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Summary

The covid-19 pandemic has caused an abrupt and unprecedented economic disruption on a global scale. In contrast to the financial sector crisis more than a decade ago, micro & small enterprises (MSEs) in emerging countries are directly affected by the disease and the restrictions to control its spread. Microfinance institutions & banks (in the following MFIs) are seeing their liquidity and asset quality metrics deteriorate. Many will require a restructuring of their domestic and international debt to avoid liquidity pressure, and the international community is poised to react in a pragmatic manner.
However, in a significant number of cases MFIs' capital positions will be severely eroded over the course of the crisis. Shareholder support is likely to be limited under current conditions, making long-term restructuring a challenging task. This will put otherwise viable institutions at risk and entire microfinance sectors under pressure. To avoid such a scenario, we advocate for the establishment of a focused investment facility (the "Facility") with the following key characteristics:

- a unique & flexible toolset of capital instruments, including subordinated & convertible debt, hybrid capital, and equity;
- active engagement with financial institutions' key stakeholders – primarily shareholders and lenders – to facilitate transactions that sustainably recapitalize financial institutions with a viable business model;
- and the capacity to actively manage its investments and facilitate the stabilization, turnaround, and ultimately growth of impacted financial institutions.

1) Impact of the COVID-19 crisis on the microfinance sector

The covid-19 pandemic has severely impacted global economic prospects, and emerging economies face significant growth risks due to the negative impact on global trade, commodity prices, emerging market currencies, tourism, and remittances. These developments have heightened credit risks associated with lending to MSEs across the emerging markets. MSEs will suffer severely from the pandemic directly due to on-going lockdowns and indirectly through the medium-term impact on the global economy. Disrupted revenue streams due to temporary closures have reduced MSEs' short-term capacity to service outstanding loans, and the longer-term economic impact will likely impair earnings and debt repayment capacity.

From the perspective of a typical MFI, we expect the crisis to evolve in two phases:

- Phase 1: Immediate impact on liquidity and funding
    - On the asset side, the institution will initially react to clients' immediate cash-flow shortfalls by offering temporary payment holidays of three to six months on a large scale. This will

[1] The views expressed in this paper represent the personal opinions of the authors and should not be read as the institutional view of I.D. Inspiring Development GmbH. For questions or comments, please contact the authors:
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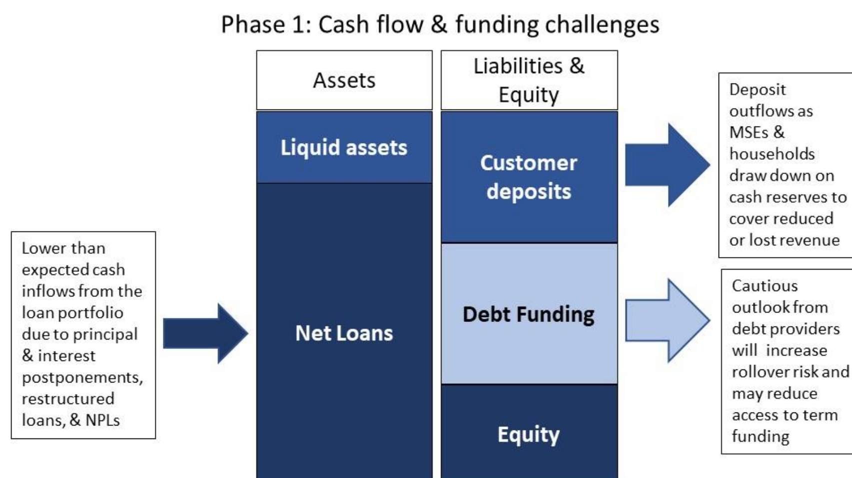
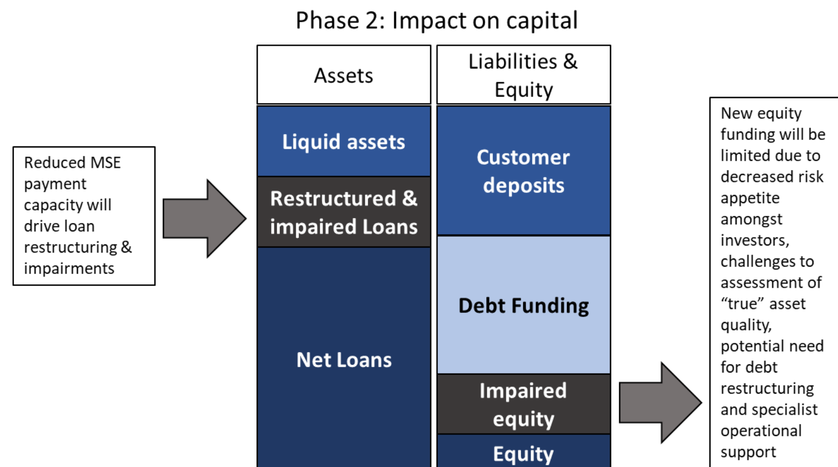
diminish cash flow from repayments, but simultaneously the MFIs will reduce loan disbursements due to tightened underwriting standards and reduced client demand.
  - On the liability side, the MFI will seek access to new financing facilities to meet scheduled repayments to its lenders. Where access to new liquidity from term lenders is limited, the MFI will have to negotiate prolongation or rescheduling with current lenders. Additionally, deposit-taking MFIs will need to manage deposit outflows of clients that utilize savings to support their businesses and families.
  - Faced with restructuring requests from a large number of MFIs, we expect international lenders to offer short-term debt restructuring options.



- Phase 2: Second wave – impact on capital
  - On the asset side, as the postponements of principal & interest payments offered to MSEs phase out, the MFI will experience a sizable increase in loan repayments. Assuming sustained tightened underwriting standards and reduced credit demand, the loan portfolio is likely to contract markedly. This will strengthen the liquidity position but negatively impact the MFI's interest income and net interest margin.
  - The share of MSE borrowers permanently affected by the covid-19 pandemic and subsequent economic shock will become visible. Additional restructuring will be applied in an attempt to match debt repayment schedules to MSEs' reduced payment capacity and to limit the immediate increase in provisioning expenses. Yet, rising NPLs will further impair interest income.
  - Regulatory forbearance and Basel guidance will allow management significant discretion in applying provisions to the growing volume of restructured loans, resulting in increasing divergence between financial reporting and both the actual quality of the loan book and the institution's real capital position.
  - To balance the effects of reduced interest income and increased provisioning expenses, the MFI will introduce cost reduction measures, at the risk of negatively impacting loan origination and recovery capacity. Loan portfolio contraction will likely be tolerated as the MFI seeks to reduce risk-weighted assets to bolster capital ratios.
  - On the liability side, initial short-term restructuring of the MFI's international debt will eventually expire, and further negotiations will be impacted by the MFI's deteriorating financial performance, weakened capital position, and opaque loan portfolio quality.



For MFIs this will become a critical moment. Some institutions will be able to absorb the shock based on existing capital buffers and decisive management response. Some others will access additional capital through direct shareholder support. Many others, however, will face severe stress and challenging negotiations with shareholders and lenders in the attempt to replenish capital. Countries with high MSE debt levels will see their entire MFI sectors struggling.

Currently, the industry lacks instruments to tackle the issues that will arise. There are no focused funds or special vehicles that would specifically target MFIs in severe distress or in need of operational turnaround. Current equity investors, including both private impact funds and DFIs, may be unable to provide the additional capital that many MFIs will seek for a variety of reasons, including investment criteria, limited capacity for assessing the long-term viability of distressed MFIs and for operational engagement, fund life limitations, and risk appetite mismatch. Therefore, we consider it vital to add a new tool – a special facility to provide much-needed capital to viable MFIs facing difficult circumstances to secure their operations and thus preventing a large-scale downsizing of entire sectors.

But is there sufficient time, and what are the challenges?

