance NGO, the SBS required that ACP report weekly on donations received, number of clients and account balances. As a regulated bank, Mibanco must complete all bank reporting requirements of the SBS, regardless of whether the requirements are relevant to the services provided. The following list provides an overview of Mibanco’s new reporting requirements\(^\text{70}\):

- Daily report on interest charged;
- Semi-monthly report on reserve position;
- Monthly financial statement;
- Monthly report on effective equity level and risk-weighted assets;
- Monthly report on principal debtors;
- Trimestrial report classifying debt quality to establish credit rating;
- Annual report.

**Security Systems.** In response to regulatory requirements, Mibanco upgraded its security systems, with more expensive guards, protective doors and walls, and new, more sophisticated safes in all its branches.

**External Audit.** The SBS requires an annual external audit, conducted at the bank’s expense. This is not a requirement of microfinance NGOs in Peru.

**Internal Audit.** The SBS also requires banks to have an internal audit department. ACP formerly had one person who conducted internal control, but who was not a professional auditor. Mibanco’s new internal audit department has three internal auditors and reports directly to the board.

**Access to New Sources of Funds**

As a formal financial institution, Mibanco has access to a range of sources of loan capital. Through the second-tier financial institution, COFIDE, Mibanco has a $6 million line of credit available in Peruvian currency (soles) at an effective interest rate of 18 percent annually. Of this amount, as of September 1998, it had $3.3 million in use. In addition, the International Bank of Luxembourg (IBL) in conjunction with a French bank, AXA, launched a pilot project in which Mibanco received $100,000 at a 10.5 percent annual effective interest rate in November 1998.

\(^{70}\) Rock, 1997, p.73.
An UNCTAD supported project, this pilot is also being implemented at BancoSol. If successful, the fund will on-lend $20 million to microfinance institutions. Finally, the Corporacion Andina de Fomento (CAF) has a bridge fund, which will soon lend Mibanco $500,000 at an effective rate of approximately 9 percent per year.71

Transformation to a commercial bank grants Mibanco the right to mobilize savings deposits. Mibanco plans to begin offering passbook and term savings accounts in the next few years, since savings are considered a stable source of capital. Mibanco is waiting to add savings to its product line until it has successfully transformed its existing product operations.

**Operational Transformation**

Mibanco’s staff implemented the majority of the operational transformation in the six months prior to the opening of Mibanco. This time frame was extremely short, considering the numerous changes it required in staff, systems, and processes. The amount of time allotted to pilot test new systems and operational procedures was less than ideal. Mibanco would have preferred to take more time to develop new products or services before opening its doors, so that existing clients would see immediate benefits. Instead, clients saw employees struggling with many operational changes that demanded their additional patience. However, given the limited time frame, it was perhaps wise that the transformation did not involve more immediate changes.

ACCION International’s technical assistance team played a key role by complementing ACP’s efforts in the transformation process. ACCION worked closely with Mibanco on the implementation of appropriate systems and processes. In a short period of time, with ACCION’s assistance, Mibanco increased branch efficiency and reduced loan officers’ time spent on paperwork, allowing loan officers more time in the field. ACCION also played a role in managing the human resource element through its involvement in organizational development, job design, and training.

**Staff Changes**

The institutional structure was revised to accommodate the transformation from an NGO into a bank. The strategic plan proposed a mix of NGO and bank managers. In the past, community development professionals managed ACP, with three senior management positions under the Managing Director. Most of the financial service management fell under the Administrative and Financial Management Department. See Annex 6.1 and 6.2 for organigrams of before and after the transformation.

Mibanco broadened its organizational chart to include five senior management positions under the Managing Director: Finance, Human Resources, Operations, Business Management, and Development. Business Management comprises most of the financial services and oversees the 13 branch offices. The Development department is responsible for designing and implementing new products, services, and procedures.

In January 1998, management made a decision to let go 50 employees deemed to be poor performers in preparation for the transition. Many of these former ACP employees found employment in traditional banks that were adding microfinance departments at higher salaries, which led to the voluntary departure of additional staff. Needless to say, this caused employee morale problems.

