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Transforming Microfinance Institutions

Providing Full Financial Services to the Poor

Joanna Ledgerwood
Victoria White

THE WORLD BANK

MicroFinance Network

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with contributions from
Monica Brand
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THE WORLD BANK

MicroFinance Network

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Foreword

The microfinance industry has seen impressive growth for longer than a decade yet still reaches only a small percentage of its potential market worldwide. How do we reach those still un-banked? What steps can we take to make microfinance available to more people and do so on a lasting basis and, as well, provide them with the financial services they need other than just credit?

Many paths have emerged in response to these questions, including the downscaling of commercial banks and the creation of start-up, for-profit microfinance institutions. However, one way, which has proven successful in many cases around the world, is through the transformation of nongovernmental microfinance providers into regulated deposit-taking financial institutions. These transformations have successfully taken place in Bolivia, Kenya, Uganda, Mongolia, Peru, and several other countries. Much has been published on these institutional success stories; however, to date there has not been a comprehensive guide to help lead nonprofit microfinance institutions (MFIs) through the transformation process.

What are the key questions an MFI must ask itself before even considering transformation? Where does one begin? How much will it be expected to cost? How will the organization change? What new challenges emerge when engaging in deposit-taking? What are the legal and regulatory requirements? Joanna Ledgerwood and Victoria White address these key questions, drawing from the experience of transformation in Uganda, bringing together the expertise of leaders from the field, the vast experience with transformation of the MicroFinance Network, and the valuable knowledge and resources of the World Bank. We are pleased to present this guide to help MFIs navigate through the challenging process of transformation.

With the publication of the *Microfinance Handbook: An Institutional and Financial Perspective* by Joanna Ledgerwood in 1998, the World Bank took a leading step in providing a comprehensive look at the world of microfinance, from providing an enabling regulatory framework, institutional capacity building, performance measuring and monitoring, and product design to effective management of microfinance institutions. The *Handbook* has been a key source of knowledge and a dominant training resource in microfinance worldwide for the last

eight years. Today, the World Bank continues to strongly support the development of financial systems that better serve the poor, within which transformed, regulated MFIs have a central place.

Since its inception in 1993, the MicroFinance Network[1] has provided a forum where the most advanced microfinance institutions can convene to engage in high-level discussions that allow them to learn from each other's experiences. The MicroFinance Network has been at the forefront of advancing the idea of transformation in microfinance as a way to reach greater scale and ensure permanence in the industry. From the beginning, network members shared the idea that financial principles applied by sound financial institutions would be the strongest foundation for growth in microfinance. Permanence in the industry became possible through the application of these principles–what we came to call the financial systems approach. With these guiding principles, many of the leading providers around the world today are members of the MicroFinance Network. Transformation has been one key way to create financial viability and scale, and to establish permanent sources of funding for microfinance institutions. The MicroFinance Network is committed to expanding the possibilities of microfinance, inspired by its pioneer members.

We believe that nonprofit institutions that transform themselves into regulated microfinance institutions will be central players in the efforts to scale up microfinance and address poverty at a global level. As more nonprofit MFIs around the world seek to establish greater permanence in their markets, wish to offer deposits and other important financial services to their clients, and seek to achieve greater penetration in their markets, we hope this guide will serve as a starting point and companion tool for helping all those involved—practitioners, policy makers, donors, regulators, investors, and technical assistance providers—through the process of transformation.

Marilou Uy
Director, Financial Sector Operations
and Policy Department
The World Bank

Maria Otero
Chair, MicroFinance Network (1995–2005)

[1] The MicroFinance Network is a global association of institutions committed to improving the quality of life of the poor through the provision of credit, savings, and other financial services. The members of the network believe in the establishment of sustainable and profitable institutions that operate on commercial principles and serve large numbers of clients who are not currently served by traditional financial institutions. The network's aim is to promote microfinance institutions that embrace a commercial strategy as a means to achieve social goals in a sustainable way and to influence the microfinance community and financial system to incorporate these double bottom line values. (See http://www.mfnetwork.org)

Acknowledgments

The inspiration for this book came from our individual experiences in the Ugandan microfinance industry and was motivated by what we saw as a need for a comprehensive guide for MFIs seeking to become regulated deposit-taking intermediaries. At the same time, the MicroFinance Network received a growing number of requests from around the world for such guidelines. These parallel interests converged in 2003 with the "transformation book project," made possible with the generous financial support of the Swedish International Development Cooperation Agency (Sida).

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He started his career as desk officer for financial systems and private sector development at the German Ministry for Economic Co-operation and Development. He was a member of the German Delegation at CGAP for several years. Dr. Hannig wrote his Ph.D. dissertation on financial sector reform in Bolivia and has published several books and papers on development finance covering microfinance (regulation and supervision, microsavings) and rural finance.

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Marguerite S. Robinson received her B.A. and Ph.D. degrees from Harvard University and served as Professor of Anthropology and Dean of the College of Arts and Sciences at Brandeis University before joining the Harvard Institute for International Development (1978–2000). She is now an independent consultant.

Dr. Robinson has worked extensively in Asia, in rural and tribal areas and among the urban poor. She served for many years as adviser to the Indonesian Minster of Finance and to Bank Rakyat Indonesia (BRI) on the development of BRI's microbanking system—now the largest financially self-sufficient microfinance system in the world. She also works in other countries in Asia, and in Africa and Latin America, advising governments, banks, donors, and others, and is the author of many papers and books on development and microfinance. Her most recent books are the first two volumes of a four-volume book, *The Microfinance Revolution,* published by the World Bank and Open Society Institute; two additional volumes are in progress. These volumes explore and analyze the demand for microfinance and the history, theories, controversies, practices, and future of the emerging commercial microfinance industry in countries and institutions around the world.

Introduction

> *The difference between transformation by accident and transformation by a system is like the difference between lightning and a lamp. Both give illumination, but one is dangerous and unreliable, while the other is relatively safe, directed, available.*
>
> —Ferguson and Naisbitt 1987, p. 85

Well over a decade ago, Promotion and Development of Microenterprises (PRODEM) created the first regulated financial institution dedicated to microfinance, BancoSol. This single event changed the way in which microfinance was viewed, revealing new possibilities for other microfinance nongovernmental organizations (NGOs) and sparking great debate within the microfinance community. "Transformation" and "commercialization" are today part of the microfinance lexicon, reflecting a shift in the industry's focus from microfinance as a social movement to the integration of microfinance into the formal financial sector. In fact, the *financial systems approach*,[1] while not embraced by all stakeholders, is widely viewed as the best way to achieve the outreach needed to substantially increase access to financial services for the world's hundreds of millions of low-income households. Stemming from the experience of BancoSol, the financial systems approach has been demonstrated to facilitate the creation of sustainable and growing financial institutions.

Much has been learned since PRODEM first created BancoSol (box I.1), and numerous NGO transformations have occurred around the world. This book draws from these lessons and looks specifically at the issue of transforming from a credit-focused microfinance institution (MFI) to a regulated deposit-taking financial intermediary. Because of the authors' familiarity with Uganda and the passage of the Uganda Micro Finance Deposit-Taking Institutions (MDI) Act in 2003, the book frequently draws on transformation experiences in this East African country.

Commercialization and Transformation

The terms *commercialization* and *transformation* are frequently used interchangeably; however, transformation is only one of the ways an MFI can commercialize.

Box I.1 PRODEM: A Transformation Pioneer

The NGO PRODEM was created in 1986 as a joint venture between Bolivian business leaders and ACCION International, a U.S.-based NGO. Its lending operations grew rapidly and by 1989 the size of PRODEM's portfolio began to exceed the available donor funds. Donor funds that took a year to acquire were disbursed in three weeks, leaving the institution with a continual need for new funding. By year-end 1991, PRODEM was serving over 22,000 active clients with an outstanding loan book of U.S.$4.5 million. Unable to offer its clients savings services and restricted from accessing commercial funds to fund its expansion, PRODEM's leadership decided to pursue a commercial bank license.

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

Today, BancoSol is one of the most successful banks in Bolivia. Since 1992, BancoSol has served over 650,000 clients and has strived to balance being a successful private commercial bank with maintaining a strong social focus. With 14 different products, the bank provides the most complete range of services compared to national competitors. Despite an increase in nonperforming loans in 2003–04 caused by a general economic crisis, BancoSol was ranked the best bank in Bolivia in 2004 by *Semanario Nueva Economia*, a leading Bolivian publication specializing in economic subjects. It has listed BancoSol as one of the top three financial institutions for the past eight years as measured by liquidity, solvency, and capital adequacy.

In 2000, PRODEM, the original NGO that created BancoSol, launched a second transformation, becoming a regulated Private Financial Fund, a legal form not available when BancoSol was created. PRODEM FFP has steadily grown and now operates 82 branches across Bolivia, offering both individual and solidarity group loans for working capital and investments. In addition, PRODEM FFP offers a wide range of deposit services, national and international money transfer services, life insurance products, foreign exchange services, service payments, payroll services, and cash advances.

Widely known for its cutting-edge innovations, PRODEM FFP has succeeded in consolidating its rural network with the use of 58 intelligent automated teller machines (ATMs) that use color-coded touch screen menus and a walk-through voice system in Spanish, Quechua, and Aymara, the three main languages spoken in Bolivia. Clients use intelligent debit cards with an electronic chip containing the client's savings account record, which is updated as the client deposits or withdraws cash. To safeguard transactions, the ATM verifies the client's identity by means of biometrics. PRODEM FFP has demonstrated that it is possible to succeed as a regulated entity with competitive market prices for financial products and services, in urban as well as rural areas.

Sources: Bazoberry 2003; Rhyne 2001; interviews with Eduardo Bazoberry, CEO, PRODEM FFP; and Kurt Koenigsfest, General Manager, BancoSol, October 2005.

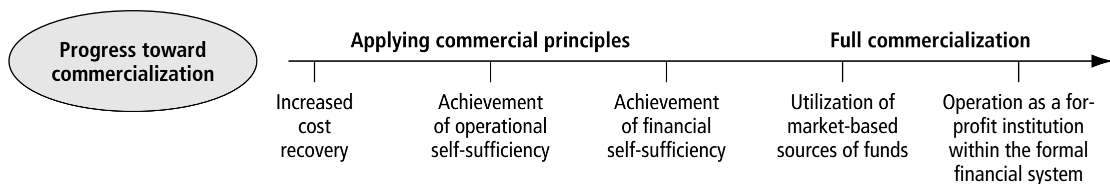
Commercialization

Commercialization of microfinance generally refers to the application of market-based principles and to the "movement out of the heavily donor-dependent arena of subsidized operations into one in which microfinance institutions 'manage on a business basis' as part of the regulated financial system" (Christen and Drake 2002, p. 4). "In [commercialization] lies the potential for truly exponential growth and ultimately, vastly improved financial services to the poor. Competition for microenterprise clients will improve product design, delivery

systems, and perhaps even outreach" (Christen and Drake 2002, p. 19). Commercialization also includes linking MFIs with commercial sources of funds, both debt and equity. This "linking" is driven by the belief that massive outreach will only be achieved when the sector can access truly commercial financial markets. See figure I.1.

An MFI can commercialize in a number of ways. One is to transform a nonprofit entity into a formalized, regulated financial institution that can, if so licensed, intermediate deposits from the public. This model is one of the prevailing methods for commercializing MFIs throughout the world and is the focus of this book. A second is to create a commercial MFI from scratch. Many of the MFIs in Eastern Europe, particularly the microbanks started by the German firm Internationale Projekt Consult (IPC) GmbH, were created this way, bypassing the more common approach of starting as a nonprofit and then converting into a share company. A third path to commercialization in microfinance is for traditional banks to become involved in microfinance. For example, Sogebank in Haiti created a subsidiary, Sogesol, to enter the microfinance market. Operating as a service company to the bank, Sogesol uses the existing branch network of the larger bank to conduct its microfinance operations. This model has shown to be cost-effective, particularly with regard to start-up costs. The "downscaling" approach also includes large banks that develop a specialized unit or division within the bank to focus on microfinance, as in the case of the BRI-Unit Desa created within the larger Bank Rakyat Indonesia (BRI). Finally, MFIs can merge—for example, XacBank in Mongolia was created in October 2001 from the merger of two existing nonbank financial institutions (box I.2).

Figure I.1 Path toward Commercialization



Source: Charitonenko 2003.

Box I.2 XacBank: Merger and Transformation

The Golden Fund for Development (X.A.C. Co Ltd.) was formed in 1998 as a microfinance provider by six local NGOs, with funding from the United Nations Development Programme. It was the first licensed nonbank financial institution (NBFI) in Mongolia. Goviin Ekhel LLC (GE) was founded by Mercy Corps with United States Agency for International Development and United States Department of Agriculture funding in November 1999 to provide small and medium enterprise loans in the Gobi region. It transformed into an NBFI in March 2000.

Operating in different parts of the country and with different lending technologies (cash flow for GE and asset based for X.A.C.), the two programs were the leading NBFIs in their respective markets. In October 2001, the two institutions merged to create XacBank. The rationale for merger was compelling—in addition to gaining access to each other's branch networks and products, the combined entity was able to meet the minimum capital requirement for a full commercial banking license, which was received on December 27, 2001.

Source: MIX Market data XacBank 2005; personal communication with Munhmandah.O, XacBank, January 2006.

Transformation

Transformation in the microfinance industry generally refers to 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 as did Microenterprise Development Fund-Kamurj in Armenia (box I.3).

Box I.3 Transformation in Armenia

The nonprofit organization Microenterprise Development Fund-Kamurj ("bridge" in Armenian) provides small loans in support of microentrepreneurship. The goal of MDF-Kamurj is to build a bridge to greater financial security for Armenian families. MDF-Kamurj emerged by joining the efforts and resources of two microfinance projects created in 1998 by Catholic Relief Services (with an investment fund of U.S.$190,000) and Save the Children Federation U.S. (with an investment fund of U.S.$280,000). These programs merged operations in September 2000 to create one professional local institution that clients could rely on in the long term. The transformation resulted in synergies and economies of scale, and expanded the geographic outreach necessary to achieve financial sustainability. By joining the technical and monetary resources of the two organizations, consolidating overhead expenses, and improving economies of scale for training and capacity development, MDF-Kamurj is constantly increasing its efficiency and scale and paving the way for long-term sustainability.

Source: MDF-Kamurj 2005. Web site http://www.mdf-kamurj.am/aboutus.htm.

For the purposes of this book, transformation is defined as *the process of a credit-focused MFI (either an NGO or a project) creating or becoming a regulated deposit-taking financial intermediary.* An *intermediary* is an institution that mobilizes deposits and then on-lends these deposits to its borrowing clients. It is important to highlight that this book focuses on deposit-taking institutions and thus addresses the two crucial aspects of financial intermediation:

1. The need for a sound and reasonable regulatory environment and capable supervision by the central bank or relevant regulatory authority
2. The institutional capacity and culture required to be a true financial intermediary taking deposits from the public, on-lending these deposits, and in doing so, complying with regulations and being supervised by a regulatory body

Regulation and Supervision

The existence of an appropriate and enabling regulatory and supervisory environment is critical to the success of MFI transformations. The Consultative Group to Assist the Poor's (CGAP's) 2003 "Microfinance Consensus Guidelines: Guiding Principles on Regulation and Supervision of Microfinance" defines *regulation* as the "binding rules governing the conduct of legal entities and individuals, whether they are adopted by a legislative body (laws) or an executive body (regulations)" and *supervision* as the "external oversight aimed at determining and enforcing compliance with regulation" (CGAP 2003, p. 6). Simply put, regulations are a set of rules to govern financial operations while supervision ensures compliance with those rules.

As microfinance has continued to grow, financial regulators have come to realize that most current policy frameworks need to be adapted to regulate

and supervise microfinance activities. They often see the need to "develop a framework of policy and eventually to integrate some portion of the microfinance spectrum into the framework of regulated financial services institutions" (Meagher 2002, p. 1). De Sousa-Shields and Frankiewicz found lack of appropriate regulation to be a significant barrier to offering savings services[2]:

> In 2000, the MIX [Microfinance Information eXchange] Market listed only 25 MFIs offering savings services. By 2003, the number had grown to 90. Still, some MFIs do not take deposits because they cannot meet the regulatory requirements to do so, or because appropriate regulatory regimes do not exist. A recent CGAP survey of MFI funding issues showed almost all financial institutions, regardless of type and region, believed regulatory barriers were, after funding, the greatest challenge to growth. Much of this concern focused on lack of suitable deposit regulatory regimes. (de Sousa-Shields and Frankiewicz 2004, p. 37)

The larger question is which institutions should be regulated. It is generally accepted in the microfinance industry that MFIs focused on credit-only services do not need to be regulated. It is also generally agreed that regulation should be applied when institutions begin taking deposits. This *prudential* regulation governs the financial soundness of licensed intermediaries to prevent financial-system instability and losses to small, unsophisticated depositors. *Nonprudential* regulation focuses on anything other than protecting depositors' safety and the soundness of the financial sector as a whole (CGAP 2003). These other activities can include, for example, the formation and operation of microlending institutions; consumer protection; fraud and financial crimes prevention; credit information services; limitations on foreign ownership, management, and sources of capital; tax and accounting issues; and interest rate policies (Microfinance Gateway 2005).

Although there are many different approaches to regulating microfinance[3] the "tiered approach" is commonly employed by superintendents and central banks around the world. The basic premise is that tiers or "windows" are defined based on the products and services an institution offers. As an MFI reaches each threshold, it can offer more services and may have fewer or more restrictive regulations. See chapter 2, Regulation and Supervision: The Policy Framework, for more detailed discussion.

Many countries are just now tackling the question of when and how to regulate microfinance. For example, in Kenya, the current challenge faced by the government is how to manage MFI supervision and regulation when MFIs in Kenya are registered under eight different Acts of Parliament. To address this, Kenya is devising a tiered approach, recognizing the inappropriateness of the existing banking legislation for the regulation of specialized activities of microfinance and the diversity of the institutions engaged in the sector. Many other countries, particularly in Latin America, have had laws in place for many years. No matter how a country chooses to regulate the microfinance sector, the most important consideration after protecting depositors is that the regulatory framework foster innovation, competition, stability, and growth for MFIs.

Why Transform?

From an institutional perspective, the primary reasons MFIs choose to transform are to offer additional products and services (particularly savings) to their clients and to gain access to capital (both debt and equity), and in so doing, expand their outreach. Furthermore, transformation to a regulated deposit-taking financial intermediary generally results in an improved governance and ownership structure.

Provision of Savings Services and Other Products

The ability to offer savings services to clients is a primary reason MFIs choose to transform. Savings mobilization can increase the number of clients served, improve customer satisfaction and retention, improve loan repayment, stabilize sources of funds, and improve governance of the MFI. In most countries, regulatory policies prohibit unregulated financial institutions from taking deposits and thus it is necessary to become licensed as a deposit-taking institution (transform) before accepting deposits from the public and intermediating these deposits.[4]

In addition, savings services represent a critical component of any household's financial management strategy. In fact, it is often argued that providing access to savings services is a much more valuable service to poor people (including those not able to access credit either because of lack of debt capacity or poor product offerings by the MFI) than credit (box I.4). The path out of poverty lies in building assets, not accumulating debt. In addition, other services—specialized housing loans, money transfers, and microinsurance—are greatly valued by clients and may only be possible through licensed financial intermediaries.

Box I.4 XacBank: Provision of Savings Services

The leading driver behind the merger and transformation of X.A.C. Co. Ltd. and GE in Mongolia was the desire to offer savings products, which required a banking license. As of May 2005, XacBank offered seven deposit products for individuals and legal entities including demand deposits, time deposits, children's savings, long-term savings, and housing deposits. Credit products have been expanded to 15, including micro-enterprise loans (start-up and growth loans) and small and medium enterprise loans, leasing products, wholesale loans, mobile lending in villages, consumer loans, overdrafts, home improvement loans, employee loans, and mortgages. The bank also offers domestic and international money remittances and foreign currency exchange services, and has plans to issue the XacBank MasterCard to existing customers.

XacBank is now one of the largest banks in Mongolia, with 42,000 borrowing clients and 53,000 savings clients as of June 30, 2005. Its loan portfolio exceeded U.S.$24 million and its savings totaled U.S.$20 million.

Source: MIX Market data XacBank 2005; personal communication with Munhmandah. O, XacBank, January, 2006.

Access to Capital

The ability to source capital is a fundamental component for an institution to grow. An MFI must be able to meet continual demand for loans by new and existing clients. Relying on donor funding to meet capital needs is not sustainable given recent trends in donor funding and the recent unwillingness of donors in general to permanently fund the growing needs for loan capital. As donor funding becomes less available and clients continue demanding well-designed and delivered products with improved customer service, it is imperative that MFIs plan for long-term sustainability and client retention. This is not to suggest that all NGO MFIs need to transform, but it does indicate that over the long term, MFIs need to ensure a path toward sustainability as donors' priorities evolve and funding becomes less available. If NGO MFIs choose not to become licensed deposit-takers they will need to continually seek funding sources to grow their portfolios and inevitably will face limitations in the amount of donor funding and debt they can access.[5] Exceptions may exist for those MFIs serving special niche markets that donors may be willing to continue to subsidize, but overall donor funding is becoming more and more scarce, particularly for loan capital needs.

According to the Consultative Group to Assist the Poor (CGAP), the current combined portfolio of MFIs worldwide is

> approximately $U.S.15 billion. Microfinance is believed to be growing annually between 15 and 30 percent, translating into a demand of between $2.5 to $5.0 billion for portfolio capital and requiring $300 million to $400 million in additional equity each year. Non-commercial investors, including donors, bilateral and multilateral financial institutions, disburse approximately $400 million annually to the sector. They simply cannot provide the level of funding necessary to support the microfinance industry's demand for capital funds particularly since much of their support goes toward regulatory change, information services, sector associations and other sector development initiatives. Hence, it comes as no surprise that a CGAP survey of over 144 MFIs found funding to be the number one constraint to growth . . . (de Sousa Shields and Frankiewicz 2004, p. xiv)

Part of an MFI's desire to transform is to offer savings services not only as an additional service to clients, but also to fund a larger volume of loans and access a stable and potentially cheaper local source of funds. Access to capital, therefore, includes accessing client deposits, commercial or concessional debt, as well as equity sources. MFIs that have transformed have been able to access a significantly broader range of financing sources, thus greatly improving their ability to rapidly scale up operations by growing, deepening, and leveraging their equity bases. See box I.5.

Box I.5 Strategic Investors—AfriCap Microfinance Fund

The AfriCap Microfinance Fund's mission is to support the commercialization of the microfinance industry by bridging the transition from a sector traditionally funded by donors to a scenario where the leading MFIs are raising most of their funds from commercial sources, whether voluntary savings, wholesale deposits, interbank liquidity, or private investment capital. AfriCap invests in only a handful of institutions across Africa that it thinks have the potential to develop into demonstration models of successful commercial microfinance. The fund is designed to provide more than just capital to its investees, and expects to play an active, patient governance role over a reasonable time frame, given its 10-year life.

Source: AfriCap 2003.

Increased Outreach

The addition of new products and services as well as increased access to capital leads directly to increased outreach for transformed MFIs. In honoring their social mission, many MFIs decide to transform to extend their services to larger numbers of low-income clients who do not have access to financial services. With the ability to offer additional products, as well as being forced to operate efficiently to satisfy the new stakeholders, including regulators and shareholders, regulated deposit-taking institutions are generally able to compete better than unregulated MFIs and are thus able to increase market share and outreach.

In addition to the numerous other benefits of transformation that may not be explicitly identified as reasons to transform, becoming regulated generally results in increased professionalism and improved governance structures, leading to more permanent institutions. This benefits all stakeholders—most important, the clients who deserve continued access to a range of financial services that meet their needs.

As mentioned, transformation is not appropriate for all MFIs. Microfinance NGOs must consider their own long-term objectives and whether the economic environment and regulatory framework in a given country are conducive to transformation. Transformation requires a tremendous investment of time and financial resources and the commitment of management and staff (box I.6). This investment should be carefully measured against the

Box I.6 Transformation from Aga Khan Rural Support Programme to First MicroFinance Bank of Pakistan

Transformation of an NGO into a bank is not an easy task, and requires careful planning. Organizations looking for transformation must have a clear mandate in mind before taking the next step. First MicroFinance Bank of Pakistan (FMFB)'s experience suggests that transformation becomes easier if the organization is well prepared. The preparation phase can take months, if not years, but the outcome is promising.

The Aga Khan Rural Support Programme (AKRSP) has been operating an integrated development program in the remote northern areas of Pakistan since 1982. FMFB was established as a nonlisted public limited company under the provisions of AKRSP's ordinance (1984) in November 2001 and was licensed as an MFI in January 2002. The last phase of the transformation was completed in December 2003 with the settlement of AKRSP's final portfolio tranche.

Transformation brings more opportunities for an MFI for outreach, sustainability, efficiency, and customer satisfaction. Despite the challenges and difficulties, positive results of the transformation experienced by FMFB are

- Access to low-cost funds
- Enormous growth opportunities
- Wide branch network
- Increased outreach
- Introduction of a range of new products and services
- Widening of income stream
- Better trained staff
- Effective use of information communication technology
- Increased transparency
- Better customer service
- Effective portfolio management
- Social mobilization and public awareness
- Opening of new markets
- Increased innovation
- Better organization

Source: Personal communication with Tejany Hussain, CEO, First MicroFinance Bank of Pakistan, December 2005.

benefits. Depending on an MFI's particular internal or external constraints, transformation may not be suitable. In addition to initial transformation costs, in the short term, operating costs will also increase as the result of taxation, regulatory requirements, improved customer service, and so on. Finally, it is important to consider the regulatory environment in the country where the MFI is operating before transforming to a licensed, deposit-taking financial intermediary.

Global Perspective: Results to Date

Experience with transforming MFIs since the mid-1990s has been largely positive based on the performance and changes that have taken place in the majority of transformed institutions. As discussed in this section, transformed MFIs have indeed widened their product range to include savings services, enjoyed increased access to capital, and increased their outreach. These changes have had a positive effect on the institutions, which has in turn significantly benefited their clients.

Provision of Savings Services

MFIs that have transformed into deposit-taking financial intermediaries have fulfilled one of the main goals of transformation—to offer savings services to the public. The majority of transformed institutions in table I.1 offer numerous savings products, specialized loans, and other important financial services. Together the regulated, deposit-taking MFIs in the MicroFinance Network included in table I.1 are providing deposit services to over

Table I.1 Profile of Members of the MicroFinance Network (Deposit-Taking MFIs), December 2004

MFI	Country	Gross loan portfolio (U.S.$ millions)	Savings[a] (U.S.$ millions)	Number of active borrowers (thousands)	Number of savers (thousands)
ASA	Bangladesh	201.1	33.6	2,772.7	2,986.6
Banco ADEMI	Dominican Republic	72.2	39.2	25.6	48.6
Banco Los Andes ProCredit	Bolivia	113.8	71.2	64.7	53.8
BancoSol	Bolivia	108.7	81.2	71.6	61.9
BRAC	Bangladesh	243.1	0.5	3,993.5	27.2
BRI	Indonesia	1,953.4	3,347.4	3,210.7	31,271.6
CERUDEB	Uganda	44.6	77.7	52.7	402.7
EBS	Kenya	40.1	57.9	59.3	413.1
Finamerica	Colombia	27.8	18.3	24.4	2.3
FMFB–Pakistan	Pakistan	3.6	6.0	9.5	18.4
K-Rep Bank	Kenya	27.3	6.0	55.4	25.4
Mibanco	Peru	128.7	86.1	113.5	53.3
PRODEM FFP	Bolivia	86.6	61.0	55.9	119.5
XacBank	Mongolia	16.1	12.9	32.0	39.2
TOTAL		3,067.1	3,899.0	10,541.5	35,523.6

Source: MIX Market (http://www.mixmarket.org) and MFI self-reported data; exchange rates from http://www.oanda.com.
a. Represents voluntary deposits.

35 million clients. Aside from the few countries that allow unregulated MFIs to intermediate deposits, these services are generally not available to the clients of unregulated MFIs.

Access to Capital

There is no question that MFIs that have transformed from an NGO or project to a regulated deposit-taking institution have benefited from increased access to capital; however, the results have been somewhat mixed in terms of defining success. Although 8 of the 14 institutions in table I.1 report more depositors than borrowers, underscoring the importance of savings services for clients, the mobilization of savings has not always met the funding needs of a transformed institution.

A sample of 67 MIX Market–listed deposit-taking MFIs with a savings collection history of more than three years showed that a relatively small *average* deposit does not necessarily correlate with a low volume of savings. This observation is true for any size, age or location of MFI. Several West African *mutuels/caisses* and the Equity Building Society in Kenya are good examples of how small savings can be an effective and significant source of portfolio funding. MFIs in the same and other markets, however, have experienced difficulty mobilizing deposits in volumes sufficient to meet portfolio needs. XacBank in Mongolia, for example, wants to decrease dependence on large institutional deposits and collect more small, less expensive passbook

Table I.2 Funding Structures of Regulated Deposit-Taking Institutions, December 2004 *(percent)*

MFI	Transformation date	Public deposits	Loans from FIs/bonds	Other	Total liabilities	Total equity	Debt/ equity
BancoSol	1992	60	23	4	**87**	**13**	**6.41**
Banco Los Andes ProCredit	1995/2005[a]	52	32	5	**89**	**11**	**8.30**
FIE	1997	38	42	7	**88**	**12**	**7.11**
Mibanco	1998	55	17	4	**77**	**23**	**3.26**
K-Rep Bank	2000	51	5	16	**72**	**28**	**2.54**
PRODEM FFP	2000	57	29	5	**92**	**8**	**11.60**
ACLEDA Bank	2001/2004[a]	38	29	13	**80**	**20**	**3.89**
Compartamos	2000	n/a	58	2	**61**	**39**	**1.55**
XacBank	2002	50	33	2	**85**	**15**	**5.50**

Source: http://www.themix.org (represents data listed on MIX at December 2005 and includes ranges from 2001 to 2005 data); Superintendency of Banks and Financial Entities of Bolivia http://www.sbef.gov.bo; ACCION Quarterly Reports; http://www.xacbank.com; ACLEDA Bank Audited Financial Statements 2004; Compartamos Annual Report 2004

Note: FI = Financial institution. For a more complete breakdown of assets and liabilities of these institutions, please refer to table 6.8 in this book. Numbers may not be exact because of errors introduced by rounding.

a. First year is transformation to a regulated deposit-taking financial institution; second year is transformation to a commercial bank.

> and current account savers. . . . [However] an assessment of 15 Latin American credit unions (Richardson 2003) . . . concludes that deposits can be an attractive source of funds if a small number of large deposits cross-subsidize the administrative costs of many small savers. (de Sousa-Shields and Frankiewicz 2004, p. 38)

In addition to funding assets with deposits, transformation has resulted in increased access to debt and equity by regulated MFIs. "Estimates vary, but the bulk of the worldwide microfinance portfolio is currently funded by deposits (25 to 30 percent), debt (35 to 40 percent) and equity (30 to 40 percent)" (de Sousa-Shields and Frankiewicz 2004, p. xiv). On the basis of table I.2, it would appear, with a couple of exceptions, that regulated MFIs have somewhat higher levels of debt and deposits, with equity funding only 10 to 20 percent of assets rather than the estimated average of 35 to 40 percent. This indicates a fairly significant ability to increase leverage in transformed MFIs.

Although some transformed institutions, primarily in Latin America, have successfully tapped private capital markets for both debt and equity, to date most investors in transformed regulated financial institutions have been social or noncommercial investors. Regulated MFIs have a distinct advantage over nonregulated MFIs in accessing capital from noncommercial funders:

> [N]on-commercial sources of investment funds now tend to focus on larger and regulated institutions. Investments from publicly owned international funds, such as the IADB's Multilateral Investment Fund (MIF) or funding from the European Bank for Reconstruction and Development (EBRD), for example, are 88% concentrated in regulated MFIs, which are the institutions most able to attract private debt or equity capital. (de Sousa-Shields and Frankiewicz 2004, p. ix)

As of December 2005, a total of 71 investment funds were listed with the MIX, including 42 that make equity investments in MFIs. Representing close to U.S.$500 million in funding allocated to MFI investments, these funds were engaged in 1,800 active investments in MFIs. However, the vast majority of these funds come from international financial institutions, bilateral donors, and individual and institutional donors (MIX December 2005).

Part of the reason for the small percentage of private investments has been the lack of quality information, on both financial and social performance, available on MFIs. There also seems to be a continued lack of understanding regarding important issues particular to microfinance. Some investors are dissuaded by the high interest rates charged by MFIs, likely because they may not fully appreciate the rates charged by alternative sources of finance for the poor—moneylenders—or the need for MFIs to charge higher interest rates to cover high operating costs relative to loan sizes. Other barriers to investment in microfinance include a lack of knowledge about particular countries and their financial markets, a lack of sufficient foreign exchange hedging instruments (for foreign currency–denominated debt), and inadequate risk/return profiles. In addition, subsidized donor funding to profitable MFIs and adverse local regulations can also negatively affect investor decisions.

A key challenge moving forward is to increase the availability of diversified funding, especially private capital (in addition to deposits), to regulated MFIs. In countries with newly formed regulatory and supervisory frameworks, local investors are now able to make investments in different kinds of institutions and are beginning to appreciate the benefits of investing locally. Also, with the hope of attracting more investment capital to microfinance, various stakeholders, including donors, regulators, and practitioners, are addressing the need for transparency and quality reporting. In September 2003, CGAP published "Definitions of Selected Financial Terms, Ratios, and Adjustments for Microfinance" (CGAP 2003). The guide, aimed at producing a standard method for calculating basic financial ratios, was a result of the efforts of a cross-section of industry representatives. In addition, the Small Enterprise and Promotion Network published *Measuring Performance of Microfinance Institutions: A Framework for Reporting, Analysis, and Monitoring* in September 2005 (Bruett 2005). This guide, developed and agreed to by rating agencies and donors, looks to standardize financial reporting, performance monitoring, and financial adjustments, and includes detailed definitions of financial terms and explanations of how to construct financial statements and monitoring reports according to emerging global standards. Designed to accompany the guide, an Excel-based tool was also developed to be used by managers and advisers to track financial performance in a standardized format for up to three years.

In Uganda, all donors supporting microfinance agreed on a standard performance monitoring tool to be used by all MFIs for donor and management reporting (box I.7). In addition, this tool allows the Association of Microfinance Institutions of Uganda (AMFIU) to aggregate industry data and provide peer group comparisons within the industry without divulging any confidential information about individual MFIs.

Increased Outreach

Based on the results outlined in table I.3 the number of loan clients served has clearly increased, and savings clients have been added by transformed MFIs.

These numbers demonstrate a significant increase in clients served by the transformed MFIs. Aside from Corposol, which experienced a significant financial crisis in 1994, all MFIs in table I.3 have dramatically increased both the number of borrowers and their portfolios of outstanding loans, and have also added a significant number of deposit

Box I.7 Performance Monitoring—Local Initiatives

One example of a local initiative to standardize information is the Performance Monitoring Tool (PMT), developed jointly by donors, practitioners, and other stakeholders in the microfinance industry in Uganda. All MFIs and all donors active in microfinance in Uganda have agreed to use the PMT and thus have agreed on standard report formats, definitions for financial and outreach data, indicators for analysis, and ratio calculation methods. In addition, the national microfinance network in Uganda has developed a performance monitoring database for aggregating and monitoring all data from the submitted PMTs to provide investors, donors, government, and other stakeholders an overview of the outreach in the industry, allowing all stakeholders to better understand the microfinance landscape in Uganda and thus better direct their interventions and investments.

Source: Duval 2003.

Table I.3 Transformation Results: Outreach

	BancoSol	Finamerica	Banco Los Andes ProCredit	Banco ADEMI	Mibanco	K-Rep Bank
Founding NGO (Country)	PRODEM (Bolivia)	Corposol (Colombia)	Procredito (Bolivia)	ADEMI (Dominican Republic)	ACCION Comunitaria del Peru (Peru)	K-Rep (Kenya)
Date of transformation[a]	2/92	10/93	7/95; 1/05[b]	1/98	5/98	9/99
No. of active borrowers of NGO at transformation	22,743 (12/91)	32,022[b] (12/93)	12,662 (7/95)	18,000 (1/98)	32,000 (5/98)	13,201 (12/98)
No. of active borrowers of transformed institution as of 2005	76,904 (5/05)	26,726 (12/05)	72,048 (6/05)	51,045 (3/05)	124,526 (6/05)	55,441 (12/04)
% increase	238	−17	469	184	289	320
Value of outstanding loans at transformation ($U.S.)	4,500,000 (12/91)	11,000,000[c] (12/93)	4,200,000 (7/95)	30,300,000 (1/98)	14,000,000 (5/98)	3,300,000 (12/98)
Value of outstanding loans as of 2005 ($U.S.)	113,321,650 (5/05)	37,400,000 (12/05)	128,470,572 (6/05)	80,848,212 (3/05)	161,192,317 (6/05)	26,743,172 (12/04)
% increase	2,418	240	2,959	167	1,051	710
No. of depositors as of 2005	68,051 (5/05)	1,827 (12/05)	64,240 (6/05)	26,502 (3/05)	48,248 (6/05)	16,355 (12/04)
Value of deposit balances as of 2005 ($U.S.)	96,000,000 (5/05)	26,800,000 (12/05)	89,318,034 (6/05)	51,045,000 (3/05)	55,712,479 (6/05)	11,558,293 (12/04)

Sources: PRODEM: Drake and Otero 1992; Campion and White 1999; MIX Market 2005; MFI self-reported data.

a. First year is transformation to a regulated deposit-taking financial institution; second year is transformation to a commercial bank.

b. Refers to date of official opening and operation as a regulated financial institution.

c. Reflects aggregate for Corposol.

accounts. This increase in outreach is undoubtedly to some extent the result of an increase in products and services, which, in many cases, can only be offered by regulated institutions. For example, in 1995 Procredito was offering a micro and small enterprise loan and a gold pawn loan. Today, Banco Los Andes ProCredit offers micro and small enterprise loans, consumer loans, housing loans, agriculture livestock loans, savings accounts, time deposit accounts, guarantee slips, national and international money transfers, and national tax and public services collection. Before transformation XacBank offered two loan products and was unable to offer savings products. As of June 2005, XacBank was offering 17 different loan products and seven savings products to serve a range of client needs.

Is Transformation a Good Idea?

In addition to facilitating the mobilization of savings, expanding the funding base, and increasing the numbers of clients reached, these institutions, through transformation, have also diversified their ownership and governance structures, increased the professionalism of their staff, improved management information systems, and improved overall internal controls. All of these changes, combined with a strategic shift to focus on customer service and provide demand-driven services, as well as the requisite need to satisfy investors and regulators and increase transparency, have resulted in overall improved performance and efficiencies that have benefited their clients. Proponents of the transformation model would argue that for the most part, transformed MFIs have met their objectives in becoming regulated institutions.

However, despite the increase in the number of transformed institutions and evidence that regulated institutions are better able to meet client demand and thus increase outreach, many skeptics believe that the commercialization of microfinance will inevitably result in the profit motive replacing the social mission. This is often referred to as *mission drift*. They cite as well the high costs associated with transformation and argue that these funds (often provided by donors) could be better spent elsewhere.

Mission Drift

Many critics of MFI transformation believe that as institutions transform into regulated entities and consequently experience demands for higher returns from shareholders, they will gravitate toward offering larger loans to higher income clients, thus shifting services away from the poor.

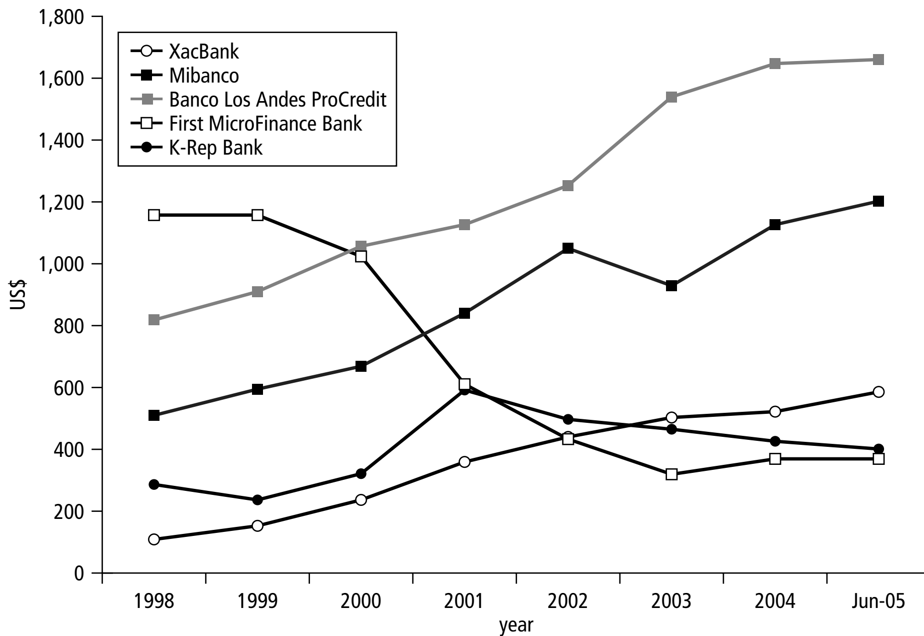
Almost all transformed MFIs have gradually begun to offer bigger loans to some of their clients (often new), but generally not at the expense of the clients at the lowest income level. Instead, many transformed MFIs have sought to offer a range of products to a range of clients, often to help offset the costs of smaller loans extended to the poorest clients.

Figure I.2 shows only modest growth rates in average loan size between 1998 and 2005 for five transformed MFIs.

An increase in loan size and in products offered does not necessarily imply mission drift. As Christen (2002) points out, this increase could indicate the natural progression of a loan portfolio, particularly as an MFI seeks to retain its clients and is compelled to offer larger loans to meet demand. This was precisely why BRAC Bank in Bangladesh has been offering Micro Enterprise Lending and Assistance loans since 1996 to small enterprise clients seeking larger loans. Loans range from U.S.$345 to U.S.$3,448 and support over 20 different business sectors today.[6]

Other than using average loan size and average deposit amount as a proxy for depth of outreach, it has generally been difficult to rigorously assess the level of outreach and impact of microfinance services because of the high cost of developing and utilizing tools to effectively measure these areas. In

Figure I.2 Average Loan Size, 1998 to June 2005



Source: MIX Market, self-reported data: XacBank, First MicroFinance Bank Ltd., Banco Los Andes ProCredit, Mibanco, K-Rep Bank.

addition, disagreement remains over what to measure and how to do it. With more tools available today and broader acceptance of different approaches, the industry is making great progress toward adding social indicators to benchmarking standards that can measure an institution's social performance alongside its financial performance (See Imp-Act Secretariat 2005 and CGAP n.d.).

Cost of Transformation

A frequent criticism of transformation is of the costs involved. While it is true that successful transformation of an MFI NGO entails a considerable amount of financial and human resources (as well as significant commitment from the board and senior management), many transformation-related activities must be viewed as activities that any maturing MFI looking to professionalize its operations, expand outreach, and increase transparency must go through. A detailed look at the costs of transformation is provided in chapter 3, Planning for Transformation, and chapter 5, Strategic and Business Planning. In many cases, investments in transformation costs have for the most part been recovered as the result of a steady flow of lower-cost funding and the increased efficiencies achieved from economies of scale.

Despite disagreement over the implications of transforming to regulated institutions and the positive or negative effect on the reduction of poverty, there is general agreement within the microfinance community that offering microfinance services through regulated institutions is an efficient and realistic means to make microfinance services permanently available. This book is intended to provide the tools needed to help build strong regulated MFIs able to reach more clients with products and services they demand, most particularly savings services.

Book Contents

This book draws on the many lessons learned during the last decade or so as institutions around the world have completed the transformation process and are now operating as regulated deposit-taking financial institutions. Its objective is to outline key issues that regulators and practitioners need to understand and address to develop a well-functioning core of formalized MFIs intermediating deposits from the public.

The book is divided into four parts, followed by an appendix. Part I—Savings and Regulation: Principles and Policies contains two chapters.

- Mobilizing Savings from the Public: 10 Basic Principles—introduces the key focus of transformation as defined here, and outlines the basic principles from the institutional, regulatory, and macroenvironment perspectives, which are important for an MFI to begin to mobilize and intermediate public deposits.
- Regulation and Supervision: The Policy Framework—examines the regulatory framework for microfinance, focusing on issues that need to be addressed to adequately and appropriately regulate and supervise deposit-taking MFIs. This chapter also provides a guideline for central banks to assist them in developing a separate tier or law for regulating microfinance and to establish the capabilities to supervise microfinance. This chapter will be useful for regulators and other government bodies involved in microfinance as well as donors interested in assisting in the development of an appropriate regulatory environment.

Part II—Transforming the Institution: Strategic Decisions focuses on the institution, specifically the strategic issues an MFI needs to address during transformation to a regulated deposit-taking institution. It begins with the development of a transformation plan for the transforming MFI to meet the requirements of the regulatory body responsible for its licensing and supervision and to ensure institutional capacity. This is followed by chapters on each of the following strategic issues that must be considered and decisions that must be made before and during transformation:

- Marketing and Competitive Positioning—includes gathering market intelligence, determining the ideal product mix, and developing and communicating the brand for the new institution.
- Strategic and Business Planning—using findings and decisions that evolve from the development of the institution's overall marketing strategy, provides a guide to developing a strategic business plan for internal use and as part of the license application, and provides a prospectus for potential investors.
- The Funding Structure—outlines how to determine and develop an appropriate capital structure and how to access funding to finance growth as a regulated institution.
- Ownership and Governance—addresses issues related to ownership and the need for a sound governance structure appropriate for a regulated shareholder institution.
- Legal Transformation—outlines options to legally transform the NGO or project into a shareholding company (or other form) and the various legal issues that need to be addressed during transformation.

Part III—Transforming the Institution: Operational Implications continues the focus on the institution and considers the operational issues a transforming MFI must address to ensure it has the institutional capacity to operate as a deposit-taking institution. Its five chapters cover the following topics:

- Human Resources Management—outlines how transformation fundamentally changes the

human resources requirements of an MFI and how to meet these new requirements.

- Financial Management—provides an overview of financial management issues that arise due to transformation, particularly asset and liability management and treasury management, and how to organize the new institution to carry out these activities.
- Management Information Systems—examines the numerous issues regarding management information systems that need to be considered with transformation and adding savings services to the institution.
- Internal Control and Audits—reviews the need to ensure adequate internal controls and audit processes as a regulated institution.
- Customer Service and Operations—highlights the increased need for a focus on customer service and the various changes to operations, including significant upgrades to the branch network, required with transformation.

Part IV includes two case studies that provide practical examples of regulating microfinance and transforming an NGO to a deposit-taking institution.

- Creating a Separate Tier: the Micro Finance Deposit-Taking Institutions Act, 2003—summarizes the experience in Uganda of developing a new law to license and regulate microfinance deposit-taking institutions (MDIs).
- The Creation of Uganda Microfinance Limited—provides an overview of the process the Uganda Microfinance Union went through to transform from an MFI NGO to a shareholding company, licensed and regulated to intermediate deposits from the public.

Finally, appendix 1, Sequencing the Introduction of Public Savings in Regulated MFIs, provides 15 steps to appropriately sequence the introduction of voluntary savings mobilization. This appendix provides a summary of the institutional issues addressed in the book, and examines how a regulated deposit-taking financial institution introduces voluntary savings to the public.

Each chapter is written as a stand-alone chapter, that is, it is not necessary to read the book in order, nor to read every chapter. To make the book as practical and useful as possible, included at the end of each chapter in the institutional sections (Parts II and III) are sample Terms of Reference for hiring technical assistance. In addition, checklists providing a summary of the various issues a transforming institution needs to consider as addressed in each chapter are included.

Notes

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1. The financial systems approach as defined in Otero and Rhyne (1994) applies market-driven principles used by formal financial institutions to the provision of financial services to the poor.
2. The Microfinance Information eXchange (MIX) Market provides detailed information on both supply (donors and investors) and demand (MFIs) for institutional funding. The MIX Market strives "to facilitate exchanges and investment flows, promote transparency and improve reporting standards in the microfinance industry" (MIX Market http://www.mixmarket.org/en/what.is.mix.asp).
3. One of the most comprehensive sources of information on regulation and supervision of microfinance is provided in the Microfinance Regulation and Supervision

Resource Center in the Microfinance Gateway (2005). The Comparative Database on Microfinance Regulation profiles 50 countries, providing detailed information about how different countries approach regulation and supervision of microfinance.

4. When an MFI is "regulated" it does not always mean it is "licensed to take deposits." In India, for example, a Non-Banking Financial Company (NBFC) is regulated, but needs a separate license to mobilize deposits. The same situation exists in the Russian Federation with Non-Deposit Credit Organizations.
5. While in many countries becoming a licensed financial institution is necessary to access commercial sources of funds (even if the license does not necessarily allow for intermediation of public deposits), this is not always the case. Experience in Uganda has shown that commercial banks provide wholesale lending to MFIs frequently even if the MFI does not have a license, provided that the MFI is self-sustainable and can assure the bank of its ability to repay the loan, and more often than not, qualify under some type of guarantee facility.
6. An increase in average loan size can also indicate that the original target of the institution was small enterprises to begin with and not necessarily the lowest income sectors of the market. This would differ from NGOs that enter the microfinance market with the express intent of reaching the poorest populations.

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Abbreviations

ABC	activity-based costing
ACLEDA	Association of Cambodian Local Economic Development Agencies
ACP	ACCION Communitaria del Peru
ADB	Asian Development Bank
AfDB	African Development Bank
AFIs	alternative financial institutions
AICPA	American Institute of Certified Public Accountants
AIDA	attention, interest, desire, action
AKRSP	Aga Khan Rural Support Programme
ALCO	asset and liability committee
ALM	asset liability management
AMFIU	Association of Microfinance Institutions of Uganda
ARO	account relationship officer
ASA	ACLEDA Staff Association
ATM	automated teller machine
BCEAO	Banque Centrale des Etats de l'Afrique de l'Ouest
BoU	Bank of Uganda
BPR	Bank Perkreditan Rakyat
BRI	Bank Rakyat Indonesia
CAC	Cooperatives de Ahorro y Credito
CAELs	CAMEL – M + S (Capital adequacy, Asset quality, Earnings, Liquidity, Sensitivity to market risk)
CAER	Consulting Assistance on Economic Reform
CAF	Corporación Andina de Fomento

CAMEL	Capital adequacy, Asset quality, Management, Earnings, and Liquidity
CAPM	capital asset pricing model
CARD	Center for Agricultural and Rural Development
CD	certificate of deposit
CEO	chief executive officer
CFO	chief financial officer
CGAP	Consultative Group to Assist the Poor
CIA	chief internal auditor
COFIDE	Corporación Financiera de Desarrollo
COSO	Committee of Sponsoring Organizations of the Treadway Commission
CSFs	critical success factors
DCF	discounted cash flow
DFID	Department for International Development
EBRD	European Bank for Reconstruction and Development
EBS	Equity Building Society
EDPYME	Entidades de Desarrollo para la Pequeña y Microempresa
EIB	European Investment Bank
ERP	Economic Reform Program
ESOP	employee stock (or share) ownership plan
FFP	Fondo Financiero Privado (private financial fund)
FI	FINCA International
FIA	Financial Institutions Act
FIE	Fomento a Iniciativas Economicas
FIMISA	Finanzas Empresarales S.A.
FMFB	First MicroFinanceBank
FPDO	Financial Private Development Organisation
FSD	Financial System Development Programme
FSDU	Financial Sector Deepening Project, Uganda
FU	FINCA Uganda
GL	general ledger
GAPI	Gabinete de Apoioa Pequena Industria
GE	Goviin Ekhel
GL	general ledger
GM	general manager
GNI	gross national income
GTZ	Gesellschaft für Technische Zusammenarbeit GmbH
HIID	Harvard Institute for International Development
HR	human resources
IDB	Inter-American Development Bank
IFAD	International Fund for Agricultural Development
IFC	International Finance Corporation

IIA	Institute of Internal Auditors
IMF	International Monetary Fund
IPC	Internationale Projekt Consult
IT	information technology
KfW	Kreditanstalt für Wiederaufban
LAN	local area network
MBB	*MicroBanking Bulletin*
MBP	Microenterprise Best Practice
MCPC	Monetary and Credit Policy Committee
MCRIL	Micro-Credit Rating International Limited
MDI	Microfinance Deposit-Taking Institution
MDI Act	Micro Finance Deposit-Taking Institutions Act
MEDA	Mennonite Economic Development Associates
MFF	Microfinance Forum
MFI	microfinance institution
MIF	Multilateral Investment Fund
MIS	management information system
MIX	Microfinance Information Exchange
MoFPED	Ministry of Finance, Planning, and Economic Development
MP	Member of Parliament
MTCS	Medium-Term Competitive Strategy
NBFC	nonbanking finance companies
NBFI	nonbank financial institution
n.d.a.	no date available
NGO	nongovernmental organization
NORAD	Norwegian Agency for Development Cooperation
OECD	Organisation for Economic Co-operation and Development
PAR	portfolio at risk
PARMEC	Projet de Appiu a la Reglementation sur les Mutuelles d'Épargne et de Crédit
PC	personal computer
PEAP	Poverty Eradication Action Plan
PIN	personal identification number
PMA	Plan for Modernization of Agriculture
PML	PRIDE Microfinance Ltd.
PMT	Performance Monitoring Tool
POS	point of sale
PRESTO	Private Enterprise Support, Training, and Organizational Development
PR	public relations
PRODEM	Promotion and Development of Microenterprises
RAID	redundant array of independent (or inexpensive) disks
RFP	request for proposal

RoA	Return on Assets
ROSCA	rotating savings and credit association
RTS	remote transaction system
RWA	risk-weighted assets
RWMN	Russian Women's Microfinance Network
SACCO	savings and credit cooperative
SEEP	Small Enterprise Education and Promotion Network
SFOL	Sociedad Financiera de Objeto Limitado
Sida	Swedish International Development Cooperation Agency
SME	small and medium enterprise
Socremo	Sociedade de Crédito de Moçambique
SPEED	Support for Private Enterprise Expansion and Development Project
SUFFICE	Support to Feasible Financial Institutions and Capacity-Building Efforts Programme
SUM	Special Unit for Microfinance
SWOT	strengths, weaknesses, opportunities, threats
TC	transformation committee
TM	transformation manager
UML	Uganda Microfinance Limited
UMU	Uganda Microfinance Union
UNCDF	United Nations Capital Development Fund
UNDP	United Nations Development Programme
UPS	universal power supply or uninterrupted power supply
U-Trust	Uganda Finance Trust
UWFT	Uganda Women's Finance Trust
VAT	value added tax
VSAT	very small aperture terminal
WAN	wide area network
WOCCU	World Council of Credit Unions

Savings and Regulation

Principles and Policies

Part I

Chapter 1

Mobilizing Savings from the Public

10 Basic Principles

For microcredit organizations that have the leadership, vision, and skills to change their institutions fundamentally, transformation to a regulated deposit-taking institution can be a route to viable long-term commercial microfinance—and to large-scale outreach to the poor. But transforming to a regulated financial intermediary is not for the vast majority of financial nongovernmental organizations (NGOs) or other microfinance institutions (MFIs). Even for a strong MFI, the process of building a large-scale financial intermediary is considerably more difficult than is generally realized.

The single most important point that transforming MFIs must understand is that successful mobilization of savings from the public, including from large numbers of low-income people, changes the institution (but not its mission) profoundly and irreversibly. Only financial institutions that are prepared for such change should open public savings facilities.

Mobilizing and Intermediating Savings in Developing Countries

This chapter focuses on some basic principles of collecting and intermediating voluntary savings from the public in developing countries.[1] It has two main aims. One is to help transforming MFI owners, boards, donors, managers, and staff members understand what to expect when opening savings facilities for the public. The other is to inform their decisions about whether collection and

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intermediation of public savings is the right choice for their institution.[2]

The principles discussed below are also relevant in a wider context. It is crucial that they are understood and used appropriately by regulatory and supervisory authorities that license MFIs applying to become regulated financial intermediaries—and that must also develop the capacity to supervise such institutions. These basic principles are also important for financial institutions that are already intermediaries, but that want to improve their savings performance, to increase their scale, or to enter the microfinance market.[3]

Experienced MFIs can operate profitably on a large scale, serving many clients, and financing all or most of their loan portfolios with deposits.[4] But this requires clear and responsible ownership, high levels of skilled and knowledgeable governance and management, an organizational structure appropriate for commercial microfinance, and a corporate culture of transparency and accountability. It also requires extensive knowledge of the microfinance market, expertise in financial intermediation among branches that may be located far apart, and experience in suitable investment strategies for excess liquidity.

However, most NGOs (and other MFIs) were not founded, and have not operated, as large-scale commercial financial intermediaries. Even those that have a strong record in providing credit and other services to the poor may have board members and managers who do not have the skills necessary for overseeing and managing large-scale growth in financial intermediaries. And MFIs that are considering or planning a transition to a regulated financial intermediary may not understand sufficiently the ways in which public savings mobilization will affect their newly regulated institutions.

Transforming MFIs typically have much to do to meet the licensing requirements of their regulatory authorities, and often the tendency is to put learning about voluntary savings on the back burner. Still, such institutions often expect to open savings services to the public shortly after being licensed as a financial intermediary. But learning to provide savings facilities to the public—including managing crucial organizational changes; recruiting experienced and financially skilled managers and staff, and training both old and new staff; upgrading information technology, reporting, accounting, treasury management, internal controls, security, and others; and designing, costing, pricing, and pilot testing new products and services—takes considerably more time and skill than is usually anticipated.

Thus, the most important first step for an MFI considering transformation to a regulated deposit-taking MFI is to acquire a full understanding of the basic principles that underlie successful voluntary savings mobilization from the public—including large numbers of low-income savers. In this context, analysis of the institution's capability and resources for mobilizing savings from the public must be undertaken and an informed decision made as to whether the institution should take this route. MFIs that then decide to undertake the challenges involved in large-scale commercial microfinance should keep the basic principles firmly in mind as they move forward.

Ten Basic Principles for MFIs that Collect Savings from the Public

Underlying the performance of successful microfinance intermediaries are some basic tenets. Ten of the most essential are discussed here. These principles are especially important for microcredit institutions transforming to regulated financial intermediaries, because such institutions tend to have little prior experience with either public savings or financial intermediation.

Principle 1. Poor people in developing countries save. The job of the MFI is not to teach them to save, but to learn their needs and design and deliver products and services that meet their demand.

Developing countries show considerable similarity in the ways poor people save in the informal sector, in the reasons they save, and in the ways they match the types of savings with the particular purposes for which they save. Evidence from a wide range of countries, cultures, and economies shows that economically active poor savers want from their financial institutions basically the same things as most readers of this chapter (and its author) demand from theirs. Low-income savers—whether in India or Mexico, Uganda or Vietnam, Bolivia or Indonesia—generally want security, convenience, liquidity, confidentiality, a choice of products appropriate for their needs, helpful and friendly service, returns, and potential access to loans.[5] And they want their financial savings to be a legally recognized asset—often the only one they have. These demands form a package—they are not a menu from which the MFI can choose. But MFIs that can deliver this package effectively can mobilize massive amounts of savings, and if they price their products right and operate efficiently, they can do so profitably.

How does an MFI learn to do this? Those that want to mobilize savings from low-income people must first understand in what ways and for what reasons poor people save—and what savers like and dislike about each savings method used. The institution can then design and deliver financial products that will maintain those aspects of their present savings methods that the savers like (for example, liquidity), and improve on those that they dislike (such as lack of security). Then the MFI can develop products and services that meet the needs of poor people better than they can do by themselves. If the institution is successful in this effort, it is likely to draw large numbers of savers.

Transforming MFIs often ask, "How can we train our clients to save?" The answer is, don't train the clients to save. Instead train your managers and staff—first to learn what the clients' demands are, and then to provide for them.

Principle 2. For credit, the MFI must trust the client. But for savings, it is the client who must trust the MFI.

Regulated MFIs that mobilize voluntary savings from the public must be—and must be perceived as—trustworthy, secure, stable, and receptive to the needs of their clients. Informal methods of savings do not provide the complete savings package discussed above. Savings held informally may be secure, but without returns; or returns may be provided, but not liquidity; or savings may be conveniently accessed, but risky. Yet regulated MFIs that provide clients with the complete package can, and have, attained wide outreach profitably.

However, being regulated and considered secure are necessary, but not sufficient, to attract most savers. Clients who are borrowers will often travel long distances and wait in long lines for matters connected with their loans (unless the MFI operates in a competitive environment where better service is available). But savers will generally not accept substantial transaction costs, including the opportunity cost of their time, to make use of savings facilities. Convenience of location and opening hours; a choice of several appropriate savings products and services that can be customized for each saver's needs; and well-trained and helpful staff are essential to attract and keep savers. And when introducing savings products, public relations becomes important—because potential savers need to know about the institution and why they should put their trust in it.

Savers who come to MFIs may be poor and illiterate, but they are typically perceptive and rational. If they are not treated with respect and served efficiently, they will return to saving in animals or in gold or they will put their cash back under the bed or beneath the floor. Or if the opportunity exists, they will move their savings to another institution. They will tell their family, friends, and neighbors about their experiences with the MFI they left. And the word will spread.

MFIs accustomed to the idea that the institution selects its customers (borrowers) often find it difficult to make the adjustments in management, attitude, training, products, and services that are required when an MFI becomes a financial intermediary providing savings services to the public.

Transforming MFIs, and their newly created financial intermediaries, must ensure that this message—for savings, it is the client who selects the institution—is understood and internalized throughout the MFI, from the board members to the security guards.

Principle 3. Certain basic preconditions are needed for mobilizing voluntary savings from the public.

MFIs with owners, board members, and managers who are interested in having their institutions become regulated, and who understand and agree with these first two principles, must consider next the preconditions for successful operation of a financial intermediary with large numbers of low-income clients among its customers. Five main conditions need to be met before a financial institution begins—and before it should be allowed by the regulatory authorities to begin—the mobilization of public savings. The first three, however, are usually beyond the control of the institution. But in some cases, MFIs with knowledgeable and powerful owners and boards have been able to work with their central banks to develop appropriate regulations and supervision for the transformed MFIs (points b and c below).

a. *The political economy:* Mobilizing voluntary public savings, especially at the early stages, requires at least a moderately enabling macroeconomy and some degree of political stability. Especially in difficult environments, careful judgment based on knowledge of the local political economy is important for institutions applying for a license to collect and intermediate public savings—and also for the regulatory authorities who will decide on the application. In this context it is also important to recognize that large-scale and competitive mobilization of voluntary public savings, including accounts held by many low-income savers, is unlikely to succeed in areas where donors or governments provide continuing subsidized credit and grant funds for microcredit. MFIs that receive such low-cost funds on a long-term basis are simultaneously provided with a negative incentive to undertake the work and costs required to meet demand for savings services.

b. *The policy and regulatory environment:* A reasonably adequate policy and regulatory environment is needed—or if not immediately possible, at least consistent nonenforcement of inappropriate policies and regulations. MFIs that are licensed to take savings from the public and to intermediate these funds need to operate in an environment characterized by liberalized interest rates and regulations appropriate for commercial microfinance. As discussed in other chapters, the latter include specifications for minimum capital requirements, capital adequacy ratios, liquidity ratios, accounting and audit standards, criteria for opening branches, reporting requirements, and the like.

c. *Public supervision:* For the protection of their customers, especially savers, MFIs that mobilize savings from the public must be publicly supervised. This generally means that their governments must be willing to modify their standard banking supervision practices so that the rules for microfinance institutions are suitable for their activities. As in the case of regulations, appropriate supervision does not mean relaxing standards. It means applying high standards in ways that are relevant for MFIs. It also means ensuring that the supervisory body has, or develops in a timely manner, the capacity to monitor effectively the performance of such licensed microfinance providers.

d. *A strong institutional performance record:* An MFI planning to transform to a regulated financial intermediary must have a strong performance record and an excellent reputation. It must have (or be prepared to add) high quality ownership, governance, and management capacity that is appropriate for a financial intermediary. The institution should have a demonstrated track record of high level performance and transparency. It should have effective and efficient operations, maintain a high rate of loan recovery, and regularly earn good returns. It should be financially self-sufficient, with considerable outreach. And it must have a corporate culture that is open to new ideas, new products, and new methods. MFIs that do not meet these criteria should not be licensed to take public savings.

e. *Preparation for far-reaching changes:* As discussed above, before the MFI becomes regulated and undertakes voluntary savings mobilization, the institution's owners, governing board, managers, and staff, as well as the licensing authorities, need to understand that basic changes in the institution's organization, leadership, infrastructure, information, and operations will be required—many of them in a relatively short period.

Efforts to mobilize public savings should begin only when all five preconditions have been met, although judgment calls may be needed concerning the state of the economy and the political context. Some leeway may be required for certain issues of regulation and supervision. In many countries commercial MFIs and the regulation and supervision of microfinance are evolving simultaneously. But an institution that is not prepared for fundamental changes should not proceed further in planning for collecting public savings.

Principle 4. Owners, board members, and managers of regulated MFIs must meet legal and regulatory requirements for accountability and qualifications.

A country's legal framework is important for commercial MFIs and their clients in a variety of ways, including contract enforcement, legal recognition of clients' savings as assets, and the legal responsibility of MFI owners and board members for their actions and their institutions.

One of the most important principles of the commercial microfinance industry is that owners, board members, and managers must be certified using international standards as "fit and proper," and they must be accountable for their decisions and their conduct. Owners of regulated financial institutions that serve microfinance clients are legally responsible for their institutions. Board members must be competent to oversee a rapidly growing financial intermediary. Managers must be well qualified—that is, experienced, financially skilled, and knowledgeable about the microfinance market. However, when MFIs become regulated, they often face special problems in these areas.

For example, unregulated NGOs providing microcredit frequently do not have clear, accountable ownership. Yet regulated financial intermediaries are (or should be) required to have qualified and accountable owners. This transition is often problematic, and changes in ownership can be prolonged and difficult.[6]

A related problem concerns the governance of the newly regulated institutions. MFIs created by NGOs sometimes appoint members of the NGOs' boards to sit on the boards of the regulated deposit-taking institutions. Some may be eminently suitable, but others may not be appropriate. Thus, some appointees to the new board may be people with considerable dedication and long-standing commitment to helping the poor and advancing microcredit, but their backgrounds are often in the social services or other nonfinancial professions. They are frequently not competent to oversee complex financial intermediaries serving a wide range of

clients. Establishing appropriate governance can be challenging, and the problems may be exacerbated by conflicts of interest among owners and board members.

Other problems that can arise during the transformation process concern management. Managers and staff of the parent NGO may be appointed to the new institution in positions for which they are unqualified. Managers of excellent NGOs, even those who initiated their institution's transformation process, are often not the right choices to manage the financial intermediaries that emerge from the transition. The skill sets required are different in many respects. Relatively few MFI managers have the financial skills and managerial experience needed to take responsibility for a fast-growing, regulated financial intermediary.[7]

When an MFI transforms to a regulated MFI and begins to mobilize voluntary savings from the public, the institution is adding to its operations not only savings, but also financial intermediation. Often little attention is given to the latter during the transformation process, but these two activities typically require a significant increase in the financial expertise of the newly regulated institution. However, finding experienced management with strong financial skills, coupled with knowledge of the opportunities and risks of the microfinance market, can be difficult. Well-qualified managers for microfinance intermediaries are scarce and generally expensive. They need to be actively sought, and their services suitably budgeted. And careful oversight by a competent, well-structured board is essential.

The basic management problem in the global microfinance industry at present is a rapidly increasing demand by regulated (or about-to-be-regulated) MFIs for financially skilled managers with appropriate administrative experience—and a small pool of well-qualified MFI managers. Some much needed efforts are being made by a variety of institutions to train managers for microfinance, and to attract experienced financial managers into microfinance, but there is a long way to go.

Meanwhile, what happens too often is that well-meaning but unqualified managers are transferred to the regulated MFI from the NGO. Such managers often fear the changes that come with regulation. They may fear losing their mission. They may also fear losing control of the institution (and their jobs) to outsiders.

Thorny problems, and sometimes acrimonious disputes, can arise when difficult questions emerge during the transition from a credit-based institution to a financial intermediary. Can appropriate owners for the new institution be found who are commercially oriented, but are also "patient investors"? Who should be appointed to the new board? How can politicization and corruption be avoided? Who is to manage the new MFI? Which NGO staff are to be appointed to the regulated institution, and which are to remain at the parent NGO (if it continues)? Are there managers and staff who should be phased out or retired? If so, what criteria should be used? What positions in the new MFI should be filled from outside? Such issues can result in instability and conflicts that increase existing tensions and factional disputes. These, in turn, can lead to operational crises—just as the MFI begins to introduce savings services to the public.

In some cases, an independent outside review of the MFI can be helpful. Usually some of the MFI's methods can be adapted to the new circumstances, and some managers and staff can be retrained. Others cannot. What is needed is "the wisdom to know the difference"—and the leadership to make the necessary changes.

Nothing is gained by postponing crucial decisions about ownership, governance, and management. Regulated MFIs created by NGOs or other microcredit organizations must have qualified owners. Their board members and managers must be competent, respectively, to oversee and to operate financial intermediaries. It is especially important that the authorities responsible for licensing deposit-taking MFIs perform careful due diligence in this regard.

The next two principles (5 and 6) focus on fundamental institutional changes that must take place when microcredit organizations transform to regulated deposit-taking intermediaries. The transitions and reorganizations discussed below need to be planned and started long before the institution begins collecting voluntary savings. For a transforming MFI, change is not an option, it is a prerequisite.

Principle 5. Regulated commercial MFIs must mobilize savings from the public, and not from the poor alone.

This principle sounds obvious, but few microcredit organizations understand how it will affect them if they become financial intermediaries.[8] Can financial institutions that want to be financially self-sufficient, and that plan to fund their microcredit portfolio substantially or entirely from savings, mobilize voluntary savings from the poor on a large scale and remain profitable? Not if they confine their savings services to poor savers.

The transaction costs are too high for a financial institution to collect savings only in very large numbers of small accounts. With the increasing development of technology, the costs of servicing small accounts may decrease in the future. Currently, however, transaction costs for a $5 savings account are typically little different from those of a $1,000 account. For this and other reasons discussed below, commercial MFIs should not collect savings only from poor people. Providing large numbers of small savers with the kinds of savings accounts that they demand (especially the much-in-demand accounts that permit an unlimited number of withdrawals) can be labor intensive and therefore costly—even if no interest is paid below a minimum balance.

Thus, when MFIs mobilize voluntary savings from large numbers of poor people, they need to raise the average account size with larger accounts. Such MFIs can then mobilize savings profitably and on a large scale, and they can afford to meet demand from low-income savers with small accounts.

However, MFIs that have transformed from microcredit organizations typically carry with them considerable baggage that can hinder or prevent needed changes. This may be in the form of the MFI's objectives, products, practices, training, attitudes, and so forth. All may have been crucial for the success of the earlier credit-based organization, and some remain essential for the new MFI as well. But others must be changed, as some assumptions and practices of the transforming organization can be counterproductive for a regulated financial intermediary. For example, when MFIs transform, they often continue defining their target market as poor people, mainly women. They may resist—sometimes through policy, and sometimes in practice—serving other kinds of clients. For reasons discussed below, this approach does not work for regulated financial intermediaries.

Successful commercial institutions that provide financial services to many poor clients also collect savings from middle- and even high-income individuals, as well as from organizations, businesses, and institutions that are located near the MFI's branch or sub-branch. This permits the MFI to meet local demand for savings services, to collect small savings from the poor, to use savings from all sources to finance an expanding microloan portfolio, and to maintain the institution's financial self-sufficiency.

Mobilizing savings from the general public has another important advantage: staggering withdrawals. If MFIs target only low-income clients, withdrawals can be clustered around certain times—when school fees are due, at religious holidays, in preharvest months, and the like. If large numbers of clients withdraw savings at the same time, the institution can face a liquidity crisis. But when savings are collected from a range of clients, including organizations and institutions, this problem is unlikely to occur except in special

circumstances such as hyperinflation, regional shock, or loss of trust in the MFI.

Collecting savings from the public, however, carries high transition risks for newly transformed MFIs. Does the MFI know how to design and deliver products, including loans, for a wider variety of clients than it has previously served? For example,

- Do staff members know how to approach and talk with new kinds of clients?
- Can the staff of institutions that have previously served only poor groups of women explain clearly the MFIs' products and services to potential male clients? To middle-income people? To organizations, institutions, and businesses operating in the MFIs' service areas?
- Savers who are not poor tend to demand individual loans (as do many low-income savers as well). A potential client who wants to save $1,000 and also to borrow is not likely to agree to join a solidarity group to obtain the maximum $100 loan available to new borrowers. Under such circumstances, the potential client is quite likely to take his savings elsewhere (even back home). Before opening its facilities for public savings, the newly regulated institution needs to design individual loan products, and must also make sure that its staff has been well trained and carefully tested in assessing the creditworthiness of individual borrowers and their enterprises. Such an institution should ask itself: Do our loan officers really know how to evaluate the creditworthiness of individual loan applicants? Do they know how to collect individual loans? Do our managers understand that some of the institution's traditional group loan customers may, for good reasons, prefer individual loans once these are offered? Is there a plan for allowing such shifts, and has the potential cost been analyzed?
- Have staff members at regional and branch offices understood and internalized the institutional changes required to mobilize public savings effectively, and are they implementing these in practice? This often takes considerable time.

MFIs that succeed as intermediaries are those that understand they can provide appropriate financial services to far larger numbers of poor people than they did previously—if they also serve other kinds of clients. Their managers understand the questions asked above, and they work hard to ensure that their institutions can answer them positively. Regulatory authorities must also fully understand these issues and risks, because they affect both regulation and supervision. For example, deposit insurance regulations sometimes make a distinction between MFIs and other financial intermediaries, setting a ceiling for deposit insurance for MFIs that is too low for them to attract larger savers. That can create a problem with far-reaching consequences because MFIs serving poor voluntary savers need the accounts of larger savers.

In their role as credit providers, some institutions specialize in microcredit while others serve a wide range of borrowers, including low- and lower-middle-income clients. But the options for savings mobilization are different. Regulated commercial microfinance institutions that want to meet local savings demand and plan to fund their microcredit portfolios with voluntary savings must serve a wide cross-section of savers. Commercial microfinance thus refers to profitable financial intermediation between borrowers with loans up to a cutoff point set by the institution (which can vary widely) and all locally available savers.

Principle 6. The numbers of borrowers can be controlled by the numbers of loans approved, but voluntary savers cannot be turned away without widespread and long-term negative effects. This fundamental difference can result in rapid, and largely uncontrollable, growth in the client base when a newly regulated MFI opens appropriately designed and effectively delivered deposit facilities to the public—and is quickly swamped with savers.

In aggregate, financial institutions that offer voluntary savings services suitable for low- and

lower-middle-income people have significantly more savings accounts than outstanding loans. Many such institutions also have higher volumes of savings than of loans.

A recent study by the Consultative Group to Assist the Poor (CGAP) on loans and savings accounts in more than 3,000 "alternative financial institutions" (AFIs)—institutions that focus on clients who are at an income level generally below that of commercial bank clients—found that "on an aggregate basis, savings accounts in AFIs outnumber loans by about four to one. This is a worldwide pattern that does not vary much by region" (Christen, Rosenberg, and Jayadeva 2004, p. 7). The study found more than 152 million active loans (disbursed but not repaid or written off) and more than 573 million savings accounts in the AFIs covered. These totals include loans and savings accounts in MFIs; in cooperatives and credit unions; and in rural, state, agricultural, development, and postal banks.[9] While the income levels of the clients holding these savings accounts and loans in AFIs are not available, "it is clear that AFIs, including those not usually thought of as microfinance providers, serve a very large number of poor or very poor clients" (Christen, Rosenberg, and Jayadeva 2004, pp. 5–6). There is no doubt that savings accounts in financial institutions are in high demand by low- and lower-middle-income people in developing countries around the world.[10]

Thus, when an MFI that has been transformed from a microcredit organization first offers well-designed and effectively delivered voluntary savings products and services to the public—especially in areas with substantial unmet demand for savings facilities—the institution may quickly find itself with large numbers of new savers.

This is the second crucial reason that basic institutional change occurs in transformed institutions. Microcredit organizations can control the number of their clients because they are borrowers, and it is the MFI that determines how many loans it makes. But regulated intermediaries cannot limit the number of savers, except by driving them away—which would create severe long-term problems for the MFI, and also defeat its mission. Thus, rapid client growth is likely to occur in an MFI offering attractive savings products and services soon after these are made available to the public. However, such large and essentially uncontrollable growth carries substantial financial, operational, and strategic risks.

Yet considerable evidence demonstrates that rapid growth in savings has been achieved by leading MFIs of various types. To give an idea of possible growth curves, box 1.1 provides examples of rapid growth in different kinds of institutions. Not coincidentally, all have excellent management and all are financially self-sufficient. Their rapid growth in savings (along with simultaneous growth in lending and fundamental changes in the organizations) made enormous demands on the high-quality management of these institutions. Extraordinary management skills and commitment were essential for the achievements of each of these institutions. Even then it was difficult. Although each still faces challenges (of different kinds), all these institutions are now industry leaders.

In preparing to collect and intermediate public savings, critical questions need to be asked—by both the transforming institution and its country's supervisory authorities—well before the MFI is licensed to collect and intermediate public savings:

- Can the institution manage and finance such rapid—and largely uncontrollable—growth in savings?
- Can the MFI coordinate and manage the different types of organizational, operational, and attitudinal changes that are required for a financial intermediary?
- Can it manage the many changes in operating procedures that must be instituted and maintained?
- Can it maintain a high-quality loan portfolio while investing the substantial human and financial resources needed to introduce and intermediate voluntary savings from the public?

Box 1.1 Examples of Rapid Growth in Voluntary Savings in Different Types of Microfinance Providers

Bank Rakyat Indonesia

In 1983 the microbanking system of the then-failing, state-owned Bank Rakyat Indonesia (BRI) had U.S.$18 million in savings after a decade of offering voluntary savings services in more than 3,600 bank units located in all the country's subdistricts (the number of accounts is not known). With interest on loans set by the government at 12 percent and interest on savings at 15 percent per year (and other major mistakes), this was a savings program that could only fail. In addition, loan defaults were high and losses large. Then in 1984, BRI's loss-making, heavily subsidized microfinance program was converted to a commercial microbanking system. As part of the reforms, BRI totally revamped its approach to voluntary savings and began pilot projects in a major new microbanking savings initiative. Ten years later, by the end of 1993, the microbanking system had U.S.$2 billion in 11 million accounts, and by 1996 the microbanking system had U.S.$3 billion in 16 million accounts. The number of savings accounts and the rupiah value of savings continued to increase substantially throughout the severe Asian financial and economic crisis of the late 1990s (see Robinson 2002b). As of 2005, BRI's microbanking system had U.S.$3.7 billion in 32 million savings accounts. The average savings account balance in 2005 was U.S.$115 (10 percent of the country's 2004 per capita gross national income (GNI) of U.S.$1,140). BRI's microbanking system, which has been profitable for more than 20 years, now operates the largest financially self-sufficient MFI in the world. It is also the first microfinance intermediary to offer shares broadly in the world's main financial markets. These two points are, of course, directly related.

Equity Bank (Kenya)

In 1994 Equity Building Society (EBS) in Kenya began its conversion from a failed mortgage lender to a commercial microfinance institution. EBS had mobilized voluntary savings between 1984 and 1993, but the institution had a narrow product focus and its managers and staff knew little about client demand. Savings stagnated. Then a new management team took over and began to revise EBS's products and services, with the result that savings grew from U.S.$3 million in 12,000 accounts in 1994 to U.S.$7 million in 41,000 accounts in 1998. By 1999 EBS was ready to begin full-scale, client-focused savings mobilization methods—learning about customer needs and designing and delivering products tailored to client demand.[a] At the end of 2004 EBS was licensed as Equity Bank, and by mid-2005, the special annual edition of *Market Intelligence: The Business and Finance Journal* that surveys and rates banks in Kenya, rated Equity Bank third out of 44 banks. By 2005, Equity Bank's savings had jumped to U.S.$121 million in 556,000 accounts—a growth in seven years of nearly fourteen times the number of accounts and more than seventeen times the value of savings. The average account balance was U.S.$217 (47 percent of Kenya's 2004 per capita GNI of $US460).

Three Bolivian Regulated Financial Institutions

Three Bolivian NGOs that transformed to regulated financial institutions (partly to be permitted to mobilize voluntary deposits from the public) show similar trends, operating in what is perhaps the world's most competitive microfinance market.

Banco Los Andes Procredit, begun in 1992 as the NGO Caja Los Andes, was licensed in 1995 as Bolivia's first regulated nonbank financial institution (Fondo Financiero Privado, or FFP). In 1996 Caja Los Andes FFP had U.S.$3 million in savings in about 400 accounts, with an average balance of U.S.$7,497. However, by 2004, Caja Los Andes FFP had more than U.S.$71 million in nearly 54,000 savings accounts. The average savings account balance was U.S.$1,325 (138 percent of Bolivia's U.S.$960 GNI per capita in 2004). At the start of 2005, Caja Los Andes FFP was licensed as Banco Los Andes Procredit.

Fondo Financiero Privado para el Fomento a Inciativas Económicas (FIE), established as an NGO in 1985, became a regulated nonbank financial institution in 1998. That year FIE had U.S.$7.8 million in 121 savings accounts, with an average savings balance of U.S.$64,425. By 2005, it had U.S.$32.7 million in nearly 61,000 savings accounts, with an average savings balance of U.S.$539 (56 percent of 2004 GNI per capita).

Fondo Financiero Privado PRODEM, begun in 1986 as an NGO, was licensed as a nonbank financial institution in 1999. In 2000, PRODEM FFP had U.S.$20 million in 854 savings accounts, with an average balance of U.S.$23,937. But by 2004, it had nearly 120,000 savings accounts, with an average balance of U.S.$511 (53 percent of GNI per capita).

Sources: BRI unit bank monthly reports and other BRI data; Equity Bank data; The MIX Market 2005; *Market Intelligence* 2005.

a. MicroSave, a large program funded by the United Kingdom's Department for International Development (DFID), CGAP, and others, was instrumental in helping EBS learn how to understand their clients' needs and to design appropriate products and services for the microfinance market.

Institutions that do not prepare adequately to meet these challenges and risks can find themselves in considerable difficulty. The financial risks include liquidity and portfolio risks. As noted, serving only poor savers can raise liquidity risk because withdrawals tend to cluster at certain times of the year. An increase in portfolio risk while introducing public savings is more common than is often realized. The process of introducing savings to the public by newly regulated MFIs is sometimes rushed by the MFIs' managers or boards who want to finance an expanding loan portfolio quickly, and who do not adequately understand the risks of improperly sequencing the introduction of savings (see appendix 1, Sequencing the Introduction of Public Savings in Regulated MFIs). Multiple problems may occur, requiring correction over a prolonged period. The result may be an overload on managers and staff, and as has happened in some institutions, a rapid decline in loan portfolio quality—which may then take substantial amounts of time and resources to overcome. The lesson here cannot be overemphasized: do not rush the sequencing in introducing savings facilities to the public.

Operational risks include human resources risk (managers and staff who are poorly trained and insufficiently motivated to undertake their new responsibilities), management information systems and other technology risks, and fraud risk. Strategic risks, generally the most serious for newly transformed institutions, cluster around risks of governance, management, and reputation.

Voluntary savings mobilization from the public is not a matter of adding a few products to a microcredit organization. If successful, it inevitably and irreversibly changes the institution, though not its mission. Those that are not prepared for such changes should not undertake to collect savings from the public. However, MFIs that are willing and able to make the changes needed to overcome the risks can profitably attain wide outreach as financial intermediaries and can serve as models of the industry for other institutions.

Principle 7. Savings is not only a service and a source of funds, but also a liability.

MFIs that mobilize savings from the public need to pay careful attention to protecting savers' funds from risks that include internal corruption, theft, loan defaults, investment losses, and others. MFIs tend to concentrate on preventing some of these risks, but may not focus sufficiently on all. Yet they are vulnerable to all these potential dangers, and continual vigilance is required for all types of risk.

- *Internal fraud:* A corporate culture of transparency and accountability is required of MFIs for many reasons, but it is especially important for deposit-taking institutions and financial intermediaries. Internal corruption is, of course, a potential problem for MFIs and also a risk for savers. Strong effective management, a clear policy of delegating responsibility and holding managers and staff accountable for their decisions and actions, appropriate management information system (MIS), careful internal supervision and controls, and a promotion and incentive system designed to encourage employee loyalty to the MFI can all help to prevent internal fraud.
- *Security measures:* Additional and improved security measures are needed when an MFI begins collecting and intermediating public savings (safes, guards, methods for transporting cash, and the like).
- *Loan defaults:* Nonperforming loans can also put savers' money at risk. As discussed, it is crucial for an MFI introducing voluntary savings products and services to maintain high loan portfolio quality. Before introducing public savings, transformed MFIs must have effective procedures in place for borrower selection and loan recovery (including collection of individual loans); accurate, transparent accounting and reporting systems; and qualified, well-managed internal supervision and audit.

- *Losses from investments:* Recently transformed MFIs are generally not experienced in investing excess liquidity generated by public savings. Yet such investment requires considerable attention and expertise. This is not yet a widespread risk among transformed MFIs because most are relatively new and do not have substantial excess liquidity. It is a significant risk, however, for some older MFIs—and it soon will be a risk for an increasing number of transformed MFIs.
- *Budgeting for new operating costs:* Common problems in transforming microcredit organizations include a propensity to plan separately for savings and loans, and sometimes a refusal to change traditional loan terms, procedures, and interest rates. Financial intermediaries must set (and adjust as necessary) the spread between interest rates on loans and savings so that it is sufficient for profitability. This includes having a spread that is adequate to cover the expenses incurred in keeping savers' money safe. New cost issues may require changes in the institutions' traditional loan products, as well as improvements in its overall efficiency.

A successful intermediary focuses on all the risks pertaining to its liabilities—and it allocates sufficient funds and human resources to do so effectively. It designs, prices, and manages its savings and lending products together.

Principle 8. New kinds of products and services, a wider range of clients, and larger-scale operations require a major effort to develop new training and incentive programs for management and staff.

The market served by commercial microfinance intermediaries—low- and lower-middle-income borrowers (men and women), and savers from all income levels—is quite different from that served by most microcredit organizations, though there is overlap. The management and staff of transformed institutions need to learn how to serve a wide range of clients profitably. The depth and extent of personnel retraining needed for this change to be made effectively is rarely appreciated at the start.

Serving a wider market. Most transformed MFIs beginning public savings mobilization have considerable experience with the microcredit market but, as noted, they usually have little knowledge of collecting or intermediating voluntary savings. Thus, managers and staff need to be trained in developing savings products and services appropriate for all types of savers. They need training in how to identify, talk with, and mobilize savings from larger savers. They usually also need to be trained in evaluating loan applicants for individual loans, and in how to collect the loans. Not all regional and branch managers and staff can carry out these new activities effectively, even after training. Some managers may have to be retired, transferred to a different type of job, or phased out of the institution.

Product design, pricing, and delivery. Training in multiple new concepts and activities is needed to ensure that the managers and staff of a transforming MFI are capable of designing and delivering appropriate products, and of reporting and remedying any important design flaws that may be discovered in the course of product delivery. Both classroom and on-the-job training are needed in market research, product costing and pricing, and in developing and implementing new operational procedures and manuals. The training must also focus on changes in internal communications, backroom operations, and management information systems; on accounting, reporting, and audit systems; and on internal controls, as well as on instituting and operating new security measures. And training must include rigorous procedures, including client feedback, for monitoring and evaluating performance results.

Trainers of trainers. Because so much that has to be learned is unfamiliar to newly transformed MFIs, those planning to collect savings from the public must make a special effort to find trainers of trainers with the right kinds of backgrounds and skills, and they must then develop their own in-house trainers. Their previous trainers are often not competent (and are sometimes unwilling) to train staff in savings mobilization, financial intermediation, and individual credit products. Some can learn, but finding suitable trainers can be difficult.

Performance-based incentives. Attractive incentives for management and staff are essential. For regional and branch offices, these should be provided to employees based on the performance of each branch, sub-branch, or other lowest-level unit that delivers financial services. Incentives for the staff of each lowest-level unit that meets its goals should include both monetary bonuses and institutional recognition. Many kinds of incentive schemes are used by MFIs (see Holtman 2003). Some may work better in some regions and cultures than others. One that has worked extremely well for 20 years in a very large institution is the incentive system developed by Indonesia's BRI (Robinson 2002b). There the incentive payment, a percentage of the unit's profits, is divided among all managers and staff who work at a particular unit, in proportion to their salaries. In addition, everyone who receives an incentive bonus is formally recognized at a ceremony presided over by BRI's highest-level managers. The incentives are based on the overall performance of each unit, with various weightings given to increases in the numbers of loans and savings accounts, growth in amounts of savings and outstanding loan portfolio, the quality of the portfolio, and the administrative performance of the managers and staff. Unit supervisors at branch level are also given incentives when the units for which they are responsible meet their goals. Further incentives are provided to units (and their branch supervisors) that are judged best in their region and best in the country.

Newly regulated institutions that want to mobilize public savings need to learn how to serve a wide range of clients profitably, and how to make (and collect) individual loans. New kinds of training are essential, as are desirable and effective performance-based incentives. These should not be based on savings performance alone, however, because portfolio quality (and other performance indicators) may then deteriorate.

Principle 9. MFIs starting to collect savings from the public should offer a few well-designed savings products and, if they do not already have one, a general purpose individual loan product. The increasingly common view—that a wide choice of products is important—should be avoided.

When beginning the mobilization of public savings, MFIs should offer a few carefully designed savings products so that savers of all types can customize their use of these products to meet their own needs. If the institution does not already provide individual loans, these should be added. As discussed, the products should be designed and priced together to enable both appropriate coverage and institutional profitability.

A savings account permitting unlimited transactions, a fixed deposit account (which includes options for relatively short maturities), one or two other savings products, and facilities for remittances and transferring funds are sufficient in the early stages. These basic products must be carefully designed for use in different combinations for different purposes by all types of savers—poor and nonpoor, individuals and institutions.

Introducing too many savings products makes sub-branch and branch management too complex and expensive, and many products are not necessary for most savers. What is needed are a few complementary products, each of which is in high demand. Savers can then customize their use of these products to meet their own needs, and they can

reconfigure the ways in which these accounts are used as their needs change over time.

For many years, product design was neglected in microfinance. Now the pendulum has swung, and product design is too often overemphasized by MFI managers who sometimes appear to think that the race is won by the MFI with the largest number of products. Well-designed savings products are essential, but they are only one element in a much larger set of requirements for successful mobilization of savings from the public—many of which tend to be overlooked as increasing emphasis has been placed on designing multiple products. Product delivery is far more difficult than product design. Convenience of sub-branch location and opening hours; attitudes of managers and staff toward clients; MIS, space use, asset-liability management liquidity, and cash management; efficiency of operations (for example, short waiting periods for savers who want to deposit or withdraw, and an effective service for remittances); quality of administration; quality of the loan portfolio; trustworthiness of the institution; and many other factors are crucial to capturing and maintaining public savings. Getting the structure and operations of these interlinkages right—which requires experienced, skilled management at all levels—is far more important than a wide range of products. The race is generally won by the MFI that demonstrates the best delivery of a relatively few well-chosen products.

As discussed, the newly regulated institution also needs to offer individual loans, which will be in demand by some savers—and the MFI must anticipate that some of its group borrowers may want to move to individual loans.

Once the savings program is well established and the transformed institution has learned to make and collect individual loans, other products can be added. If not already offered, remittances and money transfers should be added, as these are particularly important for the microfinance market. Special fixed deposit accounts for education, retirement, housing, and ceremonies and pilgrimages are popular, as are housing and education loans. Insurance products are also often in high demand, but these are generally best offered through MFI linkages with appropriate insurance companies rather than by the MFIs directly.

Thus, the key to large-scale savings mobilization from the public is a few well-designed and effectively delivered products that clients can use to customize their savings portfolios in ways that meet their particular needs. The MFI should not undertake to offer many products simultaneously, especially in the beginning. Too many products can lead to strains on management and staff capacity that negatively affect both the MFI's performance and its client service. Consistent, high-quality delivery of a few complementary products in high demand is essential. Others can be gradually added later, as demand and costs become better understood.

Principle 10. Mobilizing savings from the public takes considerable time and proper sequencing. It should not be rushed to finance expanding portfolio requirements or for other reasons.

Most transforming microcredit organizations have little understanding of how to sequence the introduction of mobilizing savings from the public. Yet this is a critical process that takes considerable time, effort, human and financial resources, and patience. Assuming that the basic preconditions have been met (Principle 3), the sequence starts with training, demand research, product design and preliminary costing, further training, and pilot projects. Next are revisions to products, delivery systems, organization, management, and others, as needed; then come more training, a gradual rollout, troubleshooting, more revisions, more planning, and finally implementation of market penetration methods. All are required and in the appropriate sequence (see box 1.2).

Box 1.2 Sequencing the Introduction of Public Savings in Regulated MFIs: 15 Steps

Appropriate sequencing is crucial for MFIs that want to add savings services for the public to their microcredit portfolios. Sequencing errors can cause multiple, severe, and extended setbacks. Not every transforming MFI needs to follow every step listed below (some MFIs may have already carried out some of the early steps), but careful attention to the different stages of introducing savings facilities is essential.

1. Assess internal capabilities, identify gaps, recruit new staff members as required, and retain outside experts as necessary.
2. Conduct research on demand among potential savers of different kinds, and on the supply of savings facilities among competitors.
3. Plan the pilot project, and design and price products and services for the pilot.
4. Determine whether the necessary institutional capacity is in place to open savings facilities for the public. Create a checklist and make sure that the tasks are completed before introducing savings to the public.
5. Develop criteria for a pilot project site and select the pilot branch.
6. Prepare for the first pilot project—a complex and multifaceted task.
7. Conduct the first pilot project, ensuring that adequate resources are available (and are used), both for the pilot and for its close supervision and regular monitoring.
8. Assess pilot results and revise products, pricing, operations, MIS, and so forth, as necessary. If a second pilot is needed, which is highly likely, begin the planning and preparations for step 9.
9. Plan the second pilot, selecting branches located in different environments, and train managers and staff of the pilot branches.
10. Implement and evaluate the second pilot.
11. Train the trainers of the trainers in preparation for the rollout phase.
12. Expand gradually to all branches, training managers and staff in each location. Do not rush this step!
13. To penetrate the market, develop a detailed, systematic approach to identifying potential savers and mobilizing their savings.
14. Select a pilot area, train managers and staff, and conduct a pilot in market penetration. Evaluate results, revise methods, and gradually roll out to all the MFI's branches.
15. Develop appropriate strategies for investing excess liquidity.

Source: Author.

These steps are discussed in detail in appendix 1 to this book, Sequencing the Introduction of Public Savings in Regulated MFIs.

Who Benefits?

No one has ever said that transforming from a microcredit organization to a regulated financial institution is simple—or that mobilizing and intermediating savings from the public is easy. These are not activities for the faint of heart. But is it worth all the trouble? What difference does it make if large-scale financial intermediaries fund loans with savings collected from the public, and serve low-and lower-middle-income households? The short answer is that commercial microfinance makes a difference—and that it benefits virtually everyone involved.

MFI clients benefit in multiple ways The emerging microfinance industry increases the options and the self-confidence of large numbers of clients from low-income households by making available to them a set of financial instruments—savings, credit, money transfers, and other products. These are

designed and implemented so that clients can select which products they want and can then customize product use in ways that meet their own particular needs. This approach helps such people to expand and diversify their enterprises and decrease risks, to store their excess liquidity safely and obtain returns on their savings, and to hold savings accounts that are legally recognized assets.

Institutions providing commercial microfinance services have been able to grow to scale profitably and to become viable for the long term. Efficiency increases with growing competition, benefiting both the financial institutions and their clients.

Governments benefit because they no longer need to provide credit subsidies or cover the losses of subsidized credit programs—and because the resulting savings can be used as needed for direct poverty alleviation programs for the extremely poor.

Economies benefit from increased production, from the new resources made available for investment, and from improvements in equity.

Societies benefit because building inclusive financial sectors helps to create an enabling environment for the growth of social and political participation, and of equity.

Notes

1. In the banking industry a savings account refers to "money that is deposited in a bank, usually in small amounts periodically over a long period, and not subject to withdrawal by check," while the term deposit refers to "an amount of funds consisting of cash and/or checks, draft, coupons, and other cash items that may be converted into cash upon collection" (Rosenberg 1993, pp. 107, 308). Because these distinctions are not always relevant in the microfinance market and because others may be more important, the terms deposit and savings (when used to refer to accounts and services) are used synonymously here.
2. The term *public savings* is sometimes used to refer to publicly owned savings. Here it refers to voluntary savings mobilized from the public; these savings may be privately or publicly owned. Many MFIs have both kinds of deposits. In contrast to voluntary savings, mandatory savings, required by many microcredit organizations as a condition of receiving a loan, are, from the clients' perspective, largely a cost of the loan; they are not discussed here.
3. Such institutions include banks of various kinds, nonbank financial institutions, credit unions, financial cooperatives, and others—including some in developed countries. Microfinance providers of these kinds can select the aspects of savings mobilization discussed here that may be most relevant for their particular needs (which will vary from one institution to another).
4. The term *large-scale microfinance institution,* as used here, is broadly construed to mean an institution that provides microfinance services on a substantial scale, and that includes both specialized and nonspecialized institutions. *Large scale* means coverage of millions of clients in large countries. For smaller countries and for middle- and high-income countries with limited demand, large scale means outreach to a significant portion of the microfinance market. Profitability means covering all costs and risks without subsidy and returning a profit to the institution.
5. There are sometimes exceptions to this list of savers' common requirements. One example is interest payments. Under Islamic (Sharia) law, money is not considered an earning asset, and gaining income through fixed interest payments is prohibited. But risk sharing and profit sharing between the owner of the capital and its user are encouraged. Thus, when strictly observed, Islamic banking principles require adjustments to standard lending and savings products, as well as to other banking instruments. Loans may be provided, but on a profit-sharing basis. While a fixed interest rate may not be paid on savings accounts, financial institutions can invest clients' savings in industries that comply with Sharia law—and can then share the profits from these investments with the savers.
6. The ownership issue can also be exacerbated by disagreements between donors or international NGOs that have established microcredit organizations that plan to transform to regulated MFIs, and the country's regulatory authorities. The former may insist on maintaining 100 percent, or at least majority, ownership while the latter may require more diversified ownership.
7. This problem is, of course, not unique to microfinance. That people who are successful in envisioning

and building institutions are often not qualified to manage these institutions once they have become large and complex is a fact well known to the business world.

8. The discussion in principles 5 and 6 is based in part on Robinson 2002a.
9. The terminology used in the CGAP study differs somewhat from that used here. In this chapter MFI is used, for convenience, to refer to all types of microfinance providers, both those that specialize in microfinance and those that serve a wider range of clients. In contrast, the CGAP paper uses MFI in a restricted sense to mean institutions that specialize in microfinance, while AFI is used there to refer to the broad category of institutions (including MFIs) that focus on clients generally below the level served by commercial banks. Both the term MFI as used here and the term AFI as used in the CGAP study include institutions such as NGOs, financial cooperatives and credit unions, rural and agricultural banks, postal savings banks, and others.
10. See also Robinson 2001, 2002b; MicroSave 2001d; Mutesasira 2000; Rutherford 2000, 2001; and Wright 1999c.

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Chapter 2

Regulation and Supervision

The Policy Framework

Financial services to poor people include not only small working capital loans but also savings services, payment transfers, loans for consumption purposes, housing loans, insurance facilities, and more. Furthermore, microfinance services can be offered by a wide range of financial institutions ranging from commercial and public banks, savings and loan cooperatives, nongovernmental organizations (NGOs), and others. Given the diversity of financial services to the poor and the institutions that offer these services, microfinance should be seen as an integral part of a country's financial system.[1]

The financial system includes financial institutions, financial markets, and financial instruments, as well as the legal environment, financial policies, and institutional frameworks. The integration of microfinance into a country's financial system requires a strategy that takes into account the overall policy and legal framework, markets and instruments, as well as the state of development of the microfinance industry.

Views regarding the role of financial systems in poverty alleviation underwent profound changes during the past decades. Until the 1990s, in many developing countries, vast amounts of mostly subsidized government funds were channeled to farmers and small enterprises, often for specific targeted activities. During the 1990s and more recently, a new approach has emerged that focuses on the performance of financial institutions in delivering services to segments of the population that have little or no access to finance. This change is substantial, with some observers referring to it as a "paradigm shift" in development finance.

Achieving a conducive policy and legal framework is generally believed to be a better way to promote microfinance and increase the depth and breadth of access to financial services (sometimes referred to as "financial deepening") than for governments and central banks to directly participate in market transactions. It is further believed that a favorable policy environment is the prerequisite for the development of viable and sound financial

This chapter was written by Gabriela Braun and Alfred Hannig of GTZ. They would like to thank David Kalyango, Assistant Chief Accountant, Bank of Uganda, and Stefan Staschen, consultant to GTZ, for their inputs and for reviewing this chapter.

institutions operating in an efficient financial system that serves the significant demand of various unbanked markets. Finally, there is agreement, for the most part, that the need for regulation and supervision arises when microfinance institutions (MFIs) take deposits from the public.

Although there is general consensus on the *need* for a favorable policy environment for microfinance, there is no current consensus on how to *create* this environment. In particular, there are competing views on whether microfinance should be subjected to specialized legislation and regulations or whether MFIs should be regulated under the existing framework in a country. "Microfinance services can be provided under a wide range of institutional models, which are regulated under laws as different as a banking law, a cooperative law, a specific microfinance law, or any other law defining a lower 'tier' of financial institutions" (Staschen 2003, p. 2).

The decision about whether to introduce a new law needs to consider the context of each country.[2] In Uganda, as in many other countries, the decision was made to develop separate legislation to regulate microfinance—this, however, is only one possible approach. It may be easier, in fact, to adapt existing legislation than to promulgate a new law. Adapting existing legislation could involve amending the law or issuing microfinance specific regulations or both.[3] However, both options may suffer from politicalization and consume a fair amount of time, or in some cases, may not be possible.

Although this book does not advocate that microfinance be regulated only under a specialized law (rather than the existing framework), it does emphasize the need to understand how microfinance differs from traditional financial services and how effective regulation and supervision should be implemented. The underlying assumption is that institutions conducting "microfinance business," whether solely or as part of a larger portfolio, may be subject to regulatory provisions that differ from traditional banking regulation. At the very least, the supervisory body needs to understand and appreciate the different risk profile of microfinance institutions.

Thus, this chapter presents an outline to design a regulatory framework that separates microfinance services from the provision of other financial services and as such discusses how to develop or revise separate legislation for microfinance. Even if stakeholders determine that separate legislation is not required, much of this chapter will still be of interest because there is still the need to understand the unique aspects of MFIs if they are to be licensed and supervised under existing legislation or under legislation adapted to microfinance.

In part due to political pressure caused by often high but unclear expectations regarding the purpose of microfinance relative to poverty alleviation, governments often make hasty attempts to produce a specialized framework in a short time, or to license MFIs under the existing framework. This can result in microfinance regulation and supervision that is ill-suited both to the developmental stage of the industry as well as to the capacities of the supervisory authorities charged with overseeing microfinance.

It is imperative, therefore, that the introduction of microfinance legislation follows a systematic approach. In this chapter, three areas are presented that must be addressed to successfully introduce and implement an adequate regulatory framework for microfinance: policy; legislation, from both strategic and practical viewpoints; and supervision.

Key Policy Issues

To begin, a number of key policy issues need to clarified and agreed upon among major stakeholders, including government, investors, the central bank and other supervisory bodies, practitioners, and international donors contributing to the sector. Whether the process of creating a legal framework for microfinance should even be initiated depends on factors including existing government policies,

Box 2.1 Consultative Process in Uganda

In Uganda, discussions on microfinance regulation started in 1996, long before the specialized microfinance law was finally passed. Initially, there was a lack of clarity and some confusion regarding key development issues of the industry. In particular, the purpose of regulating MFIs was not well understood.

In 1997, the government set up the Microfinance Forum (MFF) chaired by the Ministry of Finance, Planning and Economic Development where government, donor, and MFI representatives met to discuss how to develop an adequate legal framework to include MFIs as full-fledged sustainable financial intermediaries. The central bank, as the responsible supervisory body, took the lead in drafting a policy paper, which was, after lengthy consultations with all representatives in the MFF, accepted by all stakeholders and approved by the cabinet in 1999. This document provided the overall policy framework for microfinance in Uganda including the guiding principles for the eventual microfinance law (Micro-Finance Deposit-Taking Institutions Act of 2003), which was passed by Parliament in November 2002 and came into effect in July 2003.

During this time, the culture of consultation became deeply rooted among microfinance stakeholders in Uganda. All important industry issues (for example, outreach, credit reference systems, capacity building for MFIs, consumer protection) were discussed in the MFF or subcommittees on a monthly or quarterly basis. The culture of consultation not only contributed to a relatively smooth passage through the legal process but also significantly improved donor coordination and effectiveness. The culture of consultation was also reflected in the dialogue between the Bank of Uganda and MFIs submitting applications for licenses as deposit-taking institutions. This contrasts with other countries where only after new legislation has been introduced do the supervisory body and the practitioners start discussions to better understand each other's positions.

Source: Authors.

the stage of development of the microfinance sector, and the capacity of regulators and supervisors in the country. Given the differing agendas and needs of various stakeholders, all must be considered for the development of a vibrant and sustainable microfinance industry, fully integrated into the country's financial sector.

The design of a comprehensive microfinance policy framework requires a consultative process among all stakeholders. Although this process is time-consuming and costly, it is indispensable to developing a consistent and sustainable long-term approach for the creation of an effective microfinance industry. See boxes 2.1 and 2.2.

The consultative process must recognize and take into account the motives of the various stakeholders to regulate the microfinance industry. The most common motives include the protection of depositors through the safety and soundness of financial institutions; the protection of borrowers from high interest rates; controlling MFIs, that are sometimes seen as too far outside the formal financial sector; and facilitating access to additional funding sources.

Depositor Protection: Safety and Soundness of Financial Institutions

Savings mobilization is attractive to MFIs for two primary reasons: it can help an institution achieve long-term viability by providing a stable source of relatively low-cost funds, and it can drive large-scale outreach by broadening both the product array and the client base. At the same time, the mobilization of savings introduces new risks for the institution, most of which have implications for the larger financial system.

Prudential regulation is defined as a set of clear and fair rules governing the intermediation of

Box 2.2 Steps for Launching a Consultative Strategy

When launching a consultative process the following steps may be considered:

- Map existing legal and regulatory framework currently applied to financial service providers.
- Map existing means of delivering and providers of microfinance services in the country.
- Articulate broad goals of the legal and regulatory environment for microfinance.
- Assess adequacy of existing legal and regulatory framework for needs of microfinance industry and identify legal or regulatory bottlenecks or limitations, if any, that have slowed development of the microfinance industry.
- Determine which government authorities and bodies are likely to have an interest in this area.
- Determine which nongovernment authorities are also likely to have an interest, such as donors, MFI practitioners, national microfinance associations (if any), downscaling commercial banks, government-related funders of microfinance, and others.
- Determine which political players and interest groups will likely seek to participate in the consultative process.
- Identify champions within and outside the government who are likely to steer and lead the consultative process once launched.

Source: Authors.

financial resources between savers and investors. The purpose is to protect customer deposits from unsound lending practices. Depositors are generally not in a position to monitor the risks taken by a financial institution and to take appropriate corrective action (Diamond 1984; Staschen 1999). In contrast, borrowers put the institution's money at risk and consequently do not need protection from a public agency. Accordingly, prudential regulation is largely aimed at protecting depositors, not borrowers.

The failure of a financial institution affects not only the fortunes of its shareholders and depositors but can affect the stability of the whole financial sector. Therefore, the regulator's emphasis is on institutional sustainability and soundness of financial operations to ensure the stability of the financial system. However, the extent to which a failed MFI can pose a threat to the overall stability of the financial system depends highly on context. The scale of microfinance in the economy, the size of the particular MFI, and the scope of its integration into the payment system are some of the factors that will define the degree of systemic risk.

Borrower Protection: High Interest Rates

Another frequent argument for the introduction of a regulatory framework for MFIs is the need for consumer protection of borrowers from MFIs. Not surprisingly, many politicians and other stakeholders feel that poor borrowers should be protected from inappropriate or unethical lending practices. Sometimes these concerns focus attention on the interest rates charged by MFIs. Although it is certainly true that many MFIs charge high interest rates, this is often, at least in part, attributable to the high costs of microfinance operations relative to the size of the loans that generate revenue to cover these costs. However, there are also cases where the high rates of interest charged on loan products by MFIs are due to operational inefficiencies and in some cases even to exploitive practices. A question for policy makers, therefore, is whether to impose interest rate limits or alternatively to advance an environment that encourages MFIs (and other providers of finance to poor borrowers) to be transparent about the pricing, terms, and conditions of their loan products so borrowers can make

informed choices. Governments can also contribute to the lowering of interest rates by providing the physical infrastructure necessary in rural areas (which would lower costs for the MFIs) and ensuring that legal policies are in place for effective financial services and that efficient capital markets are developed. In fact, it is generally accepted that usury laws do not reduce borrowing costs to clients because institutions need to earn enough revenue to be sustainable and will make up revenue through charges other than interest.

Another question is how best to ensure that borrowers have the opportunity and channels for making complaints about abusive and fraudulent practices.[4] Prudential regulation and supervision by the banking supervisory authority is not the appropriate way to deal with this problem unless inappropriate lending practices put the profitability of a deposit-taking MFIs, and hence the safety of depositors' money, at risk.[5] Channels of communication for borrowers need to be established separate from the regulatory framework.

Control of MFIs

In some countries, the introduction of microfinance regulation is driven by policy makers' desires to control NGOs and other semiformal microfinance providers. An example is provided by Ethiopia, where the central bank is mandated to license all MFIs that extend small credit to rural farmers and urban entrepreneurs (Meagher 2002). Putting aside the question of whether central banks have the capacity to supervise all MFIs, a regulatory framework that aims at controlling all semiformal or informal financial activities may prevent small and innovative forms of microfinance from emerging and developing by overburdening MFIs with exhaustive regulatory requirements such as reporting mechanisms, operational standards, and business limitations. This may impede the development of an effective microfinance industry.

Facilitating Access to New Funding Sources

From the practitioners' perspective, transforming into a regulated financial institution can increase access to a broader array of funding sources; however, the types of funding sources available, such as deposits or certain debt facilities, may be restricted by the type of license. Although the focus of this book is on NGOs that transform into deposit-taking regulated financial institutions, it is important to note that not all MFIs are choosing to subject themselves to bank regulation with the intent to take deposits from the public. Some, instead, subject themselves to securities regulation (Lopez 2005) to facilitate raising funds from the local or international capital markets, and once this is in place, then decide to transform into a bank. Such is the case of Compartamos in Mexico, which initially changed legal form (from an NGO to a Sociedad Financiera de Objeto Limitado [SOFOL], which translates to "a regulated financial institution with limited objective") to issue debt securities in the Mexican capital market, and is now converting to a commercial bank to mobilize public deposits. In some countries, MFIs seek to be licensed by a government authority because this is the only way to access funding provided by a wholesale refinancing institution (see the example of Peru's EDPYME's in box 2.3), or because being regulated enhances MFIs' reputations as sustainable financial institutions.

Whatever the nature of the legal transformation, such transformed MFIs typically are able to tap a broader range of funding sources—savings, bonds, and equity provided by institutional and private investors—than their charitable or not-for-profit counterparts.

To summarize, prudential regulation in all its forms is often seen as an instrument to achieve diverse objectives, such as protection of depositors, reduction of systemic risk, and promotion of safety and soundness of the financial sector as a whole. Stakeholders should understand that prudential regulation can contribute to the development of the

Box 2.3 EDPYMEs in Peru

Through an amendment to its banking legislation in 1995, Peru established a framework for NGO MFIs to convert into regulated financial institutions called Entidades de Desarrollo para la Pequeña y Microempresa (EDPYME) (Development Entities for Small and Microenterprises). Concurrently, the Peruvian wholesale refinancing institution Corporación Financiera de Desarrollo (COFIDE) (Financial Development Corporation) received considerable funding from donor agencies and the Peruvian government, which created pressure to on-lend to MFIs. However, since COFIDE was only allowed to lend to regulated financial institutions, disbursement pressure constituted a major factor in introducing the legal framework.

Entry requirements for EDPYMEs are relatively easy to meet. Minimum capital, for instance, is set at U.S.$245,000, which is quite low in the Latin American context. However, EDPYMEs are only allowed to mobilize deposits if they have minimum capital of at least U.S.$1.35 million and receive an acceptable rating (B or higher) from a rating agency recognized by the supervisory authority. As of 2004, no EDPYME had been cleared for deposit taking. Thus, this model is unlikely to provide a good example for promoting financial sector deepening, particularly for providing an incentive to offer diversified financial services other than credit. EDPYMEs have access to sufficient funding from COFIDE, so there is little incentive to seek investors or to go into the cumbersome business of deposit mobilization. Moreover, a wholesale financial institution should be in a position to evaluate the creditworthiness of the financial institution to which it lends money instead of shifting this task to the banking supervisory authority.

Source: Staschen 1999, p. 36; Meagher 2002, p. 21; and Jansson, Rosales, and Westley 2003.

microfinance industry by enabling strong MFIs to access commercial funding or to mobilize deposits (or both), but it cannot address all issues in the development of the microfinance industry. The best way to promote the industry is to design a holistic strategic framework that clearly identifies the industry's development issues and that assigns responsibilities to the relevant actors in resolving these issues. This strategy should include key issues such as capacity-building standards and the relevance of apex organizations, as well as the effects of interest rate restrictions and direct political interventions.

The Strategic Approach to Regulation

Just as microfinance should be considered within the overall financial system of a country, microfinance regulation should be understood as an integral part of a strategic microfinance policy framework. This strategic framework will help stakeholders develop a clear understanding of the different steps to promote microfinance and will lead to the formulation of a joint vision for the future of the industry and the financial sector as a whole.

If the introduction of prudential regulation is found to be an appropriate measure for the development of the microfinance industry, the various stakeholders should begin by addressing "who" and "what" should be regulated and then address the roles and responsibilities of the various stakeholders including the government, regulatory and supervisory bodies, practitioners, and donors.

Who Should Be Regulated?

Only MFIs that intermediate deposits from the public are likely to pose risks—either to depositors or to the systemic health of the financial sector at

large—and thus require prudential regulation and supervision. Most credit-only MFIs do not need to be subjected to prudential regulation for reasons explained above.

Any decision on introducing prudential regulation and supervision should be preceded by a thorough analysis of the actual state of the industry and the performance of the leading MFIs. If the leading MFIs are not ready to transform into deposit-taking institutions, the high costs of introducing a new framework and developing the adequate supervisory capacity cannot be justified. In this case, supportive measures should be put in place for MFIs to build their capacity to provide sustainable microfinance services before pursuing a regulation strategy. If only one or two MFIs are candidates to become regulated deposit-taking institutions, it may be appropriate to try to accommodate them under existing laws, possibly through amending the existing banking and financial institutions law.[6]

The regulatory framework should be flexible enough to permit unregulated MFIs to evolve. These institutions, although typically prohibited from taking deposits from the public, may have the potential to test innovative technologies, and to grow and to maintain outreach to the poor. The coexistence of regulated and unregulated financial institutions can be supported by adopting a tiered approach, which, in theory, should facilitate appropriate regulation and supervision and prevent regulatory arbitrage.

> Defining a regulatory window distinct from other legal frameworks is a multidimensional undertaking. . . . Microfinance regulation differs in a number of ways from traditional banking regulation, just as microfinance differs from other financial services. At least in theory, these differences in regulatory requirements for microfinance should make it unattractive for other kinds of institutions to use the regulatory window, which is solely reserved for MFIs. The clear definition of microfinance-specific provisions, which renders the regulatory framework unattractive for other types of financial institutions, leads MFIs to filter themselves into the most appropriate regulatory window. (Staschen 2003, p. 15)

The fundamental issue in seeking the most appropriate tiered approach is whether there are MFIs strong enough to obtain a license as a specialized financial intermediary but find it difficult to be licensed under the existing regulatory framework due to high minimum capital or other requirements imposed on banks and other regulated nonbank financial institutions. In many countries, minimum capital requirements for non-bank financial institutions and even for commercial banks can be met by strong and sustainable MFIs that have the necessary track record to attract one of the dozens of institutional investors that have as their main objective the provision of equity to transformed MFIs (ProFund, ACCION Investments in Microfinance, AfriCap Microfinance Fund, Triodos Bank, and many others). Separate legal windows are only justified if transformation under the existing laws is not feasible for strong and sustainable NGO MFIs. As mentioned above, a critical mass of MFIs that are likely to want to offer deposit-taking services to the public, that have or will soon have the operational and management capacity to do so, and that are likely to meet rigorous licensing and regulatory requirements, should exist before introducing a separate microfinance window.

Among the countries that have introduced tiered approaches are Bolivia, Ghana, Indonesia (where the Bank Perkreditan Rakyat (BPR) constitutes a second tier of institutions recognized under the banking law, see box 2.4), the Kyrgyz Republic, Peru, the Philippines, and Uganda.

In jurisdictions with no specific microfinance enabling law (and with little chance of enacting one, either due to the small number of institutions

Box 2.4 Bank Perkreditan Rakyat

Indonesia's highly diversified and predominantly formal microfinance industry is both the result of the country's past colonial administration and the evolution of its financial sector. The key enabling factor for the rise of BPRs was financial sector deregulation in the early 1980s. Liberalized interest rates, allowing MFIs to charge cost-recovery interest rates, supported the transformation into commercially oriented MFIs and increased outreach of financial services. According to the 1988 banking reform, which constituted a tiered legal and regulatory framework and removed most banking industry entry barriers, BPR unit banks were newly established with private capital and some existing community-owned financial institutions converted into BPRs. The banking act of 1992 finally recognized BPRs as secondary banks—limited to providing savings, deposits, and credit products only—with minimum capital requirements of only 50 million rupiah (equivalent to U.S.$24,190 at year-end 1992). During the following five years, more than 1,000 new BPRs were set up, mostly by private owners, and some 600 other MFIs converted to BPRs. With the amendment of the banking act in 1998 and more recent regulations concerning the BPR industry, licensing restrictions for BPR branches were lifted, enabling BPRs to open branches in the national, provincial, and district capitals as well in the subdistricts. The central bank, as the licensing authority of BPRs, has promulgated prudential regulations, including increased paid-up capital requirements, more rigid supervision, and enforcement of performance standards in response to the financial crises in 1997, with the effect that the number of BPRs will not continue to grow as fast as during the last two decades. It can be expected that the consolidation period, which started in 2000, might force small BPR unit banks to merge with other BPRs to create larger, more efficient and professional BPRs or alternatively, to merge with commercial banks.

The following statistics, as of June 2005, indicate the success of the BPR initiative:

- Number of BPRs: 2,062
- Number of outlets: 3,086 (including branches and payment posts)
- Number of savings accounts: 6.0 million
- Number of deposit accounts: 331,814
- Number of borrowers: 2.74 million
- Loans outstanding: Rp 11.4 trillion (U.S.$1.2 billion)
- Average loan size: Rp 5.1 million (U.S.$5,300)
- Total assets: Rp 18.7 trillion (U.S.$1.97 billion)
- Nonperforming loan ratio: 8.19 percent

Source: Bank Indonesia 2005; Authors.

to which the law would apply or for legislative reasons), NGOs seeking to transform must do so under existing structures. See box 2.5 for examples.

With respect to member-based institutions, the large number and small size of most such MFIs make effective supervision almost impossible because costs would be prohibitively high. Furthermore, and perhaps more important, such institutions are unlikely to pose a risk to the stability of the financial sector (CGAP 2000), although this may not always be the case (Kenya, for example, has a large cooperative sector). Prohibiting deposit mobilization by small, community-based institutions would force savers back to riskier forms of saving, such as keeping cash or livestock if no formal savings facilities are in place (Christen, Lyman, and Rosenberg 2003).

In general, the reach of prudential regulation should have some lower boundary to exclude certain very small institutions, even if they are intermediating deposits. Nonprudential regulation for these types of institutions, usually member-based, could ensure that banking authorities and other government agencies are aware of the amount and kinds of institutions that are engaging in such activities. However, many countries do not have a

Box 2.5 Examples of Countries with No Specific Microfinance Enabling Law

The Mongolian microfinance market is too small to warrant the creation of a specific law for deposit-taking MFIs. In 2001, when X.A.C. Co. Ltd. decided it wanted to mobilize deposits from the public, it needed to pursue licensing as a full-scale commercial bank. Given the high minimum capital for bank licensing (U.S.$3 million, compared to X.A.C.'s capital of U.S.$1.2 million at the time), the company opted to pursue a merger with Goviin Ekhel LLC (GE), a leading provider of loans to small and medium enterprises. After the October 2001 merger (and following an additional U.S.$150,000 capital injection from Mercy Corps, the owner of GE), the two companies' combined capital met the minimum requirement, and XacBank (the successor organization) was licensed in December 2001. As of June 2005, XacBank had mobilized almost U.S.$20 million in deposits, equal to 83 percent of its loan portfolio.

In Russia, the government created a special type of entity, the nondeposit credit organization (NDCO). However, this was not intended as a form for MFIs, but rather was established to reduce the excessive number of banks in the country. The intention was that some of the weaker banks could trade in their licenses for NDCO licenses, and continue to operate as credit institutions but no longer mobilize deposits from small savers, hence lessening the risk to the financial system. The Russian Women's Microfinance Network (RWMN), a Moscow-based affiliate of Women's World Banking, determined that this regulatory form would work for them because NDCOs are permitted to take institutional savings deposits. Given the widespread availability of low-cost savings vehicles for private individuals in Russia, RWMN believed that institutional deposits would be its best route for raising local funds, rather than taking on the burden of becoming a full-scale bank and competing against the entrenched institutions (particularly the state-owned savings bank). Accordingly, RWMN restructured itself and became an NDCO, receiving its license in September 2005.

Microfinance activity in India has been primarily carried out by NGOs, organized in the form of trusts, societies, cooperatives, or Section 25 companies (a form of not-for-profit company in India). For MFIs seeking to become regulated, deposit-taking institutions, the options are not clear. Options being considered by some of the larger players include nonbanking finance companies (NBFC), cooperatives, and local area banks. Each of these, however, has certain advantages and disadvantages that need to be considered. An NBFC has the ability to attract equity investment from domestic and foreign investors in large volumes, but specific approval must be obtained from the Reserve Bank of India to mobilize deposits. In addition, NGOs face obstacles from a tax standpoint when considering investments in for-profit companies (potentially losing their tax-exempt status) creating challenges for any asset transfer from an NGO to an NBFC. Cooperatives, however, are able to mobilize savings from their members, yet are limited in terms of geographic outreach. Local area banks also have limited geographic presence, as well as steep entry requirements. In short, careful thought needs to be given as to which path to take when integrating MFIs into the formal financial sector in India.

Source: Contributed by Lloyd Stevens, DFID Financial Sector Deepening Project Uganda, and Victoria White, ACCION International.

special law for financial cooperatives nor are they generally under the purview of the financial regulator. Depending on the size of the sector, this could pose systemic risk if the larger ones failed. It is imperative that large financial cooperatives come under some type of effective supervision at some point, to be determined on a country-by-country basis. This may be a significant area for stakeholders to consider when developing a strategic microfinance policy framework. (See annex 2A, Note on Supervising Savings and Credit Cooperatives, for further discussion.)

What Should Be Regulated?

Even within the broad parameters of microfinance, a good deal of complexity can surround the determination of what kinds of activity should be regulated. Some of this may seem a matter of semantics—but definitions do matter. As a result, much attention is often paid to defining what is or is not "microfinance" when establishing a legal and regulatory framework for microfinance. The balancing act for policy makers and legislators is to define activities in terms broad enough to allow the industry to grow and change to respond to the needs of its target customer base, but not to be so general as to become meaningless and perhaps invite regulatory arbitrage by financial players seeking to "pass" as microfinance providers. Some policy makers have responded to this challenge by focusing on definitions of the target client base of microfinance. Others have responded by focusing attention on the kinds of financial services and products being offered. Still others have tried to address both by applying definitions or limitations to the target clients reached and products and services offered by microfinance.

How should microfinance be defined? Microfinance typically refers to the provision of financial services, primarily but not exclusively savings and credit, to poor households that do not have access to formal financial institutions (box 2.6). Many countries use quantitative approaches to define the segments of the population that can be targeted for microfinance products and services (that is, who qualifies as "poor") or to set limits on the maximum loan size of a microloan. However, limits on maximum loan sizes or the size of the borrowers' businesses restrict the ability of MFIs to offer adequate loan products to clients with potential to grow, as well as their ability to service some of the larger loan requests coming from new savings clients. Furthermore, quantitative limits can quickly fall out of date, particularly in economies that are growing increasingly more prosperous. One way to avoid this is to peg loan size limits to a percentage of core capital. As core capital grows, so do the limits on loan sizes.

Supervisors must be able to verify and enforce whatever criteria have been established. So, for example, it is likely to be difficult for supervisors to verify and enforce criteria linked largely to the type or size of business of the MFI's clients. For the purpose of prudential regulation, it may make more sense to define microfinance according to distinctive features that can be established and verified based on "patterns" of operations, rather than individual transactions—such as loan size limitations. Some of these patterns can be geared toward general client and product characteristics and the lending methodologies employed. That said, however, loan size limits are an effective instrument for preventing regulatory arbitrage; rather than absolute loan size limits, regulations may consider a more flexible interpretation, for example, 80 percent of the loan portfolio complying with the limit, or average loan amounts rather than individual loan amounts. Table 2.1 provides examples of countries with loan size limits.

How should the regulator treat compulsory savings? Many MFIs require compulsory savings from customers as a condition for receiving loans. Compulsory savings cannot be considered deposits from the public but rather a device for the MFI to enforce repayment (that is, as an element of the loan product). As long as customers are in a net borrower position (meaning that they owe the MFI more than they have deposited as compulsory savings), there is little risk to them if the MFI should act recklessly with such forced or compulsory savings. However, a more difficult situation exists when the amount of compulsory savings exceeds the amount of the outstanding loan of the customer. This can occur, for example, when compulsory savings are retained in their entirety by the

Box 2.6 Examples of Categories of Microloans

Regulators in different countries define microcredit differently—some by asset volumes or number of employees (or both) and some by less quantitative measures.

- In Peru, banking regulation defines microcredit as loans granted to microenterprises with a volume of assets, excluding fixed assets, below U.S.$20,000 and accumulated debts below U.S.$20,000.
- In Colombia, according to the definition of the banking supervisory authority, microcredits are defined as loans granted to microenterprises with fewer than 10 employees and total assets below 501 times monthly minimum wages, which at the time of the study were U.S.$115.60 per month (U.S.$58,000). The loan size granted to such an enterprise by a financial institution may not exceed 25 times monthly minimum wages (U.S.$2,890) (Jansson, Rosales, and Westley 2003).
- In the Philippines, microfinance loans are defined as small loans granted to poor and low-income households for their microenterprises and small businesses. The maximum amount of a microloan is approximately 150,000 Philippine pesos (U.S.$2,700).
- In Bosnia and Herzegovina, the Law on Microcredit Organisations states, "Microcredit organisation in the sense of this law is a non-deposit and non-profit organisation whose basic activity is the provision of microcredits to the socially jeopardised with a view to the development of entrepreneurship."
- The Pakistan Prudential Regulations for Microfinance state that the MFI shall not extend loans exceeding 100,000 Pakistan rupees (approximately U.S.$1,700) to a single borrower.
- In Honduras, the Law for FPDOs includes, "Financial Private Development Organisations are private companies, which are founded with the purpose to offer financial services in support of the economic activities carried out by micro and small enterprises."
- In Nepal, the Preamble to the Development Banks Act includes the following: "Development banks [are] connected with the development of specific sectors in order to make available financial resources and technology needed for the establishment, development, expansion and increase in the capacity and productivity of agricultural, industrial, services, trade and other commercially viable and productive enterprises, and thus impart dynamism to the development of the nation's industrial, trade and agricultural sectors and mobilize available skills, labour and capital for the development of rural and urban areas."

Source: Adapted from Staschen 2003.

MFI or somehow stay under its control, even though the principal balance on the outstanding loan is diminishing over time.

Even when the customer is a net saver (albeit a "forced" net saver) the role of prudential regulation may be limited. Rather, policy makers may want to consider what are appropriate consumer protection (or nonprudential) practices to encourage MFIs to engage in if requiring compulsory savings from their customers. Furthermore, when MFIs start to mobilize deposits from the public, not only does the need for prudential regulation arise, but to ensure clear and simple business principles, it is also strongly suggested that MFIs abandon the practice of demanding compulsory savings, and instead introduce other risk mitigating techniques, such as interest rate rebates for clients who consistently pay on time. See appendix 1 to this book, Sequencing the Introduction of Public Savings in Regulated MFIs, for more discussion on the elimination of compulsory savings when taking voluntary deposits from the public.

Table 2.1 Limits for Loan Amounts

Country	Maximum loan amount as a percentage of capital
Bolivia	1 percent for CACs (Cooperatives de Ahorro y Crédito—Savings and Credit Cooperatives) category 1 to 4 (unsecured loans)
Ethiopia	Fixed amount
Ghana	10 percent for rural banks (for unsecured loans)
	10 percent for deposit-taking NBFIs (unsecured loans)
Honduras	2–5 percent depending on kind of security
Indonesia	BPRs: 10 percent (proposed)
Nepal	Cooperatives with limited banking license: 5 percent, 10 percent, and 20 percent for first, second, and following loans, respectively
Pakistan	Fixed amount
Uganda	1 percent and 5 percent for individual loans and group loans, respectively

Source: Adapted from Staschen 2003.

Note: NBFI = nonbank financial institution.

Roles and Principles

The following definition is useful when discussing the various roles and principles related to regulation and supervision:

> Regulatory policy is formulated by the government; legislative principles incorporating the policy are passed by Parliament; to flesh out the principles, powers are conferred on a Minister to promulgate rules, generally by means of a statutory instrument; those rules are subject to enforcement by a specialized agency; the courts are responsible for the adjudication of disputes and the imposition of sanctions. (Ogus 1994, p. 104, as quoted in Staschen 2003, p. 5)

In addition to the various government bodies and courts, practitioners, including MFIs and networks of MFIs and international donors, also play important roles in the development of the laws and regulations. The following section highlights the role each of these stakeholders can play, providing recommendations for each in the process.

Political and government support for microfinance. Governments should focus on providing and developing appropriate policy frameworks, which define the market environment, the regulatory approach, institutional standards, capacity-building standards, and the requirements in building the financial infrastructure, including rating agencies, information service providers, apex organizations, associations, and other infrastructure.

- *Clarify key issues regarding microfinance regulation:* In most countries, microfinance is an important element in poverty alleviation strategies. Governments and policy makers, therefore, have a genuine interest in driving the creation of a microfinance regulatory framework. However, political support can become counterproductive if microfinance regulation is perceived as a tool to directly increase outreach by licensing a great number of MFIs and as a channeling device for government funding for development purposes. Therefore, it is important to clarify key issues regarding the need for and the direction of microfinance regulation to avoid the emergence of different and often conflicting paradigms.
- *Avoid "the rush to regulate":* Since the late 1990s, politicians and donors in many countries tend to perceive regulation of microfinance as a way to promote the sustainable delivery of financial services to the poor. However, overregulation or improper regulation may hamper the development of the microfinance industry and do not always lead to the desired effects. In addition, the introduction of a special microfinance law is too expensive in many countries (CGAP 2000).
- *Clearly distinguish between prudential and nonprudential regulation:* The objective of

prudential regulation is to ensure the soundness of the financial system and to protect depositors' money. Nonprudential regulation addresses methods regarding the conduct of business, such as standardization of reporting systems, consumer protection, and prevention of fraud and financial crimes.[7] In the political process of passing a new law on microfinance regulation, politicians may take the opportunity to impose usury ceilings with the objective of promoting development though affordable credits to the poor.[8] Governments have to understand that even if done in the most efficient way, microfinance involves higher operational costs as a percentage of assets than traditional banking. If MFIs serve clients in remote and sparsely populated areas, costs are necessarily even higher. Introducing interest rate ceilings may hamper the development of a flourishing and sustainable microfinance industry and make outreach impossible if ceilings are set too low.

- *Follow a market-oriented approach to development:* Many governments today pursue market-oriented development policies including various measures to liberalize the financial sector. However, when it comes to the objective of poverty alleviation, governments still tend to directly intervene in financial markets. Policy makers should understand that the best way to promote sustainable microfinance is the creation of an enabling environment for the establishment and operation of private providers of financial services for the poor. They should abstain from interventions that distort financial markets, such as the provision of subsidized credit, lending quotas, or, as mentioned above, interest rate ceilings.
- *Recognize microfinance as an integral part of the financial sector:* In many countries, policy makers tend to perceive microfinance as an effective tool for poverty alleviation, micro and small enterprise promotion, or rural development, but not as an integral part of the financial sector. This occurs especially when the responsibility for microfinance is assigned to specific line ministries (for example, Ministry of Agriculture, Ministry of Gender). Because these actors may be more interested in short-term impact on outreach than in long-term sustainability of institutions, the development of a strategic framework for sustainable microfinance can become a cumbersome process. It is, therefore, preferable for microfinance to be assigned to the same ministry as other financial institutions (like banks), frequently the Ministry of Finance.
- *Leave room for flexibility:* In many countries, microfinance is regulated by laws and acts that are subject to parliamentary scrutiny. If microfinance regulation becomes a political issue, legislators may feel tempted to set standards for details of microfinance regulation without delegating rule-making power to the specialized supervisory agency.[9] Legislators should understand that a law can only provide a general framework for prudential regulation and should focus on general issues. Normally, regulatory policy should be structured such that regulatory and supervisory practices can be adapted to a changing environment or easily changed when more experience has been gained. The fine-tuning of rules and guidelines should be done by a specialized regulatory body. Requiring the approval of parliament for every adjustment would lead to enormous inflexibility and ultimately impede the growth of a sound microfinance industry.

Leadership by the supervisor. Leadership by the supervising authority can be instrumental in the successful design and implementation of a microfinance regulatory framework. Because the supervisor's main interest is to ensure safety and soundness of the financial sector, she or he will argue against overburdening the regulatory framework with other or conflicting objectives such as monetary stability, credit channeling, or even redistribution of

income. However, this greatly depends on the supervisory body's knowledge and understanding of microfinance. Also, supervisory authorities may not have the necessary political accountability to implement legal frameworks. The supervisor must also be careful to balance the goal of financial sector stability with outreach, lest regulation be so strict that all growth is curtailed in the name of safety.

- *Do not regulate what cannot be supervised:* Even carefully designed regulations will be useless if they cannot be enforced by effective supervision. Effective supervision requires sufficient capacity and resources, which are often not available to the extent required to supervise large numbers of small MFIs. Entry requirements should balance the objectives of enabling strong MFIs to offer a broader range of services to their clients against not allowing large numbers of weak institutions to mobilize deposits from the public without being adequately supervised.
- *Take a strategic perspective when designing the regulatory framework:* The regulatory framework sets the parameters for the future as a basis to ensure safety and soundness of the MFIs' operations as well as the foundation for sustainable growth. Regulators should anticipate and do their best to prevent the worst-case scenario rather than simply legalize current practices (Hannig and Omar 2000).
- *Accept that microfinance supervision requires cultural change:* Most supervisors do not know how microfinance works and how it is different from traditional banking. Hence, they may be reluctant to accept any modification to normal procedures (Theodore and Trigo Loubiere 2001). It may take some time to accept and understand microfinance management techniques for handling small loans without traditional forms of collateral.
- *Consider creating a separate section or division for supervision of MFIs within the banking supervisory authority:* It is advisable to create a separate division for microfinance with specialized staff to supervise MFIs and microfinance portfolios of other financial institutions (Theodore and Trigo Loubiere 2001). As noted, microfinance is a special segment of the financial system, requiring specialized knowledge for effective supervision. Supervisors accustomed to traditional banks may stifle the growth of microfinance simply due to a lack of understanding of its approaches and nontraditional forms of risk mitigation (such as solidarity group guarantees).
- *Prevent "brain drain" of skilled microfinance supervisors:* Staff who have been well-trained, usually at significant expense, might be tempted to look for employment opportunities outside the supervisory agency. Especially in countries where there is a general lack of well-trained microfinance specialists, MFIs and even donors sometimes offer high salaries to supervisors experienced in microfinance. The supervisory agency should offer competitive remuneration schemes and other incentives such as career prospects to well-trained staff.

Support from practitioners. Open communication between MFIs and the supervisory authority has proven to be invaluable in building mutual understanding between the parties to develop acceptable supervisory mechanisms (Theodore and Trigo Loubiere 2001). Engaging practitioners in the consultative process helps to ensure that an adequate framework is developed that takes into account their capacity to fulfill rules and regulations. However, it is important to keep in mind that this process could result in the regulations being shaped in the interest of the industry rather than the broader public interest represented by the regulator, so a balance must be reached. Microfinance networks can significantly support the policy dialogue regarding an appropriate regulatory environment for microfinance. They can drive consensus building among member organizations, disseminate information on good practices, lobby,

and play an advocacy role to ensure appropriate policies. To effectively play this role, a microfinance network must have a broad membership and a clear mandate to perform its role as a voice for the industry. Furthermore, the professionalism of the board and the management and the network's ability to create alliances with national and international stakeholders are important factors for success.

- *Educate policy makers and the public about good microfinance practices and lobby for adequate frameworks:* MFIs and strong microfinance networks can play an important role as providers of information about good practices (box 2.7) and as the voice of the industry lobby policy makers to refrain from introducing inadequate regulatory frameworks.
- *Appreciate that self-regulation and supervision are not effective for deposit-taking institutions:* In some cases, self-regulation and self-supervision models are introduced due to limited resources of the supervisor. However, self-regulation and supervision produce a conflict of interest when the "watchdog" is controlled by the institutions that should be watched. Self-supervision can easily become ineffective when there is no enforcement. However, MFI umbrella bodies or associations or networks can introduce performance monitoring systems for their nondeposit-taking members to set incentives for a reporting process that may enhance transparency and discipline.
- *Be realistic about the costs and benefits of being regulated:* In most countries, the majority of MFIs are not yet ready to take on the complex task of financial intermediation. Boards of directors and management should carefully evaluate the costs and benefits of transformation into regulated institutions. Many MFIs mistakenly believe that the capacity to manage savings automatically goes along with the capacity to manage credit. Unrealistic expectations about the potential to become a financial intermediary may result in unnecessary expenses, burdens on management and staff, and may even lead to the failure of the institution.

Box 2.7 The Interest Rate Debate in Uganda

When the MDI bill was discussed in the Ugandan Parliament, members of parliament repeatedly raised their concerns about high interest rates charged by MFIs. The strong and well-recognized Ugandan microfinance network, Association of Microfinance Institutions of Uganda (AMFIU), representing the practitioners and others in the industry and with the support of major donor agencies, carried out intense lobbying activities and actively educated members of parliament and the general public about microfinance good practices. The Ministry of Finance, through its Micro and Small Enterprises Department under the supervision of the Director of Economic Affairs, also provided much needed support to the industry in this debate. At the end of the day, the members of parliament agreed not to include the issue of interest rates in the regulatory framework. However, they passed a motion that the cabinet should develop a proposal to address high interest rates and short loan maturities. This reduced political pressure during the discussion on the regulatory framework and gave the industry more time to design an appropriate strategy for consumer protection.

Source: Authors.

Enabling role of donors. Donors play a crucial role in knowledge transfer of international best practices, and can be instrumental in facilitating knowhow for governments, supervisors, and the industry. They can also facilitate information exchange between stakeholders in different countries and set the basis for an effective South–South dialogue. See box 2.8 for an example of how donors can support the industry.

Box 2.8 Uganda's Transformation Steering Committee

To help achieve the goals of donors supporting transformation in Uganda—coordination, support to mature MFIs, technical assistance, and information exchange—the major donors formed a Transformation Steering Committee. These donors include the World Bank, which is supervising the Uganda Rural Financial Services Project on behalf of IFAD; USAID's Support for Private Enterprise Expansion and Development Project; DFID's Financial Sector Deepening Project; GTZ/SIDA's Financial Systems Development Project; and the Ministry of Finance, Planning and Economic Development's Microfinance Outreach Plan. The committee meets quarterly to discuss issues pertaining to transformation, and coordinates all support to institutions by issuing joint requests for proposals and vetting all assistance provided. To date (December 2005), the committee's members have provided U.S.$4.7 million in support to five institutions, four of which have received their MDI licenses (this figure includes U.S.$2.2 million provided prior to the formation of the committee). The funds are not pooled—the committee's role is to advise its members by reaching consensus. Individual members are, however, free to override the views of the committee in granting funds. The committee also engaged a part-time consultant to serve as its administrator and secretary, and to provide technical assistance where necessary to the transforming institutions.

Source: Contributed by Lloyd Stevens, DFID Financial Sector Deepening Project Uganda.

Note: DFID = the UK Department for International Development; GTZ/SIDA = the German Gesellschaft für Technische Zusammenarbeit/Swedish International Development Cooperation Agency; IFAD = International Fund for Agricultural Development; USAID = United States Agency for International Development.

- *Coordinate support to the industry:* To build up a strong microfinance industry, donors should coordinate their support and agree on common principles based on best practices. Donor agencies should seek to agree on a division of tasks based on their comparative advantages.
- *Help MFIs upgrade their skills by setting performance standards:* Umbrella organizations can encourage greater efficiency in the microfinance sector by setting standards and introducing performance monitoring. Standards and peer grouping provide an incentive for individual MFIs to upgrade their managerial, technical, and financial capabilities, which is a condition for successful transformation into financial intermediaries.
- *Support mature MFIs to be ready for licensing:* Evidence suggests that the costs of meeting the requirements of the supervisory agency can be very high. Donors can help MFIs with good track records and high potential to become fully sustainable to prepare for regulation by providing technical assistance, subsidizing investments in infrastructure and management information systems (MIS), and so forth.
- *Provide technical assistance to develop the capacity of supervisors to supervise microfinance operations effectively:* Supervision of microfinance operations puts high demands on the human and technical capacity of supervisors. Donors can support capacity building through training and international exposure.
- *Support information exchange between stakeholders from different countries:* Donors can add great value in promoting an effective South-South exchange between stakeholders from different countries to enable them to learn from their successes and failures.
- *Accept that banking supervisory authorities might not be in a position to take on additional responsibilities (at least temporarily):* If supervisors' capacity is already overstretched by handling problem banks (which might be protected by powerful political parties), they may be reluctant to accept additional responsibilities for overseeing relatively small MFIs that do not constitute a danger to the financial sector. Donors and

MFIs should accept these reasons instead of believing central banks are narrow minded and not concerned with the poor (CGAP 2000).

The Regulatory Framework

Once all major stakeholders have agreed on the strategic approach to regulation, the detailed legal framework can be developed. When developing the regulatory framework, regulators should understand and take into account the risks MFIs face to fully ensure the adequacy of regulation. Although MFIs face many risks similar to those faced by other financial institutions, features unique to microfinance influence the risk to MFIs, which the regulator should be aware of when developing microfinance regulation and when supervising MFI operations.[10]

Risks in Microfinance

MFIs are particularly exposed to the following risks:[11]

- Ownership and governance risk
- Credit risk
- Liquidity risk
- Operational or management risk
- Interest rate risk
- Reputation risk

An MFI's performance critically depends on its ownership and governance structure. In particular, NGO MFIs are exposed to considerable *ownership and governance risk*. NGO MFIs do not have real owners with their own capital at risk, particularly institutions capitalized with donor funds where funding agencies may be primarily interested in achieving social objectives. Generally, little incentive is provided to closely observe the MFI's financial performance and to install adequate internal control mechanisms. Thus, regulators often insist that MFIs convert into companies with shareholders under private company law before they are allowed to take deposits. This may lead to the risk of regulators (and new owners) encouraging the MFI to move up market (mission drift), as happened when K-Rep in Kenya transformed to a bank (box 2.9).

Box 2.9 K-Rep Bank, Kenya

To demonstrate its commitment to serving the poor, K-Rep Bank located its headquarters in one of the largest slums in Nairobi, called *Kawangware.* Nonetheless, K-Rep Bank encountered potential mission drift, as regulators and some board members urged the bank to move into more profitable lending activities (especially after the central bank's first inspection). Some of the new staff from the banking sector tried hard to instill conventional lending practices that would exclude poor clients. It would have been difficult to overcome these challenges if the board composition and top management did not include key proponents of microfinance.

Source: Nyerere et al. 2004.

Credit risk is the probability of loans not being repaid on time or at all.[12] Although MFIs generally maintain low delinquency rates, their portfolios tend to be more volatile than portfolios of financial institutions that use traditional lending technologies. The use of collateral substitutes and reputation-based repayment incentives combined with low contract enforcement capabilities creates considerable risk. Because the borrowers' main incentive to pay back a loan is the expectation of receiving subsequent loans, delinquency may have contagious effects. Moreover, the clientele of most MFIs show a relatively high degree of homogeneity in geographical proximity or market segment, resulting in covariance risk. Because the loan portfolio usually constitutes a proportionately large share of the overall assets, a slight deterioration in repayment rates can have a substantial effect on overall performance.

Liquidity risk refers to the potential inability of a financial institution to accommodate depositors' demands to withdraw their funds or to fund increases in loan demand because of a lack of available cash. Liquidity shortages severely limit the MFI's ability to react adequately to the demand of borrowers and might force it to restrict its lending operations. Because most MFIs employ reputation-based enforcement schemes that ensure access to subsequent loans when borrowers promptly meet their obligations, liquidity shortages weaken a main repayment incentive, which may further stretch the liquidity position.

Like any other financial intermediary, MFIs are also exposed to the risk of portfolio deterioration due to system failures or management and staff weaknesses or fraudulent behavior *(operational or management risk)*. Decentralized decision making requires a sophisticated internal control system and a good MIS. In many MFIs these systems are weak and internal and external control functions are often not properly defined.

Any financial institution is exposed to *interest rate risk* from a potential mismatch in the term structure of assets and liabilities. For instance, if an MFI is tied to a long-term loan with a fixed interest rate and is therefore not able to refinance the loan with cheaper funding when market rates go down, it is forced to keep the lending rate for short-term loans high, although competitors with a more favorable term structure of their assets and liabilities are able to reduce it. In addition, interest rate caps (if applicable) seriously limit an MFI's ability to increase its lending rate if costs of capital increase.

Reputation risk is the risk to earnings or capital arising from negative public opinion (Campion 2000). For transforming MFIs, this risk can expand exponentially as the institution shifts from being a credit-only institution to one that takes on responsibility for mobilizing and intermediating public deposits. Successful savings mobilization requires that the institution be perceived as stable and trustworthy. Any damage to the institution's reputation can have significant implications for the institution's bottom line.

This overview of the major risks in microfinance shows that the risk factors are similar to those of traditional financial institutions.[13] However, in microfinance the relevance of individual risks—the risk profile—may differ considerably from traditional financial institutions.[14]

Levels of Regulation

Regulatory frameworks can be stipulated on different levels of regulation (Staschen 2003). Primary legislation, in the form of laws or acts of parliament, define general standards and principles that financial institutions must meet and that remain relatively stable over time. Secondary legislation, or "statutory regulations," that are promulgated under such laws and acts typically prescribe specific benchmarks and procedures that need to be adapted more often and are unlikely to require legislative input. Laws and acts generally have to be passed by Parliament and thus undergo a time-consuming political decision-making process whereas regulations can be altered more flexibly through an executive body such as a ministry or a central bank. Regulations are usually more detailed and can be adapted to changes in the industry, economy, or regulators' and supervisors' enhanced understanding of the risk being addressed by the regulatory regime. In addition, the supervisory authority may introduce guidelines that further specify selected sections of the laws or statutory regulations. Such guidelines are often defined in circulars; however, they only show the expectations of the supervisory body, and are not included in the requirements for compliance. Specific guidelines or circulars allow for the highest degree of flexibility by providing considerable discretionary power to the supervising authority; however, they also have a lower degree of legal enforceability.

Usually the primary legislation distinguishes between different types of financial institutions and

Box 2.10 Law #1488 of Banks and Financial Institutions (1993)

Law #1488 in Bolivia classifies financial services by financial banking institutions, ancillary financial services companies, and nonbanking financial intermediaries. A bank is defined as an "authorized financial entity devoted to intermediation and the provision of financial services to the public." *Private financial funds* (FFPs) are nonbanking financial entities whose principal objective is channeling resources to micro and small-scale borrowers in urban and rural areas. *Cooperatives and credit unions* are defined as "[a]ll societies constituted under the General Law of Cooperative Societies that have as their objective to promote savings and grant loans to their members." According to the law, all three classes must be registered with the Superintendent of Banks and Financial Entities. The minimum capital requirements and the minimum capital adequacy ratios differ for each category.

Source: Microfinance Gateway, Microfinance Regulation and Supervision Resource Center—Bolivia. http://microfinancegateway.org/resource_centers/reg_sup/.

Box 2.11 The Uganda Micro Finance Deposit-Taking Institutions (MDI) Act of 2003

The Ugandan MDI Act of 2003 includes the definition of microfinance (clarification of basic terminology, microfinance as a line of business), general principles for licensing, restrictions on certain transactions and dealings by MFIs, ownership and corporate governance (including capital requirements, maximum shareholding, and internal and external control), supervision and corrective action, receivership, liquidation, and exit. The regulations that accompany the law define capital adequacy and outline reporting requirements, asset quality, and liquidity requirements, and detail the licensing requirements and procedures.

Source: Uganda MDI Act 2003.

defines the kinds of business these institutions can undertake. It further lays down restrictions on transactions and defines minimum and ongoing capital requirements as well as maximum shareholdings by individuals or groups of individuals (see box 2.10). The law stipulates basic principles of corporate governance including internal and external control, sets rules on concentration and insider lending, provides general guidance on supervision, and spells out the rules for sanctions and corrective actions such as receivership, liquidation, and exit.

The statutory regulations define standards for those issues that may be subject to more frequent changes in the environment (asset quality, loan loss provision, and reporting requirements). To give an example, the ongoing capital requirements for different kinds of financial institutions should be defined in the law, whereas the components of the capital adequacy ratio should be defined in specific regulations (see box 2.11).

