

# **Aligning Stakeholder Interests in NGO Transformations**

*Emerging Good Practices*

**January 2011**



**Council of Microfinance Equity Funds**



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## **Preface**

“Aligning Interests,” an initiative launched in 2009 by the Center for Financial Inclusion at ACCION International and Calmeadow, examined the challenges that microfinance NGOs encounter during the process of transforming to regulated financial institutions. It focused specifically on the stakeholders and interests involved – particularly the personal interests of key individuals – during this process. The project drew on case studies, practices within and outside of microfinance, and extensive interviews with investors and practitioners. It ultimately suggested tactics and incentives to align these interests and foster a productive negotiation between participants. The resulting paper, “Aligning Interests: Addressing Management and Stakeholder Incentives During Microfinance Institution Transformations” provided background to and real-world examples of this issue and raised awareness of the challenges associated with the alignment of stakeholder interests.

Recognizing the need for a more focused, action-oriented treatment of this issue, the Council of Microfinance Equity Funds (CMEF) has shared their experiences and insights on this topic to offer a number of practical suggestions for investors and practitioners to facilitate these discussions.<sup>1</sup> As an industry association of active investors in microfinance, the CMEF is well-positioned to address the issue of stakeholder alignment. It is a critical issue to many of its members, who serve on the boards of these transitioning MFIs.

This document serves as a companion piece to the earlier paper and offers a series of “emerging good practices” that have been witnessed and employed by investors and practitioners on the ground. It also incorporates feedback from participants in four roundtables and direct feedback from Council members, who shared experiences and practices regarding this challenge. This collection of “emerging good practices” aims to smooth the process of aligning the participants’ interests not only with each other, but also with those of the new institution. Moreover, we examine the effectiveness of these practices and drive towards clarity on controversial ethical issues related to these incentives.

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<sup>1</sup> This document was drafted by Stephanie Dolan of the CMEF based upon this consultative process.





# **Aligning Stakeholder Interests in NGO Transformations**

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## **1. Introduction**

How do you recognize or quantify the time and effort that a non-profit's founder has poured into an organization? Do you reward a non-profit's board members for their countless hours donated to shaping the institution's mission, and if so, how? What role does the staff have in determining the success of an organization? What skills and qualities are necessary in a manager, and what should be done if his skill set no longer meets the needs of an institution?

Such questions normally circulate beneath the surface at any operating non-profit. However, they truly come to light during periods of institutional transition, for example, during transformation to a for-profit or a merger of organizations. As these questions are often intensely personal, they have the potential to become, on the one hand, a bitter point of contention or, on the other, an opportunity for frank discussion and collaboration.

This document represents the consensus of the majority of members of the Council of Microfinance Equity Funds (CMEF). It was drawn largely from investors' direct experiences and the practices that they employ and/or have witnessed over the course of many institutional transformations and transitions.

We note there is a minority among our membership that disagrees with some of the approaches discussed in this document, particularly the use of equity participation as an incentive to align the interests of MFI management with other stakeholders and the long-term goals of the institution.

The range of opinions and approaches underscores the fact that there is no single "one size fits all" solution to achieve alignment. The context and challenges differ from institution to institution, so the Council does not recommend any single solution. Private investors, NGO executives, and board members should approach alignment issues flexibly and with an understanding of the views of

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other stakeholders. Successful solutions will address the needs of multiple parties and will provide stakeholders the opportunity to offer creative solutions. This document is meant to offer insights and approaches to investors and practitioners who are beginning to think about structures that meet an institution's needs as it undertakes the complex transition process.

### **1.1. Why Is Interest Alignment So Critical?**

The challenge of aligning stakeholder interests could be considered the “Achilles heel” of the transition process. The distinct interests and priorities of numerous stakeholders can cause difficult, awkward, or controversial conversations and potentially break down negotiations.

However, this challenge also presents an opportunity for the industry to move forward. As part of the natural development of the industry, transformations and consolidations of MFIs will continue to occur—possibly at an increasing rate—in response to competition, product diversification, capital needs, and regulatory requirements. Often, a transformation or merger may benefit the market, an institution's clients, and/or its product offering, thus allowing it to better fulfill its mission. Rather than allowing the issue of aligning stakeholder interests to complicate, delay, or even derail the transition process, participants should see these discussions as an important instrument to foster open communication and lay out expectations, in order to confront a significant challenge and ultimately contribute to the growth of the industry.