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71 Based on the six-month LIBOR rate plus 3.5 percent.
Despite these employee reductions, the total number of staff increased from 235 employees to 260 from December 1997 to September 1998. Among the new hirings, several traditional bankers were added, especially to upper management. The board’s end goal was for Mibanco’s institutional culture to represent a mix of the two cultures, adequate to provide the security of a formal bank while catering to the microenterprise market. The board intended for senior management to include approximately half ACP employees and half bankers. However, due to some unanticipated staff departures, upper management became heavily represented by the traditional banking sector. The prevalence of bankers with strong personalities in key management positions caused some interpersonal conflicts and communication problems within the new institution and added to the employee morale problems.

From the beginning, ACP involved all staff in discussions about the pending transformation. ACP had an informal management style, in which information flowed freely and managers met with branch employees to discuss changes before implementing them. The bankers, however, formalized the communication style. They communicated changes by letters and memos rather than in meetings or through word of mouth. This caused employees to feel that they did not have a voice and were less involved in the transformation decisions. This, too, lowered employee morale and increased the polarization between the two groups: former bankers and former NGO staff. Without up-front commitment from the employees, managers had a harder time implementing changes.

Mibanco’s Managing Director and the board quickly recognized and rectified the situation. By November 1998, Mibanco had restructured its key management positions, resulting in the same balance of traditional bankers and NGO staff as the bank’s original structure. However, former ACP employees now hold the key positions that require an intimate understanding of microfinance and that have the most contact with branch staff.

Like many MFIs, Mibanco is now facing the challenge of developing strong branch managers. While loan officers tend to have strong interpersonal and analytical skills, few have the ability to effectively manage employees or operate a profit center. Mibanco is working with ACCION International to develop a leadership program to groom potential loan officers for eventual promotion to middle management. Having gained an appreciation of the seriousness of the issue through their work with BancoSol, ACCION’s technical assistance providers want to shorten the learning curve for Mibanco. They are working with Mibanco to develop upper management’s ability to recognize candidates with management potential by using criteria other than high productivity as a loan officer.

**Systems**

Prior to its official opening, Mibanco identified and began implementing a new computer system. To avoid recreating the wheel, Mibanco bought and adapted software used by other banks to fit its needs. Management selected two systems, SIAF, which manages general banking operations at headquarters, and FINESSE, platform software that tracks loan approvals, disbursements, loan management, monitoring, and collections at the branch level. The total implementation cost Mibanco approximately $1.5 million.

The new management information system offers many benefits over the previous system. The new system works in real time whereas the former was updated daily. It offers more flexibility to service multiple transactions and different currencies, and can handle a larger volume of loans and clients. The new database is centralized, with all computers and branches linked to one
another by modem. FINESSE is very new so it does not have a year 2000 problem. Mibanco has contracted with others on the upgrades needed to address this issue in SIAF.

Mibanco also revised the accounting system to accommodate multiple currencies and regulatory reporting requirements. Mibanco purchased new accounting software compatible with SIAF. The former system was more responsive to an NGO’s needs, primarily good for managing donations and project funds.

**Processes**

In becoming a formal financial institution, the SBS required Mibanco to formalize and standardize many of its previously informal processes and to document them in a procedures manual. Many implicit policies were documented for the first time, laying out and defining chains of responsibility.

One of the lessons Mibanco learned in its transformation is the importance of a good relationship between the management team and the rest of the staff, and between the bank and its clients. Some traditional bankers have a hard time understanding the importance of the client relationship in microfinance. Mibanco experienced some difficulties as a result of hiring a traditional banker for the role of Microenterprise Director, the position that directly oversees the work of the branches. Lacking microfinance expertise, Mibanco’s initial Microenterprise Director began to implement many procedural changes that were inconsistent with the methodology, most of which have now been reversed. Clients temporarily perceived these changes as diminishing customer service.

In the past, ACP loan officers were wholly responsible for identifying new clients, analyzing the client’s business, and overseeing loan collection. Initially, Mibanco separated these activities into three different job categories. Management directed the loan officers to focus on business analysis and created two new teams to handle sales and collections. These teams comprised potential loan officers who would learn all aspects of loan sales and collections before becoming eligible to be loan analysts in the future. These changes were intended to improve the efficiency of loan officers, but instead resulted in a separation of duties that reduced accountability and caused customer dissatisfaction.

Mibanco has since reverted to the division of labor for loan processing used prior to transformation. Several of the employees formerly on the loan sales and collection teams are now junior loan officers, providing direct support to loan officers. A few have remained in collections at the branch level, focusing on loans over 30 days past due. Throughout these changes, the total number of employees dedicated to the loan portfolio has remained the same, at around 130 employees.