Table 2.2 shows the differences between the levels of the regulatory framework in terms of democratic accountability, legal foundation, and flexibility to adapt to changes in the environment.

A prudential regulatory framework (which includes the law and the regulations or statutory instruments) ensures that only sound institutions enter the market, that they are managed in a profitable and sound manner, and that financial institutions and their clients are relatively insulated from the collapse or weaknesses of other financial institutions. Prudential regulation typically includes the following, among others:

- Minimum capital requirements
- Maximum shareholder requirements
- Capital adequacy requirements
- Licensing requirements
- Benchmarks for asset quality

Table 2.2 The Regulatory Framework

	Primary legislation (or laws and acts)	Regulations (or "statutory legislation," "secondary legislation," or "normative acts")	Guidelines
Democratic accountability and delegation of authority	Passed by legislative body	Promulgated by executive body charged with responsibility to execute the law	Published by supervisory authority charged with enforcing legal and regulatory framework
Degree of legal foundation	High	Medium	Low
Flexibility to be altered	Low	Medium	High

Source: Authors' adaptation from Staschen 2003.

- Limitations on risk exposure and insider lending
- Reserve and liquidity requirements
- Reporting requirements
- Sanctions and corrective actions
- Deposit insurance schemes[15]

Good and bad practices of microfinance regulation have been exhaustively discussed elsewhere.[16] The relevant issues are summarized in the following discussion.

Minimum Capital Requirements

To cover the risks of financial intermediation, deposit-taking MFIs must be sufficiently capitalized. Capital provides a cushion against a financial institution's potential losses. It further serves as a screening device so scarce supervisory resources can be used most effectively to supervise financial institutions that create systemic risk. It is often argued that minimum capital should be set at levels low enough to promote the entry of MFIs into the financial sector. Nonetheless, it would be irresponsible to set minimum capital requirements at a level that would allow large numbers of smaller and less mature MFIs to mobilize deposits from the public. It is virtually impossible to supervise them adequately. Also, higher capital requirements can complement monitoring by the regulator, because investors with their own funds at risk will demand increased internal controls.

The legal framework should define *minimum capital requirements* in a way that two objectives—the opening of the financial sector to nontraditional providers of financial services and allowing only sound MFIs with the capacity to intermediate deposits to enter the financial sector—can be pursued simultaneously.

Maximum Shareholder Requirements

Because of ownership and governance risks associated with the predominance of a few owners, legislation should *limit maximum shareholding* by any one investor. Evidence suggests that it can be more difficult to establish a balanced shareholder structure in an MFI than to raise sufficient capital to meet minimum capital requirements. A balanced shareholder structure is a critical factor when regulating MFIs that have transformed from NGOs, where typically the founder NGO becomes one of the shareholders in the licensed financial institution. Individuals and institutions that dominate the NGO are often reluctant to forgo majority shareholding in the transformed institution because they fear mission drift and loss of control.[17] However, concentration of ownership may result in insufficient internal controls and seriously hamper

external supervision.[18] Stakeholders should be aware of the need to ensure a sound ownership and governance structure that allows for efficient management and effective internal controls. Nonetheless, some time may be required for the original NGO or project founders to dilute the ownership to fully comply with regulatory requirements.

In addition to defining quantitative ratios and standards, the regulatory framework must define qualitative standards for adequate ownership and good governance (systems of checks and balances, internal controls), and outline the necessary qualifications of owners, board members, and senior management ("fit and proper" criteria).

Capital Adequacy Requirements

The *capital adequacy ratio* correlates capital with different degrees of risks with the asset side of a financial institution. It is generally accepted that a capital adequacy ratio of 8 percent, as stipulated in the Basle Capital Accord of 1988, is a minimum standard for financial institutions.[19] It is also generally accepted that given the high credit and operational risks of MFIs, capital adequacy requirements should be higher than for traditional financial institutions (Christen, Lyman, and Rosenberg 2003). For example, in Uganda, MDIs require core capital of not less than 15 percent and total capital of not less than 20 percent of risk-weighted assets as compared to 8 percent and 12 percent, respectively, for commercial banks and nonbank financial institutions.

Licensing Requirements

The following minimum criteria should be assessed before permitting an MFI to mobilize deposits from the public:

- Applicant's ability to meet minimum and ongoing capital requirements including the ability to inject more capital if required in the future
- Shareholder structure
- Background, reputation, and professional record of the owners, directors, and senior management (fit and proper criteria)
- Business plan of the applicant including the mission statement; market research results; ownership and corporate governance structure; a description of the scope of operations and services to be offered including the past record, if applicable, of management in providing these services; business strategy; and projected balance sheet and income statements and other supporting documentation
- Description of the applicant's risk management systems showing the ability to detect, measure, monitor, and control the level and types of risks that can be assumed with microfinance services
- Management information systems, the administrative and operational processes, and the internal control system; the supervisor will want to review the manuals that address risk management and various processes including:[20]
  - Credit manual
  - Human resources manual
  - Operations manual
  - Liquidity and funds management policies and procedures
  - Accounting manual
  - Audit manual
- Quality, security, and appropriateness of the premises (branch network, head office)

Once the supervisor accepts the information submitted, the applicant is notified that the application has been accepted and the period for either granting or refusing a license as stipulated in the regulatory framework commences.[21] During the evaluation process the supervisor will have meetings and interviews with the applying MFI's representatives whenever clarification is needed. The importance of this dialogue cannot be overemphasized. Complete openness with the supervisor is critical to the MFI's credibility and any issues that arise must

be brought to the supervisor's attention immediately. This helps build an atmosphere of confidence and trust between the parties, and can lead to a much smoother licensing process.

To confirm the adequacy of the systems and procedures, the MIS, the security systems, and the premises, the supervisor will conduct on-site inspections. Licensed financial institutions have to systematically and timely disclose accurate information to the supervisor. The MIS, therefore, must be able to accommodate any reporting requirement set by the supervisor. Given the importance of the MIS and the internal control system, it is recommended that minimum standards be formulated in the statutory instruments.

Before beginning the licensing process, supervisors need to gain knowledge of the microfinance sector in the country as well as become familiar with the MFIs that have a realistic chance to transform into regulated financial institutions. In some countries, although it may not be stipulated in the regulatory framework, the supervisor will conduct preapplication examinations with those MFIs that have indicated their plans to submit a license application to become a regulated institution. This enables the supervisor to have a close look at the institution and its systems and procedures before a formal application is submitted.[22] Based on the findings, the supervisor can advise the MFI on which areas need improvement to meet licensing requirements.

The execution of preapplication examinations saves time in the formal licensing process because the supervisors gain a relatively deep understanding of the key elements of the MFI's business at an early stage. Likewise, it helps prevent MFIs that are not ready for licensing from spending substantial resources applying for the license, thus saving the MFI and the supervisor significant time. However, because prelicensing examinations consume considerable supervisory resources, only candidates that are known to have some potential for transformation should be considered.[23]

Once the supervisor thoroughly understands the microfinance sector and is familiar with the leading MFIs in the country that wish to transform, the licensing process generally takes the following steps:

- Supervisor may conduct preapplication examinations and advise "licensable" MFIs on those areas that still need to be changed or improved to meet licensing requirements.
- MFIs submit applications including the documentation needed to assess the capacity of the MFI to get a license (as stipulated in the regulations on licensing).
  - Supervisor reviews application with special emphasis on a sound governance structure that allows for appropriate checks and balances regarding the shareholder structure and the background of the shareholders; for example, the supervisor will want to obtain the following from individuals proposed as board members:
    - clean references from individuals and bankers
    - certificate of good conduct
    - statement of assets and liabilities
    - statement of earnings or sources of income
    - professional and educational background
  - proper administration and management, which includes the soundness of the MFI's risk management systems and thus comprises elements such as the level of engagement of the board and senior management oversight; board committees; adequate policies, procedures, and limits; adequate risk monitoring and MIS; and a comprehensive internal control system[24]
  - the applicant's ability to adequately manage liquidity
  - trends in projected financial statements
- The supervisor meets and interviews senior management during the review process to clarify issues to make the evaluation process as transparent as possible.
- Once the supervisor feels that the documentation is complete and is satisfied with the

information submitted, she or he notifies the MFI that the application has been accepted. Once the application has been accepted the period for either granting or rejecting a license commences.
- The supervisor can request the applicant MFI to publish a notice in a daily newspaper to enable persons with objections to licensing of the MFI to come to the attention of the supervisor and the applicant. If there are any objections from the public the applicant will be given a limited period to address the objections.
- To confirm the adequacy of systems, procedures, and premises, the supervisor will conduct on-site inspections.
- During the period for either granting or rejecting the license, the supervisor may disqualify shareholders or members of the senior management that do not meet the "fit and proper" criteria and request that these persons be replaced.

Once the supervisor is satisfied that all conditions have been fulfilled, a license to allow commencement of operations will be granted. The supervisor may attach temporary or permanent conditions to the license (nonpermissible operations, for example).

Asset Quality

Given the unconventional collateral used in microfinance operations and the prevalence of short-term loans with frequent repayment periods, requirements for *provisioning and write-offs* may need to be stricter for MFIs than for traditional lenders. Provisions and write-offs should be based on the amount of loans overdue (portfolio at risk) and the number of days any payments (principal or interest) are overdue. In some countries (Bolivia and Uganda, for example), provisioning requirements are stricter for rescheduled loans than for regular loans taking into consideration that the risk of nonrepayment is higher for loans that have not been paid regularly and on time.

Central bank regulators must also work with other regulatory bodies, such as the tax authority, because provisioning requirements imposed by bank regulators may not always be accepted by tax authorities as allowable expenses, which leads to inconsistent treatment of provisioning and loan losses under the two regulatory regimes.

Risk Concentration and Insider Lending

Although MFIs do not tend to concentrate their lending activities in a small number of large borrowers, regulations typically impose limits on the size of the loans that may be granted to individual borrowers or groups of borrowers. Maximum loan sizes can be prescribed for an individual or a group of borrowers as a percentage of capital, as discussed above. More relevant for MFIs is the *risk of concentration* of large numbers of small loans in geographic areas or economic sectors. However, whether the regulatory framework should establish benchmarks to avoid covariance risk is not clear. It may be better for the supervisor to assess the quality of the MFI's risk management techniques instead of setting rigid benchmarks for portfolio diversification.

The problem of *insider lending* in MFIs is typically addressed either through prohibition or through restricting the size of loans to employees or board members (or their family members) by imposing maximum loan sizes often determined as a percentage of the institution's capital. Prohibiting lending to employees is not always advisable given that many employees, particularly those who are in remote locations, do not always have access to credit elsewhere. It may be reasonable to allow this "benefit" to employees if managed appropriately and staff turnover is taken into account. Furthermore, the regulator may want to require that these loans be fully secured, perhaps by salary.

Reserve and Liquidity Requirements

As mentioned above, even nondeposit-taking MFIs are exposed to liquidity risks. However, liquidity management becomes more complicated when the institution begins mobilizing deposits from the public. Typically, regulations prescribe a percentage of deposits that must be held in *reserve* as *liquid assets* as an ongoing requirement. High reserve requirements come at a cost because MFIs are required to hold available resources as idle funds instead of investing them in earning assets (box 2.12). This can, in turn, lead to a disincentive for MFIs to mobilize deposits in favor of accessing commercial loans (Staschen 2003).

However, liquidity risks are complex and cannot be fully measured and analyzed by a single ratio. Therefore, the supervisory authority should monitor the institution's capability to manage its liquidity effectively (for example, through cash flow analysis, measurement and control of funding requirements, management of access to funds, and contingency plans in case of a liquidity crisis) by means of an internal policy. The policy needs to be supported by an effective MIS and fully implemented with reporting to management and the board of directors. Given most MFIs' lack of experience in liquidity management, supervisors should carefully assess the quality of the liquidity management system *before* deposits are accepted.

Box 2.12 Reserve and Liquidity Requirements in Ghana

Ghana has comparatively high reserve requirements. Rural banks must hold 5 percent of total deposit liabilities with the ARB Apex Bank, 8 percent as primary (cash and balance with other banks), and 20 to 30 percent as secondary reserve requirements (government and Bank of Ghana bills, bonds, and stocks). The percentage rate for the secondary reserve requirements depends on the loan recovery rate. This means that only between 57 and 67 cents of every dollar mobilized from savers can be used for on-lending. Deposit-taking nonbank financial institutions are subject to a 10 percent and 15 percent liquidity ratio for primary and secondary reserves, respectively.

Source: Staschen 2003, p. 30.

Reporting Requirements

The MFI's ability to produce accurate and timely statistical information, both on the institution's financial position and the quality of the loan portfolio, is a key assumption underlying each of the above prudential requirements. In the licensing process, the MFI will need to demonstrate a reliable and robust MIS that is capable of consolidating, on a routine basis, information from all the branch operations and generating accurate reports for both management and external stakeholders, including the central bank. From licensing onward, the MFI will then need to generate and submit key financial and portfolio reports to the central bank (demonstrating compliance with the above prudential regulations), or face fines or other penalties. General recommendations about frequency of reporting are not possible to make, given the diversity of approaches in various countries. For example, in Bolivia and Peru, the most frequent reporting is daily, whereas in Honduras and Mexico it is monthly (Theodore and Trigo Loubiere 2001).

Sanctions and Corrective Actions

Sanctions and corrective actions deter financial institutions from contravening regulations and correct problems caused by the violation of regulations. Staschen (2003) provides an overview of the most common sanctions and corrective actions found when analyzing microfinance legislation in several countries. These include fines, imprisonment, suspension or removal of directors or the entire board,

management takeover, receivership, revocation of operating licenses, and, finally, liquidation of the financial institution. In general, the sanctions and corrective actions that may be imposed on MFIs do not differ significantly from those of other financial institutions. However, the effectiveness of sanctions and corrective actions may be clearly defined on paper, but depend critically on the strength and readiness of the supervisory authority to enforce these rules, that is, to take prompt corrective actions for clearly measurable violations of regulations. Corrective tools used with banks may not work well with MFIs, given their unique portfolios and credit methodologies. Supervisors may find that stop-lending orders, for example, are not appropriate[25] or that management takeovers are not easy given the difficulty of finding qualified managers in the microfinance industry. Because this is a new area for many regulators, some learning still needs to take place on what will work best.

Deposit Insurance Schemes

In general, the very existence of a *deposit insurance scheme* is an effective instrument to avert a "run on deposits" (the massive withdrawal of deposits when a financial institution faces problems). However, as any insurance might, deposit protection may create "moral hazard" in the sense that depositors feel safe and, therefore, do not take into account or seek all available information when choosing to deposit their funds with a particular financial institution. This absence of effective oversight by depositors may induce excessive risk taking by the financial institution. To avoid moral hazard, deposit insurance schemes normally cover a maximum value per client or per account, representing only a percentage of the total deposit volume. If a financial institution collapses, large depositors whose deposits are not fully covered by the insurance would suffer major losses, giving these depositors an incentive to take effective measures to control the risk-taking behavior of the financial institution. In contrast, small depositors who are not in a position to monitor the financial institution's behavior require external protection. Unlike in traditional financial institutions, the savers that put their money in an MFI, in general, remain below the traditional limit for covering depositors' losses and because MFIs normally do not attract many large savers, a large portion of deposits is covered by the insurance. Therefore, there may be no outside interests to control the institution effectively, which exposes an MFI to moral hazard.

Another issue related to deposit insurance is the fact that commercial banks may be reluctant to share their commonly funded deposit insurance schemes with newly licensed MFIs because they perceive these MFIs as high risks. Although it does not make much sense to establish a separate insurance protection fund for the few and relatively small regulated MFIs, it may happen, as in Uganda, that two depositors' protection funds are needed (one for commercial banks and one for MFIs) with one governing board overseeing both funds. The problem that arises from such a scheme is that the contributions to the fund provided by the few regulated MFIs will not be sufficient to cover all the risks the fund should cover. It is also unclear how the operating expenses that normally should be covered out of the returns from investing the fund's unused capital in interest-bearing assets, can be funded. Either the government or a donor agency may need to provide the necessary seed capital for the establishment of an MFI deposit insurance fund large enough to operate on a cost-covering basis. However, it must be kept in mind that regulated MFIs are likely to mobilize relatively large amounts of deposits. Depending on the amount of coverage, the fund could easily be depleted if a single institution closes. In sum, the discussion on microfinance deposit protection schemes is fairly new and does not yet provide general experience to support ways to design such schemes.[26]

Supervision

The last decade saw broad discussion of regulatory frameworks for MFIs. However, far less attention was given to the supervisory challenges in microfinance, perhaps because experience in microfinance supervision is still limited. Regulators' resources are scarce and dedicated to protecting depositors (thus, they are seldom interested in MFIs, because their efforts tend to be directed to larger institutions where most of the depositors' assets are concentrated). Effective supervision of financial institutions comprises licensing new financial institutions; establishing a framework for prudential reporting and off-site surveillance, and the execution of these activities; followed by on-site supervision. Supervision also includes the execution of sanctions and corrective actions if regulations have been violated.

This section first describes the risk-based approach to supervision compared to the traditional approach and shows why the former is more suitable for microfinance. Then, based primarily on the experience in Uganda, the supervisory process is described.

Risk-Based Approach to Supervision

Although experience in microfinance supervision is still limited, indications are that a risk-based approach to supervision might be better than the traditional approach. The focus of risk-based supervision lies in understanding and assessing the ability of a financial institution to identify, measure, monitor, and control risks in an appropriate and timely manner.[27] The traditional approach to supervision applies standardized procedures and focuses on individual transactions and the adequacy of collateral. Risk-based supervision is suited to addressing causes of problems rather than just highlighting current problems.

To understand how the risk-based approach to banking supervision can be distinguished from the traditional approach it is necessary to understand how to minimize the adverse consequences of risks (Fitzgerald and Vogel 2000):

- Risks can be avoided by not taking any particular risk. Many banks in developing countries follow this strategy, especially when competition is limited and banks are not forced to develop a broader range of financial services and products to groups that are perceived as high risk.
- Risks can be offset by shifting the burden to the borrower. Charging a risk premium (interest rates and fees) when lending to high-risk borrowers or demands for excessive collateralization of loans are typical ways to offset risks.
- Finally, risks can be mitigated by implementing appropriate risk management systems.

The traditional approach to banking supervision focuses primarily on the accuracy of financial statements, compliance with certain financial ratios, and internal controls to prevent internal fraud. The advantage of the traditional approach is that it provides a clear picture of the present condition of a financial institution, which can be measured and quantified. However, insight into potential future problems is limited.

Focusing on the current situation of a financial institution and on financial indicators merely allows supervisors to advise financial institutions to reduce or simply avoid risks when problems are found. In microfinance, risks cannot be avoided or offset through sizable and high-value collateral. The capacity to diversify risks across economic sectors and geographic areas is limited. However, many MFIs have successfully developed methods for managing risks associated with microlending using thorough analyses of the borrowers' repayment capacity and behavior, and offering strong repayment incentives. Yet, traditional on-site and off-site surveillance tools, with their focus on documentation and collateralization of individual transactions, may overestimate the risk associated with microfinance and,

moreover, are not very practical when assessing the risks of large numbers of transactions.

In contrast to the traditional approach, risk-based supervision focuses on risk management procedures. Supervisors recognize an individual MFI's ability to deal with risks associated with specific borrowers, products, and investments and thus leave room for offering nontraditional services such as uncollateralized loans. Risk-based supervision, with its focus on different risk profiles, is therefore particularly suited to nontraditional financial operations.

However, the risk-based approach makes the supervisors' job more challenging. Supervisors must understand the risk profiles of different financial institutions dealing with different products and services (and their clients) and they must be able to assess the adequacy of the measures taken to mitigate these risks. In microfinance, therefore, supervisors must have an understanding of how MFIs work and be able to assess whether an individual MFI's management and methodologies are appropriate and focused on minimizing risk. This requires a deep understanding of the specific features of microfinance, which is a binding constraint for the application of this approach, because supervisors normally have supervised only traditional financial institutions and products. Supervisors need to gain in-depth knowledge of the specific risks and the way these risks can be effectively managed.

The introduction of risk-based supervision brings along a cultural change. Traditional supervision deals with risks by placing prudential limits on the risks that financial institutions may take. As a result, supervisors are reluctant to treat financial institutions differently based on the ability of those institutions to manage risks. Supervisors that have decided to adopt a risk-based approach can be expected to be more open to nontraditional products and services and hence may be more willing to accept microfinance as a specific risk management technique for handling small and unsecured loans.

The Supervisory Process

An effective supervisory system comprises off-site surveillance and on-site examination. Off-site surveillance is based on analysis of financial data supplied by the financial institutions. The central objective is to monitor the condition of individual financial institutions, peer groups, and the financial sector as a whole. Off-site surveillance provides an early indication of an individual financial institution's problems and helps define priorities for the use of supervisory resources. Off-site surveillance relies on financial reporting in a prescribed format that is supplied by financial institutions according to certain time schedules. Normally, data on liquidity, capital adequacy, asset quality, portfolio concentration, earnings and profitability, and the balance sheet structure is collected. This will also be the case for regulated MFIs. Nonetheless, because the risk profile of MFIs is different, the focus of financial reporting may be different and reporting formats and time schedules should be adapted to the specific features of microfinance.

On-site examination enables the supervisory authority to validate the information provided by a financial institution during the reporting process, to establish the cause of a financial institution's problems, and to assess the future viability or possible problem areas that should be further observed. It also enables the supervisor to assess management's risk-management capabilities, an attribute difficult to capture through off-site surveillance. On-site examination is demanding of supervisory resources and therefore should only address the areas of greatest risks determined in previous inspections and through the off-site surveillance process.

External auditors play an important role when risk-based supervision is applied. External auditors are in the position to provide complementary information within the supervisory process, although they cannot replace prudential supervision executed by a public supervisory authority. However, in some countries, supervisory authorities use only external

auditors for on-site supervision. Whereas the supervisory authority's focus is on maintaining the stability of the financial system and the protection of depositors' money, the auditor's major task is to present the annual financial statements to shareholders and, possibly, to the general public. Because supervisory resources are scarce, a reasonable degree of job-sharing between supervisors and auditors permits supervision to be more efficient.

Drawing from the Bank of Uganda's policy, risk-based supervision comprises three major steps (Bank of Uganda 2002):

- Institutional overview and off-site surveillance
- Assessment of the financial institution's risks
- Development and execution of the supervisory plan

Institutional overview and off-site surveillance. The institutional overview is a summary report of the institution's present condition, its present and prospective risk profiles, past supervisory findings, and other key issues. It is based on all suitable information such as past examination reports, the findings of the off-site surveillance process, reports submitted by the regulated institution, and internal and external audit reports.

The off-site surveillance process comprises the following activities (Bank of Uganda 2004):

- *Monitoring the liquidity position* to periodically verify compliance with minimum liquidity requirements and observe the development of relevant assets and liabilities. Failure to meet the requirements or unusual movements in the liquidity position indicate a serious risk. Because maintenance of adequate liquidity is essential for the soundness of any financial institution, the institutions must submit their liquidity statements on a relatively frequent basis.
- *Monitoring the overall financial position* to periodically verify compliance with the capital adequacy ratio, provisioning, and lending limits. To verify compliance with the legal ongoing capital requirements, the supervisor will analyze the progression of all balance sheet and income and expense accounts and verify whether loan loss provisions and other necessary adjustments have been booked. If adjustments are not properly booked, the financial statements should be rejected and penalties should be considered.
- Because credit risk is a substantial threat in MFIs, it is important to analyze the *portfolio-at-risk* (the balance of loans overdue more than a certain number of days) report regularly. In Uganda, for example, this occurs on a quarterly basis through a review of the MFI's loan files and corresponding reports.
- The analysis of the financial situation *focuses on key weaknesses* detected in the last on-site examination to determine whether these issues have been addressed.

Off-site surveillance should define thresholds for key indicators to be monitored and benchmarks that when reached will trigger an alert. Such indicators can include an unusual growth of operations that is substantially higher than average market growth, capital adequacy ratios that approach the legal limit, and portfolio at risk ratios (the ratio of the balance of loans overdue, for example, more than 30 days, to outstanding portfolio) approaching 5 percent.

Supervisors should follow a "dialogue-oriented approach." Whenever unusual movements in key areas are detected during the off-site surveillance, the supervisor should first try to determine the underlying causes through discussions with the MFI's finance manager. If the problem cannot be resolved through dialogue with the MFI, the supervisor can conduct targeted on-site examinations that address the specific problem.

In addition to the off-site analysis of the financial institution, report on the financial institution, an institutional overview is produced and includes *descriptions of the internal and external audit,*

including the nature of any specific work performed by external auditors during the period under review; a *summary of supervisory activities* performed since the last review, including special examinations, supervisory actions, and the MFI's degree of compliance including applications (for example, for opening new branches) that have been submitted to the supervisory authority; and *considerations for future examinations.*

The institutional overview should be maintained by a supervision officer who has been assigned responsibility for the off-site analysis of a particular institution. Ideally, this person would also perform the on-site examinations, or at least closely collaborate with the examiner in charge for the particular MFI, because the whole process of risk-based supervision is based on an in-depth knowledge of the financial institution.

The risk assessment process. In preparation for the on-site examination, a preliminary assessment of major risks and the financial institution's ability to manage these risks is recommended (table 2.3).

Risk assessment in Uganda, for example, is accomplished using a risk framework that summarizes all available information on current and potential risks typical in institutions that engage in microfinance as their primary business and the external and internal sources of these risks.[28] The risk assessment takes the type of risk and the risk level into account. If, for instance, a position is large in relation to the institution's overall resources and could potentially result in a significant or harmful loss for the institution, the level of risk is considered high. In MFIs a typical example for an inherently high risk is credit risk, because the quality of the loan portfolio can be highly volatile and the loan portfolio typically constitutes a major portion of the balance sheet.

The risk framework also includes an assessment of the adequacy of the risk management systems within the MFI for the identified areas of risk. Composite risk is based on the level of inherent risk of the activity and the overall strength of the risk management system for that activity. If the risk management system does not adequately mitigate a high inherent risk of an activity, the composite risk is high. Alternatively, it can be low if risk management systems are strong and can mitigate much of the risk effectively. For example, if the credit technology (all procedures and policies for extending, monitoring, and collecting loans) is adequate to manage the specific credit risks arising from different loan products (such as group or individual loans), the composite risk can be moderate or even low. Conversely, if the lending technology is not adequate due to deficient procedures, the composite credit risk will be high. The direction simply indicates whether the risk is increasing, decreasing, or remaining stable.

Table 2.3 Example of an MFI Risk Framework (Summary)

Risk area	Inherent level of risk	Risk management	Composite risk	Direction
Strategic	High	Weak	High	Increasing
Credit	High	Acceptable	Moderate	Increasing
Liquidity	Low	Weak	Moderate	Stable
Interest rate	High	Acceptable	Moderate	Increasing
Operational	High	Weak	High	Increasing
Overall risk	High	Weak	Moderate	Increasing

Source: Bank of Uganda 2005.

A preliminary risk profile is prepared for the institution based on information compiled during off-site surveillance, auditors' reports, former examinations, and so on. It is then finalized during the on-site examination and constitutes a confidential document for internal use of the supervisory authority only. The risk profile is a living document that should be updated on a regular basis and after every examination.

A sample risk framework that provides indicative benchmarks for MDIs in Uganda is included as annex 2B, Risk Framework.

Organization and execution of on-site examinations. To be effective, on-site examinations need careful preparation. Before visiting the MFI, the examiners should review the current documentation describing the policies and procedures of the financial institution (that is, lending policies and procedures, deposit policies and procedures, accounting policies, information systems and procedures, and quality of internal controls).

Supervisory officers, in coordination with the MFI's IT manager, should extract data on all outstanding loans and deposits to generate a data file that can be reviewed with the supervisory authority's data analysis tool. The idea is to verify the integrity of the information and to validate the accuracy and reliability of the MFI's MIS (for example, have all loans reported to be rolled over been reported properly? are interest and other charges recognized as income according to the payment schedule?). Any discrepancies between reported information and the results of the analysis should be reviewed with the MFI's management. The review of the extracted data also helps verify compliance with key regulations (loan limits as percentage of core capital, capital adequacy ratios, loan loss provisioning, and others). The review of the internal audit activities should be based on the data extracted by the examiners.

The review of documentation and analysis of data, the results of the preliminary risk assessment, and a list of weaknesses identified in former examinations constitute the basis for the supervisory plan. This plan addresses all supervisory activities to be conducted and the scope of these activities (for example, full or targeted). The examination should be tailored to the size, complexity, current rating, and risk profile of the institution. Once again, supervisory resources must concentrate on areas of greatest risk.

The examination visit should focus on adequately assessing management's ability to identify, measure, monitor, and control risks. The examination includes evaluation of the risk management systems and internal controls, liquid assets, asset and liability structure as well as liquidity management, oversight, and planning procedures. Checklists for the different areas of potential risks and typical weaknesses that may cause problems can serve as a guide, especially for junior supervisory staff with little operational experience.

The well-known CAMEL system (Capital, Asset quality, Management, Earnings, and Liquidity) is often cited as a method for assessing the adequacy of a financial institution's financial and management health.[29] The CAMEL system is not associated with any particular supervisory approach nor does it focus on specific risks or measures to minimize these risks (Fitzgerald and Vogel 2000). However, the risk profile of financial institutions is implicitly given in any CAMEL rating. The CAMEL system can be adapted to risk-based supervision. For instance, for supervision of the Ugandan MDIs, a "CAELS" (CAMEL − M + S [see box 2.13]) system has been developed that includes the adequacy of the institution's risk management system, which can be determined only after the on-site examination takes place.

The final examination report should clearly and concisely communicate any supervisory issues and comment on deficiencies noted in the institution's risk management systems in each risk area (credit risk, management or operational risk, liquidity risk, governance risk, such as). On-site examinations

Box 2.13 The CAELS Rating System

An overall measurement of the MFI's performance can be obtained using a ratio that is composed of two elements:

- A quantitative CAELS (Capital, Asset quality, Earnings, Liquidity, Sensitivity to market risk) ratio
- A qualitative indication of the adequacy of the risk management systems—the Management ("M") component.

To make sure the adequacy of the MFI's risk management system gets a higher weight than any other component, the overall CAMELS ratio is computed using the formula:

$$\text{CAMELS} = \text{CAELS} - \text{M}$$

The CAELS ratio is computed by using weights for its different components. To capture the specific risk profile of microfinance, those components that constitute major risks in microfinance get higher weights. For example, the proposed weighting in Uganda is Capital, 30 percent; Asset quality, 20 percent; Earnings, 20 percent; Liquidity, 20 percent, Sensitivity to market risk, 10 percent. To assign ratings (1 to 5) to the components of the CAELS ratio, indicators and benchmarks for the different ratings should be defined. For instance, Earnings could be measured through the Return on Adjusted Equity (RoA). A RoA above a certain limit (2 percent, for example) could be given an excellent rating (1) whereas a negative RoA could be rated as poor (5). (Note: It is important not to copy benchmarks from elsewhere but to develop them in the supervisory process because only experience can lead to benchmarks that are adequate for certain types of financial institutions in specific environments.)

The overall CAELS ratio ranges from 1 to 5, where 1 is the highest rating.

The Management component of the CAMELS ratio is determined through proxies that give an indication of the quality of the MFI's risk management systems. Shortcomings in the risk management systems will reduce the rating given by the CAELS ratio. For example, if the loan tracking software has significant shortcomings, the CAELS ratio could be reduced by one point. An additional point can be subtracted if deficiencies in the internal audit are detected.

Source: Adapted from Bank of Uganda 2005.

should be conducted periodically.[30] If the on-site examination is well prepared and focused on areas that have been identified as potential risks, the costs of supervision can be kept to reasonable levels.

Summary of principles of risk-based supervision. To summarize, risk-based supervision of MFIs concentrates on the following principles (Hannig and Omar 2000):

- *Share responsibilities among key players:* Under the risk-based approach, the responsibility for risk management is shared among supervisors, owners, managers, and internal and external auditors (Van Greuning and Brajovic-Bratonovic 2000). To avoid ineffective and costly procedures, the supervisor must be willing to enter into a dialogue with the supervised institution, that is, to listen and take into account the views of senior staff and the board of the regulated institutions. Owners and managers are crucial in ensuring effective corporate governance, and maintaining professional standards, respectively. Internal auditors are in charge of continuously reviewing and ensuring that properly defined processes and procedures are followed. External auditors approved by the supervisory body play a key role in examining the accuracy of the financial statements.[31]

- *Focus on licensing:* The licensing process is not a guarantee that a financial institution will be run professionally once licensed. It is, however, an effective means of reducing the number of potentially weak financial institutions engaging in deposit mobilization from the public. Focusing on licensing enables the supervisor to enforce quality standards and minimizes the probability of failures in the future, thus limiting loss to depositors and maintaining public confidence in financial institutions. With this focus, the resources required for the supervisory process are relatively high in the first stages of the life cycle of an MFI. However, the more efficiently the licensing process has been carried out, the less costly is the subsequent supervisory process, because it is not necessary to do detailed routine transaction-focused examinations as long as there are no indications of a deterioration of the risk position of the MFI.
- *Focus on internal controls:* During the licensing process, risk-based supervision focuses on the quality of the MIS and the adequacy of internal controls rather than relying too much on external auditors.[32]
- *Focus on procedures and practices:* Assessing the quality of the loan portfolio must be based on understanding the risks associated with the key products and procedures. Rather than reviewing documentation of individual transactions, supervisors review the history and trends of portfolio quality and compare it with benchmarks. They appraise qualitative aspects of the lending technology, such as adequacy of the loan appraisal and collection procedures for different products, and the quality of the loan officers' work and management oversight. Supervisors focus their attention on areas of greatest risk and examine whether internal audits are appropriate to deal with these risks. Liquidity risk is assessed by examining the adequacy of liquidity management and the availability of flexible access to liquidity pools.
- *Use assessment tools:* Risk-based supervision uses financial ratios and other quantitative instruments and methodologies. However, these instruments need to be adapted to assess the specific risk profiles of MFIs and their portfolios. Specific benchmarks can be defined in accordance with best practices, taking into account the specific situation in a given country.
- *Focus on information disclosure:* Licensed financial institutions have to systematically and in a timely manner disclose accurate information to the supervisor. Their MIS, therefore, must be able to accommodate reporting requirements set by the supervisor. Reporting requirements should, however, take into account specific features of microfinance and should focus on the information that is needed to assess the specific risks encountered by MFIs. The frequency of reporting depends on the volatility of these risks and should take into consideration potential communication difficulties associated with operating in remote areas and with lack of proper infrastructure.

Remaining Challenges

Despite the growing body of experience in regulation and supervision of MFIs, some outstanding challenges remain.[33]

Costs of Supervision Cannot Be Covered by MFIs

Prudential regulation and supervision include the authorization of financial institutions to accept and intermediate funds from the public, on-site and off-site surveillance, corrective actions, and, at the extreme, the power to take over, liquidate, or close down financial institutions. The cost of supervision is significant and the inclusion of large numbers of small MFIs may overstretch usually tight budgets. In some countries, financial institutions are obliged

to fully or partly contribute to the costs of their own supervision. Yet, MFIs often cannot afford to fully assume these costs. For instance, Peruvian regulated MFIs were not in a position to cover more than 6.5 percent of their supervisory costs in 2000.[34] The deficit was covered through contributions from the larger financial institutions. It appears, therefore, to be indispensable for governments to finance—at least partly—efficient supervision of microfinance operations.

Owners of Regulated MFIs Do Not Necessarily Have Pockets Deep Enough to Respond to the Need for Capital Injections in Times of Financial Distress

To address the ownership and governance risk of NGO MFIs, regulators often insist that they convert into companies with real shareholders with "deep pockets" to bail out the financial institution in case of financial distress. During the late 1990s a number of specialized institutional investors for MFIs emerged. However, it is still not clear how "deep" their pockets are.[35] In addition, these organizations usually follow conservative investment strategies and therefore tend to focus on the best performing MFIs, which are often already in the position to access market funds to expand their operations. Moreover, "public" investors especially (for example, international financial institutions) typically expect to perform their role as a shareholder for a limited time, and given the fact that the issue of transformation is quite young, it is still not clear whether enough commercial investors are willing to buy the shares when institutional investors exit. Finally, with "real" commercial investors, mission drift becomes a risk, because they may decide to move away from microfinance to segments of the market that they perceive as more profitable.

Annex 2A Note on Supervising Savings and Credit Cooperatives

In most countries, savings and credit cooperatives (SACCOs) are too small to justify the cost of regulation; however, very large SACCOs operating in some countries do pose systemic risk to the country's financial system. Where large SACCOs are not present, it appears to be commonly understood that small institutions with limited geographical coverage and common-bond members know each other well enough to exert sufficient self-control on the institutions' performance. Nonetheless, the effectiveness of these mechanisms should not be overestimated. Due to the specific institutional setup of SACCOs and other member-based institutions, especially in comparison to nonmutualist institutions such as NGOs, members theoretically have a strong incentive to monitor the operations of the SACCO of which they are a member. However, these incentives are seldom strong enough to manage without any external oversight. First, because there is no secondary market for cooperative shares they are repurchased at their nominal value and not as fractions of the organization's net worth. Members thus may not have strong incentives to enforce profitability of operations, other than to receive dividend payments. Second, the "democratic" system of "one person, one vote" leads to a situation in which members, even if they owned a considerable portion of the cooperative's shares, would not have adequate voting powers. Thus, even if not donor-funded, SACCOs have a specific incentive structure that prevents members from seeing their participation as a profitable investment. They typically perceive their ownership as the only way to access financial services (Krahnen and Schmidt 1994).

As has been mentioned, the capacity of supervisors to oversee large numbers of small institutions effectively is limited. And self-supervision of financial intermediaries has not proved to be effective due to the inherent conflict of interest.

An alternative may be delegated supervision, under which the banking supervisory authority maintains regulatory power, but the tasks of regular performance monitoring and on-site inspections are delegated to a specialized third party (for instance, an independent or an umbrella body). In many developing countries, SACCOs are regulated under a special law designed for any cooperative society independent of its activity. Typically, a ministry or another public agency created for the cooperative sector is in charge of supervising them. These entities have neither the expertise nor the financial and technical capacity to prudentially supervise financial activities.[36] Power of enforcement, however, cannot be delegated to a third party because it requires legal backing by a public agency with a clear mandate to take corrective action to be effective. Delegated supervision can be effective but, so far, there are not many examples where it has been put into practice successfully.[37]

Annex 2B Risk Framework (Example from Uganda)

Quantitative Assessment

Risk Category	Indicator	Rationale	Definition	Legal reference	Source of verification	Benchmark or rating
Ownership and governance risk	Maximum shareholding	Avoid concentration in ownership	Share of one person over total equity	MDI Act, Section 21	Articles of association, announcement of change	30% with 5 years transition period; no limitation for subsidiaries of banks, reputable financial institutions or, in exceptional cases, reputable public companies with special approval from Bank of Uganda
	Minimum capital 1. Minimum paid-up capital 2. Minimum capital unimpaired by losses	Ensure adequate funds to run the business	1. Minimum paid-up capital has to be provided in liquid assets (S. 15 1)	1. MDI Act, Section 15 (1) 2. MDI Act, Section 15 (2)	Audited accounts, certificates of investment, reports, license application	25,000 currency points;[a] (a currency point at the time of licensing the first four MDIs was valued at 20,000 Ugandan shillings)
	Ongoing capital adequacy	Ensure adequate funds to run the business	Capital adequacy ratio, core capital in form of issued and fully paid-up shares plus all retained reserves and other reserves approved by Bank of Uganda	MDI Act, Section 16; Definition of weights in regulations	Licensing, monthly computation as prescribed in regulations on capital adequacy	20% total capital, 15% core capital to risk-weighted assets as follows: cash, cash equivalents, balance with Bank of Uganda, investments in government securities: 0%, Balance with other licensed financial institutions: 20% All others: 100%
Management risk	Operating cost ratio	To assess efficiency of management	Operating costs (administrative, salary expenses,[b] depreciation, board fees)/avg. portfolio outstanding	Internal benchmark	Balance sheet and profit and loss statement (monthly)	25%
	Operational self-sufficiency	To assess ability of MDI to cover all costs	Financial income/ (financial costs + operating costs + loan loss provision)	n.a.	Profit and loss statement (monthly)	No benchmark

(*Continues on the following page*)

Quantitative Assessment (*Continued*)

Risk Category	Indicator	Rationale	Definition	Legal reference	Source of verification	Benchmark or rating
	Financial self-sufficiency	To assess ability of MDI to cover all costs and preserve its value	Financial income/(financial costs + operating costs + loan loss provision + imputed cost of capital)	Internal benchmark	Balance sheet and profit and loss statement (monthly)	100%
Credit risk	Provisioning	Not to overstate income and for early identification of problem loans	Provisioning for the outstanding balance (reduced by compulsory savings balance) according to days overdue with stricter provisioning schedule for rescheduled loans	Regulations on asset quality	Statement for provisions on bad debts (monthly)	General 1% (8–30 days 5%), 31–60 days 25% (50%), 61–90 days 50% (75%), > 90 days 100% (figures in parentheses for rescheduled loans)
	Write-offs	Not to overstate assets	Remove unrecoverable loans from books	Regulations on asset quality	Balance sheet (monthly)	Latest after 180 days of loans becoming delinquent or case by case decision (for example, on death of borrower)
	Loan loss reserve ratio	To check adequate and prudent provisioning	Loan loss reserve/value of loans outstanding	n.a.	Balance sheet (quarterly)	Ratio to be compared with Portfolio at Risk, no independent ratio, therefore no benchmark
	Portfolio at risk	To assess quality of the loan portfolio	Balance of loans past due (>30 days) + balance of restructured loans/outstanding loan portfolio	Internal benchmark	Portfolio quality report (monthly)	5%
	Restrictions on insider lending	To reduce insider abuse	Maximum percentage of core capital; definition of insider in act	MDI Act, Section 18 (1c)	Statement on loans to insiders (monthly)	Unsecured and in the aggregate and outstanding <1% of core capital

	Restrictions on credit concentration	To promote risk diversification	Maximum percentage of core capital	MDI Act, Section 18 (1a)	Portfolio quality report (monthly)	In the aggregate and outstanding <1% of core capital for individual borrower, <5% of core capital for a group of borrowers
Liquidity risk	Liquidity ratio	To ensure that institution can meet its short-term obligations at reasonable cost	Liquid assets to deposit liabilities	MDI Act, Section 17 and regulations on liquidity	Liquidity statement (weekly)	15%
Interest rate risk	Gap analysis	To measure sensitivity of interest-bearing assets and liabilities to changes in interest rate	Matching interest rate–bearing assets with interest rate–bearing liabilities for 3, 6, and 12 months	MDI Act, Section 27 (3)	Term structure of assets and liabilities	Look at different time buckets (3, 6, 12 months), in each bucket assets similar to liabilities; no benchmark

a. Currency points are used rather than a specific currency amount so changes can be made to the value of minimum capital required without requiring a change to the body of the law.

b. Salary expenses only include staff in-kind donations if they are of a permanent nature (≥3 years).

n.a. = not applicable

Qualitative Assessment

Risk Category	Indicator	Rationale	Definition, criteria	Legal reference	Source of verification
Ownership and governance risk	"Fit and proper" check for owners of MDIs	To ensure responsible ownership and accountability	Reasonable assurance that owners bail out MDI in distress by assessing shareholders' net worth, signing a declaration of the willingness of shareholders to that effect, and assessing the capacity of the latter to raise additional capital; professional background (financial vs. social objectives)	MDI Act, Section 21 (4), in connection with Second Schedule for shareholders >10% and transfers >10%; MDI Act, Section 7 (4) c; regulations on licensing	Reliable information on new shareholders such as *curriculum vitae,* references, and so on; announcement in case of transfer of shares
	"Fit and proper" check for directors	To ensure integrity and competence to manage the business	Look at competence and professional background of directors	MDI Act, Section 22 (2), regulations	Reliable information on new directors such as *curriculum vitae,* references, interviews, and so on

(*Continues on the following page*)

Qualitative Assessment (*Continued*)

Risk Category	Indicator	Rationale	Definition, criteria	Legal reference	Source of verification
	Role of the board 1. System of checks and balances 2. Incentive schemes 3. Vision and mission statement	Promote good governance	1. 4-eyes-principle (two people accountable) responsibilities and powers 2. Bonus-system, fringe benefits, and such 3. Prominence of financial objectives	MDI Act, Section 24 and guidelines	Constitution and policies of MDI; on-site inspections
	Reporting of internal auditor to board audit committee	To ensure compliance of management with corporate policy and procedures as laid down by the board	Actual practice and requirement in constitution	MDI Act, Section 28 and guidelines; requirement in MDI constitution	Board policies; on-site inspections
	Dependence on donations and grants	To be aware of the influence of donors	Extent of donations and grant funding, respective terms (duration, conditions)	n.a.	Balance sheet, donations and grant contracts
Management risk	"Fit and proper" check for management	Ensure professionalism of management	Banking and microfinance skills	MDI Act, Section 7 (4) a, Section 81 (4) b, second schedule	Licensing and on-site inspections; changes in management to be announced; references, *curriculum vitae,* and others
	Human resources policy	To ensure professionalism in MDI operations	1. Recruitment policy for staff, particularly loan officers 2. Policy on staff development 3. Staff turnover 4. Job descriptions 5. Remuneration and benefits	Guidelines	Policy documents, interviews
	Adequacy of internal control systems	Ensure orderly conduct of business	1. Quality of accounting (timeliness, accuracy, compliance with international accounting standards) 2. MIS (manuals, appropriateness and quality of IS) 3. Existence of process flow documents	MDI Act, Section 28 (2i), regulations on licensing	Accounting records, systems manuals, licensing, on-site inspections

Credit risk	Product development	To assess whether proper guidelines for product development are in place	Policy on product development	MDI Act, Section 19, guidelines, on-site inspection manual	Credit manual; licensing and on-site inspections, compulsory information on new products
	Lending methodology	To ensure that proper lending policies are in place	Repayment incentives, clarity of description; borrower selection, disbursement and collection procedures	Guidelines, regulations, on-site inspection manual	Credit manual, licensing and on-site inspections
	Approval limits	To ensure risk limitation at different levels	Specification of approval limits at various levels	Guidelines, regulations, on-site inspection manual	Credit manual, licensing and on-site inspections
	Responsiveness of policies to business environment	To ensure that policy and management is flexible enough to cope with changes in business environment	Frequency of policy review	Guidelines, regulations, on-site inspection manual	Credit manual, management minutes, board minutes, on-site inspections
	Quality of documentation of loan portfolio	To ensure that proper records are kept for disbursement and collection	Procedures for loan disbursement and collection	Guidelines, regulations, on-site inspection manual	Loan dossiers, licensing and on-site inspections
	Write-off policy	To have an adequate write-off policy in place	Written policy for write-offs	Guidelines, regulations, on-site inspection manual	Credit manual, board minutes, licensing and on-site inspections
	Sectoral distribution of loan portfolio	To assess risk diversification and to take specific risks in specific sectors into account	Sectoral distribution and changes thereto due to new product development, high growth in specific sector, and so forth	MDI Act, Section 57, guidelines, regulations, on-site inspection manual	Credit manual, loan policy
Liquidity risk	Procedures for liquidity and funds management	To ensure that institution can meet its short-term obligations at reasonable cost	Arrangements for and costs of liquidity access	MDI Act, Section 27 (3)	Liquidity and fund management policy, licensing and on-site inspections
Interest rate risk	Institution monitors developments in financial markets	To be aware of developments in financial markets and their implications for institution	Monitoring procedures for developments in financial markets	MDI Act, Section 27 (3) and Section 57, guidelines, on-site inspection manual	Performance reports (monthly), investment policy, sensitivity analysis (if available), budget performance report

Source: Adapted from unpublished "Risk Framework Final," Bank of Uganda, 2001.

Notes

1. In the context of microfinance, various agencies and in particular the German bilateral co-operation, since the early 1990s, have supported an approach to "financial system development" with the goal of strengthening financial intermediation, thereby recognizing that in addition to credit, other financial services, particularly savings, are equally important to the poor (BMZ 1994, 2004).
2. For example, a new law may be required based on the lack of inclusiveness of current banking law(s) or the fact that the main providers of microfinance services are NGOs (as opposed to member-based savings cooperatives or banks that fall under supervision).
3. The term "legislation" generally includes the *primary* legislation, which is the law that governs the financial institution; *secondary* legislation includes the regulations that outline requirements that the financial institution (or that portion of business governed by specific regulations) must meet on an ongoing basis; and guidelines provide benchmarks for the supervisory body to monitor financial institution performance.
4. Some countries have introduced nonprudential regulation that is enforced by an independent overseer empowered to enforce codes of conduct, such as the Microfinance Regulatory Council in South Africa (Staschen 2003).
5. A recent publication by the Small Enterprise Education and Promotion Network underlines the appropriateness of self-regulation for the protection of consumer rights (McAllister 2003).
6. In Uganda, three years after the passage of the Microfinance Deposit-Taking Institutions (MDI) Act, there are four licensed MDIs and one more in the pipeline. Some segments of government are questioning whether the Act was worth the effort, putting the MDIs in the position of actively defending their existence. However, the MDIs are by far the largest MFIs in the country and serve over half the Ugandan market. As capacity of MFIs to sustainably deliver financial services increases, and as the capacity at the central bank to supervise more than five or six MDIs increases, so will the outreach and likely, the number of MDIs in Uganda. It would be imprudent at this point to rush to license additional institutions.
7. Christen, Lyman, and Rosenberg (2003) provides a comprehensive description of the issues that nonprudential regulation can comprise.
8. This was recently done in the Philippines. With the enactment of the new Banking Law in 2000, microfinance, on the one hand, was recognized as part of mainstream banking but, on the other hand, a section was included where the Monetary Board is inclined to regulate the interest rates imposed on microfinance borrowers (Llanto 2001).
9. During the process of passing the MDI Act, the Ugandan Parliament, for instance, temporarily considered including a section that would have subjected the approval of the statutory instruments to parliamentary scrutiny instead of leaving this to the central bank.
10. The regulator is the rule-making body and the supervisor monitors compliance with the regulations. (The regulator and supervisor can be the same institution, for example, the central bank.)
11. This list, of course, is not exhaustive. Some authors, for instance, mention new industry risk as a specific risk to microfinance. New industry risk refers to the fact that because microfinance is still young there are not many well-trained managers who are able to deal with rapid introduction of new products and technologies (Staschen 1999). New industry risk includes the risk of supervisors lacking experience with microfinance operations. In addition, according to country-specific legislation, risks such as foreign exchange risks can be associated with microfinance operations.
12. In addition, supervisory authorities are also concerned with other credit risks such as "balance due from other banks or financial institutions," and, in some cases, even Treasury Bills. (Comment from David Kalyango, Assistant Chief Accountant, Bank of Uganda, e-mail communication with Joanna Ledgerwood, 9/05.)
13. "Core Principles for Banking Supervision" (Basle Committee on Banking Supervision 1997) highlights the following risks in banking: credit risk, country and transfer risk (in international lending), market risk (risk of losses in operations that arise from movements in market prices including foreign exchange markets), interest rate risk (exposure to adverse movements in interest rates), liquidity risk, operational risk, legal risk (risk that might arise from incorrect legal advice or the failure of resolving legal issues under the current legislation), and reputational risks (arising from operational failures and other sources).
14. For further analysis on microfinance risk, refer to Vogel, Gomez, and Fitzgerald 2000.
15. In some countries, credit information services are included in the prudential regulatory framework. However, because their primary purpose is the

protection of the financial institution by facilitating a better selection of borrowers, credit information services only indirectly protect depositors through the limitation of a financial institution's risk exposure. As such, they are not always considered part of prudential regulation.

16. During the past few years, numerous comparative studies on regulatory frameworks for MFIs and operations were published. See Gallardo et al. 2005; Jansson, Rosales, and Westley 2003; Meagher 2002; and Staschen 2003.
17. There are often exceptions to this, for example, if a licensed financial institution operates an MFI as a subsidiary, or if a shareholder is a public company with diverse ownership.
18. A well-documented example is provided by the licensed MFI FINANSOL in Colombia where in 1995 the predominance of the founder NGO was one of the major reasons for a serious financial crisis that resulted in the near-collapse of the institution (Staschen 1999; CGAP 2000).
19. In 1999, the Basle Committee on Banking Supervision issued a consultative paper for improving the capital framework. One of the three pillars of the framework is the improved calculation of capital adequacy by refining the existing system of risk weightings and shifting the regulatory emphasis to assessing the banks' own risk management processes. For details see Chami, Khan, and Sharma 2003.
20. From MDI Licensing regulations, p. 330.
21. Note that it can take a long time for the supervisor to accept the application as complete. In Uganda, the application of one institution took a full year from the initial submission to be deemed complete.
22. Although not directly addressed in this book, some organizations may decide to create an MFI as a regulated institution without going through the NGO or project stage. In this case, prelicensing on-site inspections are not possible without the supervisor at least declaring his or her intention (without guarantee) that a license will be granted. Premises are prepared and policy manuals drafted after this "letter of intent" (the term used in Kenya) has been sent out.
23. In Uganda, a prelicensing inspection team comprises four to five inspectors, who, depending on the size of the branch network, will spend three to four weeks in the field.
24. Regulators normally require that the board approves the manual and policies on risk management as well as on money laundering.
25. A common tool that supervisors use to prevent financial institutions in trouble from further risk-taking is stop-lending orders. In microfinance, however, stop-lending orders can be dangerous. If the MFI stops granting subsequent loans, borrowers lose their main incentive to repay. This may lead to a rapid deterioration of the portfolio quality and, given the high weight of the portfolio in overall assets, aggravate the problem. Supervisors therefore should be careful when using stop-lending orders (CGAP 2003).
26. A facility has been created in Latin America by the donors to help mitigate liquidity constraints in the wake of external shocks (natural or other emergencies, or both); see www.emergencyliquidityfacility.com.
27. The concept of risk-based supervision should not be confused with the Basle Capital Accord of 1988. Whereas the Basle Capital Accord and subsequent amendments determine what should constitute a financial institution's capital and assigns risk weights to assets, it does not prescribe a specific approach to banking supervision.
28. The typical risks as described previously in this chapter include governance risk, credit risk, management or operational risk, liquidity risk, and interest rate risk. The supervisory authority may add other types of risks such as reputational risk, market risk (for example, arising from politization of microfinance or movements in market prices), and legal risks (lack of legal security, for example).
29. The CAMEL system has been adapted by ACCION International to the features of the microfinance industry. The ACCION CAMEL serves as a decision-making tool for MFIs, as an internal assessment tool for ACCION affiliates to provide more focused technical assistance, and as a rating instrument that is meant to contribute to the "due diligence" process of potential investors (Saltzman, Rock, and Salinger 1998).
30. For example, in Uganda onsite examinations are conducted at least once a year.
31. Empirical evidence suggests that external auditors still lack experience to assess the financial soundness of MFIs. It is therefore recommended that the supervisor regularly test the auditors' work (Christen et al. 2003).
32. The importance of internal audit and control systems is also highlighted by Van Greuning, Gallardo, and Randhawa (1999).

33. Although not a specific topic in this book, a significant challenge in many countries is to determine how to most effectively and efficiently supervise cooperatives and other member-based MFIs. This is addressed briefly in annex 2A, Note on Supervising Savings and Credit Cooperatives.
34. Jansson, Rosales, and Westley (2003) provide an overview of the sources of funds of supervisory authorities in Latin America.
35. When in 1996 the Colombian regulated MFI Finansol was declared insolvent, its institutional investors failed to recapitalize the institution according to their initial bail-out plan (CGAP 2000), though a new debt restructuring and recapitalization plan was ultimately agreed upon, leading to the launch of the new FINAMERICA in 1997.
36. For details on the Ugandan example, see Staschen (2003).
37. The best documented examples include the Cajas Municipales de Ahorro y Crédito in Peru, the BRI (Bank Rakyat Indonesia)/Unit Desa Network in Indonesia and the hierarchical supervisory model under the PARMEC (Projet de Appiu a la Reglementation sur les Mutuelles d'Epargne et de Credit) Law in West Africa (Meagher 2002).

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Transforming the Institution

Strategic Decisions

Part II

Chapter 3
Planning for Transformation

Transformation from a nongovernmental organization (NGO) to a deposit-taking financial intermediary does not simply represent a change of legal status. When a microcredit organization becomes licensed and begins to offer voluntary savings services, a wholesale cultural and operational transformation is required, compelling a full understanding and appreciation of the changes that will occur within the organization as it transforms. Transformation is ultimately about significant changes in governance as well as management and staff roles and responsibilities—all of which imply changes in how employees relate to one another and how the institution relates to its many new stakeholders. Transformation planning is, therefore, at its core, a change management process.

This chapter begins by outlining the significant institutional changes that occur with transformation. Ensuring the leaders of the microfinance institution (MFI) fully understand the implications and results of institutional transformation is thus the starting point for any transformation. What are the important issues that need to be considered? What are the fundamental changes that occur within an institution due to transformation? These changes must be carefully considered by the MFI to determine its readiness and willingness to transform. If the decision is made to go forward, the MFI must examine and potentially redefine its vision and mission in line with a regulated deposit-taking institution rather than a credit-focused project or NGO. The focus then moves to managing the process of change that comes with transformation. The institution's ability to successfully lead and manage the changes inherent with transformation is critical. The chapter then details how to develop a plan for transformation and how to manage transformation through its many stages, concluding with a discussion of the financial costs of transformation.

Fundamental Changes Resulting from Transformation

Although numerous and significant changes take place with transformation (box 3.1), four fundamental changes affect all aspects of the MFI. Each of these changes may affect the original vision and mission of the MFI and will ultimately require full commitment of the board and senior management, if not the entire staff. Each change must be fully

Box 3.1 Compartamos Savings Mobilization Project

"Savings will be the 'detonator' of Compartamos," predicts Gonzalo Ramirez, Manager, Compartamos Savings Mobilization Project, who has spent six months working on Compartamos' savings mobilization feasibility study. "'The introduction of deposits will mean radical changes at all levels of the organization. Savings can't be seen as just another product—they entail a change in our legal status, which will in turn trigger serious changes to our structure and organization.'"

Source: CGAP n.d.a.

considered and appreciated before embarking on transforming to become a regulated deposit-taking institution:

Change #1—Transformation implies ceding control to a broader group of stakeholders.

Change #2—Transformation facilitates an expanded product offering, thus broadening the institution's client base.

Change #3—Transformation leads to significant changes in human resources requirements.

Change #4—Transformation requires compliance with regulatory requirements, adding significant costs to operations.

Change #1: Transformation implies ceding control to a broader group of stakeholders.

Experience worldwide has shown that many NGO MFIs undergoing transformation to regulated institutions resist giving up operational and management control. With transformation, the ownership structure changes from an NGO or project capitalized by donors and generally governed by a board of directors of socially minded founders, to a shareholding structure with investors who demand financial returns and as part owners, share in the fiduciary responsibilities of the regulated institution. Consequently, it is appropriate that investors play an active governance role. For NGOs that have been largely controlled by a strong founder with little active board involvement, this shift can be significant. For example, one of the more important roles of the board is to appoint the new institution's managing director, or Chief Executive Officer. This is in contrast to a founder-dominated NGO, where board members are often selected by the founder—a distinction with significant implications for decision making and approval processes. The managing director of the transforming NGO is not always appointed by the new board as the head of the new institution. This reality only heightens the fear of losing control. Likewise, NGO board members also need to recognize that not all current members will necessarily become members of the new institution's board (box 3.2).

In addition to new investors, regulators form another new stakeholder group to whom the institution must now be accountable. The financial position and portfolio quality of the MFI, for example, is no longer for internal eyes only. Instead, all activities undertaken by the organization need to be clearly documented, explained, and justified to a new set of external eyes. Although donors may have played this role to a certain extent before, the regulators' reach can be more intrusive (with frequent and significant reporting requirements), costly (with fines for delinquent report submission), and far reaching (with the threat of regulatory intervention or closure). The presence of this new stakeholder thus implies a significant change in control.

Furthermore, many regulators set limits on majority ownership. For example, in Uganda, the

Box 3.2 Ceding Control

In the late 1990s, a large Asian NGO spent a fair amount of time, energy, and money planning its transformation to a regulated financial institution. Ultimately, however, the transformation failed due primarily to resistance from the board to relinquish control. Although transformation was discussed at length and it was clear who would be on the board of the bank and who would remain on the NGO board, there was a strong fear of letting go, particularly by those who would remain with the NGO because they would be left with a smaller, less important organization. A relatively acrimonious split ensued resulting in a number of senior staff and board members leaving the organization when it became clear that the commitment to transform was simply not there.

Ten years later, however, the NGO was thriving and considering transformation once again as the board members felt more confident about their roles and the position of the NGO in the marketplace.

Source: Authors.

Microfinance Deposit-Taking Institutions (MDI) Act limits the maximum ownership to 30 percent by any one owner, unless the owner is a licensed financial institution or a public institution. This generally means that founding NGOs (or their founders) cannot maintain majority ownership once they transform.[1]

Finally, as an MFI becomes regulated and thus more transparent given public reporting requirements, other interested parties may hold it to a higher level of accountability, including environmental accountability. To the extent that the transformed MFI has agricultural clients or small manufacturers, transformation may highlight the need to incorporate environmental policies, or other policies not required previously in the NGO.

Change #2: Transformation facilitates an expanded product offering, thus broadening the institution's client base.

By definition, transformation to a deposit-taking institution will result in an expanded target market. Clients who may have been uninterested in borrowing from the MFI may find the institution's deposit services suitable to their needs. In addition, as outlined in chapter 1, Mobilizing Savings from the Public: 10 Basic Principles, the regulated MFI will need to mobilize savings not only from its existing credit clients or those with a similar economic profile, but also from wealthier individuals and institutions. These higher-income savers may in turn demand a wider array of products than currently provided by the MFI. Therefore, the transformed MFI will need to consider its product mix—including credit, savings, money transfers, insurance, and others—and determine if it offers appropriate and marketable products for this broader market.

Institutions that have offered only group loans often need to develop an individual loan product. To safely and profitably offer individual loans, credit staff need to know how to accurately assess the creditworthiness of clients through expanded debt-capacity analysis that takes into consideration the client's household and business cash flow needs. Furthermore, without a group guarantee in place, alternative forms of collateral need to be identified, which may require overall changes in processes for securing and recovering collateral. New policies and procedures must be established and staff be provided with additional training.

Also, with a license to operate as a financial intermediary, the MFI may have the option to offer additional financial products such as money transfers, insurance, and, in some cases, foreign exchange services. As the transformed MFI becomes more established, various new products should be explored because they can significantly

improve revenues through fee income, often with minimal added costs. However, it is important to remember, any additional products or services offered will require compliance with regulatory requirements as well as increased staff and management skills and possibly enhanced systems.

Change #3: Transformation leads to significant changes in human resources requirements.

When an MFI becomes a licensed deposit-taking institution, significantly greater demands on staff and management lead to the need for different and enhanced skills among the institution's human resources. In general, the organization chart of a transforming NGO changes substantially with the new institution. New positions are added while some are reduced as staff are redeployed or made redundant in light of changes in overall operations. Ultimately, an increase in staff is usually the final outcome, particularly in the middle ranks (treasury staff, internal auditors, branch supervisors, information technology [IT] managers).

Transformation requires a close evaluation of senior management capacity and skills. In most transformations to date, the senior management team has been augmented with the addition of formal sector bankers either in an advisory capacity or, in many cases, as senior and middle managers. In some countries, regulators will insist on senior managers having previous formal sector banking experience. Replacing a large portion of the senior management can be disruptive to the MFI. Not bringing in the new skills needed to manage the new institution, however, can be equally disruptive. Moreover, finding the right balance between external hires and in-house training is important for maintaining or establishing the right organizational culture.

When offering voluntary savings, one of the most obvious changes in staff requirements is the need for tellers to accept and process deposits and withdrawals, as well as the need for customer representatives to market various services and help clients open new accounts. With both functions come a host of tasks that may not have been required in a credit-only MFI. For example, a supervisor may be needed at the branch level to oversee teller operations, and additional internal auditors (or at the very least additional internal controls and procedures) may be required because cash is handled at the branches, possibly for the first time.

At the head office, a treasury department may need to be established and a competent treasury manager put in place to oversee asset and liability management—a task that may not have been required when the NGO MFI had few liabilities to manage. At the management and board level, an Asset and Liability Committee (ALCO) needs to be established to monitor and make decisions on funding and placements of funds.

In addition, transforming MFIs normally need to strengthen their management information systems (MIS) and procurement policies, as well as their legal resources and fiscal management. They also often need to create public relations and investor relations functions.

These changes have the potential to alter the culture of the institution significantly. Thus, leadership needs to be proactive about defining the new culture up front, and ensuring sufficient buy-in among all staff members to the institution's new future.

Change #4: Transformation requires compliance with regulatory requirements, adding significant costs to operations.

With the license to operate as a deposit-taking financial intermediary comes the requirement to comply with a regulatory body, adding significant and often unexpected cost to the operations of the MFI. In fact, in some cases, transformed MFIs have underestimated this change to such an extent that once operating as a licensed institution they have admitted that had they known the extent and cost of compliance, they would never have transformed.

The first step in complying with regulatory requirements involves assembling the license application. The requirements for applying for a license are many and it often takes months to compile the complete application, requiring significant effort and use of resources, both human and financial.

Once the application is submitted, the MFI has to undergo a number of inspections—both of the institution with regard to its operations, and of the management and board with regard to being "fit and proper" to manage or govern a financial intermediary. The central bank will examine the entire operations of the MFI including the internal control systems, security, branch infrastructure (strong rooms, safes, positioning of tellers and supervisors), operating manuals, financial management practices including provisioning, asset-liability management, and so on. It will also examine the competence and experience of the board and senior management.

Once licensed, substantial periodic reporting to the central bank is required (daily, weekly, monthly, quarterly and annually). These reporting requirements often entail significant enhancements to the MFI's management information systems, treasury and financial departments, and overall management resources.

In addition to reporting, licensed deposit-taking institutions must maintain a certain level of reserves. In Uganda, MDIs must maintain cash reserves equal to 15 percent of their deposit base. Mibanco, a transformed NGO operating in Peru, must keep 7 percent of its domestic-denominated deposits on reserve at the central bank and 20 percent of its international-denominated deposits (of which 13 percent is to be kept on reserve at the central bank) (Campion, Dunn, and Arbuckle 2001). These reserves are not available to fund the loan portfolio and thus earn less revenue than they would if unencumbered.

Being a licensed financial intermediary also results in a different risk profile, which, in turn, requires a focus on risk management. Complying with regulations is meant to help the MFI mitigate various risks. For example, specific levels of capital are necessary to comply with both minimum capital as well as capital adequacy requirements. Specific levels of loan loss provisioning of the loan portfolio are required, which may be more conservative than what the NGO had in place. The central bank also requires a certain level of security at the branches including strong rooms, safes, additional guards, and protective doors and walls, all of which add to the expense of operations. Finally, annual external audits as well as internal audit procedures and policies must be formally approved by the central bank.

These requirements and more arise when operating as a licensed intermediary and add significantly to the cost structure of the institution and the need for skilled human resources.

Assuming each of these four changes has been considered and the consequences understood and appreciated by the board and management (see box 3.3 for a sampling of the issues a transforming MFI must be ready to confront), the next step in the transformation process is for the MFI to revisit its vision and mission statement and determine who within the organization will lead the transformation process.

Leading the Transformation

The effect transformation has on an MFI's culture is often overlooked and undervalued. An institution's corporate culture is typically defined by the values and beliefs held by its staff. As stated by the chairperson of the Drucker Foundation, "Peel away the shell of an organization and there lives a culture—a set of values, practices and traditions that define who we are as a group" (Hesselbein 1999). With the addition of new staff and the changes to processes and procedures that accompany transformation, an institution's culture is likely to be

Box 3.3 Are We Ready for Change? Questions for NGO Stakeholders

- Are we prepared (emotionally and financially) to embark on substantial capacity development to become a true financial intermediary?
- How willing are we to allow outsiders to see our operations and how willing are we to seek technical assistance in areas in which we feel we do not yet have adequate capacity?
- Are current board and management adequate to oversee the transformation process, and do we have the right skills on the board to oversee a financial intermediary?
- How will we source new equity from investors? Will the new investors be "like-minded"? How much control are we willing to give up?
- What will the ideal capital structure be for the new organization?
- How should the board of the licensed company be structured? How many board committees are required?
- Should the NGO continue to exist? If so, should it hold shares in the new organization? What role should the NGO play after transformation—shell to hold shares in the new organization? Engage in other social activities with proceeds from the investment in the new organization?
- What role should the NGO founders play in governance of the new institution, and if they own shares, what compensation, if any, should they receive for their "sweat equity"?
- Should we create a new institution or convert our current one? What are the tax implications?
- If we create a new institution, should everything be transferred to the new organization or should some assets remain with the NGO?
- When and how should the loan portfolio and other investments as well as physical assets (vehicles, computers, office equipment, and the like) be transferred—before licensing? Upon licensing? When loans renew?
- Will our product mix be adequate? If not, do we have the capacity and willingness to develop and offer new products?
- What should the name of the new company be? To what extent do we want to maintain the "brand" we have established as an NGO?
- Are our management information systems robust and our business processes efficient? To what degree will we need to change the way we operate?
- How able are we to comply with regulatory requirements, both for licensing and for ongoing operations? Do we have the staff and management skills and capacity to be a financial intermediary? How willing are we to hire externally if required?

Source: Author.

significantly affected by the transformation process. The transforming MFI needs to consider how it will ensure it retains the essential elements of its corporate culture and if it can develop a strategy to address areas in which the current corporate culture may be incompatible with its incarnation as a regulated institution. The degree to which an MFI uses an introspective and inclusive process to formulate its values has a significant impact on the extent to which staff buy into these organizational values. In general, the more connected staff feel to the organization, the more they feel like a valued client themselves, a key ingredient in providing better service to external clients. A proactive process of articulating institutional values and beliefs is critical to the transformation process (box 3.4).

The first step in planning for transformation is for the MFI to review its vision, mission, and values to ensure that transformation is congruent with its strategy for the future. Once the vision has been established, key strategic decisions must be made about who will lead the process.[2]

Box 3.4 Compartamos: Finding the Right Fit

"Compartamos management knows that changing from an MFI into a bank will require personnel with different professional backgrounds than those currently in the institution. But they are equally determined that this new influx of people and skills should not change the institutional culture—*'la mística'*—that they think is key to Compartamos' success. The challenge of upgrading skills while preserving the institution's personality falls in large part to new HR director Ivan Mancillas.

"'I'm not so worried about finding people with the right skills, but rather finding people with the right attitude,' says Ivan. 'Making sure our people have the right skills is a question of improving our training programs and our selection process. Right now, I am working on developing a training model that can be de-linked from the number of people being trained. To do this, we're going to invest in a training team, decentralize our training (which currently takes place at the Mexico City headquarters), and start using distance-learning techniques so that thousands of people can be trained at a time.'

"Enhancing the scalability and flexibility of training will be crucial given Compartamos' planned expansion from 1600 to 5000 employees by 2008. But the current practice of bringing new staff to headquarters for at least two weeks serves another important purpose besides training: namely, helping them understand and absorb *la mística*.

"To compensate for the loss of this opportunity, Ivan plans to introduce new ways to align individual staff with the institution's vision. These include creating a dedicated Employee Services team to support projects like a new leadership program, which will help employees internalize the organization's values. The Employee Services team will also be charged with developing a set of indicators that can be used to judge individuals' 'fit' with the institution. 'It's difficult because we're trying to develop indicators for subjective things,' Ivan explains. 'For example, we'll be trying to track the number of promotions and rotations that occur, to understand how managers are managing their people. We're hoping that we'll be able to combine the use of such indicators with tools like 360-degree evaluations, to make sure that each staff member is working well with their team and the institution as a whole.'"

Source: CGAP n.d.a.

Defining the Vision and Mission

As stated by celebrated satirist Jonathan Swift, vision is "the art of seeing the invisible." It involves a process of building consensus around how an institution wants to define itself in the future. Establishing a vision can be particularly challenging for a transforming MFI, because entry into a new operating environment and the need to meet new but often undefined expectations from investors and regulatory authorities can create significant uncertainty about the future. In addition, the substantial institutional changes that are taking place further add to the difficulty of building consensus. Creating a vision statement to capture the transforming institution's new vision, as distinct from its old vision, is an important tool for consensus building, because key players in the institution must be in agreement about the ultimate goals of the transformation.

The vision outlines the goals and ideals for the institution after transformation. Defining a vision is essential to establish a common understanding of goals. It is a constant reference point for strategic decisions along the way. The vision also reinforces why change—both internal change and change to the institution's public image and position in the local competitive market—is important for the institution.

A new vision not only delineates an idea of how things will be done in the future, but also indicates

Box 3.5 Uganda Women's Finance Trust: Evolution of Institutional Vision

Pretransformation Vision

An improved quality of life for all people of Uganda through the economic empowerment of women.

Posttransformation Vision

Low-income people should have access to financial services.

Source: Personal communication from Harriet Mulyanti, Uganda Finance Trust, November 2005.

Note: In addition to revising its vision, Uganda Women's Finance Trust changed its name to Uganda Finance Trust to recognize its change in focus from primarily women to all low-income people.

an end to the way things were done in the past (box 3.5). The implications of a new vision take time to comprehend and synthesize. The successful adoption of the new vision is contingent not only on leadership skills, but also on the way that vision is presented and communicated.

The mission statement reflects the purpose of the organization and therefore may also change in the process of transformation (box 3.6). At its simplest, a mission statement should include the following aspects: Who are we? What do we do? For whom do we do it? Where do we do it? And how do we do it? The answers to each of these questions will undoubtedly change with transformation, and thus need to be carefully considered in the strategy formulation phase. Any change of mission must involve the majority of the MFI staff—changing the mission without broad buy-in increases the risk of losing the original commitment of some of the staff, a risk that needs to be managed carefully.

Formulating a clear vision and mission for the licensed deposit-taking financial intermediary

- Allows for a shared mindset among staff and board members and helps communicate the need for change to others

Box 3.6 Uganda Women's Finance Trust: Evolution of Institutional Mission Statement

Pretransformation Mission

To economically empower low-income women by providing a consolidated package of savings facilities, credit services, and awareness creation in a manner that safeguards its financial sustainability and self reliance.

Posttransformation Mission

To provide unique financial services to low-income people in Uganda in a manner that delights customers and adds value to all stakeholders.

Source: Personal communication from Harriet Mulyanti, Uganda Finance Trust, November 2005.

- Clarifies the difference between where the institution is now and where the institution wants to be
- Helps maintain the focus (especially in difficult times), and provides a measure for progress in meeting anticipated changes
- Helps identify who will need to be involved to move the institution to where it wants to be (Dellien and others 2005)

Leadership

Leadership is always crucial, but especially so at times of change. Energetic leadership that is highly focused and resourceful, yet open to questioning, will enhance the response to new ideas and a well thought out approach to communications will increase the acceptance of changes by those affected. By recognizing that changes can be threatening and destabilizing, leaders who are able to present a vision in a way that is compelling and inclusive will build the consensus and buy-in of staff, board members, and others required to

Box 3.7 Eight Common Errors that Leaders of Change Make

- Not establishing a great enough sense of urgency
- Not establishing a powerful enough guiding coalition
- Lacking a vision
- Under-communicating the vision by a factor of 10
- Not removing obstacles to the new vision
- Not systematically planning for a creating short-term wins
- Declaring victory too soon
- Not anchoring changes in the corporation's culture

Source: Kotter 1998.

ensure the successful transition to individual lending (see box 3.7).

Leadership during change is as much about motivating and inspiring people as it is about making strategic decisions. Getting board members' buy-in early in the planning process is essential before transformation. If board and senior management are not in complete agreement to transform, plans for transformation should be abandoned or put on hold until such time as the key people achieve consensus. Achieving true consensus requires more than just voting at a board meeting. Often, dissenters (who may be in the minority) will remain silent or even vote in the affirmative, and then stall the process at every stage. The key transformation leaders need to carefully monitor the opinion of every stakeholder, and ensure that everyone is truly on board.

A successful strategy of many transforming MFIs is to identify a champion—ideally someone in a very senior position within the organization—who can lead the transformation process and ensure consensus building among key stakeholders. In particular, dealing with strategic issues will be key for the champion to address and build consensus. This champion does not manage the transformation process—management is ideally carried out by a full-time person hired specifically for that purpose. The champion is someone who has authority and respect within the MFI who can lead and encourage buy-in from the board, management, and staff throughout the transformation process (see box 3.8).

Box 3.8 Trust in the "Champion"

The Asian NGO described in box 3.2 that ultimately abandoned its plans for transformation due to unwillingness of the board to cede control also suffered from a lack of trust among some of the NGO board members in their "champion of change". Although most of the board members and senior management trusted completely in the champion and the promised results of creating a bank, not all did and it ultimately proved impossible to allay everyone's fears of the changes transformation would bring, particularly at a time of economic uncertainty (the Asian financial crisis). What if it was the wrong decision? Or what if it was the right decision but at the wrong time? What if our champion has hidden motives? What if we lose our social mission? At its core, transformation is about managing major change, and for this, the MFI needed someone leading this change whom everyone trusted implicitly.

Source: Author.

In addition to the champion, the transforming MFI should identify key staff members who will play leading roles in the change process. Their commitment is particularly valuable because they will work with the champion throughout the transformation. As such, it is critical that this team brings the skills, capacity, and commitment necessary, and that it represents the various stakeholders directly affected by transformation to ensure their interests are taken into consideration.

Change Management and Consensus Building

MFIs can conduct thorough diagnoses of the external environment and internal capabilities and define in clear terms the vision and mission for the institution going forward, but these alone do not ensure smooth implementation. For an institution to implement the new vision effectively, the change process needs to be well-orchestrated. Integral to the change management process is building consensus at all levels of the institution.

Building strong consensus early in the process is essential, however, it is not imperative that the MFI have complete buy-in to transformation at the very beginning; rather, managing staff's reaction to change as well as the impact of the change on staff is key to success. By having the key stakeholders on board and then managing the process so that the "early adopters" help in closing the gap with the "laggards" will ultimately improve the chance of success of the transformation. Where consensus is not possible, leadership must be able to manage dissent constructively.

A useful change management tool that helps the organization identify change management issues is the Change Overview tool in table 3.1. This framework helps provide structure to the transformation process and helps communicate the new vision and mission (Dellien et al. 2005).

All staff must understand the reason for and importance of transformation relative to the mission and future of the MFI. This requires that everyone in the institution be aware of what transformation entails and the advantages it will bring to the organization. The more thoroughly staff members comprehend the transformation process and understand its effect, the more likely they will be able to actively support the change process. In addition, it is important to integrate staff in the discussions of the impact transformation will have on the institution. Forming small working groups to analyze and discuss operational changes will help to consider the staff perspective and ensure their feedback is received to develop better processes and products and build ownership. In addition, frequent meetings and written communications will keep management and staff informed of progress and the activities required. See box 3.9.

An often neglected yet critical issue is the need to manage staff expectations and concerns. As with any change, transformation brings with it fears of redundancy and mission shift. Staff wonder if their positions will still exist after transformation.

Table 3.1 Change Overview

Dimension	What remains the same	What will change	Potential issues
Ownership and governance			
Target market			
Competitors			
Credit products			
Savings products			
Delivery channels			
Staffing			
MIS			
Financial management			
Reporting			
Risk management			

Source: Adapted from Dellien and others 2005.

Box 3.9 Change Management Project at Equity Bank

In February 2004, Equity Building Society (EBS) in Kenya conducted a needs analysis of change required during the transformation to a bank. In March they reviewed the organization's mission and vision, and developed eight Critical Success Factors (CSFs) for successful change management. In July intensive training was provided to managers and officers to develop an in-depth understanding of the eight CSFs. In September, training on the CSFs was provided to all staff and in October 2004 the transformation process began:

- A cross-functional team was formed to champion the conversion of Equity Building Society into a commercial microfinance bank; the objective of this team was the establishment of the rationale, process, and benefits of transformation.
- The team developed a mission, a vision, objectives, and strategies for the bank and communicated this throughout the organization.
- A staff competition was launched to create a name, logo, and colors for the new bank.
- An image survey was carried out to determine customers' perceptions of the proposed change.
- A customer perception survey was carried out to listen to the customers to determine what they needed and expected from the converted entity.

In November 2004, EBS incorporated the eight CSFs into all staff job descriptions, provided training in leadership skills development, and created problem-solving teams. In December 2004, Equity Bank received its banking license and in March 2005, a thorough review was conducted on the achievement of the eight CSFs.

Source: Personal communication from L'parnoi Lengewa, Equity Bank Ltd., December 2005.

Fears of competency arise as the need for new skills is anticipated—will the workload increase and if so, will everyone be able to handle the increase? Will existing staff have the right skill set or will a number of "outsiders" be hired? In addition, management needs to be aware of the potential for the increased risk of fraud occurring during the transformation. Staff may feel that management is distracted and less likely to detect fraud, or may believe that because they are likely to lose their job in any case, they might as well take what they can get.

Staff members also question the possibility of a loss of mission—will the organization shift from "helping the poor" to "profit making"? Will the MFI become too bureaucratic? Will staff members lose their right to speak up? These concerns require excellent communication with staff and a plan to maintain open lines of communication throughout the transformation process.

Without the commitment and belief of staff in the transformation process and the understood value of the ultimate goal (a license to operate as a financial intermediary), transformation has little chance of succeeding. Box 3.10 sets forth a number of steps managers can take to bolster the probability of success.

Planning the Transformation

Once an MFI understands the considerable changes required with offering voluntary savings services and complying with regulations and determines that it will proceed with transforming into a regulated deposit-taking financial intermediary, it needs to develop a transformation plan. The transformation plan is different from a business plan in that the transformation plan takes into account everything

Box 3.10 Change Management during Transformation

A number of factors can be addressed when managing change; a few are articulated here for internal project managers to use:

- As members of senior management, lead the change and clearly articulate and communicate the rationale for change.
- Plan for change, assess its impact on the broad set of stakeholders, and provide opportunities for letting go of the past and contributing to the creation of the future vision and the new way of operating.
- Emphasize ongoing communication about the changes and perceived usefulness; eliminate surprise, and clearly define new roles and responsibilities.
- Involve users in the change process to create buy-in early in the transformation and build support throughout it.
- Show links between an individual's current and future jobs and the new vision for the organization, thus contributing value and aligning expectations for employees.
- Create a positive learning environment for employees to safely learn new skills and responsibilities without fear of failure or loss of opportunities in the new organization.
- Raise red flags early—deadlines, resources, budgets, capabilities.
- Model the change for others and provide a safe learning environment for employees to be taught new skills and tasks.
- Expect resistance to change, and look for ways to help employees move beyond their initial fears, break from the old ways, and help create the new way of operating (for example, goal setting, praise, enjoyment, roles, rewards, conditions, procedures).

Source: O'Keeffe and Frederick 2004.

the MFI needs to consider to become a financial intermediary. In essence, developing a transformation plan requires a *gap analysis* of the institution—an assessment of where the MFI is now, and where it needs to be to become a true financial intermediary. In general, the transformation plan outlines the specific activities that need to take place to develop the capacity of the MFI to be a licensed deposit-taker. The business plan, conversely, addresses ongoing operations and plans for the future, and includes projected results (both financial and outreach).

That said, a business plan for a transforming MFI would include a discussion of the changes taking place and the plans for licensing and ownership and other pertinent issues, but would not specifically address the type of technical assistance that will be required for transformation and the process to become licensed. In fact, what is included in the business plan is often the result of some of the efforts undertaken as described in the transformation plan. For example, the transformation plan may indicate that market research will be undertaken to determine the needs of existing clients as well as potential new clients. From this research, it may be concluded that new products are needed. The transformation plan would outline plans to examine the current product mix and determine what is required to enhance, revise, or add products and the institutional capacity development necessary to deliver these products and how to develop that capacity. These new or revised products would be included in the business plan as a "plan" for the future and, ultimately, the financial projections in the business plan would include the estimated growth and volumes of these new products.

The business plan usually outlines the MFI's plans over the next three to five years; the transformation plan addresses the immediate future and the

Box 3.11 Independent Institutional Assessments in Pakistan

All MFIs in Pakistan that are interested in transforming into a microfinance bank must arrange for an independent institutional assessment of their "capacity and advisability to transform in the given economic, political, cultural, legal and regulatory environment" (State Bank of Pakistan n.d.). This assessment needs to include an analysis of the MFI's financial position, governance structure, human resources, control systems, and accounting and information systems. The assessment must be carried out by a team of professionals comprising an approved chartered accountancy firm and microfinance specialists, domestic or foreign, with adequate understanding and knowledge of the Pakistan microfinance sector and policy and regulatory environment. This assessment is then submitted along with a feasibility report, including the business plan and financial projections, to the State Bank of Pakistan as part of the licensing process.

Source: Authors.

period it will take to transform, usually somewhere between 12 and 24 months or longer. Finally, financial projections, normally a significant part of a business plan, are not included in the transformation plan although the costs associated with transformation are usually estimated and a funding plan developed. See chapter 5, Strategic and Business Planning, for a full discussion of the business planning process during transformation.

The transformation plan should ideally begin with an institutional assessment that honestly and clearly assesses and documents the current capacity and operations of the MFI (box 3.11). The next step is to consider where the institution needs to be to be an effective, efficient, and profitable regulated financial intermediary, and then what needs to happen to reach that state.

The most common issues and activities that need to be addressed with NGOs or projects transforming to financial intermediaries relate to institutional capacity development including human resources training, product development or refinement, treasury management and compliance reporting, among others, and capital improvements including improved branch infrastructure such as teller windows and strong rooms, and more robust management information systems.

A transformation plan would likely address the following (see annex 3A for a detailed outline of a sample transformation plan):

- Review of operations
- Legal due diligence
- Conversion to a company limited by shares (if applicable)
- Compliance with relevant regulations
- Licensing
- Strategic planning
- Funding strategy
- Ownership
- Governance
- Human resources management
- Management information systems
- Risk management
- Financial management
- Internal audit
- Operations
- Credit products
- Savings products
- Transformation budget
- Transformation funding

Often, it is beneficial to hire an external consultant to develop the transformation plan. An outsider can take an honest look at the MFI and see things that someone working directly in the institution (with a vested interest in its success) cannot see. Moreover, frequently employees and board members of the NGO MFI do not have formal financial sector experience and cannot always be expected to

know what is required to act as a true financial intermediary. It is important, therefore, that the consultant or firm selected to develop the transformation plan have formal financial sector experience, preferably in operations, and ideally with experience in managing deposits. See annex 3B for a sample terms of reference to hire a consultant or firm to develop a transformation plan.

In addition to determining the necessary activities and drafting a transformation plan, it is necessary to consider the overall management requirements during transformation and the cost of upgrading and developing the capacity of the institution to become a financial intermediary.

Managing the Transformation

Given the immense task an MFI undertakes with transformation to a regulated deposit-taking institution, it needs to carefully consider what will be required to manage the transformation, keeping in mind the need to continue to maintain operations of the MFI during the process.

The Transformation Manager

It is strongly recommended that a transforming MFI hire a full-time transformation manager to coordinate and manage its transformation activities. The amount of work involved in transformation is often underestimated and many MFIs may think this position is unnecessary. However, experience in Uganda and elsewhere has shown that it is imperative to have someone dedicated to the oversight and coordination of transformation activities—allowing senior management to continue operating and managing the MFI on a day-to-day basis. See annex 3C for sample terms of reference and an outline of the tasks and activities of a transformation manager to oversee and coordinate the transformation.

Ideally, this person will have formal financial sector experience and be familiar with the demands of operating a regulated financial intermediary. In addition, familiarity with microfinance is useful as is an understanding of the country, its culture and customs, and the regulatory environment and marketplace in which the MFI is operating.

Generally, the position is required for 12 to 24 months or longer depending on the capacity of the MFI as it begins the transformation process and the state of the regulatory environment. In Uganda, transformation managers were hired (funded by donors) for each transforming institution for an initial period of 12 months. This timing was established in anticipation of the passage of the MDI Act and the subsequent expectations for licensing. As it turned out, the time required of the transformation manager was significantly longer and technical assistance continued to be provided until submission of the license application and beyond. Furthermore, it is highly likely that technical assistance will be required once licenses are issued and the transformed MFIs begin actively offering and intermediating public deposits.

The Transformation Committee

In addition to a full-time transformation manager, a transformation committee, comprising representatives from senior management and the board, should be formed (box 3.12). This committee receives monthly or quarterly updates from the transformation manager and is responsible for making strategic and operational decisions as required.

Funding the Transformation

Practitioners and donors involved in transformation often say transformation costs "about a million U.S. dollars." The cost, of course, differs greatly depending on the MFI's existing capacity and infrastructure when it begins the process and to a great extent on the allocation of costs directly to transformation as opposed to costs associated with the normal

Box 3.12 Compartamos Bank Transformation Team

"In late 2004, Compartamos' Board of Directors decided to transform from a SOFL (finance company) into a commercial bank—and their staff found themselves in a quandary.

"'We had the One Million Client project, the new IT system, savings, insurance, transformation, training . . . too many projects,' explains Gonzalo Ramirez, a manager at Compartamos. 'Different departments were being told to do too many different things.' . . .

"In response, Compartamos launched two parallel processes designed to achieve better alignment between all of these different initiatives. First, several independent projects, including savings, were brought together and a new Bank Transformation (BT) team was formed to manage them. 'All the departments have to change something,' says Carolina Velazco, BT coordinator. 'This involves thinking about two things: (1) what you do right now, and (2) what you will have to do as a bank. So we're doing a gap analysis, laying out what steps are necessary to do the new things, and how much time this will take,' she explains. 'Now, we will start meeting with all the departments to see what they think of the gaps we've identified and the timelines, since they are the experts.' . . .

"'In March, we had a meeting with all the HQ staff to explain why we're changing into a bank—because it's the best way to achieve our goals for our customers,' she recalls. 'We explained that they need to be flexible: have a good attitude and work as a team with different departments and the coordinating team.'"

Source: CGAP n.d.b.

maturation process of an MFI. The total cost is also dependent on the size of the MFI and the number of branches it has or plans to have at the time of licensing. A significant cost, and thus one with large variances, is the extent to which the MFI needs to upgrade its management information systems (MIS) and branch infrastructure. Furthermore, costs differ depending on the country in which the MFI is operating. In general, however, transformation from a credit-focused MFI to a regulated deposit-taking intermediary tends to cost somewhere between U.S.$700,000 and U.S.$1.5 million.

Transforming MFIs frequently turn to donors for assistance in funding their transformation efforts. In Uganda, the five transforming MFIs (four of which are licensed, with the fifth in process at the time of publication) received on average approximately U.S.$1 million each from donors. However, all donor funds are not alike. Many come with restrictions on use, particularly limitations on using donor funds for capital costs. Capital expenditures (those costs that are capitalized on the balance sheet and thus add to the value of the transformed MFI) include items such as MIS upgrades and branch infrastructure development. Depending on the systems in place and the state of the MFI's branches, these costs can vary from U.S.$300,000 to U.S.$1 million. In Uganda, donors estimated that each branch upgrade would cost U.S.$25,000 to U.S.$50,000, so an institution with 10 branches in need of improved strong rooms, safes, refurbished banking halls, and teller windows, would need approximately U.S.$250,000 to U.S.$500,000 for branch infrastructure. New software systems that can accommodate voluntary savings services and comply with central bank requirements on average tend to cost about U.S.$300,000, again depending on the number of branches and thus the number of software licenses required. Hardware costs could also run as high U.S.$200,000 to U.S.$300,000 depending on the quality of hardware existing in the MFI before transformation, the requirements of the regulators, and the selected software. Donors are sensitive to funding capital expenditures because they increase the value of the institution, and therefore increase the value of its shares. Unless this increase is fully reflected in the purchase price of the

shares, donor funds (often taxpayers' money) in effect end up being passed on to the shareholders. In such cases, it may be more appropriate to fund the bulk of the capital expenditures, by either borrowing (the liability thus offsetting the asset, and not increasing the net worth of the company) or using equity provided by the new investors.

The other large part of the estimated costs of transformation is for consultants or advisory services to the MFI—particularly to develop the capacity of its human resources. These costs are normally not capitalized. Depending on how the costs for advisory services are funded, the transforming MFI may or may not need to record these costs (and the funding received to pay them) on its income statement. If donors are funding advisory services for the transformation of the MFI, some donors will pay consultants directly, thus not requiring the MFI to record the revenue and expenses on their books. Other donors will give a grant to the transforming MFI and simply request an account statement for the funds.[3]

Transformation in less developed countries can be more expensive than in more developed, higher cost countries. Less developed countries may not have a local pool of consultants on which to draw, meaning that expensive international consultants must be brought in. Additionally, MFIs in less developed countries with poor infrastructure will need to incur many more costs (generators, satellite connectivity, security) than those operating in countries with a well-developed infrastructure.

See annex 3D for a sample transformation budget with estimated costs based on consultant days or fixed contracts, and fixed purchases (software, branch upgrades, and so on) for a medium-size MFI with 10 branches. In this example, the estimated cost for transformation is U.S.$1.5 million.

Annex 3A Sample Outline for a Transformation Plan

Many of these tasks are carried out concurrently—this list is not meant to be completed in chronological order.

1. **Review of operations**
   a. Analyze overall operations with regard to efficiency and adequacy of products and processes (portfolio management, operating costs, head office and field activities).
   b. Analyze overall quality and skill set of human resources (inventory of available skills, required skills, training requirements, incentive schemes).
   c. Evaluate branch infrastructure and geographic outreach for adequacy for a deposit-taking institution.

2. **Credit products**
   a. Critically evaluate credit products including delivery mechanisms, portfolio quality, growth, staffing levels, costing, size, flexibility in structuring, legal documentation, internal controls, client demand, and so forth, and improve as necessary.
   b. Examine compulsory savings requirements and consider reducing or eliminating.
   c. Ensure consistent compliance with regulatory requirements for loan products (collateral registration, loan documentation, and provisioning, for example) at all branches; improve as necessary.
   d. Introduce additional loan products (for example, salary loans for employees of small and medium enterprises, housing loans) starting with product concepts, structure, marketing plans, and so forth and then piloting and refining before rolling out.
   e. Consider introducing other financial products (money transfer services, insurance, foreign exchange services, and so on).

3. **Savings products**
   a. Critically examine and determine institutional readiness to mobilize and intermediate public deposits.
   b. If applicable, develop modalities for making noncompulsory savings accounts fully open and accessible.
   c. Research, design, and price products for pilot.
   d. Pilot savings services in one branch for up to six months; assess pilot and refine products and processes.
   e. Train staff, design, implement, and evaluate second pilot; eventually expand to all branches.
   f. Develop strategy to expand market and seek institutional deposits and deposits from wealthier individuals.
   g. Develop strategies for investing excess liquidity.

4. **Competitive positioning**
   a. Conduct market research and competitive analysis to determine organization's comparative and competitive advantages.
   b. Consider the current product mix and determine if new product offerings are required in addition to voluntary savings.
   c. Consider existing and new delivery channels and plan for expansion.
   d. Decide upon name and logo for the regulated institution and other branding strategies.
   e. Develop marketing strategy.

5. **Business planning**
   a. Finalize various strategic decisions such as product mix and pricing and asset transfer method, and make indicative decisions for planning purposes.
   b. Update or develop three- to five-year business plan including financial projections, incorporating plans for transformation and the addition of voluntary savings and

possibly other products as well as additional operational functions, and prepare for inclusion with license application (if required).

c. Develop and implement strategy to address tax considerations.
d. Determine the role of the NGO after transformation (if applicable).

6. **Legal due diligence**
   a. Confirm legal status of the MFI and the applicable law.
   b. Confirm ongoing compliance with governing laws.
   c. Review tax status and compliance with applicable law (corporation tax, value added tax, and employee entitlements under the laws of the country).
   d. Review employment contracts and the ability to transfer employees to the new company.
   e. Review legal requirements under the law for regulated institutions.

7. **Set up and transfer to a company limited by shares** (if applicable)
   a. Outline steps required to set up a company limited by shares.
   b. Address the implications for transfer of NGO business (that is, taxation on transfer of net assets and other tax implications, current and future).
   c. Determine best timing of transfer to minimize negative consequences.
   d. Determine mechanism for transferring assets and liabilities (all at once? as loans renew?); renegotiate loans from the NGO to the regulated financial entity.
   e. Engage a legal advisor to register the new company, develop articles of association, shareholders agreement, and company articles and statutes.

8. **Licensing**
   a. Hold ongoing consultations with the regulator on licensing requirements.
   b. Analyze infrastructural and organizational changes required to obtain license.
   c. Compile and submit license application.
   d. Follow up license application with the regulator; respond to enquiries.

9. **Compliance with relevant regulations**
   a. Develop a strategy for compliance with minimum capital and capital adequacy requirements (minimum capital required as cash at time of licensing).
   b. Consider all requirements under the relevant regulations and determine what steps to take to comply; establish framework to enable compliance.
   c. Review reporting capabilities and improve to meet regulatory reporting requirements including ensuring required data are collected in a timely manner.

10. **Funding strategy**
    a. Determine the ideal capital structure based on capital requirements under the law, the required level of equity to operate profitably and to finance growth into the future, and the size of investment required externally.
    b. Determine the expected profitability hurdle (both rate of return and time to profitability) for the core investors and determine the appropriate leverage to meet that hurdle.
    c. Document information regarding sources, terms, and availability of funding.
    d. Given available sources of funds, determine the ideal liability strategy to achieve desired leverage.
    e. Determine the appropriate debt/equity split of the NGO's contribution (if applicable).

11. **Ownership**
    a. Determine ownership requirements under the relevant laws or regulations and clarify restrictions, if any, on ownership (foreigners, public sector entities, NGOs).

b. Outline the profile of desired investors and investor mix.
c. Develop an ownership plan with a carefully reasoned and researched divestiture strategy (employee stock ownership plan, listing, private placement, other).
d. Outline conditions precedent to divestiture/transfer; obtain clearances from donors, financiers (loan covenants), government, and other stakeholders.
e. Prepare prospectus including financial projections for marketing to potential investors; conduct a valuation of the company.
f. Identify potential investors and determine how they fit the profile and what their interests and restrictions are.
g. Secure equity investors: solicit investors, negotiate with investors, finalize share structure and pricing.
h. Finalize shareholding agreements including definition of shareholders; exit options, valuation of shares, timing; requirements for additional capital injections and dilution of shares; any special features regarding distribution or assignment of profits.

12. Governance

a. Develop an inventory of skills for the current board of directors, review the adequacy of board skills both to govern a financial intermediary and to satisfy license requirements, and propose additional skills if necessary.
b. Determine appropriate conduct of board business for regulated entity (adequacy of notices, attendance of meetings, depth of analysis of issues, board subcommittees).
c. Propose changes, if any, in conduct or structure of board business to enhance control and satisfy licensing and other regulatory requirements.
d. Create new board for licensed institution and define number of board members, constitution of board, board procedures, the percentage of shareholding that results in a board seat, if there will be non-owner board members, voting rights, standard issues (quorum, meetings, minutes, general assembly, appointment and renewal of board members), areas of board responsibility.
e. Develop board policies and procedures.

13. Human resources management

a. Evaluate adequacy of organizational structure and identify changes and additions required to operate as a deposit-taking financial intermediary.
b. Develop a process for qualifying existing staff for positions in the new organization.
c. Examine and determine if the current salary and incentive structure is appropriate and competitive given licensing and addition of new products and functions; revise if necessary.
d. Ensure an adequate human resources policy manual is in place.
e. Critically review management skills and assess adequacy of skills to steer organization through transformation.
f. Critically review management skills and recommend changes if required to manage a financial intermediary; identify key positions in senior management team and the skills, qualifications, and personal characteristics they will need to fulfill their roles; ensure that senior management will be acceptable to the regulator.
g. Develop and implement plan for filling personnel-related gaps through retraining, redeployment, and recruitment for required staff and management positions.
h. Establish or expand training department to include training in new products, new functions, and overall staff capacity; consider what training needs can be outsourced and what can be developed and offered internally.

14. Management information systems

a. Critically review MIS including hardware, software, and human resources.
b. Assess adequacy to support existing products, new products, management reporting, compliance reporting, flexibility to accommodate changes in procedures, decentralization of operations, and so on.
c. Upgrade or purchase software adequate for operating as a financial intermediary and acceptable to the regulator; upgrade or purchase hardware required.
d. Ensure ability to report accurately and in a timely manner to the regulator (liquidity reports, capital adequacy reports, financial statements) as well as to management and front-line staff (loan repayment reports, online savings balances, for example).
e. Determine requirements for networking and implement.

15. Risk management

a. Review policies for risk management (operational risk, credit risk, liquidity risk, market or systemic risk, foreign exchange risk, capital adequacy, exposure limits, and so on) and recommend and implement activities for improvement.
b. Ensure compliance with regard to risk management.
c. Ensure adequate internal controls are in place for a regulated deposit-taking institution.
d. Ensure policy of zero tolerance for delinquency and appropriate risk classification for microfinance loans.

16. Financial management

a. Determine adequacy of structure of finance department.
b. Determine adequacy of relevant accounting policies as a licensed institution.
c. Analyze chart of accounts for management, financial, and compliance reporting.
d. Change financial year-end if required to comply with regulations.
e. Ensure compliance with provisioning policies and reserve requirements as required by the regulator; establish a write-off policy congruent with regulatory requirements.
f. Review budgets and budgetary performance analysis framework and adequacy for compliance.
g. Establish a treasury function; review liquidity management function taking into account regulatory requirements; develop strategies to optimize returns.
h. Create an Asset and Liability Committee (ALCO); develop financial management guidelines to manage capital, liquidity, and asset quality.
i. Ensure financial policies and procedures are documented (including an accounting policy manual) and consistently followed in head office and branch network.

17. Internal audit

a. Critically review internal audit function (staffing, seniority, skills, audit plans, coverage, reporting structure, duplication, and so on).
b. Review audit subcommittee of the board (composition, independence from the finance or procurement subcommittee, corrective actions on audit reports, and so on).
c. Document internal and external audit procedures and policies as approved by the board and ensure manual is followed consistently.
d. Review gaps in compliance and propose strategies for compliance with regulation.

18. Branch operations and customer service

a. Evaluate and improve branch security procedures including vault management and cash handling.
b. Evaluate and improve number of teller windows, size of banking hall, hours of operations.

c. Evaluate and improve internal controls and risk management at the branches.
d. Establish policies for tellers including cash limits and account maintenance (opening and closing).
e. Establish new product protocols at the branches including training, piloting, targeting, incentives, and so on.
f. Develop branches as profit centers including implementing a transfer pricing system with the head office (excess funds are "sold" to head office by net savings branches, and funds are "purchased" from head office by net lending branches at a "transfer price").
g. Ensure excellent customer service is in place in all branches; if not, develop and implement strategy to achieve continual excellence in customer care.
h. Develop and implement a strategy to maintain client loyalty during and after transformation.

19. Transformation costs and strategies for funding the transformation

a. Estimate costs of transformation process broken down by activity.
b. Develop a timeline for completion of transformation.
c. Identify potential consultants and advisors.
d. Identify the sources of funding for the transformation-related expenses.
e. Prepare funding proposals and solicit funding.

Annex 3B Sample Terms of Reference for Development of a Transformation Plan

Background

Background on the organization including its mission, target market, client outreach, portfolio size, other facts, and so on.

Objective

The first objective is to determine the level of institutional readiness of MFI A to obtain a license from the central bank or other supervisory body, where it will be regulated and supervised under the relevant law to mobilize and on-lend deposits from the public.

The second objective is the development of a detailed transformation plan. This plan may also provide the basis for a donor agreement to support the institution in transforming into a privately owned, regulated MFI.

Transformation is defined as the conversion of an unregulated MFI into a licensed deposit-taking intermediary. It includes the change of legal form (where necessary), ownership, and governance as well as internal operational changes needed to meet regulatory requirements and to attract investors.

Tasks

1. Before visiting MFI A's country, the consultant will prepare a generic transformation plan to serve as a starting point for discussions. This generic plan should include the key questions that must be addressed in MFI A's transformation plan. It should be submitted at least two weeks before arriving in country.
2. Review the relevant law and regulations as well as any other pertinent documents.
3. Meet with the relevant authorities in the central bank to discuss key institutional requirements.
4. Conduct an institutional assessment to determine the level of institutional readiness to be a deposit-taking financial intermediary. The assessment should focus on identifying actions required and should cover the following areas at a minimum (see annex 3A, Sample Outline for a Transformation Plan, for an outline of all areas to consider):
   a. Assess management and staff skills and competencies including conducting a management skills audit and training needs analysis of staff (including both field staff and management staff) and the board
   b. Assess adequacy of corporate governance including
      i. Skill levels of the board in relation to providing governance for a deposit-taking institution
      ii. Frequency of meeting, levels of documentation, governance processes
   c. Review the product mix and delivery methodologies including
      i. Loan products
      ii. Savings products
      iii. Other financial products
   d. Review the Management Information Systems (MIS) and procedures and assess
      i. Extent to which the current systems meet the proposed reporting requirements
      ii. Adequacy of the proposed future system (if applicable)
      iii. General level of computerization
      iv. Ability to network between branches
   e. Assess financial management capacity including
      i. Existence of systems and procedures
      ii. Financial performance
      iii. Calculation of key ratios
      iv. Treasury management capacity
   f. Review internal audit procedures and capacity
   g. Review overall operations and systems with a view to how the addition of deposit services will require changes

5. Conduct a one-day plan development workshop with relevant stakeholders
6. Develop a transformation plan outlining the activities to be undertaken to prepare the organization for licensing and determine the cost of implementing such a plan
   a. Detailed list of activities to be completed for successful transformation
   b. Time frame
   c. Costs

Deliverables

The main deliverable will be a detailed transformation plan. This plan will be submitted in draft form within two weeks of the consultant's departure. Comments will be provided within two weeks after receipt and the consultant will have up to two weeks to respond to comments. The final version will be presented by a specified date.

Qualifications

The consultant should have formal financial sector experience as well as detailed knowledge of the transformation process. The consultant should also have microfinance experience and expertise in regulatory and supervisory issues affecting transforming MFIs, structuring and raising equity investments, internal financial management and control, microfinance service delivery, and institutional development.

Level of Effort

It is estimated this assignment will require 25 to 30 days to complete.

Annex 3C Sample Terms of Reference for a Transformation Manager

Background

Background on the organization including its mission, target market, client outreach, portfolio size, and other facts.

Strategic Objective

To better serve its customers and increase its reach and profitability, the MFI seeks to provide a wider range of financial services, including savings products, and to gain access to and intermediate savings to finance and scale up its lending operations. It has, therefore, decided to transform into a regulated financial intermediary. A Transformation Committee (TC), comprising board members and senior management, has been established to oversee the process.

Rationale for Transformation Management

Following the completion of an institutional assessment in [insert month or year] to determine the organization's level of preparedness for transformation, a detailed Transformation Plan was prepared as a guideline for the activities that need to be undertaken to prepare MFI A for transformation. Most of the activities are to be undertaken during (year), with the target timing for submitting a license application to the central bank by end of (year).

It has been established that the scope of work involved in the transformation process is of such magnitude and nature that it can not be carried out by the existing management structure without significantly diverting its attention from the day-to-day activities of the core business. Additionally, several aspects of transformation require specialized expertise. Therefore, MFI A needs a full-time on-site Transformation Manager (TM) to manage the transformation process and to coordinate the outsourcing of technical and other assistance.

The TM will coordinate all activities of the transformation, and will be responsible to and report to the Board through the CEO and the TC.

Responsibilities of the Transformation Manager

- Coordinate implementation of all activities detailed in the transformation plan.
- Provide technical support to the TC and management for implementation of transformation activities.
- Set key performance indicators to measure and regularly report on transformation status to Board and management through the TC.

Specifically, the TM will be responsible for the following:

1. Review the transformation plan and budget.
2. Coordinate the TC meetings to ensure they are held regularly and as scheduled, and ensure that all stakeholders are kept informed and involved in the process.
3. Provide technical assistance to the TC and management in areas of own expertise.
4. Coordinate the implementation of all the activities outlined in the transformation plan, including
   a. Activities for preparing the institution to comply with regulations
   b. Preparing the application and following up with the central bank
   c. Actual conversion into a regulated financial intermediary.
5. Coordinate the outsourcing and use of technical assistance for the transformation process, including
   a. Formulating scopes of work and terms of reference and designing contracts
   b. Writing proposals to donors and providers of technical assistance

c. Assisting the TC in selecting and engaging consultants or firms to carry out the activities
d. Scheduling underlying activities
e. Assembling and providing background information
f. Providing initial briefing to consultants or other interested parties
g. Ensuring quality control and compliance with contracts as well as transfer and integration of knowledge and skills to management
h. Receiving and reviewing technical assistance implementation reports for submission to and discussion with the TC.

6. Manage investor relations.

Ideal Candidate

The ideal candidate will possess the following:

- A master's degree in business administration or Economics
- At least five years experience in a large and successful regulated microfinance institution or commercial bank, or other financial institution, particularly in operations or senior management
- Experience in financial planning, management, analysis, and modeling in a financial institution
- Previous involvement in the transformation of an NGO MFI into a regulated intermediary
- International work experience with low-income entrepreneurs
- Experience with investor relations and funding negotiations
- Ability to provide direct technical assistance in a number of operational areas envisaged in the transformation process, for example, MIS, strategic and business planning, financial management, treasury management, institutional development, internal audit, operations, policies and procedures
- Advanced computing skills

Personal Traits

- Highly organized and able to accomplish complex tasks
- Diplomatic and a good negotiator
- Ability to work independently
- Results oriented
- Good leadership skills

Duration and Terms

The TM will be based in country for a period of 12 months, with a possible extension to 18 months.

Annex 3D Sample Transformation Budget

	Estimated Cost (U.S.$)	Estimated Consultant Days (if relevant)
Transformation Management and Strategic and Business Planning		
Hire a full-time Transformation Manager (budget assumes salary plus housing, transport, and education costs).	120,000	12 to 18 months
Finalize business plan (financial projections) for the next 3 years.	20,000	20
Subtotal	**140,000**	
Market Analysis and Competitive Positioning		
Engage consultant to coordinate and interpret market research.	20,000	20
Engage a local firm to conduct market research.	15,000	
Develop corporate image, brand, signage, promotion materials.	20,000	20
Subtotal	**55,000**	
Savings Products		
Market research and product design.	15,000	15
Test market strategy for savings; pilot and evaluate new and revised products and subsequent rollout.	30,000	30
Document savings policies and procedures.	20,000	20
Train staff on new products and services.	10,000	
Support development and refinement of back office operations.	15,000	15
Subtotal	**90,000**	
Credit and Other Products		
Assess and refine lending methodologies and new product development.	20,000	20
Pilot and evaluate new products and subsequent rollout.	30,000	30
Document current and revised credit policies and procedures.	10,000	10
Train staff on new and refined products and services.	10,000	
Subtotal	**70,000**	
Ownership and Governance		
Establish valuation or institutional rating.	20,000	
Develop marketing prospectus and strategy for attracting new investors.	15,000	15
Design and implement profit-sharing plan.	20,000	20
Retain legal advice on share structuring.	20,000	
Subtotal	**75,000**	
Legal, Licensing		
Analyze options of legal structures and process registration, articles, and so on.	20,000	20
Transfer assets and liabilities to new entity; legal costs and tax advice; legal work on license application.	30,000	
Subtotal	**50,000**	

Annex 3D (*continued*)

	Estimated Cost (U.S.$)	Estimated Consultant Days (if relevant)
Regulation and Compliance		
Conduct regulatory and policy analysis of systems and upgrading for compliance.	30,000	30
Provide training (ongoing) on regulatory, policy, and compliance requirements.	20,000	
Subtotal	**50,000**	
MIS and IT Consultancy		
Conduct systems audit for compliance with central bank reporting.	25,000	25
Design branded forms and passbooks for computerized teller services.	10,000	
Migrate data from existing to new system (data cleansing and input).	15,000	
Train users on new system.	15,000	
Subtotal	**65,000**	
Human Resources Development and Staff Training		
Review performance reward systems.	5,000	5
Review organizational structure, job descriptions, policies, and procedures.	25,000	25
Develop human resources development strategy and plan.	20,000	20
Subtotal	**50,000**	
Financial Management		
Engage a consultant or advisory service on capital structure.	15,000	10
Design and implement a budget model.	10,000	10
Develop treasury risk management policies and procedures.	15,000	15
Train new staff members on financial risk management.	10,000	
Subtotal	**50,000**	
Internal Controls and Audit		
Train additional internal audit staff members.	10,000	
Review internal controls, audit, and supervisory functions.	20,000	20
Review, finalize, and document policies and procedures.	15,000	15
Subtotal	**45,000**	
TOTAL CONSULTANCY EXPENSES	**740,000**	
MIS and IT Capital Costs		
Network setup for branches and head office.	10,000	
Upgrade and integrate or interface loan tracking, savings, accounting.	250,000	
Purchase new or upgrade hardware.	250,000	
Subtotal	**510,000**	
Infrastructure		
Upgrade branch infrastructure: banking halls, teller counters, strong rooms, 10 branches.	**250,000**	
TOTAL CAPITAL COSTS	**760,000**	
GRAND TOTAL	**1,500,000**	

Notes

1. This is not always the case, as evidenced by FINCA Uganda. The Bank of Uganda found FINCA International to be a financial institution (under the MDI Act [2003] financial institutions are allowed to own 100 percent of an MDI) and thus FINCA Uganda was exempted from the ownership restriction. Also, Mibanco in Peru was 60 percent owned by the founding NGO at the time of transformation.
2. Parts of this section, "Leading the Transformation," are adapted from Dellien et al. 2005.
3. This sometimes triggers a tax liability for the MFI, which should be considered when negotiating with donors.

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Chapter 4

Marketing and Competitive Positioning

Once a transforming microfinance institution (MFI) has defined its vision, mission, and values, it needs to develop its marketing and competitive strategy. This process begins by clarifying who the expanded target market will be for the regulated institution and gathering marketing intelligence to understand the target market preferences, needs, and habits, as well as the products and services offered by competitors. This marketing intelligence becomes a key input into the transformation process—from strategic planning, to business and marketing plan development—helping the institution decide which products will best suit the revised target market, and how to develop, price, and deliver them. Marketing intelligence, in combination with a thorough analysis of the MFI's strengths and core competencies, is also necessary for the MFI to determine how to position itself in the market relative to its competitors. This competitive position is solidified through branding—actively communicating a key concept, core benefit, or value proposition that becomes associated with the regulated institution and helps shape its image. As shown in figure 4.1, matching institutional strengths with well-analyzed market opportunities must drive decision making so the MFI can develop a clear strategy going forward as a regulated institution. Through understanding its target market, determining the ideal product mix, and positioning itself in the market, the MFI can then develop its business plan, including financial projections, and test the viability of its decisions.[1]

The purpose of this chapter is to outline key areas related to marketing and competitive strategy that transforming MFIs need to master to successfully make the transition to and take full advantage of being a regulated financial institution. This chapter begins with a description of marketing and how it fits within the MFI as it transforms into a regulated institution. It then outlines the process for gathering marketing intelligence—the core of any marketing and competitive strategy. Once gathered, such marketing intelligence provides the information the transformed MFI needs to

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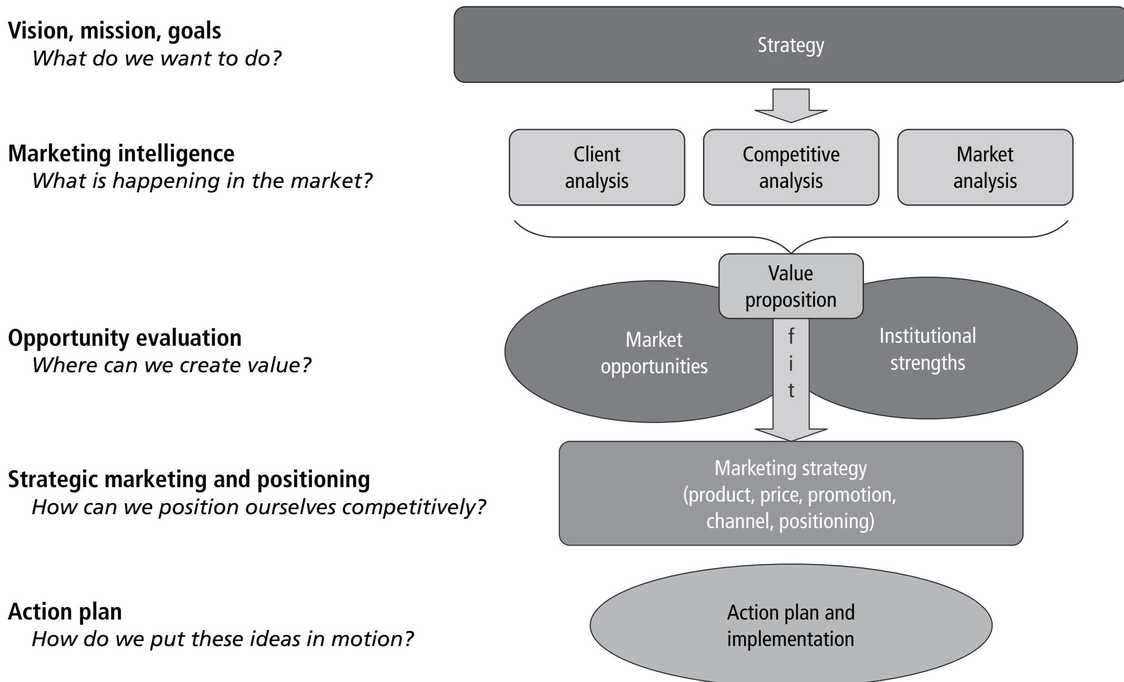
Figure 4.1 Framework for Strategic Marketing Plan Development



Source: ACCION International, Marketing and Product Development Unit.

determine its portfolio of products and services, how to price them appropriately, and the channels through which to deliver them. Finally, the chapter defines branding and the process for developing a corporate identity, including communications strategies. It concludes with an overview of how to implement the marketing plan in the transformed institution.

Marketing

"Marketing is the management discipline and organizational function responsible for understanding and conditioning the target market so clients desire and prefer the institution's offer over that of the competition" (Brand 2003, p. 18). The goal of marketing, therefore, is to create the conditions necessary so the target market is more receptive to purchasing products or services and becoming loyal customers. As is clear from the definition, knowing one's customer intimately and the factors that influence his or her decision making is a critical first step to the creation of any successful marketing strategy.

As MFIs transform into regulated entities they need more formal and sophisticated marketing and positioning strategies. For credit-focused MFIs, marketing usually refers to the provision of promotional materials (free calendars, pens, posters, flyers); for those with more of a client focus, marketing may include conducting some basic market research. MFIs operating on a noncommercial basis can generally operate with impromptu promotional campaigns and "reactive" product development efforts. However, once operating in the formal financial sector, an MFI requires a more concerted, coherent marketing strategy. Transformation takes place not only by the imposition of regulation but also in the eyes of the MFI's clients and competitors, which in turn determines an MFI's position in the marketplace. As such, transformation creates both challenges and opportunities for the MFI.

To develop a coherent marketing strategy, the transforming MFI needs to focus on the following:

- A deep understanding of its customer profiles, preferences, and key insights (via qualitative and quantitative research, data analysis, and segmentation)
- Competitive analysis (using both macro trend analysis and mystery shopping[2] as inputs)
- An integrated product portfolio (via systematic development, pricing, pilot testing, and rollout with monitoring of targets)
- Channel expansion (using automated teller machines [ATMs] or strategic partnerships, for example, to expand points of sale)
- Branding and image building (defining the value proposition and making good on the promise, developing a corporate identity, and standardizing the look and feel of the organization)
- Communications strategy and promotion (including tactical "go-to-market" initiatives)

Unlike strategic planning, which is carried out periodically (perhaps every three to five years), marketing becomes an integral day-to-day function of an MFI, much like human resources or financing strategies. Thus, some of the most successful transformed MFIs in Latin America—including Mibanco, BancoSol, and Compartamos—have set up marketing departments and significantly expanded their marketing efforts.

Marketing Intelligence

Market-driven institutions develop their strategies and operations based on client needs and competitive realities. Clients' needs evolve (such as demand for individual credit rather than group loans) and competitors become more aggressive. In many countries (including Bolivia, Haiti, and Mexico), a new entrant will literally stand outside the branches of leading MFIs and offer more attractive financing to entice the clients away. The only way to maintain one's position is by developing the capacity to not only collect, but then analyze and apply, market information to the MFIs' operations.

An MFI can influence its positioning by developing sustainable competitive advantages and then communicating that point of differentiation aggressively. This process involves assessing the MFI's strengths and weaknesses against those of its competitors and differentiating the institution in ways that prospective clients find meaningful. This process must be based on *marketing intelligence* about client needs and preferences, competitors' strategies, the MFI's strengths, and the context within which it works.

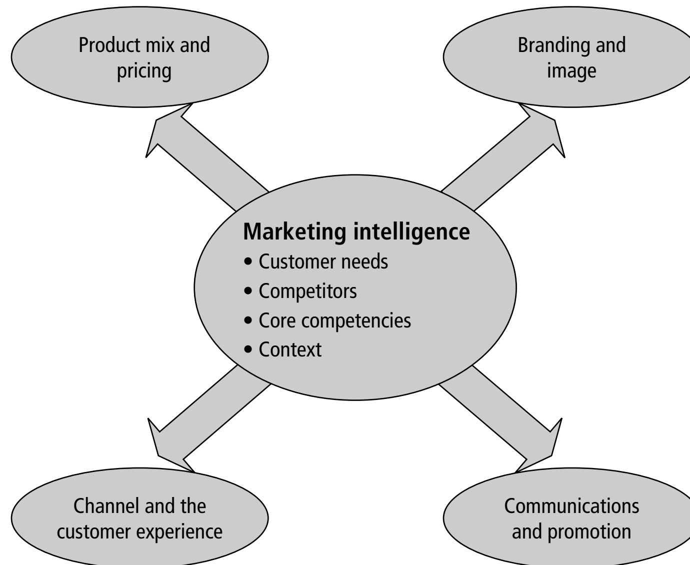
Marketing intelligence[3] refers to an institution's ability to do the following:

- Collect market data in a systematic and objective fashion (market research),
- Analyze and interpret this information (market analysis), and
- Apply it to develop strategic recommendations and action plans (marketing strategy) (Brand 2003).

As illustrated in figure 4.2, marketing intelligence becomes the building block for key areas an MFI can use to differentiate itself from the competition and create value for the customer:

- *Product mix and pricing:* the *value proposition* comprising the core product (customer needs and wants); the actual (features and design) and enhanced product (benefits); and the pricing strategy.
- *Channels and the customer experience:* how the products and services reach the client, including distribution strategy and client management. Both of these areas have strong links to operations and thus are discussed in more detail in chapter 13, Customer Service and Operations.
- *Branding and image:* key selling concept; attributes (tangible and emotional), visual identity (logo and tagline), and image (the face the MFI wants to display to the market).

Figure 4.2 Elements of Marketing and Competitive Positioning



Source: Author.

- *Communications and promotion:* the communications strategy (positioning statement, publicity) as well as the promotional efforts (tactical initiatives to induce purchase).

The ultimate success of the competitive strategy hinges on the quality and depth of an institution's marketing intelligence.

The importance of marketing intelligence is even greater for a transforming MFI. The very nature of becoming a regulated institution means that the universe of potential clients expands. In addition to microenterprise borrowers, the transformed MFI also needs to attract deposit holders—from both its traditional socioeconomic segments and higher ones—including salaried workers and other savers able to put away the coveted larger term deposits. Moreover, the transformed MFI enters a new competitive landscape in which it must track the moves and strategies not only of other microfinance providers, but banks and other formalized institutions that compete in these same market segments. To succeed in this more formal, complicated business environment, the transformed MFI must shift from being a *product-driven* institution (defining itself by its lending methodology) to being a *market-driven* institution.

The Four "C's" of Marketing Intelligence

Transforming MFIs must begin to master the four key components of marketing intelligence: client, competition, company, and context.[4]

Client. Gathering marketing intelligence on the client requires knowing the target market intimately, particularly the following aspects:

- *Client profiles:* What are the demographics and income levels of clients? MFIs typically have a good understanding of the demographic profile of the clients they serve, including their age, gender, education level, marital status, household size, and location. This information is often available from secondary sources such as country census information, or by mining (reviewing and analyzing) the MFI's database. For transforming

MFIs, this information is a starting point for clarifying and segmenting the target market.

- *Needs and preferences:* Which products and delivery channels do clients prefer? MFIs typically have some intelligence on client needs, derived from the credit officers' relationships with clients. Qualitative market research can build on this intelligence by allowing the MFI to explore more directly the wants and preferences of its clients. Quantitative market research can be used as a follow-up to qualitative research to determine the degree and frequency of the observed desires in the greater population.
- *Beliefs and attitudes:* What are client perceptions of banks? Of MFIs? MFIs typically have a weak understanding of the beliefs and attitudes of their clients unless they have actively conducted direct market research. These subjective characteristics generally need to be teased out of clients, and are critical for commercializing new products. Also, beliefs and attitudes beyond those related to financial institutions need to be considered. For example, in some Kenyan tribes, one cannot foreclose on a property if the potential buyer is from outside the community. In Uganda, some clients take witchcraft very seriously—when one transforming MFI wanted to occupy offices in a certain location someone put a dead animal outside the premises, which meant the MFI had to find an alternate location because clients said they would not enter the building.
- *Buying habits:* How do clients make decisions? Many factors and people influence a purchasing decision, whether for consumer goods or financial services. Understanding how the client makes decisions on how to fulfill his or her needs for different financial services can illuminate opportunities for the transforming MFI to improve or expand its services. For example, a client might choose a remittance provider based on its convenience to the client's workplace, so delivery channel development would be an important element of the MFI's marketing strategy if it wanted to begin offering this service.

Competition. Marketing intelligence about competition includes understanding the different institutional categories (bank, MFI, finance company, rotating savings and credit associations [ROSCAs]) from the client perspective, and the relative advantages and disadvantages of each. Only by thoroughly understanding its competition can the transformed MFI differentiate itself from others. This deep understanding involves gathering the following intelligence on all of its competitors (both regulated and unregulated):

- *Mission and objectives:* What are competitors' primary business drivers—social effect? profit? a mix of the two?
- *Business strategy:* What are competitor's business strategies and the mechanics of their business models?
- *Growth and profitability:* Which institutions are growing and why? Why are some more profitable than others? For example, if all the growth of a competitor is coming from consumer lending, it might be an opportune time for the transformed MFI to begin a savings mobilization campaign targeted at salaried employees, before the competition begins directly cross-selling.
- *Cost structure:* What cost advantages do competitors have? For example, banks may have lower cost structures because of access to cheaper sources of capital and the ability to leverage fixed costs using a more diversified portfolio of products. NGOs may be able to access cheap donor funds, generally no longer available to transformed MFIs.
- *Organizational culture:* Institutional norms, values, and other relatively intangible characteristics of competing organizations, which can sometimes be obtained through mystery shopping, can be a source of competitive advantage. For example, UniBank, an MFI in Haiti, treats the personnel orientation as an inspirational, festive event that has since become legendary in the market. The CEO is always present and infuses a sense of excitement and purpose in the staff, which carries over in how staff treat clients.

- *Image:* What is the image and position of competitors in the marketplace? For a transformed MFI, understanding its own image as well as those of its competitors is critical to determine where its relative strengths and weaknesses lie. In some countries (Tanzania, for example), banks connote security and strength, but in others (Ecuador, for example), they connote risk and instability.
- *Barriers to entry or exit:* Well-entrenched competitors can benefit from a barrier to entry based on their specialized know-how and the relationship staff develop with clients, making them reluctant to switch providers ("high switching costs").

Understanding these aspects will allow the transformed MFI to define its advantages clearly and possibly preempt competitive action.

Company. An MFI must also understand itself, both what it has been historically, and what its potential is for the future, particularly as a deposit-taking intermediary:

- *Capabilities:* What can the MFI do or develop, such as the ability to make and collect loans, attract clients, and motivate staff, or improve its MIS and technological capabilities, the learning capacity and flexibility of its staff, and the location and capacity of its branch network?
- *Competencies:* What does the MFI do well? What has helped the institution grow? What can be exploited for future competitive advantage? For example, the ability to disburse loans is a capability, but it becomes an institutional competency to do it quickly and error free. The transforming MFI should determine its key areas of expertise, such as credit methodology, client relationships, and trained personnel, and define those it might need to strengthen, such as operations, treasury functions, and risk management.
- *Organizational culture:* What is the personality of the MFI? What differentiates it from traditional financial institutions? From other MFIs? A big challenge for transforming MFIs is to preserve this "mystique" as they grow and formalize in the process and aftermath of transformation. What management pays attention to and rewards is often a stronger indicator of the organization's culture than the values it verbalizes or the ideals it espouses (Hagberg Consulting Group n.d.)—an organizational culture is defined by what an institution *does* rather than what it *says* in its mission statement or in company gatherings. Typically, the transformed MFI is trying to balance its social goals with the new demands of more profit-oriented investors. The MFI needs to understand its existing culture and then define the one it wants to have as a regulated, formal financial institution.

Context. The final intelligence the transforming MFI needs to gather concerns the context within which it operates. As an MFI formalizes its operations, its risk management processes must include a more sophisticated understanding and analysis of the macroeconomic and political environment, financial sector policies, regulation, and supervision. Among the factors that an MFI should track are the following:

- Monetary policy and price stability to determine trends in interest rates and inflation
- Exchange rate regimes, foreign exchange reserves, and trade balances
- Tax policies and regimes
- Requirements regarding accounting, disclosure, and other prudential supervision (for example, capital controls and restrictions on foreign-denominated debt)
- National rates of employment and income
- Social trends such as immigration and population growth
- Political stability and governing regimes
- Technological trends, such as the use of mobile phones and internet access

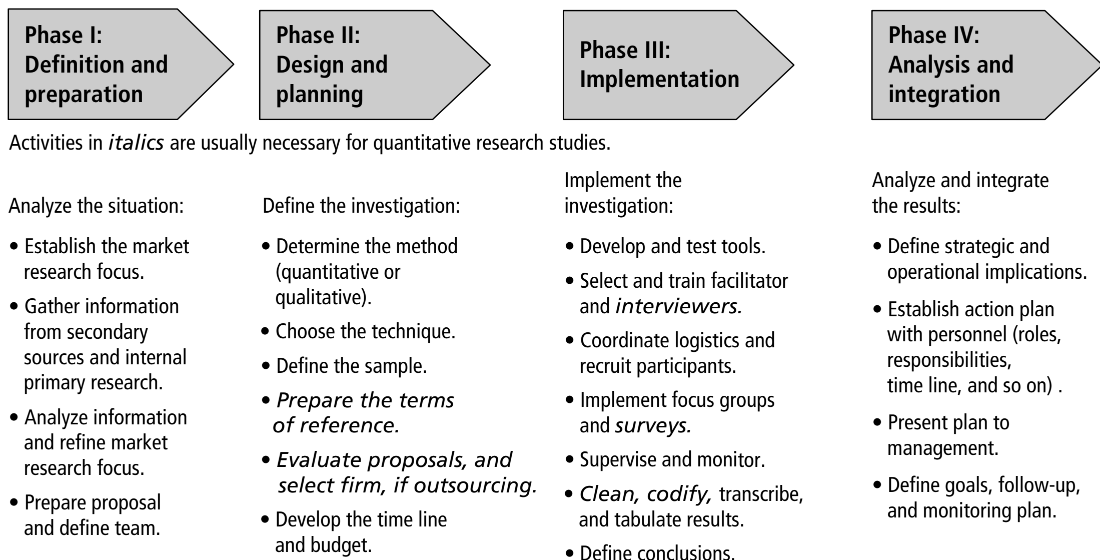
Market Research: Accumulating Marketing Intelligence

Knowing what type of intelligence to collect is half the battle—gathering it in a way that is useful to the MFI is just as important. Marketing *intelligence* refers to an MFI's ability to systematically and objectively collect, analyze, and apply data; market *research* is the process of gathering this information. The microfinance industry has benefited from a wealth of good market research tools and techniques used to gather marketing intelligence.[5] The focus of this section is how to employ these tools, including a brief review of some of the ones most commonly employed. A summary of the systematic process to collect and apply marketing intelligence is depicted in figure 4.3.

Phase I: Definition and preparation. The first step is to clearly define the objective of the market research. This clarification of focus involves listing and refining the questions to be answered by the market research and developing hypotheses based on a review of existing sources of intelligence, commonly referred to as secondary sources of information. These secondary sources include previous research results, the MFI's database, industry studies, and other intelligence that has been gathered. For example, a transforming MFI interested in researching the potential for savings mobilization might want to determine how prone existing borrowers will be to depositing their savings in the newly regulated institution. Secondary market research might involve analyzing central bank statistics regarding the savings rate of this target market, surveying loan officers, or mining the MFI's database to uncover information on disposable income or rate of forced savings.

Phase II: Design and planning. Once the objectives of the market research are defined, the MFI must determine how it will go about gathering marketing intelligence directly from clients. The first major decision is whether to use qualitative or quantitative tools and techniques,[6] though they usually should

Figure 4.3 Marketing Intelligence Gathering Process



Source: Author.

be viewed as complementary. Qualitative market research—including focus groups, mystery shoppers, or in-depth interviews—is typically the starting point for exploring a given topic. In the previously mentioned example of research on deposit mobilization, the transforming MFI could use qualitative market research—such as attribute ranking[7]—to determine what characteristics are most important to a microsaver in deciding where to deposit money. Quantitative research can be used to determine the extent to which the attitudes identified in the qualitative investigation are representative of the market as a whole. The MFI could use a quantitative survey to test different savings packages and to determine the ideal combination of savings product characteristics (number of free withdrawals, interest rate, minimum deposit balance).

Testing product bundles (grouping different attributes to create distinct offerings) using quantitative techniques allows the MFI to have reliable data on product design before pilot testing. Quantitative research can also be used to track client satisfaction levels—another key piece of marketing intelligence that allows the transforming MFI to monitor how well it is doing as it goes through transformation. For example, a focus group can uncover the interest among an MFI's clients for a new product, such as insurance, but quantitative research can help determine how great the demand for a particular type of insurance might be. Conversely, if the goal of the MFI is to diagnose why there is a desertion problem, for example, qualitative research is more appropriate, given its exploratory nature. Table 4.1 summarizes the purposes and applicability of qualitative and quantitative techniques.

The reality is that most research involves the application of both qualitative and quantitative techniques (box 4.1).

Table 4.1 Comparison of Qualitative and Quantitative Research Tools

Method matrix	Qualitative research	Quantitative research
Objective	To gain in-depth understanding of consumers' attitudes and behavior	To measure the degree and extent of the attitudes
Confidence level	Explorative, anecdotal	Conclusive, with a specified degree of certainty
Techniques	Unstructured or semistructured	Structured
Tools	Focus groups, in-depth interviews, mystery shoppers	Simple and complex surveys, database analysis (cross tabulation)
Participants	Small and homogeneous groups	Samples with a statistical representation of the population
Results	Words and descriptions	Codified results, compiled as statistics
Training and preparation	Understanding objectives of the study	Consistency and precision of questions used Computer analysis
Strengths	In-depth exploration of questions Better understanding of underlying behaviors Usually can implement with staff	Conclusive; its results can be inferred to the rest of the population Better for costly investment because it measures degree and frequency of behaviors
Weaknesses	Subjective; bias can be introduced in the execution and analysis of results Not conclusive; results cannot be inferred to the population	Bias on the form and the questionnaire Can be costly and time consuming Usually implemented by outside marketing research firms

Source: Brand 2003, p. 8.

Box 4.1 Market Research: Uganda Microfinance Union

One of the first activities conducted by the Uganda Microfinance Union (UMU) in its preparations for transformation was targeted market research to better understand the market for its current and planned products. The organization first used various qualitative research techniques, including focus group discussions and participatory rapid appraisal tools, such as product attribute ranking, relative preference ranking, and life-cycle profile analysis, among others. This preliminary research helped provide insight into clients' preferences, which contributed to the initial prototype design for various products. The organization then contracted the Ugandan survey firm Wilsken Associates to conduct a quantitative survey. The objectives of the survey were threefold: to estimate demand for both current and planned products in the different geographic regions in which UMU was operating or planning to operate, to guide efforts to refine the existing product portfolio, and to clarify UMU's competitive position. A total of 577 people from various regions of Uganda were interviewed for the survey, using random sampling with certain qualifications. Findings from this survey provided critical input into the organization's product development efforts.

Source: Contributed by Victoria White.

Phase III: Implementation. Once the intelligence gathering techniques are chosen, the MFI must determine how best to carry out the market research. Qualitative market research can be conducted in-house if staff members have been especially trained in facilitation techniques, such as the difference between probing and prompting. Another option is to outsource the market research to specialized companies, which has the benefit of maintaining objectivity but the downside of being more costly and sometimes these firms may be unfamiliar with low-income market segments or financial services. Table 4.2 provides a summary of the options.

Often an outside firm is used for the logistical aspects of the market research—defining the sample, recruiting participants, providing a place to meet, supplying refreshments or gifts to thank clients for their participation—and possibly also the implementation (focus group moderation or survey interviews) if the MFI does not have the expertise or the staff time to spare. In fact, it is more valuable for MFI staff to be listening and taking notes during focus group sessions than moderating, which can be "complex and surprisingly difficult" (Wright and Ahmed 2005, p. 2). Either way, it is important that MFI staff be intimately involved in the implementation process through reviewing discussion guides and questionnaires, attending focus group sessions, or shadowing interviewers. Although outside support can help the MFI focus its resources on quality control and the more valuable final phase of analysis, there is no substitute for hearing client feedback directly.

Phase IV: Analysis and integration. The final and most important phase is transforming research into intelligence through analysis of the results and integration into an action plan. The MFI must be heavily involved in the analysis of market research results. Outside experts, if engaged, can provide objective conclusions and recommendations, but they should complement an internal vetting and analysis of the results. The MFI's role is to define the strategic and operational implications of the intelligence gathering, and define a plan of action involving different areas of the institution. This final step is where most intelligence gathering efforts go off track, because research reports are not widely circulated or the day-to-day "urgency" overwhelms the more important planning and strategizing activities.[8]

As mentioned, most transformed MFIs formalize this intelligence function within a marketing

Table 4.2 Comparison of Implementation Options

	In-house	Contracted out
Advantages	• Allows MFI staff members who understand and care about the sector to run the process • Builds skill set of and provides experience for MFI staff • Allows MFI to internalize issues raised and lessons learned • Generates more appropriate and relevant conclusions because MFI staff members are often more familiar with the market	• Offers specialized expertise and a professional, structured process • Provides objectivity, especially in cases of high customer dissatisfaction • Brings significant resources (infrastructure, skilled staff) and experience to the process • Saves the MFI time • Should result in analyzed data and a report ready for presentation
Disadvantages	• Requires special skills to – moderate focus group discussions – develop and administer questionnaires – analyze data effectively • Diverts staff time from other duties • Results in bias, because staff members often have preconceptions	• Most market research companies lack understanding of the MFI sector • MFIs are often "low-value" clients and thus neglected or given poor service by market research companies • Good market research firms are expensive

Source: Brand 2003, p. 10.

department. The marketing intelligence officer should be responsible for managing the market research process (including defining the parameters, supervising the implementation to ensure quality control, and analyzing the results). The marketing intelligence officer should also be responsible for the up-front secondary market research—including data mining, competitive analysis, and industry trends. This position typically reports to the marketing director or the commercial manager, depending on how the MFI is structured, though the two areas must collaborate closely to operationalize the marketing intelligence. For example, the marketing intelligence director periodically participates in the regular meetings the commercial manager[9] holds with the loan officers to both disseminate results of the market research and "truth check" it with the field personnel. These kinds of communication and feedback loops[10] are critical to ensure the successful application and leveraging of marketing intelligence.

The Total Product

For transformed MFIs, increasing competition and evolving needs of the customer requires a more market-driven approach to product design and development. This market-driven approach is particularly important when dealing with lower-income communities because their priorities and ways to meet their needs vary. Even though these underserved markets might need the same generic services (savings, liquidity, credit, investment), the way they should be approached and their perception of traditional financial service providers significantly affect product design and delivery.

Broadly defined, a "product" is anything that satisfies a customer's needs or wants (Kotler 2002). From the transformed institution's point of view, a new or refined product represents an opportunity to create value, and in so doing, offers a strategic competitive advantage (Thomas 1993). Unfortunately, most MFIs miss this opportunity by focusing

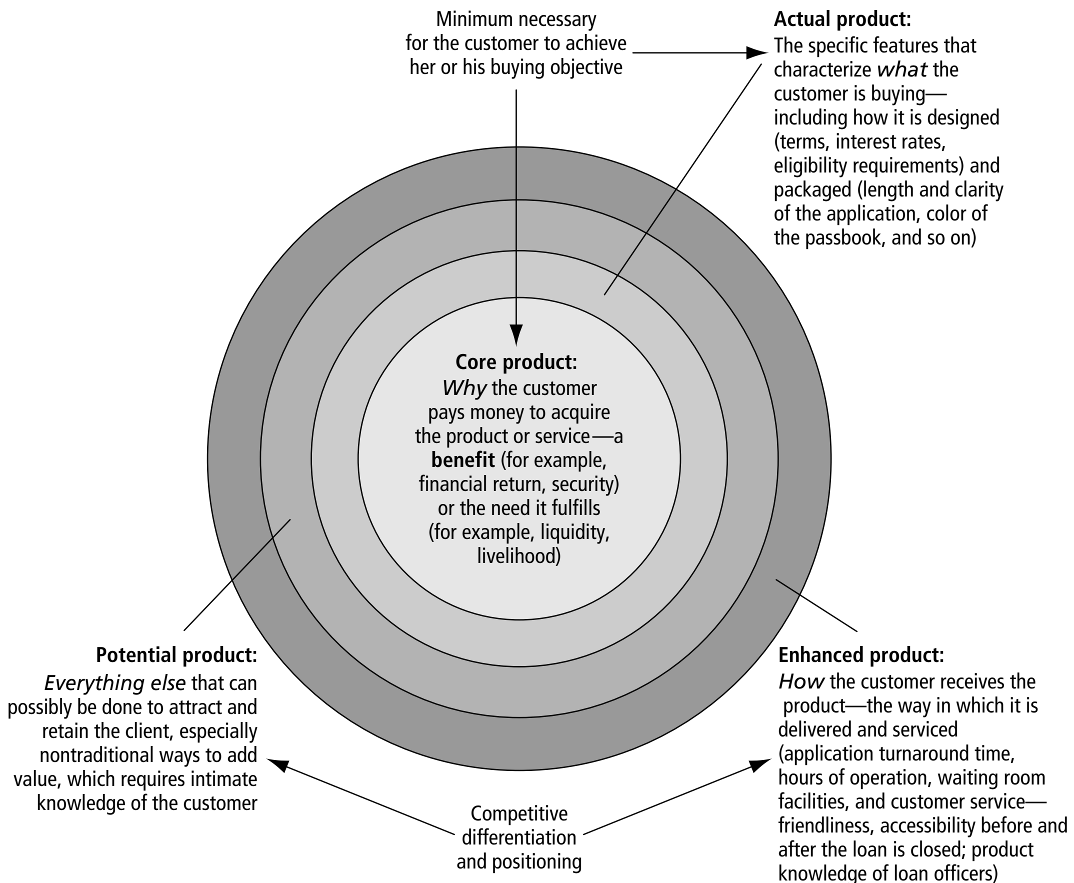
on the *features* of the product rather than its *benefits*. Features are the tangible aspects that characterize what the customer is buying, including how it is designed (minimum deposit amount, interest rate offered, withdrawal policies) and packaged (passbook, debit card). Features describe *what* the customer is buying, but not necessarily *why* they are purchasing the product.

Benefits are the true motivation for client purchase, satisfying needs and meeting customer expectations. The transformed MFI can offer benefits that can help create competitive advantages—for example, one-stop shopping (deposit, credit, and other financial services all from one institution) or products more tailored to the needs of poorer segments (forms and staff available in local languages, or flexibility in terms of minimum deposits so that clients can save small amounts each month).

Thus, a transforming MFI needs to consider the *total* product and break it down into its component parts that help explain why a customer buys (see figure 4.4).

Most institutions focus excessively on the *actual* product, although it is the other components that often drive the purchasing decision. For example, institutional image (part of the enhanced product) and brand are much more important than interest rates (feature of the actual product) in driving the

Figure 4.4 The Total Product



Source: Brand 2000.

decision of where the poor deposit their savings (Fontela 2002). Moreover, it is difficult to sustain a competitive advantage in the actual product, because it is easy to imitate features such as price or packaging.

Defining the *value proposition* means taking a total product approach—understanding in great depth what drives the customer's buying behavior (core product), responding to those needs (actual product), and differentiating the offer from what is available in the market (enhanced and potential product.) As one industry periodical explained, "product value proposition . . . articulates what the product does, how it does it, why it is better, and who would gain the most benefit by using it" (McKinley 2002, p. 2). Taking a total product approach, therefore, requires intimate knowledge of the customer. This knowledge is developed through market research, careful maintenance and mining of the database, internal communication loops, and the other sources of marketing intelligence described earlier in this chapter.

It is imperative that a transforming MFI consider its total product mix and how its products will, in part, define the institution in the eyes of its clients. The product mix the MFI decides to offer will significantly influence the type and strata of clients attracted to the MFI, particularly after becoming a regulated institution. An important part of strategic analysis and planning when an MFI transforms is to consider its overall product fit (how the current portfolio of product offerings fits with the MFI's positioning strategy), the process for new product development (how the MFI successfully takes a product from the idea phase to the market), and ultimately how it will price its products (how products are priced in relation to each other; how pricing is adjusted based on the target segment and relevant competition; and how pricing interacts with financial and social performance goals). These decisions will feed directly into the business planning process as well as shape the future funding structure of the transformed MFI.

Product Fit

Analyzing the product "fit" requires examining the entire portfolio of products to determine how well the various products—both existing and new—complement each other and how well they are aligned with the strategy of the organization.

Strategic consistency. Product fit examines the competitive position of the institution, which product design should reinforce. For example, if a newly transformed MFI has decided to position itself as providing the fastest service in the market, all of its products should have simple application procedures, straightforward eligibility requirements, and quick delivery times to reinforce this stance in the marketplace. Moreover, products must build off the core competencies and capabilities of the institution (for example, personalized customer service, technological sophistication, speed of delivery, skilled staff). Alternatively, an institution that has positioned itself as pro-poor and thus competes based on the in-depth relationship it builds with each client might not develop remittances products that require fast service, many outlets, and client anonymity. Finally, products must be aligned with the capabilities of the institution, that is, the institution must determine the major impacts of all new products on its operations including systems, human resources, physical infrastructure, and liquidity management.

Portfolio alignment. The second key aspect of product fit is how well products reinforce each other. Often, when a transformed MFI starts expanding its portfolio of products, new products cannibalize sales of existing products.[11] For example, the introduction of a home improvement loan, which may be offered with lower interest rates, might cannibalize sales of an MFI's traditional working capital credit product, because many clients will access the former product for a wide variety of needs, given that money is fungible.

Sometimes products are intentionally targeted at different segments—such as fixed term deposits targeted at middle-class salaried workers to provide a source of funding for the MFI. In this case, it is important that the positioning of the new products has a common thread to reinforce the MFI's market position in the eyes of all its target segments.

Product fit becomes even more important for a transformed MFI because it is likely trying to develop a new image as a regulated institution. When inconsistencies appear in the message—for example, when an institution does not deliver on its promise because of a failed product—the entire image is jeopardized.

Transforming MFIs should be aware of the tendency among transformed institutions to diversify their financial services because they *can*. Regulatory restrictions limit what NGOs can offer, so once an MFI transforms, it feels the need to develop all the products its regulated competitors are offering. However, just because an MFI can legally develop new product offerings, does not mean it *should* from a competitive or strategic standpoint. Portfolio diversification should be a by-product of careful strategic analysis, based on a financial, competitive, or customer service justification. For the reasons discussed in chapter 1, Mobilizing Savings from the Public: 10 Basic Principles, a few well-designed products are far superior to a wide array of less well-thought-out ones.

Product Development Process

A commercial approach to product development includes the process of taking a new financial product or service from the idea phase to the ready-to-market phase in a manner that creates a high probability of client acceptance and positive returns to the MFI.

Successful product development centers on the concept of the total product, the components of which are built upon a deep knowledge of the client, the competition, the market context, and the institution's core competencies. The *client* is first, because a product's value proposition is related directly to how well it satisfies needs and desires from the point of view of the customer. The *competition* frames the rules of the game. For example, individual loans were a key success for Caja Los Andes in challenging the Bolivian microfinance market leader BancoSol because no other MFI in the market—NGO or regulated—offered this product. However, today in Bolivia, individual loans alone are no longer a guaranteed customer draw—an MFI must now decide what additional products or services it will offer to add value for customers and lure them away from the competition. The value an institution brings to a client is the difference between the customers' expectations (defined by the competition and the context) and their experience with the product. Here is where the core competencies and capabilities of the *company* come into play. If an MFI offers a product that it is not very well equipped to sell (for example, offering a technologically sophisticated product even though the MIS is weak), the value to the client will be marginal. Finally, the MFI must take into account the *context* within which it is operating. For example, highly inflationary or otherwise volatile environments suggest that interest rates should be pegged to variable benchmarks.

A detailed example of taking a product to the ready-to-market phase is provided in appendix 1, Sequencing the Introduction of Public Savings in Regulated MFIs. The following is a summary discussion of this process as it applies to all product development (credit, savings, or other).

Effective product development involves careful planning and a methodical approach. The systematic approach to product development involves four key phases:

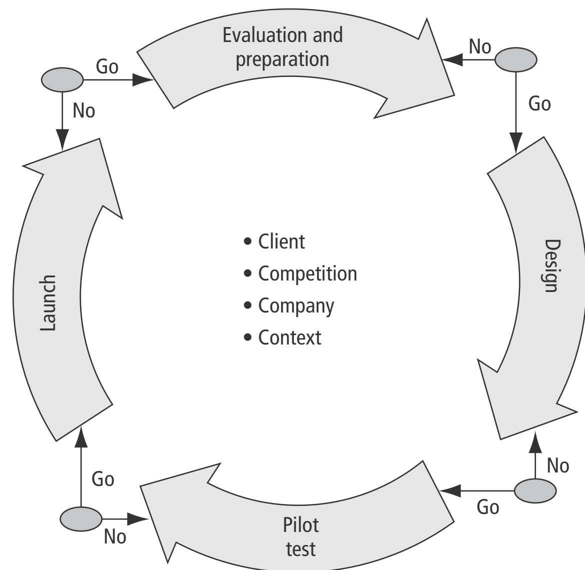
- *Evaluation and preparation:* includes evaluating the market potential and assessing the institutional readiness to incorporate the product into operations. It involves analyzing the four C's

described above, usually through investigation of secondary research (central bank statistics, industry data, existing market studies) and getting the institution ready for the product development process through naming a product champion to garner institutional buy-in, organizing a multidisciplinary team, and developing a budget and time line.

