“Hardwiring” Social Mission in MFIs

Double bottom line companies face challenges in communicating their priorities to stakeholders, and in particular investors, and in giving stakeholders confidence that those priorities and the character of the company will be preserved over time. This is a particular challenge for growing companies that need to periodically increase equity by bringing in new investors, or for companies seeking to provide liquidity for investors.

Grassroots has looked at approaches to both signaling mission stability and indeed “hardwiring” mission into company structure. Many of these approaches are used by mainstream companies: dual shares structures with differential voting is long established and is enjoying a revived visibility among tech IPOs; anti-dilution provisions give some shareholders an instrument to preserve control. Others are specifically focused on the “social responsibility” of the company: sister foundations or charitable contributions are common at many companies. More recently, Public Benefit Corp forms created in a number of US states are designed to signal that managers and Boards will consider the interests of stakeholders other than shareholders in charting the company’s course, and provide some protection from potential shareholder lawsuits when they do so.

This note reviews the widespread, if not widely acknowledged, application of such approaches within the microfinance sector, which represents the most mature of the new wave of “impact businesses”. Drawing on the experience in microfinance as well as conventional companies it explores how the particular double bottom line (DBL) character of microfinance can be more reliably signaled and preserved drawing on these examples and experience.

Our preliminary conclusion is that a more transparent and considered utilization of structural features to hardwire mission may offer as good a solution as we will find to the problems of mission drift, stakeholder incoherence and investor disillusionment. While many of these structural fixes entail side effects, putting them on the table will give investors and managers a clear choice of whether the need to lock in or hardwire social mission is worth the costs.

Grassroots’ “GIFI” initiative takes a comprehensive approach to supporting “impact first” MFIs, including mobilizing impact first equity and providing technical assistance that can support and enhance the social mission. One part of this technical assistance will look at company structure and work with management to explore whether any of the structural approaches to “hardwire” social mission will help management and anchor investors stabilize and clearly signal their company’s social character and priorities and grow a well-aligned investor base.

In the fall of 2013, planning for the IPO of Alibaba, the Chinese internet group, once again thrust the issue of multiple share classes with differential voting rights back into the public eye. While generally frowned upon by corporate governance experts, and facing academic research which seems to conclusively demonstrate that companies with such structures tend to perform worse than single class companies, differential voting rights or anti-dilution provisions intended to preserve the control of select group of shareholders show no sign of going away. Along with prominent long-standing cases like Ford Motor and the New York Times, a new generation of prominent internet companies -- Google, Groupon, LinkedIn, Facebook -- have adopted dual share classes to preserve control in the hands of founding shareholders who, it is argued, can safeguard the essential culture of the company, as well as enable managers to take a longer term perspective on building value and resist the “short-termism” of the market and corporate raiders.
The issues raised by dual class structures for these mainstream companies resonate from a slightly different perspective with “impact” or DBL businesses. How can founders and investors have confidence that the mission and character of the company will be preserved in the face of investor turnover or dilution? Indeed, a number of prominent social business takeovers by mainstream companies, including Ben and Jerry’s and Stoneyfield Yogurt have included features that incorporate differential voting or preservation of control, at least over certain matters.

Certainly the question of how to preserve and enhance the social character of microfinance has attracted significant attention and effort in recent years. The Social Performance Task Force (SPTF), Microfinance Transparency (MFT), Smart Campaign and national codes of conduct are all efforts to enhance confidence that MFIs are indeed conducting their business to benefit -- or at least not harm -- their low income clients. What we have not systematically come to terms with is how to give promoters, management and investors confidence that this commitment will be maintained and enhanced. For example, control of an MFI that complies with all the best of the SPTF, MFT and Smart can be purchased by an investor group for which this is a lesser or not at all a priority. We tell ourselves that no rational investor would acquire an MFI with a strong social brand just to squander it, but while undoubtedly often true, that is ultimately more a hope than a certainty. Even with the best of intentions, ensuring the “suitability” of financial products for low income populations requires a strong commitment and unwavering focus.¹

