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THE COST OF OWNERSHIP IN MICROFINANCE ORGANIZATIONS

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Key words:

Microfinance, ownership, corporate governance, nonprofits, transformation, global study

Abstract

This article analyses the cost of ownership in microfinance organizations. We specifically compare the ownership-cost of Shareholders Firms (SHFs), Non Profit Organizations (NPOs) and Cooperatives (COOPs). A paradoxical situation motivates us: Most providers of microfinance, both historically and today, are NPOs or COOPs, while several policy papers advocate SHFs. Based on an extension of Hansmann's (1996) economic theory of ownership we propose that cost variables related to market contracting of microfinance services favor NPOs and COOPs, whereas most cost variables related to the practice of ownership favor SHFs. We conclude that in severe imperfect markets, where most microfinance organizations operate, NPOs and COOPs are still needed.

1. Introduction

Microfinance is the supply of banking services to micro-enterprises and poor families. Private suppliers of microfinance are normally incorporated as member based Cooperatives (COOP), Non Profit Organizations (NPOs) or Shareholder Firms (SHFs). This paper compares the costs of these three ownership types. A paradoxical situation motivates us: While several policy papers advocate SHFs (Berenbach and Churchill, 1997, C-GAP, 2003, Chavez and Gonzalez-Vega, 1994, Christen and Rosenberg, 2000, Greuning et al., 1998, Hardy et al., 2002, Jansson et al., 2004, Staschen, 1999), most suppliers of microfinance are NPOs or COOPs. Estimates indicate only 224 SHFs supply microfinance (Isern et al., 2003) compared to 7000 NPOs (White and Campion, 2002) and tens of thousands of COOPs.¹

The UN Year of Microcredit in 2005 and the Nobel Peace Prize to Mohammed Yunus and Grameen Bank in 2006 have given considerable public recognition to microfinance as a development tool. Christen et al. (2004) reports an astonishing 500 million persons served, mostly with savings accounts, while the Microcredit Summit in their 2006-meeting in Halifax celebrated the milestone of 100 million borrowers. Nevertheless, microfinance still only reaches a fraction of the world's poor (Christen et al., 2004, Robinson, 2001). Hence, there is a recognized supply challenge in the market (Helms, 2006).

Other studies analyzing microfinance supply have compared the *welfare approach* and the *sustainability approach*, where the first measures success by how well it fulfills the short-term needs of the poorest while the second proposes a long-term “win-win” logic between poverty outreach and organizational sustainability (Woller et al., 1999, Morduch, 2000, Schreiner, 2002, Rhyne, 1998). Our conceptual study complements existing research as it claims to be

the first to present a systematic framework to explain the intrinsic cost-differences between ownership types.

To develop our framework we apply Hansmann's (1996) economic theory of ownership, which identifies several variables influencing the cost of ownership. We relate each of the variables to the microfinance industry and analytically compare the ownership cost of SHFs, NPOs and COOPs. The analysis of each variable is finalized with a proposition which indicates if the ownership costs in NPOs and COOPs are on average, higher or lower than the ownership cost in SHFs. Based on an extension of Hansmann's theory we propose that cost-variables related to *market contracts* favor NPOs and COOPs, whereas most cost-variables related to the *practice of ownership* favor SHFs. The proposed lower costs of ownership-practice in SHFs provide strong support for this ownership type as well as the welcoming of new investors into the industry. However, our analysis also indicates that NPOs and COOPs can more effectively mitigate the costs of market contracts, and that such mitigation is highly relevant since most microfinance organizations (MFOs) operate in severely inefficient markets. Hence, a mixture of different ownership types, similar to mature banking markets, is probably what best serves microfinance customers. We highlight the need for more research efforts to better understand and support NPOs and COOPs alongside the SHFs.

The rest of this paper is organized as follows: Section two provides information about the often recommended transformation of NPOs into SHFs, section three outlines the theory and the methodology applied followed by section four and five where the cost variables for markets contracts and the practice of ownership are analyzed respectively. Section six presents a table summarizing the discussions in the former sections. Section seven concludes and provides implications for policy advocates and future research efforts.

