



International Association of  
Microfinance Investors

Morgan Stanley

# Charting the Course:

*Best Practices and Tools for  
Voluntary Debt Restructurings in Microfinance*

A photograph of a sailboat's deck and rigging, looking out over the ocean under a clear blue sky. The boat's white sails are partially visible, and the wooden deck shows signs of wear. A red rope is tied to a metal cleat on the deck.

By the  
International  
Association of  
Microfinance Investors

With financial sponsorship and  
strategic input from Morgan Stanley

and with research  
by Microfinance Analytics

and the University of Michigan Law  
School International Transactions Clinic

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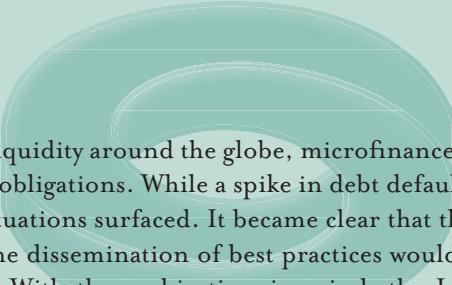
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## Foreword



As the financial crisis constrained liquidity around the globe, microfinance sector experts anticipated that many MFIs would face difficulty repaying their obligations. While a spike in debt defaults did not materialize to the extent feared, some cases of troubled MFI loan situations surfaced. It became clear that the industry would benefit from a review of MFI debt restructurings and that the dissemination of best practices would strengthen the commercial attractiveness and social impact of the industry. With these objectives in mind, the International Association of Microfinance Investors (IAMFI) and Morgan Stanley joined forces to convene a working group that would develop greater knowledge and tools for helping lenders manage orderly microfinance debt restructurings.

IAMFI is a global membership organization dedicated to helping commercially oriented microfinance investors achieve their financial and social goals. One of its key activities is facilitating dialogue among industry actors to improve the global environment for microfinance investing. IAMFI is indebted to Morgan Stanley, an IAMFI member that serves on its Board, for providing the financial sponsorship and strategic input that were essential to producing this paper.

Morgan Stanley has a longstanding commitment to strengthening communities in need by developing innovative ways to leverage the capital markets. Through its Global Sustainable Finance group, Morgan Stanley works closely with clients and investors to support the development of long-term business models capable of achieving compelling financial and social returns. Among the first investment banks to develop a dedicated microfinance effort, Morgan Stanley recognizes the importance of a strong and sustainable microfinance sector and seeks to support industry studies that provide investors with insights and knowledge.

IAMFI and Morgan Stanley thank all of the participants in the IAMFI Microfinance Lenders Working Group (IMFLWG) for their generous contributions of time, information and thought leadership in crafting best practices and tools for MFI debt workouts. We are likewise indebted to non-members who generously supported this effort with their input. The collaborative spirit of all participants made this project possible.

We owe particular thanks to the University of Michigan Law School International Transactions Clinic (ITC), which provided the IMFLWG with invaluable legal expertise and support. The ITC conducted desktop research and drafted industry tools with insightful annotations to guide investors and MFIs as they navigate debt workouts. We are also grateful to Julie Abrams, Microfinance Analytics, for her assistance in conducting interviews and discussions with over 50 industry specialists, compiling and analyzing data and contributing to the findings in this paper.

IAMFI and Morgan Stanley share the belief that commercial capital can be a positive force in delivering financial services to the world's working poor. As we finalized this study, the Indian microfinance market became seriously disrupted in Andhra Pradesh, heightening the potential for significant restructuring activity. We trust that *Charting the Course* will serve investors and the broader microfinance community by offering proactive and corrective measures that will facilitate orderly debt restructuring workouts, help viable MFIs continue to serve the socioeconomically excluded in a financially responsible manner and lessen risks to microfinance investment.

Joan Trant  
Executive Director  
January 2011

## EXECUTIVE SUMMARY

This paper summarizes findings by the IAMFI Microfinance Lenders Working Group (IMFLWG), a year-long project that the International Association of Microfinance Investors (IAMFI) spearheaded with financial sponsorship from Morgan Stanley. The IMFLWG's purpose was to achieve a better understanding of the challenges associated with microfinance institution (MFI) debt restructurings and proactively develop tools that facilitate orderly workouts. This paper, which is the result of industry research, candid dialogue among IAMFI members and input from other stakeholders, portrays a collaborative industry working to ensure that microfinance remains a sound investment opportunity.

### IMFLWG Key Findings

- Sixteen MFIs and one regional fund have recently completed or are engaged in restructuring negotiations. Troubled MFIs to date are predominately based in Latin America and Eastern Europe.
- The study estimates the face value of MFI debt in restructuring at US\$407 million.<sup>1</sup> An estimated US\$247 million represents loans by Microfinance Investment Intermediaries (MII).<sup>2</sup> With cross-border MII debt currently estimated at US\$4.2 billion,<sup>3</sup> approximately 6% of total MII debt investments in microfinance have required restructuring. Banco del Exito, a Nicaraguan MFI currently in liquidation and featured as a case study in this paper, represents 26% of the MII debt investment at risk.
- While the emergence of restructurings illustrates the relevance of the IMFLWG's work, when put into context - the global corporate default rate of non-investment grade debt in 2009 was 9.7%<sup>4</sup> - microfinance debt appears to have performed relatively well during the financial crisis. Additionally, the average net portfolio yield on microfinance debt held by microfinance investment vehicles (MIVs) of 7.9%<sup>5</sup> provides a cushion to counteract loan losses.
- Rising portfolio at risk over 30 days (PAR30) was a leading indicator of MFIs' deteriorating asset quality and impending need for debt restructuring.
- In practice, calling a default is more an art than a science, as creditors are acutely aware of the social and commercial implications of formal action against an MFI.
- The diversity of microfinance creditors is unique to, and challenging for, the formation and functioning of lenders' workout groups. Decision-making agility and willingness to play an active role in workouts differ across the microfinance investor spectrum.

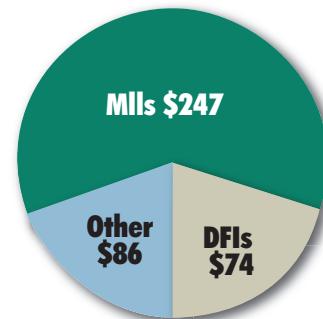
*By creating collaborative forums such as the IMFLWG to establish best practices and tools for the future, the microfinance industry has emerged even stronger from the financial crisis. Investors have voted with their capital, allocating over US\$1 billion in new capital to microfinance investment vehicles in 2009 despite continuing uncertainty in the global markets.*

Source: MicroRate. *State of Microfinance Investment: The MicroRate 2010 MIV Survey.*

MFI debt in restructuring currently estimated at US\$4.2 billion, approximately 6% of total MII debt investments in microfinance have required restructuring. Banco del Exito, a Nicaraguan MFI currently in liquidation and featured as a case study in this paper, represents 26% of the MII debt investment at risk.

**Chart 1: Estimated MFI Debt in Restructuring by Creditor Type**

MFI debt in restructuring = \$407 million  
(US\$ millions)



<sup>1</sup> Calculated based on the face value of interest-bearing, non-deposit indebtedness, including subordinated loans, per the latest available financial statements for each institution and classified by creditor type. Financial information dates are: 2009 for eight MFIs (48% of estimated debt); 2008 for five MFIs (41% of estimated debt); 2007 for one MFI and one regional fund (9% of estimated debt); 2005 for one MFI (3% of estimated debt). Total debt for 16 MFIs in restructuring using latest available MIX data (various dates) is US\$398MM. Conversions to U.S. dollars used the foreign exchange rate on the date at which the information was available.

<sup>2</sup> Consistent with the CGAP 2010 MIV Survey Report (page 5), this paper uses the term "microfinance investment intermediary," which IAMFI helped define with CGAP, MicroRate and Symbiotics, to refer to entities that have microfinance as a core investment objective. MIIs comprise Microfinance Investment Vehicles (MIVs), holding companies and other MIIs.

<sup>3</sup> Based on total MII assets of US\$8.2 billion, with an estimated 72% of MII assets invested in microfinance and an estimated 72% in debt instruments. Data source: CGAP and Symbiotics. CGAP 2010 MIV Survey Report. Washington: CGAP, 2010, pages 7, 9 and 10.

<sup>4</sup> Standard & Poor's. *Default, Transition and Recovery: 2009 Annual Global Corporate Default Study and Rating Transitions.* New York: Standard & Poor's, 2010, page 2.

<sup>5</sup> CGAP and Symbiotics. CGAP 2010 MIV Survey Report. Washington: CGAP, 2010, page 18.

- The dual pursuit of social impact and financial returns increases the complexity of restructurings. “Social first” investors reject the notion that they should take a subordinated return to “commercial first” investors, citing their equally binding fiduciary responsibilities and the importance of recycling capital to maximize impact.
- The emergence of MFI debt restructurings has highlighted the need for expanded skill sets and revised best practices among both MFIs and MIIs.
- Restructurings have led to improved MII practices in key areas, notably due diligence, loan documentation, investment loss provisioning policies and risk management.
- By proactively working together on MFI debt restructurings and creating collaborative forums such as IMFLWG to establish best practices for the future, the microfinance industry has emerged even stronger from the financial crisis.

### ***IMFLWG Recommendations for Creditors***

- Improve loan documentation by making agreements more complete and incorporating universally accepted definitions of terms and metrics.
- Use knowledgeable local legal counsel to ensure loan agreement enforceability.
- Encourage MFIs to communicate early and often on problem loan issues. Similarly, be transparent with MFIs regarding the likelihood of loan renewal.
- Use covenant breaches and waivers to prompt MFIs to take corrective actions that reduce risk and increase communication flow.
- Respond to material breaches quickly and proactively, particularly given the speed with which MFI financial performance can deteriorate.
- Create a voluntary creditor group immediately to govern dealings with the MFI.
- Develop in-house workout expertise independent from loan origination or retain an experienced loan restructuring consultant.
- Acknowledge that restructuring behavior among more commercially and more socially motivated lenders can be similar.
- Preserve the MFI as a going concern, provided a voluntary restructuring is viable and sustainable.
- Promote training to improve MFIs’ financial skill sets needed for workouts, restructurings and turnarounds.

### ***IMFLWG Best Practices & Tools***

Based on a series of discussions with creditors and MFI managers, the IMFLWG developed a set of tools designed to guide orderly MFI debt restructurings. These tools, found in Appendices 4–7, include:

- *IAMFI Microfinance Voluntary Debt Workout Principles*: a framework for creditors and MFIs to facilitate an orderly restructuring process.
- *IAMFI Microfinance Intercreditor Agreement Template*: a guide to governing intercreditor activity during a workout process.
- *IAMFI Menu of Debt Restructuring Options*: an overview of considerations around three key alternatives for restructuring MFI indebtedness.
- *IAMFI Microfinance Covenant Loan Review*: a set of annotated covenants that consider elements unique to microfinance.

## BACKGROUND

Microfinance provides financial services to low-income individuals who lack access to the formal banking sector. MFIs began in the 1970's as non-profit organizations seeking to alleviate poverty in emerging nations, helping the poor become self-employed by giving them small, uncollateralized loans for working capital. Today, microfinance encompasses credit, savings, housing finance, remittance and insurance products designed for the base of the socioeconomic pyramid.

### *The Commercialization of Microfinance*

In order to reach more unbanked communities, the microfinance industry has increasingly pursued market-based funding in addition to philanthropic support. Many MFIs have transformed from non-profit organizations to regulated entities in order to tap commercial sources of capital such as loans, equity investment and deposits. This evolution has spurred a dramatic increase in the volume of microcredit loans outstanding: the global microcredit portfolio is now estimated at US\$65 billion<sup>6</sup> versus some US\$12 billion in 2004.<sup>7</sup> Since many MFIs have limited or no deposit-based funding, and equity funding was not readily available prior to 2008, loan portfolio growth has been supported principally by debt funding.

The microfinance investor landscape is global and complex. Sources of local funding include depositors, government agencies, charitable organizations, local banks and the private sector. Foreign capital, principally from Europe and the United States, has played a predominant role in driving microfinance's expansion. Cross-border investors include 1) institutions such as banks, insurance companies, pension funds, endowments, hedge funds and foundations making mission-related investments, 2) government-funded institutions that support development in emerging nations (known as development financial institutions or DFIs) and 3) retail investors and the family offices of ultra-high net worth individuals. International Limited Partner investors (asset owners) generally channel their investments via public and private placement fund structures, and specialized fund managers undertake the MFI due diligence, investment and monitoring process on the Limited Partners' behalf.

Microfinance even participated in the growth of structured finance products: 10 Collateralized Loan Obligation (CLO) structures totaling US\$521 million in microfinance debt were outstanding as of year-end 2009.<sup>8</sup> The senior tranches of these vehicles served as an attractive point of entry for first-time microfinance investors, with established microfinance investors purchasing the higher risk, higher yield subordinated tranches.

In sum, at year-end 2009 the cumulative volume of MII debt investment in MFIs reached an estimated US\$4.2 billion, or 72% of total MII investments in microfinance (US\$5.9 billion) and 51% of total MII assets under management (US\$8.2 billion).<sup>9</sup>

Unlike donors providing grants, investors expect principal repayment and a financial yield ranging from below market to risk-adjusted and even premium returns. In response, MFIs have developed business approaches aimed at fulfilling their social mission (such as poverty alleviation, gender empowerment or financial inclusion) while generating revenues to repay investors and expand into more underserved communities.

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<sup>6</sup> Microfinance Information Exchange Inc. *Microfinance at a Glance*. Washington: MIX, November 2010.

<sup>7</sup> Microfinance Information Exchange Inc. *2004 Mix Market Benchmarking Report*. Washington: MIX, 2005.

<sup>8</sup> CGAP and Symbiotics, page 22.

<sup>9</sup> Idem, page 7.

## ***Creation of the IAMFI Microfinance Lenders Working Group (IMFLWG)***

With the increased capital flows described above, over the past 10 years MFIs have enjoyed double-digit growth but also increasing competition for clients. The drive for market share has induced some MFIs to enter unfamiliar regions, client segments and products, and even to relax loan underwriting procedures. The global economic downturn of 2008 affected MFIs by increasing the cost of funding and in some cases reducing access to capital, decelerating overall growth. Underlying weaknesses that MFIs had been able to counterbalance with high growth and ample liquidity from debt investors began to surface; as underlying financial indicators began to decline at several MFIs around the globe, microfinance lenders braced for a period of voluntary debt workouts and possible defaults.

The formation of creditor groups raised several questions. First, how should a voluntary debt workout in microfinance be conducted? After years of growth and profitability, and given the low historical rate of MFI-to-MII default of 2%,<sup>10</sup> the industry lacked precedents for undertaking such processes. Second, how should the social impact motive on which microfinance was founded affect a workout procedure, if at all? Although the majority of microfinance investors and their MII partners engage in microfinance for its double bottom line objectives of financial return and societal impact, many recent entrants are more commercially minded. And third, what are the tools, best practices and adjustments that the sector should develop both to steward the current situation and foster sound investments in the future?

