COVID-19 AND THE FINANCIAL INCLUSION VALUE CHAIN

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'From Research to Practice and Back Again' Action Group

This research report seeks to analyse the challenges and risks faced by the financial inclusion value chain actors during the recent COVID-19 pandemic. It explores the point of view of clients, Financial Service Provider (FSPs), investors and donors, policymakers and regulators to identify new arising opportunities and lessons learned to be generally applied to crises with a global reach, such as the climate change issues.

The study used a qualitative approach based on an extensive literature review and primary information from 25 worldwide stakeholders that were interviewed between July and August 2020.

The core of this report is built around two sections that present the findings from the literature review and those from the stakeholders' interviews, with rich examples and references. This publication is completed with the executive report that summarizes the key findings of this research.

AG on Research

The e-MFP 'From Research to Practice and Back Again' Action Group aims to bring together researchers, university students and practitioners in order to promote the learning of microfinance and financial inclusion; identify research needs of practitioners; identify different sources of data to conduct research; and disseminate and increase the impact of research by translating research results into practical guidance and solutions.

The Research Digest publications aim to explore the top research needs of practitioners, compiling and translating research conducted in the sector into practitioner-friendly language. To the extent possible, the publications will privilege mixed methods approaches, integrating the analysis of both quantitative and qualitative data and including diverse sources of information.

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INDEX

ABBREVIATIONS AND ACRONYMS 5
INTRODUCTION 6
VALUE CHAIN ANALYSIS – LITERATURE REVIEW 8
CLIENTS 8
FINANCIAL SERVICES PROVIDERS (FSPS) 12
INVESTORS AND DONORS 17
POLICYMAKERS AND REGULATORS 19
CROSS CUTTING ISSUES 23
QUALITATIVE ANALYSIS – STAKEHOLDERS' INTERVIEWS 26
KEY MEASURES TAKEN AND CHALLENGES 28
RISKS AND MITIGATION STRATEGY 34
OPPORTUNITIES 37
CONCLUSION AND LESSONS LEARNED 40
LESSONS LEARNED 44
BIBLIOGRAPHY 47

Abbreviations and acronyms

ADA	Appui au Développement Autonome
ADB	Asian Development Bank
ASBA	Association of Banking Supervisors of the Americas
B2B	Business to Business
BCEAO	Banque Centrale des Etats de l'Afrique de l'Ouest (Central Bank of West African States)
CSFI	Centre for the Study of Financial Innovation
CNBV	Comisión Nacional Bancaria y de Valores (National Banking and Securities Commission)
CP	Client Protection
DFI	Development Finance Institutions
DFS	Digital Financial Service
eKYC	Electronic Know Your Customer
eMFP	European Microfinance Platform
FSP	Financial Service Provider
G2P	Government-to-Person
GDP	Gross Domestic Product
GIIN	Global Impact Investing Network
IAMFI	International Association of Microfinance Investors
IFC	International Finance Corporation
ILO	International Labour Organization
IMF	International Monetary Fund
LIFT	Livelihood and Food security Fund
MDB	Mutuelle pour le Développement a la Base
MFI	Microfinance Institution
MIV	Microfinance Investment Vehicle
MoU	Memorandum of Understanding
MSME	Micro, Small and Medium Enterprises
NBC	National Bank of Cambodia
NBFC	Non-Banking Finance Company
NPL	Non-Performing Loan
NpM	Netherlands financial inclusion platform
Par30	Portfolio at Risk 30 days
PMA	Palestine Monetary Authority
PPE	Personal Protective Equipment
ROSCA	Rotating Savings and Credit Association
SME	Small and Medium Enterprises
SP	Social Performance
SPM	Social Performance Management
SPTF	Social Performance Task Force
SSF	Safco Support Foundation
UEMOA	Union Economique et Monétaire Ouest Africaine (West African Economic and Monetary Union)
WB	World Bank

Introduction

Background and context

In the last decade, the financial inclusion sector registered constant rates of growth. According to the World Bank Global Findex, between 2011 and 2017 financial penetration jumped from 13% to 35% for low-income countries, and from 29% to 58% for lower middle-income countries.[1]

However, **progress on increasing financial inclusion and reducing poverty are in jeopardy due to the global COVID-19 pandemic**. The Maya Declaration commitments towards financial inclusion and financial stability taken by regulators and policymakers have seen a slowdown.[2] The World Bank data estimations (2020) register the first increase (albeit slight) in global poverty since the Asian financial crisis of 1997-98, with Sub-Saharan Africa and East Asia and Pacific being the most affected regions (respectively with 906 and 571 million of people in extreme poverty).[3]

Over the years, the financial inclusion sector has demonstrated that providing financial services is key to support both income and consumption of the most vulnerable populations. Nevertheless, with the COVID-19 crisis, Financial Service Providers (FSPs) have been facing several problems (i.e., deterioration of the portfolio quality, liquidity and capital constraints, amongst others). While some of them can weather the crisis, others may exit the market or shift towards upper segments of the clientele. It is thus crucial to understand how to manage the crisis and recover from the effect of the crisis.

Objective of the study

The research report "*COVID-19 and The Financial Inclusion Value Chain*" aims to provide an overview to academics and practitioners on **how the financial inclusion value chain has faced and addressed both challenges and risks** derived from the recent COVID-19 pandemic. It also pursues the ultimate goal of **identifying new arising opportunities and lessons learned** to be generally applied to crises with a global reach, such as climate change.

In the last months, the financial inclusion sector has proactively produced studies and research (surveys, cases studies, financial diaries with clients, webinars, blogs, etc.) to understand the effects of this global crisis, and the measures taken by the different stakeholders. To address the need to compile and digest this multiplicity of information, the European Microfinance Platform (e-MFP) **Action Group '*From Research to Practice and Back Again*'** newly created in April 2020, conveyed the importance of looking at the entire value-chain perspective. Indeed, to overcome a challenging period, the measures taken should be interconnected and coordinated at sector level, and not being taken as single initiatives by individual stakeholders.

[1] Financial penetration has been proxied with the indicator "*Financial institution account (% age 15+)*" from the WB Global Findex database.
[2] According to the Alliance for Financial Inclusion (2019 and 2020), every year the targets to achieve are increasing, and both in 2019 and 2020, the countries that have signed the Maya Declaration commitments, reached 39% of the desired targets, meaning that in 2020 few steps were taken forward.
[3] Proxied with the USD 5.50 poverty line

Methodology

The study refers to the financial inclusion sector with a worldwide perspective, where the general term "Financial Service Providers" (FSPs) refers to all kinds of institutions, whether regulated or not, that offer financial services to individuals and enterprises excluded from the traditional financial sector. This research report seeks to present key common aspects and unique examples in order to understand the complexities of the COVID-19 economic and health crisis and its effects on the financial inclusion value chain. To achieve this, a **qualitative approach** with two main methodologies has been adopted. Firstly, the study is based on an extensive literature review, including academic papers, as well as studies and research conducted by practitioners from the financial inclusion sector. Secondly, it is based on primary information from 25 in-depth interviews carried out with key stakeholders in the value chain (10 chief executives from 9 FSPs, 9 investors, 3 regulators and supervisors, and 3 other financial inclusion organizations). Both the literature review and the stakeholder interviews mostly refer to the first 6 months after the beginning of the pandemic, from March to September 2020.

Report structure

The report is organized in four main sections. The first one provides an introductory context for the study, with the explanation of its objective and the methodology adopted. The second section provides a review of the existing literature with key findings divided by stakeholder (namely clients, FSPs, investors and donors, regulators and governments, and other key actors). The third section presents the results from the qualitative analysis in terms of the key measures taken and the challenges, risks and mitigation strategies, and opportunities for the sector. A final section concludes and presents lessons learned that can be considered as general recommendations on how to address global crises potentially affecting the financial inclusion sector.

This publication is completed with the executive report that highlights the key findings of this research.

Value chain analysis – literature review

Clients

In response to the COVID-19 pandemic, **countries have implemented precautionary measures**, in general lockdowns, curfews, quarantine and social distancing policies, with different degree of restrictiveness. In some countries, extremely cautious decisions were taken to balance the low capacity to map the extent of the problem (Duflo and Banerjee, 2020); in others (such as Angola and Benin) the situation has been kept under control without strong interventions. According to E. Duflo and A. Banerjee (2020), rather than imposing a universal lockdown, health authorities could have identified geographical clusters where quarantine measures were required.

In contrast to other crises, the COVID-19 **pandemic put under pressure the broad economy**, due to supply chain disruption and reduced demand, hampering the capacity of people, particularly the most vulnerable and poor, to sustain their livelihoods. Many people lost their jobs or experienced an income reduction. Estimates from the International Labour Organization (ILO, 2021) register an 8.3% decline in labour incomes in 2020, with significant regional differences: low-income and lower-middle-income countries being the most hit (with a 7.9% and 12.3% decline, respectively).

Clients from the financial inclusion sector, that are, in general, low-income households, and micro and small entrepreneurs, or individuals employed in the formal or informal sectors, were all affected, although to a different extent. Job interruption with potential wage reduction and job losses are much more harmful for low-wage workers who often lack access to social protection and formal safety nets; for instance, people engaged in the informal sector were hit particularly hard due to having little or no job protection (K. Malik *et al.*, 2020).

Economic sectors suffered to different magnitude. A major threat came from the declining flows of global **trade and tourism**. The closure of borders has shut down not only international commerce[4] and tourism, but also froze internal mobility affecting sectors such as transport.

Another most affected sector is the **Fast-Moving Consumer Goods** value chain that, through the traditional retailers, accounts for most of retail sales of food and household products. In Bangladesh, for example, some low-income households who run retail shops experienced negative income in April 2020, having bought more stock than they managed to sell (S. Rutherford, 2020). The disruption in a link of the value chain has an impact on all the other components depending on their degree of resilience and diversification. When the Business to Business (B2B) trade credit works as liquidity for the system, the sharp decline in retail sales hampers the capacity of storeowners to repay the trade debit they have with wholesalers. This, in turn, makes it harder also for wholesalers to repay their own trade debit, and so on up the distribution hierarchy (Reynolds and Roest, 2020).

4 According to UNCTAD (2020), trade growth registered a sharp decline (around 8%), more significant for developed countries, with most of the losses reported in the second quarter of 2020 (global merchandise trade lost more than 20% compared to Q2-2019).

The shutdown of restaurants, hotels, bars, and event venues has changed the habits related to food processing, distribution and consumption. In Kenya, for example, given that marketplaces had been closed, farmers struggled to sell their vegetables and there existed fears that the COVID-19 health crisis could soon become a food crisis (C. Christensen, 2020). **Smallholder farmers**, that represent a high share of the world's poor, are critical partners in preventing these potential food crises, as they are at the heart of many countries' food supply chains. It was observed that the agriculture sector was affected depending on the season during which the virus appeared and the movement restriction policies which were imposed. Where the pandemic arrived during the peak harvesting seasons, like in Malawi, the negative effects were greater than in those regions where the harvesting period came later, as in Eastern Africa. Farmers struggled to purchase agricultural inputs and to find the labour force due to movement restrictions and the fear of not being able to access credit to meet farming costs (as it was observed in Myanmar, M. Marinelli and P. Hariharan, 2020).