## **2. What Conflicts Are Inherent When Trying to Align Stakeholder Interests?**

A number of inherent challenges make it particularly difficult to analyze and discuss stakeholders' interests. All parties involved should be aware of these common challenges going into the transformation or merger process, so that when they are sitting across the negotiating table from each other, they can build upon these basic acknowledgments.

### **2.1. Paradigm Clash: The Non-Profit and For-Profit Structures**

The different frameworks and priorities of non-profits and for-profits can cause difficulties during the transition process. A non-profit's “ground rules”, particularly its social

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purpose, tax-exempt status, compensation practices, and governance by voluntary board members, differ substantially from a for-profit's ability to earn and use profits as it sees fit and its more formal, accountable governance by shareholders.

The differences between these two frameworks can be particularly apparent when transitioning from non-profit to for-profit. Some of the most problem-prone situations include the following:

- What to do with non-profit assets? These assets were meant to be directed towards a social purpose, rather than private individuals. Use of such assets towards a for-profit purpose during the transition may directly conflict with government rules, regulations, and donor requirements for non-profits.
- How to get everyone's approval? Stakeholders and supporters of the non-profit agreed to the NGO ground rules. If these are going to be changed through a transition, approval from all original stakeholders may be necessary, or at least advisable.
- How to incorporate new perspectives? Shareholders and investors in the new institution often bring new opinions and perspectives on the MFI's future. This will require some negotiation and perhaps compromise on all stakeholders' parts to incorporate these new opinions.

## **2.2. Preserving the Social Mission**

When an institution transitions to a for-profit institution and brings on external investors, it must focus on profitability, as a basic requirement of regulated institutions. Many NGOs worry about preserving the social mission in the face of these new pressures, particularly as they navigate changes in corporate culture as the institution becomes a for-profit. These are important issues to resolve, as fear of "mission drift" can be a breaking point in negotiations. A number of possibilities exist for maintaining the institution's social mission, including careful consideration of board composition, investor motivations, and the participation of the NGO as a stakeholder in the new institution, with the latter discussed in detail in Section 3.

## **2.3. Building a Strong Management Team**

The skills of the management team must evolve with the growth of the institution. Often, this means that the institution's decision-makers – both the original mem-

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bers and the new team – must take a close look at managements’ ability to lead an MFI following transformation or consolidation. This can be particularly complex, given the fact that frequently, the managers in question participate in the discussions and decisions about the future of the institution, its leadership team, and its staff, and are very aware of the possibility that they may need to be replaced. For a further discussion of concerns of NGO managers, see Section 2.4.a.; for possible replacement strategies, see Section 4.2.

## **2.4. Interests by Stakeholder Group**

Different stakeholders have different interests; how do we align all of these interests and all of these stakeholders not only with each other but also with the long-term interest of the institution, so that consensus can be reached and the transition can occur? To further complicate this matter, many of these interests are intensely personal; how do you reconcile personal interests with a socially oriented institution? As a result, these interests are often overlooked or avoided because people do not feel comfortable expressing them.

A number of stakeholders are broken out below, including a discussion of their interests: NGO managers, NGO directors, staff, investors, and the NGO itself. Other stakeholders are also involved in institutional transitions, including microfinance networks, donors, lenders, regulators, and clients, but we choose to focus specifically on this core group because they are often the primary stakeholders sitting around the negotiating table.

### ***2.4.a. What Factors Motivate NGO Managers?***

In most cases, NGO managers are the most important decision-makers in the transition process, because their agreement is typically critical to the decision to execute a transformation or merger. Many times, they have dedicated years of time and effort to the institution, with little financial reward. They have a multitude of motivating factors, often thinking of the MFI as a life calling, an opportunity for public prestige and status, or a source of job stability and financial security. As such, NGO managers can have a lot at stake during the transition; they are aware that their personal outcomes could range from becoming shareholders in the future institution to losing their jobs. For guidance on addressing the concerns of NGO managers, please see Sections 4.1 and 4.2.