As a trade association representing the microfinance investment community, IAMFI plays a key role in providing a forum for industry leaders to identify collective challenges and address them in a collaborative manner. As signs of stress in MFIs increased, several IAMFI members requested IAMFI to spearhead a response to the emerging risk of MFI debt default. Launched in late October 2009 with Morgan Stanley's financial sponsorship, the IMFLWG sought to achieve a better understanding of the legal and financial challenges associated with MFI debt defaults, and to facilitate orderly workouts that protect investors and permit MFIs to continue serving the financially excluded. The IMFLWG's approach has been to identify common practices in commercial restructurings and adapt them to the particular characteristics of microfinance.

IAMFI members constituted the IMFLWG, representing a range of MIIs, Limited Partner Investors, financial institutions and legal counsel with experience in cross-border workouts in emerging countries. The University of Michigan Law School International Transactions Clinic (ITC) provided additional legal support. IAMFI's Advisor for Research and Analysis, Julie Abrams of Microfinance Analytics, conducted the underlying research. The IMFLWG sought feedback from IAMFI members and non-member stakeholders. It conducted interviews, communications and outreach with over 50 constituents and held two stakeholder feedback sessions with about 70 participants, to ensure the usefulness of its recommendations and outputs. Critically, the process captured input from both microfinance investors and MFI managers.

## **KEY FINDINGS ON MICROFINANCE INSTITUTION DEBT RESTRUCTURINGS**

The commercialization of microfinance has contributed to an industry track record of impressive growth, increased financial access and market-like returns. Additionally, there is evidence that during 1994–2008 MFI debt repayment outperformed the prevalent rating grade levels assigned to MFIs (BB to B) by mainstream rating agencies.<sup>11</sup> Yet given its early stage development and inherent focus on emerging markets, microfinance investment entails risks and losses, that to some extent, are to be expected.

<sup>10</sup> Abrams, Julie and Joan Trant, ed. *Zero Is Not the Number: The Microfinance Debt Default Rate*. New York: IAMFI, 2009, page 8.

<sup>11</sup> Idem, page 18.

## Topline Statistics

While microfinance performed comparatively well throughout the credit crisis, the IMFLWG's research identified 17 microfinance workout processes around the globe that have recently been completed or are currently underway, spanning 16 MFIs and one regional microfinance fund. The workout proceedings, located in 10 countries in Latin America,

Africa and Eastern Europe, cumu-

latively represent an estimated US\$407 million of financial obligations, using the latest financial statements available. MIIs hold an estimated US\$247 million of this amount (see Table 1 above), or approximately 6% of estimated MII debt investment in microfinance (US\$4.2 billion). For comparative purposes, the global corporate default rate of non-investment grade debt in 2009 was 9.7%.<sup>12</sup>

Key characteristics of the identified workout proceedings are summarized below:

- The majority of troubled loan situations, both in face value of financial obligations and in number, have arisen in Eastern Europe (51% of face value) and Latin America (48% of face value) as indicated in Table 2 below, driven by uniquely challenging conditions in Bosnia and Nicaragua.
- While in almost all cases portfolio deterioration represented a proximate cause of financial distress, in practice multiple factors — weak management and governance, macroeconomic conditions and political environment, among others — ultimately led to the need to restructure. Investors identified outright fraud at two MFIs.
- Microfinance restructurings have occurred in non-profit and for-profit MFIs. Approximately half of the workout processes are in non-profit organizations, which creates greater challenges for creditors given the absence of shareholders to recapitalize the institution.
- Most troubled loan situations have led or are expected to lead to a restructuring of the MFI's indebtedness. However, in three cases a liquidation of the MFI is underway.
- The level of formality of creditor workout groups has varied by situation; in at least two cases creditors have formalized their actions through an Intercreditor Agreement. There are other less formal signed agreements among creditors.

**Table 2: Regional Distribution of Microfinance Debt Workouts**

| Region                        | Face Value of MFI Credit Exposure in Restructuring (US\$ million) | Number of Cases |
|-------------------------------|---|-----------------|
| Eastern Europe & Central Asia | 206   | 6               |
| Latin America                 | 198   | 9               |
| Africa                        | 3   | 2               |
| <b>Total</b>                  | <b>407</b>  | <b>17</b>       |

Source: IMFLWG research and financial statements of MFIs in restructuring (see Footnote 1 for calculations).

**Table 1: Estimated MFI Debt in Restructuring by Creditor Type**

| Creditor Type                          | Face Value of MFI Credit Exposure in Restructuring (US\$ million) |
|--|---|
| Microfinance Investment Intermediaries | 247   |
| Development Financial Institutions     | 74  |
| Other                                  | 86  |
| <b>Total</b>                           | <b>407</b>  |

Source: IMFLWG research and financial statements for MFIs in restructuring (see Footnote 1 for calculations).

<sup>12</sup> Standard & Poor's. *Default, Transition and Recovery: 2009 Annual Global Corporate Default Study and Rating Transitions*. New York: Standard & Poor's, 2010, page 2.

## *Learnings from Voluntary Debt Restructurings*

The IMFLWG research yielded a number of insights on both the development and execution of voluntary debt restructurings in microfinance, summarized below.

### **1. In the beginning, there was a rise in PAR...**

*“When PAR increases, it happens quickly. An MFI can have 15% PAR for loans overdue past one day.” — MII*

*“We spotted things going downhill late last year [2009]: PAR increasing, MFIs no longer profitable, MFIs’ inability to get new financing.” — MII*

Most troubled debt situations surfaced due to a covenant breach. Nearly every study participant cited a rising portfolio-at-risk<sup>13</sup> (PAR) - the principal measure of an MFI’s loan portfolio quality - as the primary indicator of a troubled debt investment. MIIs typically stipulated a covenant level of PAR over 30 days (PAR30) at 5% in loan agreements. Other frequently breached covenants included loan loss reserve levels, leverage ratios and minimum profitability levels.

All study participants emphasized that underperforming financial indicators were only a symptom of trouble resulting from root causes internal and external to the MFI. Key internal factors included fraud, poor governance, inadequate external and/or internal audit function, excessive portfolio growth and poor underwriting policies. Common external factors included natural disasters, domestic macro-economic conditions, international macroeconomic conditions (e.g., reduced global liquidity, lower remittances, etc.), national political environment and inappropriate regulatory oversight.

Insufficient liquidity to roll over or renew maturing liabilities – often caused by a combination of the above factors – historically is the most common element contributing to defaults.<sup>14</sup> MFIs with stable or growing loan books ordinarily do not generate free cash flow and thus can rarely shrink their loan portfolios fast enough to face an unexpected non-renewal by an existing creditor. The inability of an MFI to anticipate or offset a liquidity need can turn a covenant default into a payment default.

### **2. Knowing when to call a default is an art, not a science**

*“To issue a waiver, I need to see a concrete action plan that is reality-based. Was the situation fairly out of the MFI’s control? Was it a force majeure? I want to see really good communications from the MFI. If so, we will give a 3–6 month waiver.” — MII*

*“I use covenant waivers so that I can be at the negotiating table.” — MII*

*“You’re a lender trying to do what you can to support a sustainable organization... In bankruptcy court the only ones who benefit are the lawyers.” — MII*

*“It is important to save the ‘worthwhiles’ and get rid of marginal players.” — MII*

While lenders concurred that a covenant breach in isolation was rarely a reason to call a default, they held a range of views on the appropriate time to take action. Several investors demonstrated greater willingness to work with proactive MFIs that advised them of an impending or recent covenant breach, with less tolerance for MFIs that were unaware of their own breach until notified by the lender. In nearly all covenant breaches, the investors chose not to accelerate repayment, focusing instead on increasing the frequency of MFI reporting (i.e. from quarterly to monthly) and on other actions that enhanced information flow. Investors’ policies on handling covenant breaches varied widely; some required the MFI to obtain a waiver, while others did not. In some cases, local law or MFI auditor requirements regarding waivers determined the MIIs’ approach.

Investors emphasized the speed at which financial conditions at an MFI can deteriorate; in one case PAR30 ballooned from below 5% at December 31, 2009 to 70% in February 2010. Lenders highlighted the need to act quickly and cooperatively with the MFI and with other lenders as problems surface.

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<sup>13</sup> Generally calculated as the face value of loans with past due payments of 30 days or more plus renegotiated portfolio, divided by gross loan portfolio.

<sup>14</sup> Abrams, Julie and Joan Trant, page 9.

### **3. The diversity of creditors is unique to – and challenging for – microfinance workouts**

*With a large creditor group “it is like herding cats.” – MII*

*“It is important to have a strong leader and taskmaster, like in any strategic initiative.” – MII*

*“To those who take the money and run...people don’t forget. Behavior comes back to haunt you.” – MII*

*“You can’t get things done without trust.” – MII*

Microfinance attracts a wide range of investors, such as dedicated MIIs, government funded agencies and foreign and domestic commercial banks. While this diversity of funding is generally positive and supportive of a growing industry, investors’ varying interests, risk tolerances and decision-making capabilities can slow a workout process. Creditor diversity may pose challenges to formalizing a workout group, notably along the following lines:

- Speed of execution. MIIs advised by an investment committee were often best positioned to approve workout decisions quickly. Other entities such as DFIs, CLOs and local institutions with partial government ownership appeared less agile. Some creditors by charter were unable to accept certain restructuring solutions, such as a conversion of debt to equity.
- Local vs. cross-border. Local lenders seemed to undervalue incentives to collaborate with foreign investors. Cross-border lenders voiced concern that local creditors might gain preferential treatment through relationships or greater familiarity with the judicial system.
- Time to maturity. Creditors with the shortest time to maturity generally demonstrated a reluctance to join a formalized effort, preferring to hope for full repayment before creditor group actions such as a standstill.
- Number of creditors. In some restructurings, the number of creditors was so large that it impeded the ability to form a cohesive creditor group.

In almost all cases under review the lenders formed an organized creditor group to guide interactions with the troubled MFI. However, the research revealed that in numerous instances investors did not respond with urgency or encountered difficulty forming a unified creditor group able to negotiate collectively. The leadership role typically fell to the creditor(s) with the largest exposure – and therefore greatest interest – in achieving a solution. Larger MIIs conveyed frustration over “free riders,” lenders that did not join creditor committees but stood to benefit from the group’s efforts.

Most voluntary workout groups operated under informal agreements and in very few cases signed a formal Intercreditor Agreement (ICA) to govern creditor action. Despite the challenges in establishing an ICA, MIIs and legal experts noted that having a formal agreement among creditors is vital, as is filing it locally to ensure enforceability.

### **4. Social intent matters, but fiduciary responsibility comes first**

*“We are continuing to learn as a social investor what the balance is in protecting investors’ capital and being patient capital.” – MII*

*“All of us want to get our money back. This is no different from the ‘other world.’” – MII*

Dedicated microfinance investors have consistently expressed their commitment to achieving both financial and social returns. A restructuring situation tests this dual commitment, because it may present an opportunity to pursue a longer-term and perhaps riskier solution than mainstream investors would consider. In several workouts, some commercially oriented investors voiced expectations that the socially motivated lenders would accept less commercial restructuring terms.

Several “social first” investors rejected this scenario. While they were willing to prioritize a solution promoting the long-term survival of a viable MFI, they were unwilling to assume a *de facto* subordinated position or outcome relative to other investors. “Social first” investors emphasized that, like their “financial first” counterparts, they have fiduciary responsibilities to stakeholders and they depend on repayment to finance future activities.

In general, social mission has played a role in the decision whether to accelerate loan repayment. In recent restructurings, nearly all investors ranging from more commercially to more socially motivated avoided loan acceleration, as it would have triggered cross default provisions and a liquidity crisis, and ultimately cut off new funds for loans to the MFI’s clients. But waiting to accelerate had its consequences: some lenders that chose not to accelerate repayment placed themselves at a disadvantage relative to lenders with earlier maturities that were able to recover their capital.

## **5. The “new normal” for microfinance requires advanced skills and the development of best practices**

*“It’s important for MFIs to be transparent and apprise lenders of trouble early on. Lenders can be more helpful if the MFI is proactive in apprising of covenant breaches or upcoming problems in loan repayment.” – MII*

*“MIVs cannot act as pro bono financial advisors [to an MFI].” – MII*

*“The party that is best suited to coordinate is the MFI itself.” – MII*

The increase in restructurings signals a need for new skills in the microfinance industry. At the MFI level, workouts require a proficient management team that can re-shape its business strategy and produce projections and monthly cash flows to service debt under a range of scenarios. Management must also adapt to increased reporting requirements and heightened need to disclose problems before they escalate. Creditors reported a general inability of MFI management to produce these outputs. They also noted a limited supply of turnaround managers to take over an organization when necessary.

At the MII level, restructurings require experienced staff familiar with commercial, cross-border debt workouts in emerging markets that may lack adequate legal and regulatory frameworks. MIIs currently have almost no staff members in their microfinance investment departments with prior debt workout experience, making the restructuring processes less efficient. The research found that further education on risk management, debt restructuring and turnarounds is important for both MFIs and MIIs.

Creditor diversity, double bottom line motivations and industry inexperience with debt workouts led many study participants to support the IMFLWG’s development of industry tools, adapted from commercial lending practices to microfinance-specific needs.

## **6. The workout experience has led to positive changes in MII practices**

*“The difference between microfinance and commercial lenders is that microfinance lenders initiate restructuring discussions early. Microfinance is unique in that it has been proactive.” – MII*

*“We have learned about the dynamics of creditor groups and the importance of good and open communication.” – MII*

*“We are benefitting from our creditor group experience.” – MII*

The IMFLWG’s research uncovered recent improvements to MII procedures in the following areas:

- Due diligence. Several investors noted that they are now completing more thorough due diligence, including 1) analysis of MFI shareholders to evaluate potential recapitalization sources in times of distress, 2) assessment of MFI networks’ ability and willingness to support member MFIs, 3) review of the MFIs’ management information systems capacity and quality, 4) increased time on-site with MFIs including greater credit portfolio sampling and 5) greater attention to MFIs’ risk management capabilities.
- Loan documentation. The workout process has revealed significant flaws in standard loan agreements; for example, investors that were theoretically secured often found it difficult to perfect liens. MIIs are increasingly seeking guidance from knowledgeable local counsel at closing to ensure effective legal remedies are in place if MFI conditions deteriorate.

- Staff composition. At least three MIIs hired experienced professionals to develop a dedicated risk management function within the institution. One MII predicted a trend toward hiring more “gray hair” employees with greater experience and stronger mainstream finance backgrounds.
- Loan provisioning. The rise in troubled debt has required MIIs to become more proactive in establishing reserves against expected loan losses. MIIs have exercised significant judgment in their provisioning policies, evidenced by differing levels of provisioning in specific restructuring situations.

## **7. The global financial crisis has made the industry stronger**

*“Creditor groups are very time consuming, tremendously valuable and tremendously successful. This is the exciting part of this industry.” — MII*

*“We have agreed to work together, share some expenses, work on issues together, agree on confidentiality, and be forthcoming with the MFI.” — MII*

*“We are living up to our double bottom line mission.” — MII*

There is solid consensus among industry actors that the recent increase in troubled investments has positioned the microfinance industry for better investment and impact going forward. At the MFI level, stakeholders are driving various initiatives to address technology needs, client over-indebtedness and pricing transparency. At the MII level, fund managers have strengthened due diligence processes, loan documentation and staff capacity. Investors have voted with their capital, allocating over US\$1 billion to debt and equity MIVs in 2009 despite continuing uncertainty in the global markets.<sup>15</sup> Perhaps most importantly, the industry has shown a unique ability to address challenging conditions collectively, maintaining the sector’s prevalent culture of collegiality and collaboration.

## **BEST PRACTICE RECOMMENDATIONS AND TOOLS**

Based on its review of mainstream and microfinance lending processes, the IMFLWG has identified best practices tailored to the microfinance sector and developed tools for the orderly restructuring of troubled debt.

### ***Best Practices and Recommendations***

The following recommendations reflect best practices for lenders that will benefit both their interests and their MFI borrowers.

#### **1. Improve loan documentation**

Make loan agreements more complete and incorporate universally accepted definitions for terms and metrics. Covenants should reflect local legal, regulatory, political and economic factors, as well as the lender’s financial investment approach. Make sure the MFI borrower understands the terms of the loan, the covenants and their implications.

#### **2. Use knowledgeable local legal counsel to ensure loan agreement enforceability.**

Invest the time and money in a legal review of loan agreement terms, particularly regarding security pledges, prior to signing. Engage local counsel to review ICAs and restructuring proposals during workouts.

#### **3. Encourage MFIs to communicate early and often on issues.**

Fostering trust and proactive dialogue with MFIs maximizes the likelihood of addressing problems before cross default provisions or other actions escalate the situation. Similarly, MIIs should be forthcoming in their discussions with MFIs as to the likelihood of loan renewal and other loan-related issues.

#### **4. Use covenant breaches and waivers to prompt MFIs to take corrective actions that reduce risk.**

Breached covenants provide not only an early warning sign to MIVs but also the justification for summoning the MFI to the negotiating table. Urge MFIs to analyze breaches, identify the reasons for under-performance and respond to them substantively.

<sup>15</sup> MicroRate. *State of Microfinance Investment: The MicroRate 2010 MIV Survey*. Arlington: MicroRate, 2010, page 3.

**5. Respond to material breaches quickly and proactively.**

MFIs deteriorate much more rapidly than mainstream businesses do. An immediate, coordinated response is crucial to saving an MFI while it is still viable.

**6. Create a voluntary workout group with strong leadership.**

Establishing such a group creates strength in numbers, protects ongoing relationships with fellow lenders and MFIs, increases the likelihood of loan repayment and improves the MFI's chances of survival. Being a responsible citizen is important — the microfinance community remains small and antagonistic actions can cause reputational damage. While the research indicated that the largest creditors typically bear the greatest responsibility in workouts, criteria for selecting the creditor group leader should include 1) personality, 2) time availability, 3) interest in a negotiated, shared solution, 4) workout experience and 5) proximity to the MFI or ability to make extended on-site visits.

**7. Develop in-house workout expertise independent from loan origination or retain an experienced loan restructuring consultant.**

MIs should determine how to transition a non-performing loan from loan origination staff to workout staff, similar to what commercial financial institutions and MFIs do. MIs should also train staff on more effective monitoring and covenant waiver negotiations to manage deteriorating conditions more proactively.

**8. Acknowledge that restructuring behavior among more commercially and more socially motivated lenders can be similar.**

Commercially oriented investors should not expect the more “social” investors to take larger losses or subordinated positions. Socially motivated investors, too, must fulfill fiduciary obligations, safeguard scarce capital and avoid propping up an unsustainable MFI.

**9. Preserve the MFI as a going concern, provided a voluntary restructuring is viable and sustainable.**

Few emerging markets have clear-cut bankruptcy laws to guide an in-court restructuring process. Liquidation is unlikely to deliver value, given the challenge in servicing microloans and the likelihood that client repayment will plummet once an MFI's imminent closure is public. From a social impact perspective, the wind-down of an MFI could eliminate services to communities already underserved by the formal banking system.

**10. Increase expectations for financial skills capacity in MFIs.**

Skills-building should focus on financial projections, scenario planning and stress-testing for management, and on financial expertise and governance for Board Directors. An MFI with the capacity to develop its own revised business plan will be more committed, and more successful, in its implementation.

### ***Tools Developed by the IMFLWG to Facilitate Orderly MFI Debt Restructurings***

With invaluable research and recommendations by the ITC and feedback from Working Group participants, the IMFLWG developed the following tools to help MIs and MFIs navigate the restructuring process. The tools are provided in Appendices 4–7. To access them online, visit [www.iamfi.com/research](http://www.iamfi.com/research) and click on IAMFI Research.

**I. IAMFI Microfinance Voluntary Debt Workout Principles**

The IMFLWG developed creditor group guidelines based on the framework below; please see Appendix 4 for the Principles with complete annotations.

- The principles are designed to facilitate a voluntary restructuring effort that is proactively sought, organized and driven by lenders. Creditors often pursue voluntary restructurings under the presumption that a negotiated, out-of-court solution is preferable to formal bankruptcy proceedings.
- Lenders may initiate a voluntary debt workout when the MFI first indicates signs of distress, once financial covenants have been breached or when the prospect of a payment default arises.

- The principles developed by the IMFLWG build upon guidelines for cross-border workout negotiations in the financial sector, such as those developed by the International Federation of Insolvency Professionals (INSOL),<sup>16</sup> the London Approach<sup>17</sup> and the Asian Development Bank.<sup>18</sup> The key challenge was to adapt the commercial guidelines to the unique characteristics of microfinance.
- The IMFLWG sought input beyond IAMFI's membership. It held two stakeholder sessions in New York<sup>19</sup> and Amsterdam<sup>20</sup> with a wide range of microfinance stakeholders, including MFI senior managers and shareholders, DFIs and other key industry players.

The IAMFI Microfinance Voluntary Debt Workout Principles include:

- i. *Shared Goal of a Long-Term, Going Concern Solution.* Voluntary debt workouts aim to preserve and maximize value to the benefit of all parties, and they should be organized so that all stakeholders have an incentive to cooperate towards a successful solution.
- ii. *Creditor Coordination.* Creditors should organize their actions at the outset of the troubled loan proceedings.
- iii. *Legal and Regulatory Regime Applicable to the Debtor MFI.* Local legal counsel is important for determining the applicable regime and for ensuring that restructuring documentation is enforceable, with terms that comply with local regulatory requirements.
- iv. *Conflicts of Interest Disclosed.* Workout participants should disclose the extent of their organization's relationship with the MFI.
- v. *Standstill Period.* Creditors should be willing to abstain from enforcement actions during a reasonable period for a debtor MFI acting in good faith.
- vi. *Debtor MFI's Responsibilities during the Standstill Period.* In exchange for relief, the MFI should not take actions that negatively affect creditors' prospective returns.
- vii. *An Achievable Restructuring Proposal.* The voluntary workout must be based upon an achievable proposal that addresses governance, operational and financial issues as well as the varied objectives of creditors.
- viii. *Fair Burden Sharing among Stakeholders and Observance of Pari Passu Principle.* The absorption of losses should reflect the relative position in the capital structure of shareholders and creditors.
- ix. *Priority Status of Additional Debt Funding.* Additional funding may be required to support the MFI's operations during the voluntary workout; this funding should, as far as practicable, be afforded priority status.
- x. *Debtor MFI's Responsibility for Workout Costs.* The debtor MFI should cover or reimburse creditors for the costs of the voluntary workout.

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<sup>16</sup> INSOL. *INSOL Statement of Principles for a Global Approach to Multi-Creditor Workouts*. London: INSOL International, 2000.

<sup>17</sup> For details on the London Approach, consult: Buljovich, Esteban C. *Cross-Border Debt Restructuring: Innovative Approaches for Creditors, Corporates and Sovereigns*. London: Euromoney Books, 2005.

<sup>18</sup> Asian Development Bank. *Informal Workout Principles*. Manila: Asian Development Bank, 2005.

<sup>19</sup> The first IMFLWG Microfinance Debt Forum took place during the *Women's World Banking Microfinance and the Capital Markets Conference* on March 23, 2010.

<sup>20</sup> The second IMFLWG Microfinance Debt Forum occurred during the *Hanson Wade MicroFinancial Services World Conference* on May 11, 2010.

## 2. IAMFI Microfinance Intercreditor Agreement Template

Loan syndication is not common practice in microfinance and local law does not always specify the relative rights and obligations of lenders, particularly if the MFI borrower is not a regulated entity. An Intercreditor Agreement (ICA) among MFI co-lenders is a voluntary accord executed *after* an MFI loan becomes stressed. It sets forth the signatories' various lien positions and establishes a standstill period during which the debtor MFI may work with its creditors, shareholders and other stakeholders to develop a viable workout plan.

Not all lenders may be willing or invited to participate in the ICA and only the signatories are bound by its terms and conditions. Therefore, determining which creditors should establish the ICA is a fundamental aspect of debt restructuring. An optimal ICA represents a critical mass of lenders that can influence non-participating lenders, the MFI and other stakeholders to achieve a broadly positive outcome.

The IAMFI Microfinance ICA template, with detailed annotations, can be found in Appendix 5. It also provides advice on the formation of Creditor Steering Committees. Voluntary workout groups may use the template to formalize their agreement to restructure a troubled MFI. The ICA specifies:

- i. *Parties:* participating creditors.
- ii. *Covered Debt:* description (original principal amount, outstanding principal, interest rates and scheduled payment dates, etc.), ranking of seniorities and enhancements.
- iii. *Representations and Warranties:* authority to enter into the ICA, non-conflict validation, etc.
- iv. *Standstill Period:* initial period and conditions for renewing and terminating the period.
- v. *Forbearance and Creditors' Duties:* agreements on refraining from uncoordinated enforcement actions against debtors and on lenders' responsibilities.
- vi. *Steering Committee:* composition, function and powers.
- vii. *Escrow Account:* facilitation of transparent debtor payments during the standstill period.
- viii. *Assignability:* provisions for treatment of new players and transfer of covered debt.
- ix. *Governing Law:* often Dutch, Luxembourg, New York or English, unless the MFI's country regulations require national law.
- x. *Costs and Expenses:* allocation to debtor, with creditors minimizing costs when possible.
- xi. *Enforcement and Arbitration:* dispute resolution approach if handled outside the court system.

## 3. IAMFI Menu of Debt Restructuring Options

The IAMFI Menu of Debt Restructuring Options details various alternatives that can be made available to creditors to encourage their participation in a voluntary debt workout. It provides a description, key issues to resolve, and the pros and cons of various restructuring approaches. The options include:

- i. *Debt Buyback:* cancels debt.
- ii. *Debt Exchange:* replaces old debt with new debt under different terms.
- iii. *Debt for Equity Exchange:* exchanges debt for shares in the troubled MFI.

Past and present voluntary restructurings in microfinance have pursued several of these approaches. In practice, there is a trade-off between the level of complexity (execution risk) and the ability of the restructuring to meet the various needs of participating creditors. Please see Appendix 6 for the full Menu of Debt Restructuring Options.

#### 4. IAMFI Microfinance Loan Covenant Review

An integral part of loan documentation, covenants represent the borrower's promises as to how it will conduct itself after loan disbursement regarding financial performance, reporting and risk mitigation for the duration of the loan. The ITC conducted desktop research on loan agreements in commercial and microfinance contexts, and it reviewed, confidentially, two mainstream and four microfinance agreements. While not exhaustive, the document review was representative of commonly used clauses. The ITC focused on issues of highest concern to MFI lenders and it drafted covenants, with robust annotations regarding elements unique to microfinance. The recommended covenant modifications aim to provide additional protections to lenders once an MFI becomes distressed. They also seek to harmonize criteria and language, facilitating an MFI's compliance with multiple creditors' requirements.

For example, the covenant review suggested adding a reporting covenant that requires notice of material changes in the MFI borrower's underwriting procedures. This will reveal if an MFI seeks to expand into unfamiliar customer segments, products or geographical regions, or alter the loan approval process. For financial terms, the review recommended adding write-off, reserve coverage, capital adequacy and foreign exchange exposure covenants, among others, to the prevalent PAR30 requirement.

The review identified a series of negative and positive covenants that lenders might incorporate into their documentation to further mitigate risk. These included: restrictions on the borrower's ability to make distributions to shareholders, restrictions on consolidations and mergers, insurance coverage requirements and compliance with anti-corruption, anti-terrorism and anti-money laundering laws.

In its research the IMFLWG discovered variations in definitions and calculation methods of common covenant items. As part of a future project, IAMFI intends to develop model clauses to benefit both lenders and MFIs. The harmonization of loan agreements will facilitate MFIs' compliance and make an eventual restructuring less complex. The new model clauses will be annotated to increase clarity for MIIIs and MFIs regarding their definitions and reason for inclusion.

Please see Appendix 7 for the IAMFI Microfinance Loan Covenant Review.

### CASE STUDY: BANCO DEL EXITO (BANEX), NICARAGUA

#### *Background*

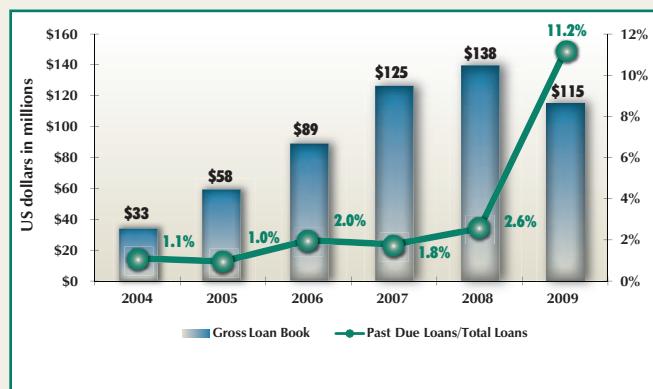
Of all the MFI loan workouts, Banex may offer the most illustrative example of the promise and risks of microfinance investing. Formerly known as Findesa, Banex was created in 2002 from the operations of FINDE, a non-profit organization working in Nicaragua since 1993. Banex received its banking license in September 2008 and by the end of 2009 was the largest MFI in Nicaragua, with a loan portfolio of approximately US\$138 million.