A study of the *High Commission for Planning* in Morocco on the way households were dealing with the pandemic found that 34% had no longer a source of income; those with a source of income (38%) stated that the money was just enough to handle daily expenditure; and 22% of the families declared having drawn down on their savings (Linge, 2020). Similarly, in Bangladesh, the results of the *Hrishipara Daily Diary Project* with 60 low-income households (funded by the Livelihood and Food security Fund - LIFT) show, during the Ramadan in April 2020, a **dramatic decrease of cash at hand**, with an income reduction higher than the expenditure contraction (Rutherford, 2020).

With no cash flows coming in, household and business owners must search for alternative sources of cash to pay for basic expenses such as rent, food or health care. In general, poor people implement **various *ex-ante* and *ex-post* strategies to prepare for and cope with shocks**. *Ex-ante* measures can include savings accumulation, insurance and migration. *Ex-post* measures can be formal and informal aid (including remittances), finding new job opportunities, cutting unnecessary (but also basic) expenses, selling assets or borrowing from formal and informal lenders. For some of these strategies, it is necessary to make forward planning (e.g., savings and insurance, stock accumulation), or to be part of a social network. In any case, it has been demonstrated that access to and use of financial services contribute to consumption smoothing and complement other coping strategies (E. McGuinness, 2020).

Informal financial services play a critical role. Based on inter-personal relationships, they are a mechanism to share the risk with peers and represent a safety net for many households in vulnerable situations, especially for rural women. For instance, rotating savings and credit associations (ROSCAs), and other self-help groups, as well as informal loans from relatives, friends or moneylenders are common solutions when the formal sector is not meeting their demand. Nevertheless, community-based mechanisms may be not sufficient in a period of overall hardship (Arnall et al. 2004).

Remittances is another coping mechanism that strengthens people's resilience in times of adversity.[5] However, the global dimension of this crisis also impacted the migrant population

5 In India, for example, payment companies and banks registered a sharp increase in reverse remittances from rural to urban centers, as workers try to return home or stick it out in urban centers during the national lockdown.

that was sending remittances to their native countries.[6] The fall of the flow of remittances made households' financial conditions even worse.

The longer the lockdown measures, the greater the difficulties for entrepreneurs to restart their economic activities without further cash injections. In the microfinance sector, this translates into two key points that are intercorrelated and represent new challenges for FSPs.

On the one hand, the pandemic may **hamper the ability of the clients to repay their due loans**. On the other hand, it may lead to **new financial needs**, that FSPs may not have the financial resources or willingness to immediately respond to (see section below "Financial Service Providers"). As a result, FSPs may contract their capacity to generate a positive impact on the lives of clients (R. Christen, 2020b). Indeed, it is important that FSPs do not retrench their essential financial services at this critical time. As any other economic sector, agriculture needs continuous financial support. Meeting the financial demand from smallholders to purchase seeds and fertilizers is essential to allow them to keep feeding the local population (C. Christensen, 2020). Unavailability of funds can create disruptions at any point in the food value chain, with the result of less food in the market and greater food insecurity (Varangis *et al.*, 2020). Finance flows need to be focused especially to those FSPs (public banks, financial cooperatives, and Microfinance Institutions - MFIs) that finance smallholder farms and agricultural Micro, Small and Medium Enterprises (MSMEs) (Varangis et al., 2020).

FSPs can support clients by providing **emergency loans** or facilitating the **access to cash grants**. However, according to McGuinness (2020), while savings and insurance can support the resilience of low-income groups during a crisis, borrowing is not recommended, because of their lower income. New loans can produce over-indebtedness (Chan, 2020) and further delay the recovery of previous consumption levels due to the commitment of repaying the new loan. Loan disbursement declined, despite an increase in the financial demand (OECD, 2020) leading to credit rationing. In this context, policymakers and regulators must provide prompt responses to **support clients' in dealing with cash-flow and repayment difficulties**.

Governments can launch **business and social measures** to support households, workers and enterprises to recover from the crisis' negative economic effects by sustaining the consumption and/or at the same time supporting the MSMEs in recovering their activities (see section below "*Policymakers and regulators*"). If they want to support low-income people - typical microfinance clients - policymakers have to pay attention also to the informal sector, as in general many firms and households do not have access to government measures, such as tax deferrals or wage subsidies. This was the case of the Government of Ivory Coast, that launched a fund (FASI, *fonds d'appui du secteur informel*) with the main objective of supporting actors in the informal sector, severely affected by pandemic (Dia, 2020).

At the same time, **financial authorities** have also an important role in supporting both borrowers and MSMEs. The moratorium has been the most common measure applied, but with different nuances (compulsory or voluntary), enabling FSPs to defer payments, restructure debts and also freeze borrowers' credit ratings. It was nevertheless observed that the moratorium is difficult

6 According to the projection of the World Bank & KNOMAD (2020), the estimated decline in remittances sent by migrants back home to low- and middle-income countries will account for USD 110 billion, which means a collapse of more than 20%.

to organize and coordinate because in some cases loan default cannot be avoided (Lieberman and DiLeo, 2020).

In the UEMOA (West African Economic and Monetary Union) area, with the objective of supporting mostly the enterprises, the BCEAO (Central Bank of West African States) implemented measures such as the deferrals on loan payment for three months, with the possibility of renewing for a similar period; and waives of interest charges, fees or late payment penalties, for those enterprises capable to provide evidence of the negative impact registered (BCEAO, 2020). In Myanmar, in order to support farmers, the backbone of the economy, the Central Bank proposed the relaxation of regulatory requirements in terms of key ratios and rescheduling of principal repayments.

Notwithstanding, some past experiences showed that debt restructuring or for all customers or write off can be *unnecessarily* costly and that a more targeted approach would create better off results (R. Christen, 2020a).

The COVID-19 pandemic has brought to light an unprecedented opportunity **for people and enterprises to use Digital Financial Services (DFS)**. Social distancing measures (and the fear that cash could be a vehicle for the virus) on one side, and government strategies on the other (especially Government-to-Person - G2P - subsidy payments to support low-income people), have pushed for a greater use of DFS by households and enterprises. According to GSMA (2021a), in 2020 the mobile money accounts grew by 13% globally, twice the forecast. In Colombia, for example, a survey conducted by the firm Bain & Company shows how six out of ten Colombians have switched from only-cash to electronic payments (credit cards and digital payments), also because of the increase in the supply of in-distance and digital services during the quarantine period (Garcia, 2020).[7] Finja, a Fintech based in Pakistan (Economist 2020), which operates entirely digitally, experienced a great increase in the provision of supply-chain finance to a very large number of small local shops and food service providers that proved to be essential in so many countries during the lockdown.

7 For example, 41% of respondents claimed to have paid for online entertainment platforms. 38% accessed bank branches through the internet, 18% made basic food purchase, 15% ordered food through virtual medical consultations and 39% used specialized work-at-home software.

Financial Services Providers (FSPs)

Quantitative effects of the pandemic – microfinance overview

In the last year, the **COVID-19 pandemic significantly and broadly impacted the microfinance sector**. To understand the extent of these effects, two main surveys carried out between the end of 2020 and early 2021 were considered:

- CGAP and Symbiotics (2021) "*Pulse Survey of Microfinance Institutions*", that covers 399 microfinance institutions worldwide among the Symbiotics' global portfolio; and
- International Finance Corporation (IFC) "*The Early Impact of COVID-19 on Financial Institutions*", a survey among 149 clients across 65 emerging markets, representing approximately 30 percent of IFC's outstanding portfolio.

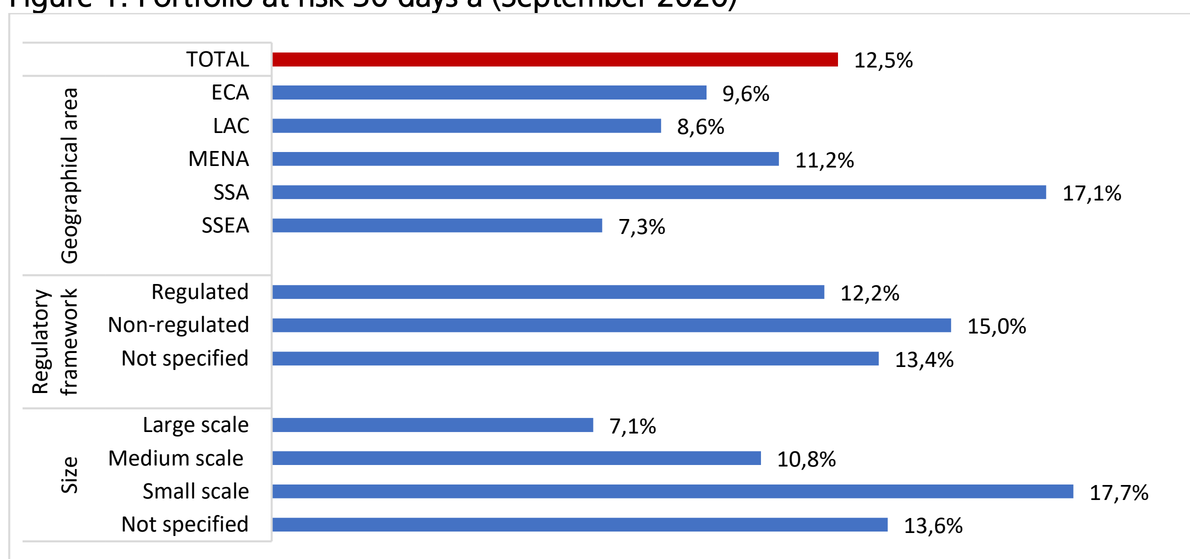
Both surveys confirm that **portfolio quality in 2020 deteriorated with significant differences depending on institutional features**.

According to IFC, almost all FSPs (96%) declared that the crisis generated negative effects on their portfolio and asset quality, and more specifically for 46% of the interviewed FSPs, these changes were significant or very significant.

Data from CGAP show that as of 30 September 2020, **portfolio at risk 30 days** (par30) **increased from 9.7% in 2019 to 12.5% in 2020** (i.e., an increase by almost 3 percentage points). Small-scale FSPs, FSPs in Sub-Saharan Africa, and non-regulated institutions were those that registered the worst performance in terms of par30 (17.7%, 17.1% and 15% respectively) - as shown in Figure 1 below.

Further, considering the ratio between **par30 and equity** ($\frac{par30}{equity}$), the situation was even worse. Indeed, on average, the par30 stood at 46% of the total equity, with the Sub-Saharan African countries showing again the worst performance (76%).

Figure 1. Portfolio at risk 30 days a (September 2020)



Source: CGAP survey. Note: 399 total respondents

In terms of **restructured portfolio**, data are not fully consistent. For CGAP, FSPs have restructured on average 19% of their portfolio, with a peak (32.3%) reached in the first semester of 2020; while for IFC on average half of the FSPs portfolio was under government moratoria or deferrals.

Nevertheless, both surveys confirm a sort of credit rationing: for CGAP, the disbursement over total assets declined from 16% in 2019 to 7% in August 2020, and for IFC, at the end of 2020, **FSPs had not fully reached the pre-crisis level of operations**, being more specifically at 84% in terms of loan collection and 80% for loan disbursement.

Finally, concerning **liquidity**, the **sector showed a much higher level of resilience** than expected, thanks to the investors and shareholders' support. Very few IFC institutions (8%) declared having experienced a shortage of funds, and only a minority (10%) forecasted a negative outlook on liquidity in the following 12 months. Among Symbiotics' FSPs, liquidity over total assets did not vary much (around 20%).

Qualitative analysis

As the pandemic hit the broad economy, the **financial sector also registered important repercussions**. On the one hand, microfinance clients faced difficulties to honour their borrowing obligations due to reduced income-generating activities and cash flows; on the other hand, FSPs had to deal with unprecedented challenges, such as the significant deterioration of the portfolio quality and potential liquidity issues, among others. In other words, the economic crisis associated with the contraction of economic activity, might turn into a financial one if FSPs cannot trust their clients to repay their loans, and if they cannot rely on the support from investors, regulators and policymakers. The role of FSPs has to be preserved as they are fundamental to identify and address communities and clients' needs.

Given the health nature of the crisis, as a first step, FSPs had to take care of their **staff and clients' sanitary safety**[8] through specific measures that promoted and educated them in adhering to national protocols (e.g., wearing masks, social distancing, limit gathering, etc.), also in light of their crucial role in serving people in the most remote areas (M. El-Zoghbi, 2020).

The extraordinary situation generated by the pandemic (i.e., branch closures, impossibility to travel or limited visits to clients) altered the normal operations of FSPs. As the microfinance business model is strongly based on a face-to-face relationship lending approach, FSPs had to consider how to substitute the direct contact with individual clients or groups of clients, without substantially affecting the required human-touch that characterizes their services.

In regard to financial performance, many FSPs faced a **sharply increase in cases of non-repayment**, in an industry where typically credit risk was seen as a minor problem and customers had an excellent repayment track record (K. G. Karmakar *et al.*, 2011). The initial peak of non-repayments reached in the first months of the pandemic were then eased in the following months, still at a level higher than the pre-crisis normal average.

8 In China, MFIs like Grassland have prioritized staff health by providing information on how to protect themselves, enabling home-based work, and giving them tools for how to stay connected to their clients digitally. See: https://www.accion.org/five-crucial-insights-from-china-for-facing-the-pandemic.

The management of crises or emergency situations requires understanding the risks to which an institution is exposed to. FSPs should develop tailored responses to distinguish between clients for whom the crisis provided an opportunity from clients for whom the crisis had a negative impact (R. Christen, 2020a).

Potentially, FSPs can address a crisis with multiple instruments, that go further than just having business continuity plans (M. El-Zoghbi, 2020), and that include ad-hoc **financial policies (**restructuring/rescheduling, refinancing, suspending interest and commissions payments, and write off) and a sound risk management system. These measures, if implemented responsibly, can represent effective tools for portfolio management.

The combined effect of credit losses from the non-performing loans (NPLs) and a shrinking portfolio (with lower revenues from new disbursements) can put serious pressure on liquidity management. **FSPs may need liquidity** to address immediate operational costs (to pay rent, salaries, etc.), **debt investment** to disburse new loans to clients and **equity capital** to absorb the losses. Moreover, FSPs may suffer from roll-over risk when they need to replace funds that are not being renewed or extended. This means that their ability to offer new loans to clients, or even grant moratorium to existing clients, could be constrained (The Microfinance Coalition, 2020a).

Given the extent of the crisis, FSPs may promote lobbying activities to call for support from their investors and governments in overcoming the shortage of funds. In Togo, for example, the Professional Association of Decentralized Financial Systems that brings together all the country MFIs requested a two-year credit line to the Government, with a subsidized interest rate, to allow their members to resume their credit activities (F. Ahlé, 2020).

While in the short-term, the focus has been on credit risk management and liquidity requirements, the medium-term period will require a shift from those concerns to **capital adequacy**. Maturing debt to be repaid to the FSPs own creditors may create further problems. In times of growth, FSPs can count on sufficient level of repayments to continue funding operations or pay back their lenders. But in times of crisis, **investors may temporarily exit** and wait for the market situation to stabilize before issuing new loans (D. Rozas, 2020). This situation might be 'imprudent' as it will disrupt the mechanism according to which FSPs are able to reach vulnerable clients (P. DiLeo and I. W. Lieberman, 2020).

Another concern for deposit taking FSPs is related to the **risk** of **a massive withdrawal of deposits,** which can be fuelled by the uncertainty about the evolution of the situation, and also by the need to cope with the economic effects of the pandemic. This risk can be minimized by maintaining the confidence of the large depositors (since small ones would not put a significant burden on liquidity) (D. Rozas and S. Mendelson 2020).

The effects of the COVID-19 crisis on the economic activities are exceptional in magnitude and extent. However, in terms of FSPs responses, some similarities (with due caution) can be found with other events, such as natural disasters or countries devastated by conflicts and war.

While most natural disasters have an immediate impact with devastating effects, requiring to plan for reconstruction when building and infrastructures are affected, the impact of a pandemic is more gradual with profound and potential long-lasting effects. For this reason, the first step an institution should take is to understand how the crisis is affecting its clientele (R. Christen, 2020b).

Previous crises can suggest best-practices on how to deal with the effects of a pandemic. In Bangladesh, the frequent risk of violent floods that put in danger micro enterprises motivated the local MFIs to equip themselves with preventative measures to provide financial relief to clients. Specifically, MFIs have developed products with flexible features to be activated when clients suffer from important losses because of the floods (i.e., suspension/restructuring/refinancing; reduction of the interest rate; in-kind disbursement in the form of seeds or animals; new loans to replace productive assets, etc.) (World Bank, 2008).

Aside with the regular forbearance measures to allow for changes in the loan terms, a study on the earthquake in Nepal (2015) emphasized the importance of defining a disaster risk management system beforehand to be prepared in case of emergency. MFIs should then design a plan defining roles, responsibilities, processes, and decision-making authorities (ADB, 2019).

In Yemen war break-out in early 2015, the MFI sector registered a quick deterioration of their financial performance. Portfolio quality was affected with a high increase of par30 that peaked at 56% in 2015 and 2016, with a decrease to 42% in 2018; operational and financial self-sufficiency indicators declined up to 2017 and started recovering in 2018; and the lack of liquidity hampered disbursing new loans, with a constant reduction in the outreach served limiting the achievement of the MFIs' social mission. In this context, the sector managed to continue serving their clientele by adopting some measures: MFIs have cut operational expenses (closing branches, reducing working hours and staff salaries), stopped disbursements, proposed debt relief measures (focused on short-term sustainability), and developed new financial credit products much more tailored to clients' needs (Yemen Microfinance Network, 2015 and 2018).

As for new arising opportunities, the pandemic has generated a positive effect in terms of higher demand for digital financial services (described in the section above) and the **improvement in the adoption of digital innovations from the supply side**.

In this regard, countries and FSPs have seized this opportunity depending on the level of existing digitization culture at institutional and country level. Where the seeds for promoting digital

transactions were already set, the COVID-19 pandemic sharply increased its use. In other cases, with less pre-existing digital innovation and inadequate infrastructure, the digital transformation process registered a slower pace.

According to the Global Digital Overview 2020, over 40 percent of the world's total population – roughly 3.2 billion people – remains unconnected to the internet. The low internet penetration level in developing countries creates many challenges for FinTech, education, health, access to employment and other social services. This is due to the fact that digital infrastructure used to be secondary in importance in developing countries to traditional forms of infrastructure such as roads, bridges and ports (I. Faye, 2020).

For FSPs, the digital channels played an important role in reducing default rates, by leveraging on a greater use of mobile-money accounts to repay loans by phones in periods of lockdown and social distancing (Mondato, 2020).

Digitalization has served also to find alternative channels to communicate with clients to alleviate clients' fears and maintain close relationships. Proactive communication by phone or video with customers can be an effective replacement of face-to-face contacts. An institution that is seen as especially responsive during the pandemic, will earn long-lasting trust and confidence of its clients and it may also gain new clients.

However, digital finance comes with its own drawbacks. FSPs faced challenges in transitioning clients to digital channels due to lack of digital readiness and financial awareness, identification documents and access to digital technology among customers. In some cases, the demand for digital services has been dependent on the degree to which FSPs clients have access to smart phones and cheap data plans (connectivity).

Financing clients only remotely can be difficult for a sector where face to face relationships with customers have been key in its success reaching out to poorer, rural customers. But also, getting a personal loan online during the current financial crisis could prove to be difficult as many FinTech lenders are becoming more cautious, especially towards new borrowers who are more difficult to assess.

Some DFS providers experienced negative performance due to their business model and the level of maturity of the sector, among other factors. DFS providers responded better to the COVID-19 pandemic when they were able to diversify their range of goods and services. Those offering only financial services (i.e., dedicated agents) have been struggling more than non-dedicated ones, with some exceptions in countries where government disbursed COVID-related subsidies, like in India. According to many DFS providers across Asia and Africa, during the pandemic, agents saw an important reduction of their revenue, up to 60% in some cases (E. Hernandez, 2020). Non-dedicated agents in several countries have been improving their activity rates as their diversification enables them to reallocate working capital towards services less affected by the crisis.

Further, the use of DFS can bring some CP-related risks, due to a fast and uncontrolled growth in the supply of DFS. It can also lead to irresponsible lending and over-indebtedness if lending policies and controls are not aligned to the debt capacity of borrowers and regulation is not in

place to supervise these activities; or if there is a low level of transparency (proper communication on the costs of fees and rules on the transactions). The perception that MFIs are too small to attract digital criminals is changing (CSFI, 2018), indeed also DFS clients are also exposed to data privacy breaches, cyber-crime and frauds.

As governments define new strategies for digital financial inclusion, encouraging the ownership of formal digital accounts and digital payments, **women risk falling further behind**. For example, Bangladesh has one of the highest gender gaps in financial inclusion, in terms of having both a formal bank account and mobile ownership: only 58 percent of women own a mobile phone, compared to 86 percent of men (GSMA, 2019) – see further the section on "Cross cutting issues".

Finally, among the opportunities raised, **health and life insurance** are other financial services offered by FSPs that played an important role in the pandemic. Unlike developed countries, where many businesses appear to be more resilient to crises also thanks to the access and use of private insurance packages (as well as effective public assistance programs), there is a lack of awareness about the value and the existence of insurance products among lower-income groups in developing countries. However, micro-insurance can be an attractive option for them (C. Joselowitz, 2020). It should be mentioned that "pandemic-related clauses" are not always included the terms and conditions of health and life insurance contracts, limiting the potential large benefits that people could have exploited during this crisis.

Investors and donors

The complexity of the effects of the COVID-19 pandemic can be explained by the high correlation between all components of the financial inclusion value chain, along the investing hierarchy. When the capacity of clients to repay is impaired, FSPs experience increased portfolio deterioration and liquidity shortages that in turn undermine their ability to repay external loans and attract new debt-based funding. This can affect investors, creating a vicious circle.

Within this context, the role of investors, shareholders and donors is fundamental as they can influence the capacity of FSPs to respond to clients' needs. FSPs can provide support and be flexible with clients, such as by offering loans moratoria and unrestricted access to deposits, mostly when both their local and foreign institutional investors (such as, for example, local commercial banks or Microfinance Investment Vehicles - MIVs) also offer them **debt relief instruments**.

In response to potential risks, the **investors promptly reacted to the COVID-19 crisis**. Immediately, after the onset of the crisis, in April 2020, social investors worldwide instigated collective initiatives with the aim to deliver effective and coordinated support to FSPs.

A first initiative, the **Memorandum of Understanding (MoU)** on "*Coordination among MIVs in response to Covid 19*", signed by 9 MIVs, stressed the need of cooperation between investors with respect to debt refinancing. It identified 4 categories of coordination between investors

and set common investing principles and processes that were to be followed when dealing with FSPs affected by the pandemic.

The second key initiative is related to the **establishment of a common Pledge** on "*Key principles to protect microfinance institutions and their clients in the COVID-19 crisis*", signed by 30 organizations. The main objective was to define a lenders' commitment frame, based on internationally recognized standards and best practices from the Social Performance Task Force (SPTF) and the International Association of Microfinance Investors (IAMFI). Concerning **restructuring rules**, these lenders refer to the IAMFI Microfinance Voluntary Debt Workout Principles[9] as source of inspiration. These principles allow for a reasonable period of relief and moratorium to viable FPSs negotiating in good faith. During the crisis period, lenders should refrain from enforcing their claims or reducing their exposure to FPSs. On the other hand, the FPSs benefiting from relief should provide to their creditors reasonable and timely access to all relevant information in order to be transparent in their reporting. For instance, according to another principle of the Pledge, investors should **manage the exposure to foreign exchange risk** by providing funding in local currency along with specific hedging arrangements, and not passing the risk on to the FSPs. For example, in Myanmar, the multi-donor Livelihood and Food security Fund (LIFT) partnered with the Currency Exchange Fund (TCX) to provide a hedging service enabling foreign investors to lend in the local currency to the microfinance sector.

In May 2020, the Global Impact Investing Network (GIIN) launched another market-wide initiative, the **R3 Coalition (Response, Recovery, and Resilience Investment Coalition)**, with the main objective of filling the financial gaps and mobilizing capital towards high-impact investment opportunities in response to the COVID-19 crisis.

In addition, the members of NpM (The Netherlands financial inclusion platform) outlined key investing principles in the "*COVID-19 Investor Statement - Impact investors in emerging markets*" signed by 14 investors. These included to remain committed to financial institutions and MSMEs, and to support MFIs facing capitalization and liquidity challenges by refinancing existing exposures when possible and engaging other leading centres of impact investment.

All these initiatives underline the **importance for investors to coordinate their global actions** with the final goal to continue supporting the financial inclusion sector, minimize the losses and share the risks among all of them. Any MIV that offers extraordinary benefits to its investees – such as an emergency liquidity fund – automatically generates positive spillovers for all other investors and shareholders of the affected institutions. Conversely, if an investor acts individually and demands the closing of its positions, it can negatively affect the other investors.

9 Those Best Practices Tools were developed after the 2008 financial crisis in 2011 to guide struggling MFIs, their creditors and stakeholder as they chose to participate in voluntary debt workouts rather than turn to litigation or court-administrated insolvency or bankruptcy proceedings for the enforcement of claims against debtor MFIs.

Not only is investors' support crucial, but also **the role of donors and multilateral development banks** is particularly critical to the survival and resilience of FSPs, also in a long-term perspective (D. Drake, 2020). With support from the public sector, Development Finance Institutions (DFIs) are better positioned to offer extra-ordinary measures (such as liquidity injections, loan guarantees or debt forgiveness) (E. Rhyne, 2020). However, according to E. Rhyne (2020), DFIs have tended to focus more on their larger stakes, rather than on the microfinance sector. These institutions should take charge or share risks with the FSPs and investors through capital injections, grants, guarantee funds and other financial instruments, with the objective of absorbing losses or mitigating risks. Further, they should especially focus on those segments hardly hit by the pandemic as well as the most vulnerable segments.

Donor-supported initiatives

During the COVID-19 pandemic, donors and international development organizations launched funding initiatives related to financial inclusion of unprecedented scale. These include, by way of example, funds from the Asian Development Bank (ADB), the International Monetary Fund (IMF), the World Bank (WB) Group and the International Financial Corporation (IFC).

Since the beginning of the COVID-19 pandemic, ADB disbursed numerous loan facilities to Governments or directly to local financial institutions in Asia and the Pacific. Among others, in mid-2020, ADB approved two loan facilities of USD 100 million and 500 million to the Governments of Mongolia and Indonesia, respectively, to respond to health and social protection needs and to enhance financial inclusion.

IMF leveraged the existing Rapid Financing Instrument, which is available for all member countries, to respond to COVID-19-related financing needs and provide rapid and low-access financial assistance. Accordingly, the access limits to this instrument were temporarily increased to meet urgent needs.

In 2020, WB Group committed more than USD 100 billion (a 65% increase as compared to 2019) as financing capacity to support the response to the health, economic, and social crisis. Among the key focus areas of intervention, WB Group dedicated a funding line to support poor and vulnerable people. IFC made available a USD 8 billion fast-track financing facility to ensure sustainable business growth and job creation, mostly intended for MSMEs.

Policymakers and regulators

A systemic crisis such as the COVID-19 pandemic cannot be managed without the support of policymakers and regulators. Given the systemic nature of the shock, one of their fundamental roles is to identify which actors of the value chain deserve greater attention, to avoid the

weakest bearing the brunt of the effects. Certainly, they act in line with their strategic priorities, and given their human resources and financial constraints.

Unlike previous crises characterized by a collapse in the demand, as the 2008 global financial crisis, the COVID-19 pandemic is primarily a **supply shock** (R. Hausmann, 2020). If firms are not producing because their workers are locked down, exclusively sustaining demand will not assist micro-enterprises' sales and profit. Government must address supply of essential goods to prevent shortages, price spikes, and suffering in the short term. It is essential to ensure transport and basic public services, as hoarding and unfair trade practices must be monitored and energetically addressed. At the same time, governments have to protect the internal demand and reassure people that financial support will be available for as long as it is needed and nobody will be excluded from subsistence aid (E. Duflo and A. Banerjee, 2020).

While in the advanced economies, governments planned for large **fiscal packages to push the economic recovery** (i.e., by expanding health-care provision, protecting payrolls, providing additional unemployment insurance, delaying tax payments, averting unnecessary bankruptcies, shoring up the financial system), in other countries policymakers lack fiscal space even in the best of times (R. Hausmann, 2020).

G2P transfers for **social security benefits** have shown a positive impact. In the Philippines, emergency transfers covered more than 70% of households (M. Rutkowski *et al.*, 2020). The investment Kenya's Government has made in its G2P payment infrastructure is proving to be critical in mitigating the impact of the COVID-19 crisis, and the government is now considering expanding the number of recipients and possibly linking benefits to the national health insurance scheme. Moreover, the government's COVID-19 Emergency Fund raised more than USD 9 million, with part of these monies to be sent as weekly stipends to low-income households that lost their work in urban areas. In this case, transfers would most likely be channelled via the M-PESA mobile money platform, which is widely used in cities (C. McKay and G. Mdluli, 2020).

The Central Banks of developing countries should call for further rounds of "unconventional monetary policies" combined with governments' fiscal stimulus (E. Diaz-Bonilla, 2020). These measures would sustain both consumption and production by increasing the demand for goods and services (The Microfinance Coalition, 2020b). **Policymakers can use several tools to help enhance the resilience of households and firms**. Measures must support employment as well as income, including strengthening safety nets, with a food component when needed (E. Diaz-Bonilla, 2020).

Supervisors and regulators can operate through new regulations and recommendations, in some cases being very prescriptive, in others leaving more margin to the FSPs and banks to decide. While their direct sphere of influence is the regulated sector, they can also indirectly assist the unregulated sector through guidance and recommendations.

They act according to their political priorities, as well as their financial and human capital constraints, which do not always match with the needs of the financial inclusion sector. The magnitude of the problem might have brought some supervisors and regulators to focus on

the "*too big to fail*" axiom, choosing to mainly support the commercial banking system, as pointed out by the Association of Banking Supervisors of the Americas (ASBA).

In Jordan, for example, the **Central Bank established more favourable interventions for banks,** injecting an additional liquidity of USD 800 million in the banking sector and reducing the mandatory reserve ratio from 7% to 5%; conditions that were not fully granted to MFIs.

In other cases, the financial inclusion sector has managed to be heard by the regulators. The Reserve Bank of India's initially announced a three-month period moratorium for banks only. After local advocacy initiatives, two months later it was extended to non-bank financial companies (NBFC) on a case-to-case basis depending on their cash position (The Microfinance Coalition, 2020). Myanmar is another country where the MFIs, such as Maha, have been constantly advocating with local authorities and lobbied through the Myanmar Microfinance Association to get uniform directions and guidance for the sector (there were some inconsistencies between the regional and national government requirements on waiving interest on loans) - (M. Marinelli and P. Hariharan, 2020). Nevertheless, the capacity to influence and raise awareness on the effective needs of the financial inclusion sector does not exist in all countries.

Supervisors and regulators have a key role to play in supporting the sector. This includes supporting proportionate risk-based and responsible market development measures to allow FSPs to continue their operations, support their clients, improve liquidity, and operate safely. With this regard, **Central Banks rely on multiple instruments**:

- Debt relief measures (allowing for massive loan term extensions – moratoria, rescheduling, restructuring, etc.)
- Changes in pricing and conditions (waiving interest, penalty fees or frequency limits and fees on withdrawal)
- Changes in prudential regulation (requirements relaxation for loan loss provisioning or categorization of the deferred loans, minimum capital adequacy and reserves, etc.)
- Liquidity injection (more favourable conditions on the liquidity facilities of the Central Bank)
- Other measures such as creating a guarantee fund, training and technical support to overcome the crisis, amongst others.

The moratorium, the most common measure adopted, saw different application methods (per number of months or interest accrual, voluntary or mandatory). For example, in Tunisia, a six-month moratorium halted loan payments to MFIs but allowed to continue accruing interest on these loans during the moratorium period (The Microfinance Coalition, 2020b). In other countries, interest accrual was forbidden or not recommended (as in Myanmar and some countries of Latin America). Nevertheless, a common fear was that too much relaxation in repayment would pollute the lending culture (The Economist, 2020), and such measures should be balanced with the need to reduce moral hazard problems.

In regard to other measures, the Financial Regulatory Authority in Egypt conducted a **stress test** on the non-banking financial sector in order to assess the ability to deal with the pandemic-related financial shock. This exercise helped to ensure a proper functioning of the sector and

to analyse the impact of the crisis on the profitability, liquidity position and financial solvency of each individual institution. Moreover, it also considered the precautionary measures adopted by the government, and how these measures impacted on the institutions' financial performance and other performance indicators (MENAFN, 2020). In Morocco, the Central Bank asked banks to withhold dividends for 2020 to be better placed to deal with any fallout from the coronavirus pandemic (Reuters, 2020).

Further, a willingness to offer credit to higher risk segments is essential during a crisis, and somehow this principle should be protected by policymakers and regulators, also with **pure capital injections**. The Palestine Monetary Authority (PMA) launched the "Sustainability" Program to provide financing to Small and Medium Enterprises (SMEs) and microprojects that had been economically affected by the COVID-19 pandemic. With a size of USD 300 million (PMA contributing with USD 210 million), this was the first direct liquidity injection intervention by PMA to be implemented through banks and MFIs.

The Reserve Bank of India's announced a moratorium covering a three-month period and injected liquidity into the system, but banks remain cautious about committing capital to the poor and the money "*ended up going to the cash rich*" (Economist, 2020).

Regulators and supervisors have also a role in **defending clients' rights** when not respected from the institutions. In Cambodia, for instance, after having noticed that borrowers were forced to sell their livestock and farms to pay off debts to banks and MFIs, the National Bank of Cambodia (NBC) urged creditors' agents not to demand loan repayment. Further, NBC has been strengthening its work on the supervision and regulation of the banking and financial sectors to provide better services in order to help clients to create or expand a business.[10]

Digital innovation

In some countries, the crisis has encouraged governments to **accelerate the digital transformation** by promoting G2P social transfers through digital platforms. While countries with greater adoption of DFS would find relatively easier to ensure continued access to financial services, many governments looked for creative ways to distribute cash safely by making basic regulatory changes, such as allowing existing e-money providers to provide cash-out services.

In some cases, Central Banks strengthened their financial tools **including DFS in their financial relief responses** to an unprecedented degree (Mondato, 2020). This may determine an increase of public attention and funding to support more inclusive policies, with an emphasis on the underserved segment, such as women, the poor and rural areas (I. Faye, 2020).

There are several examples of G2P initiatives launched during the pandemic. In all these, the emphasis must be placed on ensuring that the digitalization of payments does not lead to exclusion of vulnerable populations; all G2P programs should address any barriers that may raise as a result of transitioning to digital payments (M. Rutkowski et al., 2020).

10 Workshop on "Consumer Protection of Banking and Finances on the Outbreak of COVID-19", held in Cambodia in the second half of May 2020.

In Peru, the government launched several support programs targeting poor, rural, vulnerable households and self-employees reaching around 6 million recipients. Interestingly, millions of households have accessed the programs through virtual or non-face-to-face platforms and mechanisms, such as deposit into account, cell phone banking and electronic wallet (Perú21, 2020). This has been built on previous initiatives expanding the set of FSPs involved in the program (including private banks and mobile money providers like BIM, a national digital financial services platform).

In Togo, for example, the government launched a cash transfer scheme (with 1.3 million people already registered) linking an electronic wallet to people's cell phones.

In India, the Government & Regulatory Bodies like the National Payment Corporation of India have urged people to opt for digital or contactless payments as well as online purchases to reduce social/physical movements and minimize any possible risk of spreading the virus via cards or cash. As a result, an increase of about 12 to15% was observed in online shopping of food and groceries compared to the pre-crisis periods. However, in the cash-intensive Indian economy, digital payments involve mainly the urban areas and tech-savvy citizens.

Cross cutting issues

Social performance management

Based on the key challenges encountered by the FSPs (credit, liquidity, portfolio quality, etc.), at a first glance, it seems that this crisis can be mostly overcome with a financial perspective. Nevertheless, it would be important also **to adopt a Social Performance**[11] **(SP) and Client Protection (CP) lens.**

Many SP and CP initiatives promptly started studying the impact of the COVID-19 pandemic to provide a set of practical recommendations to FSPs to guide their steps forward in line with Social Performance Management (SPM) standards and CP principles (that were slightly adapted to the peculiarity of the crisis).

The **Social Performance Task Force (SPTF) developed a toolkit** – the "*COVID-19 Client Interview Tool*" that allows FSPs and their partners (including investors) to **implement client-centric studies** on the current situation of clients assessing their immediate health and financial needs and providing data to support FSPs' decision-making process. The tool aims to collect harmonized and standardized data to avoid duplications and facilitate comparability. In addition, SPTF organized webinars and produced publications on how to recover from the crisis with recommendations for funders, FSPs, and regulators.

11 SP defined as "the effective translation of an institution's mission into practice in line with accepted social values" (SPTF). SP management is mostly related to defining strategies and processes to achieve the desired outreach, having responsible standards towards staff and clients, protecting the clients and balancing financial and social performance.

The Financial Access Initiative (2020) published a study, "Financial Consumer Protections in Unprecedented Times", on **how the 7 Client Protection Principles apply in this peculiar circumstances of the coronavirus slowdown**.

The Center for Financial Inclusion at ACCION published "Weathering the Storm II: Tales of Survival from Microfinance Crises Past", a report produced with the European Microfinance Platform (e-MFP) presenting **lessons learned from 16 institutions** that dealt with previous crises and "The Precarious State of MSMEs: Understanding the Impact of COVID-19 and Opportunities to Support their Recovery" that shares the findings from a longitudinal survey examining how COVID-19 was impacting MSMEs in four countries: Colombia, India, Indonesia, and Nigeria.

It would be interesting to assess how having adhered to CP principles and having sound SPM practices in place before the onset of the shock influenced FSPs response and recovery from the crisis. Another interesting research question would be to understand if and how effective is financial education in limiting the negative effects of the crisis. This would give some further insights into how to prepare for future possible crises.

Vulnerable segments and gender lens

Despite the COVID-19 disease slightly affecting more men than women, it should be said that the **crisis adversely impacted the most vulnerable segments**, **including women, youth, migrants, refugees or people with disabilities**, making existing inequalities even wider.

Past health crises such as Ebola have shown that women and girls often face more negative impacts than men, with longer lasting effects (UN Women, 2020). Data from ILO (2020a) shows that women's jobs are in higher-risk sectors, with more fragile employment situations and lower social protection measures, that prevent them to promptly access to relevant resources and recover from a shock. As a result, a gender-sensitive response to the crisis may help in promoting women's empowerment and improve their coping strategies.

When looking at **digital transformation**, given that mobile phone ownership is still low in many rural areas, digitalization risks exacerbating the digital divide, especially for women. From the recent GSMA Mobile Gender Gap report (2021b), women are 9% less likely than men to own a mobile phone in low- and middle- income countries. This gap varies by market, being equal to 15% in India and only 4% in Nigeria. Moreover, women are 15% less likely than men to have access to internet. Literacy and skills are the key constraints for women to engage with digital channels. Financial institutions may train and assign staff to help women filling digital gaps and can build assistance points with the same staff helping customers mitigate challenges. Chatbots, call centres and easy-to-use instructions can also help women clients when they need (J. Fu and S. Kelly, 2020).

As for women, also **youth is a segment that has been suffering more due to the crisis.** Not only do their **labour conditions tend to lag behind but they are also more financially excluded than adults** (mostly due to lack of collateral and entrepreneurial skills). This situation has been exacerbated during the crisis.

According to ILO (2020b), 80% of the employed youth are in the informal economy, reaching a share of more than 95% in developing countries. During the crisis, more than 15% of young people lost their jobs. Further, the closure of schools in many countries may have encouraged the early interruption of studies, hampering future working possibilities. This can create a vicious circle that further broaden their vulnerabilities.

As discussed above, the COVID-19 crisis affected the entire financial inclusion value chain. Investors and donors, regulators, FSPs, and other service providers played an important role in keeping the financial sector afloat during the pandemic. As the financial sector succeeded in connecting vulnerable and underserved segments to formal financial services, **more attention should be put now towards these segments where exclusion barriers are still relevant and have been amplified by the consequences of the crisis**. It is crucial to first identify the key needs of these segments, considering clients' behavioural insights; and then, leverage a multi-stakeholder approach, engaging organizations that represent different categories, and offering tailored support.

Qualitative analysis – stakeholders' interviews

The findings from the literature review are complemented with a qualitative analysis aiming to have a deeper understanding of the effects of the COVID-19 crisis on key actors of the financial inclusion value chain. With this purpose, **25 international stakeholders were interviewed** between July and August 2020 to illustrate practical cases and examples of how they have faced and addressed the challenges and risks of the pandemic. More specifically, the following were interviewed (see the complete list in the acknowledgement):

- 10 chief executives from 9 FSPs
- 9 investors from 7 institutions
- 3 regulators/supervisors and
- 3 practitioners from 2 financial inclusion organizations

The interviewees were selected according to the type of institution, profit orientation, the geographical coverage, and their role in the organization with the objective to capture diversity and representation of key actors within the financial inclusion value chain. Nevertheless, the selection of respondents had also limitations due to time, stakeholders' availability, and budgetary constraints.

In terms of FSPs (see Table 1), the institutions were selected according to their size, legal status, clientele served (rural versus urban, vulnerable segments), and lending methodology.

The investors interviewed provide debt and equity investments to a variegated typology of Tier 2 and 3 FSPs (MFIs, banks, or Fintech companies), and in some cases also to farmers and SME organizations worldwide.

Under the regulators and supervisors' category, 3 stakeholders with different roles were interviewed, namely a national central bank, an association of banking supervisors, and a consulting firm specialized in providing capacity-building programs to financial sector regulators and supervisors.

The section below presents the most significant and interesting findings coming from these interviews.

Table 1. Data and information on the FSPs interviewed.