### ***2.4.b. What Factors Motivate NGO Directors?***

NGO directors may share similar concerns with NGO managers. They have often donated substantial time and brainpower to institutional strategy and may have been affiliated with the NGO for years, building intense loyalty and a sense of ownership. However, unlike the NGO managers, directors do not have to face the potential livelihood and financial implications of transition. Rather, their set of concerns may pertain more to issues of control, power, status, and participation in the new institution. Section 4.3 discusses ways to address the interests of NGO directors.

### ***2.4.c. What Factors Motivate Staff?***

The confidence and support of an organization's staff will affect the resulting transition and contribute to the success of the new institution. Most often, employees' concerns focus on job security, preservation of the mission, institutional culture, opportunities for career advancement, and compensation practices. Stakeholders can address these interests accordingly, through both financial incentives (such as ESOPs or profit-sharing schemes) and professional development opportunities; for a closer examination of these plans, please see Section 4.4.

### ***2.4.d. What Factors Motivate Investors?***

Assuming an investor's intention is to exit in the mid-to-long term, their interests often lie in the future growth and viability of the institution. Interests can vary from fund to fund, but often include the achievement of specific social and financial goals for the investee institution, and the elements that will ensure that goals are met – a capable management team and effective governance process. They are also concerned with the means of exit and the valuation at which they sell their shares upon exiting.

### ***2.4.e. What Factors Motivate the NGO Itself?***

An NGO undergoing a transition to a for-profit institution – or a consolidation with another institution – often has multiple interests, especially centered on mission-preservation. The group backing the NGO (i.e. directors and management, collectively) may be concerned that the transition will eliminate the original non-profit's purpose in the community or lead to mission drift at the new institution;

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the group can also be worried about the NGO's financial ability to participate as a shareholder in the new institution. As stewards of a corpus of funds dedicated to a social purpose, the NGO also has inherent obligations to use these funds properly. Section 4.5 provides a number of options to address these concerns.

These are some of the major stakeholders' primary interests during the institutional transition process. It is important that these concerns be put on the table at the beginning of the transition, when stakeholders are getting to know each other and are forming expectations. If stakeholders are aware and respectful of each others' concerns, these interests are more likely to be genuinely considered and addressed.

### **3. How Have Other Industries Handled This Challenge?**

Although the microfinance sector finds itself at a critical point in its development, it is not the first industry to face the growing pains associated with aligning stakeholder interests during transitions. It is worthwhile to briefly review how other industries have addressed these challenges.

#### **3.1. Biotech & Non-Profit Hospitals**

The biotech industry has witnessed the transformation of certain non-profit research projects into for-profit firms. Non-profit hospitals have undergone a similar transition when being sold to for-profit institutions. In this case, the managers from the non-profit hospitals often receive incentives similar to those in place at the for-profit buyer, and the hospital's social performance continues to be monitored after the transition via a series of metrics.

#### **3.2. Community Corrections**

The community corrections industry originated as NGOs with the social mission of reintegrating rehabilitated prisoners, substance abuse addicts, and the mentally ill, among others, into society. When organizations realized that they could operate as a financially sustainable, even profitable, business, the industry underwent a transformation over a 10-15 year period. As the industry reached consensus on standards to monitor social goals and ensure accountability, it also grew more comfortable with incentive compensation among both non-profits and for-profits. At times, NGO

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managers were awarded consulting contracts that required very little of them, in return for stepping out of a management role or leaving the institution entirely.

## **4. Structuring Alignment: Emerging Good Practices**

Below we outline a series of potential methods to align interests, taking a close look at a range of incentive options that have been employed by Council members, while also providing guidance on the related ethical considerations. It is important to note that these tactics are possible only when communication between the stakeholders is open, frank, and straightforward, and the institution's governance process fosters a fair and transparent consideration of the interests of all stakeholders.

### **4.1. Equity Participation**

In general, Council members reported that forward-looking share ownership is the most common and effective way to align the interests of top management with those of investors and the institution. If managers have an equity stake in the new institution, their potential future payoff is linked directly to the MFI's future success. In this way, equity participation provides both a carrot in the long term and a stick in the short term: Managers benefit as share-value appreciates, but are punished for poor decisions that negatively impact the institution.

