Lenders' Guidelines for Setting
Covenants in Support of Responsible Finance
Version 2.0 - Updated October 2016

About the Guidelines

These Guidelines were originally developed in 2014 and revised in 2016 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 finance.

Covenants are typically included in loan agreements to protect the Lender in case of deterioration in the Borrower's performance that could jeopardize future repayment of its obligations. If a covenant is breached, legal documentation allows the Lender to accelerate the loan.

As responsible investors, we also see covenants as tools to encourage good practices. We aim to finance the development of responsible, healthy institutions (FIs) that provide valued and appropriate products and services to their clientele and that operate in a financially sustainable manner. Financial sustainability allows FIs to be long-term partners for their clients as well as to repay obligations to their lenders.

The principal objective of these Guidelines is therefore to identify areas where lenders can reasonably set limits that promote sustainability in a healthy, responsible manner. As such, it is worth noting that the guidelines do not include those that may encourage institutions to take on excessively risky behavior or prioritize short-term profitability over long term sustainability: Setting high minimum growth targets, for example, or high minimum levels on Return on Equity.

A further important objective is that by providing a framework to harmonize, wherever possible, the definition of both covenants and undertakings, they intend to ease monitoring and reporting constraints for MFIs.

Using the Guidelines

The Guidelines encompass an <u>indicative set</u> of ten financial covenants and five social undertakings, as well as a framework for guiding borrowers' and lenders' behavior in case of a covenant breach. Standard calculation formulas are also suggested for each covenant.

It is recognized that the covenants herein <u>may not be applicable or appropriate for all agreements in all circumstances</u>. Hence, the Guidelines are not prescriptive, but can be adapted to business specifics of the considered borrower or to the local market context. It is also understood that not all Lenders will use all the Covenants specifically as they are detailed in this document and may have preferences for covenants that are similar in spirit though perhaps different in emphasis or calculation methodology. Lenders are nonetheless encouraged to harmonize their covenant definitions and calculations to those provided here in order to reduce the monitoring and reporting burden of FIs.

A) Financial covenants

Suggested ratios and levels:

		Definition	Suggested Formula	Suggested Level	Adjustment
A	**Capital Adequacy / Solvency**				
A.1	For unregulated institutions	Debt to equity ratio (incl. Tier 2 capital) OR	Total liabilities / Total Equity (Including Tier 2 capital using the Basel Accords[1] when deemed appropriate)	< 5/1	The formula of this covenant excludes back-to-back loans. Depending on the strength of the local national regulations and/or the borrower, lenders may choose to add a margin over the national regulatory standard for added protection.
		Adjusted equity / Assets	Total Equity (Including Tier 2 capital using the Basel Accord when deemed appropriate) / Total Assets	> 17%	
	For regulated institutions	Capital Adequacy Ratio	According to national regulations OR Total (core) capital / Risk-weighted assets (according to the Basel Accords when deemed appropriate)	According to national regulations	*CAR*: ratio of Regulatory Capital to Risk Weighted Assets • "Regulatory Capital" means the sum of the Bank's Tier 1 Capital and Tier 2 Capital, as calculated in accordance with the requirements of the [Regulator]. • "Risk Weighted Assets" means the aggregate of the Borrower's balance sheet assets and off-balance sheet engagements, weighted for credit risk in accordance with the requirements of the (Regulator]
A-2	For unregulated institutions	Net un-hedged foreign currency open position to	Total assets in foreign currency) -		The level of this covenant could be increased if it is clear that appropriate local

[1] http://www.bis.org/bcbs/basel3.htm

		equity	(Total liabilities & equity in foreign currency) [2] / Total equity (including Tier 2 capital)	< -/+ 25%	hedging mechanisms exist and that such ratio will be reduced to 25% 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 -/+25%. Conversely, in cases where foreign exchange volatility is particularly high, the limit could be set at a lower level (~20%) 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.
	For regulated institutions		According to national regulations	According to national regulations	
	For all institutions	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 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[3]			

		Definition	Suggested Formula	Suggested Level	Adjustment
B	**Profitability**				
B.1	For all institutions	Return on Assets	(Net operating income - taxes) / Average total assets	> 0%	In the case of start-up institutions that 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.

