

## Lenders' Guidelines for Setting Covenants in Support of Responsible Microfinance

As socially responsible microfinance investors, we are committed to push for the use of reasonable financial covenants and social undertakings when building debt cooperation with microfinance institutions (MFIs). This is the reason why, since June 2011, we have been working on the creation of the “Lenders’ Guidelines for Setting Covenants in Support of Responsible Microfinance” (the Guidelines).

We believe that these guidelines describe “reasonable covenants”, i.e. covenants that can contribute to ensure that our MFI partners adopt a “responsible financing” behavior which can ensure that their end clients are not harmed.

The Guidelines encompass a set of seven financial covenants and two social undertakings, as well as a proposal for common language defining borrowers’ and lenders’ behavior in case a breach of covenant would occur.

The intent of the Guidelines is not to dictate the use of a specific list of covenants and undertakings to investors, but rather to provide practical guidance on the areas to take into consideration when setting up covenants and undertakings in loan agreements.

The Guidelines also recognize that, depending on the specifics of the considered debt partner, flexibility in the setting up of the covenants can also be justified to the extent that it remains within the spirit of responsible behavior that these guidelines aim to promote.

### a) Financial covenants

		Formula	Definition	Level	Adjustment
<b>A</b>	<b>Financing Structure</b>				
A.1	For unregulated institutions:  For regulated institutions:	Debt to equity ratio (incl. Tier 2 capital)  Capital Adequacy Ratio	Total liabilities / Total Equity (Including Tier 2 capital using the Basel II rule when possible)  Total (core) capital / Risk-weighted assets (according to Basel II rule when possible)	< 5/1  According to national regulations	The level of the covenant could be increased if it is clear that an equity increase and/or the disbursement of a subordinated debt are pending within a reasonable timeframe after disbursement. In this case, the loan agreement shall mention the timeframe during which the level of the covenant will temporarily be higher than usual. The formula of this covenant excludes back to back loans.
A.2	For unregulated institutions:  For regulated institutions:  For all institutions:	Net un-hedged foreign currency open position to equity	(Total assets in foreign currency) - (Total liabilities & equity in foreign currency) / Total equity (including Tier 2 capital)	< 35%  According to national regulations  In complying with this covenant, the Borrower shall endeavor not to pass FX risk on to its clients by agreeing on a ceiling of the level of hard currency loans extended to its clients as a % of its GLP. Such ceiling will be decided on a case by case basis and acceptable to both the Lender and the Borrower.	The level of this covenant could be increased if it is clear that appropriate local hedging mechanism exist and that such ratio will be reduced to 35% within a reasonable timeframe after disbursement of the loan.  In this case, the loan agreement shall mention the timeframe during which the covenant will temporarily be higher than usual. The formula of this covenant excludes back to back loans.

<b>B</b>	<b>Efficiency and Profitability</b>				
B.1	For all institutions:	Return on Assets	(Net operating income - taxes) / Average total assets	> 0% < 10%	We recognize that in the case of start-up institutions which might not have reached break even yet, the level of this covenant could be temporarily decreased to below 0%. In this case, the loan agreement shall mention the timeframe during which the covenant will temporarily be lower than usual.
<b>C</b>	<b>Portfolio Quality</b>				
C.1	For all institutions:	PAR30 + renegotiated"	Outstanding balance of portfolio overdue > 30 days + outstanding balance of renegotiated loans (including rescheduled and refinanced loans) / Outstanding gross loan portfolio	< 5%	In certain countries where MFIs are operating in very challenging operational environments, or have not reached sufficient operational maturity yet, the covenant could be set at a higher level.  We recognize that imposing a too low covenant level to an MFI in time of crisis might tempt the MFI to: i) accelerate its disbursement rate to increase its gross outstanding portfolio to hide portfolio quality issue; ii) swap its PAR 30 loans with another financial institution if possible. Therefore, in cases where it is clear that the institution is facing exceptional portfolio quality issues, there shall be a possibility of allowing the covenant to be increased.
C.2	For all institutions:	Annualized write off ratio	Annualized value of loans written off during the past 12 months / Average gross loan portfolio	< 3%	In case an institution is facing exceptional portfolio quality issues, there shall be consideration of allowing the level of this covenant to be increased if the institution has taken sufficient measures to ensure proper monitoring of the written off loans.  Such measures include but are not limited to: i) clear approval process involving head office staff and/or BOD when writing off; ii) independent monitoring of written off loans by dedicated staff with operation and/or legal experiences (e.g. collection unit, hiring of collection officer, legal trial, seizure of collateral, etc.)
C.3	For unregulated institutions:  For regulated institutions:	Risk coverage ratio (PAR 30+ rescheduled)	Loan loss reserve / (PAR30+ renegotiated)	>90%  According to national regulations	The level of this covenant could be decreased, if an institution has a majority of its outstanding portfolio guaranteed by fixed assets which have been registered, notarized, can be legally subject to seizure according to local legislation, and are easily resalable.
<b>D</b>	<b>Liquidity</b>				
D.1	For deposit taking institutions but not regulated:  For regulated institutions:	Liquidity Ratio	Liquid assets (assets of less than one year excluding short term portfolio) / Short term liabilities (less than one year)  According to national regulations	>10%  According to national regulations	In case institutions are facing temporary cash shortage that is justified, the level of this covenant can be temporarily decreased.

**b) Social Undertakings :**

1. Report relevant social performance indicators to the Mix Market on an annual basis.  
“Relevant” means that the MFI is not expected to report on all social indicators defined by the Mix Market but on the ones that are:
  - a. Considered in line with its social mission.
  - b. Considered possible for the institution to provide given possible technological constraints linked to its MIS.
2. Endorsement of the SMART Campaign on Client Protection Principles and progressive implementation of those principles within a reasonable timeframe
  - a. The institution is expected to formally endorse the SMART Campaign by becoming a signatory online.
  - b. The institution is expected to conduct a self-assessment of its client protection practices within the first three months following the start of the debt partnership.

**c) Guidelines of Good Practices in case of Covenant Breach**

In case of a breach of one or several of the covenants or undertakings mentioned above:

We would like to encourage our Borrowing Partners to commit to:

- Immediately report on the breached covenant/undertaking to the Lender, as well as to all other lenders applying such covenant/undertaking in their agreements;
- Within a maximum timeframe of fifteen (15) calendar days after the breach has been identified by the Borrower, provide detailed explanations, as well as a detailed action plan including the proposed timeline to correct and remedy the breach;
- If the breach continues to exist during a timeframe of thirty (30) calendar days, disclose the breach to all other lenders applying such covenant/undertaking in their agreements.

On the other hand, we, socially responsible lenders will strive to:

- In case the situation requires it (which excludes by way of example situations of temporary and minimal breaches, or accounting issues), to call for a meeting with as many other international microfinance lenders as possible, and with as many domestic lenders applying such covenant, in order to exchange views on the breach, to discuss on the conditions that would make the lenders comfortable to extend a waiver, and on the circumstances that would otherwise lead to stronger actions, including but not limited to mandatory prepayment and termination of the Agreement.
- Formally respond to the waiver request of the Borrower, if any, within a reasonable timeframe of around thirty (30) calendar days after reception.

The organizations that worked together towards the creation of the Guidelines and endorse the basic goal of such Guidelines, are the following”:

- Agora Microfinance N.V. and its affiliates
- BNP-Paribas
- Cordaid
- Deutsche Bank Global Social Investment Funds
- Incofin Investment Management
- Oikocredit
- SNS Asset Management
- Triple Jump

The organizations that worked together towards the creation of the Guidelines, already expressed positive feedback about the Guidelines, and/or are in the process of endorsing the basic goal of such Guidelines, are the following”:

- Agence Française de Développement (AFD) & Promotion and Participation pour la Coopération Economique (PROPARCO)
- Agencia Espanola de Cooperacion Internacional para el Desarrollo (AECID)
- Grameen Credit Agricole Foundation (GCAF),
- Overseas Private Investment Corporation (OPIC)