2) Timelines and challenges

Simple restructuring solutions for MFI debt – in the form of standstill agreements or payment schedule extensions – will be a necessary first-order measure to provide MFIs with breathing room to deal with the immediate crisis impact and assessment of their portfolios. Additionally, local regulators are expected to cushion the initial blow to MFI balance sheets through adjustments to their provisioning requirements and special treatment of loans being restructured due to the impact of the pandemic. Finally, recent guidance from the Basel Committee indicates that IFRS 9 provisioning on loans impacted by the covid-19 pandemic will lean heavily on management judgement.

As a result of the above, MFIs might well be able to "kick the can down the road" for quite some time, perhaps well into 2021. This period can and should be used for setting up a capital support facility before MFIs are eventually forced to recognize loan losses and face the consequences.

It is equally clear that such a facility will face challenges in selecting appropriate investment targets and setting the right conditions – partly because the impact of the crisis on the viability of MFIs is uncertain per se, but also because MFIs will be forced to postpone recognition and thus reporting of credit risk losses to delay the impact on capital ratios in order to survive.

3) A capital support facility – an outline

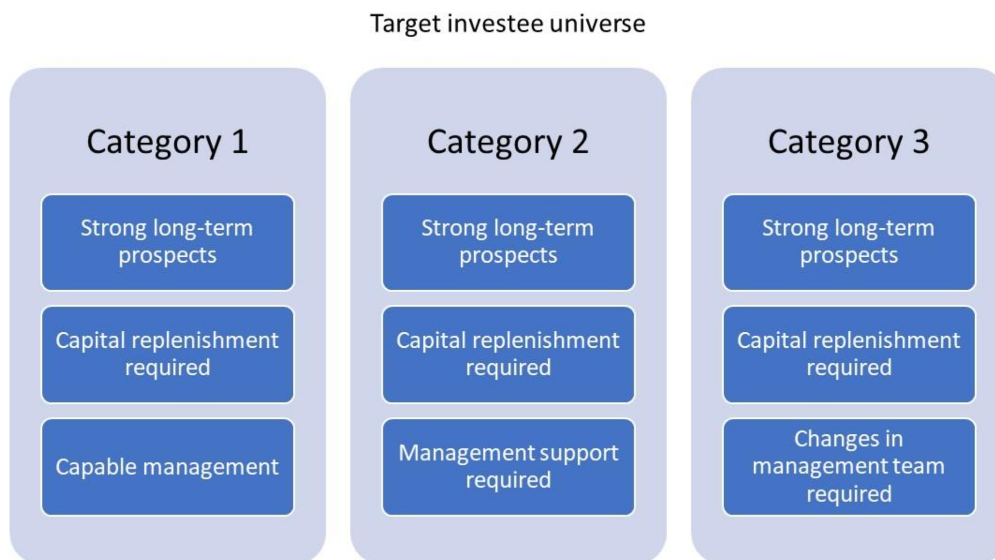
The primary objectives of the Facility should be twofold:

- to replenish the capital of MFIs with good long-term prospects in order to:
    - maintain and ultimately grow capital-constrained MFIs' capacity to deliver credit and banking services to MSEs, and
    - preserve the institutional knowledge in MFIs that may otherwise face wind-down or bankruptcy;
- to deliver attractive risk-adjusted returns on invested capital.

To achieve these goals, the Facility should draw on a flexible toolset of strategies & instruments, including acquisition of existing senior & subordinated debt, debt-for-equity swaps, (deeply) subordinated debt instruments, and primary & secondary equity. The impact of the current crisis will likely vary significantly across markets and institutions, so the value of a flexible toolset to facilitate a bespoke approach to MFIs' individual circumstances cannot be understated. Additional characteristics will need to include the following:

- The Facility will invest in MFIs with attractive long-term earnings and growth potential that face capital constraints or even insolvency due to the negative loan portfolio impact of the covid-19 crisis, employing a highly engaged, active-investor approach.
- We expect that potential targets may require significant capital & debt restructurings prior to investment, and in certain instances it will therefore be the role of the Facility manager(s) to drive restructuring negotiations with current shareholders & debtholders as a precursor to capital injections.
- In addition, the Facility should possess the capacity to actively support existing management or, in some circumstances, assume operational control to facilitate stabilization and turnaround of investee MFIs.