The former management also began a program whereby Mibanco employees were rotated from one branch to another for reasons of control and to reduce client dependence on one loan officer. The objective of reducing clients’ over-dependence on one loan officer was for clients to feel that any employee of Mibanco could serve them. According to loan officers, however, clients instead viewed the changes as poor customer service. This program has also been discontinued.

Additionally, the former management encouraged the use of collateral, a move away from the proven microfinance methodology toward the more traditional banking approach. The use of collateral, such as televisions and other personal possessions, potentially provides a false sense of security since they can easily be sold or hidden in cases of default. The use of such collateral can
distract from the real incentive to repay, which is access to more credit. The new management has returned to the previous emphasis based on collateral substitutes, such as character and co-signature guaranties.

Under ACP’s Progreso credit program, each loan required a new loan application and review. With the help of ACCION, Mibanco implemented a new loan review process. The new process has two loan evaluation methods and uses more quantitative and less qualitative information than the ACP process. All clients’ first loans undergo a thorough evaluation, known as the Type A evaluation. Businesses with an excellent repayment history do not have to undergo the same evaluation process for subsequent loans. Instead they receive the simpler Type B evaluation until their repayment practices become less than excellent, at which time they would again have to submit to a Type A review. Type B evaluations are less restrictive and allow for faster loan processing. This system provides better tracking of poor performers and rescheduled loans, and ensures better customer service for excellent clients.

Clients of Mibanco can access a new loan under the same terms immediately upon timely repayment of the last loan, all under one permanent loan contract. The loan contract is not renewable if terms of the loan agreement were not met or if the borrower wants to change certain terms such as amount or repayment period. Unfortunately, the time to process this first loan has temporarily increased from 3-5 days since all clients must undergo the initial Type A loan evaluation, leaving clients perceiving that loan processing time has worsened rather than improved. First loans should be processed faster once Mibanco gets through this period of consolidation, slowed by the loan officers’ learning curve in conducting the evaluations and the temporary glut of loans requiring Type A evaluations.

Training

Mibanco spent over $180,000 on training in one year preparing employees for the transformation. Mibanco has retained ACP’s interactive approach to training. All employees were trained on how to use the new computer system. All loan officers were trained on the new loan review process, loan sales and collections. Special emphasis was placed on training loan officers on loan sales, helping them overcome fear or distaste for selling. ACP loan officers were accustomed to a more passive sales process in which they responded to clients’ expressed needs for loans. The new sales training instructs loan officers to pursue a more active strategy in which they help clients understand how a loan could potentially benefit their business and increase their income. Additionally, loan officers had to learn to conduct the technical and financial analysis required by the new, more quantitative loan evaluation method.

In preparation for the transformation, ACP implemented a new loan officer orientation system now used by Mibanco that combines both classroom and field work. This process ensures that the bank only hires candidates who enjoy working with the informal sector, especially in the markets. Through an encouraged self-selection process, the orientation usually begins with 16 candidates and ends with only 7-8 qualified trainees.

Products

Mibanco began with only one type of product, working capital loans. Until October 1998, the loan product was exactly the same as ACP offered, at 125 percent annual compounded effective interest rate. It has a maximum loan term of 12 months, with weekly, bimonthly or monthly repayment intervals, available as an individual or solidarity group loan. Most loans have a 3-4 month term with weekly or bimonthly repayments.
In October, 1998, the bank diversified interest rates according to loan size and credit history, with rates for new loans up to $667 remaining at 125 percent, but incrementally falling to 80 percent annual effective interest for loan sizes greater than $1,667. These lower rates are only available to clients that have demonstrated a positive repayment history.

Since its creation, Mibanco has introduced two new loan types: a fixed asset loan to purchase industrial machines and another to build or repair infrastructure, such as modernization of a small factory or workshop. Mibanco now collects time deposits and offers foreign exchange services.

Passbook accounts will most likely be introduced sometime after the year 2000. While Mibanco is not currently in need of capital, savings are considered a more stable source of capital and therefore beneficial to the institution in the long run. In the short run, this is an expensive addition, as it requires the development of new policies and procedures, additional regulation and approvals, staff training, system changes, promotional materials and marketing.