#### *The Growth Years*

During 2004 to 2008 Banex emerged as a highly attractive MFI for commercial investment, delivering impressive growth (four-year loan portfolio compound annual growth rate of over 40%) and a return on equity of 32% in 2005 that ultimately declined to 15% by year-end 2008. Banex also exhibited strong portfolio quality, with portfolio delinquency averaging under 2% from 2004 to 2008.<sup>21</sup> Exhibits 1 and 2 illustrate the financial performance of Banex during 2004-2009.

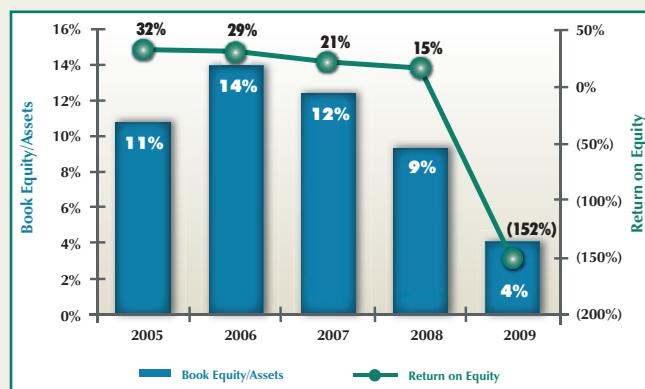
<sup>21</sup> Superintendencia de Bancos y de Otras Instituciones Financieras de Nicaragua. *Banex: Indicadores Financieros Comparativos*. Managua: SIBOIF, 2010.

### Exhibit 1: Banex Loan Portfolio Evolution



Source: Banex annual reports and Superintendencia de Bancos y de Otras Instituciones Financieras de Nicaragua

### Exhibit 2: Banex Overall Financial Performance



Source: Banex annual reports and Microfinance Information Exchange Inc.

### Exhibit 3: Banex Debt Funding



Source: Banex annual reports

Banex's high growth was largely fueled by foreign debt investment. Domestic capital invested in Banex grew at a modest pace, while international capital increased from US\$61 million in 2006 to US\$106 million by 2008 (see Exhibit 3). Although as a regulated bank (*institución bancaria*) Banex had access to deposits, this source of financing played a limited role in its growth. A portion of its foreign funding came in the form of three international CLOs that issued loans to Banex: BlueOrchard Microfinance Securities (BOMS 1) and Blue Orchard Loans for Development 2006 and 2007 (BOLD 2006 and BOLD 2007, respectively).

### Problems Emerge

By 2007 the quality of Banex's loan portfolio had begun to decline due to domestic, international and organization-specific factors. At the national level, real GDP growth steadily declined from 5.3% in 2004 to a recessionary negative 1.5% in 2009.<sup>22</sup> Like many MFI customers around the world, Banex borrowers experienced a drop in remittance inflows from the United States, reducing funds for loan repayment. Furthermore, a *no pago* (no payment) movement in the northern part of the country reduced clients' willingness to repay their microloans.

At the organizational level, Banex faced additional challenges including increasing financial leverage and an overconcentration in loans to the cattle farming sector, which suffered from depressed commodity prices for beef.<sup>23</sup> Moreover, Banex implemented a change in product mix that emphasized small and medium enterprise (SME) lending:<sup>24</sup> SME loans as a percentage of total loan portfolio grew from 50% in June 2008 to 66% by December 2009.<sup>25</sup> Importantly, SME lending requires a different methodology than the microfinance lending that had been Banex's core business.

<sup>22</sup> Bloomberg. *Nicaragua: Principales Indicadores Macroeconómicos*. New York: Bloomberg, August 19, 2010.

<sup>23</sup> BlueOrchard Loans for Development S.A. *Notice to Noteholders*. Dublin: Irish Stock Exchange, December 11, 2009.

<sup>24</sup> Ibid.

<sup>25</sup> Calculations based on: Superintendencia de Bancos y de Otras Instituciones Financieras de Nicaragua. *Banex: Estratificación de la Cartera Total por Monto y Plazo Contractual* and Banex: *Estratificación de la Cartera Comercial por Monto y Plazo Contractual*. Managua: SIBOIF, 2008-2009.

As a result of these developments, portfolio delinquency as of December 31, 2009 increased to 11.2% from 2.6% in 2008 (when restructured portfolio is included, adjusted portfolio delinquency increased to 33.8% in 2009 from 3.4% in 2008).<sup>26</sup> The high provisioning costs associated with the deterioration in portfolio quality triggered significant losses that resulted in negative net income of US\$17.3 million for the fiscal year ended December 31, 2009.<sup>27</sup> Banex's capital adequacy fell from 14.5% in June 2009 to close to 10% in October 2009,<sup>28</sup> the regulatory minimum. During 2009 Banex went into covenant default due to its breach of a PAR30 covenant and a negative pledge clause.<sup>29</sup>

### **The Restructuring**

The first public indication of action by investors to restructure Banex's indebtedness surfaced on December 7, 2009 in a ratings downgrade issued by Fitch Ratings.<sup>30</sup> This correspondence, combined with a notice to Class A noteholders (Noteholders) of BOLD 2007, provided the most significant public glimpse into the developments of the restructuring.

On January 15, 2010 Banex entered into an Intercreditor Restructuring Agreement with creditors to bolster its capital structure.<sup>31</sup> Under the terms of the restructuring, investors injected US\$4.5 million of cash into Banex in exchange for shares. In addition, US\$5.2 million of senior debt was converted into subordinated debt and US\$5.3 million of senior debt was converted into shares. Through the cash injection of equity and conversions from debt to equity and subordinated debt, Banex increased its capital adequacy from 10% in November 2009 to 16% in January 2010 (see Exhibit 4).

Important terms of the restructuring agreement included a moratorium period on all principal payments by Banex until March 2011 (requiring the company to make interest payments only), as well as a series of financial and non-financial covenants including minimum capital adequacy levels and strict adherence to the company's business plan.

International investors led Banex's restructuring efforts — not surprising given the predominance of cross-border investment — with limited participation from local investors. BlueOrchard's December 11, 2009 notice to Noteholders referenced a proposed pro forma restructuring plan in which the majority of Banex's equity ownership would shift from local to international investors, reducing Nicaraguan investors' equity ownership from 58% to 26%. The uneven participation in the workout by domestic and foreign investors was not ideal, in that the underlying goal of a restructuring is to achieve a solution shared by the largest representation possible among co-investors.

On June 11, 2010, Noteholders received a notice informing them of an event of default:<sup>32</sup> the removal of funds by Banex from a reserve account, in breach of the restructuring terms. Pursuant to the January 2010 restructuring agreement, a moratorium prohibited any enforcement action against Banex for a period of 60 calendar days following the delivery of a default notice to the parties to the agreement. On July 7, 2010 BlueOrchard issued another notice to noteholders regarding a further event of default:<sup>33</sup> Banex had failed to make a regularly scheduled interest payment under another agreement, triggering a cross-default with respect to the term loan issued by BOLD 2007 to Banex. In addition, the notice stated that Banex's capital adequacy ratio had fallen below 12% (see Exhibit 4), and Banex would suspend interest payments with respect to its loan agreements.

<sup>26</sup> Superintendencia de Bancos y de Otras Instituciones Financieras de Nicaragua. *Banex: Estratificación de la Cartera Total por Monto y Situación*. Managua: SIBOIF, 2008-2009.

<sup>27</sup> Microfinance Information Exchange Inc.. *BANEX MFI Profile: Income Statement*. Washington: MIX, 2010.

<sup>28</sup> Superintendencia de Bancos y de Otras Instituciones Financieras de Nicaragua. *Banex: Indicadores Financieros Comparativos*. Managua: SIBOIF, 2009.

<sup>29</sup> BlueOrchard Loans for Development S.A. *Notice to Noteholders*. Dublin: Irish Stock Exchange, December 8, 2009.

<sup>30</sup> Fitch Ratings. *Banco del Exito, S.A. Ratings Notice*. San Salvador: Fitch Ratings, December 7, 2009.

<sup>31</sup> Banco del Exito, S.A. *Estados Financieros, 31 de diciembre de 2009*. Managua: Banco del Exito S.A., 2009, note 18, page 51.

<sup>32</sup> BlueOrchard Loans for Development S.A. *Notice to Noteholders*. Dublin: Irish Stock Exchange, June 11, 2010.

<sup>33</sup> BlueOrchard Loans for Development S.A. *Notice to Noteholders*. Dublin: Irish Stock Exchange, July 7, 2010.

This further event of default invalidated the 60-day moratorium, freeing investors to take enforcement action. On August 3, 2010 a Nicaraguan judge ordered the liquidation of Banex. It appears that all depositors recouped their funds prior to the liquidation, given that as of July 31, 2010 the balance of deposits on Banex's balance sheet was zero.<sup>34</sup>

#### Exhibit 4: Timeline of Key Banex Events

| Date             | Event   | Capital Adequacy    | Portfolio Delinquency <sup>35</sup> |
|------------------|---|---------------------|-------------------------------------|
| 2007             | Findesa experiences loan portfolio growth of 42% and raises US\$40 million of debt capital (net) from international investors.  | 14.7% <sup>36</sup> | 1.8%                                |
| 2008             | Findesa receives its banking license and becomes Banex, and by the end of the year is the largest MFI in Nicaragua. Annual loan portfolio growth slows to 10% as the global financial crisis takes hold.  | 14.7% <sup>37</sup> | 2.6%                                |
| December 7, 2009 | Fitch Ratings issues a ratings decline notice (from BBB+ to C) and provides the first public indication of a restructuring at Banex.  | 11.6%               | 11.2%                               |
| January 15, 2010 | Banex enters into a debt restructuring agreement. Investors boost capital adequacy via a cash injection for equity and conversion of debt to subordinated debt and shares.  | 16.0%               | 11.5%                               |
| February 8, 2010 | Fitch ratings lowers Banex's credit rating from C to D.   | 15.6%               | 11.4%                               |
| April 2010       | Capital adequacy falls below 12%, allowing Banex to suspend interest payments on subordinated debt.   | 10.8%               | 12.3%                               |
| June 11, 2010    | BlueOrchard issues a notice to BOLD 2007 Noteholders informing them of an event of default under the restructuring agreement due to removal of funds from escrow.   | 10.9%               | 14.8%                               |
| July 7, 2010     | BlueOrchard issues another notice to Noteholders that Banex has failed to make regularly scheduled interest payments, invalidating the 60-day moratorium on creditor action imposed under the restructuring agreement. The notice indicates that BlueOrchard intends to accelerate indebtedness on Noteholders' behalf. | 7.6%                | 16.3%                               |
| July 23, 2010    | Through an extraordinary shareholders meeting, with presence of 100% of shareholders and a unanimous vote, Banex votes to voluntarily dissolve the bank. <sup>38</sup>  | 4.4%                | 19.0%                               |
| August 3, 2010   | Nicaraguan judge orders the liquidation of Banex. <sup>39</sup>   | 4.4%                | 19.0%                               |
| August 17, 2010  | Fitch Ratings withdraws Banex ratings, noting that it will no longer provide any ratings or analytical coverage for the institution after this date.  | 4.4%                | 19.0%                               |

<sup>34</sup> Superintendencia de Bancos y de Otras Instituciones Financieras de Nicaragua. *Banex: Balance de Situación Condensado al 31 de Julio 2010*. Managua: SIBOIF, 2010.

<sup>35</sup> Calculated as past due loan portfolio as a percentage of total loan portfolio, as defined in reports from the Nicaraguan Banking Superintendent (SIBOIF). Source: Superintendencia de Bancos y de Otras Instituciones Financieras de Nicaragua. *Banex: Indicadores Financieros Comparativos*. Managua: SIBOIF, 2010.

<sup>36</sup> As of December 31st.

<sup>37</sup> Idem.

<sup>38</sup> Superintendencia de Bancos y de Otras Instituciones Financieras de Nicaragua. *Banex: Balance de Situación Condensado al 31 de Julio 2010*. Managua: SIBOIF, 2010.

<sup>39</sup> Ibid (per SIBOIF footnote to the previous document).

## Conclusion

The causes leading to Banex's liquidation are not unique to Banex and point to the importance of adequate risk assessment systems and tools if investors and MFIs are to weather economic down-cycles and unexpected circumstances. A review of the key factors contributing to Banex's failure highlights warning signs for investors and MFIs to consider:

- Nicaragua's high dependence on the U.S. economy, which entered a deep and lingering recession
- A sociopolitical environment that became antagonistic toward financial institutions; the *no pago* movement contributed to a significant deterioration in asset quality
- Unsustainable MFI growth rates, largely fueled by cross-border capital, that may have encouraged riskier growth via SME lending using microcredit underwriting standards (potential governance weaknesses may have further enabled Banex to shift its lending focus)
- Client concentration risk from elevated exposure to the cattle industry during a time of declining beef prices
- Advantages and disadvantages to a diverse investor base in a restructuring situation; while diversity may distribute the restructuring and recapitalization burden across parties, it may also prolong and complicate negotiations (in contrast to Banex, Banco ProCredit Nicaragua appears to have surmounted the crisis by relying on deposits and one strong shareholder)

The microfinance investor community's response to Banex's difficulties demonstrates the balance of commercial and social considerations that traditional microfinance investors strive to maintain. Blue-Orchard observed in its December 2009 Noteholder notice that, "A liquidation of Banex could have a significant negative impact in the microfinance industry in Nicaragua...Nicaragua is the second poorest country in Latin America and, in the past few years, microfinance has played a significant role in supporting poor entrepreneurs."<sup>40</sup> Creditors' and shareholders' recapitalization efforts appear to have been influenced by the social ramifications of Banex's distress; a Banex investor remarked that, "If this were not microfinance, we would have cut our losses." In this case and others, double bottom line lenders have undertaken extensive efforts to keep MFIs in operation because they have determined that it served not only their commercial interests, but those of disadvantaged clients as well.

## SUMMARY

The microfinance sector has maintained remarkably high historical repayment rates and performed well compared to the mainstream financial sector during the credit crisis. But in 2009, a number of MFIs began to show signs of stress as unsustainable growth rates slowed and institutional weaknesses became exposed. In the current downturn, MFI debt restructurings represent an estimated US\$407 million of investment at risk, of which US\$247 million has been channeled through MIIs from international investors. This figure is approximately 6% of total MII debt investment in microfinance. Some level of restructurings will continue to occur as MFIs and investors increasingly use the capital markets to pursue their social mission and generate financial returns.

The research indicates that the global financial crisis has had a net positive effect in strengthening the sector. While still in an early stage of commercial development, MFIs have used the economic slowdown to shift emphasis from growth to improving governance, underwriting, risk management and consumer protection. Similarly, MIIs are strengthening their due diligence, loan documentation, monitoring and restructuring capabilities. Timely adoption of proactive and corrective measures will lessen future risks, allow MFIs to pursue sustainable growth and enhance the microfinance industry's position as an attractive investment for investors seeking double bottom line returns.