2. Transformation from NPO to SHF

Not only policy papers, but also national legal frameworks seem to consider NPOs and most COOPs as inferior banking organizations compared to SHFs. Few NPOs are regulated and allowed to mobilize savings, and the supervision of most cooperatives is generally considered outside the scope of banking authorities (C-GAP, 2003). As a consequence there has been a “call” to NPOs to transform into shareholder organizations (White and Campion, 2002, Fernando, 2004, Rhyne, 2001). Between 1992 and 2006 about 43 NPOs were transformed into shareholder organizations (Fernando, 2004, Hishigsuren, 2006). The main motivations to transform are to increase outreach, to be licensed and allowed to mobilize savings, to obtain access to new equity sources and to improve ownership control. In most cases the original NPO continues as a major owner in the new SHF (White and Campion, 2002, Ledgerwood and White, 2006). Generally speaking, transformed SHFs have been able to increase their outreach considerably (Ledgerwood and White, 2006). However, some observers fear that increased outreach doesn’t come at zero cost and warn about a possible “mission drift” (Woller, 2002). Yet, Christen (2001) does not warrant such fear. At the same time, pioneer investors in transformed SHFs indicate that there are now few NPOs with the characteristics needed to transform successfully (DiLeo and Cuadra, 2002). As a consequence, transformation as a strategy for increased microfinance outreach seems to be running out of steam. Between 2003 and 2006 only about four NPOs transformed into SHFs (Hishigsuren, 2006).

Historically, pro-poor banking has been dominated by COOPs and NPOs such as the 17th century philanthropic English loan funds (Hollis and Sweetman, 1998), the 18th century Irish loan funds (Hollis and Sweetman, 2004), the 19th century savings banks (Teck, 1968) and the

19th century Schulze-Delitzsch and the Raiffeisen cooperatives (Teck, 1968). Still the cooperatives and the savings banks continue to flourish in several highly competitive markets (Christen et al., 2004, Peachey and Roe, 2006). In mature bank-markets where different ownership types coexist, researchers find little evidence to suggest that SHFs are more efficient than the COOPs and NPOs (Altunbas et al., 2001, Crespi et al., 2004, ESBG, 2004). An unanswered question is, “Why is transformation of NPOs needed today when it wasn’t needed before?” Are policy advocates in the infant microfinance industry missing something?

3. Theory and methodology

Like Hansmann (1996) we do not advocate any particular type of ownership. Instead we search for non-legal (La-Porta et al., 1998) and non-historic (Bebchuk and Roe, 1999) variables which influence the cost of ownership in different organizational types. We concentrate our analysis on SHFs, COOPs and NPOs. SHFs are firms limited by shares like banks and non-bank financial institutions (NBFI) owned by investors whether they are profit seeking or social investors, individuals or organizations. COOPs are customer owned organizations like credit unions, building societies, savings and credit cooperatives etc. NPOs are organizations without any legal owners. We recognize that organizational objectives are not necessarily uniform within the same ownership type. Yet, we follow Hansmann’s logical reasoning that the intrinsic differences between SHFs, COOPs and NPOs lie in who controls the organization and who receives the profit from it. In a SHF, the shareholders control the organization, decide on how to distribute the profits and are free to sell their privileges. In a COOP, the ultimate control is in the hands of its members who through their voting rights, can decide on policy issues. The members are also the only ones entitled to receive the proceeds from the operations either through dividends or rebated prices on services. A NPO

may have several stakeholders influencing the organization. However, no particular group or person can legally claim ownership of it or receive residual earnings from it.

As Hansmann (1996) we view the firm as a nexus of contracts between different patrons and the firm (Jensen and Meckling, 1976). In MFOs the main patrons are employees, credit customers, savings customers, debt holders, equity holders and donors.² There are two possible relationships between the firm and the patrons. First, the patron deals with the firm through market contracts, and second, the patron can also be the owner of the firm. Both these relationships involve costs, and by analyzing these ownership types can better be understood and compared.

Market contracts are not costless. Market failures like absence of effective competition and substantial informational disadvantages, prevail in the microfinance industry (Porteous, 2006). In all the relevant markets - employees, customers (both savings and credit), debt holders, equity holders and donors - market imperfections exist. According to Hansmann the costs of market imperfections can be reduced by assigning ownership to the affected patrons or avoid having owners (NPOs). For the purpose of this paper we will concentrate on market failures affecting customers and, when relevant, donors.

The practice of ownership involves costs. Agency costs, derived from the separation of ownership and control, as well as the cost of collective decision making, are well known from the literature and will, together with other relevant costs related to ownership, be studied in this paper. The assumption is that whether assigning ownership of MFOs to investors, customers or nobody (NPOs), different costs will occur.