**Client Transitioning**

In transitioning the loan portfolio from ACP, Mibanco renewed only 80 percent of the existing portfolio. Mibanco considered the remaining 20 percent non-creditworthy due to bad credit histories or over-indebtedness identified by the new, more restrictive loan evaluation process.

Mibanco officially communicated the transformation to clients through a written letter mailed to each customer, verbally by employees, and through posters that described Mibanco’s mission statement and commitment to serve microentrepreneurs. Radio and newspaper advertisements announced the transformation publicly and aimed to attract new clients. The government was helpful in attracting other sources of free media attention, which was both positive and negative, given people’s negatives attitudes toward government involvement.

To ensure quality customer service throughout the transformation, Mibanco used client focus groups to collect input on the transformation process, extended branch hours and added cashiers to better serve clients. Mibanco rewards clients for attracting new clients to the bank. For example, for each new client referred to Mibanco, the referring client receives a basket of dry goods that are displayed at each of the branches. Nevertheless, according to a marketing survey conducted a few months after the transformation, clients perceived that they had yet to benefit from the transformation as promised. Some employees explain that perhaps the transformation was a bit oversold by ACP loan officers. Clients expected to have faster and better service, a wider variety of loan products sooner, and lower interest rates.

**6.4 Mibanco - Preliminary Results and Goals**

It is early to assess the results of ACP’s transformation into a bank. However, there are a few initial findings of the transformation’s impact on the institution and its clients. There are also a few indicators that provide insight into Mibanco’s future competition and long-term prospects.

**Short-Term Results**

From Mibanco’s perspective, transformation is already yielding the intended short-term results. From the client’s perspective, however, the transformation has not yet fulfilled its promises. According to staff and the findings of a marketing survey, former ACP clients had high expectations for the transformation and instead temporarily perceive a decline in customer

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service. Due to the rushed time frame for the operational transition, Mibanco delayed the launching of new financial products until the existing operations were fully transformed. In 1999, Mibanco began to offer a wider variety of products and services to its clients. With time, clients, too, will experience the full benefits of the transformation.

Institutional Perspective

As in most cases, Mibanco’s institutional transformation was a costly endeavor in the short-term. However, Mibanco is already realizing many benefits. It achieved its main objective for the transformation – to have access to additional sources of capital to fuel future growth. In fact, the shareholders’ investment combined with access to three new loan sources greatly exceeds Mibanco’s short-term projected capital needs.

Mibanco had originally anticipated a net loss for the first year, but due to higher than expected returns on investments, yielded a net gain of $120,000. In the future, Mibanco expects to yield a return on equity of 35 percent, with a minimum of 12 percent in difficult years.

In the past, due to a lack of competition and the ability to charge high interest rates, ACP was able to delay addressing its operational inefficiencies, such as its high level of administrative costs and low client/loan officer ratio. It was hoped that the transformation would automatically rectify some of the problem. However, given the rushed time frame, cost effective decisions were not always made. A large challenge remains for Mibanco to implement cost controls and improve its operational efficiency.

To improve efficiency, Mibanco is looking at ways to diversify its portfolio to reach more businesses, speed up the loan approval process, and reduce costs. While the loan officers no longer spend much time on paperwork, a large portion of their day is still spent traveling between the branch and client businesses. One of the solutions being considered is to open small branches closer to clients’ locations, which would facilitate access to new markets. Mibanco plans to increase the average number of clients per loan officer from 365 to 400 clients and their average portfolio from $100,000 to $160,000 in the next few years. However, the primary remaining concern is not branch costs but headquarters costs, which currently represent over 60 percent of Mibanco’s total operating costs.

Client Perspective

Since Mibanco is still in a transitional phase, its clients have yet to realize many benefits of the transformation. According to a recent survey conducted by the marketing department, the three most important factors to client satisfaction are: 1) customer service; 2) speed of disbursement; and 3) simplicity. From the client’s perspective, in the short-term, customer service worsened as they were forced to rely on employees other than their usual loan officer under the three-tier loan processing system. The number of days for disbursement of a first loan temporarily increased from three to five with the new loan evaluation process, which treated all clients as new. Furthermore, Mibanco did not lower interest rates until five months after the official opening.