- *Design of the prototype:* involves conducting primary market research with clients and evaluating the financial and operational impact the new product will have on the institution. Qualitative market research will allow the product development team to design the preliminary product features and benefits. Then, the multidisciplinary team can diagram operational procedures using flowcharts both to identify bottlenecks and incorporate internal control measures. Once the basic features have been defined and the procedures mapped out, the team can begin the financial analysis of the product to estimate break even.
- *Pilot testing:* is the phase in which the MFI introduces the product prototype in a controlled way to the marketplace. As a pilot, it involves a limited rollout, usually confined to one or two branches or market segments. Moreover, pilots have a fixed duration (usually the length of one product cycle, at a minimum) and are closely monitored to analyze the market's acceptance and the institution's readiness to offer the product. Pilot testing is a key phase to make sure costly mistakes are caught and fixed before full rollout.[12] That is why, for example, transformed MFIs will test new savings products on their own staff before trying to present the product to salaried workers, who are often a new target market. Often more than one pilot test needs to be carried out before launching the final product.
- *Launch:* is the final rollout, after the modifications called for in the pilot(s) have been made to the total product. Rollout involves developing a full-fledged marketing plan to integrate the product more completely into the MFI's competitive strategy. In addition, in this final phase the MFI will usually invest in the necessary system upgrades and full staff training necessary for institutionwide commercialization.

Each of the four phases includes specific activities and tasks that are undertaken to complete the product development process. However, the process should be thought of as iterative rather than linear, as reflected in the circular diagram in figure 4.5. Successful product development is really a process of continual refinement. Roadblocks can surface in any particular phase. For example, the regulatory analysis required in phase I may uncover legal problems with offering the product. The cost analysis undertaken in phase II might uncover a rate of return that is below an institution's hurdle rate, the minimum rate of return an institution demands that all new projects must achieve to warrant the investment.[13] Phase III's pilot test might produce outcomes that are below the institution's targets. All of

Figure 4.5 Systematic Process for Product Development



Source: Author.

these obstacles require the institution to return to the previous phase and reassess, redesign, and relaunch. The "Go-No" arrows in figure 4.5 are decision points that require check-ins at the end of each phase. The process is continual because clients' needs (and the competition) evolve over time, so an MFI must periodically decide which products need to be developed or phased out.

Pricing

When an MFI transforms, it must take a more sophisticated approach to pricing its products and services than it took as a credit-focused NGO or project. It is not sufficient to simply price or benchmark based on what competitors offer (as some transformed MFIs do with new savings products) or to calculate the price based on profitability targets without testing client price sensitivity. A comprehensive pricing strategy needs to include all of these aspects, as well as the elements described below:

Cost. Cost is the starting point for pricing and the focus of most financial institutions in general, not just MFIs. Most institutions base interest rates on a percentage markup over administrative and financial costs. Thus, it is common to see MFIs charge less for repeat clients, given that their larger loan amounts and more streamlined analysis make these loans relatively less expensive to administer (costs as a percentage of loan amounts). The challenge for a transformed MFI as it becomes a multiproduct institution offering a variety of financial services is to correctly calculate and understand the cost of each product to gauge relative profitability and determine appropriate margins. The microfinance field has progressed far in this respect, with a variety of publicly available tools—including cost allocation, marginal cost pricing, and activity-based costing—to more accurately price products (CGAP 1998; Cracknell, Sempangi, and Wright 2004; Helms and Grace 2004).

Risk. MFIs typically incorporate risk into the interest rate based on the client's capacity to pay. For example, repeat borrowers with good credit histories should be charged less than first-time clients because the risk that the former will become delinquent is lower. Risk-based pricing, whereby an MFI adjusts interest rates based on the predicted risk of a given client segment, is an important skill for the transformed MFI to develop as it expands into new markets and product categories. In general, consumer lending is typically riskier than microcredit, because in the former the loan funds are not being used productively to improve capacity to repay. Home improvement loans tend to be less risky than shorter-term working capital loans, because borrowers place a high value on maintaining this source of larger, longer-term funding (Brown 2003). Prudent pricing practices require that interest rates reflect these distinct risk profiles, therefore consumer credit typically commands higher interest rates and housing loans lower ones. More sophisticated MFIs employ statistical tools, such as credit scoring, to support these risk-based pricing strategies.

Competition. Competitive benchmarking is another key component in developing a pricing strategy, as a first step in "reality checking" the price with the market. An MFI should have someone responsible for updating, on a quarterly basis, prices offered by its main competitors (unless the market is very stagnant) to determine the competitive minimum price.[14] It is not, however, necessary to match competitive prices, unless the MFI is trying to position itself as the "low-cost provider." For example, if the competition is pursuing a loss leader strategy, whereby they offer a product or service at a considerable discount and loss of profit to attract future business, pricing becomes a more important aspect of the way the transformed MFI presents its new products. It does not mean that the MFI has to copy the strategy and compete on price, but rather, it will need to explain why its product or service is

worth more. The MFI must clearly and convincingly articulate the value proposition it is offering the client that justifies its higher price. For example, MFIs are often able to withstand competition from subsidized government programs because they offer a quick, nonbureaucratic, apolitical process that is worth more to the client than a lower interest rate. Continual competitive analysis is also critical for the most valuable, repeat clients, because they are the ones most coveted by other financial institutions.

Client preferences. Market research is critical to determine the true benefits that can justify price differences from the point of view of the client and to test client price sensitivity. Testing customer awareness and sensitivity to interest rates is done by determining how salient price is in the client's decision-making process, using specific techniques such as "top of mind" and "attribute ranking."[15] The research should include an analysis of preferences and purchasing habits to determine if payment frequency or amounts need to be adjusted. Price must be differentiated by client segment, because each segment will have different preferences and buying habits, and will also have different values to the institution. For example, borrowers who renew or take more than one type of product are more profitable for the institution because of increased individual revenue and potential new sales from referrals. These clients should be treated as preferential either through the interest rates they are charged or by other value-added benefits, or both.

Profitability targets. Pricing across the portfolio as a whole should reflect the institution's margin targets and desired capitalization rate from retained earnings (CGAP 2002). These targets are established based on expansion plans, investor expectations, debt-to-equity ratios (which limit the amount of funds an institution can commercially borrow), and external factors such as inflation. Ultimately, the targets reflect the growth strategy of the institution and thus, desired margins should be established jointly by the board and senior management.

Macroeconomy. Pricing strategies should include assumptions about inflation so that the MFI is forecasting in real terms rather than nominal. Furthermore, any anticipated devaluation of the MFI's local currency must be taken into account, especially if there are foreign currency sources or uses of cash.

Regulation. Interest rates on individual products are sometimes controlled by regulatory authorities. In some countries usury laws limit what an institution can charge for a consumer finance loan or a microfinance product. In addition, some governments or supervisory bodies establish minimum amounts that must be paid on deposits. Any pricing scheme must ensure compliance with regulatory and legal norms.

Social considerations. Numerous studies demonstrate that MFIs can bring much more value to clients by quick approval and disbursement, appropriate loan amounts and terms, and credit aspects other than the interest rate (CGAP 2002). Nonetheless, important social considerations must still be taken into account when developing a pricing strategy. The first is transparency, so clients understand the effective interest rates they are paying. Trying to hide true pricing by charging flat interest rates (rather than declining balance) is a short-term win, at best, which can ultimately damage the credibility and image of an institution. The second key aspect is reciprocity—providing value (speed of delivery, quality customer service, or other benefits) for the price charged. By this token, discounts given to preferential clients should incorporate factors such as character as well as average loan size—a lesson reflected in most credit scoring systems. Finally, the institution should be committed to a continual pursuit of efficiency and sharing

gains with its customers through rebates or one-time discounts. These social strategies can have a considerable impact on the hearts and minds of clients, which ultimately benefits shareholders through higher client retention, enhanced image, and the profitability the two can generate.

An MFI may not be able to viably charge clients a price that will cover all the administrative, financial, risk-based, and forecasted costs while being competitive and complying with local regulation. In these cases, the MFI has a variety of options. The first is not to offer the product until conditions improve through, for example, internal reengineering (to lower administrative costs), fund diversification (to lower cost of capital), or regulatory lobbying (to remove artificial limits on pricing). The second strategy is to take a "lifetime value," which assumes that losses on introductory products are recouped later in the customer life cycle. This "loss leader" strategy is commonly employed in individual microcredit programs—MFIs typically lose money on the first loan, given the intensity of the analysis that must be completed and the relatively small loan size. Of course, this strategy counts on retaining clients, which is increasingly difficult as clients become more demanding and competition increases. The final strategy is to try to recoup losses on one product through gains on another using a cross subsidy. An example of a cross subsidy for deposit-taking institutions is larger time deposits subsidizing microsavers (Maisch and others 2005). Cross subsidies can also occur when recently transformed MFIs offer microsavings to their borrowers—even though these small deposits are money losers on a unit-cost basis, MFIs can recoup the losses by strengthening customer loyalty and fomenting additional borrowing. In general, a portfolio-based approach to pricing ensures coherence among the products and alignment with the competitive strategy. The portfolio approach is critical for deposit-taking institutions because savings products should be priced in relation to each other, as illustrated in box 4.2.

Delivery Channels

In microfinance, as in any retail business, the delivery or distribution channel is a critical component of the value proposition the MFI offers to its clients. The importance of channel is even stronger when deposits become part of the MFI's product mix because of clients' preferences to have a safe, familiar setting when handling their savings. In a survey conducted by MicroSave in Uganda in 2003, channel aspects such as the physical appearance of the financial institution and ease of access were given as the predominant reasons for choosing financial services (table 4.3).

Thus, the transforming MFI must analyze its distribution channels through which clients receive products and services. Traditional microfinance business models involve a high-touch strategy in which loan officers go to clients where they live and work. This field focus made the branch little more than an operational support center for the MFI staff and simply a point of entry for the client. Many credit-focused MFIs use their branches primarily for information sessions and client intake, partnering with regulated institutions for disbursements and repayments. Transformation for an MFI becomes a physical as well as a legal process, as the newly regulated entity brings many of these functions in-house. Moreover, clients' and regulators' expectations are much greater for regulated financial institutions that mobilize savings than they are for NGOs. Below are some considerations the transforming MFI must take into account in developing its channel strategy. Many of these factors are discussed in greater detail in chapter 13, Customer Service and Operations.

Retail Format

Retail format refers to the overall appearance and feel that a seller presents to customers, including its looks, physical layout, and the mix of products it sells. The goal of analyzing retail format is to

Box 4.2 Setting Interest Rates on Savings Products

In the process of designing a new savings mobilization campaign, FIE in Bolivia developed its pricing structure around a *base rate*, in relation to which the remaining deposit products were priced. A base rate was established based on average deposit *size* as well as *term* as illustrated in the table below. Both base rates (for term deposits and for basic savings) were a function of the country's prime rate, the interbank lending rate, currency (Bolivianos versus U.S. dollars) and exchange rate, risk of devaluation, and competitors' pricing. Certificates of deposit with a term of 30 days were priced equal to the base interest rate. Longer term deposits were paid at the base rate plus the markup listed below. For a basic savings account—with no fixed deposit term—the interest paid was based on average balances: the higher the average balance, the better the markup over the base interest rate. Average deposits up to U.S.$50 received a low, fixed rate of interest based on the institution's administrative costs, independent of the base rate. No interest was paid on current accounts.

Account type Term deposits Term	**Pricing Policy**	***Base rate* = Markup (percent)**	**Interest rate on U.S.$ (percent) 2.28**	**Interest rate on Bolivianos (percent) 9.15**
30 days	base rate +	0.00	2.28	9.15
60 days	base rate +	0.50	2.78	9.65
90 days	base rate +	1.00	3.28	10.15
180 days	base rate +	1.50	3.78	10.65
360 days	base rate +	2.00	4.28	11.15
Basic savings Amount	**Pricing Policy**	***Base rate* = Markup (percent)**	**2.14**	**7.57**
U.S.$0–50	Fixed =		0.20	0.50
U.S.$51–500	base rate +	0.00	2.14	7.57
U.S.$501–1,000	base rate +	0.25	2.39	7.82
U.S.$1,001–5,000	base rate +	0.65	2.79	8.22
>U.S.$5,000	base rate +	1.00	3.14	8.57

Source: ACCION savings project in Bolivia.

Table 4.3 Reasons for Choosing Financial Service Providers for Savings

Position	Reason
1	Physical appearance (premises, guards, weapons, and others)
2	Ease of access to savings (liquidity of savings)
3	Perceptions of institutional stability
4	Ownership of institution
5	Interest paid on savings
6	Operating hours

Source: Mukwana and Sebageni 2003, from Cracknell 2005.

enhance the customer's experience while maximizing operational efficiencies. Thus, the MFI must reexamine its branch from the client's point of view, reviewing traffic flows (where do clients need to go and what does staff need to do to undertake different transactions? what volume of activity does the MFI expect at different times of the day, week, and month?), points of contact (with whom does the client need to speak?), and layout (is the space flexible enough to grow with the institution and permit future changes in format?).

Customer Service

Clients' expectations regarding service quality, security, and stature of financial service providers differ greatly when dealing with credit and savings. With credit, the onus traditionally is on the client to convince the institution that he or she is creditworthy. For savings, the positions are reversed—the institution must sell clients on why they should deposit their money in this MFI rather than the other options they have used historically. Transformed MFIs become the new players in the savings market, and must "earn" their position to compete at all. Thus, the channel strategy must include a thorough analysis of key customer service dimensions, including wait time (is there an area for customers that is clearly designated and comfortable to sit or stand while they wait to be attended?), communications (are the signs legible, visible, and written in language clients understand? does their placement take advantage of "hot spots"[16] and personal care, that is, is there designated staff who can help orient the client or assist them with procedures, forms, and questions?). For example, Uganda Microfinance Union (UMU) identified that Western Union had taken advantage of UMU's branch hot spots, displaying its own signage more in the customer's direct line of sight than UMU's materials, thus making it easier for a client to see how to transfer money through Western Union than to see UMU's various offerings.

Coverage

As an MFI prepares to transform, it needs to consider how to expand its distribution network and its corresponding area of influence. This expansion is necessary both because of anticipated growth in lending as it receives new infusions of capital, as well as development of new products that will increase demand and stretch its existing capacity, especially as it explores new markets. For example, mobilizing time deposits requires attracting salaried workers in higher income markets outside the MFI's traditional area of influence. Mibanco in Peru opened a new branch in the more affluent Lima suburb of Miraflores, specifically to attract higher income savers more prone to making larger deposits for longer terms. Location is also a consideration for microsavers and clients of other products such as remittances, where convenience (in addition to confidence) is a primary driver of where they will take their business. Of course, these customer service considerations must be weighed against measures of market density and anticipated market share, because building traditional bricks and mortar branches is an expensive way to expand. In Kenya, Equity Bank uses mobile banking vans to expand its coverage while avoiding the cost of building branches. Although each van is expensive, it can service a wide area, eliminating the need for several branches.

Cost

Transformation is an expensive process, so an MFI must consider alternative distribution strategies as it expands as a regulated institution. Many regulated MFIs have begun developing alternative points of sale where certain branch operations can be conducted—such as client intake, loan application, and payment. For example, Banco Solidario of Ecuador set up mini-branches at markets, both to facilitate loan payment for its borrowers and reduce congestion at its branches, where savers continued

to deposit money. Recently, Banco Solidario entered into partnership with a payment service provider called *ServiPagos* that offers additional cashier services—including check cashing, savings withdrawal and deposits, as well as utility and other bill payments—at its own agencies. Though Banco Solidario pays for each transaction, it is actually less expensive than conducting the same transaction within its own branches. Another strategy regulated MFIs use to increase branch efficiency and thus reduce costs is to install automated teller machines (ATMs) as a complement to teller service; however, encouraging client acceptance and use of ATMs can often be a challenge. Some MFIs, like retail banks in the United States, offer clients financial incentives to use less expensive channels such as ATMs by waiving account fees for limiting teller use below a specific threshold (that is, a limited number of free withdrawals and deposits per month at a teller window). Again, given that the channel is a critical part of the value proposition to the client, the MFI needs to compensate the client for forgoing the benefit and comfort of transacting with a live teller versus a machine.

Technology

Over time, technological alternatives such as ATMs, debit cards, and internet banking will reduce dependency on branches. But the viability of these alternative channel solutions is dependent on the cost, reliability, and availability of the technology. Connectivity is a critical issue even with regular branch expansion, because reliable "real-time" network connections are needed to settle accounts remotely and to allow clients the flexibility of using different outlets without the risk of fraud. Some MFIs have dedicated network lines to facilitate communication among distribution points and increase operational efficiency. For countries where the telecommunications infrastructure is weak, MFIs have begun pursuing alternative technologies to expand their distribution network—such as the Remote Transaction System (RTS) that was designed and pilot tested In Uganda by a consortium of MFIs and Hewlett-Packard (Magnette and Lock 2005). Another wireless channel option uses cellular technology to allow clients to receive loan disbursements and send payments remotely via mobile telephones.[17] In considering these technological alternatives, the MFI must explore safeguards to prevent identity theft, and use of redundancy (running dual systems as well as creating backup systems) in case of communication failures.

Risk

As a transforming MFI expands its operations, it needs to strengthen its security measures to manage its new distribution channels and reduce risk of fraud and theft. The risks become greater when the MFI diversifies its channels because the procedures are different, technologies new, and interests less aligned (as is the case when working with partners to provide alternative points of sale). The MFI must address each risk in turn, tightening internal control procedures to discourage employee fraud, strengthening physical security and monitoring (including both guards and cameras) to prevent robberies, and instituting control mechanisms (from personal codes to biometrics)[18] to avoid identity theft. The more difficult risk to control is the dilution of brand equity and lost opportunities for cross-selling that come, respectively, when working with partner organizations and substitute channels to expand a distribution network.

Image

Once the MFI transforms, image takes on great importance because of the new functions and market position the legal, regulated entity assumes. Safety and security are paramount concerns for savers worldwide and a regulated MFI's image must reflect this serious responsibility. As described in more detail in the next section on branding, an institution's image is determined from the point of view of the customer, but an MFI can influence the

consumer's perceptions by strengthening and standardizing its look and feel. At the most basic level, image building involves creating consistency in the colors used inside and outside the branch, unifying the look of the façades and visual communications (posters, placards, billboards), and conveying solidity (by using bold colors, capital letters, and laminated signage). Standardizing the MFI's image across distribution channels is critical, especially if it explores points of sale other than its branches. For example, Western Union requires that its black and yellow sign (with its name in bold capital letters) be visible near the cashier, regardless of whether it is in its own outlet or using a teller of another institution.

Branding

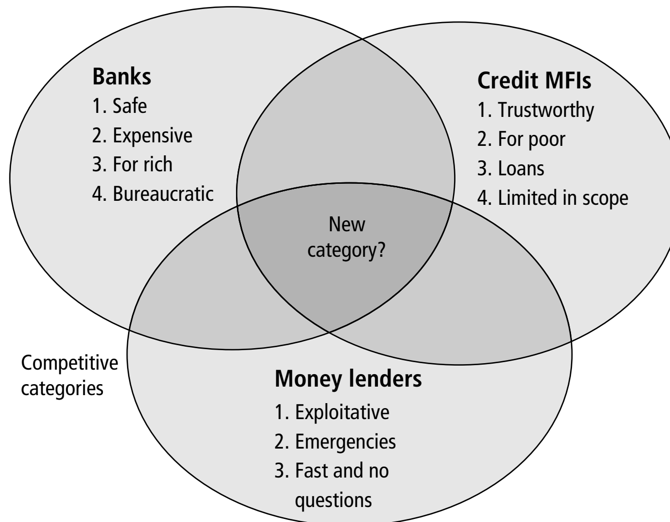
A *brand* represents a collection of information about a product or an institution[19] and typically consists of a name, identifying mark, logo, and distinguishing visual images or symbols. A brand is built not only through effective communication but also through the total experience that it offers the client (Bates 2003). Brand in its fullest definition carries connotations of a product's promise—the product or service's point of difference among its competitors that makes it unique.

Branding and its role in positioning the institution relative to the competition takes on renewed importance for the transformed MFI as it tries to define the unique space it occupies in the market and in the mind of the consumer. The transformed MFI is regulated, but it is not a conventional bank. Similarly, it is still engaged in microfinance but in a way that can be distinguished from its NGO counterparts. In marketing terms, the transformed MFI is in a new institutional category that has elements of traditional commercial financial institutions as well as characteristics of NGOs or more socially driven financial institutions. The change in legal status affects how different stakeholders view the institution. The transformed MFI has to convincingly convey messages of caring, quality service (for its existing customers), stability and professionalism (to attract clients from new segments), and reliable return on investment (for shareholders). The transforming MFI wants to be able to affect the market's perception of itself. For example, it wants to be perceived as formal and professional rather than cold or exploitative, though both attributes could characterize brands of banks in the minds of the consumers. Therefore, branding is a powerful way for a transformed MFI to influence its image and competitive positioning in the market.

For MFIs that have transformed to mobilize deposits from a broad cross section of clients, one positioning challenge to overcome is the perception clients have of them being *lenders* focused on *the poor*. To avoid the confines of this narrow association, the MFI must redefine its competitive category—the cluster of market players that customers group together for easy identification and classification. In the minds of the consumer, MFIs are not the same as banks, just as they are different from money lenders, even though they may have characteristics of each. For example, an MFI can be fast and nonbureaucratic like informal sources of financing, or can build the trust and goodwill that a good bank might earn. The goal for the transformed MFI is to have the consumer associate it with a new category with more positive characteristics than other categories such that the consumer begins to conduct all of its financial services with the transformed MFI (figure 4.6).

Branding is the process of creating and disseminating the brand and its major components: *corporate identity* (including the total product and personality), *image* (including the visual aspects of brand), and *promise* (the unique selling or value proposition). Branding is a vital component in solidifying competitive position in the market. It is fundamental to enhancing the image of the transformed MFI so that it can expand the scale and scope of its operations. For the transformed MFI to mobilize savings, it does not necessarily have to build upscale branches like a bank might. Cooperatives and credit

Figure 4.6 Competitive Categories



Source: ACCION International, Marketing and Product Development Unit.

unions, for example, have successfully mobilized savings by providing reliable service, cultivating a sense of ownership among members, and offering products tailored to the needs of their target markets.

Corporate Identity

Corporate identity is based on the associations and values encompassed in an institution's total product, core competencies, personality, and vision for the future.

An institution's identity is defined first and foremost by its total product, based on the tangible and emotional benefits it offers its customers. Brand identity is built from the institution's core competencies and competitive advantages, because these all help define the value proposition. However, it is the institution's *culture* or *personality* that helps give life to its identity and brand. Some institutions use mascots[20] or a spokesperson to help invigorate a brand. In Canada, for example, the Royal Bank of Canada uses Leo the Lion as its mascot, which makes people think the institution is strong and the "king of the jungle." In addition to conveying messages, building the personality of a brand helps make it memorable. For this reason, Interbank in Peru uses a pig mascot as part of its savings campaign targeted at children. To the delight of the children who accompany their parents to the bank, all the employees wear pig ears, helping establish it as the place to go to open children's savings accounts. However, mascots are not necessary to give an MFI a personality and sometimes can be viewed as infantile by certain segments (as was the case with Compartamos in Mexico[21]), so it is important to test ideas with the target market.

Corporate identity becomes relevant for the transformed MFI as it shifts from a nonprofit organization to an institution owned by private shareholders. As with all social enterprises (institutions that pursue social goals through market mechanisms), sometimes the profit-driven forces come in conflict with the mission, driving fears that the MFI will become too corporate (vaults, security guards, more rigid requirements for compliance) or lose focus on the poor (or both).

To realize the potential of becoming a regulated institution to further its social goals, an MFI must

clarify and crystallize its corporate identify. This soul searching begins with a well-articulated vision and mission that supersede the operational characteristics of the transformed MFI. More important, shareholders solicited for investment must understand the double-bottom-line implications of being a social enterprise, with social as well as financial goals. Equally important, the MFI must infuse its staff with this sense of purpose so that professionalism and compliance do not equal distance and rigidity in the eyes of the client.

Image

Though many use "image" and "brand" interchangeably, image refers to how the institution is perceived by clients relative to the competition, that is, the client's perception of the institution based on his or her experience (direct or indirect) through purchases of the institution's products and services or through publicity, word of mouth, or other interactions. In this way, image is strongly influenced by the more tangible aspects of the brand, such as the look of the branches or how personnel dress and behave. Because it is based on customer perception, image can differ markedly from the institution's self-defined identity. Thus, the MFI must make sure its external identity—how it presents itself to the public—transmits these values in the most visible aspects of its brand, including the name, tagline, logo, and color scheme:

Name. An MFI must decide how it will refer to itself, for example, whether to include "bank" or other regulatory distinction as part of its official name. Some transformed MFIs solve this problem by including these regulatory distinctions in smaller letters after a comma or as part of the tagline. Most transformed NGOs in Bolivia include "FFP" in their name to signal they are regulated.[22] Compartamos in Mexico, however, is questioning whether it will include the word "bank" in its name after it transforms, because low-income Mexicans have a negative image of this category. In some countries, MFIs regulated under a separate tier are not allowed to use the word "bank" in their name.

Taglines help clarify corporate identities and make them memorable. FINCA Uganda's tagline—"small loans, big changes"—helped clarify its core product and the hope it wanted to inspire in its clients. Teba Bank in South Africa used its slogan—"No one is too small for Teba Bank, or too big"—to reinforce its message that it wanted to grow with its customers. Taglines are extensions of the corporate name (they always appear together) while slogans are used periodically, as part of specific campaigns or with certain products.

Logos are graphic representations used by an institution to help it define itself. Marketers hope to sear or "brand" these mental concepts into the consumer's mind so that he or she associates the brand with the product's quality. The Uganda Microfinance Union had a diamond as part of its logo when it was an NGO. Given UMU's leadership position in the Ugandan market, it did not wish to abandon all vestiges of its corporate identity when it transformed, though it did want to have a more professional look. Therefore, UMU maintained the diamond, but used cleaner letters (nonitalicized) and bolder colors to professionalize its image without losing the positive association (see chapter 15, The Creation of Uganda Microfinance Limited, for more detailed analysis). Many financial institutions use blues or bold colors to convey confidence, professionalism, and strength.

Promise

Promise is the pledge of satisfaction and quality implied by "identifying and authenticating a product or service" with a brand.[23] The brand promise is based on the "set of assets (or liabilities) linked to a brand's name and symbol that adds to (or subtracts from) the value provided by a product or

service . . ." (Aaker 1996, p. 7). This promise and the anticipated value it implies is the reason customers are willing to pay more for a brand name product. Brand promises are articulated in *positioning statements*, which define an institution's unique selling or value proposition—a distinctive message an institution develops to differentiate itself from the competition that should be used consistently in its advertising and promotion.[24] The brand promise is the key message communicated to clients to establish or modify its image and thus should adhere to the following rules:

- *Focus:* An institution cannot be all things to all people. The MFI must determine what attributes are most important to its clients and choose an area in which it has a comparative advantage or at least a core competency upon which it can build. The institution should choose the single benefit or value component that the institution will actively communicate through its brand.
- *Distinction:* What is important in positioning is to provide a *unique* benefit that differentiates the MFI in the minds of consumers (Wright et al. 2004). The transformed MFI does not have to be safer than traditional banks or even offer as many products. Instead, the transformed MFI needs to simply establish a strong position among its target market and respond to their needs in particular. Likewise, the transformed MFI does not need to provide the same gamut of savings products that a bank does, for example: it just needs to have a few basic offerings—a liquid savings account, term deposits, and maybe a programmed savings account—with flexible characteristics tailored to the needs of its target market.
- *Emotional connection:* An MFI offers its clients both functional benefits and emotional ones, reflecting how clients feel about the institution and the total product it offers. The unique selling or value proposition must speak to a client's own priorities and needs to create a real point of differentiation from the competition. For transforming MFIs, this emotional connection with clients is often the most powerful competitive weapon at their disposal because it is very difficult to emulate. Akiba Bank in Tanzania, for example, uses the emotional power of being 100 percent Tanzanian owned as well as its focus on the common person to extend its success in microcredit into savings mobilization.
- *Credibility:* Too often, transforming MFIs try to become "just like" banks, which is a weak positional strategy. This kind of me-too approach rarely works because it is difficult to beat someone at their own game, and it does not leverage the strengths of the MFI. To change customers' perceptions, the MFI must be able to deliver on its desired positioning. For example, an MFI cannot position itself as the fastest if it has not streamlined its processes and procedures and decentralized control. Customers are not easily fooled, so the positioning strategy must be credible and consistent with the MFI's ability to deliver.

Branding includes all of these components to influence how customers experience the institution. Branding is an emotional, value-laden process rather than the physical representation—it conveys the way people think, feel, and respond when they hear or see the brand. Given the complexity and importance of branding, it is best for an MFI to use an overall look and feel that encapsulate all the products and segments rather than trying to brand individual products.

Building a Brand

A transforming MFI can take certain clear steps to shape its image in the marketplace and build its brand.

Define the customer's critical values and how they prioritize each. Successful brands connect in an intimate way with the customer. For the MFI to

know the aspects of its identity it should try to convey in its image and brand promise, it must understand what customers value and why. It is also important to understand the customer purchasing process, including who influences decision making and what the relevant substitutes are, both direct and indirect. Finally, the transformed MFI must understand the biases clients have about banks and regulated institutions in general, because these attitudes might create either barriers or opportunities for the new institution.

Understand current position of the MFI and its competitors in the market, using the marketing intelligence techniques discussed earlier in this chapter. The transforming MFI must determine its target market (current and potential) and the relevant categories to analyze (banks? unregulated MFIs? cooperatives?). It needs to understand the competition and the context within which it will operate once regulated to determine the parameters of its target market. Based on market research with the target market about the most valued attributes, the MFI can determine how clients currently view the institution and its competition.

Explore opportunities and open "spaces" in the market by asking key stakeholders (including clients, investors, and staff) what attributes differentiate the MFI from its competitors. In identifying opportunities for differentiation, the MFI should take into account attributes strongly valued by the customer, including those used to describe their ideal financial institution and products, as part of their feedback on *actual* institutions and offerings. The transformed MFI should also take a long-term outlook, identifying opportunities for differentiation that are sustainable as it redefines its position in the market.

Define a brand position and values that differentiate the institution from its competition and builds on its strengths. The MFI can leverage its transformed status to differentiate itself from the competition and identify the position it desires in the marketplace. For example, is it the fastest and simplest (few requirements, quick approval time)? Does it offer additional security with flexibility? Is it the "friendlier" financier? Is it on the cutting edge of technology? Defining the brand position should be looked at as an institutional effort involving different functions of the institution, including marketing, sales and credit, operations, field staff, human resources, and senior management.

It is important that the MFI be able to *complete the brand promise* in each customer touch point. Like customer service, branding is as much an internal strategy as it is external. The MFI must live and breathe the brand, which is based on the values of the organization. Each customer contact is an opportunity either to strengthen the brand or to cause it to lose some of its luster and prestige. From the look of the branches to the dress and attitude of the personnel, the MFI must remember that branding is based on the *customer experience*. Thus, brand values should be used as part of the screening process when recruiting new employees and evaluating the performance of existing personnel.

Communicate the brand and reinforce it through internal standardization and communication. Brand begins from within, by standardizing the look and feel across distribution channels. Symbols, graphics, and colors that are part of the corporate identity should be echoed in the color scheme of the branches, uniforms of personnel, content of promotional material, and design of business cards to reinforce and strengthen the brand identity and create a consistent image throughout the institution. Given the importance of standardization in establishing image, many transformed MFIs develop a manual of corporate images that specifies the exact hues of the corporate logos and how the logo should appear on letterhead and business cards (with sizing dimensions and locations) and explains how the logos and graphics appear if the background is dark or light, or if it is to be printed in black and white or color. This manual is presented

as part of the staff orientation and reinforced with refresher training to ensure understanding and to emphasize its importance. Many MFIs also use newsletters and other internal communications to emphasize the importance of branding efforts and keep staff updated on developments. Furthermore, senior management should lead by example, making sure all communications (memos, presentations, fax sheets) clearly display corporate letterhead, logo, taglines, and other key components of the brand.

The MFI's brand—both the concrete aspects (name, logos, taglines) as well as the intangibles (values, personality, emotion) should be integrated into all communications—both mass media and tactical. (See Communications Strategy section of this chapter.) To build awareness and recognition in the minds of the consumer and dilute misguided impressions, newly transformed MFIs should plan communications campaigns targeted solely at brand development. Professionalizing and standardizing image is critically important to branding and establishing the MFI's position as a serious, regulated institution (box 4.3).

Box 4.3 UMU Follows its Brand Statement

The ultimate expression of an organization's identity is its brand statement. Uganda Microfinance Union's (UMU's) brand statement was developed from a detailed review of its business plan, market research, and interviews with clients and staff. The draft statement was vetted by senior management, who found it fitting and representative of UMU's corporate identity. UMU's brand statement encapsulates the brand experience—what a stakeholder or client should expect when working with the institution.

UMU's experience in microfinance enables it to approach clients with honesty, respect, and sensitivity. Michael Kasibante, UMU's assistant director of research and development says, "Our goal is to create a permanent financial institution that provides opportunities for entrepreneurs."

"In every interaction with the UMU brand, several key messages should be clearly communicated. This is expressed through the branch appearance, employee dress code and product design."

Source: The New Vision 2005.

Measure and monitor for consistency and impact. Like any major undertaking—whether developing a new product or transforming to a new legal structure—thorough training and close follow-up are critical to success. Markets are dynamic and even the best defined plans can be misinterpreted or poorly implemented. Many organizations use a variety of tools, including recall (the ability of a client to remember the institution's name, tagline, or other attribute), top of mind (the ability of the client to recall without aid), and other survey techniques, to measure the impact of publicity and other external communications. Internal monitoring is equally important to ensure even remote branches are following the image guidelines and staff are being true ambassadors of the brand.[25] It is critical that MFI management adequately staff these monitoring teams and follow up diligently and proactively on their recommendations to maintain the institutional image and reinforce brand quality. Some MFIs even use contests with prizes to reward branches that are exemplary in representing the brand.

Communications Strategy

Marketing communications for a formal financial institution comprises more than just publicity. In general terms, there are two levels the transforming MFI must consider these:

1. Institutionwide campaigns that build brand and strengthen image, and
2. Tactical, product-driven communications.

Achieving success at the first level, image-building communications, makes the second level (the tactical campaigns) a more straightforward and successful process. Brand building communications strategies should complement the MFI's product-related promotional efforts, though they are distinct, complex processes.

Key Components

Key components of marketing communications include advertising, promotion, direct marketing, and public relations.[26]

- *Advertising:* For most MFIs, product-specific advertising—typically flyers, brochures, posters, or billboards—is the primary focus of their marketing efforts. A transforming MFI might also begin to sponsor mass communications, through television, radio, or newspapers, to help raise its profile or change its image, or both. Such advertising involves significant investment and thus should be part of a broader brand development strategy.
- *Promotion:* Promotion relates to all marketing activities designed primarily to persuade members of a target audience to take a specific action such as a trial purchase. Common promotions in microfinance include free gifts (t-shirts, pens), lotteries or raffles (for a television or household appliance), or discounts (one month's worth of fees waived for each referral). Promotions are most effective when the buying behavior is habitual and "sticky" or difficult to change—as in the case of savings. The goal is to inspire the client to try the services, though the MFI will only win over the customer with a superior value proposition.
- *Publicity:* Publicity is information designed to attract attention to a company, product, person, event and that is disseminated through various media. Publicity is the aspect of marketing most familiar to MFIs, which typically use brochure or other written materials (like signs or posters in the branch) or perhaps newspaper advertisements, to promote their product and services. As MFIs grow in sophistication and market size, they begin relying on media with greater reach—like radio or billboards. The goal of publicity is to package ideas, shape messages and reach audiences that may go beyond current customers, to include any other group the MFI wishes to influence, such as prospective clients, investors, regulators, or new market segments (maybe wealthier time-deposit holders).
- *Direct marketing:* Direct marketing involves targeting communications directly to individuals, typically a large number at a time using direct mail or call centers,[27] rather than through mass media. Though direct marketing has historically not been used much by traditional MFIs, the increased practice of data mining can enable MFIs to better target their communications and more finely tune marketing messages. Information stored in databases can come from the MFI's own MIS or outside sources such as third-party market research databases. For example, FIE, a transformed MFI in Bolivia, used an employer's staff list to promote a time deposit product targeted at teachers and parents of students.
- *Public relations:* Public relations (PR) involves mass communications for which, unlike advertising, there is no direct payment from the MFI to the media outlet carrying the information. The most common type of PR is client stories picked up by news media, but PR also includes company-controlled activities such as annual reports or special events—the opening of a new branch or the approval of a license application by the authorities. PR is related to publicity, the purpose of which is to build awareness of and foster a desired attitude toward a particular company, product, or service. Many transformed MFIs create external communications functions, sometimes separate from the marketing department, to issue press releases and organize events to publicize information about the MFI and its products and services.

The traditional model of the purpose and proper flow of marketing communications and direct sales efforts is captured by the acronym AIDA—create **A**ttention, generate **I**nterest, develop **D**esire, initiate **A**ction.

Executing the Strategy

In executing a communications strategy, an MFI typically will solicit the support of a publicity agency to help develop the creative content and the most appropriate media channel to pursue its positioning strategy and redefine its brand. The MFI should develop a creative brief and solicit bids from promotional firms to develop an implementation plan with media spots (brief excerpts of a television or radio commercial to be used during a campaign that convey its core message) and recommended channels for the MFI to evaluate. The creative brief should specify the following:

- *Objectives:* Clarify two to four communications objectives of the desired campaign, which should be tied to overall marketing goals and be consistent with the institution's brand, both tangible aspects (colors, logos, taglines) as well as intangibles (emotions and values, such as security, confidence, trust, and reliability).
- *Audience:* Define target audience, describing not only the composition of the target audience (demographics of the people, households, or organizations that the MFI wants to read, view, or hear a particular marketing communication) but provide relevant background on consumer insight. These insights could come from market research and marketing intelligence.
- *Message:* These are the key concepts to communicate (the unique selling or value proposition of a given product, benefits offered, and support of brand promise). The message should be focused and consistent with the desired positioning strategy.
- *Resources:* The available budget must be determined. If the budget is limited, this section could also include preferred media channels.

The proposals from the creative agencies should include the following:

- *Tools and techniques:* Communications is about storytelling. The creative agency should indicate what techniques it plans to use, for example, an engaging narrative, humor, human interest angle (like testimonials), or arresting imagery. It should also indicate the medium it recommends—print (newspaper, billboards), broadcast media (radio, television), internet, or some combination.
- *Budget:* The budget should include a breakdown of costs including the creative development as well as media placement, if the agency will handle both.
- *Implementation plan:* The proposal should outline the intended communications plan (preferred media channels, frequency, geographic coverage) and the time frame for execution.
- *Evaluation and amendment:* The MFI must have explicit mechanisms to evaluate the effectiveness of the campaign, both before and after it is launched. Ideally, the agency should offer visual and written summaries of alternative creative "spots" to be publicized, for the MFI to evaluate through informal focus groups with clients as part of the pre-test. The key aspects to evaluate are
  - Recall: Ask participants to write down everything they remember from the message to determine which aspects of the message are most impressionable.
  - Understanding: Ask participants to describe how they interpreted the message to see if they understood the principal messages.
  - Credibility: Ask participants if they believe the message; it is important that the participants not only understand the message but

believe it. Otherwise, it will not motivate them to change their attitudes or buying behavior.

– Impact: Ask participants to jot down all the positive and negative aspects of the message. This feedback is critical because sometimes small details—like phrasing or a person's expression—can interfere with the message delivery.
– Motivation: End by asking the participants what they would do after seeing the message (nothing, seek more information, purchase immediately), to determine not only their thoughts but their likely actions.

Once executed, the MFI or its advertising agency should monitor the effectiveness of the campaign based on the stated objectives. One way is to measure the number of prospects generated by different campaigns by dividing the number of inquiries by the estimated target audience (for direct marketing, it would be divided by number of clients actually contacted). Often different phone numbers or offers are used based on the medium to evaluate which one generated a greater impact. If the campaign is for awareness building, the metric to measure effectiveness would be recall—*not* sales volume because there are a variety of factors that influence whether the customer buys the product or service (attractiveness of the value proposition, image of the institution, loyalty to current provider). Based on the campaign's performance, the MFI should have the ability to amend it if it is not generating the desired reaction.

Implementation: Consolidating the Pieces

The final step in developing a marketing strategy for a transforming MFI is to consolidate the critical aspects—marketing intelligence, the product mix, product development, pricing strategy, positioning and branding, and communications strategy—into a marketing plan. To permanently integrate marketing into the regulated institution and establish accountability for ultimately developing the plan and implementing it, most transforming MFIs create a marketing unit or department.

Marketing Department

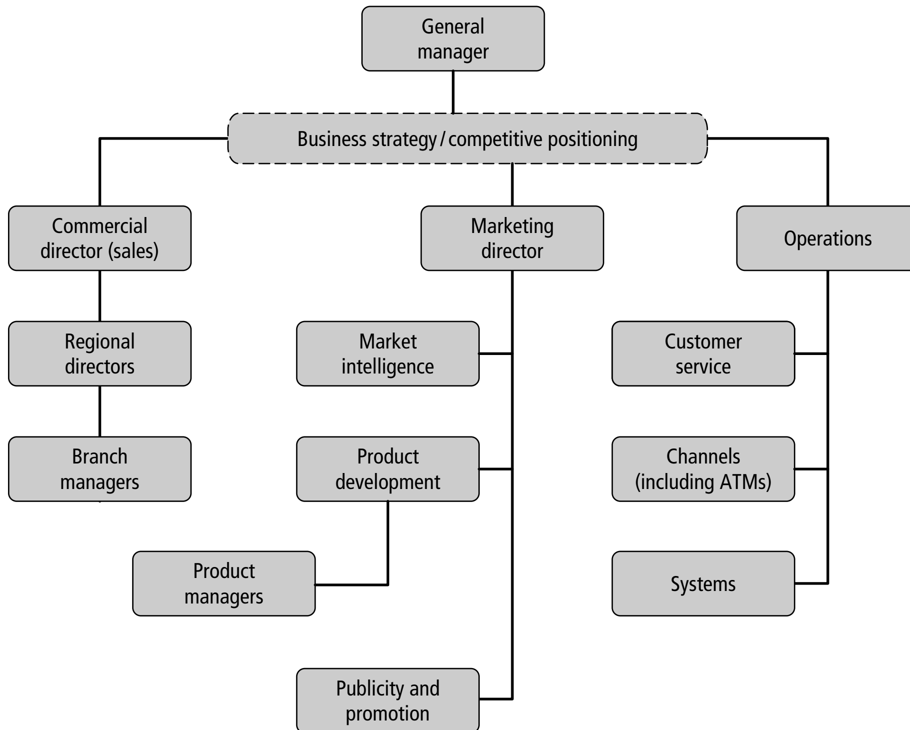
Formalizing and centralizing its marketing functions in one specialized department brings together activities that were formerly dispersed throughout the organization. These functions almost always include marketing intelligence gathering, product development, and promotion. Some formal marketing departments also play an important role in more broad-scale efforts such as competitive positioning and customer service. Because marketing is typically a new department in recently transformed MFIs, the staff usually report to the sales department or "commercial unit," which is generally what the credit department evolves into once the portfolio of the transformed MFI includes more than just loans.

Over time—as markets grow more competitive and clients become more sophisticated—marketing takes on an increasingly important role in the organization and thus the marketing director generally moves to the same level as the sales or commercial director, both reporting to the general manager or chief executive officer of the MFI. (See the sample organizational chart in figure 4.7, which highlights the reporting relations for those departments most directly involved in business strategy and competitive positioning.)

Marketing Plan

Once the transforming or transformed MFI has used the marketing intelligence it gathered and developed its product portfolio and pricing strategy, as well as its planned positioning and branding, it needs to develop a marketing plan.

Figure 4.7 Proposed MFI Organizational Structure Incorporating Marketing



Source: Author.

The simplest way to develop a marketing plan is to start with a thorough diagnosis of the four C's (client, competition, company, context) of marketing intelligence followed by a strategy built around the classic four P's—product, price, promotion, place—as outlined in annex 4A, Sample Outline of a Marketing Plan.

Most of the time spent (at least 60 to 70 percent) developing a marketing plan is invested in the diagnosis of the four C's (that is, gathering marketing intelligence). It is in this part that ad hoc charts or analysis tools are developed that will be used to define the objectives, marketing strategy, and action plan. The problems and opportunities identified in the diagnosis phase, if well done, will spell out the possible solutions and strategic routes to be recommended in the strategy and action plan. It may be useful for the MFI to engage a marketing consultant to help develop the marketing plan. See annex 4B, Sample Terms of Reference for Development of a Marketing Plan.

Brand development is typically presented as part of the "promotion-communications" P, while sales-related activities are elaborated in the "place-distribution" P. For well-developed markets with high brand differentiation, the brand development plan is tackled at the corporate strategy level and thus is separate from the marketing plan. Similarly, the competitive strategy should be fleshed out in the business planning process that precedes the development of the marketing plan.

Annex 4C provides a summary checklist of the major aspects of marketing and competitive positioning covered in this chapter.

Annex 4A Sample Outline of a Marketing Plan

I. Executive summary of business objectives, strategy, and positioning goals

II. Diagnostic
   a. Client—market segmentation, consumer buying behavior, attitudes and preferences
   b. Competition—SWOT (strengths, weaknesses, opportunities, threats) analysis, image and positioning, relative market share, and value proposition
   c. Company—sales by product and channel, profitability, core competencies, capabilities, capacity (channels, staff), technology, and other institutional analysis
   d. Context—regulatory, macroeconomic, and market overview (size, trends)
   e. Analysis of opportunities—SWOT and general conclusions

III. Objectives
   a. Business objectives—sales growth, market share, profitability and margin targets
   b. Marketing objectives—target market, value proposition (positioning, product, service, price, channel, and so forth)

IV. Strategy and action plan (summary of activities to be undertaken)
   a. Product—strategy and plan of action
   b. Price—strategy and plan of action
   c. Delivery channels—strategy and plan of action
   d. Promotion and communications—creative strategy, media channels, publicity plan

V. Resources—who, what, when, and how much
   a. Time line
   b. Budget

Annex 4B Sample Terms of Reference for Development of a Marketing Plan

Background

Background on the organization including its mission, target market, client outreach, portfolio size, and so forth.

Objective

The main objective of this consultancy is to assist MFI A to conduct market research and to develop a Marketing Plan. With the anticipated launch of a new voluntary savings product once licensed as a deposit-taking institution, MFI A has prioritized the completion of a comprehensive marketing strategy. MFI A requires support to develop a comprehensive marketing strategy, particularly with regard to image building, branding, and competitive positioning. The consultancy will be completed in two phases to allow for gathering of marketing intelligence before marketing plan is developed.

Tasks

Phase 1:

1. Prior to arrival in country, gather and review background materials on MFI A's operations, prior market research, competitors, and future growth plans (all materials provided by MFI A to the consultant three weeks prior to the in-country trip).
2. Once in country, spend three days becoming familiar with MFI A's operations and corporate culture. This will include meetings with senior staff, front line staff, and a visit to the field.
3. Work with senior staff and marketing department to develop a market research plan, beginning with defining the target market, the specific topics to be investigated, and the hypotheses to test. The market research could be focused on one of various marketing intelligence needs, including branding, competitive strategy, customer satisfaction with current offering, and product review. To help define the scope of the primary market research, the consultant should carry out an investigation of secondary sources of information on the industry, competition, and the context. Based on this review of secondary sources, the consultant will determine the need for primary market research, which could include a series of focus groups and questionnaires to be delivered by a local market research firm.
4. Participate in the hiring of local market research firm to carry out the market research and develop a terms of reference and time line for the research. The terms of reference should include objectives, recommended sampling frame, and recommended research techniques to solicit bids from local market research firms.
5. While the market research is being carried out, be available for questions and feedback from the market research team (MFI A staff and the market research firm). Ensure adequate completion of market research and collection of quality data.

It is expected phase 1 will require 15 to 20 days to complete.

Phase 2:

1. Upon completion of market research, review findings and conduct thorough analysis to determine MFI A's relative position in the market including strengths and weaknesses, opportunities and threats.
2. Using the market research and discussions with various staff and, if necessary, clients or potential clients, summarize the market research findings and draft a marketing strategy going forward.
3. Facilitate an off-site, two-day workshop with MFI A senior management on MFI A's marketing strategy. Focus of workshop should be on

honing corporate brand strategy (brand attributes and positioning statement, branding communications plan, corporate identity, corporate communications) and reviewing current product strategy (target market, brands, taglines, sales strategy, and product development).

The morning of Day One of the workshop will be spent working with key marketing and other staff to further define the goals for the workshop. The afternoon of Day One will be spent with branch managers who have direct customer contact. Day Two of the workshop would be spent with senior executives—in the morning focusing on developing the brand of MFI A and in the afternoon focusing on sales strategies for individual products.

4. Using results of the workshop, and continuing to work with MFI A's marketing managers and other staff, develop a draft marketing strategy for each product. The deliverable under this task is a Marketing Plan Matrix for MFI A as a whole and for each product. The matrixes for individual products should identify
   - Product name and product characteristics
   - Target market(s)
   - Positioning strategy—how tied to corporate strategy
   - How product characteristics, features, and benefits relate to product positioning; how benefits can be sold to position product; the primary message
   - Branding and image
   - Likely media and channels for promotion and communications
   - Other, including cross-selling strategies
   - How MFI A will position itself against its main competitors with a note on MFI A's main competition and their strategies

   In addition, a separate document should spell out the main elements of MFI A's corporate marketing strategy, and what it can do to create the desired branding and image in the marketplace.
5. Present marketing matrixes completed in task number 4 to MFI A's senior management and solicit input.
6. Finalize marketing plan matrixes off-site in close coordination with MFI A.

It is estimated phase 2 will require up to 30 days to complete.

The consultant will work closely with MFI A's staff on the above activities, building their skills and ability to better manage the roll out going forward.

Deliverables

There are two primary deliverables:

1. MFI A Marketing Plan, including Marketing Plan Matrixes for MFI A and for each product of MFI A
2. Brief completion report including description of tasks completed during both phases and final recommendations for follow up

Level of Effort

It is expected that up to 50 days will be required to complete this assignment, including the two phases.

Annex 4C Checklist for Marketing and Competitive Positioning

Marketing Intelligence

- Do you have a deep level of understanding of the client, including demographic profile, needs and preferences, beliefs and attitudes, and buying habits?
- Have you thoroughly analyzed your competition—understanding their objectives, business strategy, growth and profitability, cost structure, organizational culture, image and positioning, and barriers to entry and exit—to define your institution's competitive strategy?
- Have you analyzed your institution's capabilities, defined its core competencies, and understood its organizational culture?
- Do you have a good grasp of the context in which your organization is operating, including macroeconomic and political environment, financial sector policies, and regulation and supervision?
- Have you defined the objective of your marketing intelligence gathering—what questions are you trying to answer and what are your hypotheses?
- Have you consulted existing sources of intelligence—research reports, databases, staff knowledge—before embarking on the more costly primary market research?
- Have you determined what type of market research technique is most appropriate to answer your business objective (quantitative or qualitative) and what tools are most applicable?
- Have you decided whether you have the staff availability and expertise to conduct the market research in-house or if you should hire an outside specialist?
- Have you assigned a person or a team to oversee the implementation—to review the tools, observe the implementation, and analyze the results?
- Have you developed an action plan based on the strategic and operational implications of the intelligence gathered?

The Total Product

- Do you know what the core product is—why your clients buy the product?
- Have you enhanced the product to differentiate it from the competition?
- Have you tested the total product with the target market to make sure that both the features and benefits add differential value in the client's eyes?

Product fit

- Is the product aligned with the institutional vision and competitive strategy?
- Do the products build on your institution's strengths?
- Do you have the institutional capacity to commercialize the products?
- Is your institution in a financial position to support the investment product development requires?

Pricing

- Have you considered the financial implications of your pricing strategy, including loss leaders and cross subsidies?
- Have you analyzed the competitive implications of your pricing strategy?
- Is your pricing strategy consistent with your clients' needs and preferences?
- Have you adjusted your price for the risk implicit in the product, as well as overall assumptions regarding inflation and devaluation?
- Does your pricing strategy allow your institution to meet its profitability targets and desired rates of recapitalization?
- Are your prices in compliance with regulatory and legal norms?
- Have you considered the social implications of your pricing strategy?

Product Development

Evaluation and preparation

- Have you discussed the strategic vision for the product portfolio?
- Have you estimated the market appetite using secondary market research?
- Have you assembled a multidisciplinary product team?
- Have you garnered institutional buy-in for anticipated changes?

Design of the product prototype

- Have you segmented the market to identify market needs and preferences using primary market research?
- Have you analyzed the competition to determine comparative advantage?
- Have you diagrammed operational procedures (bottlenecks, internal control, and so forth)?
- Have you tested the systems?
- Have you estimated costs to the institution and borrowers?
- Have you projected revenues and cash flows?
- Have you verified legal and regulatory compliance?
- Have you tested prototype and marketing messages with focus groups?
- Have you finalized the prototype?

Pilot testing

- Have you defined the objectives and milestones of the pilot test?
- Have you designed the pilot test protocols?
- Have you prepared the pilot test site (systems, operational flows, and so forth)?
- Have you executed the pilot test?
- Have you monitored the pilot test?
- Have you evaluated the results of the pilot test?
- Have you made a decision about launching the product full scale?

Launching the product

- Have you developed an implementation plan?
- Have you trained staff and developed incentives?
- Have you developed a marketing strategy?
- Have you upgraded the MIS?

Delivery Channels

- Do your distribution channels comply with regulatory requirements?
- Have you developed your desired retail format (overall look, layout, and mix of products and services) to offer through different outlets?
- Have you retrofitted the branches from a customer service point of view to address wait time, client communications, and customer care?
- Does your network of distribution channels provide broad coverage, including the new markets it wants to serve?
- Have you considered alternative channels to reduce cost?
- Have you explored technological alternatives such as ATMs or remote transaction systems?
- Have you built in control mechanisms and security measures to deal with fraud, internal control, identity theft, and other risks?
- Have you upgraded and standardized your image across channels?

Branding

- Do you understand the preferences and priorities of the target market?
- Have you conducted an image study to understand how your actual and potential clients view you and your competition?
- Have you developed a positional strategy by segment?
- Have you developed a clear, concise, and credible unique selling or value proposition that will be the basis of your brand promise?
- Have you created a new image—including colors, logos, slogans, and taglines?
- Have you decided what personality you want your brand to have and developed a strategy to help create it in the minds of consumers?
- Have you undertaken efforts to standardize the look and feel of your brand across channels

and internally to enhance your institution's image?
- Have you developed a promotional strategy to help communicate your new image to your clients and hired a specialized firm to help implement it?
- Have you established a follow-up strategy to measure impact and monitor compliance?

Communications

- Have you planned advertising campaigns for the new image and products as a transformed MFI?
- Have you developed promotional campaigns to inspire new clients to try your services?
- Have you considered direct marketing efforts to target specific niches?
- Have you built a public relations function to communicate information about the MFI and your products and services to new audiences?
- Have you developed a creative brief to solicit bids from different agencies to help you with the development of different elements of the creative campaign?
- Do you have mechanisms to evaluate the effectiveness of different campaigns?

Marketing Plan

- Have you determined how you will incorporate the marketing function within your institution?
- Have you determined how you will develop a marketing plan and who will be responsible?

Notes

1. See chapter 5, Strategic and Business Planning, for developing a business plan.
2. Mystery shopping is a research method whereby people posing as regular customers anonymously visit or contact a place of business (a branch, for example) to assess customer service, product quality, employee performance, cleanliness, or overall experience (Brand 2003, p. 18).
3. Industry experts also use the term *marketing research* to differentiate the action-oriented focus of marketing intelligence from classic market research (Reid and Plank 2004).
4. Classic marketing usually just includes the first three C's, with the third C often referred to as "company," but given the important macroeconomic and political realities of developing markets, the fourth C "context" is included here.
5. See http://www.microsave.org and Brand 2003.
6. Quantitative market research techniques use statistical analysis to identify tendencies among client groups, determine correlations between variables, and measure the depth and frequency of specific trends. Qualitative research techniques use conversational formats to probe in depth attitudes and preferences of clients, and usually answer the questions "why" and "what" rather than "how often" or "how many."
7. Attribute ranking is a method for determining what elements of financial services matter most to clients and the relative importance of each (Wright et al. 2003).
8. For concrete examples of how marketing intelligence is concretely applied, see Brand (2003, pp. 14–17).
9. "Commercial manager" refers to the person managing the MFI sales force (typically its loan officers).
10. For additional discussion of how to build effective feedback loops within MFIs, see McCord (2002).
11. Cannibalization occurs when sales of one product displace or "eat" income that had been generated by another product.
12. In a recent virtual conference on pilot testing, participants emphasized the importance of these dry runs, except when markets are changing quickly or in situations where demand far exceeds supply (digests from the MicroSave Virtual Conference on Pilot Testing, March 14–18, 2005; Arunachalam 2005).
13. Banks and other regulated institutions typically use a variety of benchmarks to set this minimum "hurdle" rate of return, including the weighted average cost of capital, historic return on equity, or other profitability targets.
14. Boston Consulting Group refers to this competitive minimum as the "commodity offering" that establishes the base price point (BCG n.d.; consultant interviews and www.bcg.com).
15. Top-of-mind tests whether price is the first thing customers mention when explaining their purchasing decision or evaluation of competing products.

Attribute ranking for pricing analysis compares price to other product characteristics to determine how important interest rate is relative to other decision-making factors. Both of these tests can be performed using qualitative techniques (for initial impressions) and quantitative methods to validate the results—such as determining price elasticity, a quantitative measure of consumer's sensitivity to price (Brand 2003).

16. "Hot spots" are those areas within a branch upon which client attention is focused because of the layout and traffic flow. A critical hot spot is the wall behind the cashier or any other area that clients stare at for long periods while they wait to be attended.
17. MFIs in both South Africa and the Philippines are experimenting with loan payments and tracking via cell phone.
18. PRODEM in Bolivia has developed a variety of technologies, including digital fingerprint recognition and voice-driven smart ATMs rather than data inputs (like personal identification numbers), to create secure alternative channels tailored to a population with low levels of written and technological literacy (Hernandez and Mugica 2003).
19. Branding can be applied to the entire corporate identity as well as to individual product and service names.
20. A mascot is an animal or person adopted by an institution for promotional purposes or by a sports team to bring it good luck.
21. In 2003, Compartamos undertook market research to understand the "personality" of its corporate identity by exploring images and concepts its clients associated with its brand. To its surprise—given the modest profile of its typical female, rural client—they rejected caricatures and animated mascots. The clients of Compartamos perceived it as a parental figure and the mascots seemed juvenile.
22. FFP stands for *Fondo Financiero Privado,* loosely translated as Private Finance Company—the regulatory structure the Bolivian superintendent created for MFIs to become regulated.
23. Advertising legend, Walter Landor, as cited in Camper 2000, p. 59.
24. As defined by the pioneering advertising agent, Rosser Reeves, who invented the term. A unique selling proposition is a distinctive message an institution develops to differentiate itself from the competition that should be used consistently in its advertising and promotion.
25. Many leading corporations refer to their employees as "brand ambassadors," recognizing they are the lead representatives of the brand and its face in front of the client.
26. Other key elements—like corporate communications (such as those targeted at investor relations) or internal communications (with MFI personnel) are not included because they are typically undertaken by areas outside marketing.
27. Direct marketing by mail is not viable in many developing countries.

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Chapter 5

Strategic and Business Planning

Any organization, particularly one contemplating a significant strategic change, needs a road map for its future. Typically embodied in a business plan, this road map is an output of both strategic and operational planning. A fundamental planning tool, it identifies the key strategic goals of the organization and outlines the operational implications for achieving these goals. It allows decisions to be made regarding the allocation of resources and quantifies the likely results of actions, helping institutional leaders set realistic goals and make decisions. Furthermore, it provides staff, management, board members, and external stakeholders with a documented description of not only what the institution looks like today, but more important, the institution's vision of what it hopes to accomplish in the future.

Such a tool is particularly important for an institution that has decided to transform from a nongovernmental organization (NGO) to a deposit-taking financial intermediary. While most microfinance institutions (MFIs) already have some type of business plan, the transformation process represents such a fundamental change to the organization's internal and external operating environment that drafting a new plan is unavoidable. As detailed in various other chapters, transformation is typically characterized by the addition of new products and services, and thus entry into new markets, the recruitment of new staff, significant investment in training, upgrades in systems, and infrastructure changes. Additionally, with transformation, the organization is launched into a new competitive environment and is forced for the first time to abide by a range of new regulatory, legal, and tax requirements. And it is beholden to various new stakeholders. Each of these changes has fundamental implications for the institution's business strategy.

While most transforming MFIs are already familiar with general business planning, this chapter presents the unique characteristics of incorporating an institutional transformation into the business planning exercise. The first section provides a brief overview of the business plan development process. The second section discusses the various options MFIs need to consider to effect the actual transfer and establishment of the legal entity which will carry on the microfinance business as a regulated company. This is followed by a discussion of the core elements of a business plan, highlighting those aspects unique to transforming MFIs. The next section focuses on key considerations for financial modeling of the regulated entity's projected results

that are ultimately included in the business plan. The financial modeling section includes the effects of transformation on the projected balance sheet and income statement, recommended indicators and benchmarks to consider, and suggestions on accommodating investor requirements into the modeling exercise. Finally, given the significant impact of tax regulations on an MFI's business strategy and resulting return expectations, the chapter concludes with a targeted look at tax strategy and compliance. Any future tax liabilities as a for-profit shareholding company must be considered in the business plan for the transformed institution.

Throughout this chapter reference is made to other chapters in this book because much of the strategic and operational decisions that need to be made, and the institutional capacity that needs to be developed in a transforming institution, in turn, affect the development of the business plan. As such, the business planning process will likely continue, to some extent, throughout the transformation process as decisions are made and capacities developed. Thus, this chapter is not intended to be read in isolation from other chapters because much of the business planning process will require knowledge and understanding of all the issues that affect an MFI when transforming. It is placed near the front of the book because the business planning process should begin at the time the transformation process begins, as the institution will require a business plan (even one that continues to change) to refer to internally and a version of it to share with prospective investors, regulators, and other stakeholders along the way.

Developing a Strategy

As is often the case with the development of any kind of plan, the very process of planning is often more important than the plan itself. Strategic and operational decisions, followed by detailed financial modeling, need to precede the actual drafting of the plan, and lie at the heart of business planning. Unlike various business plans that are developed in a last minute flurry (often with little input from staff) only to be handed over to a donor and then placed on a shelf and referenced at year's end, the business plan for a transforming MFI becomes a living document. A business plan that is developed in isolation and thus does not reflect a hard-won consensus among the stakeholders of the MFI will most likely not succeed in implementation. The efforts leading to the creation of the business plan and the multiple versions that ensue are often reflections of the level of buy-in that has been achieved with a broad range of internal and external stakeholders.

As highlighted in chapter 3, Planning for Transformation, successful transformations require investment in a structured change management process. Successful change cannot be mandated by management. Staff members need to be convinced of the need for change and understand why a new strategic push—such as converting into a share capital, regulated institution—is needed and desirable. Involving staff in investigating the market, brainstorming about new products and services, and setting targets—all key components of the business planning process—are important to gaining their buy-in and ultimate ownership of the results of the business planning exercise.

In addition to the internal audience—the management and staff of the MFI—the audience for the business plan of a transforming MFI expands to include a range of new external stakeholders:

- *Investors:* The business plan, or a summarized version of it, is typically one of the primary documents used by the MFI to market the institution to outside investors. This has significant implications for the depth of financial analysis that needs to be included in the document. For example, the business plan of a transforming MFI should include detailed information on projected rates of return over an extended period. Many prospective investors request up to

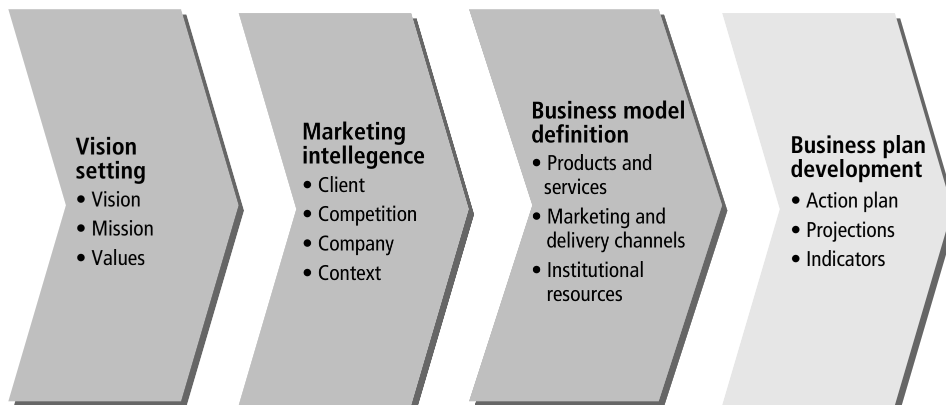
10-year pro forma balance sheets and income statements.

- *Regulators:* A comprehensive business plan is typically one of the documents that must be submitted with the MFI's application to the central bank in the licensing process. In Uganda, for example, the requirements for the components of the business plan are quite specific.[1]
- *New staff hires, in particular senior management:* Key conclusions of the business plan may be used to recruit some of the new senior staff needed to support the transformation and the institution's future operations.

Traditional business plan development typically occurs over a period of two to three months, depending on how developed the organization's overall strategy is at the outset, the depth of market research that is conducted, and the planning approach taken. For a transforming MFI, this process is likely to absorb both more resources and time than anticipated and certainly more than the business planning process may have absorbed historically. Competition and the overall operating context will be different for a regulated financial institution and will require new skills to evaluate and understand. Consideration will also have to be given to regulatory implications for the new institution and, as discussed in chapter 4, Marketing and Competitive Positioning, a broader target market will need to be defined and analyzed, the appropriate product mix determined, and the strategy for positioning the new MFI in the marketplace developed. This will result in potential changes in marketing channels, and increased access to broader sources of funding. Finally, new investors and regulators demand a new level of accountability for results that management will need to recognize in the planning process. All of these factors underscore the importance of a structured planning process that acknowledges early on the fundamental changes to a business plan implicit in an institutional transformation.

The business plan development process can be broken down into the four stages presented in figure 5.1: vision setting, marketing intelligence, business model definition, and business plan development. The first three stages reflect the key components of strategic planning. Using its decision to become a regulated deposit-taking institution, the MFI establishes (or redefines) the mission and goals for the organization; the strategic direction that, in turn, leads to the definition of the target market. It then conducts market research to further

Figure 5.1 The Business Plan Development Process



Source: Author.

understand its anticipated client base, the competition, the organization's own core competencies, and the overall context in which it is operating. This internal process of self definition leads to the development or refinement of the MFI's business model—the operational plan. The business model includes the proposed products and services to be offered; marketing and delivery channels to be used; and the institutional resources, both human and financial, needed to achieve the goals of the organization. The last stage, business plan development, pulls these components together to develop the road map for the organization going forward.

Vision Setting

As discussed in chapter 3, Planning for Transformation, the vision and mission statements of transformed organizations need to be modified to take into account changes in the target market and the broadening of relevant stakeholders including investors, new board members, and probably, a new or revised management team. Vision setting and market research tend to be iterative—the results from preliminary market research may force a redefinition of vision and mission, which itself may generate the need for additional research.

Marketing Intelligence

A business plan is typically built on the results of comprehensive market research. While MFIs may have a good sense of their current market, transformation implies a shift or expansion in target market as new products are introduced and new customer relationships are developed. Before embarking on new product development, marketing and promotion strategies, financial projections, or a broader expansion strategy, MFIs need to have a clear understanding of who their target market is, what the customers' needs are, who their competitors are, and what their potential is for substantive market penetration. For a more detailed discussion of this topic including a discussion of how quantitative and qualitative market research support marketing intelligence gathering, see chapter 4, Marketing and Competitive Positioning.

Business Model Definition

According to the work completed during the vision, mission, and values formulation; the findings of the market research; and the decisions made regarding the position of the new entity in the market, the transforming MFI needs to closely examine its current business model during the process of developing its business plan. Is the current model sufficient to achieve the new vision and mission and the position in the marketplace the organization has planned? And, most important, will decisions made regarding these questions result in a financially viable and ultimately marketable new institution? This is what the business plan, once developed, will help to determine. To develop the business plan, the transforming MFI needs to confirm and quantify the products and services the regulated institution will offer; the marketing and delivery channels it will use; and the human, physical, and financial resources it will need to operate effectively as a deposit-taking institution. These key issues will substantially influence the results of the final business plan.

Products and services. Most institutional transformations result in refining, and often expanding, the MFI's product offerings—at the very least, transformation results in the addition of voluntary savings services. Offering deposit services to the public requires the MFI not only to develop appropriate savings products, but also to examine the complete product mix including credit, savings, money transfers, and insurance in light of new or expanded target markets.

The addition of new products and services also changes the way revenue is earned and costs incurred. Fee revenue often goes up with the addition of new services and the cost of funds often decreases over time as cheaper deposits fund more and more of

an institution's loan portfolio. Costs, however, also increase with the added responsibilities of compliance reporting to the central bank, increases in management information systems (MIS) and infrastructure requirements, higher staff costs, and increased overall management needs resulting from the increase in the range of products offered.

Marketing and delivery channels. For an MFI that has historically relied on regulated financial institutions or the "village bank" (or "center" depending on loan methodology) to disburse and collect loans, transformation into a deposit-taking institution will have significant implications for its marketing and delivery channels. Infrastructure and security requirements imposed by the regulator will probably prohibit deposit mobilization outside of a formal branch structure. (Some regulations, such as the State Bank of Pakistan's Microfinance Regulations, may have provisions for mobile banking although this is likely to require significant security and internal control measures to be in place.) The result is that the MFI will have to reexamine its current infrastructure and possibly make significant changes in its overall retail strategy.

Institutional resources and capacity. Given the above, what are the institutional resources—human, physical, and financial—that will be needed to support the delivery of these products and services through the anticipated channels? This question requires the MFI to evaluate its overall organizational structure, staffing plans, branch network system, and MIS. See part III, Transforming the Institution: Operational Implications, for more detailed discussion on each of these and other topics.

Institutional Transformation and the Role of the NGO

Before moving to the fourth phase of the business planning process—developing the business plan—the transforming MFI needs to make some key strategic decisions about how it will legally transform, and what will be the continuing role, if any, of the NGO going forward. While regulatory requirements will typically define the type of institutional form required for licensing as a deposit-taking institution, the way the MFI transforms into a for-profit, share company and, if applicable, how it transfers its assets and liabilities to the new entity, and what the NGO will do after transformation, need careful consideration and analysis.

"Transformation" as used in this book results in an MFI operating as a licensed deposit-taking financial institution. Depending on the form and purpose of the original MFI, transformation can ultimately result in just the one legal entity—the licensed financial institution—or more than one including the licensed company as well as the original MFI (usually an NGO or project) or other companies. An MFI that wishes to operate with only one entity can do so through reorganizing the existing organization to meet the requirements for licensing (which may require a change in legal form) or, if already operating in the legal form required for licensing, simply change other aspects (such as ownership, or services offered) to meet licensing requirements. For example, in the case of FINCA Uganda, the original NGO was reorganized into a new share company and the NGO was closed. When Faulu Uganda decided to pursue transformation, it was already operating as a share company (the legal form required for microfinance deposit-taking institutions in Uganda) so it simply needed to expand the number of shareholders to meet the ownership requirements for microfinance deposit-taking institutions.[2] In both cases, the licensed financial institution was the only legal entity.

An MFI that wishes to operate with the licensed entity as well as the original MFI and possibly other companies often must create a new company separate from the original MFI (usually an NGO) to meet the requirements. The Uganda Microfinance Union, for example, created a new company separate from the founding NGO and transferred the

NGO's assets and liabilities to the new company. Even after licensing, it continued to operate with two entities, the licensed financial institution and the original NGO.[3]

Creation of the New Company

As mentioned above, the transforming MFI can plan to operate after transformation with just one legal entity or with two or more entities. The actual process the MFI will undertake differs depending on the approach chosen.

The one-entity or reorganization approach. In this approach, the required process depends on the legal form of the original MFI. If it is operating with a legal form that is *not* the one required for licensing, the MFI will need to be reorganized into the necessary legal form. Its charter documents need to change to reflect its new legal status, but its assets and liabilities do not move. Its capital base is converted from one composed of donated capital and retained earnings to one composed of share capital. Those with an economic interest in the original company (such as FINCA International in the case of FINCA Uganda) are issued shares. New shareholders may also be invited to invest in the reorganized company, either at the moment it is reorganized or at a later time. For this approach to be feasible, the identified party who takes ownership of the NGO's capital must be acceptable to both the central bank and the original donors. If the transforming MFI is already operating under the legal form required by the regulatory authorities, it simply needs to ensure it meets all other requirements including ownership limitations, capital requirements, and so forth.

The two-or-more entities or transfer approach. In this case, the original MFI transfers those assets (such as its loan portfolio, investments, staff, physical assets) and liabilities (such as its debt obligations) related to its microfinance business to a new company that has been created or purchased expressly for this purpose and is in the legal form required by bank regulatory authorities.[4] In exchange, the original organization receives debt or equity or both in the new institution. In most transformations to date, other investors are then invited to purchase additional shares in the new company. The new institution's capital base is thus composed of share capital issued to both the founding organization (NGO) and other external investors. The founding organization remains a legal (and in most cases, operating) entity, but may or may not offer financial services.

Each approach has different implications for the structure of the new entity and must be carefully evaluated in light of the relevant regulatory, legal, and tax frameworks. In addition, the chosen approach reflects a critical strategic decision that has significant implications for the opening financial structure of the new entity, and as such is important for financial modeling purposes. (See Financial Modeling section later in this chapter.) Finally, the approach chosen is greatly influenced by strategic decisions concerning the future role of the NGO (if applicable).

Role of the NGO as an Investor

In the reorganization approach, the original NGO survives but only as the licensed institution. No separate company is established, and thus, no assets or liabilities are transferred to a new company. Instead, the original NGO that undergoes reorganization merely changes its form to a private share company so that it can act as a regulated financial intermediary (or if already in the appropriate legal form, changes other necessary aspects). Thus, the original company continues its business of making loans and, once licensed, accepting deposits. Its capital base, however, has been transformed to facilitate share ownership (or, if applicable, expanded ownership). The presence of other lines of business may influence the approach chosen, because often it is

best to separate nonfinancial (and presumably, but not always, unprofitable) activities from financial services. Otherwise, the cost of providing these services will negatively affect the returns to investors in the MFI, and distort financial ratios monitored by the supervisory authority.

In the transfer approach, the original NGO survives as an investor or lender (or both) in the new organization. At the same time, it may retain some assets and liabilities related to other lines of business, such as literacy, health, or business development, as happened in the case of K-Rep Bank in Kenya (box 5.1).

If the transfer approach is chosen (most common to date), the role of the NGO as investor in the new entity is influenced by the way in which the assets and liabilities are transferred. MFIs that have transformed by means of creating a new entity while maintaining the original organization typically have done so in one of three ways:

- *Complete transfer model:* The NGO makes a direct sale of its microfinance assets (and all of its related liabilities are assumed) all at once in exchange for debt or equity (or both) in the new company.
- *Branch transfer model:* Over an extended period, the value of individual NGO branches are sold to the new entity in exchange for cash, debt, or equity in the new entity, or some combination.
- *Client transfer model:* Outstanding client loans to the NGO remain on the NGO's books until they are paid off (which, given the relatively short-term nature of most microloans, rarely exceeds two years), at which time the NGO invests this liquid cash in the regulated entity as debt or equity or both. All other assets and the institution's liabilities are typically transferred according to the complete transfer model.

In the complete transfer model the transfer happens on one specified date. The new regulated entity picks up the relevant closing balances from the NGO, such as the portfolio, fixed assets, and any debt that has been transferred from the NGO to the new entity. External investor debt and equity injections are then reflected as cash (or investments) on

Box 5.1 The Transformation of K-Rep and the Creation of the K-Rep Group Ltd.

The transformation of K-Rep into a commercial bank required the creation of three legal entities under the umbrella of K-Rep Group Ltd., a holding company. K-Rep Bank Ltd. is a private, for-profit shareholding company owned primarily by K-Rep Group, as well as others. K-Rep Advisory Services (Africa), Ltd., or KAS, is a private, for-profit consulting firm wholly owned by K-Rep Group. K-Rep, the NGO, was not created anew, but was reincarnated as the K-Rep Development Agency (KDA), with substantial changes in its internal operations.

K-Rep Group transferred the financial assets, liabilities, and activities of the financial services division to K-Rep Bank. The assets, liabilities, and activities of the nonfinancial services division remained with KDA, which was then divided into microfinance research and innovations, and microfinance capacity building. In 2001, the microfinance capacity-building division was spun off to K-Rep Advisory Services, which was incorporated to provide fee-based microfinance consulting services.

The new structure was intended to protect K-Rep's original vision of providing both financial and nonfinancial services to the poor. Each institution provides different services within the microfinance and microenterprise sectors. The institutions within the K-Rep Group are separate legal identities. Each has its own board of directors and own mission, vision, core values, and organizational culture.

Source: Nyerere and others (2004).

Table 5.1 The Accounting Impact of a Complete Transfer Approach

Pretransformation				Posttransformation							
ABC NGO				ABC NGO				ABC MFI			
Loans	8	Debt	6	Investment in MFI	5	Non-MF liabs	2	Loan	8	Debt	6
MF assets	3	Non-MF liabs	2	Non-MF assets	2	Grant /equity	5	MF assets	3	Equity	5
Non-MF assets	2	Grants/equity	5								
Total	**13**	**Total**	**13**	**Total**	**7**	**Total**	**7**	**Total**	11	**Total**	**11**

Note that both pretransfer and posttransfer, the net assets (grants and equity) of the NGO are unchanged. On the asset side, it has swapped loans and microfinance assets for an investment in the new MFI, and the MFI has assumed the related liabilities (debt).

Source: Contributed by Lloyd Stevens, DFID Financial Sector Deepening Programme Uganda.

Note: MF = microfinance.

the asset side in the new entity, and as debt and shares on the liability and equity sides, respectively. Likewise, the relevant value of the NGO's assets that are "sold" to the new entity typically are reflected as a combination of debt and equity shares on the liability and equity sides of the new entity. The NGO's balance sheet posttransformation would reflect the reverse: the outstanding loan and investment (the equity stake) in the new regulated MFI would appear as the NGO's assets. Assuming all the debt of the NGO was transferred to the new entity, the right-hand side of the NGO's balance sheet would be pure capital. In this scenario, a key consideration is estimating the projected actual transformation date. Table 5.1 shows this process using t-accounts, a common accounting device. For financial modeling purposes, the analyst will probably have to select a best-guess date in the future. However, this date will likely shift a number of times, thus requiring various versions of the projections model.

With the branch transfer model, the transfer happens over time. Branches are sold based on conditions established at the time the decision is made to select this model. Conditions for sale include achieving a certain level of profitability, being appropriately upgraded to operate as a regulated branch, or relevant geographic considerations. This model can be used if the NGO wants to continue microfinance operations in a distinctly different geographic area or wants to serve a distinctly different market niche (such as a lower income clientele) than the new regulated entity, both of which may initially require continued donor subsidies or present too much of a financial drain on the regulated entity. The potential for competition between the NGO and the new regulated entity, however, will need to be addressed in such a case, because geographic and market distinctions may become blurred over time (see box 5.2).

For institutions that pursue the client transfer model, the NGO invests a portion of its available cash (as shares or debt) in the new institution. As the loans on its books are paid off, the NGO uses the proceeds of these repayments to purchase more and more shares in the new entity (or provide debt). Over time, the NGO's assets shift from being largely composed of microenterprise loans to being

Box 5.2 PRODEM-BancoSol Transfer Strategy

Upon the creation of BancoSol, the directors of PRODEM decided to continue as a microfinance NGO, but to operate in different geographic areas. Based on the assumption that it was not cost effective to provide credit in rural areas, PRODEM initially retained all rural and semirural branches, transferring only its profitable urban-based branches to BancoSol in exchange for share capital. PRODEM's success at developing a sustainable model of rural microfinance lending combined with a shift in strategy to increase outreach in some of the semiurban markets as well, led to a discontinuation of this branch transfer strategy in late 1994. Ultimately, PRODEM decided to transform again (to PRODEM FFP) and discontinued selling its profitable branches to BancoSol. PRODEM FFP and BancoSol thus found themselves in competition for the same clients, a situation greatly complicated by the ownership and governance ties between the two organizations.

Source: Adapted from Campion and White (1999).

primarily composed of investment in the new entity. Alternatively, as the loans are repaid, the NGO can elect to dedicate the funds to charitable activities separate from microfinance.

See box 5.3 for an example of the way in which unique country circumstances can influence the transfer strategy.

A combination of these various models is also possible. For example, in the transformation of Uganda Microfinance Union, all client loans with payments greater than 30 days past due were left with the NGO, with the assumption that over time, as these loans were repaid, the NGO would invest this surplus cash in the new regulated entity.

Each of these scenarios has different implications for the initial level of independence (or dependence) between the two organizations. At one end of the spectrum, the branch transfer model can continue indefinitely: new branches are continuously launched by the NGO, and over time transferred to the regulated entity once they have achieved a certain level of sustainability or size. This scenario, however, creates built-in dependence between the two institutions (and could ultimately create direct competition between the two, as described in box 5.2). At the other end of the spectrum is the complete transfer model, where the assets and liabilities are transferred all at once, creating two independent entities: one, the new operating entity (the regulated institution) and the other, a shell company with investments (debt and equity) in the operating entity. The client transfer model typically falls somewhere in between these two, depending on the outstanding terms and repayment rates for the remaining loans.

Box 5.3 Constraints on Transfer Strategy

In some countries, such as India, certain forms of nonprofit institutions, such as societies or trusts, face restrictions on their ability to transfer their assets in exchange for debt or equity in the new regulated entity. In particular, such entities cannot be investors in a for-profit company without losing their tax-exempt status. Therefore, institutions facing this constraint have had to mobilize fresh capital for the new regulated entity and shift their client base, client by client or branch by branch, to the new entity, slowly winding down the microlending operations of the NGO.

Source: Authors.

Future Role of the NGO

The strategic decisions made by the NGO stakeholders regarding the future mission of the NGO ultimately affect the nature and focus of the NGO as shareholder. Will the NGO carry out its own operating activities, related to microfinance or not, or simply act as a lender and investor in the

new regulated entity? The answer to this question will influence such important factors as the expected return on investment, rates charged on debt, and conditions (if applicable) placed on the use of the NGO funds, to name a few. If, for example, the NGO was to become involved in its own community development activities, it might want to ensure a steady income stream for its own operations, a decision that could dictate taking debt in the new institution, given the relative illiquidity of equity, as well as more commercial rates on debt. These decisions all have financial modeling implications.

Transforming MFIs must also consider the sources of funds that make up their equity bases when thinking about the future role of the NGO. Most MFIs built their equity bases with donated funds and retained earnings generated from these charitable funds. For profitable MFIs, this capital base can grow to be quite substantial. Having the original NGO as a shareholder—that is, exchanging the NGO's net assets for debt or equity or both in the new entity—permits the value of these funds to stay with the NGO, eliminating possible donor concerns that such funds may end up in the pockets of private individuals or for use in other, noncharitable activities.

This option, however, is only viable if there is a genuine interest in continuing the existence of the founding NGO and if the regulators approve the founding NGO as a shareholder in the new regulated MFI. It is often argued that the NGO as shareholder is important for ensuring an ongoing commitment to the original vision and mission. If the NGO takes on a new strategic mission, such as becoming involved in community development work other than microfinance, or if the NGO remains a nonoperating entity with individuals prepared to act as trustees for its investments, this option is possible. However, if all individuals associated with the organization shift to the regulated entity, or if other investors with a commitment to the same target market are brought on board, is there a role for the NGO as an investor?

Even if the NGO takes on a new strategic vision and mission, it will likely want to access some of the resources tied up in the new regulated MFI. If it does sell its shares or recall its debt, will it continue to be accountable for proper use of these grant funds? The question of how and for how long this donated capital should be protected should ideally be proactively addressed by donors at the grant-making stage and transparently discussed by MFIs during the transformation process. For some donors of granted funds, it is not enough that the recipient simply be characterized as charitable. The organization may be required to continue to use the funds "in furtherance of the original grant purpose," a distinction that requires clear guidance on the use of proceeds from any future sale or divestment from the new regulated entity.

Development of the Business Plan

The business plan document serves as a key communication and marketing tool for both internal and external stakeholders and turns the strategic objectives and goals into an operational plan. While structurally it reflects a traditional business plan format, the business plan for a transforming MFI needs to reflect the new business paradigm. And while the general categories will not be new, the business plan will need to address particular issues and topics unique to transformation. Sometimes MFIs will find it helpful to contract out the development of the business plan, although it is key that the business plan is ultimately accepted and "owned" by the MFI. Sample terms of reference for doing so are included in annex 5A.

Some MFIs maintain two variations of their business plan: one for internal use, which includes significant details on expansion plans, new product initiatives, funding plans, and so on; and a simplified version for use with external stakeholders. The external version is also sometimes converted into the prospectus discussed in chapter 7, Ownership

and Governance. The prospectus is the marketing document used to attract external investors or other potential partners.

The following template covers the key categories and relevant issues for a business plan for a transforming MFI.

Vision and mission. As discussed previously, the expanded target market and addition of new products and services, typical in transformations, is likely to require revising or creating a new vision and mission for the regulated organization. This section may also include a summary of the overall objectives and strategy of the organization going forward.

Ownership and governance. The anticipated plans for the new MFI's ownership structure should be clearly outlined in the business plan. Depending on the level of commitment of the investors, this section may include a more general discussion of the preferred investor types, or may actually detail backgrounds and investing philosophies of those specific investors who have made a commitment to the transformed institution. This section should also spell out the institution's vision for the NGO going forward (if applicable)—specifically, whether it will be a shareholder in the new institution and, if so, whether it will have its own operations or will serve primarily as a trust for its investment. Finally, this section should provide a brief description of the proposed governance structure for the transformed institution including the number of board members and committees.

Market and marketing. Using results from the various market research initiatives, the business plan should lay out the overall market framework and clearly identify where the MFI's target market falls. This includes a brief description of the overall market size; the expanded competition, including each primary competitor's core products and geographic presence; the MFI's market share, both current and potential, given the addition of voluntary savings services; and its plans for geographic expansion. Plans for geographic expansion should include the organization's branch expansion plans as well as the use of any planned innovative technologies to expand outreach to clients beyond the traditional branch network. (MFIs should be aware that once they are licensed, the opening of any new branches or "mobile banking" arrangements might require approval by the regulatory authorities.)

Products and services. Both the core products and services currently offered by the institution, and new products or services planned for the future, need to be outlined in the business plan, including a general description of each product type and anticipated product expansion plans. Specific outreach targets and a summary of key assumptions underlying these targets should be included.

Human resources. Transformation significantly affects an MFI's staff requirements. The projected outreach for loans and savings will undoubtedly require substantial increases in staffing as well as a probable reorganization of the institutional structure to better support the expanded operating strategy and meet regulatory requirements. The business plan may include the organizational chart, a description of management positions and management committees, as well as anticipated plans for building staff capacity through external training programs or the expansion of in-house training capabilities.

Management information systems (MIS). The transformation process is typically accompanied by a significant upgrade in the MFI's MIS. This includes both a reengineering of basic processes for managing the flow of data and information in the organization, as well as significant investments in the institution's technology infrastructure. A business plan should lay out the new MFI's information technology plans, including anticipated

hardware and software purchases and other MIS purchases.

Funding strategy. Increasing access to a broader source of funding is often one of the primary reasons MFIs pursue transformation. In addition to the infusion of investor capital that accompanies conversion to a share company, transformation generally facilitates access to a wider range of funding sources, including savings, commercial borrowing, and in some cases the ability to approach the capital markets with such mechanisms as private placements. The funding options for a for-profit regulated MFI are thus significantly broader than those for an unregulated NGO. The business plan should identify the amount of funding needed and the various funding sources available. This involves exploring the range of possible debt and equity combinations that will ensure adherence to regulatory requirements for leverage, but also provide adequate liquidity and sufficient returns for the investors. In addition, available alternative funding sources, both current and new, should be considered and incorporated into the business plan. (See chapter 6, The Funding Structure, for more detailed discussion of this topic.)

Projected balance sheets, income statements, and cash flow statements derived from decisions and assumptions made on the above issues are key documents that either accompany or become an integral part of the business plan. The methods, tools, and approaches to generating these statements, referred to as "financial modeling," are discussed in detail below.

Financial Modeling Tools and Methods

Financial projections are an integral part of any business planning exercise. They help managers see the financial implications of their strategic and operational decisions and understand the cause and effect of a range of different variables. Whereas the annual budgeting process uses a fiscal year time horizon and is typically extremely detailed (budget assumptions are usually calculated for each of the major line items to facilitate budget-to-actual analysis throughout the year), the financial projections incorporated in a business plan are by definition long term (five years or more) and thus less detailed. The Chief Financial Officer or finance manager will typically spearhead the development of both—in fact, the annual budget should be developed with the longer-term financial projections in mind. Both the budget and projections will require initial strategic input from other senior management members and operational input from the branches, though in general, long-term financial projections will require more of the first, whereas the annual budget process will require more of the second.

For a transforming MFI, an already challenging exercise can become that much more complicated because of new regulatory and fiscal considerations, the shifting structure of the new entity's proposed capital structure, the need to incorporate a range of untested assumptions about product growth (particularly savings mobilization) and market penetration, the likelihood of significant new liabilities, and numerous unknown variables regarding cost implications for a regulated institution. Compliance with prudential ratios, such as capital adequacy and liquidity, must also be projected.

In general, MFIs large enough and sustainable enough to be considering transformation into regulated deposit-taking institutions are likely to have used a business plan model before. A business plan model is used to project the financial impact of business growth.

Business plan models can also be used to project investor returns, but transforming MFIs may want to consider creating a separate investor model given the range of scenario analyses needed for this exercise. An *investor return tool* is used to project the return implications of various debt and equity combinations, taking into consideration a range of

factors including tax implications, exit strategies, and purchase and sale price. Such a model will need to link to the business plan model, but should allow the user to modify key assumptions about overall funding (debt and equity) parameters. The investor return tool is discussed in more detail in the Investor Considerations section of this chapter. Similarly, most business plan models do not calculate compliance with local regulatory requirements, but the data required to do so can usually be easily extracted into an Excel spreadsheet. The calculation of prudential ratios is detailed in the Benchmarks and Indicators section of this chapter.

Financial Modeling

Given the complexity of the modeling exercise, this section highlights various considerations for the business planner related to developing the projected balance sheet and income statement for the new entity, which indicators to incorporate, and how to address investor needs. For institutions pursuing the one-entity or reorganization approach, one business model may suffice to reflect the transformation process. For institutions pursuing the two or more entities or transfer approach, it is recommended that two separate business models be created—in this approach some or all of the assets and liabilities from the NGO are transferred to the new entity.

Balance Sheet Considerations—Assets

Cash. For institutions pursuing the transfer approach, the opening balance for the cash or bank balances of the new entity will need to include any cash or other bank deposits that will be transferred from the NGO as well as the infusion of fresh investor capital unless immediately invested, in which case it would be placed in "investments" (matched by the relevant debt or equity on the right-hand side of the balance sheet). The business planner will need to determine the amount of funds to be injected and when. MFIs pursuing the reorganization approach will also need to capture any new investor contributions in these accounts.

Investments. All investments that are transferred from the NGO to the new entity need to be captured in the opening balances of the investments (assuming they are transferred as of the date of the launch of the regulated entity). This may include all the NGO's investments, or a portion of them if some are left on the NGO's books. As mentioned, if the investors' capital contributions are initially placed in an investment, that value would be captured here.

Loan portfolio. As a reflection of the MFI's strategic plan, the financial projections should incorporate assumptions about both the expansion of current products and the introduction and growth of new products. The MFI's market research results will be critical here to support the MFI's assumptions regarding the projected number and volume of loans, growth in average loan size, and fee structures (see chapter 4, Marketing and Competitive Positioning, for a discussion on pricing of loan and savings products):

- *Number of products:* If introducing new loan products, the business planner will need to gather the relevant information about product attributes, potential market size, and institutional implications for these products.
- *Average growth in loan size:* As clients grow with the institution and with the introduction of new loan products to serve a wider target market, the average loan size should be closely examined in the modeling exercise.
- *Outreach assumptions:* The business planner will need to carefully consider market potential for each of the loan products. These assumptions should be based on comprehensive market research.

Fixed assets. The projection of fixed assets will be driven by marketing and delivery channel decisions. Transformation will likely require significant investments in infrastructure and information technology that will need to be reflected in the business plan. MFIs should expect to conduct a thorough evaluation of their system capacity as part of the transformation planning process. In addition, any projected new branch openings and the related fixed assets need to be considered. Some of the more significant fixed asset purchases include computer hardware, computer software, communications equipment, electrical assets, safes, as well as upgrading the branches (such as remodeling to accommodate tellers and safes), and overall "face lifting" of branches and the head office. Costs will vary significantly among transforming MFIs depending both on the operating and regulatory requirements to which they need to adhere and the state of the MFI's infrastructure before transformation. (Some of the costs associated with infrastructure may not be capitalized and thus would be recorded as expenses on the Income Statement.)

Balance Sheet Considerations—Liabilities and Equity

A key aspect in financial modeling of a transforming MFI is the structuring of the liabilities and equity side of the balance sheet of the new entity. The initial capitalization of a regulated financial institution is typically determined by three interconnected factors—capital regulatory requirements, the institution's growth plans, and the level of leverage necessary to attract outside investors.

Capital adequacy and leverage. Regulators are interested in seeing solid capital bases, with conservative leverage ratios. Investors, eager to maximize their return on investment, generally like to see more aggressive leverage ratios. Balancing these different interests is crucial in the financial modeling process. Key considerations are outlined in the following discussion:

- *NGO debt and equity (if applicable):* As discussed above, the mechanisms for transferring the assets and liabilities of the NGO to the new regulated entity can vary. For modeling purposes, there are three critical components:
  - How much of the NGO's assets and liabilities will be transferred to the new entity and when will the transfer occur? This transfer can occur in one transaction or can be structured to occur over time. The first option tends to be cleaner, and is certainly easier from a modeling perspective.
  - How will the NGO be compensated? Will the new entity pay for the net assets (assets less liabilities) directly in cash, through debt, or issue shares to the NGO, or a combination?
  - How will the NGO's assets and liabilities be valued? The valuation of the NGO for purposes of determining exact compensation is discussed in chapter 7, Ownership and Governance. For modeling, this is a critical issue because the agreed on value has direct implications for the NGO's stake in the new entity, including consideration of maximum ownership limitations.
- *Tax considerations:* Tax implications also need to be considered if the transfer approach is taken in the modeling of the debt and equity split during the transfer and also for the new entity and its investors. The differences in tax liabilities for interest payments as opposed to dividends can be substantial. These differences can have a significant impact on investor preferences and will affect the financial modeling exercise.
- *Investor return expectations:* The MFI will need to ensure attractive returns for prospective investors; therefore, the business planner will need to experiment with various leverage scenarios that meet the investment hurdles of external

investors while providing sufficient comfort to central bank regulators.

- *Projected growth:* The determination of the appropriate capital structure needs to be considered in light of the MFI's current and projected asset growth. Capital adequacy considerations (discussed in Benchmarks and Indicators, below) will ultimately be a key factor in the institution's ability to finance expected growth.

Deposits. Transforming MFIs will introduce voluntary savings products, many for the first time. MFIs need to be realistic about their growth expectations. While transformation can significantly expand funding resources, an MFI's entry into voluntary savings mobilization may or may not result in an immediate significant effect on the balance sheet. Transforming MFIs tend to overestimate growth in the volume of individual savings accounts, yet underestimate the number of accounts. A realistic estimate of the savings volume is important because it affects the overall debt-to-equity structure of the new entity. In addition, care will need to be taken to ensure that projected savings balances are matched by regulated liquidity levels on the asset side. See discussion of liquidity ratio in Benchmarks and Indicators section.

Commercial debt. Becoming a regulated financial institution often results in the MFI being able to access commercial funding. Some MFIs will have existing loans as well as access to new loans, and others may be borrowing commercially for the first time. For existing loans, the debt agreements between the NGO and any current creditors need to be renegotiated in the transformation process. Options include leaving the debt obligation with the NGO, which then on-lends to the new entity; transferring the debt obligation to the new entity; or using newly injected cash from investors to pay off the debt. An estimation of new borrowings that the new regulated entity will access will need to be made and should be done in parallel with assumptions about the institution's equity base, thus taking into account capital adequacy requirements and investor considerations.

Retained earnings and dividend payments. By definition, a nonprofit NGO is typically required to reinvest all retained earnings back in the institution. A for-profit share company, however, can choose to reinvest all its earnings, or reward its investors with dividend payments, assuming adherence to all regulatory and legal requirements. Assumptions concerning the amount and timing of these dividend payments will need to be incorporated into the projections. Also, as reiterated in the investor return discussion below, withholding tax should be anticipated for dividend payments.

Share capital. Projections will need to accommodate both the starting capital of the institution and any additional capital injections required over time. This will be an iterative process, taking into consideration regulatory requirements, growth plans, and investor leverage targets.

Income Statement Considerations—Revenue

On the revenue side, the business planner will need to incorporate assumptions about interest rates and fee structures for current and any anticipated revenue-generating products, including credit products and others. For example, if money transfer or foreign exchange services are offered, the revenues from these services need to be included. These assumptions should take into consideration the likelihood of an increasingly competitive environment, and thus the potential need to reduce interest rates in the future.

Also, nonfinancial income such as training fees or others needs to be considered and estimated (if applicable). Many transformed MFIs have set up

visitor programs whereby the MFI charges visitors from other countries to learn from their transformation experience. Although this may be hard to estimate at the early stages of transformation, it is something the MFI might consider in the long term.

Income Statement Considerations—Expenses

One of the biggest risks of modeling the future financial performance of a transformed MFI is underestimating the true cost of both the process itself and future operating costs. The costs of transformation can be divided into short-term initial costs and longer-term ongoing costs. See chapter 3, Planning for Transformation, for a detailed discussion of the costs of transformation. A brief summary of these costs is provided here; however, not all will be recorded by the transforming MFI, particularly if a donor is willing to pay some of the expenses directly.

Cost of transformation. Transformation entails significant costs. While the total price tag will depend on the MFI's starting point, estimates for transformation range from U.S.$700,000 to U.S.$1.5 million, with an average around U.S.$1,000,000.[5] Most of these costs will be incurred by the NGO. If subsidized directly by donors, these expenses may not even pass through the NGO's profit and loss statements. Those that do, however, will likely have a significant impact on the NGO's bottom line at the time of transformation, so will be important to reflect in the projections for the NGO.

- *Feasibility study and capacity-building technical assistance:* This is a significant expense. While historically this expense has largely been funded by donor sources (and thus may not typically appear in an institution's profit and loss statement), institutions planning to transform should budget for this line item. These anticipated expenditures should be carefully estimated and either budgeted by the relevant department or in a separate transformation budget. Any anticipated donor funds to cover these costs should be shown as operational grant income (except if grants are being used to cover fixed asset purchases needed for transformation, in which case they would be capitalized, because the fixed asset would be shown as an asset). Note that an MFI unable to source external funding and thus financing many of these costs internally will often be able to amortize transformation costs over time. As such, their "start-up" costs could be passed on to the newly transformed institution and spread out over a period of three to five years.
- *Registration fee or license fee:* Regulated financial institutions often have to pay an initial registration or license fee, as well as annual renewal fees, which in many countries are tied to the number of branches that the bank has. While these are typically not significant costs, they do need to be planned.
- *Legal costs:* Significant legal support is usually needed with an institutional transformation. This includes drafting shareholders' agreements, structuring debt clauses, drafting new by-laws for the regulated entity, and structuring a myriad of asset and liability transfer documentation, if needed. In addition, it is useful to have a legal (and ideally regulatory) expert review the license application.
- *Upgrading of branches and enhancement to MIS:* With the introduction of savings services, MFIs are often forced to upgrade their branches to portray a more professional image to both the central bank and prospective depositors, and enhance their MIS to manage additional products and to meet regulatory requirements. While most of these costs would be capitalized and thus have been discussed under fixed assets above, there will be some costs, such as refinements to reporting systems, annual fees for software licenses, increases in stationery costs, and so forth, that should be projected under expenses.

- *Additional staff training and training materials development:* The transformation process requires a significant investment in staff training. A separate training budget should be developed that includes both external training and an increase in in-house training material development and delivery.

New costs as a regulated institution. Once an institution is regulated, it faces additional costs that did not exist when it was an NGO.

- *Interest costs on debt:* With the introduction of voluntary savings, MFIs will incur interest costs, some for the first time. In addition, as commercial borrowings increase, MFIs' financing costs will increase and need to be projected.
- *Provisioning:* Loan loss provisioning requirements stipulated by the regulator need to be incorporated into future projections, as do realistic assumptions about the institution's portfolio quality going forward. This may increase the loan loss provision expense of the regulated institution relative to the NGO.
- *Audit fees:* As institutions expand operations, audit fees typically increase. Fees are often priced based on number of branches.
- *Competitive salary increases:* As a for-profit entity, the MFI may need to reposition its salary scale to remain competitive and retain key staff. This should include an evaluation of the organization's broader remuneration scheme, including the staff incentive scheme.
- *Other employee costs:* Transformation to a for-profit, regulated company typically requires full compliance with standard benefits in the country, including social security and health insurance. Depending on the status of the MFI's human resources policies and procedures at the time of transformation, additional expenses could be incurred.
- *Additional staff:* The growth ensuing from transformation will require the addition of various staff positions in addition to new senior management or branch staff. These include internal auditors, accountants, information technology support staff, trainers, treasurer, and other support staff. The appropriate timing for the addition of such staff should be linked to relevant factors, such as number of loans, number of savings accounts, and so forth.
- *Additional training:* Usually with new products (voluntary savings, new credit and other products) and with new line functions (treasury management, internal audit, tellers) a significant amount of training needs to take place to develop and refine new skills, usually on an ongoing basis. Often this requires that an in-house training department be established. Costs associated with this must be anticipated and projected.
- *Board fees:* Board members of private, shareholder companies generally require some kind of remuneration for their service, in addition to the direct costs of travel, meals, and lodging. MFIs will need to estimate the number of board meetings anticipated per year and include these costs in their expense projections.[6]
- Costs related to deposit mobilization:
  - Depositors' insurance: Depending on the country and regulatory framework, public savings may or may not be insured. For example, in Pakistan, the Microfinance Ordinance requires that microfinance banks credit 5 percent of their annual after tax profits to a depositors' protection fund.
  - Marketing: As a deposit-mobilizing institution, marketing and branding costs are likely to go up significantly. This may be reflected in the creation of a marketing department, increased production of promotional and advertising materials, and increased transportation costs.
  - Security: Savings mobilization will typically require an increase in security measures at the

branch level. In addition to infrastructural upgrades, necessary expenses may include additional guard shifts and costs associated with additional training needed for guards.

- *Legal fees:* Basic corporate legal fees increase with transformation to a regulated, for-profit entity.
- *Tax implications:* As detailed in the Tax Strategy Considerations section below, transformation to a for-profit company can have significant tax implications for the MFI.

Benchmarks and Indicators

A crucial component of the modeling process will be the identification of critical benchmarks and targets for success.

Financial ratio analysis plays an important role in business planning. Whether included in the actual business plan model or shown separately on a linked spreadsheet, financial ratios are a key output of the modeling process. For a regulated financial intermediary, monitoring these ratios is particularly critical. Failure to operate within certain risk parameters can lead to the suspension of banking activity by the central bank. Important ratios to incorporate into the modeling for the purposes of complying with the regulations of the supervisory body include the following:

- *Liquidity ratio:* For institutions that mobilize savings, most regulatory frameworks require a certain portion of these savings to be held in a very liquid or safe form. Reserves are usually specified to include short-term market-yield government securities purchased from the central bank. These requirements are usually expressed as:
  - reserves as percentage of demand deposits,
  - reserves as percentage of savings and time deposits.

  For example, in Uganda, liquid assets must be a minimum of 15 percent of savings deposits. In Pakistan, microfinance banks must hold at least 10 percent of time and demand deposits in liquid assets.
- *Capital adequacy ratios:* The ratio of total capital to risk-weighted assets needs to be closely tracked in the modeling exercise to ensure that the projected capital base remains sufficient in future years. The calculation of this ratio depends on two critical factors:
  - Risk weighting calculation: The denominator in this ratio is calculated by applying a particular *risk weighting* to each asset category on the balance sheet. Assets with relatively little risk, such as cash, normally carry a risk weighting of zero percent, but those with higher risk, such as an MFI's loan portfolio, will often carry a risk weighting of 100 percent. Each country will have its own approach to risk weighting, depending on local bank risk, historical trends, and relevant collateral options.
  - Minimum capital adequacy ratios: The prescribed minimum percentage is dictated by the central bank and will differ both between countries and the different tiers of capital—tier 1 or primary capital and tier 2 or secondary capital. Key ratios to incorporate into the modeling for management purposes include tier 1 capital to risk-weighted assets, and total capital (including secondary capital) to risk-weighted assets.
- *Operating efficiency:* The ratio of operating costs to average loan portfolio is a key indicator for efficiency. While not usually an enforced prudential ratio, the operating expense ratio is used as a key benchmark by the Bank of Uganda, for example. Institutions that offer savings, however, need to recognize that they will compare unfavorably to those that do not if gross loan portfolio is used as the denominator; therefore, average total assets may be a more appropriate denominator for financial intermediaries when calculating the operating expense ratio.
- *Profitability ratios:* The institution's return on assets (net income to average assets) and return

on equity (net income to average equity) are of particular interest to investors. In addition, investors will be interested in various return calculations, such as the internal rate of return (see the Investor Considerations section below for more explanation).

- *Portfolio quality ratios:* Portfolio at risk greater than 30 days and the loan loss reserve ratio (loan loss reserve as percentage of portfolio) are two indicators that management should track when evaluating the quality of the portfolio.

Additional ratios that should be incorporated into modeling for investor purposes are discussed in the following section.

Investor Considerations

In addition to projecting the operations, the business planner should also be prepared to include projections for prospective investors on the internal rate of return. The traditional return on equity or adjusted return on equity ratios[7] provide management and investors with the *institutional* rate of return on the institution's equity base for that particular year. It does not provide an indication to an investor of what his or her particular return will be, because this will depend on dividend payout ratios, the composition of debt and equity the investor holds in the institution, and the relevant tax rates. While each investor will undoubtedly conduct individual due diligence and generate individual investment return projections, the MFI should be able to present general return projections to potential investors. This analysis goes beyond showing the average return on equity, and incorporates key investor considerations, such as debt/equity split, time and price of exit, discounting, tax, and so forth.

Investor return tool. Given the impact of various debt and equity structures on the return calculation, a separate modeling tool should be developed to provide maximum flexibility in projecting the various options. This tool should link with the financial projections, pulling through key asset and liability categories, including total assets (cash, loan portfolio, and fixed assets), any projected savings, and previously negotiated or relatively secure external debt balances. This gives the user flexibility to input various debt and equity balances, as well as a variety of debt conversion scenarios (assuming some portion of convertible subordinated debt). Likewise, the projected earnings before interest and taxes from the business projections can be pulled through, allowing the user to calculate the impact of a variety of interest rate assumptions, including portfolio yield, savings rates, and commercial debt rates , on the MFI's net income.

Important considerations for calculating a prospective investor's return include the combination of debt and equity, time and prices of exit, applicable taxes, macroeconomic variables, and dividend assumptions.

Combination of debt and equity. As discussed in chapter 7, Ownership and Governance, investors will be looking to maximize their returns, often through a combination of debt and equity. The projections should allow the user to input a variety of different combinations of debt and equity, based on the expected returns, and liquidity needs of both the MFI and investors (see exit strategy below). This should include regular term debt, convertible debt, and equity. The model should allow the user to shift convertible debt from the liability to the equity section as needed.

Time and price of exit. Despite the growth in investment funds, investing in microfinance continues to be a relatively illiquid business. Three key factors investors will be considering are (a) estimated investment horizon, (b) to whom will they be able to sell, and (c) at what price. For purposes of modeling investor return, the first and third issues are critical. Most of the investment funds for MFIs today are limited life funds; that is, they are

required by their investors to divest within a seven- to ten-year horizon. Scenario analyses will therefore need to reflect the minimum time horizon (generally seven years). For purposes of calculating an internal rate of return, it is recommended that a range of sale price values be used (for example, one times book value, or 1.25 times book value).

Tax. Investor return figures should incorporate the relevant tax rates including tax on interest (for any kind of debt instrument), tax on capital gains (for the eventual sale), and withholding tax (the tax the institution will need to withhold and remit to the relevant tax authority on any payment to an external party). Figures should be provided both for international and local shareholders, because tax rates tend to differ between residents and nonresidents in most countries.

Macroeconomic considerations. Currency devaluations can significantly affect the return on investment for local currency debt holders. A variety of scenario analyses should be included showing the impact of various currency fluctuations.

Dividend assumptions. Although it is unusual for start-up companies to pay dividends in their first few years of operations, investors will probably want to see some kind of dividend return after year two or three. Withholding tax should also be anticipated for dividend payments.

See box 5.4 for tips on how to use Microfin, a popular business planning model when making projections for a transforming MFI.

Tax Strategy Considerations

MFIs need to consider potential tax liabilities during the business planning process and incorporate taxes into the transformed institution's obligations in the business plan.[8] Even if an MFI has received a comprehensive tax exemption, this may change with transformation; thus, tax planning and management should play an important role in business and strategic planning processes. Such planning should consider the financial impact if the MFI were to lose any exemptions it may currently enjoy. Furthermore, an exemption from paying tax does not necessarily convey an exemption from complying with tax reporting and filing requirements. MFIs may be required to meet tax reporting and filing requirements even if they owe no tax at all.

A comprehensive tax management strategy is grounded in (a) tax compliance and (b) tax planning. First and foremost, a tax management strategy must be based on a firm understanding of often complex rules for tax filing and payment obligations. Only after an MFI fully comprehends its tax compliance obligations should it begin to develop a plan for legitimately minimizing any taxes due.

Tax Compliance

The importance of tax compliance cannot be overstated. A failure to meet, on a timely basis, requirements for filing, paying, or remitting withheld amounts to local tax authorities can lead to sizeable fines and penalties. For example, in Tanzania, a late filing of a tax return is subject to a 2.5 percent penalty, and a late payment of income tax (more than six months after the accounting period) is subject to a 25 percent penalty. In Uganda, late payments are subject to a penalty of up to 20 percent of the amount of payable tax. Accordingly, an MFI should be aware of both its tax filing and payment obligations, and of its obligations to withhold taxes on payments that it makes to others. The changes in tax position that may come about because of transformation must be closely studied.

The following are basic questions that an MFI should be asking its tax advisors to ensure that it is complying with its tax obligations:

- What tax forms are required to be filed? When are these forms due?

Box 5.4 Microfin Tips

One of the more widely used business plan models for MFIs is Microfin, developed by Chuck Waterfield and Tony Sheldon with initial funding from Women's World Banking and the Consultative Group to Assist the Poor (CGAP). This model is a sophisticated Excel spreadsheet that has been designed to assist MFIs to develop detailed financial projections, including projected balance sheets, income statements, and cash flow statements after capturing a wide range of assumptions related to products and services, staffing, branch openings, funding sources, and so forth. It can be downloaded for free from http://www.microfin.com. The following provides some tips to Microfin users when modeling the transformation process.

Microfin Tip #1: Create Two Models If Using the Transfer Approach

It is recommended that the user create two separate models to model the transformation process. The first models the NGO. The second picks up the closing balances of the NGO model as the opening balances for the new regulated entity. Note that Microfin 4.0 has a feature to automate the shift in portfolio from one model to another.

Microfin Tip #2: Loan Modeling

Microfin versions through 3.5 allow the user to model only four term loan products. Version 4.0 and above, however, permit 10 term loan products and also support two lines-of-credit products.

Microfin Tip #3: Determining NGO Stake

Assuming the NGO sells its net assets to the new entity and receives a combination of debt and equity in return, the user can create NGO debt and equity line items in the FinFlows sheet.

1. Create NGO debt line item on the FinFlows sheet.
2. Create NGO equity line item on the FinFlows sheet.
3. Set value of NGO equity equal to appropriate amount.
4. Set value of NGO debt equal to equity of NGO in closing balance from NGO model, less portion of equity, less any discount.

Microfin Tip #4: Savings Modeling

In addition to support for compulsory savings, Microfin 3.5 allows the user to model four savings products. Microfin 4.0 increases this to five savings products and provides a redesigned, more versatile method of projecting savings activity.

Microfin Tip #5: Financing

When projecting future financing in Microfin 3.5 or 4.0, you can enable the "automated default financing sources" on FinFlow and choose a blend of debt and equity financing with trigger levels to bring in new equity when leverage levels get too high or capital drops below minimum capital requirements.

Microfin Tip #6: Financial Ratios

Versions 3.0–3.5 of Microfin include some of the key ratios used by management. It is recommended, however, that the user replicate the projected financial statements onto the user-defined sheet and generate the full range of ratios required by regulators. Note that Microfin 4.0 includes additional ratios that are useful for commercial bank transformations, particularly a number of liquidity and reserve ratios.

Microfin Tip #7: Time Frame

Microfin only models for a five year period, because projections beyond five years are rarely particularly useful. For purposes of calculating basic investor return rates, however, it is recommended that the analyst extend the institution's projections out by a couple of years, using conservative growth rates. These extended projections can be modeled on the user defined sheet. An alternative is to link two Microfin models by having the year five figures from the first model feed into the initial balances of the second model.

Source: Author.

- If taxes are owed, when are payments due?
- What are the penalties for missing a filing or payment deadline?
- What recordkeeping is required?

In some jurisdictions the change in corporate status undertaken to affect a legal transformation may change the answers to some of the above questions. Thus, as part of an MFI's legal transformation, it is important to have competent tax counsel advising the transforming MFI on tax compliance issues, as well as more forward-looking, tax planning issues.

Tax Planning

Tax planning is the second leg of a comprehensive tax management strategy. Tax planning, however, is appropriate only when undertaken in a manner that does not compromise the MFI's tax compliance requirements. That said, the earlier tax planning is begun the better, because tax planning considerations can inform many business decisions undertaken by an MFI during the transformation process. (See, for example, the discussion in chapter 6, The Funding Structure, regarding the difference in tax treatment of dividends and interest in determining whether to issue stock or debt to raise capital.)

Key to tax planning is a basic understanding of how taxable net income is calculated and if this will change with the change of legal form (if applicable) or as a result of becoming regulated. This includes understanding what income is subject to tax, what types of expenses are deductible from gross revenues for purposes of calculating net income, and how long tax losses can be carried forward.

A first challenge facing any transforming MFI is to determine what types of taxes it will be subject to. This is not always a straightforward determination. As discussed earlier in this chapter, the decision to either reorganize the NGO as a share company or create a new company and transfer the assets and liabilities is heavily influenced by the tax implications of one approach over another. In many countries, an asset transfer is likely to trigger a number of "transaction" taxes related to the transfer of assets from the original company to the new company. (See box 5.5.) While such taxes can sometimes be waived, a transforming MFI will need to thoroughly investigate the implications of the different options.

Box 5.5 Reorganize or Transfer: Two Unique Approaches in Uganda

As in most countries, the sale of assets from one company to another creates a potential tax liability in Uganda. Even if no profit is made on the sale of the assets, the fact that the seller (the NGO) has been exempt from paying income tax on the profits generated from these assets over the years can raise a number of tax issues for revenue authorities. In FINCA Uganda's case, the decision to reorganize as opposed to creating a new legal entity avoided the potential for this *asset transfer tax*. The NGO simply reorganized itself from a company limited by guarantee to a company limited by shares, thus avoiding any transfer of assets from one company to another. In Uganda Microfinance Union's case, however, the interest in having two separate companies, the NGO and the new regulated entity, required the institution to create a new company. This decision was also based on legal advice provided to UMU that outlined options for seeking an exemption from the asset transfer tax, including the argument that the sale of assets is occasioned by a change in legislation, with which the NGO is trying to comply, and that there is no new benefit to the organization. UMU ultimately received a tax exemption from the Uganda Revenue Authority on this basis.

Source: Author.

Different types of taxes may be triggered at different points in an MFI's life cycle depending on the MFI and the tax exemptions available to it. Most MFIs are subject to one or more of the following types of taxes: employer payroll taxes (such as social security funds, or tax liabilities of their employee but collected and remitted by the employer on behalf of its employees), value added taxes for services received or taxable supplies consumed, stamp taxes, capital or net worth taxes, transfer taxes, and other national or local taxes.

Taxes on income. In some jurisdictions, taxes are imposed on the net income or profits of all MFIs, irrespective of the designation of the MFI as a charitable organization or the use to which such net income is put (for example, reinvested in the business of the MFI, rather than paid out as dividends to shareholders). In other jurisdictions, a form over substance approach is taken by tax authorities such that the legal form an MFI takes will determine its tax status.

As part of the planning process, an MFI should determine whether it will likely qualify for exemptions from any of these taxes. As a general rule, the chances of qualifying for an exemption from an income or profits tax tend to diminish as the MFI becomes more overtly commercial in its ownership structure, operations, and activities. However, if an exemption appears likely, it is important to determine the extent of the exemption and the process by which to apply for it.[9]

Deductible expenses. In planning, the MFI needs to determine what types of expenses can be deducted from income for purposes of calculating its net income. This analysis normally depends on the sources of the income and may change with regulation. Therefore, as a general rule, expenses that are incurred wholly and exclusively in the production of income should be deductible when calculating net income. For example, because interest payments made on microfinance loans are a source of income to the MFI, expenses incurred directly in connection with generating those loans typically would be allowed as a deductible business expense.

However, the rules for what constitutes an allowable deduction vary from jurisdiction to jurisdiction and will likely depend on the type of financial institution license the MFI receives. For example, depreciation schedules may or may not change with regulation but they will certainly affect the amount of deductible expense allowed by the tax authorities. Furthermore, in most jurisdictions, the onus of proving that an expense is an allowable deduction is on the taxpayer. Accordingly, tax counsel should be consulted in determining the deductibility of expenses for the regulated company. To ensure that tax authorities permit a deduction, it is also important to maintain appropriate records to support the requested deduction. This requires the development of back-office operations that maintain accurate and transparent records that will be acceptable to local tax authorities.

Another deductible expense that formal, commercial financial institutions typically are permitted to take by tax authorities is for specific provisions made for "bad or doubtful debts." The timing of when such a deduction can be taken may differ depending on the type of financial institution license the MFI has. In some jurisdictions, tax authorities will defer to bank regulatory rules regarding the timing of making provisions for bad or doubtful debts. In other jurisdictions, however, tax authorities apply a different set of rules than those applied by bank regulators. This means that the regulated financial institution may need to keep two sets of records regarding its loans—one for bank regulatory purposes and one for tax regulatory purposes.

Losses carried forward. Another forward-looking tax planning issue relates to the extent to which losses of an MFI may be carried forward to future years. This issue may be of particular relevance to

institutions that incur losses in their first years of operation as transformed institution. A first question for tax planners is whether those losses can be offset against future years when the transformed institution is operating at a profit. A more complex question is whether losses generated by the MFI before transformation can be carried forward to offset the future profits of the regulated entity. In some jurisdictions, the answer to this second question turns, in part, on how significantly the ownership of the transforming MFI has changed since the losses were incurred. Where a new institution separate from the original MFI is incorporated to conduct deposit-taking business, it may be difficult to make the case that losses incurred by the original MFI should be carried forward to the new, deposit-taking entity.

Annex 5B provides a summary checklist of the major aspects of strategic and business planning covered in this chapter.

Annex 5A Sample Terms of Reference: Development of the Business Plan

Background

Background on the organization including its mission, target market, client outreach, portfolio size, and so forth.

Objective

The focus of this assignment is to work with MFI A to (1) identify the future strategic goals for the organization, including its vision and mission as a regulated deposit-taking institution; (2) outline the operational processes required to operate as a regulated MFI; and (3) project the future financial goals as a regulated MFI using a financial projection tool. The primary output will be to develop a draft long-term business plan with MFI A. This plan will outline the core strategic thrusts of the organization for the next three to five years as it transforms and becomes a deposit-taking intermediary. With the senior management team and findings from available market research, it will identify future markets for the transformed MFI, identify the appropriate products and services, and set institutional targets for key indicators. The plan will also address the human resources, system, infrastructure, and financial resources needed to achieve these targets. Finally, it will provide projected financial statements for the organization.

Tasks

The business planning assignment will follow a standard business planning approach, one that first addresses strategic planning, then tackles operational planning and financial modeling. The consultant will work together with MFI A senior management in all aspects of this assignment. Knowledge transfer will be a critical aspect of this assignment, particularly concerning the use of the financial projection model. Specific tasks include the following:

1. Prior to arriving in country, gather and review key reference documents including transformation plan, most recent budget, historical financials, market research reports, relevant banking laws, and so forth.
2. Facilitate a one-day strategic planning workshop with core senior management team members. Topics to be addressed will include
   a. MFI A's mission and goals
   b. definition of markets and clients
   c. analysis of competitive positioning and general operating environment
   d. analysis of MFI A's transformation plan and goals including proposed ownership structure and capital structure
   e. a review of plans for transferring assets and or setting up a new company and the process for doing so
   f. development of a strategy to achieve transformation as well as maximize outreach and profitability
3. Conduct interviews with senior management staff to develop key aspects of operational plan:
   a. Products and services
   b. Marketing channels
   c. Resources needed
   d. Financing strategy
4. Meet with MFI A's legal counsel to better understand tax implications of transformation and tax considerations as a for-profit, share company.
5. Working closely with MFI A's Finance Manager, develop or utilize an existing long-term financial projections model that models implications of the operational plan.
6. Use the model to determine how realistic the proposed transformation strategy is and what, if any, additional strategic and operational changes will be needed to transform. Ensure knowledge transfer by thorough training in use of model.

7. Create a projected balance sheet, income statement, cash flow statement, and key ratios for the new organization.
8. Using results of projected financials, develop a separate investor return tool that can be used to model various liability and equity scenarios. The model should be user friendly and allow the user to analyze return implications of different scenarios.
9. Develop a draft strategic business plan.

Deliverables

Long-term business plan in final draft form including financial projections.

Level of Effort

It is expected that the consultant will spend approximately 20 days in country and a total of 30 days to complete this assignment.

Annex 5B Checklist for Strategic and Business Planning

Strategic Planning

- Do you have a new strategy for the regulated entity, distinct from the NGO strategy?
- Have you incorporated a revised vision, mission, and values into the plan?
- Have you ensured maximum stakeholder buy-in to these new values?
- Have you conducted sufficient market research to understand the market, and in particular, the market potential for the goods and services you both offer today and plan to offer in the future?
- Do you have a good feel for your current competitors and any new competitors that may arise with transformation?
- Have you investigated the different options for transferring assets and liabilities?
- Have you developed a strategy for the ownership and governance of the regulated institution?
- Have you thought about and examined existing and potential marketing and delivery channels as a regulated MFI?
- What are the products and services you plan to offer?
- Have you been realistic with your assumptions about additional staffing and infrastructure needs to operate as a deposit-taking institution?
- Have you developed a funding strategy to support the anticipated growth, as well as one that will attract the kind of investors you seek?
- Have you set financial and social benchmarks for measuring success?

Financial Modeling

- Do you have an updated financial projection tool for your current business?
- Have you investigated the different options for transferring assets and liabilities?
- Have you determined the capital structure of the new organization?
- What will be the debt-equity split for your investors?
- How much is the NGO worth?
- Assuming a net asset transfer from the NGO to the new entity, how will the NGO be compensated?
- Have you incorporated all the relevant regulatory ratios into the projections?
- Have you accurately budgeted for the costs of transformation?
- Have you accurately budgeted for the new costs you will incur as a regulated institution?
- Have you developed a model to facilitate investor return analysis?
- Have you considered your investor exit strategies?
- Have you investigated the applicable taxes for resident and nonresident investors?
- What are your assumptions for dividend payouts?

Tax Management

- Prior to transformation, does the MFI pay any taxes?
  - If so, what taxes?
  - If not, why not—available exemptions, charitable (not-for-profit) status, treaty exemption, other?
- Will transformation cause previously exempted or other taxes to apply?
  - If so, what taxes?
  - Will allowable deductions also increase?
- Have you determined the following with respect to income tax:
  - How is this tax calculated—on gross receipts, net income, or some other measure?
  - What is the applicable tax rate?
  - What types of payments likely to be received by the MFI will be included in gross income?

  - If taxed on net income, would the following payments be deductible against gross income for purposes of determining the MFI's net income? (Are there any limitations to the deductibility of such payments?)
    - Regular business expenses (salaries, rent, and so on)
    - Interest payments (to shareholders, to other third-party lenders)
    - Provisions for writing off bad debts or reserving for bad debts (and if provisions are deductible, how must the MFI establish that the bad debt will not be paid?)
    - Other expenses
  - Is it possible for the MFI to apply losses incurred in prior years to offset income in the current year? If so, what limitations apply to the carry forward of losses?
- Have you determined the following with respect to withholding taxes:
  - What types of payments are subject to withholding taxes? What withholding rate applies to each type of payment?
    - Applicable to payments to residents (including employees)?
    - Applicable to cross-border payments?
    - Availability of bilateral tax treaty to reduce or eliminate withholding tax?
  - When and how is an MFI required to remit such withholdings to tax authorities?
- Do you know how the amounts of other taxes—payroll taxes, value added taxes, transfer taxes, capital or property taxes, other—are determined?
- Have you considered the following compliance issues:
  - What tax forms are required to be filed? When is each of these forms due?
  - If taxes are owed, when are tax payments due?
  - What are the penalties for missing a filing or payment deadline?
  - What recordkeeping requirements are imposed by local tax authorities?

Notes

1. These include mission statement and overall goals, market research, ownership and corporate governance, management, financial analysis, business strategy, organizational chart, projected balance sheets, and profit and loss accounts.
2. This does not preclude the MFI from issuing more shares rather than simply selling existing shares to new investors, particularly if additional capital is being provided.
3. MFIs that provide other services in addition to financial services likely need to separate out the financial services before becoming a licensed financial provider. They can create new companies to carry out either the financial services or the nonfinancial services, whichever makes more sense.
4. Sometimes the new company is not actually a new entity, but rather is an existing company that may have been regulated previously as a nonbank financial intermediary but now has few or no assets or liabilities (often called a "shell company"). At least one transforming MFI in Ecuador found it useful to buy such a shell company to benefit from grandfathering of certain regulatory requirements, such as smaller minimum capital requirements, than were likely to be imposed on a new start-up company. In India, a number of MFIs are pursuing acquisition of or merger with a preexisting nonbanking financial company, particularly those that already have obtained permission from the Reserve Bank of India to accept public deposits. This path is pursued with the belief that the acquisition or merger can be implemented much faster than obtaining a fresh Non-Banking Financial Company registration from the Reserve Bank of India.
5. Estimations drawn from various discussions with a range of MFIs.
6. A recent study by the Council of Microfinance Equity Funds (2005) reported that only 7 of the 21 MFI respondents reported policies in place to remunerate directors for their board service. A number of institutions, however, did report that they reimburse their directors for travel, meals, and lodging expenses. For international social investors, these expenses are, of course, significant and generally exceed the amount of remuneration reporting institutions pay to their directors. A number of investment funds, however, will cover their own direct costs; a few of them have separate technical assistance grant facilities to cover certain direct costs of the MFI.

7. Adjusted return on equity is calculated by incorporating the effects of subsidies, inflation, loan loss provisioning, and other items in an MFI's net operating income.
8. This section was contributed by Deborah Burand.
9. An MFI might look to several sources for applicable tax exemptions. The local tax code is one. If an MFI is a current grant recipient from a foreign donor country, another source of tax exemptions can be the bilateral agreement or treaty that governs generally the donor-recipient relationship between the donor country and the recipient country. While the plain language of many of these treaties appears to offer substantial tax havens to MFIs, the scope and duration of tax exemptions enjoyed under these treaties often are subject to local tax authorities' interpretations of their treaty obligations. Moreover, once the grant period ends so too does any exemption enjoyed under the treaty. (In some jurisdictions this has caused MFIs to ask bilateral donors for "no-cost" extensions of their grants to prolong their tax-exempt status.)

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Chapter 6

The Funding Structure

One of the key outcomes of the business planning process is an estimate of the funding required for the regulated institution to achieve its operating and outreach goals as a transformed microfinance institution (MFI). Accessing and structuring this funding is often a new challenge for transforming MFIs. Because the traditional microfinance nongovernmental organization (NGO) or project normally starts with some form of grant capitalization, such organizations tend to focus in their initial years on the asset side of their balance sheets—building up the loan portfolio, procuring the necessary fixed assets to support operations, and maintaining an adequate supply of liquid cash. In contrast, the MFI's liabilities are normally relatively small and underdeveloped. For microfinance NGOs that have achieved a level of sustainability, retained earnings may provide some funding, but for the most part, donor funds provided as grant capital are likely to have been the most prevalent funding source.

As the microfinance industry has matured, some microfinance NGOs have been able to increase their liabilities by borrowing from donors, social funds, commercial banks, and other sources, either on commercial or noncommercial terms. Some of this debt has been provided by local banks, possibly with credit enhancements such as guarantee mechanisms, and some has been provided by international lenders or international funds capitalized by donors. To date, most international lenders issue loans denominated in foreign rather than local currency, a condition that raises foreign exchange risk to a level many MFIs are unprepared to face.[1]

The amount of debt that microfinance NGOs can access rarely exceeds one or two times their equity base. This can prove to be a significant constraint on an MFI's ability to rapidly scale up operations and widen its client base, because growth is ultimately limited by the ability to fund an increase in assets. Without access to capital markets, NGO MFIs must often rely on donor funding to sustain their growth. Relying on donor funds for capital accumulation places the MFI at the mercy of onerous bureaucratic hurdles as well as changes in political priorities. Funding loan capital needs with retained earnings, although helpful, is a slow road to growth. And the amount of local and international debt available to fund the loan capital needs of microfinance NGOs has not yet reached a scale that can significantly fuel the growth of many microfinance NGOs. Accordingly, it is no surprise that the results from a recent CGAP/MIX survey of 140 MFIs indicated that MFIs generally perceive

the lack of funds as the greatest constraint to growth (CGAP/MIX 2004). As a regulated institution, the range of funding options available widens substantially. This potential increased access to capital often initiates the desire of a microfinance NGO to consider transformation.

As regulated financial institutions, MFIs are subject to ongoing supervision by a regulatory authority, providing depositors, commercial investors, and other banks a greater sense of security. As such, the MFI has the potential to *leverage* its equity by a range of multiples more than it can as an NGO. Leverage occurs when an MFI uses its equity base to access debt from external parties. The amount a financial institution can leverage is determined by capital adequacy standards to which they must adhere as a condition of their license. According to the capital adequacy requirements set under the Basle Convention (the international standard for regulated financial institutions), an institution's capital base or equity as a percentage of its risk-weighted assets should be at least 8 percent. That is, if a financial institution had U.S.$1 million in equity, it could support total assets of at least U.S.$12 million (implying at least U.S.$11 million in debt and other liabilities), depending on the risk classification of its assets. In many countries, however, regulatory bodies impose higher capital adequacy standards for MFIs to compensate for the perceived higher level of risk of microfinance activities. Thus, regulated MFIs cannot leverage their equity base as highly as commercial banks. However, the ability to leverage the equity base at all provides a great advantage for regulated MFIs over unregulated MFIs to fund their portfolio growth and ultimately reach more clients.

The transformation process provides MFIs an opportunity to proactively create a new funding structure that will support their vision for the future. Determining what this structure should look like and the options available (and the pros and cons of these different options), as well as determining the optimal mix of these different options, are all decisions the transforming MFI must make. This chapter begins by outlining the various funding sources available to regulated MFIs, then highlights the factors to consider when developing a funding strategy. The myriad of financial instruments available to MFIs is then examined, with examples provided of how other transformed MFIs have incorporated these instruments into their funding structures. The chapter concludes with a summary of key findings for optimal leverage that emerge from this review of various financing strategies.

Funding Sources

Transformation from an NGO to a regulated deposit-taking intermediary allows MFIs to both diversify and augment their capital funding sources. Capital represents the broad source of funds used by financial institutions, including deposits, borrowings, subordinated debt, bonds, private equity, and retained earnings. The term "equity capital" is a subset of this and refers exclusively to the equity portion of the balance sheet, including share capital, retained earnings, and various reserves. A balance needs to be established between the amount of debt (for example, deposits, commercial bank loans, private placements, and publicly issued bonds) and the amount of equity that form the capital structure of the transforming or transformed MFI.

With transformation (which usually implies the creation of a shareholding company) MFIs gain access to two important new sources of capital—*private equity* and *public deposits.*

As a share company, the equity base is converted from one funded by grants to one composed of share capital, retained earnings, and in some cases subordinated debt. As highlighted above, NGOs are typically limited in their ability to leverage equity. The average leverage ratio (debt to equity) among NGO MFIs that report to the *MicroBanking Bulletin* (MBB)[2] is 2.2:1 compared to 10:1 among banks in the reporting sample (The Mix, 2003 benchmarks).

Table 6.1 Evolution of Funding Sources for Maturing MFIs

Funding sources	Start-up NGO	Self-sufficient NGO	Mature NGO	Newly transformed MFI	Mature transformed MFI
Stages of growth for maturing MFI →					
Deposits from public					
Term deposits				X	X
Demand deposits				X[a]	X[a]
Debt					
Commercial debt			X	X	X
Subsidized debt		X	X	X	
Bond offerings					X
Equity					
Retained earnings		X	X	X	X
Donated equity	X	X	X		
Share capital				X	X

Source: Author.
a. MFIs licensed under legislation specific for microfinance are typically not allowed to offer current accounts, a type of demand deposit that allows the account holder to transact using checks. Such a product is generally only permissible with a commercial bank license.

Not surprisingly, increased leverage correlates with larger portfolio size, which ultimately can enable an MFI to improve its return on equity, thus providing the potential to attract additional equity capital.

Table 6.1 identifies typical funding sources available to an MFI as it matures from a start-up NGO to a newly transformed financial institution to a mature, regulated financial institution. The proportion of commercial debt in relation to subsidized debt generally begins to grow as the MFI's funding needs expand beyond what subsidized funders can support. At this stage, however, MFIs tend to confront limitations in the amount of funding lenders are willing to make available, as their debt in relation to the equity base begins to exceed funders' comfort levels (this usually happens when debt-to-equity ratios reach 1:1 or 2:1).

Funding Considerations

Traditional capital planning states that a company should adopt a capital structure that maximizes the price of its stock. The amount of debt included in a company's capital structure will impact earnings per share and, consequently, the company's stock price. The use of fixed rate instruments (usually debt) to raise additional capital magnifies the potential return on equity (MCRIL 2005). For example, more debt in a capital structure (relative to equity) will eventually push up the price of this debt, as lenders raise their interest rates to respond to the increased risk of lending to a highly leveraged borrower; at the same time, the higher the percentage of debt relative to equity, the greater the leverage, and hence the potential for higher returns on equity.

However, for most transforming MFIs, capital structure planning is about much more than share price maximization. Most MFIs focus on providing financial services to a target group at a lower economic level than traditional clients of commercial banks. As such, these MFIs seek to advance a "double bottom line"—in addition to achieving financial objectives, they are also intent on meeting development or social objectives (CGAP 2004a).

This double bottom line concept is what currently sets most transformed MFIs apart from traditional financial institutions. This raises the obvious question—how does the double bottom line influence the balance between the appropriate amount of debt and equity?

The fundamentals of financial management assume that a value-maximizing firm will establish a target optimal capital structure and then raise new capital in a manner that will keep the actual capital structure on target over time (Brigham and Houston 1998). For an MFI seeking to maximize its double bottom line, this target capital structure will depend on a range of variables, all of which need to be considered in the transformation process. These variables can be grouped into four main categories:

- Institutional ideology
- Business model
- Investor considerations
- Regulatory and fiscal environment

Each of these factors needs to be examined in depth in any strategic planning exercise.

The range of capital models used by transforming MFIs is almost as broad as the number of institutions that have transformed. This section, therefore, does not provide a recipe for the optimal capital structure, but instead lays out key factors to consider.

Institutional Ideology

The appropriate capital structure for a transformed MFI is ultimately a reflection of the MFI's institutional ideology. The relationship of debt to equity, the type of debt sourced, the characteristics of the types of investors that are invited to the table, are all influenced by the ideology of the MFI. As discussed in more detail in chapter 9, Human Resources Management, ideology combines an organization's core values (the guiding principals of the organization) and core purpose (the organization's reason for being) (Collins and Porras 2000). It represents the envisioned future of the organization and, as such, needs to be clearly communicated to and understood by both current as well as prospective stakeholders. In concrete terms, and as discussed in chapter 3, Planning for Transformation, the MFI management and board need to be clear about the vision and mission for the organization before they attempt to attract outsiders to share in that vision.

Not surprisingly, many investors in microfinance share the goal of achieving a double bottom line. Microfinance investment funds (debt and equity) are gradually moving toward greater commercialization, but very few are purely commercially oriented.[3] Each investor, however, will have his or her own interpretation of this double bottom line concept, the clarification of which is the first step in investor negotiations. (See chapter 7, Ownership and Governance, for a more thorough discussion of investors and return objectives.)

The choice between local and international investors, for example, is a key strategic decision that ultimately plays an important role in the institution's overall funding strategy. This discussion may be moot if local law does not permit foreign ownership of financial institutions. However, where local law is silent on this question, it is important to ask whether local ownership is an important goal for the key stakeholders of the institution. If so, how much, if any, foreign ownership is acceptable? Although local investors can provide important connections to additional sources of local financing, they may have limited resources (relative to international investment funds). International investors may bring sizable resources, both financial and in the form of expertise, but they may also be looking for returns that justify the perceived country risk. What is the right mix? To answer this question, the pros and cons of different types of investors need to be viewed through the lens of the institution's own ideological framework.

Two additional considerations that affect capital structure planning are (a) the level of institutional priority given to savings mobilization, and (b) management's appetite for risk. For some transformed institutions, the introduction of savings products and the importance given to their mobilization are seen as intrinsic to the overall mission of the organization, and a core reason for transformation. These institutions often develop savings products that are intended to be used by the institution's target customer base—generally low-income clients. For others, savings is seen more as one funding source among many. These differing perspectives will influence the proportion of additional external borrowings (excluding savings) that will be mobilized. Likewise, although regulatory requirements will determine the maximum degree of leverage a financial institution can take on, an MFI's management and board members will still need to make decisions about the ideal amount of leverage based on the risk-return trade-off for various types of liability options. This will ultimately influence the level of volatility and thus the types of liabilities considered acceptable for the MFI's longer-term funding strategy.

Business Model

The MFI's business model is another determining factor in capital structure planning. The types of financial products the institution plans to offer in the medium to long term—both assets and liabilities—need to be considered. On the asset side, the range of loan sizes and terms anticipated in the future is an important consideration. As mentioned, the launch of voluntary savings often expands the types of clients being served by the MFI and the products and services demanded by these clients. With transformation, the popular short-term—four to six months—working capital loan is often supplemented by longer-term individual loans, such as for home improvement, home purchase, or more open-ended lines of credit.[4] These products need a more flexible range of funding sources, ideally longer term and lower cost.

The funding strategy for a deposit-taking financial intermediary, however, involves more than just matching terms of assets and liabilities. Liability management itself becomes a key component of an institution's funding strategy. Clearly, savings product design (whether savings will be offered, what kind of savings products will be offered, average account size, interest rates, term, growth potential, and so on) will factor into any funding projections. In addition, the type and availability of various forms of funding expand with transformation, allowing for a more discriminating approach to funding decisions. Each funding source will need to be evaluated from the perspectives of amount, term, interest rate, currency, and time and collateral or other credit enhancements required to access it. As such, any funding strategy analysis will need to evaluate implications for interest rate risk, foreign currency risk, and asset-liability term mismatch. (See chapter 10, Financial Management, for a more detailed discussion of key financial risks and funding gap management.)

Investor Considerations

The capital structure of a regulated MFI is affected by various issues related to investor demands and preferences, including ownership requirements, return expectations, and exit strategies.

Investor ownership requirements. Individual investor requirements (or regulatory restrictions) for minimum or maximum ownership stakes as well as the ownership role of the NGO (if applicable) affect the capital structure of the regulated institution. For international investment funds in particular, the costs involved in making an investment, including both up-front costs of carrying out due diligence and ongoing costs of managing the investment, are not insignificant. Thus, most funds will

have minimum amounts of investment both in terms of currency amounts and percentage amounts they are willing to consider. This can range from U.S.$500,000 to U.S.$1 million for some of the smaller social investment funds to several millions of dollars for the larger funds. The relative size of the investment will also be shaped by the role the investor anticipates playing in the new organization. Many of the current social investment funds prefer to hold a minority stake, but require a board seat as a condition to investing.

As discussed in chapter 5, Strategic and Business Planning, if the transforming NGO creates a new company that becomes the regulated financial institution, it transfers all or a portion of its assets and liabilities to this company in return for some combination of debt and equity in the new institution. The NGO becomes a shareholder of, and more often than not, also a lender to the new institution. The value of the net assets (assets less liabilities) of the NGO at transformation and the percentage of the NGO's ultimate ownership stake in the new institution are thus two important factors that need to be incorporated into the capital structure plans. In addition, the nature and focus of the NGO going forward (that is, does it continue with financial operations? does it continue with other nonfinancial operations? does it remain solely a trust?) have critical implications for the structure of the debt or equity arrangements and therefore for other investors. A going concern, for example, will likely want access to a steady stream of income, and thus prefer a certain amount of debt with reliable, fixed interest payments. A nonoperating trust, on the other hand, may be less concerned with realizing short-term income and more interested in longer-term capital appreciation, thus preferring to hold more of its investment in share capital. The future role of the NGO thus needs to be clarified early on in the transformation planning process because this and investor ownership requirements ultimately influence the overall capital structure of the institution.

Investor return hurdles. Different investors will have different return expectations that will need to be clarified up front. The specific return demanded by each investor will vary, based on how much risk can be tolerated and the time horizon of the investment. As discussed in more detail in chapter 7, Ownership and Governance, many microfinance investment managers expect to see returns on equity of 20–25 percent in their portfolio, which after devaluation and operating costs, will generate internal rates of return of around 12–15 percent. Scenario analysis exercises that facilitate testing the return implications of a range of different debt-equity combinations are important to the planning process (box 6.1).

Investor exit requirements. Different investors will likewise have different expectations regarding the term of their investments. Some funds are limited life funds, implying that the fund will in 7 to 10 years have to sell its shares in various investments to refund either the initial investor group or make new investments. Others may not have a mandated time frame to exit, but will likely have expectations about the preferred length of their investment. Each investor's investment horizon needs to be understood up front and incorporated into capital structure planning decisions. In some cases this will require a legal analysis to determine if the transformed MFI is allowed to buy back its shares from exiting investors. Some regulators prohibit such buybacks, thereby putting the burden of such a possible exit on the other shareholders of the institution or forcing the institution to bring in new shareholders. (See chapter 7, Ownership and Governance, for a more detailed discussion of exit strategy.)

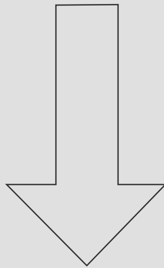
Regulatory and Fiscal Environment

A host of legal and regulatory issues can shape the form (debt or equity) and amount of financial sources that an MFI seeks to attract. These include

Box 6.1 Risk vs. Return

The type of financial instrument is directly related to the level of risk involved. This can be seen in the order of payments made to creditors and investors in the event of the bankruptcy of the company. If the company is wound up (liquidated), the proceeds from the bankrupt estate are used to pay its obligations. Those at the front of the line have the best chance of being repaid, while those at the end of the line (the common equity holders) may receive little or nothing. The figure below shows a typical order of payment priority.

Less risky, lower return



More risky, higher return

Compulsory savings
Voluntary savings up to protected amounts
Liquidator's expenses
Wages and salaries due
Secured lenders
Voluntary savings in excess of protected amounts
Unsecured lenders in order of seniority
Preferred shareholders
Common shareholders

Source: Adapted from the Ugandan MDI Act, Section 73, part 2.

tax considerations, the regulatory framework, and the level of development of capital markets.

Tax considerations. Tax law considerations can influence the optimal capital structure of a transforming or transformed MFI, particularly if the MFI is subject to profits (income) tax. Differing tax treatment applied to payments of dividends as opposed to payments of interest may influence an MFI's determination of whether to issue stock (equity) or source debt to raise capital. For example, in most countries, for purposes of calculating net income (gross revenues less deductible expenses), payment of dividends to shareholders is not a deductible expense. In contrast, the payment of interest to lenders is normally deductible. Hence, an MFI may find important tax advantages by funding a significant amount of its capital needs with debt rather than equity.[5] Note, however, the MFI must also consider the relevant tax policies applicable to the investor—investors will also want to minimize their own tax liability and maximize their return. Withholding taxes on dividend income, for example, may or may not be the same as the taxes on interest income.

Table 6.2 shows how it can be tax advantageous to an MFI to fund some of its required capital with debt rather than equity. It assumes, rather simplistically, that three MFIs have the same gross income and deductible operating expenses, and that the shareholders of all three MFIs expect an annual return of 25 units. (This example does not address the implications for the investor of different tax treatments for dividend income and interest income.) MFI A shareholders provided equity only and receive a dividend of 25 units. MFI B shareholders provided a mix of equity and debt and receive 10 units of interest and 15 units of dividends.

Table 6.2 Tax Implications of Equity and Debt Financing

	MFI A	MFI B	MFI C
Gross income	150	150	150
Deductible expenses			
operating expenses	(30)	(30)	(30)
interest payments on shareholder loan	0	(10)	(20)
Net income—before profit taxes	120	110	100
Profit taxes (assume 30% of net income)	(36)	(33)	(30)
Net income after profit taxes	84	77	70
Dividend payment to shareholders	(25)	(15)	(5)
Retained earnings	**59**	**62**	**65**

MFI C is much more highly leveraged than either MFI A or B. It pays 20 units of interest on its shareholder loan and only 5 units of dividends. MFI C ends up with more retained earnings although its shareholders received the same amount (25 units) as the shareholders of MFIs A and B.

Furthermore, as noted in chapter 5, Strategic and Business Planning, if an MFI seeks to access sources of commercial capital outside its country of operation, it needs to consider whether its home country has any bilateral income tax treaties in place that would reduce the rate of withholding taxes that would otherwise be imposed on the cross-border payments that it will make to its equity and debt holders.

Regulatory framework. The type of license (bank, nonbank financial institution) the regulated financial institution has is an important determinant in capital structure planning. Meeting minimum capital requirements (the minimum amount of equity needed to start a financial institution) and capital adequacy requirements (the amount of equity needed relative to assets), are fundamental to the funding strategy planning process. Moreover, the type of capital (core capital and total capital) required to meet capital adequacy requirements differs depending on the type of license the financial institution holds. (core capital, or tier 1 capital, refers to paid-up share capital and certain disclosed reserves. Total capital refers to core capital plus secondary, or tier 2, capital including loan loss provisions, hybrid capital instruments,[6] subordinated debt, and other undisclosed reserves. See chapter 10, Financial Management, for a more detailed description of regulatory capital.

In Uganda, for example, the prescribed minimum capital requirement is approximately U.S.$270,000 (500 million Uganda shillings) for Microfinance Deposit-Taking Institutions (MDIs). This is substantially lower than commercial banks in Uganda, which are required to have U.S.$2.2 million (4 billion Uganda shillings) as minimum capital, and nonbank financial institutions, which are required to have U.S.$550,000 (1 billion Uganda shillings).[7] Capital adequacy requirements, however, are higher for MDIs, requiring core capital of not less than 15 percent and total capital of not less than 20 percent of risk-weighted assets. For commercial banks and nonbank financial institutions, core capital of not less than 8 percent and total capital of not less than 12 percent are required.

Although minimum capital requirements certainly provide a starting point for estimating capital requirements, the anticipated growth projections, combined with leverage limits (embodied in capital adequacy regulations) will ultimately determine the amount of equity needed over time. In Uganda,

where the stronger MFIs have asset bases in excess of U.S.$5 million, the prescribed minimum capital adequacy ratio of 20 percent for MDIs will undoubtedly require equity bases significantly higher than the prescribed minimum capital requirement of approximately U.S.$270,000. An MDI with U.S.$5 million in risk-weighted assets,[8] for example, would need a minimum of U.S.$1 million in total capital or U.S.$0.75 million in core capital to be in compliance.

The types of savings products permissible under the particular regulatory framework selected will also affect capital structure planning. In many countries, regulated MFIs are permitted to offer time and nonchecking demand deposits but not current accounts. In Uganda, MDIs are prohibited from on-lending compulsory savings that are taken as a collateral substitute. In Bolivia, the Fondos Financieros Privados (FFPs or private financial funds) likewise cannot directly offer current accounts or foreign exchange services. These limitations typically translate to lower minimum capital requirements than for commercial banks, and ultimately affect the range of funding options available to an MFI. The inability to offer a client the full complement of financial services can negatively affect the institution's ability to capture a certain market segment. Small or medium businesses seeking savings and checking facilities in one institution will be difficult to attract. In addition, in countries such as Uganda where the prescribed minimum capital adequacy ratio for MDIs is almost twice that for commercial banks, the need for a greater proportion of higher-priced equity in the institution's funding structure will also affect the institution's overall pricing strategy, and in particular its ability to offer competitive interest rates on savings accounts.

Maturity of capital markets. In some countries, capital markets are simply too underdeveloped or too shallow to support more sophisticated financial instruments normally used to match risk with return. This is particularly evident in the limited sources of medium and long-term financing found in many developing countries. República Bolivariana de Venezuela and Zimbabwe, for example, have interest rates so high it is impossible to find medium-term financing, much less long-term (Lopez 2005). In other markets, the investment appetite has yet to be developed, a key factor in understanding the risks involved in liquidating an investment opportunity. In such markets, which typically lack an active public stock exchange and have very few viable investors looking for investment opportunities, the exit strategy for a microfinance investment is problematic. Although various clauses can be included in shareholders' agreements to provide viable exit options for an investor, the risk of not being able to redeem an investment is a genuine issue in many countries.

Funding Structure Options

With a target capital structure in mind, an MFI will need to develop a financing strategy that considers the range of funding options available including deposits, commercial borrowing, and equity as it develops financial projections and begins to negotiate with external funders. As depicted in Table 6.3, funding structures for transformed MFIs tend to evolve quite significantly, especially in the first few years of operating as a regulated financial institution.

This section examines the range of funding options available to transforming MFIs. While different regulatory environments will permit different instruments, this section is meant to provide MFI managers and board members with an understanding of how these instruments compare with each other. Transforming MFIs may wish to engage external advisers to help examine the funding options available and determine the ideal funding structure. Annex 6A, Sample Terms of Reference: Funding Structure, provides a sample terms of reference for a consultancy to assist in developing a funding structure for a transforming MFI.

Table 6.3 Evolution of Funding Structures
(percent)

	XacBank (2000)		Banco Los Andes (1995)[a]		Mibanco (1998)	
	2002	2004	1999	2004	1999	2004
Demand deposits	32	15	3	7	0	12
Term deposits	22	35	24	43	18	43
Loans from financial institutions	18	33	54	32	28	11
Other liabilities	2	2	8	7	5	11
Equity	26	15	11	11	49	24

Sources: Superintendency of Banks and Financial Entities of Bolivia (http://www.sbef.gov.bo); Superintendency of Banks and Insurance Companies of Peru (www.sbs.gob.pe); ACCION International network affiliate database, December 31, 2004, quarterly report information; Munhmandah.O, XacBank.

Note: Years in parentheses are dates of transformation.

a. Reflects date of transformation to FFP. The institution underwent a second transformation in 2005 when it received its commercial bank license. The bank is now known as Banco Los Andes ProCredit.

General Note on Cost of Capital

The cost of capital, used here to refer to all funding sources, is determined by a variety of factors, including interest rates, tax rates, the administrative costs of sourcing the funds (particularly relevant for savings), regulatory restrictions, capital structure policy, dividend policy, and investment policy.

Although the interest rates set on externally accessed debt and the overall tax rates in the country are typically beyond the control of an MFI, most of these factors are influenced by the institution's own operating, financing, and investment policies, thus underscoring the importance of more proactive funding strategy planning. Although a full costing exercise is beyond the scope of this chapter, experience has shown that transformation initially results in a general increase in the cost of liabilities for the institution as the MFI shifts away from subsidized loans to more commercial debt, followed by an overall decrease once the institution has developed a proven track record and is able to begin tapping public deposits. Table 6.4 highlights the downward trend in financial costs evidenced by some of the more mature Bolivian transformed MFIs (those with at least five years experience as regulated institutions). It is important to note,

Table 6.4 Cost of Funds
(financial costs as percentage of average balance of savings and debt)

Bolivian MFIs	Transformation date	1999	2000	2001	2002	2003	2004
BancoSol	1992	9	9	7	5	5	5
Banco Los Andes	1995[a]	10	10	9	6	5	5
FFP FIE	1998	10	11	9	7	6	5
FFP PRODEM	1999	n.a.	n.a.	8	7	5	5

Source: Web page of Superintendency of Banks and Financial Entities of Bolivia (http://www.sbef.gov.bo).

Note: n.a. = not applicable.

a. Reflects date of Caja Los Andes' transformation to FFP. The institution underwent a second transformation in 2005 when it received its commercial bank license (now Banco Los Andes ProCredit).

however, that these figures do not adjust for the administrative costs of mobilizing savings, estimates of which vary significantly, ranging from as low as 2 percent to as high as 30 percent of total operating costs (de Sousa-Shields and Frankiewicz 2004).

Transforming MFIs also need to consider the cost of equity in their cost of funds analysis. For MFIs accustomed to grant capital, the cost of these funds (in addition to the very real cost of actually seeking, negotiating, and accounting for them) has generally been limited to the cost of inflation. For institutions capitalized by investor share capital, however, the cost of capital is the rate of return paid to the investors, a rate that will be higher than that demanded by depositors and lenders given the higher risk associated with equity versus debt. In general, equity will thus be the most expensive source of funding for a transformed MFI; it will also, however, be the most useful for raising additional sources of funding.

Deposits

With transformation to licensed deposit-taking institutions, regulated MFIs have the potential to offer new services through the addition of savings products. Over the last decade, MFIs have become increasingly aware of the importance of voluntary savings services to meet the needs of poor households. At the same time, the mobilization of voluntary savings offers MFIs access to a relatively stable and inexpensive source of funds denominated in local currency. However, the challenges and costs incurred in carrying out cost-effective savings mobilization strategies that respond to different client needs should not be underestimated. In addition to the challenges inherent in launching any new product, savings mobilization often requires MFIs to invest in infrastructure for marketing, sales, and service of deposit accounts. (See appendix 1, Sequencing the Introduction of Public Savings in Regulated MFIs, for more detailed discussion.)

Savings services are generally offered as either demand deposits (accessible anytime) or time deposits (locked in for a specific period). Time deposits tend to be more sensitive to interest rates than demand deposits, and thus give management a degree of control over the amount of time deposits they mobilize. An increase in interest rates on larger time deposits can mobilize needed resources relatively quickly, though at a price. (At the same time, however, such depositors will be quick to withdraw their funds if the interest rate decreases, assuming other more lucrative options are available.)

The choice of the kinds of savings products a transformed MFI will offer depends on a wide variety of factors, including client preferences, competition, costs, and funding resources, among others. The following provides a brief summary of some of the more popular product offerings:

Demand deposits. Demand deposits (or savings accounts) are fully liquid accounts in which the saver may deposit and withdraw any amount at any time with no advance commitment (although there may be charges for each transaction). The saver must generally maintain a minimum required balance. Examples of demand deposit accounts include:

- *Passbook savings accounts:* Clients receive a record book in which their deposits and withdrawals are entered to keep track of individual transactions. Such account holders can easily deposit money and typically earn some interest income. Most accounts are remunerated at relatively low rates to compensate for the relatively high expense of administering them.
- *Sight deposits:* Such accounts do not require a minimum or maximum amount and withdrawals are typically possible without notice. The account, however, does not pay interest. The transaction may be made using passbooks, debit cards and ATMs, or point-of-sale devices, or a combination.
- *Current accounts:* These accounts are demand deposit accounts that allow the account holder to transact using checks. As noted in table 6.1, the offering of current accounts usually requires a full commercial banking license.

Time deposits. Time deposits are savings products in which a client makes one or more deposits that cannot be withdrawn for a specified period without a penalty. At the end of the term, the client can withdraw the entire amount plus the interest accrued. The financial institution offers a range of possible terms and usually pays a higher interest rate the longer the term, although at some point rates tend to decline as the risk of interest rate changes increases. Because time deposits tend to be larger than other types of deposits, have contracted withdrawal times, and involve fewer transactions, time deposits can provide a significant source of relatively low-cost funds that facilitate asset liability management. This is particularly true if an MFI can attract large and institutional depositors.[9]

- *Certificates of deposit (CDs):* A CD is a debt instrument issued by a bank that locks in interest for a specific period (six months, one year, five years, for example). Such instruments usually carry penalties for early withdrawal. A number of transformed institutions have issued CDs successfully. Most have been issued locally and tend to be bought by local institutional investors. In some cases, however, MFIs have issued CDs internationally as a way to tap into the foreign capital markets. The first well-known example of this strategy was BancoSol in Bolivia, which issued six-month CDs on the U.S. market in 1995. Today, more than 50 percent of BancoSol's liabilities are in CDs.
- *Programmed savings:* Programmed (or contractual) savings plans require clients to deposit a fixed amount on a regular schedule. They usually pay interest, and can be a popular product for families trying to save for a large purchase—a home, school fees, or a special occasion, such as a marriage.

Experience to date has shown that as transformed institutions mature, deposits as a percentage of funding liabilities increases (see box 6.2). As of December 2004, 69 percent of BancoSol's liabilities were in the form of voluntary deposits (demand and term deposits), and 27 percent were borrowings from other financial institutions. (BancoSol is the oldest transformed MFI, and despite having a commercial bank license, BancoSol does not offer checking account facilities.) In addition, ACLEDA Bank in Cambodia, which transformed in 2000 into a bank specialized in microfinance and again in 2004 into a full-fledged commercial bank, was already funding 47 percent of its assets from public deposits at year-end 2004. Although some of ACLEDA's depositors are large companies, the government, and NGOs, the primary users of this service are small savers (Fernando 2004). Last, XacBank in Mongolia, which transformed into a commercial bank and started mobilizing deposits in 2002, was financing approximately 58 percent of its assets through public savings by the end of that same year.

In addition to deposits making up a large percentage of overall liabilities funding, transformed

Box 6.2 Mobilizing Savings from the Public

Mibanco in Peru and BancoSol in Bolivia are two institutions that have implemented successful savings programs. At December 31, 2004, 72 percent of Mibanco's total liabilities were classified as public deposits, representing 71 percent of the total portfolio. Of these public deposits, 19 percent were demand deposits, while the remaining 81 percent were time deposits. Mibanco had 46,170 clients with demand deposit accounts, with an average balance of U.S.$361. At BancoSol, public deposits represented 69 percent of total liabilities at December 31, 2004, of which 19 percent were demand accounts. The bank had 58,622 demand deposit accounts, with an average deposit of U.S.$256.

Sources: ACCION International network affiliate database, December 31, 2004, quarterly report information; Curran 2005.

Table 6.5 Deposits from Public as Percentage of Total Loan Portfolio

Regulated MFI (transformation year)	Country	1999	2000	2001	2002	2003	2004
BancoSol (1992)	Bolivia	68	73	77	79	78	76
Banco Los Andes ProCredit	Bolivia	30	30	41	54	60	63
FFP FIE (1998)	Bolivia	50	53	41	49	50	43
FFP PRODEM (1999)	Bolivia	n.a.	75	78	77	79	71
Banco ProCredit El Salvador	El Salvador	n.a.	50	47	51	53	68
Mibanco (1998)	Peru	26	25	43	46	59	68
K-Rep Bank (2000)	Kenya	n.a.	74	55	69	75	65
ACLEDA Bank (2001, 2004)[c]	Cambodia	n.a.	n.a.	9	21	32	48
CARD Rural Bank (2002)	Philippines	51	60	55	36	45	72

Source: Superintendency of Banks and Financial Entities of Bolivia (http://www.sbef.gov.bo); Superintendency of Banks and Insurance Companies of Peru (www.sbs.gob.pe); ACCION International network affiliate database, years 2000–04 quarterly report information; CARD Rural Bank Annual Reports (1999–2003); the Microfinance Information eXchange (http://www.themix.org).

Note: n.a. = Not applicable.

a. In early 2005, FFP Caja Los Andes was converted into a commercial bank and renamed Banco Los Andes ProCredit.

b. In June 2004, Financiera Calpiá was converted into a full-service bank and renamed Banco ProCredit El Salvador.

c. In December 2003, ACLEDA Bank was issued a full commercial banking license, after operating for over three years as a Specialized Bank.

MFIs increasingly rely on deposit taking to fund their loan portfolios as is evident in table 6.5.

Time deposits versus demand deposits. Although the figures in table 6.5 point to a general trend among regulated institutions toward using public deposits to finance an increasing percentage of their loan portfolios, these deposits have tended to be time deposits captured from institutions or related parties rather than the public at large. Very few transformed institutions have mobilized significant demand deposits to fund their portfolios.

Many transformed MFIs look first to capture time deposits, although some may start by offering various liquid and semiliquid services to their existing borrowing customer base. Others start by trying to offer time deposits to institutions such as local medium to large corporations or donor agencies that might have excess liquidity that needs to be banked. Often, members of the public are hesitant to place their hard-earned savings with a new institution that has yet to prove itself—even though the parent NGO of a newly transformed MFI may have had a solid reputation in the marketplace, the newly regulated institution should not expect this to translate into the public confidence needed for successful savings mobilization. However, this varies depending on the context in which the MFI is operating. If there are no other options, or if the *positioning* process during the transformation is handled exceptionally well, savers may readily come to the new institution. Furthermore, as mentioned above, the particular regulatory framework under which the MFI is licensed may limit the types of deposits the institution can offer, which may limit the uptake of services by the public.

Finally, there are significant cost implications with mobilizing large numbers of small deposits, compared to a smaller number of larger and longer-term deposits. Although a number of transformed institutions have initially been able to mobilize a sizable amount of institutional savings[10] (often referred to as the "Robin Hood" strategy, whereby savings are mobilized from higher-income communities and on-lent to lower-income clients), such depositors tend to be more interest rate sensitive

than smaller, individual microsavers seeking convenience and safety. Mobilizing microsavers tends to take time as well as large investments in marketing and infrastructure to achieve a significant level of outreach.

Deposit services constitute an important part of the complete relationship most regulated financial institutions aim to establish with their clients. Although safety and access are key determinants for most microsavers, as competition increases, MFIs may be forced to offer deposit services at more competitive interest rates.

Commercial Borrowings

Although mobilizing savings may be important in the long run to satisfy both the clients and financial needs of the MFI (such as a more stable and lower-cost source of funds), commercial borrowings can offer expedient access to large volumes of funds. Unlike savings mobilization, which requires investment in infrastructure for marketing, sales, and service, accessing commercial debt in the private and public markets can be initiated without significant operational changes or costs. This assumes, however, relatively strong financial performance of the MFI as well as the existence of available sources of financing to the MFI. Establishing funding relationships with other financial institutions and financial markets is an important aspect of determining the funding structure of a transformed MFI and a crucial aspect of liability management.

This section examines some of the key debt instruments used by transforming and transformed MFIs to tap into a broad range of debt financing.

Pretransformation debt. In the period leading up to transformation, many MFIs purposely seek to borrow from investors who express interest in potentially taking an equity stake in the transformed institution. These "relationship-motivated" borrowings can act as a sort of courtship, allowing both the lender and the borrowing MFI to get to know each other. Sometimes the likelihood of the possible conversion of debt into equity is established up front and spelled out clearly in the loan documentation—such as a convertible debt instrument, whereby the financial terms (for example, conversion ratio or price) and trigger events (conditions precedent to a conversion into equity) for conversion are described in detail. In other cases, the financial terms of the loan are developed to function as a quasi-equity–quasi-debt instrument to permit the lender to engage in a form of profit sharing with the borrower. This, for example, was one of the motivations behind an investment company formed by the International Finance Corporation (IFC) and FINCA International to invest in FINCA's operations in the Kyrgyz Republic. This investment company (now called FMCC) invests in "participations" in FMCC, which, although held on the books of FMCC as debt, allow the investment company to share in the profitability of FMCC's assets in lieu of more conventional interest payments. The return is based on a formula that considers FMCC's return on assets and then allocates to the participations a relative share of that return.

Seeking commercial loans (if possible) in the lead-up to a transformation results in at least two other important, although sometimes overlooked, benefits. First, leveraging the assets of a transforming institution before the actual transformation may significantly improve the return on equity of the transforming institution, thereby attracting a greater number of potential equity investors. Second, borrowing commercially offers managers of a transforming institution the opportunity to begin managing the liability side of the MFI's balance sheet and setting up an asset-liability management function. Managing interest rate risk and liquidity risk are important skills to master before engaging in mobilizing and intermediating deposits from the public. Borrowing commercially offers managers valuable exposure to these issues before public deposits are put at risk. (See chapter 10, Financial Management for more information.)

However, although commercial borrowing before transforming may make enormous practical

sense, such borrowings may complicate the transformation process unless lender-borrower relations are well managed. As a general rule, any medium- to long-term borrowing relationship initiated within 24 to 36 months of the scheduled legal transformation should involve an in-depth discussion of the borrower's transformation plans with the potential lender. Care should be taken to negotiate loan agreements that are flexible enough to accommodate the likely change in legal form (and ownership) as a result of transformation.[11] And at the time of transformation, the MFI will need to seek consent (typically in writing) from each of its existing lenders to the legal transformation and, if applicable, the transfer of the debt.

Choosing private finance or public finance. A preliminary question when developing a funding structure with commercial debt, although not one often asked by borrowing MFIs, is whether to tap private (such as commercial bank loans and private placements) or public markets (such as public bond offerings). In part, this question is rarely asked because the public debt market has generally not been available to MFIs, transformed or not. However, in recent years the industry has witnessed a few of these transactions, such as Mibanco's public offerings in 2002 and 2003. (See annex 6B, Additional Information on Microfinance Bond Offerings, for more information.)

Accordingly, for MFIs considering both private and public markets as possible sources of commercial borrowing, the following general factors should be evaluated:

- Business terms (pricing, tenor, collateral, covenants, grace period)
- Liquidity of debt instrument (extent to which debt instrument can be freely resold to ideally, a broad group of potential buyers)
- Disclosure requirements
- Market visibility
- Debt management opportunities (possibility of restructuring, getting covenant waivers)
- Speed and transaction costs of accessing debt
- Documentation requirements
- Legal liability concerns

All of these factors are interrelated. For example, the more sophisticated the lender or investor, the less disclosure is required. The less disclosure required, the less liquid the asset and, finally, the less liquid the asset, the higher the interest rate. If considered on a continuum, private financing—in particular, commercial bank loans, which require the least amount of disclosure and are among the least liquid of all debt issuances—would be more expensive than public financing.

As highlighted in table 6.6, both markets have their advantages and disadvantages. Transforming

Table 6.6 Advantages and Disadvantages of Private and Public Finance

	Advantages	Disadvantages
Private market	• Faster • Less disclosure than in a public offering • Less legal liability risk • Easier to restructure or get covenant waivers if necessary • More accessible, historically, for MFIs	• More expensive • Contains more restrictive covenants • Offers the MFI less market visibility than a public offering.
Public market	• More liquidity (more easily traded among investors) • Cheaper (price) • Greater market visibility	• Disclosure requirements more onerous • Legal liability risk greater • Can be slower to issue • More difficult to restructure or renegotiate terms

MFIs will need to evaluate their commercial borrowing options in light of these factors.

Term loans and lines of credit. Two of the more common forms of commercial borrowing are basic term loans and lines of credit. Sometimes loans are credit-enhanced, whereby a third party provides some form of guarantee or collateral to make them more accessible.

Generally less common than loans, credit lines can constitute a significant source of financing for MFIs and can also prove to be an important tool for contingency planning should the transformed institution find itself in an unexpected liquidity crunch.[12] Credit lines do not appear as a liability unless they are drawn upon. A variation of a line of credit is the revolving line of credit. Under the terms of a revolving line of credit, the borrower can borrow and repay repeatedly, up to the limit of the revolving line of credit. Banks typically charge a commitment fee for this option, which is applied in lieu of interest to the amount of funds that it has committed but that the borrower has not accessed. A revolving line of credit is particularly useful to MFIs that experience seasonality in their loan capital needs because it allows them to repay unused amounts when they have excess cash but then borrow again when cash requirements increase. In some countries, however, such as Tanzania, revolving lines of credit can be difficult to find because local banks have not developed the technology to manage them.

Loans and lines of credit can come from a myriad of sources,[13] including local foundations, international funds specializing in microfinance, local governments, international financial institutions (such as multilateral agencies or development banks), and commercial banks. Although the characteristics of these types of funders, which in general provide both debt and equity financing, are explored in more detail in chapter 7, Ownership and Governance, a short analysis of the availability, pricing, and term of the types of debt they provide is outlined below.

- *Local foundations:* At the local level, a number of countries have private foundations that have been established, often by donors, to promote the micro or small enterprise sector. Such organizations are usually small and thus do not often provide a significant amount of funding over the long term; however, they can provide access to relatively low cost funds.
- *Local governments:* Government agencies interested in facilitating economic development have also made available loan facilities or guarantees to assist MFIs to access local sources of funds. These facilities encourage banks that might otherwise not see business potential in microfinance to consider wholesaling funds to MFIs. In some cases, guarantees from donor agencies or governments have helped reduce the amount of cash collateral necessary to be pledged by the borrowing MFI.
- *Specialized international funds:* These funds, such as Deutsche Bank Microcredit Development Fund, Dexia Blue Orchard Micro-Credit Fund, Hivos-Triodos Foundation, OikoCredit, Novib, and ResponsAbility, offer loans to MFIs at close to market interest rates. Their risk profiles largely reflect the risk profiles of the investors in the funds, ranging from commercial or private investors (Dexia Micro-Credit Fund) to donors (Deutsche Bank MC Development Fund). Although very few of the funds are fully commercial, most use a commercial approach to investment analysis and monitoring. They tend to take greater risks and accept lower return, however, than investors that purely maximize profit (CGAP 2005).

Loans from these funds are typically made in foreign currency and thus need to be evaluated closely for foreign exchange risk and who ultimately takes this risk. Such foreign currency loans can create adverse foreign exchange positions for the institutions, namely the mismatch of foreign currency liabilities and local currency–denominated assets. Although many specialized laws aimed at deposit-taking MFIs prohibit them

from engaging in foreign exchange transactions, this prohibition does not always apply to borrowing in foreign currency.[14] To mitigate this risk, some borrowing MFIs use the proceeds of these loans as cash collateral to secure local loans or lines of credit denominated in local currency. Although this kind of "back-to-back loan" structure can partially limit the foreign exchange risk that arises when borrowing foreign currency but lending local currency, the MFI effectively pays twice for the funds—once to its international lender and once to its local lender (the interest paid by the local lender on the cash collateral provided by the MFI is often minimal). In addition, the MFI takes on the credit risk of the local bank where the deposit is located as well as the country transfer risk—the risk that the hard currency may be blocked from leaving the country to repay the international lender due to central bank restrictions or national debt rescheduling. A recent Consultative Group to Assist the Poor (CGAP) Focus Note highlighted that although many MFIs are taking on hard currency debt because the interest rates appear lower in nominal terms, they are not factoring in the significant foreign exchange risk they are creating. "Of the 105 MFIs in the survey that reported foreign debt, only 25 fully hedged their currency risk" (CGAP 2005, p. 11). Although a certain level of currency exposure may be manageable, MFIs should have very clear guidelines for managing their foreign exchange gap.

Often as a condition of borrowing, some international lenders require prospective borrowing MFIs to be rated by a microfinance specialized rating agency. The Inter-American Development Bank (IDB) and CGAP offer matching grants to MFIs to help cover these costs. As of October 2005, 19 rating agencies had been approved for CGAP matching grant eligibility.[15] In addition to satisfying the requirement of the lender, ratings provide useful information for the management and board of the transforming MFI about the strengths and weaknesses of the institution. As such, the rating often serves more than just the purpose of meeting lender requirements. However, the effort involved in preparing for a rating should not be underestimated. The level of detail and thoroughness applied by a rating agency is undoubtedly significantly more than that applied in a typical donor assessment. It is suggested that MFIs carefully review the various publicly available rating reports as one step in preparing for the rating exercise.[16]

- *International financial institutions:* The investment arms of bilateral and multilateral development agencies, such as IFC, Germany's Kreditanstalt fur Wiederaufbau (KfW), or IDB, can provide sizable loan capital at relatively competitive rates, though typically in hard currency. MFIs, however, need to be aware that the bureaucratic hurdles in these agencies can add significant delays to accessing these funds. In spite of this, the majority of direct foreign investment—debt and equity—in microfinance (U.S.$648 million, or 56 percent), however, continues to comes from these institutions (CGAP 2005). When investments in microfinance by multilateral agencies, bilateral agencies, and government programs are aggregated, the public sector finances at least 75 percent of all foreign capital investment in microfinance (CGAP 2005).
- *Commercial banks:* Local or international commercial banks can provide a key source for both term loans and lines of credit. Transformation into a share company, with investor capital at risk, generally provides banks a greater sense of comfort in extending financing. In addition, depending on the particular regulatory framework under which the MFI has transformed, transformation can bring MFIs access to the interbank market in the country. This market offers financial institutions access to relatively short-term funding sources.

To date, most commercial bank loans to MFIs have been structured as one lending bank to one

borrowing MFI (often called single bank loans), although the emergence of syndicates of lending banks coordinated by an agent bank (often called syndicated loans), seems probable as commercial banks and other lenders attempt to share risks and experiences in lending to MFIs.

Documentation for a commercial bank loan typically includes a credit agreement, possibly with an attached promissory note. Some microfinance investment funds, particularly those funded by European investors, document their loans as stand-alone promissory notes. As well, some local commercial banks use loan documentation in the form of a note (particularly for overdraft facilities) rather than a credit agreement.

Subordinated and convertible debt. The term subordinate means "below" or "inferior to." In the event of bankruptcy, liquidation, or reorganization, subordinated debt can only claim assets after senior debt (bank loans and all other debt) has been paid off. Due to its higher risk, such debt typically carries a higher interest rate.

Because of the nature of subordinated debt, central banks often permit its inclusion in calculating an institution's supplementary (tier 2) capital (but not in the core capital, or tier 1, calculation). The portion of subordinated debt that can be included in the capital adequacy calculation is often a function of the term (final maturity) of the debt. In Uganda, for example, MDIs can include 100 percent of the face value of any subordinated debt in their supplementary capital calculation (the value of which, however, is limited to 50 percent of the face value of tier 1 capital) as long as the debt has at least five years remaining until maturity. Once the debt reaches the five-year term, it loses 20 percent of its face value on an annual basis. See table 6.7 for an example of a relevant calculation.

Table 6.7 Simplified Example of Capital Adequacy Calculation with Subordinated Debt

	Total value (thousands)	Year 1	Year 2	Year 3	Year 4	Year 5
Tier 1						
Common shares	300.0	300.0	300.0	300.0	300.0	300.0
Retained earnings	30.0	45.0	65.0	85.0	110.0	140.0
Total Tier 1 capital	***330.0***	***345.0***	***365.0***	***385.0***	***410.0***	***440.0***
Tier 2						
Subordinated debt						
Book value[a]	500.0	500.0	500.0	500.0	500.0	0
A. Value with 20% annual deduction		400.0	300.0	200.0	100.0	0
B. Max. allowed: 50% of Tier 1	165.0	172.5	182.5	192.5	205.0	220.0
Value for Tier 2 calculation (greater of A or B)		**172.5**	**182.5**	**192.5**	**100.0**	**0**
Total capital		***517.5***	***547.5***	***577.5***	***510.0***	***440.0***
Risk-weighted assets (RWA)		***1,000.0***	***1,500.0***	***1,700.0***	***2,000.0***	***2,300.0***
Tier 1/RWA (percent)		***35***	***24***	***23***	***21***	***19***
Total capital/RWA (percent)		***52***	***37***	***34***	***26***	***19***

Source: Author.

a. Example assumes subordinated debt contract expires in year five.

Box 6.3 K-Rep Convertible Income Notes

"As part of the asset and liability transfer from the NGO to the new bank, a portion of the NGO's net worth was invested in *convertible income notes*. This long-term debt instrument resembles equity in that it does not have a fixed return and is only retired when all shareholders agree to retire it or when it is converted into equity; it does not have a predetermined term. The income notes generate returns only when dividends are declared, and appreciate through retained earnings. This mechanism allows K-Rep automatic access to additional funds to maintain its ownership percentage if needed."

Source: Campion and White 1999, p. 56.

Subordinated debt instruments are also often convertible into equity, allowing investors flexibility based on estimated returns (box 6.3). Although convertible debt usually carries a lower interest rate than nonconvertible debt, convertible debt offers investors a chance to participate in the profitability of the MFI in exchange for the lower rate. (In some environments, however, having an option to convert debt into equity limits the debt's qualification as tier 2 capital.) (See chapter 7, Ownership and Governance, for a detailed discussion of subordinated and convertible debt.)

Legal issues in accessing commercial debt. Given the overwhelming dominance of the loan portfolio in an MFI's asset structure, the legal authority of an MFI to pledge its loan portfolio as collateral is particularly relevant when accessing commercial debt. The ability of an MFI to do so depends on the pledge law of the jurisdiction where the MFI's assets are located. Additionally, if an MFI has been a recipient of donor grants, underlying grant agreements may limit the institution's ability to pledge grant-funded assets without grantor approval. If the donor is a bilateral agency such as the U.S. Agency for International Development (USAID), U.S. regulations incorporated by reference into USAID grant agreements will also be relevant.[17]

Before pledging a loan portfolio or any MFI asset, including establishing a cash collateral account as part of a back-to-back loan structure, MFI management should ensure its lawyers carry out legal due diligence of its existing credit agreements, as well as engage in strategic thinking about future borrowings. With respect to any existing credit agreements, the MFI should note if there are any "negative pledge clauses." This is a clause, often found in unsecured credit agreements, whereby the borrower agrees not to pledge its assets (or not to pledge more than an agreed amount of its assets, thereby leaving room for a possible future pledge of some lesser amount of assets). Once a negative pledge clause has been agreed with one borrower, it can become very difficult to provide a significant pledge of assets to future lenders without first returning to that lender with a request for a waiver of the negative pledge clause. Typically, the original lender will, at that point, require a commensurate amount of pledged assets for its loan as well.

With respect to future borrowings, it is also important to recognize that once a pledge of assets has been made to one lender, it is unlikely that many future lenders will be content with unsecured loans because they effectively will stand behind the secured lender should there be any repayment problems. This race for assets to pledge, in and of itself, can reduce the overall amount of borrowings that can be undertaken in the future because eventually the MFI will run out of assets to pledge. Hence, some borrowing MFIs have consciously decided to pay a higher interest rate for unsecured loans rather than to start borrowing, albeit more cheaply, on a secured basis.

A second legal question commonly posed by potential lenders is whether the MFI is legally authorized to borrow and on-lend the proceeds of such borrowings to its clients. This can be a difficult question to answer in some jurisdictions due to a

lack of clarity in local law. Some countries have sought to address this issue in the specialized laws or regulations that are being adopted to support the microfinance industry. In the Kyrgyz Republic, for example, the question of legal authority to borrow and on-lend is directly addressed in the specialized microfinance law that was adopted in 2002.[18]

Bonds. Bonds offer an investment opportunity to investors willing to take more risk than with a simple loan, but less risk than taking an equity stake. Bonds are a form of loan agreement under which a borrower agrees to make payments of interest and principal on specific dates to the holders of the bond. Differences in contractual provisions and the underlying strength of the company backing the bond lead to major differences in bonds' risks, prices, and expected returns (Brigham and Houston 1998). MFIs looking to place bonds will need to consider both internal and external factors in their pricing. They will need to match the coupon interest rate (the stated annual rate of interest on the bond) and the term with their own needs—both what they can afford as well as the strategic needs of the company. In addition, they will need to have a clear understanding of the pricing and terms for other similar bond issuances in the market. Bonds are offered either to a select group of potential investors (private placement) or made publicly available and thus evaluated by the financial markets in terms of yield versus risk (public offering). The limited market for private placements means higher costs than public placements, due to a more limited base of potential buyers, higher perceived risks, and limited secondary markets (Lopez 2005).

- *Private bond placements:* Private bond placements offer MFIs an opportunity to tap a broader range of investors than straight loans from commercial banks, though reaching a narrower market than public offerings, discussed below. A private placement is debt that is sold directly to institutional investors, such as banks, mutual funds, insurance companies, pension funds, and foundations. In many countries around the world, securities laws allow borrowers (issuers of these privately placed notes) to avoid normal securities registration requirements because the debt being issued is offered to only a small group of sophisticated investors.

  Documentation for a private placement generally includes a stock or note purchase agreement, and a private placement memorandum (a form of a disclosure document about the issuer). A number of legal restrictions specified in the documentation limit the sale and resale of privately placed notes (including time limits that require buyers to hold the notes for a specified period before reselling).

  The first private bond issuances in microfinance were made by BancoSol in 1996 and 1997 for a total of U.S.$5 million. Both of these were private placements and both were backed 50 percent by a guarantee from USAID and held 720-day maturity terms.[19] Since then, a few other MFIs have made private placements. Compartamos in Mexico, for example, decided to first subject itself to Mexico's securities regulatory authority rather than bank regulatory authorities when it opted to issue debt securities in the Mexican capital market rather than transform to a bank to offer deposit-taking services to the public.[20] Compartamos has issued and placed four tranches of debt, the first three of which were private placements: the first in 2002 for 100 million Mexican pesos (U.S.$10 million), the second and third in 2003 for 50 million Mexican pesos (U.S.$5 million) each.
- *Public bond offerings:* A registered public bond offering has the broadest range of possible investors of all the forms of debt financing discussed here. Because of the presumed lack of sophistication of public investors in registered public offerings, the securities laws of many countries require the issuer to register the offer of securities with a national securities regulatory authority before making public offers and sales. These registration requirements impose a high

level of disclosure responsibility upon the issuer. Documentation typically includes an indenture (a formal agreement between the issuer of a bond and the bondholders), an underwriting agreement (the agreement between the issuer and the lead underwriter of the syndicate, which makes explicit the public offering price, the underwriting spread, the net proceeds to the issuer, and the settlement date), an agreement among the underwriters, and a prospectus (disclosure document).

Public bond offerings are a relatively new phenomenon in the microfinance industry and have been largely limited to Latin America. Mibanco in Peru launched a 20 million Peruvian nuevos soles (U.S.$5.8 million) public bond in 2002, then again for the same amount in 2003, followed by a U.S.$2.9 million bond later in 2003. (See annex 6B, Additional Information for Microfinance Bond Offerings, for more detail on this transaction as well as more information on bonds and securitization.) In Compartamos' case, a public offering was pursued after the three private placements discussed above. A bond issuance for U.S.$50 million was approved in 2004 and the first tranche in the amount of U.S.$19 million was issued soon thereafter, targeting local institutional investors. A 34 percent guarantee from the IFC enabled the five-year bonds to receive a AA rating by the local affiliates of Standard & Poor's and Fitch Ratings.

Debt issued in the public market can take the form of Eurobonds or registered public offerings. Eurobonds are public offerings of debt securities outside the United States that are not registered with the U.S. Securities and Exchange Commission or any other national securities regulatory authority. Often this type of bond is issued to foreign investors outside the country of the issuer. Eurobonds are listed on either the London or Luxembourg securities exchange. These listings impose certain requirements on the issuer—such as to file an offering circular with the securities exchange and undertake to provide corporate documents, annual reports, and financial statements to the exchange on an ongoing basis. Documentation used in Eurobond offerings typically includes an invitation telex, indenture or fiscal agency agreement, subscription or underwriting agreement, agreement among managers and selling group, and offering circular (disclosure documentation).

Bond placements bring challenges. With the exception of the BancoSol placements and some bonds recently announced, most bond issuances seen in the microfinance industry to date have been made locally. As with foreign credit lines, foreign exchange risk continues to present hurdles to international foreign currency placements. In addition, although private placements can be made in a range of operating environments, public bond issuance typically requires the approval of the country's securities exchange or banking regulators, or both, depending on the particular regulatory environment. Furthermore, successful bond issuance requires a relatively deep financial market and well-placed brokerage support, not always readily available in many developing markets. In many countries where MFIs operate, the capital markets are simply not sufficiently developed for this kind of debt product.

Moreover, taking an MFI to the capital markets requires long and detailed planning. Two key steps in the process are the completion of an external rating and the development of investor prospectus materials. For publicly traded bonds, a rating by one of the specialized microfinance rating agencies will not satisfy the broader investor base that typically invests in bonds. Accordingly, issuers usually turn to one of the three major global rating agencies: Moody's Investors Service, Standard & Poor's Corporation, and Fitch Investor Services.

In Mibanco's case, for example, the bank had to obtain two ratings to meet Peruvian regulatory requirements. The local agencies—Equilibrium and Class & Asociados—rated the first bond issue AA, qualifying Mibanco's paper for purchase by the regulated pension funds (Conger 2003). A road show

was then organized to present Mibanco and the characteristics of the bond issue to potential buyers. As Mibanco's first bond issuance, this initial offering was only slightly oversubscribed and the price at 12 percent (690 basis points above the corporate interest rate for low-income bank clients) was considered relatively high (Lopez 2005). Mibanco's third bond issuance, in 2003, however, reflected a significant change in market perception: the third issuance was oversubscribed by 70 percent and obtained a yield of 5.75 percent.

Although bonds can help extend the average term of an MFI's liability structure, they do tend to require a relatively large amount of management time as well as incur significant legal expenses. As a general rule, issuing bonds will also subject the MFI to some form of securities regulation, particularly if it is issuing in a local capital market (as opposed to a private placement or Eurobond offering). This kind of regulation is different from the regulation that bank supervisory authorities impose. The goal of securities regulation is aimed at transparency and information sharing with the view that the market will then discipline the issuer in response to the information it receives. Stiff financial and possibly even criminal penalties may be exacted on the issuer and its officers for inadequate or misleading disclosure about an issuer's financial condition.

Equity Capital

The common equity portion of a transformed institution's capital is composed of two principal accounts: retained earnings and shareholder's equity. The retained earnings account is built up over time as the institution reinvests a portion of its net income back into the company, rather than paying it all out in dividends. The shareholder's equity arises from the issuance of shares in exchange for capital.

Bank regulators usually require regulated, deposit-taking institutions to be formed as companies where ownership is evidenced by shares. Therefore, most transformations involve the establishment of a new share company and the issuance of shares to equity investors. There are various options for structuring these shares, including issuing common stock and preferred shares. Common stock represents an ownership interest in an institution, but to the typical investor, a share of common stock entitles the owner to the following:

- Receive dividends if the company has earnings out of which dividends can be paid, and only if the board, with shareholder approval, chooses to pay dividends rather than retain and reinvest all the earnings. Whereas a bond contains a promise to pay interest, common stock provides no such promise.
- Sell the shares or a portion thereof at some future date, perhaps at a price greater than the purchase price although as previously mentioned, there are currently limited secondary markets for MFI shares; as well, the sale of shares could give rise to capital gains or losses depending on the valuations assigned to the shares when bought and when sold, which could trigger a tax liability.

Most share offerings of transformed MFIs are for common stock, although there have been a few cases where preferred shares have also been offered. Preferred stock is a hybrid—it is similar to bonds in some respects and to common stock in others (box 6.4). Like bonds, preferred stock has a par value and a fixed amount of dividends or a fixed formula for determining the amount of dividends that accrue to the preferred stock, which must be paid before dividends can be paid on the common stock. However, if the preferred dividend is not earned, the directors can omit it without forcing the company into bankruptcy. In addition, preferred stock rarely carries the same voting rights as common stock, because it is viewed as more akin to debt than equity. Whether preferred shares are treated as debt or equity for purposes of calculating capital adequacy ratios depends on their characteristics. According to the Basle guidelines, preferred shares can be included as core (tier 1) capital if they are perpetual (have no maturity date on which they

Box 6.4 Mibanco Issues Preferred Shares to CAF

The Corporacion Andina de Fomento (CAF), a multilateral financial institution, holds 3.82 percent of Mibanco. Its shared ownership is structured as nonvoting preferred shares. The preferred dividend is the highest of the weighted average annual interest rate in foreign currency paid by the three largest banks in the Peruvian banking system and the common dividend. The dividend must be distributed when there is distributable net income, otherwise it accumulates.

Source: Mibanco's 2004 Annual Report, p. 64.

must be repaid) and are noncumulative (if a dividend is forgone in a given year, the shareholders do not have the right to claim the skipped dividend in future years).

Whether the regulated institution's stock is structured as common or preferred, determining a value for these shares can be particularly challenging. Shareholders investing their own risk capital look for a return (through both capital appreciation and dividend payout) that matches the risk of their investment. Although some socially responsible investors may be more patient and less demanding of this return, the realities of political instability; currency devaluations; and burdensome tax, reporting, and holding period requirements for the repatriation of funds (not uncommon in many developing countries), create MFI risk profiles that will only be appealing if matched by impressive returns.

For the purpose of this chapter, which is to provide information to help a transforming MFI determine the appropriate funding structure, it is important to understand that the agreed on share price will influence the amount of equity, and thus the amount of debt, an MFI will need or can carry. Thus the *ideal* funding structure is influenced in large part by the amount at which shares are valued. Financing with more debt increases the expected rate of return for an investment, but debt also increases the risk of the investment to the owners, thus requiring an even greater return to match this risk. As with many aspects of transformation, negotiations with equity investors and with lenders become somewhat iterative as investors are secured and share price finalized (and the amount of investment to be received is known) while at the same time debt capital is negotiated and offers secured. (See chapter 7, Ownership and Governance, for a detailed discussion of shareholder and equity financing.) How it all looks at the end may not be similar to how the transforming MFI envisioned it in the original draft of the business plan.

Legal issues in accessing equity capital. An MFI's legal authority to conduct microfinance business is likely to be questioned several times in several different forms over the course of investor negotiations. The question may first arise in connection with due diligence conducted by the potential investor. It may then be raised in the documentation that evidences the proposed loan or investment, often in the form of a representation and warranty in a loan agreement or stock purchase agreement whereby the MFI is asked to state that it has all governmental authorizations necessary to conduct its business. Local counsel also may be asked to confirm the accuracy of this representation in its legal opinion.

It should not be surprising that the lack of a straightforward answer to this question can have a chilling effect on even the most enthusiastic of investors. Unfortunately, however, due to ambiguities in local law, sometimes it may be very difficult for an MFI to give a clear answer. Indeed, one value of transforming into a regulated, deposit-taking financial intermediary, according to some investors, is that the licensing and registration process of a transformed institution makes clear the institution's legal authority to conduct its microfinance business.

Although potential lenders may focus on donor-imposed prohibitions about the pledging of donor-funded assets, potential equity investors are likely to be more concerned with whether the MFI in which

they are about to invest actually owns its assets. Put differently, it is not unusual for potential equity investors to ask for some form of comfort, either in writing or otherwise, that former or current donors will not exert claims of ownership over the assets of the transformed institution. In one case in Kenya, however, several donors were reluctant to state in writing their position with respect to the ownership of donor-funded assets. As a compromise, these donors agreed to meet with potential investors to give verbal assurances that the donors would not seek to seize control of the assets that had been acquired with donor funds. In other cases, as occurred in Uganda, donors, including the USAID Kampala Mission and Oxfam Novib, provided letters to the transforming MFIs that made clear that the capital grant funds provided for fixed asset purchase or the financing of the loan portfolio were fully controlled by the transforming institutions. Approaching past and current donors for letters of this sort, however, can be a time-consuming and cumbersome process and should be started well in advance of the actual transformation. In other cases, donors have addressed this ownership issue with grant recipients at the time that grant agreements and obligations end—the "close-out" period of grant agreements.

Going public. Although a few MFI transformations have eventually resulted in public listings, including Mibanco's listing on the Lima stock exchange and BancoSol's listing on the Bolivian stock exchange, transaction volume has been minimal. Most trades are prearranged and conducted separately through private firms. As financial markets deepen in various countries, however, this may change.

Optimal Leverage?

Regulators and industry participants often suggest that regulated MFIs should not be permitted to leverage themselves as highly as commercial banks. Given the typical characteristics of microfinance, such as the volatility of the loans (usually short-term and unsecured), regulators have argued that MFIs need to maintain a higher proportion of capital relative to their risk-weighted assets than commercial banks. They argue that the traditional commercial bank limit of 8 percent capital to risk-weighted assets does not provide MFIs sufficient cushion to weather unforeseen hurdles. This perspective is reflected in the ACCION CAMEL (Capital, Asset quality, Management, Earnings, and Liquidity) guidelines, which recommend that an institution's risk-weighted assets represent a maximum of six times its equity, or a minimum capital to risk-weighted assets of approximately 17 percent (the inverse). In Uganda, the MDI legislation is even more conservative, setting a minimum ratio of 20 percent for total capital to risk-weighted assets. (See chapter 2, Regulation and Supervision, for more discussion of this topic.)

Box 6.5 shows the extent to which Indian MFIs are leveraged.

Capital structure policy involves a trade-off between risk and return and as highlighted above, organizational mission, management and board's appetite for risk, and regulatory requirements all influence the target capital structure for an MFI. The appropriate degree of leverage for each institution is ultimately dependent on its ability to manage the increase in risk that it brings. As evident from figure 6.1, leverage ratios for a sample of transformed MFIs vary significantly, reflecting each institution's own institutional objectives, respective operating environments, and varying expectations of their respective ownership groups. In addition, it is important to note the dynamic aspect of capital structures. What may be appropriate for today's operating environment may not be appropriate a year or two years from now. Recently transformed MFIs, for example, are likely to have lower debt-to-equity ratios than more mature regulated institutions with a few more years of regulated operations behind them. This is demonstrated by the relatively

Box 6.5 Equity and Leverage in Indian MFIs

In India, commercial, cooperative, and local area banks are required by the Reserve Bank of India to maintain a minimum capital adequacy ratio of 9 percent, while the minimum capital adequacy for nonbank finance companies is 12 percent if they do not accept public deposits and 15 percent if they accept public deposits. An analysis of the most recently available information on capital adequacy for 110 of the leading Indian MFIs demonstrated that the average capital adequacy ratio (CAR) of Indian MFIs is 18.4 percent. Only four of the eight largest MFIs (portfolio size above 100 million Indian rupees [approximately U.S.$2.3 million]), however, have CAR in excess of 12 percent, indicating that the larger Indian MFIs have become highly leveraged. As highlighted in the analysis, this is largely due to the fact that a sizable number of them have yet to generate sufficient profits to contribute to their capital from internal accruals.

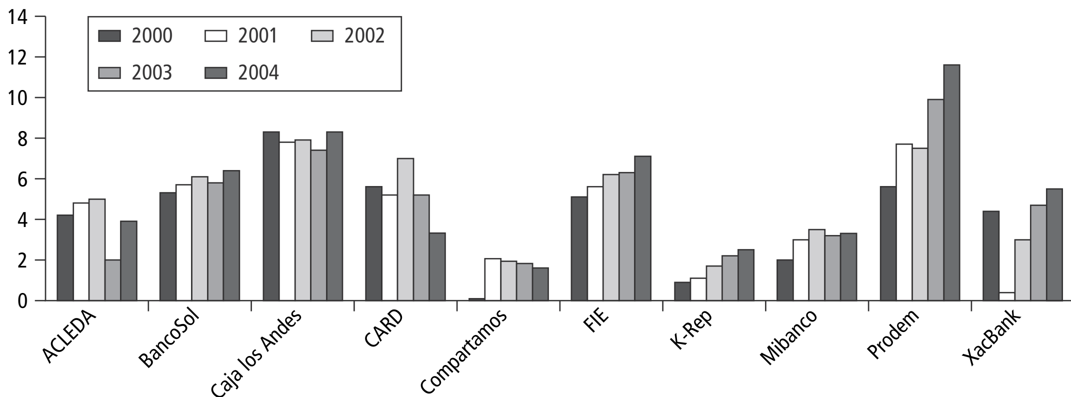
Source: MCRIL 2005.

higher debt-to-equity ratios of the Bolivian institutions (FFP Prodem, FFP FIE, Banco Los Andes ProCredit, BancoSol) shown in figure 6.1.

Table 6.8 summarizes the funding structure as of year-end 2004 of a selection of transformed MFIs with at least one year of operating experience as a regulated institution. With the exception of the operating and regulatory environments, which will be common between MFIs operating in the same country depending on where they operate and how they are licensed, respectively, these variables are unique to each institution. A few guidelines, however, can be synthesized from the experience of these institutions:

- *Savings as source of financing:* Savings can ultimately provide MFIs with a cheap and reliable source of funds. Institutions, however, should not underestimate the time and resources, as well as costs, required to build up a sizable savings portfolio.
- *Types of savings products:* Most of the transformations reflected in table 6.8 involved licensing as a form of nonbank financial institution,

Figure 6.1 Debt to Equity Evolution, 2000–4



Sources: www.themix.org; Superintendency of Banks and Financial Entities of Bolivia www.sbef.gov.bo; ACCION Quarterly Reports; www.xacbank.com; ACLEDA Bank Audited Financial Statements (note: subordinated debt considered as a liability not as equity for this analysis); Caja Los Andes Audited Financial Statements; BancoSol Audited Financial Statements; K-Rep Bank Annual Reports; Compartamos Annual Reports; CARD Bank correspondence.

Table 6.8 Comparison of Funding Structures, December 2004
(percent)

Indicator	BancoSol	Los Andes	FIE	Mibanco	K-Rep	PRODEM	ACLEDA	Com-partamos	CARD	XacBank
Date of transformation	1992	1995[a]	1997	1998	2000	2000	2001/2004[b]	2000	2002	2002
Deposits from the public	60	52	38	55	51	57	38	0	62	50
Checking	0	0	0	0	0	0	0	0	0	0
Savings	11	7	9	12	43	13	27	0	62	15
Term	47	43	29	43	8	43	11	0	0	35
Other	1	2	0	1	0	1	0	0	0	0
Loans from other financial institutions	23	32	42	11	5	29	29	30	8	33
Bonds	0	0	0	6	0	0	0	28	0	0
Subordinated debt	0	0	0	0	0	1	10	0	0	0
Other	4	5	7	4	16	4	3	2	7	2
Total liabilities	**87**	**90**	**88**	**76**	**72**	**92**	**80**	**61**	**77**	**85**
Preferred shares	0	0	0	0	0	0	0	0	7	0
Common shares	10	8	7	17	18	6	15	5	10	13
Retained earnings	3	1	3	5	0	1	2	33	6	2
Other	1	1	3	1	10	0	3	1	0	0
Total equity	**13**	**10**	**12**	**23**	**28**	**8**	**20**	**39**	**23**	**15**
TOTAL SOURCES	100	100	100	100	100	100	100	100	100	100
Debt to equity[c]	**6.41**	**8.30**	**7.11**	**3.26**	**2.54**	**11.6**	**3.89**	**1.55**	**3.3**	**5.5**

Source: http://www.themix.org; Superintendency of Banks and Financial Entities of Bolivia http://www.sbef.gov.bo; ACCION Quarterly Reports; http://www.xacbank.com; ACLEDA Bank Audited Financial Statements 2004 (note: subordinated debt considered as a liability not as equity for this analysis); Compartamos Annual Report 2004; CARD Bank correspondence.

a. Caja Los Andes FFP underwent a second transformation in 2005 when it received its commercial bank license. The bank is now known as Banco Los Andes ProCredit.

b. ACLEDA recently conducted its second transformation, converting from a microfinance bank to a commercial bank in 2004.

c. Ratios calculated using actual values, so rounding may lead to slight differences from simply dividing “total liabilities” row by “total equity” row.

prohibited from mobilizing current accounts. The balance between time and noncurrent demand accounts in Latin America has tended to be weighted in favor of time deposits, because many of these institutions have proactively targeted higher balance institutional savers for its CDs. K-Rep, however, has successfully mobilized a significant number of microsavers, savers from the same target group as its current loan products.

- *Loans from other financial institutions:* As MFIs transition to mobilizing public savings, their reliance on borrowing from banks will likely fall because savings can be a cheaper source of local currency debt.
- *Bond issuances:* Only a few MFIs to date have mobilized resources by issuing bonds. As highlighted above, this avenue requires both relatively liquid local capital markets and a significant investment of resources and management time.
- *Preferred versus common shares:* Very few MFIs have included preferred shares in their initial share offerings. However, this appears to be changing as institutions have begun to incorporate different classes of investors in their shareholding groups. In Uganda Microfinance Union's case, for example, the NGO retained preferred shares in the new MDI, but is not a significant common shareholder. Thus, the NGO receives an income stream from these shares, but does not hold any voting rights. (See chapter 15, The Creation of Uganda Microfinance Limited.)
- *Maximum leverage:* Among the selection of institutions shown in table 6.8, FFP PRODEM reflects the highest debt (which excludes deposits) to equity ratio, at 11.6. (FFPs in Bolivia are required to maintain a minimum capital adequacy ratio of 8 percent, one of the lowest in the sample of institutions presented.) Given both restrictions at the regulatory levels and the perceived higher risk found in microcredit portfolios, the industry is likely to continue to see more conservative leverage ratios for microfinance than for commercial bank lending.

Annex 6C, Checklist for the Funding Structure, provides a summary checklist of the major aspects of the funding structure addressed in this chapter.

Annex 6A Sample Terms of Reference: Funding Structure

Background

Background on the organization including its mission, target market, client outreach, portfolio size, and so forth.

Objectives

The objective of this consultancy is to advise MFI A on an appropriate capital structure to meet regulatory requirements. In addition, the consultant will assist MFI A to achieve the following:

- Determine appropriate funding mix as a licensed deposit-taking institution for the next five years, given MFI A's business needs and social mission.
- Review and refine the business plan with the proposed capital structure in mind.
- Review funding sources available to MFI A.
- Identify prospective risks given the proposed capital structure.

Tasks

To develop an appropriate funding structure for MFI A, the consultant should complete the following tasks:

1. Review the ownership and governance requirements stipulated in the law and regulations, such as capital adequacy, deposit to loan ratio, and so forth.
2. Review, if applicable, the rating or valuation report (or both) for MFI A. (The valuation report provides an indicative valuation estimate of the market value of the shares of MFI A.)
3. Review the business plan, with emphasis on the growth projections and proposed funding needs.
4. In coordination with the Finance Manager and the Transformation Manager, refine the business plan (having in mind the proposed capital structure).
5. Propose potential funding sources the MFI A could access.
6. Develop recommendations for MFI A to determine appropriate and effective ways to
   a. diversify funding sources, with a view toward managing liquidity and market risks;
   b. lower financial costs;
   c. balance leverage with required investor returns; and
   d. secure permanent access to a pool of available funds to meet MFI A's planned growth.
7. Complete sensitivity analysis showing different rates of return for investors based on different capital structure options.
8. Outline possible risks of the proposed capital structure.

Deliverables

1. A comprehensive report that proposes the ideal or preferred capital structure for MFI A to meet regulatory requirements and to operate on an ongoing basis as a licensed deposit-taking institution.
2. A refined business plan that includes the proposed ideal capital structure.

Qualifications

The firm or individual should have the following qualifications:

- MBA or master's degree in finance or related studies
- At least two years of working experience in microfinance or banking (or both) in developing countries

- Extensive experience in financial modeling for microfinance in a regulated setting
- Extensive experience in accessing capital markets
- Banking experience in the areas of treasury, governance, or risk management
- Familiarity with the work, interests, and scope of various investors, both social and private.

Timing

It is estimated this consultancy will require 12 to 15 days to complete. Because the capital structuring is an input to several of the next steps in MFI A's transformation process (securing and negotiating with potential investors, among others) the consultancy should commence as soon as possible.

Annex 6B Additional Information on Microfinance Bond Offerings

Despite difficult market conditions, a wave of bond issues for MFIs occurred over the last few years in Latin America, helping develop longer-term funding sources for transformed institutions. Table 6B.1 provides details on transactions for two institutions: Mibanco and BancoSol.

In July 2004, the first offering (for U.S.$40 million) of Blue Orchard Microfinance Securities I was held, the largest microfinance bond issued from U.S. capital markets. In May 2005, a second offering for an equivalent amount was held. This offering supports MFIs in nine developing nations, and both offerings were enabled in large part by a guarantee from the Overseas Private Investment Corporation. This guarantee was secured by two socially responsible investment firms, Geneva-based Blue Orchard Finance and U.S.-based Developing World Markets. These two organizations, along with Grameen-USA, joined with a few other equity investors to form a special purpose company called Blue Orchard Microfinance Securities I to issue the bond (Baue 2004). The international consulting firm IPC also recently announced a bond deal of its own: Euro 6 million worth of bearer bonds (unregistered bonds on which interest is paid out to the holder, regardless of to whom they were issued), Euro 3 million in 3-year bonds at 5 percent, and Euro 3 million in 6-year bonds at 6.5 percent were offered.

Table 6B.1 Examples of Recent Bond Issuances

	Mibanco			BancoSol	
Year of issuance	2002	2003	2003	1996	1997
Amount (U.S.$ million)	5.8	5.8	2.9	2.0	3.0
Currency	Peruvian soles	Peruvian soles	Peruvian soles	U.S.$	U.S.$
Coupon (percent)	12	5.75	5.75	13	9
Tenor	2 years	2 years, 3 months	1 year, 6 months	2 years	2 years
Credit enhancement	50% USAID	50% CAF	None	50% USAID	50% USAID
Sale mechanism	Public offering	Public offering	Public offering	Private placement	Private placement
Main buyers	Local pension funds (83%), mutual funds (17%)	Mutual funds (33%), public entities (29%), pension funds (26%)	Public entities (60%), mutual funds (21%), pension funds (20%)	Bolivian institutions	Bolvian institutions
Raters	Class & Asociados S.A., Equilibrium Clasificadora de Riesgo S.A	Class & Asociados S.A., Equilibrium Clasificadora de Riesgo S.A	Class & Asociados S.A., Equilibrium Clasificadora de Riesgo S.A	n.a.	n.a.

Source: Adapted from Conger 2003.

Note: n.a. = Not applicable.

Note on Securitization

Securitization refers to the pooling of assets with an income stream and the repackaging of those assets in the form of marketable securities for sale to investors. The securities are secured (or collateralized) by the assets themselves or by the income derived from them. The resultant income from the assets represents the primary source of payment of income to the investors. Although used extensively in the United States by mortgage lenders and credit card companies, securitization has not been widely used in the microfinance industry. As highlighted by Jansson (2003), this is due to a range of variables, including the typically large (greater than U.S.$25 million) amount needed to be cost effective and various legal requirements that make securitization of a large number of small loans a prohibitively onerous and expensive process.

Although not unique to transforming MFIs, securitization can offer an interesting option for MFIs in need of funding or those constrained by limited leverage ability. In a securitization deal, assets of the MFI, such as the loan portfolio, are sold to another institution providing an infusion of cash into the MFI, and perhaps even more relevant for transformed MFIs, removing the assets from the MFI's balance sheet, thus reducing the amount of required reserves that are associated with the assets being "sold." As such, instead of having to wait for loans to be repaid to realize liquidity, securitization results in cash for the regulated MFI as well as frees up the amount of capital required to be held on reserve. As mentioned above, however, the transactions costs and legal requirements associated with a securitization limit its cost effectiveness for most MFIs.

Annex 6C Checklist for the Funding Structure

Funding Strategy

- Is the mission and vision of the new institution clearly documented?
- Do key stakeholders share the same mission and vision of the new institution?
- Does the institution have a "double bottom line," and if so, is it understood by all stakeholders?
- Have financial projections been developed for the new institution? Do these projections allow the user to use various combinations of debt and equity to model projected growth?
- Have the regulatory and legal implications of various funding options been clearly explored?
- Are the tax implications of paying dividends versus interest expense clearly understood?
- Is the nature and focus of the NGO going forward clear? (Does it continue with financial operations? Does it continue with other nonfinancial operations? Does it remain solely a trust?)

Deposits

- Have the goals for savings mobilization been clarified?
- Has the target market for the savings product been clearly defined?
- Have the implications of launching a voluntary savings product on other product offerings been thoroughly thought out?
- Have the necessary investments in marketing, security, internal controls, financial management, and so forth been made?
- Has a complete product costing exercise been conducted to establish appropriate interest rates and fees?

Commercial Borrowings

- Does the MFI have a clear sense of what the debt options in its market are?
- For the relevant debt instrument
  - Are the terms, including pricing, tenor, and grace period, transparent and clear? How do they compare to the overall financing strategy?
  - What are the liquidity implications, including the extent to which the debt instrument can be freely resold to a broad group of other investors?
  - Does the MFI understand the relevant disclosure requirements associated with this debt instrument?
  - Does the MFI understand the implications for market visibility?
  - Has the MFI analyzed the various debt management opportunities (possibility of restructuring, getting covenant waivers)?
  - Has the MFI analyzed the speed and transactions costs of accessing this debt?
  - Has the MFI closely evaluated the documentation requirements?
  - Are there legal liability concerns?

Equity

- Has the institution developed a list of prospective investors who share the same goals?
- Have the various prospective investors clarified their expectations for expected return, term, exit strategy, governance, and so on?
- Can the NGO exchange noncash items (portfolio, fixed assets, and so on) for shares in the new company? If not, does the NGO have sufficient liquidity to pay in cash? If not, have other alternatives been examined?
- Does the new investor group agree on an appropriate valuation approach? If not, can a compromise be reached?

Notes

Contributions to this chapter were made by Deborah Burand, former Director of Capital Markets, FINCA International. She also is the source of tables 6.2 and 6.6.

1. CGAP (2005) highlights that 92 percent of debt is issued to MFIs in hard currency.
2. The *MicroBanking Bulletin* is one of the principal outputs of the MIX (Microfinance Information eXchange). It is a publication that presents financial and portfolio data on MFIs around the world, organized by peer group. The MIX is a nonprofit organization that supports the growth and development of the microfinance industry through various means of information dissemination. See www.themix.org for more information.
3. In fact, a recent CGAP survey of development investors and social investment funds (see CGAP 2004b, p. 1) highlighted that almost 90 percent of the almost U.S.$1 billion in foreign investment in microfinance comes directly or indirectly from public sources. Of the U.S.$250 million invested directly by social investment funds, half can be traced to development investors, the private-sector funding arms of bilateral and multilateral donor agencies. These social investment funds typically hold a longer-term investment horizon and are willing to forgo some financial return for deeper market penetration.
4. The range of products a regulated MFI can offer, however, will also be constrained by the relevant legislation or regulations under which the MFI is operating. In Uganda, for example, the Microfinance Deposit-Taking Institutions Act specifies a two-year limit on the term of loans. This limitation is likely to affect an MDI's ability to offer housing loans.
5. It should be noted that when such debt is issued to shareholders, rather than to third parties, regulatory concerns may reduce some of the tax advantages to the MFI of issuing debt. For example, there may be prudential bank regulatory concerns that limit or influence the financial terms under which debt can be issued to shareholders of deposit-taking institutions. Also, there may be tax regulatory concerns that interest payments on shareholder loans are, in effect, disguised dividend payments and should be treated as such.
6. "Hybrid" instruments are those instruments, such as convertible bonds or preferred shares, that exhibit qualities of both debt and equity.
7. In Uganda, currency points are used to determine minimum capital required. For MDIs, the minimum currency points are 25,000; for nonbank financial institutions, minimum capital is 50,000 currency points; and for commercial banks, 200,000 currency points are required. At the time of publication, a currency point was worth 20,000 Ugandan shillings.
8. An MFI's risk-weighted assets will typically exclude the value of all cash, and include 20 percent of the value of certain bank deposits and the full value of the remaining assets, such as the loan portfolio and fixed assets. The process of risk weighting assets is discussed in more detail in chapter 10, Financial Management.
9. Adapted from CGAP Savings Information Resource Center Glossary site: http://microfinancegateway.org/resource_centers/savings/glossary?PHPSESSID=a0799328b0d68f776781d1c57a6012af.
10. Examples include XacBank in Mongolia, Finamerica in Colombia, and Caja Los Andes in Bolivia.
11. In some cases, the lender will prefer to have a right to call the loan upon such a significant change in the legal form and business of the borrower. If that is the case, the borrower should make sure that an early repayment of the loan will not adversely affect its cash flow. MFIs may need to discuss with the lender how the cost of such prepayments will be allocated among the parties to the loan agreement. In other cases, the lender may be willing to consent to an assignment of the loan obligation to the newly created institution. And, of course, there are endless variations between these two positions that a lender may take.
12. However, if the unexpected liquidity crunch has also caused the institution to breach one of its covenants under the line of credit, the line may be unavailable.
13. The MIX (http://www.themix.org) provides information on all microfinance investment funds that report to them. The site currently includes 72 different international investors.
14. Reports of a Ghanaian MFI that borrowed in foreign currency without managing the foreign exchange risk, requiring the Ghanaian central bank to intervene when the value of the MFI's local currency assets were no longer in line with its foreign currency liabilities, only serve to heighten growing concern over this issue within the microfinance industry. As a result, many practitioners and international lenders are paying increasing attention to deal structures and instruments that could be developed to assist MFIs to hedge or otherwise mitigate foreign exchange risks.
15. Approved raters include ACCION International, Apoyo and Asociados Internacionales S.A.C., BRC Investor Services, Class & Asociados SA, CRISIL, Ecuability, Equilibrium, Feller Rate, Fitch Ratings, JCR-VIS Credit Rating Company Limited, MCRIL,

Microfinanza srl, MicroRate, MicroRate Latin America, Pacific Credit Rating Holding Inc., Planet Rating, Planet Rating (ES), Planet Rating (FR), and Standard & Poor's. See http://www.ratingfund.org for more information.

16. Examples can be found on http://www.ratingfund.org.
17. Some commercial lenders have creatively sought to avoid running afoul of such pledge prohibitions imposed by donors by seeking a security interest in only those assets that are acquired with the proceeds of their loan. Given that money is fungible, it remains to be seen how well this approach will work should a borrowing MFI run into debt servicing problems—particularly if the asset quality of the loan portfolio that is securing the commercial borrowing suddenly deteriorates.
18. See Chapter 1, Article 1. Definitions for "micro-finance company," "micro-credit company," and "micro-credit agency" in the Law on Micro-finance Organizations in the Kyrgyz Republic (approved by the Legislative Assembly of the Parliament of the Kyrgyz Republic, July 11, 2002; approved by the People's Representative's Chamber of the Parliament of the Kyrgyz Republic, July 3, 2002).
19. BancoSol has not placed bonds since this time, because it has been able to place CDs instead at cheaper rates.
20. Compartamos became a licensed and supervised financial institution in 2001 with its transformation into a Sociedad Financiera de Objeto Limitado or SOFOL (limited purpose financial institution) and in 2006 was in the process of transforming to a commercial bank. Not surprisingly, given the financial disclosure requirements imposed on Compartamos by Mexican securities regulatory authorities, Compartamos received the first CGAP award to MFIs worldwide for the quality of its financial reporting.

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Chapter 7

Ownership and Governance

Institutional transformation has profound implications for the ownership and governance structures of a microfinance institution (MFI). Transformation results in the capital base of the MFI changing from one of donated grant capital and retained earnings to one that includes investor share capital. Whether the transformation is structured as the creation of a new company or as a reorganization of the old, the introduction of shareholders with equity at stake significantly changes the nature of the institution. Shareholders represent a different type of stakeholder than donors providing grant capital. Their effect on governance, strategic direction, institutional culture, management, and policies and procedures cannot be overstated. Transforming MFIs need to consider carefully the type of equity investors they seek and be prepared for what can be a time-consuming and resource-intensive negotiation process.

As in any industry, the types of investors seeking to invest in microfinance vary. The particular nature of the microfinance industry, with its focus on financial *and* social returns, adds even more variation to investor profiles. Their investment objectives, return expectations, time horizons, and exit strategies may differ significantly from one another, as do the implications for their role in governance.

This chapter begins with a review of key issues associated with microfinance investors: What are the desired characteristics of an investor in a transforming MFI? What are the pros and cons of different types of investors and what is the appropriate number of investors? The answers to these questions are influenced by the MFI's vision for the future as outlined in previous chapters. The next section provides an overview of how to seek and attract potential investors. The process of securing investors includes a significant amount of institutional marketing and due diligence on both sides—investor and investee. Such preliminary discussions, however, mark only the beginning of the investor negotiation process. As discussed in chapter 6, The Funding Structure, the amount of equity and debt a transforming MFI will seek is somewhat fluid. In addition, some investors will want to begin with debt, anticipating converting it to equity when the MFI is licensed or after it begins operations. Others may want to start with both debt and equity, while others seek a pure equity investment. Thus, the next section details a wide range of issues related to the structure, timing, and commitment of

investments as well as the implications for management and overall operations of the MFI. These issues and more make up the negotiating phase—key to solidifying the right ownership structure for the new entity. Finally, the chapter examines the implications of this new ownership group on the governance of the institution, including ways to build and grow an effective board and, in doing so, how to ensure management accountability.

Choosing the Type of Investor

The broad definition of *investor* includes an individual or institution that invests money in any kind of investment product whether it is debt or equity. Shareholders represent those investors holding equity in an institution; they may also hold various forms of debt as well. The selection of investors, and in particular the shareholders—the owners of the institution—is one of the most critical steps in the transformation process. Just as various investors will have their own investment criteria to assist them in their investment decisions, MFIs should have a clear sense of the characteristics they are looking for in investors. The financial and nonfinancial value-added of each investor needs to be closely evaluated in relation to the particular needs of the MFI into the future. Key distinctions among investors add complexity to this process, underscoring the need for MFIs to clarify preferred investor profiles up front. The relationship and balance between the different investors will also need to be considered in the selection process.

Desired Investor Characteristics

Before embarking on the process of finding investors, the key stakeholders of transforming MFIs (typically board members and senior management of the NGO) should think strategically about the *type* of investors they are seeking. This strategic analysis should consider the following crucial distinctions about the attributes various investors can bring to the organization. Each of these attributes should be envisioned along a continuum, because investors seldom fit only at the extremes:

- Strategic or financial investors
- Majority or minority shareholders
- Local or international investors
- Microfinance experience or formal financial sector experience

Investors in MFIs include a broad range of institutions and individuals with financial and social motivations. Understanding where prospective investors fall on the spectrum of each of these characteristics can help the MFI's stakeholders in the negotiation process and will ultimately help craft a more cohesive group of investors. Taking into account the motivations and desires of potential investors will help the MFI create the ideal mix to meet the needs of the MFI into the future.

Strategic or financial investors. In broad terms, the types of investors transforming MFIs might consider can be categorized along a continuum, with purely strategic investors at one end and purely financial investors at the other. While it is rare to find investors motivated purely by strategic or financial considerations when seeking an investment in microfinance, the distinction is useful for providing MFIs a framework for thinking about the different objectives that will shape investors' actions and expectations. Strategic-focused investors are likely to bring specific expertise or connections or both. Of utmost importance to them will be issues shaping the strategic direction of the organization—its vision, mission, target market, product mix and range of services, market share, and social impact. They will want a board seat and may want some degree of direct influence in the overall management of the organization. In extreme cases, strategic investors may be acquiring shares with the ultimate (and possibly unstated) goal of taking over the institution.

Box 7.1 Aligning Shareholders with the Mission

"In our experience we have had to deal with short-term, profit-oriented investors vs. long-term investors. In the first case these individuals were attracted by the returns of the institution and not so much by the social side. They also saw some political opportunities from investing in a microfinance institution because of its broad outreach and the economic sectors it reaches. Problems with this type of investor soon came up, but fortunately the majority of the shareholders were more social and long-term oriented, leaving the other shareholders alone in their intent to change the bank's orientation. In the end the minority profit and politically oriented shareholders sold their shares."

Source: Personal communication, Kurt Koenigsfest, BancoSol, January 2006.

More financially focused investors will be concerned with the results of the business, and may or may not be as concerned with the mission and vision of the MFI (see box 7.1). They will likely be interested in using board representation to ensure a healthy financial return and to protect their underlying investment, and will certainly seek to influence operations if they feel their financial interests are threatened in any way.

While strategic investors may at times be perceived as more active investors, with their focus on operational issues, it would be wrong to categorize financial investors as passive. In the microfinance industry today very few investors, either strategic or financial, are truly passive. Instead, through their board representation, both types of investors have sought to play an active role in overseeing management and influencing the direction of the organization.

Majority or minority shareholders. During the development of the business plan and the funding strategy, the MFI's vision of how much of the new regulated entity will be sold to external shareholders should be decided. This decision is typically directly linked to what portion of the new entity will be retained by the founding NGO (if applicable). If the NGO retains the majority stake in the new entity, this limits the portion available for external purchase to just a few minority shareholders. It is important to note that for external minority investors, a dominant NGO shareholder may raise concerns about their ability to have much influence over board decisions, particularly if there are inadequate legal protections under host country law for minority shareholders.

While to date equity funds have generally come in as minority investors (Profund, AfriCap, Gateway, ACCION Investments, and others), they have tended to prefer to invest in MFIs with relatively diverse shareholding structures where no one shareholder is a clear majority owner.

In an attempt to encourage more diversified ownership, a number of regulatory frameworks prescribe maximum ownership holdings. In Uganda, for example, no person or group, including the founding NGO, may hold more than a 30 percent share of a microfinance deposit-taking institution (MDI), unless the shareholder is a wholly owned subsidiary of a bank licensed under the country's Financial Institutions Statute, 1993,[1] a reputable financial institution, or in exceptional cases, a reputable public company.

The total percentage of the new entity to be sold sends a clear message to prospective investors regarding the level of influence external investors are likely to have. An MFI that will continue to be owned 80 percent by the founding NGO will present a very different investment opportunity than one seeking external investors for 80 percent of the new entity. Minority shareholders generally fear being taken advantage of by majority shareholders. Two of the bigger concerns of minority shareholders are their inability to change management if it is not achieving the anticipated goals (financial or

social), and fear of expropriation of value by a majority shareholder including misallocation of investment resources, related-party transactions, and inappropriate transfer pricing. To limit these concerns, minority shareholders will try to obtain provisions in either the Articles of Association or the Shareholder Agreement to give them protection in the decision-making process within the transformed MFI, particularly in legal environments that lack adequate statutory protection for minority shareholder rights. Thus, offering prospective investors a minority stake only results in a tradeoff—while it ensures control for the founding NGO, the value of an NGO-controlled MFI will be less to an investor than a non–NGO-controlled MFI.[2] As stated by valuation expert Aswath Damodaran, "there is clear evidence that practitioners apply control premiums in private company transactions, ranging from 15 percent to 20 percent for a majority stake" (Damodaran 2005b, p. 58). While empirical evidence is scant, Damodaran cites a study that found that "minority transactions are valued at a discount of 20 percent to 30 percent on majority transactions in 'market oriented' economies like the UK and the U.S." (Damodaran 2005b, p. 59). Minority discounts may well be greater in emerging markets. For example, another study conducted by Luis Pereiro (n.d.) finds that the median discount for minority holders in Argentina is 38.7 percent.

While each investor will have unique investment goals and mandates, the transforming MFI should also be aware of the tendency for ownership blocs to form among investor groups. While individually no one investor may have majority control, a group of similarly minded investors (for example, local versus foreign or nonprofit versus for-profit) might ultimately form a majority bloc. While critical matters of governance will typically require more than a 51 percent majority vote, each investor will need to be evaluated both on an individual basis and from the perspective of how the investors as a group might influence and interact within the broader shareholding structure. (See chapter 8, Legal Transformation, for a discussion of how the Shareholder Agreement can be used to protect minority rights.)

Local or international shareholders. Another key strategic decision for the transforming MFI is to determine the ideal balance between local and international shareholders (box 7.2). Some jurisdictions may impose legal constraints on foreign ownership—either prohibiting foreign ownership altogether or limiting the amount of foreign owners to a minority position. Where there are no such constraints, the ideal balance of local and international owners will differ by country, and by institution, depending on the MFI's strategic vision, the depth of local financial markets, and the general perception by international investors of the country's risk profile.[3] Local shareholders bring critical market knowledge and local connections, and for those shareholdings that are linked to board representation, local shareholders may, but not always, also imply active and consistent governance participation. International shareholders, however, bring more of a global perspective and international connections, many of which may have the "deep pockets" so valued by regulators. Such connections can be particularly useful in times of capital increases. Board participation by international investors, however, can be difficult and expensive because of the distances involved in attending board meetings, although this is not likely as much of an issue for strategic investors.[4] Sometimes this issue can be addressed if the international investors appoint local residents to be their representatives on the board.

Microfinance experience or formal financial sector experience. Also of key importance is the investor's experience and knowledge of the sector, particularly for those investors who intend to play a governance role. While in general, board formation may or may not be tied to shareholdings, this link has been a more direct one among the MFI transformations to

Box 7.2 XacBank: Balancing Different Types of Shareholders

XacBank in Mongolia recently attracted a number of new international shareholders, including Triodos Bank (through the Triodos Fair Share Fund and Triodos-Doen Fund), Shorecap International, and MicroVest. These investors join an already sizable group of local, privately owned commercial entities. XacBank cites the following benefits of foreign and local shareholders:

Foreign

- Governance standards (board)
- Best practices for reporting and operations
- Accounting standards
- Contacts for possible additional investment or new business
- Possibility of additional debt
- Possibility of technical assistance
- Experience in other markets with successful and unsuccessful products
- Hard currency financing
- Credibility to the organization (shows local market that a foreign institution is willing to invest)
- Patience—foreign shareholders may be more patient and willing to wait for returns
- Sophisticated management practices
- Prestige

Local

- Knowledge of the local market
- Contacts that can bring other business
- Less sensitive to currency risk
- Local currency financing
- Dilution of foreign ownership
- Less need for extensive legal process when investing; less formal procedures; lower cost

Source: Personal communication, Munhmandah O., XacBank, November 2005.

date, and thus should be considered an important variable in the investor selection process. Because it is assumed that the transformed MFI will continue in the business of microfinance, the board will undoubtedly require some microfinance knowledge among its members. In addition, as a regulated entity, the board as a whole will need to include individuals with in-depth financial sector knowledge, and a solid foundation in accounting, financial analysis, and legal expertise. While the NGO's future board members may not be the same as the current ones (this will depend on the future role of the NGO, if applicable), the NGO's representatives on the new company's board will also need to bring the expertise appropriate to the needs of the new regulated financial intermediary. As such, the NGO's current board members will need to evaluate their own credentials in light of the skill sets needed for the new company. Achieving the right balance between those with microfinance industry experience and those with broader formal financial sector experience will be important.

Types of Investors

Investors in MFIs generally fall into the following principal categories: founding NGO (if applicable), founding directors and senior management, multi- and bilateral institutions, socially responsible funds, commercial (or private sector) investors, local investors, employees, local government, and clients or the community.

Founding NGO. In most NGO transformations to date, particularly those in Latin America and other jurisdictions that have a civil law tradition, the assets and liabilities relating to microfinance of the founding NGO have been transferred to the new regulated MFI in exchange for some combination of debt and equity (what this book refers to as the "transfer approach"). Therefore, the founding NGO becomes a lender to or shareholder in (or both) the new entity and plays an important role in maintaining the regulated entity's commitment to the mission, as well as providing intimate knowledge about the microfinance business, the

organization itself, and the local context. The transforming MFI needs to decide the appropriate ownership percentage for the NGO and the appropriate level of debt and equity (leverage) in the regulated institution. A range of variables, including regulatory limits on ownership and the size of the NGO at transformation, strategic decisions made by the NGO stakeholders about the future mission of the NGO itself, and who will negotiate on behalf of the NGO, influence these decisions.

While regulatory limits, if any, on maximum ownership holdings will affect the percentage ownership for all prospective investors, it has particular implications for the founding NGO. For example, if ownership is limited to a 30 percent equity holding and the value of 30 percent of the new entity's start-up capital base is less than the value of the assets the NGO transferred (less liabilities assumed), this "excess" value will typically be structured as debt between the NGO and the regulated entity. If, however, the NGO will not be an owner in the new entity, these net assets (assets transferred less liabilities transferred) could be exchanged for various forms of debt provided by the NGO to the new entity (assuming there is sufficient capital in place to ensure compliance with relevant minimum capital requirements and capital adequacy guidelines). By investing debt in the MFI, the NGO could ensure a steady cash flow from interest and principal payments, as compared to the relatively illiquid equity investment that may not pay dividends.

What the MFI ultimately decides the original NGO will do after transformation is important to external investors in the new regulated entity. If the NGO becomes a lender to or shareholder in the new entity, the way in which it invests or deploys its own resources (such as the funding that it has withdrawn from the regulated entity) affects its own financial position, the financial position of the regulated entity, and, by association, the reputation of the other investors. Other investors will want to know the terms and conditions of any outstanding financial commitments held by the NGO, because they may influence the NGO's position as lender to or shareholder in the new entity. Additionally, as business partners to the NGO, other investors will want to ensure that whatever the NGO does with this funding adheres to accepted standards of professionalism. The issue of reputation risk is important for any new investor group, and though clearly a sensitive one, will need to be addressed up front. (It is generally recommended that issues such as noncompetition and arm's-length transactions be contemplated and addressed in the Shareholder Agreement.)

While the founding NGO can serve as an active voice for the transformed institution's mission, assuming it has the requisite voting rights, regulators (and other investors) may worry whether the founding NGO, as a shareholder, would be able to meet its share of future capital calls. This concern is particularly troubling if the founding NGO continues to exist as a nonoperating entity with few income-producing assets other than its investment in the transformed MFI. In addition, an NGO's inherent lack of owners means there are doubts about who is accountable.

A final consideration with NGO ownership is the question of who is actually responsible for negotiating the NGO's investment interest. Depending on the future role of the NGO, the NGO's board membership may change. Some NGO board members may stay on the NGO's board and ultimately represent the NGO on the new regulated entity's board. These or other members may individually also be investors themselves in the new entity, creating a potential conflict of interest if they are also negotiating on behalf of the NGO.

Founding directors. The individuals responsible for starting the original NGO may represent another important shareholder group, as was the case for both Uganda Microfinance Limited (UML) and Uganda Finance Trust (U-Trust). While the concept of sweat equity is difficult to apply when start-up and ongoing capital has been provided by

Box 7.3 Uganda Women's Finance Trust: Founder Members' Shares

Formed in 1984, Uganda Women's Finance Trust (UWFT) was the oldest indigenous MFI in Uganda. With the passage of the MDI Act in 2003, UWFT decided to transform into a licensed deposit-taking institution by creating a new company, Uganda Finance Trust. Given the MDI Act's restrictions on ownership (no more than 30 percent by any one party), it was decided that UWFT would own 30 percent of U-Trust, with the remaining 70 percent owned by UWFT's founding members, employees, and international investors that could bring expertise and deep pockets to the table.

From the start, it was believed consideration should be given to the 20 years of sweat equity that the founder members, all local individuals, had put into building UWFT. At the same time, it was recognized that all of UWFT's equity, including accumulated earnings, had been acquired using donor funds. The key was to strike a balance between rewarding the founder members, while not putting donor funds in the hands of private individuals. The solution was to offer the founder members a limited number of shares (5 percent of the total shares of U-Trust), at an approximately 50 percent discount to book value. This allowed the founder members to be rewarded, while also ensuring that only those who continued to be dedicated to the institution participated (because they had to put up their own funds to purchase the discounted shares). The transaction took place before other investors came in, so the dilution caused by selling shares below book value resulted only in a decrease in the value of UWFT's stake. Because the size of the discounted sale was modest, it only reduced UWFT's accumulated earnings by about 30 percent and did not affect its donated equity at all. Accordingly, the donors approved the discounted share program. Almost all the founder members participated in the program, and most bought additional shares at full book value. U-Trust became the fourth licensed MDI in Uganda in October 2005.

Source: Contributed by Lloyd Stevens, DFID Financial Sector Deepening Programme, Uganda, November 2005.

donors, mechanisms can be used to reward the initial efforts and personal sacrifices made by those individuals who founded and built the transforming institution. These can include special bonuses paid to such individuals to facilitate their share purchases just prior to the legal transformation by the NGO. Other options include providing access to subsidized loans from other investors or from the NGO itself to allow these individuals to purchase shares (though issues around the risk inherent in using a loan to purchase equity should be closely evaluated).

In addition, some MFIs have offered key founding individuals discounted share prices on the new MFI shares (box 7.3). This can be done in a variety of ways—either the new company sells shares to the founders at a price less than that paid by other investors or the other investors themselves sell some of their existing shares to these founders for a lower price than what they paid. Both scenarios represent a reduction in the value of the shares for other shareholders for the benefit of the founding directors. If the arrangement also includes options for the purchase of additional shares in the future at a discounted price, the value of the shares will be further diluted. Local laws and regulations will need to be analyzed to determine if there are any prohibitions that would restrict funding made available by the MFI (either the NGO or the new regulated entity) to its directors. Restrictions on insider loans, for example, will likely be included in the relevant central bank regulations. In addition, tax considerations might make one method of providing lower-cost shares preferable to other methods.

Such mechanisms for facilitating participation by the founders will likely require full buy-in from the other investors unless completed far in advance of

the time of transformation. Potential investors may also be concerned that the founding directors may not be able to meet future capital calls. As well, given the close association these individuals have with the founding NGO and with the management of the organization, their ability to put the interests of the new regulated entity above those of the NGO or the management may be compromised. Both of these are important factors to openly discuss during the negotiation process.

Multilateral and bilateral donors. Multilateral or bilateral organizations such as the International Finance Corporation (IFC) or the German Kreditanstalt für Wiederaufbau (KfW) represent an ownership group that can offer distinct advantages to a transforming MFI. On the positive side, such organizations bring significant cachet and are able to attract other investors by offering stamps of approval. In addition, they typically have large amounts of capital to invest, although internal regulations of these organizations normally do not allow for repeat investments. On the downside, such entities can be extremely bureaucratic and at times are less innovative in structuring their investments because of concerns about setting possible precedents for future investments. Thus, their presence can cause significant delays in the shareholder negotiation process. In addition, the representatives of these institutions who play a governance role tend to change frequently, creating problems with consistent board representation.

Another important element to consider with multilateral or bilateral organizations is their influence on how operations are run. Many of them have specific social and environmental standards that can significantly affect the operations of an MFI. These include standard limits on the kinds of businesses the MFI can service (for example, no clients that trade in alcohol) and in some cases include portfolio allocation requirements toward gender, geographic outreach, or market segments (or all). Meeting these requirements can be particularly difficult for MFIs employing a decentralized framework for making credit decisions.

Socially responsible investors. This group encompasses a broad range of funds looking for both financial returns and social returns, including funds capitalized specifically to invest in MFIs, such as Profund in Latin America, AfriCap in Africa, or on a more global level, Shorecap, Unitus, and ACCION Investments, as well as general funds established to invest in a range of socially responsible activities, such as Triodos-Doen Foundation and Oikocredit. A recent CGAP study on foreign investment in microfinance identified 45 private social investment funds dedicated to microfinance (CGAP 2004), though most of these funds provide debt rather than equity.[5]

Specialized equity funds are typically managed by individuals with a solid understanding of and experience in banking or finance or both as well as in microfinance. These funds, therefore, can bring important benefits to the governance of the institution. Because the fund's main purpose is to realize a gain on its investment, both socially and financially, it typically plays an active governance role providing key input at a strategic level. Such funds, however, do not usually have sizable amounts of capital to invest although they can serve as a key link to other, larger funding sources for both debt and equity. While more flexible than the larger funds, they, too, have investment committees that need to be consulted, a process that can sometimes delay any negotiation.

Commercial investors. Commercial investors include institutional investment funds, mutual funds, private funds, or individual investors. Pure commercial capital, however, has yet to play a significant role in MFI shareholder options. Various factors explain this, including commercial investor limits on asset allocation,[6] relatively unclear exit strategies associated with most MFI investments, the small size of investment being offered compared

with transactions costs incurred, and the fact that commercial investors are typically looking to maximize their financial return on investment—a goal that may place little priority on social returns. A few commercial banks, however, have shown interest in investing in transforming NGOs, such as Citibank in Finamerica[7] in Colombia and Credito in Mibanco in Peru; however, most have done so primarily for public relations reasons. Others have created separate service companies dedicated to microfinance including Banco Pichincha in Ecuador, Sogebank in Haiti, and ABN Amro in Brazil.

Local investors. Participation by certain well-known, reputable local investors can help enhance the MFI's image and credibility in the eyes of regulators, depositors, and other key players in the local financial sector (Drake n.d.). Similarly, local investors (either private or public) can offer an understanding of the local environment to board discussions that a board composed of only international investors may fail to have. It is important, however, to select "like-minded" investors and define their views regarding key issues upfront.

Employees. A number of transformed MFIs have incorporated staff into their ownership structures, ranging from the buy-in by BancoSol's executive management team at 5.95 percent of the organization to more broadly based employee share ownership programs.

Employee share ownership plans (ESOPs) vary significantly in their design. K-Rep Bank in Kenya, CARD Bank in the Philippines, and Banco ADEMI in the Dominican Republic each developed an ESOP to reward the contribution of staff to the organization but did so in different ways. At K-Rep, eligible members were awarded one share in addition to each share purchased—a scheme supported with funding from CGAP. At CARD, eligible staff were simply given shares (though staff only benefit from dividends, they are not able to sell, transfer, or convert the shares to cash), and at Banco ADEMI, 20 percent of shares were given to ADEMI employees by means of a special bonus based on accumulated severance and pension benefits (Campion and White 1999). In ACLEDA's case in Cambodia, however, the ACLEDA Staff Association (ASA) was created as a profit-sharing plan whereby employees purchase stock at the same prices offered to other investors and share in the same dividend and share appreciation benefits (Clark 2006). See Box 7.4.

The risks inherent in such schemes, however, need to be clearly articulated and explained to staff. For ESOPs that do not have a mechanism in place to buy back employee shares, such shares are relatively illiquid, especially for small blocs of shares owned by individual employees. In addition, it is likely that a newly transformed MFI will not pay dividends for some time. Finally, encouraging employees to invest money in the institution where they work, even to buy discounted shares, does not represent prudent risk diversification for the staff themselves: if the company goes

Box 7.4 ACLEDA Staff Association, Inc.

ACLEDA Bank's employee share ownership program was designed to allow employees to share in the ownership of the bank. ACLEDA Staff Association (ASA Inc.) is a corporation established under Cambodia's commercial law. It operates as a Trust, whereby it owns in trust shares of ACLEDA Bank for the employees who are in turn stockholders of ASA. ASA has the right to purchase shares from ACLEDA Bank to a maximum of 19 percent of the share capital of the bank. In addition, ASA has the right to appoint two directors to the ACLEDA board. At the end of 2004, each staff member held on average 1,200 shares of ACLEDA Bank stock, representing a total of 18.47 percent equity in the bank.

Source: Clark 2006.

bankrupt, the employees lose both their savings and their jobs.

Furthermore, a poorly designed ESOP can create a wide range of conflicts of interest between board, management, and employees. Just as a dominant NGO owner can make commercial investors wary of investing, an employee group with a dominant share of the transformed MFI can pose a similar concern. The perception is often held, true or not, that employees will not have the resources necessary to meet additional capital calls and will make decisions out of their own self-interest rather than the MFI's interests. For these reasons and others, ESOPs have historically not played a dominant role in NGO transformations.

Other, and perhaps better, ways can be found to provide incentives to staff and encourage their buy-in to the transformation process—ways that are less complicated and that pose less financial risk to staff from the lack of liquidity in MFI shares than an employee share ownership structure. Some have considered, for example, a "shadow ESOP" that rewards staff with a form of profit sharing in the transformed MFI, but does not require the actual buying and selling of shares. This obviates the difficulty in giving employees an illiquid asset, as well as eliminates the need to provide voting rights to employees. However, before undertaking any employee-related program, the MFI needs to be clear about the goals and motivations that underlie its interest in having employees hold equity or equity-like interest in the transformed MFI.

Government. Another option for an ownership group is the government. Such circumstances often occur if donor funding for the founding MFI has been channeled through a government ministry resulting in effective "ownership" of the MFI by government. This was the case of PRIDE Uganda, which received funding from the Norwegian Agency for Development Cooperation (NORAD) through the Ministry of Finance and the Ministry of Gender in Uganda. While government ownership may provide some comfort to regulators, it may well dissuade private sector investors and carry the perception of "special treatment." In general, local government ownership is probably more negative than positive. Furthermore, regulators will likely encourage the government to divest ownership sooner rather than later to ensure appropriate governance and reduce political influence.

Community and clients. Clients and local community members represent another ownership group. Client ownership, in particular, is often pursued as a means to both build wealth among the key target group and encourage more active participation by the clients in the design and implementation of the institution's products and services. However, investing in shares in a financial institution does carry more risk for the client than placing funds on deposit, a difference that needs to be explained clearly and transparently. In addition, regulatory concerns that at least some portion of investors demonstrate an ability to access more capital if required (the "deep pockets" qualification) may limit the level of client ownership. Finally, as with any client owned and governed entity, the potential for conflicts of interest will also need to be addressed, as personal interests (lower interest rates on loans, higher interest rates on savings, and the like) have the potential to supersede what is best for the institution.

A number of transformations, such as CARD Bank in the Philippines and SKS in India, have made ownership by clients a priority. In SKS' case, a donor provided capital to facilitate ownership by the clients. Trusts were created to serve as vehicles for this equity ownership. Alternatively, CARD Bank issued stock directly to clients (box 7.5).

Table 7.1 provides a summary of the key pros and cons of the different investor groups.

Finding the Appropriate Balance

Given the options available, what is the appropriate balance? The answer to this question ultimately lies in the transforming institution's reaction to many of

Box 7.5 Client Ownership at CARD Bank

As stated by Dr. Jaime Aristotle B. Alip, the Founding President and Chair of CARD Bank, "Only by creating a vehicle for asset ownership, can we ensure that the poor will gain control over their own resources and over their own destiny" (Campion and White 1999, p. 69) Created in September 1997, CARD Bank was initially owned by CARD NGO, a few members of the board of directors, and management staff. Over time, this ownership structure has shifted away from board and staff ownership to include greater participation by clients through additional share offerings targeted at clients, a process that started in 2000. Part of this was facilitated by offering qualified clients the option to convert their compulsory savings into equity shares, an initiative that was also accompanied by a significant amount of client training given the higher risk implications of equity over savings. By the end of 2004, CARD Bank's ownership structure was composed of CARD NGO (43 percent), CARD management and board (21 percent), and clients (36 percent). Consistent with the CARD vision, CARD plans to ultimately transfer full ownership of the bank to the landless poor.

Source: Authors.

Table 7.1 Pros and Cons of Various Investor Groups

Group	Pros	Cons
Founding NGO	Can help maintain commitment to vision and mission.	With no owners, NGO itself may lack deep pockets in eyes of central bank. Without an owner, NGO may have a weak governance structure and lack accountability.
Founding directors	Personal commitment to success of institution. Example of private risk capital.	Depending on how ownership is structured, may present conflict of interest. May also lack deep pockets.
Multilateral and bilateral donors	Can help maintain commitment to development and poverty mission.	Internal structure and operating procedures often cause delays and may impede effective participation. Environmental and social mandates can create operational challenges.
Socially responsible investors	Allocate experienced staff and resources to monitor performance of MFI; can make quick decisions in case of capital call. Technical know-how can provide confidence for other investors; availability of technical assistance in some cases.	Limited capital; medium-term investment horizon. Potential for conflict of interest when managers of the fund also manage or are linked to the technical assistance provided.
Commercial investors	Profit and efficiency orientation; provide a familiar face to the capital markets.	Danger of short-term, profit-maximizing investors; seeking clear exit strategy.
Employees	Builds employee buy-in to financial future of institution.	Can present risk to staff. Typically staff lack deep pockets to make additional capital calls. Lack of liquidity (market for shares) can also complicate structures.
Local government	May help positive image of MFI; generally have deep pockets; can positively influence regulators.	May scare away other investors; may politically influence decision making with regulators; may be perceived as receiving special treatment.
Clients and community	Community shares in the success of the institution; provides sense of ownership.	Difficulties in structuring and in determining who represents the community; typically lack deep pockets expected by regulators; potential for poor governance and conflict of interest.

Source: Author.

the factors discussed above. A few common guidelines can be summarized based on lessons learned from the experiences of other NGO transformations:

- *Limit excessive majority shareholding by any one investor:* Whether it is the founding NGO or another shareholder, the presence of an overly dominant shareholder with board control can raise concerns from potential investors that they will have limited influence in the governance of the MFI. Having the NGO as dominant, majority shareholder, for example, can raise concerns by even the more patient commercial investors. As mentioned, minority shareholders typically have little ability to change a management team whose objectives may no longer be in line with those of the minority shareholder.
- *Build a diverse ownership group:* Given the varied expertise required to govern a regulated financial institution, the MFI may find it useful to try to balance the different investor groups' skills. In addition, a broader group of investors has the potential to offer the institution a wider source of external financing as well as more diverse governance representation. Also, abuses that arise from concentrated ownership, particularly in the banking industry, are well known. While a diverse ownership group does not preclude such abuses, it does limit the potential for various conflicts of interest that can arise from dominant control.
- *Introduce investors to regulators early on:* In many countries, the transformation of NGO MFIs into regulated financial institutions is still a new concept. The types of investors that are common to microfinance (specialized equity funds, NGOs, and the like) are often not typical of bank shareholders. As a result, supervisors may initially be skeptical of such entities qualifying as "fit and proper." Efforts need to be made to inform and expose regulators and supervisors to the range of equity investors active in microfinance.
- *Ensure adequate deep pockets among investor group:* To avoid concerns by regulators that additional capital may not be forthcoming if needed, care should be taken to select at least some investors with immediate access to additional resources. An NGO, which by definition has no owners, will typically not be perceived as having the deep pockets necessary to convince regulators that additional capital could be easily provided.
- *Select investors who are willing and able to play an active governance role:* While in theory building a diverse group of shareholders allows the institution to benefit from a wide range of contacts, technical know-how, and funding sources, these benefits can only be realized if the investor takes a sincere interest in the investment. There is certainly room for silent investors, but MFIs should focus on bringing in active investors with ideas and contacts to share.
- *Select investors with an eye to enhancing image and credibility in the local financial sector:* As discussed in more detail in chapter 8, Legal Transformation, the challenges inherent in cross-border investments underscore the importance of encouraging greater local participation. Local investors with positive reputations can both help build the MFI's image and credibility in the market and provide critical market knowledge for the institution's business strategy.

Table 7.2 presents the ownership structure of various transformed MFIs. With the exception of Finamerica, the sample reflects the prevalence of socially responsible investors and the founding NGO as investors. As mentioned, commercial investors are only starting to enter the market.

An important consideration the transforming MFI should address before seeking potential investors is the number of shares and thus the value per share the new entity will issue. The per share value is typically a factor of the anticipated investor profile. The country's laws normally set a minimum

Table 7.2 Shareholding Participation in Regulated MFIs as of December 31, 2004 *(percent)*

	BancoSol	Mibanco	Fin-america	Financiera Compartamos	K-Rep	ACLEDA	CARD
Founding NGO	PRODEM	ACP	Corposol	Compartamos AC	K-Rep	ACLEDA	CARD
Country	Bolivia	Peru	Colombia	Mexico	Kenya	Cambodia	Philippines
Participating Investors							
Founding NGO	20	64	0	37	29	33	43
Founding directors	0	0	0	5	0	0	0
Multi and bilaterals	0	4	0	10	37	25	0
Socially responsible investors	46	27	9	22	24	25	0
Commercial investors	28	5	91	26	0	0	0
Employees	6	1	0	0	10	18	21[a]
Clients and community	0	0	0	0	0	0	36

Source: ACCION Investments; K-Rep Bank Web site, www.k-repbank.com; ACLEDA Bank Web site: www.acledabank.com.kh; CARD Bank Web site: www.cardbankph.com.

Note: Participation may not add to 100 percent because of rounding.

a. Includes staff and board members.

par value and the MFI will thus likely be required to specify in its documents of incorporation the amount and number of shares of authorized capital it will issue. If the MFI is expecting largely institutional investors, with significant sums of money to invest, it is likely to issue fewer shares at a higher price per share than if it is expecting numerous individual investors with limited resources to commit. Because an increase in the number of authorized shares will usually require the approval of a majority of the board, the initial amount of authorized shares should be sufficient to accommodate anticipated future issuances, but not so high above the current level of subscribed shares to risk significant dilution of shareholder value.

Seeking Potential Investors

The process of identifying, attracting, negotiating with, and concluding a deal with a group of investors is time consuming and prone to constant setbacks. For this reason, as well as the ability to extract a better valuation from investors later on, some MFIs decide to delay the external investor recruitment process until after the legal and institutional transformation concludes (assuming the MFI NGO is eligible to receive a temporary exemption to any cap on shareholder percentage ownership). Whether external investors are sought up front or after the legal transformation, the process of finding investors is a lengthy one and needs to be supported with the necessary resources, both financial and human. It is recommended, for example, that a project manager be designated to head the process. This individual will be responsible for communicating and managing relations with prospective investors, responding to various queries, drafting multiple versions of the business plan that end up being required throughout the transformation process including various financial projections, clarifying and documenting the various decisions made

throughout the negotiation process, and other issues as they may arise—in short, this individual is responsible for managing the MFI-investor relationship process and must establish clear and open lines of communication and control.

Depending on the skill set of the transformation manager (see chapter 3, Planning for Transformation) and the skills needed to manage the shareholder negotiation process, the investor project manager could be the transformation manager or someone in the finance department. Even so, the MFI may want to hire an external consultant for identifying potential investors. A sample terms of reference for this is included in annex 7A.

There are four phases in the process of seeking and securing investors:

- Marketing
- Due diligence
- Negotiation and documentation
- Funding

Marketing Phase

Having developed a general profile of the shareholder types and characteristics the MFI is seeking, the marketing and promotional phase can begin. There are four critical steps in this phase.

Develop a shareholder prospectus. The prospectus serves as an initial marketing tool, used to generate interest among prospective investors. It includes a general overview of the institution including its management, history, vision for the future (outreach, products, geographic scope, and the like), the overall financial projections, and expected returns. This document is not as detailed as the institution's business plan but will certainly draw from the plan as its basis. It should be prepared as a promotional piece with the goal of attracting potential investors, but also provide concrete, realistic numbers, for both outreach and financial goals.

The prospectus should tell a story. While historical figures of outreach and portfolio quality will indicate product demand and market knowledge, the transforming institution will need to sell a vision of its future with respect to client growth, expansion of financial services, and improved financial return. It will need to demonstrate an understanding of the anticipated implications of becoming regulated, including capital requirements, operational implications, and overall trends in the financial sector. The development of this document is typically completed by the project (or transformation) manager in consultation with the MFI's senior management and board, and involves numerous iterations of the institution's financial projections above and beyond those included in the MFI's business plan.

The document should be developed for broad dissemination. As such, the MFI will need to think carefully about what elements of its future strategy it feels comfortable sharing with various investors who are invariably also considering other investment opportunities. Given the variation in prospective investor types (ranging from targeted microfinance funds staffed by experts in microfinance to private individuals with little or no technical knowledge of microfinance), the prospectus should use limited microfinance jargon, and instead use clear, results-oriented language. As well the MFI needs to tailor the document to the type of investor it is seeking: commercial investors will want to see the profitability potential while those seeking more of a double bottom line may look for innovation, outreach, and other such goals.

Create a preliminary list of potential investors. With the prospectus developed, the next step is to target potential investors. Most MFIs at the stage of transformation already have a number of contacts in the investor community, either directly through previous debt or grant arrangements or through secondary contacts with board members, donors, or other bankers. In addition, for those MFIs seeking to attract international funds, a number of

information sites maintained by the microfinance community[8] provide general contact information on the various funds currently investing in microfinance. Having already deliberated on the preferred type of investor, the MFI should begin initial background research on various investors and create a preliminary list of potential contenders whose profiles match what the MFI is seeking.

Conduct a virtual "road show" for the initial group of prospective investors. The project (or transformation) manager should send the prospectus to potential investors that meet the MFI's criteria and begin a dialogue with those who demonstrate interest.

Set up one-on-one meetings. For investors that have shown interest, an initial meeting is necessary to present and expand the overview of the MFI and the institution's vision for the future as presented in the prospectus. This will provide the opportunity for prospective investors to become familiar with senior management and the overall operating environment, as well as raise any particular concerns. For investors who make frequent visits to the region or are already based in the region, such a meeting can take place on-site at the MFI. For others, the MFI may need to schedule a visit to the investor. This second approach is less appealing because it will likely need to be funded directly by the MFI and furthermore, does not allow the investor to see the MFI's operations. However, if necessary, the MFI should arrange to meet with a number of different investors on the same trip, if possible.

The degree to which investment goals and the overall vision and mission for the MFI are shared by the investors will ultimately have a significant impact on the level of cohesion within the investor group. The marketing phase provides the MFI the opportunity to gain a deeper understanding of potential investors. Determining where each lies on the strategic-financial investor spectrum is particularly important at this stage, because it drives the extent to which the investor will want to be involved in the day-to-day management oversight of the MFI. In addition, the desire regarding the level of investment—majority or minority—will also be important to understand at this stage. Both the strategic-financial perspective and the majority-minority perspective will have significant implications for dividend policy, exit strategies, board role, and veto rights in constituent documents, among other issues.

Due Diligence Phase

Once preliminary interest has been expressed by an initial group, a more in-depth due diligence exercise is scheduled to allow potential investors to gain a deeper understanding of the MFI, its management, and its operations. The due diligence exercise includes a review of the institution's documented policies and procedures and numerous interviews with senior management as well as branch staff. In addition, the prospective investors may meet with local legal counsel, tax experts, and the regulatory body. So that a consistent message is delivered by all employees (and board members) involved in the due diligence exercise, a practice session should be conducted in advance, during which all the company's presentations are made to a neutral third party for feedback and critique. It may be useful for the transforming MFI to encourage potential investors to coordinate such that they perform their due diligence jointly. The due diligence exercise typically focuses on the following key areas:

- *Management and board:* One of the most important elements of an investor due diligence is the investor's assessment of the quality of the management team and staff of the MFI. Through interviews and various discussions, the potential investor will attempt to gauge the vision, qualifications, and overall attitude of the staff and will seek to understand the current

governance structure and nature of those sponsoring the transformation.

- *Financial:* The financial analysis includes a thorough review of the MFI's historical and projected financial position, including earnings potential, operating efficiency, portfolio quality, capital adequacy, and liquidity.
- *Market:* Through conversations with the MFI's senior management team and research and development group, as well as through various third-party sources, the potential investor will evaluate the overall supply and demand for microfinance services in the country.
- *Economic and political:* The relative stability of the economy (currency, inflation, and so forth) and the government are key factors in any due diligence exercise. Potential investors will likely assess the private investment climate and any recent political developments, and review the relevant regulatory framework and government policy specifically with respect to interest rate ceilings and foreign exchange policies and risks.
- *Legal and tax:* Analysis of the overall legal and tax framework in the country will include, among other things, requirements regarding share purchases and sales, requirements for registration of foreign investors with the appropriate regulatory and government authorities, tax treatment of payments of interest and dividends (including any applicable withholding), rules for determining capital gains, statutory rights of minority shareholders, and litigation norms.

The due diligence exercise requires the MFI to share detailed institutional history and financial information, not all of which the MFI may be comfortable sharing. Some of this information may be considered by the MFI as proprietary and confidential. It is thus important to discuss issues of confidentiality up front with any participant in the due diligence process. This may involve developing and executing a written confidentiality agreement. This is particularly important if prospective investors intend to evaluate a number of different MFIs in the same country before committing to any one of them. (See chapter 8, Legal Transformation, for further information on confidentiality agreements.)

A substantial number of follow-up information requests often result from a due diligence visit by a potential investor. The most important document (and the one that requires the most time and energy) is the MFI's business plan including financial projections. While the prospectus mentioned above is typically used for broad marketing of the investment, potential investors who proceed to the more in-depth due diligence phase will normally want to see the much more detailed business plan. The project or transformation manager should be prepared to develop multiple drafts of this document as the prospective investors weigh in on capital structure, overall pricing, return expectations, and the like. This often includes requests for multiple scenario analyses, more thorough market analysis results, and explanations for the valuation of the proposed NGO holding in the new entity. (See chapter 5, Strategic and Business Planning, for a discussion on developing the business plan.)

The due diligence exercise is resource intensive and time consuming for both the MFI and the potential investor. In general, the cost for this exercise is typically born by the investor, though in some cases, the MFI may be asked to contribute. Results of the due diligence process will significantly influence the price the investor is willing to pay for shares in the MFI.

Preliminary discussion of key issues. The due diligence exercise presents both the MFI and potential investors the opportunity to begin discussing some of the more critical negotiation issues, including how much control the investor will expect to have over management, how frequently dividends will be paid, and options for divesting from the MFI. While an MFI investment deal will ultimately

involve a myriad of ownership and governance issues (discussed in more detail below), these three—control (or protection of minority shareholder rights), dividend pay-out policy, and exit options (or restrictions on share transfers)—are critical components of an investment strategy and should be clarified up front. Therefore, the MFI's senior management and board will need information and opinions on these different issues before entering the negotiation process. The distinction between strategic and financial investors is particularly relevant for these issues. While both strategic and financial investors will be looking for some degree of influence in the overall management of the company, the areas they focus on may differ. However, both will have exit expectations that will need to be addressed.

Preliminary commitment by investors. Following conclusion of the due diligence process, the prospective investor will prepare an initial investment recommendation (typically referred to as the preinvestment stage or stage 1 review that will reflect a "go" or "no-go" recommendation from the analyst). For institutional investors, the analyst will likely have to present this recommendation to the investment committee of the fund.

Once prospective investors have indicated they are interested in pursuing an investment, the long process of negotiation begins, leading to decisions on the various issues about the investment and the finalization of the investor group.

Negotiation and Documentation Phase

This section highlights the more important issues that transforming MFIs and investors need to consider in the negotiation process, including capitalization, governance, management, financial policies, institutional mission, dispute resolution, and share transfer and exit.

To facilitate discussion of these various issues, a *term sheet* is typically used to focus investors. The term sheet is often introduced as an agenda-setting document, and then filled in throughout the negotiation process to help organize the negotiation and ultimately the documentation process. Term sheets are particularly helpful if multiple parties are participating in the negotiation because they forces all parties to focus on the same issues at the same time. If the investor group is being represented by one lead investor, a common term sheet is a simple way to keep the other investors in the group aware of the current status of negotiations.

A term sheet is typically a nonbinding document that outlines the parties' agreements on key business and legal conditions that will shape the investment. The agreements reached during the negotiation of the term sheet will be incorporated into the documents (primarily the Shareholder Agreement, discussed in chapter 8, Legal Transformation) that will govern the underlying investment transactions, so all parties should pay attention to how issues are resolved and expressed in the term sheet. The negotiation of a term sheet also helps to clarify early in the negotiation how the different issues combine or interact to affect the interests of the different shareholders. All parties should feel comfortable asking for clarity in the language used in a term sheet if it is new or confusing. Typically, the term sheet is drafted by nonlegal participants reflecting the business side of the agreement. Lawyers then transform the term sheet (once agreed upon) into a Shareholder Agreement and other legal documents. In some cases, however, the term sheet may be drafted by the same legal counsel that is charged with drafting the Shareholder Agreement and Stock Purchase Agreement. Counsel may be asked to draft and redraft many versions of the term sheet over the course of the negotiations.

Term sheets should accomplish the following:

- Summarize the offering of shares.
- Identify the investee company's purpose.
- Detail the legal structure of the investee company.

- Define the capital and share subscriptions (including share price or formulas to be used to determine pricing at the time of sale).
- Specify general terms and conditions for shareholder meetings and board meetings, governance structure, and responsibilities of the investee.
- Detail procedures for future sales of shares.
- Outline exit strategies, if any, and agreed restrictions on share transfers.
- Specify expectations for financial and accounting practices to be adhered to by the investee, as well as any key operational standards.
- Identify the governing law and dispute resolution procedures to be followed under the investment documentation.
- Any special conditions.

Annex 7B, Sample Term Sheet Outline, provides a sample term sheet skeleton.

While the term sheet is used primarily during the negotiation process, as mentioned above, agreements reached during this process are documented in the draft Shareholder Agreement. Because this is a legal document ultimately drafted and finalized by lawyers, its contents are discussed in detail in chapter 8, Legal Transformation, and are thus not discussed here.

Capital amount and instrument. Investors in microfinance have a range of investment instruments. As discussed in detail in chapter 6, The Funding Structure, these include common and preferred shares, straight debt, convertible debt, subordinated debt, and any combination of these. The starting point in the negotiation process is determining the actual amount of capital, both debt and equity, to be invested by the various shareholders, including the absolute amount and the ultimate ownership percentage. In addition to the minimum requirements imposed by bank regulators—minimum capital and the capital adequacy ratio—MFIs and their potential investors will need to consider the amounts and types of investment instruments:

- ***Common versus preferred shares:*** Common equity is the highest risk, highest reward equity instrument. It increases in value as the MFI's retained earnings grow. In addition, common equity shareholders can benefit from dividend payments. Common shareholders also elect the board of directors. Holders of preferred shares, by contrast, receive a fixed dividend paid out of the MFI's earnings. Such shareholders are not assured a dividend payout, but will receive their dividend ahead of common equity shareholders, and in case of liquidation, will have a prior claim over common equity shareholders on the MFI's assets. Preferred shareholders typically do not have any voting rights and consequently do not have an influence on the selection of the board.[9]
- ***Debt-equity combinations:*** From an investor's perspective, the amount of equity and possibly debt is determined by three key factors: liquidity, return, and risk. Each investor will have unique expectations for these three variables.
- ***Convertible or subordinated debt:*** In addition to standard term debt, debt options can also include convertible debt or subordinated debt as discussed in chapter 6, The Funding Structure.

  Convertible debt is defined as debt that can be exchanged for another type of security (typically equity shares) usually at the option of the holder (although there are obligatorily convertible debt issuers). It is often structured to specify the conditions under which it will be converted from debt to equity. Some convertible debt will expressly describe the specific number of common equity shares to be issued in exchange on a specific date for the converted debt at a predetermined conversion price. Other convertible debt will offer "trigger points" that give the lender and borrower the option to convert debt into equity and may specify a predetermined

conversion price or may, instead, establish a formula for determining the price at the point of conversion.

Subordinated debt is any debt that is junior in claim on assets to other debt. Subordinated debt gives priority for repayment, either structurally or contractually, to more senior debt. Theoretically, the spread between subordinated and senior debt should correlate to the risk of the company. For a AAA risk, for example, the gap between subordinated and senior debt should be negligible. Lenders may choose to lend, at least partially, on a subordinated basis because of the typically higher returns subordinated debt generates. A borrowing MFI also may encourage shareholders to consider lending on a subordinated basis rather than taking straight equity because such debt may qualify, at least in some jurisdictions, to be counted as tier 2 capital while at the same time helping the MFI increase its return on equity due to this increased leverage.

Conversion is typically at the option of the investor. The value of this option to convert depends on the conversion price and the period in which the holder can convert. For example, an option to convert if the value of the company doubles in six months will have very little value, given how unlikely this would be. Convertible debt will thus typically have a lower interest rate than term loans, which have an established date or term for repayment. (The value of the option to convert will normally be reflected in a lower interest rate.) Any savings on the cost of funds comes at the expense of the shareholders who must accept a smaller share of dividends or net worth if there is a conversion. Typically, the returns to a convertible holder in an MFI with poor or mediocre performance will be below the returns of other debt holders. The returns to a convertible holder in an MFI with good or excellent performance will be somewhere below the original equity holders (because the conversion price will likely be somewhat higher than the original price at which the other equity holders bought) but above the returns of other debt holders.[10]

Conversion at the option of the MFI will have the opposite dynamic. The value of the option to convert will be added to the cost of the credit. The amount of this addition again will depend on the period in which the MFI is able to convert and the price at which the MFI must convert.

Share price and valuation. One of the more difficult discussion points in the investor negotiation process is establishing a "fair price" for the shares to be sold to external parties. How much are the shares of the MFI worth? What is the "true" value of the assets that are being transferred to the new company? Should there be a discount or a premium paid to the NGO for these net assets?

> *"Valuing a closely held business is like forecasting the weather: Everyone wants an absolute, scientifically determined, accurate answer, but no one has come up with a way to achieve this goal."*
>
> Tuller 1994, p. 17

Business valuation in any industry is more an art than a science and the microfinance industry is no exception. No generally accepted standards, regulations, or rules apply and no single methodology or approach that will provide the right answer. The "market price" for an MFI is particularly difficult to determine because there are very few countries in which the microfinance industry is fully integrated into the financial markets, thus limiting the number of comparable cases. In addition, as in any new industry, there is unknown industry risk. Finally, in most cases, shares are not yet freely traded (they are illiquid), which adds further complexity to calculating the right price (Drake n.d.).

While valuation techniques differ significantly, a variety of common techniques and methods can be used for estimating the value of any business. Relatively small businesses, like most MFIs, generally use one or a combination of the following valuation methods: book value, price-earnings comparisons, and discounted cash flow analysis.

- *Multiples of net assets (book value method):* In the book value method, only those balance sheet accounts that reflect assets expected to generate earnings for buyers are included in the calculation. While relatively easy to understand and readily calculated from basic financial statements, book value seldom reflects the fair market value of assets. In addition, the book value method does not take into account the MFI's ability to generate future profits. Therefore, this method is recommended only as a starting point in negotiations. In most of the initial transformations that occurred in Bolivia, shares were acquired at or near book value. This was due, in part, to reluctance on the part of the MFIs at the time to charge any kind of premium on what was initially donated grant capital, but was also a reflection of the relative novelty of the transaction and the fact that it was a "buyer's market." Over the last decade, however, both sellers and buyers have become more sophisticated in their analyses, leading to more aggressive negotiation on both sides.
- *Price-earnings ratio or price-to-dividends comparisons:* This method simply matches an MFI's prior year profits with an average price-earnings ratio derived from published trading records of public companies in similar industries, providing MFIs a comparable with which to start negotiations. However, because sales of microfinance shares are few and far between and sales of formal financial sector shares are likely not relevant due to size and liquidity differentials, comparisons are difficult. A recent analysis of small financial institutions in developing countries highlighted that multiples paid for banks are much higher than those for MFIs, averaging two to three times book value (O'Brien 2006).
- *Discounted cash flow:* The generally accepted definition of the value of a business is that it equals the future benefits, usually cash benefits, that will accrue to that business, discounted back to a present value at an appropriate capitalization (or discount) rate (Tuller 1994). Using the MFI's financial projections for the new regulated entity, the financial analyst can develop preliminary cash flow projections for the institution. The next step is to estimate the risk of actually attaining the expected future benefits projected by the MFI (or alternatively, determining the premium for attaining even greater benefits than anticipated). Risk is reflected in a business valuation by determining the cost of capital of an investment—that is, ascertaining the rate of return available in the marketplace on comparable investments. This is expressed as a discount rate—the interest rate used in determining the present value of future cash flows.

Conducting a discounted cash flow (DCF) analysis on an MFI raises two critical issues: which cash flows and what discount rate should be used? Financial projections produced by the MFI are often used by prospective investors as a starting point in estimating future profitability. A number of important adjustments, however, are typically made, most of which present a more conservative picture of return potential of the investment. These can include more aggressive provisioning (for uncollectible loans), more conservative macroeconomic indicators (currency devaluation, inflation, and the like), more conservative growth and outreach projections, and less optimistic improvements in operating efficiency (such as scenario analyses with higher operating cost ratios, or smaller loan officer case loads). These revised projections are then used as the basis

for calculating the "free cash flow" used in the DCF analysis, defined as any cash in excess of what is needed for growth (an analysis that will also likely require additional dialogue and agreement among the parties).

The second issue, the discount rate to use, is complicated by the level of subjectivity applied to evaluating risk. The discount rate is determined by two factors: the general level of interest rates in the marketplace, and the amount of risk premium demanded by the market. It is the key variable in calculating how much an investor should pay today as a reflection of what the company will be worth tomorrow, a year from now, five years from now. Although advanced markets (the United States and Europe, for example) yield a fair amount of information about correlations between risk and return, the same is not true for some of the less developed economies. What is the risk premium that should be applied to a small company, in a new industry, in a relatively unstable political and economic environment, in a relatively illiquid market? These issues—size, industry maturity, macro environment, and liquidity of shares—each influence the perceived level of risk for an investment in an MFI. Each investor is likely to have his or her own perspective on these risks, underscoring the level of subjectivity applied to the analysis and the inevitable need to engage in a negotiation process.

The *capital asset pricing model* (CAPM) is one of the more widely used models for incorporating risk into business valuations. This model attempts to construct a method to introduce factors that measure the premium an investor should expect as compensation for holding high-risk assets (Tuller 1994). The model is based on the assumption that any stock's required rate of return is equal to the risk-free rate of return plus a certain risk premium. (See annex 7C for a more detailed explanation of how to develop a discounted cash flow analysis.)

The choice of method largely depends on the information available to the investor and the context in which the MFI operates. It is typical, however, for a range of valuation methods to be used and then triangulated with each other. Comparable methods that draw on either previous transactions in the industry or previous transactions in similar entities are unlikely to be useful for MFIs transforming in new regulatory contexts, and while price-earnings ratios may be readily available for the various banks in the country, traditional commercial banks tend to have a very different profile from MFIs, which by definition tend to be unique entities serving targeted markets.

A number of MFIs contract with external firms to assist with the overall valuation process, and investors may engage a third party to review the book value of the institution's assets and liabilities. This resembles an in-depth financial audit, although it may also include delivering an opinion on the institution's financial projections. These valuations can be costly. MFIs should think carefully about the timing, because such exercises can become obsolete if conducted too early in the transformation process.

What is an appropriate valuation method for microfinance? While the historical experience in MFI transformations has been to use one times book value, the shift to more commercial approaches to microfinance has recently led to both discounts and premiums being applied to the MFI's book value. A recent analysis of various MFI valuations highlights price-to-book multiples of between 0.6 and 1.4 for the purchases of equity in MFIs (O'Brien 2006). For example, in December 2004, ACCION Investments, Pachamama Holdings Corp. Finanzas Empresariales S.A. (FIMISA), and Mibanco together purchased 47.2 percent of BancoSol for approximately book value. The average purchase price for Mibanco shares in 2004 was 1.27 times book value. And the most recent purchase of Finamerica by the three cajas de compensacions[11] was between 1.4 and 1.8 times book value depending on the

Table 7.3 Precedent Transactions for Valuing MFIs

Country	Entity	Date	Percentage sold or purchased	Price to book value	Price to net income
Peru	Mibanco	Dec 2004	5.02	1.48	6.52
		Dec 2004	22.80	1.35	5.95
		Oct 2004	7.80	1.36	5.99
		Jul 2004	0.41	1.08	4.74
		Jul 2004	4.61	1.07	4.71
Average for Peru			n.a.	*1.27*	*5.58*
Bolivia	BancoSol	Dec 2004	47.20	0.98/1.00[a]	4.31
Colombia	Finamerica	Nov 2004	90.10	1.80/1.40[a]	42.80
Ecuador	Solidario	Oct 2004	2.60	0.85	4.32
		Aug 2003	19.80	0.89/1.00[a]	4.69
Nicaragua	Confia	2002	—	0.90[a]	—
Average for Latin America			n.a.	*1.12*	*4.9*[b]
Ghana	First Allied S & L	Apr 2004	33.50	—[c]	17.20[d]
	SASL	Aug 2004	100[e]	1.0	—
Kenya	K-Rep	Sept 2004	13.40	0.62	5.35
	Equity Building Society	Apr 2003	15.90	1.59	7.86[f]
Malawi	OIBM	March 2003	30.5	1.13	—
Average for Africa			n.a.	*1.09*	*6.6*[g]
AVERAGE[h]			n.a.	**1.09**	**7.5**

Source: Drawn from O'Brien (2006, p. 11).

Note: — = not available. n.a. = not applicable.

a. O'Brien (2006) obtained second number from Silva (2005). The differences in price-to-book value result from the time book value is measured, that is, the day the transaction closes or the day agreement is reached. Thus, in some cases differing values are reflected for the same transaction.

b. Excluding Finamerica.

c. Using the price of U.S.$600,000 to be paid by AfriCap for new shares equivalent to 33.5 percent and existing equity as at December 31, 2003, an approximate price-to-book ratio of 1.8 times can be deduced.

d. Discussions with AfriCap suggest that the multiple paid was four to five times adjusted forecast earnings.

e. This was the original capitalization of Opportunity International's commercial bank in Ghana.

f. Based on 2003 net income.

g. Excluding First Allied (see note d).

h. Based on the average for all Mibanco transactions and excluding the outlying values for the other transactions, being Finamerica at the top end.

calculation method, reflecting the premium paid for control of the institution. See table 7.3.

In many countries with relatively undeveloped equity markets, the market for traditional bank shares is shallow. It follows that the market for MFI equity would be even more illiquid. Thus, true arm's-length equity transactions in microfinance equity, other than initial share purchases in transforming entities, can be counted on one hand, and even these cases have involved only a small handful of specialized equity investment funds or multilateral and bilateral investors, rather than truly private investors.

Return to investors. Nominal returns on equity for more profitable MFIs can reach 20 to 30 percent per year. The actual returns enjoyed by investors, however, will vary depending on such factors as

the dividend payout ratio, the possible devaluation of the local currency in which the equity investment is denominated (if applicable), and taxes that may be imposed on sales of stock and on dividend payments. In addition, investment funds will need to cover their own operating costs and balance returns from "good investments" against "bad investments."

Accordingly, many microfinance investment managers expect to see nominal returns on equity of 20 to 25 percent (in foreign currency terms) in their portfolios, which, after operating costs and averaging in losses from investments that did not generate returns, will generate internal rates of return of around 12 to 15 percent. Investment funds generally have established hurdle rates for potential investments. These rates reflect all potential macroeconomic risk (foreign exchange, inflation, and the like) and country risks as well, though the latter may be difficult to estimate in countries without active bond or stock markets. Most investors in microfinance, however, are also looking for a "social" return, although an equivalent quantifiable formula is not as straightforward. As a substitute, investors often look for achievements in reaching social goals, such as volume of outreach, demographic penetration, average loan size as a proxy for poverty, and others.

Board seats and voting rights. Unlike in MFI NGOs, the governance structure of an MFI with shareholders tends to reflect the ownership structure of the institution. Decisions need to be made as to what proportionate amount of equity (10 percent, 15 percent, or more?) entitles an investor to a board seat. To date, most transformed MFIs are owned by a small group of investors with no one single investor in a controlling position (with the exception of those transformed MFIs in which the founding NGO remains the majority shareholder). The benefit is that investors generally take governance seriously, with investor representatives likely to attend board meetings regularly and stay actively informed about the operations of the MFI.

Usually board seats are aligned with voting rights. Unless expressly provided by the transformed MFI's charter, bylaws, or Shareholder Agreement, shareholders' voting rights are typically governed by host country law. However, in most countries, parties are allowed to reach express contractual agreements providing an assignment of voting rights that are not allocated according to the actual size of each shareholder's relative ownership interest. Where this is the case, shareholders enjoy a great deal of flexibility to agree contractually to a wide array of voting arrangements, particularly if host country law also allows preferred nonvoting shares to be allocated to investors.

Often at issue in discussions of shareholder voting rights is the question of what constitutes control. While control is usually evidenced by a simple majority shareholding, host country law may require supermajority or unanimous votes on certain matters to protect the rights of minority shareholders. Or minority shareholders may ask for contractual agreements that impose supermajority or unanimous votes on certain sensitive matters to protect their particular interests. Once negotiated, the Shareholder Agreement should reflect all of the various agreements reached with respect to shareholder voting rights to the extent permitted by host country law.

While the link between ownership of shares and board representation is an important one, it should not undermine the equally important role of independent directors—board directors who are neither direct shareholder representatives nor members of management. The use of independent directors is important to ensure an objective, institutionwide perspective. They can play an important role in areas in which the interests of shareholders, management, and the company may diverge, such as executive remuneration, succession planning, changes of corporate control, takeover defenses, large acquisitions, and the audit function (OECD 2004). They can

also bring an objective view to the evaluation of the performance of the board and management and can fill skills gaps in the board. (Despite such advantages, very few MFIs currently have independent directors.)

Mission retention. With the majority of MFIs subscribing to a double bottom line and the current prevalence of socially responsible investors in microfinance, a key discussion point is the potential investors' commitment to the social goals of the institution. Such social goals are often defined in the company's mission statement. Pushing shareholders to articulate the importance they place on mission-oriented goals is valuable because this will help guide decision making at the board and within management of the transformed MFI. Not all investors will share these same values or goals.

For those that do, however, the MFI's ability to report against agreed on social indicators becomes a critical piece of board reporting. Board members and shareholders may find it appropriate to request that senior management prepare reports from time to time that provide information about the transformed MFI's mission adherence. As with nearly all of these issues, local counsel should be consulted and asked to advise the parties as to the appropriate scope of information to be shared and the rights and responsibilities of shareholders who wish to access such information. To assist management in handling such requests for information, it may be in the transforming MFI's interest to reach agreement up front (and to document that agreement in the investment documentation) as to the form, content, and frequency of such reports.

Role in management. The level of involvement an investor wants to assume in the MFI's management is another important point of discussion. Both strategic and financial investors may request the right to appoint or approve a certain number of the senior executives of the organization. This could also include the right to veto the level of remuneration granted to and the removal of the Chief Executive Officer (CEO), Chief Financial Officer, or any other senior management team member earning a salary over a certain level. The cost implications of high salaries and the commensurate effect on the bottom line may make financial investors, in particular, sensitive to staff compensation issues. Discussions should also be held about the potential investor's understanding of which management issues would require board involvement or approval (or both) and expected frequency of communication between the board and management.

Future capitalization. The negotiation process will need to address estimates of when, if ever, additional capital needs to be mobilized and how this need is likely to be met and by whom. Shareholders should discuss how they would respond to requests from regulators for additional capital contributions to be made to the transformed MFI. While the low minimum capital requirements imposed on regulated MFIs may make this issue seem rather remote, regulated MFIs face higher, more conservative capital adequacy requirements than those imposed on banks.

This variance in capital adequacy requirements is an important issue for investors because it can affect the relative competitive position of specialized deposit-taking MFIs if they are unable to be as highly leveraged as banks. Similarly, as a transformed MFI nears the capital adequacy limit, pressure will be exerted to do one or more of the following (to the extent permitted by host country law), all of which can affect investor positions:

- Increase its retained earnings (increase profitability or reduce dividend payouts).
- Issue more equity.
- Issue subordinated debt (debt that can qualify as tier 2 capital, depending on the jurisdiction).
- Reduce the size of its loan portfolio (through securitization or sales), or slow growth in its loan portfolio.
- Shift its loan portfolio and other assets to lower-risk-weighted assets.

Generally, solutions that encourage sustainable growth and do not require a reduction in assets are preferred although the industry is starting to see some examples of securitization of loan portfolios.[12] Shareholders thus usually need to respond to ensure the transformed MFI meets its capital adequacy requirement. Shareholders can either forgo dividends, make an additional equity investment, or provide subordinated debt (if subordinated debt qualifies as tier 2 capital in the jurisdiction in which the MFI is operating).

In addition, potential investors should discuss liquidation rights in the event the MFI is liquidated, and preemptive rights that entitle all shareholders to participate in any increase in equity capital.

Financial policies. Important financial decisions and the standards for how the company's financial information is presented will also need upfront discussion. These will generally include dividend policies (conditions for payout, approval, veto rights), the production of financial statements (frequency, format, timing, approval, and so forth), and the acquisition and leasing of fixed assets.

Approval of dividend payout is typically left to a majority vote of the shareholders, although both strategic and financial investors will probably want some kind of veto ability over any declaration or payment of dividends or other distribution. The delivery of audited financial statements within a set period following the end of the financial year is a standard requirement of shareholders and they may want the right to veto annual audited statements. Significant purchases are business decisions that affect the valuation of an investor's interest and the company's operations as a whole. As a result, investors will typically require a veto right on the purchase of assets over a certain value.

Dispute resolution. Despite best efforts to forge a cohesive group of directors, board disputes do occur from time to time. Traditional approaches to dispute resolution include an escalating set of steps that the parties agree to take to reach resolution. Some international investors leave little room to negotiate these provisions; they require standard dispute resolution provisions in all their investments. Others, however, may allow some flexibility in determining the number of steps to take to resolve disputes, the timetables involved, and even the law that will govern arbitration. In general, the four escalating steps are conciliation, mediation, arbitration, and litigation. Each of these steps should be clearly documented in the Shareholder Agreement (or other investment document). (See chapter 8, Legal Transformation.) It is important however, for the MFI and potential shareholders to at least consider the preferred method of dispute resolution during discussion in the negotiation phase.

Restrictions on transfer and exit. At some point, investors may want to divest their investments in the MFI, either through the transfer or sale of shares. Both options need to be discussed thoroughly and processes agreed upon before moving forward with the investment decision.

- *Restrictions on transfer:* Limitations on the ability of parties to transfer their interests are likely to be viewed differently by varying shareholders depending on their respective investment horizons and return expectations. It would be reasonable for an MFI to request a strategic investor to agree to a two to five year restriction on transfers. From the majority shareholder perspective, such a restriction would be important, because a strategic investor is assumed to bring important connections, perspective, and expertise to the venture, which may take time to be fully implemented. A financial investor, however, will be wary of an extended period during which transfers are prohibited. Although most financial investors are looking at a three to five year investment horizon, they may be reluctant to limit their ability to sell if the option presents itself. As such, a one- to two-year restriction may be their limit.

Some of the most restrictive provisions regarding share transfers are those that prohibit any transfers unless all shareholders agree, or the transfer takes place to an affiliate of the transferor.

- *Exit strategy:* Each investor will have his or her own time horizon for exiting any investment holdings. Because the market for microfinance securities is still relatively underdeveloped, investors may aim at this point to include specific *exit mechanisms* in the Shareholder Agreement to limit the risk of not being able to liquidate their investments as needed. Relevant clauses may include the following:
  - Drag-along right: Drag-along rights enable one shareholder to force another to join in the sale of the company. The owner doing the dragging must give the other shareholder the same price, terms, and conditions as any other seller. Drag-along rights help to eliminate minority owners and put a larger percentage of the company up for sale—a potentially more attractive purchase than only a portion of a company and typically at or above a prenegotiated price.
  - Tag-along right: Tag-along rights are used to protect shareholders from being left out of an important sale. For example, if a majority or other important shareholder sells its stake, the other shareholder (often a minority shareholder) has the right to join the transaction and sell its stake in the company. The majority shareholder is effectively forced to include the other shareholder in the negotiation. Tag-along rights are extremely important to financial investors.
  - Rights of first refusal: In the event that the regulated entity decides to issue additional stock, each investor has a right of first refusal to purchase a proportional percentage of shares of the new offering, based on the holder's percentage ownership interest in the MFI. Some MFIs have expanded this clause so that any sale by a shareholder will first be offered to the other shareholders on the same terms as a third party will be offered (or has agreed to). The right of first refusal may add time to the sale process and may also reduce the value of the shares for every shareholder. When a Shareholder Agreement provides for a right of first refusal, a number of related legal and business issues will also need to be addressed—for example, how much time does the nonselling party have to consider the offer to purchase the equity for sale? What constitutes a legitimate offer? If all or part of the consideration for the sale involves noncash payments, who decides the value of that noncash consideration?
  - Right of first offer: As implied, the right of first offer requires that any shareholder wishing to sell his or her shares must first offer the shares to the other shareholders, before any such offers are made to third parties. A right of first offer is typically viewed as less of a restraint on the selling shareholder's ability to sell its shares than is a right of first refusal. As a result, financial investors are likely to prefer a right of first offer to a right of first refusal. However, this type of provision also requires drafting clarity in specifying the period during which the sale is to be made of the shares in question. Issues of what constitutes equivalent consideration may also need to be addressed if shares can be acquired with noncash payments.
  - Put options: Put options give the owner the right, though not the obligation, to sell a specified amount of an underlying security at a specific price within a specific time. The prenegotiated price is typically a function of the MFI's performance—the investor is thus mitigating its liquidity risk but accepting the venture's business risk. These options are typically triggered by the passing of a specific amount of time or the inability of the company to meet specific financial goals. A financial investor, particularly focused on

issues surrounding the timing of exit and return, may be more likely to insist on a put option. (Note that other strategic investors may also require a put option, given reputation risk and the typical lack of market for shares.) A key point of contention when negotiating a put option is determining who will stand on the other side of the put, meaning who will buy the shares being "put?" Some investors may seek the right to "put" their shares to the founding NGO or to the MFI itself. For an NGO with its own illiquid investments in the MFI or, alternatively, with a range of other community development commitments, the issue of liquidity will need to be closely examined. As for the MFI, it is unlikely that such an arrangement will be accepted by the bank superintendent. The MFI must check local laws to ensure that, as a regulated financial institution, the MFI has requisite legal authority to buy back its own shares. In some countries, bank regulations and laws prohibit or restrict the buying back of shares by financial institutions because this could unduly erode its capital base. In addition, while in the short term such a buy-back plan will increase the relative shareholdings of the other investors, the MFI's decision to use cash that otherwise could have been invested in the loan portfolio or paid out as dividends could ultimately have a negative effect on shareholder returns.

- Call options: Call options give a party the right (but not the obligation) to buy from other shareholders a specified amount of an underlying security at a specified price within a specified time. Call options have not been widely used in MFI transactions.

Finalizing the investor group. The final steps in the investor negotiation process are documenting the many decisions reached among the various investors and reaching consensus on next steps. As mentioned above, this process is best facilitated by someone within the MFI who has the time to coordinate the drafting of multiple versions of various documents and in cases in which a group of potential investors is approached at the same time, this process can be greatly facilitated if the group appoints a lead negotiator. This often happens among a group of socially responsible investors who share many of the same investing philosophies. This approach can save the MFI significant time and resources, but may reduce the institution's bargaining position.

The Funding Phase

The final step in the process, the actual contribution of the investors' capital, can take longer than parties expect. Once the final terms and conditions of the term sheet have been converted into a draft Shareholder Agreement (see chapter 8, Legal Transformation), institutional investors must present the potential investment and key documentation to their respective boards and investment committees for final approval. Depending on the bureaucratic hurdles that need to be overcome (generally, the larger the investment, the larger the hurdles), this final process can take a matter of a few weeks, or can consume over a year. To avoid being surprised by these kinds of delays, the types of approvals that are likely to be required (and lead time involved in getting such approvals) should be discussed early in the negotiation process with each investor.

A useful tool in managing any complex transaction, such as an equity negotiation, is to set out, up front, a "drop dead date" (DD Date in box 7.6) for the conclusion of the transaction. For example, for NGO MFIs that have chosen to assemble their equity investors before the actual legal and operational transformation, the drop dead date could be the last date by which the MFI intends to apply for its deposit-taking license from its bank regulators. Working backward, the project manager can then map out the next-to-last step that needs to be taken before the drop dead date, and then the step before that, and so on. Very quickly investors should begin

Box 7.6 Example of Time Line to Complete Investor Negotiations

This is an example of a timeline to complete investor negotiations if all is to be concluded before the MFI is licensed. Sequencing and time frame will depend on regulatory requirements and investor needs. "DD Date" is drop dead date.

Investors fund capital contributions and shares are issued	DD Date
Investors execute Shareholder Agreement	DD Date minus 3 days
MFI receives license	DD Date minus 5
MFI delivers license application (with list of expected shareholders) to regulator	DD Date minus 65
Investors commit to fund capital contributions when MFI receives license	DD Date minus 70
Investors secure all internal approvals necessary to invest	DD Date minus 73
Investors agree to final draft of Shareholder Agreement	DD Date minus 80
Last comments due on Shareholder Agreement	DD Date minus 85
Near final draft of Shareholder Agreement distributed for comment	DD Date minus 90
Investors meet for face-to-face negotiations on last issues	DD Date minus 100
Investors receive initial draft of Shareholder Agreement	DD Date minus 110
Term sheet agreed	DD Date minus 120

Source: Author.

to identify whether they will be able to meet these deadlines and to identify the likely time frames they will need to agree to a term sheet, finalize the Shareholder Agreement, complete their legal due diligence, and receive internal approvals to invest. It also gives the project manager a time frame to work with as he or she marshals resources of the transforming MFI to support the negotiation process. Even if actual dates are not assigned to this process, the theoretical time line helps to ensure that the negotiations are sequenced appropriately.

Effective Governance

A key challenge for any transforming MFI is to ensure that its corporate governance structure, procedures, policies, and practices are aligned with the regulated MFI's new business strategy, operations, and risks.[13] For the purpose of this book, governance is broadly defined as the system of checks and balances whereby stakeholders of the MFI (its owners, senior management, donors, regulators, customers) ensure that the MFI fulfills its institutional mission and is managed effectively. As this sample list of stakeholders suggests, both internal and external governance agents form this system of checks and balances. Before transformation, the most significant external agent typically is the donor community. After transformation, MFIs are subjected to a much broader array of external governance agents, including most notably its owners and prudential regulators.

In traditional NGO-to-share-company transformations, this change in governance is driven by the new shareholders, as they seek representation on the board in proportion to their shareholdings. The board will likely include some representation from the original NGO (but not necessarily from the NGO's board and depending on the future role

of the NGO, this board may also need to be reformed). Additionally, the transforming MFI's new bank regulators will undoubtedly impose certain governance requirements.

A country's banking law or specialized microfinance law and its implementing regulations generally spell out desired qualifications (or disqualifications) of board members and is often accompanied by a requirement that the prudential bank regulatory authority review the backgrounds of all proposed directors, typically known as "the fit and proper test." In addition, regulations may dictate the form of the MFI's governance structure (such as rules defining certain required board committees, their composition, and respective roles and responsibilities), and liabilities of directors. As a general rule, directors may be held personally liable for their actions as board members, and if such actions are found to fall short of the "standard of care" expected of directors of financial intermediaries (this standard is often defined in local law), directors may be subject to civil and criminal penalties. Thus, directors should pay particular attention to their added fiduciary responsibilities resulting from governing an MFI licensed to mobilize deposits from the public.

An important issue that confronts many transforming MFIs is how to develop effective boards that can respond to a growing number of internal and external stakeholders, many of who may be new to the MFI—such as its shareholders, regulators, and new customers (depositors and new types of borrowers). One of the more significant undertakings is to develop and grow the necessary expertise within boards of directors to ensure each member is fully informed and able to understand the risks and challenges that confront a deposit-taking institution (box 7.7). Another challenge is to establish a governance structure that sets clear boundaries between management and governance, while also

Box 7.7 Improved Governance through Diverse Owners

In 1992, GTZ and the Mozambican Ministry of Labor set up a lending and business advisory program that was eventually transformed into an independent and sustainable "credit-only" institution. SOCREMO (Sociedade de Crédito de Moçambique) was created in 1998, with the Mozambican state (94 percent) and two local NGOs—CCM and UGC— (6 percent) as shareholders. SOCREMO then sought additional capital from investors to meet the share capital requirements for microfinance banks in Mozambique of metical 25 billion (approximately U.S.$1 million). With investments of the financial institution GAPI (Gabinete de Apoio à Pequena Indústria) of approximately 20 percent and LFS (the German management and consulting company LFS Financial Systems GmbH) of approximately 9 percent, the institution complied with the minimum capital requirements and applied in 2003 for a license as a microfinance bank. In May 2004, SOCREMO received a license as a microfinance bank and changed its name to Socremo-Banco de Microfinanças, or Socremo. At this point, the state owned approximately 61 percent of Socremo.

Under its new status as a regulated financial institution, Socremo sought to further diversify its ownership structure to strengthen the governance of the institution and to increase the capital base to at least metical 70 billion (U.S.$2.8 million), the minimum capital requirement for commercial banks. Through investments of the German Kreditanstalt für Wiederaufbau (KfW Entwicklungsbank), the Swiss State Secretary of Economy (SECO), and the African microfinance investment company AfriCap, plus additional capital contributions from the existing shareholders GAPI and LFS, the share capital of Socremo increased to metical 83.6 billion (U.S.$3.4 million), clearly surpassing the minimum capital requirements for commercial banks.

(*Continued on the next page.*)

Box 7.7 Improved Governance through Diverse Owners (*Continued*)

	January 2006		
Shareholder	**Mozambican metical**	**U.S.$**	**Percent**
GPE	17,530,261,363	717,131	20.98
UGC	1,598,515,833	65,392	1.91
CCM	1,598,515,833	65,392	1.91
GAPI	10,229,584,477	418,473	12.24
LFS	7,490,476,262	306,422	8.96
KfW	15,274,135,096	624,837	18.28
AfriCap	15,168,055,000	620,497	18.15
SECO	14,667,000,000	600,000	17.55
TOTAL	**83,556,543,865**	**3,418,145**	**100.00**

With the entry of the three new investors, the share of the state was reduced from an initial 94 percent to only 21 percent. The selection of the new shareholders was based on certain criteria: (a) experience in commercial micro and small and medium enterprise finance, (b) willingness to play an active role in governance, (c) ability to provide funds for refinancing the growth of the bank, and (d) willingness to fund technical assistance.

Currently Socremo has eight board members—each shareholder is represented on the board. However, some of the board members were nominated in 2003 (GPE [state], CCM, UGC, GAPI, and LFS) and their terms expired in March 2006. At that point, only shareholders with 10 percent or more ownership were eligible to have a board seat with the exception of the two founding NGOs, who share one seat between them.

The active participation of all new investors with experience in commercial banking and microfinance has significantly strengthened the competency of the board, something unlikely to have been achieved without external investors.

Source: Christoph Diehl, Socremo, February 2006.

establishing policies and procedures for holding management accountable for its performance. This section addresses these two aspects of corporate governance—building and growing an effective board that can adequately respond to internal and external stakeholders, and holding management accountable.

Building and Growing an Effective Board

The extent and direction of changes required in the board when transforming from an NGO to a shareholding company can have a significant impact on the overall performance and effectiveness of an MFI. A forward-thinking, informed board can stimulate and promote the maturation of the MFI it governs while providing a stabilizing influence that can mitigate the risks of rapid growth that often accompany a transformation.[14]

Size and composition. The number of members on MFI boards ranges from 5 to 25, with most falling in the range of 7 to 9 members. In determining the “right” size of a board, a number of factors should be considered. Ideally, the board will be large enough to complete work effectively, help secure funding as needed, advance the reputation of the MFI, provide continuity, and ensure that quorums

are easily met for meetings—yet will be small enough to allow for substantive decisions to be made and for board members to establish a relationship of trust and accountability with each other.

Another factor is the number of shareholders that want board representation and the number, if any, of independent directors to be seated on the board. In all cases, the final number of board seats should be an odd number to avoid the possibility of tied votes. (However, an effective board usually operates on consensus making the possibility of an evenly divided board vote highly unlikely.)

The composition of an MFI board is perhaps more important than its size. It is not unusual for bank laws and specialized MFI laws to authorize supervisors to review the qualifications of each director of a regulated financial intermediary to determine his or her suitability. As a general rule, this kind of supervisory assessment is focused on screening out those individuals who are wholly inappropriate to direct the activities of a regulated financial intermediary, rather than determining the ideal members.

Purpose. The work of the board of a regulated MFI is largely focused on (a) establishing the business strategy and organizational structure of the transformed MFI, (b) ensuring the adequacy of resources (financial, leadership, and reputation) to execute the MFI's strategy, and (c) designing and implementing policies and procedures to manage that strategy (the controls necessary to ensure managerial accountability).

In practice, this means that the board will often take the lead within the MFI on the following issues:

- Confirming the mission and purpose of the MFI (this can be particularly thorny for transforming MFIs in the process of redefining their mission in the wake of transformation)
- Selecting the CEO, establishing compensation, and supporting the CEO while monitoring his or her performance
- Ensuring effective organizational planning (including succession planning at both the board and executive levels)
- Ensuring the MFI has adequate resources (human and financial) to fulfill its mission and purpose, and monitoring deployment of these resources to make sure that they are used effectively and efficiently
- Approving and monitoring performance of the MFI's strategy (CEO should have responsibility for developing and creating such strategy while the board approves and monitors its execution)
- Representing the MFI to the public and, where necessary, enhancing the MFI's image; and acting as the formal point of contact for all bank supervisory concerns
- Serving as last resort for dissatisfied MFI staff
- Identifying, and if possible, foreseeing risks and ensuring that the MFI operates prudently to mitigate or avoid such risks
- Approving external audits and ensuring proper internal control (internal auditor reports to board or board's audit committee)

An MFI should seek out board members who can contribute unique and needed skills to govern the MFI effectively. To this purpose, some transforming MFIs have "mapped" the expertise of their existing board members to determine areas that could use strengthening, and to build synergies within the entire board. For a transforming MFI this may mean consciously seeking out individuals with experience in governing a financial intermediary or an understanding of the laws and regulations to which the transformed MFI will be subject.

Board members of the MFI NGO prior to its transformation face an important and in some ways unique challenge. They must provide continuity to the transforming MFI, including a reminder of its history (and dedication to its social mission) as well as acknowledge and respond to the very different challenges and risks faced by a deposit-taking

institution. This includes understanding the different role and time commitment that is likely to be asked of board members of the regulated MFI. Some transforming MFIs have secured board training for the NGO board members to help these members comprehend the new roles they may be asked to play in the governance structure of the regulated MFI. In other cases, NGO board members may ask or may be asked to leave the board (or not join the new board) as the MFI transforms.

The degree to which the new regulated institution's board interacts or overlaps with the founding NGO (if applicable) and its board is determined by local law and regulations as well as by the ultimate role of the NGO going forward. In many countries, local law may not permit interlocking directors between the NGO and the regulated institution. Furthermore, a board member representing an NGO that simply acts as a trust for its investment in the new entity will have very different interests than one who represents an NGO involved in similar or even competing activities. The potential for conflicts of interest needs to be carefully evaluated when defining this relationship.

Roles and responsibilities. The responsibilities of those members who are invited to join or remain on the board of a transforming MFI should be clearly articulated.[15] At a minimum, board members of a regulated MFI should do the following:

- Know the mission, purpose, and goals of the MFI and its policies and programs.
- Understand the MFI's strengths and weaknesses.
- Prepare for, attend, and participate actively in board and board committee meetings.
- Ask substantive questions.
- Review and understand the MFI's financial statements.
- Support the majority view of the board and act in a way that forges consensus.
- Maintain confidentiality of information shared with and among board members.
- Maintain independence, objectivity, personal integrity, and ethical standards.
- Make informed judgments.
- Avoid even the appearance of conflicts of interest.

Board members (existing and new) should also understand the new legal liabilities they will likely face as members of the board of a regulated financial intermediary. The bank law or specialized microfinance law will specify the standard of care that is expected of directors, including rules related to conflicts of interest that are to be avoided by insiders such as board members (box 7.8). These laws and implementing regulations will also spell out the penalties—civil and criminal—that may be triggered upon a willful or negligent breach of this standard of care.

Box 7.8 Conflicts of Interest

Many MFIs develop a conflict of interest policy to protect the MFI and its reputation from actual or even the appearance of conflicts of interest. For regulated MFIs, the banking or specialized MFI law typically defines what constitutes a conflict of interest. However, MFIs can always take a more conservative position than that articulated in the law. At a minimum, a conflict of interest policy will be in writing, will outline board procedures for determining whether a conflict exists, and will make clear the answers to (a) who is to be covered by the policy (who is an insider—board members, officers, employees, members of family of the above), (b) what types of transactions are covered by the policy (all transactions, only transactions above a certain material amount, only financial transactions or also employment or service contracts), and (c) what the procedures are for bringing potential conflicts of interest to the attention of the board. A sample Conflict of Interest policy can be found in annex 8C to chapter 8, Legal Transformation.

Source: Author.

