CGAP

Insights for Inclusive Finance

SEPTEMBER 2020

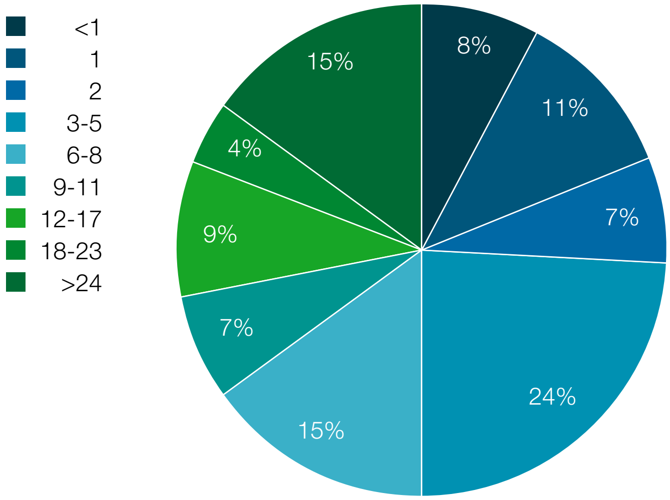
Debt Restructuring in Microfinance

The twin global crises of a health pandemic and economic lockdowns are severely harming the livelihoods of low-income people around the world. Many providers driving the financial inclusion of these populations also are at risk. Microfinance providers (MFPs) are bracing themselves to ride out this health and economic storm (Meagher et al. 2020). In addition, moratoria and worsening portfolio-at-risk rates are putting the liquidity of MFPs under pressure (Zetterli 2020). Perhaps not surprisingly, MFPs and funders are returning to the negotiating table to respond to liquidity and, possibly, solvency issues facing distressed MFPs. See Figure 1.

Introduction

In July 2020, nearly 300 participants from 30 countries joined CGAP workshops to discuss how the COVID-19 crisis is affecting MFPs and their funders, microfinance investment vehicles (MIVs), in terms of renegotiating and restructuring debt claims on distressed MFPs. This Briefing touches on the key insights and recommendations that emerged from the workshops. The views in this Briefing are not intended to be representative of the views of any single panelist, the institutions they represent, or the whole sector.

FIGURE 1. **How many months of operating expenditures plus 90-day debt can MFIs cover with cash on hand?**



Source: Zetterli, 2020.

For more information about the survey and to participate, see "CGAP Global Pulse Survey of Microfinance Institution," https://www.atlasdata.org/pulse.

Uniqueness of the crisis

Workshop participants agreed that this crisis is different from others that the microfinance sector and its funding sources have weathered in the past in at least two key respects: (i) its global nature and (ii) its uncertain duration and uneven (and changeable) breadth of impact. Another factor that makes the response to this crisis different from many others is that, in most cases, MFPs and their funders are starting from a negotiating position that this crisis and its adverse impacts are not the fault of any of the parties, but rather are due to factors outside of their control. All of these factors are likely to shape the evolution of MFP (debtor) and MIV (creditor) conversations going forward.

- **The global nature of this crisis** is stretching the capacity of MIVs to respond and is shaping their positions at the negotiating table. MIVs are engaging with a range of MFPs from diverse geographic locations that are facing a variety of challenges. At the same time, MIVs often are interacting with fellow creditors that have invested in many of the same MFPs. This increases the need for coordination across diverse stakeholder groups and a common understanding of the economic and legal contexts within which negotiations are taking place.
- **The uncertain and possibly prolonged and changeable nature of this health and economic crisis** makes contingency planning extremely challenging for MFPs and their funders. Against this backdrop, it can be difficult to develop short-, medium-, and long-term strategies for negotiations among MFPs and their creditors and other stakeholders. Moreover, as the crisis continues over a prolonged period, there also is a high risk of negotiation fatigue setting in for all parties at the table.
- **The generally collaborative intentions of MFPs and their funders establish** a very different starting point from earlier restructuring negotiations in the microfinance sector. Unlike debt restructurings and workouts that come about because of missteps by an MFP, many MFPs are struggling during this pandemic due to no fault of their own. Consequently, many of the MIV workshop participants stressed that they viewed themselves as willing collaborators acting in partnership with the troubled MFPs with whom they are negotiating. However, this collaborative approach should not be taken for granted, particularly as negotiations continue over time. Most participants stressed that processes need to be put in place to ensure smooth collaboration. The ground rules for those processes need to be established early and then adhered to by all stakeholders to maintain a mutual sense of collaboration across the relationships of MFPs with their creditors.

Observations and expectations on the restructuring process

Given the uniqueness of the crisis, MIV representatives emphasized the following:

- There need to be high levels of transparency about the changing financial conditions of MFPs. In a typical creditor–debtor relationship, information asymmetry often shapes the level of trust in the relationship. In this crisis, where almost every day brings a surprise of sorts, MIVs do not want any further surprises from their borrowers. Maintaining timely and relevant information flows from MFPs to creditors are key to maintaining the trust necessary for a collaborative negotiation.

- MFPs need to treat their similarly situated creditors equitably. To ensure equitable treatment of like creditors, MFPs need to understand the varying perspectives of their creditors and the nature of the debt obligations they owe to those creditors. Only then can an MFP determine which creditors should be treated similarly. Some of the key aspects to be aware of include the following:
    - Levels of debt subordination and seniority
    - Collateral (secured vs. unsecured) or other form of credit enhancement (guarantee, etc.)
    - Currency of obligation
    - Term or maturity of payment obligations, such as timing of payment schedule and nature of payment obligation (e.g., bullet, amortizing, demand, etc.)
    - Creditor structure such as fixed term vs. open-ended funds, public sector vs. private sector lenders, and local vs. foreign lenders
    - Legal limitations and regulatory constraints imposed on creditors
    - Documentation covenants and events of default (e.g., scope, triggers, and implications for other loans such as cross-default vs. cross-acceleration)
    - Presence of other creditor claims, such as shareholder loans or affiliate or network management fees.
- MFPs need to appreciate MIVs' resource limitations and constraints. Many MIVs are working on a global scale to respond, often simultaneously, to troubled MFPs in varying stages of distress. This means that MFPs should act in ways that make it easier for MIVs to respond to an MFP's needs and challenges. MFPs that are credible, trustworthy, and organized in creditor communications are more likely to develop good working relationships with their MIVs—even MIVs that may be distracted by other MFP negotiations.
- MFPs need to understand the challenges presented by varying MIV fund structures and the expectations of MIV funders. For example, differences in MIV fund structures, such as a fund's duration, portfolio investment guidelines, and governance, are likely to shape MIV goals and flexibility in their negotiations with MFPs. MFPs that understand MIV structural and funding challenges can tailor their approaches accordingly and avoid proposals that are unlikely to be received well by their MIV creditors.

MFP representatives emphasized the following:

- MFPs are first and foremost focusing on working with their clients to help them navigate the health and economic consequences of the pandemic. This involves dealing with many factors outside the MFP's control, such as the pandemic's impact on client livelihoods and welfare—for example, local regulatory requirements and health and safety concerns for employees.

- Some MFPs find themselves in a situation that is new to them, and they have limited, if any, experience in managing intercreditor arrangements and debt workouts alongside already significantly stretched managerial resources. In addition, they are managing several, sometimes competing, demands for information about the impact of the pandemic on their operations—requests for information may be coming from a host of stakeholders, including regulators, creditors, equity investors, boards of directors, donors, and others.
- Accordingly, MFPs are looking to their creditors to give MFPs the breathing room to take stock of how the situation is evolving and to consider its likely impact on MFP operations and financial condition. MFPs also are looking to creditors to work collaboratively to give troubled MFPs relief from and/or align the creditor obligations imposed on an MFP, including payment, reporting requirements or information demands, and financial covenants.

Tips and tools for MFPs

Maintaining trust. To gain the attention and, possibly, forbearance of creditors, MFPs need to take steps to build trust with their creditors from the outset. This trust often is grounded in transparency about the changing financial condition of the MFP, a clear view of what is needed from creditors at the moment, and a demonstrated commitment to treating similarly situated creditors fairly and equitably. Where it is necessary to deviate from "equitable treatment"—either because of circumstances or a creditor demand—care should be taken to communicate to other affected creditors the rationale for the deviation and, if appropriate, preferential treatment of a particular creditor.

Leading creditor negotiations. The "right" person within an MFP to lead negotiations with creditors will depend on the individual circumstances, such as size and organizational structure, of an MFP. Moreover, while it is important to speak with "one voice," there may be value in bringing in different representatives of an MFP at different stages of creditor negotiations. For example, some MFPs have involved board members or shareholders at certain points in negotiations to demonstrate their strong commitment to the financial and operational viability of the MFP. Other MFPs have avoided including their CEOs in day-to-day negotiations, preferring instead to bring in the most senior leadership only when there is a particularly difficult issue to resolve with the creditors. Whoever leads the negotiations, that person should know the MFP's financials well, understand the level of acceptable risk, and have a strong mandate to speak on behalf of the MFP.

Understanding intercreditor dynamics. MFPs also should be aware of how intercreditor dynamics may be shaping the positions taken by their creditors at the negotiating table. While this may be the MFP's only debt negotiation to manage, its creditors may be responding to past or anticipating future negotiations with fellow creditors for other troubled MFPs. Creditor concerns about setting precedents, which may be of little importance to any single MFP, may matter a lot among the creditor community of MIVs.

MFPs that face a recalcitrant creditor or group of creditors may need to probe to learn what is motivating this creditor response. With that information, the MFP may be able to design an approach that does not inadvertently set a precedent for this or other negotiations. In some cases, this may be as simple as identifying unusual factual circumstances confronting the MFP that are unlikely to be present in other negotiations to make it easier for creditors to distinguish this particular negotiation from others. In more complicated cases, the MFP may need to develop a negotiation strategy that convinces a critical mass of creditors to help persuade fellow creditors to be more accommodating of the MFP's position.