<sup>40</sup> BlueOrchard Loans for Development S.A. *Notice to Noteholders*. Dublin: Irish Stock Exchange, December 11, 2009.

The IMFLWG's efforts to produce useful industry information on the emerging issue of troubled MFI loans culminated in: 1) a review of past and current defaults and restructurings, 2) an analysis of factors leading to default and the immediate consequences for MFIs and lenders, 3) the development of best practices and 4) the design of four industry tools with annotations to guide investors and MFIs in their use.

The IMFLWG builds on Morgan Stanley's and IAMFI's commitment to foster a strong, sustainable micro-finance investment environment. IAMFI will continue to collaborate with stakeholders on the implementation of IMFLWG recommendations and tools, in order to facilitate orderly MFI debt restructurings that protect investors and sustain viable MFIs.

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## APPENDIX 1: ABOUT IAMFI AND MORGAN STANLEY

### *About IAMFI*

The International Association of Microfinance Investors (IAMFI) is a global membership organization dedicated to helping commercially oriented microfinance investors achieve their financial and social goals. It offers credible, objective industry information, conducts research, hosts educational and networking events and works to improve the global environment for microfinance investing. IAMFI supports investors so that they may deploy their capital more effectively, thereby increasing access to financial services for the unbanked poor.

For more information about IAMFI, please visit [www.iamfi.com](http://www.iamfi.com).

### *About Morgan Stanley Global Sustainable Finance*

Morgan Stanley's Global Sustainable Finance (GSF) group harnesses the power and discipline of the capital markets to enhance environmental sustainability, advance economic opportunity and support community development. GSF works closely with clients and investors to support the development of long-term business models capable of achieving compelling financial, social and environmental returns and to build a suite of impact investing products. With active commitment of Morgan Stanley senior management, GSF taps intellectual capital and financial expertise across the firm to develop innovative solutions for society's greatest challenges.

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## APPENDIX 2: IAMFI MICROFINANCE LENDERS WORKING GROUP PARTICIPANTS

BlueOrchard Finance USA, Inc.  
 Gray Matters Capital  
 International Association of Microfinance Investors  
 J.P. Morgan  
 Mary Rose Brusewitz  
 MicroCredit Enterprises  
 Microfinance Analytics  
 MicroVest Capital Management  
 Minlam Asset Management  
 Morgan Stanley  
 Triodos Investment Management BV  
 Triple Jump  
 University of Michigan Law School International Transactions Clinic

## APPENDIX 3: STUDY PARTICIPANTS

|   |  |
|---|--|
| BlueOrchard Finance S.A.                                  | Mary Rose Brusewitz  |
| BlueOrchard Finance USA, Inc.                             | Microcredit Enterprises  |
| Calvert Foundation  | MicroRate  |
| Deutsche Bank Global Social Investment Funds              | MicroVest Capital Management   |
| Developing World Markets                                  | Minlam Asset Management  |
| Fitch Ratings   | Morgan Stanley   |
| Freedom from Hunger                                       | Office National du Ducroire /<br>Nationale Delcrederedienst            |
| Grameen Crédit Agricole Foundation                        | Henk van Oosterhout  |
| Grassroots Capital  | Opportunity International  |
| Gray Ghost Ventures                                       | Overseas Private Investment Corporation                                |
| International Association of<br>Microfinance Investors    | Paul Rippey  |
| IPM (Políticas para la Empresa)                           | SME Partners   |
| J.P. Morgan   | Triodos Investment Management BV                                       |
| Dr. Johnson Wagona Makoba<br>(University of Nevada, Reno) | Triple Jump  |
|   | University of Michigan Law School<br>International Transactions Clinic |

## APPENDIX 4: IAMFI MICROFINANCE VOLUNTARY DEBT WORKOUT PRINCIPLES



### **IAMFI Microfinance Voluntary Debt Workout Principles**

*Preamble:*

The following principles have been developed to guide struggling debtor Microfinance Institutions (MFIs), their creditors and other stakeholders as these parties participate in voluntary debt workouts rather than turning to litigation or court-administered insolvency or bankruptcy proceedings for the enforcement of claims against debtor MFIs. These principles are meant to inform the entire workout process; accordingly, they are most effective when consulted as soon as a debtor MFI's weaknesses appear to be threatening its overall creditworthiness or ongoing viability.<sup>41</sup> This document offers annotations in the shaded areas to clarify the principles' purpose and application.

#### **1. Shared Goal of a Long-Term, Going Concern Solution**

Voluntary debt workouts are aimed at preserving and maximizing the long-term, going-concern value of the debtor for the benefit of all involved parties. The voluntary workout for viable debtor MFIs should be structured such that all relevant parties have an incentive to cooperate towards a successful workout solution within a reasonable time horizon.

Not every struggling debtor MFI can or should survive. For viable debtor MFIs, however, both shareholders and creditors should be willing to provide longer-term financial support to the debtor MFI. This support can take a variety of forms, such as agreeing to waivers of events of defaults and related covenants, accepting interest moratoriums, forgoing penalty fees, extending loan maturities, further lending of new money for working capital and participating in debt-for-debt exchanges, debt buybacks and, where the debtor MFI is organized as a joint stock company, debt for equity exchanges.

Having a robust and varied menu of options for a voluntary debt workout is advisable where the workout is likely to involve creditors with varied motivations, investment horizons and funding sources. Such menus of options can help to encourage a critical mass of creditors to participate in the voluntary debt workout. Giving creditors a variety of ways to participate in a debt workout also can mitigate against, although not wholly eliminate, the possibility of damaging creditor "holdouts" that choose to opt out of the debt workout in order to frustrate a successful voluntary resolution of the claims against the debtor MFI.

The legal authority and capacity of creditors to utilize such debt restructuring tools may vary depending on their institutional aims, investment horizons and sources of funding. At the outset of the workout, participants should identify how these motivating forces will affect the behavior of creditors during the greater workout process.

In return, debtor MFIs (including management and shareholders of such MFIs) should be willing to consider such restrictions as dividend blocks, management salary caps and limitations on pledging of assets, among other measures. In some circumstances, even greater cost-cutting measures, governance changes and equity dilution may be appropriate.

<sup>41</sup> For guidance regarding more specific aspects of the voluntary debt workout process, IAMFI has developed three more tools. The *IAMFI Microfinance Intercreditor Agreement Template* provides an annotation of common terms often found in an *ex post* intercreditor agreement, and includes, among other aspects, advice on the formation of a Creditor Steering Committee. The *IAMFI Menu of Debt Restructuring Options* details various debt restructuring alternatives that can be made available to creditors to ensure their participation in a successful voluntary debt workout. The *IAMFI Microfinance Loan Covenant Review* suggests adaptations to common loan agreement clauses that can advance a voluntary debt workout. To access all tools, go to [www.iamfi.com/research](http://www.iamfi.com/research) and click on IAMFI Research.

## 2. Creditor Coordination

Creditors should coordinate their actions at the outset of the proceedings. Timely and effective creditor coordination helps to ensure an efficient and viable debt workout. In some workouts where there are a significant number of creditors, this coordination may be achieved best through the creation of a committee composed of a small number of creditors (often those with particular expertise in managing informal workout negotiations) that will lead the negotiations and ensure the efficient progress of the voluntary workout proceedings.

The interests of relevant creditors are best served by coordinating their responses to a debtor MFI in financial difficulty. Ideally such coordination will be facilitated by the creation of one or more representative coordination committees, and by the appointment of professional advisors to advise and assist such committees and, where appropriate, the relevant creditors participating in the process as a whole. To ensure the legitimacy of such creditor coordination, if a creditor committee is established, it is important that its members be chosen carefully so that they can represent all creditor interests.

## 3. Legal and Regulatory Regime Applicable to the Debtor MFI

Ideally, reliable local counsel should be engaged by both creditors and the debtor MFI at the point in time when financing is first provided to the debtor MFI in order to ensure that the applicable loan documentation is enforceable and that the financing being extended to the debtor MFI comports with all applicable legal and regulatory requirements. Similarly, the local laws and regulations in the home jurisdiction of the debtor MFI may affect a voluntary debt workout. Accordingly, reliable local counsel should be retained by both creditors and the debtor MFI to ensure that the agreed debt workout solution is enforceable in the jurisdiction where the debtor MFI operates.

The involvement of reliable local counsel at all stages of the relationship between lender and debtor MFI will maximize the chances of a successful transaction or, should the debtor MFI run into difficulties, a successful voluntary debt workout process. Some voluntary debt workouts will provide a menu of options to stakeholders, and legal counsel will need to be retained to ensure that all components of this menu of options are enforceable in the jurisdiction where the MFI operates.

## 4. Conflicts of Interest Disclosed

Each creditor or equity holder that participates in the voluntary workout process should disclose, at the outset of the proceedings, to the other creditors and equity holders the extent and nature of its relationship to the debtor MFI.

Creditors and equity shareholders of the debtor MFI may have multiple interests in and/or relationships with the debtor MFI such as debt holdings, equity holdings, guarantees or other credit enhancements, and technical assistance or delivery of other services. Because these multiple interests may give rise to conflicts of interest (or the appearance of conflicts of interest) in the course of a workout, disclosing the extent and nature of these interests and relationships will help encourage the trust and transparency that are crucial to a successful voluntary workout process. In voluntary workouts where a party holds debt and equity stakes, via the same institution, in a debtor MFI, such a party should not act in ways that would impair or undermine the financial recovery of creditors who have no equity interest in the debtor MFI. Moreover, parties that hold both debt and equity stakes in the debtor MFI in a single institution should be prepared to limit their negotiation role in the voluntary debt workout as appropriate.

Furthermore, it may be appropriate for creditors to consider separating debt restructuring functions from debt origination functions to avoid having the same individuals who made the initial decision to extend credit to the debtor MFI now negotiate the terms of the MFI's voluntary debt workout. While this separation of functions may not be feasible yet for creditors that have limited staff and resources, over time such a separation should help lead to more efficient and effective voluntary debt workouts for all concerned parties.

## 5. Standstill Period

All relevant creditors should be willing to cooperate in giving a reasonable period of relief ('Standstill Period') to a viable debtor MFI that is acting and negotiating in good faith. Creditors participating in the Standstill Period should agree to refrain during that time period from enforcing their claims against, or reducing their exposure to, the debtor MFI.

During the Standstill Period, creditors should refrain from taking steps to enforce their credits or foreclose their collateral against the debtor MFI. Sometimes creditors also agree that payments due and payable during the Standstill Period should be directed to an escrow account. All creditors participating in the Standstill Period are entitled to expect that their position during the Standstill Period relative to other creditors will not be prejudiced.

In order for creditors to agree to the Standstill Period, the debtor MFI's shareholders also may need to take steps toward a successful voluntary debt workout. These can include bringing in more capital, diluting the value of existing shareholders' equity, allowing creditors a share in future profits of the debtor MFI, restricting future payment of dividends and imposing senior management salary caps, among other actions.

The Standstill Period might be afforded on either a formal (through the execution of an Intercreditor Agreement) or informal basis. Irrespective of its form, the agreed Standstill Period should be used by creditors and other relevant parties for sharing information about the debtor MFI's financial difficulties, as well as for assessing proposals for resolving them. To this end, parties may find it useful to standardize some of the reporting requirements imposed on the debtor MFI to ensure that concerned creditors receive the same information at the same time regarding the debtor MFI.

## 6. Debtor MFI's Responsibilities During the Standstill Period

A debtor MFI that is benefiting from the Standstill Period should not take action that affects the prospective return of relevant creditors (either collectively or individually) as compared with their positions at the commencement of the Standstill Period. The debtor MFI also should provide and allow creditors and their advisors reasonable and timely access to all relevant information relating to its assets, liabilities, business and prospects, as well as inform creditors of any formal communications between the debtor MFI and its local supervisory authority.

The debtor MFI's management and shareholders must be active participants in the development of the restructuring plan, as they likely share a great deal of responsibility for the MFI's weaknesses and problems, and will stand to gain from ensuring the long-term viability of the institution.

A successful voluntary workout requires the free flow of what may be sensitive information from the debtor MFI to its creditors so that the creditors may evaluate accurately the debtor MFI's financial position in a timely manner. Creditors should expect the debtor MFI and its shareholders to take reasonable steps towards correcting the problems that resulted in its financial distress.

## 7. An Achievable Restructuring Proposal

The voluntary workout should be based on an achievable restructuring proposal that addresses governance, operational and financial weaknesses of the debtor MFI, as well as the investment horizons and any relevant social objectives of the creditors participating in such workout.

A restructuring proposal should result only after conducting an independent due diligence review of the debtor MFI's cash position, financial standing and long-term viability. A proposal should contain forecasts based upon documented and reasonable assumptions as to future events, with evidence that the debtor MFI can generate sufficient cash flow and profit to meet its obligations existing after restructuring.

A successful restructuring proposal likely will require business planning and financial calculations.

To help ensure a successful restructuring proposal, both creditors and the debtor MFI should consider hiring a professional advisor with expertise in restructuring and voluntary workouts. Because the debtor

MFI may lack sufficient capacity to hire an appropriate advisor, stakeholders should be willing to assist in the selection and appointment of such an advisor to the debtor MFI. In some cases, creditors may choose to appoint an independent firm to help the MFI improve its processes, operations and management. Any costs or expenses incurred with regard to such a technical or financial evaluation should be incurred by the debtor MFI.

## **8. Fair Burden Sharing among Stakeholders and Observance of Pari Passu Principle**

Creditors should be willing to absorb a fair share of any losses that result from the debtor MFI's difficulties; provided, however, that equity shareholders of the debtor MFI bear the ultimate risk of such MFI's failure. Creditors cannot be expected to bail out shareholders or management of the debtor MFI. On the other hand, creditors that engage in a successful turnaround of a debtor MFI should receive a fair portion of the financial benefits of the turnaround.

Creditors in identical or similar positions should receive identical or similar treatment during the voluntary debt workout.

Loss sharing among different classes of creditors, and between creditors and different classes of shareholders, should be based on an analysis of the recovery each party would have made in a theoretical liquidation of the debtor MFI.

This means, for example, that unsecured creditors should be treated differently than secured creditors. Similarly, in some situations, the equity shareholders should expect to have their shareholdings in the debtor MFI diluted, perhaps significantly, if creditors opt to participate in a debt-for-equity conversion or new capital infusions are made by other parties. Similarly, the debtor MFI should not use the workout process to improve the position of any one creditor vis-à-vis other creditors of a similar rank or status, unless all other similarly situated creditors first agree.

## **9. Priority Status of Additional Debt Funding**

If additional debt funding is provided, whether during the Standstill Period or under any restructuring proposal, the repayment of such additional funding, so far as practicable, should be accorded priority status as compared to other claims of indebtedness of the debtor MFI.