As loans are renewed, however, clients are beginning to see that subsequent loans are processed in less time at lower interest rates than they were under the Progreso program. In addition, as compared to an NGO’s, Mibanco’s own future appears stable. However, clients are not yet convinced that they will continue to have their needs served as they once did. Again, there is

73 The first year is a short year, May 2 – December 31, 1998.
much distrust of government involvement and traditional banks do not have a good reputation for providing customer service to this market.

Mibanco is identifying ways to further improve customer service. Some improvements will come naturally once staff are trained and the MIS is fully operational. For example, Mibanco expects that first loans will once again take only three days to issue. However, it will take time to reverse the negative perceptions caused by the transformation, as Mibanco seeks creative ways to benefit from and maintain the positive reputation ACP established with its clients over its 16 years of providing microfinance services.

**Competition**

The microenterprise market is still widely underserved in Peru. Traditional banks, EDPYMEs, microfinance NGOs and the CMACs are all increasing their outreach, yet none of them pose an immediate threat to Mibanco. Market research indicates, however, that all have the potential to become direct competitors in the microfinance market.

**Traditional banks.** Traditional banks have created small and microenterprise departments to reach that market, but they tend to have much higher average loan sizes (over $5,000) and are having trouble developing successful methodologies. These banks offer similar interest rates, ranging on average between 120-140 percent annually, but are experiencing higher percentages of portfolio at risk of 12-14 percent. Traditional banks are serving the low-income population, particularly salaried employees, with consumer loans at effective annual interest rates around 135 percent. This is a saturated market in which Mibanco has no plans to enter.

**EDPYMEs.** As of September 1998, seven NGOs had converted into EDPYMEs in Peru. Of these, 4 are located in Lima, Mibanco’s current target market. While these transformed NGOs do offer rates and services that are competitive, their outreach is small relative to the potential market. They also suffer from the same transformation issues that Mibanco is currently experiencing of increased tax liabilities and reporting requirements. EDPYMEs have additional institutional weaknesses since they remain 100 percent owned by the NGO and capital requirements are very low, requiring only $256,000 of paid-in capital.

**NGOs.** There are many NGOs in Lima that provide microfinance services. These, too, offer competitive rates and services but have limited growth potential as NGOs, due to capital constraints.

**CMACs.** The _Cajas Municipales de Ahorro y Credito_ (CMACs) along with the traditional banks pose the greatest potential threat in terms of future competition. The CMACs are a highly efficient network of 13 microfinance institutions that received significant technical support from the German consulting firm, IPC. They have an average operational efficiency ratio of 20 percent compared with Mibanco’s 50 percent. Due to their levels of efficiency, they are able to offer lower effective interest rates ranging from 60-90 percent annually. They operate with limited infrastructure. Loan officers spend such a significant amount of time out in the field that they are not even assigned desks. They have a more diversified portfolio than Mibanco, offering microenterprise, small business and consumer loans, and savings accounts.

There are a number of issues that the CMACs need to overcome before they will be able to compete directly with Mibanco. Currently they are only allowed to operate outside of Lima but the head of the SBS Microenterprise Unit predicts this law will be amended in the next few years. While they were recently converted into corporate entities, they are still 100 percent owned by the
respective municipalities, leaving the governance system essentially unchanged. They are seeking private investors, but conflicts of interest are impeding them from agreeing on whether they should be sold individually or as a network and under what terms and conditions. Local politics still play a large role in the CMACs, as several board members are local government officials.

Depending on how soon and the manner in which these issues are resolved, Mibanco will need to prepare for the impending competition that will result from the Cajas Municipales as well as from the traditional banks as they move along the learning curve. Clients are slowly becoming more educated with the increased level of publicity aimed at the microenterprise sector. Clients are beginning to become aware of alternative options and compare differences in interest rates, fees and services. To ensure its long-term competitiveness, Mibanco will need to become more efficient.

**Long-Term Goals**

In announcing the creation of Mibanco, the government publicized that by the year 2000, Mibanco would expand to 18 branches in Lima and eight in the provinces. Mibanco also set a target to reach a loan portfolio of $200 million with 100,000 active clients.