Target investee universe

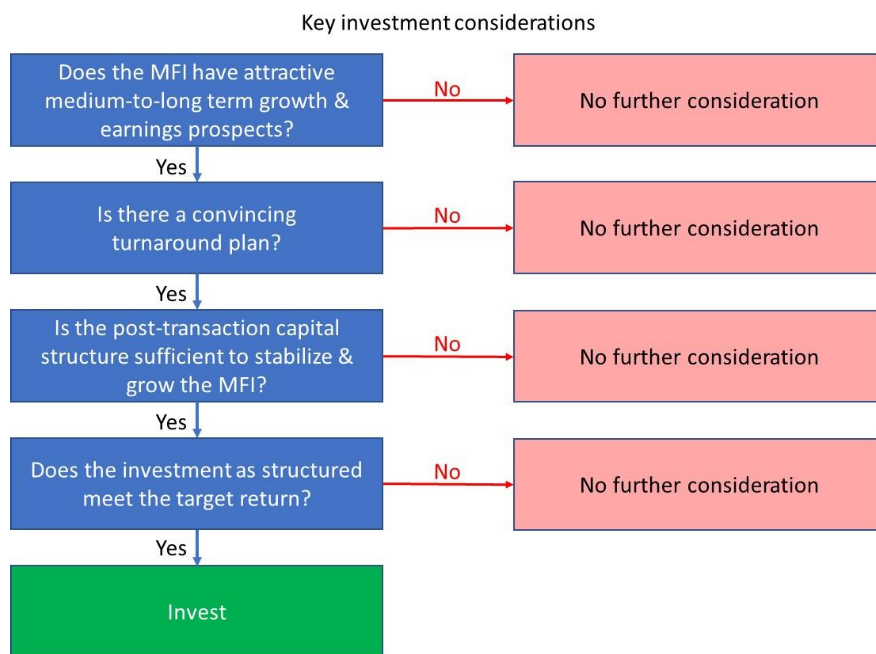


We envision such Facility to be a disciplined, activist investor with the capacity to evaluate opportunities and invest during a period of economic and operating environment stress. To do so successfully, the Facility must be armed with several key capabilities:

- Sourcing & market assessment: broad market knowledge and the capacity to identify potential investment targets

- Due diligence & valuation: extensive analytical capability to assess asset quality, provisions and collectability of NPLs in circumstances of reduced information quality and heightened uncertainty, and draw appropriate conclusions regarding valuations
- Debt & capital restructuring: capacity to effectively drive debt and capital restructurings alongside or in advance of investment
- Investment structuring & negotiation: apply a creative and flexible approach to appropriately match investments to the individual circumstances of MFIs, and to persuasively engage with existing stakeholders to drive sustainable outcomes
- Management support & direct management capability: equip current MFI management with specialist resources or, in certain circumstances, initiate changes in management to facilitate stabilization and turnaround.

The Facility should not act as a passive investor or as a "bailout" fund. Rather, it should employ a disciplined and selective approach to investment target selection, and we believe that an appropriate target return is necessary to ensure such discipline. Given the nature of the investing environment and the complexities of investing in MFIs facing capital constraints or stress, careful application of capital and operational support capacity is critical to successfully restoring investment targets to sustainable growth and ensuring continued access to credit and banking services for the MSEs they serve.



Conclusion

The covid-19 pandemic will have a significant impact on MSEs in emerging economies and the MFIs that serve them. MFIs now face liquidity challenges and in future will be confronted with deteriorating asset quality and capital pressures. A specialized investment Facility is needed to support capital replenishment of MFIs with attractive long-term prospects through a combination of debt restructurings and new investment, with the goal of preserving the institutional knowledge in sustainable but temporarily distressed institutions and ensuring the continued flow of credit to emerging market MSEs.

We advocate for a roundtable discussion of such a Facility amongst key industry players with the goal of exploring options for its implementation and outlining key next steps.