Coordinating with all creditors. Workshop participants also wanted to know how they could determine whether they should engage with creditors multilaterally or bilaterally. There is no one answer to this question because of the differing circumstances in which MFPs may find themselves as they first run into problems meeting their obligations to creditors. But even when advising MFPs confronting similar circumstances, participant views diverged widely. Some participants indicated that it is best to start multilateral discussions as soon as possible after the MFP becomes aware of the likely risk of running into financial difficulties with many of its creditors. Other participants were of the view that it is better to start multilateral discussions only after first engaging in a round of bilateral creditor negotiations to gather initial input to inform the negotiation strategy and avoid the complexity of multicreditor negotiations.

Participants also noted that, in some cases, multilateral negotiations may be initiated by MIVs, not the MFP. Some MIVs have intensified performance monitoring and stress testing to predict when an MFP's financial condition is likely to deteriorate. They are using the results of this monitoring and testing to launch coordinated efforts with peer creditors and approach their borrowers as a group. Several initiatives have been launched to facilitate investor coordination, including the CGAP Funder Alignment Technical Group, the Memorandum of Understanding on "Coordination among MIVs in response to Covid 19," and the Microfinance Institution Pledge.[1]

No matter whether a multilateral negotiation is instigated by the MFP or by a group of its creditors, the typical first step in launching a multilateral negotiation process is to hold a coordination call with all significant creditors. Where there are many creditors, some MFPs have opted to identify one or two creditors to lead the negotiation process. The choice of the lead creditor will depend on the pre-existing relationships between the MFP and the creditor and the nature of the lender. For example, is the lead lender's claim (such as local vs. international, secured vs. unsecured, etc.) on the MFP representative of most of the creditors it expects to lead? Is the lead lender more familiar with the MFP than the other creditors are? The lead lender or lenders should help the MFP define the negotiation process, including communication lines, timeline, and milestones.

Hire external experts. Several workshop participants that represent MFPs have hired external resources that have experience managing creditor relations and the subsequent creditor negotiations. These resources can range from independent experts that have financial and legal debt restructuring experience to board members of MFPs. Among other things, they can help an MFP determine how best to present its financial and operational condition to its creditors and plan for what is likely to come in the restructuring process if

1 For more information on "Coordination among MIVs in response to Covid 19" and the Microfinance Institution Pledge, see covid-finclusion.org, https://www.covid-finclusion.org/investors.

those conditions deteriorate and losses have to be absorbed by creditors. While the costs of paying for external resources may seem counterintuitive, particularly at a time when financial resources are already stretched, several workshop participants noted that involving experts can help to save time and money.

Conclusion

One of the workshop participants summed up the key to a successful debt renegotiation and possible restructuring along these lines: when money is in short supply, the most valuable currency is information. Developing and managing information flows between MFPs and their creditors, as well as between creditors, will be key to bringing collaborative resolutions to the challenges facing MFPs and their funders as they confront the health and economic consequences of this pandemic.

However, the challenges will not be limited to debt restructuring. The crisis is testing resilience of the whole microfinance sector and of its capacity to successfully navigate into the recovery stage. To help this process, CGAP is publishing a crisis response roadmap that offers step-by-step guidance on how to handle the current crisis and points to practical tools to help with the process (Abrams forthcoming).

References

Abrams, Julie. Forthcoming. "COVID-19 Crisis Response Roadmap." Washington, D.C.: CGAP.

Meagher, Patrick, Denise Dias, Juan Carlos Izaguirre, Stephen Rasmussen, Matthew Soursourian, and Stefan Staschen. 2020. "Microfinance and COVID-19: A Framework for Regulatory Response." Washington, D.C.: CGAP. https://www.cgap.org/research/publication/microfinance-and-covid-19-framework-regulatory-response

Zetterli, Peter. 2020. "Is There a Liquidity Crisis Among MFIs, and if so, Where?" CGAP blog post, 16 July. https://www.cgap.org/blog/there-liquidity-crisis-among-mfis-and-if-so-where

The authors of this Briefing are Deborah Burand and Ivo Jeník. The authors thank the workshop panelists for their valuable contributions: Amy Bergstraesser, legal counsel at Symbiotics; Mary Rose Brusewitz, member in charge of the New York Office at Clark Hill PLC; Ana Demel, vice chair of the Board of Directors at ProMujer; Elitsa Georgieva, head of Risk and Recovery at Symbiotics; Edward Marshall, partner, general counsel, and CCO at Developing World Markets; Lorraine McMillan, global director of Capital Markets & Innovative Finance at Vision Fund International; Andrée Simon, president and CEO at FINCA Impact Finance; Dan Smith, vice president and general counsel at FINCA Impact Finance; Candace Smith, senior expert in private sector development finance; Luca Torre, co-founder and co-CEO at Gawa Capital; David Wolf, associate general counsel at Global Communities. Thanks also go to David Crush and Estelle Lahaye of CGAP for their insightful comments.