This debate within the microfinance community mirrors a longstanding debate about the nature and responsibilities of shareholder corporations, dating in the U.S. to the 1930s. This debate has revolved around the concept of Corporate Social Responsibility (CSR) into which framework initiatives such as SPTF, MFT and Smart fit quite comfortably. But an exclusive focus on such CSR type initiatives ignores how the debate has moved on, focusing more recently on dedicated corporate forms more suitable to a DBL or social enterprise.² These forms respond to the view that “like-mindedness”, a “social” brand, or mission statements while helpful to confirm and preserve the social character of a business, are ultimately insufficient and unreliable.

These challenges are welcome, in the sense that they arise from the growth and increasing diversity of the MF funding base, and a shift in emphasis and priorities that has both facilitated that diversification and been driven by it. But that diversity can best be accommodated by recognizing that different investors will look for different solutions. As Kate McKee notes:

“Yet consensus is elusive for some difficult areas, such as defining returns that balance the interests of clients, providers and investors. Convergence around a single global standard for acceptable growth or profitability is unlikely. Nor is it advisable . . . . [but guidance] can help shareholders with diverse preferences better align within MFI ownership structures . . . .”³

¹ See the “Mor Report”, http://www.ifmr.co.in/blog/2014/01/07/rbi-releases-report-of-the-nachiket-mor-committee-on-comprehensive-financial-services/
Prioritizing MFIs’ Social Mission: is hardwiring necessary?

Before examining how mission might be “hardwired” into a company it is worth reviewing the counterargument: that hardwiring is not necessary because investors or an acquirer want the company because of rather than in spite of its social mission, and that to dilute or dispose of the social component would destroy the value that they paid good money for. This view has often been expressed with respect to bank acquisitions of MFIs like KMB Bank in 2005 or more recently Edifycar as well as DBL companies in other sectors.

One of the more articulate recent presentations has been in the case of Plum Organics, an organic baby food company in the US acquired last year by Campbell’s. In a recent article, Plum’s co-founder and President Neil Grimmer puts the argument clearly:

Profitability Because of Purpose, Not Despite It

A skeptic might propose that by formally committing to social and environmental standards, a company might be sacrificing profitability for purpose - in short, that it's bad for business. I assert that this is a misnomer to be flipped on its head. The success of some of today's most beloved brands - like fellow B Corps Warby Parker, Etsy, Patagonia, Ben & Jerry's - has not been despite their social and environmental missions, it's been because of them.

The criticism also assumes that brands have a choice to disregard social and environmental responsibility - another antiquated perspective the modern company cannot risk falling fool to. Not only do consumers demand better from the brands they support, in the digital and social media driven era, companies don’t have the luxury of assuming that anything less than the highest standards of corporate citizenship are acceptable. In the most pragmatic terms, responsible business is a good business decision.

Just Good Business Sense

One of the reasons Plum has become the fastest-growing baby food brand in America is because our core customers share the values we wear on our sleeve. Earlier this spring, Plum Organics was acquired by the Campbell Soup Company. Often when a small, mission-driven business is acquired by a larger company, there is speculation and concern that the values might fade away.

We’re proud to say that nothing could be further from the truth. Not only did Campbell not prevent us from reincorporating as one of the first Public Benefit Corporations in the State of Delaware (two months after our deal closed), they helped us get it done. Adopting this legislation for Plum is just a natural extension of how we do business and Campbell supports that. But counter-examples abound. In the U.S. such high profile sales of social businesses as Ben and Jerry’s and White Dog Café incorporated provisions that required acquirers to preserve the mission, or erected some impediments to drift: a self-perpetuating board to oversee the social activities in one case and a restrictive licensing agreement in the

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latter. In the case of KMB bank the acquiring Italian bank was required to commit to preserve the microfinance business for a fixed period as part of the deal.\(^5\)

The discussion also may be different when the social business serves an economically diverse or largely higher income population versus a low income population. Whereas in the former case a premium price may be charged which the relatively affluent consumer chooses to pay for a product consonant with their values, in the latter case, as Chuck Waterfield of MF Transparency has argued, there is a zero sum transfer between the relatively affluent investor and the low income client. Businesses with a significant proportion of affluent clients thus have much more scope to reconcile competitive or enhanced profitability with mission than do businesses with predominately or exclusively poor clients.

