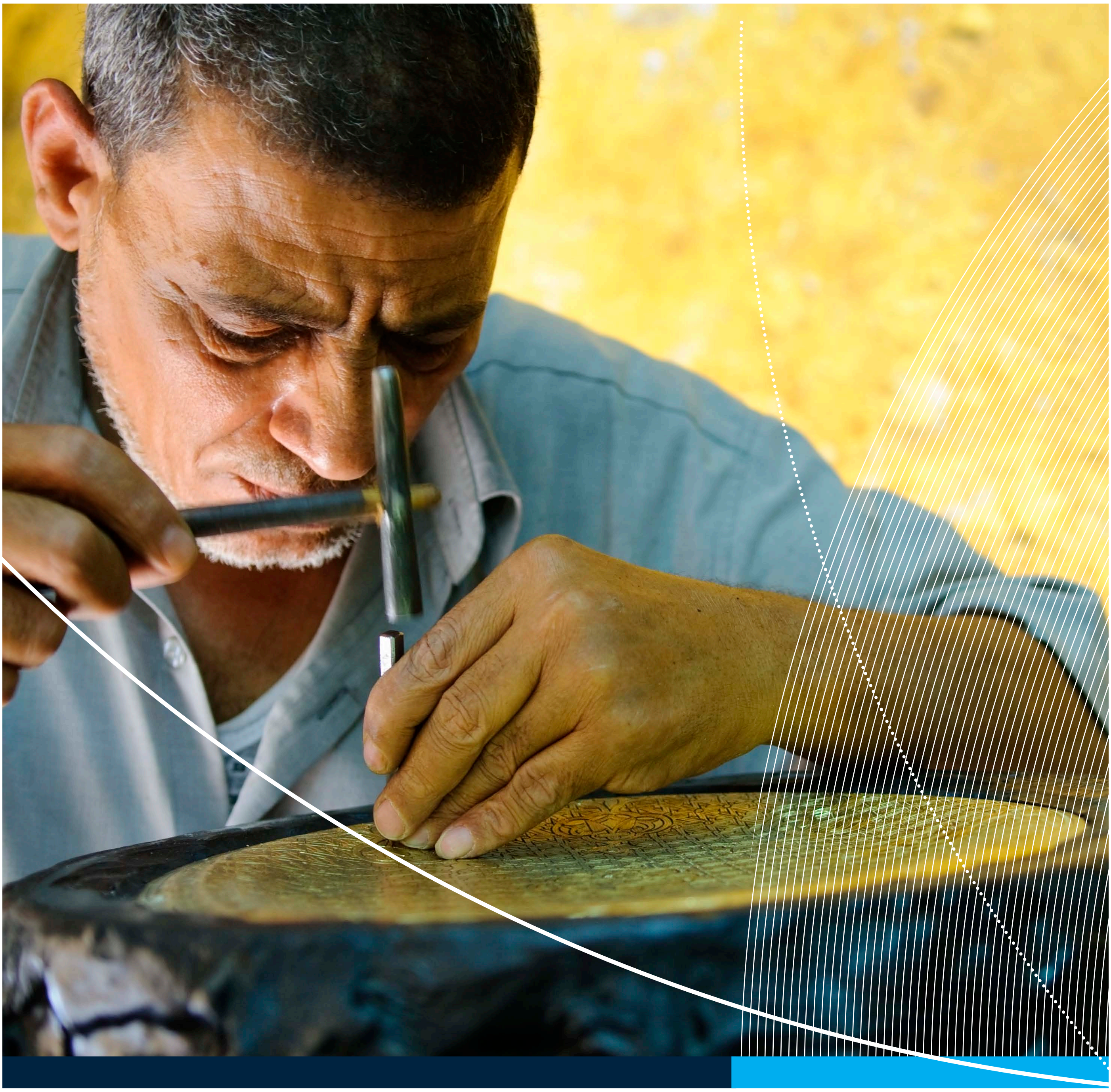

Transforming Microfinance Institutions in the Arab World

Opportunities, Challenges, and Alignment of Interest

IN PARTNERSHIP WITH

International Finance Corporation
WORLD BANK GROUP
Creating Markets, Creating Opportunities

TRANSFORMING MICROFINANCE INSTITUTIONS IN THE ARAB WORLD

Opportunities, Challenges, and Alignment of Interest

DISCLAIMER

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Acronyms

ACM	L›Autorité de Contrôle de la Microfinance (Tunisia)
ASA	ACLEDA Staff Association
CEO	Chief Executive Officer
CRS	Catholic Relief Services
EFSA	Egyptian Financial Supervisory Authority
ESOP	Employee Stock Ownership Option
IFC	International Finance Corporation
MFI	Microfinance Institution
NGO	Non-Governmental Organization
ODTI	Other Deposit-Taking Institution
PMA	Palestinian Monetary Authority

Foreword

Over the past 50 years, much has been accomplished in improving financial inclusion worldwide. Access to financial services for the bottom of the pyramid, practically unthinkable only a few decades ago, has increasingly become a reality, and microfinance institutions (MFIs) have played a key role in this process. Part of MFIs' success across the globe can be traced to the process of "transformation," an institutional evolution towards a more professionally run, for-profit company that has brought economies of scale and operational efficiency to many MFIs, so that they may serve more low-income people with a greater offering of financial products at better rates.

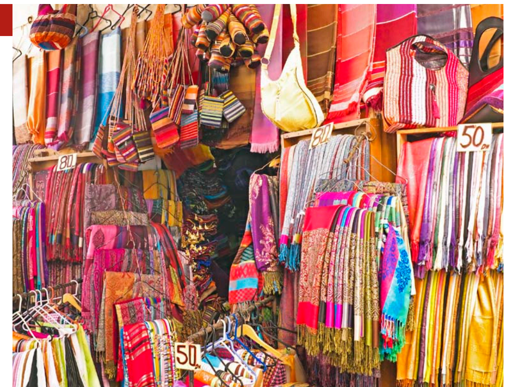
Though the microfinance industry in the Arab World is well established and growing, only a handful of Arab MFIs have transformed from not-for-profit to for-profit companies. The recent trend of introducing or improving the regulatory environment for MFIs in the Arab World has made the question of transformation more relevant than ever, and in some countries more than others. This paper analyzes the possibility of transformation for MFIs in this region by exploring its advantages – including access to capital, increased outreach, improved efficiency, and governance – as well as disadvantages. It summarizes the experiences of some MFIs that have already undergone transformation, both inside and outside the region, and contextualizes what transformation would look like under the regulatory environments present in the Arab World. This paper speaks to MFI practitioners in the Arab World who may be pondering whether transformation is right for their organization and strives to address the concerns of MFIs that are weighing the pros and cons of transforming into a share-capital company.

This report represents the third report in a series of papers developed jointly by the Microfinance Network of Arab Countries (Sanabel) and International Finance Corporation (IFC).

We hope you enjoy this report.

Xavier Reille

Manager
EMENA Financial Institutions Group (FIG) Consulting
International Finance Corporation



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Introduction

Transformations in the microfinance industry have been common practice globally since the late 1990s. Currently, transformed MFIs transact the bulk of all microfinance operations, measured by number of clients as well as portfolio size. However, the few transformations that have taken place in the Arab World have mostly involved transforming international microcredit programs into registered institutions, with many of them remaining unregulated. The reasons for this are mostly related to the broader enabling environment and to legal frameworks and regulations that include an increase in taxes owed under the new legal status. In addition, concerns of mission drift, long central to discussions of transformation, have led to skepticism of the process altogether. Lastly, MFI employees may have concerns about the transformation process, ranging from their personal beliefs to uncertainty about their future under a new for-profit company.

In recent years, however, regulations in some Arab countries have changed, and other barriers to transformation, such as concerns about mission drift and doubts among staff, have been handled with greater delicacy and success. Accordingly, the time has come to take a closer look at what this process might actually entail.

This paper presents the authors' deeper dive into transformation in the Arab context, and discusses the benefits, costs, challenges, and opportunities associated with transforming a not-for-profit into a for-profit entity – not necessarily a bank. While what has worked elsewhere may not necessarily be applicable in the Arab World, the body of evidence is quite clear that institutional growth is sustained by a variety of funding channels, and that the opportunity to grow and better serve the underserved has encouraged many MFIs in the Arab World to reconsider transformation.

This study also presents the results of a survey conducted jointly by IFC and Sanabel to better understand where MFIs in the Arab World currently stand in the transformation process. The survey was sent by email to a select group of MFIs that are either the leading MFIs in their countries or have already expressed interest in transformation. It was composed of two sections. The first collected background information, particularly about their current legal structure and plans to transform. The second was addressed to MFIs that have already transformed or are considering transformation, to understand how they view the benefits and challenges.

As a part of this undertaking, the survey also asked questions about the MFIs' interest in allowing staff to participate in the transformed entity's equity by setting up a employee stock option plan (ESOP). This is a form of staff compensation in which select staff are awarded shares in the share-capital company that employs them. A few MFIs in other regions have implemented ESOPs during transformation to address staff concerns, reward hard work, and align individuals' goals with those of the institution. The survey sought to measure interest in ESOPs among respondents, as well as ask how they view the benefits, challenges, and appropriate terms of ESOPs. For MFIs wishing to explore this concept more deeply, Annex I of this paper addresses ways to implement ESOPs, and presents examples of MFIs that have elected to offer them.

Definitions: What is transformation?

The first known case of transformation in the history of microfinance was that of PRODEM, a microcredit NGO in Bolivia, into a microfinance bank called Bancosol. In these early days, the term "transformation" was defined as the process of changing from a non-regulated entity to a prudentially regulated one that could mobilize savings. Over time, however, the definition broadened. In their seminal paper "Transforming Microfinance Institutions: Providing Full Financial Services to the Poor," Joanna Ledgerwood and Victoria White define transformation as:

> *"…the institutional process whereby an NGO microfinance provider or a microfinance project creates or converts into a share-capital company and becomes licensed as a regulated financial institution. Transforming from an NGO or project to a regulated financial institution may involve becoming licensed to be a deposit-taking institution or only as a credit institution. Other forms of transformation include a donor or government project transforming into a locally managed and registered institution (but not regulated), either independently or with international partners."*[1]

This is indeed quite a broad definition, and some aspects of it are not necessarily relevant to the Arab World. As such, for the purposes of this paper, transformation is defined as:

> *"The process whereby a credit-focused MFI (a project, NGO, not-for-profit or for-profit company owned by an NGO or by one owner) creates or becomes a for-profit, share-capital company with multiple shareholders,*[2] *which may or may not become a deposit-taking financial intermediary,*[3] *depending on regulations in a given country."*

The Term "Transformation" and the Confusion It Creates for Some in the Arab World

It must be noted here that the term "transformation" in Arabic (تحول) has caused some confusion in the microfinance sector in the Arab World. Many (wrongly) think it means that an NGO, a public entity funded by grants and exempted from taxes, will become a private entity owned by individual investors – often the same ones who were serving as volunteers on the NGO's board – who will then be making personal gains from that grant money and those tax exemptions. However, this is not the case.[4] Figure 1 below depicts this paper's definition of transformation, step by step, which progresses as follows:

- **Phase 1:** An NGO exists that runs microfinance operations. This NGO is likely to have been funded by grant money at some point and is likely receiving tax exemptions. Suppose the NGO has a value of x.

- **Phase 2:** When a decision is made to transform, a new for-profit company is created to run the microfinance operations. The parent NGO continues to exist and owns 100%[5] of the shares (x) in the for-profit company. While this parent NGO no longer runs the microfinance operations,[6] it may continue to provide *non-financial* services to microfinance clients, such as financial education, business training, marketing support, business incubators, or other activities that benefit the community at large.

1 Ledgerwood, J., & White, V. (2006). "Transforming Microfinance Institutions: Providing Full Financial Services to the Poor." Washington DC: The World Bank.

2 This could be prudentially or non-prudentially regulated.

3 An intermediary is an institution that mobilizes deposits and then lends these deposits on to its borrowing clients.

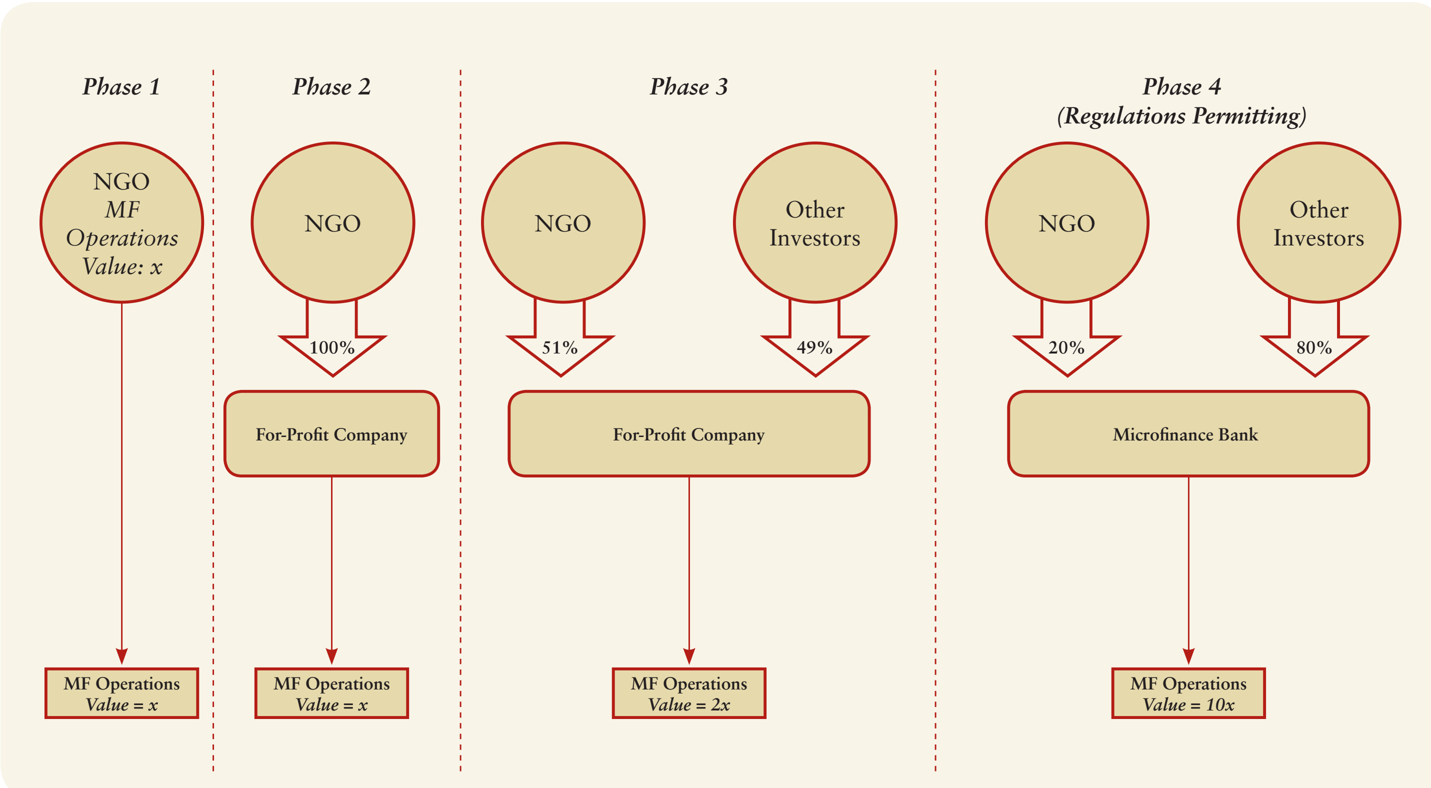
4 Perhaps this confusion is sufficient reason for the sector to start thinking of alternate terminology in Arabic.

5 In some cases, the regulation does not allow one owner to have 100% of the shares, so the NGO would have 99% and 1% would be registered in the name of the staff or the board until more investors are brought in.

6 The transfer of the outstanding portfolio from the NGO to the newly established company might be done in one shot. This was the case with Enda Tamweel (Tunisia), where the regulator insisted that over a short period all active borrowers sign a paper accepting transfer to the new entity. Alternatively, clients may be migrated to the new entity at the time of loan renewal.

- o Note that the NGO still owns and manages all grant money received and profits generated by the NGO's activities. The transformation here is not related to the ownership of the NGO, but rather to the type of legal entity that runs the micro-lending or intermediary operations.

Figure 1: Depiction of Transformation



- **Phase 3:** As one of the main objectives of transformation is to increase capital so that an MFI can reach more people, new investors will eventually be invited to invest in the new for-profit company. Because mission drift is a big concern for MFIs undergoing transformation, MFIs try to retain influence over the mission by keeping a simple majority of shares in the NGO's hands (51%). As new investors contribute the remaining 49% (or less, if the NGO and individual founders retain more than 51% of shares), this leads to an almost doubling of the capital of the for-profit company, while the parent NGO continues to exist and be the majority shareholder. [7]

- **Phase 4:** The ultimate state that an MFI embarking on transformation should strive for is to become a microfinance bank (regulations permitting) with a much larger scale of operations, and to increase its capital by inviting yet more investors. The parent NGO should continue to have a smaller proportion of the shares in the microfinance bank, whose value will eventually be much higher per share (assume here *10x*). Note that while the NGO's *share* of total equity may drop over time, the NGO's original holding value (x) will not erode unless the NGO chooses to divest. In fact, the original holdings' value should increase as the company grows and, if permitted, the NGO may even choose to invest more in the growing company to retain a higher equity share.

7 In cases where the NGO/MFI provided some non-financial services before transformation, those services and the staff who provided them usually stay in the NGO. The NGO may then add other non-financial services, as is often the case.

Transformation in the Arab World

Since the late 1990s, some simpler forms of transformation have been witnessed in the Arab World. These cases mostly involved transforming international microcredit programs into registered institutions, albeit with many remaining unregulated. These cases included, but are not limited to:

1. The spinning off of the Save the Children (US) microcredit programs in the Middle East into locally managed and registered (but not regulated) institutions. In Jordan, the Jordanian Women Development Society (JWDS) was established as an NGO in 1996 but was transformed again in 1999 into a limited liability, not-for-profit company, Microfund for Women. In Lebanon, the Lebanese Association for Development (Al Majmoua) was also established as an NGO in 1997. Similarly, in Palestine, FATEN was established as a limited liability, not-for-profit company in 1998. And later in Egypt, the Save the Children program was spun off into an independent microcredit program under the umbrella of the Women Health Improvement Association (WHIA), which was then registered as Al Tadamun Microfinance Foundation.

2. The transformation of the Global Communities (formerly CHF)[8] programs in the Middle East into Vitas-branded companies. The two companies in Lebanon and Palestine are regulated by their respective central banks, while the one in Jordan is in the process of becoming regulated by the central bank.[9] Vitas Iraq remains regulated by the NGO directorate as a branch of a foreign NGO in Iraq.

3. FINCA Jordan also began operations as a not-for-profit, but soon transformed into a for-profit company fully owned by FINCA International.

4. The Aga Khan Agency for Microfinance (AKAM), a foundation registered in Switzerland, began a microfinance program in Syria in 2003. In 2008, under the new microfinance law, AKAM incorporated the First Microfinance Institution - Syria (FMFI-S) as a microfinance company with a deposit-taking license, supervised by the central bank – the first case in the Arab World where the founding international NGO kept only part of the equity and a capital increase was offered to investors, namely EIB, KFW, and IFC.

5. In 2010, Al Kuraimi Money Exchange in Yemen was transformed into Al Kuraimi Islamic Microfinance Bank, benefitting from the Microfinance Banking Law No. 15 for 2009. Upon transformation, the bank's owners (private individuals) remained the same as those of the money exchange company.

6. In 2015 in Palestine, two NGOs, Asala and ACAD, transformed into for-profit companies and brought in other investors to secure more capital and comply with the minimum capital requirement under the Palestinian Microfinance Act issued in 2011. The two companies are licensed and supervised by the Palestinian Monetary Authority (PMA).

7. The most recent example of transformation in the Arab world comes from Tunisia. In December 2015 a microcredit NGO, ENDA Inter-Arabe, established ENDA Tamweel, a microcredit company licensed and supervised by the Microcredit Control Authority (itself established under the Tunisian Microcredit law issued in 2011). Initially, the new entity was almost fully owned by the founding NGO, but it is currently in the process of bringing in additional investors.[10]

8 Global Communities (formerly CHF) was one of the largest not-for-profit international networks of microfinance lending in the Middle East, particularly invested in Jordan, Lebanon, Palestine, and Iraq. Over the years, its programs transformed and unified under a single brand called Vitas Group, a holding company for Vitas microfinance subsidiaries throughout the Middle East. Vitas Group is wholly owned by Global Communities.

9 The transformation of the Global Communities programs was done in several steps, which included various institutional forms. In Lebanon, the program was initially transformed into a company called Ameen (99% owned by Global Communities), and this company was registered later as an S.A.L finance company regulated by the Central Bank of Lebanon. It later changed its name to Vitas Lebanon. In Jordan, the program was transformed into the Middle East Microcredit Company (MEMCO), which began as a not-for-profit company and was later transformed again into Vitas Jordan, a for-profit company. The Ryada program in Palestine was converted into a private shareholding company, 97% owned by Global Communities; Vitas Group put in some new equity and owns 3% of the company.

10 It is expected that more MFIs in the Arab World region will be replicating this model in the future.

Benefits of Transformation

The primary reasons many MFIs choose to transform are to offer additional products and services to their clients, to gain access to capital in the forms of both debt and equity, and to expand their outreach to more of the un- and under-banked. Transformation to a regulated financial institution also typically results in improved governance and ownership structures.[11] Taken together, a well-managed transformation benefits microfinance clients, staff, and owners alike.

The First Transformation: PRODEM and BancoSol, Bolivia

In 1991 a microfinance NGO called PRODEM made a decision to transform into a fully regulated bank. The following year BancoSol opened, marking the first microfinance NGO-to-bank transformation. It soon became a model for the industry, helping to advance the concept of transformation among MFIs and to expand their focus beyond credit to include a wider range of financial services, including savings. Today BancoSol is a profitable bank, the 5th largest in Bolivia, offering a full range of financial products to close to 500,000 clients. Its total gross loan portfolio of $132.3 million (as of December 2016) accounts for 27% of Bolivia's microfinance portfolio. Economies of scale have also improved operational efficiency, allowing BancoSol to compete in a highly competitive market through its interest rates, which averaged 15.8% by end-2016. Additionally, the bank has mobilized deposits totaling $79.4 million (December 2016), which lowers the bank's cost of funding and, more importantly, has given low-income people in Bolivia access to savings.

The bank's tremendous growth could not have been achieved without the increased efficiencies, better governance, and abundant financing that came with transformation. Its successes are also partly owed to the linkages created with the organizations that invested in its equity, such as ACCION, a microfinance network and investor dedicated to helping MFIs reach sustainability and scale.

Increase Access to Capital

For MFIs to continue to serve their clients in a sustainable manner, they need to be able to raise capital continually. Relying on donor funding alone to meet capital needs is not sustainable. In recent years, as donor funding has become scarcer or failed to keep pace with clients' growing demands for financial products and services, NGO-MFIs in the Arab world have begun to borrow from development finance institutions and commercial banks. However, their leverage was limited by: 1) their inability to increase their equity except through donations (which are very limited, especially for sustainable, profitable MFIs), or through the accumulation of annual profits (which are also limited); and 2) the limited financial leverage ratio allowed in many countries due to their legal status. Beyond balance sheet and regulatory limitations on leverage, banks and lending agencies may perceive microfinance NGOs as too risky or informal to invest in or lend to. Transformation into a for-profit company will likely boost the institution's reputation. Accordingly, MFIs may choose to transform to allow themselves to access new equity and debt sources, and to increase their financial leverage as a result of changing their legal status and having new investors on board.

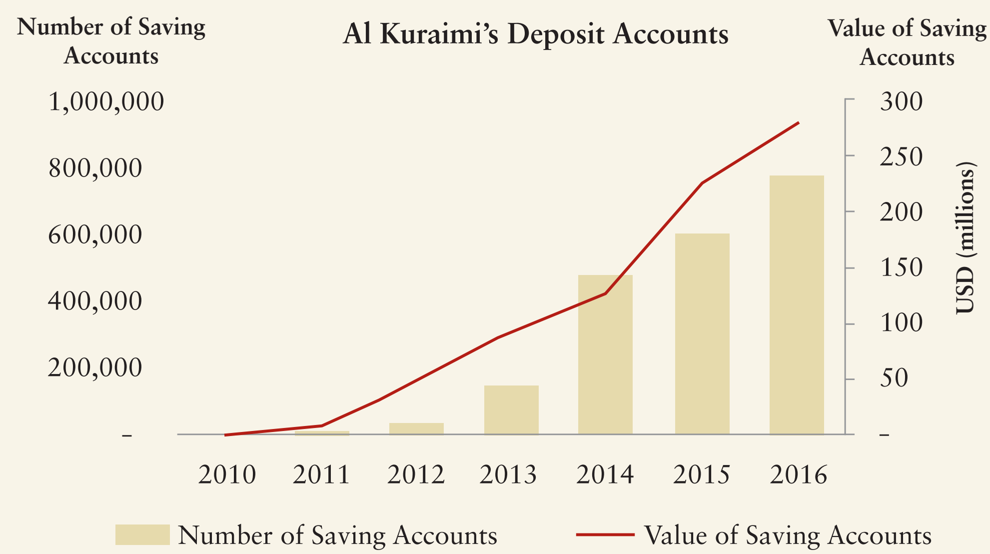
11 Ledgerwood, J., & White, V. (2006). "Transforming Microfinance Institutions: Providing Full Financial Services to the Poor." Washington DC: The World Bank.

Expand Financial Services

Globally, the ability to offer to clients additional products such as payments, transfers, remittances, and savings has motivated many MFIs to transform. Additional products can increase the number of clients, improve customer satisfaction, improve loan repayment, multiply revenue streams, and in the case of savings, provide a stable source of funds for the MFI.

In the Arab World, savings are currently only allowed in Yemen (microfinance banks), Syria (non-bank financial institutions, or NBFIs), and Sudan (microfinance banks). In these three countries, new players have entered the microfinance market, while others have chosen to transform: FMFI in Syria, which transformed from an NGO into an NBFI and can now mobilize savings, and Al Kuraimi Islamic Microfinance Bank in Yemen, which transformed from a money exchange company into a microfinance bank, as discussed earlier.