In our analysis we identify cost-variables found in or deduced from Hansmann (1996). We start with cost-variables related to market contracts followed by variables related to ownership. For each variable we compare the cost of SHFs with the cost of COOPs and NPOs. We end each comparison with a proposition indicating, all else constant, whether the ownership cost for the studied variable is higher or lower in COOPs and NPOs compared to SHFs. In section six we present a table summarizing our analysis by assigning the term 'higher' or 'lower' to each of the studied variables. We do not at any point try to indicate how much higher or lower the cost might be. When the analysis provides no clear indication, we assign the symbol '?'. We generally do not try to compare cost differences between COOPs and NPOs, but recognize also that there can be considerable differences between these ownership types. Occasionally in the text we make the reader aware of such differences. We do not claim that the cost-variables analyzed are all similar in importance. Nor do we claim that we cover all relevant cost-variables.

4. The costs of market contracts

According to Hansmann (1996), the costs of market imperfections can be reduced by ownership assignment. In the following we analyze cost-variables identified by Hansmann and apply them to the microfinance industry. We discuss how the costs of market contracts vary depending on whether the supplier of microfinance is a SHF, a COOP or a NPO.

Market variable # 1: The cost of limited competition

Customers pay the price of limited competition in microfinance markets; First, in the form of high interest rates on loans or low interest on savings offered by monopoly/oligopoly MFOs, and second in the form of under-consumption, or no consumption at all, of important banking services. Some microfinance markets, especially rural, have no formal supplier of financial

services at all (Christen et al., 2004, Robinson, 2001). Where MFOs exist, the markets are normally characterized with a severe lack of competition, and most clients have limited bargaining power vis-à-vis the provider of microfinance. However, exceptions exist. In Bolivia where competition has been increasing, the average annual yield has decreased during the last decade from 50% to just above 20% in the leading MFOs (Porteous, 2006).

In a situation with limited competition all MFOs, regardless of ownership, lack an important incentive to streamline operations. However, all else constant, since SHFs have owners with the right to appropriate the organizations' profits they have a stronger incentive than NPOs and COOPs to exploit their customers. Hence, on average the following proposition should hold:

Proposition # 1:

The ownership-cost related to limited market competition is lower in NPOs and COOPs than in SHFs.

Market variable # 2: The cost of “lock-in” market power

Monopolistic exploitation can occur also after beginning to patronize with a MFO. The use of non-tangible collaterals, like credit history and group guarantees, has been the main innovation in microfinance and has made it possible for MFOs to mitigate the risk of lending (Aghion and Morduch, 2005, Ghatak and Guinnane, 1999). However, an unexplored side effect of the innovations can be that they may increase the difficulty in shifting between credit providers. If a credit-group wants to shift from one MFO to another, all the members have to jointly agree. Single members wanting to shift need to be accepted into new credit-groups. Similarly, the importance of credit history in lending appraisals may lead to a lock-in

situation. Normally clients start with a small loan. From here a credit history can be built and increases in loan amounts can often be expected (Aghion and Morduch, 2005). Yet, credit history is an intangible asset which in markets without effective credit rating bureaus is difficult to transfer from one MFO to another.

The cost of “lock-in” market power in the microfinance industry has not, as far as we know, been subject to major research efforts. However, as competition in several markets is increasing and the need to remain in good standing with a single lender decreases (Vogelgesang, 2003), it becomes increasingly important with contracts that allow an easy shift of suppliers. Marr (2006) provides insight into the complexity of establishing new credit groups. Hence, if we accept that group lending and credit history make it more difficult to shift between suppliers, then the cost of lock-in can be mitigated by assigning ownership to customers (COOPs) or ownerless organizations (NPOs) with fewer intrinsic incentives to exploit the customers.

Proposition # 2:

The ownership-cost related to “lock-in” market power is lower in NPOs and COOPs than in SHFs.

Market variable # 3: The cost related to the risk of long-term contracting

Most microfinance services offered today are short term services like demand or short time deposits, money transfers and credit for working capital or emergencies (Aghion and Morduch, 2005). However, important banking services like insurance, longer term time deposits, business credits to finance fixed assets, agricultural credit, credit for higher education and housing all require longer term contracting. Yet, in countries with highly

volatile markets (employment, commodities etc.), where contract law and enforcement is inadequate and public regulation is a scarce resource (Todaro and Smith, 2006), such long-term contracting is problematic. Offering 30 years repayment time on housing loans would in most microfinance markets be a significant risk for both the customer and the MFO.

By making the customers the owners of the firm, the cost of long term contracting can be mitigated. What customers might lose as customers, they will gain as owners, and vice versa. This variable therefore supports the existence of COOPs.

When it comes to comparing this variable between SHFs and NPOs, neither the theory nor the evidence as we know it, indicate differences in costs between the two organizational types.