#### ***4.1.a. How Can This Be Designed?***

Managers should purchase full-price shares in the new institution at the time of transition. With some of their own capital invested in the institution, managers now have "skin in the game". Managers can earn additional shares over time through performance-based agreements, which would complement annual bonuses focused on short-term achievements. Equity participation can also be extended to management, and to other staff, through the establishment of an employee stock ownership plan (ESOP). Section 4.4.a. offers a more detailed discussion of this option.

#### ***4.1.b. How Much Is Acceptable?***

In order to effectively influence behavior, the potential payoff from equity participation should be a significant amount relative to the manager's base salary.

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The acceptable ranges for share ownership vary widely among institutions and investment funds, but it is important that management compensation be reasonable: Management should keep the interests of the shareholders at the forefront, giving precedence to growth in shareholder value over their own individual compensation. Investors consulted for this guidance generally felt comfortable with 3-5% of total equity for CEOs, 1-3% available to other managers and directors, and total management ownership in the 5-10% range.

#### ***4.1.c. How Can Managers' Equity Stakes Be Effectively and Appropriately Structured?***

Because many managers lack the resources to purchase shares at the time of transformation, a vesting schedule can be constructed to aid management in this endeavor. This allows management, over a specified period of time, to either earn shares in the institution or convert share options that become available to them, typically tied to specific financial and social goals.

Two sample vesting schedules are:

- A 5-year vesting schedule could allow the employee to earn one-fifth of the total number of shares available to him each year.
- A portion of the shares could vest immediately, with the rest vesting incrementally over a pre-negotiated 3-5 year period.

An alternate mechanism can sometimes be employed: The CEO, or select members of management, can be offered a loan to facilitate their purchase of full-price shares in the new institution. To encourage their long-term commitment to the success of the for-profit, debt-forgiveness on loan payments is offered for each year that the manager stays at the new institution.

Investors agreed that it is optimal to have managers purchase their stakes at full price. However, favorable pricing mechanisms may be employed at times to offer reduced-price or partially subsidized shares to management. Granting of free shares to management is not recommended; however, we acknowledge that it may be common practice in certain markets, and hence necessary in order for investors to remain competitive.



#### ***4.1.d. How Do Legal and Ethical Considerations Play Into This?***

On the whole, Council members have used the above mechanisms for equity participation because they are forward-looking: They offer the possibility to purchase or earn shares based on future performance, and draw on resources earned by the for-profit institution.

Practices that allow managers to acquire equity by drawing on NGO resources, rather than funds earned by the new institution, are not advised because, in such cases, non-profit resources would be used for individual benefit. In general, backward-looking bonuses and/or outright share compensation in the new institution (“sweat equity”) raise legal and ethical questions when an NGO’s resources are involved. An NGO’s resources are created under the premise that capital from funders has been raised to further a social mission, and tax-exemption has been granted by the government based on this charitable purpose. As such, the use of NGO funds (explicitly or implicitly) to pay for shares to be granted to or subsidized for managers is ethically problematic and may be legally prohibited.

#### **4.2. Packages for Exiting Managers**

When an institution undergoes a significant transition, questions may arise regarding the ability of existing NGO management to lead the new institution. Most importantly, if a manager is replaced, it must be done in a transparent manner and accompanied by appropriate incentives. If the board is undecided as to the NGO CEO’s capacity to head the regulated institution, the board could set, at the time of transformation, one-year performance goals for the CEO, coupled with effective incentives. This allows the CEO an opportunity to test himself/herself in the new position, and also gives the board a clear timeline to assess his abilities.

##### ***4.2.a. Severance Packages***

In most industries, exiting managers who have been terminated are paid severance packages by the organization. These lump-sum payments are mandated by labor laws in some countries or employment contracts, and are usually based on the manager’s tenure at the organization, his monthly or annual salary, and his perceived contribution.