Figure 2: Some Insights from Regional Surveys



In the Arab World, some regulations not only limit the type of products MFIs can offer to credit only, but also place restrictions on MFIs' credit offering. These restrictions vary from countries where the loan cap is linked to the total outstanding portfolio (0.2% of total portfolio in Jordan) or to the equity of the MFI/MFB (0.1% in Yemen). In these cases, the MFI can increase the cap by increasing its portfolio or equity, respectively. However, this is not the case in countries like Tunisia, where the loan cap is 20,000 Tunisian dinars (about $8,000), or in Egypt, where it is 100,000 Egyptian pounds ($5,670). Some of these regulations also limit the lending to business activities.[12] Though there might be good intentions behind some of these regulations, such as keeping the focus on the poor and unserved, their impact is usually negative as they limit opportunities to upscale and to serve a big unserved segment in the market, whose needs are far higher than the capped loan but are not served by the banks. They also limit opportunities to provide low-income people with financing for non-business purposes such as home improvement and education.

The addition of new products and services where regulations permit, as well as increased access to capital, can lead directly to increased outreach for MFIs that have transformed. This objective is typically closely aligned with the social missions of MFIs, which strive to extend their services to larger numbers of un- and under-banked individuals.

12 Exchange rate on 13 November 2017 is 1 EGP= 0.06USD and 1 TND: 0.40 USD

Improve Efficiency

The growth following transformation may lead to economies of scale through which improvements in operational efficiency lead to improved profitability and self-sustainability. As operating costs decrease, the MFI may also become more competitive in the market, which is increasingly important in countries with crowded microfinance industries. However, because the growth following transformation does incur expenses, transformation is unlikely to reduce costs in the short term.

Enable Ownership, Improve Governance, and Gain Legitimacy

While NGOs often have volunteer boards of directors, they do not have formal "owners" and the directors tend not to have true "skin in the game." Transformed institutions, however, become shareholding institutions in which owners have a vested interest and liabilities and responsibilities are more clearly defined. In addition, regulators require licensed financial institutions to appoint a "fit and proper" board, and transformed MFIs often introduce additional board committees, such as risk, nomination, remuneration, and audit committees. Improved governance can lead to more robust procedures in setting strategic plans, positioning the MFI in the market, responding to crisis, and appointing the general manager. While there are many benefits to transformation, in some cases MFIs have made the decision to transform based on a requirement by the regulators.

Transformation and Regulatory Frameworks in Arab Countries

While there are many incentives for MFIs to transform, to do so requires an enabling regulatory environment. In the Arab World, a wave of regulatory changes in recent years have opened the door for the entry of new for-profit players, beginning in Syria (2008), Yemen (2009), and Sudan (2011),[13] and followed by Tunisia (2011), Palestine (2011), Egypt (2014), and Jordan (2015). These new regulations brought the sector under the supervision of the central bank (Syria, Yemen, Sudan, Jordan, Palestine) or under other entities (in Tunisia L'Autorité de Contrôle de la Microfinance, or ACM, and in Egypt the Egyptian Financial Supervisory Authority, or EFSA) and allowed for the entry of new for-profit players.

As previously mentioned, in some countries such as Syria, Yemen, and Sudan, regulations have permitted deposit mobilization and other financial services, while in Tunisia, Palestine, and Jordan, regulations have only allowed institutions to continue providing credit. In Tunisia, the new regulations encouraged the transformation of NGO-MFIs into for-profit companies by allowing the latter to have a higher cap on the loan size (20,000 Tunisian dinars, four times what an NGO-MFI can provide). However, in Egypt the new regulations did not give any clear benefits for for-profit companies compared to NGOs. On the contrary – and perhaps unintentionally – disincentives were created through higher income tax, a doubling of supervision fees, and so on, making operations costlier and placing greater limitations on the product offering.[14] Furthermore, a legal opinion issued by the State Council's General Assembly for Edicts and Legislation stated that NGOs cannot establish nor become shareholders in companies, which could provide yet another obstacle to transformation. However, to date this remains an opinion, and there is no precedent to confirm that it would hold if an NGO in Egypt did in fact pursue transformation.

Insights from Leading MFIs in the Arab World

The effects of regulatory environment in dissuading some MFIs from transforming were reflected in IFC and Sanabel's survey of 20 MFIs in the Arab World, of which 11 (55%) are currently not-for-profit. Of those, eight MFIs (73%) operate in regulatory environments that allow for transformation. Only five are planning to transform over the coming five years. This is likely because, despite regulatory changes that now allow MFIs to transform into NBFIs, in some countries (such as Egypt and Jordan) there are *no clear incentives* for MFIs to transform from NGOs into for-profit companies, as the new regulations remain restricted to credit only, and thus do not allow MFIs to expand their product offering.

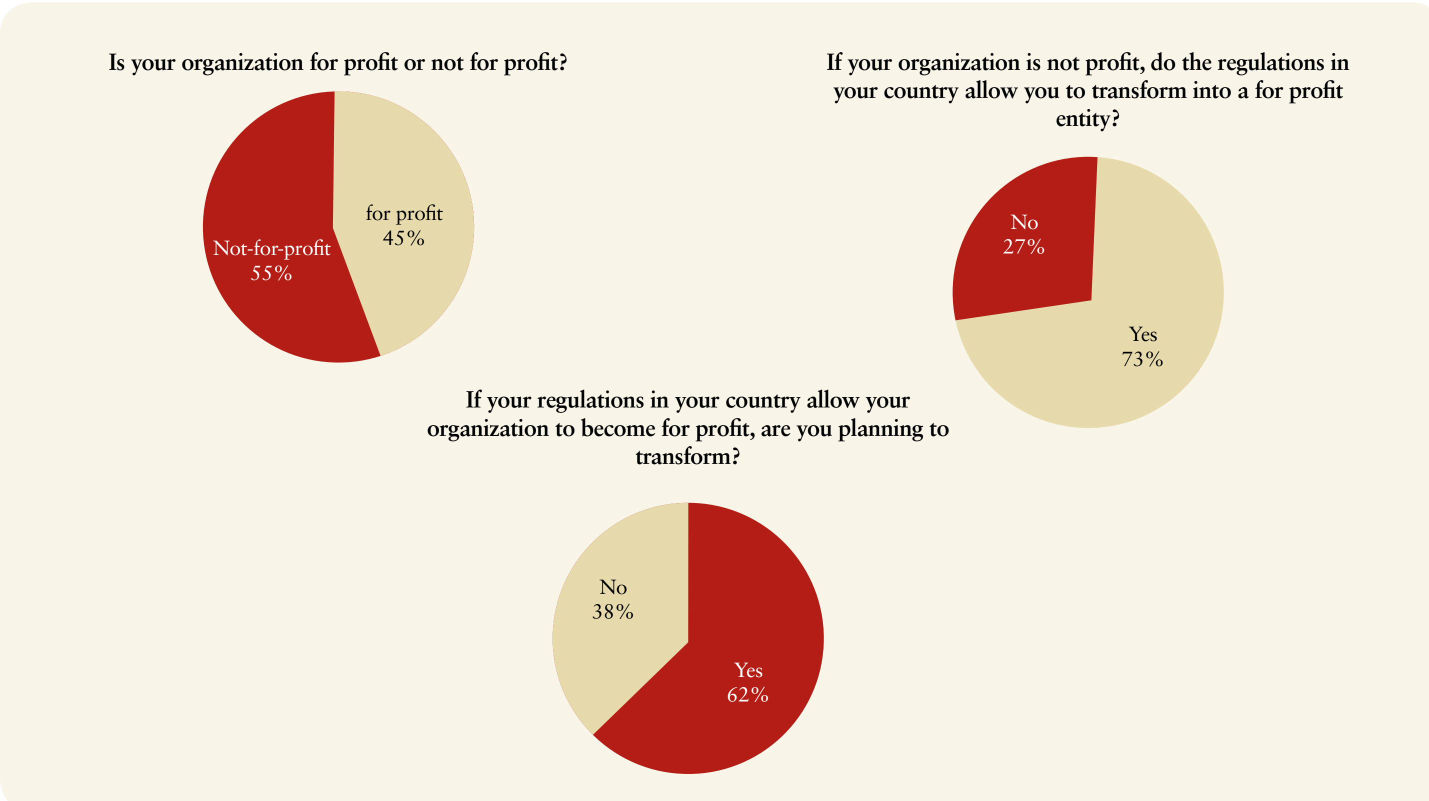
In Palestine, new regulations prohibited NGOs from micro-lending, forcing them to choose between transformation or quitting the practice altogether. In fact, a few small players, such as YMCA and Islamic Relief, shut down their credit operations as a result. However, some of the larger players, such as ACAD and ASALA, transformed from NGOs into for-profit companies. Though the regulations did allow for the establishment of not-for-profit micro-lending companies, in those two cases, the NGOs could not meet the minimum capital requirement of $5 million on their own, and so needed to bring in other shareholders. However, this same regulation has not yet incentivized FATEN, the largest player in Palestine,[15] to transform from a not-for-profit to a for-profit company.

13 This was before the events known as the Arab Spring occurred.

14 Regulated MFIs (both NGOs and for-profit) have a ceiling of 100,000 Egyptian pounds on loan size and can only loan for business purposes. Meanwhile NGOs can loan for a wide variety of purposes, such as housing and education, and can lend above this ceiling so long as they do not report to EFSA about these loans, which unlike microcredit companies they can legally do.

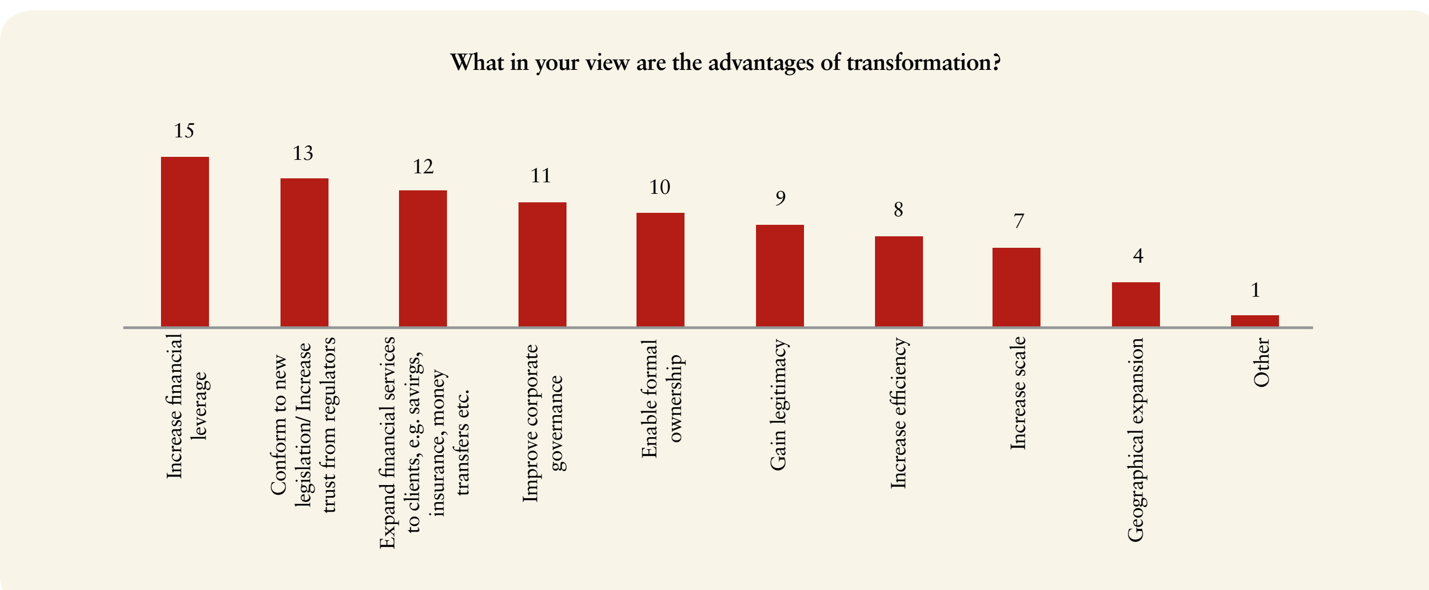
15 FATEN's portfolio was more than 50% of the total sector portfolio by the end of 2016 according to IFC's publication: "Key Developments in Palestine's Microfinance Sector" (2017).

Figure 3: Some Insights from Regional Survey



Though only five of the 20 MFIs surveyed (20%) plan to transform in the near future, the survey's results show that many recognize the benefits of transformation. As shown in the graph below, MFIs believe the key benefits of transformation are increased financial leverage, conforming to new legislation, expanding financial services, and improved governance and ownership.

