Lenders' Guidelines
for
Defining and Monitoring Responsible Covenants in the Covid-19 context
(LGRC) Version 2.1, Updated for COVID Context
CLEAN Version September 18th 2020

Context

Faced with an unprecedented crisis, the investor community in inclusive finance succeeded in providing a highly coordinated response to support the sector during the COVID-19 pandemic, ensuring, amongst others, the provision of ongoing refinancing in a responsible manner, the set-up of handshake agreements and coordinating technical assistance (TA) initiatives, with the ultimate objective of enabling Financial Service Providers ("FSPs") to adequately respond to changes in business conditions and the opaque market conditions that arose with the onset of the pandemic.[1]

As early as Q2 2020, these FSPs started to experience consequences of the pandemic and the resulting lockdowns and government-imposed moratoriums. The full impact of the crisis is expected to materialize when moratorium periods end, as "COVID-19 restructuring" progressively migrates into Portfolio at Risk (PAR) numbers and provisioning levels, resulting in temporary and also more structural breaches of many covenants.

Several FSPs have proactively requested more flexibility and alignment on covenant definitions and on a transparent and efficient waiver process.

Recognizing the value of harmonized covenant definitions and calculations, the SPTF's SIWG had developed the *Lenders' Guidelines for Setting Covenants in Support of Responsible Finance Version 2.0 (the "LGRC")* in 2014 and which was revised again in 2016[2].

Building on the tools that are already generally accepted as market standards, and with the understanding that in times of crisis it is even more important, from both a risk management and a mission-related objective, to make sure to keep clients and staff at the center of decision-making and ensure they are protected, the SIWG investor group wishes to complement the LGRC to better reflect specific COVID-19 related effects and suggest a process for monitoring, data gathering, and managing breaches of covenants.

Objectives

Starting from the existing LGRC for a general approach towards defining covenants, this document provides additional guidance on alignment and adjustments to covenants linked to restructuring and

[1] For information on these initiatives, including the "MoU" – Memorandum of Understanding on "Coordination among MIVs in response to Covid 19") – and the "Pledge" on "Key principles to protect microfinance institutions and their clients in the COVID-19 crisis", see https://www.covid-finclusion.org/investors

[2] For the LGRC, see https://sptf.info/images/SIWG-Reasonable-Covenants-Updated-Dec2016.pdf. These were developed in response to a need for practical guidance when setting covenants and social undertakings in loan agreements, while continuously encouraging responsible finance. For easy reference, they are reproduced in the Appendix to this document.

moratoriums arising in the context of the COVID-19 crisis, and data required for tracking risks, forecasting and stress testing.

In particular, we aim to provide guidance with respect to:

1) **definitions of the financial covenants** linked to **portfolio quality** and **restructuring** taking into account the impact of the health crisis and in particular, **regulatory moratorium**;
2) the **treatment** and **management** of **breaches of covenants and waivers** under these current exceptional circumstances;
3) **responsible monitoring** of the impact of the crisis on **credit risk and solvency**, through collection of **forward-looking data** allowing for better risk assessment and forecasting, including stress tests, among others.

For the sake of clarity, the purpose of this document is <u>not</u> to provide or re-define appropriate levels for the financial covenants. In most situations, covenant levels must be tailored to the specifics of the FSP and its reaction to the crisis; limited information and high uncertainty with respect to the realization of the crisis do not allow to set new standardized and common limits.

<u>Lender's Guidelines</u>

1. Definitions related to COVID-19 rescheduling

We recognize the definitions and suggested formulas of financial covenants provided in the *LGRC* as generally accepted market standards[3], although we do understand that some fund specific requirements or institutional peculiarities may sometimes require deviation from the suggested standards.

At the start of the crisis, many countries imposed moratoriums on loan repayments, making it difficult to calculate the true level of the portfolio at risk. **In calculating portfolio ratios, it is suggested as a rule and to the extent possible, to follow the regulators' advice and continue this calculation post-crisis.**

In the absence of mandatory or voluntary regulatory guidelines, we recommend following the national or sector approach if any, or consider the approach presented by the Borrowers, subject to further analysis and comfort. Typical elements to be considered for analysis may include, but are not limited to:
- Imposed lockdowns and other restrictions in the country
- Rescheduling Period (Assuming typically moratorium or rescheduling period of 3 months)
- Type of rescheduling: Only principal or including interest

<u>In line with the general approach above, we suggest the following revised definitions:</u>

Problem Exposures means the sum of (a) loans overdue for more than 30 days or Portfolio At Risk 30 (PAR30) and (b) Regular Restructured Loans

[3] For Suggested Formulas and Suggested Levels, see https://sptf.info/images/SIWG-Reasonable-Covenants-Updated-Dec2016.pdf

Regular Restructured Loans means each exposure where any of the original terms have been modified in any way either through modifications of the prior loan contract / repayment schedule or through the signing of a new loan contract excluding:

(i) restructured loans that are included in the amount of loans overdue for more than 30 days (to avoid double-counting), but including loans that are overdue between 1 and 30 days;

(ii) situations in which the only change has been a conversion of the loan from hard currency to local currency, with appropriate adjustment in interest rate;

(iii) any Restructured Loans that have been performing (e.g., no payment defaults) for at least 3 consecutive months and

(iv) COVID Restructured Loans.

COVID-19 Restructured Loans shall be defined as loans **overdue** or **restructured** for a defined period of time in the context of government imposed or recommended moratorium or loans allowed to be classified as performing as per the regulator in the context of the COVID-19 crisis. It is understood that COVID-19 restructured loans shall exclude

(i) Loans that fall back in arrears for more than 30 days despite the moratorium, which shall be included in the loans overdue for more than 30 days (i.e. PAR 30). This is understood that loans falling back in arrears up to 30 days despite the moratorium shall be reported in the respective Problem Exposures category;

(ii) COVID Restructured Loans that are restructured again post moratorium or after the above defined period of time (upon such restructuring to be defined as 'Regular Restructured Loans'). This is understood that loans that receive more than one restructuring or grace period under the government imposed or recommended moratorium continue to qualify as COVID 19 Restructured Loans;

(iii) any COVID Restructured Loans that are performing for at least 3 consecutive months[4] or once the moratoria or grace period have expired.

The above definitions allow carving-out COVID-19 Restructured Loans from the original covenants on portfolio quality in a more consistent manner. **While it is generally accepted to exclude the COVID-19 Restructured Loans from the covenants, whenever possible, COVID-19 Restructured Loans shall be reported and monitored separately** as long as the restructuring, moratoria or grace periods are active, in order to be able to better track and monitor the migration and performance of the COVID-19 Restructured Loans "post-moratorium" (see also Section 3 below on Responsible Monitoring and Data Collection). New covenants can be considered separately for Regular Restructured Loans and COVID-19 Restructured Loans. New covenants shall be based on the Borrower's projections and forecasts. The Risk Coverage Ratio or Open Credit Exposure Ratio may be adjusted accordingly to reflect the exclusion of COVID-19 Restructured Loans.

Portfolio quality ratios excluding COVID-19 Restructuring may be reassessed at a later period (to be defined between the lenders and the borrower) upon more clarity on quality of the COVID-19 restructured portfolio.

2. Management of breaches

[4] This is understood that whenever covid restructured loans are defined at the regulatory level, one should follow the regulatory definitions to the extent possible, unless duly justified.

Best risk management practices recommend addressing breaches with waivers or amendments, typically based on Borrowers' projections. FSPs may also require formal waivers for regulatory or audit purposes.