Creditors and equity shareholders should understand that additional debt funding might be necessary to ensure the debtor MFI's value as a going concern or to permit the debtor MFI to continue to meet its social objectives, and that such additional funding likely will only occur if such funding is accorded priority status relative to pre-existing debt obligations of the debtor MFI. In all cases, however, current shareholders of the debtor MFI should try their utmost to invest additional equity or bring in new equity, and cannot expect to rely only on additional debt funding for the debtor MFI.

## **10. Debtor MFI's Responsibility for Workout Costs**

The debtor MFI should be responsible for the costs of the voluntary workout when creditors are enforcing their claims. To the extent such costs are under the control of creditors, however, these costs should be both clearly defined and minimized.

Most loan agreements impose on debtors the burden of paying all costs related to the enforcement of such debt obligations. This principle should be respected in voluntary workouts. However, because the workout process can be expensive, with struggling debtor MFIs perhaps lacking the capacity to meet their cost obligations, it is critical that creditors engaged in the workout process act efficiently and minimize the costs to the debtor.

## APPENDIX 5: IAMFI MICROFINANCE INTERCREDITOR AGREEMENT TEMPLATE



### IAMFI Microfinance Intercreditor Agreement Template

*Preamble:*

This document represents an annotated term sheet for Intercreditor Agreements (ICA) in voluntary microfinance institutions (MFI) debt workouts.<sup>42</sup> A key purpose of an ICA typically is to provide the debtor and its assets relief from the actions of its creditors for a set period of time, often called the “Standstill Period.” The Standstill Period gives the debtor the opportunity to work with its creditors, shareholders and other relevant stakeholders (which, for a distressed MFI, could include bank regulators or other local government authorities, donors, affiliated networks and providers of credit enhancements, to name a few) to see if it is feasible to develop a cohesive and viable workout plan, which may include restructuring or rescheduling its outstanding debt obligations, and addressing and resolving operational, governance or other issues that threaten the viability of the debtor’s business or operations.

The *ex post* execution<sup>43</sup> of an ICA with a Standstill Period functions in a roughly analogous fashion to the initiation of formal insolvency proceedings in jurisdictions where the law provides that entering into such proceedings results in a stay or other types of limitations on creditors’ ability to take action against the debtor or the debtor’s assets in order to satisfy their claims. A critical difference, however, is the voluntary nature of the creditors’ participation in an ICA. Only those creditors that decide to enter into the ICA will be bound by its terms and conditions.<sup>44</sup> Consequently, the relief provided by the Standstill Period in an ICA may be limited and less certain than the parties to the ICA may have hoped.

Accordingly, it is important to weigh the amount of time that it takes to negotiate the terms of an ICA against the likelihood that a critical mass of creditors will agree not to take actions against the distressed MFI for an agreed period of time and under a specified set of circumstances. In some cases, this is time that could be better spent in direct negotiation with the distressed debtor, particularly in a microfinance context where the debtor’s viability shows signs of quick deterioration. Even where an ICA with an embedded Standstill Period is agreed, if either the Standstill Period lapses without showing progress toward reaching an acceptable workout plan (and such period is not extended by the creditors participating in the ICA) or circumstances change in a way that is particularly adverse to some or all of the participating creditors, then the ICA is likely to terminate.

<sup>42</sup> For guidance regarding more specific aspects of the voluntary debt workout process, IAMFI has developed three more tools. The *IAMFI Microfinance Voluntary Debt Workout Principles* guide struggling MFI creditors, the MFI and other stakeholders in a voluntary restructuring effort that is proactively sought and led by lenders. The *IAMFI Menu of Debt Restructuring Options* details various debt restructuring alternatives that can be made available to creditors to ensure their participation in a successful voluntary debt workout. The *IAMFI Microfinance Loan Covenant Review* suggests adaptations to common loan agreement clauses that can advance a voluntary debt workout. To access all tools, go to [www.iamfi.com/research](http://www.iamfi.com/research) and click on IAMFI Research.

<sup>43</sup> This ICA term sheet presumes that it is being executed *ex post*, not *ex ante*, in that creditors of the distressed debtor are agreeing to the terms of an ICA *after*, not before, the debtor has run into trouble. There are other types of ICAs in which creditors engage *ex post*, for example, to come to an agreement on the terms for sharing in collateral being pledged by a debtor.

<sup>44</sup> The ICA needs to include a critical mass of creditors so that parties to the agreement can be assured that there are no other similarly situated creditors taking advantage of the temporary restriction by unilaterally pursuing collection actions against the debtor. On the other hand, as discussed herein, there may be certain types of creditors—such as creditors that have extended trade/supplier or interbank lines of credit to the borrower—whose debt is so different or relationship with the MFI is so unique as to make participation in the ICA irrelevant or unproductive.

This Term Sheet contains terms and conditions frequently found in *ex post* ICAs that include Standstill Periods. As distressed debt workouts can vary significantly, however, this Term Sheet (and its resulting ICA) will need to be tailored narrowly to the facts and circumstances of the specific situation. Experience indicates that some of the most important facts and circumstances that will impact the voluntary debt workout of a distressed MFI, and, thus the scope and suitability of an ICA, include:

- 1) nature and number of affected creditors: local or foreign, legal form, sources of funding (capital markets or other funding sources), motivations (primarily social or financial/commercial), extent of other microfinance exposure/experience, status (development financial institution, development bank or private entity), to name a few;
- 2) priorities among creditors: secured or unsecured, senior or subordinated;
- 3) nature of debt obligations owed by distressed MFI: currency (local or foreign), maturity profile (short-, medium-, long-term), intended use of proceeds (working capital, supplier credits, interbank liabilities, other), to name a few;
- 4) nature of debtor MFI: legal form (nonprofit or for profit, regulated or unregulated, tax-exempt or tax-paying), capital structure and sources of funding (retained earnings, deposits, donations, borrowings, equity, capital markets, other), existing cash position and access to additional sources of capital, product offerings (credit, savings, insurance, remittances, nonfinancial services, other), target customers and social objectives, governance, type of shareholders (individuals, institutions, government-affiliated, etc.), to name a few;
- 5) primary factors that led to distressed situation of debtor MFI: weak corporate governance, poor systems and controls, fraud, operational or management problems, external factors (country risk, acts of God, regulatory interventions, foreign exchange issues, etc.), to name a few;
- 6) local legal and regulatory regime applicable to debtor: applicable bankruptcy regime, applicable supervisory regime, laws relating to general enforceability of claims, dispute resolution for a, transparency/clarity of local legal and regulatory regime, adequacy of local counsel, to name a few;
- 7) social objectives of creditors and debtor (and other related stakeholders);
- 8) viability of alternatives to proposed debt workout;
- 9) nature and extent of legal actions, if any, already commenced against debtor; and
- 10) percentage of affected creditors willing to be bound by an ICA or participate in an informal intercreditor arrangement.

Finally, even where an ICA is agreed among a critical mass of affected creditors, it is likely that other actions will be required by actors that are not party to the ICA to ensure that the objectives of the ICA are fulfilled. For example, there may need to be a limitation or block placed on dividends issued to shareholders of the debtor MFI. Or, there may need to be actions undertaken by the debtor MFI itself in order for the terms of the ICA to be realized, such as the establishment of an escrow account into which scheduled debt payments are made by the debtor MFI. The shaded areas in this document offer annotations to clarify the purpose and application of the ICA's terms and conditions.

#### *Parties:*

[List of creditors to participate in the ICA]

This requires a determination as to which creditors should participate in the ICA. The answer to this question will turn on what debt is to be covered by the ICA.

This also requires a determination as to whether any third party guarantors should be party to the ICA and/or how these guarantors will be brought into the ICA should their guarantees be called during the term of the ICA.

Note that typically the debtor is not expected to be a party to the ICA. The debtor, however, will need to be party to subsequent agreements that are required to implement the proposed workout; and, if an escrow arrangement is contemplated for managing scheduled debt payments of the debtor during the workout process, the debtor will need to be party to that escrow arrangement.

Some creditors party to the ICA may find it advisable to separate the loan origination function from the debt workout function when choosing who will represent their interests in a debt workout negotiation. This can help to avoid internal conflicts of interest and also assist in “professionalizing” the debt workout negotiations.

*Covered Debt:*

[Description of the debt to be covered by provisions of the ICA] (the “Covered Debt”)

This requires a determination as to what kind of debt is expected to be covered by the ICA, and, thus, subject to its standstill provisions. Short-term credits, which could include interbank lines or suppliers’ credit, often will be excluded from a restructuring or rescheduling. It is possible, however, that the ICA would attempt to include such debt in its standstill provisions until the terms of the workout are agreed, or otherwise attempt to impose a requirement for the extension of the ICA (and its standstill relief) on the condition that certain short-term lines of credit that are necessary for the ongoing business of the debtor be renewed or rolled over.

At the point of entering into the ICA, creditors normally identify and describe the outstanding debt obligations owed to them by the debtor. Such identification may include, among other things, ranking of seniorities (the relative priority vis-à-vis other creditors, such as senior, subordinated, pari passu, etc.), existence of credit enhancements (collateral, guarantees, etc.), the original principal amount, the current outstanding principal amount, applicable interest rates (on current and overdue amounts), the scheduled payment dates and events of defaults.

*Representations and Warranties:*

[Description of the creditors’ valid status, power/authority to enter into ICA, legal validity of ICA, non-conflict, authorizations, beneficial ownership of Covered Debt, etc.]

Among other things, these representations and warranties are intended to guarantee the validity of the ICA. These representations and warranties also provide an opportunity for all creditors to the ICA to describe their respective positions vis-à-vis the debtor and each other.

*Standstill Period:*

Commencing on [effective date of ICA] (the “Initiation Date”) and ending on [XXX] (the “Termination Date”) unless renewed by the parties to the ICA. During this period (the “Standstill Period”), the parties to the ICA agree not to pursue foreclosure or to collect the [principal payments in respect of] debt obligations owed to them by the debtor.

A key reason for entering into an ICA is to give some relief to the debtor from creditors’ actions for a specified period of time, the Standstill Period.

Identifying the beginning of the Standstill Period is extremely important since it establishes the date after which all principles applicable to a restructuring process will typically apply. For instance, the Standstill Period may commence on i) the day when a significant number of creditors is notified of a meeting with the trouble debtor to discuss its distress situation, ii) the day when a restructuring meeting takes place, iii) the day when the debtor generally stops making payments to all creditors, iv) the day when the debtor defaults on a significant financial obligation, or v) the day when the debtor publicly announces its moratorium.

Parties to the ICA will need to determine on a case-by-case basis which debt obligations (principal, interest, default interest, etc.) are being impacted by the Standstill Period. This determination will likely turn on the debtor's financial condition. If an escrow arrangement is contemplated by the parties to the ICA, the resulting escrow arrangement should be drafted in a manner consistent with this provision.

- 1) Conditions for renewing the Standstill Period shall include: [XXX].
- 2) Conditions for terminating the Standstill Period shall include: [XXX].

The conditions for renewing a Standstill Period and terminating a Standstill Period are subject to negotiation. Note, however, that creditors often will insist on retaining an individual, as opposed to collective, right to terminate the Standstill Period early in the event of certain actions of others—such as if a significant creditor commences litigation against the debtor, or the debtor enters into a bankruptcy proceeding or a regulator intervenes in the operation of the debtor.

Standstill Periods typically are relatively short in duration. This will require, therefore, provisions to allow for its renewal should creditors agree.

Typically only those creditors agreeing to renew or extend the Standstill Period will continue to be bound by the terms of the ICA and its Standstill Period. Even then, there are likely to be preconditions for such a renewal or extension. One common precondition for renewing a Standstill Period is the affirmative decision by a requisite number of creditors that the debtor remains a going concern. Such affirmative decision may be made through a vote of unanimity, supermajority or simple majority at the Steering Committee (described below). It is not unusual for creditors to require a supermajority to renew or terminate a Standstill Period. This can be articulated as a requirement that creditors on the Steering Committee holding, in the aggregate, at least 66 2/3%, or 75% of the outstanding principal amount of Covered Debt consent to such renewal or termination. Note that if a higher percentage, such as 90%, is required, this gives disproportionate control to the smaller creditors in relation to their exposure to the distressed debtor, possibly providing an effective veto right.

Conditions for terminating the Standstill Period before its expiration date may include bankruptcy and insolvency proceedings, government intervention such as expropriation and, of course, the expiration of the Standstill Period without an affirmative decision by creditors to renew. In the latter case, parties to an ICA also may allow a grace period for the automatic termination, thereby defining the termination date for the Standstill Period to be a specified number of days after the expiration of such Standstill Period.

As noted above, if the debtor is a regulated MFI, there may need to be additional conditions for early termination of the Standstill Period that would be triggered by actions taken by local regulatory/supervisory authorities if such actions are adverse to the interests of the creditors.

#### *Forbearance and Creditors' Duties:*

During the Standstill Period, each creditor agrees that:

- 1) it will not seek to enforce or accelerate loan repayment, or to sue or pursue other judicial or arbitral remedies against the debtor and/or the debtor's assets.

During the Standstill Period, creditors typically agree under the ICA to refrain from undertaking a number of enforcement actions against the debtor and the debtor's assets. This is intended to ensure that individual creditors will not take uncoordinated collection actions at the expense of other creditors and/or to the detriment of signatory creditors to the ICA as a whole.

Please note that ICAs with strict forbearance clauses may be unpalatable to some creditors. On the other hand, even those creditors that are reluctant to be bound by an ICA may find it in their mutual interests to sign an ICA if they believe that giving the debtor standstill relief is necessary to achieving a satisfactory resolution of the troubled debt.

- 2) it will not change its Covered Debt obligations so as to:
  - (a) increase the principal amount, or amend or modify the amortization schedule;
  - (b) increase the interest rate or margin, or increase any fees payable in connection therewith;
  - (c) change or modify any default or event of default (other than to eliminate or waive any such default or event of default, or to increase a grace or notice period with respect thereto);
  - (d) change the redemption, prepayment or defeasance provisions thereof (or of any guaranty thereof) in a manner materially adverse to the debtor;
  - (e) add any covenant or obligation, or modify any covenant or obligation to make it more restrictive;
  - (f) confer any additional rights to such creditor or its affiliates, or make any other change that could reasonably be expected to be materially adverse to any other creditor; or
  - (g) change the currency in which such Covered Debt is payable.
- 3) [it will not call all or part of any third party guarantees of its Covered Debt.]

This provision is likely to be controversial and needs to be negotiated among creditors. An alternative, which may not be workable given the terms of the applicable third party guarantee, is to cause any creditors that call on third party guarantees during the Standstill Period to use their commercially reasonable best efforts to include such resulting reimbursement obligation under the terms of the ICA as other Covered Debt.

- 4) it will maintain the confidentiality of all information obtained from the other creditors as well as the debtor.