**Alternatives to Hardwiring**

While as shall be seen, attempts to more or less hardwire mission are more prevalent in microfinance than generally recognized, there are alternatives.

*Forgo transformation*: A number of MFIs have responded to the challenge of assembling and preserving an aligned group of investors by deferring transformation from an NGO to a shareholder structure. Grassroots has encountered a number of high-performing MFIs, both financially and socially – who state flatly that they “will never transform”. In other cases, NGOs have struggled with the transformation question for many years. While the primary goal of maintaining control within the founding NGO and thus preserving mission is obviously achieved by deferral, this comes at a high cost with respect to the ability to attract capital, the ability to achieve a regulatory status that would allow new activities, and sacrifice of the valuable new expertise and perspectives that a more diverse group of investors can ideally provide.

*Likeminded investors*: A less drastic approach is to transform and accept capital but strictly limit shareholding to “like-minded” investors. The challenge here has been that with the exception of a few philanthropies like Ford, DFIs like SDC, or social investors like Agora or Oikocredit, MFIs have been understandably wary of how reliably “like mindedness” can be identified and how permanent the alignment will be. This problem has been exacerbated by the lack of precision in discussing what “social” means concretely, and how it will be implemented in all the myriad scenarios that an MFI will face. The ubiquity and imprecision of the “social” label carried by most microfinance investors masks very wide differences in theories of change, and performance expectations or requirements. These differences –which investors themselves may not be fully aware of at the outset -- will eventually express themselves, potentially upending an apparent consensus over strategy and priorities. Nevertheless, so long as shareholding remains within the hands of a committed, highly aligned group, this strategy can be successful, as evidenced by AMK in Cambodia.\(^6\)

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\(^5\) In this latter case, there are some indications that this commitment has weakened. In 2009, KMB – which translates as “small business lending” in Russian, changed its name to Banca Intesa. In 2011 the bank ranked 14\(^{th}\) among the top 20 Russian banks lending to micro and small businesses. according to a Jan 2013 “Landscaping Report: Financial Inclusion in Russia” published by CGAP. The bank’s most recent data on the MiX Market is from 2008.

\(^6\) See, “MFI Shareholders and Directors can help achieve social goals” by Tanmay Chetan CGAP Blog, 20 Aug 2012.
Faced with the uncertainty or shortcomings of these two approaches, better alternatives would enable MFI promoters, management and actual or prospective investors to much more precisely articulate their priorities and objectives, determine whether their objectives were aligned, articulate strategic priorities, and hold each other accountable for achieving agreed goals when it came to the social bottom line and to the interaction of social and financial objectives.

Today we can point to enormous progress towards enabling us to meaningfully articulate measurable social objectives. While data, benchmarks and research continues to accumulate, enough clarity and evidence now exists to enable stakeholders to much more explicitly articulate priorities, seek agreed improvements in performance and hold each other accountable. This progress provides a basis for incorporating structural features into MFIs that can enhance the confidence with which investors engage with specific MFIs.

The process of building, diversifying and distinguishing among the private impact investor community enables MFIs with varying emphases and strategies for their social mission to meet capital requirements from well aligned investors: “The question is not “whether” the sector needs commercial capital to meet unmet demand for quality financial services but what type.”

**Goals of Incorporating Structural Features**

In summary, incorporating structural features to confirm and preserve the social character and priority of a DBL business can serve a number of purposes:

- **Growth Capital:** Enable MFIs to access capital markets with a reduced risk of losing their social character. No one is served well when an MFI performing strongly on social and financial grounds is starved of capital, or fails to meet regulatory requirements to offer a more diverse array of products.

- **Signaling:** Enable /encourage prospective investors and employees to self-select: if they don’t share the priorities, probably not a good fit.

- **Scenario anticipation:** Encourage a more concrete discussion of scenarios that an MFI might face: how to respond to profit pressures; choosing between new products or territories; infrastructure priorities.

- **Coherence and efficiency:** Provide for more coherence and obviate the need for managers to constantly balance /mediate different visions; reduce the need for interminable, inconclusive existential discussions.

- **Accountability:** Clearer accountability /credibility for microfinance and impact investment: the confounding of microfinance’s social and financial objectives has meant that its performance in either regard is difficult to assess and improve; it is never clear if shortfalls were due to faulty design or execution or the need to compromise between two priorities that may at times conflict.

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7 McKee, CGAP 2012, p 21.
Possible Structural Features

1. Shareholder Agreements and Other Legal Agreements

Grassroots’ conversations with MIVs and board members highlighted several ways to employ Shareholder Agreements (SHA) to verify like-minded social investors and indeed, McKee cites examples of a number of investors who have begun to incorporate mission adherence, client protection, social performance reporting into legal documents (p10). In addition, a number of relatively standard SHA clauses might be utilized to preserve mission or exercise some discretion in accepting new shareholders, such as right of first refusal (ROFR), and these are not repeated here.

Non-standard clauses might include provisions that state clearly the MFI’s social priority, subject to a financial sustainability floor. Such a clause would be similar to approaches employed by Certified B Corporations (B Corps). Companies also undergo periodic third-party assessment and certification against rigorous standards of social and environmental performance, accountability, and transparency allowing them to gain the status of a Certified B-Corp. B Corps, which originated in the U.S., are now being established in other countries and at least one MFI (Juhudi Kilimo) has been certified. Building on the B Corp initiative, a Benefit Corporation is a distinct legal structure that provides for the by-laws or charter of a company to prioritize non-financial goals and the interests of all stakeholders other than just shareholders’ profits. Not clear if the B Corp and Benefit Corp provisions are enforceable in all jurisdictions, but nevertheless they serve a signaling function.

One advantage of incorporating more rather than less explicit articulation of goals and priorities into legal agreements is that it can indirectly address the “responsible exit” issue. To the extent that a new shareholder must accede to certain priorities and restrictions by signing legal agreements, the likelihood that investors who do not agree with these priorities would seek to invest is diminished.

The primary disadvantage to confirming mission in an SHA is that it is a blunt, unwieldy instrument and there is an understandable reluctance to include too much detail and specificity with regards to, for example, budgets or dividend policy. Amendments to such features of SHAs typically require unanimous shareholder approval and thus are more appropriately delegated to a Board, which can exercise some judgment in light of evolving context. Thus while a SHA can set some basic understandings and expectations, substantial and critical discretion will likely remain.

2. Foundations and Charitable Giving

Non-profit foundations or other parallel /sister entities related to the MFI and partly or wholly funded through MFI profit allocation or dividends can be used to execute social interventions. An alternative is charitable giving can be financially equivalent while obviating the need to deliver social outputs directly.

In both cases, how well coordinated the grant supported activity is with the MFI’s assessment of client need and theory or strategy of impact is a key consideration. Many companies deliver a carefully crafted, highly coordinated

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8 The Benefit Corporation legal structure has been established in 18 of the United States, including Delaware, where Grassroots is registered as a Public Benefit Corporation (PBC). “B- Corps“, which is the certification against the above-mentioned standards, now exist in 24 countries and requires companies to either adopt Benefit Corporation status or legally amend their governing documents to preserve their mission against changes in management or ownership.

9 Juhudi Kilimo, first African MFI to become Certified B Corp: https://www.bcorporation.net/blog/juhudi-kilimo-the-first-african-b-corp
package of products and services to clients: Nitilapan / FDL and Sembrar Sartawi come to mind in LAC and Janalakshmi and BASICS in India. In other cases, corporate giving or foundations are not coordinated as part of the social strategy: the execution of the social activities is outsourced to independent third parties who presumably need to respond to diverse funders and have their own priorities and strategies.

A prominent and controversial example of this approach is Compartamos, whose active foundation is funded from the company’s dividends, thereby – to some commentators – justifying the company’s persistent high level of profitability. A less controversial example is Janalakshmi, where the founding NGO, assured a 25% shareholding through anti-dilution provisions, relies on dividends as an important source of funding for highly coordinated social initiatives.

In either case, the question arises what level of giving is meaningful. As a point of reference, in 2012 Wells Fargo, the largest corporate philanthropist in the US in dollar terms, gave the equivalent of 1.3% of its pretax profit in 2011. Goldman Sach’s giving has spiked in recent years and was 3.9% of it 2011 pretax profit. Warren Buffett, who disapproves of corporate giving and whose Berkshire Hathaway gives nothing, notes that it is unusual for companies to give in excess of 2%.10

Another point of comparison is self-identified social businesses. Among GIIRS rated companies in the emerging markets, 37% gave more than 1% and 31% gave 5% or more, with 5% reporting giving more than 50% of profits.

While these numbers are difficult to evaluate since it is not known what other social initiatives the companies may be pursuing that could absorb profits above the line, they suggest that donations in the single digits may not meaningfully distinguish a “social” business from its conventional counterparts.11

Grassroots is looking at such foundations and forming a view of several key dimensions as part of its GIFI eligibility criteria:

- How substantial is their funding relative to the overall profitability of the core microfinance business?
- How are their activities integrated with the core microfinance business and the overall theory of change, both at a management and a governance level?

3. Budget allocations

An alternative to a distinct parallel entity tasked with undertaking social interventions is to include budget allocations within the MFI or subsidiaries within an MFI Holding Company that are tasked with social interventions. Funding could be set as a proportion of total profits, or some or all of profits above a certain level. Some MFIs already employ a form of this approach, explicitly committing to reducing interest rates or increasing expenditures on social initiatives.

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11 This will be a particular issue in countries which mandate that all companies allocate a portion of profits to social initiatives, such as Peru (15% of profits) and India under the new 2012 Companies Law http://social.yourstory.com/2014/01/india-csr-contributions-impact-investments.
commitments whenever ROE exceeds a set level, for example 20%; examples include Equitas in India and MBK in Indonesia.\textsuperscript{12}

In this approach, a view on the appropriate level of allocations or the ROE ceiling still needs to be taken. The concerns about coordination of interventions raised by the foundation approach may be somewhat alleviated, although in many cases the board of the MFI and the foundation may have little or no overlap, permitting the problem of poor coordination to arise.

4. Anti-dilution

In a number of cases various anti-dilution mechanisms have been employed, either explicitly with social mission in mind or to preserve “local” or some other characteristic of the controlling shareholder group. These mechanisms can take the form of non-voting shares, anti-dilution provisions in SHAs, or of creating holding company structures that preserve control by what effectively becomes a minority shareholder bloc on a consolidated basis. The flip side to preserving mission in this way is that it entrenches a controlling group that may not be easy to influence or dislodge as new challenges arise or if performance lags.

For better or worse, MFIs as different as BANEX in Nicaragua and ACLEDA in Cambodia have incorporated requirements intended to ensure that a particular group of shareholders -- in one case “local” investors and in the other employees -- retain a significant or controlling interest.\textsuperscript{13} Recently, such a strategy has been incorporated into regulation in the case of Bolivia, where a new corporate form (IFD) combines foundation with new shareholder capital into a hybrid type of non-profit / for profit company in which the foundation must always retain at least 51% ownership.