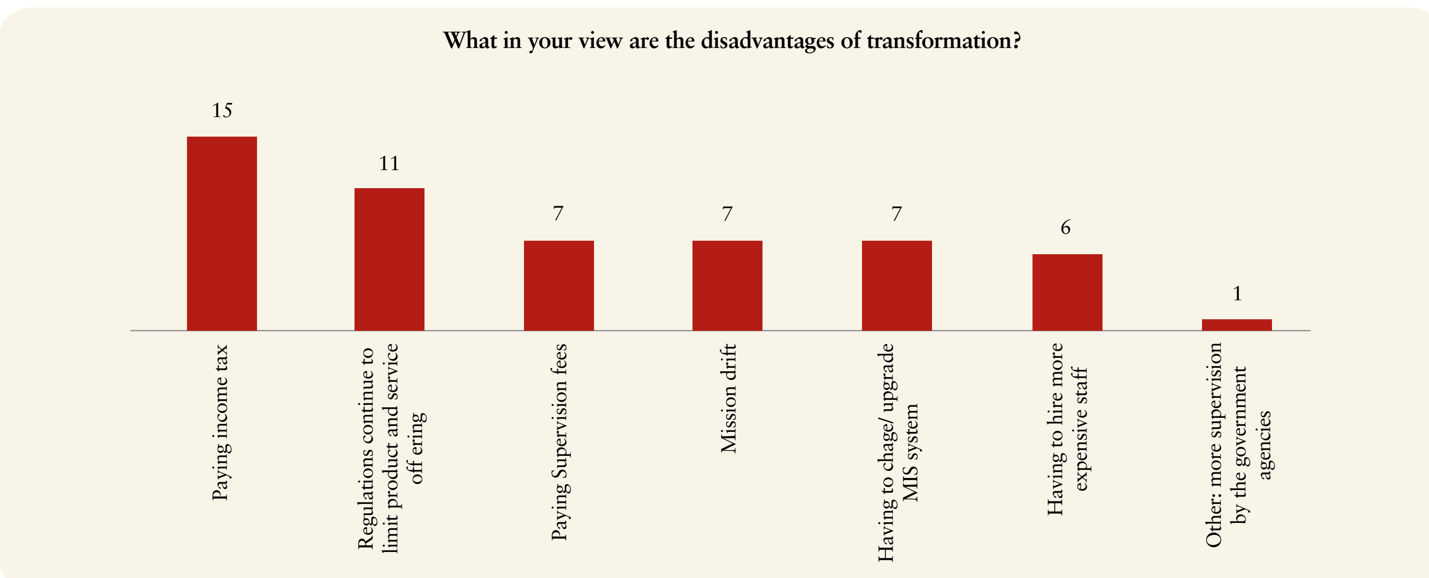
Figure 4: Some Insights from Regional Surveys



Challenges of Transformation

While the international trend towards transformation has been positive and there is substantial evidence that regulated institutions are better positioned to meet client needs, it has not been without criticism, and the MFIs surveyed are fully aware that transformation does not come without challenges. The five most commonly mentioned disadvantages to transformation relate to financial (taxes and fees), operational (improvements to management information systems) and business decisions (product offering and mission drift). Each MFI must calculate for itself if the income tax and fees owed under a new legal status are sufficiently offset by the institutional growth achievable as a larger, regulated entity. Other important challenges exist, but with the right strategy they can be addressed.

Figure 5: Some Insights from Regional Surveys



Mission Drift

Mission drift occurs when an institution's activity no longer fulfills its mission or purpose. Often in microfinance transformations the concern is that the for-profit company will behave like a purely commercial lender, the same lenders that ignored low-income populations and made it necessary for the microfinance NGO to serve the underserved in the first place. Thus, the risk of mission drift is perceived to be high, particularly during transformation, when the NGO loses control over business decisions.

As discussed above, one of the main advantages to transformation is the increase in financial leverage, made possible by not only an increase in capitalization but also by greater trust among lenders and regulators for a more formal entity that is partly owned by investors. However, new equity investors will expect seats at the board, the right to supervise and appoint top management through a vote, and may bring new ideas about the MFI's direction that deviate from its original mission.

However, it is important to bear in mind that the NGO does not necessarily dissolve after transformation, that not all investors who come looking to place capital need to be accepted, and that governance rules can be drafted with mission preservation in mind, while still allowing each investor to benefit the MFI's future. Most importantly, the NGO can still play a powerful role in shaping the institution post-transformation, albeit through a different role.

Role of the NGO After Transformation

It is common practice for an MFI's NGO to use the proceeds from the sale of the MFI business to buy majority stock in the for-profit MFI. As the majority shareholder, the NGO can strongly influence those business decisions that are the responsibility of the board, such as the appointment of the CEO, the approval of a five-year strategic plan, market positioning, mission definition, and other high-level factors that set the MFI's strategic priorities.

Furthermore, the NGO can negotiate for more than one vote, as with ACLEDA Bank in Cambodia, where the NGO held onto three out of nine votes after its transformation. Also, the NGO often chairs the board, giving it leverage in decision making. The chairperson appointed to represent the NGO may be one of the founding members of the MFI, thus ensuring the continuity of its vision and mission. Also, when a "shareholders agreement" is negotiated with new investors, the document normally defines the organization's key objectives, as well as target market and the products and services it will be offering. The document also establishes the voting percentage threshold necessary to change these key objectives, which can be set to quite high to curb the risk of mission drift. The following section digs deeper into the issue of governance and how to ensure that new investors share the same institutional vision.

Aside from embracing their new roles as shareholders, there are other roles an NGO can play when it no longer provides loans. Financially the NGO is typically in a very comfortable position, because usually most of its staff migrates to the new for-profit lender, in which the NGO is likely a shareholder. In some cases, even after buying shares in the new company, the NGO may also hold considerable amounts of cash from the sale of their credit operations. That liquidity may increase later if the NGO decides to further dilute (or even totally divest) its holdings in the for-profit company. With these funds, the NGO may wish to offer non-financial services in business education, health, child development, and so on, so long as they do not compete with the new for-profit MFI in which they hold shares. Often, these new non-financial services are aimed at the MFI's clients, so the services from the NGO and MFI are actually complementary.

Why an NGO Should Not Continue to Provide Financial Services

The need to eliminate financial services from the NGO completely is a lesson some institutions have learned the hard way. While in theory the NGO should easily transition to providing non-financial services, in practice the temptation to continue providing financial services remains strong and, sometimes, difficult to ignore. To understand the struggle, it is useful to recall why an NGO typically enters the financial intermediation business in the first place: to correct a perceived market failure, namely the reluctance of commercial financial intermediaries to serve low-income clients. Recognizing how financial access can help the poor improve their lives, such foundations become interested in serving as proxies for commercial banks, and providing such financial services to the underserved. Over the years, NGOs have been successful at providing financial services and addressing the market failure they sought to solve. If the market is self-correcting, then the NGOs' reason to offer financial services vanishes. As for-profit MFIs and even commercial banks show interest in low-income clients, then in theory NGOs should respond positively, and withdraw from the sector to make room for these new players. Indeed, it is typically at this point that an NGO considers transforming its microcredit operations. But the NGO itself still exists post-transformation and thus must face new questions about its role.

Cautionary Tales from Past Transformations

The experiences of BancoSol in Bolivia, the pioneer in MFI transformation, Finsol in Colombia, and MFBs in Pakistan provide cautionary tales for other NGO-MFIs looking to transform thinking about still offering financial services.

The First Tale: PRODEM and Bancosol, Bolivia

PRODEM's transformation into BancoSol has been considered very successful overall. Now serving close to 500,000 clients, after more than 20 years of operation the bank is universally recognized as a well-managed, sustainable organization. Nonetheless, perhaps due to lack of precedent from which to draw best practices, BancoSol experienced growing pains post-transformation.

When the NGO, PRODEM, decided that it wanted to transform, it believed there was an opportunity to continue its role as a financial intermediary that would work in concert with the new, regulated, for-profit MFI bank. Only those PRODEM branches that were profitable were transferred to the new bank; PRODEM would continue to operate the other branches and, in theory, pass them on to the new bank once they became profitable.

While at the time this looked like a good idea, in retrospect the flaws became clear. For starters, PRODEM was clearly subsidizing BancoSol, and therefore subsidizing that company's shareholders, which PRODEM considered unfair, although it was still the bank's largest shareholder.

Furthermore, such an operation required that both organizations, NGO and bank, be closely coordinated. In practice this turned out to be quite difficult. A few years after initiating operations, BancoSol started to experience other growing pains, (mostly related to organizational structure, staffing, and controls) that led to a slowdown in its growth rate. However, PRODEM continued to grow its portfolio at the same rate. What to do then with the clients and branches that were ready to graduate to BancoSol? Realizing that the bank was not ready for them, and upset with what it perceived as mismanagement at the bank, the NGO then opted to retain their profitable portfolio. The cycle was broken and the relationship between the NGO and bank was damaged. The NGO, which by then had refurbished its institutional identity and brand, felt that its interests were not well aligned with those of the bank. Within a couple of years, both organizations were viciously competing head-to-head.

Shortly thereafter, the NGO underwent yet another transformation into a second for-profit regulated entity. This time around, PRODEM stopped providing financial services and dedicated itself to providing non-financial services to the second for-profit MFI's client base. However, PRODEM was still the largest shareholder in BancoSol and owned 100% of the second for-profit MFI, which directly competed with BancoSol and was clearly PRODEM's favored son. The ensuing complications of having two competing entities created an unhealthy situation that eventually led PRODEM to divest from BancoSol. The difficulties involved in this could have potentially ruined what otherwise has proven to be a remarkable milestone in improving and expanding financial inclusion in Bolivia.

The Second Tale: Corposol and Finsol, Colombia

A second cautionary tale comes from Colombia in the 1980s, when an NGO called CORPOSOL, the leading provider of financial services for low-income people in Latin America, sought to transform.

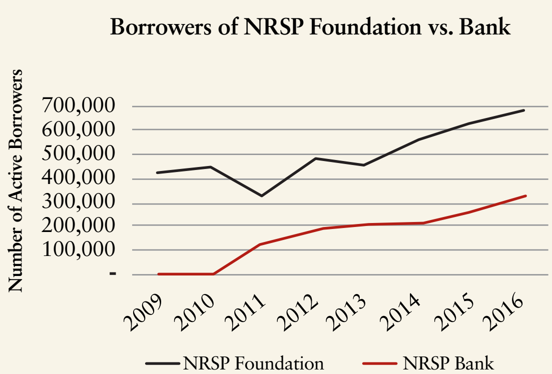
The NGO looked for like-minded investors and raised enough capital to create a regulated entity, Finsol, to which the NGO's portfolio was transferred. However, while the portfolio began to be booked in Finsol's accounts, it continued to be managed by CORPOSOL staff. For these services, the NGO charged Finsol a predetermined fee. The NGO also agreed to take back any non-performing loans. While on paper, both entities were quite separate, in practice there was no independence; CORPOSOL's managers were really calling the shots at both organizations.

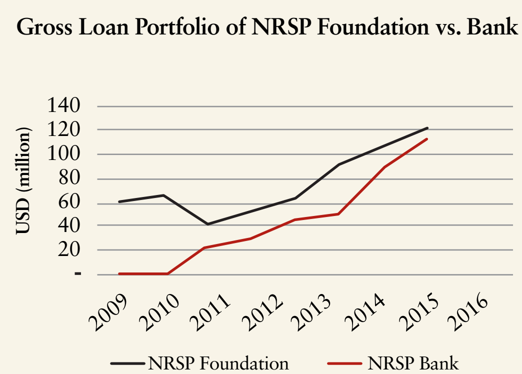
All went well until unreasonable growth expectations, fueled in part by the NGO's desire to increase the fees it was receiving for servicing the portfolio, resulted in growth that was too rapid. As is often the case, too much growth soon resulted in a deterioration of portfolio quality. According to the agreement, the resulting bad portfolio was transferred back to CORPOSOL and thus the key performance indicators of Finsol remained immaculate, regardless of its deteriorating portfolio quality. As delinquency increased, however, CORPOSOL struggled to properly provision for those bad loans, eventually exhausting its capacity to receive more bad loans from Finsol. Once this was exposed, the whole house of cards came tumbling down: Finsol was forced to hold on to its bad loans, and its indicators rapidly went from very good to very bad. Finsol in effect declared bankruptcy, the NGO ceased operations, and CORPOSOL's CEO faced many legal consequences.

The Third Tale: Microfinance Banks in Pakistan

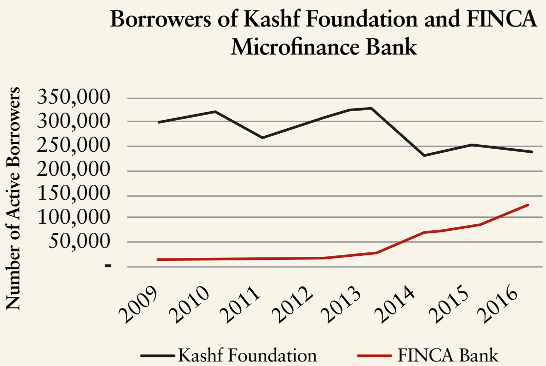
Another illustrative example comes from Pakistan, where three significant transformations have taken place over the past few years. The first is the National Rural Support Program (NRSP) transformation in 2010/11. NRSP was a program that existed since 1991, integrating microcredit with health, education, and other services, using community organizations as a delivery channel. The transformation plan geared towards transforming around 40 profitable branches into a bank. Due to its large size and outreach, the transfer centered around clients instead of portfolio, with 150,000 clients transferred to the new entity along with 1,000 employees. The plan was incrementally to transfer more and more clients to NRSP Bank for a monetary consideration, but this was curtailed when the central bank stepped in, opining that the payment against the portfolio was against the spirit of the transformation, hence the NGO did not transfer any further clients. Leveraging its existing network, however, the bank managed to grow its client base to 177,000 in the first year.