In the context of the COVID-19 crisis, we recommend the following approach in case of breaches of covenants (from the least formal to the most formal):

- **No action** may be accepted for a short period of time (up to 3 months typically), for instance in the context of restructuring negotiations, handshake agreement discussions, or in the context of additional data collection or due diligence to obtain more clarity and information to re-define appropriate new covenant levels / waiver period.

- Less formal approach in the form of "**notification letter**" or "**acknowledgment letter**" may be accepted, acknowledging the breach while confirming no acceleration and reserving all other rights for a defined period of time (up to six months typically).

- **Formal waivers or amendments of specific covenants** defining effective period and eventual new levels of accepted financial covenants.

- For a new loan agreement, we recommend some **grace period**, also ranging up to 3 months, with the possibility of establishing staggered levels allowing the FSPs to return progressively to more normalized levels.

- **Handshake, standstill or more formal restructuring agreements are expected to cover breaches of covenants** and whenever possible, participants in the restructuring process may agree on a unified set of financial covenants and process to address breaches to be considered by the lenders. This is in accordance with the spirit of the MoU and Pledge[5].

It is also suggested to agree on the **timeframe** for the waiver during which the covenant will be in breach compared to the accepted level and the process for monitoring and reevaluation.

3. Responsible monitoring and data collection

In order to allow FSPs to adequately respond to the health crisis and support their borrowers, it is important that investors provide **flexibility** with respect to the definition of covenants and inclusion of COVID-19 restructured loans, and important for the investor community to monitor the evolution of these restructured loans and track potential migration into non-performing loans.

Even if lenders can acknowledge and waive COVID-19 restructured loans from this calculation, FSPs must continue to report on these restructured loans separately and regularly in a transparent way.

Both the MoU and Pledge commit to transparency, and the Pledge has section 2.2 devoted to shared information and reporting, specifying that information collected should be as minimally burdensome as possible and coordinated among the lenders. To that end, a group of MIVs developed a Crisis Assessment

[5] For the MoU and Pledge, see https://www.covid-finclusion.org/investors

and Monitoring Tool (CAT)[6] to reduce the reporting burden on investees during the COVID-19 crisis and collect timely and additional liquidity information.

The tool is complementary to existing lenders monthly reporting formats. It has three parts:

1. Regular (monthly) operational and liquidity reporting, including indicators such as level of collection, disbursements, number of branches operating, and qualitative information.
2. Monthly cash flows forecasts;
3. Ad-hoc reporting on lenders and refinancing, including a breakdown of loan obligation for more clarity and lenders compliance with handshake agreements or other coordinated actions.

Additional reporting beyond covenants may be required on portfolio provisioning, vintage analysis (on defaults and recoveries), cash flow forecasting, and stress tests.

As part of their responsible monitoring, the **lenders shall encourage FSPs to provide information on client and staff protection during this crisis** (when applicable and for information only) and to reinforce their commitment to client centricity as well as. This includes amongst other:

(i) ensuring great caution in handling its end clients, especially those that might have issues in repaying their loans - the FSPs shall ensure that their staff abides by the best practices in terms of debt collection practices and recoveries including actions that are prohibited from taking in case of default -,

(ii) collecting regular information to understand the situation and needs of clients, especially the most vulnerable,

(iii) treating staff responsibly, which includes protecting staff from health risks and making every attempt to limit staff retrenchment, even during potential cash shortages.

4. Forecasting and stress testing

Forecasting

In the early stage of the crisis, financial projections were difficult to provide given the volatility in the pandemic trajectory and extent of the crisis. Yet as the microfinance sector has embraced the "next normal", it is critical for FSPs to develop sufficient forecasting capabilities, to test and forecast the impact of the crisis on their financial sustainability, segment portfolio by sector, product, and/or region to identify which parts of the portfolio are more vulnerable to stress than others and forecast portfolio in arrears and provisioning levels, the effect on P&L and capitalization, write offs, and permanent losses. These forecasts will enable lenders to identify which remedial actions should be taken to support FSPs (extension of terms, waivers, covenant revisions, additional capital and terms) and make decisions on recapitalization, merger or liquidation.