Proposition # 3:

The ownership-cost related to the risk of long term contracting is lower in COOPs than in SHFs.

The cost of asymmetric information

Asymmetric information increases the cost of market contracting. In microfinance, a situation of asymmetric market information is present in particularly four relationships; MFO – borrowers, MFO – depositors, MFO – donors and MFO – debt holders, the latter being outside the scope of this paper.

Market variable # 4: The cost of asymmetric information between MFOs and borrowers

In a principal – agent model the principal, the MFO, knows little about how the agent, the borrower, will use a loan or if the loan will be repaid. Hence, all banks establish expensive

screening and selection processes together with follow up and monitoring of the customers to minimize agency-costs (Freixas and Rochet, 1997). In addition, microfinance often mitigates these risks through the use of group guarantees. Involving neighbors, family members and friends in selecting and monitoring clients reduces the costs of adverse selection and moral hazard. In addition, a borrower will be less inclined to default when knowing that friends and family members will have to bear the loss. To further decrease the cost of asymmetric information, ownership of the MFO can be fully assigned to the borrowers, like in a credit cooperative. However, a well known challenge in larger COOPs is individuals exploiting the firm at the expense of other borrowers. This is probably why most COOPs have difficulties in expanding outside their local communities, and why a common bond between the members is seen as a prerequisite for successful COOPs (Magill, 1994).

When it comes to comparing the costs in SHFs and NPOs, neither theory nor evidence (as far as we know) provide sufficient indications to indicate differences between the ownership types.

Proposition # 4:

The ownership-cost related to asymmetric information between the MFO and the borrower is lower in COOPs where the members have a strong common bond than in SHFs.

Market variable # 5: The cost of asymmetric information between MFOs and depositors

One of the banks' major functions is to monitor borrowers on behalf of depositors (Freixas and Rochet, 1997). However, the depositors are in a poor position to determine exactly how the bank is managing their money (Diamond, 1984). Since the owners of SHFs don't share profit but only losses with their depositors, they have pecuniary incentives for opportunistic

behavior, including risky lending (Jensen and Meckling, 1976, Hansmann, 1989, Rasmussen, 1988).

In several SHFs most shareholders are NPOs, socially oriented funds or donors with limited incentives to exploit depositors (Goodman, 2005, Ivatury and Reille, 2004, Ivatury and Abrams, 2005). Yet, there is a strong push in the industry to attract more profit driven investors, both local business people (Jansson et al., 2004) and international investors (Ivatury and Reille, 2004, Abrams and Stauffenberg, 2007). Since owners of SHFs are free to sell their shares and several donors have a limited time horizon to their investments, more profit minded investors will probably enter the industry in the years to come. Consequently the agency costs derived from asymmetric information between SHFs and customers will probably increase.

As a response to asymmetric information between banks and depositors, governments impose regulation and deposit insurance schemes. Today, even a country like Congo (DRC), crippled by conflict and poverty, has a banking law aimed at reducing depositors' risk. During the last decade emphasis has been placed on how to effectively regulate microfinance operations and organizations, and most of the important bilateral and multilateral agencies have commissioned policy documents and guidelines (Berenbach and Churchill, 1997, C-GAP, 2003, Chavez and Gonzalez-Vega, 1994, Christen and Rosenberg, 2000, Greuning et al., 1998, Hardy et al., 2002, Jansson et al., 2004, Staschen, 1999). However, what seems generally overestimated is the capacity of such schemes to effectively monitor institutions in countries where corruption blossoms and banking authorities are generally weak. Another issue seemingly not being taken much into account is how the presence of deposit insurance schemes encourage SHFs to take on more risk than COOPs (Fisher and Fournier, 2002).

To minimize the agency costs related to asymmetric information between depositors and MFOs, ownership can be attached to the depositors (COOP) or it can be given to an organization without owners (NPO), with fewer incentives to exploit depositors.

Proposition # 5:

The ownership-cost related to asymmetric information between the MFO and the depositors is lower in COOPs and NPOs than in SHFs.

Market variable # 6: The cost of asymmetric information between MFOs and donors

Donors play a major role in the microfinance industry (C-GAP, 2004a), and their existence influences ownership structures. Donors, as depositors, do not know precisely how MFOs use the money received. Even though (some) donors impose costly monitoring schemes like auditing, rating, follow up visits and on-site experts, there is still a considerable risk that the MFO will distort the use of a donation. Therefore, since NPOs have no owners and implicit fewer incentives to exploit donors; all else being equal, donors prefer contracting with NPOs (Easley and O'Hara, 1983, Glaeser and Shleifer, 2001, Hansmann, 1996). In addition, several donors face legal constraints in partnering with SHFs since the shareholders can appropriate donors funds (e.g. the Danish and Norwegian agencies for development, DANIDA and NORAD). Regarding COOPs, we assume that most donors find it relatively unproblematic to provide funds, so long as the members are below a defined poverty level.