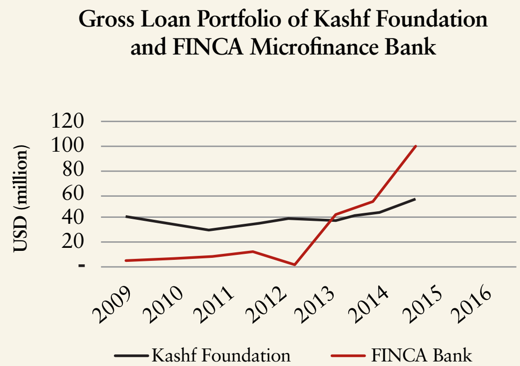
The graphs below demonstrates the performance of the two institutions from before the transformation until the end of 2016, with the foundation outperforming the bank but converging:



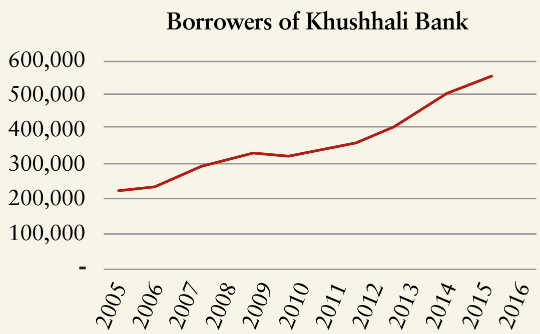


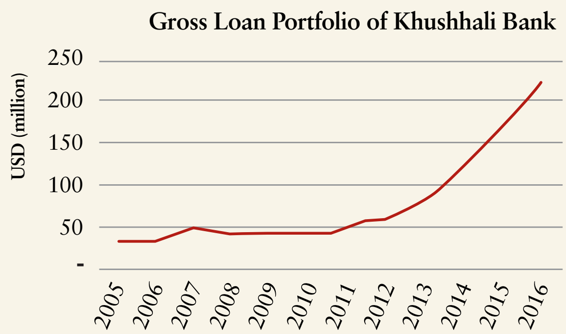
The second transformation was with the Kashf Foundation, which catered mostly to enterprise loans for the microfinance sector, and spun off its larger ticket loans to the Kashf Microfinance Bank in 2008/09. At its debut, however, the new entity ran into some hiccups, partly due to capital pressures, as the budget had not incorporated a currency devaluation against the US dollar. As a result, the bank was acquired by FINCA Holding in 2013. As the graphs below demonstrate, the foundation has always maintained an edge in terms of outreach, and only after the entry of FINCA did the bank's loan portfolio start to overtake that of the foundation.





The third example below shows the progress of Khushhali Microfinance Bank, which is the current market leader and, unlike in the examples above, enjoyed a full transformation. Established in 2000 and jointly owned by 16 commercial banks and the government, it was privatized in 2012/13, when it was taken over by a large commercial bank along with a consortium of impact investors. The management implemented a strategic plan to transform the entity into a viable high-performing entity. Here the growth trajectory is very different from our other cases of partial transformations.





Source: Pakistan Micro Watch and IFC's portfolio data

The conclusion is that learning from best practices and experiences developed over the past few decades increases the likelihood of success for a post-transformation NGO that embraces its role as a shareholder and offers only non-financial services as the law permits.

Governance and the Right Investors

After transformation, while an NGO may retain voting control and have a right to name the chair and other board members, the MFI must still consider the individual opinions of new investors, thus it is important to select the right type of investors. Fortunately for MFIs looking to transform, there is an entire community of MFI-focused or socially-focused investors and networks ready to invest. Many socially-motivated international investors with experience in microfinance already know the concerns of mission drift, and may have been party to a transformation before. They tend also to share a "double bottom line" focus with their investee MFIs.[16] Nonetheless, they do have financial expectations.

An investment firm's profitability expectations and current portfolio may give an MFI a good idea of that investor's intentions. Due diligence appraisals run in both directions. To this effect, it is important to bear in mind that while the NGO might still be in control, the addition of new investors requires that their opinions and points of view be taken into consideration. For this process to be a win-win situation, a careful selection of the new investors is paramount.

Selecting the Right Investors – Nicaragua and Peru

In 2015, a large rural MFI in Nicaragua called FDL was approached by more than six potential investors. Given the size of the investment required, two or three investors were sufficient. To decide which ones to give preference to, the NGO created a matrix of desirable characteristics. This included rubrics detailing, alongside the financial terms on offer, equally important considerations such as track record as a socially responsible investor, reputation, perceived "image boost", technical assistance programs, degree of board participation in the new company, and other perks, such as the "shield" against expropriations or other unreasonable actions by governments that multilateral organizations are commonly believed to provide. One of the investors selected was also chosen because they were affiliated with a religious institution that the NGO believed represented a set of common values.

In the case of MiBanco, the first transformation in Peru, the NGO was adamant that it did not want to have the government as an investor. This was largely because even partially state-owned entities are subject to additional regulations and restrictions. But equally important was the fact that historically, in Peru, government participation has been associated with subsidies, thus clients might get the wrong idea about the obligatory nature of repayments if the government is part of the ownership structure.

- Non-financial characteristics that an MFI may find desirable in a potential investor include:
- Microfinance network affiliation
- Image building (for example by having a global development finance institution as an investor)
- Technical assistance on offer
- Social responsibility track record
- Experience with microfinance
- Who the board representative will be
- Willingness to join, and experience with, board committees
- Adherence to the SMART campaign

Carefully considering the expectations of investors is not just useful as a mitigation strategy against mission drift. It can also be an opportunity to work with investors that have ample experience with MFIs, and who may bring knowledge and strategies that deepen the for-profit MFI's ability to achieve its mission. One such example is the case of NRSP in Pakistan, in which IFC, KfW and Acumen invested, with all three providing technical assistance having a member on the new MFI's board. There are also intangible benefits that come from improving the exposure and image of an MFI through its association with well-recognized multilateral or international development organizations. MFI

16 It may take the parent NGO, being the majority shareholder, some time to adjust the expectations of minority investors, and this can in turn make board dynamics quite challenging in the first few years.

networks can also cross-pollinate the skills of their member institutions, enriching each with experiences from elsewhere. It is also not uncommon for investors already active in microfinance to provide technical assistance in addition to their capital contributions.

Lastly, MFIs with a long tradition of employee participation in governance may want to preserve that culture after transformation. MFIs may choose to offer ESOPs to some or all employees, for many reasons. One of these may be to empower employees' voices with a vote at the board level (though not all ESOPs guarantee a vote, as we explore further below).

When Staff Are the Right Investors – ACLEDA Bank, Cambodia

ACLEDA Bank provides a good example of how employee participation in governance helps preserve institutional culture. ACLEDA began operating in a Thai refugee camp in 1992 and was organized into largely autonomous agencies spread across five of Cambodia's 20 provinces. It was staffed by refugees, widows, displaced persons, and other victims of war. The agencies' relative autonomy, and the flat social class hierarchy of their staff, empowered employees at all levels with a sense of ownership. This was also reflected in ACLEDA's democratic governance structure. Each branch manager held a seat in the General Assembly, the decision-making body, and held an equal vote on issues ranging from the appointment of a director to the organization's strategic plan, thus ensuring that their voices were heard in adhering to the institutional mission.

That same general assembly would vote on whether or not ACLEDA would transform, and thus vote themselves out of power and surrender control of the MFI's focus and direction. Thus, when contemplating ACLEDA's transformation, the managers had to grapple with how to incentivize staff buy-in to the transformation. The most tangible way to preserve staff's sense of ownership was through an ESOP. All staff, regardless of seniority or tenure, were invited to own equity shares of ACLEDA Bank through a trust called the ACLEDA Staff Association (ASA).

ASA has a right to elect two voting Board Directors to ACLEDA Bank's board, which was comprised of nine total board seats, to ensure that staff voices are heard. To demonstrate their commitment to empowering staff's voices, ACLEDA NGO provided the association with a low-interest loan. As of June 2016, ASA owns just under 26% of ACLEDA Bank's equity.

Even MFIs that do not traditionally invite employees to participate in institutional governance may want to consider empowering some of their most senior staff with equity participation and a vote on the board, in order to preserve their influence on the MFI's direction and thus better align the MFI's social mission with its non-profit roots.

Increased Costs

Many NGOs considering transformation view the costs to be extremely high. Costs include a valuation exercise to know how much the new company may be worth; legal fees both for the incorporation into a for-profit company and for shareholders agreement negotiations; and taxes, both ongoing income taxes levied on a for-profit company, and taxes on the sale of the NGO's portfolio to the for-profit company.

Transformation procedures require that the MFI engage experts, including lawyers and tax experts, to oversee certain aspects of the process. In the case of more complicated transformations, some MFIs even hire a transformation manager. If transforming into a regulated entity, the for-profit company may also need to improve their management information system and hire additional accountants and auditors to manage the more advanced reporting required by regulation.

There is no denying that an NGO-MFI must make an upfront investment into its own operations to be compliant with regulations post-transformation. However, not all transformations incur the same costs. For example, an institution transforming into a deposit-taking institution would have to invest millions in a stronger, safer, and more-complicated core banking system, as well as hire new senior personnel in line with central bank requirements. However, in many Arab countries, NGOs most often transform into non-prudentially regulated, for-profit, credit-only MFIs, and as such do not need, in most cases, to invest in new managers or banking software. Internally, for credit-only institutions, operations may continue seamlessly with business as usual, with the bulk of institutional changes occurring at the governance level.

Regional Insights: Enda Tamweel

Enda Inter-Arabe, founded in 1990, is the largest and oldest microfinance institution in Tunisia. In 2011 the Tunisian government instituted a microfinance law that aimed to attract capital and expand the commercial microfinance market. Enda began to transform in 2015, and a new entity, Enda Tamweel, was created; at this point, the institution had 200,000 active clients. Enda Tamweel, the first microfinance institution in the Arab World, has taken the unprecedented step of raising a syndicated bank loan of 111 million Tunisian dinars (around $ 45 million) without any guarantee.* This loan has been granted by a group of 13 Tunisian banks, led by Amen Bank, for a period of five years starting March 2017. The loan is amortizable at a rate of 3% plus the money market rate. The amount of this syndicated loan covers more than half of ENDA Tamweel's financing needs for 2017.

ENDA Tamweel's ability to raise such funding reflects its positive risk assessment as well as the growing interest of the participating banks in microfinance. It is highly unlikely that ENDA would have been able to access such financing had it not transformed into an NBFI. This is one example of how the costs of transformation are outweighed by tangible, more long-term benefits. Being able to negotiate with one bank (as opposed to several, as was the case in the past) facilitates the negotiation process and allows ENDA to access larger volumes of financing at a lower cost than through foreign borrowing.

Given the success of this syndicated loan, ENDA Tamweel has been approached by several major local and international players, which have expressed interest in setting up a similar arrangement to cover 50% of ENDA's financing needs for 2018.

**Exchange rate today (11/01/2018) is 1 USD = 2.47 Tunisian Dinar*

Still, even in the case of transforming into a credit-only for-profit institution, operating costs will increase, because beyond the aforementioned upfront costs, for-profit companies pay higher income taxes, and in some countries, such as Palestine, they also pay a value-added tax on personnel. In Egypt, for example, a for-profit company will pay double the quarterly fee that an NGO would pay on their portfolio.[17]

However, there is substantial evidence that investments in transformation costs, both upfront and ongoing, have for the most part been recovered as the result of a steady flow of lower-cost funding[18] as a for-profit and increased efficiencies achieved from economies of scale (Ledgerwood/Right).

17 While an NGO pays 0.25% of their average outstanding portfolio each quarter as a quarterly fee to EFSA, a microcredit company pays twice that rate.

18 Lower-cost funding comes mainly from mobilizing deposits, which is not the case in most of the Arab countries so far, as the regulation only allows for credit-only companies. However, becoming a for-profit and having some known banks and investors as shareholders can help attract more financial leverage for a relatively lower price.

Gradual Transformation – ENLACE, El Salvador

In 2009 a microfinance NGO in El Salvador run by Catholic Relief Services (CRS) recognized that it needed to strengthen its operations and increase its capital. It decided to incorporate as a for-profit, non-bank company called ENLACE. As a share-capital company, ENLACE had to follow corporate laws, but could continue offering credit through its traditional village banking model without adhering to prudential regulations.

CRS retained shares in ENLACE and was cautious in its selection of other investors. CRS had NGO partners in El Salvador who implemented non-financial services such as business training, health awareness, women's empowerment workshops, and women's health education seminars. In addition to inviting these NGO partners to hold shares in ENLACE, CRS also approved investments from one microfinance investment vehicle (due to their experience in the industry and region) and two socially responsible international investors, one of which had Catholic ties.

ENLACE benefited from a very comprehensive shareholder's agreement, with covenants limiting changes to ENLACE's mission and vision, defining how dividends were to be paid out, determining the sale of shares, and protecting the preemptive rights of other shareholders to buy those shares. The NGO's general manager stayed on as ENLACE's CEO, helping preserve the institution's culture and mission.

Over the past seven years, ENLACE has chosen to slowly adhere to prudential regulations as if it were regulated, even though it is not. For example, it complies with board composition rules, maintains committees such as audit and risk, and creates financial reports for its board with the same format and detail as that required by the regulator. They also fulfill the requirements of provisions, liquidity, and capital.

Today ENLACE complies with all regulations, a remarkable achievement given that in 2010, when it transformed, nothing really changed in its day-to-day operations. In 2017 ENLACE remains a small but impressive player in El Salvador. By September 2017 its gross loan portfolio reached $21 million with 47,500 clients, which may seem small compared to MFIs in larger markets, but in El Salvador makes it the largest microfinance institution, with more clients than even network-affiliated local MFIs like Finca and Procredit. Despite accounting for less than one-tenth of 1% of El Salvador's total financial sector assets, ENLACE serves 6% of the country´s total borrowers. It boasts a return on assets of 5.17% and return on equity of 16.64%.

ENLACE´s transformation has been gradual and strategic. If they were to transform into a bank tomorrow, there would once again be few changes in day-to-day operations because the MFI already operates like a small bank. As yet, it has no plans to transform into a bank.