During the Standstill Period, creditors are likely to work with the distressed debtor to gather information that is pertinent to an evaluation of the debtor's business operations, prospects, financial condition, capital structure and reasons for distress. This clause concerns the confidentiality of information as against non-parties to the ICA. In the "Steering Committee" section below, members of the Committee have duties to share more information than stipulated under this current clause.

Note that creditors may be subject to other confidentiality obligations to third parties (such as the creditors' investors or regulatory/supervisory authorities), in which case this confidentiality provision will need to be further negotiated and its language further tailored.

A possible additional provision could be added here that would require creditors to amend their respective loan agreements (or provide waivers) so as to standardize the form and substance of information required to be delivered by the distressed debtor during the Standstill Period. This would ensure that creditors would receive the same information at the same time as other creditors, while also alleviating the burden on the distressed debtor of providing multiple reports.

#### *Steering Committee:*

A Steering Committee shall be formed consisting of the following creditor representatives: [XXXX].

A Steering Committee will be most useful in debt workouts where there is a large number of creditors, or there are creditors that have limited exposure, expertise or resources and would prefer to delegate some of the creditor coordination responsibilities to fellow creditors. To date, in microfinance debt workouts, the trend is not to provide for a Steering Committee.

This provision defines the composition of a Steering Committee. A key task of the Steering Committee is to convene at regular intervals to determine whether to extend the Standstill Period in light of the financial conditions and status of negotiations with the debtor. All creditors party to the ICA may choose to be represented directly on the Steering Committee, or they may choose to elect a smaller subgroup of creditors.

The size and composition of the Steering Committee may vary, largely depending on the function of the Committee (as decision-maker or coordinator), the extent to which creditors' interests are aligned (long-term versus short-term, secured, unsecured or subordinated) and the number of signatory creditors to the ICA. A bigger Steering Committee tends to better represent all creditors' interests, but size may come at the expense of efficiency. Regardless of the size, a Steering Committee's composition needs to take into consideration the interests of both big and small creditors. In sum, the composition of the Steering Committee will shape its overall "legitimacy" and, hence, its effectiveness.

If members of the Steering Committee learn of relevant information relating to the debtor or the subject matter described herein, they agree to share such information with the other creditors party to the ICA as soon as practicable; provided, that such sharing of information does not constitute a breach of other confidentiality obligations they are under.

This provision is necessary only if some creditors party to the ICA are not members of the Steering Committee.

[All] Decisions of the Steering Committee shall be made by votes of the Required Creditors. Required Creditors means creditors representing at least [XX]% of the aggregate outstanding principal amount of the debtor's debt as of [\_\_\_\_, 20\_\_].

This defines the quorum for decisions of the Steering Committee. There may be some decisions, however, where all creditors participating in the ICA will want to agree before being bound by the terms of the ICA. If signatory creditors to the ICA are unwilling to delegate the decision-making function to the Steering Committee, this foregoing clause may be narrowed so that the role of the Steering Committee is merely to facilitate communication between debtor and creditors, and to coordinate among creditors.

It is imperative that the Steering Committee maintain transparency of its decision-making process and be answerable to creditors party to the ICA throughout its dealings with the debtor.

#### *Escrow Account*

To facilitate payments by the debtor to its creditors during the Standstill Period, an escrow account will be established to be administered by [\_\_\_\_\_] (the "Escrow Agent").

Escrow arrangements can be difficult to establish, and the unwinding of (or payouts from) an escrow account can be contentious. Escrow accounts are most often established where creditors believe that there is a need to facilitate an orderly and transparent allocation of payments by the distressed debtor to its creditors during the Standstill Period.

Note that since the ICA is binding only on signatory parties, the debtor also will have to agree to participate in such an escrow account arrangement. Similarly, payments owed to creditors that are not party to the ICA would not be included in such escrow arrangements, unless the affected creditors separately agreed to participate.

A question to be considered by the creditors is whether such escrow account should handle only payments of principal or all payments (interest and default interest, among others) owed by the debtor. Arrangements also need to be established to describe how and when payments are to be released upon the termination of the Standstill Period.

The Escrow Agent may be a bank or the debtor, depending on the size of the Covered Debt and the trustworthiness of the debtor. A bank serving as the Escrow Agent is safer but more expensive, whereas the debtor as the Escrow Agent is cheaper but riskier.

*Assignability:*

No assignment or transfer of Covered Debt shall be made during the Standstill Period [, unless such assignment or transfer is allowed by the written consent of {the Steering Committee/all signatory creditors}, and such assignee or transferee agrees to be bound by terms of ICA].

This is a matter for negotiation among the creditors. At issue is how willing creditors are to permit (or require) other new players to be bound by the terms of the ICA and its Standstill Period. Transfer of Covered Debt to affiliates of the debtor generally should not be allowed, as such a transaction may be a preferential treatment that defeats the purpose of the ICA's forbearance clauses.

*Effective Date:*

Effective upon execution of ICA [to take place by \_\_, 20\_\_]

*Governing Law:*

This is often Dutch, Luxembourg, New York or English, unless the MFI's country regulations require national law.

*Costs and Expenses: [to be negotiated]*

Most loan agreements impose on the debtor the burden of paying all costs related to the enforcement of such debt obligations; this should be respected in voluntary workouts as well. However, because the workout process can be expensive and the struggling debtor MFI may lack the capacity to cover expenses, it is critical that creditors mitigate and minimize the costs to the debtor.

*Enforcement and Arbitration:*

- 1) Any dispute that cannot be resolved through negotiation within [XX] days shall be resolved by arbitration administered by [name of the selected arbitration administrator].
- 2) Place of arbitration shall be [XXX]
- 3) [XXX] language shall be used throughout the arbitration proceedings.
- 4) Arbitration decisions shall be final and binding.
- 5) Each party to a dispute shall bear its own expenses in the arbitration, and the fees and expenses of the arbitrator and the administrative costs and expenses of the [arbitration administrator] shall be divided equally among the parties to the arbitration.

This provision assumes that the parties to the ICA will prefer arbitration for the resolution of disputes. Note that parties to voluntary debt workouts may be reluctant to enter into binding provisions that would restrict their options in the event of disputes. Some creditors may have policies in place that do not allow for arbitration as a means of dispute resolution, whereas others may insist on arbitration. In such cases alternative approaches need to be mutually agreed upon for dispute-resolution purposes.

## APPENDIX 6: IAMFI MENU OF DEBT RESTRUCTURING OPTIONS



### IAMFI Menu of Debt Restructuring Options

The following set of options serves to guide the initial design of a restructuring proposal by lenders, shareholders and MFI management.<sup>45</sup> There is a trade-off between the level of complexity, or execution risk, and the ability of the restructuring to meet the various needs of participating creditors.

| IAMFI Menu of Debt Restructuring Options |  |  |   |
|--|--|--|---|
| Option                                   | Debt Buyback   | Debt Exchange  | Debt for Equity Exchange  |
| Description                              | <ul style="list-style-type: none"> <li>• Use of cash to retire existing MFI debt at a discount</li> </ul>  | <ul style="list-style-type: none"> <li>• Exchange of existing debt for new MFI debt securities</li> </ul>  | <ul style="list-style-type: none"> <li>• Exchange of existing debt for MFI equity</li> </ul>  |
| Issues                                   | <ul style="list-style-type: none"> <li>• Level of discount</li> <li>• Fixed price versus auction mechanism</li> <li>• Amount and type of eligible debt</li> <li>• Source of funding for buyback</li> </ul> | <ul style="list-style-type: none"> <li>• Terms of new debt securities (adjustments to principal, interest rate, tenor, etc.)</li> <li>• Nominal vs. net present value reduction</li> <li>• Amount and type of eligible debt</li> </ul> | <ul style="list-style-type: none"> <li>• Ownership percentage for converting creditors</li> <li>• Dilution of existing shareholders</li> <li>• Corporate governance</li> <li>• Regulatory approvals</li> </ul>      |
| Pros                                     | <ul style="list-style-type: none"> <li>• Low complexity</li> <li>• Likely to provide maximum discount</li> <li>• Avoids equity dilution (unless funded via issuance of equity)</li> </ul>                  | <ul style="list-style-type: none"> <li>• Medium complexity</li> <li>• No cash required</li> <li>• Avoids equity dilution</li> <li>• Flexible: can offer different types of debt securities</li> </ul>                                  | <ul style="list-style-type: none"> <li>• Reduces debt</li> <li>• No cash required</li> </ul>  |
| Cons                                     | <ul style="list-style-type: none"> <li>• Loss of liquidity for MFI</li> <li>• Moral hazard</li> <li>• Requires cash</li> </ul>   | <ul style="list-style-type: none"> <li>• New financial terms and covenants</li> <li>• May not reduce face value of debt</li> </ul>   | <ul style="list-style-type: none"> <li>• High complexity</li> <li>• Dilutes existing equity</li> <li>• Some creditors may not want or cannot own equity</li> <li>• New shareholders may seek early exits</li> </ul> |

<sup>45</sup> For guidance regarding more specific aspects of the voluntary debt workout process, IAMFI has developed three more tools. The *IAMFI Microfinance Voluntary Debt Workout Principles* guide struggling MFI creditors, the MFI and other stakeholders in a voluntary restructuring effort that is proactively sought and led by lenders. The *IAMFI Microfinance Intercreditor Agreement Template* provides an annotation of common terms often found in an ex post intercreditor agreement, and includes, among other aspects, advice on the formation of a Creditor Steering Committee. The *IAMFI Microfinance Loan Covenant Review* suggests adaptations to common loan agreement clauses that can advance a voluntary debt workout. To access all tools, go to [www.iamfi.com/research](http://www.iamfi.com/research) and click on IAMFI Research.

## APPENDIX 7: IAMFI MICROFINANCE LOAN COVENANT REVIEW



### IAMFI Microfinance Loan Covenant Review

#### *Preamble:*

This document summarizes the confidential review of loan agreements used by microfinance investment intermediaries (MIs) that the University of Michigan Law School's International Transactions Clinic (ITC) conducted for the IAMFI Microfinance Lenders Working Group.<sup>46</sup>

Covenants in loan agreements function as promises from the borrower as to how it will conduct itself after the disbursement of a loan. Covenants are highly negotiated and can take many forms: negative, affirmative, reporting, financial, "stoppers" and "maintenance." Covenant breaches can contribute to, as well as signal, the distress of a microfinance institution (MFI). Healthy MFIs may breach loan documentation covenants from time to time, and in those cases, lenders typically are amenable to providing waivers or amendments. In times of stress, however, lenders may react with much greater concern and may be unwilling to waive covenants or amend the underlying loan documentation, particularly if there are multiple breaches or defaults are escalating for the troubled MFI.

Breaches of covenants typically are the basis for a declaration of an event of default, which in turn could give the lender the right to accelerate repayment of the loan. While it would be very rare for a lender to accelerate solely on the basis of a single or even multiple covenant breaches (in contrast to a payment default), lenders view breaches with concern as they may imply more serious problems. Multiple covenant breaches or a particularly egregious breach may cause the lender to bring the borrower back to the negotiating table. This review describes standard covenants in MFI loan documentation and offers additional covenants that might be useful for advancing a voluntary debt workout with a stressed MFI. It groups covenants into four general categories: reporting, financial, negative and affirmative covenants. The annotations in the shaded areas clarify the covenants' purpose and application.

#### **I. Reporting Covenants**

Reporting covenants ensure the lender is receiving timely information about the borrower and the borrower's financial condition. These include systematic reports on a monthly, quarterly or annual basis, as well as reporting requirements triggered by a particular event or change in the borrower's condition. Reporting covenants allow the lender to monitor the condition of the borrower and take corrective action if warranted.

##### **Ia. Accessibility of MFI's books and records to its lenders**

Allowing the lender to observe the books and records of the borrowers may provide reassurances, or raise red flags, that financial statements alone do not provide. Information that the lender or the lender's representative learns during such examinations would be subject to any confidentiality provision. The lender also may want to include language clarifying whether the lender or borrower will assume the costs for such inspection.

<sup>46</sup> For guidance regarding more specific aspects of the voluntary debt workout process, IAMFI has developed three more tools. The *IAMFI Microfinance Voluntary Debt Workout Principles* guide struggling MFI creditors, the MFI and other stakeholders in a voluntary restructuring effort that is proactively sought and led by lenders. The *IAMFI Microfinance Intercreditor Agreement Template* provides an annotation of common terms often found in an *ex post* intercreditor agreement, and includes, among other aspects, advice on the formation of a Creditor Steering Committee. The *IAMFI Menu of Debt Restructuring Options* details various debt restructuring alternatives that can be made available to creditors to ensure their participation in a successful voluntary debt workout. To access all tools, go to [www.iamfi.com/research](http://www.iamfi.com/research) and click on IAMFI Research.

**ib. Any other information concerning the Borrower that Lender may reasonably request from time to time**

This provision can augment the accessibility provision, above, and act as a catch-all to include any documents that the lender does not currently anticipate requesting but may need at a later time.

**ic. Accounting standards to be used by reporting MFI borrowers**

All of the borrower's financial reports should use the same accounting standards, which may be dictated by the national accounting standards used by the auditors in a particular country, or by regulatory authorities if the MFI is regulated. It is preferable that the borrower use the same accounting standards for all of its debt obligations and related reports, so that all lenders receive the same information in a timely and consistent manner. Deferring to the borrower's preference of accounting standard should be in everyone's interest.

**id. Notice of any new debt finance obtained from third parties**

As a part of due diligence, prospective lenders will typically ask the borrower for financial information regarding its existing debt. Current lenders may require notice of key financial terms of any new debt financing so that lenders are aware of all of the borrower's debt obligations.

**ie. Notice of any early redemption or prepayment by MFI of debt obligations owed to third parties**

When healthy borrowers redeem or repay their debt obligations early, other lenders typically benefit because the borrower is paying down its existing debt. However, early redemption or repayment to third parties can become problematic when the borrower is in trouble or facing liquidity constraints. This provision requires notice of early redemptions or prepayments of debt obligations owed to other lenders. See the corresponding provision under "Modified Covenants Once a Problem Arises" in section 5 below.

**if. Notice of material changes to borrower's underwriting procedures**

Any material changes to the borrower's underwriting procedures — and to their application — could affect the creditworthiness of the borrower. This provision would also uncover a shift in the MFI's target customer base, which may be important to lenders seeking specific social objectives.

**ig. Notice of change in rating or any new rating by a rating agency (must provide copy of new rating report)**

Ratings may focus on the borrower's overall systems and financial performance, on the MFI's social impact or on the likelihood of a default of a particular debt obligation. This provision helps to keep the lender apprised in the event that the borrower's rating is downgraded. Note, however, that MFIs do not generally undertake regular ratings so a downgrade could lag, rather than signal, MFI troubles.