If we accept that in theory, donors prefer to partner with NPOs and COOPs with poor members, how can we explain an increasing number of donors joining the bandwagon of recommending NPOs to transform into SHFs? We believe that the answer(s) are partly found

in understanding the combined effect of the 12 variables studied in this article, but recommend additional research aimed at better understanding donors' behavior. However, *ceteris paribus*, we assume that the following proposition holds:

Proposition # 6:

The ownership-cost related to asymmetric information between the MFO and the donors is lower in NPOs and COOPs serving poor members than in SHFs.

5. The cost of ownership-practice

Hansmann (1996) argues: *[...] ownership has two essential attributes: exercise of control and receipt of residual earning. There are costs inherent in each of these attributes*" (Hansmann, 1996, p. 35). In what follows we analyze six cost-variables related to what we call "the practice of ownership".

The cost of controlling managers

With a few exceptions (e.g. PT Bank Dagang Bali in Indonesia) the owners and the managers of MFOs are separate bodies where the first delegates most decision making authority to the latter. The separation of ownership and management leads to agency costs (Fama and Jensen, 1983b, Jensen and Meckling, 1976, Fama and Jensen, 1983a). Hansmann (1996), defines these agency costs as: *"the sum of the costs incurred in monitoring [the management] and the costs of managerial opportunism that result from the failure or inability to monitor with complete effectiveness"* (Hansmann, 1996, p. 38). We start by analyzing the monitoring costs followed by studying the costs of managerial opportunism.

Ownership variable # 1: The cost of monitoring the management

The cost of monitoring management can, according to Hansmann (1996), be divided in three: 1) owners' costs of informing themselves about the operations, 2) the cost of communicating between the owners, and 3) the cost of communicating owners' decisions to the management. These costs depend on the importance, frequency and duration of the relationship between the owner and the firm.

Members of COOPs entrust their valuable savings, make frequent use of the services and often continue being members over a long period of time. Normally members live relatively close to each other and in the neighborhoods of the COOP. This could indicate that COOPs have an advantage compared to other forms of MFOs. However, a major problem in large COOPs is the high number of owners which leads to a substantial duplication of effort in becoming informed. The high number of owners also leads to a problem of "free riders" where each and every one has little incentive to effectively control management. Therefore, cooperatives generally require costly and bureaucratic processes to keep the members informed and alert (Normark, 1996). There is the additional challenge that many members of cooperatives have low levels of literacy and numeracy and limited knowledge about monitoring managers and banking operations. Therefore, even though members have personal incentives to monitor management, the overall monitoring costs in COOPs, particularly in large COOPs, are generally high.

Some argue that NPOs don't have costs of monitoring management since there are no owners to inform or to communicate with. The fact is quite different. Most organizations, including NPOs, delegate monitoring to boards (Fama and Jensen, 1983b). Board members in NPOs are mostly middle and upper class professionals (Lapie, 2001). Some of these pay high importance to their duties, but generally NPOs struggle to recruit board members who are

willing to dedicate the time and effort needed to effectively oversee the operations (Labie, 2001). To balance the need for professional board members, some NPOs have members from international donors sitting on their boards (e.g. several of the FINCA affiliates). While this might improve the oversight of operations it also increases the costs of communications, travels, board fees etc.

Most SHFs have few owners. This reduces the cost of monitoring; yet, with more than one owner the cost of duplication of efforts cannot be avoided. An element pushing the cost is the number of owners situated in the north while most MFOs operate in the south, and often ownership is shared between distant owners [e.g. European and American] (Goodman, 2005). Nevertheless, on average, there are good reasons to believe that the costs of monitoring managers in SHFs are generally considerable lower than in COOPs and NPOs.

Proposition # 7:

The ownership-cost related to monitoring managers is higher in COOPs and NPOs than in SHFs.

Ownership variable # 2: The cost of managerial opportunism

When ownership and control are separated, it is impossible to completely prevent managers from getting involved in self-dealing transactions – those not fully aligned with owners' interests. Owners with strong incentives to monitor management can reduce these agency costs. Pecuniary incentives, where individuals or organizations can directly benefit from improved operations, are assumed to be strong. Hence, profit-motivated owners should be more competent in reducing agency costs. This logic is implicit in most ownership literature

and is highlighted by microfinance policy makers advocating the need for owners with their own money at stake (Helms, 2006, Jansson et al., 2004).