The FSPs are encouraged to work with the lender(s) to provide the necessary information to properly forecast for the current year and support with budget for the coming years.

[6] The CAT is available here: https://sptf.info/working-groups/investors

Stress tests for FSP Borrowers

The COVID-19 pandemic creates both an urgency and a context for harmonized stress testing.

The traditional approach to the stress testing of financial institutions focuses on capital adequacy and solvency. There are several tools that have recently been developed (e.g., a structural framework for the joint stress testing of solvency and liquidity by the IMF[7] and a stress testing tool developed by BFA[8] to help institutions understand the leading indicators and potential outcomes of the crisis). The primary data required for these stress tests includes financial statements, inflows and outflows, maturity of liabilities, and up-to-date information on COVID-19's impact on the portfolio, including any government measures.

There is also a TA coordination group[9], and a forum for collecting information and tools relevant to the financial inclusion sector's response to the COVID-19 pandemic.[10]

Lenders are encouraged to provide assistance to their portfolio companies to apply these and other new tools and initiatives. If any model should be promoted, it should come from the FSPs or be initiated by the sector.

[7] https://www.imf.org/en/Publications/WP/Issues/2020/06/05/Liquidity-at-Risk-Joint-Stress-Testing-of-Solvency-and-Liquidity-49325
[8] https://docs.google.com/spreadsheets/d/1hT6SGkF1KH3s3WOcq5z0YsFbJaxmOfwH9tAKyQDudcA/copy
[9] https://www.ada-microfinance.org/en/covid-19-crisis
[10] https://www.covid-finclusion.org/

Appendix: Redacted Lenders' Guidelines for Setting Covenants in Support of Responsible Finance (LGRC) 2.0

The table below is an excerpt from the Lender's Guidelines which were finalized in 2016. ***The table is reproduced here as a reference only***. It is not the scope of this document to redefine these financial covenants. For the full covenants, including suggested definitions and levels, see https://sptf.info/images/SIWG-Reasonable-Covenants-Updated-Dec2016.pdf

		Formula	Comments in the Context of COVID-19
A	**Capital Adequacy / Solvency**		
A.1	For unregulated institutions	Debt to equity ratio (incl. Tier 2 capital) OR	
		Adjusted equity / Assets	
	For regulated institutions	Capital Adequacy Ratio	
A-2	For unregulated institutions	Net un-hedged foreign currency open position to equity	
	For regulated institutions	According to national regulations	
B	**Profitability**		
B.1	For all institutions	Return on Assets OR Cost to Income Ratio	rA view: consider it more useful to understand the bank's operating profitability under current operating environment

		Formula	
C	**Portfolio Quality**		
C.1	For all institutions	PAR30 + Impaired Restructured Loans	rA: Impaired Restructured Loans should be defined in line with the definitions above (Regular vs. Covid) so it is clear if Covid Restructured are excluded or included (we have seen both) TJ: suggest to delete “Impaired”
C.2	For all institutions	write off ratio	
C.3	For unregulated institutions	Risk coverage ratio (PAR 30 + Impaired Restructured Loans)	TJ: suggest to delete “Impaired”
	For regulated institutions	According to national regulations	
	FOR BANKS ONLY **As an alternative to C.1, C.2, and C.3,**	OCER (Open Credit Exposure Ratio)	rA view: this is the most crucial ratio for us, aligned with Eduoard’s comment that there are some ratios we can be flexible on, but we need to know how much equity is at risk. Our recommendation is to use for banks and non-bank FIs and to include a proportion (20-30%) of covid-restructured loans
D	**Liquidity**		
D.1	For deposit taking institutions	Liquidity Ratio	rA view: preference to include a coverage ratio, ie: for unencumbered liquid assets (i) to cover 3 months of liabilities for non-deposit taking institutions or (ii) as a % of customer deposits for deposit funded institutions