The pressure from the government to expand rapidly resulted in unrealistic goals and expectations for Mibanco employees. To illustrate, in 1996 and 1997, ACP’s annual client growth was 36 percent and 24 percent respectively. According to the strategic plan, the goal for Mibanco’s client growth in 1998 is 75 percent, which is three times the amount achieved last year. The Asian economic crisis and recession in Latin America have reduced the expansion of businesses. Mibanco’s senior management is currently in the process of revising its growth projections to be more realistic.
Annex 6.1: Organigram - ACP Prior to the Transformation

Board of Shareholders

External Audit

Board of Directors

Internal Audit

Managing Director

Institutional Relations

Lawyers

General Secretary

Development Director

Finance Director

Investments

Accounting

Human Resource Director

Selection and Development

Training

Personnel Management

Organizational Development

Systems

Marketing

Microenterprise Director

Small Business Director

Business Management

Operations

Administration

Network Operations

Collections

Branches
7. OTHER MICROFINANCE INSTITUTION TRANSFORMATION CASE STUDIES

Each transformation is unique. This chapter provides a brief summary of the institutional transformations of the remaining MFIs discussed in Part I. It presents the significant characteristics of the transformation process that resulted in the creation of the following regulated, privately owned MFIs: Finansol, Caja Los Andes, Financiera Calpiá and BancoADEMI.

7.1 Actuar Bogota / Corposol / Finansol

Created by influential Colombian businesspersons with the technical assistance of ACCION International, ACTUAR Bogota was launched in 1987 as an NGO dedicated to supporting the development of microentrepreneurs by providing credit, training, and other services. From its inception, ACTUAR Bogota pursued aggressive growth. By the end of 1992, ACTUAR Bogota had nearly 25,000 active borrowers, while maintaining excellent asset quality. This growth was funded with a combination of donations and bank borrowings backed by various types of guaranties from its board members, ACCION International’s Bridge Fund, FUNDES (a Swiss-based foundation), and others. These different sources of capital, however, proved insufficient to support ACTUAR’s growth trajectory. By late 1992, management and the board began to explore the possibility of transforming ACTUAR into a regulated financial intermediary.

ACTUAR first examined the possibility of creating a bank similar to BancoSol in Bolivia. This option, however, would have required $13.7 million in capital. A second feasibility study was then conducted of an alternative model, the *compania de financiamiento comercial* (commercial finance company, CFC), which required only $2.6 million in capital. Ultimately, ACTUAR Bogota decided to purchase an existing commercial finance company (CFC), which became Finansol S.A. in November 1993. Shortly after establishing Finansol, ACTUAR legally changed its name to Corposol and became a holding company. Corposol assumed 71 percent ownership of the new finance company through successive capital increases. Other founding members of Finansol were the Corporación Financiera de Desarrollo, a national development bank subsequently privatized, with 7 percent; ACCION, CALMEADOW, and FUNDES with 4 percent each; and individual Colombians holding the remaining 10 percent. In addition, Corposol maintained controlling interest in Mercasol, a commercial retailer, and acted as a fundraiser for three other not-for-profit programs: Corposol Client Training; Agrosol, the rural branch for Corposol’s credit, training and technical assistance services; and Construsol, set up to provide technical assistance and credit for home or business improvements.

In early 1995, Finansol began to experience serious problems in portfolio quality. Several factors contributed to this crisis. After purchasing the finance company, Corposol continued to provide training services to clients, through its non-profit subsidiaries, while Finansol provided the loans. Credit officers, however, remained employees of Corposol, resulting in a functional split between the two entities. As such, Finansol was left with little control over its loan disbursements.

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74 Rock and Otero, 1997, p. 94.
75 Steege, 1998.
Secondly, in 1994, the Colombian banking superintendent restricted asset growth of all regulated banking activities to 2.2 percent per month. Finansol, as a regulated financial institution, was subject to this new policy, while Corposol, the unregulated NGO, was not. To avoid this restriction, new loans were periodically transferred from Finansol’s books to Corposol’s. The transparency of financial reporting was thus undermined, obstructing effective oversight. Thirdly, Corposol, with majority ownership in Finansol, aggressively promoted a range of untested loan products, leading to a breakdown in loan methodology.

Toward the end of 1995, the Colombian regulatory authorities decided to impose greater provisioning requirements for consumer debt. Finansol was forced to allocate large amounts to provisions, significantly eroding the capital base of the company and ultimately placing Finansol in violation of minimum capital requirements. In December 1995, the banking superintendent required that all operational ties between Finansol and its founding NGO be severed. Corposol was forced to cede its shares in Finansol to creditor banks whose loans to Corposol had been collateralized by those shares, and shortly thereafter was forced into liquidation. The regulators opted not to intervene in Finansol, but instead allowed a team composed of the new Finansol President, ACCION International, FUNDES, ProFund and other minority shareholders to seek new capital. This new capitalization process took almost a year.