Name of the FSPs	Country	Legal status	Key products and services	Target	N. borrowers	Gross loan portfolio (Millions of USD)
Banca Afirme	Mexico	Bank	Business loans Consumer loans Savings - Credit and Debit card Insurance	People in the country	n/a	50 (Dec-20)
Banco FIE	Bolivia	Bank	Business loans Savings - Credit and Debit card Micro-insurance	Small and micro enterprise	195,786 (Jun-19)	1,734 (Jun-19)
COOPEC Support for Women's Initiatives for Self- Promotion (Sifa)	Togo	Cooperative	Business loan Micro-insurance	Low-income women living in northern Togo	51,494	5.9
Mutuelle pour Le Developpement a la Base	Benin	Mutual Savings and Credit	Business loan Savings Micro-insurance			
Musoni	Kenya	Microfinance Institution (cashless)	Business loan (Agri and MSMEs) Consumer loan (education, emergency)	Low income and unbanked people	44,082 (Jun-19)	22.9 (Jun-19)
OXUS Tajikistan	Tajikistan	Microfinance Institution	Business loan (Agri and MSMEs) Consumer loan (green, home improvement)	Micro-entrepreneur and farmers in rural areas	14,308 (Dec 19)	13.8* (Dec-20)
OXUS Kyrgyzstan	Kyrgyzstan	Microfinance Institution	Business loan (Agri and MSMEs) Consumer loan (green, home improvement)	Micro-entrepreneur and farmers	8,399 (Dec-19)	8.6* (Dec-20)
SAFCO Support Foundation (SSF)	Pakistan	Non-Banking Finance Company	Business loan (Agri and MSMEs) Micro-insurance	Micro-entrepreneur unbanked and low-income people	91,359 (Jun-20)	13.3 (Jun-20)
Select	Malawi	Microfinance Institution	Business loan Consumer loan (housing, education, emergency) Micro-insurance	Micro-entrepreneurs, low-income households, salary earner	n/a	n/a

*estimates

Sources: Mix Market and FSPs websites

Key measures taken and challenges

Clients: key effects from the pandemic and key measures offered to alleviate their indebtedness

As pointed out by the representatives of the FSPs interviewed, and in line with the findings from the literature review, the **effects of the pandemic at client level were very heterogenous depending on multiple factors** that influenced the clients' capacity to cope with such an unexpected shock.

Economic sector and type of employment have been key factors. In Togo, for instance (but also in Bolivia, Benin, and Kenya), the small businesses in the transportation and restaurant sectors were the most affected and almost all clients from COOPEC SIFA failed to repay their loan. Indeed, there was an increase in transportation costs that had an impact on the price of products, and the impossibility for these small commercial businesses to trade and sell due to the closure of markets and borders. In Kyrgyzstan, the most affected clients were employees, especially those engaged in the breeding sector. Also, some manufacturing firms producing final goods suffered because they could not receive raw materials from other regions. In Malawi, the situation was difficult for all SMEs, particularly those working with private schools (because of their closure). Conversely, employees in the public sector were less affected as their salaries were not reduced, but eventually delayed).

While in Benin, Bolivia, Tajikistan and Togo, the agricultural sector did not experience significant problems due to seasonality and given that there was no business interruption during the pandemic, in Kenya, some of the food value chains (such as tomato and sugar) were disrupted. In general, although restaurants and hotels were forced to close, the agriculture sector showed an increase in the overall demand, despite the difficulties of bringing products from producers to buyers.

For Banco Fie in Bolivia, clients' **age group** was an important determinant of resilience, as younger people are more flexible and able to more easily switch to other economic activities, and their health is normally less affected if they are infected with COVID. However, as mentioned above in the "*Cross cutting issue*" section, youth are in general more vulnerable and were more negatively impacted by the crisis.

To respond to the income reduction due to profit losses among their clientele, and to **reduce the credit pressure on clients**, all the FSPs interviewed have taken **extra ordinary debt relief measures,** either those imposed or recommended by the central bank/supervisory authority, or measures individually introduced by the FSPs. The most common measures consisted of loan rescheduling or restructuring, allowing for some months of grace period, not accruing interest or without late payment fees.

In many cases, **FSPs took ad-hoc measures tailored to the clients' segments or products**. Musoni, in Kenya, offered additional moratorium to clients in the most affected sectors - schools, restaurants, hotels, and other small businesses dependent on imports, especially from China. Rather, Banco Fie in Bolivia, granted the possibility of postponed reimbursements only to clients with small-sized loans (between 100 - 20 thousand USD) and offered new consumption loans to those clients with good payment histories. Afirme, in Mexico, in case of group lending,

cancelled a portion of the principals to be repaid based on the loan cycle and group behaviours. These examples show the importance of monitoring the evolving social and economic context as well as the situation of each individual customer to promptly act with tailored solutions.

FSPs: key measures taken to alleviate clients' indebtedness and key challenges

At the outbreak of the COVID-19 pandemic, FSPs had to **protect and safeguard both staff and clientele**. Accordingly, all the interviewed FSPs have put in place safety measures in line with the World Health Organization requirements or national protocols to assure confidence among staff and clientele and to overcome operational and logistical issues. They have provided the necessary Personal Protective Equipment (PPE) to staff (such as masks, sanitizers, etc.), allowed for remote working where feasible, and split the team into shifts. In Bolivia, Banco Fie provided transportation solutions for their employees and life insurance to all workers.

Despite measures taken to avoid loan defaults, most FSPs registered a **sharp deterioration of the portfolio quality.** According to the interviewed FSPs, the increasing credit risk was indeed their most critical problem. As the economic activities of the clients were increasingly impacted, FSPs were more likely to register delays in repayments. In some cases, the par30 reached unprecedented peaks. Musoni experienced a dramatic increase up to 35% in mid-2020, from a pre-crisis average of 10%. OXUS Kyrgyzstan, who faced non-performing-loan issues even before the pandemic, showed a further increase in the par30 after the onset of crisis. SSF saw a threefold increase of par30, despite still within reasonable levels. In addition, most of the FSPs interviewed saw around half of their portfolio restructured (i.e., Afirme, Banco Fie, SSF, and OXUS Kyrgyzstan).

In contrast, Select (Malawi), who mostly serves public sector employees did not register significant arrears in the repayments because clients were dependent on government salaries. Similarly, COOPEC SIFA whose portfolio is mostly concentrated in the agriculture sector did not register an important increase in par30.

The greater resilience of the agri-sector and, in general, the less restrictive lockdown policies in rural areas (compared to urban areas) turned to be a strength for the interviewed MFIs that operate mostly in rural areas and specialize in agricultural lending.

Within this context, this report found that the **major challenges** for FSPs were in loan collection and consequently new loan disbursement, that can be summarized with the following table:

Table 2. Major challenges for FSPs

Problems with loan collection	Limited loan disbursment
• Clients' income reduction (difficulties to repay) and moratorium • Movement restrictions and limited monitoring	• Liquidity issues or conservative strategies • Clients' profile got riskier • Difficult to assess clients remotely

The **problems with loan collection** were related to the clients' income reduction and subsequent impossibility to repay their loans on time – which has been accommodated by moratoria measures. Further, loan collection was also affected by movement restrictions that prevented loan officers from visiting and monitoring clients. For those FSPs whose business model was based on a close relationship between clients and credit officers, **daily disbursement and collection operations eventually slowed or were interrupted**. In Togo, where the microfinance sector goes deep into the rural areas, and the relationship between client and loan officer plays an important role, the sector was particularly hit. Dealing with group lending in a time of social distancing and with a maximum number of people allowed in gatherings was also a challenge. Afirme in Mexico tried two solutions for the loan collection. Following national rules, at the beginning of the pandemic it continued the physical meetings with smaller sub-groups. Then, it realized that peer enforcement is more efficient with all group members gathered and started successfully organizing meetings through an online platform.

The second major challenge for FSPs is related to loan disbursements. While many clients were/are in need of extending the repayment schedule of their existing loans, in Kyrgyzstan, Malawi, and Pakistan there was also an increase of the financial demand to compensate for income, profit and cash flow reductions. However, with a slower loan recovery and increased levels of risk of existing and potential clients as a consequence of the economic hardships, FSPs were **not fully able or willing to renew loans from existing clients or to finance new clients**.

Also considering the difficulties to conduct proper loan assessments remotely, several FSPs decided to limit or suspend loan disbursement to new clients. As a consequence, in some cases, loan disbursement was concentrated on the upper segments of their existing clientele. This point is very important as the **FSPs may automatically exclude the most vulnerable and in need clients** (see further section on mission drift "Risks and mitigation measures"). Afirme, for example, concentrated new disbursements to those groups with good credit history and good behaviours; SSF launched top up loans only for existing clients.

Nevertheless, **liquidity issues have proved to be less severe than expected**, in line with the findings from the IFC survey presented in the introductory section. Despite the literature pointed out that disbursing emergency loans in a period of crisis is not the best solution (Chan, 2020; McGuinness, 2020), where feasible, some FSPs continued disbursing loans to support the local businesses and households (albeit with some limits): (i) COOPEC Sifa continued disbursement thanks to the access to government funds for farmers; (ii) Musoni did not stop lending but tightened the screening process; (iii) OXUS Kyrgyzstan and OXUS Tajikistan limited the maximum loan amount for the riskier segments. Among the main topics discussed during the

interviews with the FSPs, the importance of looking at a social impact perspective and the attention towards the market segments were of great interest. This is a positive sign of acting as responsible financial institutions.

For those FSPs with sound governance, and with loyal shareholders and investors willing to support them, liquidity issues were of secondary importance. This is the case of Musoni, who asked for **capital injection** from its shareholders, or OXUS Kyrgyzstan that negotiated to reschedule the repayment of the principals with its international investors. These measures prevented them from suffering from any liquidity problems. By contrast, Select Malawi who had liquidity problems already before the pandemic, suffered from a lack of funding even though the portfolio quality was not particularly affected by the crisis.

Investors and donors: key measures taken to alleviate FSPs problems and key challenges

Social investors demonstrated to be prompt and proactive in reacting to the pandemic. All investors interviewed offered a number of forbearance instruments (re-negotiation of principal or interest payments and covenants) and some of them also offered capital injections to alleviate the credit pressure faced by the FSPs and to address their liquidity needs.

It was observed among the FSPs interviewed that those with stronger networks (such as OXUS, or Afirme which is part of a financial group) received significant support from their lenders. In some cases, these measures were of some alleviation, as for the case of SSF in Pakistan where lenders put on hold principal payments for one year (despite that they refused to provide additional lending).

As pointed out by some investors, it is important to be understanding and ready to waive or renegotiate covenants with the investees. In turn, investors required a frequent (weekly or monthly) reporting of the FSPs activities to be regularly informed on the situation and its evolution.

Given the rapid evolution of the pandemic, **having updated and truthful information on the FSPs performance** has been fundamental because the crisis effects in some cases are not fully reflected in the financial indicators and, of course, not reflected in the existing financial statements. For example, in some countries the regulators do not ask financial institutions to track the portfolio under moratoria as part of the rescheduled portfolio, it is counted as performing loans; or the reduction of expenses (due to branch closure or salary cut) can produce an improvement of the operating expenses that somehow can balance the losses. Further, when dealing with credit risk management it is important that all elements (i.e., moratoria, rescheduled or restructured loans, and write-off) are clearly distinguished in the portfolio analysis to avoid a biased picture of the reality.

Investors/donors' support was relevant not only for the debt relief measures, but also **for allowing FSPs to improve some practices in the field or take advantage of the arising opportunities**. Investors indeed realized that younger and less formalized institutions have further need to strengthen their capacity. *Appui au Développement Autonome* (ADA) provided financial support to develop a continuity plan for COOPEC SIFA in Togo and *Mutuelle pour le Developpement a la Base* (MDB) in Benin, as well as to buy kits and telephones to continue

communication between loan officers and group loan members. Alterfin rather supported its MFIs to purchase the required PPEs. On the other side, stronger FSPs may need more capital (in form of equity or debt) to invest in new technologies or take advantage of emerging opportunities.