#### **4.2.b. Golden Parachutes**

A recognition package, also known as a “golden parachute”, augments the legal minimum required by a severance package with an additional bonus. However, it is sometimes difficult to determine what constitutes an “appropriate” amount. To address such concerns, structures can be put in place to determine whether or not a bonus is “reasonable”: The board, not the CEO, should determine and approve this amount; a brief study can be conducted to determine if the amount is comparable within the regional industry. The bonus could be paid by the new institution, while the required severance is paid by the original non-profit; and, whenever possible, the practices regarding severance and potential bonuses should be outlined in the non-profit’s founding agreements.

It is important to recognize that the provision of a golden parachute can be a contentious issue. Such a package can raise the same ethical and legal questions discussed in Section 4.1.d: if an NGO provides a golden parachute to a manager, NGO resources have been used for individual benefit. A less controversial practice draws on a tactic employed by the community corrections industry (discussed in Section 3.2), in which the for-profit institution offers an NGO manager an advisory position in the new institution that allows for ongoing involvement at a reduced level of active authority. However, this is an option that some Council members recommend utilizing only on a limited basis.

### **4.3 Aligning Interests for NGO Board Directors**

Because NGO board directors often share a number of similar interests with top managers, members use similar approaches to aligning their interests.

#### **4.3.a. Equity Participation for NGO Board Directors in the New Institution**

Investors interviewed for this paper said that NGO directors who wish to invest in the new institution most often use personal funds to purchase shares. Moreover, they ideally should buy in at full price, although preferential pricing or restricted share grants with long-term vesting could also be considered. Council members agreed that the NGO board directors’ share of total equity is typically modest, at most a few percent.

### **4.3.b. Board Director Compensation**

While commercial firms beyond microfinance typically provide an annual retainer for board directors, as well as additional compensation for heading a committee, this has not been the norm in microfinance. However, many MFIs, upon becoming for-profits, offer a modest form of board-director compensation to their members, typically based on meeting attendance, ranging from \$500 – \$1,000 per meeting. We recommend that this practice become more standardized and transparent across the microfinance industry, in order to help professionalize corporate governance.

## **4.4 Aligning Interests for Staff**

Because staff interests regarding institutional transition often revolve around job security, compensation, and the mission of the new institution, we examine a number of practices below to address this range of concerns.

### **4.4.a. Employee Stock Ownership Plan (ESOP)**

An ESOP is a trust through which employees can buy stock in their employer. While many investors and networks at transformed institutions choose not to establish an ESOP, CMEF members generally acknowledge that this can be an effective mechanism for increasing employee “buy-in” for the transformation. It can give staff a stronger stake in the institution’s success, as well as offering financial incentives to them through dividends and share appreciation. In practice, ESOPs have been set up both for senior management and for all employees. Typically, staff’s ability to buy into the shares depends on their seniority and tenure at the institution.<sup>2</sup>

In addition to addressing employees’ compensation concerns, an ESOP also offers employees a voice in the governance process; often, staff aggregate their voting rights to elect a board representative to express their concerns and uphold the institution’s mission.

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<sup>2</sup> For greater detail on two ESOPs that have been implemented in microfinance, please see “Aligning Interests: Addressing Management and Stakeholder Incentives during MFI Transformations.” The paper describes the ESOPs in place at K-Rep and ACLEDA, including a specific case study on ACLEDA.

**4.4.a.1 Challenges of ESOPs.** While ESOPs have proven effective in many public companies in the U.S. and Japan (among other locations), they are still relatively rare in the microfinance industry. There are a number of innate difficulties with implementing an ESOP at MFIs, which board members should recognize and address while structuring the plan:

- The benefit of stock is often not appreciated or well-understood in developing countries, so stock tends to be rarely used as a reward.
- Shares in the institution may not necessarily inspire top performance for staff, since acquisition of stock is not directly linked to employees' performance.
- Many developing countries lack a legal framework for ESOPs.
- Shares are often illiquid because few MFIs are publicly traded institutions; this means that staff face difficulties in both valuing and trading-in their shares.

**4.4.a.2. Addressing Challenges related to ESOPs.** If an MFI chooses to create an ESOP, we recommend that it focus intently on educating employees about the benefits and risks of share ownership. Additionally, we suggest that the institution's management and board work closely with a law firm and/or regulators to gain a clear understanding of the legal issues around such a plan. If, for legal reasons, an ESOP proves impractical, an employee association can be created that imitates the structure and function of a trust.