Yet, history has proven that large groups of firms, like nonprofit hospitals and savings banks, have been able to survive without having owners with personal pecuniary incentives to control management. This indicates that there must be alternative mechanisms to ownership control that keep managers working hard. The often mentioned alternative mechanisms are; competition, legal and moral constraints, public regulation, incentive pay aligned with owners' interests, and the management labor market (Hansmann, 1996).

However, it should not be forgotten that most MFOs operate in countries ripe with corruption, where the legal frameworks are mixed (at best), law enforcement is weak and effective government regulation is, to put it mildly, uncertain. Therefore, there are good reasons to believe that the effects of some of the alternative governance mechanisms are more limited in most microfinance markets. Similarly, as mentioned, competition is in most markets still weak. Adding to this is the challenge related to the lack of managerial capacity in the industry (C-GAP, 2004b) which reduces managers' incentives to improve performance. Since no better options are available for the owners, managers continue to produce slack results.

Increased use of incentive pay could solve some of MFOs' governance challenges. However, aligning the interest of banking managers too much with the interests of owners with pecuniary incentives is problematic in banking firms, since this could induce managers to take higher risks at the expense of depositors and other debt holders (John and John, 1993).

Labie (2003) suggests that organizational culture and cross-control between managers plays a major role in controlling NPO managers. We share his view, but on average, consider it generally difficult for MFOs to balance the lack of ownership control with other mechanisms so as to minimize managerial opportunism. Hence, SHFs have an advantage compared to COOPs and NPOs.

Proposition # 8:

The ownership-cost related to managerial opportunism is higher in COOPs and NPOs than in SHFs.

Ownership variable # 3: The cost of collective decision making

When ownership is shared between different owners there are likely to be different opinions regarding policies and strategies. The universal approach to dealing with this problem is to adopt a voting scheme. However, regardless of being able to reach a decision with the help of a predefined voting scheme, heterogeneity in interests between owners results in increased costs of collective decision making. These costs can, according to Hansmann (1996), be divided into three groups: 1) decisions taken which are not aligned with all owners' interests, 2) the often considerable time and effort it takes to participate in the decision making process and, 3) resolving conflict between owners.

In theory, investors have a single well-defined objective - to maximize the financial returns on their investments. However, owners of SHFs are a heterogeneous group consisting of profit seeking investors, "green" investors, donors with holistic motivation and multilateral agencies like the IFC of the World Bank (Ivatury and Reille, 2004, Goodman, 2005). When these types of owners are to align their preferences, the cost of collective decision making increases.

As mentioned, some NPOs have transformed into SHFs. As far as we know, no study is available regarding the cost of collective decision making in these transformed organizations. Yet, it is probably not an understatement to assume that they can often be relatively high. Elisabeth Rhyne (2001) describes how different owners in Banco Sol in Bolivia (transformed from Prodem) at certain stages struggled to maintain control with one block pushing hard for faster profits while another block was seeking to maintain Banco Sol's unique microfinance identity. This power-play is costly. Nevertheless, to improve monitoring and decrease agency costs, policy advocates continue to recommend the inclusion of profit minded investors as a counterweight to domination by the original NPO (Jansson et al., 2004). Whether the benefit of including profit minded owners outweighs the cost of having owners with diverging interests should be the subject of further research.

In COOPs there is a diverging interest between net-borrowers and net-depositors (Ledgerwood, 1999). Balancing the interests of depositors and borrowers, where depositors push for increasing deposit interest rates and minimizing risk in lending, and borrowers push for reduced interest rates and increased lending risk, is a costly and difficult task. Still, Falkenberg (1996) suggests that the diverging interests between net-borrowers and net-depositors can be an effective mechanism to reduce the costs in cooperative enterprises. Having some owners claiming higher interest rates on their deposits and other owners claiming reduced interest rates on loans can impose slim and efficient operations. However, at the same time, to maintain success, COOPs need to invest in time consuming communication processes between members and management. Cooperatives can easily develop into bureaucracies or management controlled organizations (Spear, 2004, Normark, 1996,

Cornforth, 2004, Rasmussen, 1988). Therefore, we suggest that the cost of collective decision making is higher in COOPs than in SHFs.

Since NPOs are governed by missions and bylaws and not by owners, it can be argued that the cost of collective decision making is limited. However, missions change and their interpretations vary. Trustees and founders often diverge in opinion, and board meetings can be temperamental. Therefore, we find it difficult to propose whether the cost of collective decision making is higher or lower in NPOs than in SHFs.