In early 1997, Finansol, renamed FINAMERICA S.A., restarted operations. In 1998, FINAMERICA achieved financial solvency, and as of year end, had 9,800 active clients and a loan portfolio of $13.4 million.

7.2 Caja Los Andes

In July 1995, Caja de Ahorro y Préstamo Los Andes (now Caja Los Andes) was established as the first Bolivian Private Financial Fund (PFF). Caja Los Andes grew out of the NGO, PRO-CREDITO, established in 1991 by a group of private individuals. Since its inception, PRO-CREDITO had received technical assistance from the private consulting firm IPC, financed by the German development agency, GTZ. Launched with the founding vision of creating a regulated financial intermediary, PRO-CREDITO began operations with a sophisticated management information system and hired loan officers with business backgrounds. Within three years of operations, PRO-CREDITO had 7,684 active clients, and an outstanding loan book of $2.9 million.

The PFF category was introduced in Bolivia in April 1995. Within only a few months, PRO-CREDITO sold its $4.4 million portfolio to the newly established PFF, Los Andes, and paid for shares in the new institution in cash with the resulting funds from the sale. As of June 30, 1998 the ownership structure comprised PRO-CREDITO with 38.9%, public development agencies, including the IDB (22.6 percent), Corporacion Andina de Fomento (13 percent) and COSUDE (6.4 percent), and private individual investors (19.1 percent). PRO-CREDITO now acts solely as a holding company for the new PFF; it does not provide any services itself.

The transformation of PRO-CREDITO into a PFF highlights a number of advantages of transformation. Los Andes has been able to expand its access to capital through deposit mobilization, second-tier lenders and interbank funds. Secondly, the organizational transformation of the NGO into Bolivia’s first PFF has raised its profile among financial institutions and donors, further facilitating funding mobilization. Finally, as a PFF, Los Andes now has access to the Superintendency’s Credit Bureau, a source of valuable information for any

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7.3 Financiera Calpiá

Financiera Calpiá evolved from the Salvadorian Asociación de Medianos y Pequeños Empresarios Salvadoreños (AMPES), created in the aftermath of the 1986 earthquake with funding from the German technical assistance agency, GTZ. The founding vision of AMPES was to support small and micro businesses through the establishment of a financing facility. A rotating credit fund, called Servicio Crediticio, was separately implemented by GTZ within the entrepreneurs association to focus exclusively on financial services. Internationale Projekt Consult (IPC) was contracted by GTZ to provide specialized financial expertise.

During 1988-93, the fund provided micro loans on a cost recovery basis in the San Salvadoran market. Having demonstrated financial viability, Servicio Crediticio decided to initiate a transformation process into a for-profit, regulated financial intermediary primarily to access new sources of funds, particularly from the Inter-American Development Bank (IDB) and commercial banks. AMPES hoped that transformation would improve their borrowing terms by lowering interest rates and guaranty requirements, lead to increased access to external funding and remove the link between growth and donor support.

AMPES opted to create a financiera, as opposed to a commercial bank, and in 1994 began the formal planning for transformation to a regulated financial institution. In March 1995, Financiera Calpiá started operations. At the time of AMPES’ transformation, financieras only required $1 million in capitalization, yet permitted flexibility in product offering.

In designing its ownership structure, the MFI aimed to balance the social and profit objectives of a microfinance institution. Its shareholders include institutions that support Calpiá’s mission, and who own activities support the microenterprise sector. Six principal shareholders were identified from foreign multilateral banks and local non-profit organizations with interest in the micro-business sector. Fundacion Calpiá, a non-profit organization established to promote the interests of micro, small and medium businesses in El Salvador, owns 30 percent of the shares. Three local NGOs, each involved in a range of different socio-economic development projects, together own 19.74 percent. Together with Fundación Calpiá, these organizations own almost 50 percent of Calpiá thus ensuring the social mission of the financiera is maintained. Two public development agencies, Banco Centroamericano de Integracion Economica (BCIE) and the IDB’s Multilateral Investment Fund, each with 25 percent ownership, represent the for-profit objective while having a long-term perspective and development interest. Eight local entrepreneurs represent the balance of Financiera Calpiá’s ownership (0.26 percent).