**ih. Notice of Events of Default (including incipient default), litigation (actual and threatened), cross-defaults or accelerations**

This clause requires the borrower to inform the lender of defaults, events of default and other serious events that are likely to be known to the borrower before they would be known to the lender, such as accelerations of other debt obligations. There is some overlap between this provision and the requirement that the borrower deliver, at set times, a certificate to the lender confirming that no event of default has occurred.

**ii. Notice of changes in regulatory status/compliance (including filings), material comments/examinations from any regulatory authority (including information filed with local stock exchange)**

As MFIs become increasingly regulated by host government authorities, this provision notifies lenders of any regulatory actions taken or proposed to be taken against the borrower. The clause would include any instances where local authorities may assert control over an MFI's actions that could impede its capacity to do business or repay its debt obligations.

**ij. Notice (and sharing) of any management letter or other communication sent by auditors and details of any proposed change in auditors (including termination and appointment)**

It is common in loan agreements for lenders to receive copies of all audits of the borrower, including any qualified audits. In some loan agreements, the lender requires the borrower, as a condition precedent to disbursement, to provide a letter authorizing its auditor to share information directly with the lender. This proposed clause offers broader firsthand access to the auditors' communications, and would uncover a potential problem signaled by an intended change in auditors.

**2. Financial Covenants**

Well-designed financial covenants permit the lender to influence the future conduct of the borrower, reducing repayment risk. The loan agreements under review revealed a variety of financial covenants measuring the quality of the MFIs' assets (usually focused on microcredit portfolios), liquidity, solvency and foreign exchange exposure. This section provides definitions for the more standard financial covenants and offers suggestions for improving their usefulness.

**2a. Portfolio at Risk (PAR) over 30 days and PAR over 90 days**

The PAR ratio represents the value of loans past due for a specific period as a percentage of total outstanding loans. It describes the overall health of the MFI's microcredit portfolio, although recent experience suggests that high growth in microcredit portfolios may have masked some quality problems. A limit on the PAR<sub>30</sub> ratio (past due over 30 days), such as 5%, is most commonly used as a financial covenant; lenders may consider imposing a limit on the PAR<sub>90</sub> ratio, also. For consistency and completeness, the PAR ratio calculation should include all restructured, refinanced, rescheduled and renegotiated loans.

**2b. Write-off ratio**

This ratio measures the percentage of the borrower's microcredits that it has removed from the balance of its microcredit portfolio because they are unlikely to be repaid. A large or rising level of write-offs is a warning sign of the MFI's financial deterioration.

**2c. Reserve coverage ratio**

This ratio measures the loan loss reserves that have been established by the borrower to cover losses on its microcredit portfolio.

**2d. Risk coverage ratio**

This ratio shows how much of the microcredit portfolio at risk (PAR) is covered by the borrower's impairment loss allowance. It gives the lender an idea of how well-prepared the borrower is for potential loan losses.

**2e. Capital adequacy ratio**

This ratio measures the amount of the borrower's capital relative to the amount of its assets (which, in the microfinance context is predominantly its microcredit portfolio). It gives the lender an indication of the borrower's solvency and its ability to meet its obligations and absorb unexpected losses. Lenders may require unregulated MFIs to measure a simplified capital adequacy ratio of equity to assets. For regulated MFIs the capital adequacy ratio is often defined and its required minimum level prescribed by local laws and regulations. MFI requirements may be more stringent than those imposed on more formal banking institutions. If the MFI falls below required regulatory capital adequacy levels, the regulator/supervisor may intervene independent of a lender's covenant requirements.

**2f. Foreign exchange exposure limits**

In response to the cross-border nature of microfinance investing, this measure imposes a limitation on the amount of the borrower's net foreign currency position (assets denominated in foreign currency less liabilities denominated in foreign currency) in any single foreign currency or in aggregate.

## **2g. Operational self-sufficiency (OSS) ratio**

This ratio measures the ability of the MFI to generate sufficient revenue to cover its costs, including financial expenses, loan loss provisions and general operating expenses. The ratio is calculated by dividing the MFI's revenue (generally interest income derived from its microcredit portfolio) by the sum of its expenses for a given time period. An indicator above 100% indicates that the MFI has reached operational self-sufficiency for the period.

## **2f. Liquidity requirements**

Lenders may impose liquidity requirements on the borrower in excess of those imposed by local regulators, to ensure that the borrower has a stable funding base and can meet its financial obligations in a timely fashion. For example, liquidity covenants may impose limitations on 1) average maturity of the borrower's liabilities as compared to the average maturity of its assets, 2) amount of the borrower's short-term liabilities and 3) liquid reserve requirements (invested in cash-equivalent or other relatively liquid assets). Lenders may set different liquidity requirements for a deposit-taking MFI and one that does not access deposits as a significant funding source.

## **3. Negative Covenants**

Like financial covenants, negative covenants generally help the lender to influence the future conduct of the borrower so as to reduce the risk of non-payment. Negative covenants disallow material changes in business or legal form, restrict excess leverage (restrictions on debt and leases), prevent the borrower from conveying security interests in property to other lenders (negative pledge clauses) and require the borrower to maintain its assets (restrictions on dividends, sales of assets, etc.). Sometimes the covenants described below are framed as Affirmative Covenants rather than as Negative Covenants, but with the same substantive effect.

### **3a. No material change in the general nature of borrower's operations**

This covenant limits fundamental changes in the borrower's business, ensuring that the borrower will substantially remain the same entity, with its business and assets intact, to which the lender agreed to extend credit. For many nonprofit lenders, funding must further their benevolent purpose in order to maintain nonprofit status; a material change in the MFI's business (such as a significant shift in the target customer base away from poor populations) could affect adversely the lender's tax exempt status. This issue may be addressed in a "Use of Proceeds" section.

### **3b. No change, revocation or suspension of borrower's legal form or good standing/status**

Like the covenant described above, this clause aims at ensuring that the borrower will remain in the same legal form and standing (with all governmental approvals necessary for that form) as when the lender disbursed its loan. A change in the MFI's legal form, standing or status may have an adverse impact on repayment ability. In some agreements, this is framed as an affirmative covenant (i.e. the borrower will maintain its legal form and good standing).

### **3c. No changes in borrower's loan-loss provision policy**

MFIs, by definition, are lending institutions. Changes in operational policies, such as loan loss provisioning, can impact the borrower's overall creditworthiness and hence the borrower's ability to repay its obligations. Loan-loss provisioning policy changes also may mask problems in the microcredit portfolio. Lenders may allow some changes to take place in the MFI's operational policies so long as they do not pose a material adverse change to its financial health. In those instances this negative covenant would be modified to reflect such a materiality provision.

### **3d. Restrictions on affiliate transactions**

Transactions between the borrower and affiliated entities entail the risk that such dealings may not be conducted on an arm's length basis, allowing an affiliated entity to take financial advantage of the borrower, or for assets to be moved out of the borrower without appropriate compensation. This clause may also be framed as an affirmative covenant that permits only arm's length transactions with affiliated entities.

### **3e. Restrictions on incurrence of new foreign currency liabilities**

Fluctuating exchange rates can make foreign currency-denominated liabilities more expensive to repay if the MFI's local currency weakens, given the frequent mismatch of foreign currency debt and local currency loans to the MFI's clients. Like the foreign exchange exposure limits clause in the Financial Covenants section, above, this clause seeks to reduce the borrower's foreign currency exposure risk.

### **3f. Restrictions on loan portfolio exposure to any one borrower, any group of borrowers, any industry sub-sector, geographically, etc.**

This negative covenant attempts to avoid concentration risk. It seeks adequate diversification of the MFI's microcredit portfolio, protecting it against risks that are likely to occur seasonally or to strike only certain client segments. Some local laws and regulations of regulated, deposit-taking MFIs specify similar limitations. Lenders may impose more conservative diversification rules than the bank regulator applies, and impose the regulator's, or more conservative, diversification rules on unregulated MFIs as well.

### **3g. Restrictions on borrower's ability to dispose of assets outside the ordinary course of business or in an aggregate amount over [XXX] in any year**

In standard due diligence, the lender considers the borrower's assets prior to extending credit; this covenant addresses the conditions under which an MFI may dispose of its assets. Because few businesses can operate without some transfers of assets, lenders often allow some standard exceptions to this restriction. They may allow transfers that take place in the ordinary course of business. They also may allow transfers or sales of assets that are below an aggregate value in any given year. In the microfinance context, this restriction would limit sales or transfers of a microcredit portfolio.

### **3h. Restrictions on borrower's ability to declare dividends or make other distributions to shareholders**

The lender needs to ensure that the borrower retains an adequate level of liquidity. If the lender determines that shareholder disbursements would harm the MFI's financial health, this clause would restrict the borrower's actions. In the event of MFI distress and particularly in a workout, the clause ensures that equity stakeholders are not enriched at the expense of lenders. Some local laws and regulations impose similar "dividend blockers" on regulated, deposit-taking MFIs should those MFIs fail to meet certain financial ratios.

### **3i. Restrictions/prohibitions on consolidations and mergers**

Lenders typically seek to restrict the ability of the borrower to engage in mergers or consolidations because the assets of the borrower would become subject to the debt obligations and other liabilities of the merger partner. Similarly, the resulting change in the MFI's corporate entity may adversely affect the borrower's contracts, licenses, regulatory approvals, etc. In some cases, lenders will allow a borrower to merge if 1) the borrower is the surviving entity and 2) there is no event of default before or after giving effect to the merger.

### **3j. Restrictions on liens**

This is the so-called “negative pledge” covenant. It is designed to prevent the borrower from, in effect, subordinating the lender’s unsecured loan to that of others by granting priority security interests over the MFI’s assets and revenues under circumstances that could reduce the pool of assets available to satisfy claims of general unsecured creditors. By preventing the borrower from encumbering assets, the lender preserves them as a source of repayment. Some unsecured lenders allow exceptions for certain categories of liens, such as 1) liens for purchase money indebtedness (e.g. liens attached to to-be-acquired assets), 2) liens operating by provision of law and 3) certain small amounts of liens (a permitted basket of secured debt).

## **4. Affirmative Covenants**

Affirmative covenants, like negative covenants, are highly negotiated and customized to the unique credit, reputational or legal risks posed by the transaction. As noted above, some affirmative covenants are framed as negative covenants (and vice versa) depending upon the contract. Reporting covenants often are considered a subset of “affirmative covenants.”

### **4a. Use of proceeds of loan**

This covenant describes the intended use of the loan and requires the borrower to apply the loan proceeds only for specified purposes. There typically is a corresponding event of default if the loan proceeds are not so used. Cash is fungible so this can be a difficult provision to enforce, but lenders generally include it to 1) improve the overall likelihood of loan repayment (i.e. by requiring the proceeds of the loan to be invested in income generating assets like a microcredit portfolio), 2) change the capital structure of the borrower (by permitting loan proceeds to be used to refinance pre-existing debt obligations) or 3) in the microfinance context, ensure that the borrowing MFI adheres to the lender’s social mission. Some loan agreements put the use of proceeds clause in a separate part of the agreement, outside of the affirmative covenants.

### **4b. Compliance in all material respects with all applicable laws, Central Bank/bank supervisory requirements and any other regulatory requirements**

Violations of legal requirements may cause substantial penalties, may require the borrower to terminate operations or may expose the borrower to significant claims from third parties. Any of these events could have a significant and adverse impact on the borrower’s ability to repay the loan. This covenant attempts to protect the lender from such an event.

### **4c. Maintenance of all necessary consents (either such consents will remain in effect or are promptly renewed or replaced)**

This covenant, like the compliance with local law covenant above, ensures that all consents remain in effect or, if they expire, are promptly renewed or replaced. This is predicated on the assumption that such consents are necessary in order for the borrower to continue operating as an MFI. Any invalid consents may affect the MFI’s ability to conduct business and thus impair its capacity to fulfill its loan obligations.

### **4d. Compliance with anti-corruption, anti-terrorism and anti-money laundering laws**

International concern over transparency in cross-border financial transactions is growing, and investors making foreign direct investments are subject to the laws of the various jurisdictions their activities touch. This covenant addresses risks that the lender’s activities (and the onlending activities of the MFI borrower) may cause by requiring the MFI to comply with all applicable anti-corruption, anti-terrorism and anti-money laundering laws and regulations, including “Know Your Customer” (KYC) requirements. U.S. lenders may include specific mention of U.S. laws and regulations such as the Foreign Corrupt Practices Act, the Trading with the Enemy Act, the Patriot Act and, potentially, export/import and anti-money laundering regulations.

#### **4e. Maintenance of insurance in such amounts and covering such risks as is usually carried by companies in similar business in borrower's country of operations**

This covenant requires the borrower to maintain customary insurance against risk of loss. The challenge with this covenant is that in some countries where MFIs operate insurance is not available. Sometimes loan agreements include a related provision, which requires a prepayment of the loan to the extent that an insurable loss takes place and the loss is not replaced with the insurance proceeds. This would be unusual in a microfinance context, however, since the most valuable assets of a MFI are microcredits, not physical assets.

#### **4f. Maintenance of protection against interest rate risks and mismatches**

The lender wants to ensure that the borrower maintains adequate protection against interest rate risk so that there is no material mismatch between the interest rate yields on its assets (the microcredit portfolio) and the interest rates charged on its liabilities (the MFI's loan obligations). A significant mismatch in the rates charged could cause liquidity or cash flow problems for the MFI.

### **5. Modified Covenants Once a Problem Arises**

Once an MFI is in financial distress, the lender may decide to modify its loan agreements. The two following covenants may prove helpful in a voluntary debt workout and are being used or contemplated by lenders to distressed MFIs.

#### **5a. Standardizing timing and content of MFI reports and notifications to lenders**

Once lenders become aware that a borrower is in financial distress, they may consider amending their loan agreements to standardize the borrower's reporting and notification requirements for all of the MFI's debt obligations. This would ensure that no lender is getting more or faster information than others. Additionally, it would ease the MFI's administrative burden of multiple reports and notice requirements at a time when more pressing challenges should take priority. Reporting covenant modifications may also increase the frequency (e.g. from quarterly to monthly) of cash flow statements, management reports, lists of current liabilities, company reports, etc.

#### **5b. Prohibiting any early redemption or prepayments by MFI of any debt obligations**

If the borrower is in financial distress, the lender may consider adding a negative covenant against prepayment or early redemption of any of the MFI's debt obligations in the event that it encounters a liquidity issue. (Note that this is different from a prohibition on prepayment of a particular lender's outstanding loan.) This general prohibition on prepayments of any debt obligations is the lending equivalent of a "dividend blocker" and is aimed at preserving the MFI's net cash flow. This provision also can protect the lender against a moral hazard, namely that the borrower will cherry pick among its debt obligations and make early repayment on the most expensive or otherwise onerous obligations to the disadvantage of lenders that have provided more borrower-friendly terms and conditions.

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