Directors will often ask the MFI to procure some form of insurance or provide an indemnity to cover any civil penalties that might be imposed on directors or to pay legal costs should regulatory authorities pursue the directors for alleged misbehavior. The extent to which such insurance or indemnity can actually be obtained from a third party (director and officer insurance) or given directly by the MFI will depend greatly on local practice and laws where the MFI is located. In some countries, for example, director and officer liability insurance is not offered. And even where such insurance or indemnities can be obtained, directors should be informed that such protection is not typically available when criminal liability is at issue.

Structure. A typical board consists of a board chair, several board committees, and individual board members. In each case, roles and responsibilities must be defined to organize the efficient conduct of the board's work. The board chair, in addition to his or her individual responsibilities as a board member, will often serve as a partner with the CEO or general manager to ensure that the MFI achieves its mission and purpose. This often includes discussions on an ongoing basis with the CEO about issues confronting the MFI, especially issues of particular concern to the board. The board chair will also provide leadership in policy setting and management oversight.

The board chair sets the agenda for board meetings with the CEO and chairs the meetings. The effectiveness of those meetings is often highly dependent on the board chair's ability to build an agenda that is structured by priorities and by time, and by his or her ability to manage the agenda. In managing that agenda, the board chair will be responsible for time management, encouraging participation of board members, focusing the discussion by framing the issue at hand, determining the need for action during the meeting, assigning follow-up responsibilities, and recognizing accomplishments. When the board determines to act, the board chair's responsibility is to ensure that such actions are in line with the MFI's organizational priorities and governance concerns.

The board chair is also responsible for ensuring that the board carries out its mandate and will typically delegate authority or appoint board committee chairs. The board chair will also take on other responsibilities as assigned from time to time by the board.

A board's responsibilities are diverse and labor intensive, requiring significant time both in and out of board meetings. With transformation, the stakes are raised still higher, making it necessary for the board of a transforming MFI to operate as efficiently and responsibly as possible. Accordingly, it is not unusual for a transforming MFI to rely heavily on its board committees. These committees guide the board in making informed decisions, and, in some cases, are delegated authority to act on behalf of the overall board. As discussed in chapter 3, Planning for Transformation, many transforming MFIs create a board transformation subcommittee.

Regulated MFIs might form a range of board committees, varying according to the needs of the MFI and to the requirements of the MFI's regulator, which may mandate the formation of certain types of committees. Some of the most typical board committees established by transformed MFIs and their usual functions follow:

- *Executive committee:* authorized by the board to act on problems or delegated decision-making responsibilities between board meetings, with such decisions to later be ratified by the full board
- *Audit or finance committee:* oversees expenditures and budgets; ensures internal control and financial analysis; recommends expenditure power of executive director within board-approved budget; hears reports of internal and external auditors
- *Personnel and compensation committee:* reviews strategic personnel issues; reviews overall

compensation policy; makes recommendations for compensation of CEO and other senior management

- *Risk management committee:* monitors the adequacy and implementation of the risk policy strategy of the MFI
- *Nominating committee:* develops board member responsibilities; identifies potential board members and judges qualifications; and conducts board orientation for new members
- *Ad hoc committees:* formed to respond to specific issues and usually for a limited period of time

Ensuring Management Accountability

Institutional transformation provides MFIs the opportunity to clearly define the line between management and governance. Governance is not management. The board should not act as surrogate managers of a transformed MFI. The extent to which a board is willing to *not* take on a management role will depend on its confidence in the MFI's current management and the policies and procedures the board has put in place to review and monitor the MFI's management. The accountability of management to the board should be accomplished through the following:

- A robust and meaningful reporting system for delivering information from management to the board
- Effective use of third-party reviews of the MFI's performance and operations
- Measurable performance benchmarks by which management's performance can be transparently and fairly assessed

Reporting system. As an MFI transforms, the amount, type, and frequency of reporting that a board may expect to receive from management is likely to increase. More information, however, does not always imply better analysis. A board that is deluged with information, or given information without adequate time for review, will not be able to monitor and oversee management effectively.

An appropriate reporting system addresses at least two issues—reporting policies that govern the flow of information from management to the board, and infrastructure for providing reliable content in these management reports (typically supported by the MFI's management information system [MIS]).

The function of reporting policies is to establish a mechanism for providing information from management to the board in a timely manner to allow the board to perform its monitoring function. Thus, an MFI's reporting policies should clearly outline the board's expectations for the scope, timing, and manner (including level of detail, form of presentation, and the like) by which management reports to the board.

In determining the appropriate scope of information presented to the board, the following is suggested, at a minimum (FDIC 2003):

- Income and expenses of the institution
- Capital outlays and adequacy
- Loans and investments made in the reporting period
- Past due and restructured loans and investments
- Problem loans (present status and workout plans)
- Allowances for possible loan losses
- Concentrations of credit
- Losses and recoveries on sales, collections, or other dispositions of assets
- Funding activities and management of interest rate risk (if the MFI is borrowing in a foreign currency, reports should also include information about management of foreign exchange rate risk)
- Performance in all of the above areas compared to past performance and benchmarked against peers' performance (trend analysis)

- All insider transactions that benefit, directly or indirectly, directors, officers, employees, or related interests
- Activities undertaken to ensure compliance with applicable laws (lending limits, interest rate restrictions, consumer protection and truth in lending requirements, tax obligations, and so forth)
- Any extraordinary event or development that is likely to affect the integrity, safety, or profitability of the MFI

In some cases, the MFI's bank regulators will require evidence that such information has been delivered and reviewed systematically by the board. Under some legislations the board must also take notice of any communication from the regulator as well as reports from ad hoc committees such as those related to money laundering or others.

A transforming MFI needs to establish early on the types of information that will be presented at each board meeting as opposed to the information that is presented annually. Attached as annex 7D is a sample board agenda, outlining types of information that directors typically expect to see. Often the minimum number of board meetings is set by the regulators. While the depth of discussion held at meetings is left to the board, it is not unusual for bank regulators to ask for the minutes of recent board meetings as part of their on-site audit. Accordingly, the minutes of each board meeting must fully and fairly reflect the extent of discussion that took place.

A second issue to address when building a robust and meaningful reporting system is to ensure that the MIS used by the MFI is providing reliable information. To avoid the "garbage in, garbage out" dilemma, the MFI should determine early in the transformation process how to track and evaluate the ongoing effectiveness of its MIS. It would be a gross dereliction of board responsibilities for directors to assume that the need for consistent MIS evaluations (in particular of the loan portfolio tracking and accounting systems) ends with receiving a license to take deposits. (For further discussion on reporting, see chapter 11, Management Information Systems.)

The board must also understand how the MIS is being used by management. Data are not the same as information. An effective management team will translate the data provided by its MIS into information that enhances its decision making as well as meets reporting requirements to the board and to regulatory authorities. An inquiring board will look for concrete evidence that management is using its MIS to inform operations.

Making use of third-party reviews. In addition to the steps that a board itself may take to monitor and supervise management, third parties can offer a valuable review of compliance with board policies and procedures, as well as applicable laws and regulations, and the accuracy of information provided by management to the board. At least five sources of this kind of third-party or independent review can be tapped by a board: (a) bank supervisors, (b) internal auditors, (c) external auditors, (d) legal counsel, (internal and external), and (e) rating agencies and consultants.

Management should make sure the board is apprised of all reports submitted to and, just as important, received from the regulators. However, some information is delivered directly to the board putting the onus on board members to ensure this information is appropriately shared with management. With respect to the audit function, sound governance practice dictates that direct authority be given to the board or its audit committee to hire, fire, and evaluate its internal and external auditors. (However, a regulated MFI may be limited by the banking or MFI law with respect to the maximum number of years that an external auditor can serve the MFI, because rotating external auditors are less likely to be hostage to the interests of the firms they

audit. There may also be requirements for regulators to approve the external auditor, or to limit the MFI's choice of external auditors to a specified class of auditing firms.) As with supervisory reports, boards or their audit committees should review all findings with management and monitor management's efforts to resolve any identified problems.

Boards should also have direct access to the MFI's internal legal counsel and, if necessary, be given authority to hire outside counsel or other experts, at the MFI's expense. The reports of rating agencies should be provided to boards as well because these can provide useful information about how the MFI compares with its peers. A robust rating report also can uncover management weaknesses that the board may not have observed or be aware of.

Establishing benchmarks for management's performance. An important part of the board's oversight and monitoring responsibilities is to establish transparent, fair, and measurable benchmarks against which management's performance can be measured. Employees are most likely to complete those tasks that are systematically measured and evaluated. This setting of performance benchmarks is easier said than done, particularly for a newly transformed MFI in which both management and the board are still sorting out what is reasonable to expect of the transformed MFI's performance. Performance benchmarks should be established to align with the achievement of the MFI's business plan. A well-designed performance benchmark can operate as a red flag, highlighting to the board and management disconnects between operations and policy goals.

Transformed MFIs often use a form of ratio analysis to manage and assess their performance. A typical ratio analysis is a CAMEL evaluation—Capital adequacy, Asset quality, Management efficiency, Earnings, and Liquidity. Of these five CAMEL elements, for most regulators the key element is management performance. (See chapter 2, Regulation and Supervision: The Policy Framework, for further discussion.)

Often overlooked in the development of performance benchmarks is the inclusion of elements that can measure and encourage the advancement of the social mission of a transformed MFI. Given the strong interest of regulators in the ongoing solvency of the deposit-taking institutions they supervise, combined with pressure by shareholders keen to earn a return on their investments, financial performance indicators are likely to absorb more of management's attention. Social mission-oriented benchmarks often have a less vocal constituency to pressure management to adhere to the MFI's avowed social objectives. It is often the MFI's board that takes responsibility for focusing management's sustained attention on maintaining the social mission. Accordingly, the board shares responsibility for adopting and refining indicators to monitor the MFI's social performance. This is complicated, however, by the lack of consensus within the microfinance industry on reliable indicators of social mission performance.

Annex 7E, Checklist for Ownership and Governance, provides a summary checklist for use by transforming MFIs in selecting potential investors and ensuring competent governance.

Annex 7A Sample Terms of Reference: Advisory Services on Ownership and Governance

Background

Background on the organization including its mission, target market, client outreach, portfolio size, and so forth.

Objectives

The objective is to assist MFI A to develop appropriate selection criteria as well as strategies for sourcing and securing new investors to meet transformation requirements. If applicable, the consultant should also recommend strategies for divesting a portion of ownership to the employees. Finally, the consultant should provide information to strengthen the board of directors to enable the members to provide sufficient strategic support as MFI A transforms as well as after transformation.

Tasks

The consultant will, in close coordination with the CEO and General Manager,

1. Develop strategies for securing new investors. Specific tasks include
   a. Discuss with current board and senior management the various types of investor profiles and determine preferred potential investor profile. Given the financial and technical demands of operating as a regulated MFI, an ideal investor is one with "deep pockets" or that has the capacity to inject capital, if required, and technical expertise that will be of benefit to the company.
   b. Develop a list of potential investors.
   c. Prepare a draft prospectus jointly with staff based on MFI A's business plan to use as a marketing tool; prepare various scenario analyses to assist in developing the appropriate capital structure.
   d. Draft an initial term sheet for negotiations.
2. Explore the possibility of an Employee share ownership plan (ESOP). Specific tasks include
   a. Review staff financial capacity with regard to compensation and incentive system.
   b. Interview staff to assess level of understanding and responsiveness to employee share ownership.
   c. Propose options for issuing shares.
   d. Propose the structure of an ESOP.
   e. Propose a trust, or other body to hold shares.
3. Develop strategy for developing or restructuring the board and revising procedures. Specific tasks include
   a. Recommend additional expertise required to strengthen the board in line with capacity requirements.
   b. Determine number of seats for the board.
   c. Recommend rules relating to the representation of new shareholders on the board.
   d. Recommend committee structure and determine which committees are advised.

Deliverables

1. Recommendations on securing new investors, including, but not limited to, appropriate capital structure and investor profile
2. Draft prospectus
3. Proposal for an ESOP (if determined appropriate)
4. Strategy for developing and restructuring the board
5. Completion report summarizing the findings and recommendations of the consultancy, highlighting follow-on activities

Timing

The consultancy is expected to take 15 to 20 days to complete.

Annex 7B Sample Term Sheet Outline

1. Issuer or Investee
2. Offering (amount and type)
3. Initial closing date
4. Sponsors/investors/shareholders

Company Purpose

5. Investee's company purpose

Legal Structure of Investee

6. Incorporation
7. Licensing process

Capital and Share Subscriptions

8. Capital
9. Number of shareholders
10. Capitalization of the investee
11. Payment timetable (dates of initial and subsequent capital contributions)
12. Payment of subscriptions (amounts and form)

Shareholders Meeting

13. Shareholders meetings
14. Shareholder voting rights and procedures

Governance

15. Board of directors
16. Board meetings
17. Board voting rights and procedures

Subsequent Sales of Shares

18. Sale of shares
19. Agreements regarding exit strategies

Financial and Accounting Practices

20. Financial and accounting policies

Operating and Credit Policies

21. Operating policies
22. Target market

Coordination of Activities

23. Activities of investee (regulated MFI)
24. Activities of investee with affiliated parties (such as original NGO or other shareholders)

Dispute Resolution and Governing Law

25. Agreed manner and procedures for resolving disputes among parties
26. Governing law to be applied to designated documentation

Table 7B.1 The shares of the investee's capital stock will be distributed between the shareholders as follows:

Shareholder	Number of shares	Percentage shareholding	Local value	U.S.$ value
MFI NGO				
MFI ESOP				
MFI founder				
Technical partners				
Investor A				
Investor B				
Socially responsible investment funds				
Investor C				
Investor D				
TOTAL				

Annex 7C Discounted Cash Flow Valuation

Two basic elements are required to perform a discounted cash flow valuation: the appropriate *discount rate* and the appropriate *cash flows.*[16]

The Discount Rate

The discount rate is usually based on the Capital Asset Pricing Model (CAPM), according to which

$$E r MFI = r_f + \beta_{MFI}[E r M - r_f]$$

where

- $E r MFI$ is the discount rate for the MFI
- r_f is the *risk free rate,* or the return required by investors in riskless assets
- β_{MFI} is the *beta,* or the correlation of the MFI's returns to the overall market's return
- $[E r M - r_f]$ is the *equity risk premium,* or the difference in returns between what an equity investor in the market as a whole expects and the risk free rate

In developed equity markets much data are available that may be drawn upon to calculate the discount rate. However, even in developed markets determining these variables is more of an art than a science. In emerging markets with less data available, the challenges are much greater. In some countries, the CAPM may be impossible to calculate and the local bank rate may provide a more appropriate rate for the discount rate.

Risk free rate. The risk free rate should reflect returns on investments that match the equity investment horizon as closely as possible for which there is no default risk and no reinvestment risk. In developed markets, 10-year inflation-protected government bonds are typically used. In emerging markets, government debt carries significant default risk and often significant reinvestment risk. Some solutions are as follows:

- Use the rate that the most risk-less companies in the country pay on local currency debt and then adjust the rate slightly higher to reflect the fact that these companies still have default risk (Damodaran n.d.); or
- Use the U.S. risk-free rate, and then add on a country risk spread between U.S. treasuries and local government comparable bonds.

Beta. The beta reflects how a given company's returns correlate to the overall market's returns. In developed markets this is typically calculated using a regression analysis of the market price of stock and a market index (S&P 500, NYSE composite, or the like) over a period. This information is almost never available in MFI transactions. It is possible to calculate an accounting beta by analyzing the fluctuation of the company's net income relative to the market. It is also possible to use an average of betas from comparable firms, adjusting for differences in leverage between the comparable firms and the firm being valued. However, it is difficult to find firms comparable to MFIs that have market prices. Usually, betas from small financial institutions in developed markets are used as a benchmark.

Equity risk premium. The equity risk premium that investors have historically required is typically used as the best measure of what investors expect equity to return in the future. Generally, this is measured by the historic spread between the geometric average return to stocks over the risk free rate. The historical equity risk premium is calculated based on the equity returns from large companies listed on major stock exchanges. Therefore, many valuation experts adjust the equity risk premium up to reflect additional return that investors in small companies expect.

Illiquidity discount. Most MFI shares are very illiquid. According to Damodaran, "studies of returns in developed markets suggest that restricted (and therefore illiquid) stock traded at discounts of 25 to 35 percent" (Damodaran 2005a, p. 35). Many valuation experts apply such a discount to illiquid assets—however, there is some research that suggests that this discount is too high. Also note that the equity risk premium for small companies should cover a portion of the illiquidity discount.

Minority discount. Significant empirical evidence indicates that investors "apply control premiums in private company transactions, ranging from 15 to 20 percent for a majority stake; conversely, this translates into an equivalent discount for a minority stake" (Damodaran 2005b, p. 58). However, little research supports this practice. Lack of control clearly reduces value, but measuring control is difficult. In countries with strong protection of minority interest, such discounts should be less. With high performing MFIs, the value of control is less than in troubled companies.

Cash Flows

Cash flows are derived from the MFI's projections. These projections should reflect a reasonable scenario, because downside cases should be covered by the discount rate rather than the cash flows. The projections period should take the company to a relatively stable period of growth. Dividends projected to be paid out are often taken as the relevant cash flows to investors. However, more properly free cash flows to equity should be calculated taking into account.

Net income after taxes

+ Depreciation
− Increases in fixed assets ("gross property, plant and equipment")
+ After-tax interest on permanent debt
− Increases in operating net working capital

Permanent debt is typically long-term debt that does not fund the MFI's productive activities. Operating net working capital includes items such as accounts receivable, accounts payable, and others.

Typically cash flows are projected until the MFI reaches a stable growth period and then the terminal value is calculated. This may be a projected sale value, which may be calculated as the present value of the sum of future cash flows into perpetuity; however, terminal value is often estimated as a multiple of projected book value at the end of the period.

See example of discounted cash flow valuation in tables 7C.1 and 7C.2.

Table 7C.1 ABC Microfinance Projected Financial Statement

In local currency	Historical 2003	Projected 2004	Projected 2005	Projected 2006	Projected 2007	Projected 2008	Projected 2009	Projected 2010
Total assets	114,319	160,046	224,065	268,878	309,209	324,670	340,903	357,948
Net loan portfolio	102,345	143,283	200,596	240,715	276,823	290,664	305,197	320,457
Accounts receivable	2,211	2,874	3,737	4,858	6,315	8,209	10,672	13,874
Gross property, plant, and equipment	8,648	9,513	10,464	11,510	12,662	13,928	15,320	16,853
Depreciation	4,089	4,703	5,408	6,219	7,152	8,225	9,459	10,878
Total liabilities	87,134	129,986	193,362	235,744	272,191	283,117	293,772	307,479
Accounts payable	2,321	2,785	3,342	4,011	4,813	5,775	6,930	8,317
Permanent debt	2,000	2,000	2,000	3,000	3,000	5,000	7,000	7,000
Shareholders equity	22,864	25,275	25,360	26,123	29,205	30,777	33,201	35,153
Financial income	24,563	33,672	42,125	48,143	56,749	58,133	61,039	64,091
Financial expense	5,487	8,086	11,922	14,565	16,800	17,634	18,462	19,368
Other operating income (net)	1,354	1,567	1,876	2,234	2,362	2,988	3,348	3,348
Provision expense	1,535	2,149	3,009	3,611	4,152	4,360	4,578	4,807
Administrative expenses	11,258	15,618	21,664	25,275	28,236	29,066	29,909	31,405
Depreciation	533	613	705	811	933	1,073	1,234	1,419
Income before taxes	7,103	8,772	6,700	6,115	8,989	8,988	10,204	10,441
Taxes	2,131	2,632	2,010	1,834	2,697	2,696	3,061	3,132
Tax rate (percent)	30	30	30	30	30	30	30	30
Net income after taxes	4,972	6,140	4,690	4,280	6,292	6,292	7,143	7,308
Return on assets (percent)	4.35	4.48	2.44	1.74	2.18	1.99	2.15	2.09
Return on equity (percent)	21.75	25.51	18.53	16.63	22.75	20.98	22.33	21.38
Debt-to-equity ratio	4.00	5.33	7.84	9.29	9.59	9.55	9.27	9.18
Exchange rate	5.65	6.64	7.67	8.70	9.73	10.76	11.79	12.82
Net income after taxes	4,972	6,140	4,690	4,280	6,292	6.292	7,143	7,308
Dividend payout on previous year's income	0	3,729	4,605	3,518	3,210	4,719	4,719	5,357
Dividend payout (percent)	75	75	75	75	75	75	75	75

Source: John Fischer, ACCION Investments, for purpose of example.

Table 7C.2 Discounted Cash Flow Example for ABC Microfinance

INCOME APPROACH—Discounted cash flows to equity		2004	2005	2006	2007	2008	2009	2010
Periods from valuation date		0.00	1.00	2.00	3.00	4.00	5.00	6.00
Free cash flows to equity								
Net income		6,140	4,690	4,280	6,292	6,292	7,143	
+ Depreciation		613	705	811	933	1,073	1,234	
+ After-tax interest on permanent debt		70	70	105	105	175	245	
− Increases in net working capital		199	305	1,453	655	2,932	3,308	
− Capital expenditures		865	951	1,046	1,151	1,266	1,393	
+ Terminal value		—	—	—	—	—	—	27,049
Free cash flows to equity		$5,760	$4,209	$2,698	$5,524	$3,341	$3,921	$27,049
Discount rate multiple		1.00	0.78	0.61	0.48	0.37	0.29	0.23
Present value of cash flows	**$21,870**	**$5,760**	**$3,289**	**$1,647**	**$2,635**	**$1,245**	**$1,142**	**$6,153**

Long-term growth rate	4.00%	
Discount rate	27.99%	
Risk-free rate of return	5.10%	Long-term U.S. Treasury coupon bond yield
Beta	0.70	Relevered beta from beta guideline companies
Market equity risk premium	7.20%	Long-horizon expected equity risk premium
Small stock equity risk premium	5.10%	Stock, bonds, bills, and inflation at 2004 yearbook (Ibbotson Associates)
Country risk premium	12.75%	

Table 7C.3 Sensitivity to long-term growth rates and discount rates

Discount rate 1.00% interval	Long-term growth rate 0.50% interval				
	3.00%	3.50%	4.00%	4.50%	5.00%
25.99%	$23,129	$23,259	$23,394	$23,536	$23,684
26.99%	$22,366	$22,479	$22,598	$22,721	$22,850
27.99%	$21,666	$21,766	$21,870	$21,978	$22,091
28.99%	$21,022	$21,110	$21,201	$21,296	$21,395
29.99%	$20,428	$20,505	$20,586	$20,670	$20,757
Value indication		**$21,870**			

Source: John Fischer, ACCION Investments, for purpose of example.

Annex 7D Sample Board Agenda for Transformed MFIs

The following provides an example of a board agenda for a transformed MFI.[17]

Annual Board Meeting

1. Performance to date in implementing the strategic plan
2. Annual plan
3. Audit plan, including management letter from external auditor and meeting with external auditors
4. Annual budget
5. Management compensation
6. Evaluation of management information systems (MIS)
7. Risk management parameters (credit limits, borrowing limits, others)
8. Staff development plans, including succession planning
9. Approval of financial statements
10. Board development plans (evaluation of existing board, growing skill base, recruiting new members)

Each Board Meeting

1. Review proposed agenda (include new items as necessary).
2. Review minutes of last board meeting (revise as necessary).
3. Deliver and review of management report on action items from last board meeting.
4. Review financial performance indicators:
   (a) Year to date versus plan (profit and loss, balance sheet, key financial ratios)
   (b) Asset quality (loan portfolio and any other assets)
   (c) Employee productivity
   (d) Significant credit exposures (concentrations by loan size, geographic distribution, product)
   (e) Problem loans
   (f) Branch performance (using rating system so that relative judgments can be made about each branch and its operating efficiencies, for example, profitable, break-even, loss)
   (g) Other
5. Review of social mission performance indicators
   (a) Year to date versus plan (size of loan portfolio, average loan size, number of clients, client profile, client retention, target client outreach)
   (b) Other
6. Delivery and review of market environment report (changes in applicable laws and regulations, peers' and competitors' performance, new entrants to market, donor policies)
7. Delivery and review of compliance report (how has MFI complied with reporting requirements of its stakeholders—donors, lenders, regulators? any complaints? any delays in delivering reports on time?)
8. Delivery and review of treasury report
9. Delivery and review of audit report
10. Delivery and review of board committee reports if not addressed above
11. Other action items

Annex 7E Checklist for Ownership and Governance

Investor Types

- Has the MFI's board and senior management developed general guidelines for the types of investors being sought?
- Is the MFI seeking to attract strategic or financial investors, or a combination of the two?
- Are all regulatory and legal restrictions on shareholders clearly understood, including
  - restrictions on percentage ownership and foreign ownership,
  - dividend repatriation limitations?
- Will the NGO continue to operate and if so what will its relationship be to the new regulated entity?
- If the NGO will become an investor in the new regulated entity, have the board and senior management achieved consensus on the ideal percentage holding for the NGO?
- Does the MFI plan to include some form of employee ownership? Have the relevant tax and legal implications been assessed?

Seeking Investors

- Has an investor selection plan been developed?
- Has a shareholder prospectus for the new regulated MFI been developed, providing key information on the MFI's management, history, vision for the future (outreach, products, geographic scope, and the like), overall financial projections, and expected returns?
- Has the prospectus been shared with prospective investors?
- Is the MFI prepared to welcome prospective investors, including gathering the historical information needed for a comprehensive due diligence process?
- Has a due diligence process been scheduled for prospective investors?
- Has the MFI discussed issues of confidentiality of information with the potential investors?
- Has the MFI clarified its own position on the more critical investment negotiation issues, including role of board in control of institution, anticipated dividend payout policy, and options for exit strategies?

Key Negotiation Issues

Has the MFI determined its own position and has agreement been reached with the prospective investors for each of the following issues?

- Strategy for capitalization of the new institution, including the amount needed and instruments
- Governance assumptions: voting rights, shareholder meetings, shareholder influence
- Management, including approval of senior management, for day-to-day management of the institution
- Financial policies, including dividend payout policy, standards for bookkeeping and financial statements, and acquisition and lease of assets
- Mission, including control of and adherence to social mission goals
- Dispute resolution process
- Restrictions on transfer and various exit strategies, including such clauses as drag along and tag along rights, rights of first refusal, right of first offer, put options, call options, and so forth

Governance

- Is the line between governance and management clearly defined?
- Does the MFI have a robust and meaningful reporting system in place?
- Has the board defined an appropriate risk policy and strategy that includes a reliable system for monitoring?
- Has the board made effective use of third-party reviews of the MFI's performance and operations?
- Has the MFI developed measurable performance benchmarks by which management's performance can be transparently and fairly assessed?

- Is there a climate of trust and candor?
- Does the board foster open dissent?
- Does the board rotate responsibilities among board members to ensure a wide understanding of the business?
- Does the board ensure individual accountability?
- Is a mechanism in place to regularly evaluate the board's performance?
- Are board committees working effectively?

Notes

The authors would like to thank John Fischer of ACCION International for his very helpful comments and additions to this chapter.

1. Note, the Financial Institutions Statute 1999 was replaced with The Financial Institutions Act 2004.
2. MFIs may also offer preferred shares to minority investors. This is discussed further later in the chapter.
3. In some countries, international investors are not permitted to invest in financial institutions or, alternatively, regulators insist on a minimum level of shares to be held locally.
4. Some regulators will permit at least some board meetings to be conducted telephonically. Holding meetings by telephone can significantly lower the costs of a board meeting for international investors, but if overused, may adversely affect the quality of the meetings.
5. See http://www.themix.org for a list of debt and equity investors in microfinance.
6. See de Sousa-Shields and Frankiewicz for an interesting discussion of asset allocation strategy.
7. Citibank has since divested its holdings in Finamerica.
8. For a comprehensive list of investors in microfinance, see www.themix.org.
9. Most transformations to date have primarily issued common stock, though there are increasing examples of institutions issuing preferred shares to provide investors with greater flexibility. Such shares provide a mechanism for attracting more equity without diluting board control among the common stock shareholders. Depending on the terms and conditions of the preferred shares, such shares may or may not qualify as tier 1 capital. MFIs should carefully review the regulatory framework to determine what kind, if any, of preferred shares may count toward tier 1 capital requirements.
10. Input provided by John Fischer, ACCION Investments in Microfinance, personal communication, August 2005.
11. Cajas de compensacion are not-for-profit organizations in Colombia that redistribute and invest in social services the mandatory payroll tax levied on all Colombian companies. The recent purchase of Finamerica included the following cajas de compensacion: Colsubsidio, Cafam, and Comfandi.
12. India has recently witnessed an occurrence of various securitization deals. The large volume of transactions and homogeneity of loan products makes securitization more feasible than in other countries.
13. This section was written by Deborah Burand.
14. For a thorough discussion on the role of boards, see Natilson and Bruett (2001).
15. For more discussion of this topic, see Council of Microfinance Equity Funds (2005).
16. This summary was provided by John Fischer, ACCION Investments.
17. Contributed by Gail Buyske, independent consultant.

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Chapter 8

Legal Transformation

The legal transformation of a microfinance institution (MFI) is a complex and sophisticated transaction requiring significant expenditures of resources, both human and financial. This chapter highlights key legal issues to consider when changing the legal form of an MFI from a nonprofit, unregulated institution with unspecified owners, into a for-profit, regulated company whose ownership is evidenced by shares. It addresses the general legal issues that will affect the transformation process. The issues are treated in the sequence of the key decisions that often drive the transformation process. As such, some of the issues addressed here have been highlighted in previous chapters; this chapter, however, is intended to present a consolidated picture of the various legal issues facing transforming MFIs.

This chapter faces the significant challenge of defining in general terms legal issues that are, by their nature, country-specific. There are sure to be exceptions to every generalization made in this chapter, possibly significant exceptions that could trigger the need for further legal analysis to effect a sensible legal transformation. Thus, the discussion does not constitute and should not be treated as legal advice. Any microfinance organization contemplating a legal transformation should consult its own counsel to advise it on the laws and regulations that will shape this complex transaction.

The chapter begins with recommendations on organizing the legal aspects of the transformation process. It describes the jurisdictions whose laws are likely to be relevant to a legal transformation and emphasizes the important role that counsel can play in spotting legal issues and advising MFIs intent on transforming. The host country laws that are likely to influence decisions of whether and how to transform are surveyed as is the importance of proactively managing existing contractual obligations of transforming MFIs. Finally, the chapter addresses crucial legal and related documentation issues likely to arise in the course of attracting outside investors into a transforming MFI.

Managing the Legal Aspects of Transformation

MFIs considering becoming regulated deposit-taking institutions should conduct an in-depth analysis of the legal and regulatory environment

This chapter was written by Deborah Burand, former Director of Capital Markets, FINCA International. She would like to thank Mark Flaming, independent consultant, for his review of this chapter and for his valuable comments.

before investing substantial time and resources in the transformation process. Many of the important choices regarding the transformation will be prescribed by laws and regulations. A full understanding of the scope and implications of those laws will inform early decisions about whether to transform, and then set direction for the transformation plan and guide choices about legal counsel and technical assistance. Annex 8A, Sample Checklist of Legal and Regulatory Issues, provides a sample of key issues to investigate when considering transformation.

Choosing Counsel

Given the complexity of the legal and regulatory issues that accompany transformation, it is important to retain counsel very early in the transformation process. Accordingly, local counsel should be among the first expert advisers to be retained by a transforming MFI.[1] Typically the board members of a transforming MFI are able to provide some recommendations for local counsel, especially if they are based in the country where the MFI is transforming. Local counsel would generally report to senior management who in turn would advise the board of any legal issues.

Given the various legal issues that may arise in the process of conducting a legal transformation and the variety of skills and knowledge necessary, more than one lawyer will probably be required. Therefore, it is not unusual for a transforming MFI to choose *lead counsel*, typically a lawyer or law firm charged with the responsibility for handling major banking, corporate, tax, and securities law issues. If all such expertise is not found within the lead firm, lead counsel will delegate to (and manage) other lawyers outside the lead firm in the analysis of relevant specialized areas of law. For example, FINCA Uganda used two Ugandan firms to advise it on legal issues related to its transformation, combining a law firm expert in Ugandan corporate, securities, and banking law with tax counsel based in the Ugandan offices of an international accounting firm.

Early in the process of selecting lead counsel, transforming MFIs should attempt to identify the range of potential areas of legal expertise needed to support their transformation. As candidates for the role of lead counsel are found, they should be asked to indicate in which of these legal areas they are expert, and, just as important, in which areas they are likely to need outside legal support. If it becomes clear that other counsel will be needed to supplement the expertise of lead counsel, transforming MFIs should also ask lead counsel candidates to identify lawyers or other law firms that could provide this expertise, particularly those lawyers with whom they have worked successfully in the past. This last line of questioning serves at least two purposes. First, it helps the transforming MFI to identify other candidates with legal expertise. Second, it may indicate how well counsel is likely to perform the role of lead counsel with responsibility for managing lines of communication among an entire team of lawyers serving the transforming MFI.

Selecting local counsel early in the transformation process can help transforming MFIs avoid costly mistakes. In addition, the local counsel that guides an MFI through the process of legal transformation may end up being the same counsel that later handles complex legal issues that are outside the competency or time constraints faced by the transformed MFI's in-house counsel.[2] A well-managed selection process also serves to inform local counsel about the range of legal needs of the transforming MFI and also serves as an opportunity for the local lawyers of the transforming MFI to begin identifying possible legal issues that may require further analysis in the course of the MFI's legal transformation. When reviewing local counsel candidates, another important consideration is the extent to which such counsel is likely to inspire confidence in not only the MFI's senior management and governing board, but also in outside investors because these investors—local and international—might require the MFI's local counsel to offer local legal opinions regarding the legality, validity, and enforceability of certain investment documentation.

Given the newness of many of the specialized laws and regulations being applied to microfinance deposit-taking institutions, few local legal practitioners will have much experience in interpreting such laws and regulations. This lack of experienced legal advisers, combined with the limited applicable experience found within the regulatory authority charged with implementing these new laws and regulations, can cause even the most optimistic MFI managers to question whether to transform. However, waiting until there is absolute legal clarity is not usually a realistic option. Legal and regulatory risk is something that all regulated financial institutions face no matter where they operate, be it Uganda, Uruguay, or the United States. Moreover, some transforming MFIs believe that where there is legal or regulatory uncertainty, it is better to be one of the first institutions to transform to help guide and establish the precedents being adopted by the local authorities who will implement these new laws and regulations. Time will tell whether being a market leader is strategically sound.

Negotiating Counsel Fees

Another issue that can add to the complexity of hiring legal counsel is the question of fees. The transforming MFI may have difficulty anticipating the full range of legal support it will need in the course of its transformation, especially when initial fee negotiations take place with local counsel. For law firms that prefer to bill on an hourly basis, the risk to the MFI is that the billing clock will race out of control and it may end up with a much larger legal bill than anticipated. This is particularly likely to happen if there is no clarity within the MFI about who has the authority to request legal advice from counsel. Lawyers, on the other hand, are reluctant to negotiate a fixed fee, as opposed to hourly charges, if they cannot delineate a detailed (and often narrow) scope of work describing the legal services they will be offering for the fixed fee.

One approach that some transforming MFIs have taken when negotiating legal fees is to establish a cap on the overall amount of fees that will be charged for producing a defined set of deliverables as outlined in a detailed scope of work. This approach tries to accommodate both the MFI's need for cost controls and the legal counsel's need to be reimbursed for the time it spends on a given issue. This approach also forces an early discussion of the kind of information and advice that will be rendered by legal counsel within a defined scope of work. While this conversation can be difficult, because MFIs will try to broaden the scope of work and legal counsel will try to narrow it, it is always easier to have this discussion before, rather than after, legal work is done and the bill for services is submitted. It also puts the onus on counsel to initiate additional dialogue with the MFI if and when the scope of legal work expands beyond what was originally anticipated.

A third approach is to arrange to pay counsel on a retainer basis. While there are many variations on how retainer arrangements are structured, the underlying principle is for the client to pay an agreed amount for a set period during which counsel agrees to make him or herself available to respond to whatever needs the client has that are within the counsel's technical realm of competence. Retainer arrangements tend to be used more often for ongoing legal advisory relationships than for complex transactional advice. Accordingly, certain aspects of the legal transformation may lend themselves better to retainer arrangements than others. For example, survey work done to map out the host country's legal and regulatory regime under which a transformation might take place is more amenable to retainer arrangements than the legal work that would be involved in structuring and documenting a complex Shareholder Agreement among multiple investors.

MFIs should also negotiate up front with their legal counsel how administrative costs and expenses related to legal advisory services will be shared. Some law firms run their administrative and support services as profit centers so clients can sometimes be very surprised by the costs billed to them for items

such as photocopying, phone calls, and delivery services.

Annex 8B, Sample Terms of Reference: Hiring Local Counsel to Support Legal Transformation, provides Sample Terms of Reference that might be adapted by transforming MFIs to guide their discussions with local counsel about the range of initial legal services that may be needed to support legal transformation.

Surveying the Legal and Regulatory Landscape

Each jurisdiction has a unique set of laws and regulations that will define the basic options for transforming the legal structure of an MFI. Each jurisdiction organizes those laws and regulations in different ways, and with varying degrees of clarity regarding precedent and application.[3] The following discussion addresses basic legal issues that are likely to govern the transformation process in most jurisdictions.

Whose Laws Matter?

Transforming an MFI requires navigation through a sometimes uncertain and complex landscape of laws and regulations. It is therefore important to identify early on the legal jurisdictions that will govern the process. Most applicable laws and regulations are found in the country where the transformation is taking place, that is, where the transforming MFI will be incorporated and subject to prudential bank regulation (referred to here as the "host country"). However, when foreign stakeholders such as equity investors, lenders, and donors are involved with the transforming institution, the laws of other countries—those where foreign stakeholders are incorporated or resident—may also be relevant to the analysis. For example, foreign nonprofit organizations that plan to take an equity shareholding in a newly transformed institution may need to analyze the impact of such a shareholding on their tax-exempt status under their country's law. Similarly, the tax treatment of cross-border payments by the transforming MFI to its foreign investors (debt and equity) may vary according to the terms of the bilateral tax treaty, if any, between the host country of the transforming MFI and the country where the cross-border payment is to be made. Even the laws and regulations governing the conduct of bilateral donor agencies may affect the capital structure or investor-seeking strategies of a transforming MFI that has received grant funds from such a donor.[4]

Forms of Legal Organization with Authorization to Provide Financial Services

Many MFIs that begin as nonprofit organizations are organized under local foundation laws or charitable organization laws. While the laws and regulations governing transformed institutions vary from jurisdiction to jurisdiction, nonprofit MFIs are typically required by bank regulatory authorities to change their legal form before they can be licensed to take deposits from the public.[5] Legal research should begin with a survey of the various legal forms of organization available to the transforming MFI, including the authorization assigned to each legal form related to financial intermediation, the applicable supervisory regimes, and the criteria for organization (registration process, licensing criteria, ownership, governance, staffing, capital requirements, and the like).

Bank regulatory authorities are generally concerned about the legal form deposit-taking institutions take because they want to ensure that such institutions have a clear ownership structure with ownership rights defined by shares. A clear ownership structure allows bank supervisors to impose corrective actions on a weak deposit-taking institution and, very important, to hold the institution's owners accountable for responding to such actions, including in some cases, providing additional capital commensurate with their existing ownership share.

A growing number of countries are adopting or considering the adoption of a multitiered regulatory approach that applies a specialized prudential bank regulatory regime to the conduct of microfinance that reflects the varying risks different types of microfinance services pose to the financial system as a whole. See chapter 2, Regulation and Supervision: The Policy Framework, for further discussion. Ideally, MFIs operating in such a system would be able to transition from one tier to the next. This tiered approach often presumes that MFIs will be relatively unencumbered (other than in addressing prudential regulatory concerns) in evolving and transitioning from one tier to the next. However, nonbank regulatory issues can cause such transitions to stall. For example, corporate or securities laws may inadvertently prevent MFIs from seamlessly transitioning from one legal form to another without incurring significant expense or disrupting existing business operations. Given that much of microfinance is based on relationship lending, putting even a momentary halt to lending operations to conform with corporate or securities law requirements usually is not feasible. As a result, MFIs intent on transforming may find themselves at odds with host country laws and regulations that never contemplated such corporate changes (see box 8.1).

In some situations, rather than establish a new shareholding company, MFIs may decide to either purchase a shell financial company or merge with an existing financial institution. In such a case, the transforming MFI needs to know what legal issues to be aware of and should conduct a due diligence exercise on the existing company. The transforming MFI will also need to engage legal counsel to determine what documentation is required to complete the merger and ultimate transfer of assets from the NGO to the company.

Also important in evaluating various options is to begin estimating the burden and costs of complying with the prudential regulatory regime applied to each legal form once the MFI begins to take deposits. This is the time to determine whether existing or potential competitors are likely to be subject to similar regulatory requirements. How level is the regulatory playing field for those interested in serving a similar customer base? If it is uneven, what is the likely impact of these differing regulatory burdens on the transforming MFI's ability to maintain or grow its market share in relation to competitors that are facing different, perhaps more favorable, levels of regulation?

Box 8.1 Transformation and Host Country Laws and Regulations

In Uganda, most MFIs are registered as NGOs under the Nongovernmental Organizations Act or as "companies limited by guarantee" under the Companies Act (or as both). Others are registered as savings and credit cooperatives under the Co-operatives Act. To apply to become a deposit-taking institution, applicants must be organized as companies limited by shares (a form of limited liability company with share capital) *before* the Bank of Uganda will entertain their applications to become deposit-taking MFIs. This requirement caused some transforming MFIs in Uganda to worry about the time and expense (including tax consequences) of unwinding ownership and shareholding structures if they are not subsequently approved by the Bank of Uganda.

In the Kyrgyz Republic, the National Bank of Kyrgyzstan requires all microfinance companies (the legal form of specialized finance and credit institution permitted to offer microcredit and take time deposits to fund such lending activities) to be organized as joint stock companies. Formation documents of the applicant and its state registration certificate must be submitted to the National Bank as part of its license application. Effectively this means that, as in Uganda, all applicants for a license to operate as a microfinance company in the Kyrgyz Republic must first become a joint stock company before submitting their license applications for review by the National Bank of Kyrgyzstan.

Source: Author.

Tax Laws

The host country's tax laws will also shape the way an MFI chooses to transform its legal form. Because tax law is rarely neutral in its response to the manner by which a legal transformation is effected, tax planning and advice is important *before* the change in legal form is undertaken. For example, tax laws may influence how assets are transferred (see chapter 5, Strategic and Business Planning). A transfer is likely to trigger a number of "transaction" taxes related to the transfer of assets from the original company to the new company. Some of these taxes can (but do not always) include

- Capital gains taxes payable by the original company for the "gains" it realizes during the sale of premises or shares to the new company
- Transactional tax (or stamp duties) on conveyance of assets (including, possibly, the entire loan portfolio transferred to the new company)
- Income taxes payable by the new company if any assets are transferred to it without delivery of commensurate consideration for those assets (for example, if a loan portfolio is given or donated to the new company instead of sold to it for shares, debt, or cash)

Other assets such as office equipment, vehicles, and even buildings may also need to be transferred to the new entity. In each case, MFI management should integrate these asset transfers into the overall asset transfer strategy and also should seek an analysis of the tax implications of such transfers to determine if they will give rise to unexpected tax obligations (see box 8.2). Establishing a credible fair market value for those nonfinancial assets being transferred is also important to protect the transferor and transferee from future scrutiny by tax or bank regulatory authorities.

Box 8.2 Kyrgyz Microfinance Law

The specialized Kyrgyz law on microfinance provides that shares of a deposit-taking microfinance institution may be issued only in return for cash. As a result, it is impossible to exchange an existing loan portfolio for shares in the new deposit-taking company. One possible rationale for such a provision is to avoid confusion or disagreement over the appropriate valuation of transferred loan portfolios and, thus, the resulting valuation of new share issuances.

A potential solution to this problem is for the transferor to "donate" most of its loan portfolio to the new company. However, that solution is very tax disadvantaged because Kyrgyz tax authorities are likely to treat such a donation as taxable income of the transferee and thus subject to a 30 percent profits or income tax. As a result, loan portfolio transfers from one institution to another can take a much more complicated and lengthy route than might be expected, particularly where cash proceeds of loan repayments are applied on a rolling basis, by the transferor, as consideration for shares in the new company.

Source: Author.

Labor Laws

Labor laws also need to be addressed when changing an institution's legal form. For MFIs that are simply reorganizing or for MFIs planning to create or buy a new company but expecting to continue to conduct front-office operations out of the original NGO, these labor law issues may be less substantial because few or no staff members are being transferred from one institution to the next. MFIs transferring much of their staff to the regulated entity may face substantial financial liabilities (tax, pension, and so on) that could be triggered by the termination of positions even if all staff members are being immediately reassigned to the new entity.

Managing Constituent Documents and Preexisting Obligations

An MFI in the course of a legal transformation usually must amend or adopt new constituent documents (such as the certificate of incorporation, articles of association, and bylaws) and add investor agreements. These governing documents may have different names in different jurisdictions, but their basic functions are the same—they provide the corporation its legal existence under the laws of the jurisdiction in which it is incorporated and set out the rules that apply to the corporation's governance structure, its internal management, and the collective agreements of its shareholders.[6]

Constituent Documents

Even where a legal transformation is effected by the reorganization of a preexisting entity rather than the establishment of a new entity, the transforming MFI will still likely need to amend its existing constituent documents. In both cases—a preexisting entity or a new entity—these changes are often motivated by factors ranging from responses to requirements of regulatory authorities in the host country to the transforming MFI's new ownership structure and business objectives. The kinds of changes that are required will vary by jurisdiction, but the following general guidelines will be indicative.

Company charter. The constituting document of the transformed MFI, usually the *charter*, typically establishes the company's name,[7] the company's purpose, amount of authorized shares, and the number of directors. Some transforming MFIs give great thought to the language used in their charters to describe their companies' purposes. To some extent this may reflect the broader discussions that often take place over whether and how to modify the transforming MFI's mission statement once the transformation is completed. And in some jurisdictions this is prompted by host country regulators that may require the transformed MFI to include some reference to its broader social purpose or products in the constituent documents.

Thus, the regulated MFI's mission statement may be included in the constituent documents or other investment documentation. However, in jurisdictions where the doctrine of ultra vires[8] applies, it may make sense to opt for a broader company purpose than that currently contemplated by the transformed MFI's mission statement. In those jurisdictions that adhere to the ultra vires doctrine, company acts (acts the regulated entity carries out) or acts of the company's agents may be overturned as void or voidable if it is found that such acts were outside the scope of the company's business purpose as expressed in its constituent documents. Similarly, because mission statements may change from time to time, it may be wise not to include them in constituent documents that are hard or time consuming to amend.

In addition to a mission statement, social goals that define the target market and, in some cases, specify guidelines for loan portfolio or client may also be included in the constituent documents of the MFI, such as its charter, particularly if required by the regulators.[9] An example of one such clause would be

> [MFI A] will not modify the nature or the scope of the Project [typically defined in the Shareholder Agreement], nor will it make any significant change in the activities or operations of its business, so that at any time at least 50 percent of the loan portfolio under its management will be provided for the financing of small and micro entrepreneurs defined as those businesses with less than . . .

The key, of course, in negotiating such language is to strike the right balance. The language should not curtail too severely the MFI's ability to respond to the changing market it serves.

Company bylaws. The company's *bylaws* will typically set out the rules for how the transformed MFI will be run. Bylaws usually will specify the duties of officers, appointment of corporate and board committees, election of directors, and rules and procedures governing share transfers. The MFI's bylaws should also outline the conditions under which dividends can be paid. Because many of these issues will be subject to bank regulatory standards or requirements, a good starting place for drafting bylaws is to first look at the prudential bank regulatory regime that will be imposed on the transformed MFI to make sure that the proposed bylaws are consistent with this regime.

A transforming MFI will likely revisit many times the question of which provisions governing investor rights should be addressed in the constituent documents and which investor rights should be addressed in investment documentation such as the Shareholder Agreement. In some jurisdictions, local law may require that investor rights and obligations be addressed in the constituent documents to be enforceable.[10]

Preexisting Contractual Obligations

The term *legal due diligence* refers to an exhaustive review of all existing and, in some cases, prior legal agreements that may affect or be affected by the organizational change. Most nonprofit organizations have never had cause to conduct a legal due diligence exercise. To ensure that the legal transformation does not disrupt existing contractual obligations, each contractual agreement to which the MFI is party should be reviewed in detail. MFIs that are pursuing purchase of or merger with an existing nonbank financial company should also conduct such a review for contracts of the existing company. The agreements that may arise in a legal due diligence exercise include these:

- Grant agreements
- Mortgages
- Credit agreements (where the MFI is the borrower)
- Pledge agreements (where assets of the MFI have been pledged to secure the MFI's borrowings)
- Guarantee agreements or related reimbursement agreements (if the MFI is the beneficiary of a third-party guarantee and the MFI has agreed to reimburse the guarantor should the guarantee ever be called)
- Leases
- Licensing agreements
- Service agreements
- Agency agreements (if the MFI has agreed to act as the paying agent for other service providers such as insurance providers)
- Vendor agreements
- Employee contracts
- The MFI's own form of loan agreements with its clients

Careful due diligence will prevent the inconvenience of a counterparty claiming that his or her loan agreement, lease agreement, pledge agreement, grant agreement, or the like has been violated by the change in legal form or asset transfer of the transformed MFI. Moreover, a violation of some contracts may trigger cross-defaults in other contractual obligations of the transformed MFI, precipitating a domino-like fall that will worry regulators and stakeholders, and possibly other existing and potential counterparties. Consequently, counsel should be hired to conduct the legal due diligence and it should be carried out early in the process and comprehensively. The MFI (with counsel) should also maintain accurate records of the documents counsel has reviewed so these records can be disclosed or form the basis of a future legal opinion that may be required to give comfort to outside investors that the legal transformation will not violate any existing contractual arrangements of the transforming MFI. Thus, the MFI should build in lead time for receiving all necessary consents,

waivers, and amendments to existing contractual agreements.

Liability transfers can be nearly as complicated as asset transfers, particularly if the MFI has any outstanding debt financings at the time of its transformation. A legal transformation may cause a borrowing MFI to breach standard loan covenants such as provisions that prohibit or severely curtail disposal of the MFI's assets, or prohibit mergers and other significant changes in the management or underlying business of the borrowing MFI. The act of taking deposits may also result in the borrowing MFI being unable to meet certain financial or debt ratios previously agreed on with its lenders.

Moreover, lenders do not always understand or appreciate the rationale for a transformation, nor might they be particularly well-informed about the impact of a transformation on the quality and legal priority of their outstanding loans to the MFI. As a result, MFIs should be prepared to explain to their lenders the ramifications of the legal and operational transformation on their outstanding borrowings. While some lenders may take comfort in learning that the borrowing MFI is soon to be subject to formal regulation and supervision, others may be surprised to learn that once the transformed MFI starts taking deposits, unsecured loans to the transformed MFI are likely to be legally subordinated by regulatory authorities to these depositors' claims.

Other lenders may even take the opportunity of the liability transfer to try to improve their position relative to the borrowing MFI. In one case of an MFI undergoing an asset and liability transfer in preparation for transformation into a deposit-taking institution, a lender conditioned its consent to the transfer of its loan on a significant renegotiation and changes aimed at improving the lender's position in certain key financial terms in the underlying loan obligation. Had the loan not been so sizeable, and had the lender not represented such an important relationship to the MFI, the MFI might have simply prepaid the outstanding loan and ended the borrowing relationship.

Of course, prepaying a loan is only possible if the MFI has excess cash or access to another source of financing (such as new investor capital) that it can use for such prepayment. Also, some lenders are not willing to allow a prepayment and will make sure that their loan documents contractually prohibit prepayments (or, at the very least, do not expressly permit any prepayment). Still other lenders may impose a significant financial penalty on any MFI borrower wishing to prepay all or part of its outstanding loan obligations. Should this be the case, the cost of the transformation will clearly increase.

One way to minimize this situation is to discuss with all lenders, at the time the terms of new loans are being negotiated, the likelihood that a legal transformation will take place during the life of the loan and to include in the loan documentation the lender's prior consent to a transfer of the loan at such time to the new entity (see box 8.3). If that prior consent is not possible, the borrowing MFI should attempt to minimize the financial penalties that would be imposed upon prepayment. Even if the lender is unwilling to document its consent to a transfer of its loan at such an early date, having had the discussion with the lender before the loan is disbursed may pave the way for a smoother negotiation when the time comes for the liability to be transferred or assumed by the new company.

If assets of the original MFI have been pledged as collateral for a loan, it may not be enough to get the lender's consent to simply move the loan obligation from the original company to the new company. The lender may also need to consent to the transfer of the pledged loan portfolio. An asset transfer conducted in a series of transactions may pose the added challenge of maintaining the proper balance of debt and collateral (see chapter 5, Strategic and Business Planning). The transitional period is likely to make many secured lenders queasy and may result in a long negotiation as the parties attempt to reach agreement on the actual timing of the liability transfer and related collateral transfer. Annex 8A, Sample Checklist of Legal and Regulatory Issues,

Box 8.3 Possible Prepayment Clause

The following is an example of a prepayment clause that might be used in a loan agreement to allow an MFI borrower to prepay all or part of the outstanding principal amount of loan (called here the "Advance[s]") and all accrued interest thereon:

The Borrower may, upon at least__business days' notice to the Lender (which notice shall be irrevocable) stating the proposed date and aggregate principal amount of the prepayment, and if such notice is given, the Borrower shall, prepay the outstanding principal amount of the Advances in whole or ratably in part, together with accrued interest to the date of such prepayment on the principal amount prepaid; provided, however, that if any prepayment of an Advance is made on a date other than the last day of an interest period for such Advance, the Borrower shall also pay any amounts required to compensate the Lender for any additional losses, costs, or expenses that it may reasonably incur as a result of such prepayment, including, without limitation, any loss, cost, or expense incurred by reason of the liquidation or reemployment of deposits or other funds acquired by the Lender to fund or maintain such advance.

Source: Author.

includes a sample checklist of issues to consider when entering into loan agreements in which the borrower is an MFI that anticipates transforming during the life of the loan.

Negotiating Investor Documents

Most MFIs that adopt a shareholder structure will want to attract new equity investors. The transforming MFI must know the legal and regulatory requirements of its host country that are likely to affect the investment appetite of its targeted investors. Such knowledge will help the MFI propose investment structures and exit strategies to meet its potential investors' needs and interests. Annex 8A includes a list of issues that local counsel should review and discuss with the transforming MFI before negotiations commence with potential equity investors.

Preparing for Negotiations with New Shareholders

As discussed in chapter 7, Ownership and Governance, potential investors will want to conduct customary due diligence before making an investment decision. From the investor's perspective, the purpose of due diligence is to fully understand the business of the MFI, including its markets, customers, financial condition, legal position, and all other significant risks inherent in the business. This understanding can only be reached by undertaking a thorough examination of the MFI. At the same time, the MFI has equal interest in conducting due diligence of its own on potential investors. Not only should the MFI be comfortable that its potential investors are able to finance and close on any capital contribution commitments they make, but given recent money laundering and antiterrorist financing concerns, the MFI should also understand the identity and reputation of its potential investors and their funding sources.

Before entering into negotiations with any potential investor or allowing any due diligence exercise to begin, the MFI should develop a standard confidentiality agreement for all potential investors to sign. The agreement should oblige each potential investor (and its agents) to keep confidential any information provided in connection with the due diligence process, and commit the investors to not use the information for any purpose other than to evaluate the potential investment. The transforming MFI should learn all host country restrictions on ownership that might affect its potential investors before entering negotiations.

> **Box 8.4 Foreign Investment in India**
>
> The government of India allows foreign equity investment in nonbanking finance companies (NBFCs) subject to a ceiling of 51 percent and a minimum amount of U.S.$500,000. MFIs feel that this amount is on the high side. For full foreign ownership of NBFCs, the minimum amount prescribed by the government is U.S.$5 million, which is considered out of reach for the microfinance sector. As a result, not many investors are reportedly showing interest in equity contributions to microfinance NBFCs.
>
> *Source:* Staschen and Bhattacharjee 2004.

For example, local law may contain restrictions on foreign ownership or require a certain minimum percentage of ownership by nationals or residents (see box 8.4). Local law may impose restrictions on voting rights of foreign owners. Similarly, other less direct laws and regulations may dissuade potential investors from investing in a transforming MFI, such as tax benefits that accrue to the MFI or its investors only if certain local ownership or management requirements are met, or notification and registration requirements imposed on foreign investments but not similarly required of local investments. The MFI needs to be aware of these limits or restrictions before it seeks foreign investors, rather than late in the negotiations after significant expense and time have been invested by all parties.

Where distinctions are made in the host country's laws and regulations between the benefits and obligations imposed on local and foreign investors, local counsel should advise on what solutions or ownership structures could be used to minimize such disparity. In some cases, for example, it may be that local nominees can be used to hold the equity interest of foreign investors in trust without triggering the disparity in treatment accorded to foreign investors. Of course, this type of nominee ownership must also be approved by the MFI's bank regulatory authorities.

Advice of local counsel will be critical for the development of suitable documentation for investment transactions in the transformed MFI. Before engaging potential investors, the MFI should be clear about which documents are necessary for the transaction, and which provisions should be specified in which document.

The investment documentation can take several forms. Most common is the Shareholder Agreement. In many jurisdictions, most of the necessary documentation will be contained in this one agreement. All existing shareholders and the new investors will sign it. The documentation may also be divided among several agreements. For example, sometimes the initial shareholders and the new investors will enter into a Stock Purchase Agreement (see explanation below) that governs the sale of shares, and limit the Shareholder Agreement's scope to addressing issues related to how shareholders will conduct themselves once their initial allotment of shares has been issued.

Shareholder Agreement

A Shareholder Agreement is a highly customized document that defines the objectives and mission of the company and its governance structure and defines the particular objectives and concerns of the various shareholders who are party to the agreement. It also reflects the requirements of the host country law where the investment is being made. Shareholder Agreements typically attempt to inject stability and rules of engagement into what may otherwise be an uncertain investment. Often the exercise of negotiating a Shareholder Agreement provides the parties important insights into differing shareholder attitudes about key business issues.

A primary objective of the Shareholder Agreement is to spell out the rights and responsibilities of the shareholders in relation to each other and also in relation to the governing body of the company,

its board of directors. The Shareholder Agreement defines the rights and obligations associated with different classes of shares, and clarifies the obligations of the different classes of shareholders in cases of regulatory intervention or bankruptcy (see chapter 6, The Funding Structure, for further discussion). The Shareholder Agreement also attempts to ensure that shareholders act appropriately with respect to the investment's interest.

The following describes some of the more significant issues normally addressed in Shareholder Agreements:

Shareholder meetings. The investment documentation typically outlines the procedures for shareholders' meetings. As with all of these issues, host country law may set forth certain requirements with respect to shareholders' meetings, such as the minimum number of meetings, location of meetings, and the like. However, where host country law is silent, the shareholders must address at least the following issues:

- When and how often will shareholders meet?
- Who has the right to call meetings?
- When can special meetings be called (by whom and for what purpose)?
- What advance notice must be given to shareholders of meetings? (Can such rights to notice be waived, through attendance or by written waiver or both?)
- What constitutes a quorum to make binding decisions (presence of shareholders or their nominees representing a simple majority of all share capital)?
- Under what circumstances, if any, will shareholders be authorized to act without a physical meeting? Can telephonic meetings be held (do bank regulatory authorities permit such telephonic meetings)?

Board meetings. Investment documentation will also contain provisions to address the procedures for board meetings. The same questions raised with shareholders' meetings are relevant to board of directors' meetings. Similarly, host country laws may dictate some of these procedures, particularly where there is a bank regulatory interest present. Local counsel should be able to advise the parties about any statutorily imposed voting requirements obliging the parties (shareholders or board members) to obtain more than a simple majority vote before taking certain actions.

Management role. Investment documentation sets out the powers and duties of the officers of the transformed MFI. Accordingly, investment documentation should reflect any and all host country requirements in this regard. For example, it is not unusual for prudential bank regulatory authorities to describe in detail the role and functions and necessary credentials of the internal auditor. Day-to-day management issues requiring board involvement or board approval or both, as well as the frequency of communication between management and board, should also be clearly articulated in the Shareholder Agreement.

Future capitalization issues. The Shareholder Agreement spells out shareholders' rights and obligations with regard to capitalization going forward.

- *Sources of financing:* Other sources of financing are likely to include borrowings and third-party equity investments. Investors may request the right to approve major borrowings and may impose a desired debt-to-equity ratio on the regulated MFI. Depending on the agreement reached with investors, the Shareholder Agreement could provide, for example, that indebtedness over a certain amount may not be incurred except upon receiving unanimous shareholder approval, or supermajority, or unanimous vote of the MFI's board. With respect to equity investments by third parties, the key issues will surround the conditions under which such equity

investments should be permitted. The board or all shareholders will likely have to pass resolutions to authorize the MFI's issuance of shares and the related capital increase resulting from these new equity investments.

The conditions for making subsequent capital contributions are also likely to be specified in the investment documentation. Depending on local law, this can be included in the constituent documents of the transformed MFI or it may be contained in the Shareholder Agreement. Among other things, this will set forth whether such contributions are voluntary or mandatory. If such contributions are mandatory, the documentation needs to specify the consequences if a party fails to make the mandated contribution. Similarly, if host country supervisors have the authority to impose mandatory capital contributions on investors, the investment documentation should reflect these relevant regulatory requirements.

- *Liquidation rights:* In the event the transformed MFI is liquidated, the investors' shares entitle them to participate in the liquidation proceeds once all outstanding liabilities of the company have been settled and paid. Generally, rights to the liquidation proceeds will be allocated in line with the relative size of each investor's shareholdings. However, host country laws may provide special rules for the dissolution and liquidation of regulated institutions. The investment documentation should be drafted in a manner that is consistent with these host country requirements, if any.
- *Preemptive rights:* Preemptive rights typically entitle each shareholder to participate in any increase in the equity capital. This gives each shareholder the right to subscribe to newly issued shares of the company according to its respective ownership interest, unless this right is waived. In some jurisdictions, host country laws give investors such preemptive rights as a matter of law. Local counsel should be able to advise as to whether there are any circumstances under which statutory preemptive rights exist and whether they can be excluded by contractual agreement in the investment documentation.

Financial policies. Relevant financial policies that are included in investment documentation include dividend payment policies and the production of financial statements.

As mentioned, the MFI's bylaws normally outline the conditions under which dividends can be paid. Some countries impose mandatory profit retention requirements on companies. Bank regulatory authorities, as well, are often authorized under certain specified circumstances to restrict the payment of dividends by regulated financial intermediaries.

Outside of such mandated requirements on profit retention, shareholders may also agree to retain a certain amount of reserves within the MFI before paying out dividends to shareholders. This required reserve amount can be expressed a number of ways—as an absolute amount or as a fixed percentage of profits, for example. The Shareholder Agreement should specify any such agreements entered into by the shareholders of the transformed MFI.

Host country laws, particularly those imposed on regulated financial intermediaries, are likely to shape the provisions found in investment documentation regarding the appointment of auditors and preparation and publication of the MFI's financial reports. The Shareholder Agreement generally requires that the MFI also provide a monthly financial report to the board within a set time after the end of each month, consisting of the monthly and year-to-date financial statements on a consolidated basis. The board may also require quarterly budget figures. The right to veto the approval of the company's annual financial statements may be included in the Shareholder Agreement. A less actively involved investor may be satisfied with the ability to exercise a veto right only in the event that outside

auditors issue a qualified opinion on the financial statements.

Dispute resolution. One important function is to prevent shareholder disputes from arising in the first place, and if such disputes are unavoidable, to provide dispute resolution mechanisms that allow the parties to avoid a protracted and costly court battle. While it is rare for boards to face significant conflicts (because most are resolved in numerous side communications that take place outside the board room) the lack of clear guidance on how to proceed if such a situation should arise can leave the institution exposed to a dangerous impasse. It is therefore important to address the rules for how to handle disputes up front, and clearly document the process in the Shareholder Agreement or an equivalent document.

The following are some of the more typical provisions for dispute resolution:

- *Conciliation measures:* These are among the first steps to be taken in the event of a dispute, controversy, or claim arising among the parties. Often the parties will agree to try to settle all disputes amicably and in good faith. Sometimes they may go so far as to agree to a process by which notice of a dispute will be communicated to high-level executives of all parties involved in the dispute. For example, if the dispute was among three shareholders, high-level executives of these three companies would be notified. These executives then have requisite authority within their organizations to settle the dispute. This consultation and negotiation period has a clear time frame in which consultations and negotiations will take place. If after the specified time no resolution has been reached, any involved party may escalate the issue to the next step—either to mediation, arbitration, or litigation.
- *Mediation:* At this point, an independent and impartial mediator is selected, as is the process for determining where the mediation will take place, and the language in which the mediation will be conducted. If mediation fails to result in a resolution of the dispute within a specified time, the parties may go to the next step—arbitration, the hearing and determination of a dispute by an impartial referee agreed to by both parties, or litigation, a legal proceeding in a court.
- *Arbitration:* Many parties to joint venture agreements favor arbitration over litigation, believing that in some countries arbitral proceedings are shorter and less vulnerable to corruption than legal proceedings. Local courts may still become involved in the dispute, because redress to local courts may be necessary to enforce the resulting arbitral award. However, when parties agree to arbitrate their disputes, they typically are agreeing to not pursue their claims any further and may expressly state in writing in the Shareholder Agreement that all awards of arbitrators will be final and binding upon the parties to the arbitration. In this case, the parties also agree to forgo rights of appeal once an arbitral award is rendered.

  Arbitration provisions may vary, but they generally will include rules that outline these:
  - The process for appointment of arbitrators (often each party to the dispute will appoint one arbitrator and then a chair will be appointed by those arbitrators)
  - Place of arbitration
  - Language of arbitration proceedings and all submissions
  - Agreement to treat arbitral award as binding and conclusive
  - The law governing arbitration proceedings

  Not unlike court proceedings, the parties will also have agreed that all expenses related to arbitration, excluding legal fees, will be borne by the party against whom a decision is rendered, or apportioned in accordance with the arbitral award if there is a compromise decision.

- *Litigation:* Given that the purpose of dispute resolution provisions is to avoid the costly alternative of litigation, the processes for litigation itself are typically not included in a Shareholder Agreement as a dispute resolution alternative. As noted above, parties that opt for arbitration generally forgo their right to take the issue to court.

Share transfer or exit. Shareholder Agreements typically include or refer to a buy-sell agreement (see Stock Purchase Agreement discussion below) that places conditions on the shareholders' rights to acquire or sell shares (see chapter 7, Ownership and Governance, for a thorough discussion of options). If the company is privately held, as are most transformed MFIs, the value of the shares cannot be easily ascertained by the "market"; therefore, the Shareholder Agreement may provide guidelines for share valuations for transfer or sale.

Competition with shareholders. It is not always easy to engage shareholders in a discussion of whether it is appropriate for them to invest in more than one MFI in a given market. However, some Shareholder Agreements will expressly address the question of competition by including a provision that requires all shareholders to agree not to compete with the investee company in the business of microfinance. In some jurisdictions, noncompete clauses are not enforceable, so prior to negotiating the language of such a clause, local counsel should be consulted to determine if it is likely to be of any use.[11]

In some cases, noncompete clauses will be designed to apply rather narrowly, for example, only to certain designated geographical areas or target customer bases. If a shareholder balks at agreeing to a noncompete clause, even if narrowly drawn, the transformed MFI still has a few options. For example, the Shareholder Agreement can include a clause that would prohibit a shareholder from using or disclosing any confidential information it receives about the transformed MFI's customers, business practices, or other sensitive data to advance its own business interests. This may be sufficient protection for the transformed MFI, particularly if coupled with a broad confidentiality agreement requiring the shareholder to keep confidential all information it acquires pursuant to the Shareholder Agreement.

Business dealings with shareholders. Host country law is likely to encourage arm's-length dealings between the transformed MFI and its shareholders, directors, and officers. This encouragement may be advanced in the bank, regulatory, or specialized microfinance law, tax law, or even in corporate law.

Other investors will want to ensure that all dealings between the transformed MFI and any of its shareholders, directors, and officers are conducted on an arm's-length basis or at least work to the benefit of the MFI. The Shareholder Agreement may address this issue directly with a provision that requires any and all future transactions between the transformed MFI and any of its shareholders, directors, and officers be made on an arm's-length basis. Sometimes the Shareholder Agreement also will require all shareholder or director business dealings with an investee company to be reported to and approved by the board of directors. Directors appointed by the affected shareholders then are typically required to recuse themselves from voting on the appropriateness of any such dealing. Some transformed MFIs have gone one step further and developed conflict of interest policies that all board members are required to sign when appointed to a board seat. Annex 8C, Sample Conflict of Interest Policy, provides an example of a conflict of interest policy that addresses some, but not necessarily all, of the possible conflicts of interest that may arise for directors and officers in their dealings with the regulated MFI they govern and manage.

This part of the Shareholder Agreement is particularly important in MFIs with shareholders who also play a material role in its management and

operations. In some MFIs, a shareholder may also be contracted with to manage operations, or provide technical assistance to management. In this case, the Shareholder Agreement needs to ensure that such arrangements are governed by terms and conditions that treat the shareholder the same as any third-party service provider, and provide for termination of the agreement if necessary.

Stock Purchase Agreement

The basic provisions that govern the sale of the shares may be included in the Shareholder Agreement, or in a separate Stock Purchase Agreement. The documentation typically provides the due date of the capital contribution, identifies the bank account to which payments should be made, and describes any other legal or contractual requirements that are preconditions to the making of the capital contribution or issuance of shares. More specifically, the documentation often will provide for the following:

- The number of shares to be issued or sold and the purchase price of the shares
- Representations and warranties of the issuer and seller of shares warranting, among other things, that the issuer of the shares
  - Is a company in good standing,
  - Has the requisite legal authority to enter into the Stock Purchase Agreement (or Shareholder Agreement) and to perform its obligations, and
  - Has provided to shareholders financial statements of the business that were prepared in accordance with generally accepted accounting principles and fairly represent the financial condition of the issuer.

Sometimes the *buyers* of shares will also make certain representations and warranties, including that the buyer is a company or private individual in good standing and that the buyer has the authority to enter into the agreement and perform its obligations under the agreement. If the shares are not being purchased with cash but are being paid for with a promissory note, or the shares are being issued against a future promise to pay, additional warranties may be required from the buyer regarding its financial position.

Annex 8A Sample Checklist of Legal and Regulatory Issues

Questions to Address When Considering Transformation

Legal form

- Applicable laws and regulations
- Corporate status
- Tax-status implications, if any

Powers

- Types of services and products MFI can provide to customers
- Types of investments MFI can make and transactions it can enter into
- Types of financing MFI can access

Regulatory process

- Licensing criteria
- Ownership criteria or limitations (impact on investors for entry and exit)
- Governance and management requirements (including foreign ownership restrictions, residence requirements, level of skills required of senior management, and so forth)
- Staffing requirements (management criteria and required positions)
- Minimum capital requirements (amount, form, and authorized use of funds)
- Initial reserve requirements

Applicable supervisory regime

- Capacity to supervise (expertise, human resources, ongoing training)
- Reputation
- Respect for rule of law and transparent rulemaking
- Legal authority (source of authority, accountability)
- Extent of level playing field among likely competitors targeting same or similar customer base (including nonprudential as well as prudential regulatory regimes)

Supervision

- Risk-based or rule-based (or in between), extent of on-site and off-site supervision
- Reporting requirements (how much, how often, with what level of detail)
- Loan loss provisioning requirements (and interaction with applicable tax laws)
- Capital adequacy requirements
- Unsecured lending limits
- Loan documentation requirements
- Physical security requirements
- Branching limitations (and requirements)
- Cost of regulatory compliance (as paid by regulated institution)
- Corrective action powers (triggers, enforcement procedures)
- Involuntary and voluntary liquidation procedures (interaction with bankruptcy regime)

Questions for a Borrowing MFI to Address When Entering into a Loan Agreement before Transformation

Prepayment provisions

- Is the borrowing MFI permitted to prepay all or a portion of its loan? If so, how are costs of prepayment allocated between borrower and lender?
- If the borrowing MFI is to be assessed a prepayment penalty, would conversion of the outstanding loan into equity or assumption of the loan by the new regulated MFI trigger a prepayment penalty?

Affirmative covenants

- Is the borrowing MFI required to maintain existing ownership or governance structures?
- Is the borrowing MFI required to report on significant changes in business?

Financial covenants

- Is the borrowing MFI required to maintain financial ratios that are likely to change (even if

only for an interim period) as the result of transferring assets from the borrowing MFI to the new regulated MFI?
- Is the borrowing MFI required to maintain any debt ratios that will be difficult to achieve once the regulated MFI starts taking deposits?
- Are there any debt ratios in the financial covenants? How broadly are these drafted? What do terms *debt* and *indebtedness* mean? Would they include deposits?

Negative covenants
- Is the borrowing MFI permitted to sell or transfer substantially all of its assets? If not, how do these restrictions affect asset transfer plans of the borrower?
- Is the borrowing MFI allowed to establish a subsidiary, change its management, change its legal form, and so forth?

Events of default
- Is it an event of default if the borrowing MFI changes its legal form, transfers a substantial amount of its assets, liquidates, or other?
- Is there a cure period (if any) for covenant defaults (as opposed to payment defaults)?
- Is there a cross-default or cross-acceleration clause? If so, what are the triggers of such a clause?

Assignment rights
- Can the borrowing MFI assign its rights or obligations under the loan agreement to another party (for example, the successor, regulated MFI)?

Credit enhancements
- Is the loan secured by a pledge of the borrowing MFI's assets, or a third-party guarantee, or other credit enhancement? If so, how will such credit enhancement be affected by the contemplated legal transformation, be it a reorganization or asset transfer?

Syndicated loans
- Is the loan syndicated? If so, how do the amendment and waiver provisions work? (How are consents to amendments or waivers of syndicated loan agreement achieved—number of votes, process for meeting of syndicate members, other?)

Issues to be Discussed with Local Counsel before Commencing Negotiations with Potential Investors

The following is not a comprehensive list. Additional issues may arise that will also need to be addressed under host country law.

Documentation
- Which constituent documents of the transforming MFI need to be amended to reflect the transformation and possible involvement of new equity investors?
- What new constituent documents will need to be drafted to reflect the transformation and possible involvement of new equity investors?
- What other documents need to be drafted or amended to reflect the transformation and possible involvement of new equity investors?
- What resolutions, registrations, or other corporate actions will need to be obtained in connection with the contemplated transformation and involvement of new equity investors?
- Are there any terms of the contemplated transformation and involvement of equity investors that should be set forth in a particular document for such terms to be enforceable by means of specific performance? If so, do local courts enforce provisions of shareholder agreements by means of specific performance?
- What is the likely consequence of setting forth the social mission of the investee company in its constituent documents or other agreements? Is there any ultra vires risk in doing so? Are there

any legal obligations that would influence the matters addressed in the statement of the investee company's purpose (such as requirements by bank regulators to define target customers, maximum size of microcredits, and so forth)?

Corporate

- Are there any local legal issues that may be triggered by the due diligence process? For example, are there any legal restrictions that the transforming MFI must comply with when giving information or access to third parties (such as bank secrecy rules)?
- What is the legal framework for issuing shares to investors against cash contributions?
  - What agreements need to be entered into for shares to be issued? Are there any board resolutions or shareholder resolutions that need to be obtained before shares can be issued?
  - What existing agreements need to be amended? Are there any requirements to file registrations with host country authorities (for example, with a companies or commercial register)?
  - What, if any, approvals or notifications must be registered with host country supervisory authorities?
- Does host country law give any statutory rights to minority shareholders? If so, what are the applicable thresholds for such rights to apply (how much of an interest must a minority shareholder hold to benefit from such statutory rights)?
  - Do minority shareholders have preemptive or veto and control rights? Are any other rights accorded to minority shareholders by host country law? In each case, what, if any, exclusions are permitted?
  - Are there any decisions that host country law would require all or a supermajority of shareholders to agree to before giving effect to such decisions?
  - Are there any other duties of majority shareholders with respect to treatment of minority shareholders or the investee company?
- What is the legal framework for shareholder voting rights?
- What legal rights, if any, do shareholders have to accessing information of the investee company and to what extent may shareholders request management reports from the investee company? Can any such rights, access, or information be validly excluded or limited? Under what circumstances?
- Can different classes of shares be issued under host country law? What is the legal framework for doing so?
- What is the legal framework applicable to shareholder meetings? What matters are reserved for approval by shareholders' meetings (as opposed to board of director meetings)? What are the statutory voting requirements with respect to such matters?
- What are host country requirements for the size, composition, and powers of the board of directors? What are the rules for appointing directors? For holding meetings? What matters require supermajority or unanimous approval of board of directors?
- What are the rules for appointing officers of the investee company?
- What is the legal framework applicable to distributing profits of the investee company? Are there mandatory reserve requirements? Any other restrictions regarding the distribution or retention of profits?
- What restrictions or other legal issues might arise, if any, in connection with payment of dividends in local currency to foreign shareholders?
- What are the rules for financial reporting by investee company?
- To what extent do investee company and shareholders need to structure their dealings and

arrangements on an arm's-length basis? Are there any prohibited transactions between the investee company and its shareholders?
- What requirements should be included in shareholder noncompete clauses or documents to be enforceable under host country law?
- Are share transfer restrictions enforceable? Are there rules applicable to how such restrictions are structured that would limit or otherwise impact the enforceability of such restrictions?
- Are there any rules that are likely to affect the validity and enforceability of exit mechanisms? Are first refusal and rights of first offer permissible? Are put and call rights enforceable? How must these rights be structured to ensure their enforceability?

Foreign ownership

- Are there any restrictions under host country law that would affect the ownership of equity interests in the investee company by foreign entities or persons?
- Are there any residency requirements or nationality requirements applicable to directors?
- Are there any notification or registration requirements that would be triggered by an investment by a foreign entity or person in the investee company?
- What, if any, tax law or other law benefits are there if certain requirements regarding local ownership or management are met? (For example, are more onerous taxes imposed on foreign-owned companies?)

Annex 8B Sample Terms of Reference: Hiring Local Counsel to Support Legal Transformation

The following are suggestions only and may need to be revised substantially to reflect host country legal issues or issues of particular concern to the transforming MFI.

Background

Background on the organization including its mission, target market, client outreach, portfolio size, and so forth.

Objective

The objective of this engagement is to provide legal counsel to MFI A during the process of its transformation into a regulated shareholding company thataccepts and on-lends deposits from the public.

Tasks

1. Develop a timetable outlining the necessary documents, approval processes, and likely length of time for incorporating MFI A as a joint stock company (from the time all necessary documentation is filed with host country authorities to the time registration and all approvals are likely to be obtained).
2. Prepare written memorandum analyzing rights, obligations, liabilities, and corporate governance requirements of joint stock companies in host country, including
   - Appointment, removal, number of required directors, number of board meetings, and so forth; and
   - Liabilities and responsibilities of MFI A's directors and officers (under host country's corporate law and microfinance or banking law [as appropriate] and offer recommendations to address such liabilities, such as acquisition of director and officer insurance and the like).

   Where deemed advisable or required by host country law, draft conflict of interest policy for board members of MFI A to execute.
3. Conduct legal due diligence of all existing contractual obligations of MFI A—loan agreements (if currently borrowing), grant agreements (past and present), personnel contracts, lease arrangements, vendor and other service agreements, forms of loan and other agreements with customers, and so forth. Identify which contracts will need to be revised to reflect MFI A's change in legal form. Where necessary, draft amendments, consents, and waivers.
4. Draft all constituent documents (such as Articles of Incorporation or Charter), relevant approvals (including any MFI A board resolutions), share certificates, and so forth necessary to incorporate MFI A as a joint stock company and to authorize the issuance of share capital.
5. Offer general preliminary advice on options available for transferring assets (financial and others) from old institution to new institution, including, to extent applicable, the labor, tax, and other laws that might be triggered by transfer of financial assets, nonfinancial assets, and personnel. Also advise on whether it is possible under laws and regulations of host country to reorganize existing company into new company, and, if such a reorganization is possible, analyze tax and other legal consequences of implementing a reorganization.
6. Develop a memorandum outlining a tax planning strategy for MFI A's legal transformation, which will include, among other things,
   - Tax consequences of transferring assets (such as an existing loan portfolio, investments, cash, physical assets) from one form of corporate entity to another (a related issue to be

analyzed is whether a one-time transfer or staggered transfer of the loan portfolio is optimal from tax management point of view), and
  - Tax consequences of issuing shares (and later selling shares) to investors (including to initial shareholders) including how to establish the tax basis of MFI A's newly issued shares for purposes of later calculating capital gains or losses on subsequent sales of such shares.
7. Develop a memorandum outlining MFI A's labor law responsibilities with respect to its employees, which will include, among other things,
  - An analysis, with suggested recommendations, of how best to transfer personnel from one institution to another;
  - An analysis of how to handle termination of personnel that are not being transferred to the new institution (including description of liabilities and obligations owed by MFI A to such terminated employees); and
  - Recommendations on how to structure future employee contracts to be entered into by the new institution, and development of a form of employee contract that can be used by MFI A after transformation.
8. File with appropriate local authorities
  - All necessary constituent documents, approvals, share certificates, and so forth necessary to incorporate MFI A as a joint stock company;
  - All necessary documents for tax registration of MFI A; and
  - A completed application to operate as a licensed financial institution (once application is filed, MFI A may request local counsel to monitor status of applications with bank regulatory authorities and provide status reports to MFI A senior management).

Deliverables

1. Timetable for incorporating MFI A as a joint stock company
2. Written memorandum analyzing rights, obligations, liabilities, and corporate governance requirements, and conflict of interest policy for board members, if applicable
3. Legal due diligence report of existing contractual obligations of MFI A
4. Draft constituent documents, relevant approvals, share certificates, and so forth to incorporate and issue share capital
5. Advice on appropriate method to transfer assets to new company
6. Written memorandum outlining a tax planning strategy for transformation
7. Written memorandum outlining labor law responsibilities with respect to MFI A's employees
8. Confirmation of filing of various necessary documents as well as license application

Level of Effort. It is estimated that the legal transformation process may take 6 months to 1 year or more. Counsel fees will be negotiated up front either at an hourly rate, fixed fee, retainer, or some combination of these three.

Annex 8C Sample Conflict of Interest Policy

The material below is for illustrative purposes only and is drawn from, with certain modifications, a form of conflict of interest policy that is often used by U.S. not-for-profit organizations. Any actual conflict of interest policy should be reviewed and modified by local counsel to reflect host country law requirements.

Article I
Purpose

The purpose of the conflict of interest policy is to protect this organization's (Organization) interest when it is contemplating entering into a transaction or arrangement that might benefit the private interest of an officer or director of the Organization or might result in a possible excess benefit transaction. This policy is intended to supplement but not replace any applicable laws governing conflict of interest applicable to organizations of this type.

1. ***Interested Person***
   Any director, principal officer, or member of a committee with governing board delegated powers, who has a direct or indirect financial interest, as defined below, is an interested person.
2. ***Financial Interest***
   A person has a financial interest if the person has, directly or indirectly, through business, investment, or family
   a. An ownership or investment interest in any entity with which the Organization has a transaction or arrangement,
   b. A compensation arrangement with the Organization or with any entity or individual with which the Organization has a transaction or arrangement, or
   c. A potential ownership or investment interest in, or compensation arrangement with, any entity or individual with which the Organization is negotiating a transaction or arrangement.

Compensation includes direct and indirect remuneration as well as gifts or favors that are not insubstantial.

A financial interest is not necessarily a conflict of interest. Under Article II, Section 2, a person who has a financial interest may have a conflict of interest only if the appropriate governing board or committee decides that a conflict of interest exists.

[Note that host country law may have a very different definition of what constitutes a "financial interest" and who constitutes an "interested person." Accordingly local counsel should review and revise this to meet host country requirements.]

Article II
Procedures

1. ***Duty to Disclose***
   In connection with any actual or possible conflict of interest, an interested person must disclose the existence of the financial interest and be given the opportunity to disclose all material facts to the directors and members of committees with governing board delegated powers considering the proposed transaction or arrangement.
2. ***Determining Whether a Conflict of Interest Exists***
   After disclosure of the financial interest and all material facts, and after any discussion with the interested person, he or she shall leave the governing board or committee meeting while the determination of a conflict of interest is discussed and voted upon. The remaining board or committee members shall decide if a conflict of interest exists.
3. ***Procedures for Addressing the Conflict of Interest***
   a. An interested person may make a presentation at the governing board or committee meeting, but after the presentation, he or she shall leave the meeting during the discussion of, and the vote on, the transaction or arrangement involving the possible conflict of interest.

b. The chairperson of the governing board or committee shall, if appropriate, appoint a disinterested person or committee to investigate alternatives to the proposed transaction or arrangement.
c. After exercising due diligence, the governing board or committee shall determine whether the Organization can obtain with reasonable efforts a more advantageous transaction or arrangement from a person or entity that would not give rise to a conflict of interest.
d. If a more advantageous transaction or arrangement is not reasonably possible under circumstances not producing a conflict of interest, the governing board or committee shall determine by a majority vote of the disinterested directors whether the transaction or arrangement is in the Organization's best interest, for its own benefit, and whether it is fair and reasonable. In conformity with the above determination it shall make its decision as to whether to enter into the transaction or arrangement.

4. ***Violations of the Conflict of Interest Policy***
   a. If the governing board or committee has reasonable cause to believe a member has failed to disclose actual or possible conflicts of interest, it shall inform the member of the basis for such belief and afford the member an opportunity to explain the alleged failure to disclose.
   b. If, after hearing the member's response and investigating further as warranted by the circumstances, the governing board or committee determines the member has failed to disclose an actual or possible conflict of interest, it shall take appropriate disciplinary and corrective action.

Article III
Records of Proceedings

The minutes of the governing board and all committees with board delegated powers shall contain

a. The names of the persons who disclosed or otherwise were found to have a financial interest in connection with an actual or possible conflict of interest, the nature of the financial interest, any action taken to determine whether a conflict of interest was present, and the governing board's or committee's decision as to whether a conflict of interest in fact existed; and
b. The names of the persons who were present for discussions and votes relating to the transaction or arrangement, the content of the discussion, including any alternatives to the proposed transaction or arrangement, and a record of any votes taken in connection with the proceedings.

Article IV
Compensation

a. A voting member of the governing board who receives compensation, directly or indirectly, from the Organization for services is precluded from voting on matters pertaining to that member's compensation.
b. A voting member of any committee whose jurisdiction includes compensation matters and who receives compensation, directly or indirectly, from the Organization for services is precluded from voting on matters pertaining to that member's compensation.
c. No voting member of the governing board or any committee whose jurisdiction includes compensation matters and who receives compensation, directly or indirectly, from the Organization, either individually or collectively, is prohibited from providing information to any committee regarding compensation.

Article V
Annual Statements

Each director, principal officer, and member of a committee with governing board delegated powers shall annually sign a statement that affirms such person

a. Has received a copy of the conflict of interest policy,
b. Has read and understands the policy, and
c. Has agreed to comply with the policy.

Notes

1. Legal advisers who are expert in the laws and regulations of the host country are called here "local counsel"; legal advisers who are expert in the laws and regulations of countries other than the host country are called here "international counsel" or "foreign counsel."
2. Some transforming MFIs, particularly those in Latin America, have hired a lawyer during the transformation process to work within the MFI (thus, "in-house"). This person often then heads up the new legal function for the regulated organization (if applicable).
3. Ideally, it would be clear which laws and regulations govern the process. However, the legal and regulatory environment that comes to bear on transforming MFIs can be confusing, inconsistent, and even contradictory, particularly for institutions transforming into regulated institutions. In some jurisdictions, the legal and regulatory environment is in an indefinite state of flux as new laws are considered and new regulations drafted to address the unique risks posed by deposit-taking microfinance activities.
4. See discussion in chapter 7, Ownership and Governance, regarding the need to clarify with donors, at the time of grant-making, their expectations for how grant funds will be applied and any restrictions that will be imposed by donors on assets funded by such grants.
5. Depending on the laws of the host country, some forms of legal organization and incorporation are more amenable to future legal transformations than others. Increased recognition of this fact has caused some MFIs to front-load their analyses of legal transformation strategies. These MFIs begin their analysis of possible legal transformation strategies at the time that the MFI is first established—even when a legal transformation is not likely to come for many years. For example, some MFIs incorporate from the very start in a legal form that would likely be acceptable to bank regulatory authorities should the MFI eventually choose to apply for a deposit-taking license. This avoids the future need to consider complex legal transformation issues at the same time as just as complex, if not more so, operational transformation issues are being managed.
6. Investor or Shareholder Agreements are discussed later in this chapter under "Negotiating Investor Documents."
7. Some jurisdictions will impose requirements or limitations with respect to the words that can be used in names. In the Kyrgyz Republic, for example, the name must include words that designate the type of MFI being operated—such as microfinance company (MFC), microcredit company (MCC), and microcredit agency (MCA). Also, MFIs operating in the Kyrgyz Republic may not use the words "National," "State," "Kyrgyz Republic," or "Kyrgyzstan" in their names. (See Article 3. Name of a microfinance organization, The Kyrgyz Republic Law on Micro-finance Organizations in the Kyrgyz Republic (approved by the Legislative Assembly of the Parliament of the Kyrgyz Republic, July 11, 2002; approved by the People's Representative's Chamber of the Parliament of the Kyrgyz Republic, July 3, 2002.)
8. *Ultra vires* is Latin for "beyond powers." It refers to conduct by a corporation or its officers that exceeds the powers granted by law.
9. The mission statement may also be included in the Shareholder Agreement depending on whether the MFI wants to ensure new investors are in agreement with the transformed MFI's mission.
10. For example, in some countries, majority voting requirements and rights of minority investors must be addressed in the company's constituent documents to be enforceable. Or certain formalities must be provided for in the constituent documents (and observed) to grant preemptive rights to one investor over others.
11. However, host country laws also may limit the scope for competition by limiting the kinds of institutions on which board members can sit, thereby at least eliminating interlocking director positions. In Uganda, for example, directors sitting on boards of microfinance deposit-taking institutions (MDIs) may not also sit on the boards or serve in any executive capacity with other Ugandan institutions. (See Article 26 (3) of the MDI Act.)

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Transforming the Institution
Operational Implications

Part III

Chapter 9

Human Resources Management

A microfinance institution's (MFI's) human resource base is its greatest asset. Although this statement is true for most organizations, it is particularly true in the case of MFIs. Like all financial service provision, microfinance is built on customer service. Relationships established between client and loan officer or between client and other branch staff lie at the heart of microfinance technology. Loan officers are often described as "walking encyclopedias." Their in-depth understanding of the local market and the challenges faced by their clients—both in their businesses and homes—as well as their typically high community standing, are a great asset, although difficult to quantify. While valued for different reasons, all of an MFI's staff, from back-office data clerks to head office managers, contribute to its success.

As outlined in chapter 3, Planning for Transformation, the process of transforming an unregulated, nonprofit nongovernmental organization (NGO) with a primary focus on credit services into a regulated, for-profit share company with the capacity to offer both credit and savings services requires change at all levels of the organization. Although numerous experts are contracted and significant resources expended in attracting investors, upgrading systems, and developing the capacity to intermediate deposits, transforming MFIs have historically not appreciated the importance of investing in the change management process itself. The extent to which internal and external *change agents* follow a transparent, clear, and open process for this transition directly correlates with the success of the transformation. In a wide range of industries, the inability of change agents to manage the people side of the business change process has resulted in inefficient and unsuccessful change projects and an inability to realize new business strategies and objectives (Hiatt and Creasey n.d.). Transformation of MFIs is no exception.

Change is difficult. Before transformation, relationships among staff members are defined and expectations are more or less understood. Organizational change disrupts the established dynamic, leading to fear and uncertainty among staff members about the future. When change is first proposed, some people will "deny that it is necessary, or try to minimize the scope of change, deflect or delay the change, or simply ignore it" (Carlson 1992, p. 115). However, if the change process is well-managed, these reactions can be addressed up front and strategies developed to prevent them

from blocking the change process. If the process is not well-managed, such resistance can either significantly prolong or even overtly sabotage the transformation.

This chapter presents a framework for thinking about, planning for, and addressing the impact of institutional transformation on an MFI's human capital. It examines three key elements that influence the human capital of an organization: the structure, the staff, and the culture. To use a metaphor, consider the MFI as a house. The blueprint, outlining the framework of the house and carefully designed by an architect, is the *organizational structure*—the organizational chart that shows how each unit in the organization relates to the others, and the job descriptions that specify staff roles and responsibilities. The concrete building blocks represent the *staff*—each member carefully selected for both quality and the degree to which he or she fits in with and supports the other building blocks already in place. Finally, the mortar represents the intangible institutional *culture*—the sticky substance that holds all those blocks together, without which the house will be at risk of collapsing. It is imperative for the transforming MFI to adapt the organizational culture to meet its needs as a regulated MFI, to ensure an appropriate organizational structure is in place, and finally to ensure the right staff are in the right positions and are well-trained.

It should be noted that the human capital issues discussed in this chapter are relevant for a range of different transformation models, whether the transformation is structured as the creation of a new company or as a reorganization of the old company. It does not, however, address the future human capital issues associated with the founding NGO (if applicable). These issues will vary dramatically depending on how the NGO redefines itself after transformation. Thus, the decision about who moves to the new company (if applicable) and who remains with the NGO depends heavily on the decisions made regarding the future role of the NGO.

Adapting the Organizational Culture

A commonly expressed concern of institutions considering transformation is the fear that transformation will significantly change the corporate culture of the organization. The following statements articulate that apprehension:

- "Our staff is motivated by poverty alleviation. Transformation to a for-profit company may force a mission change."
- "We do not want to lose the personal relationship we have with our clients."
- "If we have to hire formal bankers, we may lose touch with the real needs of our target market. They also may not relate well to current staff and thus tension will be created in our organization."
- "Having to standardize our policies and procedures will limit our ability to innovate and be flexible to client needs."
- "Creating all these new departments just adds bureaucracy and hierarchy."

Each of these statements represents valid concerns and has direct implications for the institutional culture of an organization. The development of a new business strategy; incorporation of a range of new stakeholders, including investors and supervisory authorities; upgrading of policies, procedures, and systems; changes in the organizational structure and staffing patterns; and the introduction of a range of new products and services—all affect the way people carry out their work, how people interact with each other in their work, and ultimately how people feel about their work. These are all defining aspects of an institution's culture—the shared set of beliefs and values that permeate an institution's workforce.

Institutional culture can be deliberately changed or molded by dynamic leaders. It can also, however, change inadvertently if the change process is not well-managed. The experience of BancoSol, the first institutional transformation from an NGO to a

commercial bank, highlights the importance of addressing these issues up front. The NGO's social welfare culture included an ingrained antibanking ethos that for many staff proved too difficult to reverse (Rhyne 2001). Despite investments in a human resources specialist, tensions grew in BancoSol as experienced bankers were hired for many of the specialized functions, such as asset and liability management and internal control. Tension between the old guard and the new guard was also evident in the ACP/Mibanco transformation, as formal bankers were brought into senior management positions with very different communication and operating expectations.

Assuming some element of cultural change is inevitable with transformation, what can leaders do to manage this change process proactively?

Defining a Culture

Culture is a composite of personal reactions and a reflection of individual beliefs that have evolved over time, becoming a set of shared values. All staff members in an organization have their own sets of personal values and beliefs about what they do and how they feel about their work. These values and beliefs influence the way in which they treat other staff, communicate to both superiors and subordinates, and view their overall contribution to the organization. These factors together influence what staff believe about the organization, and how they interpret the organization's mission and vision.

New staff coming into the organization will also have their own sets of values and beliefs based on prior work experience as well as initial impressions of the new organization. Proactive steps taken by the transforming MFI can mitigate a potential culture clash among staff:

- *Articulate institutional values:* Regardless of leadership changes, management changes, institutional restructuring, or technological changes, an organization's core values should endure. Thus, all staff in the organization must be able to clearly articulate these values. Working sessions with staff to define institutional values can advance this process. The resulting value statements should be incorporated into all induction sessions, made visible to both staff and clients in the branches and at the head office, and be used in all communication materials to ensure maximum buy-in.
- *Recognize and encourage distinct roles of old staff and new staff:* Old guard versus new guard, old timers versus new timers, NGO staff versus bank staff. Transformation provides an opportunity to renew and recreate organizational culture. Although efforts do need to be made to minimize culture clash, MFIs also need to recognize the benefits of the process. As explained by Bolman and Deal (1991, p. 249),

  > Newcomers are expected to bring new ideas and perspectives. It is their destiny to be agents of evaluation and reform. Old-timers act as a force for cohesion, stability, and the wisdom of the past. If the newcomers fully succumb to the press of historical tradition, the organization risks stultification and decay. If the old-timers fail to play their part, the organization risks chaos and disarray.

- *Incorporate core values into the recruitment process:* In recognition of the first two points above, the recruitment process can be used to reinforce an institution's commitment to its values. Although external recruits with formal banking experience may bring significant technical expertise, those with strong personalities and limited exposure to microfinance can easily upset the communication patterns in the organization. The interview process, therefore, must focus on some of these issues, including the individual's level of commitment to the vision of the organization. This could be determined by incorporating a field visit into the review process, as well as

making it mandatory that all new senior management spend their first week in the field, working at a branch and interacting with clients.

- *Build consensus on the target market:* One of the more common fears with transformation is staff concern that converting into a for-profit institution will force a shift in target market or "mission drift." As discussed in chapter 4, Marketing and Competitive Positioning, target markets will naturally expand with a growing institution, but a transforming institution needs to think strategically about the kind of market image it seeks. The development of new products (particularly those that attract a higher-end customer), the increased professionalization of both staff and infrastructure, and the addition of more formal operating procedures—all characteristics of transformation—affect the MFI's market image and ultimately the kind of client attracted to the institution. Consensus among staff (both old and new) as to who the regulated institution will serve needs to be built early on, particularly with an MFI's front-line staff (tellers, loan officers, customer care officers, and others) who serve as the primary relationship builders with customers.
- *Incorporate the double bottom line into performance evaluations:* The structure of an institution's performance management system has a profound impact on the values and goals of a workforce. By incorporating social indicators, such as increases in levels of food security, housing, health care, or education of the MFI's clients, into employees' performance evaluation frameworks, an institution can help institutionalize the "double bottom line" culture.[1]
- *Select partners with shared values:* The institution's core values should also guide the selection of technical assistance providers and, even more important, the selection of investors (see chapter 7, Ownership and Governance). The influence of these outside stakeholders on the corporate culture of an institution should not be underestimated. Investors, particularly those with board influence, can have a significant impact on setting institutional priorities and direction, two factors that critically affect the culture of an organization.

The core values of an institution are reflected in the institution's overall strategic goals, its business model, the type of staff hired, and the way staff interact with each other and the institution's clients. Stated values lead to specific goals. Goals are operationalized through the development of a business model with clear objectives and strategies for implementation. This in turn leads to hiring people who commit to these objectives and share similar values. Investments are then made in training and equipping these individuals to achieve the institution's overall goals (figure 9.1).

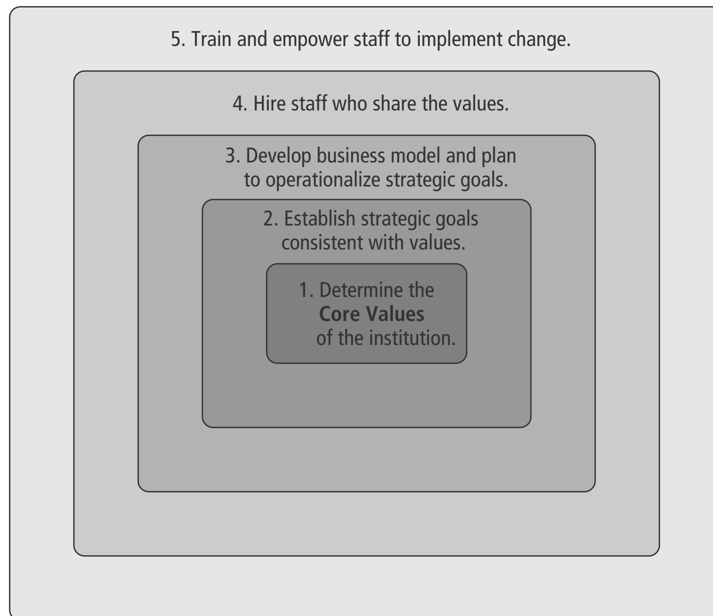
Each MFI must determine the values appropriate for the institution and constantly seek to have those values internalized by every board member, manager, and staff member.

Building Commitment to Change

The transformation process will undoubtedly change the organization radically. Because customer needs and expectations are constantly changing and because market competitors are never far behind, an MFI cannot afford *not* to change. This culture of change is particularly evident in institutions committed to continuous improvement. As discussed in chapter 3, Planning for Transformation, any far-reaching organizational change, including institutional transformation, requires active leadership. Top management and the board must act as champions of change. They must be clear about why transformation is being pursued and be able to clearly articulate the anticipated benefits, as well as challenges, to staff.

The process of building commitment to change can be facilitated through developing an ongoing communications strategy. Organizations that

Figure 9.1 Model for Sustainable Change



Source: Author.

encourage open communication channels between senior managers and front-line staff, between back office and front office, and between customers and staff tend to be more open to change. Materials about the transformation need to be written and concepts need to be spoken such that staff understand and can relate. Newsletters that address their concerns head-on, workshops that encourage active questioning and participation, and managers who are committed to an "open-door" policy send signals that the opinions and views of staff matter and will be listened to in building the new corporate vision. Uganda Microfinance Union, for example, encouraged staff to raise concerns, issues, or questions. A monthly newsletter, *Transformation News*, was developed to provide updates on key activities in the transformation process. Articles included easy-to-understand explanations of the new regulatory framework, interviews with top management on fundamental transformation issues, and overall status updates on new product developments and expansion plans. Other ways to help build a commitment to the transformation process include the following:

- Scheduling time in branch manager meetings to specifically discuss the status of different transformation initiatives
- Providing staff an opportunity to interact and ask questions of potential investors
- Periodically sending articles or news clippings on transformation to branch staff
- Including feedback from and summaries of external training courses for "banking" skills that staff members have attended in newsletter to branches.

Although not written specifically for microfinance, the quote below highlights the importance of using a proactive communication style to sell the vision of transformation. This new vision needs to be communicated in a simple way that motivates

staff but is also personal, making staff feel a part of the transformation.

> In more successful transformation efforts, executives use all existing communication channels to broadcast the vision. They turn boring and unread company newsletters into lively articles about the vision. They take ritualistic and tedious quarterly management meetings and turn them into exciting discussions of the transformation. They throw out much of the company's generic management education and replace it with courses that focus on business problems and the new vision. The guiding principle is simple: use every possible channel . . . (Kotter 1998, p. 12).

Some MFIs use the "balanced scorecard" to ensure staff are committed to change, particularly from a strategic perspective (box 9.1).

Box 9.1 The Balanced Scorecard

Used by a number of transformed MFIs, including BancoSol and Mibanco, the balanced scorecard is a management system (not only a measurement system) that enables organizations to clarify their visions and strategies and translate them into action. The scorecard views the organization from four perspectives (financial, customer, internal business processes, and learning and growth), and assigns metrics to each of these perspectives. It provides feedback around both the internal business processes and external outcomes to continuously improve strategic performance and results. "When fully deployed, the balanced scorecard transforms strategic planning from an academic exercise into the nerve center of an enterprise" (Arveson 1998).

Source: Author.

Adapting the Organizational Structure

Early in the transformation planning process, the MFI needs to evaluate whether it has the right organizational structure to support the new business strategy. Organizational structure is more than just the boxes and lines arranged hierarchically on an organizational chart. It is "an outline of the desired pattern of activities, expectations, and exchanges among all levels of staff in the organization" (Bolman and Deal 1991, p. 46). As such, it includes how the MFI organizes its operations—the departmental and branch operating units, as well as staff roles and responsibilities. Within the context of preparing for transformation, this section focuses on building an organizational structure that responds to the changing operating needs of the MFI, understanding the formal and informal reporting lines that evolve from this structure, and developing appropriate job descriptions for the staff within the structure. Some MFIs may choose to hire external consultants to look at human resources issues and make recommendations about the appropriate organizational structure and staffing. Annex 9A, Sample Terms of Reference: Human Resources Management, provides Terms of Reference for a human resources management consultancy.

Building the Right Organizational Structure

All organizations, regardless of transformation, need to constantly look toward the future and assess themselves, not only from the perspective of how they respond to current client needs, but how they might respond to future client needs. This concept of managing the present from the future (Goss, Pascale, and Athos 1998) should guide the thinking about organizational structure. Managers need to realize that this is an ongoing process. Although transformation can lead to a fundamental restructuring of the MFI's operations—a process that could take anywhere from two to

five years—building the right organizational structure is not a one-off activity.

As discussed in chapter 5, Strategic and Business Planning, one of the first steps in the process of transformation is to develop a long-term business plan that takes into account the anticipated changes that will come with transformation. Among other things, this plan articulates the institution's outreach goals, both geographic expansion and number of clients reached; the anticipated products and services to be provided; and the human and physical resources needed to achieve these plans. This last point, the necessary human resources required to support the future business strategy, may not always be fully appreciated by transforming MFIs. To begin with, certain organizational constraints can impede an MFI's ability to realize its optimal organizational structure:

- *Absence of several critical functions:* With many NGO MFIs, the organizational structure typically revolves around the provision of credit, evidenced by senior management teams primarily composed of a credit or operations manager (in some organizations this position is referred to as the commercial manager) whose primary responsibility is managing the organization's loan portfolio; and a finance and administration manager, whose primary responsibility is to monitor and report on the financial performance and administration of the MFI. With the addition of deposit mobilization, a number of functions or departments including asset and liability management, treasury, human resources management, internal controls, planning, marketing, and external relations (investors, regulators) may be new to the licensed organization or become more complicated, usually requiring new staff positions and responsibilities.
- *Insufficient focus on staff development:* Many MFIs are beginning to reorient themselves toward their external clients in an effort to more proactively address customer service issues, but insufficient attention is often paid to staff as the internal client.
- *Outdated or inappropriate authority levels:* NGOs often lack appropriate internal controls and may not have efficient reporting structures. Staff at the head office may be tasked with financial management or human resources management, but in fact defer to the managing director for all decisions. Conversely, relatively junior staff may be tasked with making and approving large purchases, without requisite checks and balances.
- *Underdeveloped managerial processes:* MFIs often start with many soldiers and few generals. Over time, some of these soldiers are promoted to generals, yet many do not have the necessary skills nor does the MFI always invest in the necessary training. Promoting good loan officers to branch managers makes sense from many perspectives—they know the business, they know the market in which they work, they are respected by their colleagues, and promotion from within improves staff morale. However, additional training and support are needed to ensure the promoted loan officer can truly take on the role of branch manager. In some cases, and for some positions, hiring externally may be required.
- *Inadequate management information systems:* NGOs are frequently hindered by poorly performing management information systems (MIS). Accurate and timely reporting from branches to the head office may be impeded by communications or data-capturing constraints. Similar problems exist in many MFI head offices as well.
- *Absence of appropriate governance:* NGO boards are often made up of individuals who do not have their own personal resources at stake. These individuals are generally well-respected leaders in their communities, but this lack of financial ownership can limit effective governance. Furthermore, NGO boards may not have members who possess all the skills necessary to manage a financial institution. (See chapter 7, Ownership and Governance, for further discussion.)

Although the prevalence of these characteristics will differ across MFIs, the following section outlines two critical organizational structure issues that transforming MFIs may need to address in the transformation process—establishment of new head office departments and positions, and the restructuring of branch operations.

Establishment of new departments and positions at head office. The need to add or reevaluate head office departments and positions will depend on the complexity of the MFI before transformation. In some cases, for example in fairly large and sophisticated MFIs (even if unregulated), transformation requires much less change than in other cases. Key areas and functions that typically need to be reevaluated include the following (see annex 9B, Examples of Job Responsibilities for Senior Staff, for detail on the responsibilities of senior positions discussed below):

- *Chief Executive Officer:* One of the more difficult decisions facing a transforming NGO is whether the current head of the organization is the right person to serve as head of the transformed institution. The personality and skill set of the founding director or current NGO director may not be consistent with the type of person needed to lead the new regulated institution. Despite the many cases of consistent leadership throughout the transformation process, there are still a number of cases where the board of the regulated institution has opted to recruit externally for a new director with more specific banking expertise. Whether the NGO director or a new hire ultimately leads the regulated MFI, training and external exposure visits will undoubtedly be needed. As well, the CEO typically needs to be approved by the regulatory authorities as a condition of granting the license.
- *Chief Financial Officer:* Most MFIs already have a finance manager in place, but transformation to a regulated, deposit-taking financial intermediary may require the recruitment of a more senior individual to be the Chief Financial Officer (CFO). This individual will have responsibility for creating the vision for and managing the long-term financial strategy of the organization. New responsibilities will include establishing guidelines for the regulated institution's tolerance for risk and expectations from investments; establishing the process of financial statement reporting in compliance with central bank requirements and other new stakeholders, both internal and external; and managing a more complex liquidity position and other treasury functions.

  In many regulatory environments, the CFO needs to be vetted and approved by the regulator as part of the application process. In some cases, this individual must meet certain academic qualifications or hold certain degrees, or qualifications such as Certified Public Accountant or Association of Chartered Certified Accountants.
- *Risk management or treasury function:* Deposit mobilization adds complexity to asset and liability management. Managing the spread between deposits and loans is not a skill the finance manager of an NGO will have had much chance to exercise. MFIs typically elect to hire this experience externally, and invest in additional training for all branch staff. The CFO may initially be able to handle this work load, but as deposits grow, liquidity management becomes more complex, justifying the hiring of an individual exclusively dedicated to the treasury function. A cross-departmental risk-management committee (or Asset and Liability Committee, ALCO) is also normally established to closely evaluate the evolving structure of the MFI's balance sheet and the risks and returns inherent in this structure (box 9.2). (See chapter 10, Financial Management, for a detailed description of the treasury function.)
- *Human resources function:* Although many NGO MFIs have an individual responsible for managing human resources, often with

Box 9.2 Risk Management at XacBank

In recognition of the increasing sophistication and size of operations, XacBank established a risk management committee in 2001 to monitor the institution's current and forecasted positions in key risk categories, including credit risk, asset-liability management (liquidity risk, interest rate risk, foreign exchange risk), and new product risk. The committee meets on a bimonthly basis and includes executive management and senior management representatives from Operations, Finance, and Marketing.

Source: Contributed by Lloyd Stevens, DFID Financial Sector Deepening Programme, Uganda, November 2005.

administrative duties as well, transformation and the ensuing demands for upgraded staff skills, increased training opportunities, and more aggressive hiring practices call for a more senior staff member to serve as Human Resources Manager and for the human resources function to be upgraded to a full department (box 9.3). Key functional areas for this department typically include developing the human resources plan for the organization, administration of salary and benefits, recruitment, coordination of internal and external training, establishment of staff performance monitoring and evaluation systems, publication of a staff newsletter, and identification and documentation of human resources policies and procedures.

- *Internal audit function:* The hiring of internal auditors and the creation of an independent Internal Audit department is largely driven by organizational size. As client numbers increase and transaction volumes multiply, an MFI needs to invest in a concrete system of controls. In particular, MFIs that begin offering voluntary savings, an undertaking that significantly increases both customer volume and security risk for the institution, must develop internal audit expertise. The Internal Audit department is one critical component of the internal control function. The role of this department is to provide an independent check on institutional compliance with established policies and procedures. (See chapter 12, Internal Controls and Audit, for further discussion.)

Box 9.3 HR Management at Uganda Microfinance Union

Before the transformation planning process, Uganda Microfinance Union (UMU) relied on the individual tasked with branch management to oversee key aspects of human resources management. These activities were largely limited to managing leave time, ensuring payroll was processed, and coordinating the overall performance review process. As the organization grew, and in acknowledgement of the increased importance of the organization's human capital, UMU hired a full-time Human Resources Manager, elevating what was a largely administrative task to a full department position, reporting directly to the CEO. In addition, UMU established a training function within this department, tasked with all new entry training and refresher training for current staff.

Source: Author.

The Chief Internal Auditor (CIA) is another senior position that the regulators will want to approve. As with the CFO, the CIA is often required to have certain academic or professional qualifications. With enough preparatory time, an MFI can identify the necessary external training courses and build this capacity within its current team. Alternatively, external recruitment is a quick way to bring in this expertise.

The CIA should be a professional accountant familiar with a variety of audit techniques, standards, and systems. Given the nature of microfinance business and the role of internal audit, this individual must also possess a willingness to work

with the poor and go into market areas where clients work. This requirement may be unappealing to a formal sector bank auditor; thus, it is critical to vet candidates properly to ensure the necessary commitment to the MFI's target group.

- *Operations function:* For MFIs that have historically relied on commercial banks to service their clients' disbursement and repayment transactions, transformation and the institutional shift to deposit mobilization can require the launch of extensive front- and back-office operations at the branches. The installation of in-house tellers, an increase in the range of products and services offered at the branch, and more sophisticated funds management activities increase activity levels at the branches. A number of MFIs put in place an Operations or Supervision Department to oversee branch operations. (See chapter 13, Customer Service and Operations, for further discussion.)
- *Information technology function:* The addition of savings mobilization results in the MFI becoming a true financial intermediary, multiplying the level of scrutiny and supervision by government regulators and others. The ability to produce timely and accurate reports becomes a critical factor in how the organization is viewed externally. Failure to produce these reports can result in fines and penalties, and also prompt shareholders and regulators to question the soundness of the organization's operating ability. Upgrading the MIS often equates with the creation of a full department tasked with not only supporting the new hardware, software, and communications infrastructure, but also ensuring timely and accurate reporting. (See chapter 11, Management Information Systems, for further discussion.)

These system and department changes also lead to upgrading the information technology (IT) staff. The IT manager is responsible for managing and influencing the MFI's IT infrastructure, including hardware and software procurement and installation, staff training on hardware and software, system documentation, and development of MIS for both accounts and operations. This individual should report directly to the head of the organization. Preferably, the IT Manager will have previous project management experience, in addition, of course, to qualifications and experience in IT. Knowledge of accounting is also important.

- *Marketing function:* As the MFI begins to expand its geographic presence, as products and services grow, and as competition becomes a significant force in the market, the need for strong marketing capacity in an MFI grows. The need for more sophisticated marketing initiatives with a strong and consistent brand image, particularly important for savings mobilization, is often addressed through the creation of an independent marketing department. (See chapter 4, Marketing and Competitive Positioning.)
- *Market research and product development function:* In addition to increased marketing capacity, transformation typically requires increased investment in an institution's market research function. With the opportunity and need to expand product offerings, the research, development, piloting, and expansion of new products becomes a core function of the organization. While an NGO may have relied on external technical support for many of these activities in the past, building greater in-house capacity in market research and product development are important investments for future competitiveness.
- *Investor relations function:* Given the expansion of stakeholders to include shareholders and regulators, it is important for the transformed MFI to develop an investor relations function. This function develops specific external communication such as the Annual Report, communicates with external investors, and, in some cases, ensures compliance with regulators. The investor relations function may not require a separate department—at least initially—but

should be recognized as a role that requires an individual or team to take responsibility and be accountable for communicating to investors.

The creation of these new departments and staff positions ultimately redefines the organizational structural of the institution. The MFI's organizational chart will change significantly after transformation. See annex 9C, Sample Organizational Charts, for examples of transformed MFI's organizational charts as well as a description of each of the positions in Socremo MFB's proposed organizational structure.

Restructuring of branch operations. The creation of new head office departments is typically accompanied by the creation of parallel units or skills at the regional or branch level. These changes often lead to an increase in decentralization, as branches begin to function more and more as discrete profit centers.

Staff additions at the branch level needed to support these changes are dependent to a large extent on the current operations of the transforming MFI, but usually include the following:

- *Tellers:* For MFIs that have historically relied on either commercial banks or group meetings "under a tree" to process repayment and disbursement transactions, transformation to a deposit-taking institution results in the addition of teller services at the branch level.
- *Accountants:* As repayment and disbursement transactions are brought in house, the complexity of managing branch-level accounts increases. Some MFIs have opted to continue to post transactions at a head office level, and others have found it more efficient to decentralize some of the transaction posting to the branch level. This decision ultimately depends on a range of factors, including the structure of the MIS (centralized or decentralized database), internal controls, local accounting capacity, and the like. If an MFI elects to pursue a more decentralized approach, branch-level accountants may be required, as will be capacity building of branch managers to oversee and supervise these new accountants.
- *Customer service officers:* Market image and competitive positioning become key challenges during an institutional transformation. The addition of a customer service or information officer to the branch's core staff can help present a more client-focused image to anyone walking into a branch office. This individual is typically stationed at the front of the branch to answer any questions and to advise clients on available products and services.
- *Supervisors:* Branch managers are often responsible for the overall supervision of the branch operations at MFI NGOs. With transformation and the addition of banking halls, teller windows, marketing or customer service officers, and others, some MFIs develop the position of supervisor within the branches. The supervisor focuses on the front-office operations and ensures that branch staff are performing their jobs well and providing excellent customer service. The supervisor typically has some level of authority to approve transactions above what tellers or other branch staff can approve. Ultimately, the supervisor assists the branch manager in ensuring the branch operations run smoothly.
- *IT capacity:* Upgrading an MFI's IT, common in a transformation, will undoubtedly lead to the need to increase IT skills at the branch level. Although not all systems will require the placement of network administrators at the branch level, the MFI will need to carefully plan how system support will be provided to branches in a timely and accurate way. As noted in chapter 12, Internal Control and Audits, MFIs that have historically relied on ledger keepers or manual methods of tracking accounts will find that computerization can reduce the number of staff required, forcing MFIs to reassign or lay off staff members.

Revising Job Descriptions

Transformation provides a unique opportunity to revisit existing job descriptions and develop new ones. Technological innovations, the introduction of new products and services, and other operational changes may significantly change day-to-day responsibilities for certain positions. Job descriptions will need to be developed with these changes in mind.

A reasonable and comprehensive job description should include the following:

- *General statement of duties:* brief statement that broadly explains duties.
- *Key responsibilities and performance measures:* identify key responsibility areas and detail specific activities. Under each responsibility area, ensure easily tracked performance measures.
- *Core competences required:* identify key technical abilities and general skills considered to be prerequisites.
- *Required qualifications:* identify specific educational background or prior experience needed.
- *Attributes desired:* identify general personal characteristics needed.
- *Supervision received:* identify who will supervise this position.
- *Supervision exercised:* identify other positions that this position is responsible for supervising.
- *Customer and peer contact, internal and external:* identify with whom the incumbent interacts on a day-to-day basis.
- *Tools used:* identify specific tools, such as computers or vehicles, the employee is expected to operate.
- *Vertical and horizontal promotion opportunities:* identify career path opportunities for this position, with clear explanation of experience and training requirements needed for promotional opportunities.

A key component of a comprehensive job description is the section on performance measurement and appraisal. The management style termed "managing for results" is not linked to any one type of institutional structure, but transformation into a regulated, share company often encourages a more results-oriented management style. The number of, and level of engagement by, external stakeholders including investors and regulatory authorities typically increases pressure on management to reach targets and achieve results. Transformation provides MFIs the opportunity to draft more detailed, performance-based employment contracts to capture some of these targets.

The drafting of new job descriptions can create fear among staff if they feel their positions are being restructured or their skill sets are no longer valued. Thus, the process of developing job descriptions should be conducted ensuring maximum inclusiveness and transparency. At the same time, however, management needs to be honest about what skills and positions will be needed in the transformed institution. This issue is particularly relevant for MFIs that are creating new companies with the transformation process. Most of the NGO staff will be transitioned to the new regulated institution, but management should see the transformation exercise as an opportunity to reassess staff capacity. The typical approach to transitioning staff from the NGO to the new regulated institution is to terminate the NGO staff contracts and, using new, clearly documented job descriptions, undertake a transparent recruitment process for the new institution. Not all NGO staff will find homes in the new institution, and this reality should be communicated to staff in a transparent manner. However, this communication process must be implemented with a great deal of sensitivity and awareness of the potential for fraud and underperformance of staff if employees fear dismissal. MFIs need to exercise enormous caution in how they communicate this message to their staff. The payment of termination benefits and other financial liabilities (tax, pension, and so forth) that could be triggered by the termination of positions, even for staff who are being reassigned to the new entity, will also need to be closely evaluated.

Because of sensitivities surrounding the drafting of job descriptions, a number of transforming MFIs have opted to hire externally for this exercise. An external consultant can ask certain questions about an individual's day-to-day activities that someone internally may not be comfortable asking. In addition, assuming the consultant has broader financial system exposure, such an individual could provide the MFI leadership (usually the board) with key insights into the new roles and responsibilities to be assumed by staff in the transformed institution and the requisite skills. This certainly applies to senior management positions, because the scope of their areas of responsibility typically expands with transformation, but is applicable, too, for front-line and back-office staff.

Ensuring the Right Staff

Once the right organizational structure is established, the responsibilities of the branches defined, and job descriptions documented, these positions need to be staffed by people who have the right skills and attitudes for the job, or at a minimum, have the capacity to learn the skills. Likewise, the MFI will need to demonstrate that it has the commitment and willingness to invest in developing and nurturing these skills.

Managing a financial intermediary is a complex process, particularly challenging for institutions that have remained relatively centralized, relying on the visionary founder or a few top leaders to set direction and make decisions (Ledgerwood 1999). With the increase in external scrutiny by regulators and others, MFIs often need to build significant managerial and technical expertise throughout the organization. The shift to a regulated MFI is often characterized by a significant *professionalization of operations*. Staffing levels need to be examined not only from the perspective of today's requirements, but also based on future needs. Staff capacity needs to be built in critical managerial and technical areas, calling for investments in training and capacity building. New recruits might be needed to fill some of the more senior technical positions. Managing the balance between internal promotion and external recruitment takes careful planning. Finally, institutionalizing an appropriate performance-based management system to motivate and retain staff is important.

Optimizing Staffing Levels

A quickly growing MFI often hires staff in a reactive manner—staff are recruited in response to pleas from branch managers or other head-office staff to ameliorate what is perceived as staff overload. Transformation planning allows an MFI to instead shift to a more proactive hiring pattern. The goal is to bring in the necessary staff today to achieve the right balance and number of qualified staff for tomorrow.

As highlighted above, staffing level issues for a transforming MFI include both insufficient staffing and overstaffing. This change in personnel requires careful planning early in the transformation process. Five steps can be taken to identify and meet this changing demand for personnel:[2]

Select a planning horizon. The planning horizon is directly related to the term of the institution's strategic plan. If an MFI has a five-year strategic plan, a five-year human resources plan should be feasible. Three to five years for personnel planning is typically the most useful and practical.

Project the supply of personnel. Staff retention rates indicate employee satisfaction and must be monitored. If not communicated well, transformation planning can result in the perception of unpredictability, encouraging some staff to actively seek out other more stable opportunities.

Forecast the demand for personnel. To determine the institution's optimal staffing level not only for

today, but also well into the future, the MFI can use a range of strategies. When managers know their operations well, they should have a good sense of the right number of people required for their departments to function effectively. New managers or managers of new departments may have a harder time with this exercise, which underscores the importance of exposure visits and forums for management-level exchanges among MFIs. In addition, many MFIs already use financial projection models that require the structuring of a "model branch." Because 80 to 90 percent of employees are in the branch systems, optimizing staffing in the branches should be a priority (Carlson 1992).

Identify emerging excesses and shortages and make plans to resolve shortages and excesses. This step simply requires a comparison of the projected supply of staff with the projected demand year by year, often known as a gap analysis. Because of the sensitivities involved in such an evaluation and the need to ensure a long-term perspective, MFIs might find it best to contract externally for this analysis. (See annex 9A for sample terms of reference.) In addition, because such an assessment can generate anxiety among staff who may see it as an assessment of their performance, the analyst should emphasize that the objective of the gap analysis is not to determine who should be fired, but instead to provide the organization with an assessment of skill shortages to identify both priority recruitment areas and required training programs. (Ultimately, however, institutions will likely have to make some hard decisions regarding staff capacity.) With gaps identified, the MFI then needs to draft a concrete plan for resolving the shortages and excesses, clearly the most challenging step in the process.

Consider the costs. Significant costs will arise from additional personnel salaries and benefits as well as training costs, which need to be factored into the projected financials.

Building the Right Skills Mix: External Recruitment and Training

Using results of the gap analysis, the MFI needs to make decisions about which positions to recruit for externally and which to upgrade through additional training and exposure. Hiring externally provides the opportunity to upgrade the MFI's level of professionalism quickly. Internal training and development will improve the skills and attitudes of the existing work force, but it takes time. Transformations of NGO MFIs to regulated financial institution have typically involved external hiring for key technical positions, such as the Treasury Manager, the IT Manager, and in some cases, the Human Resources Manager. These external recruits can contribute significantly to upgrading the skill base of the MFI, but their additions to the institution's capacity obviously need to be carefully weighed against their impact on the payroll. In most developing countries, people with senior banking skills are usually scarce, allowing the few that exist to command high market prices.

Institutional commitment to training. Training must be a core activity of the MFI focused on building the skills to enable the institution to meet its goals. Training must be viewed as an investment, not an expense. Resources need to be committed to building internal training courses as well as identifying appropriate external training opportunities. The selection, management, and training of internal trainers are crucial. Although a training coordinator is often hired to help coordinate the delivery of training, training is actually often conducted by MFI staff with hands-on experience. This implies that they have been trained as trainers and that their supervisors are supportive of the training process. Perhaps, even more important than the actual training is the development of a culture in which individuals strive to learn and are motivated to continue to pursue new challenges. Such a culture

includes supportive managers who see the value in training and are motivated to find ways to develop their staff. Managers will generally support training opportunities for their staff if they feel the training adds value to staff members' abilities to carry out their duties.

Balancing in-house training and external training. Building a solid training and development infrastructure is critical to the professionalization process of the MFI, particularly for institutions committed to filling senior management positions through internal promotion. Most NGO MFIs have internal training programs heavy on introductory sessions for new staff and methodology training for loan officers. Training for specific technical skills or more general management skills is often outsourced. Because loan officers typically make up a significant portion of the staff, this makes economic sense. However, as an MFI begins to expand its presence and decentralize its operations, an over-reliance on external training can become costly.

The appropriate balance between in-house training and external training opportunities will depend on a range of factors, including the quality and relevance of external training, the relative importance of the training to the MFI's competitive advantage in the marketplace, the number of staff who need to be trained, and the frequency of the training. These factors will differ between institutions, but a common thread among transforming institutions has been their commitment to building a strong in-house training function. Using external training to fill gaps in the internal training program can continue. However, the disadvantages of using external training are the cost of the training per person, the dependence on the external training schedule, and the fact that usually no external course is specifically tailored to the MFI's methodology. With the continuous growth that comes with transformation and the increasing importance of products that require more sophisticated analysis, it often makes sense to begin developing the in-house training capacity of staff. Key in-house training modules include new staff induction, methodology training for products (including cash flow analysis techniques for individual lending), delinquency management, sales and marketing, customer service, and basic budgeting for branch managers.

Balancing on-the-job training with classroom training. Most learning in a financial institution occurs on the job, as specific skills are internalized, deepened, expanded, and supplemented through day-to-day experience. Building and disseminating solid on-the-job training is a key resource for institutions. Such training, however, also needs to be balanced with more structured classroom training. On-the-job training programs often do not provide the theoretical knowledge that the employee needs to properly execute his or her work, particularly for field and loan officers. In addition, the quality of the on-the job training can be irregular, depending on who is tasked with orienting the staff member. Supplementing on-the-job training with structured classroom training can help address some of these issues (box 9.4).

Box 9.4 Training of Loan Officers

As is the case with many quickly growing MFIs, U-Trust initially relied heavily on on-the-job training to build capacity among its field staff. A well-developed rotation program provided new staff with broad exposure to various departments. The significant increase in staff hiring combined with the introduction of more sophisticated risk assessment technologies, however, prompted the development of supplementary standardized classroom training.

Source: Author.

Career path management. The possibility of moving up in an organization can be a significant motivator for staff. Thus, MFIs should link training programs to performance appraisal systems. Yearly performance appraisals should identify additional training needs for all employees, while the different workshops attended should be valued in the overall development of the employees. Career path management balances the MFI's need to have qualified people in each position and the need to use different positions to develop qualified individuals.

Table 9.1 presents a summary of primary training needs for transforming MFIs by position. The training needed to support transformation and to provide an MFI with the necessary human resources base is not limited to functional skill development. Instead, a wide range of management skill-building sessions and attitude development are often just as important in this process.

Priority Training Needs

All the training needs identified in table 9.1 are important. The following summarizes some of the more significant training priorities at the branch level.

From branch supervisor to branch manager—With the trend toward decentralization and the requisite shift toward more branch-based transactions, transformation has tended to also increase the roles and responsibilities of branch managers. Within the NGO structure, branch managers often play more of a senior loan officer role, largely acting as a supervisor for the loan officers in the branch. With transformation, however, they take on a much more significant management function as branch staffing levels (including tellers, possibly for the first time), internal control requirements, liquidity management, reporting, security, and other needs expand. Branch managers faced with these tasks for the first time can be supported with specific management skills training in leadership and decision making, as well as more technical training in financial statement analysis, budgeting, and liquidity management.

Prioritization of quality customer service—Increasing competition in today's markets is forcing MFIs to adjust their strategies and restructure their operations. The importance of building strong customer relations is recognized as key to building a competitive advantage in the marketplace, particularly for organizations adding deposit services. Because so many factors affect a customer's experience, customer service needs to be incorporated as an overall enterprise objective and philosophy. Thus, transforming organizations are placing greater priority on exposing their staff to customer care or customer service training. Some form of service quality training has become compulsory in many of the leading MFIs. (See chapter 13, Customer Service and Operations, for further discussion.)

From loan officer to relationship officer—The shift from credit only to a credit and savings institution has a profound impact on the role of the MFI's primary client contact point—the loan officer. Although loan officers by definition are traditionally trained to market a relatively narrow set of products (or one product), the shift to deposit taking requires a significant increase in both their understanding of product offerings and the way in which they interact with clients (box 9.5). Whereas the key themes for marketing microloans are speed of service, price, and perhaps flexibility, the themes for microsavings are liquidity and security, the latter of which requires building trust in the marketplace. As mentioned in chapter 1, Mobilizing Savings from the Public, regulated commercial MFIs must mobilize savings from the broader public, not from the poor alone. This requires a major effort to train management and staff to deal with a broader target market.

Table 9.1 Training Needs for Transforming MFIs

Personnel	Management skills	Functional skills	Attitudes
All staff	• Leadership • Goal setting • Planning • Monitoring and control • Productivity management • Cost management • Problem identification, analysis, and resolution • Quality control	• Customer service • Marketing and brand image awareness • General banking practices • Auditing • Computer technology • Human resources development • Management accounting	• Results orientation • Improvement orientation • Active, involved management • Staff development • Problem resolution • High standards • Receptiveness to change • Profit orientation • Customer focus • Open communications • Constructive critique • Objectivity • Initiative • Assumption of responsibility
Senior management	• Change management • Managing relations with external stakeholders: supervisory authorities, shareholders, and the like	• Asset liability management • Risk management • Treasury management • More sophisticated human resources management • Regulations (for example, money laundering, and so forth) • Governance (dealing with new players and rules)	• Responsible to external board and regulators • Double bottom line
Branch managers	• Managing for results	• Budgeting • Financial accounting • More advanced credit analysis and cash flow analysis techniques • More advanced delinquency management • Human resources development • Customer service • Security (especially if handling cash)	• Shift from role as senior loan officer to true manager • Money laundering
Loan officers	n.a.	• More advanced credit analysis and cash flow analysis techniques • More advanced delinquency management • Customer care • Sales	• Shift from sellers to buyers: credit only to credit and savings
Back-office staff	n.a.	• More advanced IT capacity • For accountants: cash to accrual accounting, basic liquidity management	n.a.

Source: Adapted from Carlson (1992, box 5.4).
n.a. = Not applicable.

Box 9.5 From Loan Officer to ARO

With the introduction of a wider range of product offerings, including savings services, FINCA Uganda recognized that the term *loan officer* no longer reflected the true role of this position. The organization coined a new term *account relationship officer* or ARO, to reflect the expanded role such staff are playing in servicing the financial needs of their clients.

Source: Interview with Clare Wavamunno, and Millie Kasozi, FINCA Uganda, March 2004.

Box 9.6 Expanding the Market

In an effort to reach further down market with its individual loan product, UMU shifted its analysis from a largely collateral-based assessment to a more thorough assessment of the borrower's capacity and willingness to repay. With an expanded focus on the cash flow of the client's business, the revised individual loan appraisal format required a significant investment in the training of loan officers, branch managers, and senior management.

Source: Author.

Improved client risk assessment techniques—The addition of individual loans (if not offered previously or at least not to clients with higher income levels) requires investment in significant loan officer training. Building the ability among loan officers to calculate capacity to repay based on simplified cash-flow analysis requires an investment in both classroom training and on-the-job monitoring and supervision (box 9.6). This shift may also lead to changes in the profiling of loan officers, requiring recruitment efforts to focus on applicants with more developed financial analysis skills.

Motivating and Rewarding Performance

Identifying staffing levels and building the right skills mix responds to a transforming MFI's need to identify and attract the right quantity and caliber of employees. The next challenge is how to retain and motivate these staff. Critical motivating influences already mentioned include developing a comprehensive training and development program, ensuring clear and transparent promotional opportunities for staff, and empowering staff through greater decentralization as improvements in systems and internal controls allow branch-level staff to take on more responsibility. This section considers a fourth, perhaps more basic motivator—monetary compensation.

Staff compensation. Institutional transformation into a for-profit company has two important implications for staff compensation: (a) the fact that the company is changing from a nonprofit to a for-profit can create certain expectations among staff that salaries and benefits will increase (in spite of the continued commitment to social objectives), and (b) transformation provides MFI managers a unique opportunity to introduce or redesign the way in which staff are motivated, monitored, and rewarded.

MFI staff members in positions similar in title and job description to positions in traditional banking, such as tellers, loan officers, data capturers, and the like, may begin to compare their salaries with friends or family members in similar positions at local banks. This may lead to unrealistic expectations about what transformation will mean for their own pay. By proactively addressing these concerns, an MFI's human resources manager can help avoid deterioration in staff morale. In some cases, staff members are simply misinformed. Investing in an external salary survey is often useful for showing true averages and for making transparent benefits, in-kind contributions, and bonuses. In other cases, staff may not be

Box 9.7 Ten Steps to Redesigning an Incentive Scheme to Accommodate an Institutional Transformation

1. Redefine and clarify strategic goals of the new transformed institution. These may not be the same as the goals of the original MFI NGO.
2. Analyze new culture, clientele, products, and processes. Introduction of savings products, new technology advances, changes to branch-level procedures, and the like will affect incentive scheme design.
3. Redefine the objectives of the incentive scheme. What is the MFI trying to achieve, and what results does it expect? Also, what problems is it trying to fix?
4. Conduct a cost-benefit analysis of such a scheme. How much is the regulated institution willing to spend?
5. Decide which staff members and positions will be affected by the scheme.
6. Perform technical design work including formula development and calibration, as well as spreadsheet testing. It is useful (and should be obligatory) to carry out sensitivity and scenario analyses. It helps to use a participatory process.
7. Choose incentive mechanisms. Examples are merit pay, incentive pay (bonus schemes), perquisites, benefits, profit sharing, gain sharing, ownership, or a combination of these mechanisms. Consider staff expectations, levels of risk involved, and regulatory restrictions.
8. Field test in a controlled environment at one or two branches.
9. Sell the scheme to the staff. Do not underestimate the need to build buy-in to changes in an incentive scheme. Changes in performance indicators (either additions or deletions), weightings, or actual bonus values need to be carefully explained and promoted to staff.
10. Monitor the performance of the scheme. Make adjustments based on regular reviews (for example, semiannually).

Source: Adapted from Holtmann 2003.

aware of the true financial picture of the organization. Communication is critical. Conducting basic information sessions with staff that focus on the general financial performance of the institution is very useful. This session could also include an overview of the basic fiscal and regulatory changes that will affect the organization as a regulated, for-profit entity.

Assuming a scenario in which a new organization is created and staff are shifted from the NGO to the new regulated MFI, the NGO staff contracts would be terminated and new contracts issued by the regulated MFI. This provides MFIs with the opportunity to realign the salary scale, change titles and positions as needed, and restructure the overall compensation package. Incorporating staff input and managing expectations regarding compensation are important components of the change management process.

Adapting incentive schemes. The transformation process provides MFIs an opportunity to introduce, or redesign, a staff incentive scheme as part of compensation. Targets for the transformed institution may be different from those for the NGO, products and services may have expanded, and priority areas for the institution's growth plans may have changed. All these factors can be incorporated into an MFI's incentive scheme design (see box 9.7). Incentive schemes in the microfinance industry range from monthly bonus payments based on a variety of different variables to profit-sharing plans and employee stock ownership plans (ESOPs).[3] Staff incentive schemes need to be adapted and

tailored to the specific situation prevailing in each organization or MFI.

Some of the key issues a transforming MFI should consider in incentive scheme design are highlighted below:

- *Balance between base and incentive:* Transformation provides MFIs the opportunity to structure or restructure the relationship between base pay and bonus pay. In finding the right balance, an MFI needs to consider the appropriate level of risk staff is able (that is, has control over) or willing to assume. The higher the proportion of incentive in the overall compensation package, the higher the risk for the staff member. As suggested by Martin Holtmann in MicroSave's *Staff Incentive Schemes Toolkit* (2003, p. 19),

  > For loan officers, the variable (performance-related) portion might account for between 20 to 50% of total compensation. Levels much below 20% will probably not have much of an effect on behavior, while levels above 50% may attract risk-seeking individuals to the job. Other MFI staff members such as those engaged in savings mobilization and back-office work would probably find variable pay accounting for 50% of total compensation unduly harsh. For such occupational categories it may be more appropriate to let the variable (incentive) part of compensation vary between 15 and 30% of total pay.

- *Individual versus unit incentives:* Incentive schemes can be developed for individuals, branches, or units, depending on the activities and responsibilities of each individual and the particular behavior the institution is trying to encourage (box 9.8). An institution's choice of individual or unit (such as branch) based schemes is ultimately affected by a range of factors, including capacity of the MIS, preference for encouraging individual performance or fostering teamwork and cohesiveness in the unit or branch, operating structure of the MFI, risk of free-rider behavior, and size of the unit.[4]
- *Staff incentive schemes for savings:* Performance-based incentive schemes for loan officers are relatively common. However, little is known about effective incentive schemes for staff who mobilize savings. The major difficulty in establishing individual performance-based incentive schemes for savings is attribution—mobilizing savings involves every member of a branch. Furthermore, the volume of savings depends as much on seasonal fluctuations that

Box 9.8 Individual versus Branch Incentives at UML

UMU (now UML) has always maintained that one of the secrets to its success is its team approach to service delivery, which is not only based on teamwork but also on team spirit. A flat operating hierarchy and an open-door policy at all levels of the organization contribute to a motivating environment. When embarking on the process of developing a monetary incentive scheme for staff, UML wanted to ensure this team approach would endure. Therefore, although UML recently decided to begin tracking performance by loan officer, and has thus shifted to a more individual-based incentive scheme, branch performance is still incorporated. Incentives for loan officers are computed based on number of loans disbursed, portfolio growth, and portfolio quality. Branch manager incentives include these same parameters, plus compliance with reporting requirements and operating policies, as well as branch profitability. Back-office staff, including accountants, cashiers, support staff, and customer care officers, receive incentives based on the profitability of the branch.

Source: Authors.

vary from branch to branch as it does on the level of promotional activity. Nevertheless, failing to recognize the vital contribution of branch staff to raising deposits and serving clients effectively and efficiently does little to encourage individual and thereby collective excellence (Holtmann 2003).

Incentives can be provided for good performance for savings mobilization through branch-based awards given on the basis of most improved or best performing branch. Individual awards can be provided to tellers meeting peak targets. In most cases, it may be sufficient to construct a simple formula-based scheme that takes into account outreach (that is, the development of the number of accounts) and deposit volume. When deposits are mobilized through branches, the incentive awards (such as monthly bonuses) should be based on group performance and should be shared equally among the staff members (or prorated for part-time staff). As with any incentive scheme, savings-based incentive schemes need to be carefully designed and tested. See Holtmann and Grammling 2005.

Annex 9D, Checklist for Managing Human Resources, provides a summary checklist of the major transformation-related human resources issues discussed in this chapter.

Annex 9A Sample Terms of Reference: Human Resources Management

Background

Background on the organization including its mission, target market, client outreach, portfolio size, and so forth.

Strategic Objective

By transforming its operations, MFI A seeks to meet the following key objectives:

1. To provide a variety of financial services, including savings, credit, and money transmission, to low-income people
2. To enhance access to more commercial funding including savings, debt, and equity capital
3. To portray credibility in the eyes of potential customers and the public
4. To promote professionalism and best practice in service delivery
5. To increase efficiency, sound financial management, profitability, and institutional sustainability

To this end, MFI A has identified the need to strengthen its human resources (HR) management function. This will entail reviewing and, where needed, establishing policies, systems, and job descriptions in all areas of human resources management including the following:

- Organization and management development
- Recruitment and human resources planning
- Performance management
- Compensation and incentives
- Employee relations and services

MFI A requires assistance in defining the appropriate structure for its HR function as well as developing and increasing the competencies of its HR staff.

MFI A also requires assistance to develop an appropriate organizational structure for the transformed MFI including draft job descriptions and training needs.

To meet these objectives, the following two phases will be undertaken:

Phase I

Tasks

1. Interview senior management and, if possible, board members to determine the business drivers and organizational context of MFI A.
2. Assess the current HR policies and systems.
3. Assess the current capabilities of line managers and supervisors through focus group discussions, interviews, and assessment tools.
4. Conduct a survey of employees to identify concerns with and requirements of the HR department.
5. Facilitate a management retreat where the leaders will define the philosophy, values, and policies that will guide the institution in developing, formulating, and reviewing its HR programs and processes, as well as define and agree on their role and the behaviors they will model as leaders.
6. Identify the areas to be developed to achieve a strong HR function.
7. Develop an implementation strategy for carrying out the HR function and identify the roles required to ensure HR has the capability to achieve its strategies and programs, specifically:
   - Determine the appropriate HR department structure.
   - Define the department's goals and vision and clarify each position in the unit.
   - Prepare job descriptions and competencies required for the HR positions.
   - Train HR key staff and associates.

Deliverables

1. Prepare assessment report of current HR policies, systems, and capabilities of management.

2. Draft HR philosophy, values, and policies.
3. Draft HR plan including programs and processes to be put in place to support business strategies and address gaps.
4. Draft HR implementation strategy, department structure, and required HR positions including job descriptions.

Level of Effort. It is estimated phase I will take 20 to 25 days to complete.

Phase II

Tasks

1. Working jointly with management and the HR department, develop an organizational structure to meet the needs of the regulated MFI.
2. Develop draft job descriptions for the positions identified.
3. Assess the current competency levels of the managers and selected staff to determine current capabilities and identify training needs.

Deliverables

1. Draft organizational chart.
2. Draft job descriptions.
3. Prepare assessment report of key managers and selected staff.
4. Prepare training recommendations for employees based on assessment results.

Level of Effort. It is estimated phase II will take 25 to 30 days to complete.

Annex 9B Examples of Job Responsibilities for Senior Staff

Chief Financial Officer

The Chief Financial Officer (CFO) is the most senior financial advisor to the Chief Executive Officer and reports directly to him or her. The CFO creates the vision for and manages the long-term financial strategy of the organization. Key responsibilities include the following:

- Oversee the finance department; as required, hire accountants and finance staff, and develop and ensure adherence to appropriate policies and procedures.
- Produce financial and other reports for management, directors, auditors, regulators, tax agencies.
- Manage balance between risk and return by maintaining a positive spread between the interest rates on earning assets and the interest cost of funds (asset liability management).
- Manage cash and funds transfers.
- Develop annual budgets and contribute to annual projections.
- Oversee interbranch transfers.
- Prepare documentation for external funders, regulatory and governmental authorities, external auditors, and financial consultants as needed.
- Ensure reliability and integrity of financial and operating information systems.
- Manage capital expenditures and all procurement for the institution.
- Establish and enforce internal controls.
- Maintain the general ledger.
- Oversee funding requirements and liquidity management.
- Oversee tax filings.
- Manage the staffing and training of financial personnel to ensure maximum efficiency and high quality performance.

Treasury Manager

The function of the Treasury Manager is to manage the institution's overall liquidity position. This includes ensuring adequate liquidity levels at branches and head office, adhering to reserve requirements and other liquidity ratios mandated by the central bank, minimizing the cost of foregone earnings on idle funds and avoiding the cost of emergency borrowing, maximizing the return on investments outside the loan portfolio, and managing the interest rate spread between loans and deposits. Key responsibilities include the following:

- Review cash holdings at branches on a consistent basis and facilitate transfer and pricing of excess to branches with cash shortfalls.
- Monitor balances on bank accounts to evaluate availability of idle cash for investment.
- Monitor interest rate risk, liquidity risk, foreign exchange risk (if applicable).
- Prepare liquidity reports required in normal operations, for treasury management meetings, for ALCO meetings, or to meet compliance reporting requirements.

Human Resources Manager

The responsibilities of this position include managing and influencing the strategic design and delivery of human resources services in the areas of compensation, staffing, and training. Key responsibilities include the following:

- Develop annual HR plan for the organization in consultation with top management; ensure quality implementation of plan.
- Direct internal and external recruitment activities.
- Develop individual professional development plans; identify and coordinate staff development and training opportunities.
- Ensure all HR policies are in place and well documented in Human Resources Manual.
- Develop or update incentive scheme as part of overall staff compensation.
- Implement performance management systems, coach managers on performance issues, assess management training needs.
- Administer benefits and salaries.

Internal Auditor

The function of the Internal Auditor is to verify that the internal controls set by management effectively mitigate risk throughout the MFI. Although approaches differ between Francophone and Anglophone systems, the Internal Auditor should report directly to the board of directors. Key responsibilities include the following:

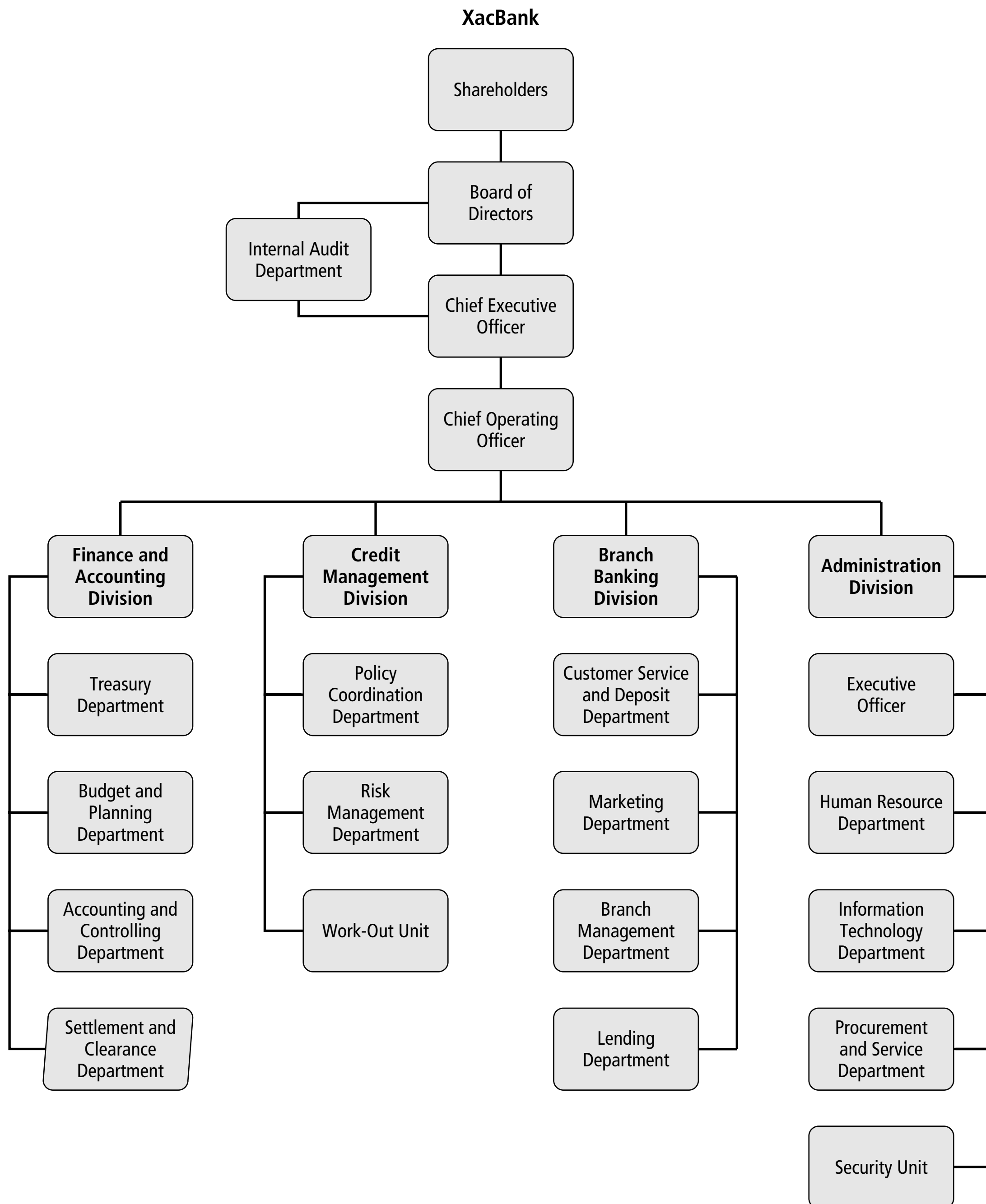
- Oversee the internal audit department: hire internal audit clerks, develop and ensure adherence to appropriate policies and procedures, establish standards for executing internal audits.
- Oversee scheduling and execution of internal audits, including these:
  - Compliance audits to ensure compliance with all applicable laws and regulations;
  - Financial audits to ensure accuracy of accounts and reports;
  - Management audits to check the degree to which employees follow policies and procedures correctly (includes methodology audits to ensure credit evaluation, disbursement, repayment procedures being appropriately applied);
  - Special investigations (as needed) to check for fraud or gross misconduct.
- Ensure audit work is properly planned and conducted, that reports meet audit standards, and that audit evidence adequately supports the conclusions.
- Coordinate and support external audit process.
- Assist with general information requests from external and internal sources.

Information Technology Officer

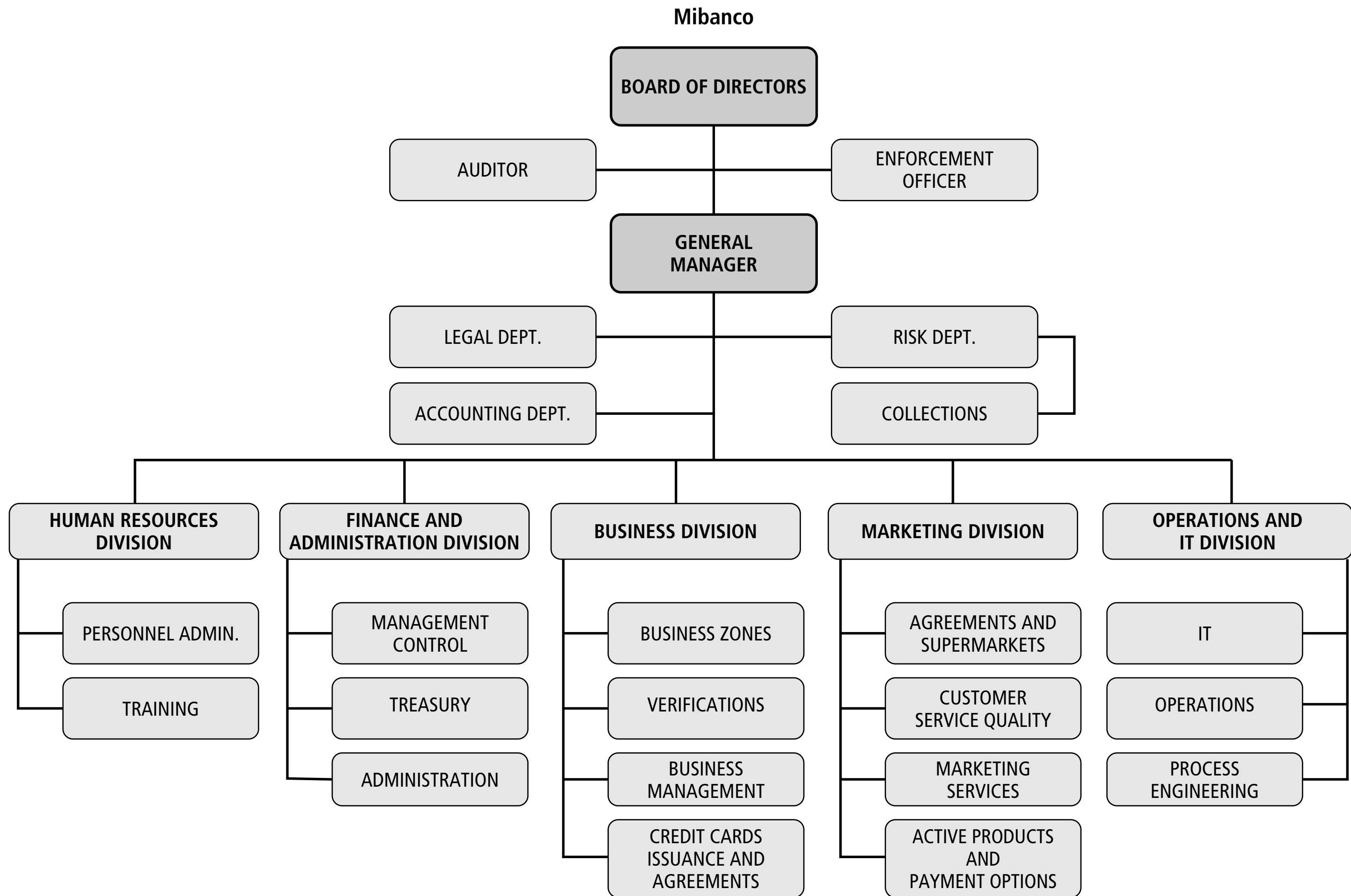
The IT officer is responsible for managing and influencing the MFI's information technology infrastructure, including hardware and software procurement and installation, staff training on hardware and software, system documentation, and development and implementation of MIS for both accounts and operations. The IT Manager should report directly to the head of the organization. The IT Manager has primary responsibility for overseeing the day-to-day running of the MFI's information systems. Key responsibilities include these:

- Project management: If and when the MFI implements a new system, the IT manager is responsible for overall project management of installation and rollout of the new system. This role will require
  - Development and management of project plan
  - Coordination of project communications
  - Facilitation of project committee
  - Management of customization requests (working closely with the software vendor), management of staff training on new system
  - Serving as the primary point person for the software and hardware vendors.
- Ongoing system maintenance, support, and development will include these:
  - Coordinating branch hardware and software setup
  - Creating new system users
  - Establishing and maintaining user security controls
  - Overseeing the daily rollover
  - Ensuring a timely month-end consolidation
  - Overseeing the data transfer process from branches to head office
  - Coordinating future system development requests.
- Management information systems: The IT Manager has primary responsibility for ensuring appropriate MIS are in place and able to meet management needs.
- Training: The IT Manager is responsible for developing and carrying out (along with other IT department staff and the HR department) a comprehensive training plan for all staff in both hardware and software. With a new system, this will require the implementation of an initial assessment of staff computer skills, followed by the development of an appropriate training schedule, materials, and courses.

Annex 9C Sample Organizational Charts

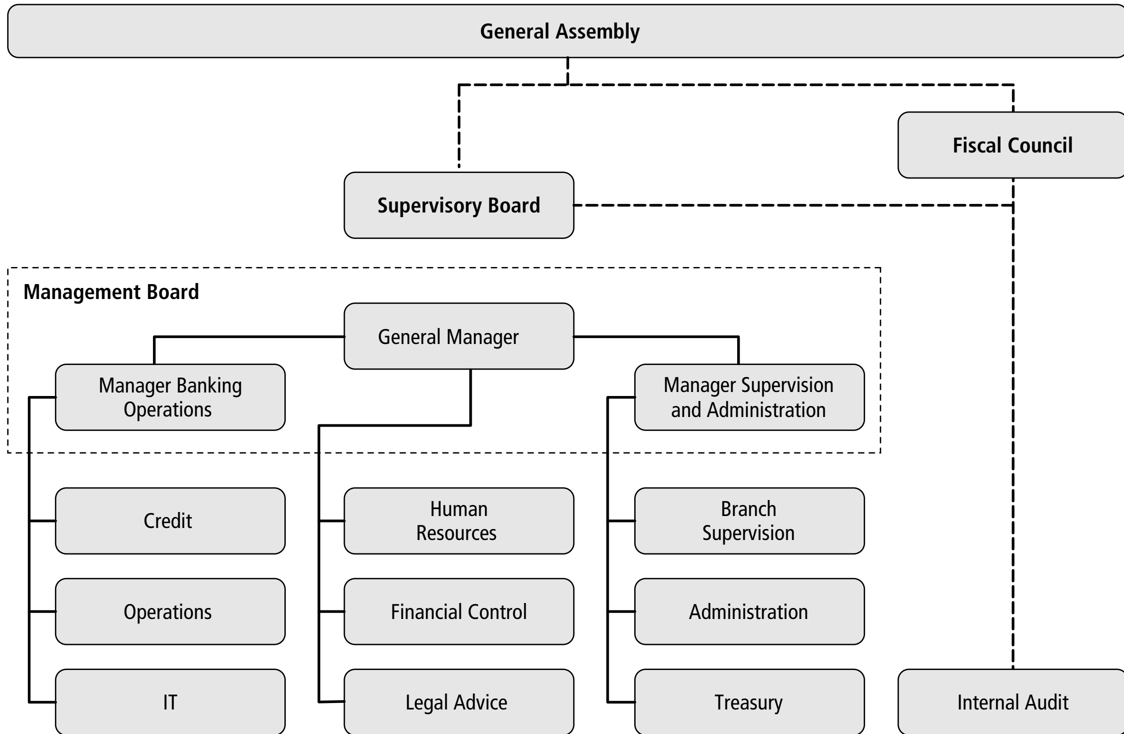


Source: http://www.xacbank.org.



Source: Marisa Silva, Mibanco, personal communication, June 2005.

Socremo—Banco de Microfinanças de Moçambique
Proposed Organizational Structure after Transformation (please see description of each position below)



Source: Contributed by Christoph Diehl, Socremo, and LFS.

When designing Socremo MFB's future organization chart, the following goals and principles were emphasized:

- Clear distribution and assignment of tasks, responsibilities, and competencies;
- Separation of operative functions and control functions up to Management Board level;
- Strong target-group orientation and high degree of flexibility with regard to clients' needs;
- Even distribution of workload between members of the Management Board.

Duties and Responsibilities of the Management Board

The *general manager* (GM) heads the management board (MB) and carries the overall responsibility for the institution's business, including business areas delegated to other members of the MB. In addition, the GM carries exclusive MB level responsibility for the human resource, financial control and legal advice departments.

The *manager banking operations* (MBO) reports to the GM. The MBO carries MB level responsibility for all credit and noncredit operations. As such, the MBO is the line superior to all staff in the credit, operations, and IT departments in all branches of the bank. With respect to credit, the MBO leads the headquarter credit committee and is responsible for all loan contracts exceeding department level or branch level limits.

The *manager supervision and administration* (MSA) is responsible for branch supervision (with respect to all credit and noncredit operations),

internal administration as well as for treasury. As with the MBO, the MSA reports to the GM.

Duties and Functions of Departments and Units

Portfolio of the GM. The human resources department is in charge of developing a human resources policy, guidelines and procedures for recruitment, elaboration of staff development plans, and creation of in-house training facilities. The HR department is headed by the GM and its proper establishment is one of her or his key responsibilities.

The financial control department is headed by the chief accountant who is responsible for all activities of the department, in particular accounting, liquidity management, and external and internal reporting of the bank. The department works closely with the credit and other departments to ensure proper flow of information and reporting. Primary tasks include liquidity management and budget monitoring. The financial control department is also responsible for proper reporting to the central bank and the tax authorities. It reports directly to the GM.

The legal advice unit is in charge of all legal questions concerning the bank (in connection with its clients as well as other legal issues) and assumes a support function in this respect. In addition, the legal adviser may be directly charged with enforcement of persistently delinquent clients. While the legal advice unit bears a service function for all operative departments in the bank, its assignment carries a clear focus on support to the credit department.

Portfolio of the MBO. The credit department is responsible for credit risk management and growth of the loan portfolio. It is exclusively in charge of all loan generation and follow-up tasks for all credit products offered (microloans, small and medium enterprise loans, consumer loans, housing loans, agricultural loans, and so forth). This includes direct marketing tasks, client relationship management, loan analysis, and loan decision making, as well as loan enforcement. Furthermore, the credit department is responsible for the continuous improvement of existing credit products and the development and implementation of new credit products. The head of the credit department reports to the MBO.

The banking operations department is in charge of all tasks related to payment transactions, account management, and savings. At an advanced stage of institutional development, it is envisaged to establish subdivisions for each of these tasks. The head of the banking operations department reports to the MBO.

The IT department has a service function and supports all units of the bank in terms of procurement, usage, and maintenance of information and communication technology (hardware and software). It is in charge of developing and modifying the bank's IT systems in accordance with changing informational needs. Requirements for IT system adjustment are defined on a continuous basis. The IT department further ensures adequate data security and the fulfillment of requirements of the supervisory authority for an IT system. The head of the IT department reports to the MBO.

Portfolio of the MSA. The branch supervision department supervises all branch credit- and non-credit-related activities. It ensures maintenance of high quality standards and compliance with all internal rules, guidelines, and procedures. It also seeks to improve standards and procedures and make related proposals. The head of the branch supervision department reports to the MSA.

The bank's branches are organized as independent profit centers. In specific cases, a branch may consist of several outlets. While branches enjoy decentralized decision-making procedures, control functions are centralized at the head office. Each branch is headed by a branch manager who is responsible for all decisions related to the branch

(human resources, administration, operations, credit, and accounting). Branch managers report to the MSA. In addition, branches have credit as well as operations units to cover all credit- and noncredit-related activities. All staff in these units come under the MBO.

The administration department is in charge of administration and maintenance of the bank's fixed assets as well as the storage of confiscated securities. The administration department is responsible for procurement, car pool, security, housekeeping, and so forth. The administration department is headed by the MSA.

The treasury department ensures adequate refinancing of the bank. In this function it not only supports the Asset and Liability Committee (ALCO) in raising appropriate financial resources but also monitors the bank's financial and operative margins and proposes interest rate policies. The head of the treasury department reports to the MSA. In addition, she or he reports directly to the ALCO and participates in ALCO meetings.

Internal Audit Unit. The objective of the internal audit unit is to provide independent judgment and consulting to continually improve the bank's operations with respect to adequacy and efficiency. The Internal Audit Unit reports to the Supervisory Board, which also appoints the personnel of the Internal Audit Unit. The unit has direct reporting lines to the Supervisory Board as well as to the Fiscal Council. The Internal Auditors evaluate internal control systems and risk exposures associated with the bank's governance structure, its credit and noncredit operations and its information systems. The goal of the Internal Audit Unit is to ensure compliance with laws, regulations, and contracts; maintain and increase efficiency of operations; and safeguard the bank's assets. The Internal Audit Unit regularly makes proposals for improvements based on shortcomings identified in any area of the bank's operations.

Asset and Liability Committee. The Asset and Liability Committee manages the bank's exposure to market risks. The Committee consists of all members of the MB. Responsibilities of the ALCO include (a) decisions with regard to the bank's exposure to market risks and supervision of their implementation, (b) development and adoption of medium and long-term financial and liquidity plans, (c) identification of funding needs and development of business strategies on the mobilization of funds, and (d) continuous review of market conditions and adaptation of business operations accordingly.

The organization structure above reflects the planned future organization of Socremo MFB. Although formal prudential requirements are already met by Socremo MFB's organizational structure, local management capacities must still be built to (a) fill more of senior management positions described and (b) support envisaged growth of the institution. This implies a need for training of current staff to fully assume senior management functions as much as it implies recruiting new staff for new business areas.

Annex 9D Checklist for Managing Human Resources

Culture

- Have you clearly articulated your institutional values? And are these values understood and appreciated by all levels of staff?
- Do you have a plan for limiting the potential for culture clash between current staff and new recruits?
- Have you identified a leader for the transformation process?
- Do you have a strategy to ensure staff buy-in to the need for an institutional transformation?
- Do you have a plan to communicate the transformation process to your staff?
- Do you prioritize your own staff as internal customers?

Organizational Structure

- Does your organizational chart currently reflect the business units needed to support your future business strategy? If not, do you have a plan for incorporating these new departments into the organizational chart?
- Does your current human resources function have the capacity to support the upgrading of staff skills, increased training opportunities, and more aggressive hiring practices needed to prepare the institution for transformation?
- Are staff job descriptions updated?
- Do these job descriptions identify key responsibilities and provide key performance measures?

Staff

- Do you have a detailed financial projection model that enables you to project number of staff needed in the future?
- Do you have the appropriate number of staff to support anticipated growth?
- Do you prioritize training and development in your institution evidenced by a culture in which individuals strive to learn and are motivated to continue to pursue new challenges?
- Do you have a strong in-house training program, complemented by external training opportunities?
- Have staff been adequately trained?
- Do you have the capacity to develop new training modules in house?
- Does your current senior management staff meet the academic and professional requirements of the regulator? If not, can you source this expertise locally?
- Have you analyzed your staff compensation in light of competition with both other MFIs and commercial banks?
- Have you implemented a performance-based incentive scheme? And have you a plan to incorporate changes to product offerings, priority areas, and other criteria anticipated with transformation?

Notes

1. For further information see Thys, Tulchin, and Ohri (2005).
2. This section draws heavily from Carlson 1992.
3. Although ESOPs can be useful for enhancing general motivation, the direct impact of an ESOP on actual staff performance tends to be much more limited. Shareholdings are usually very diluted and there is a marked lack of direct relationship between individual performance and the (potential) annual dividend payout. Likewise, it is doubtful whether the expected long-term appreciation of the share price would actually serve as a sufficient long-term incentive device capable of "binding" important staff members such as middle managers and preventing them from leaving the organization.
4. Although the introduction of individual loans is not driven by institutional structure, the transformation process from a credit-only NGO to a deposit-mobilizing regulated intermediary often pushes MFIs to offer individual loans, if they are not offered already. In general, the underwriting of individual loans requires more in-depth cash flow analysis, and

often results in a more personal client–loan officer relationship. For institutions with primarily village bank or group loan portfolios, or for institutions that have historically not held individual loan officers responsible for their own individual portfolios, this shift to individual lending does have implications for the institution's incentive scheme.

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Chapter 10
Financial Management

Transformation from an NGO to a regulated deposit-taking financial institution introduces a range of new internal and external pressures, many of which are magnified by technological advances, financial innovations, and general developments in the country's overall financial system. These new pressures have significant consequences for the financial, operational, and strategic risks faced by the institution, increasing demands on the responsibilities, structure, and staffing of the microfinance institution's (MFI's) financial management function.

Financial risk incorporates liquidity, interest rate, foreign exchange, capital adequacy, and other market risks. *Operational risk* arises from day-to-day product and service delivery errors and includes human resources risks, information and technology risk, and fraud risk. *Strategic risk* encompasses internal risks associated with poor business decisions and external risks associated with changes in the business or competitive environment. Generally the most serious for newly transformed institutions, strategic risks include governance, management, and reputation risk. Effective financial management enfolds the range of strategies, policies, and procedures used by financial institutions to minimize these risks while optimizing financial performance.

As with any comprehensive risk-management strategy, effective financial management for a regulated financial institution is a continual process of systematically assessing, measuring, monitoring, and managing the key risks in the organization. Effective financial management is defined by a wide scope of activities that extend far beyond traditional accounts management and financial reporting, and involves a range of actors beyond those who staff the finance department.

MFIs transforming into regulated financial institutions need to convince prospective investors and regulators before receiving their licenses that they have the internal capacity to manage these additional demands. Building this capacity calls for planning and requires restructuring and fundamental changes to staff roles and responsibilities in the finance department.

Starting with an initial overview of the functions of financial management in a regulated MFI, this chapter examines four core components of financial management that will change or be redefined with transformation. These include financial planning and budgeting; financial control including accounting, financial reporting, and financial analysis; treasury management; and investor relations. The chapter highlights the changes transforming MFIs

should expect in each of these areas and provides guidance on developing capacity in anticipation of these changes.

Financial Management Functions

Financial management of a regulated financial institution typically includes the following functions:

- Planning—business planning, budgeting, forecasting, and capital budgeting
- Controller—accounting, financial and compliance reporting, procurement and general financial administration such as payroll and others (although this is sometimes considered administration and not finance), and usually some financial analysis
- Treasury—asset liability management, capital adequacy management, and funding and investment activities
- Investor relations—communication with shareholders and other stakeholders, such as the annual report and annual meeting

Some of these functions will be new to the transforming institution and others will be familiar but require improvement. Because of the nature of their capital bases and typically limited funding sources, microfinance NGOs may not have dedicated staff for treasury operations. Similarly, transformation to a regulated for-profit company often triggers a change in tax planning. Likewise, while onerous reporting is certainly not new to donor-funded NGOs, the addition of investors and regulators as stakeholders alters the institution's reporting requirements. As a regulated institution, the importance of each of these functions will vary depending on how the MFI is financed (debt-equity mix), how it chooses to invest these funds (variety and risk level of asset base), and to whom it is ultimately responsible (shareholders and regulators).

Key Players

The institution's board, management, and staff all play a role in financial management—the board lays out the broad strategy for achieving profitability goals and sets limits on the level of acceptable risk; management determines how to operationalize these goals and remain within acceptable risk parameters; and staff in all departments, not only finance and administration, play the critical role of implementing the operational steps to achieve the goals. In addition, support partners such as international NGOs and donors often influence decisions relating to the institution's chart of accounts, financial management policies and procedures, and overall reporting structures and requirements. With transformation, this group expands to include two additional stakeholders—investors and regulators—both of whom have clear expectations for the institution's approach to the risk-return trade-off.

While shareholders' investment goals (some combination of profit maximization and social return) will vary, regulators are quite clear about the level of risk they are willing to permit. Specifications about what should be included in a financial institution's policies and procedures, or specific guidelines for operating ratios and on-site inspection capability, are examples of regulator tools that are used to influence and monitor risk-return behavior.

Box 10.1 demonstrates how one MFI in South Africa creates accountability for risk management.

Organization of the Finance Department

The expanded scope of financial management will typically require the reorganization of the finance department. As demonstrated in figure 10.1, traditional NGO finance and administration departments usually include a finance manager, a few accountants or bookkeepers, and an individual or two tasked with administrative duties, such as overall office management or procurement. The finance manager is often a skilled accountant with some management experience and generally takes

Box 10.1 Risk Management at Teba Bank, South Africa

Risk governance structure. Teba Bank has established a risk-management structure that includes a General Manager for Risk, who reports to the General Manager. At the board level, risk addressed in the Audit Committee, a dedicated Risk Committee, and a Directors' Affairs/Strategy Committee. The asset and liability committee and the credit management committee report to the Risk Committee.

Risk governance process. Teba Bank's board is ultimately responsible for the risk-management process; the Risk Committee is appointed to assist the board to fulfill this responsibility. The board reviews and approves risk strategies and policies developed and recommended by management. The board Risk Committee approves the Enterprise Risk Management Framework; through this framework ownership of key risks is allocated to the most appropriate senior official. Members of senior management sign off on the Risk Management Framework as the risk owners. Risk management is a continuous and evolving process, involving monthly risk assessments.

Risk appetite. Teba Bank's board sets the risk appetite of the institution, similarly to setting major risk thresholds. The risk appetite is the degree of uncertainty that Teba Bank is willing to accept to reach its goals. It covers products, markets, treasury limits, lending, and the like.

Risk reporting. The board receives quarterly reports covering the top 10 risks, the risk register, and the risk watch report. Management receives these reports monthly.

Source: Pikholz and others 2005.

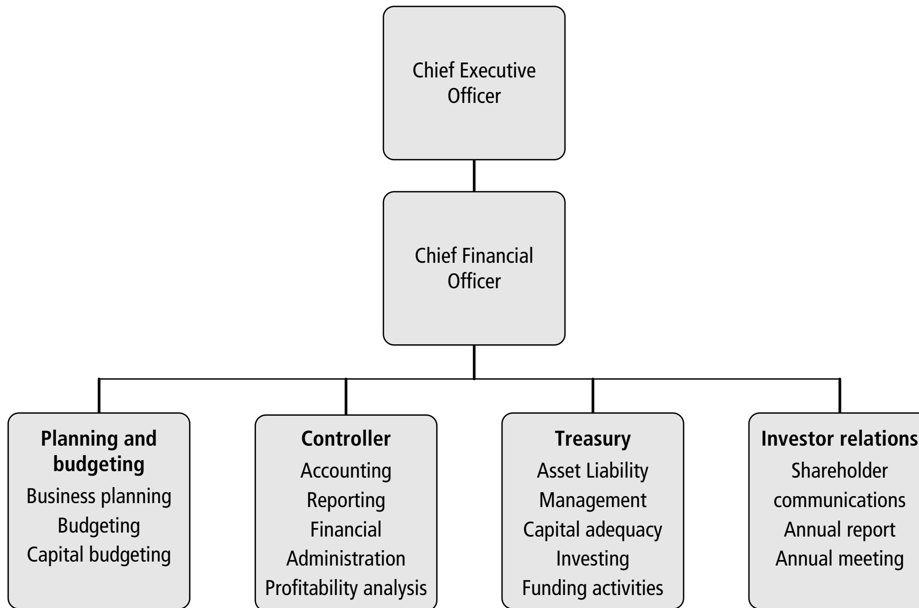
Figure 10.1 Financial Management Functions of an NGO MFI

Source: Author.

on the role of an expanded controller including preparation of financial statements, funds management, budgeting, and procurement activities.

As mentioned in chapter 9, Human Resources Management, with transformation, the NGO finance manager role is typically upgraded to Chief Financial Officer (CFO). As the complexity of the institution's financial operations expands, the key activities of the finance manager expand and the required skills extend beyond accounting and

Figure 10.2 Financial Management Functions in a Regulated Financial Institution



Source: Adapted from Falletti 1992.

budgeting to include leadership, strategic management, financial policy development and implementation, and investor relations.

Additional positions are also required within the finance department, some of which require specific skills and expertise and thus may need to be sourced through external recruitment or built internally through investment in training and exposure visits (or a combination of both). Figure 10.2 presents an example of the various functional areas of a finance department of a regulated MFI: planning and budgeting, controller, treasury, and investor relations.

These functional areas—planning, control, treasury, and investor relations—are not necessarily separate departments and depending on the size of the financial institution, these areas may not be staffed with full-time individuals. Instead, various units within the finance department may be tasked to carry out the different functions. For example, the chief accountant or controller may be responsible for financial reporting, while all the finance department staff may be involved in planning. In addition, some transformed institutions set up a risk department specifically to address and mitigate the numerous risks a financial intermediary faces. While this book addresses various types of risk in different chapters, risk is not specifically considered an area within the finance function because of the large part credit risk plays in risk management, and credit risk is not specific to the finance area (nor specific to transformation).

Financial Planning and Budgeting

Planning commits the MFI's strategic vision to concrete goals and objectives. Planning is generally done for a multiyear period and at the head office level with input from the different departments. Budgeting supports planning by ensuring that the resources needed to achieve the plan are available and used efficiently. Budgeting is generally completed on an annual basis (or more frequently) and by all operating units of the MFI.

Planning

Planning encompasses multiple levels of analysis. *Strategic planning* sets broad objectives and goals, that is, the overall plan to achieve the vision for the institution. *Business planning* defines actions and tasks to accomplish the strategic plan. *Financial planning* translates the goals, strategies, and activities developed at the strategic and business planning levels into financial operating targets.[1] The finance department provides input to both the strategic and business planning processes. It is typically tasked with translating the defined goals, strategies, and activities into measurable financial targets to be included in or to accompany the business plan. The complexity and stakes of this latter role increase notably when the MFI transforms to a regulated intermediary. Taking on investor capital, using this capital to leverage commercial borrowings, developing new savings products for clients, and investing these resources in a wide variety of investment instruments with varying terms and rates—all bring new levels of risk, further complicating the planning process. At the same time, the need to produce realistic and achievable financial targets increases with the need to satisfy both investors and regulators.

Translating defined goals into measurable financial targets requires developing financial projections. This task involves creating the format and structure of the projections model, overseeing the assumptions incorporated into the model, managing the input of other operating departments into the modeling process, and finally, developing a wide range of scenario analyses based on preliminary results. These financial projections ordinarily cover a three-to-five-year period. (See chapter 5, Strategic and Business Planning, for a detailed discussion of business planning.)

Budgeting

A second key function of the finance department is to coordinate development of the annual operating budget, which, depending on the MFI, may also include development of monthly or quarterly budgets. As part of the licensing process, regulators will review the adequacy of the institution's budgeting systems, particularly important for bank examiners employing a risk-based approach to supervision. (See chapter 2, Regulation and Supervision: The Policy Framework, for a discussion of risk-based supervision.) Although most NGOs will have some form of annual budget, transformation generally requires improvements in this process. Budgeting includes the following:

- Defining the process
- Establishing formats and a schedule for developing the budget
- Providing training and guidance to the relevant units to ensure a systematic approach
- Providing data on actual income and expenditures to the relevant units
- Providing overall feedback on budget drafts
- Preparing the final budget for senior management and board approval.

Most of these tasks are carried out by the finance department, which also develops and implements a monthly or quarterly reporting process for comparing actual results to budget. This process should include an analysis of any notable variances, both for the overall institution and individual branches or units.

Capital Budgeting

In addition to operating budgets, the MFI also needs to prepare an annual "capital" budget for those items that require capital expenditures and are capitalized on the balance sheet. Compared with operating budgets, capital budgets are generally much larger and can critically affect the financial structure of the MFI. Furthermore, the benefits of a capital expenditure are often ongoing and spread over a period of years.

While the ultimate decision on capital expenditures is made by the board or senior management, planning and analysis for capital budgeting decisions are generally led by the finance department. With the addition of shareholders expecting a financial return on their investments, capital budgeting becomes more complex than when, as an NGO, the MFI periodically received donor funds to build a new branch or improve its infrastructure. As a regulated institution with owners, the MFI needs to assess each potential capital expenditure according to its ability to enable growth of the institution as well as provide financial returns. Thus, capital budgeting becomes a complicated and difficult task involving analysis of various options before submission to the board for approval.

Capital budgeting is a complex undertaking[2] and generally involves the following:

- Establishing long-, medium-, and short-term operating and financial objectives
- Identifying, measuring, and ranking the various capital expenditure projects on the basis of the following:
  - Degree to which they meet the MFI's objectives
  - Operational impact
  - Yield on the investment
- Exploring alternate sources of capital (internally generated funds or debt or equity)
- Determining the "hurdle rate" and identifying those projects that offer the most attractive returns (comparing the break-even point between the yield on the capital expenditure and the weighted cost of capital for the MFI)
- Selecting the most viable projects for capital expenditure and seeking board approval

Two areas in particular are critical for sound capital budgeting—appropriate corporate policies and capable budgeting techniques. Policies need to be clearly established that reflect and support the following:

- The ideal capital structure, that is, amount of debt to equity relative to assets
- The ideal mix between long-, medium- and short-term debt
- The best mix between leased and purchased assets
- The process for determining the hurdle rate
- The need for earnings to be retained in the MFI to fund growth
- The MFI's appetite for risk (both management and board)

While the ultimate decision for capital expenditures lies with senior management and the board, the finance department and the various operating areas of the MFI must prepare estimates for capital expenditure options. Without accurate and sound estimates and projections, senior management and the board will not have the appropriate information to make decisions. When making decisions involving the use of capital (whether borrowed or internally generated), the MFI needs to be confident in its ability to accurately project the cash inflows and outflows, and ultimately the returns on such expenditures.

In addition to planning and budgeting revenue and operational expenses, the transforming MFI also needs to be aware of any tax liabilities that may arise as a for-profit regulated MFI. As explained in chapter 5, Strategic and Business Planning, transformation from a nonprofit entity to a for-profit corporate structure will most likely result in a tax liability for the institution. Corporate tax liability can be sizeable (30 to 40 percent of net earnings), highlighting the need for comprehensive tax planning far in advance of the actual transformation.

Financial Control

The control function of a financial institution generally includes accounting, reporting, financial administration, and possibly financial analysis. The accounting function compiles and consolidates financial information for the MFI. The reporting function ensures adherence to appropriate accounting and regulatory standards and develops financial

statements and reports for management and for external use, including compliance reporting. General financial administration activities include procurement, payroll, fixed asset management, and other services—however, because these generally do not change much with transformation they are not discussed here. Finally, various types of financial analysis, such as periodic profitability analysis, may be carried out within the controller's unit (often in conjunction with the product development or marketing units of the MFI).[3]

Accounting

An MFI must ensure its accounting system is transparent and flexible in capacity, yet rigid in controls and standards. Controls and standards become especially important with transformation; for example, the account nomenclature, or system of accounts, must be consistent with international accounting standards as well as with those required by regulators.

An adequate accounting system includes the following (Branch and Klaehn 2002):

- A detailed chart of accounts with clear definitions
- Definitions of reserving and provisioning accounts for loan or investment losses
- A definition of depreciation and methods of depreciation
- A definition of how assets are revaluated
- Levels of accounts to facilitate more in-depth analysis
- The ability to limit time period of accruals (see discussion of cash and accrual below)

Complying with regulatory accounting standards and reporting requirements often demands a range of changes in account preparation. Given the amount and quality of material already available on accounting, this section is limited to highlighting key changes that may be required with transformation. (For further information on this topic, see the reference section at the end of this chapter.)

Chart of accounts. The chart of accounts is the core of an institution's accounting system. The structure and design of the chart of accounts will ultimately determine the type of financial information that can be accessed and therefore analyzed by management or reported to external parties. In most regulatory frameworks, the central bank or other regulators provide specific expectations for the institution's chart of accounts. Before the regulator's prelicensing inspection visit, an MFI will need to ensure its chart of accounts conforms to central bank requirements. For MFIs that began as projects of international organizations, or those with more homegrown accounting processes, this transition can be profound.

Cash to accrual. While some differences exist between countries, most regulatory accounting requirements stipulate some level of accrual-based accounting. Most MFIs use standard cash accounting, which means income and expenses are recorded when cash is actually received or expended. Under an accrual-based accounting system, when a business performs a service, makes a sale, or incurs an expense, the accounting entries are booked, regardless of whether cash has changed hands. Thus, revenues are recorded as they are earned and expenses as they are incurred, not necessarily when cash is received or disbursed. The shift to accrual-based accounting may involve upgrades in management information systems and adjustments to accounting practices, and in some cases may affect the financial position of the MFI. As with the recording of interest revenue, the way in which financial expenses are recorded can affect the institution's bottom line.

- *Adjusting for accrued interest revenue:* It is standard practice in the banking industry to reflect interest revenue earned regardless of whether it has been received.[4] When loan payments are received, the interest income is recorded as revenue and as cash. Under accrual-based accounting, when loans are not paid, the

interest is treated as earned and the interest income is typically recorded as revenue and as *accrued interest or interest receivable* on the asset side. Based on the assumption that the interest will be received later, this transaction has the potential to overstate interest income if it continues on loans that are unlikely to be repaid.

The decision whether to accrue interest revenue on delinquent loans and the amount of time interest revenue is accrued and through what accounting transactions, differs according to regulatory requirements and accounting standards in the country. Banks commonly stop accruing interest once a loan is past due more than 90 days. However, central banks differ in their treatment of accrued interest. For example, in Uganda, the regulations state that any loan that has interest or principal unpaid for 30 days or more is considered nonperforming and placed on a nonaccrual basis. Thus, interest due but uncollected on these loans is not accrued to income but is instead shown as "interest in suspense." Any interest on loans previously accrued as income but uncollected must be reversed and credited to the interest in suspense account until payment is received. In Russia, where accounting standards are designed to maximize taxable income (and hence tax proceeds to the government), the opposite is true. Institutions must continue to accrue interest income—and pay tax on this income—on nonperforming loans for five years.

- *Adjusting for accrued interest expense:* When MFIs borrow from external sources, they incur liabilities that carry financing costs that need to be paid periodically, such as quarterly or semi-annually. As such, these liabilities accrue interest expense. Financial statements need to be adjusted to capture this cost. If interest owed is not accrued, the MFI's financial costs are understated, thus overstating profitability.[5]

Provisioning and loan losses. Accounting for loan losses and adequately provisioning for potential loan losses are two more areas in which adjustments to financial statements are often needed when an MFI transforms. With the shift away from donor funds toward client savings and other commercial borrowings, the importance of adequate provisioning cannot be overstated from a risk-management perspective. While stronger MFIs often already have relatively conservative provisioning policies, transformation to a regulated financial institution can result in more aggressive provisioning and write-off requirements. Alternatively, in some regulatory environments, the provisioning policy requirements for the relevant institutional category still reflect more traditional bank credit risk, and thus actually represent less conservative policies for MFIs that typically have shorter loan terms. In either case, the MFI will need to ensure that its provisioning and write-off policies follow regulatory requirements, while at the same time ensuring, from a management perspective, the risk in the portfolio is adequately provisioned. Changes to provisioning policy can have significant implications for an MFI's bottom line. Furthermore, in some cases "over-provisioning" (in excess of what the regulator mandates) might have fiscal implications—the tax authorities may require that the MFI reverse any negative impact on earnings at the time of calculating taxes.

Table 10.1 presents the provisioning requirements embodied in the Ugandan Microfinance Deposit-Taking Institutions (MDI) Asset Quality Regulations as an example. For MDIs in Uganda, this level of provisioning is probably adequate for management purposes, but each institution needs to determine if it should provision more conservatively for management purposes while still adhering to regulatory requirements.

Reporting

With transformation, an MFI's internal and external reporting requirements undergo comprehensive changes. Financial statements, including the balance sheet, income statement, and cash flow

Table 10.1 MDI Reserve Requirements

Days outstanding	MDI reserve calculation (%)	
	Normal	Rescheduled loans
Current	1	1
8–30	1	5
31–60	25	50
61–90	50	75
91–180	100	100
>180	100 (and write off)	100 (and write off)

Source: Bank of Uganda, Microfinance Deposit-Taking Institutions (Asset Quality) Regulations 2004.

Note: At the end of each month (or other period), the MFI calculates its required *loan loss reserve* (balance sheet account) by applying the relevant percentage allocations to the outstanding balances of its loans in the various aging categories. It then compares this total value (the required loan loss reserve) to what it currently has in this account. If the required reserve is higher than the current reserve, the MFI will need to *provision* (a debit to expenses) the amount of the gap. If the required reserve is less than the current reserve, the MFI can either reverse the necessary provision (a credit to expenses) or maintain the higher level (preferred).

statement, need to be produced on a monthly basis and should incorporate budget to actual comparisons. Internal management reports also need to reflect the key risk areas of the transformed institution, including capital adequacy, asset quality, liquidity, and interest rate and foreign exchange risk (if applicable), many of which will be new to management and thus require investment in training to ensure managers understand the essential relationships and trends.

The controller will ordinarily also be responsible for producing financial reports for compliance with regulatory requirements and for producing reports for external stakeholders including investors. Regulators have specific reporting requirements for supervising deposit-taking institutions and transforming MFIs may not appreciate the significant amount of time and resources required to comply with reporting requirements. Off-site supervision is characterized by frequent report submission and generally covers the perceived risk areas highlighted in table 10.2. Depending on the capacity of the

Table 10.2 Examples of Central Bank Reports

Topic	Frequency	Description
Liquidity requirements	Weekly	Requires various data from balance sheet and computation of liquidity ratios.
Minimum capital requirements	Monthly	Report of core capital, supplementary capital, and computation of capital requirements.
Portfolio quality	Monthly	Reports client population, deposits, portfolio statistics, and aging information.
Schedule of provisions	Quarterly	Details of specific and general provisions. Also requires sector information on nonperforming loans.
Insider lending	Monthly	Details of loans extended to shareholders, directors, and staff.
Loan sizes as percentage of capital	Monthly	Often included in portfolio quality report. Captures regulatory limitation on lending more than certain percentage of capital to one individual or firm.
Sector analysis	Monthly	Often included in portfolio quality report. Requires segregation of portfolio by retail, manufacturing, and service sectors.
Deposit breakdown	Monthly	Analysis of deposit holders by size and number of accounts.
Financial statements: balance sheet, income statement, cash flow	Monthly	Financial statements presented in standard format.

Source: Adapted from MDI Act 2003.

institution's management information system, some of the required reports may be automatically generated while others have to be developed using basic spreadsheets. Working in close coordination with the MFI's information technology department, the finance department needs to manage and ensure data transfer protocol, data security, and data reliability.

As mentioned in chapter 11, Management Information Systems, inaccurate or late reporting generally triggers fines or penalties for the licensed institution, or in some cases prohibition from declaring and paying dividends, the suspension of opening branches, or at the extreme, the suspension of lending operations. This underscores the need for reliable systems and timely processing. In addition, on-site inspections (usually conducted annually) require a formidable amount of report preparation and can consume substantial amounts of the controller's resources and time.

Profitability Analysis

With the increase in competition that typically accompanies transformation, earnings and cost analysis (the analysis of institutional profitability from a variety of angles) becomes a critical tool for transforming MFIs to ensure they will be able to compete as licensed institutions and provide optimal returns to their shareholders. Identifying the sources of profits and losses provides a financial institution important input into strategic decisions related to branch operations, product design, and customer targeting, while understanding revenue and cost structures guides management on where and how to expand the delivery of services, and how to refine existing delivery channels so they are more efficient.

A comprehensive management accounting system analyzes the profitability of the institution from several perspectives:

- Branch profitability analysis considers the value and efficiency of the distribution network.
- Product profitability analysis looks at the contribution of each service or product relative to net operating income.
- Customer profitability analysis examines the contribution of individual customers to the earnings of the institution.

Each of these reporting elements emphasizes a different aspect of profitability and reflects different income streams, expense allocations, and techniques for pricing internal funds transfers.

Branch profitability analysis. Most mature MFIs organize their branches as profit centers; operating costs, provision for loan losses, depreciation, and all other branch costs are accounted for at the branch level and measured against revenue generated by the branch. Setting up branches as profit centers can help to improve efficiencies and productivity of line staff because they can directly analyze the financial status of their own business unit.[6] Accounting systems, therefore, need to be flexible enough to create branch-level financial statements.

When treating branches as profit centers, a *transfer pricing* system needs to be set up to enable excess liquidity to be transferred between branches. Because some branches are net borrowers of funds and some are net suppliers of funds, profit center financial management calls for the development of an internal funds transfer pricing mechanism. This mechanism establishes a cost of funds for funds transferred to and from the head office or between branches. A branch that disburses a larger volume of loans than the deposits it collects needs to receive funding from head office (or another branch) to fund those loans. A branch that has excess deposits can "sell" funds to the head office or to another branch. With transfer pricing, the branch that has excess deposits receives payment (interest revenue) for those funds, while the branch receiving funds pays a fee (interest expense).

Some MFIs allow branches to transfer funds directly between one another and others set up a

central financing facility at the head office. In either case, if the head office determines that no excess funding is available within the system, it accesses external funding and then "on-lends" to its branches. Whether funds are accessed from within the branch network or externally (or both), an internal funds transfer price needs to be established Three approaches can be taken to selecting this price or rate, generally determined by senior management or the board and changed periodically (Cracknell and Sempagni 2002):

- *The marginal rate at which an institution can borrow funds:* This approach argues that the full opportunity cost of capital should be charged, that is, the rate at which an institution would have to borrow funds to finance its loan portfolio were deposits not available. This provides an incentive for branches to mobilize savings locally rather than relying on the excess liquidity of other branches within the network.
- *The long-term investment rate:* This approach argues that the long-term interest forgone on investing deposits should be charged.
- *Behavior-management rate:* The rate is set depending on the type of behavior management wants to encourage in the branches—either increased deposit mobilization or increased lending. If the MFI is encouraging savings mobilization, the rate used should be lower than the interest rate on loans to borrowers, but higher than the rate paid on voluntary savings. (The relevant rate on savings should include the true cost of mobilizing the savings, not just the interest rate paid to savers.) Alternatively, funds sold to the head office or other branches should be priced at a rate lower than that paid by borrowers on loans to encourage branches to lend out excess funds.

If the MFI wants to, it can set the "buy" and "sell" transfer prices at slightly different rates to allow for a small spread for the treasury department in head office to cover the costs of mobilizing and transferring these funds (whether through consolidating excess savings or borrowing commercially).

From an accounting perspective, each branch maintains incoming and outgoing registers to record all interbranch transfers. At the end of every month, the branch prepares a statement listing all transfers to and from head office and each branch with which it has transferred money. A copy of the statement is sent to the relevant branches and the head office. The head office then prepares reconciliations for each branch and compares them with those forwarded by individual branches. This enables the head office to monitor interbranch transfers and effect the transfer pricing credits or debits. The interest revenue earned and interest expense incurred with transfer pricing does not result in cash being paid or received (excluding the actual amount of excess funds being transferred). The transfer pricing itself is for accounting purposes only to reflect the profit-unit concept at the branch level. That is, the revenue branches receive for selling excess funds and the interest expense branches incur for borrowing funds are simply accounting entries. Unless the MFI has set different transfer prices for selling and buying funds, the final effect of transfer pricing on the MFI on a consolidated basis is zero.

Product profitability analysis. Product profitability analysis requires all (or most) revenue and costs to be attributed to the products of an institution, rather than to profit centers. Products can include loans, deposits, and other services, and should include all products offered by the branch (or MFI). A variety of mechanisms can be used to allocate costs and revenue to provide an understanding of product profitability and, in turn, determine the efficiency of various business processes.

> "The purpose of all cost allocation methods is to assign shared, or 'indirect,' costs to individual products, customers, branches, or other cost objects (sometimes called cost centers) as defined by an organization. Many if

not most, nonfinancial costs in a financial services institution are indirect, requiring some sort of allocation system if management wants to analyze product costs" (Helms and Grace 2004, p. 1).

This section identifies two of the more common mechanisms used in the financial sector: traditional cost allocation and activity-based costing. While it is beyond the scope of this chapter to describe these approaches in detail, the following provides a brief summary:

- *Traditional cost allocation:* Traditional cost allocation methods use allocation bases to distribute income and costs among products. The process involves allocating income and costs line by line from the profit and loss account to products, deciding on what basis each line or "allocation unit" should be allocated, such as to direct labor hours or total account balances of a specific financial product. Next, a notional charge or transfer price is levied on loans and applied to savings products, reflecting the fact that capital for lending is mobilized from savings. Finally, marginal cost analysis is used to assist management in making decisions related to loss-making products.[7]
- *Activity-based costing:* Activity-based costing (ABC) assigns income and costs based on resources (such as staff time or infrastructure usage) consumed. The focus of ABC is on specific product delivery activities, such as loan application processing, loan disbursement, loan monitoring, and loan recovery. ABC allows managers to more fully understand the true costs of each product, identify excess capacity in their operations, and make informed decisions to improve efficiency (box 10.2).[8]

See annex 10A, Sample Terms of Reference: Activity-Based Costing, for sample terms of reference to hire a consultant to carry out an activity-based costing exercise.

Customer profitability analysis. Institutional understanding of customer profitability tends to be limited in microfinance. Profitable customers are often lost through overpricing, and unprofitable customers are won by underpricing or are subsidized by more profitable customers (Richebacher 2003). Very few MFIs have a clear understanding of the connection between customer types or particular market segments, and costs. Methods to further this understanding range in complexity from simple analysis, such as using percentages of sales, to developing complicated allocation methods based on actual activities that incur costs. In general, these approaches are derived from the product profitability analysis discussed above—the unit profitability of each product is multiplied by the number of units sold to a particular customer (Falletti 2002).

Implementing customer profitability models requires an MFI to allocate costs by customers. Such an allocation needs to be coupled with a move away from the more traditional product management focus to a customer management focus. In the product management model, for example, one manager handles mortgages, another term deposits, and another working capital loans. The managers do not necessarily know how any one customer interacts with the entire MFI. For any one product, a customer may be a low-value customer, but she or he may be very valuable if considered across the organization. Yet, because the product managers cannot know this, they may underinvest in the customer. If the MFI followed a customer management model, the customer's true value would be apparent and could be managed accordingly. As mentioned in chapter 9, Human Resources Management, some MFIs using this customer-based approach no longer refer to their line staff as credit officers or account officers but rather as "relationship managers."

A combination of all three models—branch, product, and customer—can also be used to analyze profitability. In addition, information gathered can support planning efforts, measure performance for compensation and incentive programs, and help to

Box 10.2 Activity-Based Costing

Costing is a powerful tool that helps managers discover the true costs of products. Better management information on products helps managers make critical decisions about product design, delivery mechanisms, and pricing. The costing exercise also raises awareness of the cost components of different products, reveals hidden costs, instills cost consciousness in staff, and uncovers excess capacity and other operational problems.

Traditional cost allocation distributes administrative costs directly to products. ABC traces administrative costs first through activities and then to products. By first assigning costs to activities, ABC allows managers to more fully understand the costs of each product, identify excess capacity, and make informed decisions to improve efficiency.

ABC also facilitates customer segment analysis within particular product groups. For instance, managers can compare the costs of new loans and repeat loans, current loans and delinquent loans, savings accounts of varying balance sizes and transaction frequencies, and other useful customer segments.

An MFI can also cost branches (and branch activities) using ABC. Head-office costs can be apportioned to branches based on the number of cost drivers each branch "absorbs." This bypasses the need for arbitrary head-office allocation ratios and percentages.

Furthermore, using ABC allows managers to measure unit costs for many operating activities at the overall and branch levels. Unit costing is the cost every time a particular activity is performed. For example, an MFI may find that every time it opens a deposit account it costs $1.42 to perform the activity "open deposit account." This unit cost can vary depending on the time allocated to that activity overall, the number of times that activity is performed in the period, and any overall cost changes during that period.

Measuring unit costs at the branch level allow MFIs to set interbranch benchmarks in terms of unit costs for each activity. The assumption is that what goes into a branch's processes and activities should be relatively standard across the branch system. Setting unit cost benchmarks for certain activities will help the branches standardize their processes and target inefficient or subproductive activities and will allow measurement of branch performance compared with peers. Finally, measuring (and comparing) unit costs at the branch level can also assist branches to track and address periods of excess or under capacity, allowing for changing staff levels at key times of the year.

Source: Contributed by Lorna Grace, USAID Rural Economic Diversification, Honduras, August 2005.

accurately price products. Ultimately, the likelihood of conducting in-depth profitability analysis will depend on the MFI's level of technological sophistication and available resources. MFIs should first undertake a realistic cost-benefit analysis of the different options before investing too much time and resources in any one approach.

Treasury Management

The evolution of an MFI from a donor-funded NGO to a commercially financed and regulated institution is typically characterized by an increase in the variety and market base of liabilities. At the start-up phase, the donor-funded NGO usually has access to relatively low cost funds and relatively limited funding sources. Management is generally most concerned with how these resources are invested, that is, in the loan portfolio or other investments. As the MFI's funding needs grow beyond what is available from donors, attention often shifts to mobilizing sources of commercially based funds. In many countries, the MFI's limited bargaining power combined with relatively unsophisticated capital markets limits the financing

options available. However, as the institution evolves, the funding options generally expand, although often at a higher cost than the concessionary funds previously available. At the same time, competition between MFIs operating in the same markets may force a reduction in the MFIs' lending rates. Thus, maintaining an adequate spread between the rates charged on loans and the rates paid for financing (spread management) becomes critical to the sustainability and profitability of the MFI (Christen 1997). Once regulated, managing the spread between lending and deposit services, specifically, also becomes critical.

Different institutions use different terminology for the treasury function. For the purposes of this book, the term *treasury management* is used to encompass all functions related to managing the institution's balance sheet (and, if applicable, off-balance sheet items). Treasury management is divided here into three areas, each of which are discussed below:

- Asset liability management (ALM)
- Capital adequacy management
- Investing and funding activities

Some transforming MFIs may wish to engage an external consultant to assist them in establishing an adequate treasury management function. See annex 10B, Sample Terms of Reference: Treasury Management, for sample terms of reference for advisory services in treasury management.

Asset Liability Management

ALM seeks to manage the balance between risk and return by maintaining a positive spread between the interest rates on earning assets and the interest cost of funds. It involves understanding the risk and return trade-offs in the institution's business strategy and making these trade-offs clear so that the board of directors and senior management can make informed business decisions for the institution (Ledgerwood 1999). ALM analyzes the structure of an MFI's balance sheet and the risks and returns inherent in this structure. ALM encompasses liquidity management, interest rate and foreign exchange gap management, and liabilities management.

The target results of ALM (Falletti 1992) are to achieve the following:

- Protect the shareholders and depositors.
- Maintain sufficient liquidity to cover cash flow requirements, and invest idle liquidity profitably.
- Manage the interest rate gap to maximize earnings within risk limits.
- Generate attractive foreign exchange earnings within risk limits.
- Price products to support asset and liability management and maximize the MFI's earnings.

Because ALM affects so many aspects of the organization, it is normally carried out by a committee rather than a single person or department, though an individual in the finance department may be tasked with supporting the committee. This committee is called the Asset and Liability Committee, or ALCO. Generally, financial institutions have two ALCOs—a board ALCO and a management ALCO. The board ALCO sets the policies that the management ALCO implements. The management ALCO typically includes the CFO and other senior managers who meet at least monthly (preferably weekly) to make decisions about balance sheet structure and off–balance sheet positions based on an evaluation of the interest rate environment. A large part of the committee's task is to forecast and adjust the MFI's interest rate position (discussed below) for the coming months to maximize the net interest margin, while also protecting depositors' funds (Christen 1997). Therefore, the committee examines the operating environment (including the macroeconomic environment and findings from marketing intelligence, such as competitor rates, central bank reports, and newsworthy financial

Box 10.3 Risk Management at Equity Bank

Risk governance structure—A management Asset and Liability Committee (ALCO) oversees risk management at Equity Bank in Kenya. Members of the management ALCO include the Chief Executive Officer and key functional heads (Operations, Finance, Credit, and Treasury). The management ALCO reports to the full board, as does the board's own ALCO and risk-management committees. These committees comprise the Chief Executive Officer and two board members with a key functional head as its secretary.

The members in the board's ALCO and risk-management committees have the technical skills to guide both the board and management. They enable the board of directors to discharge its responsibilities for risk management oversight. The board's Audit Committee assesses the effectiveness of all risk-management initiatives.

Risk governance process—The management ALCO committee is responsible for risk management on a day-to-day basis. Key risks mitigated include credit, operational, and compliance risks. Financial and market risks are managed by optimizing the balance sheet's funding mix, maturity profile, capital adequacy, and exposure to foreign exchange and interest rate fluctuations. The management ALCO consults regularly with the board's ALCO and risk-management members to implement the policy set by the board.

Risk appetite—Equity's board sets the risk thresholds for all aspects of the bank's operations and exposures. The board ensures that these meet or surpass applicable and explicit statutory prudential requirements set by the government, central bank, and the Ministry of Finance.

Risk reporting—The management ALCO meets weekly to assign and review individual responsibilities of members along their functional duties. The ALCO submits monthly reports to the board's ALCO and risk-management committee and produces a quarterly report for deliberation by the full board.

Source: Pikholz and others 2005.

sector initiatives), the risks and opportunities it faces within this environment (such as the need to make any product or pricing adjustments or reevaluate market expansion plans), and trends in key financial ratios. A "feedback loop" will ensure policies and strategies are appropriate and the risk levels are within the risk parameters set by the institution (Campion 2000). All of the decisions made by the management ALCO must be in keeping with the policies set by the board ALCO. See box 10.3.

Liquidity risk. Deposit-mobilizing MFIs must maintain minimum liquidity levels at their branches. Liquidity is measured by comparing the shortest-term assets to total assets or deposits. The treasury manager must ensure the operating units have an adequate level of liquidity at all times, and must manage the institution's overall investment strategy. At the same time, must minimize the cost of forgone earnings on idle cash and avoid the costs of emergency borrowing, forced liquidation of assets, or reduced loan disbursement. In addition, transformed MFIs must comply with the regulator's stipulated minimum reserve requirements.

Liquidity risk arises from either a shortage of funds to cover obligations or from excess funds sitting idle and not earning revenue. While most NGO MFIs are familiar with cash flow management— ensuring that cash coming in is equal to or greater than cash going out—liquidity management incorporates not only cash obligations, but also other short-term assets and short-term liabilities. With transformation, the variety of these other short-term assets and liabilities tends to expand, adding complexity to the liquidity management process.

The goals of liquidity management include the following:

- *Honoring all cash commitments on a daily and ongoing basis:* Liquidity management requires cash flow forecasts to be prepared for the head office, each branch, and the institution as a whole. These forecasts should be prepared every week, with each day's activity forecasted. Once per month, to help management anticipate near-term transactions, cash flow forecasts for the remaining weeks in the month should also be prepared. Likewise, given the often time-consuming nature of lining up external funds, MFIs should prepare three- to six-month forecasts.

  As a regulated institution, the MFI begins to broaden its asset base with more sophisticated investment activities and diversify its liabilities with the introduction of voluntary savings. Therefore, the components to be included in the cash flow forecast expand. Without historical data, estimating the trend in these new net inflows or outflows will be difficult. For deposit flows, for example, MFIs will need to make some assumptions about how customer behavior might vary according to season. Market research on savings and loan patterns could help validate these assumptions. For an MFI planning to offer both demand deposits and time deposits, the distinction between the two is generally not relevant in terms of their trend and seasonal behavior when making liquidity projections (Bald 2000). However, the MFI must be prepared for exceptional circumstances, such as political instability, that may result in larger than planned withdrawals. Deposit-taking MFIs need to have contingency plans in place, such as contingent lines of credit.

  Other potential new components related to cash flow management include the cash effects from long-term investing and financing (such as share capital increases or dividend payments). Although new to the MFI, these cash flows tend to be relatively easy to predict because they are largely under the control of MFI management and are generally known well in advance. Unlike the small but frequent cash transactions resulting from the majority of deposits and loans, cash flows in this category do not have to be approximated. Instead, the MFI can capture each one with its expected amount and the probable time that it will occur.
- *Complying with central bank minimum reserve requirements:* As regulated financial institutions, MFIs need to comply with minimum reserve requirements imposed by the regulator. These requirements state that a certain amount of cash needs to be held on deposit with the central bank "in reserve." These holdings earn little or no interest, cannot be used for lending or other investments, and are netted against deposits for purposes of calculating available liquidity. Reserves need to be closely monitored both for compliance with regulations and for impact on liquidity management and cash planning.

  Minimum reserve requirements differ by country and also vary between different institutional types and their particular supervising authorities. In general, however, all short-term liabilities are reservable while long-term obligations and equity capital are exempt from minimum reserves. In particular, reserves apply to all customer deposits (transaction balances, demand deposits, savings accounts, time deposits), and short-term liabilities (such as money market deposits, commercial paper, and interbank loans offered to investors). Each day the MFI needs to aggregate its liabilities in the reservable categories, multiply the balance by the applicable percentage rate, and calculate the reserve requirements over all categories (Bald 2000). This total reserve requirement is the minimum that the MFI must have on deposit with the central bank. Reserve requirements are normally expressed as ratios, which may differ by

regulatory authority. In Uganda, for example, the MDI regulations require that institutions maintain a reserve ratio equal to or exceeding 15 percent. This ratio is defined as the total of liquid assets including cash, balances with the central bank or other financial institutions, treasury bills of up to three months, and other government securities, divided by total deposits (savings and time deposits).

Another liquidity ratio typically examined by regulators is the *current ratio*. This ratio compares current assets to current liabilities. It reveals the ability of the MFI to meet short-term debt service payments and calculates the degree of coverage provided by short-term assets.

- *Avoiding the cost of unplanned and expensive borrowing:* In addition to projecting future cash flow needs, liquidity management involves developing contingency plans for unplanned funding shortfalls. Most MFIs achieve this by negotiating lines of credit from local banks—the institution is only charged for the amount of the line of credit used, often with a commitment fee on the unused portion of the line. The ALCO will typically set operating parameters that reflect the level of liquidity risk the institution is prepared to accept. These parameters include a fixed percentage of the available credit lines that the individual tasked with liquidity management is allowed to utilize in the normal course of business. Some unused borrowing capacity should always be maintained to allow for emergencies or unexpected situations. Depending on the MFI's market credibility, the depth of the financial markets in the country, and regulatory restrictions, the MFI could also address liquidity needs by borrowing from private individuals by offering higher rates of interest to large certificate of deposit (CD) holders (Christen 1997).
- *Minimizing the cost of forgone earnings on idle cash:* While having too little liquidity can lead to unplanned and excessive interest payments, having too much liquidity is a lost opportunity for additional investment income. Clear procedures and guidelines for both monitoring and investing any idle cash should be in place.
- *Maintaining cash balances at the branches that neither exceed the maximum insured limit nor result in excess "idle" cash:* As part of their daily control activities, branch managers must closely monitor their branch cash position to ensure cash levels remain below the maximum value for which the branch is insured and above minimum operating needs. If the cash level in the vault falls below a certain minimum limit, a cash delivery needs to be ordered; if it reaches a certain maximum limit, cash needs to be placed in a nearby commercial bank or wherever management has designated excess cash to go, for example, a regional office or head office. Policies for these occurrences need to be clearly documented and enforced throughout the branch network.

Internal controls and limits as well as procedures and guidelines for managing and monitoring liquidity need to be developed and followed regularly.[9] A liquidity policy that is developed by the board and implemented by management, should do the following:[10]

- Specify who is responsible for liquidity management in the MFI. Often this will be the treasury manager, the finance director, or another high level executive.
- Clarify the scope of authority and signatory powers assigned to the liquidity manager.
- Define acceptable liquidity instruments as well as the size of transactions and signature requirements. On the asset side, this will typically include vault cash, balances with other banks, and relatively liquid investment instruments. The policy will need to specify limits for maximum exposure to any one bank, as well as clearly specify acceptable types of investment instruments. On the liability side, the board will need to define allowable funding instruments. Generally,

a liquidity manager will only have authority to borrow short term.

- Describe the general methodology for liquidity planning.
- Include a set of operating parameters that reflect the level of liquidity risk the MFI is prepared to accept. These operating parameters may include the following:
  - Minimum and maximum limits for holdings of cash assets at head office and branches,
  - Minimum and maximum levels of vault cash, and
  - Maximum percentage of available credit lines that the liquidity manager is allowed to borrow.

Interest rate risk. Interest rate risk arises when interest rates on assets and interest rates on liabilities are mismatched, both in rates and terms. Interest rate risk occurs after assets and liabilities have been priced and loans have been booked. For most NGO MFIs, the majority of assets are short term and the majority of liabilities are long term, limiting the risk that increases in the MFI's funding costs may not be matched by increased lending rates. For institutions that transform and begin mobilizing and intermediating deposits, however, interest rate sensitivity analysis becomes more important. Parameters of interest rate risk need to be defined and related policies established reflecting the appropriate technique for analyzing such risk, and for developing and evaluating strategies to control it.

Gap management is one method used to analyze interest rate exposure to changes in market rates. It measures the difference between the volume of assets and the volume of liabilities that will be repriced during a week, month, quarter, or year.

Financial institutions usually analyze their gap position in the following time buckets: 1–30 days, 31–90 days, 91–180 days, 181–365 days, and more than one year. Each asset and liability category is classified according to the time that it will be repriced (as opposed to when it will mature), and is then placed in the appropriate time bucket. For example, if a loan matures in three years, but every six months the interest rate is set in reference to an external indicator, this loan would fall in the period labeled 91–180 days. The gap for each time bucket is then calculated by subtracting the liabilities from the assets. The cumulative gap position is calculated by adding up the period's respective gaps. See table 10.3 for an example.

A funding gap (assets less liabilities, the "Difference" row in table 10.3) of greater than 0 is referred to as a positive gap, and represents an asset-sensitive position: interest rate–sensitive assets for a particular time period outweigh liabilities. Because there are fewer repriced liabilities to fund the repriced assets, a decline in interest rates would lead to increased risk. A funding gap of less than 0 is referred to as a negative gap, and represents a liability-sensitive position. If interest rates decline, risk is reduced because lower-priced liabilities will

Table 10.3 Gap Analysis

	0–30 days	31–90 days	91–180 days	181–365 days	Over 365 days	Total
Assets	80	100	60	40	20	300
Liabilities	−100	−80	−60	−50	−30	−320
Difference (assets less liabilities)	−20	20	0	−10	−10	−20
Gap ratio (assets to liabilities)	0.80	1.25	1.00	0.80	0.67	0.94

Source: Author.

Table 10.4 Interaction between Funding Gap and Interest Rates

Funding gap	Change in interest rates	Risk	Value of the MFI
Positive	Up	Down	Up
Positive	Down	Up	Down
Negative	Up	Down	Up
Negative	Down	Up	Down

Source: Adapted from Falletti (1992).

be funding more assets that are still priced at the higher rate.[11] For most NGO MFIs, assets are normally short term while liabilities are longer term, resulting in a positive funding gap. This will likely change with transformation.

Gap management theory assumes that declining interest rates will be beneficial to a liability-sensitive institution (that is, one in which repricing liabilities exceed repricing assets in the time period) and that rising interest rates will benefit an asset-sensitive institution (Falletti 1992). See table 10.4. Gap management, however, relies on a number of assumptions that may not always be true. It assumes, for example, that all assets and liabilities in a given period will reprice in the direction of the movement of market interest rates and that the rates in a given period will change by the same magnitude. Neither of these assumptions holds true on a consistent basis. As a result, more sophisticated financial institutions have increasingly begun to use *duration analysis* to assess their current and projected asset-liability positions. Duration analysis measures the mismatch between the aggregate durations of assets and liabilities. It is a complex computation and generally involves scheduling the periodic cash flow (both principal and interest) of asset and liability portfolios and then measuring the size of the relative market value change given a certain relative change in interest rate. (For a more detailed explanation of duration analysis, see Bald 2002 or Falletti 1992.)

Foreign exchange risk. Foreign exchange risk occurs when an MFI holds cash or other investments (assets) or debt (liabilities) in foreign currency. It is the risk of loss due to changes in the value of foreign currencies relative to the MFI's domestic currency. Whether the MFI incurs a gain or loss depends on both the direction of the exchange rate change and the level of foreign currency assets in relation to foreign currency liabilities. As with interest rate risk, gap analysis can be used to assess the impact of a devaluation or revaluation of the currency. If foreign currency assets exceed foreign currency liabilities, revaluation will produce a gain if the value of the foreign currency increases and a loss if the value of the currency decreases; if foreign currency assets are less than foreign currency liabilities, the opposite is true. The effect of these gains and losses on an MFI's financial position as well as the frequency and the way in which they are recorded for accounting purposes are dependent on the accounting rules in the country in which the MFI is operating.

Capital Adequacy Management

An MFI's capital plan is usually developed within its business plan. The appropriate level of capital is determined by three interconnected factors: regulatory requirements, growth projections, and investor return expectations. While regulators are eager to see high capital levels, shareholders want to maintain the lowest level of capital necessary to ensure higher returns on their investments without incurring undue risk—maintaining this balancing act while ensuring that growth targets are achieved is at the core of capital adequacy management. Treasury is responsible for monitoring regulatory capital requirements, comparing the projected capital level to both strategic and regulatory standards, developing plans for raising the necessary capital, and executing approved capital financing plans (Falletti 1992). Carrying out these activities in an appropriate and profitable manner requires a solid

understanding of regulatory reporting requirements, effective investor relations, as well as robust systems.

Each country has rules prescribing the minimum amount of capital required for various institutional forms—banks, development banks, nonbank financial institutions, and the like—as well as the minimum capital adequacy requirements, reflecting capital as a percentage of risk-based assets. For example, in Uganda, the minimum paid-in capital requirement for MDIs is 500 million Uganda shillings (approximately U.S.$270,000) in cash. Meeting the statutory minimum capital, however, is often immaterial because MFIs that have the capacity and the size to transform frequently have capital in excess of the statutory minimum capital requirements. Capital adequacy requirements, however, require close monitoring. Capital adequacy is calculated as follows:

$$\text{Risk-asset ratio} = \frac{\text{Qualified capital}}{\text{Weighted risk-based assets}} \quad (10.1)$$

Known as the Basle Capital Accord,[12] this widely accepted methodology for calculating capital adequacy is used globally by central banks to set requirements for capital in relation to the size of business. Qualified capital is expressed either as tier I or *core capital* divided by risk-weighted assets, or as the larger *total capital* that comprises tier I and tier II capital, divided by risk-weighted assets. Table 10.5 summarizes the differences between tier I and tier II capital.

The denominator of the ratio in equation 10.1 reflects a calculated value for the MFI's assets, based on risk weighting. While the actual percentage weightings may differ by country, the process of adjusting assets for risk entails multiplying each asset value by a percentage weighting. Assets with the greatest risk are "risk adjusted" by 100 percent; those with little or no risk (such as cash reserves in the central bank) are risk adjusted by 0 percent. In most countries, an MFI's microfinance portfolio will be risk weighted by 100 percent because it is typically viewed to consist of unsecured loans. Table 10.6 summarizes the various risk weightings by asset category.

Table 10.5 Definition of Capital

Tier I	a. Paid-up share capital and common shares
	b. Disclosed reserves
	c. Perpetual noncumulative preferred shares
Tier II	a. Undisclosed reserves
	b. Asset revaluation reserves
	c. General provisions and general loan-loss reserves
	d. Hybrid (debt and equity) capital instruments
	e. Subordinated debt

Source: Adapted from Bald (2002).

The target values for the risk-asset ratio set forth by the Basle Capital Accord is 8 percent (of which the core capital element must be at least 4 percent). As mentioned in chapter 6, The Funding Structure, for MFIs, experience suggests a higher ratio may be more appropriate because of various characteristics of the microfinance sector, including higher volatility of loan delinquency, high operating expenses in relation to loan or portfolio size, and potentially restricted access to additional funding from shareholders or donors if necessary to recapitalize the institution in times of crisis. The Ugandan Microfinance Deposit-Taking Institutions Act (clause 16, p. 20), for example, stipulates that licensed MDIs must have a core capital adequacy ratio of less than 15 percent of risk-weighted assets, and a total capital adequacy ratio of less than 20 percent of risk-weighted assets. If they fail to adhere to capital adequacy requirements, the central bank may suspend or restrict operations.

In most countries, subordinated convertible debt[13] can be included in the capital adequacy calculation, depending on the term and remaining life of the debt. However, because subordinated convertible debt is not normally available to cover losses of a financial institution, it is limited to a maximum

Table 10.6 Risk Weights by Category of On–Balance Sheet Asset

Risk weighting (percent)	Asset category
0	a. Cash b. Claims on central governments and central banks denominated in national currency and funded in that currency c. Other claims on OECD central governments and central banks d. Claims collateralized by cash of OECD central government securities or guaranteed by OECD central governments
0, 10, 20, or 50 (at national discretion)	a. Claims on domestic public sector entities, excluding central government, and loans guaranteed by such entities
20	a. Claims on multilateral development banks (IBRD, IADB, ADB, AfDB, EIB) and claims guaranteed by, or collateralized by, securities issued by such banks b. Claims on banks incorporated in the OECD and loans guaranteed by OECD-incorporated banks c. Claims on banks incorporated in countries outside the OECD with a residual maturity of up to one year and loans with a residual maturity of up to one year guaranteed by banks incorporated in countries outside the OECD d. Claims on nondomestic OECD public sector entities, excluding central government, and loans guaranteed by such entities e. Cash items in process of collection
50	a. Loans fully secured by mortgage on residential property that is or will be occupied by the borrower or that is rented
100	a. Claims on the private sector b. Claims on banks incorporated outside the OECD with a residual maturity of over one year c. Claims on central governments outside the OECD (unless denominated in national currency, and funded in that currency) d. Claims on commercial companies owned by the public sector e. Premises, plant and equipment, and other fixed assets f. Real estate and other investments (including nonconsolidated investment participations in other companies) g. Capital instruments issued by other banks (unless deducted from capital) h. all other assets

Source: Bald 2002, p. 92.

Note: ADB = Asian Development Bank; AfDB = African Development Bank; EIB = European Investment Bank; IADB = Interamerican Development Bank; IBRD = International Bank for Reconstruction and Development; OECD = Organisation for Economic Co-operation and Development.

of 50 percent of tier I. In Banque Centrale des Etats de l'Afrique de l'Ouest (BCEAO) countries, for example, subordinated convertible debt that has at least five years remaining until conversion can be included at 100 percent in the calculation of total capital (assuming it is less than 50 percent of the core capital). Once the convertible date is less than five years, the portion of debt that can be included in the capital calculation falls by 20 percent per year. (See chapter 6, The Funding Structure, for more discussion on capital adequacy and capital planning.)

Investment and Funding Activities

In close coordination with the CFO, the treasury function is also normally tasked with negotiating the MFI's various funding relationships as well as investment of excess funds. This effort involves managing the relationships and negotiations with commercial lenders and other funders. It also includes the responsibility for managing investments such as treasury bills, term deposits, bonds, and others. Although neither of these activities may be new to the transforming MFI, their complexity and the amount of funds may be significantly greater than when operating as an NGO or project. The MFI must establish investment guidelines and policies for the CFO and treasury manager to be able to adequately manage investment and funding activities. (See chapter 9, Human Resources Management, for a discussion on the responsibilities of the CFO and treasury manager.) In addition, the structure of the department should adhere to the common banking principal of segregation of duties; those responsible for transacting actual investments should be different than those recording or reconciling them.

Dividend payout policies will also affect the investment strategy of the transformed MFI. These policies should include the required processes and procedures that need to be undertaken for both investments and for dividend payouts and should be agreed to by the board or its ALCO.

Investor Relations

In addition to regulators, transformed MFIs also need to satisfy shareholders who come with their own demands for timely and accurate information. The shareholder reporting process must synthesize key elements of information needed for a comprehensive understanding of the financial condition and performance of the institution, as well as its overall direction.

The investor relations function is tasked with supporting all shareholder communication. For a privately held MFI with only a few investors, this function may be handled by the CFO or treasury manager. For institutions listed on a public exchange or with a large number of independent investors, a dedicated investor relations unit may be required. The relevant tasks include providing financial and other company information to its shareholders, the financial community, and the public at large as requested. The investor relations function must ensure that all information is accurate, informative, of the highest quality, and meets regulatory requirements. The investor relations function also plans and organizes the annual shareholders meeting, writes and disseminates the annual report, and organizes and facilitates other investor meetings.

Annex 10C, Checklist for Financial Management, provides a summary checklist.

Annex 10A Sample Terms of Reference: Activity-Based Costing

Background

Background on the organization including its mission, target market, client outreach, portfolio size, and so forth.

Objective

The primary objective is to use activity-based costing to analyze the cost structure of MFI A's credit and savings products and to develop an understanding of why and how costs are incurred and the overall implications for MFI A's product offerings.

Tasks

The consultant will perform the following tasks:

1. Identify the appropriate credit and savings products for focus in the analysis.
2. Create an activities dictionary that delineates the core operational processes and activities associated with different products.
3. Determine allocation bases and quantify them.
4. Conduct interviews with all relevant product and administrative staff members to identify staff time estimates per activity.
5. Assign cost drivers, and determine unit activity costs.
6. Apply activity unit costs to products.
7. Allocate costs, including capital costs, and conduct a final costing analysis, as well as a marginal cost analysis.
8. Write recommendations to improve design and delivery, as well as the price structure of MFI A's products, and to integrate activity-based costing into MFI A's operations.

Deliverables

The following deliverables are required:

1. Activities dictionary that delineates the core operational processes and activities associated with MFI A's products
2. Consolidated results from interviews with relevant staff members
3. Final costing analysis and marginal cost analysis
4. Recommendations for adjustments to products to increase efficiency and to align pricing with results of costing analysis
5. A brief completion report summarizing the findings and recommendations enumerating tasks going forward and ways to integrate activity-based costing into MFI A's operations

Level of Effort

It is expected that approximately 20 to 25 days will be required to complete this assignment.

Annex 10B Sample Terms of Reference: Treasury Management

Background

Background on the organization including its mission, target market, client outreach, portfolio size, and so forth.

Objectives

Transformation into a regulated financial intermediary requires a high level of professional treasury management to ensure that such areas as liquidity management, asset liability matching, capital adequacy, and investment policies are managed in a way that balances risk and return to the institution while protecting depositors, shareholders, and other stakeholders. In addition to being required for the sound and prudent management of the organization, such policies are a requirement of the law and the regulations. In preparing to become a licensed financial intermediary, MFI A plans to engage a treasury management consultant.

The specific objectives of this consultancy are to

- Assess the treasury management capacity of MFI A.
- Develop treasury management guidelines and policies that consider the appropriate risk management framework.
- Develop models and tools for effective treasury management, establish the treasury department, and assist or mentor the treasury manager to assume responsibility for the treasury function.

Tasks

To meet the objectives, the consultant will perform the tasks listed below, working closely with the treasury manager:

1. Review the legislation and its implementing regulations, specifically those related to liquidity and funds management.
2. Review MFI A's treasury management policies and systems as a component of an ideal risk management framework.
3. Assess the treasury management capabilities of MFI A's software platform.
4. Review and assist MFI A in finalizing an Asset Liability Management framework to balance risk and return. This framework must comply with the regulations provided under the law.
    a. Develop a process for the day-to-day management of liquidity and cash forecasting, considering MFI A's headquarters location and its branches; and draft a user guide for liquidity management.
    b. Develop guidelines and implement tools to mitigate foreign exchange risk and interest rate risk.
    c. Recommend the proper constitution of an Asset and Liability Committee (ALCO) for management and for the board, including responsibilities, policies, goals, and operations (membership, frequency of meetings).
5. Develop capital adequacy policies, including weighted assets and types of capital available and potential implications. These policies must comply with regulatory requirements.
6. Recommend guidelines to help MFI A's management develop the necessary policies to invest various funds under management.

Deliverables

The following deliverables are required:

1. An assessment of the treasury management capabilities of MFI A's software platform and recommended modifications
2. An Asset Liability Management framework to balance risk and return, including:
3. Recommended policies to ensure capital adequacy
    a. Draft of documented processes for liquidity management both for day-to-day and for longer term

   b. Draft of user guide for liquidity and cash management
   c. Recommendations on the proper constitution of an ALCO
4. Recommended investment portfolio guidelines
5. A brief completion report summarizing the findings and recommendations enumerating tasks and benchmarks for the treasury manager going forward

Qualifications

- Degree in business or related field such as accounting or economics
- At least five years of experience as a treasury manager for a commercial bank or microfinance institution
- International consulting experience in treasury management

Level of Effort

It is expected that approximately 35 to 40 days will be required to complete this assignment.

Annex 10C Checklist for Financial Management

Structure of Finance Department

- Have the scope and objectives of the finance department been clearly identified and documented?
- Is the organizational structure appropriate to support the expanded scope of the finance functions?
- Does the MFI have the human resources skills needed to accommodate the expanded scope of the finance department after transformation?
- Does the CFO or finance manager have the skills and credentials necessary to lead the finance department of a regulated financial institution? If not, have appropriate candidates been identified?

Planning and Budgeting

- Does the MFI have a long-term financial projection model?
- Is the model flexible enough to accommodate and reflect new products, new funding sources, and the like, expected after transformation?
- Does the MFI have a detailed annual budget and is it reviewed by management on a regular basis?
- Does the finance department lead the annual budgeting process?
- Is the budget process participative?
- Does the MFI analyze actual to budget on a consistent and meaningful basis?
- Has the finance department investigated all relevant tax implications for after transformation?
- Has a capital budget been prepared?

Accounting

- Does the institution's chart of accounts comply with regulator guidelines?
- Are the MFI's accounting procedures in line with regulatory standards and requirements?
- Are the MFI's provisioning and write-off policies in line with regulator requirements? Does the MFI consistently follow these?
- Does the MFI's treatment of interest income and expense adhere to regulatory requirements?
- Has the MFI conducted a needs assessment of all stakeholders' reporting requirements, including the regulator and investors?
- Has the current management information system been assessed for capacity to respond to such reporting requirements?
- Have the relevant compliance reports been approved by the regulator?
- Has Internal Audit reviewed the integrity of these reports?

Treasury

- Has the MFI reviewed the relevant laws and regulations on liquidity and funds management?
- Has the board established clear guidance on the MFI's level of acceptable liquidity risk?
- Have ALCOs been established at both the board and management levels?
- Have asset-liability management procedures been established?
- Have staff been trained in producing relevant management information for asset-liability management risk monitoring?
- Has the treasury management capacity of the software been assessed?
- Have policies and procedures for capital adequacy management been established?
- Have investment guidelines and policies been drafted and agreed on?
- Have dividend payout policies been drafted and agreed on?
- Have forecasting tools been developed to estimate liquidity needs?
- Have process flows and procedures been drafted for investment and dividend payout policies?

Investor Relations

- Has a person or unit been tasked with the investor relations function?

- Have policies and guidelines been put in place to guide all external communications?
- Has a process been established to produce annual reports and other shareholder information?

Notes

1. Planning framework drawn from Falletti (1992).
2. Because capital budgeting is relatively complicated, it is not covered in this chapter in detail. Further information on capital budgeting can be found in Helfert (1982) or Bergeron (1977), as well as many other sources.
3. While not always included directly in the control or accounting function, profitability analysis is discussed here because the financial data required and the transfer pricing mechanism that may follow are managed here.
4. Some MFIs capitalize (record as an asset on the balance sheet) the interest revenue expected when the loan is disbursed (this is often the case for MFIs operating with British accounting standards). Under this system, when a loan is disbursed, the MFI's loan account is typically debited by the principal plus the full amount of expected interest; the client's account is credited by the principal portion; and an "unearned interest revenue" account is credited by the interest portion, and netted against the loan account. On the installment due date, regardless of whether the client pays, the "unearned interest revenue" is debited, and "interest revenue" is credited. When the client pays, "cash" is debited for the full payment, and the loans account is credited.
5. For one to accrue interest expense, the amount of interest owed as of the date of the balance sheet is debited on the income statement as a financing cost, and is credited as a liability on the balance sheet in the accrued interest expense account.
6. The MFI can expand the profit center approach to include the head office as well by pricing the services the head office provides to the branches. When branch managers are assessed on the overall profitability of their branches, they, in effect, determine the value added by the head office through deciding whether to "buy" head-office services. This helps to ensure efficiency and relevance of head-office activities.
7. See Cracknell and Sempangi (2002) for more in-depth discussion of this topic.
8. See Helms and Grace (2004) for more in-depth discussion of this topic.
9. For specific tools for monitoring and projecting liquidity, see Biety (2005).
10. Drawn from Bald (2002, p. 106).
11. Another measurement, the *gap ratio* (see table 10.3), compares the rate-sensitive assets to the rate-sensitive liabilities. A gap ratio of more than 1 is a positive gap, and a gap ratio of less than 1 is a negative gap.
12. See Imboden and Stevens (2005) for a succinct summary of Basle II and its application to microfinance.
13. Subordinated term debt typically includes conventional unsecured subordinated debt capital instruments with a minimum original fixed term to maturity of over five years and limited life redeemable preference shares.

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Chapter 11

Management Information Systems

Changes inherent in transforming to a regulated financial intermediary have significant implications for a microfinance institution's (MFI's) management information systems (MIS). The people, policies, and processes that govern the way data are collected, processed into information, stored, analyzed, and accessed, all undergo change. The introduction of new products, compliance with regulatory reporting requirements and accounting standards, support for teller services, and greater demands for portfolio analysis, all pose new information requirements on the transforming MFI. These new requirements must be supported without jeopardizing ongoing information needs. In addition, systems must possess the flexibility to accommodate the growth of the MFI going forward. Although the size of the gap between a transforming MFI's current MIS and the systems it will need as a regulated, deposit-taking institution will vary by institution and by country, in general, the MIS upgrade process tends to be one of the more expensive and time-consuming aspects of the transformation process.

To transform successfully, MFIs will need to ensure that their systems and use of IT are closely aligned with their business strategies, both in the short and longer term. In particular, the MIS will need to provide the transformed MFI with levels of flexibility and reliability that accommodate the changes associated with regulation. Ideally, it must also become a stable platform from which IT initiatives, such as automated teller machines (ATMs), point-of-sale transactions, or cell phone banking, can be launched. To achieve this goal, MFIs must dedicate sufficient time and resources to the MIS upgrade, employ structured project management methodologies, and incorporate change management activities.

This chapter provides an overview of the changes required to an MFI's information systems as part of the transformation process. It first considers the planning that needs to take place before an MIS upgrade, then addresses the actual MIS upgrade process, leading to the requirements for software and infrastructure, and finally, implications for MIS security needs and the MFI's human resources.[1] The bulk of the chapter is focused on the software requirements for loan portfolio management, savings management, accounting, and reporting, because many aspects of these functions will either be new or require revisions for the MFI to operate as a regulated deposit-taking entity.

Planning for an MIS Upgrade

MIS involve much more than just computers—they include the "policies, procedures, and practices that direct an organization's operations and the staff that interact with the information, combined with the software and hardware."[2] Thus, change management is a vital part of the MIS upgrade process. (See chapter 3, Planning for Transformation, for more information on change management.)

MIS upgrades can include the implementation of new banking software, a reengineering of basic information processing procedures, investments in information technology (IT) training for staff, and the revamping of an institution's reporting framework. In planning for an MIS upgrade, MFIs should consider the following key components:

- Project management
- Strategic thinking
- Process assessment

Project Management

To identify the proper new system and successfully implement it within the time frame of the transformation process, MFIs will find it imperative to manage the upgrade process formally as a project and adhere to good project management practices. Managing any project presents numerous challenges, but technology projects add an extra layer of complexity because of the high expectations of technology, the breadth of stakeholders that are affected by systems, and the linked time frames within the overall transformation strategy.

To help ensure proper leadership and institutional acceptance of the results, the MFI should create an IT task force to upgrade process. The IT task force should be aligned with the organizational culture and structure, properly identifying who is responsible for critical IT decisions. This ensures that IT-related decisions embody uniform principles and are properly placed within the business strategy and resources of the organization. The task force should include a senior level manager responsible for the team, representative managers from each of the key business units, the IT manager, and a representative sample of general users. This task force oversees and is directly involved in the MIS upgrade process. This committee could be a subset of the transformation committee discussed in chapter 3, Planning for Transformation.

Project analysis and planning is by far the most critical phase in the MIS upgrade process because failure to identify an activity or requirement may ultimately delay or even prevent transformation. Although MFIs may find this approach somewhat time consuming, clearly establishing the needed MIS changes as a project will save significant amounts of time, money, and effort in the longer term.

Certain challenges are unique to IT initiatives. Technology is often seen as a panacea for all problems—when it fails to deliver as promised or on time it can cause morale issues. Aligning and managing expectations is therefore important throughout the entire process. IT project management and analytical experience are also difficult to come by for MFIs. Rare is the MFI that has the full range of staff expertise in house. Leveraging outside experts will be necessary along the way, so it is important to plan and allocate resources accordingly. Because technology affects everyone in an MFI, including customers, regulators, and the board of directors, there is a complex web of stakeholders to manage—both their participation and their expectations must be guided. Furthermore, this type of IT project is likely to follow tight time frames and budgets; therefore, activities and resources must be managed very closely.

See box 11.1 for a summary of factors leading to the success of IT projects.

Box 11.1 Critical Success Factors for IT Project Management

- Technology choices should always further business objectives; the MFI must have explicitly clear business goals everyone understands and to which everyone is committed.
- Management must establish clear standards for success with specific targets to measure results and quantify return on investment; otherwise, employees may feel no sense of accomplishment and investors may not be satisfied with results.
- The project must have a project champion, generally a well-respected, high-level senior manager with the ability to sell the new vision. This person might be the general manager or the operations manager.
- The project must have an internal MIS project manager responsible for keeping the project moving forward on schedule, following up with others to ensure work is completed.
- The project must have a task team to do the work comprising fair representation of the stakeholders across the organization; the project manager is responsible for leading this team.
- Management must clearly define the requirements for solution in the beginning.
- The project must have senior management leadership, buy-in, and accountability for outcomes, including from business unit managers.
- The rationale for change must be clearly stated and communicated to all stakeholders.
- The project must have adequate resources for not only the new software but for internal staff time, specialized technical assistance, training, hardware, and other capital investments.
- Planning, planning, planning, and even more contingency planning should be done to ensure the process meets designated milestones and remains in synch with the overall transformation process.
- Corners must not be cut on training or change management activities; this will inevitably interfere with a smooth process and result in project cost overruns. Investing in people is just as important as, if not more than, investing in technology.

Source: O'Keeffe and Frederick (2004, pp. 6–7).

Strategic Thinking

With transformation, regulatory oversight opens the door to delivery of more and different financial products, which leads to the ability to grow the customer base. In turn, transformation also provides access to additional sources of capital to fund the growth. Hence, when identifying the requirements for the new information system, the MFI must consider more than just compliance with regulatory reporting to determine the best application. The MFI should clearly articulate its business goals, taking into consideration client demands and available technology innovations. To prepare for this, opportunities and challenges of accessing and using technologies locally need to be assessed. At this point, the MFI should articulate the vision in terms of the "what" (branchless banking, for example) and not the "how" (smart cards, connectivity, or a point-of-sale network). The how will be determined later in the process based on priorities, availability of technology, viability, and resources.

The next key output of a strategic thinking exercise is a criteria set for evaluating the technology options. This will vary in length, characteristics, and priority by institution, but generally includes some of the following attributes—customer driven, extendable, usable, reliable, secure, and affordable. It is imperative that the IT task force and the transformation committee come to agreement on these priorities before beginning the due diligence of the different options, to prevent the evaluators from becoming enchanted with the bells and whistles of

new technology. Because this is a critical step in the process and requires a special set of skills, the MFI should consider engaging a third party to lead the strategic thinking session. If the chosen facilitator is not an expert in technology, the IT manager should prepare a summary of the technology landscape for the given country or region, to be used during the session.

Ultimately, significant capital investment in equipment, hardware, and technical assistance will be required to employ the new applications successfully and prepare the MFI to manage the expected growth. The MFI is strongly advised to choose a solution that will bring them the greatest return in the long-term (five to seven years).

Process Assessment

Process assessment refers to assessing the various business processes that take place within the MFI to effect its operations. (See Chapter 12, Internal Control and Audit, for a brief discussion on process mapping.) Although a full-scale reengineering effort of the core processes of the MFI is not mandatory for transformation, it is important to at least identify the core processes that will be most directly affected by the upgrade of the information system. Adopting a new MIS provides an excellent opportunity to address inefficient or outdated processes and procedures that may have been developed and passed down over time. Rather than simply automating what is in place, the processes should be assessed, redesigned, streamlined, or eliminated as appropriate with the new technology. Technology's greatest value added is not when it is laid over existing processes but when business processes and practices are examined and revised to both take advantage of the technology *and* improve overall efficiency and client service (although care should be taken not to let the technology drive the business processes). Becoming a regulated deposit-taking institution should lead the choice of technology, which, in turn, should enable new and better operations.

Once the core processes are identified, they should be classified as either priority processes, background processes, or mandated processes. Each process should then be evaluated for its salience and value to the institution to determine whether improving each process is worth the investment as part of the MIS upgrade. Precious IT resources and transformation money should focus directly on the processes with the most potential for improvement that will generate economic value (directly or indirectly) for the organization.

MIS Upgrade Process

Following a standard approach to managing the MIS upgrade process is critical to overall success. The four core phases include the following:

- Needs assessment
- Design
- Research and selection
- Implementation

In general, from start to finish the MIS upgrade process will usually take a full 12 to 18 months. It is vitally important that the MFI document the MIS upgrade process, most particularly the research and selection process if seeking donor funding (box 11.2).

Needs Assessment

As a first step, the IT task force needs to analyze the existing systems and compare these to what will be required to operate as a regulated deposit-taking institution. From this analysis, the task force can identify the primary activities required for the MIS upgrade and estimate the resources needed. This assessment of current and future information needs results in a *requirements document*. See annex 11A for a sample requirements document.

Box 11.2 Documenting the Process

The four core phases of the MIS upgrade process should be carefully documented at each stage, particularly if the MFI hopes to access donor funding for part or all of the cost of acquiring a new MIS. Given the high price, the procurement of an MIS typically falls in the most complex and closely scrutinized level for donors (for example, requiring international competitive bidding, in the case of the World Bank). Although each donor's procurement rules will differ, generally they seek to ensure high standards of transparency and value for money. If a particular donor has already been identified before the start of the process, the MFI should ensure that the donors requirements are met at every stage. If the donor is not yet known, the MFI will have to go even farther, and attempt to anticipate every possible requirement.

In anticipation of receiving donor funding, a transforming MFI in Uganda moved forward with the needs assessment, design, research, and selection phases (but not contracting). When a willing donor was found, the process (and in particular, its documentation) did not meet the donor's requirements and the MFI ultimately had to fund the full MIS purchase with its own resources.

Source: Contributed by Lloyd Stevens, DFID Financial Sector Deepening Programme, Uganda, November 2005.

In the assessment, the MFI must clearly identify the input, processing, output, and communications requirements for the MIS after transformation. Involving external stakeholders, many of whom will be new to the MFI, such as the regulatory body and investors, as well as internal users—including all departments affected by transformation, senior management, and operational users of the current MIS—in the requirements definition is critical to ensure a complete set of specifications early on as well as buy-in from the various stakeholder groups. Unclear requirements are the number one reason IT projects go over budget and miss deadlines. Changes late in the process will affect all levels—technology, processes, budgeting, training, and rollout.

Consultations with each of the stakeholders should allow the MFI to determine the scope of the project including both an overview of issues and the specific detailed requirements of the information system for the newly transformed organization. A sample set of requirements and the common source are shown in table 11.1.

Based on the high-level requirements, a set of MIS project tasks should then be determined. For example, the requirement to provide compliance reporting calls for a series of activities regarding communications alternatives to ensure the required information is available. It is important to prioritize

Table 11.1 Sources and Requirements

Source	Requirement identified
Central bank regulations	• Minimum regulatory requirements for licensing, as documented in central bank policies and procedures • Ongoing regulatory reporting requirements • Accounting and loan processing regulations
Transformation committee, transformation plan, business plan	• Time frame for transformation • Estimates of business growth, including both transaction processing and geographic expansion plans • Details of new products and changes to existing products
Senior management, transformation, business plan	• Anticipated future business model • IT vision and strategy • Resources available for MIS transformation
System users	• User requirements for upgrade or new system

Source: O'Keeffe and Frederick (2004, p. 4).

requirements. The output of this exercise should be a project plan, complete with task breakdown, resource budgeting, external technical assistance needs, and allocation of responsibilities. Project dependencies, risks, and responsibilities should also be analyzed and included in the project plan, which ultimately should be submitted via the IT task force to the transformation committee for approval and allocation of resources.

Furthermore, a process to identify requested system changes or upgrades should also include a defined method for communicating the change to the MIS department or external MIS supplier (or both) and a subsequent method for recording, vetting, prioritizing, and authorizing the changes. A change request database, possibly related to a support call database, can help manage change requests through to implementation.

The skills required to carry out this analysis may be beyond those available in a purely technical IT department and in some cases could be well suited to an external consultant who has both an understanding of the regulations and business environments as well as of information systems as a whole. See annex 11B for sample terms of reference for a consultant to carry out the needs assessment. Regardless of who carries out the assessment, the findings should be verified with the IT task force and the transformation committee to ensure the requirements have been correctly interpreted and the objectives of the project are clear.

Design

In the design phase, the IT task team envisions the "what" of the solution and assigns priorities to the requirements. Once a change has been given initial approval, further analysis may be necessary to understand the details of system changes required to fulfill the request. These details should be documented as proof that the effects of the change have been thoroughly considered. The output of this phase is a *specifications document* that is used in the next phase to research technology options.

Research and Selection

The next phase, research and selection, is usually completed in two iterations. First, a high-level scan is done of all available options with some basic research to narrow the options down to a short list of three because the amount of due diligence done after this stage is significant. Once the short list has been identified, each vendor is requested to make an on-site visit and demonstration. A Request for Proposal outlining the necessary system requirements should then be developed and given to each vendor. Once the proposals are received from the vendor, they are evaluated and rated according to the priorities and resource criteria set outlined by the IT task force. Leveraging an external consultant for this phase can be valuable if in-house expertise does not exist. See annex 11B for sample terms of reference to engage a consultant to assist in the selection of software. Donor funding may be available for this type of exercise, such as through the Consultative Group to Assist the Poor Information Systems Fund.[3] The final goal of the research and selection phase is to select the software application for implementation and to negotiate a contract with the chosen vendor.[4]

Implementation

The final phase of the upgrade process is implementation. A detailed implementation plan should be created to outline the specific activities, including the resources and time frames for delivery. The activities in this phase may include hardware installation, network upgrade, software installation, data migration, testing, training, and process realignment.

If implementation involves a significant upgrade, or complete replacement of a system, data migration or conversion will be required. This involves

Box 11.3 Dos and Don’ts of Data Migration

Do:

- Confirm exact data requirements with the new supplier.
- Use trained data entry clerks who understand the importance of data accuracy.
- Design tools for data entry to validate data as it is entered.
- Schedule time for data cleaning before actually converting—expect exceptions.
- Do a trial run to understand how the data will be converted into the new system; understand how each piece of data will be used.
- Work with previous software suppliers to map the old database structure to the new one.

Don’t:

- Skimp on time or resources when confirming data requirements—it will be much harder to fix data errors once the data is actually in the system.
- Expect branches or users to do data entry without supervision and training.
- Presume the new software supplier will immediately understand the old database.

Source: Contributed by Geraldine O’Keeffe, December 2005.

either transferring data from a previous system to a new database, or capturing data electronically if the current MIS is manual. This process will directly affect the data quality of the final system so it is critical that it is carried out correctly. Some guidelines for data migration are suggested in box 11.3.

Following data conversion, and equally important, is testing. Delivery of a system change, either as a patch or a full version upgrade, must be sufficiently tested before implementation. Testing has two main objectives—to ensure the change works as specified and to ensure it has not had any adverse effects on the rest of the system. Standard test routines should be followed to ensure that all processes are carried out with the new version of the software (for example, new loan creation, disbursement, end-of-period processing). These tests should be made on a replica of the live system with all test results documented and issues reported back to development.

Once systems and user acceptance testing have been completed, a pilot run of the software or software upgrade should be carried out to identify any additional issues that arise through the use of the software on a daily basis. During the definition phase for the pilot test, criteria should be established to judge when and whether the pilot is successful.

Training of users and technical staff must also take place during the implementation phase. Training programs need to be designed, taking into account the existing skills of users and any changes to business processes that will accompany the new system. Training methods should include hands-on training sessions, with accompanying training manuals. An assessment of technical training requirements for systems personnel should also be carried out to ensure that the skills are available, either in house or through an outsourcing arrangement, to support the new technology.

This phase culminates with a system evaluation to ensure optimization of the technology. Despite testing, issues may still be identified after implementation. A postimplementation review will help to identify these outstanding issues, and will provide a valuable learning exercise that should assist with future MIS or technology projects.

The implementation phase can take anywhere from 2 to 12 months depending on the size of the institution and the approach taken for the conversion to the new system. (See box 11.4 for a summary of conditions that could make it take longer.) Again, it may be useful to hire an external consultant to assist in the implementation process. (See annex 11C for sample terms of reference.)

Box 11.4 Rollout of Bankers' Realm at UMU

Before initiating its preparations for transformation, Uganda Microfinance Union (UMU) relied on a manual account management system, built primarily off ledger cards (yellow for loans and pink for savings) and a separate centrally based automated accounting package (Solomon IV). This system faced limitations in efficiency, consolidating data, and trend analysis, underscoring the need for a new system to respond to the reporting and tracking requirements of a regulated microfinance deposit-taking institution (MDI). The resulting conversion from a totally manual system—characterized by ledger cards, ledger keepers, waste sheets, and tedious month-end balancing—to Bankers Realm, a holistic banking software, was not an easy one. The first branch to go live was UMU's newest urban branch, opened in August 2002 and computerized in October 2002. The computerization of the rest of UMU's branches took over two years to complete and was challenged by many issues. Strong project management proved critical throughout the transition process.

Source: Author's findings.

Given the length of time required for an MIS upgrade, the transformation committee will find it imperative to work closely with the IT task force to properly align and sequence activities so as not to put the transformation process and regulatory approval at risk.

Software Requirements

When transforming to a deposit-taking financial intermediary, many MFIs need to consider purchasing new software. Credit-only institutions often operate with software designed primarily for loan tracking. Upon becoming a deposit-taking institution, the software must be upgraded to manage and monitor client savings as well.

Although not all transforming MFIs will need to purchase new software, for those that do, evaluation tools such as that provided by Mainhart (1999) should be used to assess potential software applications. This framework breaks down the assessment of an MIS application into the following components: functionality and expandability, usability, reporting, standards and compliance, administration and support, technical specifications and correctness, and costs. Criteria are listed for each component and a system can be assessed according to how well it meets this general criteria set and the specific priorities of the institution.[5]

Although all criteria listed within this framework should be considered in terms of relative priority, certain topics are of particular importance for transforming MFIs:

- *Deposit account management:* functionality and flexibility to support different savings and deposit products
- *Finance and accounting:* functionality to perform a full range of accounting activities and to meet required compliance standards, as well as improved asset, liquidity, and deposit management
- *Loan tracking:* capability to monitor and manage the loan portfolio, particularly portfolio aging, in addition to greater flexibility with individual loan products and the decision-making processes
- *Scalability of the system to support institutional growth:* ability to support diverse new products as well as an increased volume of users necessary for scaling the institution as it grows through transformation
- *Flexibility to incorporate new requirements:* because transformation can open many new doors, the MIS must be flexible enough to

enable the organization to pursue new opportunities easily as they emerge

- *Report generation:* greater control and ease for adjusting and generating reports, especially those required to comply with regulatory requirements
- *Governmental and supervisory adherence:* proper audit capacities and security measures as well as full control of the chart of accounts to ensure institutional compliance

In addition, transformation often increases the number of accounts per customer, as additional loans and savings products are cross-marketed. As discussed in chapter 10, Financial Management, the MFI will most likely want to analyze customer behavior and performance across all products; therefore, access to an interface that shows the client portfolio with summary information about the client's performance in each product becomes important. Although this information may be available through detailed analysis of each account, it is much easier and more valuable to analyze client behavior collectively. Multiple products accessed by the same client make a strong case for systems that are integrated and customer focused, because such systems provide the ability to associate several accounts to one customer and thus more efficiently manage the customer relationship. The alternative is an account-centric system whereby each account is considered separately from all other accounts or even completely separate systems—however, these generally make it difficult for summary behavior to be extracted.

MFIs must clearly identify their requirements in these areas, and all other requirements, before they select an MIS solution. Pressure to transform should not compromise the time allocated to the process of software selection, contract negotiation, and implementation. A major project such as this will benefit from laying down foundations to support the new system and ensuring that both business and technical needs are addressed by the chosen solution.

Whether current systems will be retained after transformation or a new MIS selected, certain issues important to the software requirements must be addressed, including system design, loan portfolio management, savings and deposit management, accounting, reporting, systems integration, and security. Given different regulatory environments from one country to the next, this is not an exhaustive list of issues relevant to all systems but rather should be used to stimulate ideas and help MFIs identify potential weaknesses in their MIS. See box 11.5 for an example of one variable an MFI might consider when choosing an MIS.

Box 11.5 Availability of Local Skills

One often overlooked factor in selecting an MIS is the availability of skills in the local market. The presence of a few local standard MIS packages offers an institution a much deeper talent pool on which to draw, be it IT specialists or tellers trained in a certain package. In Uganda, for example, Equinox, a banking solution sold by Neptune Software plc, has been adopted by four of the largest providers of microfinance (one bank, one credit institution, and two MFIs). Over time, this will create a broad pool of staff well-versed in this system's functionality. Because it is an open secret that MFIs often recruit from their competitors, this offers a resource from which to draw, and reduces reliability on a few key staff members. If an institution selects an obscure MIS that no other company in its market is using, all new staff will have to be trained from scratch. Of course, the institution may look at this the opposite way ("if no one else uses this package, my IT staff will be less likely to be recruited by a competitor"). On balance, however, the benefits of recruiting and replacing staff from a deep local talent pool outweigh any benefits of "trapping" staff by giving them nontransferable skills.

Source: Contributed by Lloyd Stevens, DFID Financial Sector Deepening Programme, Uganda, November 2005.

System Design

The design of the overall information system must balance system security and privacy with access and flexibility. This trade-off can be outlined by the IT manager or consultant, but ultimately senior management and the board have the responsibility to determine the levels of risk the institution is willing to assume to provide greater customer service and ease of access.

Furthermore, natural tension arises between customization at the department or branch level and the need for institutionwide information standards to ensure continuity and efficiency of services to customers as well as compliance reporting. Too much or too little flexibility between these levels generally results in poor communications, and a variable quality of responses. For example, variations in loan application requirements between branches raise challenges for information consistency. However, a loan officer may need to be able to offer different terms (within reason) for a loan product to respond to customer needs and general market demands. Technology can help create the necessary consistency and control across the organization but also provide significant flexibility. Setting some loan product parameters at the global or product level, but allowing others to be defined at the individual account level by the loan officer is one example of how system design can meet the needs of the MFI. Another is setting the security features of an MIS to restrict changes to the chart of accounts at the branch level. Although the IT manager or consultant can lay out all the data standards and business policies that need to be considered, ultimately senior management must decide which elements are institutional standards and which are defined at the department or branch level.

Finally, business needs must drive the technology choices. These generally include software capabilities first, then hardware requirements that support the software requirements and business decisions. However, there are exceptions to this order of thinking, hence the importance of having clear business objectives agreed to at the onset of transformation so that a clear vision of the necessary IT design can be created to support those objectives in a comprehensive and holistic approach.

Loan Portfolio Management

As discussed in chapter 10, Financial Management, regulations affect the way in which a licensed MFI needs to process and monitor its loans including treatment of interest in arrears, tracking of restructured loans, loan loss provisioning, and aging of loans in arrears.

Interest treatment. Although the regulator may not specify explicitly the way in which an MFI should account for interest, it will most likely stipulate acceptable treatment for interest revenue on loans in arrears. If one is to meet these requirements, the way in which the MIS handles overdue interest beyond a certain period of time, say 30 days overdue, needs to be considered. Given that this time period may vary, a degree of flexibility to specify interest treatment at the product definition, account, and global level is a useful feature in a software application. Without this ability it is likely that some programming would be required to make changes to interest treatment. This latter option may be entirely appropriate given that interest treatment is unlikely to change on a frequent basis, and may be a one-off customization change for a software supplier or programmer.

Loan loss provisioning. A well-designed system to support loan loss provisioning can help improve the efficiency and accuracy of this critical process. An integrated loan portfolio and accounting system should reduce the effort required to calculate and post provisions. At the same time, however, this must occur in a transparent way to allow checks on accuracy.

Ideally, provisioning is fully automated as part of the end-of-month processes. However, use of a spreadsheet can also provide the necessary functionality. The major concern with a spreadsheet system is potential errors that may arise due to manual inputs. Controls should be in place to ensure that provisions are calculated using correct data from the MIS and that calculated provisions reconcile with accounting entries. With an off-the-shelf application using a relational database, static (or preferably dynamic) links to a spreadsheet should be possible to eliminate data entry errors. Dynamic links to the necessary calculation template will ensure correct data extraction. Static links that require manual manipulation to complete processing are prone to errors; this susceptibility, however, can be offset by using tiered spreadsheets, limiting manipulation, and locking formulas for accuracy. Whichever method the MFI chooses should be tested with the software vendor to ensure sufficient usability.

Aging of arrears. Provisioning also introduces the issue of aging brackets used for reporting arrears. Typical options for these brackets are weekly or monthly, with the ideal system allowing the MFI to input its own. Consideration must be given to the length and number of aging brackets that the regulators require for provisioning purposes. For example, the regulator may require provisions on a monthly basis up to 180 days, whereupon loans are written off. An issue would arise in this case if the system only allowed a maximum of up to 120 days. Applications should be flexible enough to allow the institution to define the aging brackets.

Exiting clients and dormant accounts. A mechanism for monitoring and reporting clients who leave the MFI may be required by regulators or simply desired by management. If so, the first step is to establish the criteria that define an exiting client, possibly using a period within which a client does not renew a loan or ceases to hold any savings. A report to identify such clients or alternatively, an automated system that makes these accounts inactive, can help identify, and ultimately report on, these clients.

Dormant accounts may also be an issue. Many regulators set a definition of a dormant account, establishing a period for inactivity after which the account is considered dormant. Often, savings balances in dormant accounts must be set aside, or even turned over to the central bank for safekeeping until the client or an heir comes forward to claim them, a process known as "escheatment."

Rescheduled loans. If the MFI has a policy of rescheduling loans, such loans will probably need to be tracked and reported separately because of their higher risk. The regulator may also require higher provisioning on these loans. A unique identifier should be associated with restructured loans so they can be easily identified and separated from the rest of the portfolio. This could be achieved by introducing restructured loans as a new product type in the MIS so that when a loan is restructured it is transferred to this product type with different provisioning levels. The functionality within an MIS for such transfers and regeneration of payment schedules needs to be investigated to ensure that the application can adequately handle the defined requirements (separate tracking of rescheduled loans, for example).

Additional client data. Transformation may place greater demands on customer information requirements of the MIS, possibly including information by client or loan such as sector of employment, gender, age, and so on, as well as the ability to capture more detailed household financial information needed for some individual loan analyses. If this information is not already being collected, management will need to decide the most efficient and effective way to collect, store, report, and analyze it. New forms may need to be designed, input screens

altered, or certain fields made mandatory. Alternatively, the MFI may need to build a separate database to capture this information, which, over time, may become a key source of trend data useful for more sophisticated risk analysis. The collection of this information will have front-office implications that may well increase workload and slow down processing time. A way must also be found to gather this information from existing clients.

Even if the required customer information is already being collected, transformation may require mapping of existing categories to those set out by the regulator. A good example of this is “sector of employment.” The regulator may only want a high level categorization whereas the MFI may require more detailed information about the nature of their clients’ work. A method to map, tier, or move existing data categories needs to be designed and implemented, ensuring that the MFI does not lose any required detail. Transformation may also provide an opportunity to carry out data cleaning activities on existing information, possibly through validation of information with clients and purging of data not being used.

Savings and Deposit Management

Before transformation, the savings and deposit module of the MIS may either not exist or be underutilized because of a lack of or limited savings products offered by the MFI. Thus, the savings module may represent the most significant investment of resources resulting from MIS transformation. Identifying the requirements for this module may be complicated by the fact that new savings products may not yet be designed or they may be in a pilot stage. However, one advantage of using a proven off-the-shelf application is that it should already have a robust deposit management module with flexible parameters, so the MFI does not necessarily need to know the precise characteristics of the deposit products before progressing with the application selection.

New savings products. With regulation, MFIs can introduce a variety of new savings services, usually ranging from open access savings accounts to fixed deposits. As with all new products, the MIS will be affected and careful consideration needs to be given to how the MIS will support the provision of these products and how the MIS will make available the necessary information to track development and performance.

Good communication between the MIS team and the product development team will help build an understanding of the limitations of the system and how these may affect the design of new products. This should not mean that system limitations should determine product design but rather, system issues should be considered while planning new products to allow for programming efforts if required. If a savings module is currently in place, the MIS department could provide the existing product definition criteria available in the system to the product development team so they are aware of what is immediately available as opposed to what features would require customization. Additionally, communication will help ensure the MIS department incorporates testing and rollout of new products as part of its schedule, rather than being informed at the last stage of product rollout, thus limiting the ability to perform adequate testing.

Introducing new savings products will likely require new reports. Certain features of savings products (perhaps number of free transactions) may result in a requirement to report on an element of customer behavior previously not collected (perhaps number of transactions per month). An MIS application that includes a report generation tool (for example, Crystal Reports) that allows end users to create and format their own reports is extremely beneficial for this purpose. However, the tool will only be useful if the required data exists in the database. If a report is needed on data that is not currently contained in the system, both a change to the database structure and to the software code will be needed, which most likely will mean supplier

intervention for an off-the-shelf package. Depending on how frequently this report is needed, a spreadsheet report might provide an adequate alternative.

Savings product criteria. Just as the MIS department can provide information to the product development team, the product development department should be able to detail the information requirements for savings products—both those available immediately and those to be offered in the future—and provide this information to the MIS department (or IT task force). It may be impossible to predict specific details of future products, but it should be possible to identify the criteria that will be used to define a savings product as well as the common options for each criteria. For example, one criterion is "interest procedure," with the options of flat, tiered, minimum balance, and average balance. Once these requirements have been gathered and analyzed, the MIS department can assess the level to which current, or proposed systems, meet them.

A review of the top dozen banking software applications shows a finite set of parameters necessary to handle savings product—mainly minimum and maximum opening balance limits, interest amounts, interest calculations and accrual posting, and withdrawal restrictions and fees. As long as the software has the ability to set these business rules at the global, product, and account levels, and enables some user-defined options for each, an MFI should be relatively assured that any future savings products can be accommodated.

To give an indication of what these common criteria are and to help identify any issues that should be addressed in the definition process, the criteria used with the MIS software Bankers Realm[6] is provided as an example in table 11.2. (The criteria have been modified slightly to show only the key criteria and should not be interpreted as a replica of the product definition interface available within this application.)

Some additional issues may need to be defined for savings products, such as "who will act as the account beneficiary," and "how will joint accounts be treated." Whether defined at the account or customer level, this functionality should be available as part of the MIS.

System distinction between compulsory and voluntary savings. Many MIS applications recognize the use of compulsory or forced savings accounts that are linked to loan accounts. The introduction of voluntary savings, which by definition should be independent from loan accounts, may require that the MIS apply different conditions to these accounts and, therefore, classify them differently. For example, forced savings accounts may contain system controls to ensure that the client is saving according to schedule or retains a minimum balance relative to the client's loan amount. In contrast, voluntary savings accounts will have neither of these requirements but will have different conditions, such as a number of free withdrawals per month. How the application associates one savings account with a loan account but considers another as independent may need to be addressed if the transformed MFI continues to require forced savings on its loan products. To deal with this requirement, the MIS application may need to have two different product types so that forced savings has a different product definition interface than voluntary savings. This implies that the system must apply different logic to compulsory and voluntary products, and may also require an additional data entry step for tellers.

A separate classification for voluntary and compulsory savings is particularly important in situations in which forced savings accounts are drawn on to make loan repayments in arrears. Unless such transfers are authorized by the customer with documentation, voluntary accounts should never be used for loan repayments. Ideally this policy should be enforced by the system so that transfers between these accounts are not possible. If system control is

Table 11.2 Savings Product Definition

Criteria	Options	Key questions
Product type	Savings, fixed deposit	What different types of savings products are offered?
Product ID	User definable	What unique identifier will be used for each product?
Account prefix	User definable	How will an account numbering system identify the type of product? For example, all account numbers beginning with 2 may be savings, and 203 might be open-access savings.
Minimum balance	Free text field (enter numeric values)	What is the minimum balance? Is there a penalty for falling below this balance? If so, how is it applied? Are reports available to show accounts that are below minimum balance?
Interest rate	Percentage	Monthly or yearly?
Interest frequency	Daily, monthly, weekly, yearly	How often will interest be paid and is this part of a system procedure (end of month, for example)?
Interest calculation method	Flat, tiered, minimum balance, average balance	What procedure will be used to calculate interest?
Interest start date	Immediately, first of month, and the like	Will interest be paid in the first month the account is opened?
Interest rounding	For example, nearest thousand, round down	How should interest calculations be rounded?
GL account interest payable	Select from available GL accounts	If integrated, which account will be used to capture interest payable?
Charge type and amount	Fixed, per transaction, none	Will a flat fee be payable or will it be based on account usage?
Free transactions	Free text field (enter numeric values)	How many free transactions are allowed? Within what time period?
Transaction costs	Enter cost per transaction	None
Minimum or maximum fee	Limits on charges	Is there a minimum or maximum set charge?
GL account fee income	Select from available GL accounts	If integrated, which account will be used to capture fees received?
Dormancy criteria	Various—dormancy on zero balance followed by closure after certain time, dormancy on no account activity for specified period, below a certain balance	When will accounts be made dormant? When will dormant accounts be closed? How will dormant accounts be reactivated? Criteria and cost for reactivation? What will happen to balances in a dormant account?
Checkbook	Yes or no	Is a checkbook available for this product?
Tax rate	Enter rate of tax	Is tax applicable on interest paid? What rounding is used for these calculations? What GL account is used for tax received?
Debit balance allowed	Yes or no	Will this account be allowed to go in debit?

Source: Modified from O'Keeffe (2003).

Note: GL = General ledger.

not possible, a manual system should be designed to ensure that transfers from voluntary savings accounts to loan accounts have the necessary customer authorization and paper trail.

There may be no requirement for the system to differentiate between compulsory and voluntary savings products if compulsory savings are abandoned with transformation. In this instance, existing products need to be reclassified within the system or migrated to the new system, which may require a back-end change in the database (unless a feature exists within the MIS to change the product type). Some systems require the loan account to be associated with a savings account or minimum account balance as a mandatory field. Obviously, this condition will need to be removed or turned off if forced savings are no longer part of the loan product.

Access to account information. The success of voluntary savings mobilization depends heavily on clients' trust in the MFI and their belief that their money is safe and accessible during banking hours. Many new savers take some time to develop this trust and require constant proof that their money is credited to their account and available for withdrawal should they require it. This proof has MIS implications because customers may frequently request account balances and statements of transactions. The way in which the MIS supports this need must be considered, along with the pros and cons of available options in light of the organizational environment.

Table 11.3 considers some possible alternatives for meeting client needs for information.

In addition, MFIs should consider electronic customer inquiries by phone, by internet, or at kiosks. Although this may be beyond the capacity of the MFI in the first or second year after transformation, institutions most likely must go in this direction if they are to be competitive, responsive, and cost effective as they grow. Including these requirements into the overall requirement set at this stage is, therefore, important.

Fraud prevention and detection. The introduction of, or increase in, savings products can pose new opportunities for internal and external fraud and hence raises the importance of the internal control capabilities of the MIS. (See chapter 12, Internal Control and Audits, for more discussion on fraud prevention.)

One way to reduce the opportunity for fraud is through client identification. MFIs will have addressed the issue of client identification as part of credit operations but the move to savings and the commensurate withdrawals may put more pressure on identification processes, possibly exposing weaknesses in the system. An MIS that can support an electronic identification method, such as a scanned signature and photo card, a smart card, or even biometrics, will help to minimize the risk of unauthorized transactions resulting from forged identification. In choosing the identification system, the MFI will need to consider the literacy level of clients, availability of technology and infrastructure to support the technology, the level of security required, and the cost. In some cases, the identification method can have multiple functionalities. For example, smart cards enable client identification, branchless banking, and off-line transaction capabilities as well as passbook functionality.

Increased worldwide concern about money laundering and financing of terrorism may result in MFIs being held to new regulations requiring implementation of Know Your Customer policies and procedures, as well as being responsible for reporting suspicious transactions to the central bank. The extent to which these regulations are in place and enforced varies from country to country but MFIs can realistically assume that at some stage in the future, as regulated MFIs, their MIS will need to support such measures. New requirements may include record-keeping obligations and verification of identification, both of which could entail changes to the MIS. Criteria for suspicious transactions (for example, an extended period with no transactions followed by a large deposit or withdrawal) need to be defined and

Table 11.3 Client Information Sources

Option	Description	Pros	Cons
Manual passbooks	Manual book that becomes the client's property; shows all transactions and balances; updated by a member of the MFI staff either after each transaction or at the client's request	No expensive equipment required Easy for customers to understand Easy for staff to update	Time consuming Costly Loss of passbook could present security concern for client Human errors in transcribing Fraudulent creation of books Possibly requires dedicated staff to update Difficult when customer has multiple accounts
Computer-updated passbooks	Manual book that is updated using specially designed printers; held by client and updated after each transaction or on client request	Faster updating Accurate Difficult to duplicate for fraudulent purposes	Expensive printers Availability of printers Expense of passbooks that must be compatible with printers Loss of passbook could present security concern for client Possibly requires dedicated staff Difficult when customer has multiple accounts
Account statement	Single statement printed periodically or on client request	Cheaper than passbooks Only print for customers who require Use same printers as used for receipts Fast and accurate	Some customers may not interpret as easily as a passbook Multiple statements for multiple accounts Frequent requests Potentially mandated by the central bank at least annually
Smart cards	Embedded computer chip in a plastic card that stores client and account information	Clients can move from one branch to another All client information held in same place Opens up options for remote transactions Very difficult to duplicate, reducing likelihood of fraud	May not eliminate the need for printouts Relatively expensive technology to produce cards (although decreasing) Requires client education to build up trust in the technology Requires accessible device for clients to read or check account balances

Source: O'Keeffe and Frederick (2004, p. 16).

reports made available to identify such transactions. These criteria may change over time so flexibility needs to be incorporated into any system of identification.

Current accounts and overdraft facilities. Transformation to a deposit-taking institution may entitle MFIs to offer current accounts—demand accounts that allow the user to transact with checks and possibly access an approved overdraft. If so, the MIS needs to include functionality to support these products. The minimum requirements will include the posting of check-based transactions, clearing of funds, checkbook administration, and processes for

approving and monitoring overdrafts. At the transaction level, personal checks must be validated against a register that shows the check series allocated to each account. Checkbook administration processes will need to update this register as well as ensure that all appropriate charges are applied each time a new checkbook is issued. The ability to stop payment of a specified check number is also required, along with the possible levying of a charge for this service.

The MIS should contain processes that automatically clear effects on a daily basis, updating account balances with the cleared funds. A register of all presenting banks, along with the required days for clearing of each, must be maintained if the system is to automatically determine the value date for a check-based transaction. While provisions for premature clearing of effects may be necessary, the security surrounding this, and indeed all clearing processes, must be flawless. Finally, the MIS should facilitate the reconciliation of clearing accounts, either electronically if transaction data can be imported from the clearing bank, or manually using reports designed for this purpose.

If an overdraft facility is available to current account holders, the system and supporting business processes must be available to administer and monitor these products. The approval of overdraft limits should pass through the necessary authorization steps, both on and off the system, to ensure that these credit lines are well controlled.

Interbranch transactions and branchless banking. Allowing access to a savings account from any branch will be an attractive benefit for many customers. This functionality may, however, be restricted by the extent to which branches have access to a centralized database of customer information as well as by communication technologies that allow branch staff access to verify client details at the client's home branch. Account access devices based on magnetic stripe or smart cards may eliminate or reduce the burden on branches and be an attractive alternative for providing interbranch or branchless banking through, automated teller machine (ATM), point-of-sale (POS) devices or mobile telephone banking access technologies. Fax, chat, or text messaging could be less expensive alternatives, but may not be viable in the long term given the large number of potential transactions.

Teller services. MFIs that have not historically provided teller services will need to consider how they will provide clients with convenient access to their now increased range of services. Form and location of customer access points are important strategic business decisions with an array of implementation issues, including several issues that influence the MIS. First, the physical location of tellers needs to be suitable to the hardware, taking into account appearance as well as functionality, security, and access to electricity. The supervisor also needs to have visual access to the tellers as they carry out transactions. Second, the software needs to allow tellers to input transactions securely as they occur, obtain the necessary vouchers, and update passbooks (if used). Third, tellers need reports to reconcile their cash with the system posting at the end of day (such as a cashier summary sheet). Other functions include the general navigation of the interface, its drill-down capability (ability to click on an item to see a greater level of detail), teller and system performance, the array of available transactions, secure log in, voiding capabilities, multi-transaction and summary views, and others. Careful planning for the user interface with the MIS to accommodate ease of use and availability of required information from a limited number of screens makes the teller's job easier and ultimately contributes to higher levels of customer service.

Accounting

The accounting module may be the module least affected by the transformation process although this will depend on the extent to which the accounting

function is already computerized and how consistent it is with regulatory requirements. Regulatory requirements and growth may still affect the chart of accounts and other accounting functions. (See chapter 10, Financial Management, for more discussion on accounting for transformed MFIs.)

Integration with the general ledger. A key issue during transformation is the determination of how the general ledger (GL) will be updated in a timely and reliable manner with a sufficient level of internal control. Whether updating is completed in real time, with changes in the savings and loans modules immediately reflected in the relevant accounts, or on a periodic basis, usually as part of the end-of-day processing, needs to be decided. The end result should be the same—a GL account balance that reconciles with individual ledger accounts. Transformation will not change this basic requirement, but it may result in higher transaction volumes that ultimately strain the interface between nonintegrated modules and the underlying processing power of the MIS. Depending on how the current MIS is designed, this may result in an increase in the time required to update the accounts module, possibly making it unrealistic to obtain a balance sheet and income statement by the end of each day, a condition many regulators require. Therefore, preparation for transformation should assess the scalability of a transfer process between modules, ensuring that the system has the capability to meet current and future demands. If this capability is absent, an alternative should be designed and implemented, such as moving from end-of-day processing to twice or three times a day, or to real-time posting.

Although an integrated application may not present issues regarding processes to update the accounting module, any assumption that an integrated MIS will automatically ensure all ledgers are balanced may be inaccurate. Depending on the system, MIS posting directly to the GL control account could result in the ledgers not balancing. To identify such errors and mismatches, a system must provide functionality to identify when ledgers do not reconcile, perhaps through warning messages that appear during the end-of-day processing. When conducting due diligence on a new information system, this capability should be verified. Balancing ledgers, while always a crucial task for MFIs, becomes even more critical when reporting to regulatory agencies. This is due, in part, to penalties for misreporting as well as the responsibility for overall compliance.

Chart of accounts. If an MIS is not centralized and each branch has its own account installation module, a standardized chart of accounts must be implemented. For enforcement purposes, a system to administer and control the chart of accounts from a central point is required. This system must ensure that all branches remain synchronized when new accounts are added or changes are made to existing accounts. Spreadsheets can be useful tools to assist in this task, acting as a central record of all accounts, showing which branches use which accounts, and providing a detailed description of their usage. Reporting regulations will also affect the administration of the chart of accounts. Security features of an MIS that restrict changes to the chart of accounts at the branch level may be implemented—however, security needs to be carefully balanced with efficiency.

A system needs to be established to ensure that the MFI's chart of accounts is aligned with central bank formats to meet regulatory requirements. This involves ensuring that any internal change to the chart of accounts does not adversely affect the detail required on compliance reports. Thus, the system for administration and control of the accounts must also track which accounts are required by regulators to ensure they are not affected by any internal changes.

Other accounting functions. The way an MFI records its fixed assets and depreciation must

comply with regulatory requirements. In certain cases, the regulatory body may stipulate the life of each asset type or the acceptable rate of depreciation, or both. The MIS should be able to produce a fixed asset register at any time showing the net book value of each asset and, if necessary, additional information including the purchase price, supplier name and location, date of purchase, and depreciation rate and term. Ideally, the MIS will automatically apply the depreciation expense as part of the end-of-month process. Otherwise this can be tracked in a spreadsheet and manually posted to the accounting module monthly.

Regulations may differ on the issue of cash-based accounting versus an accrual system but it is important to ensure that the MFI is in compliance. A shift of accounting treatment from cash-based to accrual (or the reverse) can pose a challenge and should be carefully analyzed. For example, a shift to accrual-based accounting may introduce issues about reversals after a certain period on a nonperforming loan. Before shifting accounting procedures, the MFI must ensure the MIS is capable of either identifying such reversals or preferably automating them.

Tax implications may arise if interest income is accounted for on a cash basis. As part of the end-of-year process, the MFI may be required to accrue interest income for a certain period before calculating taxes due. This requires the ability to identify the interest portion of payments due for a specified period, which may not be straightforward depending on the way the system tracks payments (as principle only or principle plus interest).

Value added taxes (VAT) may also be applicable in some countries. If so, the system must be capable of automatically tracking VAT due from customers based on interest income or other fees. In instances in which interest is accrued, VAT may need to be accrued as well because VAT is what is payable to the authorities, rather than the actual amounts received from the customer.

Reporting

Regulatory reporting requirements generally affect all elements of the MIS. Reporting content and frequency may vary but generally comprise liquidity, capital adequacy, portfolio quality, financial position (balance sheet, income statement, cash flow statement), loans extended to insiders, and loan loss provisions. Frequency ranges from daily or weekly to quarterly. Late submission of reports may carry financial penalties for the MFI as would inaccurate reporting. Therefore, establishing the necessary business processes and maximizing alignment of the MIS with these processes is critical. See chapter 10, Financial Management, for more discussion on regulatory reporting requirements.

The ability of an MFI to meet regulatory reporting requirements is likely to be assessed as part of the application for an operating license, adding further importance to this area. Therefore, the MFI must identify all the data fields and reporting formats up front to ensure the application selected can meet the requirements or, alternatively, that the vendor (as a condition of the contract) can provide the reports or the capability to develop the reports going forward.

In identifying the reporting requirements, the MFI should confirm that it clearly understands the regulatory requirements and, of critical importance, that guidelines have been finalized by the regulatory body before commencing MIS changes. Once clarified, each required data element needs to be compared with those currently available in the system. If the required data is not currently collected, a format for collection will need to be designed and a decision made about what should be manual or automated. The volumes of data and the cost of collection will assist with this decision-making process, as will a discussion of the way in which information will be used. For example, reporting on clients' economic activity for sector-based risk analysis will require a high volume of data and therefore may

justify automation. In contrast, loans extended to insiders will generally be low volume and can be tracked using a simple spreadsheet.

Once mechanisms of data collection have been identified, the way in which the information will be processed and with what frequency must be determined. This includes consolidation of data from branches and any required calculations such as computation of capital adequacy. Clear responsibility for these processes needs to be established and may require cooperation from multiple departments including IT, branch staff, and head office. Despite these multiple responsibilities, one person should be responsible for overseeing the processes and for ensuring that reports are complete, accurate, and submitted on time. Table 11.4 outlines the process necessary to *design* reports to meet regulatory requirements.

Reports submitted to the regulator will generally need to be signed by the chief executive officer or the most senior accountant (or both), which implies that availability of these key people will need to be confirmed in advance of each submission. The method of submission may also have implications. If electronic submission is permitted, security measures such as electronic signatures may need to be established.

Submission of reports can give rise to ad hoc data requests from regulators, who may wish to investigate some element of a report in more detail. The nature and frequency of these requests cannot be predicted, so the MFI must have reliable access to reporting and database skills that can be promptly applied to these requests.

Efficient systems to collect, collate, process, and submit reporting information will reduce the risk of

Table 11.4 Design Process for Reporting

Task	Steps
Information gathering	Study the reporting requirements as set out in the law and its implementing regulations; review loan agreements, memoranda of understanding, and contracts with stakeholders to determine reporting requirements. Conduct staff interviews and site visits to assess what reports are currently generated, when they are generated, and how they are used.
External reporting policies	Draw up an external reporting compliance policy detailing a framework specifying who must produce what reports and when. Present the framework to the key staff responsible for its implementation.
Internal reporting policies	Draw up an internal reporting compliance policy, which should include recommended changes to internal reporting, its policies, and its procedures to clarify who must produce what reports and when. Establish a framework for action and monitoring once reports are produced and distributed. Present the policy to the key staff responsible.
Reporting matrices	Draw up a matrix of • mandatory external reports that the organization must produce once it is licensed; and • currently produced internal reports, who receives them, and when, and the value that they add or do not add.
Meet with regulators	Meet with the central bank to review the proposed reporting framework and ensure that the system, once modified as proposed, will meet all the requirements.
MIS gap analysis	Work with IT department to ensure that the information systems are in place to generate the mandatory reports and the reports are being produced and provided to the appropriate personnel. Identify gaps where the appropriate reports do not exist or where the necessary data are not collected and recommend solutions to fill gaps and implement.
Implementation	Train staff involved in implementation of the internal reporting policy and framework.

Source: Adapted from Enlaiten Ltd., from O'Keeffe and Frederick (2004).

missing deadlines or submitting inaccurate reports. All processes should be formally tested to identify any issues and, where applicable, backup procedures should be designed to ensure that loss of communication links, for example, does not jeopardize the ability of the MFI to comply. In addition, new reporting requirements may emerge over time and systems development will have to incorporate these changes. If a development effort must be launched each time new reports are required, or changes to existing reports evolve, how best to carry out these changes, either in house or through requests to the software supplier, must be determined. The latter option requires a responsive supplier that can rapidly turn around such requests. Ideally, with an integrated MIS, the MFI should have the capability to generate new reports through a user-friendly interface and the necessary in-house skills.

Operations requirements and regulatory requirements. Operational and management reporting requirements must be carefully balanced with those of the regulatory body. Information key to the organization, including operations, management and the board, must remain available even while changes are implemented to effect transformation. Identification of critical management reports and analysis of the data that make up these reports will help to ensure the availability of information. Table 11.5 outlines the process for meeting reporting requirements.

Expanding Outreach Services and Delivery Channel Technology

Transforming MFIs are often keen to examine and revise delivery channels to improve their outreach. Numerous initiatives emerging in the microfinance sector demonstrate how technology can help MFIs expand outreach and improve their services. Such upfront delivery channel options include ATMs or point-of-sale networks (for transactions), handheld computers (for remote data capture), smart cards (for off-line transactions and identification), biometrics (for authentication), and interactive voice response (for client access to account information) to name just a few. Each of these technologies has effects on the MIS.

Four main issues need to be considered with any delivery channel initiative: MIS stability, level of integration, information processing and security, and technology standards of the targeted delivery channel. In addition, MFIs must consider not only the increased outreach and additional convenience afforded to clients but also the timing and sequencing, and the capital and effort required to launch these initiatives successfully. Taking on too many large-scale changes simultaneously, particularly during the transformation process, is risky, overwhelming, and challenging for staff to manage. The IT task force is responsible for prioritizing such initiatives and allocating funding and human resources to ensure success and business value added for each initiative.

First, and perhaps most important, the stability of the MIS should be prioritized over new initiatives. If weaknesses are present in the existing system, the introduction of new services with associated new technologies and processes will probably add further instability to the system, jeopardizing both the MIS and the success of the new services. The stability of the system should be assessed from the perspective of both management and users, and from a technological standpoint. Only if all stakeholders can verify that the system is meeting their information requirements and can vouch for the capacity of the system and organization to absorb the change associated with a new initiative, should new projects be considered feasible.

The second consideration involves determining exactly how a new technology will interface with the existing or revised MIS. Such an interface typically involves a mechanism to transfer data from one application to another, for example, from devices such as handheld computers or ATMs to the main

Table 11.5 Process for Meeting Reporting Requirements

Task	Management information requirements	Regulatory reporting and other stakeholder information requirements
Needs assessment and agreement	Documentation of all management information needs including the required frequency of production of reports Agreement internally on the meaning of common terms Agreement of departments responsible for producing particular information Agreement of a policy on data integrity and completeness	Documentation of reports required, including their formats and due dates Definition of terms Guidelines on completion of reports Agreement of departments responsible for producing particular information
Analysis	Confirm that all data required can be captured in an appropriate and affordable manner Define and agree on report layouts for programmer to implement Define access rights for the various reports Determine the skill level required of the staff who produce the reports	Confirm that all data required can be captured in an appropriate and efficient manner; if not, determine the process to be used to obtain the information at a future date. Determine the skill level required of the staff producing reports. Work with a programmer to ensure defined reports are produced by the system.
Implementation process flow and procedures	Capture test data for input into the system Review reports produced from the test data Agree and make amendments needed for customization of system Test system-produced reports after customization Write guidelines for production of the system-produced reports	Capture test data for input into the system. Review reports produced from the test data. Agree and make amendments to report layouts. Define any system gaps and need for customization of system. Test system-produced reports after customization.
Review and evaluation	Coordinate meetings to review and accept system-produced reports and their accompanying guidelines	Coordinate meetings to review and accept system-produced reports and their accompanying guidelines.
Periodic audits	Internal Audit department to review the integrity of reports on a periodic basis	Have internal audit department review the integrity of reports on a periodic basis.
Reports	Produce matrix of internal reports with due dates and officers responsible Calendar prompting for reports to be produced and submitted Information on late submissions	Produce matrix of regulatory reports with due dates and officers responsible. Produce matrix of external reports with due dates and officers responsible. Have calendar prompting for reports to be produced and submitted. Supply information on late submissions.

Source: Adapted from Enlaiten Ltd., from O'Keeffe and Frederick (2004).

system, and possibly both ways. In designing an interface, or analyzing an MIS system that possesses an interface, alternatives for communications, security, and efficiency of the transfer process must be explored. If the internal MIS application requires development of a connector or interface, responsibility for this development must be clearly established. It cannot be assumed that the MIS software

provider will be willing, or able, to build the interoperability between the two technologies. At the same time, limitations on access to source code may prevent other programmers from building the interface. At a minimum, MFIs should look to use applications that follow standard protocols for data transfer, or off-the-shelf commercial applications should be given priority over proprietary options.

Third, MIS's ability to process and track transactions captured through new delivery channels needs to be considered. New services present management with an opportunity to better understand clients through a new source of information. Thus, delivery channel technology will affect not just the input requirements of the MIS but also the processing and output as well as security requirements. Ideally, the MIS not only interfaces with e-banking solutions but also incorporates the information from these sources as part of the overall information available to management to support its decisions.

Finally, the technology standards of the new delivery channel should be considered. For example, many countries have existing arrangements to share delivery channel infrastructure amongst member institutions—commonly called *switching networks*. The networks allow members' clients to transact via all devices (ATMs or POSs) on the network, regardless of which member owns the device. The device owner collects a small fee (called the interchange fee) for each transaction performed by another institution's client. Typically these delivery channels require clients to use a bank card (magnetic stripe or smart card) to gain access. By joining the network and adopting the same card specifications as the other switched network members an MFI can instantly give its members broad access to a delivery channel that it would not normally be able to afford on its own. Even in countries where no switching network exists, MFIs can still consider "white label" bank card arrangements, whereby an institution with an existing investment in infrastructure agrees to, for a fee, issue cards and process transactions on their access points (ATMs or POS devices) for the benefit of the MFI's clients. The bank cards can be labelled on the front with the MFI's logo. These type of shared infrastructure arrangements are only possible if compatible technology standards are selected for the delivery channel.

Infrastructure

Transforming MFIs recognize the importance of a solid infrastructure platform designed to support both growth and change. Systems already under strain cannot be expected to cope with increasing numbers of transactions, more complex data, and increasing communications requirements arising from regulatory reporting. An institution needs to have confidence in both the application software used as well as the hardware, communications, and other infrastructure required to run the MIS application. This confidence is characterized by system accuracy, trust by users in that accuracy, user-friendliness of the system, and ease of information retrieval to support daily operations.

Hardware

If new software has been selected to support transformation to a deposit-taking institution, generally hardware requirements then need to be identified and new hardware procured and installed, preferably acting on recommendations of the software supplier. Alternatively, if the existing software is to be retained, the hardware will need to be assessed for its capacity to support future levels of activity (within the context of new architecture design, initial use, and replacement plan). Analysis of the existing system should identify any hardware issues currently limiting the system and if feasible, systems load testing should be carried out to observe the way in which systems cope with increasing demands and to identify maximum capacity.

Information Communications Technology

Transformation places new demands on the MIS's ability to centralize information from different operating locations. Regulatory reporting requirements and liquidity management compel the head office to be aware of the position and performance of the MFI's branches with greater frequency and reliability. The current frequency of physical transfer of data may no longer be sufficient, prompting MFIs to establish a wide area network (WAN) that permits the electronic transfer of data between two or more locations. Various communication alternatives can support setting up a WAN. Determining which is most suitable for the MFI requires balancing factors such as cost, transmission speed, and reliability. Other factors beyond regulatory requirements drive decisions (and justify the cost of a WAN) to centralize control of data—increased data integrity, better risk management (increased security, decreased fraud), branchless banking, version control, and easier customer information access. WANs leverage IT resources and facilitate easier analysis of data for new product development, marketing, and strategic planning. A WAN also enables better communications across a geographically dispersed staff, easier coordination scheduling, easier information dissemination, alternative training options, better virtual project management, and generally better staff monitoring and institutional oversight. Each of these drivers must be considered when designing the new technology infrastructure.

Availability of telecommunications alternatives will vary considerably from one country to the next and are constantly changing as new technologies emerge and regulations governing their use change. Some of the typical alternatives include dial-up, leased line (copper or fiber optics), wireless, and satellite. Each MFI will need to investigate which alternatives are available to them and then rate them according to reliability, speed, and cost. Additional considerations include interoperability with existing and planned hardware and software applications, availability of support (in-house versus external), supplier reputation and general customer service, and the cost of backup strategies. A short list of vendors should be given the opportunity to demonstrate their services so that they can be tested, especially where the technology or service is relatively new.

Communications requirements need to keep in mind both current and future operations and services to ensure the communications infrastructure is flexible enough to cope with both change and growth. Given the importance of communications and the costs of alternatives, the selection of a communications supplier or telecommunications alternative should follow the same structured decision-making process as the software selection process. Requirements must be analyzed and alternatives identified. The decision should be based on an established set of criteria including strengths, weaknesses, and implementation requirements, to ensure that the connection will operate as intended. Senior management, with input from technical experts and the IT task force, should be heavily involved in the decision-making process.

Power

When upgrading systems during transformation, the availability and quality of power supplies must be considered. Protection against power surges can be achieved either through use of a universal power supply (UPS) or a stabilizer attached to the main power supply. Although both protect against unstable power supply, only the UPS will provide backup power in the event of full failure. Generators or battery-powered inverters could also supply backup power. Of all these options, only the inverter will ensure that low levels of power will be supplemented. Each of the options has associated costs that need to be weighed against the possibility of losing data or losing access to real-time data if there are power outages.

MIS Security

Security consists of measures taken to protect the MIS, both physically and logically, from any event that may compromise the integrity of the information produced by the system, or may contribute to the unavailability of the system. This includes protection against unauthorized access, system misuse, and physical or software related failures. Protecting the technological and information assets that make up the MIS is an ongoing concern for those responsible for IT. Transformation, however, may highlight security issues from the perspective of both regulators and potential investors.

MIS Security Policy

A transforming MFI should develop a comprehensive IT security policy outlining its policies and procedures. The IT security policy should identify risks to the systems and provide an analysis of the likelihood of occurrence and impact on systems. Risks include active threats that arise from intentional misuse of the system, and passive threats such as system faults or natural disasters. Policies and procedures should demonstrate the controls to mitigate the likelihood or impact of these risks. Finally, a security log should be kept to show how the security policy has been implemented and updated over time to address changes to the security environment. Any new policies should be reflected in the document.

Control Environment

An MIS can be controlled by a combination of application controls and general controls, both of which seek to limit the likelihood or impact of breaches in security.

Application-based controls are set by and depend on the features and programming of the MIS. Because application controls are software-specific they may be beyond the MFI's ability to design but should be analyzed when assessing the security features of an MIS. Ideally, application controls should cover data input, processing, and output, and include procedures such as error handling, input validation, and control totals. Standard feature requirements for any MIS application include tracking every user on the system with a user-defined profile, transaction type, date and time stamps, as well as restrictions. Profiles should be easily established by role (loan officer, teller, branch manager) as well as by feature (loan disbursements, new applications, savings account look-up). The application should also include basic utilities and restrictions to ensure proper administration of and access to the application and the corresponding database. Only users with high-level clearance should be authorized to access these capabilities.

General controls consist of hardware, software, and manual procedures that create a control environment. Table 11.6 lists some common general controls used by MFIs.

Human Resources Implications

Many of the issues discussed in this chapter require an MFI to have sufficient access to the appropriate IT resources. The MFI must ensure that the correct mix of technical, management, business, and interpersonal skills are held by those charged with responsibility for the MIS. Supporting hardware, software, and MIS users can be a time-consuming task requiring a mix of skills. Increasing the use of technology throughout the MFI will have a concurrent effect on the levels of support required. Whether support is provided by an in-house IT department, or contracted to a third party, an efficient ratio of support personnel to users should be maintained. This ratio will be influenced by the extent of the users' technical experience but generally can be determined through analysis of support

Table 11.6 Typical General Controls

Type of control	Description	Sample controls
Physical	Protects against physical hazards and unauthorized physical access to systems	Restricted access to key hardware and to storage locations; protection from hazards; fire extinguishers, and power surge protection
Logical	Protects against unauthorized access to systems	Network and database security including passwords and access controls, encryption during data transfer, and audit trail
Human	Protects against unintentional damage resulting from user actions	Training, organizational culture fostering security
Implementation	Protects against exposing the system to additional risk as a result of systems development	Formal change control procedures, testing, documentation to support changes
Operational	Protects against failure of systems and security measures	Routine systems maintenance and monitoring, data backups, disaster recovery planning, and IT Internal Audit

Source: O'Keeffe and Frederick (2004, p. 29).

calls received. A database of support calls can assist with the support function, enabling prompt resolution of calls through identification of common fixes and known issues.

Additionally, transformation puts pressure on those in leadership roles in IT, because of demands to take advantage of technological alternatives to help the MFI achieve its goals. MFIs that have experienced gradual adoption of IT may need to take stock of available resources to ensure that the capacity of the MIS to support and grow with the organization is not jeopardized by a lack of appropriate skills. Leveraging consultants for discrete tasks, using available local support services when required, and using application support services are alternatives to building internal capacity. Still, providing professional development opportunities for technical staff will be critical for keeping pace with the rapid changes in technology and staff desire to keep skills up to date.

IT Staff Issues

The ability of an MFI to attract IT staff will depend on the market availability of IT professionals as well as competition for these skills from other employers. Competing with private sector salaries may be beyond the means of many MFIs but some effort to recognize the competing salary scale may help both attract and retain staff. In many instances, IT departments suffer from high staff turnover. Although the loss of any experienced staff can be detrimental to an MFI, loss of an experienced IT staff member can leave the organization at serious risk, particularly if systems are not formally documented. Ensuring that MIS responsibility and knowledge is managed to avoid over-dependency on a limited number of staff members, as well as ensuring systems are well documented, can help to protect against such risk.

Providing technical training to employees of the MFI is a major responsibility for the MIS department, particularly as the MFI goes through transformation. In addition, however, senior management and business unit managers should fully understand the system and ensure that its ability to manage is not compromised by a lack of technical comprehension. Management training will help ensure that ownership of the MIS lies with those that depend on its information, namely

management. Perhaps the most important goal of investing in management technical training is to ensure that technology becomes firmly integrated in the organization recognizing the ways in which IT can help accomplish existing business goals and objectives as well as identify new opportunities.

Technical training needs are likely to be continually in demand and constantly evolving, and therefore should be addressed as part of the human resources (HR) training function. Depending on the extent and frequency of training courses, trainers may be outsourced or identified from existing IT staff. If internal staff is used, care must be taken to ensure that those with technical understanding also have the necessary skills for imparting this knowledge to others. It should not be assumed that all IT workers make effective trainers.

HR Information Systems

In light of expanding staff numbers, transformation may be an opportunity to equip HR departments with a system for personnel records, if such systems do not already exist. Whether an off-the-shelf application or developed in house, a personnel records system should provide the necessary functionality to track and manage personnel, and include competency profiles, performance history, training, salary, benefits, and personal information. Additionally, payroll functionality should be available either as part of the HR information system or through the MIS itself.

Box 11.6 presents some of the lessons learned from MIS upgrade projects during MFI transformations in Uganda.

Annex 11D provides a summary checklist of MIS considerations for use by transforming MFIs.

Box 11.6 Lessons Learned in Uganda

Key lessons learned through the process of transformation related to MIS in Uganda include the following:

- Ensure all senior management own and lead the decision-making process for the MIS upgrade initiative. The organization as a whole must buy into the vision for the MIS and not view it as an IT project. All costs must be sufficiently prioritized and evaluated to determine the economic value added for the investment.
- Clearly and thoroughly document all phases in the MIS upgrade process, for both internal and external purposes.
- Establish clear requirements for the MIS before and after transformation. This should be achieved through consultation with all stakeholders and consider both short- and long-term impacts of transformation.
- Ensure central bank guidelines are finalized before starting any software modifications. Definitions of terms used within regulations should be clarified with the regulators to avoid any errors during interpretation.
- Map out and plan the activities required for an MIS upgrade project to help ensure that the transformation process is not held up by any "forgotten" requirements and that management is aware of the extent of work required to transform the MIS.
- Do not underestimate the time and resources required to prepare IT and MIS documentation. Multiple inputs and revisions may be required if documentation raises policy issues that must be addressed at the organizational level.
- Do not underestimate the timing necessary for arranging suitable housing for hardware, particularly when teller services are being established. Renovations, stabilizing electrical sources, and networking involve reliance on external suppliers that may adversely affect the MIS transformation plan; therefore, it is critical to have

(*Continues on the following page.*)

Box 11.6 Lessons Learned in Uganda (*Continued*)

contingency plans and to initiate these steps as soon as possible.

- Consider trends in telecommunications evolution and affordability when designing systems so that even if not currently feasible, systems implemented will not limit the flexibility to incorporate additional connectivity as it becomes affordable.
- Ensure that access to a range of IT skills is available either in house or through a reliable outsourcing arrangement. Skills should include a mix of technical specialists, business analysts, technical trainers, and management with an overall vision for the role of technology in the MFI.
- Dependence on software suppliers to make continual customization changes can slow down the MIS transformation process considerably. Availability of programming capacity in house can help MFIs reduce such dependencies and is especially recommended for the report development function.
- Formalization of systems to support IT capabilities and services should be included as part of MIS transformation. This includes hardware deployment, user support, systems security, IT audit, and systems change control.
- Flexibility and scalability of the MIS software are two of the most important features to address transformation needs.

Source: O'Keeffe and Frederick (2004, p. 35).

Annex 11A Sample Requirements Document

This sample requirements document was contributed by Samuel Richard Mutebi, FRIENDS' Consultant, May 2006.

To transform into a regulated deposit-taking institution, MFI A needs to upgrade its MIS to efficiently meet the needs of its growing client base and to comply with regulatory requirements. This document contains an assessment of the existing management information system (MIS) and provides specifications for a new system to meet MFI A's information processing, monitoring, and regulatory requirements.

Current Management Information System

MFI A currently operates with an ad hoc computerized system. Loan tracking is performed manually. Reports are manually compiled using MS Excel at the head office. MFI A has off-the-shelf accounting software for accounting operations, which is run in parallel with the manual system. All branches are connected to cellular telephones for communications.

Accounting system. The system handles all accounting functions by tracking financial and nonfinancial transactions, handles budgeting, and generates scheduled and ad hoc reports as well as other documents. The system is designed in modules with the general ledger as the central accounting module for summarizing and posting accounting transactions. Modules can be purchased separately.

Modules include the following:

- General ledger
- Accounts payable
- Purchasing
- Order processing
- Project controller
- Account receivable
- Inventory
- Cash manager
- Payroll

Security management and control. The computer is in the accounts department and the accounting software has the following security features:

- Access to the system is controlled by user definable password.
- Categories of users are assigned by specific job description, which enhances internal controls.
- A password protection feature allows division of responsibility.
- An audit trail shows transaction details and the user who completed the posting.

Database management system. MFI A's system is hosted on a Microsoft SQL server database management system.

Hardware. The system is running on a stand-alone personal computer (PC) with 128 MB RAM, 2 G HDD, and CD drive. Backups are stored on 650 MB CD. There is one universal power supply (UPS) and a LaserJet 2100 printer.

Procedures and documentation. Easy and detailed user and operations manuals are available for reference. However, they are not updated to incorporate site modifications and enhancements.

MIS to Be Implemented

MFI A will purchase an appropriate banking system to handle loans, savings deposits, and other financial products. Improving the system will involve migrating the accounting system to a local area network (LAN) and abandoning the manual system.

Software. The banking system to be purchased will be installed in branches and other units responsible for providing financial services to clients. A database

program and report writing tool will be installed at head office to host and analyze data from all the branches and units. It will generate consolidated reports for management, regulators, and other authorized stakeholders.

The system to be procured should meet the specifications outlined below in addition to other functional features.

Loans
- Process both individual and group loans.
- Keep track of repeated loans.
- Handle up to 100,000 accounts.
- Define loan code to identify loans with same characteristics (for example, interest rate, term) within a particular loan product.
- Allow amortizations on weekly, monthly, quarterly, and annual basis.
- Control minimum and maximum loan disbursement.
- Allow variable grace periods.
- Allow flexible interest days in a year.
- Calculate fees, charges, and penalties.
- Allow flexibility in defining minimum and maximum terms.
- Allow both cash and accrual treatment of income.
- Allow both fixed and floating rates and flat and declining-balance interest calculation methods.
- Allow flexibility in accruing interest with respect to date.
- Allow flexibility in posting interest with respect to date.
- Provide ability to fix interest rate at both product and account level.
- Allow biometric verification.

Savings and Term Deposits
- Handle both voluntary and compulsory savings.
- Have account opening minimum amount.
- Have a possibility of authorized overriding of the above minimum amount.
- Allow joint accounts.
- Observe processing of fees and other charges.
- Have a number of transactions permitted in a given period.
- Prepare standing orders and instructions.
- Have a minimum and maximum interest-earning balance.
- Use tiered interest.
- Have variable interest days in a year.
- Have flexibility accrued in interest.
- Provide early withdrawal penalty.
- Allow flexibility on interest posting date.
- Use photo and signature verification.
- Have biometric verification.

Customer Information
- Individual, individuals in a group, and group
- Nonperson entities
- Personal, home, and business information
- Memo field to capture complementary information not handled in standard fields
- Client status (normal, delinquent)
- Group information
- Modification of client information
- Ability to delete client information with authorization

Collateral
- Allow both physical and financial assets.
- Record value of security, valuation date, and expiry date.
- Provide description of the security.

Input and processing
- Real-time transaction processing
- Both single and batch data entry
- Front- and back-office facilities
- Cash and check deposits
- Accept other bills
- Interaccount transfer
- Event-triggered transactions (penalties)
- Periodic computer-generated transactions (interest)

Inquiries
- Loan balance (principal, interest, and charges)
- Overdue payments (principal, interest, and charges)
- Loan statement
- Loan repayments

- Loans financial data
- Loans nonfinancial data
- Collateral
- Savings balance
- Client information
- Credit history

Reports
- Listing of loans
- Collection report
- Delinquency report
- Portfolio at risk report
- Performance report by credit officer
- Client's status report
- Portfolio at risk by aging analysis and business activity
- Loans profile by gender
- Ad hoc report facility

Security management and control
- Access to the system controlled by definable password
- User groups that access only those menus relevant to their functions and responsibilities
- Dual control on key transactions
- Change of password at any time
- Detailed audit trail
- Built-in backup procedures

Infrastructure and hardware

Database

Database should be a relational open database management system. Servers and client PCs together with the necessary computer accessories and electrical equipment will be procured to support the new software.

Architecture

The branches will have LANs of about five PCs depending on the size of business and volume of work. The banking system will be installed on those LANs in a decentralized environment. The integration between the new banking system and the accounting system residing on the head office LAN will be through a flat file. Both systems will be uploaded to the database at head office periodically.

Communication

The intention is to use wires access point at head office. Cellular data units will be used periodically to transfer data from branches to the head office via an Internet service provider (ISP). Transfer of data and reports from branches to head office will be through e-mail, file transfer protocol, and in exceptional cases, diskettes and hard copies.

Electrical Installation

The electrical system will be reinstalled to match computer network requirements. Appropriate universal power supply (UPS) will be used to ensure clean power supply. Generators will be installed in branches and head office to avoid disruption in operations from power failure.

Budget

The estimated total budget is approximately U.S.$600,000.

Annex 11B Sample Terms of Reference: MIS Assessment and Software Selection

Background

Background on the organization including its mission, target market, client outreach, portfolio size, and so forth.

Objectives

MFI A understands that its current management information systems (MIS) are inadequate to meet regulatory requirements and to support operations as a deposit-taking financial intermediary. It believes that improving its MIS is key to receiving its license to operate as a deposit-taking intermediary.

Phase I: Needs Analysis

The objective of this assessment is to review MFI A's institutional needs for an information system and use information elicited from the institution to prioritize its information technology (IT) requirements. Members of staff from the IT and operations departments will be available to work as members of the Needs Analysis team and assist in conducting an inventory of the institution's current information systems.

Tasks

- *Assess information flows:* using a mix of interviews, observation, and review of documentation, assess the information flows within the institution and the workflows that result in the capture and use of information.
- *Compare institutional documents with observed practice:* Determine and document any gaps between actual observed processes and the institutional policies and procedures manual currently in place.
- *Investigate technical and budgetary constraints:* Work closely with MFI A's IT and finance managers to gain a deep understanding of the institution's current and future technology environment as a licensed institution, as well as the budgetary implications for the implementation of the recommendations.
- *Prioritize initial requirements and features:* Using a workshop format, work with staff representatives to categorize the list of initial requirements and define a list of essential, useful, and optional features for an ideal information system.

Deliverables. A Needs Analysis report outlining institutional needs is the main deliverable, and it should include the following:

- Summary of current processes with descriptions
- Summary of reports used or required
- Proposed improvements and future needs, including meeting regulatory reporting requirements
- System requirements and technical environment
- Draft budget including hardware, software, implementation costs, and recurring annual costs

Phase II: Software Evaluation

The objective of this evaluation is to assess the quality and suitability of the current software application for MFI A's operations and reporting requirements.

Tasks

- *Review application's functionality:* Thoroughly investigate the significant features of the software and investigate any deficiencies in its operations. Drawing on knowledge of the functionality available in commercial microfinance packages targeted for institutions similar to MFI A, develop a comparative matrix of functionality. This matrix should indicate commonly available features that are either missing or poorly implemented in the current software, and highlight any functionality that is well-designed and implemented.
- *Assess application design:* Assess the application design and determine whether the software design, the technological platform, and

development tools conform to current and emerging standards.
- *Conduct user satisfaction interviews:* Conduct a series of interviews with current users to determine their levels of satisfaction with the application, in particular the user interface and reports produced.
- *Review the technical support process:* Investigate existing procedures for the resolution of software bugs, the procedures for incorporating new functionality, and the skills of the teams responsible for both tasks.
- *Review documentation:* Obtain copies of all documentation available for different categories of users (such as user manuals, system administration manuals, and online help) and assess their quality and suitability.
- *Assess future direction:* Evaluate various options for the future direction of the software, including continued internal development and support of the current application, or shift to an off-the-shelf package.

Deliverables. A Software Evaluation report will be the main deliverable, and should include the following:

- A list of the main features of the software application, indicating which work well and which are inadequate for the institution's needs as a regulated MFI
- A list of key features that are missing
- A summary of user interviews, indicating overall level of satisfaction
- An assessment of the quality of the software design and technical support process
- Recommendation for future direction for the application

Phase III: Software Selection

The objective of phase III is to enable MFI A to evaluate and select software that will best suit its needs and requirements.

Tasks

- *Ensure needs analysis is complete:* Assist MFI A in evaluating and thoroughly understanding present and future needs ensuring that a needs analysis report with the appropriate level of detail exists.
- *Construct a short list of possible vendors:* Using the list of available vendors from the CGAP Web site or other sources, identify three vendors who are able to meet MFI A's requirements. Create a detailed questionnaire and contact selected vendors to obtain information about the capabilities of their products.
- *Review vendor information:* Review information received from vendors and assess the fit of the software functionality against MFI A's institutional requirements, using a framework structure such as that available on CGAP's Web site.
- *Recommend one supplier:* Conduct further due diligence to assist MFI A in narrowing the choice down to one vendor; thoroughly review the cost elements of the implementation proposal, highlight any areas of hidden costs, and determine a realistic budget for the implementation. Ensure the services offered under the implementation are comprehensive and appropriate. This may require further in-depth research on the products and vendors, reviewing a demonstration version, and contacting current clients of each product.

Deliverables. There are three deliverables required for phase III:

- Request for Information: a detailed questionnaire for short-listed vendors to complete
- Software comparison matrix document with summary of product functionality presented in a format that allows for easy comparison
- A recommendation for one selected vendor's proposal, listing proposed services to be provided, with the associated costs

Optional deliverable: If time permits, assist MFI A in preparing a proposal for donor or investor funding to cover the costs of implementation of consultant recommendations, further consulting services, or procurement of software and hardware.

Qualifications

- Degree in information technology or related field
- At least five years of experience as an information technology manager for a commercial bank or microfinance institution
- International consulting experience in management information systems

Level of Effort

It is estimated this assignment will take up to 50 days to complete.

Annex 11C Sample Terms of Reference: Advisory Services on Implementation of MIS Upgrade

Background

Background on the organization including its mission, target market, client outreach, portfolio size, and so forth.

Objectives

To achieve and maintain a license as a deposit-taking financial intermediary, MFI A must demonstrate that it prepares and maintains adequate books of accounts, records, computer systems, and other nonfinancial records that show a true state of affairs, and that comply with international accounting standards. The adequacy of this MIS will need to be approved by MFI A's External Auditor, and verified by the regulator through on-site and off-site inspections.

MFI A has determined it needs to upgrade its MIS to meet the requirements as a regulated deposit-taking institution. The objective of this consultancy is to assist and advise MFI A in the upgrade process.

Tasks

The consultant will work with the in-house MIS department headed by the MIS manager. The tasks outlined below will be implemented in two parts. The first part is estimated to take 20 days and will consist of the following tasks:

- Develop a transition plan from the current working environment to the new environment with due consideration for MFI A's resources, technology, and caliber of staff.
- Work with the vendor to develop an implementation plan for installing, testing, and rolling out the new software systemwide.
- According to the new system's requirements, ensure that the data in the old systems are able to transfer to the new system. Provide MFI A's MIS manager the necessary data transfer risk information so the latter is able to see inconsistencies or gaps in the data, as well as oversee the correction of the data so that a complete, "clean" dataset is available for migration.
- Assess readiness of test sites (hardware, communications, electricity, and the like).
- Review the vendor's training plan to ensure that staff receive the appropriate training.
- Ensure that the MIS department has the full capacity to oversee the migration of data to the new system so that the test site becomes fully operational. The old systems should continue to operate in parallel to provide a foundation for evaluating the output of the new system and for fall-back purposes.
- Provide the MIS department the technical capacity to test user acceptance at the pilot site(s).
- Assess vendor's user manual for completeness and understandability.
- Provide the MIS department information on proper rollout of the system to all branches.

The second part, to be done four months after the commencement of system installation, is estimated to take 10 days and will consist of the following tasks:

- Compare the output from the new system to that of the old system. Evaluate the new system. If acceptable, recommend to MFI A that it cease processing on the old system.
- Conduct system audit to determine full compliance of the new MIS with law and regulations. If there are gaps, work with the vendor and MFI A's MIS department to resolve the gaps. Where appropriate, request modifications of the system.

Deliverables

- Transition plan
- Implementation plan for installing, testing, and rolling out the new software systemwide

- Technical guideline for the MIS department to oversee data migration and data transfer risk information
- Preparation of the test sites
- Appraisal of vendor's training plan on system use
- Technical guideline to ensure that the MIS manager has full capacity to test user acceptance at the pilot site(s); suggest additional training as necessary or, where appropriate, request modifications of the system
- Assessment of user's manual
- Rollout plan for the entire branch network
- Facilitate the process of addressing user comments and requests for modification in a timely manner
- Comparison of output of new against old system
- System audit to determine full compliance of new system to law and regulations

Qualifications

- Degree in information technology or related field
- At least five years of experience as an information technology manager for a commercial bank or microfinance institution
- International consulting experience in management information systems

Level of Effort

It is expected that approximately 30 days will be required to complete this assignment.

Annex 11D Management Information Systems Checklist

General

- Have the central bank licensing requirements been confirmed as they relate to the MIS?
- Have the central bank licensing requirements been fulfilled as they relate to the MIS?
- Does the MIS comply with the accounting treatment specified within the regulations?
- Can the MIS produce all regulatory reports in a time frame that is acceptable to management?
- Are there are any issues with the accuracy of information contained within any of the regulatory reports produced by the MIS?
- Have backup processes been identified and tested to ensure that loss or failure of any part of the MIS does not jeopardize the ability of the MFI to meet reporting requirements?
- Have disaster recovery procedures been implemented and tested to ensure that loss or failure of the MIS would have an acceptable impact on operations?
- Are the necessary operational reports, as identified by management, available and reliable?
- Have all new savings products been fully tested in the MIS, including reporting requirements, and are any MIS-related issues preventing their availability?
- Is the capacity of the IT department sufficient to support and maintain the MIS in a controlled manner?
- Has MIS security been deemed sufficient, with appropriately designed controls, as verified by Internal Audit and management?
- Have procedures been established and tested for system change control? Is there confidence that system updates and changes will not jeopardize the availability of the MIS?
- Has the MIS taken into consideration predicted rates of growth and does it have the scalability and flexibility to support the MFI for at least the next five to seven years?
- Have users of the MIS received sufficient training and are they fully aware of how the system should be used or have a clear path for becoming properly versed?
- Has an IT governance structure been established with clear means for vetting technology choices?
- Have communication procedures been established between the IT department and management to facilitate a regular exchange of information to ultimately ensure that IT and business strategy are well aligned?
- Have any e-banking or delivery channel initiatives either in place or being considered been properly sequenced so as not to adversely affect the availability and reliability of the MIS during the transformation period?

System Design

- What MIS strategy will strike a balance between security and customer service?
- How can technology further the strategy via processes and policies?
- What data should be centralized and standardized?
- What features and capabilities should be centralized and standardized institutionwide?
- What features and data should be defined at the department, branch, and account levels?

Handling of Interest in the Loan Portfolio Portion of the MIS

- How does the regulator require overdue interest to be accounted for? How does this compare with the MFI's existing treatment? Does the system have the functionality to treat interest income in this way?
- If overdue interest is placed in an "interest in suspense" account, how will the system process recovered payments? Is it possible to age interest in this suspense account?

- If the regulator changes its requirements for the treatment of interest on any loans, how flexible is the system for handling variations to the current treatment? Can the user make required system changes or is programming by the vendor required?
- Are there tax regulations that require a different treatment of interest other than that stated by regulator? If yes, how will these tax regulations be dealt with?

Loan-Loss Provisioning

- What is the regulator's policy on provisioning? How does it define terms used (risk amount, for example)? What aging categories are required?
- How do regulatory requirements differ from current provisioning policies?
- Can the current system be configured to automate the provisioning process? If yes, how can the accuracy of the provisions be checked? If no, what manual system will be developed to support the provisioning process?
- Are additional reports required to assemble the necessary information for loan provisioning? If provisioning will require manual input to another system how will this be reconciled with the loan portfolio system and the general ledger?

Aging of Arrears

- What age brackets does the regulator require and how do these compare with those in the current or future system?

Exiting Clients and Dormant Accounts

- Do regulations require reporting on exiting clients? Is there a system in place to monitor these clients? If yes, is it adequate to meet regulatory needs? If not, what are the requirements and how could they be reported by the system?
- What are the regulations on dormant, unclaimed, and abandoned accounts? How are these defined, and how must they be tracked? At what point, if any, must balances in these accounts be turned over to the central bank?

Restructured Loans

- Are loans restructured? If yes, how does the system deal with restructured loans? Are they tracked and aged separately from normal loans?
- How can the application be used to ensure enforcement of restructuring policies and proper tracking for aging and provisioning?
- Is the system capable of provisioning on restructured loans?

Additional Client Data

- What customer information does the regulator require?
- Does the MIS have the ability to store the data?
- If it is not currently collected, what processes will be used to collect this information from both new and existing clients? Will clients need to be contacted individually to collect this information?
- If it is collected, how accurate is the existing data and does it fit in the required categories?
- What additional customer information might the MFI need to collect to ensure sufficient market intelligence for product development and risk management in the new transformed operating environment?
- What priority has been assigned to collecting this data if there are resource limits?

New Savings Products

- Are procedures in place to involve the MIS department in the development of new products?
- Can new products be introduced without programming efforts?

- How extensive is the product definition interface?
- Are the criteria and options identified as current and future requirements available within the system? If not, which are missing and how critical are these?
- Have all aspects of the product been fully tested on the system—interest calculations and fees, for example?
- Are the necessary reports available to track progress and operations of these products? If not, can reports be designed in house or will they require programming effort?
- If an in-house report generation tool is available, is the necessary data held in the database?

Savings Product Criteria

- What criteria are required to define savings products in the MIS? Are these criteria currently available in the MIS?
- Are all required options available for each criteria?
- If additional criteria exist in the system that have yet to be defined in the policy for the product, how will these criteria be established? (How should dormant accounts be treated, for example?)

Compulsory and Voluntary Savings

- Do voluntary savings accounts and compulsory savings accounts require different defining criteria within the MIS (that is, different product definition interfaces)? If yes, how will the MIS application support the different criteria of each product?
- What controls are available to prevent unauthorized transfers from voluntary savings accounts to service loans?
- Will forced savings accounts be retained after transformation? If not, what will happen to the existing accounts?

Customer Access to Account Information

- What information do customers want? When? With what frequency?
- What is possible for the MFI to produce, taking into account available resources, client satisfaction, and security?
- What method will be used for customers to track their account transactions? What implications does this method have on cashiers and front-office IT, processes, and policies? Are all the necessary resources for this method readily available—for example, printers, paper, cards?

Fraud Prevention and Detection

- What mechanism will be used for client identification at the time of withdrawals and how does the system support this?
- What is the state of Know Your Customer regulations in the country of operation?
- What are the implications of these requirements on the MIS?

Current Accounts and Overdraft Facilities

- Will checking accounts be offered?
- How will checks be administered?
- How will the MIS handle check-based transactions, for example, capturing check details on the system at the time they are received?
- What are the central bank regulations regarding current accounts? How will these regulations, and the market in general, influence product design and processes?
- Have all processes to support these products been carefully designed and tested (checkbook administration, check returns, stop payments, movements to and from clearinghouse, clearing, reconciliation with clearinghouse, reporting, and the like)? How will the system support charges associated with these accounts (cost of checkbooks, counter checks sold, stamp duty, and

charges associated with stopping payments on lost or spoiled checks)?
- Are overdrafts allowed on these accounts? What will be the process for approving new overdrafts? How will the quality of overdrafts be monitored (frequency of credits, proximity of balance to limit, or other)?

Interbranch Banking

- Are interbranch transactions required?
- What is the current customer and market demand for easy, convenient access to savings accounts?
- What systems, manual or electronic, are in place, or could be installed, to handle these transactions?
- Are there opportunities to develop branchless banking?

Teller Services

- Are teller services currently available? If yes, will they need to be changed to accommodate increased transaction volume arising from additional products and growth? If not available, how will they be accommodated?
- Is the physical location suitable for the hardware required?
- Have cashier procedures and supervision tasks, and the way in which the system will support these, been defined?

Hardware

- What are the software supplier's recommended specifications for client machines?
- What server is required?
- What is the projected size of the MIS database in one, two, and three years? What size hard disk and what processing capacity are required to support this database size?
- Does the size of the network warrant a dual processor?
- Will a redundant array of independent (or inexpensive) disks (RAID) be used to protect data against hard disk failure?
- What will be the limiting factor in the speed of the system—the network or the hardware? (If network is slow, there is no point in investing in a top-of-the-line server, for example.)

Information Communications Technology

- How frequently will communications be required—periodically or continuous (real-time connection versus batch uploads)?
- What will be the typical size of the data being transferred?
- How many locations need to be connected?
- What information communications technology infrastructure is available?
- What level of reliability is required? How will the business be affected if the communications link becomes unavailable for different lengths of time?
- What information needs to be sent—entire database or just partial records? How might these requirements change over time?
- What specifications of the new system, other than data transfer, rely on or could leverage connectivity? What are the specific requirements? What is the priority ranking of these additional connectivity requirements?

Power Supply

- What is the quality, strength, and reliability of the power supply at each location?
- What are alternative sources of power?
- What additional power hardware is required to ensure a stable and reliable source of power?
- What MIS hardware options have the lowest power requirements?

- What power hardware options are the most durable for the price?
- Which power hardware options have the longest life or lowest replacement?

Notes

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1. Although not discussed directly in this chapter, there is a growing trend to try to "outsource" and share as much as possible certain services, particularly MIS. Buying MIS services and processing, thus avoiding the need for substantial investments and constant upgrades, or "sharing" MIS and back-office tasks among several MFIs, is now being done by some transformed MFIs.
2. CGAP IS website: http://www.microfinancegateway.org/resource_centers/technology.
3. See CGAP IS Fund http://www.isfund.org/.
4. See CGAP IS Site http://www.microfinancegateway.org/resource_centers/technology/iss_software/ for tips on negotiating a software license.
5. The CGAP Technology Resource Center maintains information on over 60 MIS options for microfinance institutions. See http://www.microfinancegateway.org/resource_centers/technology/iss_software/.
6. Bankers Realm is a banking software product developed and marketed by Craft Silicon and installed in various MFIs and smaller banks throughout East Africa and other locations (http://www.craftsilicon.com).

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Chapter 12

Internal Control and Audits

Expanding funding sources to include client savings; adding cash handling through on-site tellers; and committing to consistently report timely and accurate financial, portfolio, and outreach information to regulators and other stakeholders are just a few of the changes inherent in most microfinance institution (MFI) transformations. Each of these changes significantly effects the level and nature of risks faced by the MFI, requiring commensurate changes in its internal control system.

Risk management should be proactive and anticipate risks before they are experienced. *Internal controls* manage risks before they happen (preventive control) and measure to what extent the risks have occurred (detective control). *Internal audits* assess the adequacy of internal controls and how well risks are being managed.

> Internal control is a process, effected by an entity's board of directors, management and other personnel, designed to provide reasonable assurance regarding the achievement of objectives in the following categories: effectiveness and efficiency of operations; reliability of financial reporting; and compliance with applicable laws and regulations (COSO http://www.coso.org/key.htm).

Internal controls form an integral part of the overall risk-management framework in a financial intermediary. Although various risks MFIs face have already been discussed in this book—primarily in chapter 2, Regulation and Supervision: The Policy Framework, and chapter 10, Financial Management—this chapter specifically addresses risk management through internal control systems. To assist transforming MFIs in implementing the appropriate level of internal controls, this chapter begins by presenting the critical components of an effective internal control system. It then focuses on one of the primary risks of weak internal controls—fraud. The chapter then highlights the particular preventive controls (designed to avoid an unintended event or result) that MFIs can put in place to maintain reasonable levels of risk, as well as the detective controls (designed to discover an unintended event or result) that provide a warning system for existing problems requiring closer investigation. The chapter concludes with a discussion of the role of the supervisory agency in evaluating these internal controls.

Components of Effective Internal Controls

The internal control system adopted by an MFI needs to ensure, as far as is practical, the orderly and efficient conduct of business. Internal controls are most effective when they are directly incorporated in the processes that support operations and enable a quick response to changing conditions. For a system of internal controls to be effective, the following elements must be present:

- Honest and capable employees
- Clear delegation and separation of duties
- Proper procedures for processing transactions
- Suitable documents and accounting records
- Adequate physical control over assets and records
- Independent verification of performance

These key elements work together to achieve a foundation for sound internal control through directed leadership, shared values, and a culture that emphasizes accountability for control. Most nongovernmental organizations (NGOs) operating as credit-only institutions have some of these elements in place—in fact, it would be difficult to operate successfully and sustainably without some degree of controls. However, with the addition of savings services and the requisite handling of cash (which some credit-only NGOs avoid at the field level), as well as the requirement to comply with regulations, these elements become imperative to the success of the transformed intermediary.

Because of their importance in risk mitigation, specific internal control requirements are typically included by regulatory authorities in the licensing and ongoing operational requirements of the transformed MFI (Campion 2000). The Basle Committee on Banking Supervision[1] in its paper "Framework for Internal Control Systems in Banking Organisations" (1998) identifies five main categories of common internal control breakdowns, most of which can be directly correlated with the lack of one of the above effective internal control elements, and all of which are relevant for deposit-taking MFIs:

- Lack of adequate management oversight and accountability, and failure to develop a strong control culture within the bank
- Inadequate recognition and assessment of the risk of certain banking activities, whether on- or off-balance sheet
- The absence or failure of key control structures and activities, such as segregation of duties, approvals, verifications, reconciliations, and reviews of operating performance
- Inadequate communication of information between levels of management within the bank, especially in the upward communication of problems
- Inadequate or ineffective audit programs and monitoring activities

A useful starting exercise for the board of directors and senior management in preparing for institutional transformation is to assess the adequacy of the current internal control system by looking at the common areas of internal control breakdowns highlighted above.

Management Oversight and the Control Environment

The control environment refers to the overall attitude, awareness, and actions of the board of directors and managers regarding the internal control system and its importance. The control environment is the foundation for all other components of internal control, providing discipline and structure.

The board, along with senior management, sets the tone of the organization and establishes a culture within the organization that emphasizes and demonstrates to all levels of personnel the importance of internal controls. As discussed in

chapter 7, Ownership and Governance, transformation most often results in new owners, which generally implies increased governance responsibilities and the need for requisite skills. Commensurate with changes in the governance structure is the need to examine the overall risk-management structure of the transformed, or transforming, institution. Under many jurisdictions, the board is required—often through a board audit committee—to review any and all communications from the auditors and act on them. Each director of the board may be held personally responsible and failure to comply may in some cases be punishable by law.

Senior management is responsible for implementing internal control strategies and policies approved by the board and for developing processes to manage and mitigate risks. Roles and responsibilities of the board, management, and staff should be clearly delineated and adherence should be enforced. Senior and line management should demonstrate that they accept control responsibility and not just delegate that responsibility to financial and audit staff.

Improving internal controls requires constant follow-up by management. Transforming MFIs should implement tools and procedures that help determine causes for noncompliance, redesigning poorly defined or poorly communicated procedures, and taking disciplinary action against those who do not follow procedures or commit fraud. Disciplinary action in response to fraud should be consistent and serious, with the message of zero tolerance clearly communicated throughout the MFI.

The following questions provide a guideline for an MFI to evaluate its quality of management oversight and its control environment (COSO 1994):

- Do board members and senior management set a day-in, day-out example of high integrity and ethical behavior?
- Is there a written code of conduct for employees, and is it reinforced by training, top-down communications, and requirements for periodic written statements of compliance from key employees?
- Are performance and incentive compensation targets reasonable and realistic, or do they create undue pressure to achieve short-term results?
- Is it clear that fraudulent financial reporting at any level and in any form will not be tolerated?
- Are ethics woven into criteria that are used to evaluate individual and business unit performance?
- Does management react appropriately when receiving bad news from subordinates and business units?
- Is a process in place to resolve close ethical calls?
- Are business risks identified and candidly discussed with the board of directors?

Risk Recognition and Assessment

Every MFI faces a variety of risks from external and internal sources that must be assessed. (See box 12.1.) Because economic, industry, regulatory, and operating conditions will continue to change, mechanisms are needed to identify and deal with the special risks associated with change.

Risk areas that become more prominent as MFIs transform into regulated deposit-taking institutions are *liquidity risk* or the prospect of income or equity losses stemming from inadequate access to cash; *interest rate risk*, that is, the prospect of volatility in net income and the economic value of equity in response to interest rate changes; *legal and compliance risk*, including compliance with regulations, reporting, and capital adequacy requirements; and *operational risk*, or the vulnerabilities an MFI faces in its daily operations, including portfolio quality, fraud, and theft. Each of these risks increases with the addition of new products and savings intermediation as well as new information systems.

Creating a risk-management framework and culture within a transforming MFI requires the development of a comprehensive system of management controls, accounting and internal controls, security procedures, and other risk controls.

Box 12.1 Categories of Risks

Bank examiners in the U.S. Federal Reserve System focus on the following risks:

- Credit risk—The risk of financial loss resulting from a borrower's late or nonpayment of a loan obligation or that a guarantor will fail to meet the obligation. Credit risk applies to lending and investing activities.
- Liquidity risk—The risk of loss arising from the possibility that the MFI may not have sufficient funds to meet its obligations or be unable to access adequate funding.
- Market risk—The risk that an institution's financial condition will be adversely affected by changes in market prices or rates (including interest rates, foreign exchange rates, or equity prices).
- Operational risk—In the simplest definition, this is risk of loss that arises directly from service or product delivery, resulting from human or system error. It is a risk that arises on a daily basis as transactions are processed. Operational risk transcends all divisions and products of a financial institution. This includes the potential that inadequate information systems, operational problems, unforeseen external events, or breaches of contracts (including fraud) will result in unexpected losses. Risks associated with human resources, governance, and information technology are included in this category.
- Legal and compliance risk—Losses arising from failure to follow relevant legal and regulatory requirements.
- Reputation risk—The risk to earnings or capital arising from negative public opinion, which may affect the institution's ability to sell products and services or to access other funding.
- Strategic risk—The risk to earnings or capital arising from adverse business decisions or improper implementation of those decisions. This risk is a function of the compatibility of the organization's strategic goals, the business strategies developed to achieve those goals, the resources deployed against these goals, and the quality of management capacities and capabilities.

Source: Comptroller of the Currency, United States Department of the Treasury, cited in Pikholz and others 2005.

Control Activities

Control activities are policies and procedures (in addition to the control environment) established by management to achieve specific objectives. Control activities occur at all levels in the MFI and form an integral part of daily activities. They help ensure that policies and procedures address risks. Periodically the controls must be tested and evaluated for effectiveness, and revised as necessary. Table 12.1 shows the range of control activities.

Information, Communication, and Monitoring

Pertinent information must be documented and communicated in an effective and timely manner that enables staff, management, and the board to carry out their responsibilities. An effective internal control system requires comprehensive and accurate internal financial, operational, and compliance data as well as external market information about events and conditions relevant to decision making (Basle Committee on Banking Supervision 1998). Management information systems (MIS) must be secure and supported by adequate contingency arrangements.

Virtually all employees produce information used in the internal control system or take actions needed to effect control. Everyone in the organization is responsible for communicating upward problems in operations, noncompliance with the code of conduct, or other policy violations or illegal actions. In addition, management must demonstrate open communication within all levels of the organization and set up effective mechanisms for

Table 12.1 Control Activities

Process steps	Role	Responsibilities
1. Identify and prioritize key risk exposures.	Senior management	Identify and prioritize risks.
	Board	Review and approve.
2. Develop strategies to measure risks.	Senior management	Develop key risk measurement indicators.
		Set acceptable range for risk.
	Board	Approve indicators and range.
		Monitor results.
3. Design polices to mitigate risks.	Senior management	Design operational policies, systems, and guidelines to reduce risk.
		Provide clear instructions for procedures to implement policies.
	Board	Approve operational policies.
4. Implement controls and assign responsibility.	Senior management	Assign responsibility for implementation.
	Branch management	Implement control procedures.
		Monitor compliance.
	Operating staff	Provide input on appropriateness of policies and procedures.
		Offer suggestions for policies needed.
		Comply with established policies.
5. Test effectiveness and evaluate results.	Board and management	Review results of operations.
	Internal audit staff	Monitor compliance with policies.
6. Revise policies and procedures as necessary.		Repeat the steps above for new policies and procedures.

Source: Lehman 2003.

monitoring to see that its directives are understood and carried out, and if not, determine why not.

Internal control systems need ongoing monitoring including periodic evaluations that assess the quality of the system's performance over time and report deficiencies. Monitoring of key risks should be built into the daily activities of the MFI. Furthermore, an effective and comprehensive internal audit of the internal control system should occur periodically.

The following questions provide a guideline for the transforming MFI to evaluate its communication and monitoring controls:

- Are policies and procedures clearly documented and communicated to all necessary staff members?
- Are appropriate controls built in as new systems are designed and brought on stream?
- Is the MIS secure?
- Are communication lines in the MFI open?
- Does management have effective mechanisms to monitor the quality of the control systems on a daily basis?
- Is an effective internal audit function in place?

Most transforming MFIs will find it useful to hire an expert to assess their existing internal controls relative to what is needed as a regulated deposit-taking institution and then determine how to build effective internal controls into all systems. See annex 12A for sample terms of reference.

Risk of Poor Controls: Overview of Fraud in MFIs

Fraud is a deception deliberately practiced to secure unfair or unlawful gain. The most common types of fraud in MFIs are falsified or altered documents, fictitious loans, kickbacks, embezzlement of funds, collusion in issuance of loans, and manipulation of financial data through omitting the effects of transactions or incorrectly using accounting policies and procedures. Weak internal controls not only allow errors and unintentional mistakes to go undetected but also allow for fraud. Generally fraud can be detected through an unexplained increase in delinquency, the discovery of accounting irregularities, or irregular staff behavior.

Although certainly not unique to transforming or transformed MFIs, fraud in any financial intermediary can manifest itself in different forms and have significantly different implications than in a credit-focused NGO. For financial intermediaries using depositors' funds to finance their portfolios, fraud can lead to low-income depositors losing their savings and borrowers losing access to credit. It can also lead to a deterioration of clients' willingness to repay loans or a run on the MFI's deposits (or both). The discovery of fraud by the regulator can lead to the application of stop-lending measures, which can destroy a hard-won culture of repayment as clients lose faith in future loan renewals.

Furthermore, during the process of transformation MFIs are more vulnerable to fraud because of the significant changes taking place, while at the same time, MFIs may become more able to detect fraud. Changing systems, introducing new products, and standardizing policies and procedures can lead to the discovery of fraud when weak information and accounting systems and a lack of standardization of products and services are revealed. With transformation, MFIs often install new MIS and are shocked to discover fraud has occurred but has gone undetected because of an insecure system. In addition, fraud can increase during a period of transition in which all systems are being revised and communication may not be clear or time lags exist between when the controls are established (or revised) and communicated to staff or documented in policy manuals. Furthermore, as the MFI transforms, it must develop an awareness of new and complex types of fraud as new products are developed and new clients are pursued (box 12.2).

As MFIs transform and refine their internal control systems, they will find it important to balance the effectiveness of fraud control with the cost and burden of cumbersome procedures. As discussed in previous chapters, during transformation the MFI must manage the changes taking place and work to maintain staff morale and a culture of ethics.

If fraud is identified, the MFI needs to move quickly to control current and potential damage. Consequences should be severe, and they should be written, conveyed verbally, and strictly followed. Policies should be in place to outline the consequences of fraud and actions to be taken by the MFI.

Box 12.2 Compartamos Savings Mobilization Project

Gonzalo Ramírez Reyes, Manager of the Compartamos Mobilization Project states, "Right now, Compartamos staff is not allowed to physically touch clients' money. And we make sure clients know that at every meeting, for example, by asking them questions like 'When a Compartamos staff member asks you for your loan service fee, what do you do?' The answer is that there is no loan service fee and that the clients should report the staff member to management. When we start mobilizing savings, we will have to come up with new antifraud mechanisms and ways of maintaining customer trust in the institution."

Source: CGAP n.d.

Preventive Controls: Policies and Procedures

The single most important factor in the prevention of fraud within an organization is a well-motivated staff. The most important factor in the prevention of unintentional errors are policies and procedures that are well-understood by employees who are motivated to follow them (Lehman 2002).

MFIs that transform to become licensed institutions often need to formalize the many policies and procedures that are "known to everyone" but not documented in a consistent and complete format. Formally documenting everything becomes a necessity with transformation, both to satisfy licensing requirements as well as to demonstrate greater accountability to the MFI's new stakeholders, including shareholders, regulators, and depositors.

Policies and procedures inform all employees what is expected of them, how they should perform their duties, and what the consequences are if they do not perform as required. Policies and procedures should be clearly documented in a regularly updated operations manual that is appropriately disseminated. Operations manuals should clearly define the steps required for each transaction, explain how to handle exceptions, and delineate lines of authority. Staff responsibilities are thus more easily understood with staff knowing how to perform tasks and in what sequence, and ultimately how their tasks originate and who uses their output. MFIs should establish a standard format for operations manuals that allows for insertion of updates and removal of outdated procedures. Controls such as revision dates, a flexible page numbering system, central control of number of copies issued of each manual and to whom, and numbering of each copy, will improve communication and the ability to maintain standards. Furthermore, if the MFI operates on a WAN, manuals should be online providing a cost-effective means of communication and enhancing staff accountability for compliance (Champagne 2004).

Internal control policies and procedures should either be documented in a separate Internal Controls manual or should be an integral part of operational manuals. In addition, regulated MFIs require a clearly written Internal Audit manual. (The Internal Audit manual is discussed under Internal Audit in the next section.)

Internal controls must be considered in all processes in the MFI, including those newly planned as a regulated institution—that is, savings mobilization. "Process mapping," which links specific risks to specific controls, is a useful tool to help ensure that controls are built into all systems and that they effectively address risks (box 12.3). Process mapping also helps to ensure that controls are cost-effective and processes are efficient.[2]

Human Resources Policies

Human resources policies that address hiring, training, remuneration, and staff termination serve as potential controls for preventing misappropriation of assets and unintentional errors. The transformation process offers MFIs the opportunity to rewrite and change these policies to incorporate a more proactive approach to fraud prevention. (See chapter 9, Human Resources Management.)

Hiring. Staff in transforming MFIs must understand and "own" the vision of the institution—particularly as it changes with transformation. When hiring new staff, an MFI must follow solid recruitment practices including checking references, and be willing to invest the time and resources to find the right people. Hiring well becomes particularly important during transformation because the MFI will likely need to hire people with skills that the institution has not previously had to seek, such as treasury managers or internal auditors. All positions should have a written description defining duties, responsibilities, and performance standards. When first hired and then annually thereafter, all employees should

Box 12.3 Process Mapping

Process mapping is an exercise that MFIs undertake to describe a particular process (opening a savings account, for example) including the inherent risks and the procedures that control those risks. Process mapping allows the MFI to identify missing controls as well as redundant controls that suboptimize customer service and operational efficiency goals.

Process mapping is not a quick exercise—it requires time, thoroughness, and thoughtfulness. One of the most difficult aspects of process mapping is not the mapping exercise itself, but the analysis of the map, looking for what is *not* there but *should be* there.

As a new process is being developed, the risk analysis should be conducted in conjunction with the process map. When a procedure is developed, from a risk perspective it is helpful to brainstorm all the types of risks inherent in that process at all levels, including determining the identify of the intended "risk owner." To develop procedures for a new savings product, for example, not only should the risks be identified, but so should what is to be done to mitigate them. The intended actions to control the risks become steps within the process. In this manner, controls are built into the process, rather than tacked on later.

Building controls into a process ensures the controls are integrated and has proven to be far more effective and efficient than adding controls onto an existing process. When controls are added later, they are often susceptible to erosion, or are "peeled" off, when a process becomes subjected to performance pressures, such as customer waiting time. The control activities, then, should be commensurate with risk tolerance, and answer the question "What do we do about this risk?" The steps in the process can be viewed to examine why each step is being performed and then evaluated from a risk perspective and compared with the value of that step for customer service, efficiency, and economy.

Source: Pikholz and others 2005.

be required to sign a "code of ethics" developed and approved by the board.

Training and development. A good training and development program is a critical aspect of internal control. As an MFI transforms, new staff skills are required. This presents an ideal opportunity to promote the transformed organization's core values of honesty and integrity and communicate the zero tolerance policy against fraud. Training should include a session to explain the reasons behind internal controls and emphasize how fraud and errors hurt the institution and its clients. In addition, the institution will find it imperative to have its policies and procedures well-documented and standardized, enabling the training of new and existing employees to be clear and consistent.

Remuneration. Employees should have strong incentives to perform their jobs in a responsible and competent manner. Those who do not feel sufficiently compensated will be much less likely to carry out their jobs with thoroughness and attention to detail. Likewise, they are much more tempted to commit fraud, especially in economies in which the sums that they handle daily represent months or possibly years of salary. Transforming MFIs are often shocked at the remuneration required by new staff who bring skills and experience from the formal financial sector. However, a competitive salary, including a performance-based incentive system that rewards high productivity, is a strong preventive control in deterring sloppy or fraudulent employee behavior. Transformation allows MFIs the opportunity to realign salary structures and incentive schemes, as well as other forms of compensation, to encourage good performance.

Rotation of personnel and mandatory leave. Periodically, employee job functions should be rotated

unannounced and the rotation should be long enough to discover fraud, if any. Job rotation also helps train staff to perform other jobs, allowing them to fill in when other employees take vacation or are sick. Leave policies should require all employees to take off at least five consecutive working days.

Termination. Employee awareness of the potential negative consequences for inadequate job performance or fraudulent activity can also be a preventive control. If a policy is not already in place, transformation allows the MFI to send a clear message that staff members will be immediately terminated and taken to court (if possible) if they perpetrate fraud.

See box 12.4 for an example of how K-Rep Bank in Kenya employed human resources policies to reduce fraud.

Box 12.4 K-Rep's Controls to Reduce Fraud in Kenya

To reduce its exposure to fraud risk, K-Rep employed the following mechanisms:

1. Introduced an education campaign to encourage clients to speak out against corrupt staff and group leaders
2. Standardized all loan policies and procedures so staff cannot make any decision outside the regulations
3. Emphasized management training to increase managers' capacity and to introduce strict supervision processes
4. Established an inspection unit that performs random operational checks
5. Enforced the following human resources policies:
   - Immediately fired staff involved in fraud
   - Maintained a profile of fraudulent staff and use it to refine recruitment
   - Refrained from posting staff to home areas to reduce the opportunity and temptation to collude
   - Made loan products available to staff
   - Paid staff well relative to other available job opportunities in the area
   - Rotated staff regularly within a branch
   - Transfered staff periodically to other branches

Source: Campion (2000, p.19).

Administrative Controls

Administrative controls establish lines of authority and responsibility (with ultimate responsibility resting with management), and segregate the operating and recording functions.[3] Although certainly important for unregulated MFIs, these controls become even more critical for regulated financial intermediaries, considering the responsibilities the MFI has taken on to protect client savings and investors' equity.

Segregation of duties. An effective internal control system relies on an appropriate segregation of duties. The participation of two or more persons in a transaction creates a system of checks and balances and reduces the opportunity for fraud. For example, a person handling cash should not post to the accounting records, or loan officers should not disburse loan proceeds for loans that they approve, and those with authority to sign checks should not reconcile bank accounts. If segregation of duties is not always possible, the supervisor should perform additional procedures to offset the lack of adequate internal control (WOCCU 2002).

Dual control. At least two keys or combinations under the control of at least two different people should be required to access vaults, files, or other storage devices. Dual controls should be established for counting or transferring cash, negotiable collateral, investment securities, reserve supply of checks, night depository, mail receipts, automated teller machine (ATM) cash, dormant savings accounts, and spare keys to cashier drawers.

Savings management. Once an MFI begins collecting voluntary savings, specific internal controls for savings management must be implemented. Generally, controls for savings management are achieved by setting rules for common transactions. Examples of such rules include the following (Branch and Klaehn 2002):

- Document all teller transactions with receipts.
- Include teller identification on all passbook entries or receipts.
- Prohibit tellers from keeping client passbooks at the institution.
- Ensure the internal auditor or supervisory committee reviews employee and official savings accounts, including family member accounts, on a quarterly basis for unusual or abnormal activity.
- Notify clients immediately in person, telephone, or writing if a deposit error occurs.
- Ensure all change of address requests are in writing and signed by the client.
- Effect account closures only if the client advises the MFI in writing and presents the proper identification.
- Ensure the signature card is promptly pulled from the active account file and placed in a closed account file once an account is closed.
- Maintain a list of closed accounts including account number, client name, and reason for closure for review by the manager.

Cash control. Cash management is discussed in detail in chapter 13, Customer Service and Operations; however, because it is a critical area for new financial intermediaries given the addition of teller services and savings mobilization, it is addressed briefly here.

The primary sources of cash received on an ongoing basis by a licensed MFI are loan repayments and savings deposits. With transformation, most licensed MFIs will set up (if not already in existence) banking halls with teller windows to accept loan payments and savings. Ideally, both a paper trail and computer entries should document the collection of cash.

Controls to prevent the conversion of cash by officials or employees for their own personal use should be established, including the following:

- Require all cash receipts from any source to be recorded in a cashbook and reconciled to the daily cash deposit.
- Establish cash limits for the total amount that can be kept on the premises, in the vault, and in each cashier's drawer.
- Conduct periodic unannounced cash counts.
- Balance cashiers' cash drawers with the general ledger daily, with no cashier leaving the premises until balance has been confirmed.
- Limit access to the vault and cashier drawers to those individually responsible for the funds in the vault or drawer.
- Immediately verify under dual control cash upon receipt.
- Count cash under dual control if tellers buy or sell funds to the vault or another teller.
- Document all transactions made by and between cashiers with a receipt.
- Equip vault and cashier drawers with adequate, functioning locking devices.
- Prohibit cashiers and employees from transacting business on their own accounts or those of related persons.

Security measures. With the addition of savings mobilization from the public, transforming MFIs need to ensure that banking halls are secure. Teller stations should have locked drawers and there should be grill or glass partitions between teller stations and the public. Doors and windows should be equipped with grills, bars, and alarm systems. Guards should be present at the banking halls and trained in what to do in the event of a robbery. All staff members should be trained in how to act in a robbery and what steps to take after the thief has left the branch.

As regulated institutions, all MFI branches will require a vault that should be maintained in a strong room. The vault will be used to keep legal documentation backing up loans and investments, the cash box, blank sequentially numbered forms such as checks and receipts, expense vouchers and documentation, and cash.

Protection of assets. Access to assets should be by authorized personnel only. Supervisors and senior management should conduct periodic physical inventories of assets, protect assets by purchasing adequate insurance, require the use of passwords to access the computer system, and change passwords on a quarterly basis.

Accounting Controls

The need for accurate, timely, and secure accounting systems becomes even more crucial for the MFI as a financial intermediary because depositors' savings are at risk. Internal controls must be designed to ensure the integrity of all financial transactions and the bookkeeping system. They should provide reasonable assurance that transactions are performed according to management's direction and by the right people. In addition, transactions should be recorded and financial statements prepared according to accepted accounting principles. In some countries, regulators will check to ensure this is the case.

Controls are implemented through financial policies, specific procedures, job responsibilities, and regular follow-up routines. The following policies are designed to ensure such integrity. Transactions should be (Lehman 2002):

- *Valid:* The system should not permit the inclusion of fictitious or nonexistent transactions in journals or other accounting records.
- *Properly authorized:* The appropriate people should authorize transactions.
- *Complete:* Controls should be in place to prevent the omission of transactions from the records.
- *Properly valued:* An adequate system includes procedures to avoid errors in calculating and recording transactions at various stages in the accounting process.
- *Properly classified:* Transactions must be classified according to type.
- *Recorded:* Transactions must be recorded at the proper time (timeliness).
- *Properly included:* Transactions must appear in subsidiary records and be correctly summarized (posting and summarization).
- *Supported:* All transactions must be supported with proper and valid documentation.

Controls for validity, completeness, and valuation are best maintained by independent checks and segregation of duties within the accounting function. Each person performs only certain functions within the system and each person's work is checked by at least one other.

Specific internal controls in the accounting system a transforming MFI should ensure it has in place are described in the following sections.[4]

Daily posting and monthly reconciliations. Posting records daily makes it much easier to locate errors and make corrections. On a monthly basis, staff members must individually balance each general ledger account with its supporting subsidiary ledgers (loan ledgers, bank and investment statements, individual cashier records) and with the respective general ledger control accounts. Someone other than the person who prepared the subsidiary and reconciliations between the subsidiaries and general ledger accounts should conduct a review of the reconciliations.

Internal reports. Accounting systems should be designed to facilitate the preparation of the internal reports (such as nonperforming loans, dormant savings accounts, and the like) necessary to review key operational areas. Regular reviews should be undertaken by a staff member not involved in

the transactions and irregularities discussed immediately with a supervisor.

Sequential numbering. Sequentially numbered instruments used for checks, cash receipt vouchers, and journal vouchers assist in reconciling and controlling used and unused items. All unissued, prenumbered items should be retained under dual control.

Audit trail. Records and systems should provide an audit trail that allows each transaction to be traced from its inception to completion. Sufficient detail must be included in all documentation of transactions. For example, each time a transaction occurs, it must be documented through preparation of a voucher. Vouchers result in a paper trail for each transaction. Such paper trails allow the MFI to have adequate internal control over its record keeping and ensures that its assets are safeguarded. Vouchers are supported by invoices and check stubs or cash requests and generally include the following:

- Number and nature of voucher
- Name of department
- Date prepared and name of person who prepared the voucher
- Account name and number
- Amount of money
- Source and description of the transaction
- Authorized signature(s)
- Attachment of original invoices and cash requests
- Proof of delivery or completion of services rendered

Reconciling loan and savings information. The accounting system tracks information on loan account transactions and savings account transactions and aggregates the information to create financial statements. At the same time, the loan tracking system tracks information on loans, while the savings module tracks information on savings accounts. Some data, such as disbursements and payments or withdrawals, is captured by both the accounting and the loan or savings systems. Many transforming MFIs choose to use integrated software—meaning the various modules are integrated so information entered in one is also captured in others if appropriate. However, if the MFI is not operating with an integrated system, the two systems may capture the data at different times and from different sources, resulting in discrepancies. These discrepancies need to be reconciled frequently.

Bank accounts. Once an MFI is licensed it will still need a relationship bank for external transactions. MFIs should adhere to the following practices (Lehman 2002):

- Use only prenumbered checks for disbursements.
- Have proper documentation support for checks.
- Cancel supporting documents when paid.
- Have dual signatures and authority limits.
- Keep voided checks, but ensure signatures are obliterated.
- Post or deliver checks directly to payee (if hand delivered, obtain a receipt).
- Record all checks in numerical order in the cash disbursements journal, and allocate each check to the proper operating expense account number.

Bank reconciliations. Accurate and timely bank reconciliation is critical to maintaining internal control over cash. Reconciliations must be prepared at least monthly for each bank account to reconcile the bank balances on the bank statements to the general ledger or cash book balance. A supervisor must review all bank reconciliations. Bank reconciliations can also be considered a detective control (as well as a preventive control) because errors, such as improper accounting for or transferring of funds, can be detected through the reconciliation process.

Detective Control: The Internal Audit

The Institute of Internal Auditors defines internal audit as follows:

> Internal auditing is an independent, objective assurance and consulting activity designed to add value and improve an organization's operations. It helps an organization accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management control, and governance processes.[5]

Internal audit is carried out by determining if financial and operating information is accurate, and internal policies and procedures are being followed. Internal audits differ from external audits in that they are for the purpose of the MFI itself, not for third parties. Internal audits focus on evaluating controls and detecting fraud, whereas external audits focus on whether financial statements reflect historical events clearly and accurately. Internal audits are carried out continuously throughout the year, while external audits are done annually at the end of the fiscal year.

Regulators will want to ensure that before an MFI is licensed, it has an effective and thorough internal audit department. Once the MFI is licensed, the supervisory body will periodically examine the internal audit function to ensure its continued effectiveness.

All MFIs, particularly when licensed, must have an Internal Audit manual that outlines the role of the internal audit, the qualifications of the internal auditors, the structure and functions of the internal audit department, and the methodologies and tools to conduct internal audits. See annex 12B for a sample outline of contents for an Internal Audit manual.

The Internal Audit Department

In general, an NGO MFI will typically have two or three relatively junior staff—often reassigned loan officers—in the audit function reporting directly to the managing director and focusing primarily on branch audits. With transformation, the MFI needs to rethink the scope of the department, its management, and the skills needed by auditors.

The audit department is responsible to do the following:

- Work with the board and management to devise and maintain a system that ensures all major risks of the MFI are identified and analyzed.
- Plan, organize, and carry out the internal audit function, including the preparation of an audit plan, scheduling and assigning work, and estimating resource needs.
- Report to both the audit committee and management on policies, programs, and activities of the department.
- Coordinate coverage with the external auditors, and ensure that each party is not only aware of the other's work but also well briefed on areas of concern.
- Make recommendations on the systems and procedures being reviewed, report on the findings and recommendations, and monitor management's response and implementation.
- Review and report on the accuracy, timeliness, and relevance of the financial and other information that is provided for management.
- Conduct any reviews or tasks requested by the board, the audit committee, the chief executive officer, or the finance director, provided such reviews and tasks do not compromise the independence or objectivity of the internal audit function.
- Provide both management and the audit committee with an opinion on the internal controls in the MFI.

Specifically, a regulated MFI needs to have an internal audit manager or chief internal auditor, internal auditors, and an audit committee.

Chief Internal Auditor. While most NGO MFIs will have an internal auditor in place, central bank expectations for professionalism and independence and the commensurate level of maturity needed for this position may require the MFI to recruit externally for a chief internal auditor (CIA). The CIA reports directly to the board of directors or the audit committee of the board (see below), which permits the auditor to report findings on an objective and independent basis without risk of unwarranted dismissal. Regulators look for specific skills in a CIA. It is recommended that this individual be a professional accountant with familiarity with a variety of audit techniques, standards, and systems. In Uganda, the MDI Act of 2003 states that the internal auditor must be approved by the central bank and must carry out the following duties:[6]

- Evaluate the reliability of the information produced by accounting and computer systems.
- Provide an independent appraisal function.
- Evaluate the effectiveness, efficiency, and economy of the institution's operations; evaluate compliance with laws, policies, and operating instructions.
- Provide investigative services to line management; certify returns submitted to the central bank by the institution; and establish appropriate accounting procedures and accounting controls in respect of the institution's business, and ensure compliance with same.
- Require management of the institution to implement and maintain appropriate internal control procedures and management information systems.
- Review operations and transactions of the institution that could adversely affect the well-being of the institution.
- Ascertain the nature of the external audit, coordinate the internal and external audits, and consider rectification and implementation of issues raised by the external auditor.
- Perform an audit of the financial statements of the institution to detect irregularities and illegal acts in the conduct of the institution's business.

Internal auditors. The specific requirements for internal auditors, including their qualifications, profiles, and other criteria, will be dependent on the needs and the size of the MFI after transformation. Generally, additional internal auditors will be needed with transformation because of the addition of savings products and the numerous issues that accompany accepting cash at the branch level. Furthermore, with transformation come many more complex transactions, making it important to ensure that audit staff have the necessary skills to audit a much broader scope of operations. For example, internal auditors will no longer only audit credit and other transactions at the branch, but will also need to audit various back-office activities that are new to the transformed institution. In addition, various new head-office functions such as treasury, supervision, and control will also need to be audited. Internal auditors of regulated deposit-taking MFIs should generally possess much more comprehensive skills than those of credit-only MFIs:

- A thorough knowledge of the principles, procedures, and practices of accounting and financial records and transactions
- A knowledge of audit procedures, including planning, techniques, test, and sampling methods involved in conducting audits
- A knowledge of computerized accounting and auditing record keeping systems
- An ability to gather, analyze, and evaluate facts and to prepare and present concise oral and written reports
- An ability to establish and retain effective working relationships with other MFI staff and to communicate clearly and effectively, both orally and in writing
- An ability to work unsupervised

Although many MFI NGOs may have appointed internal auditors by simply reassigning loan officers,

this method is unlikely to suffice once the institution transforms. Although credit officers understand the business well, reassignment may create difficulties in that they see themselves as peers of the staff they are auditing.

Audit committee. If no distinct audit committee exists on the board, the entire board assumes this duty. Whether a separate audit committee is needed is a function of the ability of the board to act as a unit to perform these duties (or in some jurisdictions, a board audit committee is required by the regulators). When it becomes too cumbersome or time consuming for the board to act effectively in this capacity, the board should form an audit committee, which in turn formally reports back to the board. Once it is determined that an audit committee should be created, the required qualifications for committee members must be determined (financial literacy, or experience in finance, audit, or accounting); at least one member should be designated the "financial expert." The financial expert is someone who has a good understanding of generally accepted accounting principles and financial statements and has the ability to assess the general application of good principles in connection with the accounting for estimates, accruals, and reserves, and has experience in preparing, auditing, analyzing, or evaluating financial statements (AICPA 2004).

Generally, audit committees have three to four members each with three-year terms, ideally with one member rotating each year. The committee should meet at least four times a year and before the annual meeting for the full financial year. The audit committee should have a charter setting forth its purpose, authority, composition, quorum, terms, meetings, reporting, and responsibilities. This charter should be ratified by the full board. See annex 12C for a sample charter of an audit committee.

The audit committee is responsible for reviewing external audit reports (those performed by the external audit firm, regulators, and tax authorities) and ensuring any required corrective action is taken by management. It also oversees and reviews the activities of the CIA and assesses progress in meeting the audit plan. During the last meeting each year, the audit committee establishes dates of meetings for the upcoming year, plans audit coverage for the year with external and internal auditors, and approves the internal audit plan including the budget for staff time and the financial budget.

The following questions provide a guideline for an MFI to evaluate the effectiveness of the audit committee(COSO 1994):

- Has the board recently reviewed the adequacy of the audit committee's written charter?
- Is the audit committee functioning and, in fact, independent of management?
- Do audit committee members possess an appropriate mix of operating and financial control expertise?
- Does the audit committee understand and monitor the broad organizational control environment?
- Does the audit committee oversee appropriateness, relevance, and reliability of operational and financial reporting to the board, as well as to investors and other external users?
- Does the audit committee oversee existence of and compliance with ethical standards?
- Does the audit committee or full board have a meaningful but challenging relationship with independent auditors, internal auditors, senior financial control executives, and key corporate and business unit operating executives?

Operations of the Internal Audit Department

The specific design and implementation of an internal audit function will vary among institutions depending on the size, number of branches, lending methodology, and reporting systems. The internal auditor has the responsibility to review all policies established by the institution and then to design a series of internal control questionnaires, or checklists, to use in determining whether those

policies are followed. As policies are revised or updated, the checklists need to be revised as well. In addition, periodic "spot-check" audits of selected financial transactions should be carried out.

Developing an audit plan. One of the primary tasks of an internal audit department is to develop an audit plan for the coming year. The audit plan establishes the audit frequency, the types of audits performed (normal branch audits, follow-up audits, snap or spot-checks, operational audits, and process audits), and the staff resources required.[7] The board audit committee must approve the audit plan. The audit plan should include the following (Champagne 2004):

- The master audit plan showing the priority units to be audited, the frequency, the risk assessment, and the date of the last audit
- Based on the frequency and date of the last audit, audits scheduled for the coming year
- The total staff hours required to perform these audits compared to available audit hours in the upcoming year (if a deficiency in staff hours is found, a decision needs to be made whether to reduce the scope of the audit or the coverage, to increase staff, or a combination)
- The financial resources required to perform the plan, including both operational and capital expenditures

Audit scopes to a large extent affect the staff hours budgeted for each activity. This means that the detailed audit scopes for branch and head office audits need to be drafted to establish some basis for whether the intended scope can be performed in a quality manner in the time allotted. Audit objectives need to be clearly stated to meet regulatory requirements for the evaluation of the following:

- The reliability of the information produced by accounting and computer systems
- The effectiveness, efficiency, and economy of the institutions' operations
- Compliance with laws, policies, and operating instructions
- The adequacy of internal control procedures and management information systems
- The potential for operations and transactions to adversely affect the institution's well-being.

To comply with regulations, the annual audit plan should generally include a plan to certify or sign off on reports provided to the regulator. Internal audit must perform whatever tests it feels are required to assert to the central bank that the report content is accurate. The actual certification is a management responsibility and should be carried out by the chief financial officer or the chief executive officer. Certain reports should also be signed off by the board. The internal and external auditors perform tests as required to confirm accuracy of what management has certified. These reports may be weekly, monthly, quarterly, or annually and must be submitted within stipulated time frames. In addition, the audit plan should state how the MFI will coordinate activities as required with the external auditor, and how it will address recommendations for corrective action on issues raised by the external auditor.

Ideally, the annual audit plan includes a full branch audit and a follow-up audit as deemed necessary, depending on the nature of audit findings and confidence in the effectiveness of corrective action taken, and at least one surprise spot audit in each branch once a year.

When branch audits are conducted, the audit should be planned in advance and the planning—to include audit objectives, audit resources, and work programs to establish procedures for testing—should be documented in the working papers. The scope, duration, and any audit requirements with respect to working space and documents should be communicated to the branch manager at the beginning of each audit. The branch manager's concerns

should be discussed and considered in the performance of the audit.

In the course of a branch audit, audit findings often reveal process improvements that could benefit the whole organization. Corrective action must then be recommended at a higher management level than the branch manager.

With transformation, auditing the head-office departments becomes much more complex because the focus no longer remains primarily on operations, that is, what goes on in the branches and is consolidated at the head office. Rather, with a licensed deposit-taking institution, auditors will be required to audit much more complex activities at the head office, including treasury, MIS, and others and thus, as mentioned above, additional skills are required. At least two internal auditors should be assigned to perform head-office audits to ensure accuracy and checks and balances.

Developing the audit report. Audit reports present the significant findings first, showing the impact on the MFI if the condition is allowed to persist, and whether the corrective action indicated will fix the problem. To assist the audit department in more fully developing their audit findings to show the relevance to the organization, a process should be developed in which audit findings are analyzed to show the criteria used to measure the condition (what should be), the condition noted (the "as is"), the cause of the deviation between what should be and what is, the effect of the condition if allowed to persist, and recommendations to resolve the problem. This process, geared toward properly identified causes, is what will diminish, control, or eliminate the unfavorable condition.

The audit report should be layered to meet the needs of multiple readers, including the audit committee, senior management, and line management, because each requires differing levels of detail. A sample audit report structure is provided in annex 12D.

Training the audit staff. Audit staff will benefit from periodic training on some or all of the following topics:

- Developing audit findings
- Writing reports and determining adequate corrective action
- Developing and maintaining working paper standards
- Conducting fraud investigations
- Using audit planning process and documentation
- Using process mapping techniques
- Learning general banking topics, treasury management, supervision

Periodic surveys could also be useful to determine if staff are satisfied with the internal audit process and if they feel they are being represented fairly and accurately by the internal audit department.

Rating system. Some MFIs develop a rating system to reflect the success of various branches and other business units in managing risk and maintaining adequate systems of internal control. Publication of the rating guidelines and proposed branch audit scope serves to motivate branch managers to improve their operations in anticipation of the next audit. To further motivate compliance and corrective action, the audit rating can be incorporated into the MFI's performance incentive program.

The following questions provide a guideline for an MFI to evaluate its internal audit function (COSO 1994):

- Does internal audit have the support of top management, the audit committee, and the board of directors as a whole?
- Has the written scope of internal audit responsibilities been reviewed by the audit committee for adequacy?
- Is the organizational relationship between internal audit and senior executives appropriate?

Table 12.2 Common External Audit Services for an MFI

Service	Purpose	Activities	Output
Annual financial statement audit	To confirm that the financial statements are free from material misstatement	Audit, on a test basis, key account balances and underlying evidence or procedures	Audit report, including an opinion, financial statements, and notes
Management letter	To obtain constructive comments that management can use to improve operations or internal controls	By-product of the annual financial statement audit	Management letter
Special purpose audit	Generally to audit compliance with donor requirements, including use of funds	Review of specific issues as requested by the client, usually on behalf of the donor	Special audit opinion and report
Agreed upon procedures	To obtain detailed results of specific testing procedures for selected transactions or account balances	Performance of agreed upon procedures	Report of results of procedures without opinion; users draw their own conclusions

Source: Lehman 2002.

- Does internal audit have and use open lines of communication and private access to all senior officers and the audit committee?
- Are audit reports covering the right subjects distributed to the right people and acted upon in a timely manner?
- Do key audit executives possess an appropriate level of expertise?

Detective Control: The External Audit

An external audit is a formal and independent review of an MFI's financial statements, records, transactions, and operations. It is performed by professional accountants to lend credibility to the financial statements and other management reports, and identify weaknesses in internal controls and systems.

In most countries, regulators must approve the external auditor and once approved, the MFI may not change the external auditor without approval again from the central bank. Some regulators also require external auditors to change every few years.

The scope of an external audit can vary significantly depending on the objectives of the audit. The financial statement audit is the most common, but management letters, special purpose audits, and additional agreed upon procedures to be audited may also be undertaken (table 12.2).

Commissioning the Audit

The external auditor is usually engaged by, and ultimately responsible to, the board of directors through its audit committee. The process of commissioning an external audit begins by determining a scope of work that lists the MFI's requirements and upon which audit firms can base their proposals (box 12.5). The scope of work generally needs to be approved by the full board.

Evaluating external audit proposals. The MFI must seek a balance in selecting the audit firm. It wants auditors who are rigorous and objective. At the same time, it wants to work with audit staff that have the ability and judgment to understand the unique circumstances and challenges of microfinance. The relationship must be constructive, such that the MFI feels that the auditor's recommendations are supportive and the auditor feels that the

Box 12.5 Key Elements of the External Audit Scope of Work

1. Introduction—Describe institution to be audited, party engaging the audit, and a brief statement of services requested.
2. Description of the MFI and its organizational structure—Identify key financial managers, list of branches, and the like.
3. Prior year audits—Provide, if applicable.
4. Objective—Clearly state the financial statements and period to be audited.
5. Scope—Specify expected procedures (for example, adherence to specific standards, client visits, and so forth).
6. Audit report and financial statements—Describe expected content and presentation of the statements.
7. Management letter—List general areas to be addressed and specific areas of concern.
8. Agreed-upon procedures—List additional procedures to be audited, such as review of portfolio systems, MIS, or internal control.
9. Timing—Provide deadline for completion of audit report.
10. Preproposal survey—Ask the bidding firms to spend time at the MFI (at their expense) to gain information and understanding of the organization.
11. Proposal format—Outline in detail the items to be included in the proposal:
    a. Understanding of the work
    b. Audit approach—timing, procedures, and so forth
    c. Audit team—roles, experience, qualifications
    d. Firm information—relevant experience, statement of independence, principal clients, adherence to standards
12. Cost proposal—Request separate submission.
13. Deadline for submission of written proposals.
14. Oral presentations to the board (if desired).

Source: Lehman 2002.

MFI is making a good faith effort to address valid concerns. Answers to the following questions will help an MFI select an appropriate external auditor:

- Does the audit firm demonstrate an understanding of the MFI by identifying elements of concern or focus?
- Which set of auditing standards will the audit firm use to conduct the audit?
- Does the audit approach reflect a review of industry's guidelines? (See the CGAP [1998] publication, *External Audits of Microfinance Institutions: A Handbook*.)
- Does the audit team include personnel with adequate experience and qualifications?
- How well did the prospective auditor respond to questions during the oral presentation?
- Does the proposal include any added value (for example, suggestions on how to conduct the audit more efficiently)?

Negotiating the fee. The fee is generally a function of the level of effort and the hourly rates charged by the firm. The bidder with the lowest price is not always the best choice for the engagement. However, the most expensive well-known firms with international affiliations do not necessarily come with a guarantee of technical or ethical quality. The selection of an external audit firm and amount of the fee should be based on factors reviewed above and presented to the board for approval. In some cases, regulators may determine the remuneration to be paid by the MFI to the auditor approved by the regulator.

Contract or engagement letter. A contract or engagement letter is used to formalize the audit appointment. Generally, the audit firm will issue the letter. The MFI must ensure that the final agreement for the audit work reflects the work outlined in the terms of reference and the proposal, as well as the agreed level of effort and cost.

Other Detective Controls

In addition to the use of internal and external audits, an MFI can ensure other detective controls are in place. For example, timely and relevant data from the MIS can provide significant information to help detect errors or fraud. Inventory management also can provide an effective means of detecting fraud or a lack of adequate internal controls. Management should periodically check that the inventory balances are correctly stated in financial and other records.

Supervision: Evaluating Internal Controls

Transforming MFIs must address internal control and risk management issues specific to the laws or regulations with which it must comply. Many of these issues are geared toward risk management because the supervisor's role is to ensure that depositors' savings are not at undue risk.

Supervisors need to ensure that the internal control system in regulated MFIs supports the appropriate management of assets as well as deposits, thus protecting the institution from possible loss, fraud, or inefficient use. Furthermore, the supervisor needs to examine the reports and data generated by the MIS for accuracy, reliability, integrity, and relevance to decision making at the different levels within the MFI as well as for its stakeholders. Finally, the supervisor must ensure the MFI adheres to prevailing rules and regulations applicable to the MFI's internal control policies, including procedures, practices, competence, and independence.

Prelicensing

Before licensing an MFI to intermediate public deposits, a regulator will require the MFI to demonstrate strong internal controls. As discussed in chapter 2, Regulation and Supervision: The Policy Framework, internal controls are at the core of risk-based supervision. Before licensing, the transforming MFI must demonstrate the following:

- Branch and head office premises have strong rooms and safes that meet central bank requirements and banking halls that will adequately contain customer flows.
- The MIS meets certain capabilities with respect to functionality and expandability, usability, reporting, and administration and support.
- The internal control system ensures operational efficiency and effectiveness, reliable and accurate reports, and compliance with applicable laws and regulations.
- A sufficient risk-management program is in place to identify, measure, monitor, and control the level and type of risks to be assumed.
- Well-documented and standardized manuals have been produced for risk management, credit, human resources, operations, liquidity and funds management, accounting, and internal audit.
- The CIA's responsibilities are clearly outlined and a competent qualified CIA is in place.
- The central bank has approved the external auditor's duties, appointment, and tenure.
- Appropriate governance is in place (or soon to be), including adherence to board member qualifications and completion of specific duties and responsibilities as outlined in the law or the regulations.

Ongoing Supervision

Once regulated, supervisors require all MFIs to have an effective system of internal controls consistent with the nature, complexity, and risk inherent in the MFI's activities. This system also needs to respond to changes in the MFI's environment and conditions. In those instances in which supervisors determine that an MFI's internal control system is not adequate or effective for the specific risk profile,

the supervisor will take appropriate action (Basle Committee on Banking Supervision 1998). For example, in Uganda, MDIs must do the following:

- Provide a letter of assurance to external auditors stating that all financial and other related transactions on- and off-balance sheets including contingent liabilities have been disclosed.
- Report to a credit bureau details of all nonperforming loans classified as doubtful or loss as well as all customers involved in financial malpractices including bouncing of checks due to lack of funds or fraud.
- Maintain accurate books of accounts including vouchers, securities, records, computer systems, and other financial and nonfinancial records that show the true state of affairs and that explain its transactions and financial position to the central bank; records must be in English and in accordance with international accounting standards.
- Publish audited financial statements in the newspaper with the external audit report and management letter four months after year-end.
- Disclose to the regulator the name of any person or group of related persons who hold 10 percent or more of total voting rights.
- Take reasonable precautions to prevent loss or destruction of books, accounts, vouchers, securities, records, computer systems, and other financial and nonfinancial records; must prevent falsification of entries, facilitate detection and correction of inaccuracies, and ensure that unauthorized persons do not have access to or use of information; keep corporate records for 10 years.
- Allow the central bank to freeze monies in any account that is believed to contain the proceeds of a crime.
- Send written notice to customers of dormant accounts and unclaimed balances and hold such balances in dormant register at head office for three years without assessing any service charges; after five years, funds must be remitted to the central bank.

Below are examples of possible findings by the regulatory authorities that would warrant action to be taken to enhance internal controls:

- Inadequate segregation of duties with limited internal controls in place
- Inactive audit committee
- Unacceptable or lack of external audit
- Management reports and accounting records destroyed or missing
- Employees or officials with financial problems or overt high standards of living from no apparent source
- Multiple family members or related parties controlling operations
- Inadequate or no review of internal control reports provided by the MIS
- Computer entries with no identification as to who performed the transaction
- Employees sharing passwords with other individuals
- An MIS lacking adequate controls and audit trail with little or no security features
- High employee turnover
- Poorly trained staff

All transforming institutions must determine what specific internal controls and risk management policies they must adhere to or consider once licensed. A key task in the internal control review process for transforming MFIs is to study the relevant laws and regulations and ensure compliance.

Annex 12E provides an extensive checklist for deposit-taking MFIs to use in determining whether adequate controls are in place.

Annex 12A Sample Terms of Reference: Internal Controls Assessment

Background

Background on the organization including its mission, target market, client outreach, portfolio size, and so forth.

Objectives

The purpose of this consultancy is to strengthen MFI A's internal control and audit policies and procedures to ensure that the institution is able to mitigate risks properly and on time and is able to satisfy the regulators that its internal audit function is sound. The related tasks should consider many areas of the institution including branch operations (loans, cash, and accounting), MIS, and risk management.

The assignment seeks a thorough study of the current internal controls and audit procedures of the institution to assist MFI A to put in place sound internal control and audit policies and procedures.

Tasks

The consultant is responsible for completing the following tasks. Because one of the objectives is to build institutional capacity, the internal audit department should be closely involved in the execution of these tasks.

1. Review the relevant laws and implementing regulations; if applicable, review the findings and recommendations of the prelicensing inspection report on internal controls and audit management.
2. Review the branch operations policies and procedures covering loans, cash, and accounting as stated in the Branch Operations manual (or, if applicable, the Internal Controls manual) and assess the adequacy and effectiveness of those policies and procedures in ensuring that internal controls and supervision are in place; if necessary, recommend improvements.
3. Review the Internal Audit manual and recommend changes to ensure that the internal audit department is able to detect noncompliance and fraud.
4. Review MFI A's banking software and assess the integrity of data and access controls.
5. Assess the capacity (expertise, skills, and availability) of the internal audit department and the audit committee to implement, monitor, and supervise; recommend changes and improvements to the internal audit department, its policies, and its procedures to comply with best practices and regulations.
6. Recommend reporting formats for the internal audit department to report effectively to the audit committee of the board, and transmit findings and recommendations to the management and branches.
7. Recommend to the board sound risk-management policies and guidelines to ensure adequate internal controls relating to credit, operations, and compliance.

Deliverables

1. A comprehensive report that contains the following:
   a. Recommendations on how to address the findings of the regulators as stated in their prelicensing inspection report (if applicable)
   b. Enhancements to the control policies and procedures stated in the Branch Operations manual
   c. Improvements to the Internal Audit manual; recommended strategies to ensure that the internal audit department is able to detect noncompliance and fraud

   d. Assessment of MFI A's MIS for data integrity and access controls including suggestions on how MFI A could best use the system for ensuring controls
   e. Assessment of the capacity of the internal audit department and audit committee to monitor and enforce internal controls; recommend skills and training requirements as necessary
   f. Recommended reporting formats including, but not limited to, internal audit report to the board, the regulators, management, and to concerned branches
2. Proposed risk-management policies and guidelines for internal controls relating to credit, operations, and compliance
3. Brief consultancy completion report that includes recommended follow-up steps or action plan for MFI A

Qualifications

The consultant should have the following qualifications and experience:

- Postgraduate degree in business administration, banking, finance, or related field; formal audit designation preferred
- At least five years of experience in internal audit or risk management or both, preferably within a commercial banking and microfinance setting
- Familiarity with international best practices on internal control and audit
- Experience in reviewing controls within management information systems

Level of Effort

It is estimated this consultancy will take 20 to 25 days to complete.

Annex 12B Internal Audit Manual: Sample Outline of Contents

This outline is from Joyce Lehman, Internal Audit Consultancy conducted under the SPEED Project, Uganda, October 2002.

1.0 **Risk management overview**

2.0 **Internal control system overview**
- 2.1 Definition
- 2.2 Elements

3.0 **The role of internal audit**
- 3.1 Place in risk-management process
- 3.2 Reporting protocol
- 3.3 Oversight responsibilities
- 3.4 Liaison with external audit

4.0 **Qualifications of the internal auditors**
- 4.1 Professional
  - 4.1.1 Education or experience
  - 4.1.2 Code of conduct for the profession
- 4.2 Personal characteristics
  - 4.2.1 Integrity
  - 4.2.2 Confidentiality
  - 4.2.3 Courteous with staff
  - 4.2.4 Independence

5.0 **Structure of the internal audit department**
- 5.1 Chief Internal Auditor
  - 5.1.1 Duties
  - 5.1.2 Reporting
- 5.2 Staff
  - 5.2.1 Duties
  - 5.2.2 Reporting

6.0 **Function of the internal audit department**
- 6.1 Check for compliance with established policies
  - 6.1.1 Credit
  - 6.1.2 Cash handling
  - 6.1.3 Accounting
  - 6.1.4 Procurement
  - 6.1.5 Payroll
  - 6.1.6 Compliance reporting
  - 6.1.7 Financial statements
  - 6.1.8 Fixed assets
  - 6.1.9 Inventory and stores
  - 6.1.10 Petty cash
  - 6.1.11 Other
- 6.2 Confirm accuracy of manual transactions

7.0 **Internal audit methodology and tools**
- 7.1 Audit planning—budgets, schedules, and so forth
- 7.2 Audit documentation
- 7.3 Audit forms—design work plans or questionnaires for each area of established policy
- 7.4 Audit files
- 7.5 Audit reports
- 7.6 Security of work space

Annex 12C Sample Audit Committee Charter

This sample audit committee charter is adapted from Champagne (2004).

Purpose

The purpose of the audit committee is to assist the board of directors in fulfilling its oversight responsibilities for reducing the risk of unreliable financial reporting, ensuring the operational effectiveness and efficiency of the internal control system and the audit process, protecting the company's assets from misappropriation, and ensuring effectiveness of the company's process for monitoring compliance with laws and regulations and code of conduct. While the committee has the responsibilities and powers set forth in this charter, it is not the duty of the committee to plan or conduct audits to determine that the company's financial statements are complete and accurate and are in accordance with generally accepted accounting principles. This is the responsibility of management and the independent auditors. Nor is it the duty of the committee to conduct investigations.

Authority

The audit committee has authority to conduct or authorize investigations into any matters within its scope of responsibility. It is empowered to do the following:

- Appoint, compensate, and oversee the work of any registered public accounting firm employed by the company.
- Resolve any disagreements between management and the auditor regarding financial reporting.
- Preapprove all auditing and nonaudit services provided by either internal or external auditors.
- Retain independent counsel, accountants, or others to advise the committee or assist in the conduct of an investigation.
- Seek any information it requires from employees—all of whom are directed to cooperate with the committee's requests—or external parties.
- Meet with company officers, external auditors, or outside counsel, as necessary.
- Review and approve proposals to outsource any internal audit activities.

Composition

The audit committee will consist of at least three and no more than four members of the board of directors. The board will appoint independent directors as committee members and the committee chair. Each committee member will be both independent and financially literate. At least one member shall be designated as the "financial expert," as defined by professional accounting standards.

Meetings

The committee will meet at least four times a year, with authority to convene additional meetings as circumstances require. All committee members are expected to attend each meeting, in person. The committee will invite members of management, auditors, or others to attend meetings and provide pertinent information, as necessary. It will hold private meetings with auditors (see below) and executive sessions. Meeting agendas will be prepared by the chief internal auditor and provided one week in advance to members, along with appropriate briefing materials. Minutes will be prepared by the chief internal auditor.

Responsibilities

The committee will carry out the following responsibilities:

Financial statements

- Review significant accounting and reporting issues, including complex or unusual transactions and highly judgmental areas, and recent

professional and regulatory pronouncements, and understand their impact on the financial statements.
- Review with management and the external auditors the results of the audit, including any difficulties encountered.
- Review the annual financial statements, and consider whether they are complete, consistent with information known to committee members, and reflect appropriate accounting principles.
- Review other sections of the annual report and related regulatory filings before release and consider the accuracy and completeness of the information.
- Review with management and the external auditors all matters required to be communicated to the committee under generally accepted auditing standards.
- Understand how management develops interim financial information, and the nature and extent of internal and external auditor involvement.
- Review interim financial reports with management and the external auditors before filing with regulators, and consider whether the reports are complete and consistent with the information known to committee members.
- Review procedures for the confidential, anonymous submission by staff of concerns regarding questionable accounting or auditing matters. Review any submissions that have been received, the current status, and the resolution if one has been reached.

Risk management and internal control

- Provide oversight on the company's guidelines and policies with respect to business risk management.
- Question management, the chief internal auditor, and the independent auditors about significant risks or exposures facing the company; assess the steps management has taken or proposes to take to minimize such risks to the company; and periodically review compliance with such steps.
- Consider the effectiveness of the company's internal control system, including information technology security and control.
- Understand the scope of internal and external auditors' reviews of internal control over financial reporting, and obtain reports on significant findings and recommendations, together with management's responses.

Internal audit

- Review with management and the chief internal auditor the charter, plans, internal audit manual, budget, activities, staffing, and organizational structure of the internal audit function.
- Ensure there are no unjustified restrictions or limitations on internal audit scope.
- Review and concur in the appointment, replacement, or dismissal of the chief internal auditor.
- Review the effectiveness of the internal audit function, including compliance with The Institute of Internal Auditors' *Standards for the Professional Practice of Internal Auditing*, or similar document.
- On a regular basis, meet separately with the chief internal auditor to discuss any matters that the committee or internal audit believes should be discussed privately.

External audit

- Review the external auditors' proposed audit scope and approach, including coordination of audit effort with internal audit, estimated fees, and timing of auditor visits.
- Review the performance of the external auditors, and exercise final approval on the appointment or discharge of the auditors.
- Review and confirm the independence of the external auditors by obtaining statements from the auditors on relationships between the auditors and the company, including nonaudit services (such as tax services), and discussing the relationships with the auditors.

- On a regular basis, meet separately with the external auditors to discuss any matters that the committee or auditors believe should be discussed privately.
- Ascertain that the external auditor's service does not exceed a continuous period of three years.

Compliance

- Review the effectiveness of the system for monitoring compliance with laws and regulations and the results of management's investigation and follow-up (including disciplinary action) of any instances of noncompliance.
- Review the company policies relating to compliance with ethics, conflict of interest, and the investigation of misconduct and fraud, and review significant cases of staff conflict of interest, misconduct, or fraud.
- Review the findings of any examinations by regulatory agencies, and any auditor observations.
- Review the process for communicating the code of conduct to staff, and for monitoring compliance with the code of conduct.
- Obtain regular updates from management and legal counsel regarding compliance matters.

Reporting

- Regularly report to the board of directors about committee activities, issues, and related recommendations.
- Provide an open avenue of communication between internal audit, the external auditors, and the board of directors.
- Report annually to the shareholders, describing the committee's composition, responsibilities and how they were discharged, and any other information required by bylaws or regulations, including approval of nonaudit services.
- Review any other reports or issues that relate to committee responsibilities.

Other

- Perform other activities related to this charter as requested by the board of directors.
- Institute and oversee special investigations as needed.
- Review and assess the adequacy of the committee charter annually, requesting board approval for proposed changes, and ensure appropriate disclosure as may be required by law or regulation.
- Confirm annually that all responsibilities outlined in this charter have been carried out.
- Evaluate the committee's and individual members' performance on a regular basis.
- Review with management the policies and procedures with respect to officers' expense accounts and perquisites, including their use of corporate assets, and consider the results of any review of these areas by the internal auditor or the independent auditors.

Approved by the board of directors at its meeting on ___________ of _____________, 20___.
Signed by: ___________________________

Chair of the board of directors.

Annex 12D Sample Format for Quarterly Audit and Inspection Activity Report to the Audit Committee of the Board of Directors

This sample format for a quarterly audit and inspection activity report is adapted from Champagne (2004).

The chief internal auditor will prepare and deliver a quarterly activities report to the audit committee of the board of directors as of the last full three months ended since the last meeting of the audit committee. The report will include the following, at minimum:

1. Status of previously reported issues (follow-up on management actions to determine that corrective action was taken and is achieving desired results, or the management or board has assumed the risk of not taking corrective action on reported findings).
2. Report to audit committee any external audits in progress.
3. Audit reports issued: audit date, date issued, rating (if assigned).
4. Significant and material findings during quarter and recommendations. Reportable audit findings include irregularities, illegal acts, errors, inefficiency, waste, ineffectiveness, conflicts of interest, control weaknesses. (Material would be 5–10 percent of net income; 0.5–1 percent of total assets; 0.5–1 percent of total revenues; 1 percent of total equity)
5. Comparison of audit plan to actual
   a. Comparison of financial budget to actual for internal audit department with explanations for variances, and projections as of year-end with implications for completing audit plan for year
   b. Comparison of labor hours expended to date to labor hour budget in annual plan with explanations for variances, and projections as of year-end with implications for completing audit plan for year
   c. Proposed amendments to audit plan to cover any expected shortfalls in annual audit coverage
   d. Audits in progress: audits during quarter as per annual audit plan, other audits conducted during quarter not in plan, other assignments by management (showing reason and status)
   e. Fraud investigations (showing status, amount of loss, how perpetrated, revised control recommendations)
   f. Conclusion as to the sufficiency of resources to complete annual audit plan
6. Training and professional development
   a. Status of audit staff training in comparison with annual training program
   b. Recommendations for upcoming training opportunities and requirements
7. Annually (normally last meeting of year)
   a. Summary of accomplishments of prior year's audit plan
   b. Summary of achievement of internal audit's development and performance objectives
   c. Audits planned and labor hour budget, including a brief description of risk analysis or other method used to schedule audit coverage
   d. Evaluation of controls for each major area of institution to assess the control strengths, weaknesses, and exposure for each area, highlighting areas requiring special audit and management attention for the coming year
   e. Capital and operating budget for department
   f. Annual training plan, including a summary of staff qualifications, experience, education, and certification

Annex 12E Checklist for Internal Control and Audits

This checklist is drawn from Pikholz and others (2005, pp. 112–23).

Cash

1. Is all cash kept in a locked vault or safe during nonbanking hours?
2. Is the vault protected by an adequate burglary and/or robbery alarm system?
3. Is the movement of vault reserve cash subject to dual control and record keeping?
4. Is a record maintained showing denominations and amounts of reserve cash?
5. Is each teller supplied with his or her own cash fund and his or her own vault compartment for overnight storage (of keys and stamps at least if cash is sold to the reserve at each end of day).
6. Does teller management prescribe and enforce cash limits for each teller fund?
7. Is the cash total maintained at each branch kept to prescribed levels, and are levels reasonable?
8. Are interteller transfers made by vouchers verified by both tellers?
9. Is each teller's cash checked daily to a control total developed by the accounting system?
10. Is each teller's cash periodically verified on a surprise basis by designated individuals, and is a record of the count retained?
11. Do tellers provide receipts to customers for all transactions?
12. Do tellers participate in a structured training program that provides guidelines for handling all types of transactions?
13. Are tellers closely supervised, assisted, and trained on the job?
14. Is a two-week leave or absence rule enforced?
15. Are tellers prevented from having access to accounting records, once processed?
16. Are teller differences cleared daily?

ATMS and PINs [Automated Teller Machines and Personal Identification Numbers]

1. Is daily access to the ATM under dual control?
2. Do the location, lighting, and construction of the ATM provide adequate security for customers and servicing personnel?
3. Are customers' PINs mailed or delivered separately from ATM cards?

Interoffice and Interbranch Transactions

1. Are the suspense accounts for interoffice and interbranch transactions reviewed daily by a designated person?
2. Are transactions recorded on two-part forms that identify the sending and receiving offices and the party initiating the transfer entry?
3. Is the reconcilement activity performed at a central location by a person or group with no authority to originate interoffice or interbranch transactions or handle cash?

Due from Bank Accounts

1. Are only designated officers allowed to draw on due from bank accounts?
2. Are limited balances kept in accounts that may be drawn upon by drafts?
3. Are due from bank advices, paid drafts, and statements sent directly to an independent reconciling unit within the MFI?
4. Are all due from bank accounts reconciled regularly in accordance with an established frequency schedule?
5. Is a separate general ledger account or individual subsidiary account established for each due from bank account?
6. Are bank statements satisfactorily reconciled on a timely basis with individual difference items, identified by date and amount?
7. Are approved depositories designated?
8. Are guidelines established for average balances to be maintained at each depository?

9. Are guidelines established for the write-off of old reconciling items?

Credit Products

1. Is the MFI's loan policy formalized and approved by the board of directors?
2. Does the loan policy specify lending limits for various ranks of officers and loan committees?
3. Are there procedures for periodic reporting of concentrations of credit?
4. Is there an adequate audit trail of loan proceeds disbursed, such as disbursement by check or deposited to the borrower's account?
5. Is there a signed application on file for each loan?
6. Are credit files set up for each borrower?
7. Are loan records posted and reconciled with the general ledger control accounts daily?
8. Are paid notes and loan agreements and related documents returned promptly to borrowers and cancelled or marked "paid" where appropriate?
9. Are past due account reports prepared by someone other than a teller or cash handler?
10. Are data processing personnel prohibited from making or adjusting entries to borrower's accounts?
11. Does the board regularly receive statistical reports describing the overall performance of the loan portfolio?

Collateral and Securities

1. Is all collateral (securities) receipted with multicopy, prenumbered forms that provide a customer receipt, credit file receipt, and vault receipt?
2. Is all collateral or security held under joint custody, and do the collateral forms provide for the initials of the joint custodians on all collateral movements?
3. Are adequate procedures in effect to monitor the value and condition of all collateral?

Interest and Fees

1. Has the MFI established definite loan rate and fee policy guidelines for various credit products?
2. Are the exact terms (basis of interest and fee computations, rate, and amount of fees) stated in every loan agreement?
3. Do changes in terms require the formal approval of the person or group authorized to grant the loan?
4. Are customers provided formal receipts for their loan payments that are dated and identify the persons receiving the payments?
5. Are the rates and amounts of loan income expected for the year and for each month set down in a formal budget, and are variances analyzed and corrective action taken?

Loan Losses

1. Has a formal policy been adopted for writing off assets?
2. Does that policy specify write-off criteria, procedures for periodic review, and collection efforts to be undertaken?
3. Does management evaluate the adequacy of the general reserve at least quarterly?
4. Are notes and loan agreements representing written-off loans placed in joint custody and is supporting collateral adequately protected?
5. Are collection efforts reasonable and effective?

Fixed Assets

1. Does the MFI's inventory control system provide controls over access to movable property?
2. Are signed receipts required for the removal of equipment?
3. Are purchasing and sales activities segregated from the bill paying function?
4. Do the MFI's policies and procedures preclude conflict of interest or self-dealing in the selection of vendors, suppliers, and insurers?

Savings Deposits

1. Are the rules and regulations governing savings deposits established, approved by the board of directors, and published?
2. Are new accounts personnel prohibited from performing teller and accounting duties?
3. Are signature cards and other appropriate account opening identification obtained and filed when accounts are opened?
4. Are account numbers assigned in an orderly and controllable fashion?
5. Are original passbooks prenumbered?
6. Do tellers issue receipts for all deposits, including date, amount of deposit, and teller identification?
7. Do tellers stamp the date and a teller identification number on all transactions accepted?
8. Are subsidiary controls reconciled to the general ledger daily, and are reconciling items investigated by persons who do not handle cash or post savings transactions?
9. Are customer differences and complaints handled by someone who does not receive, process, or post savings transactions?
10. Does the control system provide for placing holds on accounts requiring special attention (for example, dormant accounts, deceased owner accounts, lost passbook accounts, accounts pledged as loan collateral, accounts requiring further data, and so on)?
11. Do withdrawals over a certain amount require supervisory approval?
12. Is a closed account report generated and circulated to designated officers?
13. Are accounts with no activity for a specified period transferred to dormant status and placed under dual control?
14. Is interest calculated and credited to customer accounts independently? Is this done by persons free from teller, account opening and general accounting duties?
15. Are employee account transactions specially classified, reported, and reviewed?
16. Are interest journals reviewed by independent personnel and are large amounts reviewed and recalculated?
17. Are exception reports reviewed by a control person who does not receive, process, or post savings transactions?

Fixed Deposits

1. Has the MFI established a formal policy, approved by the board of directors, governing the fixed deposit function?
2. Is each depositor required to complete and sign an application in which penalty provisions for premature redemption are disclosed?
3. Are all fixed deposit contracts countersigned by an independent MFI official?
4. Is special approval required for premature redemption?
5. Are certificates transferred to a noninterest bearing demand deposit general ledger classification at maturity?

Security

1. Do the windows permit a clear view of the MFI's or bank's interior and are they kept reasonably unobstructed?
2. Have exterior lights been installed to illuminate all darkened or shadowed areas around the MFI?
3. Is the vault area illuminated at night?
4. Is there an emergency lighting source?
5. Are the locks on exterior doors and windows tamper-resistant?
6. Are doors and windows equipped with steel bars or other burglar-resistant materials?
7. Are all unusual entrances (air conditioner intakes, manholes, skylights, and the like) protected by an alarm, steel bars, or other?
8. Is there a regular procedure for securing side and back doors while the MFI is open for business?

9. Are all entrances to the teller work area locked while the MFI is open or while customers are in the MFI?
10. Is there a documented procedure for opening and closing the building and vaults that protects against attacks?
11. Are armed guards on duty in the lobby during banking hours?
12. Are there alarm-activating devices at lobby teller stations?
13. Is there an emergency power supply for use if the regular supply fails?
14. Are vaults made of steel-reinforced concrete?
15. Are vaults equipped with a dial combination lock, a time lock, and a substantial lockable day gate?
16. Are safes too heavy for relatively easy removal, and are they securely anchored to the premises?
17. Are safe doors equipped with a combination lock?
18. Are the vault walls, floor, ceiling, and door protected by an alarm system?
19. Is the vault equipped with an alarm or telephone so that an employee locked in the vault can sound an alert?
20. Is opening of the vault under dual control?
21. Are there standard operating procedures for the safe transit of cash not needed at each office?
22. Are precautions taken to prevent theft of all unissued forms, checks, drafts, and the like?
23. Are tellers and other lobby personnel regularly trained in robbery and postrobbery procedures?

Emergency Preparedness

1. Does the MFI have a formal emergency preparedness plan that has been reviewed and approved by the board of directors?
2. Does the plan provide for alternate physical facilities in the event that the MFI's head office or other vital facilities are destroyed?
3. Are vital records protected by duplication and safe off-premises storage?
4. Is there a plan for continuity of management?

Insurance

1. Has the MFI's policy with regard to insurance been approved by the board of directors?
2. Does it call for formal analysis and consideration of all insurable risks and types of coverage?
3. Does the MFI retain all insurance policies in an orderly file, and are all riders and endorsements attached to the policies?
4. Are policy expiration dates properly diarised to assure prompt payment of renewal premiums?

Computer Processing

[Pikholz and others (2005) drew this section from Gordon Morris & Associates (1991).]

1. Are computer operations performed where they cannot be seen by the general public and unauthorized visitors?
2. Does the server room have heat or smoke detectors, temperature and humidity control equipment, water sensors, and alternate power supply (UPS system)?
3. Are emergency plans for computer processing included in the MFI's emergency preparedness plans?
4. Do emergency plans include procedures for the safe storage of data files and documents?
5. Do emergency procedures include power-off procedures, restart, and recovery procedures for equipment failure?
6. Does the contingency plan specify conditions for off-site processing?
7. Is there a policy for retention of backup data files to ensure that adequate recovery capability exists?
8. Are there operating manuals for the system and users, including error messages with appropriate responses, restart, and recovery procedures?
9. Are programmers prohibited from running test programs against live production files?
10. Have controls been established for each source of data entering the automated system?

11. Is output reconciled to input by persons not responsible for the data entry?
12. Are parameter changes properly approved, documented, and tested?
13. Are parameter changes reported and reviewed by an appropriate officer?
14. Is access controlled by user IDs and passwords that are tracked by the system and reported?
15. Are changes to access levels reviewed by an appropriate officer not responsible and without ability to initiate such changes?
16. Are controls in place for vendor supplied changes to ensure proper installation?

Notes

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1. The Basle Committee on Banking Supervision is a committee of banking supervisory authorities that was established by the central bank governors of the Group of Ten countries in 1975. It consists of senior representatives of bank supervisory authorities and central banks from Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, the Netherlands, Sweden, Switzerland, the United Kingdom, and the United States. It usually meets at the Bank for International Settlements in Basle, Switzerland, where its permanent Secretariat is located.
2. For a detailed explanation of process mapping, see Champagne and others (2004).
3. Parts of this section are summarized from two World Council of Credit Unions sources: Branch and Klaehn (2002) and WOCCU (2002).
4. Some of this section is summarized from WOCCU (2002).
5. See http://www.theiia.org/index.cfm?doc_id=5402#1__What_is_internal_auditing_.
6. The Microfinance Deposit-Taking Institutions Act, 2003, Part IV, Section 28, p. 30.
7. Some MFIs may want to also include client audits, especially of client groups, in their audit programs.

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Chapter 13

Customer Service and Operations

The transformation of a microfinance institution (MFI) into a regulated deposit-taking institution requires a number of significant operational changes. In the branch network, banking halls often need to be created or expanded complete with teller windows, sales desks, customer service points, and desks or offices for supervisors and branch managers. Procedures for cash management at the branches and deposit account management, both often new to the transforming institution, need to be developed and implemented. Policies and procedures for both current and new products need to be clearly documented in standard format and distributed to branches and head-office staff. Furthermore, the operations area (in some cases referred to as "supervision") will be thoroughly reviewed by regulators as part of the licensing process. In fact, the licensing decision is likely to be based, in part, on the efficiency and professionalism of the overall operations of the MFI. In sum, the operations of the transforming MFI need to be examined, upgraded, standardized, well-documented, and the appropriate personnel trained.

In addition, with transformation to a deposit-taking institution, the customer's experiences and expectations with regard to products and service levels change. Regulated MFIs have to ensure they provide excellent customer service. For many credit-only nongovernmental organizations (NGOs), clients principally interact with the MFI's loan officers. In many cases, clients may never enter the MFI's branches because all loan transactions occur "under a tree" or in separate community centers. This generally changes with transformation because the primary delivery channel for the institution's products and services becomes the branch and is thus the focal point for customer service efforts. Conducting transactions in the branch will define the way in which clients perceive the institution and dramatically influence their buying behavior. With the addition of deposit mobilization, transforming MFIs often need to spend significant time and resources upgrading their branch networks and reexamining the way in which clients are served and information is communicated. The branch network is critical to communicating the corporate brand and is a vital determinant of the cost structure of the institution.

As mentioned in chapter 12, Internal Control and Audits, credit-only NGOs often structure their lending operations so that staff do not handle cash, which helps reduce the temptation of fraud and

generally makes internal controls and accounting easier for the MFI. In addition, the opening and closing of savings accounts, deposits, withdrawals, and other teller transactions are likely to be new to the transforming MFI. Furthermore, while the MFI may have general policies on managing documentation and inventory, those policies will need to be reevaluated in light of regulatory expectations.

Operations becomes a critical component of a transformed MFI's strategy to meet compliance requirements, strengthen its position in the marketplace, and realize its commercial and social goals.

This chapter begins with a general discussion of the evolution of operations with transformation—both function and structure. Given the close link between customer service and operations in a transformed MFI, the next section introduces key aspects of customer service, providing concrete suggestions on how to evaluate and improve it. The bulk of the chapter then focuses on branch operations concluding with a discussion on specific back-office operations—cash management, deposit account management, and documentation management—that transforming MFIs typically need to further develop or in some cases address for the first time as they plan to intermediate public deposits.

Transformation of Operations

The operations of an MFI include planning, directing, delivering, and controlling the daily activities related to the delivery of products and services. The operations department supports the application of operating policies and procedures and ensures overall reconciliation between the different functions of the MFI, providing ongoing feedback to senior management. In particular, the operations department oversees the functioning of the branch network from the operating perspective and frequently, the marketing perspective as well.

Role of the Operations Department

Operations activities for an MFI NGO tend to be largely supportive—typically considered "back-office" functions—supporting the more "front-office" functions of the commercial activities that provide direct service to the clients, such as mobilizing clients, disbursing loans, receiving payments, and other daily activities. For a regulated deposit-taking institution, however, the role of the operations department expands beyond the back-office functions, as teller and marketing functions are added, both of which involve direct client interaction. At the same time, the efficiency of some of the more traditional back-office functions, such as transaction processing, become more important to client satisfaction as clients become more discerning in their choice of service provider. As discussed in chapter 9, Human Resources Management, the addition of supervisors at the branch level (and sometimes at the head office as well) to assist with the front-office functions helps branch managers ensure that the overall operations of the branch run smoothly. The role of the operations department in a transformed MFI therefore extends beyond simply providing back-office support and includes the following:

- *Ensuring adequacy and maintenance of infrastructure:* The operations department is responsible for maintaining delivery channels. It must ensure that the branch network, sub-branches, agencies, automated teller machines (ATMs), and tellers are sufficient for the volume of business being generated. In transforming MFIs, the operations department not only needs to maintain delivery channels but may well need to develop new delivery channels as part of the transformation process. This can be a significant task, particularly for MFIs that have never managed cash before and realize that the existing infrastructure is unable to accommodate large banking halls. For example, Compartamos in Mexico considered partnering with other

institutions and using third-party payment systems on an outsource basis to compensate for their insufficient branch infrastructure.

- *Managing performance:* The operations department monitors all aspects of branch performance, comparing efficiency indicators across the branch network and ensuring branches meet their savings, portfolio, and profitability targets. Operations staff members also work to motivate front-line staff and to develop a team approach to achieve greater productivity. An effective operations manager, in conjunction with the branch manager, closely monitors the activities and accomplishments of branch staff and helps staff reach performance targets, and helps the MFI attain its profit targets on schedule.
- *Ensuring adherence to policies and procedures:* Clients expect branches to perform consistently, and tend only to notice when things go wrong or do not meet expectations. The operations department, jointly with the internal audit department, ensures that policies are followed consistently in all branches. This not only helps to reduce the possibility of fraud but also helps to ensure standardization across branches. It may also follow up with client complaints and, if necessary, propose changes in policies or procedures.
- *Identifying systems or applications problems or weaknesses:* The operations department is responsible for ensuring all systems in the branches are working. For example, it is responsible for monitoring all transaction systems and ensuring tellers are able to use the systems effectively when trying to post a transaction or carry out end-of-day processing. Thus, the operations department serves as a link between the information technology department and the branches.
- *Ensuring adequate and secure operating and cash balances:* The operations department, jointly with the treasurer, is responsible for ensuring the branches have enough cash. Operations must also ensure that any excess cash is handled safely and securely, by establishing comprehensive cash management procedures for handling large sums of cash, use of safes in the branches, teller approval limits, transporting cash to and from the branch, and any other cash-related issues.
- *Identification of process bottlenecks:* The operations department has a great advantage in seeing how the day-to-day business flows occur at the branch level. Coordinated attempts are made to understand process bottlenecks through process mapping (discussed briefly in chapter 12, Internal Control and Audits) and improving all procedures.
- *Maintaining brand consistency:* The operations department works to ensure that every branch looks and feels the same and ensures the MFI's brand is evident and consistent.[1]
- *Maintaining high levels of client service:* The operations department works closely with the marketing department (which is normally responsible for conducting market research and monitoring levels of client service), helping to manage call centers, register complaints and questions, and monitor suggestion boxes.[2]
- *Maintaining high levels of product knowledge:* The operations department helps to ensure that each staff member is fully aware of the client benefits of each financial service provided by the institution. Jointly with the marketing or the human resources department, operations staff perform product-based training and conduct product knowledge tests.
- *Optimizing branch marketing:* In coordination with the marketing department, the operations department ensures that branches maintain a consistent and coherent approach to marketing products and services. The operations department monitors the display of client communications, including posters, brochures, and other materials.
- *Optimizing customer service:* Operations staff members are also in a position to receive feedback from clients on a daily basis and ensure that

client service goals are being met. Operations staff members work closely with the human resources department to ensure adequate training of front-office staff and to ensure that appropriate incentives are established for branch personnel.
- *Reporting to senior management:* Operations or supervision staff members provide an invaluable service to senior management by reporting on activities, accomplishments, problems, and plans for the branches or units. They may also propose new products or improvements to existing products or services and follow up on feedback or findings made by internal audits, external audits, and regulators.

Structure of the Operations Department

The structure of the operations department depends on the organizational structure and the size of the transforming MFI. Operations staff may be concentrated at head office and make frequent visits to branches, or separate operations staff may be based in the branches. In branches that are not large enough to warrant their own operations manager or supervisor, the branch manager may take on this role.

Job descriptions for operations staff vary among institutions, but in general operations staff spend significant time in the banking halls where they can oversee tellers and customer service agents, and provide approvals for transactions beyond the line staff limits, as well as assist with customer queries or complaints as they arise. Often operations managers' or supervisors' desks are placed specifically where they can see each of the tellers' workstations and can monitor client flow, addressing any problems that may arise. By physically keeping all the teller windows in sight, operations managers or supervisors can ensure that tellers are following policies, especially those related to cash management.

Generally, the operations manager at the branch reports to the branch manager and will have line staff who report to him or her. However, this reporting hierarchy depends in large part on the branch manager's duties and the reporting structure of the credit officers. If the branch is large enough, some MFIs have both a credit manager or supervisor and a savings manager or supervisor, who oversee the line staff and in turn report to the branch manager. In smaller branches, there may be only one manager or supervisor or even one manager or supervisor overseeing two or more small branches.

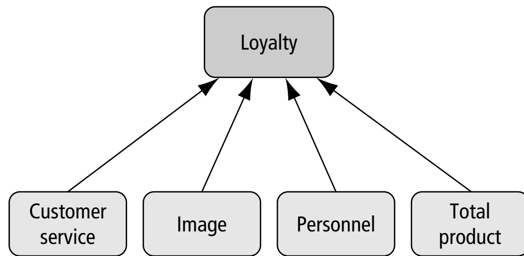
Customer Service Framework

An MFI may have all the right products and guidelines in place, but if its branches are congested, its personnel uninformed, and its procedures inconsistently applied (all key elements of operations), client satisfaction and loyalty will be low.[3] Customer service is the ability of an institution to constantly and consistently satisfy clients' wants and needs. With transformation, MFIs need to significantly increase their focus on customer service, particularly given the competitive environment in which the transformed MFI may find itself.

Although not necessarily intuitive, customer service also includes areas of the MFI that do not come in direct contact with the client. For example, if back-office support staff are slow inputting loan application information, the resulting delayed disbursement will impact service quality as much as a rude teller. For this reason, the entire institution is involved in providing excellent customer service. Customer service is one element of customer satisfaction that, in turn, generates customer loyalty (figure 13.1).[4] Other aspects such as total product and image are discussed in chapter 4, Marketing and Competitive Positioning.

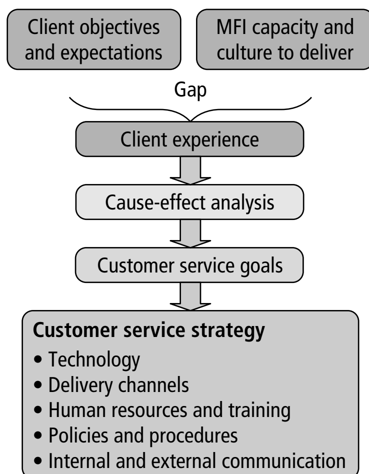
The quality of customer service can be measured by the difference between the customer experience and his or her expectations. Excellent customer service is achieved by exceeding customers' expectations—even slightly—both consistently and

Figure 13.1 Elements of Customer Loyalty



Source: Churchill and Halpern 2001.

Figure 13.2 Customer Service Framework



Source: Marketing and Product Development Unit, ACCION International.

creatively. Too often, however, the gap between customers' preferences and the perceived level of service received breeds dissatisfaction. See figure 13.2. This gap can be caused by a variety of factors discussed in chapter 4, Marketing and Competitive Positioning. These negative factors include the following:

- *Inadequate market research:* Does management understand customer needs and preferences? Has management correctly analyzed competitive standards against which the client is measuring the MFI?
- *Flawed business model:* Have the perceptions of customer needs and preferences been successfully translated into design of the product, policies, and procedures?
- *Implementation problems:* Is the service gap related to a failure in the execution of the company's business model, whether delivery channels, information technology, human resources, or communication?
- *Raised expectations:* Is there consistency between internal and external communications? Have promotional campaigns falsely raised client expectations? Has the social or political context within which the MFI is working changed, thereby affecting client needs and preferences?

Customer Service Strategy

Given the multifaceted nature of potential customer service failures, strategies to improve the customer experience are based on a variety of factors that include standardization of policies and procedures, delivery channels, human resources, technology, and communications within the MFI.

Policies and procedures. Systemizing procedures and standardizing policies is a challenge for MFIs as they transform but is vitally important to achieving consistency and reliability—both crucial characteristics of good customer service. Many MFIs pride themselves on tailoring solutions to individual clients and decentralizing authority to make decisions. Nonetheless, MFIs will find it important that the transformation process identify minimum standard levels and quality controls to ensure good service is maintained as the MFIs' services expand in scale and scope. In addition, policy adjustments are often necessary to meet customer expectations for flexible, accessible, fast service. This issue is particularly relevant for microfinance and other service industries in which the distinctions between "product" and "customer service" are blurred, given that the former can be as intangible as the latter.

Delivery channels. Branches can become a source of service problems in transformed MFIs, as they try to manage higher traffic flows associated with expanded services. Wait time is a consistent customer complaint, along with disorganization, lack of orientation or guidance, and insufficient seating. In addition, convenience, including location of the branch and its hours of operation, can contribute to or hinder excellent customer service. Many transformed MFIs explore channels complementary to their branch network, such as ATMs and remote transaction systems, to meet the higher service levels customers expect from a regulated financial institution (as opposed to an NGO). With all delivery channels, the challenge is to maintain consistency across all points at which the customer interacts with the MFI, in terms of service quality, available information, and other "tangibles."[5] (See chapter 4, Marketing and Competitive Positioning, for further discussion on delivery channels.)

Technology. Technology becomes relevant for customer service because it enhances information quality, speed of service, and convenience. Technology—point-of-sale devices, personal digital assistants, credit scoring, biometrics, and other innovations—has the potential to improve information reliability and reduce processing time and transactions costs. However, technology upgrades during the transformation process can actually create short-term service problems as bugs are worked out, temporary patches are removed, and staff become familiar with the new systems. Many of the service strategies involve developing and documenting contingency plans to deal with the inevitable system crashes or freezes, power outages, or data loss. The goal is to move the MFI from an ad hoc approach to a more systematic approach to dealing with these issues to maintain quality customer service.

Human resources. The human resources area is usually the primary focus of customer service efforts—MFIs require staff to attend training that emphasizes the MFI mission and the importance of excellent customer service. Such training is a critical lever in improving service quality because it is founded on an understanding that excellent customer service begins internally. If the internal clients are not satisfied, they will probably not provide good customer service to external clients. A transforming MFI should conduct an assessment of staff satisfaction, ideally through internal focus groups, to identity the root causes of service problems for both the internal and external clients. The most common human resources–related causes of negative external customer service include

- Low employee moral caused by lack of a professional development path, perceived unresponsiveness to needs, meager pay in relation to level of effort, lack of recognition, perceived lack of transparency, low authority levels, and micromanagement
- Poor or outdated training in policy and procedures, skills development, or product details
- Weak organizational culture that is not centered on the client or service (This issue is one of the greatest challenges in developing and implementing a customer service strategy.)

Addressing human resources issues requires adjustments in recruitment, training, delegation of authority, remuneration, and professional development. See chapter 9, Human Resources Management, for further discussion.

Communications. Both internal and external communications are critical components in customer service—external communications establish external clients' expectations and internal communications determine how the internal client satisfies them. Most important, the promises communicated in the promotional material must match what the MFI delivers. Underpromising to keep customer expectations low and then overdelivering is the best outcome. Consistency is an important

component of communications, which is why manuals or information sheets with frequently asked questions can be helpful customer service tools. Studies consistently show the value of soliciting client feedback not only in improving delivery of financial services but as an active ingredient in promoting positive "word of mouth" among the target group.[6] Mechanisms to solicit client feedback include the following:

- *Client surveys:* carefully worded and tested surveys, easy to complete in a timely manner designed to solicit client feedback on specific issues or in general
- *Focus group discussions:* carefully moderated discussions with groups of clients designed to solicit client feedback on key issues
- *Suggestion boxes:* many suggestion boxes that sit dusty and unused because clients feel their opinions will have limited impact on the MFI (The volume and quality of suggestions can be significantly increased through active promotion of the suggestion box as a feedback mechanism. Posters soliciting client feedback can be prominently displayed, and a board showing institutional responses to client suggestions can be created and set up.)

A feedback system is also important for internal clients—to deepen and update understanding of their needs and communicate actions taken to meet them. Feedback systems involve not only collecting information (through suggestion boxes, staff meetings, impromptu field visits, or other means) but also tabulating and acting on the information proactively to improve service.

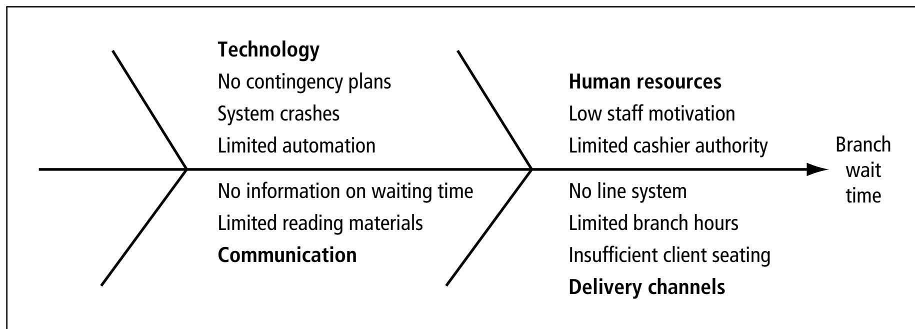
Improving Customer Service

The business process of improving customer service is based on a systematic, multidisciplinary, phased approach outlined below. The MFI will likely find it useful to appoint a customer service champion to lead the process.

Analysis and preparation. The process starts with understanding the problems, their root causes, and what the MFI hopes to achieve. This information is gathered using a variety of marketing intelligence—gathering techniques, including staff interviews, labor climate surveys, focus groups, mystery shoppers,[7] time and motion studies,[8] and (if necessary) quantitative surveys with clients. The goal of this phase is to elicit the following results:

- *An understanding of the customer experience and the key contact points:* The results of the research are analyzed to understand the key contact points or "moments of truth" that affect client perception of service quality. For example, if good clients (large depositors, or those that always pay loans on time) are not given preferential treatment when they visit the branch (contact point), they may not feel the MFI appreciates their business.
- *Determination of root causes:* Considering how each of the various areas discussed above contribute to customer service problems will help uncover the root causes. For example, if customers are complaining about the waiting time in branches, it may be because of technology problems, issues within human resources, a lack of communication with clients, or improper delivery channels (see figure 13.3).
- *Definition of institutional vision for customer service:* Mystery shopping and time and motion studies are performed on the MFI, as well as on its competition to establish industry standards or benchmarks against which the MFI can measure its own performance and set goals for minimum levels of service quality. In general, the MFI must determine what it hopes to achieve in its efforts to improve customer service and how much it is willing to invest. Transformation is the time when the institution can decide to establish differential service levels—a baseline minimum standard it wants to commit to uphold as part of its brand promise and, potentially, an elite level for preferred clients.

Figure 13.3 Possible Root Causes of Long Wait Time



Source: Marketing and Product Development Unit, ACCION International.

Strategy development. Once the analysis and preparation phase is complete, findings are presented and brainstorming sessions are held by component and by segment to compare those service dimensions most highly valued by clients with the cost and complexity of implementing various solutions. Solutions that are easy and inexpensive to implement and are prioritized by the client—such as organizing transactions slips in the branches or adding more seats for clients—are implemented immediately.

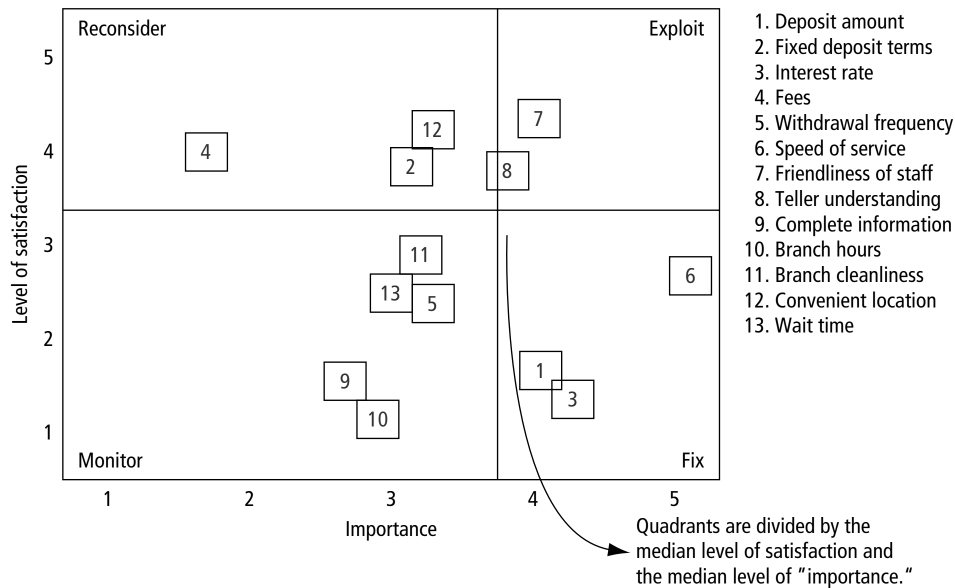
To solve more complex customer service problems, quantitative surveys, such as those that measure the relative importance of different service dimensions and how well the MFI performs on each one, may be helpful in prioritizing different recommendations. As shown in figure 13.4, this fictitious MFI should focus on lowering minimum required balances, raising interest rates paid on deposits, and improving wait time—the dimensions of service most important to clients and in which the institution is performing relatively weakly.

The timing to implement various solutions depends on the cost, institutional capacity, and strategic importance in the MFI's overall positioning. In all cases, the MFI must define its goals and establish target standards of quality by which it will measure its progress in improving customer service. The customer service champion is charged with defining the areas that need to be improved and with monitoring the progress.

Pilot and implementation. Those recommendations that are more complex—such as developing a new external communications plan or implementing a qualitative incentive scheme that rewards internal customer service—involve a variety of areas within the organization and should be piloted before rollout to ensure smooth functioning and buy-in. The pilot plan should include the following:

- *Parameters:* Certain core components of the strategy must be tested before institutionwide rollout. Parameters should identify the number of pilot test sites, the duration of the pilot, and the frequency of the monitoring and intervention.[9]
- *Work plan:* The work plan sets out the different functional areas that will be involved in the pilot, the responsibilities of distinct personnel, the time line of activities to be tested, and interim and end goals.
- *Training:* Both front-line and back-office staff are trained, that is, all branch staff including guards and others join the training for team-building purposes and to emphasize the point that customer service is by its nature a multi-disciplinary function. The training is typically

Figure 13.4 Relative Importance of Service Dimensions



Source: Marketing and Product Development Unit, ACCION International.

interactive, to permit branch level staff to personalize the strategy (within limits).

As part of the piloting process, it is important to also develop a monitoring plan. The goal of monitoring is to supervise the implementation of the recommendations, monitor outcomes, and revise the strategy accordingly. The monitoring plan should include a clear definition of how the service indicators will be monitored, and how frequently. For example, will the MIS generate certain indicators or will they be observation-based? The customer service team needs to determine how difficult it will be to incorporate new variables into system reports before deciding whether it makes sense to manage the pilot manually instead. See table 13.1 for examples of possible solutions to improve customer service and client satisfaction, as well as monitoring indicators.

Once a strategy for customer service is completed, it must be communicated to all staff. Compiling the different elements of the strategy into a user-friendly customer service manual with the following components will help solidify understanding within the MFI:

- Customer experience map with the key contact points and how staff can add value at each one
- Frequently asked questions with agreed upon answers
- Customer handling procedures, including how to process complaints and queries and escalation policies that govern when to bring in managers
- Functional roles that outline the responsibility of each staff member with respect to service and sales support
- Feedback loops that define how client information is collected, tabulated, and most important, acted upon
- Contingency plans in case of system crashes, power outages, or other unexpected events

Ultimately, excellent customer service is the responsibility of the operations department working closely with the marketing department, if applicable. As discussed below, the layout of the

Table 13.1 Improving Customer Service

Recommended solution	Indicators of success
Internal promotion	Number of job postings
Employee of the month	Improved morale
Regularly scheduled staff meetings	Improved morale
Incorporate personal milestones in newsletter	Improved morale
Well-organized information board	Compliance
Dress code	Percentage of staff with colors
Customer service training	Test
Objectives for tellers	Number of transactions per day; percentage without error
Greeter or "orientation agent"	Reduced wait time
Smart cards with identification	Number of transactions per day; percentage without error
Feedback mechanisms (including suggestion boxes with posted actions)	Number of suggestions per number of active clients

Source: Contributed by Monica Brand, ACCION International, September 2005.

branch—including the presence of a customer service representative, the location and availability of transactional documents (deposit and withdrawal slips, for example), rope lines, seats for clients—has great impact on customer service. In addition, teller management—including how tellers execute transactions, how they are trained, and how they are remunerated—is also a key operations function and an important determinant of service quality. Many transforming MFIs hire an outside consultant to assist them in developing a strategy to improve customer service. See annex 13A for a sample terms of reference.

Branch Structure and Service

Like customer service, branch structure and service is a function shared by both marketing (as part of the delivery channel strategy) and operations.[10] However, the operations department is normally responsible for key components of branch management, including opening new outlets, layout and configuration, teller and cash management, and traffic flows.

Branch Location

Given the importance of the branch network as a delivery mechanism, carefully locating and establishing each branch office is vital. Branches must be located in areas that provide frequent, accessible, and convenient service for existing and potential clients.

Branch location is particularly challenging for transforming MFIs. Credit-only MFIs generally select office locations according to a different set of criteria than savings-based financial institutions. To control costs, many credit-focused MFIs locate their offices off the main road or in converted residential spaces. This approach is fine for providing loans because most clients are prepared to sacrifice convenience to obtain a loan. The same does not hold true with clients wanting to access savings services.

Feasibility studies. Branches should be located based on a macro-level feasibility study. Feasibility studies determine high potential towns that match the MFI's mission, vision, and growth plans. The study considers likely demand for financial services and proximity to other branches and any competing financial institutions. The feasibility study should be

Box 13.1 Locating Branches of Transforming MFIs

Before transforming to a microfinance deposit-taking Institution, FINCA Uganda located many of its regional offices on the outskirts of regional centers, because this provided good access to its rural village banking clients for its field staff (actual delivery of financial services occurred at the village level in FINCA Uganda). However, to compete for deposits, FINCA Uganda has relocated many of its regional offices and has had to rethink its delivery strategy.

Source: Cracknell 2005.

conducted in conjunction with the marketing department.

Accessibility and expansion potential. Branches should be located in areas that allow the MFI to provide accessible, frequent, and convenient services to its clients (see box 13.1). Careful research conducted in conjunction with the marketing department will help to determine where target populations are located and underserved with financial services. Locations within those target communities can then be evaluated. The MFI should also consider the expansion potential of the branch.

Providing rural services. An approach adopted by many transforming MFIs is to operate through a branch network supplemented by subbranches or agencies. Subbranches are smaller than branches but otherwise fully functional, though they may operate on a local server during the day and update information overnight. Agencies only operate one or two days per week, generally in smaller towns with opening times coinciding with market days. Some MFIs pilot test subbranches in medium-size towns with each subbranch location selected to provide sufficient space if the subbranch were to graduate into a full branch as its client base grows.

Alternatively, licensed MFIs, if approved by the regulator, can operate mobile banking units to reach rural areas. In Kenya, for example, Equity Bank operates mobile banking through vans equipped with online access through very small aperture terminal (VSAT) communications. The vans can operate as independent branches with staff serving clients from the van, or more often, used to operate agencies for one afternoon a week in different locations around an Equity Bank branch (Coetzee, Kabbucho, and Mnjama 2002).

Branches can also be supplemented, depending on the institution and its target market, through agency relationships, ATMs, point-of-sale devices, or other technological advances. (See chapter 11, Management Information Systems, for more discussion.)

Proximity to other branches. To control management and monitoring costs, some MFIs open branches in relative proximity to other branches within their networks. This allows the MFI to provide multiple access points for clients within a given region and to expand into areas in which it is already known, thereby reducing marketing and promotional costs while also containing management costs.

Competition. High-potential locations often already have a number of existing financial institutions. The transforming MFI must determine if there is sufficient unmet demand for another financial institution or if it has competitive advantages to offer that might attract dissatisfied clients. A location with limited competition may prove an ideal opportunity, but then the MFI must question why there is no competition and verify that enough market demand exists.

Location may also be a function of the maturity of a financial institution. The initial branches of many transforming MFIs may be situated in smaller towns with limited local competition. However, with transformation and expansion, MFIs have a

Box 13.2 Finding Quality Premises

"It can be difficult to obtain suitable premises outside regional towns. This is because each branch must be strategically located within a town or trading centre. The branch should be located in a secure area and should have a strong perimeter wall at the back of the branch. The physical strength of the building is important due to low construction standards outside Kampala. This often means when FINCA Uganda moves to set up a branch in a town or trading centre, there are a limited number of buildings, which are well located and strong enough to become a branch. In practice this means negotiating with landlords and existing tenants. It can also mean undertaking substantial infrastructure improvements."

Source: Interview with Shafi Nambobi, FINCA Uganda, from Cracknell (2005).

much greater ability to compete effectively with larger commercial banks, and thus many open branches in major metropolitan areas.

Once a high potential location has been selected, the institution needs to select where the branch should be positioned. Sometimes the decision is forced by the availability of suitable premises (box 13.2). However, other factors such as foot traffic, transport routes, potential for expansion, facilities, and security should also be considered.

Foot traffic. *Foot traffic* refers to the number of people from the intended target group that pass by the branch during a given period. Locations with heavier foot traffic offer much higher potential for savings mobilization and the provision of other services than locations with low levels of foot traffic. More remote areas with lower population density may not be able to justify a full branch, but may justify opening an agency branch or implementing mobile banking (if allowed by the regulator).

Transport network and security. A branch is likely to draw clients from surrounding areas with good transport links. Good transport links can make cash-based transactions safer. However, generally branches should not be located too close to bus terminals because in many countries these are unsafe locations, favored by pickpockets and other petty thieves. Branches should be situated in relatively secure areas.

Facilities. The branch should have access to utilities, water, electricity, and ideally, mobile phone network access and the Internet, and be accessible to the management of the financial institution. The importance of these attributes leads to an almost inevitable bias toward locations serviced by tarmac roads.

Branch Infrastructure

Branch-based banking is underpinned by the establishment, maintenance, and expansion of appropriate infrastructure. Relatively standardized branches with a banking hall, tellers, a back office, and space for supervisors and credit officers will account for most of a bank's physical infrastructure.

Branches must meet the requirements of the MFI, its clients, and its regulators. Both the institution and its clients need an environment that enables efficient transactions and effective communication. Regulators require secure premises appropriate to the business being undertaken within the branch.

- *Client focus:* A client-focused banking environment requires careful consideration of the allocation of space, and the use of client service and branch-based sales desks. The branch needs to accommodate credit staff and branch management while providing a sufficient number of teller windows, queuing space for clients, and customer service and sales desks. It also needs to support effective communication with clients.

- *Regulations:* Most supervisory authorities stipulate minimum standards that must be met for regulated institutions to mobilize savings. These standards deal primarily with security, such as requiring armed guards at the entrance, specifying the dimensions and wall thickness of strong rooms, safes, and dictating standards for the teller windows and customer service areas. Many MFIs do not meet these standards, either because they outsourced these functions (such as disbursements and payments) as NGOs or because they were never mandated by a third party to install these features. Thus, many MFIs have to upgrade their existing branches to properly handle cash functions as part of the transformation process and comply with these regulations.

Many financial institutions providing mass market financial services operate predominantly from rented premises for good reasons. The capital outlay required to own premises is significant and reduces cash available for lending. Also, in many countries regulators prefer financial institutions to maintain fixed assets at a lower level than core capital—to ensure depositors' savings are not being used to finance long-term assets.

However, reliance on rented premises comes at a price. In the absence of banking premises built specifically for providing savings, it can be difficult to create an ideal banking hall, especially outside capital cities where the choice of suitable buildings is limited. Extensive renovations are often required and frequently internal walls and partitions need to be removed to create a large enough area for a banking hall.

Older banking halls can be especially difficult to render suitable, because they were designed at a time when manual procedures predominated, requiring considerable space for back-office operations. Today, the focus is on providing space for clients and for staff interaction with clients. Over time, regulated institutions commonly develop "model branch" layouts to standardize the allocation of key functions (cashier, teller stations, waiting area, customer service, staff meeting rooms, back office, ATM), facilitate location of space, and streamline purchase of equipment and furniture.

Building the infrastructure of a branch can be very expensive. On average, in Uganda, for example, the transforming MFIs spent between U.S.$25,000 to U.S.$50,000 each for four or five teller branches to meet central bank licensing requirements.

One of the most expensive requirements, often making up half the cost of preparing a new branch, is the construction of the strong room. Strong rooms are normally constructed from reinforced concrete. MFIs need to ensure that the strong room does not connect with an outside wall, has reinforced walls, ceiling, and floor and an appropriately secure door. Given the cost of preparing a branch, many transforming MFIs look where possible to rent premises formerly occupied by other financial institutions, and ideally, with an existing strong room.

Security. Once the transformed MFI begins offering savings services, it must make sure that an enhanced security system is in place. It must purchase safes for all branches offering savings services to keep cash for potential withdrawals. It must ensure there is minimum risk of robbery by keeping safes in the strong rooms. It must also introduce dual custody of keys or combinations to the strong rooms and safes to ensure there are checks and balances. (See chapter 12, Internal Control and Audits, for more discussion). At a minimum, the following are required:

- Doors and windows should be equipped with steel bars or other burglar resistant material
- The strong room should be operated under dual control
- Keys to the entrances of the premises should be assigned to specific officers who should sign for them

Box 13.3 Bank of Uganda Questionnaire on Premises

Ownership of premises. Are premises owned or leased, and, if leased, is the lease sufficiently long to produce economic returns and has landlord approval been obtained for upgrades?

Approvals. Have approvals been provided from local authorities, security companies, electrical service?

Banking hall. Does the banking hall suit the type of business to be undertaken in the premises?

Staff operating area. Is the space for each individual adequate? Does the branch have appropriate conveniences?

Lighting and ventilation. Are these appropriate throughout the premises?

Outer doors, walls, windows. Are the outer doors heavy duty, secured with two or more locks of good quality? Are the windows and glass walls reinforced with metal grills or made of antiburglar or bulletproof glass?

Strong room. Is the strong room conveniently situated? Does it border with outside walls? Is there space to accommodate the needs of the institution? Are duplicate keys stored off the premises? Is there dual control for entry?

Freestanding safe. Is it fireproof? Is access to the safe and the room in which it is kept under the control of more than one person?

Cash loading area. Is it protected from public view and access? Is cash in transit protected by police or a security firm? Are there security guards at the premises at all times?

Teller tills. Are they restricted to individual tellers during working hours?

Alarm system. Is there an alarm system installed in the premises? If yes, is it connected to the police or a security firm? Are switches located in the strong room, cashiers' cubicles and teller stations, and manager's office?

Emergency plan. Is there an emergency plan? Is it documented? Are there fire extinguishers located in appropriate places?

Source: Based on Cracknell (2005).

- All branches should be equipped with security alarm systems
- Teller stations should all have lockable cash drawers
- Cash should be transferred under armed escort at different times and hours of the day or week (There should be no pattern formed of when cash is transferred.)

See box 13.3 for more detail about making premises suitable for a deposit-taking MFI.

Space allocation. Balancing space requirements for the front and back office and savings and credit functions is a perpetual challenge. The high transaction volumes that follow when mobilizing savings from the general public has a number of implications:

- The banking hall must be sufficiently large to accommodate peaks in transaction volume during the day, month, and year. It should be large enough to accommodate queue management systems should these become necessary. The number of tellers should be sufficient to manage anticipated peak loads, and the banking hall should have space to accommodate additional teller stations to enable growth in business volume.
- Space should be available to position client service, inquiries, account opening, and sales desks. These functions are frequently combined into a single desk in physically smaller branches.

Increasingly, the branch or operations manager or supervisor will occupy an office that connects to the banking hall and to the back office to allow for

easy access by both staff and clients. This positioning also allows for quick response if queues begin to develop in the banking hall.

Space requirements should be closely integrated with the processes of the MFI. For example, supervisors should sit close to tellers to ensure minimum time delays if supervisor interventions are required. Also, the supervisor's desk should always be positioned so that he or she can see each of the tellers as they carry out their day-to-day tasks. The space required by back-office operations should be limited where possible through computerization of many back-office functions. For example, supervisor approvals can be provided online in most modern banking systems.

In many branches, the credit department sits off the banking hall to provide easy access for clients. Although credit officers sometimes sit directly in the banking hall, a dedicated interview room is usually available to ensure privacy to clients seeking loans. The challenge with operating a credit department adjacent to the banking hall is that it can quickly lead to the banking hall being crowded with clients waiting for loans.

Branch Communications

A client-focused MFI supports effective brand management and client communications and encourages branch-based sales. The banking hall should be used to communicate with clients through use of signage, name tags, and posters. Two-way feedback should be encouraged through well-promoted suggestion boxes with responses to clients' suggestions clearly displayed nearby.

Running an efficient and focused front office requires that all staff in contact with clients be able to answer basic inquiries. Most clients fail to distinguish between a teller and a loan officer when it comes to the provision of basic information, yet in many recently transformed MFIs, tellers have minimal knowledge of loan products and loan officers have poor knowledge of savings products.

Given that clients and potential clients congregate at the branch, it should be a key focal point for sales. Sales should be driven by a branch-based marketing focus, and, where possible, by branch-based marketing staff. (See chapter 4, Marketing and Competitive Positioning, for further information on marketing and communications.)

Signage. Signage should use clear, concise language that clients can easily understand. Signs must be visible in a crowded banking hall, so clients know they are in the right place for the services they require. For this reason, signs hanging near the entrance or waiting area should provide clear instructions on basic functions. Smaller signs placed on tellers' windows and other "hot spots" should be used for supplemental information ("Did you know that . . . ?") and promotions. All signage should be consistent with the corporate brand to help strengthen the image of the MFI.

Name tags. It is surprisingly common for staff to remain unidentified to their clients. In such cases poor service is identified as an institutional failing rather than the fault of a specific individual. Name tags identify staff as employees and give the impression that the MFI is open and transparent and accountable for its actions. Name tags also tend to promote service excellence among staff and encourage better communication.

Client information. Client information includes informative posters, price lists, brochures, and notice boards. The target market must understand the information provided and brochures and the like should always be available to clients. Graphics and photographs should be used to assist a semiliterate market. If information is poorly presented, communication with clients becomes much more difficult. The transforming MFI needs to take care that out-of-date posters and brochures are changed when prices or product features change. In some cases, clients are presented with too much

information and are, therefore, unable to determine what is important to read. In other cases, communication materials are presented casually in handwriting rather than in print and in a format that is inconsistent with the corporate brand—thus lessening the impact potential of the brand.

Customer service desk. Many MFIs offering savings services operate customer service desks within the banking hall. Customer service desks serve as a principle point of contact with clients. Customer service staff members are trained to have in-depth knowledge of the MFI's products and services and are able to facilitate product sales even if other officers are responsible for the closure of a particular sale. If customer service staff members cannot answer an inquiry, they should be able to channel questions to an appropriate officer within the branch.

In addition to assisting clients, customer service desks promote efficient services. They remove clients with questions from queues, enabling queues to flow faster. Customer service desks effectively screen client contact, ensuring the client is directed to the right officer and enable the officers to be more effective and more efficient. In smaller branches, customer service desks may commonly also open new accounts, whereas in larger branches and where demand justifies, this function is often delegated to a specific account-opening desk.

Branch-based sales. Sales desks placed directly in banking halls have a number of distinct advantages over more traditional counter-based sales. Sales desks increase the visibility of highlighted products to clients and increase the accessibility of products to clients—those wanting to inquire about new products and services do not have to queue to ask a question. Thus, sales desks can significantly increase sales of new or existing products. Furthermore, sales desks allow sales officers to explain the products to clients comprehensively, which can be especially important in illiterate and semiliterate markets or for more complex financial services. See box 13.4.

Box 13.4 Importance of Sales Desk for Complex Products

Shortly after becoming a bank, Equity Bank launched its *Jijenge* contractual savings account to encourage and reward regular savings. However, it was a more complex product to sell to clients. Clients wanted to see the additional return they would receive from disciplined savings. Equity decided to run a spreadsheet-based simulation to explain the product. Initially sales of *Jijenge* were strong, but when Equity decided to remove the sales desk, sales of *Jijenge* slumped.

Source: Cracknell 2005.

A key role of the head-office marketing function is to support branch-based sales. The marketing department must ensure widespread product knowledge throughout the institution. Its product-related marketing materials must be carefully developed and tested to communicate product benefits clearly. National sales campaigns should be carefully coordinated and communicated clearly to every branch to ensure that branches have the right materials and training to handle increased sales.

Teller Management

Hiring and managing tellers may be new to regulated MFIs if they did not accept cash at the branches prior to transformation. Proficient tellers and effective teller management, combined with the ability of the MFI to manage peak loads and continually focus on improving processes and procedures, are key to efficient delivery of financial services. Teller management ensures that tellers operate efficiently. Efficiency comes from carefully planning transactions so they can be performed quickly and accurately again and again.

Teller screening. Tellers need to be proficient with numbers as well as with computers. They must also

have an amiable nature and be able to speak with clients in a knowledgeable and friendly manner. Transforming MFIs (which are often also computerizing) may find their existing staff are not completely comfortable with computers, which leads to inevitable delays as tellers are trained how to use computers and perform basic keyboard skills. When hiring tellers, MFIs will find it important to test applicants' computer skills before employment. If possible, the banking system should also be designed to ensure minimal keyboard and mouse entry.

Teller experience. Along with basic proficiency, teller experience is a critical factor in processing transactions quickly. The performance of experienced and inexperienced tellers often differs significantly. In a sample carried out by MicroSave of tellers at Equity Bank, experienced tellers achieved transaction volumes of 250 transactions per day. Inexperienced tellers started with transaction volumes of 100 transactions per day; after two weeks on-the-job transaction volumes increased to 140 to 150 transactions per day. After the end of the first month tellers had generally reached an acceptable level of performance (Cracknell 2005).

Teller withdrawal limits often vary depending on the level of experience of the teller, so that inexperienced tellers are subject to greater levels of supervision. One solution employed by some MFIs is to divert large cash transactions to an experienced teller who is provided with note and coin-counting machines.

Tellers are typically held responsible for cash shortages and require time to gain confidence and dexterity in counting money. Cash-counting machines can significantly reduce the performance difference, although machines are unlikely to replace manual counting, in part because touch helps tellers detect fake currency, which only the more expensive counting machines can do.

One step that can increase the productivity of all tellers, but particularly inexperienced tellers who require more supervision, is to enable online supervision. Considerable time is lost transporting physical vouchers between cashiers and managers or supervisors. With online supervision, an alert appears on the supervisor's screen indicating that a particular transaction requires supervision, enabling the supervisor to authorize the transaction online.

Teller performance monitoring. MFIs should monitor the performance of tellers at an individual level and at a branch level. Performance monitoring must include both efficiency and effectiveness measures. Efficiency implies measuring the number of transactions of different types undertaken by different tellers in a typical period, with care taken to ensure speed is matched with accuracy.

Some managers feel that performance measurement cannot be calculated purely on the basis of branch averages, given that transaction types and volumes differ in every branch depending on the precise segmentation of the branch's clients. Thus, trends in performance over time, both of the branch and individual tellers within the branch, should be measured as well.

Teller stations. The physical attributes of teller windows are critical to ensuring that tellers make fewer errors. Teller stations should be large enough to accommodate a computer (and printer, if necessary) and still provide sufficient counter space for the teller to efficiently count cash. Bulletproof glass, obligatory in many countries for regulated institutions, should not hamper communications between the teller and clients. Tellers should be provided with cash drawers carefully segmented to allow different denominations to be held separately.

Personnel issues. As transaction volumes in a branch increase, responding to the legitimate needs of tellers to have breaks and vacations becomes increasingly difficult. Rural branches with seasonal fluctuations and branches with a large percentage of salaried workers experience natural fluctuations in the workflow that can be used to accommodate staff leave. However, in urban branches with a large percentage of microfinance clients, transaction

volume can be relatively stable. In this case, whenever a teller takes vacation, long queues can develop. Mitigation strategies include training staff in multiple skills so they can take over temporarily, or larger institutions may employ “floating” cashiers or tellers who move between branches in a particular region or city.

Peak Load Management

A typical front-office environment, particularly in a rural or semiurban branch, has fairly irregular levels of activity—at some times of the day, week, or month, banking halls can be filled to capacity, while at other times they are empty. The situation can also differ from branch to branch depending on location and the local market.

Managing peak loads in the banking hall is particularly important in banking for low-income clients, because transactions tend to be in smaller amounts and of greater frequency. An MFI’s ability to manage peak loads is a key determinant of its customer service quality and the profitability of its savings products. Peak loads affect both wait time and the capacity of the physical infrastructure. Manual procedures can further exacerbate peak loads, while the MFI’s product range and banking hours may also influence the peaks and valleys of service provision.

Product range. An MFI’s product range can significantly influence transaction behavior within a banking hall. For example, salary accounts create monthly fluctuations around the month end; school fee loans create periodic fluctuations around the dates for payment of school fees; and agricultural loans create seasonal peaks in activity around planting and harvest seasons.

Banking hours. Extended banking hours are extremely beneficial for clients who would otherwise have to take time from their business activities to perform financial transactions. However, the ability of a deposit-taking institution to extend its business hours depends on how long end-of-day processing takes, and in some countries, on central bank regulations.

Box 13.5 Payment of School Fees at Centenary Bank

Centenary Rural Development Bank in Uganda processes payments for school fees. Payments are made three times a year, in January, May, and September. At the time of year when payments are received, Centenary is almost always overwhelmed with clients. Typically, queues stretch down the street before the bank opens. Centenary has responded by opening for longer hours during the season for payment of school fees.

Source: Cracknell 2005.

See box 13.5 for an example of how product range and banking hours interweave to influence customer service.

If extending branch hours becomes too costly an option, a number of easily implemented solutions can improve customer service using generally recognized principles of customer psychology and common perceptions of waiting. (See box 13.6.)

Other possible solutions to manage peak loads include the following:

- *Remove inquiries from queues:* Clients with questions slow down queues of clients wanting to perform simple transactions. Removing clients with questions from queues not only speeds up service, but also ensures that the client’s problem receives the fullest attention. Understanding clients’ questions in detail often leads to appropriate solutions. For example, when Equity Bank in Kenya found that many clients queued to ask whether their salaries had been received, it introduced boards that indicated for major employers whether salaries had been received and posted to client accounts. Other general

Box 13.6 Using Psychology to Improve Perceptions of Customer Service

Perceptions of waiting	Solutions for improved customer service
• Unoccupied time feels longer than occupied time. • Anxiety makes waits seem longer. • Uncertain waits seem longer than known, finite waits. • Unexplained waits are longer than explained. • Unfair waits are longer than equitable waits. • The more valuable the service, the longer the customer will wait. • Solo waits feel longer than group waits.	• Have reading materials, videos, or other information available. • Allow clients to fill out inquiry forms or deposit slips while waiting. • Reduce stress by clarifying the process or creating a numbering system. • Provide information on expected wait times or post reason for delays (server crash or the like). • Have an equitable system or clear rules for preferential treatment. • Compensate the client's patience by providing flexible products or a surprise soft drink. • Never leave a client unattended without at least asking if she or he can be helped.

Source: Contributed by Monica Brand, ACCION International, September 2005.

strategies to remove inquiries from queues include directing questions as clearly as possible through signage to customer service desks; publishing answers to frequently asked questions; and assigning staff to the front office to manage queues through providing direct assistance to clients. For example, SogeSol in Haiti hired "flow captains" to manage client inquiries while they waited in line, thereby reducing branch congestion and wait time.

- *Introduce single point queuing systems:* In banking halls with sufficient space, single point queuing systems should be introduced. In most cases such queuing systems consist of a series of ropes winding around the banking hall to ensure that clients queue in a single line. The next available teller serves the client at the front of the queue. Single point queuing systems are popular with clients because they are seen to be equitable—they ensure service on a first-come, first-served basis—and because they ensure that an individual client with a question causes minimal delay to all clients equally.
- *Match staffing to expected activity levels:* The branch manager should ensure whenever possible that staffing levels are matched to expected activity levels. During the busiest periods, all teller windows should be staffed for the longest possible time. This is no easy task, because a branch cannot afford to maintain full-time staff based on peak levels of activity. However, part-time tellers can generally be employed or more tellers than normally required can be hired, but trained also to market products and services. During slack periods in the month, tellers can market to potential clients in marketplaces, at schools, and at other likely venues. Another strategy is to restrict staff leave to the middle of the month if possible.
- *Specific extensions of banking hours:* Specific extensions of business hours are possible when the MFI and its clients can predict peak periods of activity, for example, for the payment of school fees or for the payment of salaries. In such a case, the MFI needs to communicate the extension of business hours carefully to ensure

that enough clients modify their transacting behavior to take advantage of the extended business hours.

- *Introduce new technology:* Technology, specifically computerized banking systems, can offer solutions to decongest banking halls. Implementation of a wide area network (WAN) that networks individual branches together allows an MFI to offer branchless banking. However, the effectiveness of the WAN depends on the availability of an appropriate communications infrastructure, either through telephone lines, VSAT links, or microwave-based line-of-site systems. Optimizing the WAN is vital to ensure fast transaction speeds, especially in a fully centralized system. However, optimal solutions are often expensive, so the MFI will have to make a conscious but informed choice on its communications strategy. (See chapter 11, Management Information Systems, for more discussion.)

  Technology also can be used effectively to increase the accessibility of services by introducing increased points of access through mobile banking, cash machines, point-of-sale devices, or ATMs. ATMs have become a viable solution for MFIs, as long as regulators provide approval and oversight, and the MFI ensures secure access. (See chapter 11, Management Information Systems, for more discussion.)

Ensuring Continuity of Services

Continuity of services means ensuring appropriate power management along with appropriate disaster recovery and off-line procedures. To effectively offer savings services, power management should be almost seamless. Constant power availability is achieved either through inverter-based interruptible power supplies, through generators on a trip switch, or at the lowest cost, through generators started manually. Off-line procedures are manual procedures enabling basic account functionality to continue when computerized systems go off line.

Disaster recovery is the MFI's ability to recover any lost data. Several layers of data management are usually required, including tape backup at the branch and head-office level. In very large deposit-taking MFIs, disaster recovery can involve parallel processing of transactions using two similar but physically separate servers. The regulator will normally define minimum acceptable disaster recovery standards for licensed deposit-taking institutions.

Managing Cash

Handling of cash is often new for many transforming NGO MFIs. Proper cash handling ensures that records are kept for cash movements and stocks of cash, that stocks of cash are securely kept and controlled, and that no unauthorized persons gain access to cash or important documents. Furthermore, cash holding must be kept to the lowest level consistent with foreseeable needs and within insurance limits, with the surplus deposited in nearby commercial banks. The operations department is responsible for processing all cash to and from the central bank, commercial banks, or other branches. The operations manager is also responsible for daily monitoring and adherence to cash limits as established by the head office. This section provides detailed guidance for transforming MFIs establishing cash management procedures for the first time.[11]

Cash balances include amounts in the cash and treasury registers and the cashier's (or teller's) balances as per the cashier's register, and should be reconciled with the general ledger cash account. (Some regulated MFIs have a "chief cashier" who sits behind the tellers [often in a "cash cage"] and disburses cash to the tellers. Other MFIs have only tellers, sometimes also called cashiers, who hold cash at their stations. For the purposes of this section, the term *teller* will be used for either cashiers or tellers when discussing cash management, with the

exception of the chief cashier. Teller windows, cash counters, or cashier stations are all referred to as teller stations.)

Monitoring Cash Levels

The branch must hold sufficient cash to meet depositors' demands. However, the amount to be held at one time should be balanced between the desired return on investment, security, and liquidity considerations. Cash levels are part of the liquidity policy established by the asset and liability committee (ALCO) and will include limits at the teller stations and each branch (see chapter 10, Financial Management, for more discussion). Security considerations greatly influence the amount of cash to be held at the teller's station and in the strong room.

Treasury book and strong room. The "treasury book" or "strong room cash record book" is a register of stocks of cash held in the strong room. All movements of cash into and out of the strong room are recorded in the treasury book. The strong room is always under dual control of the branch manager and branch accountant or chief cashier. Both dual custodians must be in each other's presence when entering the strong room. Accessibility to safes in the strong room is also under dual control. Bundles of each cash denomination are arranged and stored separately to facilitate checking. Reserve cash should be kept in an inner fireproof safe in the strong room. Keys to the strong room must be recorded in the keys register, which should also be under dual control, and signed for by the key holders. Whenever keys change hands, both the person giving and the person receiving must sign the register. Duplicate keys should be kept with the nearest commercial bank as items for safe custody.

Throughout the day, if the amount of cash in a teller's station exceeds the maximum amount determined by management, it should be given to the chief cashier using a treasury voucher. The teller gives the excess cash balance to the chief cashier who counts the cash and enters the received amount in the treasury book. The teller signs the treasury book and the chief cashier puts the cash and the treasury book in the strong room with the assistance of a dual custodian.

Supervision. The branch manager or operations manager (or supervisor) should check cash transactions on a daily basis. She or he must monitor cash levels maintained at each teller's station for compliance with limits set by management. On a random basis, the manager or supervisor should count the cash in each teller's cash drawer and compare the amount with the computer balance.

Transaction processing. All cash transactions must be handled only by the tellers and not by any other staff members. The teller must always count all cash from the client in the client's presence and clarify any discrepancies before it is placed in the cash drawer. Once the amount has been counted, the teller enters the account number and the amount into the computer system, date stamps and initials the passbook (if applicable), and returns the passbook to the client. Where duplicate vouchers are involved in a transaction (either with or without a passbook), the teller should keep the original for the MFI's files and give the client a duplicate.

Transactions are all posted in a receipts or payments book (sometimes called a "cashiers' counter book" or "receiving cashier's on hand account"). All receipts and payments made and cash received from or paid to the treasury (strong room) are recorded in this book. Posting in this book should take place before cash is paid out and after cash is accepted. If an error occurs, tellers should prepare cash error vouchers that should be approved by the branch manager or supervisor.

Procedures for handling excess and shortages. If a teller does not balance his or her teller balancing

report at the end of the day, the chief cashier or supervisor should note any differences and work with the teller to locate the differences. If the difference cannot be found, it should be charged to a suspense account under the tellers' subledger. If the difference is above the allowed limit, the balance should be charged to the teller concerned. More than three teller shortages should result in dismissal of that teller.

Cash overages are also credited to the suspense account and if not claimed for six months (or whatever period has been determined by policy) should be moved into a profit and loss account. If the shortage can be traced to a client and records clearly indicate the error, the client's account is charged and an advice is sent accordingly. Similarly, if an overage is traced to a client, his or her account should be credited and advised through a credit advice.

Cash Security

To keep control of cash that is held by the tellers, all tellers must ensure the door to the cash drawer is locked at all times regardless of whether the teller is at the station. No cash should be kept in the cash drawer at the teller's station overnight—it should all be in the strong room. Tellers should be the sole keepers of keys to their teller stations, cash drawers, and stamps throughout working hours. Tellers should guard their stamps so they cannot be accessed by somebody reaching over the service counter.