Financiera Calpiá received significant technical assistance from IPC to prepare for the operational transformation, especially in improving its accounting and management information systems in accordance with required regulatory standards. At the time of transformation, Calpiá’s loan portfolio was $4.4 million with 8,100 loans outstanding (2,000 agriculture loans) and its portfolio at risk (over 30 days) was 2.7 percent. By December 1998, Financiera Calpiá’s portfolio had grown to 29,101 clients representing over $22 million loans and $2.8 million in voluntary savings.
7.4 BancoADEMI

The Association for the Development of Enterprises (ADEMI) was launched as a non-profit organization in 1982 by successful Dominican businessmen. With a vision of “democratizing credit” for the urban poor, ADEMI adopted a market-oriented approach to the provision of microcredit from its inception. In early 1983, ADEMI commenced lending operations with both group and individual loans, and formed a partnership with Banco Popular. Loans were disbursed in the form of checks drawn on a Banco Popular account, and clients were required to cash the checks and make repayments at the bank. Throughout the 1980’s and 1990’s, ADEMI experimented with new loan products, new lending methodologies, and expanded geographical outreach. GTZ, ACCION International, Banco Popular and USAID (with funds channeled through FondoMicro) provided technical and financial support, solidifying the consolidation of ADEMI’s operations.

Beginning in the early 1990’s ADEMI embarked on a period of both expansion and innovation. By 1991, ADEMI had 8,400 active clients with $5.2 million in assets and had achieved financial self-sufficiency. Small-scale lending was introduced and grew rapidly after 1992, accounting for four-fifths of the increase in the portfolio by 1994. Significant innovations were also introduced, with the piloting of home improvement loans, the introduction of a pension plan for employees, and the launch in 1996 of the ADEMI Mastercard in conjunction with Banco Popular. By the end of 1996, ADEMI was serving over 16,200 clients and had US$39 million in assets.

This increase in growth, combined with developments in the regulatory framework encouraged ADEMI to begin to review its legal status. The significant increase in outreach was accompanied by a quickly growing capital base. By late 1997, ADEMI’s equity base had increased to $18 million, raising questions over the appropriateness of ADEMI’s NGO status and encouraging management and regulators to examine other institutional alternatives. In addition, since 1992, ADEMI had been mobilizing deposits in the form of loans from clients to ADEMI, and by December 1997, these funds represented 25 percent of the portfolio. At the same time, the Dominican Republic’s monetary code was revised to allow the Banking Superintendency to regulate any institution engaged in financial intermediation, even those that were not officially mobilizing deposits. Many of the fiscal advantages of non-profit status were eliminated in revisions to the fiscal code, including tax exemption. Together, these issues led ADEMI to pursue the establishment of a new formal sector bank.

After conducting a thorough feasibility study, ADEMI decided to create a development bank. The development bank category, however, is only transitory; ADEMI plans to register as a loan and savings bank, once this new regulatory category is officially established. A development bank (and loan and savings bank) is permitted to offer formal time deposits, including both savings accounts and promissory notes, but not checking accounts or certain foreign exchange services. On September 11, 1997, the Monetary Board approved the banking license for BancoADEMI, and in early 1998, BancoADEMI opened its doors.

As of July 1998, BancoADEMI’s shareholders include the founding NGO (24 percent), the board of directors (39 percent), an employee-owned private company (20 percent) and a private bank (17 percent). BancoADEMI has eight board members, including one representative from the NGO, one representative from the employee-owned company and six private individuals. Originally, the new bank was to focus on only the larger loans for the first few years, allowing ADEMI to continue to service the micro market for 2-3 years. After this period, the bank would

then assume responsibility for the micro market as well. This plan, however, was accelerated within the first six months of BancoADEMI’s launch, largely due to concerns over creating two separate cultures. BancoADEMI now assumes responsibility for all lending. ADEMI, the NGO, will act solely as a holding company for the investment.
BIBLIOGRAPHY AND SUGGESTED READING


Foundation for Development Cooperation on Behalf of The Banking with the Poor Network. The Policy and Regulatory Environment for Microfinance in Asia. P.O. Box 10445 Adelaide St., Brisbane QLD 4000, Australia. E-mail: fdc@ozemail.com.au