Proposition # 9:

The cost of collective decision making is higher in COOPs than in SHFs.

Ownership variable # 4: The costs related to access to equity capital

The type of ownership influences access to equity capital. NPOs have no other sources to draw upon other than excess earnings and uncertain funding from donors. COOPs can also turn to their members. Further growth in NPOs is hampered by a severe equity constraint (Gibbons and Meehan, 2002), and the ability of COOPs to attract extra capital from their generally poor members is limited. The possibility of increased access to equity capital is a major reason for transforming from NPOs to SHFs (Fernando, 2004).

SHFs are unrivalled when it comes to possible access to equity capital. There are a limitless number of sources and the available capital is almost infinite. Many commercial investors have entered or are about to enter the microfinance industry (Ivatury and Abrams, 2005, Ivatury and Reille, 2004, Goodman, 2005, Abrams and Stauffenberg, 2007). By mid-2004 commercially oriented, but still donor dominated, investment funds had invested nearly US

\$1.2 billion, as loans or equity, in about 500 MFOs. Most of the investment was concentrated in a small number of SHFs (Ivatury and Abrams, 2005).

Proposition # 10:

The ownership-cost related to access to equity capital is higher in NPOs and COOPs than in SHFs.

The costs related to capital “lock-in”

Capital “lock-in”, defined as the difficulty of disinvesting capital, can be studied from at least two angles: capital efficiency and service availability.

Ownership variable # 5: The costs of capital efficiency as a result of capital “lock-in”

If NPOs are inferior in accessing equity capital, they are even more sluggish when it comes to reducing capital investment when demand declines. As competition increases, some NPOs risk being overcapitalized. Nimal A. Fernando, the microfinance specialist of the Asian Development Bank, raises the question as to whether the NPOs BRAC and ASA in Bangladesh have too much cash on their hands.³ Another example is Diaconia FRIF in Bolivia, with total capital of more than USD13 million where nearly 98% is equity.⁴ While a SHF can easily move capital from managers’ hands to owners’ hands, the capital placed in a NPO is either lost or stays with the institution until its dissolution.

Similar to a SHF, a COOP can pay dividends, either in cash or as rebated prices on services, and thereby reduce its capital investment. However, this is not easily done since COOP managers tend to be powerful (Rasmussen, 1988). Hence, on average, SHFs are also more effective in capital disinvestment than COOPs.

Proposition # 11:

The ownership-cost related to capital efficiency as a result of capital “lock-in” is higher in NPOs and COOPs than in SHFs.

Ownership variable # 6: The costs of service availability as a result of capital “lock-in”

“Lock-in” of capital can be an advantage for poor households. When capital cannot be moved, the services cannot easily be taken away from the customers. When SHFs decide to close operations or shift to more profitable market segments, NPOs will normally tend to stay in business even if their financial return is far below a regular market return. This is also true for COOPs who cannot abandon their own members.

The risk of capital divestment is similar to what in the microfinance industry is termed “mission drift” (Woller, 2002). Christen (2001) reported little evidence of mission drift in transformed SHFs in Latin America, while Woller (2002) argues that mission drift is inherently more evident in SHFs than NPOs. What should also be kept in mind is that today’s owners of a SHF are not necessarily tomorrow’s. Most investors, including those seeking a double bottom line, naturally seek opportunities with increased returns.

Also, studies from other sectors, like US health centers, indicate that nonprofits perform better than the for-profits in serving the underserved (Khoury et al., 2001).

Proposition # 12:

The ownership-cost related to service availability as a result of capital “lock-in” is lower in NPOs and COOPs than in SHFs.

6. Comparing ownership types

Table one summarizes the analysis in sections four and five. Based on an extension of Hansmann's theory, we propose that cost-variables related to microfinance market contracts generally favor NPOs and COOPs, whereas most cost-variables related to the practice of ownership favor SHFs.

Insert table one here

The 12 propositions are a starting point for better understanding the cost of ownership in MFOs. These propositions should become the subject of hypothesis development and empirical testing. Local contexts are likely to affect the importance and effect of the cost-variables. However, we assume that in most markets, the different variables will follow the patterns proposed in the propositions.