Counterfeit notes. Each branch manager should maintain a file of circulars from the regulator informing financial institutions of serial numbers of counterfeit notes. If the teller detects a counterfeit or forged note he or she should confiscate it immediately. Particulars of the client including name and address should be taken for further investigation by the police. If detected after the depositor has gone, the teller should record it as a cash shortage and give the counterfeit note to the branch manager. The note is subsequently handed over to the police by the branch manager. The branch manager should keep a record of the note numbers in a separate register.

Transfer of cash to banks or head office. Just as there are limits for cash to be held at teller stations, limits also need to be set for the total amount held in each branch. Once this amount is exceeded, cash needs to be transferred either to a nearby commercial bank branch or to the head office. All physical cash transfers must be done with security or police escorts (or both) and times when cash transfers take place should be varied.[12]

Deposit Account Management

Because transforming MFIs are generally offering savings services to the public for the first time, specific procedures for managing deposit accounts need to be established and communicated to the branches. Account procedures should be standardized and documented in a manual that is easily accessible and understood by all staff involved in savings account management. Specific policies and procedures need to be put in place for opening accounts (savings or term deposits), receiving deposits, making withdrawals, closing accounts, dealing with lost passbooks, and handling dormant accounts. (See Branch and Klaehn 2002 for more information on how to establish deposit account procedures.)

One of the areas that becomes vitally important once a regulated MFI begins mobilizing deposits from the public is confidentiality. Staff must never reveal to third parties any information regarding the savings or deposits of clients unless the third party produces written authorization from the saver or a written order from a competent authority in accordance with applicable law. It must be clear to

all staff that account information is confidential, available only to the depositor and his or her beneficiaries or legal representatives.

Some of the processes involved in deposit management can result in bottlenecks—particularly for newly transformed MFIs just beginning to mobilize deposits from the public. These common process-oriented bottlenecks need to be identified and removed wherever possible.[13] A systematic study of procedures using flowcharts to portray particular processes (typically referred to as process mapping) can be undertaken to facilitate this analysis. The following reflects specific processes relevant for the operations of transforming MFIs beginning to accept public deposits:

Account opening. Extensive account opening requirements help protect financial institutions against potential fraud and money laundering. However, they also penalize illiterate and semiliterate clients who end up making frequent visits to open a single account.

Teller limits and supervisor approvals. Low teller withdrawal limits strengthen internal control but create additional approval procedures that can significantly increase total transaction time. The volume and value of withdrawal transactions should be carefully examined when considering appropriate teller and supervisor limits.

Manual processes. Manual processes are a significant cause of delays. Some delays result directly from the manual process, for example, the extraction of client ledger cards. More significant delays result when manual processes encourage *batch* rather than *serial* processing; for example, while it may seem much more efficient for a supervisor to approve five over limit withdrawals at a time, rather than one individual over limit withdrawal, such batch manual transactions can significantly increase client waiting time.

Passbook replacement. Replacement of passbooks can be a lengthy process if security features and the need to perform checks and reconciliations on passbooks mandate that replacement be performed centrally. In addition, if the passbook replacement process is poorly handled, resubmission of documents can double the time taken to replace the passbook.

Account card issuance. Card issuance is a frequent cause of delays and is a common cause of client complaints. Client account cards are usually carefully configured for security reasons—they include the client's photograph, signature, and account number. Often this means that cards are produced centrally or even outsourced. Reasons for delays include an inability to produce cards at a sufficient rate to meet the demand from new account holders and for replacements, poor processes resulting in the mismatch of photograph and client account details, and batching of cards at branch and at the printing facility to reduce delivery costs.

End-of-day processes. Although not an obvious cause of delays for the client, extensive end-of-day processes have two major effects on service levels. First, staff work longer hours than necessary, which has an inevitable effect on staff welfare and consequently service quality. Second, extensive end-of-day processes act as a disincentive to extending banking hours.

An internal culture of continuous improvement needs to be engrained in transforming MFIs. Such a culture is difficult to instill, but it starts with strong individual commitment to a collective institutional mission. As discussed in chapter 3, Planning for Transformation, this culture enables the organization to maintain service quality, despite growth. It implies that the institution is always preparing for the future with planned upgrades to systems, to services, to processes, and in staff capacity, and that a good percentage of these planned upgrades actually occur.

Documentation Management

The experience in Uganda of NGO MFIs transforming to regulated microfinance deposit-taking institutions revealed a surprising lack of documented and standardized policies and procedures. Much of the day-to-day operations were based on on-the-job training and experience being passed on as the MFI grew. Manuals the MFIs did have had often become quite out of date and were not being used. Furthermore, many transforming MFIs did not have adequate (for the regulators) document security and inventory management—both important areas a transforming MFI likely needs to improve.

Policies and Procedures

Once an MFI decides to become regulated and intermediate public savings, it will find it imperative to ensure all policies and procedures are documented and standardized throughout the organization. Most regulators will not license a financial institution to take deposits before inspecting the various operating manuals and ensuring through branch visits that policies and procedures are followed in a standardized manner. See chapter 12, Internal Control and Audits, for more discussion on the importance of policies and procedures.

An MFI should have stated policies for every aspect of management and operations, including, but not limited to the following:

- Personnel, including guidelines for hiring, evaluating, and terminating
- Credit, including client eligibility, loan terms and conditions, collateral requirements, loan monitoring and collection, and delinquency follow-up
- Savings, including account opening, deposits, withdrawals, interest payments, and account closing
- Cash management, including cash transfers and petty cash
- Accounting, including authorization levels and segregation of duties
- Budgeting
- Financial management, including how to determine loan-loss reserves and provision for loan losses
- Asset and liability committee (ALCO)
- Operating expense and asset purchase approvals
- Internal audit (and possibly internal control)
- Physical security of records and assets
- Reporting requirements—who, what, and how often

These manuals should be written clearly and concisely. Care should be taken to eliminate contradictions and keep redundancies to a minimum. Furthermore, a system should be in place to ensure updates to any of the manuals are uniformly distributed and all branches are operating from the same manuals.

While all the manuals are important as an MFI is preparing to transform, one particular area that will need review is the credit manual. As a previously credit-focused organization, the assumption may be that the credit side of operations is well documented and standardized and, thus, does not need further attention. However, the regulator will likely require specific and precise documentation for each loan and during inspections will randomly check loan files. The transforming MFI, therefore, must determine how the regulator will classify risk on unsecured loans or loans secured by unconventional collateral and whether the current loan documentation is acceptable. If not, some policies and procedures currently followed for credit products may need to be altered or refined and existing documentation supplemented, which may, in turn, require a revision of the credit manual.

In addition to ensuring that the loan documentation will comply with regulatory requirements, as a regulated institution, the MFI must ensure that all documents, not just credit files, are securely held at the branch.

Document Security

All documents held as security for loans should be registered in a securities register at each branch. When supervisors conduct on-site inspections at the branches they will verify (on a random basis) the physical existence of items recorded in the securities register and ensure that all security forms are completed fully and correctly. Supervisors will check that the MFI's books, registers, and vouchers are all properly maintained and only used by authorized persons. They will also confirm that all important documents such as government stocks, insurance policies, title deeds, and all pledges for loans (properties, crops, and so forth) are recorded in the securities register and maintained in the strong room, inaccessible to unauthorized persons (ARB Apex Bank Limited 2004).

Loan files must be kept in cabinets that are locked so unauthorized persons do not have access.

Inventory Management

With the addition of voluntary savings products, various stationery items, such as passbooks, checkbooks (if applicable), fixed-deposit receipt books, and other stationery products, must be held at the branches. The MFI should number standard documents, forms, and vouchers to facilitate references being made to such documents by the MFI staff.[14]

In general, all stationery should be procured through the head office and issued to branches upon requisition. However, a branch may, under special circumstances, purchase general stationery from the local market. Decentralized procurement of stationery items should be discouraged and properly controlled. Where the branch is given some latitude, the MFI must ensure that normal control procedures are adhered to. All purchases should be authorized and duly recorded.

All stationery should be properly recorded and stored, and movements (especially issuance) controlled. Inventory should be taken quarterly at each branch and the value of physical stock reconciled to the general ledger at the branch.

Inventories should be kept in good condition and accessible in a controlled manner. Each item should have a "bin" or "stock card" or some system to record different types of stationery. The quantities and description on the stock card should match the actual quantity physically in the branch. A register should be maintained at the branch for savings passbook stock and, if applicable, checkbook stock.

Control of passbooks. Control of passbooks is a serious issue for regulators and must be strictly adhered to, thus passbooks must be controlled as part of stationery. When a batch of passbooks is received, serial numbers must be recorded in the register from the beginning to the end. When a new account is opened, a requisition is made to the branch or operations manager or supervisor. The branch manager, with another officer with dual control to the strong room, will provide the new accounts officer (or teller) with the requisitioned passbook, and confirm that all numbers of the quantity removed are numerically accounted for and that the lowest number follows sequentially from the last number in the register as removed.

The officer responsible then lists each passbook serially in the issuance register and accounts for any balance at the end of the day. A new accounts register should be properly maintained at the branch for each year.

Control of fixed-deposit receipt book. Fixed-deposit receipts are engraved forms issued in books of generally 100 to 200 each, with receipts and counterfoils serially numbered. The branch stock of unused books must be kept under dual control in the strong room and recorded in the unutilized "assets in stock" register. The register should show date of receipt, serial numbers, date of issue, and unused stock at hand.

Annex 13B provides a summary checklist of the major aspects of customer service and operations addressed in this chapter.

Annex 13A Sample Terms of Reference: Improving Branch-Level Customer Service

Background

Background on the organization including its mission, target market, client outreach, portfolio size, and so forth.

Objectives

The objectives of this consultancy are to improve and standardize customer service levels at MFI A's branches, and increase customer satisfaction of internal as well as external clients.

Tasks

Phase 1: Analysis

- Review and document processes and service quality to establish baseline.
- Collect and analyze information on competition (to determine expectations).
- Obtain information on client profile and preferences (data mining or market research or both).
- Analyze information and establish benchmarks to finalize proposal for approval.
- Compose multifunctional team to diagnose problems and identify key strategy components.

Phase 2: Design and Develop Customer Service Strategy

- Diagram the process flow from MFI A client's point of view ("client experience").
- Analyze the delivery channels (that is, branch layout, appearance, and the like) from a service viewpoint.
- Define areas of improvement by functional area (requirements) and strategies by segment.
- Determine how to add value with each point of contact with the client.
- Recommend new processes, procedures, and policies.
- Prioritize different recommendations to determine which can be implemented now (minor changes) and which will need to be piloted (major changes) based on cost-benefit, institutional capacity, and other factors.

Phase 3: Conduct Pilot Test(s)

- Establish the pilot parameters (location, duration, budget) and goals (tracking indicators).
- Establish and validate operational requirements.
- Prepare the pilot branch.
- Test tools and systems.
- Train personnel.
- Implement pilot.
- Supervise pilot and monitor indicators.
- Analyze results and define initial conclusions.
- Revise strategy to present to general management for approval.

Phase 4: Rollout

- Define the strategic and operational implications.
- Develop support materials.
- Establish an action plan.
- Train personnel.
- Develop systems.
- Define goals and indicators for monitoring.
- Draft a customer service manual.

Deliverables

1. A written analysis of current customer service quality including the establishment of benchmarks
2. A proposed customer service strategy to be implemented
3. Results of pilot tests
4. A plan for rollout to all branches
5. A draft customer service manual

Level of Effort

It is estimated each phase of this consultancy will take between 1 and 2 days to complete and will be carried out over a period of 12 months.

Annex 13B Checklist for Customer Service and Operations

Customer Service

- Have you defined your institutional vision for customer service, including where it fits into the MFI's competitive strategy?
- Have you mapped out your processes from the point of view of the customers—internal and external—to identify customer service problems?
- Have you conducted a thorough analysis to determine the root causes of the customer service problems?
- Have you met with staff members to engage them in brainstorming solutions to the customer service problems?
- Have you prioritized the different solutions based on value or importance to the client, feasibility (in terms of cost and capacity), and anticipated impact (improvement in customer satisfaction)?
- Have you identified and implemented the quick solutions?
- Have you planned a pilot for the more complex strategies, defining the parameters, work plan, training, and monitoring?
- Have you developed a customer service manual that includes frequently asked questions, customer handling procedures, functional roles, feedback loops, and contingency plans?

Branch Structure and Service

- Have you determined the ideal branch locations taking into account accessibility, expansion capabilities, competition, security, and facilities?
- Have you ensured the appropriate branch infrastructure including security, compliance with regulations, and space allocation?
- Have you established effective communications within the branch network including signage, client service desks, and client information?
- Have you ensured effective and efficient teller management including appropriate teller screening, training, performance monitoring, and teller positions?
- Have you put in place ways to effectively manage peak loads?
- Do you have in place appropriate disaster-recovery and off-line procedures?

Cash and Deposit Account Management

- Have you established effective ways of monitoring cash levels and procedures for handling excess and shortages?
- Have you established procedures and processes for managing deposits, including teller limits and supervisor approvals, end-of-day processes, and account opening?

Documentation Management

- Have you documented policies and procedures to manage all aspects of operations?
- Have you ensured all documents held as security for loans are registered in a securities register at each branch?
- Have you ensured processes for appropriate inventory management are in place in all branches?

Notes

Parts of this chapter were drawn from "Serving Depositors: Optimising Branch Based Banking," by David Cracknell, African Programme Director, MicroSave, February 2005. Contributions to this chapter were made by Monica Brand, Vice President, Marketing and Product Development, ACCION International. The authors gratefully acknowledge their contributions.

1. Some MFIs create a multifunction team responsible for brand consistency, separate from the operations department.
2. For more information on survey instruments, see Wright, Cracknell, and Parrott (2004).
3. The Customer Service Framework section was written by Monica Brand, ACCION International.

4. Adapted from Churchill and Halpern (2001) and Kotler (2002).
5. Tangibles, including the appearance of physical facilities, equipment, personnel, and printed and visual materials, are one of the five key dimensions used by consumers in assessing service quality in a broad variety of service sectors (Zaithaml and Berry 1996). The other four are Reliability (dependable and accurate performance); Responsiveness (willingness to help customer and promptness of service); Assurance (knowledge and courtesy of employees); and Empathy (caring and individualized attention to customers).
6. For further information on the design and operation of feedback mechanisms, see McCord (2002).
7. Mystery shopping (also known as secret or ghost shopping) is a research method whereby people posing as regular customers anonymously visit or contact a place of business (a branch, for example) to assess customer service, product quality, employee performance, cleanliness, and overall experience (Brand 2003).
8. A time and motion study is a detailed analysis of the operations required to carry out a specific job or transaction to identify bottlenecks, redundancy, or unnecessary steps with the ultimate goal of increasing efficiency and productivity.
9. The institution can have a *closed* pilot for a minimum time during which intervention is prohibited, to give the institution time to adapt to the new strategy before adjusting.
10. This section is adapted from Cracknell (2005).
11. Drawn from Mungereza & Kariisa Consultants Limited (2002).
12. For further information, see Bald (2000) Module 6.
13. The Deposit Account Management section is based on Cracknell (2005).
14. Inventory management is summarized in part from ARB Apex Bank (2004).

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Case Studies | *Part IV*

Chapter 14

Creating a Separate Tier: The Micro Finance Deposit-Taking Institutions Act, 2003

Uganda's economy is one of the most liberalized in Africa. After decades of political and economic crises, Uganda embarked on a wide-ranging Economic Reform Program (ERP) in 1987. Since then, reforms have led to the restoration of macroeconomic stability and high economic growth. A considerable increase of foreign direct investment has been recorded and progress has been made in the privatization of state-owned enterprises. Inflation has been maintained below 10 percent since 1992. In sum, the Ugandan government has focused its interventions on the creation of an enabling environment for sustainable, private sector–driven economic growth. In 1991, financial sector reforms were introduced as an additional key element in the overall ERP launched in 1987. The results of the financial sector reforms have been impressive. Financial sector deepening increased, interest rates were liberalized, and the banking sector was strengthened.

In 1997, the government introduced a comprehensive policy framework to address widespread poverty. The Poverty Eradication Action Plan (PEAP) aims at reducing absolute poverty to less than 10 percent of the population by 2017. One of the critical preconditions for poverty reduction identified in the PEAP is sustained economic growth. The government's concentration on poverty eradication combined with the positive economic developments led to a drop in the proportion of Ugandans living below the absolute poverty line from 56 percent in 1992–93 to 35 percent in 1999–2000. However, because of a slowdown in economic growth caused by a number of factors, such as unfavorable terms of trade and the continuing conflict in Northern Uganda, poverty incidence in 2002–03 increased to 38 percent. Uganda continues to be one of the world's poorest nations with a per capita annual income below U.S.$300.

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As the backbone of private-sector activities, the financial sector plays a major role in all of the government's reform initiatives. Microfinance in particular has received much attention as an important device for poverty alleviation and for increasing the productivity of the self-employed in the informal sector, especially in rural areas (MTCS [Medium-Term Competitive Strategy for the Private Sector] 2000–05) 2000; PMA [Plan for Modernization of Agriculture] 2000). In June 2005, President Yoweri Museveni appointed a Minister of Microfinance—quite remarkable given that, only 10 short years earlier, microcredit was a fairly new concept.

This chapter chronicles the development of microfinance regulation and supervision in Uganda. It begins with an overview of the financial sector in Uganda, followed by a description of the process to establish a regulatory framework for microfinance and ultimately, the creation of the Microfinance Deposit-Taking Institutions (MDI) Act 2003, and the supervisory function within the Bank of Uganda. The chapter concludes with a brief description of the licensing process, and a review of the key success factors and remaining challenges within the Ugandan microfinance sector.

The Financial Sector

In 2005, Uganda's banking sector consisted of 15 commercial banks, 12 of which were foreign owned. In March 2005, foreign-owned banks together held 84 percent of total assets, with the two biggest banks, Stanbic Bank and Standard Chartered, holding market share of about 52 percent and 55 percent of total assets and total deposits, respectively.[1] Having acquired Uganda Commercial Bank Limited in 2002, Stanbic Bank was the largest bank in Uganda with 68 branches—the largest branch network in the country. Centenary Rural Development Bank ranked second with 18 branches nationwide. The remainder of the banks each had six or fewer branches. In addition to commercial banks, there were six credit institutions licensed by the Bank of Uganda (BoU), all locally owned (five privately and one publicly). These operated almost exclusively in Kampala, with the exception of Postbank Uganda Ltd, which offered savings and credit services up-country. Finally, there were four licensed microfinance deposit-taking institutions (MDIs), discussed below.

Because of various far-reaching reforms designed to strengthen the financial sector and improve banking supervision, the Ugandan banking system today is fundamentally sound and more resilient than in the past. The small number of large and reputable foreign banks that dominate the banking sector are well-managed and well-capitalized. In addition, the banking sector's profitability over the last few years has been bolstered by the high interest rates on treasury bills, a preferred investment instrument for many of the highly liquid banks, and a steady reduction in nonperforming loans.

Since 1993, the government of Uganda has taken considerable efforts to improve financial intermediation and foster financial sector deepening. The key elements of financial sector reforms that were implemented in the structural adjustment policy package, particularly with the Bank of Uganda Act of 1993 and the Financial Institutions Act amendment of 1993, included the following:

- Legal independence of the central bank, the Bank of Uganda (BoU), establishing monetary authority and overall responsibility for supervision of all financial institutions
- Liberalization of interest and exchange rates
- Strengthening of banking supervision
- Strengthening of competition in the financial sector
- Reduced government ownership in financial institutions
- Permission for new financial services
- Other reforms, such as removing restrictions on capital transfers, reducing the corporate tax rate, and legalizing foreign exchange deposits

The new Financial Institutions Act (FIA), which went into effect March 2004, has further improved the prudential framework.[2]

Despite these achievements, the Ugandan formal financial sector still remains relatively small and is characterized by a number of structural weaknesses:

- The spread between the deposit and lending rate has remained relatively high, indicating a lack of competition as well as high operating costs.
- Commercial banks' balance sheets reflect their preference for liquid low-risk and high-yield treasury bills.[3]
- The banking sector is highly concentrated. In 2005, the top five borrowers and depositors for each bank represented about 34 percent of all loans and 18 percent of all deposits in the system.
- Lending is also highly concentrated by sector. Commercial bank loans to manufacturing, trade, and services account for about 80 percent of total private sector lending. Agriculture, which accounts for 40 percent of gross domestic product (GDP), received only 11 percent of commercial bank loans as of June 30, 2004 (IMF 2005).

Regional concentration is considerable. Almost all banks concentrate their activities around the capital Kampala and in one or two other large towns. While certainly improving, the Ugandan financial sector, even in comparison to other East Africa countries, is characterized by a lack of financial depth.

The steps taken to strengthen the financial sector are expected to increase the public's confidence in bank operations, lead to a broader deposit base, and finally result in more efficient financial intermediation. Nonetheless, the effects of these measures will only be felt in the medium term. Given the low level of competition and the attractive options for investing in low-risk liquid assets,[4] whether banks will be willing in the next few years to lend to the largely neglected micro, small, and medium-size enterprises sector, especially in rural areas, is questionable. Thus, microfinance institutions (MFIs) are expected to play a critical role in addressing huge segments of the population with little or no access to financial services.

With growing donor support for the sector, Uganda experienced a proliferation of MFIs during the 1990s. In 1990, it was estimated that MFIs were providing loans to approximately 50,000 clients; in 2003 there were an estimated 1,500 microfinance outlets serving about 400,000 borrowers and 900,000 savers. Given that the clients of these institutions are typically very poor women with no collateral and that legal enforcement of these loans is almost impossible, Ugandan MFIs typically employ a lending technology based on joint-liability groups combined with compulsory savings to ensure timely repayment. A number of the larger institutions (and all of the MDIs) also now offer individual loans.

Regulation of Microfinance Deposit-Taking Institutions

This section reviews the early steps made regarding the principles for regulating MDIs, then examines the BoU policy framework from which the legislation ultimately emanated.

Early Progress

Discussions on microfinance regulation in Uganda began in April 1996. The initiative to regulate microfinance business originated from different stakeholders—MFIs, policy makers, and the central bank—all with somewhat differing interests and motivations. Larger MFIs taking compulsory savings were witnessing increasing demand from their customers to provide small voluntary deposit facilities. Although it is difficult to assess to what extent illegal deposit-taking took place, undoubtedly a number of MFIs took deposits from the public for

on-lending purposes. In this context, a growing number of MFIs voiced their interest in creating a regulatory framework for microfinance that would enable them to broaden their funding base and increase their business and services to clients. So while a certain degree of regulatory drive originated from the industry itself, it was not necessarily with full awareness of the consequences and requirements a prudential regulatory regime for microfinance would imply.

At the same time, microfinance was already appearing on the political agenda as a potentially effective tool for poverty alleviation. Policy makers and politicians argued in favor of regulating microfinance operations, but again without being fully aware of the implications for the industry of a legal framework. Many were driven by the belief that low-interest microcredit would lift people out poverty.

The central bank—following a prudential view—also developed more interest in microfinance activities. In particular, the executive director supervision began to gather information to understand the microfinance business. The BoU became increasingly aware that the microfinance business was growing, and that some services provided by MFIs apparently took place in a regulatory void. The BoU also started to feel growing pressure from groups outside the central bank to handle microfinance under a regulatory framework still to be developed. In early 1996, based on initial talks at an African Banking and Finance Seminar in Berlin, BoU officials requested the German government, through their development agency Deutsche Gesellschaft für Technische Zusammenarbeit (GTZ), to carry out a financial sector study in Uganda with the objective of identifying possible fields for cooperation. When the study was carried out in February 1996, the BoU clearly voiced the need, among others, to source best practice policy and technical input to set up a microfinance regulatory framework.

This request proved to be the start of what was to become a five-year capacity-building initiative for the BoU. During an appraisal conducted in mid-1997, one of the major project components identified was microfinance regulation and supervision.

In late 1997, the Minister of Planning chaired a meeting at which it was agreed that the government and the private sector involved in microfinance needed to meet as a group to discuss issues of policy, capacity building, and outreach. In February 1998, this group, under the auspices of the Consultative Group to Assist the Poor (CGAP) Working Group on Savings Mobilization, and in conjunction with GTZ, the United Nations Development Programme (UNDP), and the French government (which provided the funding and logistical support), held an Africa-wide conference on microsavings mobilization in Kampala (GTZ/UNDP/Cooperation Francaise 1998). The conference gained strong support from the BoU. These discussions in particular had a strong bearing on the BoU's inclination to address the issue of small deposit mobilization more actively.

In May 1998, several sponsors (the government of Uganda, the World Bank, the European Union, the UK Department for International Development, the UNDP, and the USAID-funded project Private Enterprise Support, Training, and Organizational Development [PRESTO]) organized a workshop on the national policy and strategic framework for micro and rural finance covering a broad range of issues such as regulation, apex structures, capacity building, and funding strategies. The workshop turned out to be a seminal event bringing practitioners, government officials, members of parliament, BoU representatives, and relevant donor agency representatives together.

Initial discussions between stakeholders were characterized by some degree of confusion. In particular, the reasons for regulating MFIs were not well understood. Some stakeholders perceived regulation as a way to promote MFIs and hence improve access to financial services for the poor, while others wanted to enable strong MFIs to mobilize deposits. Many matters remained unresolved, including the basis for classifying MFIs and licensing them; determining acceptable performance

ratings on capital, asset quality, and loan-loss provisioning, profitability, and efficiency indicators; as well as the potential of self-regulation. It was agreed that continued deliberation in this area would be undertaken by the BoU. The Ugandan government took the lead in the microfinance policy debate and formed a committee on which the government as well as MFIs and donor organizations were represented. This committee was chaired by the Ministry of Finance, Planning and Economic Development (MoFPED). At a later stage it became the Microfinance Forum (MFF). The MFF, which remains active to date, meets on a regular basis to discuss key policy issues in microfinance development in Uganda and has played an important role in furthering the industry.

Despite the lack of clarity and the large number of unresolved issues, political pressure on the BoU to license and regulate MFIs increased. The BoU, however, followed a cautious approach and emphasized the need to balance competing interests before drafting a law. This approach proved fruitful, not only because there was still a lack of consensus among stakeholders on how to deal explicitly with the microfinance sector, but also because internal BoU knowledge and experience on microfinance had to be developed gradually before substantial steps in drafting a law could be taken. The strategic approach, therefore, was to draft a policy statement on microfinance as an initial step to first clarify major principles and standards for microfinance regulation. After cabinet approval of the policy statement, the drafting of the legislation was meant to follow based on an established consensus on principles and standards.

BoU Policy Framework as a Strategic Approach to Microfinance

The BoU took the lead in proposing a policy framework for microfinance regulation. However, consensus on the general approach to microfinance regulation was lacking inside the BoU itself, the result of both minimal knowledge of best practice microfinance, which is to be expected in many central banks, and the fact that the various departments with a stake in microfinance had very different views on what the policy should be. Because the development finance department was involved in channeling credit to specific sectors, it argued that the policy should explicitly focus on lending conditions to banks and MFIs involved in microfinance business. The research department thought the policy statement should emphasize the role of MFIs in poverty alleviation. The supervision department argued that the policy should focus on clear and strict principles to ensure safety and soundness of microfinance operations applying a conservative approach to regulate and supervise microfinance in accordance with supervision principles for commercial banks.

After numerous efforts to reflect best practices and balance the differing views of the different departments, a consensus was gradually reached. The various BoU parties agreed that developing a good framework was the best way to promote micro and rural finance and would improve financial deepening, as opposed to having the government and the central bank directly participate in market transactions. With the objective of encouraging the broadening and deepening of the financial sector by including MFIs as fully fledged sustainable financial intermediaries, the supervision department of BoU finally took the lead in drafting a policy paper.

Throughout the process, the policy direction and major principles were discussed bilaterally with major stakeholders, in particular government representatives, practitioners, and some donors. In these early stages of policy discussion, the stakeholders had differing views on the effectiveness of the consultative process. Some of them made substantial efforts to position their interests in the design of microfinance policy. With the BoU leading the regulatory debate at that time and following its strictly prudential approach on microfinance, some stakeholders expressed their frustration, because from their point of view, their recommendations were not adequately reflected in the discussions.[5] Although the discussions were controversial, the

draft policy statement benefited considerably from these consultations.

One example of a fruitful discussion was the debate over how to handle compulsory savings. Opposing the initial BoU preference for treating compulsory savings as regular deposits from the public, the practitioners successfully forwarded convincing arguments that explained the common practice of using compulsory savings to secure loans and highlighted the net borrowing position of such clients. Therefore, such savings were seen as an integral part of the lending methodology rather than funds for financial intermediation. The BoU finally agreed to allow credit-only MFIs to continue to employ compulsory savings (or loan insurance funds as they are often called) as part of their lending methodology, as long as they were tracked separately and not used for on-lending purposes.

Consultations also focused on key issues such as minimum capital for MFIs (higher capital as a cushion for potential losses or lower capital to ease entry for many institutions), the definition of microfinance as a "line of business" (rather than a product only offered by a specific type of institution), and the role of savings and credit cooperatives (SACCOs), which were not to be covered by microfinance legislation.

The draft policy statement was finally presented to and approved by the BoU Monetary and Credit Policy Committee (MCPC) in April 1999. It was then approved by the cabinet in July 1999 as the Government of Uganda Policy on MFI Regulation. In the policy statement, BoU spelled out the following guiding principles (BoU 1999; Katimbo-Mugwanya 2000):

- The rationale for regulation is to protect depositors and to ensure the stability of the financial sector. As a consequence, no organization shall be allowed to take deposits from the public until it is regulated and supervised by the BoU.
- To ensure that MFIs are strong enough to cover the risks of intermediation, they must be sufficiently capitalized. Minimum capital and ongoing capital requirements must be strong enough to enable the organization to absorb any losses without losing depositors' money.
- It is necessary to encourage excellent portfolio quality for those MFIs that mobilize deposits, especially because the portfolio constitutes the major asset of most MFIs.
- Sufficient liquidity levels must be maintained at all times.
- Because of specific features of microfinance (for example, character-based lending, decentralized decision making, dependence of loan decision on loan officers' experience, appropriate incentive schemes for clients and staff), the success of MFIs is particularly dependent on the qualifications and proper conduct of management. Therefore, management standards for MFIs that mobilize deposits must be high.

To regulate microfinance, the BoU policy statement suggested a tiered framework that reflects the concept of microfinance as a line of business. The tiered approach in Uganda defined four categories of financial institutions offering microfinance services:

Tier 1: Commercial banks, licensed under the Financial Institutions Act of 2004 (FIA).

Tier 2: Credit institutions, licensed under the Financial Institutions Statute 1993 (since replaced by the FIA 2004). Credit Institutions have lower minimum capital requirements than commercial banks and are not permitted to perform all operations and services banks are allowed; they can, however, take deposits from the public.

Tier 3: MFIs that are allowed to take deposits from the public and as such are regulated and supervised by the BoU under a new framework (now the MDI Act of 2003).

Tier 4: Non-deposit-taking institutions such as credit-only NGOs or any other non-deposit-taking initiatives and small

> member-based institutions mobilizing subscriptions from their members alone are not regulated by any law governing the financial sector nor supervised by the BoU.

This basic approach was extensively discussed at the MFF and finally gained approval from all relevant stakeholders. Consultation was then taken to a higher level in November 1999, when the microfinance regulatory policy was discussed with an international audience at a high-level policy workshop held in Kampala with representatives from the BoU, Ugandan Ministries, selected practitioners, donor agencies, and representatives of central banks and finance ministries from seven African, Asian, and Latin American countries (Hannig and Katimbo-Mugwanya 2000). The strategic approach proposed by Uganda found broad acceptance in this forum, encouraging major stakeholders to continue with the next step—the drafting of a microfinance regulatory framework.

With the BoU's increasing understanding of microfinance, and in particular with the role the BoU assumed it would have in supervising microfinance in the future, the BoU board approved in mid-1999 the establishment of a Microfinance Unit. This move was in response to the request by the executive director supervision, who clearly anticipated an enormous additional workload for the BoU in drafting a legal framework for microfinance and managing the complex supervisory tasks thereafter. The new unit was given a budget and formed under the nonbank financial institutions department.[6] It initially consisted of four inspectors with strong accounting backgrounds. One of these four was the senior inspector who assumed the coordination role; the other three were younger inspectors who showed a willingness to learn about state-of-the-art microfinance practices.

The decision to place the new unit under the nonbank financial institutions department was based on the understanding that microfinance is a nonbank financial service. Given the relatively early stage of regulating microfinance in Uganda, creating a stand-alone microfinance supervision department within the BoU was not seen as an option. Most of the staff of the commercial banking department at that time was highly absorbed in consultations on the new banking legislation (the Financial Institutions Act) with the Ministry of Finance and the financial industry. However, because regular meetings to discuss the various drafts of the microfinance legislation were usually chaired by the executive director supervision, the staff of the commercial banking department was deeply involved in the microfinance discussions as well.

Immediately after the creation of the new unit, staff training became a top priority. Staff members were sent to participate in international microfinance training programs (such as the microfinance training programs at Boulder, Colorado, and Frankfurt, Germany, as well as exposure trips to other countries with relevant microfinance experience—Bolivia, Indonesia, and India, for example). In addition, on-the-job staff training was provided by international experts. As a result, the BoU staff in charge of microfinance became highly qualified in a comparatively short time and therefore were in a position to lead the consultations with stakeholders on the microfinance legislation most effectively.

The Micro Finance Deposit-Taking Institutions Act

The BoU was assigned the task of drafting legislation for the legal framework for tier 3 institutions, taking into account the specific nature of the microfinance business. The systematic drafting was carried out by a task force set up by the BoU supervision department comprising representatives from the BoU supervision and legal departments and a GTZ adviser as a resource. From the beginning, the members of the task force followed a risk-based approach focusing on the major risks of

microfinance institutions and operations. To keep the legislation lean, the members agreed to address ownership, governance, and management risks under the law, while the more concrete provisions on how to deal with credit, liquidity, and interest rate risks would be addressed under specific regulations. At the same time, the task force was asked to ensure that the microfinance legislation was fully in line with new Financial Institution bill (FIA 2004) that was at the time under parliamentary discussion.[7]

Elements of the Act

According to the MDI Act, MDIs can conduct *microfinance business*, defined as accepting and on-lending deposits from the public using microfinance methodologies.

MDIs are prohibited from engaging in high-risk activities without approval of the central bank. The assumption is that these institutions neither have the capacity to absorb potential losses associated with these activities nor the necessary risk-management systems in place that would enable them to mitigate associated risks. Section 19 of the MDI Act provides a long list of activities that are not allowed for MDIs, including the following:

- Engage in foreign exchange transactions.
- Operate current accounts (demand accounts with checking facilities).
- Underwrite securities.
- Engage in commerce.
- Engage in trust operations.
- On-lend compulsory savings taken as a collateral substitute.

According to the MDI Act, any institution applying for a license to carry out microfinance business shall become a company limited by shares. Because of the history of bank failures in Uganda, the BoU was sensitive to the issue of good corporate governance. MFIs that evolved out of the nonprofit sector operating as NGOs do not have real owners, because their funders are typically not in a position to provide additional capital if needed nor do they have appropriate incentives to provide adequate management oversight. In addition, they may be more concerned with meeting social rather than financial objectives. The need to have owners, and specifically owners with "deep pockets," became a crucial element of the MDI Act. Bank supervision requires clear identification and demarcation of the roles and responsibilities of owners and prompt reactions to emerging problems. In addition, owners and senior management have to be "fit and proper," the MDI must have a proven track record in microfinance, and the MDI must have proper legal status, which, according to Ugandan legislation is best achieved by registering as a company limited by shares.

The MDI Act also provides for good corporate governance though a system of checks and balances created by mandatory positions that have to be approved by the BoU. These include the chief executive officer, senior managers (finance, operations), and internal and external auditors.

When drafting the legislation, the BoU considered minimum capital of 35,000 currency points,[8] the equivalent of 700 million Uganda shillings (approximately U.S.$387,000), invested in liquid assets as adequate to obtain a license as an MDI. This was changed to 25,000 currency points, the equivalent of 500 million Uganda shillings (approximately U.S.$276,000) in the final version of the Act. To take deposits, any financial institution must be adequately capitalized to absorb losses without resorting to using depositor funds. Furthermore, by bringing in considerable capital, owners of an MDI show they have sufficient stake in the institution and thus will be motivated to ensure its continued capitalization.

Because of the different risk profiles of MFIs compared to traditional financial institutions, ongoing capital requirements are stricter than those for commercial banks and credit institutions. The core

capital adequacy ratio, therefore, was set at 15 percent of risk-weighted assets and the total capital adequacy ratio cannot fall below 20 percent at any time, compared to 8 percent and 12 percent, respectively, for commercial banks in Uganda as set in the FIA 2004.

Recognizing the danger of abuse when ownership is concentred in a few hands, the draft legislation also included provisions to restrict ownership by an individual or a group of individuals to 20 percent of the shares of an MDI. This was subsequently changed to 30 percent in the final version of the MDI Act. Furthermore, an individual seeking to own more than 10 percent of the shares must obtain explicit approval from the BoU.

Minimum capital and other licensing requirements act as a rationing device allowing only strong institutions to come under the surveillance of the BoU—a logical decision given the limited capacity of any central bank to supervise financial institutions, and the necessity of ensuring only financially viable institutions engaging in deposit mobilization from the public, particularly the poor.

While the political pressure on the government to issue the MDI law was increasing, the final draft of the bill submitted in April 2001 to MoFPED was delayed by intense discussion between MoFPED and the BoU. Numerous sessions took place, often ad hoc, with both the government and the BoU favoring, in principle, the same approach to safety and soundness of MFI operations. Discussions focused on particular aspects such as the new name of tier 3,[9] on deposit protection, and on the number of shareholders. The prudential spirit of the draft bill, however, was never questioned.

In September 2001, the draft MDI bill was accepted by the cabinet. The next step was for Parliament to pass it into law. In October 2001, a first Information Exchange and Lobbying event on the MDI bill[10] was held, organized by the Association of Microfinance Institutions of Uganda (AMFIU) in its function as the chair of the MFF Sub Committee on Lobbying.[11] The new Parliament had just been elected in June 2001 and was therefore not familiar with the process that had already taken place; thus, stakeholders felt it necessary to sensitize Members of Parliament (MPs) on microfinance before submitting the bill and to provide a forum for interaction between MPs and microfinance practitioners. During the event, no major issues were raised on the MDI bill. MPs were much more concerned about high interest rates, the future role of tier 4 MFIs, outreach, and the role of the government in microfinance.

Following the bill's submission to Parliament in January 2002, a second Information Exchange and Lobbying event was organized in April 2002, facilitated by AMFIU, the MFF, and the BoU supervision department.[12] The purpose of this event was for members of the relevant committees of the Ugandan Parliament[13] to learn the contents of the MDI bill and its context for them to be able to explain and present it in the plenary sessions of Parliament. Attendance by MPs was relatively high, with 59 out of 75 invited MPs participating.

The debate focused on the following issues:

- How would the new law promote smaller MFIs, especially in rural and remote areas? Because MPs perceived the MDI bill as an instrument to promote microfinance, one of the major concerns was the minimum capital requirement of (at that point) 700 million Uganda shillings, which was felt to be too high to enable small MFIs to come under regulation of the BoU.
- Were interest rates on microloans too high and loan terms too short term? The MPs argued that poor people could not afford to pay high interest rates, and loan terms were too short term to facilitate productive investment. Some of the MPs insisted that the MDI bill address these issues.

After long deliberation, many of the participants understood that the law and the policy framework would not affect tier 4 institutions as long as those

institutions abstained from mobilizing deposits from the public, but would enable stronger MFIs to offer additional financial products and services. However, many MPs still had concerns.

The MDI bill was discussed in Parliament in August 2002 and the final reading took place in a two-day plenary session in November of that year. In the meantime, the Parliamentary Finance Committee had several hearings with officials from the BoU supervision department and MFI practitioners. After lengthy debate the bill was finally passed on November 20, 2002. The still-persisting concerns of some MPs were addressed by the following motion:

> It is hereby resolved that the Cabinet undertakes to bring to the August House within six months a Bill regulating the activities of Community-Based Financial Institutions referred to as Tier IV in the Report of the Committee on Finance, Planning and Economic Development guaranteeing affordable interest rates and reasonable period of repayment to the borrowers. (Staschen and Akampurira 2003, p. 1)

Apart from a few amendments that saw the MDI's minimum capital requirements reduced to 25,000 currency points (500,000 Uganda shillings or approximately U.S.$276,000)[14] and the maximum shareholding by one party raised to 30 percent, the original bill remained intact. The MDI Act was assented to by the President in April 2003 and came into force on July 1, 2003. In the meantime, the BoU developed regulations through discussions with potential MDIs; these regulations were finally approved by BoU management in December 2003.

Following the discussions in Parliament, the MFF commissioned AMFIU to prepare a proposal to regulate MFIs not covered by the MDI Act. In March 2003, AMFIU, with the support of the GTZ/Sida Financial System Development Programme, conducted a study to analyze the existing legal and institutional framework for tier 4 MFIs (Staschen and Akampurira 2003). Discussions on whether to nonprudentially regulate credit-only MFIs to ensure sound business practices and transparency were still ongoing at the end of 2005.

To summarize, although the MPs reiterated their commitment to support microfinance, their enthusiasm for poverty alleviation (particularly within their own constituencies) without sufficiently understanding the basic principles of microfinance complicated the debate and the passage of the bill. Because the deliberations on the bill created an increased public awareness of microfinance practices, throughout the parliamentary process, the danger existed that MPs would insist on reintroducing interest rate caps or other restrictive measures that would have been tremendously detrimental to the industry. Furthermore, it seems that the skeptical view of the bill held by MPs was partly due to the fact that the new Financial Institutions Act governing tier 1 and 2 financial institutions, which would give the BoU more power to intervene in weak financial institutions, had been tabled to Parliament shortly before. Meanwhile, the BoU began to get ready for the next step—preparing to license and supervise MDIs.

BoU Approach to Risk-Based Supervision of MDIs

The MDI Act clarifies and defines the term *microfinance business* and outlines the most important requirements for licensing, restrictions on certain transactions, ownership and corporate governance of MDIs, and principles for supervision and receivership or liquidation. These principles were based on the perception that the risk profile of MDIs differs significantly from that of commercial banks and credit institutions.

The risk-based approach to supervising microfinance is based on an understanding of the MFI's risk profile. This approach identifies the key strategic,

operational, and financial risks of the MFI, allowing supervisors to concentrate resources on the areas of highest risk. The supervisor puts more emphasis on assessing future performance than on past performance and also gives greater emphasis to some of the more qualitative aspects of an MFI's operations, including management practices, the effectiveness of governance and internal control, quality of management information systems, soundness of corporate policies, and the professional capacity of staff and procedures. The risk-based approach relies on ongoing off-site surveillance and targets on-site supervision to those MDIs with a high risk profile. In addition, the approach uses intense licensing procedures to carry out substantial inspections of MDIs prior to licensing. Furthermore, it requires comprehensive information disclosure by the supervised institutions.

The statutory instrument lays down the detailed regulatory principles of microfinance institutions and operations as the foundation for risk-based supervision. To determine the risk profile of potential MDIs, the BoU conducted a survey of selected microfinance institutions throughout 2001.

Taking into consideration international practices for regulation and supervision of microfinance as well as the risk categories that were felt to be most relevant in Uganda,[15] the BoU designed a risk-based framework that incorporates both quantitative indicators and qualitative measurements for each risk category. For a detailed outline of the risk framework, see annex 2B, Risk Framework Using the Uganda Example at the end of chapter 2, Regulation and Supervision: The Policy Framework. The application of this framework requires considerable effort and upfront cost when potential MDIs apply for a license. However, once the licensing process is completed, the framework focuses the ongoing supervision on areas of greatest risk within the particular MDI, combining a prospective view with the assessment of past performance.

Risk-management systems lie at the heart of risk-based supervision. These include the governance role of the board of directors, the adequacy of the management information system, and the MFI's internal control policies and procedures.

Licensing Begins

At the time of publication, four MFIs in Uganda had been licensed as microfinance deposit-taking institutions. In order of licensing these are FINCA Uganda Limited, PRIDE Microfinance Limited, Uganda Microfinance Limited, and Uganda Finance Trust Limited. Each of these institutions underwent a prelicensing, on-site examination that included a detailed analysis of the institution's strategic, credit, and operational risks. These inspections all took place in mid-2004, following the official adoption of the MDI implementing regulations.[16]

As shown in table 14.1, the gap between the inspection and actual licensing varied widely, from 5 months in the case of FINCA Uganda to 19 months for Uganda Finance Trust.

The primary cause for the difference was the time it took for each institution to finalize its ownership structure. Each of the MDIs faced different challenges in meeting the BoU's ownership requirements, as discussed below. In addition, there was some confusion surrounding the timing requirements set forth in the MDI Act. Article 91 of the act states that

> any person who, immediately before the commencement of this Act was carrying on microfinance business in Uganda shall, immediately upon the coming into force of this Act apply for a license under this Act and within twenty four months from the commencement of this Act comply with the requirements of this Act or wind up its business within six months.

The BoU warned MFIs taking deposits from the public against doing so until they were

Table 14.1 Licensing Sequence

MDI	Prelicensing inspection	Submission of application	Issuance of license
FINCA Uganda Ltd.	July 2004	August 16, 2004	November 23, 2004
PRIDE Microfinance Ltd.	February 2004	September 10, 2004	June 30, 2005
Uganda Microfinance Ltd.	August 2004	December 17, 2004	June 30, 2005
Uganda Finance Trust Ltd.	April 2004	June 29, 2004	October 12, 2005

Source: Contributed by Lloyd Stevens, DFID Financial Sector Deepening Programme, Uganda, January 2006.

licensed, meaning that most of the largest MFIs would have 24 months to become licensed or return customer deposits (which one ultimately ended up doing). However, the Act was gazetted (published in the official government newspaper) on September 5, 2003, with a retroactive effective date of July 1, 2003. It was thus unclear if the institutions had until July 1, 2005 (two years from the effective date) or September 5, 2005 (two years from the date of gazetting). The issue was finally clarified in May 2005 by the BoU, with July 1 set as the deadline—hence the licensing of two institutions (PRIDE Microfinance Ltd. and Uganda Microfinance Ltd.) on the same date. Uganda Finance Trust Ltd. had been relying on the September 5 date, and took several extra months to finalize its ownership and become licensed. (Based on the substantial progress made in meeting the licensing requirements, the BoU allowed it the extra time.)

FINCA Uganda

At the time of licensing, FINCA Uganda Ltd. (FU) had over 48,000 loan clients and a portfolio of 10.5 billion Uganda shillings (about U.S.$5.8 million), making it the second largest MFI by clients and third by portfolio. As the Ugandan affiliate of FINCA International (FI), FU's management and its overall strategy were heavily influenced by the FI head office in Washington, DC. One of FI's main requirements in transforming FU was that the company remain under its control. As discussed previously, the MDI Act limits ownership by any one organization or individual to 30 percent. The law does, however, allow an MDI to be a wholly owned subsidiary of a reputable financial institution. FI was able to demonstrate to the BoU that it met this requirement, and accordingly the license was granted with FI effectively owning 100 percent of the shares of FU. This greatly simplified the licensing process, because there was only one investor to be vetted, and no shareholder group to negotiate with and finalize. FI has undertaken to reduce its ownership over a five-year period, but to date no other investors have purchased shares in FU.

PRIDE Microfinance Limited

PRIDE Uganda began as a Ugandan government project with funding from the government of Norway. In 2002, a registered NGO was formed, which assumed all of the project's assets and liabilities. Then, in 2004, in anticipation of transformation, a share company called PRIDE Microfinance Ltd. (PML), majority-owned by the NGO but with additional shareholders, was formed and the assets and liabilities of the NGO transferred to it. However, before licensing, questions were raised by the government as to the procedures followed in the creation of PML. Ultimately the full ownership of

the company reverted to the government of Uganda. This resolved, at least on an interim basis, the question of ownership of PML, allowing the BoU to grant it its license before the July 1 deadline. At the time of its licensing, PML had 51,500 loan clients and 18.4 billion Uganda shillings (U.S.$10.2 billion) in portfolio, ranking first in clients and second in portfolio.

PML has been given a limited time to reduce the government's ownership and bring in private owners who will jointly hold a majority position. At the time of publication, no other investors had purchased shares in PML.

Uganda Microfinance Limited

At the time of licensing, Uganda Microfinance Limited (UML) was the largest MFI in the country by portfolio (20.7 billion Uganda shillings, or U.S.$11.4 million) and the third largest by borrowers (35,000). UML is the subject of chapter 15, The Creation of Uganda Microfinance Limited, so is not discussed in detail here.

Uganda Finance Trust

Although its parent Uganda Women's Finance Trust (UWFT) was the oldest MFI in Uganda, UWFT was the last of the four MDIs to receive its license. Its portfolio of 12.2 billion Uganda shillings (U.S.$6.7 million) ranked third in size among the four MDIs, and its borrower base of 20,100 ranked fourth. However, UWFT had been actively mobilizing savings deposits from the public for years, accumulating 4.4 billion Uganda shillings (U.S.$2.4 million) in savings from 72,000 depositors, far more than its competitors. With the passage of the MDI Act, UWFT was in clear contravention of the law and, therefore, under the most pressure to become licensed.

In many ways, U-Trust followed the most traditional path and was the only MDI to strictly adhere to ownership limitations: it formed a new company with the NGO retaining 29.8 percent of equity (just under the 30 percent ceiling outlined in the MDI Act); and outside investors, comprising a number of social investors (44.6 percent), founders (13.5 percent), and a staff investment vehicle (12.1 percent), holding the remainder. However, the presence of so many parties, as well as the company's belief that it had until September 2005 rather than July 2005 to become licensed, led to delays in its final approval.

One other MFI in Uganda (Faulu Uganda Ltd.) is in the process of transforming and hopes to submit its license application to become an MDI sometime in 2006. No other MFIs in Uganda interested in transforming are yet financially sustainable so it is unlikely that additional MDIs will be licensed in the near future.

Key Success Factors

Because of its overall positive experience, microfinance in Uganda has increasingly drawn attention from governments, donor agencies, experts, and practitioners from numerous other countries. One of the areas of greatest interest is microfinance regulation and supervision, with Uganda becoming a showcase for the collaborative development of a legislative framework.

The major success factors are summarized below.

Enabling Policy Framework

Microfinance was and still is high on the political agenda of the country. Uganda has a consistent and enabling policy framework for financial sector development. The government is committed to creating and maintaining an environment conducive to the sustainable growth of the microfinance industry. This includes divesture from direct credit delivery through government programs, the

promotion of national coordination and linkages through the MFF, and support of an enabling policy and regulatory framework. Moreover, the government continues to support capacity-building efforts within the industry.

Clear Policy on the Way in Which to Regulate

The 1999 policy statement clearly defined the goals of the new legislation. Because this policy, which focuses on safety and soundness of microfinance operations, was widely adopted, drafting of the microfinance legislation was based on agreed upon principles and could, therefore, take place under relatively benevolent circumstances.

Clear Mandate for the BoU in Formulating the Draft Policy and MDI Bill

After the many unresolved issues and lack of clarity on microfinance regulation that emerged at the policy workshop in May 1998, it was important to clearly give the BoU the mandate to lead the discussion. A small group within the BoU developed major principles on how to regulate the industry. By following a strictly prudential view driven by the understanding that the best way to promote microfinance would be to provide a conducive regulatory framework for the industry, the BoU could limit politicization of the debate and push forward a set of principles in line with international best practices.

Stakeholder Consultation and Collaboration

Consultation and collaboration among the relevant stakeholders contributed significantly to the success of the legislative process in Uganda. The proactive commitment of a number of key leaders in public agencies, MFIs, and donor organizations led to the collaborative atmosphere. The MFF chaired by MoFPED, in existence since 1997, played a major role in guiding the strategic coordination of the relevant stakeholders. Furthermore, numerous individuals in Uganda became "champions of change" and played key roles in leading the change process.

Donor Support, Coordination, and Collaboration

Donor funding, policy advice, and technical input played a substantial role in the development of the Ugandan microfinance regulation; however, in each phase of drafting policy and regulations for microfinance, the ownership of the process was clearly with the BoU and other Ugandan stakeholders. Even so, a crucial success factor was the close collaboration among major donors in providing skilled technical staff as well as relevant best practices.[17] Donor coordination has been particularly strong in Uganda. All relevant donor agencies recognize and agree on good microfinance practices. In January 2002, 13 donor agencies adopted guidelines incorporating sound principles for providing support to microfinance in line with good practices[18] and in 2003, 15 donor agencies endorsed an MFI Performance Monitoring Tool that provides uniform reporting formats for all donor-funded MFIs (Ledgerwood, Mutebi, and Mpendo 2003). As discussed in chapter 2, Regulation and Supervision: The Policy Framework, the leading donors supporting transformation also formed a Transformation Steering Committee to coordinate support to the industry on transformation-related issues.

Role of Politics

There was strong political will to promote microfinance as part of the overall development agenda in the country. Government not only actively supported the design of the legal framework, but also addressed the bottlenecks in microfinance—such as deficient infrastructure, lack of skilled human resources, and the need for capacity building—in relevant policy documents. As a result, an overall vision for microfinance emerged, which included the regulatory framework as a major strategic target.

Role of AMFIU

AMFIU played a critical role in influencing the overall policy framework for microfinance in Uganda, particularly when the draft MDI bill was discussed in Parliament. As discussed above, AMFIU, in cooperation with the BoU and supported by several donors, organized a number of information exchange events to explain the bill to the MPs. In addition, AMFIU regularly participated in policy debates to encourage the government to adopt good microfinance practices and was called to several hearings of the Parliamentary Committee on Finance when the bill was being evaluated. AMFIU also actively disseminated general information on microfinance, and educated the public on the importance of savings for poorer clients and other issues that were considered critical (for example, the reason for high interest rates relative to traditional commercial lending) through publications in the mass media, flyers, and workshops. The role AMFIU played in promoting understanding by MPs and addressing their concerns cannot by overstated.

Remaining Challenges

Despite the measurable success of the efforts to supervise and regulate the microfinance sector to ensure its sustainability and continued assistance to poor people, several challenges still remain.

Lack of Clear Vision for a Financial Systems Approach

Despite lengthy discussions on the new legislation, the majority of stakeholders do not yet have a clear understanding of how microfinance can be integrated fully into the formal financial system. To make microfinance sustainable in the medium term, all stakeholders must gain a better understanding of the financial systems approach[19] and develop a shared vision of further steps to achieve this (Goodwin-Groen, Bruett, and Latortue 2004).

Lack of Clear Strategy for Addressing Failing MDIs

The corrective action tools available to supervisors for dealing with weak or failing banks do not always work well or as desired when applied to regulated microfinance institutions. Stop lending orders, for example, would be inappropriate to apply to MDIs because the asset quality of MDI loan portfolios is so largely dependent on the promise of accessing future loans.

Danger of Politicization

Through the intense political debate on the MDI legislation, microfinance gained much public and political attention. Some politicians seem to see microfinance as a panacea for poverty alleviation and insist that interest rates should be brought down. Stakeholders, therefore, have to take a proactive approach to rapidly react to political statements or initiatives that might have harmful effects on the industry (Goodwin-Groen, Bruett, and Latortue 2004).

Regulation and Supervision of Savings and Credit Cooperatives

The 1999 policy statement makes clear that savings mobilization by member-based institutions will not fall under the regulation of the central bank. Nonetheless, in Uganda more than 1,300 savings and credit cooperatives (SACCOs) mobilize resources from mostly poor people. Stakeholders increasingly express concern about the lack of prudential oversight for these savings. A way needs to be found to increase transparency and oversight for the sector without overstretching the BoU's capacity.

If SACCOs continue to grow, the BoU may consider submitting the largest ones to direct supervision as is done in some Latin American countries (Jansson, Rosales, and Westley 2003).

Notes

The authors wish to acknowledge the contribution of Lloyd Stevens, DFID Financial Sector Deepening Programme, Uganda, who provided the section, "Licensing Begins."

1. Bank of Uganda Web site http://www.bou.or.ug.
2. The FIA 2004 seeks to rectify weaknesses in the current banking legislation and to improve corporate governance by clearly stipulating the responsibilities of the board of directors, external and internal auditors, and management of financial institutions. It places tighter restrictions on insider lending and large exposures than the Financial Institution Statute 1993 (which the FIA 2004 replaced) and seeks to reduce ownership concentration to prevent financial institutions from being owned and controlled by one person or family. The new FIA updates Uganda's banking legislation to an international code of best practice as set out in the Basle core principles for effective banking supervision.
3. Public expenditure as a share of GDP increased from 16.4 percent in 1997–98 to 24.9 percent in 2001–02 (IMF 2003, p. 3). Given the insufficient rise in domestic revenue, the large deficits have been covered by increased donor support resulting in increased injections of liquidity to contain inflation. These sterilization operations have exerted pressure on real interest rates and the exchange rate, raising concern about crowding out of the private sector and adversely affecting export growth.
4. In 2004, longer-term government bonds with maturities between two and ten years were issued, which led to a decline and stabilization of the Treasury Bill rate. In the medium term this might have an effect on the commercial banks' investment strategies.
5. Some stakeholders apparently felt their views were successfully included in the general debate on microfinance regulation (CGAP 2000, box 6 on Uganda). Other observers of the consultative process found that in 1999 "the dialogue was mainly just between GTZ and BoU until a letter was sent in November 1999 to the BoU Governor" on behalf of 12 to 15 of the largest MFIs and apex organizations (Bell 2003, p. 20). The reality was that the consultative process involving stakeholders was intense but initially mostly bilateral.
6. The Bank of Uganda at the time had a commercial banking department that supervised tier 1 institutions, and a nonbank financial institutions department, which supervised tier 2 and eventually tier 3 institutions.
7. It should be noted that members of the task force were of the opinion that converting MFIs into deposit-taking intermediaries could have been achieved with lower transactions costs by amending the draft Financial Institutions bill rather than creating new legislation. However, this political decision had already been made.
8. The minimum capital is expressed in currency points to allow for inflationary adjustments. According to the MDI Act 2003, minimum capital can be varied by MoFPED with approval of Parliament and the definition of currency points (Schedule 1) can be changed by the MoFPED with approval of Parliament. In May 2006, one currency point was equivalent to 20,000 Uganda shillings. (As of May 2006, the exchange rate was 1,810 Uganda shillings per U.S. dollar).
9. The name of the new institutional type was discussed at length. In late 2000, stakeholders finally agreed on the term *micro deposit-taking institutions,* which, with the passage of the law, was changed to *microfinance deposit-taking institutions.*
10. For a summary of all workshops and information exchange events that were conducted before the MDI Bill was passed by Parliament, see Ledgerwood, Burand, and Braun (2002).
11. AMFIU is a national microfinance network with 79 regular member microfinance institutions and 14 associate members (apex bodies and donor projects) as of December 2004. It was established in 1996 through the association of several institutions interested in microfinance and was registered in 1999 as a company limited by guarantee. AMFIU actively lobbies government to create and support a conducive environment for microfinance, disseminates information, and links local and international microfinance stakeholders. AMFIU is highly regarded by its member organizations and generally accepted as the voice of the Ugandan microfinance industry.

12. Throughout the process a number of additional workshops on experiences with transformation in other countries, tax implications for transforming MFIs, and general policy issues for various groups of stakeholders were held. See Ledgerwood, Burand, and Braun (2002).

13. The committees were the Committee on Finance, Planning and Economic Development, which was in charge of presenting the bill and providing recommendations to the plenary; the Committee on Agriculture, Animal Industry and Fisheries, which is in charge of the PMA (Plan for Modernization of Agriculture) and closely linked to the Strategic Plan for Expanding Outreach and Capacity for Sustainable Microfinance in Uganda; and the Committee on Social Services, which is linked to some past directed government lending programs.

14. To ensure the BoU cannot raise minimum capital without the consent of Parliament by raising the value of one currency point, the MDI Act stipulates that the value can only be changed by MoFPED with the approval of Parliament (see endnote 8 above). The draft MDI bill had provided that the value of currency points could be adjusted with the approval of the Cabinet.

15. Ownership and governance risk, management risk, credit risk, liquidity risk, and interest rate risk.

16. The BoU was already focused on these institutions for several reasons. They comprise the four largest MFIs in the country, several were already mobilizing savings deposits (in various ways and to varying degrees), and each had formally indicated its intention to transform in writing to the BoU.

17. USAID provided assistance in the field of strengthening MFIs through the PRESTO project and between 2001 and 2004, through the Support for Private Enterprise Expansion and Development (SPEED) project, which provided direct support to MFIs with potential to transform into MDIs. Since 1998, GTZ has provided assistance to the BoU on the design of the BoU policy framework for microfinance and the drafting of the MDI Bill. GTZ also supported training and capacity building for BoU staff and facilitated the transfer of know-how through various capacity-building trips for BoU staff to other countries (Bolivia, Indonesia, and India, for example). Both agencies also provided considerable support for the information exchange and lobbying activities that were organized when the bill was discussed in Parliament. In addition, expertise from other countries (Bolivia, in particular) was brought to Uganda, especially when the legislation and the regulations were developed. Other agencies involved included the European Union-SUFFICE Programme, the UK Department for International Development, SNV, the World Bank, and the Stromme Foundation.

18. Donor Principles for Support to Uganda's Microfinance Industry, 2001.

19. The *financial systems approach* applies market-driven principles used by formal financial institutions to the provision of financial services to the poor, as defined in Otero and Rhyne 1994.

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Chapter 15

The Creation of Uganda Microfinance Limited

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

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

In early 2002, before officially launching preparations for transformation, UMU operated out of a small, four-room house. The senior management team included two executive directors and a head-office manager, the latter tasked with branch operations, human resources, and new product development. The staff complement totaled 120, most of whom knew each other personally. The organization served just over 10,000 active borrowers and approximately 20,000 savers out of nine service centers, and relied on a completely paper-based, manual accounting and account-tracking system. Portfolio quality was excellent, and the organization had experienced no known cases of fraud.

By June 2005, UMU no longer resembled the organization it had been just three years earlier. It had long since shifted premises to a 14-room, two-floor professional building. A core group of external investors, none of whom had been involved in the initial transformation planning, had been

assembled to finance and lead the new MDI going forward. The senior management team had been expanded to include eight department heads, each managing fully staffed departments, including operations, credit, internal audit, human resources, finance and administration, information technology, research and development, and marketing. The organization's geographic presence had grown from 9 to 20 service centers (including branches and agencies or subbranches), staffed by a total complement of 330. Client outreach had more than tripled to 91,000 savers and 36,000 active borrowers. The manual management information system (MIS) had been replaced by a sophisticated banking software, and formalized policies and procedures manuals had been developed for all operational activities. At the same time, however, portfolio quality had deteriorated and incidents of fraud had been detected at some of the branches.

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

Background

Despite initial start-up challenges, the founders' commitment to offering quality financial services to a broad range of Ugandans facilitated organization's growth from a small project to one of the leading microfinance institutions in Uganda.

From Boston to Busiika

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

Uganda Microfinance Union was incorporated on July 21, 1997, as a company limited by guarantee[2] and registered as a nongovernmental organization (NGO). The company's initial board was composed of six directors, including its two

founders, two Ugandan businessmen, a central banker, and a human rights activist.[3] The original vision of the institution was "to offer quality financial services to micro-entrepreneurs and low-income people (female or male) living in the rural, periurban, and urban areas in the Republic of Uganda" (UMU 2001 End of Year Report). With the goal of serving marginalized communities, UMU began operations in the small township of Busiika, Charles' hometown located in Luwero district, approximately 22 miles from the capital city Kampala. After less than a month of additional research and planning, UMU's first loan was disbursed on August 11, 1997. During those initial months, Charles played the role of finance manager, systems manager, and client mobilizer; Rodney served as the commercial manager, loan officer, and collections officer. Their first employee, who served as the sole teller, was also hired at this time, someone who remains an employee of the company today.

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

With a year of operations under its belt, UMU began a number of fruitful discussions with the donor community. In late 1998, Novib (Oxfam Netherlands) provided a sizable grant of approximately U.S.$300,000 to support both the capitalization of the loan portfolio and operating costs. In 1999, an additional U.S.$500,000 grant was secured from the United States Agency for International Development (USAID) Private Enterprise Support Training and Organization Development (PRESTO) project, $400,000 of which was for the loan portfolio and the remaining $100,000 for fixed assets. In addition, in late 1999, UMU received a second loan from the BoU for 100 million Uganda shillings (approximately U.S.$66,000 at the time) repayable over one year. By late 2000, the small research project, started with a minimal $32,000 in 1997, had amassed a capital base of over 1.2 billion Uganda shillings (approximately U.S.$700,000).

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

Growth of Operations

Since reaching their 100th client in September 1997, UMU grew steadily and became one of the largest MFIs operating in Uganda. As illustrated in table 15.1, UMU registered exponential growth as the organization moved quickly to open branches throughout the country. In 2001, the organization posted its first profit of approximately U.S.$40,000, achieving self-sufficiency after only four years of operations. While the combination of a burgeoning private sector and a relatively shallow financial system in the late 1990s created significant demand for microfinance services in Uganda, UMU's particular operating strategy also helped encourage rapid market penetration.

Broad market perspective. From its opening days, UMU's goal has been to provide a range of financial service to eligible unbanked member of the

Table 15.1 Growth of UMU's Credit Operations

Year	Number of active loan clients	Outstanding portfolio (million Uganda shillings)	Number of service centers[a]
1997	421	38	1
1998	1,098	126	1
1999	1,762	278	2
2000	7,598	1,202	5
2001	10,417	2,858	7
2002	20,598	6,730	11
2003	28,625	12,285	14
2004	36,864	18,812	15
August 1, 2005[b]	27,700	19,035	18
December 31, 2005[c]	31,145	20,601	20

Source: UMU internal documents.

a. Includes branches and agencies (subbranches).

b. UML statistics.

c. UML statistics at year end 2005.

community, and ultimately even attract clients away from banks by offering better and more efficient service. As such, UMU's target market has included both self-employed microentrepreneurs and salaried workers in the branches' catchment areas.

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

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

Consolidating Resources

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

With growth in the loan portfolio continuing at a rapid pace, UMU's funding needs became more

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

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

Planning and Managing the Transformation

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

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

Transformation Options

The decision to transform was ultimately spurred by the evolution of events occurring at the regulatory level and the corresponding time line of donors contributing to the sector. The process of developing a regulatory and supervisory framework for microfinance in Uganda had started as early as April 1996, and in July 1999, the BoU policy statement on microfinance regulation and supervision was passed by cabinet, creating separate tiers for different financial institutional types.[4] Within this policy framework, the new MDI legislation was developed to specifically respond to the special characteristics of microfinance. Minimum capital was set at a modest level (500 million Uganda shillings, approximately U.S.$276,000), though balanced by a relatively conservative minimum capital adequacy ratio of 20 percent (total capital to risk-weighted assets).

The legislation expects the primary services of an MDI to be short-term loans (up to two years) to microentrepreneurs, and savings and time deposits

from the public, although it is acceptable for MDIs to have some loans of longer duration, provided that short-term loans remain the core of the business. Special permission is required for an MDI to engage in payment services, international money transfers, and other services. MDIs are prohibited from a range of activities, including current accounts and foreign exchange operations. In the short to medium term, however, UMU felt the legislation would provide the institution room to offer all its current products (provided it obtained permission on payments and transfers) and to aggressively develop new savings products as well.[5]

As discussed in more detail in chapter 14, Creating a Separate Tier: The Micro Finance Deposit-Taking Institutions Act, 2003, the BoU followed a relatively transparent and participatory process in drafting and circulating the new microfinance legislation and the corresponding regulations. UMU, along with other transforming MFIs in Uganda, was an active participant in the numerous forums and discussion groups held to develop the overall strategy and approach to regulating microfinance operations. In addition, UMU's chief executive officer himself was a former BoU examiner, and thus well versed in the general procedures and expectations of the BoU. Although continual delays in the publishing of the final regulations did add some confusion to the process, the path toward transformation for UMU initially appeared to be relatively straightforward.

Managing and Funding the Transformation

As early as 2001, UMU began discussions with various donors to explore accessing financial and technical support for the transformation process. As part of a larger donor effort to support the microfinance industry, a number of donors included funds in their projects to finance technical assistance and anticipated capital expenditures to prepare MFIs for licensing. The donors included USAID, through its Support for Private Expansion and Enterprise Development (SPEED) Project; the European Union, through the Support to Feasible Financial Institutions and Capacity-building Efforts (SUFFICE) Programme; and DFID, through its Financial Sector Deepening Uganda (FSDU) Programmme. The SPEED Project, for example, conducted a competitive tender to select institutions for assistance based on interest, potential for success, and current and projected financial performance, with the aim of selecting three institutions for significant financial support in the transformation process. In what was ultimately a pivotal point in the institution's evolution, UMU was one of the three institutions selected for this assistance, making it eligible for substantial technical and financial support for transformation.

As a starting point, the SPEED project jointly contracted ACCION International and Shorebank Advisory Services, two U.S.-based organizations, to conduct due diligence of UMU and to develop a preliminary transformation plan for the institution. This exercise was carried out in October 2001; at its conclusion, a detailed transformation plan was agreed on by the institution and funders. This plan included a total of 111 activities that needed to be completed prior to licensing. Key areas included strategic and business plan development, credit methodology refinement, financial management upgrading, improvements in governance, human resources capacity building, development of an investor relations function, MIS upgrading, savings product development, and ultimately submission of the application to BoU. Responsibility for these activities was primarily allocated to UMU and a newly appointed in-house transformation manager, seconded from ACCION, with additional support provided by other ACCION staff members, Shorebank staff members, and MicroSave[6] staff members in key technical areas. The transformation manager was contracted for one year (though extended to 14 months) beginning in April 2002 and was tasked with ensuring completion of these 111 activities. Funding for the transformation manager and

numerous short-term technical assistance missions was provided by the SPEED project, for a total of just over U.S.$450,000. In total, this funding supported approximately 500 days of external technical support to UMU over a period of 18 months. With the departure of the transformation manager in June 2003, ACCION International continued to support additional short-term missions to UMU and in 2004 installed a resident adviser to work closely with the organization on product development. The cost of this additional support totaled approximately U.S.$200,000 and was provided by ACCION (funded from various sources).

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

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

Operational Transformation: Upgrading and Systemizing

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

Human Resources Management

When UMU first began preparing for transformation, its senior management team consisted of the chief executive officer, the executive director, and a head-office manager, who was tasked with branch oversight, human resources, and product

development. The absence of a second tier of senior managers at head office made sense for UMU as a young, start-up NGO. However, with over 20,000 members and more than 10,000 loans when it began the transformation process, UMU needed to reinforce and expand its management team. Thus, one of the more urgent initial tasks was to recruit a number of senior managers, including a chief financial officer, a chief internal auditor, a human resources manager, and an information technology manager. These positions were filled over a 6- to 12-month period, resulting in a very different organizational structure and senior management team. In addition, in early 2004, UMU created a head of credit position, reporting directly to the chief executive officer, and staffed for the first two years by an individual seconded from ACCION International. The head of credit is responsible for overseeing credit operations in the organization, including maintaining strong portfolio quality, ensuring adherence to policies and procedures, and managing the collections team.

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

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

Financial Management

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

Additionally, UMU's financial statement preparation was significantly upgraded to adhere to appropriate accounting principals and to respond to BoU reporting requirements. The upgrading included changing the organization's chart of accounts, introducing cost center financial reporting at the branches (for example, allocating fixed asset depreciation and loan loss provisioning to each branch), introducing accrual accounting (as appropriate), conducting monthly budget to actual analysis, and developing a new series of reports to be submitted to the BoU.

Management Information Systems

UMU recognized that a key factor in the organization's successful MDI application would be the effectiveness of its tracking systems and the accuracy and timeliness of its reporting. UMU's manual account management system, built primarily with ledger cards (yellow for loans, and pink for savings) and a separate centrally based automated accounting package (Solomon IV) faced limitations in efficiency, consolidation of data, and trend analysis. It was clear the system would be insufficient to respond to the reporting and tracking requirements of a regulated MDI. Moreover, the BoU specifically required MDIs to have an acceptable, automated MIS to ensure accurate and timely reporting. The process of conceptualizing and implementing a new MIS was thus a critical component of the transformation process.

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

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

Internal Controls and Audit

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

risks associated with money transfers or larger individual loans.

The large portfolio of responsibilities implied that the internal auditor, once hired, would require dedicated and trained staff and that UMU would need to create an internal audit department. A detailed Internal Audit manual was needed to document UMU's various audit policies and procedures, as well as the distinct UMU internal audit methodology. A manual was thus developed that incorporated internal control systems, risk methodology, personnel qualifications, audit methodology, audit responsibilities, audit reporting requirements, standards for each audit, and a variety of audit tools. An internal audit department was created and a chief internal auditor hired as well as three internal auditors.

Product Mix and Branch Operations

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

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

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

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

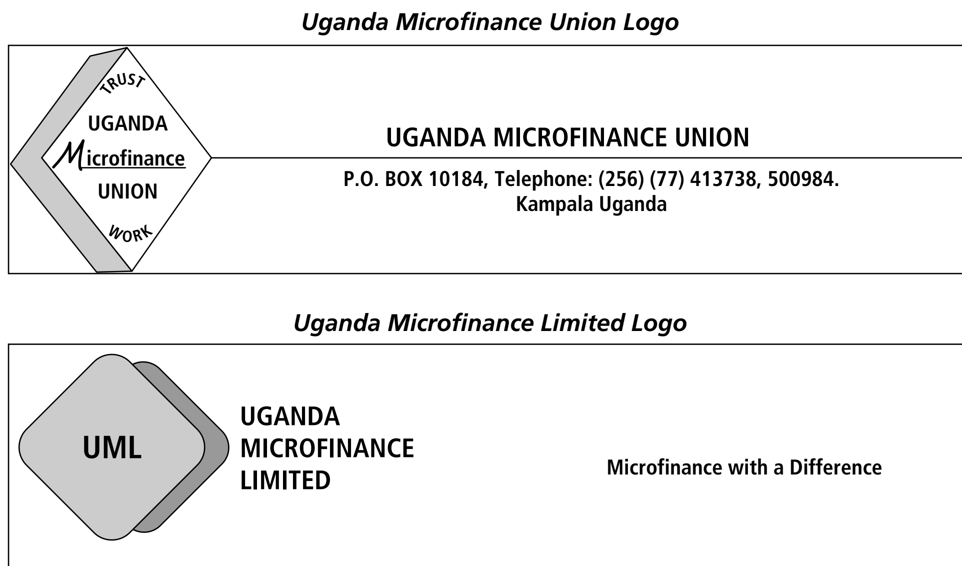
Unlike many of the MFIs operating in Uganda, which frequently meet clients in informal community venues, UMU, from day one, had formal banking halls, tellers, safes, and security, with all client

transactions occurring in the branches. Loans are disbursed to the client's savings account, and repayments are accepted, at the teller windows. The introduction of voluntary savings services in UML, however, increased the volume of transactions in the organization, requiring changes in back office operations and the refurbishing of some banking halls.

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

- *Redesigning the logo:* UMU NGO's logo was a three-dimensional blue diamond, with the organization's name (in blue and red) and the two words, "trust" and "work" inscribed inside (see top portion of figure 15.1). This logo had been drafted by the founders in the initial days and was meant to convey a trustworthy, reliable organization. With competition increasing and the organization aiming for a more professional look, the decision was made to redesign the logo for UML to portray a clean, professional look, while retaining the blue and red color theme (see bottom portion of figure 15.1).
- *Relocating "hidden" branches:* To try to encourage greater brand recognition, UML has relocated some of its branches to higher traffic locations.
- *Differentiating "hot spots" from "cold spots" in branches:* Within its branches, UML distinguishes between high traffic areas, better for placing UML publicity materials, and "cold spots" better for general administration or operations communication materials.
- *Adding customer service agents:* Each branch is now staffed with a customer service agent, available to answer any client questions or advise clients on UML's products and services.

Figure 15.1 The Evolution of Uganda Microfinance Union's Logo



Source: UML Marketing Department.

Structural Transformation: Creating UML and Attracting Investors

In addition to the multitude of operational changes required to comply with BoU MDI regulations, UMU also needed to transform into or create a new for-profit company, capitalized with a minimum of 500 million Uganda shillings (approximately U.S.$ 276,000) and owned by BoU-approved investors, none of whom could own more than 30 percent of the organization.[7] The MDI Act and accompanying regulations also provide specific requirements for the composition and duties of the board of directors in line with sound corporate governance practices. The BoU made clear there would be a rigorous investigation of prospective owners. They expressed particular concern that owners be able to provide the "deep pockets" necessary to supply the MDI with additional capital if required. In connection with this, the BoU expressed some skepticism that local NGOs would have the financial resources to be significant owners of MDIs.

Creation of UML

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

Attracting Investors

UMU's initial vision for UML's ownership group, as articulated in the transformation plan, included a diverse group of investors, including the founding directors, the NGO itself, UML staff through an employee share ownership program, local private investors, and some international investors including various technical partners, multilaterals, and socially responsible investment funds. Over the course of three years, the types of investors involved, the anticipated ownership role of the NGO and the founding directors, and the structure of the MDI's overall capital base changed significantly (see table 15.2).

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

Investor Negotiations: Round One

Early in the transformation process, a few local private companies were approached as potential investors in UML. While UMU's projected returns were impressive, these private investors were ultimately deterred by what they perceived to be an illiquid market for the shares. Although a viable exit strategy remained an important issue for all prospective investors, international investors, and particularly those seeking both social and financial returns, were easier to attract. At the time of transformation, UMU was already borrowing from a number of international funders including Triodos and Novib, who also sought equity investments in the sector. In addition, UMU had established technical assistance relationships with organizations that also had investment arms, including ACCION International with ACCION Investments in Microfinance and Shorebank Advisory Services with its

Table 15.2 Ownership Structure of UML
(percent)

	Initial proposal	Structure at licensing (August 2005)	Current structure (at time of writing)
Local private investors and directors	10	99.99	40
UMU NGO	25	<1	<1
Staff	10	0	0
Technical partners	20	0	0
Multilaterals and bilaterals	20	0	30
Socially responsible investors	15	0	0
Commercial funds	0	0	30
	100	**100**	**100**

Source: Uganda Microfinance Union Transformation Plan; author.

Shorecap Fund. The organization's first prospective investors meeting, held on July 16, 2002, thus included five international institutional investors: Novib, Triodos, ACCION Investments in Microfinance, Shorecap, and the East African Development Bank, the first four already partners of UMU.

This first investor meeting was the kick-off gathering for what became a complex and ultimately inconclusive negotiation process between the four founding directors of UMU and the four international investors, Novib, Triodos, ACCION Investments, and Shorecap. A series of investor meetings was held in late 2002 (the second of which was also attended by AfriCap Microfinance Fund, a socially responsible investment fund for regulated MFIs in Africa) and throughout 2003. In addition, a due diligence exercise was carried out in April 2003 jointly by representatives of each of the international investors. Discussions throughout this period focused on the terms of the investment, including the amount of capital, percentage ownership, investor rights, exit strategies, and governance implications. Although agreement was achieved among the investors on most of these topics, two issues proved to be significant stumbling blocks for all parties involved—the mechanism for facilitating ownership for the founding directors and the valuation of the NGO's net assets.

Ownership for the founding directors. For any start-up company that decides to sell shares to external investors, the issue of founder compensation is likely to arise. The technology world, for example, is full of stories of entrepreneurs who were compensated for their initial efforts by receiving shares on favorable terms to reflect the value they had added and, in many cases, will continue to add to the company. This concept of "sweat equity," however, is difficult to apply when start-up and ongoing capital is composed of public money, granted by donors for charitable purpose, and retained earnings, at least a portion of which has been earned from these grant funds. Historically, some transformed MFIs have compensated the founders and leaders through preferential terms on shares they purchase in the new company or, in a few cases, through granted bonus packages to facilitate share purchase. Determining what is appropriate compensation and how such benefits should be funded can become particularly difficult negotiating points.

In UMU's case, the directors argued that their role in building UMU from the ground up provided the rationale for them to acquire shares on preferential terms. The legitimacy of such a claim was generally acknowledged, though one investor emphasized the importance of structuring such an agreement to provide incentive for longer-term

commitment of the founders and continuing management performance. It was also argued that the directors should make a contribution of their own funds to the degree possible. The relatively high starting capital (at the time, estimated to be approximately U.S.$3 million—based on capital adequacy requirements, not minimum capital), however, made this a difficult proposition in light of the founders' desire to hold a stake significant enough to ensure board representation and ongoing influence. A myriad of alternatives was considered to facilitate ownership by the founders, such as a loan facility from the NGO, discounted shares, and stock options based on future performance of the MDI, none of which, however, was ultimately acceptable to all parties.

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

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

With the withdrawal of Triodos and Novib from the prospective investor group, the group was narrowed to the founders, ACCION Investments, and Shorecap. Throughout 2004, ACCION Investments and Shorecap continued to negotiate with the UMU founders. Various proposals on each side were put forward and each ultimately rejected by the other side. Negotiations appeared to be at a deadlock.

Investor Negotiations: Round Two

With the breakdown in discussions with ACCION Investments and Shorecap, UMU began exploring other investment partners, including Aureos East Africa Fund, a Nairobi-based investment fund capitalized by Norfund, CDC (the UK government's instrument for investing in the private sector in developing economies), and others. By late 2004, a separate agreement had been reached between UMU's founding directors and Aureos, outlining a significantly different ownership and capital structure. This structure included a very small amount of common equity and a significant portion of preferred shares. The founders would own 40 percent

of the common shares (none would individually own more than the 30 percent limit), with the remaining 60 percent to be held by Aureos and others. Aureos also agreed to place a convertible loan with UMU NGO to be converted into perpetual preferred shares in the MDI once a license was granted, and in addition, offered a term loan to UML once licensed. The NGO's value would be nominally reflected in the face value of perpetual preferred shares issued to the NGO. These shares would carry a predetermined rate of return and would ensure a steady income stream for the NGO. The NGO itself would cease microfinance operating activities but in the future was anticipated to offer various grants to the community out of the stream of dividends from the preferred shares.

This new proposal was a creative one. It established different tranches of investors and thereby addressed many of UMU's founders' previous concerns. The smaller amount of common equity allowed the founders to obtain a significant stake in the common equity for a minimal investment. The preferred shares were envisioned to provide a home for the NGO's capital and a significant source of funding for UML, yet would not place UML in violation of the 30 percent maximum ownership restriction, because this was applicable to core capital only (which does not include preferred shares). It also would mean the NGO would not have a governance role in the MDI. The issue of valuation for the NGO was to be encapsulated in the rate of return of the preferred shares rather than the amount of investment (that is, the book value of the transfer).

This new agreement was presented to ACCION Investments and Shorecap for consideration in late 2004. Despite significant efforts on both sides to find a mutually agreeable deal, both investors ultimately declined to participate, citing concerns about the variation in economic and political rights among the parties. In early 2005, a Shareholder Agreement was signed between the four founding UMU directors and Aureos. Soon thereafter, Aureos invested U.S.$960,000 in a convertible loan with UMU, portions of which were anticipated to be converted into both common and preferred shares in UML, ensuring Aureos a 30 percent holding in the new MDI. The remaining 30 percent of the company was offered to Norfund, which would also invest a similar amount in a similar combination of debt, common equity, and preferred shares. After three years of negotiation, the investor negotiation process appeared to be concluded.

Submitting the Application

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

Financial Transformation: Launching the MDI

With license in hand, the final step in UMU's transformation was the formal transfer of the NGO's assets and liabilities to the new entity. After years of

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

Regulatory Implications

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

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

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

Ownership restrictions. As an MDI, the portion of common shares any one investor can own is limited to 30 percent of the total. Exemptions, however, can be obtained from this restriction for wholly owned subsidiaries of banks already licensed under Uganda's Financial Institutions Statute or "reputable financial institutions."[8]

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

Compulsory savings. As previously mentioned, once the MDI Act was passed, MFIs that were mobilizing deposits either had to apply for a license and comply with the act's requirements within twenty-four months or wind up business within six months. This included being able to demonstrate that all compulsory savings (also known as loan insurance funds) pledged as security for a loan agreement were both unencumbered and managed in a separate account. Thus, such funds cannot be

Table 15.3 MDI Provisioning Requirement *(percent)*

Time	Regular	Rescheduled
Current	1	5
31–60 days	25	50
61–90 days	50	75
91–180 days	75	100
>180 days	100	100

Source: Bank of Uganda, MDI Act 2003; BoU Asset Quality Regulations 2004.

on-lent and must be managed quite distinctly from voluntary savings.

Provisions. UMU's prior provisioning policy was significantly less conservative than that required by the BoU (see table 15.3). In preparation for transformation, UMU converted its policy to be in line with the BoU's requirements. This policy change coincided with an increase in delinquency in the loan portfolio, resulting in significantly higher provisioning expenses than the organization had previously witnessed.

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

Transfer of Assets and Liabilities

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

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

This created a conundrum for UMU: if it converted the NGO's net worth to common shares, it would violate the ownership limitation. Even if only a portion of the NGO's net worth was converted to common shares, the founders were actively seeking a solution that would not install the NGO, which itself had no owners, as a significant owner of the MDI. (Because the founders of the NGO were all themselves becoming owners of the MDI, the NGO itself was not represented by a separate interest group seeking a separate stake in the new entity.) Likewise, if the NGO's net worth was converted to preferred shares, the remaining core capital composed of the founder's own contributions would be insufficient to ensure adherence to capital adequacy requirements. The third option, renegotiating with the external investors to have them increase their

committed contributions, would add significant time delays to the process and was thus not considered a viable option.

A solution was ultimately found in the creation of a premium account—the NGO could purchase a minimal amount of common shares, but at a premium. The value of this "premium" would be reflected in a premium account. This premium is included in the core capital calculation, yet does not affect the ownership structure, which is determined solely by the number of common shares held by each party. As such, UMU NGO is an investor in UML, but not a relevant owner (ownership of common shares is less than 1 percent). Its value has been converted into a premium share account in the MDI's core capital, as well as into preferred shares.

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

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

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

Equity Assignment and Board Formation

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

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

Governance

As of May 2006, the board of UML is currently composed of investor representatives, including three of the four founding directors of UMU, and two representatives from Aureos, one of whom also represented Norfund's holding. The organization is also planning to add other independent directors.

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

UML and the Future

As of May 2006, UML had been operating for ten months. Although licensed, it has only just completed the transfer of assets, solidified its investor group, and continues to upgrade its systems and processes to BoU standards. Although much was accomplished during the three years of preparation and negotiation, UML as a new operating entity is still establishing itself, particularly in the eyes of the regulators and investors—its new stakeholders. UML anticipates some immediate challenges.

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

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

Mobilizing savings. UML's long-term financial projections show a considerable reliance on public deposits to fund the projected growth in the loan portfolio. With just ten months of new marketing efforts, it is still too soon to evaluate the success of UML's new savings products. The institution's ability to shift its market perception from primarily a microlender to also providing a safe place for savings will determine the success rate of its savings efforts. This will be further challenged by the fact that the other newly licensed MDIs—FINCA Uganda Limited, PRIDE Microfinance Limited, and Uganda Finance Trust Limited—are embarking on the same efforts.

Incorporating staff ownership. UML remains committed to bringing in staff as owners. The current intention is to make 7.5 percent of the company available for employee share ownership, although details of this plan are still being finalized.

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

Notes

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1. Speech by Mr. C. N. Kikonyogo, Governor, Bank of Uganda on the Opening of the Co-operative Bank's First Microenterprise Agency Office, June 1997. Nakivubo, Uganda.
2. "A company limited by guarantee is an alternative type of incorporation used primarily for nonprofit organizations that require corporate status. A guarantee company does not have share capital, but has members who are guarantors instead of shareholders. The guarantors provide an undertaking to contribute a nominal amount toward the winding up of the company in the event of a shortfall upon cessation of business. It cannot distribute its profits to its members, and is therefore eligible to apply for charitable status if necessary." (Company Registration Online Web site)
3. Initial board members included Rodney Schuster, Charles Nalyaali, Ronald Kasibante (former Managing Director of Shell, Uganda), Willie Patrick Ogule (Group Secretary and Head of Legal Services of dfcu), Joannita Babumba (Principal Banking Officer of the Bank of Uganda), and Taaka Awori (human and children rights activist, as well as Program Advisor, UK Department for international Development). By 2001, the latter two were no longer active board members.
4. See chapter 14, Creating a Separate Tier: The Micro Finance Deposit-Taking Institutions Act, 2003, for a detailed description of the Ugandan legislation and the process its of development.
5. MDIs or "tier 3 institutions" can move up to tier 2 or tier 1 licenses as they mature. See chapter 14, Creating a Separate Tier: The Micro Finance Deposit-Taking Institutions Act, 2003, for more information.
6. MicroSave is a Nairobi-based project that promotes the development of a market-led and client responsive approach to delivering financial services among MFIs. See http://www.microsave.org for more information.
7. See chapter 14, Creating a Separate Tier: The Micro Finance Deposit-Taking Institutions Act, 2003, for a complete explanation of Uganda's microfinance regulatory environment.
8. See Part IV Ownership and Corporate Governance, of MDI Act 2003, clause 21 (Government of Uganda 2003).

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Appendix 1

Sequencing the Introduction of Public Savings in Regulated MFIs

Microfinance institutions (MFIs) that are considering the process of introducing savings facilities for the public should pay careful attention to the sequencing that will be needed—and to the time and the human and financial resources required. And most important, such MFIs must be prepared for the fact that their institutions—but not their missions—will change fundamentally and irreversibly.

Fifteen steps—from initial training to investing excess deposits—are discussed below. Before proceeding, however, both regulatory authorities and MFIs should make sure that basic country preconditions are met: at least a moderately enabling macroeconomy, an appropriate policy and regulatory environment, and a supervisory body that has the capacity to monitor MFI performance effectively.

And the MFI must also examine itself—without use of rose-colored glasses! Does it have the quality of ownership, governance, and management needed for a financial intermediary? Has it demonstrated a track record of high-level performance, broad outreach to microfinance clients, transparency, and consistent profitability? Is its corporate culture open to new ideas, products, clients, and methods? If the answers are positive, the MFI is ready to start.

Fifteen Steps: From Studying Savings Demand to Investing Excess Liquidity

It takes time and considerable work to develop the capacity for designing the components that meet savers' demand for security, convenience, liquidity, good service, confidentiality, returns, and access to loans—and for delivering this package effectively and efficiently. But this is the package that brings large numbers of savers to MFIs, enabling them to mobilize, and maintain, large-scale and relatively stable savings. However, appropriate sequencing in introducing savings to the public is essential for achieving that goal.

A series of 15 steps is shown in box A.1. This sequencing may seem time-consuming and

This appendix was written by Marguerite S. Robinson.

Box A.1 Sequencing the Introduction of Public Savings in Regulated MFIs: 15 Steps

1. Assess internal capabilities, identify gaps, recruit new staff as required, and retain outside experts as necessary.
2. Conduct research on demand among potential savers of different kinds, and on the supply of savings facilities among competitors.
3. Plan the pilot project, and design and price products and services for the pilot.
4. Is the necessary institutional capacity in place to open savings facilities for the public? Create a checklist and make sure that the tasks are completed before introducing savings to the public.
5. Develop criteria for a pilot project site and select the pilot branch.
6. Prepare for the first pilot project—a complex and multifaceted task.
7. Conduct the first pilot project, ensuring that adequate resources are available (and used) for the pilot and for its close supervision and regular monitoring.
8. Assess pilot results, and revise products, pricing, operations, management information systems (MIS), and so forth, as necessary. If a second pilot is needed (very likely), begin the planning and preparations for step 9.
9. Plan the second pilot, selecting branches located in different environments, and train managers and staff of the pilot branches.
10. Implement and evaluate the second pilot.
11. Train the trainers of the trainers in preparation for the rollout phase.
12. Expand gradually to all branches, training managers, and staff in each location. Do not rush this step!
13. To penetrate the market, develop a detailed, systematic approach to identifying potential savers and mobilizing their savings.
14. Select a pilot area, train managers and staff, and conduct a pilot in market penetration. Evaluate results, revise methods, and gradually roll out to all the MFI's branches.
15. Develop appropriate strategies for investing excess liquidity.

Source: Author.

cumbersome—because it is. But these stages in developing the MFI's capacity for collecting and intermediating savings are necessary to establish a solid foundation that will serve the institution well over time—and that will also help greatly in preventing costly and time-consuming mistakes.

Circumstances will vary somewhat among different institutions, and some will have already completed, in full or in part, some of these steps before becoming regulated. Thus, sequencing the introduction of savings mobilization from the public should be adapted by each MFI to its current stage of development. The sequencing can be somewhat flexible, depending on particular circumstances. But newly regulated MFIs should be careful not to skip steps they need. Most of them will need most steps described here—though some may find this difficult to believe at first. The motto here is "Haste makes waste!"

Depending on a wide range of factors—including country-level economic, political, and natural events and changes; the quality, skills, leadership, and patience of MFI boards and managers; the MFI's financial and human resources; and others, not the least of which is luck—large MFIs will need about three years to complete these steps. Small MFIs with few branches may be able to manage with less time. But in years two and three, MFIs following this general sequencing should be mobilizing substantial amounts of savings and beginning to establish their reputations as microfinance intermediaries.

1. Assess Internal Capabilities, Identify Gaps, Recruit New Staff as Required, and Retain Outside Experts as Necessary.

Transforming MFIs generally do not have in-house management and trainers who are experienced in voluntary savings mobilization and competent to train managers and staff in collecting and intermediating public savings. Such institutions typically lack many of the resources and skills needed for building and managing large-scale savings facilities, for undertaking financial intermediation, and for managing rapid growth. They may also be inexperienced in research on savings demand and in the design, pricing, and delivery of savings products (and individual loan products as well). Sometimes MFIs hurriedly hire local bank staff who often turn out to be the wrong people for the job.

At this stage MFIs usually need internationally experienced outside experts to work closely with management in assessment of internal capabilities and, where needed, recruitment of new managers and staff—and to advise on the MFI's overall planning, research, and sequencing. Donors have begun to play an important role here by funding some or all of this kind of expertise for a year or so at the time of an MFI's transition to regulated status. Thus, outside experts are brought in to work with management in demand research, product design, product delivery, pilot projects, cost studies, accounting and auditing, internal controls, and the like. They also help to train the institution's trainers, as well as head office, regional office, and branch office managers and staff. In addition, managers and staff may be sent to regional or international microfinance training programs.

Watch out for:

- Ignorance—it is not bliss, and it can hurt you!

Newly regulated MFIs need to go slowly at this stage and make sure they know what they are doing. However, they may now be pushed by their owners, boards, or managers (or in some cases by regulatory authority deadlines) to mobilize savings soon after they are licensed to do so. Those taking this position are often unaware of the risks of opening voluntary savings facilities before the MFI is ready. Outside experts can sometimes help by discussing with owners and managers the basic reasons that the MFI should not begin collecting savings until it is well prepared—and by explaining the considerable risks of not accepting this view. In addition, the microfinance training programs to which MFI managers and staff are sent need to be carefully selected, because many provide little information about savings.

2. Conduct Research on Demand Among Potential Savers of Different Kinds, and on the Supply of Savings Facilities Among Competitors.

Demand research must be carried out to learn the views of current and potential clients about savings products and services. Research on what the competition is doing is important for product design and pricing.

As discussed in chapter 1, Mobilizing Savings from the Public: 10 Basic Principles, transformed MFIs need to attract savings from middle- and higher-income clients and from institutions, as well as from low-income savers. Therefore, samples of all types of savers should be included in the demand research. The MFI's managers and staff need to be trained in how to identify, interview, and interest such potential clients in the institution's new savings program. The MFI's first task in demand research is to learn in what forms and for what purposes people in the area to be served are currently saving—and what they like and dislike about their current options (see chapter 1). Accurate answers to these questions can be elicited only by in-depth interviews, and experts are usually needed to guide

this process in the beginning. Questionnaires can be used effectively after the first pilot project—when the institution has learned what questions to ask, how to ask the questions, and how to understand the answers. The knowledge that comes from this process of learning about savers enables an MFI to design products and services that combine the characteristics of informal savings methods that savers like with solutions to the problems of informal savings methods they dislike. This information is essential input for the MFI's product design stage.

Research on the competition is somewhat easier, but also must be carefully done. A transformed MFI entering the savings market needs to know about its main competitors: their market segments and shares, their comparative advantages and disadvantages, and their products and services. An accurate assessment of the competition is a strong advantage for a newcomer to the market.

Some transformed MFIs contract their demand research out to local research firms. But serious problems can arise from this approach. Often such firms, even those experienced in other kinds of research, are not competent to conduct these kinds of field research or to analyze the results at a quality level. The reported results may be useless—or worse, accepted nonetheless and used by the MFI. Also, by using this approach, the MFI's managers and staff do not acquire the field experience they need to understand the complex conceptual frameworks within which their potential savers make decisions about savings. Nor do they learn firsthand the strategies and tactics employed by their competitors. And MFIs that outsource demand research will not gain the in-house experience needed to train their staff in best practices research methods.

However, the capacity of some research firms to carry out such work is beginning to improve. This early trend should accelerate in the future as the commercial microfinance industry (and its profitability) become more widely known, and as the opportunities the industry affords for research become better understood.

But the best option for transforming MFIs today is to have internationally experienced outside experts working closely with their own managers and staff to conduct demand research (the relationship between MicroSave and its MFI partners is an excellent example of this approach). If a research firm is used, it should be carefully vetted by outside experts, and it should conduct the research as a team with the MFI's own managers and staff. The demand research should not be entirely, or even largely, contracted out.

Watch out for:

- Missing the market, while misinterpreting the demand.

Managers and staff who come from microcredit organizations may be uncomfortable interviewing middle-income clients and heads of local organizations and institutions that are potential savers. They may also have difficulties learning about competition from banks and larger financial institutions. In such cases they may be unable to obtain accurate information (and may not report—or even know themselves—that their information is inaccurate). Staff who are not well trained in savings may have a tendency, especially when interviewing low-income people, to put words in respondents' mouths, rather than listening carefully to what they say. But contracting out demand research does not resolve these problems, and it adds others. Outside experts should be closely involved, as needed, in the research and analysis and should work directly with the institution's managers and trainers.

3. Plan the Pilot Project, and Design and Price Products and Services for the Pilot.

When the research on demand and on the competition has been completed and its results analyzed and discussed by managers and staff (with outside

experts where needed), it is time to plan the pilot project. And trial products, services, and systems must be designed for use in the first pilot.

The transforming MFI will need to design and price products and delivery systems to be tested in at least one, and usually two, pilot projects—with the second based on the results of the first. The MFI's new products and services are then revised and gradually expanded to all branches. Continuing monitoring of the competition is advisable because the nature of the competition, and sometimes the competitors themselves, can change quickly in response to new entrants to the market (or for other reasons).

The first pilot project is essential for four main reasons:

- To determine whether the products that have been designed are in demand, and whether they can be efficiently and effectively delivered by the pilot branch.
- To analyze the costs and the pricing structure. Pricing products for the first pilot project is difficult because neither the extent of demand for the different products nor their costs is yet known. Only provisional interest rates and fees can be set for the pilot. One of the main functions of pilot projects is to ensure that the MFI's products and services are priced correctly before they are rolled out to all branches, that operating costs are understood, and that spreads enable profitability. The information needed for costing and pricing must be collected from the pilots, carefully analyzed, and incorporated into product design and pricing—before the institution attracts large amounts of savings.
- To test information systems, communication facilities, security methods, space requirements, backroom operations, accounting, reporting, internal controls and audit, and the like.
- To train managers and staff and to test a performance-based incentive scheme suitable for a financial intermediary.

Information from the demand research should be used to design a few simple products. A good package of products with which to begin consists of a passbook savings account with unlimited withdrawals, a fixed deposit account, and a limited withdrawal account. Remittances and money transfers should be added at the second pilot or, for small institutions, at the rollout stage. There is no one right way to design the initial products, but some things seem to work better than others. Some thoughts on product design and pricing are given below.

Passbook savings account. This is the single most essential account, because there is enormous demand for a savings account with unlimited transactions. Savers who open other types of accounts usually open a passbook savings account as well. Although some passbook accounts do not provide interest, an interest-bearing account is a better option for an important reason. Fully liquid passbook accounts are very popular, but they tend to be labor-intensive. If the MFI offers passbook accounts to large numbers of poor people with small account balances, the average account size must be raised with larger accounts. And larger account holders tend to be interest-sensitive. Thus, the pricing of the passbook account is crucial. It should be designed with a tiered interest rate so that no interest is paid on minimum monthly balances up to a certain amount (say, U.S.$10 to $20). But the largest savers—who are crucial for the viability of the product—must be paid market rates. In between there should be one or two tiers of interest rates, depending on how the account size distribution falls.

Fixed deposit account. Fixed deposit accounts (also known as time deposits) are useful for a wider range of savers than is generally understood. These accounts should be offered with one-, two-, and three-month maturities, in addition to those with longer maturities. To be competitive, fixed deposit accounts must offer market rates to all account holders.[1] Middle- and high-income savers use fixed

deposit accounts, as do local businesses and institutions. But these accounts are also used by some low- and lower-middle-income savers who generally choose the shorter maturities. Thus, some farmers, fishing people, and others with irregular seasonal incomes use the accounts to store excess liquidity at high season for use during the low season. Some artisans use fixed deposit accounts as well. They monitor the prices of the raw materials they use on a monthly or bimonthly basis. If the price is low, they close the account and purchase the materials they need (wood, leather, cloth, cement, and the like). But if the price is high, they roll over their accounts and wait for a drop in the price of the product in demand. And some low-income people use these accounts as well for long-term savings goals (weddings, funerals, education, ceremonies, pilgrimages, house repairs, business expansion, and so forth). Fixed deposit account holders often hold passbook savings accounts as well.

Interest-bearing, limited withdrawal account. This account may offer interest on all deposits while restricting the number of withdrawals (commonly charging fees for withdrawals above the number permitted). Typically, the interest rate for limited withdrawal accounts is lower than the rates for both the highest tier of the passbook account and the fixed deposit account. And this intermediate account is usually more liquid than the fixed deposit account, but less liquid than the passbook account. Transaction costs are usually highest on the passbook account and lowest on the fixed deposit account, with the limited withdrawal account again in the middle. But this account often offers interest to all account holders, thus providing an opportunity for savers with small accounts to obtain interest on their deposits. These accounts are used to save for such purposes as paying rent, paying employees, and other regular weekly or monthly expenses.

The limited withdrawal account is also a product that can be politically useful for the institution. People with very small financial savings are generally not eligible for the fixed deposit account because it typically has a relatively high opening balance. And such savers would also not normally receive returns on their passbook accounts—because their monthly balances would be below the minimum required for payment of interest. This leaves an opening for political criticism that the institution pays interest to high-income savers but not to low-income ones. Such criticism can be deterred by the limited withdrawal account. Inquiring politicians and journalists can be informed that savers with very small accounts are free to choose between a passbook account that provides no interest on small balances, and the limited withdrawal account that pays interest but limits liquidity. Many low-income savers with small accounts choose liquidity over interest. The limited withdrawal account is not generally a very popular account. But it gives people a choice, and it can be politically advantageous. And it is useful for rounding out the initial package of savings products—which clients use in various ways, customizing their savings portfolios to meet their particular needs.

Lotteries. If country regulations and local culture permit, the liquid and limited withdrawal accounts can have a lottery attached to them, whereby savers receive free lottery tickets each month based on their minimum monthly balances (for example, one ticket for every U.S.$5 or $10 of savings). Such lotteries are often run semiannually. If the first prize is a large one (a motorcycle, car, or a substantial amount of cash), and if smaller prizes are also given, lotteries are generally very popular with savers and encourage saving. But they must be operated with scrupulous transparency—and perceived as such. The costs have to be carefully analyzed, but such lotteries can be (and are) conducted profitably, and on a large scale. They should be run at the branch or regional office level, not at the national level—they work best if savers know people who have won.

Keep it simple and efficient. These three accounts are a good way to start. Though it is not easy, these accounts can be administered efficiently and effectively, even in the first years. And the combination of the three accounts is popular. Bank Rakyat Indonesia's (BRI's) microbanking system has used a combination of accounts similar to these for 20 years now, and BRI microbanking has been profitable every year. As of 2005, the fully liquid accounts (with tiered interest rates) in the microbanking system account for 90 percent of the total value of microbanking savings (which is U.S.$3.7 billion), and for 99 percent of the total number of microbanking savings accounts (32 million). Of the three types of accounts, the fully liquid account is the most difficult to design, price, and implement (see Robinson 2002b, chapter 13). But it is well worth getting it right.

It is also useful to analyze what kinds of savings products do well among the competition. There may be local variations on what products are popular, and this is well worth investigating. MFIs can, of course, add other special accounts later on, if they consider them manageable, cost-effective, and in demand—for example, long-term fixed deposits for education, housing, and retirement; checking accounts; savings accounts that are coupled with loans (a loan is provided after a contractual savings requirement has been met); and others. Remittance services are especially important in many areas. But it is best to start with a few carefully selected, complementary products.

Watch out for:

- Too many products and too low an interest rate spread.

Offering too many products, especially in the first pilot project, makes the pilot difficult to manage and expensive to administer. It is not necessary to provide all the products that savers may have mentioned during the demand research. What is essential is to design a small number of complementary products so that each client can customize the use of these products to suit his or her own needs. The interest rate spread must be set carefully, with interest income estimated to cover the operating costs of savings mobilization at the pilot project (one-time start-up costs should be budgeted separately). Interest rates for loans may need to be raised.

4. Is the Necessary Institutional Capacity in Place to Open Savings Facilities for the Public? Create a Checklist and Make Sure the Tasks Are Completed Before Introducing Savings to the Public.

The MFI's managers (advised by experts and overseen by some board members) should check carefully for overall institutional readiness for mobilizing public savings. A detailed list is needed for the tasks that must be completed before savings accounts are offered in the first pilot project. The contents of the list will vary somewhat depending on the country, the MFI's history, and other factors. Nonetheless, some requirements are essential for all newly regulated MFIs; others can be added as necessary for particular environments or special circumstances. Some examples can illustrate the kinds of institutional capacities that are required. Thus, the questions below must be answered affirmatively, and the tasks completed, before the MFI begins its new savings program in the first pilot branch.

- Have all outstanding matters affecting the legal status of the MFI and issues of ownership been resolved?
- Is an appropriate governing board in place?
- Is the management capable of operating a rapidly growing financial intermediary?
- Is the financial management team in place, trained, and ready? Do they have the facilities they need?
- Is the MIS appropriate and reliable? Is it capable of accurate tracking of deposits, withdrawals,

and funds transfers? Do managers and staff know clearly how to operate it, and are they able to use the information that is generated to make timely decisions?

- Have the MFI's physical infrastructure (its head office and any regional offices, and branches and any subbranches), its communications, and its transportation facilities been carefully evaluated in light of the new demands to be placed on them? Have the plans for needed changes, including increased security, been made, and have the costs been estimated? Are the funds available for the necessary upgrades of facilities?
- Are the internal controls and the internal supervision processes ready and tested? Have appropriate reporting, bookkeeping, and internal audit systems been established?
- Have the MFI's treasury management, asset-liability management, and liquidity management been revised to reflect the MFI's new financial responsibilities?
- Has the MFI carefully studied underlying loan delinquency issues? MFIs that use compulsory savings to cover borrower delinquency will need to introduce alternative risk mitigation strategies *before* introducing voluntary savings for the public. Savers often do not like to keep compulsory and voluntary savings accounts in the same institution, and the MFI should phase out its compulsory savings when its new savings products have been tested and introduced.
- Has the MFI established sources of finance for its loan portfolio—first for pilot branches and then for all branches—when compulsory savings are phased out? There will be at least a several-year period when savings cannot yet finance the total portfolio and when mandatory savings should have been phased out. Financing for the portfolio during this period must be carefully planned.
- Has the cash management system been established, and the transfer price mechanism planned?[2]
- Do the human resources managers understand the changes that will occur in the institution—and the ways in which these will affect recruitment, training, staffing, and distribution of responsibilities? Are they capable of moving ahead in the new directions required? Are they on board?
- Are appropriate training programs and performance-based incentive systems in place and fully understood by managers and staff?

Watch out for:

- The common syndrome: "We're too busy now. Let's just start collecting the savings and do the rest later."

Completing the requirements on the checklist must precede the opening of the new savings program. Inverting the sequencing order will likely result in quite rapid, extended, and costly chaos—which will probably also have a negative effect on the MFI's reputation. Watch out particularly for perfunctory or evasive answers about the MFI's performance and capability. The board should require that responses to the above questions are both affirmative and backed by compelling evidence.

5. Develop Criteria for a Pilot Project Site and Select the Pilot Branch.

When developing criteria for the location of the first pilot project, a number of factors need to be taken into account. There will undoubtedly be considerations related to specifics of the country and region, including demography, infrastructure, politics, and the like. But there are also important criteria that apply generally. Thus, the pilot branch should have a track record of performance in the top quarter or so of the MFI's branches, but should not be among the very best. It must be an experienced, well-performing branch because if the first pilot does not succeed, there are not likely to be others. But the pilot branch should experience the same kinds of problems that are likely to be encountered by other branches later on.

- The population in the pilot location should be reasonably typical of at least a major portion of the country. And there should not be a language barrier between the MFI personnel and the potential clients.
- The location should be above average for population density, should have a mixed market economy, and should not be in an acute state of conflict.
- The first pilot should not be located in an area of intense microfinance competition.
- The pilot branch should be located in a province and district where the authorities are not heavily engaged in subsidized microcredit or opposed to commercial microfinance.
- The branch selected should be not more than about two hours from the head office on reasonably dependable roads, because high-level managers must be at the site frequently. But the pilot should not be conducted near the head office. Among other reasons, mistakes will inevitably be made, and it is best to make them in a less visible place!
- Adequate space will be required at the branch for a substantial projected increase in the number of clients. The branch will also need space to accommodate additional staff, as well as some on-the-job trainees from other branches. The spatial layout of the branch building and grounds must allow for this expansion.
- The pilot branch should have a good operational and financial performance track record for at least three years. It should not have any major organizational, management, or operating problems—for example, endemic staff conflict, recent fraud, high or volatile portfolio at risk (PAR), and the like. On the contrary, the pilot branch should have a good reputation in the area it serves.
- A highly qualified branch manager must be responsible for the pilot branch—a person with strong leadership skills who is experienced, financially skilled, hardworking, open-minded, committed, and motivated. Ideally the pilot branch selected would already have a well-qualified manager who knows the service area. However, if the branch that best fits the other requirements does not have such a manager, another manager can be transferred there. But one way or the other, a well-qualified branch manager is essential for the first pilot.

Watch out for:

- Too many branches in the pilot project. MFI boards and managers often have a tendency to want to conduct a number of pilot projects in different areas right at the start. This is a serious mistake. The first pilot is difficult, and it requires the constant attention of high-level managers from the head office. The pilot should be carried out only in one limited service area, although all the MFI's subbranches and other outlets in that area can be included.
- Selecting a favorite branch in an inappropriate location. Board members and managers sometimes have their own favored areas and may want the pilot project to be located in a particular branch for personal or political reasons. Informing them early in the process about the selection criteria—and the reasons behind them—helps to mitigate problems of this kind.
- Selecting a branch in an area with especially poor infrastructure and communications, endemic conflict, or strong political opposition.
- Selecting a pilot branch that does not have a well-qualified manager, and not transferring a highly qualified manager to the pilot branch.

6. Prepare for the First Pilot Project—A Complex and Multifaceted Task.

This is a crucial step that too often is dangerously shortened because the board or the chief executive officer wants to get savings started quickly—usually because the loan portfolio is expanding. This is not

the time to rush savings mobilization to finance loans. It is also not the time for major expansion in the loan portfolio. If additional funds are required for the portfolio, the MFI should borrow from the financial markets or access other commercial sources of funds. In addition to the checklist for the institution discussed above, another list is needed for the preparations to be made for the pilot project itself. The pilot branch management and staff will need to be trained, the building may need renovation, operations will need to be revised, and the logistics for the introduction of voluntary savings products and services (and the documentation of their results) must be organized.

Some examples of questions that must have positive responses based on completed tasks—before the pilot project opens for savings collection—are given below:

- Has the license for a regulated MFI been issued? Have the regulators given final permission for the MFI to take deposits from the public, and have other requirements been met? Do the permissions cover the pilot branch?
- Have the head-office managers and the pilot branch manager taken an active part in the planning of the pilot project, and have they demonstrated that they are capable of running the pilot?
- Have the appropriate high-level managers at the head office allocated substantial portions of their time to the pilot for an extended period? Have others been appointed to take over some of their other responsibilities? There will undoubtedly be problems and mistakes in the pilot. But the pilot must succeed if the MFI is going to become a financial intermediary—and it is the responsibility of the head office to make sure that the pilot works.
- Have prototype products and pricing, delivery mechanisms, and simple manuals been developed? (These will be revised later when the results from the first pilot are known).
- Is an appropriate MIS in place and tested at the pilot branch, and are the branch managers and staff able to use it effectively?
- Have the record-keeping systems for monitoring the pilot project and for use in analyzing its results been set up, and are they ready for operation? These would include, for example, recording the number of savers and amount of savings by product; the account size distribution by product (crucial for setting interest rates when the savings products are introduced in other branches); and the information needed for cost analyses—including labor costs—by product. Also, in the financial reporting, start-up costs such as extensive training, renovation of buildings, and purchase of new security systems and of MIS for the pilot branch should be accounted for separately from recurring costs. If grants or subsidized loans are provided for these capacity-building expenses (an excellent use of donor funds for highly promising institutions), these should be accounted for separately. And in the financial statements of the branch, adjustments should be made for any grants and subsidies used.
- Have arrangements been made for careful monitoring of the loan portfolio so that in the midst of all the new savings activity, the pilot project is not marked by a decline in portfolio quality? If compulsory savings have been used to cover loan delinquency, other risk-management strategies for overdue loans must be introduced and tested now. They will be essential for use in the second pilot project as mandatory savings are phased out (step 7).
- Is the training of the pilot branch staff under way? This is a crucial activity that requires considerable continuing attention from the head office. Qualified and experienced trainers are needed to conduct the training sessions, and sufficient time must be allowed for the training sessions. One month, including fieldwork among potential savers (who should not live or work in the service area of the pilot branch), is about right for most institutions. In addition to the pilot branch personnel, members of the MFI's training department and a few managers and staff from other branches should be trained at

these pilot training sessions—so that there will be trainers and staff reserves to draw upon as the savings program is gradually rolled out to other branches. Participants should be tested and evaluated. At the end of the training, a careful review is needed.

- Have simple, local marketing strategies been developed? (This is not the time for a major marketing effort). Are managers and staff able to explain accurately and understandably to prospective clients the comparative advantages of each product, and how the products can be used together to meet a client's particular needs?
- Has a draft been developed of the criteria that will determine when the pilot has achieved sufficiently good results for the MFI to proceed safely to the next step? These must be general criteria, not specific targets. The criteria should be designed for use in an evaluation of the results for each product after six months of the pilot, as well as for assessing the overall pilot (step 8). These draft criteria will be used to rate such indicators as branch resources, level of outreach to low-income savers and to other individuals and organizations, amount of savings, account balance distribution, and average account balance. (Is it high enough for institutional profitability?). Also included are measures for ascertaining whether operational efficiency, product costs and pricing, and the blended cost of funds are suitable. Others focus on PAR, results from confidential customer and staff feedback, and a variety of additional indicators. The draft criteria should be revised during the pilot, as more information becomes available on the challenges, risks, and strengths of the branch's performance.
- Has the branch been renovated (if necessary), and is the use of space appropriate for the activities to be carried out? Is the space in the branch suitable for rapid expansion should this become necessary?
- Are the branch's transportation and communications facilities adequate?
- Are there enough cashiers?
- Is the branch neat and attractive, with information about the new products clearly posted?
- Are the security arrangements adequate and have they been tested?
- Are there sufficient supplies of bankbooks, forms, brochures, and other supplies on hand? (It is amazing how often this is forgotten!)

Watch out for:

- Haste! The pilot project should not be started until both the pilot branch and the head office are ready. It should not be ended until it works well (or is terminated because of exogenous reasons or severe problems at the MFI).
- Underestimating the difficulties and the management needs of the pilot project. The MFI should keep in mind that it cannot go forward with savings mobilization until the first pilot works—and that there is no replacement for sufficient, high-quality management resources. This needs to be planned from the start—and implemented throughout.

7. Conduct the First Pilot Project, Ensuring That Adequate Resources Are Available (and Used) for the Pilot and for Its Close Supervision and Regular Monitoring.

The aim of the first pilot project is to introduce the new savings projects successfully, to maintain a high-quality loan portfolio, to remain profitable—and to learn from the experience. As noted, the primary objectives of the first pilot include testing both the new products and the ability of the pilot branch to deliver them effectively; monitoring costs by product and preparing any pricing revisions that may be needed for the next stage of the program; and training managers and staff. Other aims are testing information, communication, and security systems; learning the market for savings; and testing a performance-based incentive scheme suitable for a financial intermediary.

When the items on the checklists discussed in steps 4 and 6 above are complete, the MFI is ready

to open its doors to savers. At this point, MFIs have a tendency to want maximum publicity in advance of opening their new savings programs. But this must be avoided. The MFI should publicize its new savings program locally and quietly at first. Otherwise, the institution may be swamped with large numbers of savers before it is able to serve them adequately.

Another tendency at this stage is to place targets on savings amounts and numbers of accounts, as well as to set targets for specific products. Both should be resisted. The pilot project is not the time for savings targets (one reason is that no one has any idea how to set such targets). An overall target may result in more savings clients than can be responsibly handled at first, while the resultant overload on the branch can result in a decline in the quality of the loan portfolio.

Product targets are also counterproductive for a pilot designed to learn the products that savers want, and the costs of delivering these products. If a saver wants a passbook account, but the staff sells her on a limited withdrawal account so the branch can meet the target for that product, the MFI will not get the information it needs. And savers using products inappropriate for their needs are unlikely to stay long. Staff should explain products and their uses to clients. They should not try to sell one product over another (which will happen if product targets are introduced).

During the pilot project, especially in the first few months, head-office managers should be available on a daily basis to troubleshoot and to monitor and analyze results. Considerable evidence indicates that even when pilot staff are well-trained in new products and methods, a long period typically elapses before the new approaches and attitudes are firmly ingrained at the branch. Close monitoring, supervision, internal controls, and on-the-job training are key. The pilot project should be analyzed and evaluated on a weekly and monthly basis for the first six months. Customers of different types should be interviewed, and both praise and complaints should be recorded and analyzed—for immediate action and future analysis.

This is also the time to revise and refine the criteria (developed in step 6) that will be used for the more formal six-month overall evaluation of the pilot (step 8). The evaluation process should be designed to indicate clearly whether the products meet specific client needs, whether they are priced to enable profitability, whether managers and staff are qualified for their new responsibilities, whether operations and product delivery are effective and efficient, whether portfolio quality remains high, and overall, what the effects of the pilot have been thus far on branch outreach and profitability.

Specifically, costs need to be carefully monitored by product (including operating costs and costs of funds). Minimum monthly account balance distribution must be carefully watched, because the results will be needed for setting interest rates in the second pilot. MIS and other systems need to be tested. Asset-liability and liquidity management must be closely monitored. Accounting, reporting, and audit need to be regularly reviewed, as do internal controls and supervision. Space use should be analyzed. But unless problems are very serious, it is best not to alter the products, services, and pricing during the first six-month period. Such changes may confuse or disappoint customers and could also make the results of the pilot difficult to interpret.

The morale of branch managers and staff also needs to be examined. They may feel confused, overworked, or underappreciated—or all of the above. More staff (and space and computers) may need to be added. If gaps are found in training, or incentive programs are not serving to motivate staff, these should be recognized as matters that must be addressed quickly by the head office. And all the ongoing activities of the branch need to be continued at a high level of quality. This is a difficult time for managers and staff (and for internal supervisors). But frequent recognition and praise from the head office for achievements can go a long

way toward heading off staff demoralization. At the end of six months, materials should be prepared for a careful overall review of the pilot (see step 8 below).

Watch out for:

- Requests for quick results by the chief executive officer or board
- Difficulties in branch management
- Decline in loan portfolio quality
- Very low average account size
- A high weighted cost of funds
- Mismatched asset-liability structure (for example, long-term loans and short-term savings)
- Publicity about the savings products that is too early and too widespread
- Long lines and client complaints
- Security lapses
- Overworked and demoralized staff
- Inadequate internal controls
- Problems with MIS and security systems
- Poaching of best managers and staff members by competing MFIs (if the pilot is successful, word will get around!)

8. Assess Pilot Results and Revise Products, Pricing, Operations, MIS, and so Forth as Necessary. If a Second Pilot Is Needed (Very Likely), Begin the Planning and Preparations for Step 9.

At the end of six months of operating the first pilot, the head office (with the help of outside experts) should carry out a careful assessment of the results of the pilot project. The evaluation, which should take about a month, can be carried out simultaneously with initial planning for a second pilot (which will be needed in most cases).

This evaluation should include calculation of standard indicators and ratios for financing structure, financial performance, risk, outreach, efficiency, productivity, loan portfolio quality, and others. Asset-liability, liquidity, and cash management are crucial. Start-up costs should be calculated separately. Indicators and ratios for the pilot branch should be compared with those of similar branches at the MFI that do not yet have voluntary savings.

In addition, other items that will help in assessing the pilot and in planning for the next steps should be reviewed and evaluated, including these:

- Management, staff capability, and workload
- Management and staff training, incentives, and morale
- MIS and communications
- Security systems
- Backroom operations
- Loan portfolio quality and, for MFIs that have a history of using compulsory savings to cover borrower delinquency, achievement of a successful alternate risk-mitigation strategy so that such savings can be safely phased out in the second pilot
- Client satisfaction with products and product delivery (a representative sample of savers should be interviewed and asked for their suggestions for improvement)
- The economic activities and other characteristics of a sample of savers' households
- The number of savers with multiple accounts (a sample of these savers should be interviewed to learn how they use the different accounts, because this information will help in later stages of introducing new products to potential clients)
- Other specific achievements or problems of the pilot project that can be useful for designing and delivering the institution's products and services in its other branches, as well as for improving future performance in the pilot branch.

After the review, the MFI should decide whether the pilot has achieved sufficiently positive results for the institution to move to the next step. If the results are not clear, or not satisfactory, the problem areas should be addressed and the pilot continued with necessary changes made. However, if the results are

generally good—savers like and use the products, managers and staff members are well trained and active, the loan portfolio quality is high, and the interest rate spread is sufficient for profitability—the MFI is ready to move to the next step.

The decision on whether to revise and continue the first pilot project or to move on to a second pilot is rarely clear-cut. At this point, it is a judgment call. The only answer lies in having managers with good judgment.

Watch out for:

- A too-rigid schedule

Boards and managers have a tendency to schedule pilot projects for specific periods and then move on to the next stage according to the calendar. The answer to when the MFI is ready to move to the next stage cannot be found on the calendar. That approach can cause very serious difficulties later in the sequence. The first pilot can take from six months (a minimum for useful results) to a year, and longer if major problems arise. The products and operations being tested in the pilot should not be offered elsewhere until they work well enough in the pilot branch to be revised and used in other branches with reasonable confidence, and until the costing and pricing are well understood. The findings from the review of the first pilot are then used to design revisions to products, pricing, and operations that will be tested in the second pilot.

9. Plan the Second Pilot, Selecting Branches Located in Different Environments, and Train Managers and Staff of the Pilot Branches.

Most MFIs will need to move to a second pilot, conducted in multiple environments and incorporating specific revisions in products, pricing, operations, training, incentives, management and staffing, and the like. However, some small institutions with only a few branches can use the gradual rollout to all their branches as their second learning experience. Thus, MFIs that are small, that had excellent results in the first pilot, and that are not geographically dispersed can skip the second pilot. But MFIs that do not fit all these criteria should not do so.

The primary purposes of the second pilot are to do the following:

- Test revised products, pricing, and operations, as needed; revise training programs and conduct additional training; and make any necessary management and staff changes at the head office and at the pilot branch offices.
- Test the revised savings products in a number of locations in both urban and rural settings. The branches selected for the second pilot should represent a range of economic, political, geographic, and demographic environments. They should be located in areas with different levels of infrastructure and communication facilities and different degrees of competition.
- Test the ability of the head office to coordinate the introduction of savings mobilization simultaneously in different areas.

The second pilot is also the time to introduce two other important changes—first, to introduce individual loans (or where relevant, to expand these), and second, to phase out compulsory savings where possible, convincing clients to transfer their mandatory savings to one or more of the MFI's new savings products. It is usually too difficult to undertake these two changes in the first pilot, but they need to be included in the second pilot so that the MFI has had experience with both when it begins financial intermediation in all its branches.

Individual loans. Pilot branches at this stage should begin offering individual loans or expanding the number of such loans already offered. It is usually too demanding of MFI resources for this major change to be introduced in the first pilot. However, for reasons discussed in chapter 1, Mobilizing

Savings from the Public: 10 Basic Principles, the MFI's capacity to evaluate individual loan applications and to make and collect such loans is an important component of its savings mobilization effort, as well as of its lending portfolio.

Phasing out compulsory savings. The other key change is to phase out compulsory savings. Voluntary savings products—which are what clients want—are fundamentally different from compulsory savings products, and the two approaches reflect widely disparate philosophies. Microcredit institutions that require mandatory savings as a condition of obtaining a loan generally assume that poor people must be taught to save, and that they must learn financial discipline. In such institutions borrowers are often required to save in illiquid products, with their savings used by the microcredit institution to finance its loan portfolio. Also, many microcredit institutions treat compulsory savings as collateral, using the savings to cover missed loan payments. The compulsory savings approach typically provides clients with little or no choice of savings products (and often with no returns on their savings). And frequently the client has no access to her savings—except by forgoing her option to borrow from the institution. In addition, the client is usually not permitted to save unless she borrows. Compulsory savings raise the cost of loans to the client, but do not meet the needs of most low-income savers.

In contrast, MFIs that emphasize the role of voluntary savings in microfinance typically assume that the economically active poor already save in a variety of forms, and that they do not need to be taught to save. Such clients do, however, need a choice of products. And low-income people, as well as others, demand savings facilities that do not require them to go into debt to save. An institution aiming at collecting savings from the public—including substantial numbers of poor customers—needs to learn to provide a choice of savings products and services appropriate for client demand.

For the second pilot, the salient point is that compulsory savings provide savers with multiple disadvantages—and that many savers do not want to place voluntary savings of significant amounts in institutions that require mandatory savings. Accordingly, compulsory savings should be phased out when the new savings products have been introduced in the pilot branches, and when these branches are operating fairly smoothly. At that stage borrowers can be told that they no longer need to maintain compulsory savings, but they should be encouraged (not forced) to move their compulsory savings to one or more of the new savings products.

This is a crucial point for the MFI. As indicated, where compulsory savings are used to cover loan delinquency, the second pilot should not start until alternate risk mitigation methods have been introduced and used successfully. In addition, a carefully developed plan for financing the loan portfolios of the pilot branches (one that is replicable in all branches) must be in place during the second pilot as compulsory savings are phased out.

Both these innovations—introducing or expanding individual loans and phasing out compulsory savings—should be tested in a quarter to a third of the branches selected for the second pilot (and a minimum of two branches in smaller institutions). The branches need not start these two activities at the same time, nor do all pilot branches need to undertake these changes simultaneously. Each should start when the head office and the branch manager think the branch is ready.

Locating the pilots. As discussed, the first pilot branch must be fairly close to the head office. But the branches in the second pilot can be farther away, and as noted, they should represent a range of environments. However, all selected branches should have experienced branch managers with above average performance records and an interest in learning and implementing new approaches, products, and services. Depending on the size of the institution and its management capacity, the second pilot could

add 2 to 10 branches to the ongoing first pilot branch.

The first pilot branch should be continued along with the branches of the second pilot, both because its clients need continuing service and because the first branch is a source of longer time-series data. But revisions should be made in products, pricing, operations, and the like, so that this branch operates with the same products and procedures as the new pilot branches.

Training managers and staff of the pilot branches. As soon as the branches have been identified, their managers and staff should be trained at the head office in the new concepts, products, and operations that are to be tested in their branches. The experiences of the first pilot should be thoroughly reviewed as part of the training. The participants should then be assigned on a rotating basis to several weeks of "on-the-job" training at the first pilot branch. To the extent feasible, managers and staff involved in the first pilot branch should help in the training for the new pilot branches.

By this time there should be some in-house trainers capable of providing this type of training—some of it general and some specific to particular positions (manager, cashier, bookkeeper, internal supervisor, and others). But outside trainers will probably also be needed to meet the training needs of the second pilot.

A "flying squad" should be established at this point. This is a small team of people who are trained to be experts in operational and technical aspects of introducing and intermediating savings collected from the public. Members of this team will then be available to travel to any of the pilot branches for troubleshooting (and they will be available later in the rollout phase when the savings products are expanded to all branches).

Managers and staff located in the pilot branches selected to introduce individual loans and phase out compulsory savings need to be well trained in evaluating individual loan applications and in encouraging borrowers to move their compulsory savings into one or more of the new savings accounts being offered. Once these pilots are running, selected managers and staff from the other pilot branches should be sent on a rotating basis for "on-the-job" training at these pilot branches, so they will be better prepared for the rollout stage.

Watch out for:

- Underestimations of the difficulties and the management needs of the second pilot project
- A mismatch between the number of pilot branches selected and head-office management capacity (The second pilot requires substantial head-office coordination and rapid troubleshooting, and it involves considerable management and staff training as well as extensive travel to the various pilot branches. If high-level management is not available on a continuing basis, serious problems can develop quickly.)
- Deterioration in loan portfolio quality
- Insufficient or inappropriate training and branch managers and staff who are not well trained in how to explain the new products and services to customers and in how to deliver them effectively
- Possible resistance, especially from some former microcredit institution staff, to the introduction of individual loans and to the phasing out of compulsory savings (If such resistance occurs, it is likely to come from management and staff—not from clients!)

10. Implement and Evaluate the Second Pilot.

Implementation of the second pilot is similar to that of the first pilot, except that it requires far more coordination. Needed changes in the first pilot's products, pricing, operations, reporting, incentives, supervision, and the like must be made, and the revised program then introduced in all the pilot branches. In each branch, accurate and transparent records must be kept of the performance and the costs of the revised products. The loan portfolio

quality of each branch and subbranch has to be carefully watched (with immediate action taken in case of missed payments). Steps 7 and 8 above need to be followed carefully in all pilot branches.

Evaluation of the branches in the second pilot should be conducted after about six months of operation. The first pilot branch should be reevaluated at the same time. About two months are then required for the full evaluation of the second pilot (the amount of time needed depends on the skill of the evaluators, the size of the institution, the number of pilot branches, and the results of the pilots). At that point the decision should be made whether to continue the pilots or to move to the rollout stage. If the latter decision is made, it will then take at least another month to revise products, operations, and pricing as necessary for the rollout; and to plan and organize the large-scale training program that will be needed before the rollout of the savings program to all branches.

Careful analysis of the data is crucial, because the lessons from the pilot branches must be learned before the products are rolled out to all the MFI's branches. For example, in branch A a product does extremely well but there are few takers for the same product in branch B. Why? Or a product is successful in all the MFI's branches but is very costly in some and not in others. What are the reasons? Do the problems arise from inefficiency, too low an average account size, poor management, untrained or unmotivated staff—or various combinations of such factors? The reasons for the problems that arise and their solutions need to be understood. Any major difficulties should be resolved at the pilot stage to avoid widespread problems at the rollout stage.

Watch out for:

- A substantial increase in the complexity and demands of the work (often not sufficiently anticipated). Head-office managers must now analyze far more data than in the first pilot branch, troubleshoot quickly wherever needed, and focus on understanding the reasons for major difficulties and significant differences in performance among the pilot branches.
- Rushing this step. MFIs should not move to the rollout phase until they are sure they have got the pilots right!
- These pilots being perceived locally as being successful. If so, there are likely to be increasing attempts by other institutions to hire the MFI's best managers and staff.

11. Train the Trainers of the Trainers in Preparation for the Rollout Phase.

At this stage in its savings effort, the MFI should have a core group of head-office managers, branch managers and staff, trainers, and a flying squad—all with extensive involvement in the pilot projects. They should be knowledgeable about the savings products (and any new loan products), pricing, operations, intermediation, and other aspects of the new facilities to be offered to the public. However, the other managers and staff members of the MFI typically know relatively little about these products and processes, and they need to be brought up to speed before the rollout takes place.

There are two main objectives in this step. The first is to conduct a short but intensive training program so that all the MFI's senior managers are knowledgeable about savings mobilization in general, and about the planning for the institution's development as a financial intermediary, in particular. This savings training program should take about four days on average and should cover the conceptual background, all aspects of the first and second pilots, lessons learned, and plans for expansion.

A wide variety of topics and issues must be covered in this program for senior managers. These include treasury management, asset liability management, liquidity and cash management, transfer pricing, funding needs for start-up costs, MIS, infrastructure, security, internal controls, accounting, reporting, client profiles, customer service, staffing

needs, training, and others. Exposing all head-office managers and senior staff to the main issues at this juncture is well worth the effort. Also, a summary of this training session should be provided in a one-day or half-day session at a board meeting (with longer briefings for interested board members).

The second objective is to provide extensive training to the group of trainers and managers who will then be responsible for training regional and branch managers and staff—as a crucial part of the gradual expansion of savings mobilization to all branches. Depending on the size of the institution and other factors, there may not yet be a sufficient number of in-house trainers qualified to conduct this training of the trainers. In that case, head-office managers, flying squad members, and outside experts will also be needed to serve in this capacity.

This assorted group must learn to teach the MFI's new concepts, operations, and experiences to the people selected to train the MFI's personnel during the rollout phase. The training of trainers should take about a month, with the first half conducted at the head office. The second half of the training is best carried out in one of the regions where the MFI operates. The entire group of trainers and trainees should participate in a training session in the region selected. This will enable them to gain experience in training regional and branch staff in that area, and to resolve training issues and problems while they are still together. And head-office managers can see for themselves how each trainer functions.

As part of the savings training program, a casebook should be prepared for use in different kinds of training sessions. The casebook contains examples of how savings were mobilized from different kinds of savers in the MFI's pilot branches. It highlights the methods for contacting potential savers, the questions they had, the answers given, the problems encountered by the branch, the solutions found, the mistakes made (and how these might be avoided in the future). These cases demonstrate various ways that savers use different kinds of savings accounts and how they customize account use to fit their particular needs. They also explore the reasons that households save, and provide lessons in how to explain the MFI's savings products in ways that make them attractive to households.

In addition, the casebook focuses on how the pilot project branches mobilized larger savings accounts from both nonpoor individuals and local corporations, associations, and institutions.[3] Important for all levels of training, the casebook (with continuing additions of examples) is later used also for in-depth work with the regional and branch staff during the rollout and market penetration stages of training (steps 12, 13, and 14).

When the training of the trainers for the rollout is complete, the MFI is ready to expand gradually to all its branches.

Watch out for:

- Inadequate training of the trainers. This is common and can cause problems as soon as the expansion gets under way.
- Weak spots and misunderstandings (or even hostility) on the part of some participants, a not uncommon occurrence. Not all senior managers necessarily support fully the MFI's new products and activities. This training session is a good time to spot any holdouts.
- Unrealistic expectations about the time needed for the rollout and subsequent follow-up and troubleshooting.

12. Expand Gradually to All Branches, Training Managers, and Staff in Each Location. Do Not Rush This Step!

Expansion should now take place gradually to all regions covered by the MFI, with several trainers working in a region for about a month on average. Then the trainers move on to another region. If there are enough trainers, expansion can take place in several regions simultaneously. However, it is better to use a smaller number of highly qualified and experienced trainers and have them move from

region to region, than it is to try to cover many regions at once with less-qualified trainers.

During the rollout process, branch managers and staff must be trained to identify and interview potential savers. They need to be taught to match the MFI's products and services to the clients' varied savings purposes. And they will need training in how to collect different kinds of savings, and how to develop customer loyalty. The trainers should make a special effort to elicit and discuss ideas of branch staff who have the advantage of knowing their areas.

Specialized training on operations is also carried out for different groups, focused on the specific responsibilities of internal supervisors, branch managers, credit officers, cashiers, and so forth. In addition, the trainers can help the branches with specific preparations and logistics involved in introducing their new savings products.

This step must not be rushed. When the trainers leave, branch managers and staff must be well experienced in the various aspects of voluntary savings mobilization and financial intermediation, and must be able to run their now-expanded branch operations. Frequent visits by head-office managers (and regional office managers where relevant) to all branches are necessary, both during the training and after the trainers have left—so that problems and misunderstandings can be caught early. If certain branches have particular problems after the trainers have finished, the flying squad can be sent in to help.

A large institution with good management and sufficient resources should be able to roll out gradually and safely to all its branches in about four months on average. Small institutions may be able to have their new savings program available in all branches in about two months of rollout.

Watch out for:

- A decision by the board or chief executive officer to cut the rollout process short
- Middle managers who may resist the changes being undertaken

Both are common tendencies. A decision to rush the rollout can have very severe consequences, not only for savings but also for the quality of the loan portfolio and for staff morale. Another potentially serious issue is resistance from some middle managers. The managers of the pilot projects were carefully selected to be highly qualified. But now all the branch managers are involved. They have typically been promoted over time, based on their abilities in positions with different requirements from those now expected. Some managers may be unwilling or incompetent (or both) to undertake the many new challenges that the MFI faces in becoming a financial intermediary. This can undermine the rollout in unhealthy ways that must be handled effectively and quickly by the head office. This can happen in widely scattered branches, taking considerable time and high-level management resources. Bottom line: there are no good reasons to cut short the necessarily lengthy process of introducing savings mobilization on a solid foundation.

13. To Penetrate the Market, Develop a Detailed, Systematic Approach to Identifying Potential Savers and Mobilizing Their Savings.

When all the branches of an MFI have begun mobilizing savings from the public, there is a tendency to think that the hard work is over. Not so! To achieve market penetration, some crucial steps remain.

Designing, pricing, and delivering products effectively and efficiently, training managers and staff, and solving the logistical and management problems of expansion are necessary, but insufficient, conditions for penetrating the market. After the rollout, typically most of the savings are mobilized from the areas nearest the branch or subbranch, with much of the service area left unserved. Also, the MFI is likely to find after the rollout that some branches have mobilized funds from microenterprises and local factories, but not from government offices and schools. Others have accounts from government offices and cooperatives, but not

from schools and religious institutions. Some branches have accounts from cooperatives but not from local factories, while some have the reverse. Some have mobilized savings from the agricultural sector, but not from the service sector. Others have accounts only from savers who live or work very near the branch.

What is now required is a systematic approach to savings mobilization throughout the service area of each branch. This phase of expansion uses a coordinated and systematic approach to funds mobilization. The approach builds on the methods of locating and estimating savings potential that were developed in the pilot projects and recorded in the casebook. But the focus is now on identifying large numbers of potential savers who are then systematically contacted, with the aim of mobilizing their savings and maintaining them as clients (and having them build credit ratings).

At this stage, MFIs that want to mobilize savings quickly can train branch staff to identify a number (say, 100) of the largest potential savers in their service areas—including individuals, organizations, and institutions. The purpose is not to mobilize savings only from those with potentially large accounts, but rather to test the systematic approach on larger savers first so that more of the MFI's portfolio can be financed from savings at this stage. Once developed and tested, this methodology can be used to locate potential savers of all kinds, both large and small. MFIs that do not need to finance their portfolios with savings so quickly can use a cross-section of the population for their initial systematic contacts. In both cases, savers with small accounts seem often to follow larger savers whom they trust, placing their savings in the same MFI.

Watch out for:

- Fatigue

Managers and staff have been through long periods of intense activity at this point, with savings adding considerably to their previous workloads. Starting a major new systematic effort to penetrate the market is not likely to generate great enthusiasm in the regions. Encouragement and appropriate incentives and training are crucial. This is particularly important because by this time, the best employees may be receiving offers from other MFIs.

14. Select a Pilot Area, Train Managers and Staff, and Conduct a Pilot in Market Penetration. Evaluate Results, Revise Methods, and Gradually Roll Out to All the MFI's Branches.

A pilot area is selected, and managers and staff are trained in systematically identifying potential savers and collecting their savings. Possible savers are located through planned visits to subdistricts, villages, and urban neighborhoods to meet and interview heads of local institutions and government offices, local organizations, informal leaders, and other community contacts. From these interviews, the branch draws up lists of potential savers and marks their locations on a large-scale map of the area. In each branch or subbranch, a schedule is drawn up showing the staff members who are to visit particular potential savers on particular dates. And a draft manual of these methods is prepared.[4]

Managers and staff must be trained in how to conduct these interviews—both those with local officials and leaders and those with potential savers. They should be taught how to explain the uses and comparative advantages of each type of savings product. And they should be trained to keep records of their visits and of any follow-up actions required. Most of the interviews of potentially large savers are done by regional, branch, and subbranch managers, credit officers, and other staff who normally carry out field-related operations.[5]

The interviews are also important for gaining information about other potential savings sources in the area. Staff need to be trained both to look for potential sources of savings that are found almost

everywhere (schools, religious institutions, cooperatives, and the like), and to identify sources of savings that are particular to their areas (such as tea estates, silver mines, garment factories, tourist attractions, and so forth). The casebook is useful for prompting questions in interviews, such as these: "Are there people in this area who have seasonal incomes?" "What kinds of work do they do?" "Are there people here who receive regular remittances?" "How do they receive their remittances?" "Does it take a long time?" And so on.

Once the staff is trained, a pilot project should be carried out (in an area not previously used for a pilot). If well managed and coordinated, staff who have already been through the previous training sessions on savings can learn relatively easily to locate savers and mobilize savings. But their follow-through in visiting savers tends to drop off when the training is finished and the trainers leave the pilot. The staff have learned that visiting large numbers of potential savers, especially in dispersed areas, is hard work.

At this stage, performance-based incentives for managers and staff should be reviewed and revised to take into account the new activities of the branch (or other lowest-level outlet of the MFI). The revised incentives should then be tested in the pilot. If well designed, these can encourage and motivate staff to follow through in contacting potential savers throughout the service area of the branch, to market the MFI's new products and services, and to gain new clients for the MFI. As in the earlier pilots, staff incentives should not be provided for savings alone but should be included as part of an ongoing incentive program for high performance in profitability, portfolio quality, number of clients, and volume of loans and savings. Rewards—in both cash and institutional recognition—should be provided to all managers and staff of the lowest level units that have met their goals.

The pilot should be evaluated after about three months, and if it is working well, preparations can be made for a gradual rollout. The methods, training, and operations of the systematic approach to mobilizing savings can now be revised as necessary and gradually introduced to all branches. The draft manual on market penetration should be revised and, as in the earlier rollout, the expansion should be carried out with sufficient trainers in each region working closely with the regional managers and staff. The presence of the trainers in the branches also represents an opportunity for troubleshooting any other problems that may have developed. In cases of serious problems in particular branches, the flying squad can be sent there as well.

This is the stage of the systematic approach to market penetration at which the MFI begins to mobilize large amounts of savings. Such matters as security precautions, internal controls, asset-liability management, transfer pricing, liquidity management, and cash management all need to be carefully reviewed and improved where necessary.

The previous steps in the sequence were all necessary. But without a systematic approach, market penetration tends to move slowly (allowing competition to move in). However, with these methods, substantial market penetration can be achieved within a few years. But performance at the final rollout stage is highly sensitive to incentives, the quality of management and training, and the coordination by the head office. Yet the goal is within reach. It is this step that ultimately makes it possible for an MFI to achieve widespread outreach through large-scale financial intermediation.

Watch out for:

- Insufficient incentives for management and staff. Some boards and chief executive officers may object to staff incentives that are sufficiently attractive to produce the desired performance level. But market penetration is both difficult and crucial—and staff incentives are essential to achieving it.
- Management issues. As discussed in chapter 1, at this stage the branch can no longer control the number of its clients and may undergo rapid and

uncontrollable growth. This represents a major challenge for both branch and head-office management. If a dynamic and skilled branch manager understands the importance of the systematic approach and coordinates the activities well, the branch can capture savings quickly and manage its growth (with the help of the head office). But a branch with an uninterested, unmotivated manager is unlikely to do well. And if the head office does not put a high priority on managing growth effectively, the growth problem may go away on its own!
- Problems arising from managing larger amounts of savings. As the value of the MFI's savings grows, asset-liability, liquidity, and cash management may become more difficult. And security, internal controls, and MIS may need considerable upgrading.
- Inadequate coordination. This activity requires high-level management and coordination. If the methodology, the training, and the incentives are not carefully coordinated, a successful market penetration rollout will not result.

15. Develop Appropriate Strategies for Investing Excess Liquidity.

As market penetration increases, savings are likely to overtake lending. Several years after the completion of step 14, the number of savings accounts will probably exceed the number of outstanding loans. Eventually the volume of savings may also be larger than the amount of the outstanding loan portfolio. This general trajectory assumes that the institution continues to serve low-income and lower-middle-income borrowers (as well as others, in some cases), and that it collects savings from all available savers.

Before the amount of savings overtakes that of outstanding loans, it is crucial that MFIs develop appropriate strategies for investing excess liquidity. Reaching the pot of gold at the end of the rainbow is not the end of the road—these funds have to be lent out or invested (usually both). Loans to creditworthy low- and lower-middle-income borrowers should increase, and any remaining funds should be well invested. However, the latter is often easier said than done. Legal regulations and profitable opportunities vary considerably by country and by type of MFI. But as each MFI approaches this stage of the savings mobilization process, its board should consider its investment options carefully. Some MFIs invest in treasury bills. Some deposit funds in the interbank money market. Some keep fixed deposits in banks. And some have other forms of investments, including investing in MFIs located outside their service areas. Some are beginning to invest in MFIs in other countries. Some combine several of these strategies.

But in the microfinance industry, little has been done so far in studying or teaching best practices for investing MFIs' excess savings. This gap needs to be addressed soon. As the commercial microfinance industry develops, the number of MFIs with more funds in savings than in outstanding loans is growing. Increasing attention should be paid to identifying suitable options for investing excess liquidity, and to disseminating information about the relative advantages and disadvantages of different options under varying conditions.

Watch out for:
- Boards and chief executive officers unqualified to choose investments.
- MFIs that begin to lose mission, depositing their funds in banks rather than lending them out to new creditworthy borrowers who demand loans. When governments set treasury bill interest rates, they should realize that very high rates encourage this undesirable result.
- Governments that use the savings of state-owned MFIs for their own purposes (for example, savings in state-owned institutions that are used to finance the government budget or lent out in politically related large loans with poor repayment records).
- Insufficient central bank or bank superintendency oversight.

Box A.2 Estimated Average Times for Sequencing the Introduction of Savings Facilities for the Public in Newly Regulated MFIs

Indicator	Step 1	Steps 2–3	Steps 4–6	Steps 7–8	Steps 9–10	Steps 11–12	Steps 13–14	Step 15
Tasks	Assess and improve capabilities; recruit management and staff as needed	Conduct demand research; design and price pilot products; plan pilot	Prepare for the first pilot, including training	Implement and evaluate the first pilot and begin plans for second pilot	Plan, train, implement, and evaluate second pilot; revise as needed for rollout	Train trainers of the trainers, then train MFI staff; conduct rollout gradually to all branches	Develop systematic approach to market penetration; conduct and evaluate market penetration pilot; rollout to all branches	Develop strategies for investing excess savings liquidity
Estimated average time (months)	3	3	4	7	6	6	5	Ongoing
TOTAL: 34 months								

Source: Author.

How long will the whole process take?

The time between step 1 and step 15 will, of course, vary by country-level factors, and by the institution—its overall environment, its size, and its ownership, governance, and management. But some general parameters can be suggested. Barring catastrophic events (political upheaval, financial system collapse, major natural disasters), the process for most institutions should take about three years.

Box A.2 provides a breakdown of the time estimate from steps 1–14 (step 15 is an ongoing process). It is assumed that the prerequisites reviewed at the start of this discussion have been completed before step 1 is begun. These are, of course, only approximate times. As noted, some MFIs can finish sooner, especially small MFIs with good management as well as MFIs that have already completed some of the steps before becoming regulated and beginning this process. And some MFIs may take longer.

Although this is a long process, it should be kept in mind that by the second and third years, MFIs using this kind of sequencing process should be mobilizing significant savings and starting to establish their reputations as financial intermediaries.

The Crucial Role of Appropriate Sequencing

Using appropriate sequencing, qualified MFIs can move in about 15 steps from microcredit organizations to self-sufficient financial intermediaries. As noted, not all institutions need all these steps. But all should understand the underlying principles, the reasons for the sequence of steps, and all should heed the warning signals. The aim of sequencing is

not speed. It is building solid and lasting foundations for commercial MFIs—so they can serve large numbers of low- and lower-middle-income clients and others, and can finance their loans wholly or largely with public savings. Such institutions can meet large-scale demand from savers, substantially expand their loan portfolios, maintain financial self-sufficiency, and accumulate and invest excess liquidity.

Notes

This appendix is based on a paper, "Mobilizing Savings from the Public: Basic Principles and Practices" (Robinson 2004). The writing of that paper—aimed at MFIs transforming to regulated deposit-taking institutions—was supported by the USAID-funded Support for Private Enterprise Expansion and Development (SPEED) project in Uganda, and Chemonics, the implementing agency for the project; and by Women's World Banking.

1. Somewhat lower interest rates can sometimes be used in remote areas where there is little competition and where the MFI may have higher transaction costs. This holds both for fixed deposit accounts and for the highest interest rate tier in the passbook savings account.
2. The transfer price is the interest rate on funds that are deposited by a lower-level outlet of the MFI (unit, subbranch, or other) into a higher-level office (branch or regional office), or that are borrowed by a lower-level unit from a higher-level one. The rate, periodically adjusted by the head office according to the overall liquidity position of the MFI, is used to indicate the relative emphasis that the head office wants placed on savings and loans.
3. See Robinson (2002b, chapter 13) for a detailed discussion of the casebook developed by BRI's Unit Desa system for training its trainers and managers, as its savings program expanded from the pilot project stage to expansion to all units. Examples used in that casebook included funds mobilized by the pilot branches from a large variety of organizations and institutions: 32 schools, 6 village associations, 20 government offices, 11 cooperatives, 6 agricultural estate companies, and 25 local groups (including the Armed Forces Pension Association; the Bus Terminal Employees Association; the Tea Factory Drivers' Welfare Group; and various women's, sports, and religious groups).
4. See Robinson 2002a, chapter 13, for discussion of the way the sequencing for market penetration was done at Indonesia's BRI.
5. However, bookkeepers, cashiers, guards, cleaning staff members, and others can also be trained to conduct interviews on savings demand with local potential savers, especially with friends, family, and neighbors.

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