Moreover, we encourage ESOPs concerned about the illiquid nature of shares to draw on lessons from past successes to structure mechanisms that imitate or facilitate a more liquid market.<sup>3</sup> For instance, share buybacks from managers can be pre-negotiated according to vesting schedules for meeting future performance goals; equity-like instruments can be designed to provide cash payments pegged to the value of the MFI's equity; or the institution can set up a company-run "gray market" that matches buyers and sellers of shares. Alternatively, a leveraged ESOP can be created that allows employees to use shares as collateral to borrow from the company.

#### **4.4.b. Profit-Sharing Schemes**

Given the difficulties associated with setting up an ESOP, a profit-sharing scheme may be a less-taxing mechanism that aligns staff interests with those of the MFI.

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<sup>3</sup> In particular, we point you to the ACLEDA case study referenced in the footnote above.

These schemes distribute a portion of the company's profits to employees at year-end, or at previously-negotiated intervals. Such schemes can be set up solely for management or expanded to include a range of—even all—staff, with allocations typically based on an employee's years of work and their role at the institution. This type of mechanism offers a strong financial incentive to employees, which can be tailored by the institution to represent longer or shorter-term incentives and/or meet specific professional or institutional benchmarks.

#### ***4.4.c. Professional Development***

Because many NGO employees are concerned about job security during and after a transition, as well as the culture and mission of the new institution, close and frequent communication with the staff is key to keeping them abreast of progress, managing expectations, and addressing their questions and concerns. Moreover, professional development trainings, extensive workshops, and technical assistance may offer employees an opportunity to develop their skills, pursue a career at the new institution, and provide continuity in terms of staffing as well as culture.<sup>4</sup>

#### ***4.5. Aligning Interests for the NGO***

As discussed in Section 2.4.e, the NGO itself has its own interests heading into an institutional transition. The NGO often becomes a shareholder in the new financial institution, a role that many investors favor. In some cases, the founding NGO may cease to operate after the transition, functioning only as a shareholder in the new MFI; however, often it will continue to serve the community. Should the NGO remain in operation, we recommend that it not remain engaged in microfinance, as this can potentially lead to competition and/or a conflict of interest with the new institution. Instead, the NGO may focus on other social issues, using the dividends from the new MFI to finance these activities.

Having the NGO as an owner in the new MFI also opens the door to broader forms of alignment, including those related to the institution's social mission. If the NGO is a shareholder, this can help preserve the social mission, provide stability through the

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<sup>4</sup> For an example of a successful staff development process, please see the ACLEDA case study in the paper referenced in previous footnotes, as well as *When There Was No Monday: Building ACLEDA Bank in Cambodia's Evolving Financial Sector* by Heather Clark (2006).

tumultuous transition process, and maintain continuity among investors, since many shareholders hope to exit in the medium-term. However, we recognize that having the NGO as a shareholder sometimes has the potential to create tensions at the board level. As a result, key matters related to social and institutional mission should be documented in the shareholders agreement.

## **5. Conclusion: “Aligning Interests” in Practice**

The issue of aligning interests, both among stakeholders and with the long-term interests of the institution, is a multi-faceted challenge that can act as a significant barrier to the industry’s development. At the same time, there is an opportunity to make a significant change in industry awareness, discussion, and practices around this issue and break a troublesome bottleneck holding back the microfinance sector. Below, we share a number of processes and standards that could be implemented to address this challenge at the institutional level and the industry level.

### **5.1. How to Incorporate These Practices at Individual MFIs?**

Three practices could be considered by and put in place at NGOs to help address, or even preempt, the difficulties of aligning interests among an institution’s many players:

- **An NGO “prenup”:** A start-up NGO should consider if transformation or consolidation might be possible in its future, and, if so, its founding agreements should scope out the implications as thoroughly as possible. Founding documents, funding agreements, and employee contracts should be composed with this possibility in mind, and should anticipate and structure specific processes regarding share ownership by NGO managers and board directors in the new institution, particularly sweat equity or severance packages; staff interests; and potential future roles for the NGO.
- **Loans rather than grants:** Founding organizations could provide long-term loans, rather than grants, to institutions to ease the subsequent process of withdrawing funds and shifting them to the new institution upon transformation and/or consolidation. However, if grants are used, institutions should reach an agreement with the donor foundation as to what happens to this funding upon a transition.