Dual class structures are typically criticized for “entrenching the controlling investors, leading to inefficiency and underperformance” as the FT recently noted in an article about the Alibaba issue.\textsuperscript{14} But the FT went on to note that dual class shares can help avoid the dreaded “short-termism” and also offer investors greater certainty: “investors have at least knowingly delegated control to chosen individuals rather than having the issue decided for them at the whim of City insiders.” The FT goes on to say that “to prevent ossification into mediocrity, structures should have sunset clauses [providing they will expire on a specific date unless reauthorized] built into them. . . .”

Holding company structures can also be used to retain (or prolong) effective control of an MFI within the hands of a promoter group, even as new investors dilute the original groups’ consolidated ownership. While this type of

\textsuperscript{12} In some countries, such an approach is explicitly or implicitly encouraged by regulation. Indian authorities have made clear their discomfort with “venture capital” type returns in the microfinance sector. In Bolivia, Supreme Decree No 1288 of July 2012, adds a 12.5% tax on earnings of regulated financial institutions (FIs) when return on equity (ROE) exceeds 13%.

\textsuperscript{13} Steps to facilitate or require MFI employees and / or clients to own shares in the MFI (ex: ACLEDA, some East African MFIs affiliated with Desjardins) can give rise to unintended consequences, including accelerating the loss of control they were intended to preclude. This risk is particularly acute in jurisdictions where directors are required to maximize shareholder financial value; this has been a driver in a number of sales of US social business to commercial buyers, most famously, Ben and Jerry’s.

\textsuperscript{14} Financial Times, “Rethinking Equity after Ali Baba”, Sep 27, 2013
structure does not have any necessary bearing on a company’s social commitment, it can be used to prolong the ability of a socially committed shareholder group to maintain a company’s focus on its social goals even as a company grows and incorporates new shareholders (FIE, Apoyo Integral and Procredit) by forestalling the founder’s loss of control over the MFI.15

Golden or preferential shares, provide for extra or special voting rights to a class of shareholders and are another way for a promoter group to retain control of the MFI and its mission even as new investors are incorporated. For example, in Mibanco the founding NGO, ACP, has common stock A shares with voting rights whereas the B shares issued to other investors are non-voting. At least one MF network considered a golden share structure as it was bringing new investors into its subsidiaries. The use of preferred stock or shares can also result in a similar outcome, in that preferred shareholders contribute capital but do not have voting rights, maintaining control with the common stock shareholders. A variant would give the original promoter group voting control so long as financial performance benchmarks were met, but control could be at least temporarily lost if performance fell below a specified threshold. Such a structure was used in the original sale of a majority shareholding in Stoneyfield Yogurt of the US to Dannon.16

5. Perpetuation of governance

A variant of the golden or non-voting share approach is to preserve voting rights, but provide for the Board to be self perpetuating with certain responsibilities, in particular those regarding mission, placed under the Board sole authority while other matters, for example sales or mergers, remaining subject to shareholder approval. Such an approach was used in the case of Ben and Jerry’s in the U.S. as part of the Unilever acquisition. The Board’s ability to perpetuate itself could be curtailed if it failed to achieve agreed financial performance benchmarks

An alternative would be to assign the control of the board to the NGO shareholder (via number of board seats assigned and importance, ex: assign the Board President position, and making it difficult to remove the NGO seats-ex: requiring 75% shareholder vote). In microfinance, the transformation of Credisol in Honduras provided for two board seats to be reserved for the founding NGO, the Diocese of Trujillo.

Conclusion

Various means of “hardwiring” social mission into MFIs’ corporate structure, documents or policies are more prevalent than often recognized or acknowledged, and there is a substantial, if unexamined, body of experience with these efforts. As part of its “GIFI” initiative, Grassroots will work with socially oriented MFIs to determine if one or another of these features might be helpful in assembling an aligned group of investors and prevent instability or tension in executing the company’s social priority.

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15 Shareholders of KMB Bank rejected control by the Procredit Holding precisely because they feared it would result in poorer liquidity or valuations because of Procredit’s perceived social objectives. See Banking on Small Business: Microfinance in Contemporary Russia, Gail Buyske, Cornell University Press 2007.
16 See also DiLeo, 2001.