		Definition	Suggested Formula	Suggested Level	Adjustment

[2] All indexed local currencies are considered foreign currencies and all hedged foreign currencies are considered local currencies

[3] In alignment with SMART Campaign (http://www.smartcampaign.org/) and Universal Standards / SPI4 (http://www.cerise-spi4.org/)

C	Portfolio Quality				
C.1	For all institutions	PAR30 + <u>Impaired Restructured Loans</u>[4]	Outstanding balance of portfolio overdue > 30 days + outstanding balance of <u>Impaired Restructured Loans</u> / Outstanding gross loan portfolio	< 5%	Portfolio quality metrics tend to vary significantly from market to market, and in certain, more challenging operating environments, the covenant may be set at a higher level. Imposing a too low covenant level to an FI 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. If it is perceived that portfolio quality is only temporarily under strain, then it is suggested that the loan agreement defines the timeframe during which the covenant will be higher than 5% (or the level that is considered appropriate for the given country/ market under normal circumstances). Note as well that in some markets and/or for some institutions, PAR90 may be a more relevant indicator than PAR30, especially for FIs lending to Small and Medium Enterprises and for Leasing companies.
C.2	For all institutions	write off ratio	Value of loans written off during the past 12 months / Average gross	< 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

[4] See section "FOR BANKS ONLY" below for the definition of Impaired Restructured Loans.

			loan portfolio		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.) Note as well that write-offs may also be combined with PAR30 and renegotiated loans (or PAR90+ renegotiated loans as the case may be) as one overall portfolio quality covenant in order not to unduly influence the FI's write-off policy.
C.3	For unregulated institutions	Risk coverage ratio (PAR 30 + Impaired Restructured Loans [5])	Loan loss reserve / Outstanding balance of portfolio overdue > 30 days + outstanding balance of Impaired Restructured Loans	>90%	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. Again, as above, PAR90 may be a more appropriate indicator than PAR30 in some markets/ institutions especially for FIs lending to Small and Medium Enterprises and for Leasing companies.
	For regulated institutions		According to national regulations	According to national regulations	
	FOR BANKS ONLY **As an alternative to C.1, C.2, and C.3,**	OCER (Open Credit Exposure Ratio)	(Problem Exposures* – Loan Loss Reserve) / Tier 1	< 20%	* Problem Exposures means the sum of (a) loans overdue for more than 30 days and (b) Impaired Restructured Loans.

[5] See section "FOR BANKS ONLY" below for the definition of Impaired Restructured Loans.

			Capital		Impaired Restructured Loans means each exposure where any of the original terms have been modified in any way ("Restructured Loans"), 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; and (iii) any Restructured Loans that have been performing for at least 6 months.

		Definition	**Suggested Formula**	**Suggested Level**	**Adjustment**
D	**Liquidity**				
D.1	<u>For deposit taking instituti ons</u>	Liquidity Ratio	According to national regulations OR Unencumbered Liquid assets* / Total Deposits	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. * cash on hand + interest and non-interest bearing accounts and investment < 1 year, excluding pledged assets

B) Social Undertakings

Social Undertakings are typically not binding on the Borrower but including them in the loan documentation can raise the FI's awareness and underscores their importance to the Lender. Some suggested social undertakings include the following:

1. 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 and 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. [6]

2. Annual reporting of relevant social performance indicators to social data collection platform(s).
   "Relevant" means that the Borrower is not expected to report on all social indicators defined by the USSPM/SPI4, but only 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.

3. Commitment to develop a Social Performance Management system to implement social and environmental activities and monitor their performance in line with the industry standards on social performance management (Universal Standards for Social Performance Management).

4. Commitment to obtain a social rating or other external SPM assessment within a specific timeline

5. 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 the Lender to determine the drivers of profitability and whether these drivers are excessive (irresponsible lending) or due to more efficient business operations.

[6] The Universal Standards and SPI4 can be found at http://sptf.info/spmstandards/universal-standards

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 commits to:

- Immediately report on the breach to the Lender, as well as to all other Lenders applying similar covenants/undertakings 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, while requesting a waiver on the breach for the period for which it expects to be out of compliance;
- 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:

- Discuss the reasons for the breach and engage with the Borrower on the action plan for restoring compliance with the covenant;
- Formally respond to the waiver request of the Borrower, if any, within a reasonable timeframe of around thirty (30) calendar days after reception;
- In case the situation requires it (which excludes by way of example situations of temporary and minimal breaches, or accounting issues), 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, discuss on the conditions that would make the lenders comfortable to extend a waiver, and the circumstances that would otherwise lead to stronger actions, including but not limited to mandatory prepayment and termination of the loan agreements.

The organizations that worked together to create the Guidelines and endorse the basic goal of such Guidelines are the following: