Lenders' Guidelines for Setting Covenants in Support of Responsible Microfinance

About the Guidelines

These Guidelines were devised by a group of "socially responsible investors", both public and private investors, in response to a desire for practical guidance when setting up covenants and social undertakings in their loan agreements to continuously encourage responsible microfinance. By providing a framework to harmonize, wherever possible, the definition of both covenants and undertakings, they intend to ease reporting constraints for MFIs.

Using the Guidelines

The Guidelines encompass an indicative set of seven financial covenants and three social undertakings, as well as an indicative common language defining borrowers' and lenders' behavior in case of a covenant breach.

It is recognized that the covenants herein may not be applicable or appropriate for all agreements in all circumstances. Hence, the Guidelines are not prescriptive, but can be adapted to business specifics of the considered borrower or to the local market context.

a) Financial covenants

		Formula	Definition	Level	Adjustment
A	**Financing Structure**				
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) According to national regulations or 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, it is suggested that the loan agreement mention the timeframe during which the level of the covenant will be higher. 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) (Where all indexed local currencies are considered foreign currencies and all hedged foreign currencies are considered local	< -/+ 35% According to national regulations In complying with this covenant, the Borrower shall commit not to pass FX risk on to its clients by agreeing on a ceiling of the level of hard currency loans extended to its	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, it is suggested that the loan agreement mention the timeframe during which the covenant will be higher than -/+35%. The formula should include all foreign currencies in the case that there are multiple foreign currencies. The formula of this covenant excludes back to back loans.

			currencies)	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.	
B	**Efficiency and Profitability**				
B.1	For all institutions:	Return on Assets	(Net operating income – taxes) / Average total assets	> 0%	In the case of start-up institutions which might not have reached break even yet, the level of this covenant could be set to below 0%. In this case, it is suggested that the loan agreement mention the timeframe by which the covenant will become positive.
C	**Portfolio Quality**				
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 FIs are operating in very challenging operational environments, or have not reached sufficient operational maturity yet, the covenant could be set at a higher level. Imposing a too low covenant level to an FI in times of crisis might tempt the FI to: i) accelerate its disbursement rate to increase its gross outstanding portfolio to hide a 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, it may be set at a higher level. In these cases, it is suggested that the loan agreement define the timeframe during which the covenant will be higher than 5%.
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+ renegotiated)	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.

D	Liquidity				
D.1	For deposit taking institutions:	Liquidity Ratio	According to national regulations Or Liquid assets* / Total Deposits (*) cash on hand + interest and non-interest bearing accounts and investment < 1 year	According to national regulations (if national regulation is considered adequate) >30%	The second ratio can be used for non-regulated institutions or for regulated institutions in countries where the prudential ratios provided by the regulators are not considered adequate or easy to monitor by the lender.

b) **Social Undertaking**

1. The Borrower commits to maintain an average annual ROA level below 7.5% (net of donor subsidies) during the term of the loan.
In the situation where the positive year end ROA (excl. donations) exceeds 7.5%, an investigation will be triggered, wherein the Borrower shall adequately provide the Lender with sufficient information to explain such profitability level and the multi-year trends related thereto. However, purely exceeding 7.5% will not be considered a reason for calling back the outstanding amount as there might be justification for an R0A to be higher than 7.5% in certain circumstances. The 7.5% line shall act as a threshold to engage the Borrower in a dialogue on its performance as part of the regular annual supervision process and reporting. This dialogue shall allow to determine the drivers of profitability and whether these drivers are excessive (irresponsible lending) or due to more efficient business operations.

2. Annual reporting of relevant social performance indicators to the Mix Market.
"Relevant" means that the Borrower is not expected to report on all social indicators defined by the USSPM/SPI4 and Mix Market but on the ones that are:
   i) Considered in line with its social mission;
   ii) Considered possible for the institution to provide given possible technological constraints linked to its MIS;
The Borrower is encouraged to use industry recognized social performance reporting tools such as the Universal Standards for Social Performance Management (USSPM)'s SPI4[1].

3. Endorsement of the SMART Campaign on Client Protection Principles (CPP) and progressive implementation of those principles within a reasonable timeframe.
"Reasonable" timeframe should be aligned with business plan / level of maturity of the Borrower.
   i) The Borrower is expected to formally endorse the SMART Campaign by becoming a signatory online.
   ii) The Borrower is encouraged to monitor its implementation of the client protection practices by using industry recognized tools such as the CPP module of the USSPM's SPI4.

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:

The Borrower is encouraged to:
- Immediately report on the breach to the Lender, as well as to all other lenders applying similar covenants/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.

Lenders are encouraged to:

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[1] The USSPM and SPI4 can be found at http://sptf.info/spmstandards/universal-standards

- 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 loan agreeements.
- 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":

- Agence Française de Développement (AFD)
- Agencia Española de Cooperación Internacional para el Desarrollo (AECID)
- Agora Microfinance N.V. and its affiliates
- BNP-Paribas
- Cordaid
- Deutsche Bank Global Social Investment Funds
- Grameen Credit Agricole Foundation (GCAF),
- Grassroots Capital
- Incofin Investment Management
- Oikocredit
- Overseas Private Investment Corporation (OPIC)
- PROPARCO
- SNS Impact investing
- Triodos Investment Management BV
- Triple Jump