As for the FSPs, liquidity was also an issue for some **investors**. They **had also to look at their shareholders and funders** to make sure that they also could **retain the necessary liquidity** to be fully committed to their partners.

The liquidity shortage **limited funding to their existing clients**. In some cases (such as the Luxembourg Microfinance and Development Fund), disbursements were stopped to keep a conservative approach and observe the evolution of the pandemic. Almost all (except a few cases for Verdant and Bamboo Capital Partners) confirmed that disbursement to new clients was put on hold due to the impossibility to carry out field due diligence and the potential higher risk of the FSPs.

The crisis showed that the **collaboration between investors got stronger and was crucial**. Most of the interviewed investors declared that major decisions have been taken in concert with the other lenders, preferring lenders-group arrangements, rather than bilateral arrangements with the institutions. This is important **when dealing with the same institutions** to ensure the adoption of measures that are coordinated and balanced, and to share data and information on the sector with the investors' communities. These principles are also illustrated in the MoU signed by 9 MIVs that has been discussed in the literature review part or this report.

Cooperation between investors can take different forms. As told by Alterfin, another investor had organized a field visit to carry out due diligence on an organization in Nicaragua that at the end could not proceed because of the pandemic. Therefore, Alterfin, who visited that institution a few months before, shared the field visit analysis with all key findings and this collaboration resulted in a co-investment agreement.

Regulatory framework: key measures taken to support the financial sector and key challenges

Preserving financial stability, as well as availability and continuity of financial services provision, are the key objectives of financial regulators to avoid systemic risks. Nevertheless, this has been very challenging given the magnitude of the problem that transversally hit all countries and regions, and the need to balance relief for the clients and the FSPs. The pandemic is likely to delay the progress of financial inclusion across the globe as the financial sector has been struggling to manage the shock.

For the end-clients, governments distributed **financial aid to households and enterprises**. In many cases, they have promoted electronic wallet solutions and other digital options.

In all countries interviewed, **Central Banks implemented or proposed debt relief measures in support of borrowers**. The most common measure was the introduction of a moratorium, voluntary or mandatory, in general between 2 and 6 months. The role of policymakers and regulators is to support the sector with a mix of interventions including, in addition to debt

relief measures, capital injection or grants, settlement of guarantee funds or other mechanisms to support the financial sector.

In Mexico and Tajikistan, the Central Banks proposed a loan loss provisioning relaxation, reducing the obligatory reserves for the portion of portfolio under moratoria, and ASBA proposed more flexible NPLs' classifications.

Further to directly support FSPs, in some cases, such as the State Bank of Pakistan or the Central Bank of Bolivia, they created a subsidized credit line or guarantee fund to manage the liquidity risk. In Togo, MFIs had the opportunity to access an existing credit line specifically for the agriculture sector and the government offered some benefits in terms of utilities payment for the initial three months from the outbreak of the pandemic.

According to the stakeholders interviewed, in some cases the **support from the Central Bank did not sufficiently accommodate the microfinance industry** but focused mostly on the banking system. In both Tajikistan and Malawi, for example, they injected liquidity only for the banking sector. Actually, MFIs in Malawi or from the UOMEA area have asked for a credit facility line for MFIs that was not however considered. Advocacy of FSPs jointly with their local networks served to obtain further support.

Digital innovation: key changes registered in the use and service delivery and key challenges

When talking about **digital innovation**, countries and FSPs have seized this opportunity depending on the level of infrastructure, access to technology, connectivity, and existing digitization culture at institutional and country level. Where the seeds for promoting digital transactions were already set, the COVID-19 pandemic has sharply increased its use. In other cases, with less innovation and where the country infrastructure was still inadequate, the digital transformation registered slower improvements.

FSPs took advantage of existing DFS to further increase their usage. OXUS Kyrgyzstan already had some ATMs in a few branches. After realizing that the pandemic contributed to the increase in the volume of transactions, they decided to install them in every branch.

In Pakistan, SSF was relying on its agents' network to collect the payments, especially in the rural areas. During the pandemic, many of the agents' shops were closed because they were not classified as "*essential*" economic activities, allowed to operate by the government. To adapt to this regulation and ensure continuity of loan repayments, SFF expanded its network with a new network of agents also engaged in essential businesses (such as groceries and medical stores).

The majority of the interviewed FSPs reported an increase in the use of digital channels for **communication with their clients**, especially during lockdown, through an application that requires an internet connection and the use of a smartphone (such as WhatsApp, Viber, or Skype). OXUS Kyrgyzstan, for example, started to use phone calls and WhatsApp to receive applications by clients for restructuring and to negotiate related conditions with each of them. As mentioned, Afirme in Mexico stopped field visits to their groups and introduced digital platforms such as Zoom and Skype to run their weekly group meetings.

As pointed out by the Toronto Center, an organization that provides practical training for financial regulators and supervisors, in some cases, the absence of digital payment systems has made **government safety net pay-outs inefficient and difficult to handle**; and in any case, where the Electronic Know Your Customer (e-KYC) identification was not possible, people had to queue at bank branches to validate their identification and to receive cash payments. Inadequate identification protection triggered digital fraud. The National Banking and Securities Commission in Mexico (CNBV) has noticed an impressive increase in cyberattacks against FSPs.

In markets with low mobile penetration and poor infrastructure, it was not possible to foster digital solutions. This is not only a matter of investment from FSPs, but actually a problem related to the general environment. In Malawi, the IT infrastructure is limited in terms of internet service providers, with just a couple of reliable players, and connectivity downtime remains a challenge. Internet is quite expensive in the country, and it cannot be afforded by the microfinance institutions' clientele, typically rural and low-income people. The pandemic has indeed exacerbated an existing and well-known problem.

Risks and mitigation strategy

Clients

During the pandemic, the financial needs of low-income population increased to meet the new cash-flow dynamics, balance any income reduction and invest in their business activities. In this regard, the biggest risk they have faced is related to the **credit crunch** and potential increase of their financial exclusion. FSPs had difficulties in disbursing new loans, especially to new clients. As a result, particularly non-clients have undergone a sort of credit rationing, where supply does not meet demand. Select Malawi, for instance, decided to stop expanding into the private sector; COOPEC Sifa in Togo have increased their lending in agriculture because it showed to be the most resilient sector, and consequently reduced the disbursement among the most affected sectors. Kyrgyzstan OXUS have also become more stringent, and have tightened its screening process. This behaviour could create a **credit crunch that affects low-income people, likely the most in need and vulnerable**.

In terms of **client protection**, likely the most widespread risk is related to **aggressive and abusive loan collection**. FSPs in need of liquidity could adopt irresponsible practices to recover the loans among clients that on their own side have difficulties in repaying;[12] or alternatively, FSPs with collateralized loans could force the clients to sell the collateral or seize the assets, which they would have not done in a normal situation. Other potential risks are related to:

- **Not tailored products**: this risk is relevant for new disbursements, especially if the FSPs move to other client segments, and do not have products adapted to the needs of the new clientele.

12 In a study conducted in Pakistan by Oxford Review reveals that, although 60% of loan officers said they offered repayment flexibility to borrowers, 96% of clients said they had not been offered repayment flexibility during the crisis. This circumstance could be a consequence of loan officers' income earned based on the repayment of existing loans and new loans disbursements. In fact, while this type of incentives structure enhances the efficiency of MFIs in normal times, it implies that, given the hard times to face some loan officers were still demanding repayments from customers, even when senior staff have established policies creating repayment moratoriums (K Malik, 2020).

- **Not transparent communication**: FSPs may not have clearly communicated the forbearance measures (cases in which they apply, how to request, impact on the Credit Bureau, costs and fees, etc.).
- **Lack of privacy**: remote working (downloading files from the internal MIS, bringing loan files home) and digitalization may affect the procedures to protect customers' information and the ways to ask for their consent
- **Lack of complaint mechanisms**: clients may not have full access to the complaint mechanisms available (when for instance branches were closed or staff were in smart working – in case of call centres).

The use of DFS exposes clients to some **CP-related risks**. It could lead to irresponsible borrowing and over-indebtedness, data privacy breaches and low levels of transparency, among others.

Other minor risks clients have been exposed to are related to:

- **Savings-panic**: As the pandemic started spreading, the uncertainty created some initial **panic** among customers that led them to increase **savings withdrawals.** This was for example observed in Togo by COOPEC SIFA, where however the situation stabilized in one month.
- **Risk of changing repayment culture and moral hazard**: Even though the microfinance sector has been always characterized by high rates of repayment[13], the moratoria interventions could affect the credit payment culture. This was not however registered among the FSPs interviewed (particularly among Banco Fie and OXUS Tajikistan) who perceived that the good payment culture among their clientele and their reluctance to be perceived as risky played a role.

FSPs

During the pandemic, the FSPs have been exposed to a number of **significant financial risks** such as the (i) operational (ii) credit, (iii) liquidity, (iv) solvency and (v) exchange risks.

The first risk FSPs had to cope with is the **operational risk**, especially during the first months of the pandemic, and in those countries that adopted stringent lockdown measures, with FSPs closing their branches and promoting remote working for their staff. Where branches were allowed to stay open, FSPs had to align with government requirements and adopt all safety measures, including social distancing. In both cases, the operations of the FSPs were slowed down, with the consequent risk of not fully serving their clients and the impossibility or limitation to recover payments.

To promptly react to the emerging risks and ensure continuity of operations, FSPs implemented business continuity plans (where not available, such as Select or MDB, FSPs designed an ad-hoc plan). In general, these plans include internal crisis management systems, the definition of roles and responsibilities, priority operations, and key personnel, as well as a risk map, with different scenarios and potential strategies to adopt.

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13 According to the "Microfinance Barometer" (2019), in the last ten years, globally on average, par30 was ranging between 6 and 7%.

Those FSPs already dealing with digital payments had to manage an increase in digital operations, with a consequent risk of not being fully prepared; potential fraud and cyberattacks through digital channels became prevalent.

The most severe and common risk the FSPs had to deal with is the credit risk, related to the deterioration of the portfolio quality, given by the increase of rescheduling, restructuring and loans under moratoria. FSPs with the support of their investors, hardly worked to mitigate it. A more detailed and frequent monitoring of the portfolio has helped to understand its real composition, with clear distinction between par30 and other debt reliefs measures, such as the rescheduled or restructured loans, moratoria and write-off. For example, loans under moratorium are not counted within the portfolio at risk, but at the same time, when the moratoria end, there is a likelihood that these loans register future repayment delays.

FSPs can also organize (remotely or in person) clients' follow up to understand the reason behind a late repayment, reminding the payment after moratorium, and to identify the best solution to get the loan repaid.

Credit risk directly affects the profitability and sustainability of the institution through the loss of portfolio and related loan loss provisioning, loss of income for the uncovered interest and penalty fees. It also may indirectly hamper the growth of the institution. Indeed, credit risk comes together with the liquidity risk. FSPs limited or suspended disbursements both to existing and new clients because of lack of funding or willingness to preserve their capital and ensure their long-term solvency. More specifically, FSPs revised their credit policies and procedures towards the adoption of more conservative requirements. For instance, in Tajikistan OXUS created an anti-crisis committee that set the maximum loan size and introduced limitations regarding clients' repayment capacity.