7. Conclusions and implications

In this article we have studied the cost of ownership in microfinance organizations. Our analyses indicate that the costs of microfinance market contracts are generally higher in SHFs than in COOPs and NPOs, while the costs of ownership-practice are lower in SHFs than in COOPs and NPOs. The proposed lower costs of ownership-practice in SHFs provide strong support for the continued promotion of this ownership type as well as the welcoming of new investors into the industry. Nevertheless, such promotion should not be done at the expense of COOPs and NPOs who, according to our analyses, can more effectively mitigate the costs of

market contracts. Such mitigation is highly relevant since most microfinance organizations (MFOs) operate in severely inefficient markets. Probably the development of markets with a mixture of the different ownership types is what best serves the customers.

Comparing our propositions with policy papers indicates that policy advocates consider the costs of ownership-practice to be more important than costs related to market contracts. Whether this is based on a comprehensive analysis remains unanswered. However, we propose that the costs of market contracts have not been sufficiently included when advocating ownership types in the microfinance industry. Certainly the problems related to asymmetric information between depositors and MFOs are being debated. Yet, the response to these problems, through prudent regulations, supervision and deposit insurance schemes, seems to be inadequate. In developing economies suffering from very weak institutional frameworks as well as imperfect markets and incomplete information (Todaro and Smith, 2006), installing prudent regulations seems far fetched.

Several policy papers seem to be guided by agency theory applied to the relationship between owners and management. In addition to this, we recommend future policy papers as well as academic research to broaden their theoretical perspectives. A better understanding of NPOs and COOPs and their possible role in market economies, particularly in the microfinance industry, is needed. Adequate use of stakeholder theory to help identify 'Who' and 'What' really counts in MFOs can help (Mitchell et al., 1997, Freeman, 1984, Freeman, 1994).

Also, history can help broaden the perspectives. For example, the history of the savings banks can probably provide important insights to better understand the existence of NPOs in the microfinance industry. As NPOs today, also the first savings banks were in need of equity

capital from donors; either wealthy philanthropists, local authorities or community funds like corn chambers meant for lean years. The NPO ownership type, still present in most savings banks, gave the donors the assurance they needed to support the new initiatives. However, as the banks grew and started to depend more on commercial funding and deposits, the nonprofit form was kept, but now as a response to asymmetric information between depositors and the banks (Hansmann, 1989, Hansmann, 1996, Pampillon, 2003, Ograda, 2003, Pohl, 2003, Rønning, 1972). A question which remains unanswered is why transformation of NPOs into SHFs is needed today when it wasn't needed before. Legal frameworks provide a part of the answer, but shouldn't policy advocates then be concerned with adapting the frameworks to NPOs' and COOPs' needs? The history of the savings banks and their continued success in several markets should demonstrate that being commercially oriented and mobilizing savings is not necessarily incompatible with being an NPO.

Imperfect markets and exploitation of customers are likely to continue in most developing countries for several decades. At the same time, some donors will continue to search for partners with less intrinsic motivation to exploit them. Hence, we expect COOPs and well performing NPOs to continue to play an important role in the microfinance industry. However, this is only possible if adequate legal and policy support is given. Historically, support of novel ownership forms has been important to underpin the growth of pro-poor banking systems like the savings banks in England and Norway, the cooperative banks in Germany and the savings and credit associations and the mutual savings banks in the USA (Teck, 1968, Hollis and Sweetman, 1998, Rønning, 1972). Therefore, if COOPs and NPOs are to continue to play a dominant role in the industry, alongside the needed SHFs, they will need better policy and legal support. Further research on how to better understand and support NPOs and COOPs is needed.

Notes:

1. www.woccu.org
2. Service providers including rating agencies, networks, auditors, credit bureaus, providers of technical assistance etc. are also important patrons of MFOs. However, they are considered outside the scope of this article.
3. Question raised by Mr. Fernando on the 25th of September 2006 at the devfinance@ag.ohio-state.edu discussion list.
4. Rating report 2006, www.planetrating.com

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Table 1: Ownership costs in Cooperatives and Nonprofits compared to Shareholder Firms

Proposition number	COST VARIABLES:	COOPs	NPOs
	<u>Cost of market contacts:</u>		
1	Limited competition	Lower	Lower
2	“Lock-in” market power	Lower	Lower
3	Long-term contracting	Lower	?
4	Asymmetric information, MFO – borrowers	Lower	?
5	Asymmetric information, MFO – depositors	Lower	Lower
6	Asymmetric information, MFO – donors	Lower	Lower
	<u>Cost of ownership:</u>		
7	Cost of monitoring	Higher	Higher
8	Cost of managerial opportunism	Higher	Higher
9	Cost of collective decision making	Higher	?
10	Access to equity capital	Higher	Higher
11	Capital efficiency as a result of capital “lock-in”	Higher	Higher
12	Service availability as a result of capital “lock-in”	Lower	Lower