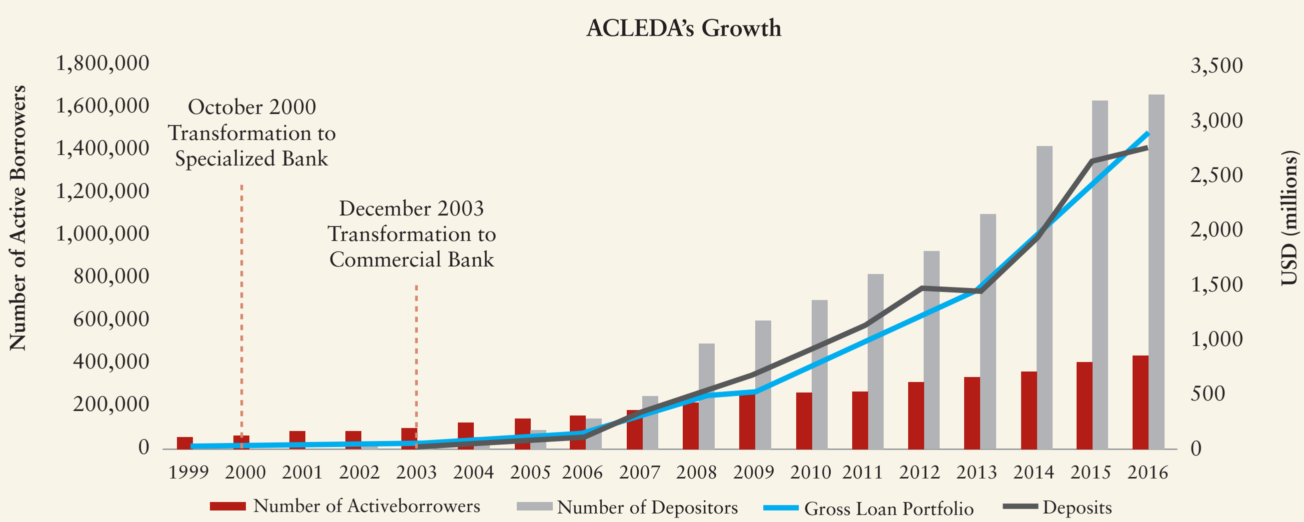
ACLEDA's Remarkable Growth Story

Under the auspices of the International Labour Organization and UN Development Program, ACLEDA was established in January 1993 as a national NGO for developing small enterprises and credit by a group of founders named below. Two factors led its board and international partners to conclude that it should be transformed into a commercial bank: expansion of its network to cover all of Cambodia's provinces and towns, and shoring up its ability to operate at a profit to ensure sustainability. This transformation would not only provide a secure regulatory framework that was lacking under its previous status, but would enable it to enlarge its range of funding options (such as equity injection, taking public deposits, and obtaining commercial interbank loans) to support expansion of its core microfinance business.

With assistance from USAID, IFC's Mekong Project Development Facility, and UNDP, to name a few benefactors, a three-year program for transformation commenced in 1998, which culminated in the granting of a specialized license as a microfinance bank in October, 2000.

Under the process, the original NGO transferred its assets and on-lent its liabilities (long-term loans from donors) to the new ACLEDA Bank. In return it has received 44.91% of the bank›s capital of $4 million, while the ACLEDA Staff Association, a trust established to give its staff an equity interest, has purchased 6.09%, and the remaining 49% has been taken up in equal parts by four foreign investors, namely IFC, DEG (Germany), FMO, and Triodos Bank (both of The Netherlands).

In December 2003, ACLEDA Bank was licensed as a commercial bank after having tripled its capital to $13 million, and was named ACLEDA Bank Plc. Since then, it has been able to dramatically increase its outreach to reach larger numbers of unserved and underserved individuals in Cambodia. From serving approximately 98,000 active clients with an outstanding portfolio of $40 million in 2003, today ACLEDA serves a total of 440,000 active borrowers with an outstanding portfolio of just under $3 billion. It also serves a total of 1.6 million depositors with a value of deposits equal to $2.7 billion.



Source: https://www.acledabank.com.kh/kh/eng/ff_history

Data from MixMarket

Aligning Incentives for NGO Founders and Managers

Management Capacity

As organizations grow, the skills needed to effectively manage them change. As MFIs evolve from small endeavors to more complex structures, managers' skillsets should grow in complexity and nuance. For example, the human resource skills needed to manage 30 or 40 employees differs from those needed to manage an organization with several hundred employees. The same can be said for financial management and information technology, or almost any other functional area of an MFI.

This becomes even more evident during transformation, especially if the new company will be prudentially regulated. Beyond additional reporting requirements, a prudentially regulated institution would demand, seemingly overnight, a higher level of competence and expertise in departments such as treasury, legal, information technology, audit, and administration, as well as from the CEO and board. Banking laws in some countries may require a CEO with banking experience, a requirement which the NGO manager may not fulfill. Even where this is not a requirement, transforming into a prudentially regulated institution may require skills, experience or an ability to dispassionately distance oneself from the institution, which the individual who built the NGO may not have or be able to do. For example, a general manager who is attached to the way things used to be may not adapt to the way things must be moving forward.

In the case of a transformation into a non-prudentially regulated entity, the change in requirements will be more gradual and for the most part a function of the speed of growth of the institution. Thus, the existing general manager may be the right person to carry the institution forward post-transformation, but an honest conversation about their role post-transformation can align stakeholder interests and prevent misunderstandings. Any discussion of a general manager's or senior staff member's future after transformation must also assess their abilities and desire to continue to lead the institution.

Given that the NGO's success is owed in large part to its general manager, it may in fact be more beneficial for them to continue to lead the institution. While it is still advisable to carefully appraise the NGO's general manager, in many cases their skills and experience are transferable to the share-capital company, especially with additional training in the areas that may be new to them, such as how fit-and-proper boards function. Furthermore, staff already know and may be loyal to the manager, and, equally important, the manager will likely strive to preserve the institution's mission.

However, while founders and managers of microfinance NGOs may acknowledge the financial and business gains from a transformation, they may struggle to support such a decision for personal reasons. In many cases, managers and founders love their institution, and have made personal sacrifices, both financial and social, for the sake of the MFI. They have most likely created and fostered the institution, spent countless hours anguishing over it, and derived enormous satisfaction from their labors. Staff have become like family, and clients like friends. For the general manager, the MFI is a calling, a source of deep pride and esteem within his or her local community.

NGO managers also often receive salaries that are below the market for their positions. If the manager is lucky, there is a pension, but in many cases managers have had to cut their own pensions for the sake of the institution. Such sacrifices are deemed acceptable when the MFI is not-for-profit, but not so much after transformation to for-profit. Questions linger, such as whether they will be compensated for past contributions ("sweat equity") and whether they will be able to share in future profits.

If the general manager or other senior staff wish to not stay on with the transformed entity, their know-how will undoubtedly be useful to the institution in a different role. The new CEO may need guidance early on, and the former NGO manager could prove vital to the new CEO's success post-transformation. Their knowledge may be passed on through a paid advisory role to the new CEO for one to two years. Or, in lieu of an advisor position, general managers can also stay on with the NGO and represent it on the for-profit MFI's board, often as chair of the board with a large influence on the MFI's direction.

Whether the general manager and senior staff take on different roles, stay with the NGO, or leave altogether, the replacement process must be transparent, and with proper incentives and severance packages to thank and reward the CEO and/or senior staff for their time and sacrifices, as well as to ensure a smooth transition. Still, a one-time severance package might not be enough, as this does not permit the former general manager to share in future profits that will come as a result of his or her efforts. Thus, profit-sharing schemes may also be included in the severance package. If the MFI chooses to offer an ESOP, the former general manager can participate in the expected upside as well. This can be done either as an individual or as part of an employee association, depending on the rules of the association and the general manager's role post-transformation. This issue is discussed further in Annex 1 of this paper.

Compensating Past Sweat Equity and Future Profits

An MFI looking to transform is usually doing so not because it needs a lifeline, but because of its own success. It has reached a point at which, to continue growing, it needs a different structure. Its past success rested on both tangible and intangible sacrifices and hard work. Founders, managers, and staff vital to the MFI's success story may rightly expect some recognition and financial compensation. Additionally, now that the MFI will turn a profit, there is an opportunity for a profit-sharing scheme that can both compensate for sweat equity in the past, and align incentives between staff and the institution in the future.

The most clear-cut way to compensate staff for their sweat equity is with a one-time bonus. Beyond this, pay raises that bring the staff to levels that are at market or above market levels can also be seen as compensation (though some may argue that a for-profit MFI should be paying market salaries anyway). Another option is recurring, annual bonuses based on individual and institutional performance.

A more direct way to share in future profits is with an ESOP, which can be used to compensate for past sweat equity by awarding a slice of future profits, or to further align staff and investor interests, or both.

Rewarding Sweat Equity – TRM-KIF, East Timor

An example of an ESOP designed to reward only past sweat equity comes from Tuba Rae Metin (TRM), which got its start as a Catholic Relief Services (CRS) project in the nascent, war-torn country of East Timor in 2002. After a civil crisis in 2006, CRS was forced to leave the country at that point, faced with the prospect of having to close the operation, TRM's staff, under the leadership of the CEO, chose to take over the institution and continue to operate TRM without any support from CRS. To survive the difficult years that followed, the institution adopted a culture of extreme austerity, and took measures such as cutting all staff salaries, including management's, to half of their previous amount.

In reaction to legislation that requires NGO-MFIs that mobilize over $500,000 in deposits to transform into an Other Deposit-taking Institution (ODTI), TRM initiated a comprehensive strengthening of its operations, with the support of technical assistance from the IFC among others, especially in areas such as MIS, operations, and finance. Despite facing a difficult business environment, by 2014 TRM was poised to transform into a deposit-taking institution.

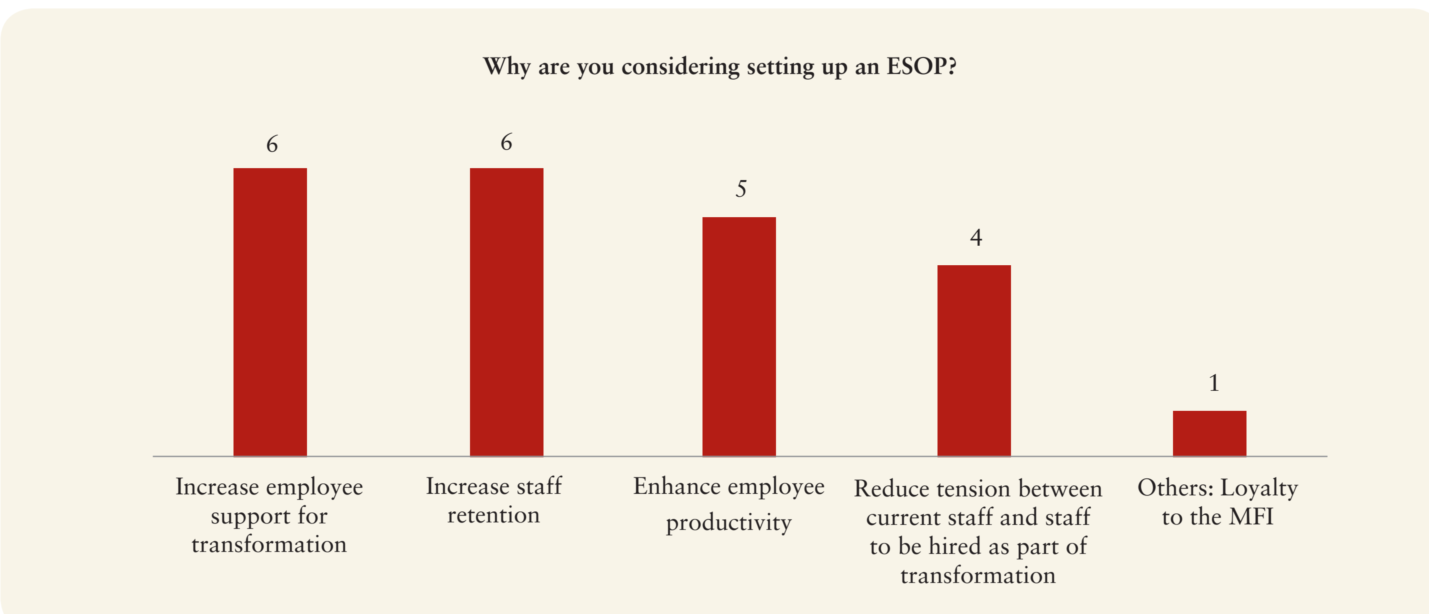
The NGO and two international backers felt that the time was ripe for TRM to reward the sacrifice and dedication of employees who refused to let the institution fail despite extreme external pressures, as well as create an incentive to retain highly-skilled employees in a market hungry for qualified employees. In 2016, a holding company was established to aggregate 77 employees' shares in the new, regulated MFI's stock. 12.5% of equity was granted to the employees' association at a preferential, book value, with no right to a vote. While employees as high on the organization chart as the CEO and as low as a driver were offered shares, not all employees received shares. Thus, TRM-KIF had to address the concerns of employees left out of the ESOP, which they did through an education campaign explaining what was being offered, to whom, and why.

"[Management] did what I thought was a very good job in communicating what an ESOP is, who was chosen, and why. It was very transparent and clear, and easier to understand than the policy statements I've seen implemented elsewhere."

– Christian Andersen, BOPA Microfinance

ESOPs incur costs and have their own challenges. While a significant number of MFIs across the globe have chosen to offer them, this number is still a minority. Nonetheless, the topic remains interesting for Arab MFIs that have begun to discuss, though not yet implement, ESOPs. Of the 20 MFIs in the Arab World surveyed by IFC and Sanabel, 50% would consider setting up an ESOP when they transform, of which more than half say they would do so to increase employee buy-in at the time of transformation, and/or to retain staff.

Figure 6: Some Insights from Regional Surveys



For this reason, in Annex 1 of this paper we have included a more in-depth discussion of ESOPs for MFIs curious to learn more. That said, ESOPs are in no way key to transformation and may not be for every institution.

Concluding Remarks

Any assessment of whether or not an MFI is ready to transform must weigh the pros and cons individually for themselves. The pros have long been well known to industry practitioners: greater capital that leads to economies of scale and promotes outreach; improved financial leverage; additional funds to invest in operational efficiencies; greater institutional legitimacy and recognition; and, in some cases and regulation permitting, a broader product suite.

However, after a few decades of witnessing MFIs transform worldwide, the challenges are just as clear, such as how to preserve the mission, accommodate additional costs such as taxes, adapt to a new governance structure, and define the role of the NGO after transformation. Some of these challenges, such as cost, are purely financial and must be analyzed with cost-benefit analysis and estimates of growth and profitability in the future – particularly the improvement in operating efficiency associated with economies of scale. Other challenges are less quantifiable, harder to outline, and thus more difficult to address in a manner that feels satisfactory.

This paper has highlighted several cases of how MFIs in other regions have addressed these challenges and achieved satisfactory results. The careful selection of board members, investors, and new management is paramount when considering the preservation of the mission. The NGO can also play a critical role in preserving institutional culture by being empowered through the new for-profit MFI's board.

Such guidance notwithstanding, the institution itself is comprised of individuals who will inevitably have opinions and stakes in the transformation. Executive management and staff can derail the process if they are not convinced that the transformation benefits the MFI, its clients, or staff. While this may seem like a minor concern to manage during a tiring transformation process, it is critical to address it head-on.

Luckily many tools exist – new roles, generous severance packages, one-time bonuses, recurring annual bonuses, and ESOPs – for addressing staff concerns that range from losing out on profits made on the backs of their past labor (sweat equity) to losing their voice in shaping institutional direction (preserving the mission).

Of course, what has worked elsewhere may not necessarily be applicable in the Arab World. Nevertheless, the body of evidence is quite clear that to sustain growth, and thereby reach more clients, institutions need to access additional forms of funding. To do so, NGOs do not necessarily need to consider the daunting task of transforming into banks. Transformation can be a gradual process, in which the initial transformation is only into a for-profit company, owned by shareholders, but not prudentially regulated. In this way an NGO-MFI can chart its own course and make the best decisions for itself.

Annex 1: ESOPs

As discussed above, ESOPs can be a powerful tool for aligning the interests of management and investors, rewarding past sweat equity, sharing future profits, and sweetening buy-out packages of exiting general managers. Additionally, share ownership provides clear incentives to employees, both financially, in the form of dividends and share appreciation, and psychologically, by giving employees a sense of ownership and, if permitted, a role in the board's decision-making process. In fact, some MFIs have offered ESOPs even when not transforming, as a means of retaining talent.

Retaining Staff in a Competitive Market – Financiera Confianza, Peru

In 2006 Financiera Confianza in Peru was operating in an increasingly crowded and competitive market in which highly skilled employees (such as their own) were often poached by competitors. In response to market pressures, and in recognition of loyal staff's hard work and dedication, Confianza decided it needed to create additional incentives and compensation packages to retain and reward employees.

At the time, Confianza's founding NGO and major shareholder, SEPAR, preferred not to dilute its own shares, but it did want to participate in supporting the ESOP. The NGO and other investors agreed that Financiera would issue 10,300 Class C shares to executive and middle managers to buy and hold individually. As preferred stock, Class C shares did not imply a right to a vote at the board (except in the unusual case of insolvency or liquidation), but they did receive a premium on dividends (Class A share dividends plus 1%) and preference in dividend payouts.

Thus, while employees could not participate in the decision-making organ of the institution, they did benefit from higher dividends, and their compensation was directly tied to the performance of the institution whose success depended on them. In the end, nearly 60 people bought Class C shares, about half of them with financing from a minority shareholder in Confianza.

In 2011, when the institution was acquired by the BBVA Microfinance Foundation, the ESOP further aligned the interests of staff with those negotiating the acquisition to ensure a smooth transition. Although BBVA eventually bought all Class C shares, thereby dissolving the ESOP, they did so at a nice premium that rewarded staff handsomely.

When considering an ESOP, each MFI must decide for itself who will be invited to participate in an ESOP, be it by seniority (employees who have been with the company longer than a certain number of years), hierarchy (branch managers and their superiors), a combination of the two (branch managers and up who have been with the company a minimum number of years).

Another option is to make the ESOP open to all staff. In fact, 70% of survey respondents said they prefer this option, though a majority believe that the percentage of shares should be assigned based on seniority and hierarchy (as represented by salary). Granted, other investors may disagree on who is invited into the ESOP, or more importantly, how many total shares should go to employees. There is little consensus among respondents over what portion of shares should be made available to employees. In the table below, we summarize how our featured case studies and other MFIs assigned and rationed employee shares. Notice that in the case of Confianza, shareholders did not want to dilute their shares and instead chose to issue class C shares for middle and top-level managers to hold individually.[19]

According to the survey, MFIs in the Arab World believe that the most important factors to be considered when setting up an ESOP are as follows:

Figure 7: Some Insights from Regional Surveys

19 Class C shares are preferred stock that pay a premium on dividends, for example dividends plus 1%. Holders of class C shares do not have a right to a vote at the board (sometimes with an exception in the case of insolvency or liquidation). In the case of bankruptcy, class C shares are given preference in dividend payouts.

Most MFIs in the survey, including those who do not plan to transform or cannot transform because of regulations, believe that all employees should have the option to buy shares in the newly formed entity. In addition, it appears that the majority would be willing to allow staff to own somewhere between 5-15% of the shares, assigned based on seniority.

NGO	New MFI	Country	Year	ESOP % of shares	Purpose
TRM	KIF	East Timor	2016	12.5%	Sweat equity reward for 77 employees
ACLEDA	ACLEDA Bank	Cambodia	1999	19%**	Open to all employees
SEPAR	EDPYME Confianza*	Peru	2006	Issued Class C shares	Open to middle and top-level managers and their families
FINDESA	Banco Banex*	Nicaragua	2008	5%	Open to about 40 managers to generate greater loyalty and productivity
Equity NBFI	Equity Bank	Kenya	2005	5.5%^	Open to select employees either at a discount or through a grant
Kenya Rural Enterprise Program (K-Rep)	K-Rep Bank^^	Kenya	1999	10%	Awarded based on seniority and tenure. Each share bought by employee, matched with one share granted.

**Not a transformation*
***ESOP association held 25.89% as of June 8th, 2016*
^3.25% as of April 2017
^^Now rebranded as Sidian Bank

Employees can hold shares either individually or through a holding company or association. The latter is recommended because an association has its own governing body that oversees the transfer of shares among its members (who are employees of the MFI). An association has its own bookkeeping and governance structure, and can enforce ESOP rules more closely and effectively than if shares were held individually. An association can also provide liquidity for the illiquid shares of employees who are leaving the MFI or those who simply wish to sell. An association can either have cash designated for such a function, or, as in the case of ACLEDA, hold regular trading days whereby employees agree to buy and sell stock among themselves on a particular day.

ACLEDA Bank's management were keenly aware of employees' lack of capital to buy shares and addressed this issue by permitting ASA to buy shares at any time following a capital call, up to a maximum share ownership of total equity (just over 25% as of 2016). Every six months, ASA holds an open exchange and sets a price peg for any share exchanges in the following months. By acting as an internal exchange for ACLEDA's illiquid shares, ASA also provides liquidity for employees looking to sell or exit ASA. This mechanism allows the thousands of employees who participate in ASA to save and invest small amounts over time, then buy shares from ASA when their personal finances permit. In this way ASA can also buy unassigned stock (stock held in the name of the association) to later sell to incoming employees who wish to participate in the ESOP scheme. At other MFIs, staff must be selected in order to join, but the function of the association as a holder of unassigned stock functions similarly.

Forming an association has other advantages. When an employee does leave the company, whether they quit or were fired, they may be disgruntled, and such shareholders can be tricky to deal with at the board level, where other investors are looking to manage their investment and direct the future of the institution. Thus, the association is an appropriate place for disgruntled former employees and shareholders to make their voice heard and negotiate their exit. Associations also make the issue of governance easier: if an MFI's board decides to grant a vote to employees, the association has an internal system for appointing their representative.

For this reason, some argue that CEOs who are awarded shares should hold them individually, outside of the association, because CEOs within associations may unwittingly apply social pressure to be chosen as the association's board representative and mouthpiece, which creates conflicts of interest at the MFI's board level. Furthermore, at association meetings, other employees may not feel that they can speak freely if the CEO is present.

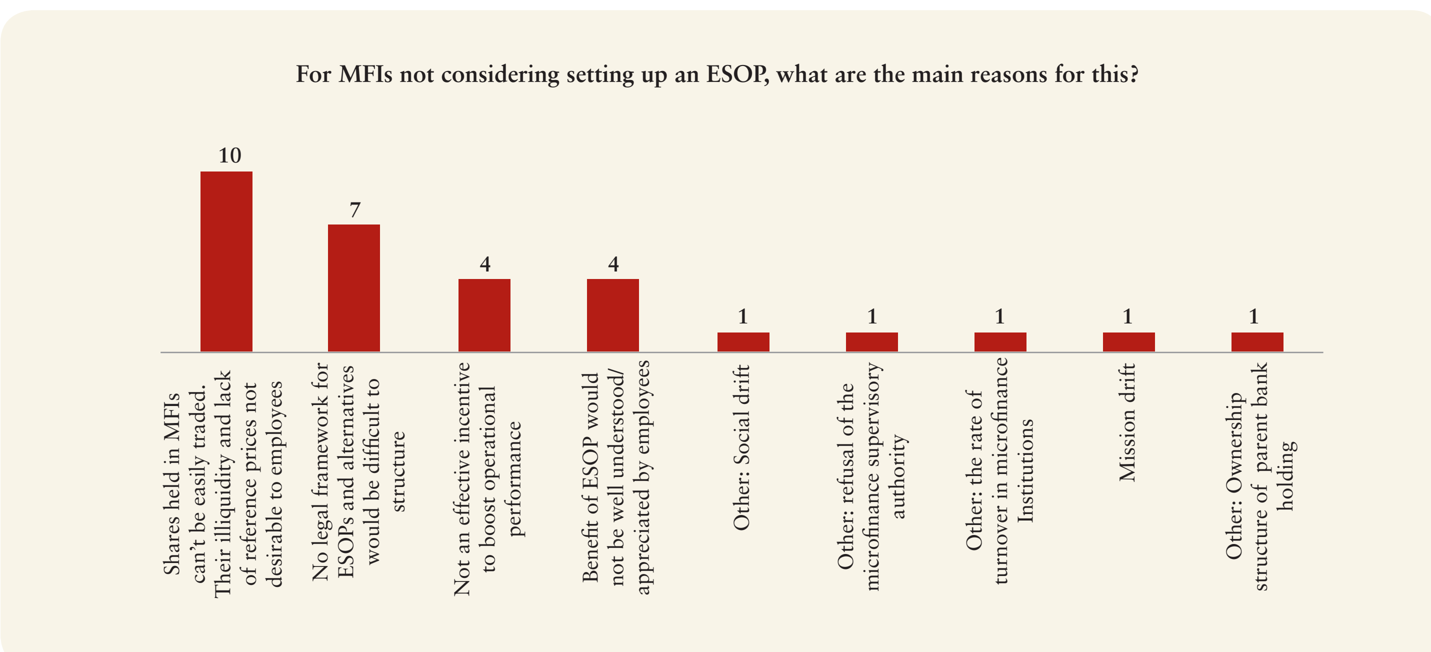
> *"If we did it over again, I would say that the CEO should not have been included in the holding company nor have been the general manager of the holding company as well. This presented a conflict of interest."*
> *–Carlo Peysack, former Chief Financial Officer of Banex*

However, opinions on this issue vary. If a former CEO holds shares individually, there could be conflicts of interest at general assembly meetings, or, if they ever leave the company, they may continue trying to exercise influence they should no longer have. Thus, a CEO who holds shares through an association benefits from the association as much as other staff. In the event that a CEO is included in the employee association, it is recommended that, to avoid conflicts of interest, they choose to forego being the association's representative on the MFI's board to avoid even the appearance of conflicts of interest.

Challenges of ESOPs

Establishing an ESOP is not without its challenges. Aside from the difficulty of assigning a percent of shares, and of deciding who should receive what, other issues arise once an ESOP has been defined, such as how employees will pay for their shares, or to whom they will sell them. MFIs in the Arab World that have opted not to establish an ESOP have noted some of these issues. The most important concerns they have are the difficulty of selling shares, the difficulty of structuring a legal framework for ESOPs, and the risk that employees may not comprehend the benefits of an ESOP.

Figure 8: Some Insights from Regional Surveys



Managers and Staff Have Little Capital to Buy Shares

While employees may be invited to buy stock in the company, they often lack the personal capital to do so. Thus, one question to address is who pays for that stock and at what price. Many investors want to see employees buy equity to demonstrate their commitment to the future of the institution. However, acknowledging that staff may be unable to pay out of pocket and that this is presented as a reward or compensation, investors and NGOs sometimes agree to a share-financing scheme.

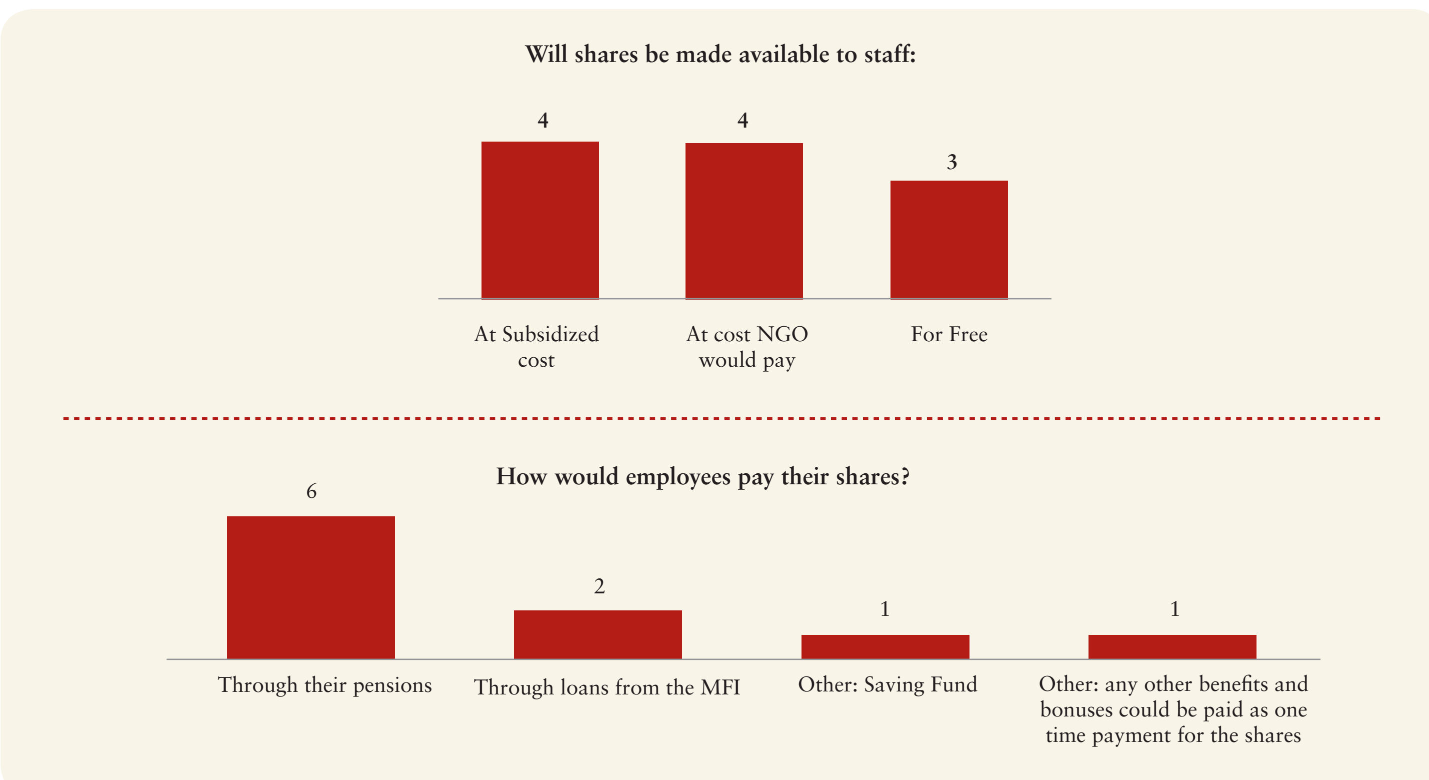
One common method is debt financing, whereby the NGO gives a loan to the ESOP association to purchase the shares, at a market or preferential share price, and then individuals buy shares from the association when they have saved enough money to do so. This was the case with ACLEDA, where the ACLEDA NGO provided a start-up loan to the ESOP association, ASA.

Alternatively, debt financing can go directly to the employee. For example, an NGO or another investor may offer individual loans to employees. The latter was the case with Confianza, where a minority shareholder in Confianza provided loans to middle and top managers to buy Class C shares. Whether acquiring debt or saving for shares, select employees may receive a bonus to help them cover the cost of shares (especially in recognition of their sweat equity).

If an NGO wishes to be more generous, it can also give the employee association a grant with which to buy the shares, as in the case of TRM. There, the NGO gave shares to a special group of staff members who had been with the institution a long time, at no cost to themselves, as a reward for all their sacrifices over the years. The association can then either sell shares or grant them to select employees, as agreed with the MFI's management.

Of the survey respondents, over 70% believed that employees should buy shares at a preferential rate, while a minority believed the shares should be given at no cost. For employees who do pay for their shares, 80% believed they should do so through either a pension or a loan.

Figure 9: Some Insights from Regional Surveys



Illiquidity of Shares

One reason why transforming MFIs might consider not setting up an ESOP is that in certain regions (including the Arab World) MFI shares may not be easily traded. Where this is the case, staff members who acquire shares might consider it of little value, instead of a privilege, even if the shares are offered at a discount. The inexistence of a secondary market makes it difficult to determine the correct market value. This could be especially true if a significant down-payment (or even full payment) is required from those chosen to participate.

The design of a successful ESOP should contemplate the appropriate and transparent discussion of benefits, as well as the risks associated with share ownership. Further, efforts should be made to enhance the shares' liquidity. To this effect, the employee association discussed above (the ACLEDA example in which designated trading days helped make the market for buyers and sellers) could prove a valuable tool. The MFI's NGO (or other investors interested in doing so) could provide for the association to have adequate liquidity through a financing scheme, such as a loan. With this liquidity, the association can buy the shares of staff members wishing to sell. This is especially important in the case of employees who express their intention to sell upon termination of their employment. Shares acquired by the association can then be held as an investment, and/or sold to other staff members (existing and/or qualifying newcomers).

Option Pricing Example

The price of shares can be pre-determined as a function of factors established by the association itself – for example, a fixed multiple of the MFI share's book value, such as 1.2 or 1.5 times the book value. When the auditor prepares the annual financial statements, he or she can also be asked to calculate book value. Once published, that would be the prevailing reference price for the remainder of the year. Given that book value is a function of an institution's profits, the greater the profit, the higher the price of shares.

Costs

Perhaps the most serious disadvantage of establishing an ESOP is the high implementation cost associated with it. These costs include valuation expenses, custodian fees, and the cost of organizing a trading platform. Unless the MFI is listed on the stock market, these costs may make the design and implementation of ESOPs impractical.[20] Each MFI must determine for itself whether or not the benefits of an ESOP outweigh the costs.

Risk of Owning Company Stock as an Employee

While many regard ESOPs as effective mechanisms for motivating and compensating staff, ESOPS can result in increasing the individual risks of employees. All staff members face a risk to their incomes if the MFI fails or files for bankruptcy. The risk position of employees may be even greater if they have invested some or all of their assets in the MFI, given that shareholders typically only get money out of a bankrupt company once all other claims have been paid out. In most cases, shareholders receive nothing.[21] Thus, compared to other shareholders, employees in an ESOP scheme in the event of bankruptcy lose both their investment and their jobs. Furthermore, when compared to other shareholders, they are the least likely to be experienced with equity investments. Thus, financial education for staff on ESOPs and shareholding more generally is paramount. Once again, an ESOP staff association can play an instrumental role in safeguarding staff's interests and providing education and advice.

20 Holtmann, M. (March 2008). "Owning a Piece of the Pie: Understanding Employee Stock Ownership Plans." *Microfinance Insights*, 41-43.

21 Holtmann, M., & Grammling, M. (2005). "Designing and Implementing Staff Incentive Schemes." Microsave.

Limited Improvement in Short-term Staff Performance

Long-term incentives based on institutional performance, such as ESOPs, do have a notable role to play in ensuring staff commitment. However, their impact on short-term goals tends to be very limited. An employee will likely not be motivated to recover a loan in arrears simply to marginally boost the value of his or her shares in the company. For this reason, it is important to note that ESOPs should be complemented with effective incentive schemes to motivate staff. In fact, ESOPs might be a more useful tool for employees who are responsible for multiple, complex and long-term tasks that are difficult to operationalize and evaluate.[22]

To summarize, ESOPs are a particularly elegant solution for aligning incentives, and can take many forms and be customized to meet an MFI's unique needs. For example, ESOPs can be granted in perpetuity, as in the case of ACLEDA, or for a limited time, as in the case of TRM-KIF. Employees can hold shares either individually, as with Confianza, or as part of an association, as with ACLEDA. ESOPs may be open to either all employees or employees selected based on factors such as tenure or seniority. In countries where no market exists to value an MFI's shares, the MFI may develop its own valuation method for employees. ESOP associations can also provide liquidity by allowing the buying and selling shares among staff approved to participate in the scheme.

Despite this flexibility, the costs in terms of money and time make ESOPs a challenging tool to implement, which involve many legal and financial challenges that need to be resolved through lawyers and advisors. Thus, an institution that elects to offer an ESOP must do so with eyes wide open, and make an honest assessment of whether it can accommodate the heavy costs and administrative demands of an ESOP in its early set-up phase. If so, the benefits will be reaped for years to come.

22 Holtmann, M. (March 2008). "Owning a Piece of the Pie: Understanding Employee Stock Ownership Plans." Microfinance Insights, 41-43.

Annex 2: Survey Methodology and Respondents

Survey Methodology

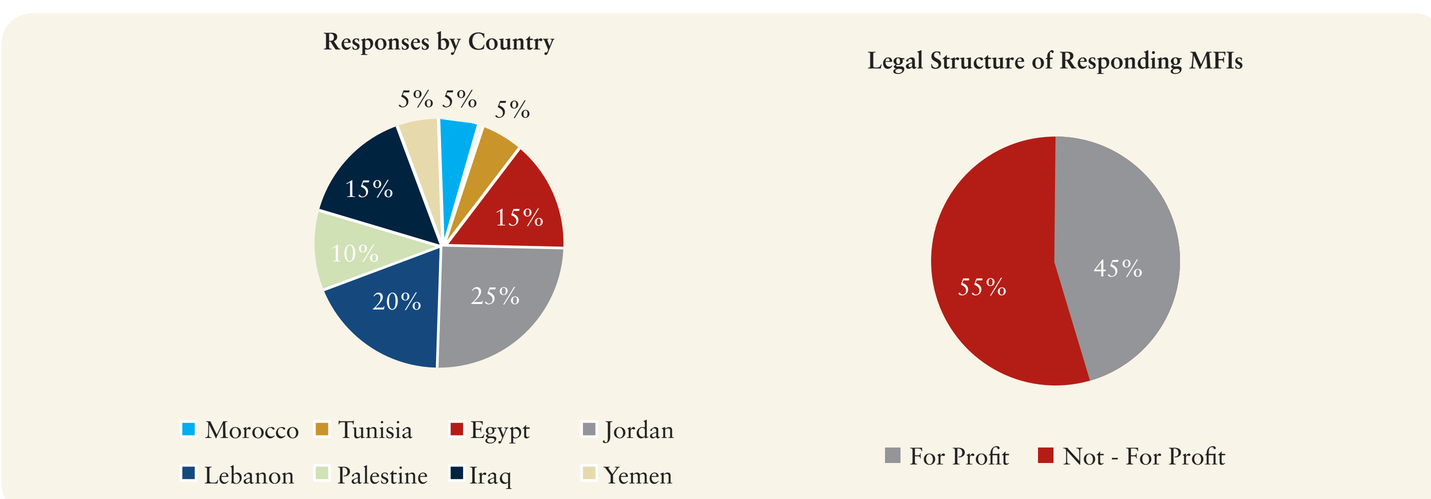
The findings of this report are based on a survey conducted by IFC and Sanabel in March 2017 designed to better understand where MFIs in the Arab World currently stand along the transformation process and what are their views on setting up Employee Stock Ownership Plans as they transform. The survey was sent to a select number of MFIs via email and was composed of two main sections. The first section was designed to collect background information on the responding institutions, particularly with regards to their legal structure and their plans to transform. The second section was addressed to MFIs who have already transformed or are considering transformation to understand how they would set up ESOPs in their institution, if a decision is taken to do so.

In addition to the survey, the authors have benefitted from multiple conversations with the leaders of many of the responding MFIs, as well as from a thorough literature review documenting MFI's experiences with ESOPs globally.

Profile of Respondents

The survey was sent to a select group of MFIs, who are either the leading MFIs in their countries or have already expressed interest in transformation. Responses were received from 20 different institutions operating in eight Arab countries, with a slight preponderance in Jordan and Lebanon.[23] In terms of legal structure, 55% of the responding MFIs are currently not-for-profit and 45% are for-profit. Of the not-for-profits, 73% operate in a regulatory environment that allows for transformation.

Figure 10: Some Insights from Regional Surveys



23 While this may not seem like a large number of responses, these 20 MFIs combined serve more than 75% of the region's active borrowers, so we can consider this sample to be representative.

Responding MFIs	
Country	**MFI Name**
Morocco	Al Amana
Tunisia	ENDA
Egypt	ABA
Egypt	DBACD
Egypt	Al Tadamun
Jordan	NMB
Jordan	MFW
Jordan	Tamweelcom
Jordan	FINCA
Jordan	AMC
Lebanon	Al Majmoua
Lebanon	Vitas
Lebanon	Emkan
Lebanon	Ibdaa
Palestine	FATEN
Palestine	Vitas
Iraq	Vitas
Iraq	Altheqa
Iraq	Izdiharona
Yemen	Al Kuraimi

Notes

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