- **Third-party advisors:** NGOs undergoing a transition should consider bringing in a third-party advisor to lend transparency to the process and facilitate open communication. This advisor would act as a mediator among all stakeholders, guide conversations, and apply good practices to create a framework for offering incentives to align participants' interests. This third party should be agreed upon by all stakeholders and be paid out of pre-launch costs, in much the same way that incoming investors share pre-launch legal costs.

## **5.2. How to Incorporate These Practices at the Industry Level?**

The industry as a whole could benefit from the following “next steps,” which are focused on big-picture challenges associated with the alignment of stakeholder interests:

- **Recognition of and open discussion about this issue:** This topic should be an important component of negotiations. With basic guidelines (such as these) and third-party advisors familiar with good practices, awareness and conversation about personal and institutional interests should become an inherent part of transformation and consolidation discussions.
  - **Continued dialogue:** This discussion of emerging practices represent a step towards gaining further consensus among practitioners, investors, and donors about appropriate, even necessary, ways to recognize and address stakeholder interests.
  - **Further documentation of incentives:** In order to truly understand the various mechanisms employed to align interests, an industry-wide effort could document the types and amounts of incentives offered to stakeholders in the past, and the success or failure of the proposed transition. Similarly, the industry would also benefit from greater sharing of information about compensation for CEOs, COOs, and CFOs at transformed MFIs in order to benchmark industry norms. Moreover, the industry would also benefit from a deeper effort to examine practices employed beyond microfinance, not only in the non-profit hospital and community corrections sectors, but also in family-owned businesses.
  - **Expertise in this area:** Professional advisors engaged in negotiating institutional transitions could develop expertise in the area of alignment of stakeholder interests. This would win them credibility on the topic, as well as acceptance from all parties involved in the process.
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Ultimately, essential business concepts, applicable to every industry, lie at the heart of this challenge: frank communication, clear planning, strong management, effective compensation and incentives, and transparent governance practices. For greater detail on these topics, we refer you to the original, full-length paper, “Aligning Interests: Addressing Management and Stakeholder Incentives During Microfinance Institution Transformations,” in which the topic is more fully illustrated in the context of actual cases.



## **Annex 1: Practices and Mechanisms That Have Worked – and Those That Have Not**

<b>What has worked</b>	<b>What has not worked</b>
Inclusion of all key stakeholders in transition process and frank conversation about their interests	Lack of communication re: stakeholder interests and expectations, including valuation
Institutional commitment to training, workshops, and open communication with staff re: transition	Cultural clashes between new and old staff, or during consolidation
Clear definition of the NGO's role after transition	Not considering the NGO's future
Organized, transparent, collaborative transition	Transition led by one key decision-maker
Providing a minimum severance payment for departing non-profit managers	Side-stepping the non-profit key managers when determining future management of MFI
Strong governance practices, frequent board participation, and careful selection of new investors	Weak transition team, mission drift, weak communication with and involvement of board
Allowing key NGO managers and for-profit managers to hold equity stakes in the new MFI	Not considering mechanisms for long-time key staff and directors to purchase equity
Forward-looking bonuses, ESOPs, or profit sharing, offered by the new MFI	Backward-looking sweat equity or outright granting of shares for non-profit managers
Addressing the possibility of transition in non-profit's founding documents	



## **Council of Microfinance Equity Funds**

### **About the Council of Microfinance Equity Funds (CMEF)**

The Council of Microfinance Equity Funds (CMEF) is the membership organization that brings together the leading private entities that make equity investments in microfinance institutions (MFIs) in the developing world. The Council's members seek both social and financial returns from their investments in these institutions, which provide a range of enabling financial services to the financially excluded. Through the Council, members seek ways to improve their oversight of investee MFIs, enhance the performance of their investments and develop best practices and standards for the industry. CMEF ultimately aims to strengthen the microfinance industry and advance the expansion of commercial microfinance.

**Council Coordinator:** Center for Financial Inclusion at  
ACCION International