In order to cope with the liquidity risk and manage it, FSPs can cut some expenses (Musoni cut staff salaries by 12%, OXUS Kyrgyzstan closed some branches), or look for additional funding. Moreover, it is imperative a proper and constant oversight of cash flows, together with constant communication with lenders, to improve the transparency and confidence for the lenders. OXUS Tajikistan or SSF in Pakistan, for example, created four stress-test scenarios and liquidity plans taking into account disbursement ratios, par30 and restructuring measures and they have been sending monthly updates to their investors.

Funding is also related to potential foreign exchange risk if investments are provided in hard currency, especially in periods where the local currency has depreciated due to the crisis. Nevertheless, it is a common rule, also promoted by the Pledge agreement mentioned above, to provide funding in local currency with hedging arrangements taken by the investors. This was also confirmed by the stakeholders interviewed, according to which investors to the extent of possible have been providing funding in local currency that in turn is hedged through risk management products (such as The Currency Exchange Fund of MFX) or other in-house instruments.

In the long run, a solvency risk can emerge if credit risk continues its deterioration trend and FSPs erode their equity (due to default and loan loss provisioning). On the contrary, FSPs with strong reserves and equity, together with good recovery should be able to absorb the losses.

Both investors and FSPs do not seem really worried about this risk because while liquidity can evolve very fast, in general capital losses require longer periods. Nevertheless, non-regulated institutions that are not asked by Central Banks for strict accounting measures, might be unprepared to deal with the capital erosion. To mitigate the solvency risk, and besides the improvement in the recovery rate performance, FSPs need to properly manage credit risk and keep liquidity under control to improve cash-flows.

In this context, FSPs are also exposed to **social performance risks** such as (i) mission drift, and (ii) hampering the clients.

Mission drift risk is more concrete than what emerged from the interviews. In a period of fund shortage, FSPs may opt to temporarily finance only the upper-side of their clients' segment, with a consequent exclusion of the most vulnerable and riskier. The adherence to their own social mission may mitigate this risk to ensure keep targeting the same segments as before.

Investors

The investors interviewed confirmed that one of their greatest risks is related to **asymmetry of information**, not only between the FSPs and investors, but also among investors that finance the same FSP. To mitigate it, they firstly worked to improve the communication with FSPs, and on the reporting system by making monitoring more regular (in general from quarterly to monthly reporting) with ad-hoc questions on the crises. This improves the confidence on FSPs and likelihood of continuing disbursing. Secondly, investors collaborated to ensure having the same set of information.

Similarly to FSPs, investors also faced **liquidity risk**, that somehow was not registered so severe, and slightly hampered their capacity to disburse to their FSPs.

In terms of social performance, investors may face exactly the same kind of risks of FSPs. It important to underline that also in their case, there is the potential **risk of mission drift** to move towards less risky FSPs. Interviewees declared that they are not changing their risk appetite and that they remain committed to their existing partners, although, also in their case, they may increase the risk of financial exclusion, given their difficulties in reaching new institutions.

Opportunities

This COVID-19 crisis is proving to be a breaking point with the past, where it is necessary to undertake a change of path.

Among the stakeholders interviewed, the **crisis as catalyst for digital finance and related behavioural changes is the** opportunity that emerged with most emphasis that has involved the entire value chain. During the pandemic the demand for digital financial services has definitely taken a major step forward, encouraging the supply side to accommodate this need. Investors and partners should support FSPs through the transition to digitalization. Also, the regulators must step in.

The crisis has, therefore, accelerated innovation already in place. The opportunity is on one hand, for households to transact digitally (for daily payments or money transfer) and small enterprises to use digital finance instruments for their business (payments to suppliers and from clients), and on the other hand, for FSPs to be more efficient and responsive to clients.

Clients' financial behaviours are already changing. While in the past 20% of Banco Fie customers used ATM services and mobile banking apps, as of mid-2020 this figure reached 35%. In some cases, this change has been driven by governments that launched G2P digital social transfers which have increased people's familiarity with digital transactions. In other cases, it was a change driven by the FSPs. OXUS Tajikistan accompanied this change with training, educating and encouraging clients to make payments at the ATMs, with positive results.

Digitalization can be exploited **to deliver financial services** (for loan disbursements and repayments, money transfers, bill payments, etc.) but also as a **means to communicate with clients** and provide them with financial education training.

FSPs may **define new procedures for loan disbursement and collection**, such as mixing remote and field visits, which will make the process more efficient and cost-effective, while trying to find the right balance between human relationship and adequate level of digitalization to the clientele served. FSPs may launch a paperless loan application, where everything is collected in a tablet, including the digital signature if permitted by regulation. FSPs may use digital channels to **virtually meet with clients** to make partial loan applications, convey important messages, clarify questions, send reminders, and share information on loan and savings balances. FSPs can take the opportunity to formalize some of the existing informal mechanisms into an acceptable form of new group lending methodology (R. Christen, 2020).

As mentioned, digitalization may be easier for those FSPs that had already took some initial steps, rather more difficult for those starting from scratch. Each FSP need to follow its own path and possibilities. For instance, MDB in Benin declared that it has not yet the necessary means to digitize the entire process, and they started establishing Mobile Money numbers at each branch.

From the **regulatory perspective**, this crisis should be an opportunity for the Central Banks to open up towards DFS, as the National Banking and Securities Commission in Mexico (CNBV)

has been doing, and start to incorporate DFS providers into the legal and regulatory framework. Supervising DFS is a complex matter that requires knowledge sharing and training to be further enhanced. On their side, investors can support the development of DFS by contributing to the cost.

However, the expansion of digital financial services face constraints (described already in the "*Key measures taken and challenges*" section above) that first derive from where the country stands in terms of infrastructure, connectivity, digital culture, but then also on knowledge and competencies. To fully exploit this new opportunity, the financial sector needs to identify the main gaps and constraints to address them and therefore promote innovation.

In some countries the COVID-19 outbreak has exposed weaknesses that will need to be addressed. This crisis should be an engine to **better protect the FSPs from potential future crises**, with proper risk management systems, business continuity plans and client protection measures to ensure not harming clients.

During a crisis, FSPs, especially those with poor governance or management systems, may collapse, while others will see opportunity to grow and innovate. As a **Darwinian "*survival of the fittest*"**, only those institutions capable to adapt to the changing needs of their clients may succeed. This is not necessarily a negative effect for the market because it actually helps remove the weakest participants and helps to re-organize and consolidate those institutions who will survive. Where needed, FSPs have to **adapt their products and services** to the new clients' needs or improve internal systems.

The crisis also demonstrated the importance of having credit covered by **health or life insurance services**. For instance, Afirme that was already offering insurance products before the crisis, realized that the product has now a greater acceptance and satisfaction from its clientele.

Finally, another opportunity is to continue leveraging the initiatives that were created among different actors, such as the microfinance networks (i.e., the advocacy activities) or the collaboration between investors, to continue working in a cooperative way. Further, they should not be limited to initiatives within the same category, but rather they should group the entire value chain actors to allow for having different opinions from different and comprehensive perspectives.

Conclusion and lessons learned

The outbreak of the COVID-19 pandemic has put at risk the progress towards poverty reduction and access to finance worldwide. The financial inclusion value chain has been exposed to unprecedented challenges and risks, whose effects are likely to be long lasting and need to be analysed and addressed with a comprehensive perspective.

Challenges and measures taken

- Impact on clients mostly depended on the economic sector where they work and the type of employment, as well as their resilience capacity to deal with emergency and shocks. In general, borrowers registered **difficulties to honour their commitments** towards FSPs due to their income reduction.

- In support of low-income households, workers and enterprises, **policymakers and regulators launched initiatives** such as social transfers, wage and income financial aids, and tax postponement. Central Banks required or recommended FSPs to adopt debt relief measures to alleviate credit pressure on borrowers.

- Accordingly, FSPs applied moratoria, rescheduling and refinancing policies, waive of interest and penalty fees, among others, for all clients or in some cases, FSPs took ad-hoc measures tailored to the clients' segments or products. As a result, they registered a **deterioration of the portfolio quality** (due to the difficulties in loan collection), defined by the FSPs interviewed as one of the most critical problems encountered. In some cases, the par30 reached unprecedented peaks.

- To overcome operational and logistic issues, FSPs adopted **safety measures** to protect the health of staff and clients and implemented **business continuity plans**.

- **Liquidity shortage** was an initial concern to address immediate operational costs (to pay rent, salaries, etc.), debt investment to disburse new loans to clients and equity capital to absorb the losses, proved to be less severe than expected. However, FSPs **limited the disbursement to new and existing clients** (credit rationing), despite some FSPs observing an increase of the financial demand.

- During this crisis, the **interventions from investors and donors** have been relevant to alleviate FSPs problems and key challenges. They have offered debt relief instruments to FSPs, and to a lesser extent also capital injection. Investors asked for more frequent monitoring on the FSPs performance.

- Investors launched initiatives **to coordinate their global actions** with the aim to deliver effective and coordinated support to FSPs. It is worthwhile to mention the Memorandum of Understanding (MoU) on "*Coordination among MIVs in response to Covid 19*" signed by 9 MIVs; the common Pledge on "*Key principles to protect microfinance institutions and their clients in the COVID-19 crisis*" signed by 30 organizations; the *R3 Coalition (Response, Recovery, and Resilience Investment Coalition)* launched by the GIIN; and the

"*COVID-19 Investor Statement - Impact investors in emerging markets*" signed by 14 investors.

- On their part, also **investors had to look at their liquidity and commitments** towards their lenders and shareholders (that in some cases have limited the new disbursements).

- **Donors and international development organizations** (including ADB, IMF, IFC, WB) **launched funding initiatives** related to financial inclusion of unprecedented scale.

- **Policymakers and Central Banks had to decide where best to intervene** considering their human and financial resources constraints, as well as their political priorities.

- In support of the FSPs, **Central Banks offered a number of financial instruments to support the financial sector**: debt relief measures, changes in pricing and conditions, changes in prudential regulation, liquidity injections, and other measures. In some countries, advocacy from the microfinance sector pushed the Central Banks to get favourable interventions. In other cases, they preferred to act on the banking sector only.

- The **COVID-19 pandemic accelerated the adoption of DFS** on the part of the FSPs, intended as delivery channel and means of communication with clients. Governments that promoted G2P social transfers through digital platforms contributed to the increase in low-income people's familiarity with technologies. Nevertheless, **DFS expansion faces some barriers** in terms of internet and mobile phone penetration, infrastructure, and digital financial awareness.

Risks

Table 3. Risks

Risks	*Stakeholders involved*	*Description and mitigation measures*
Credit crunch	Clients	Liquidity shortage, difficulties in assessing remotely clients that translated into the stop or limitation of new loan disbursements or focus on clients with very good credit history, with a consequent exclusion of the most in need and vulnerable segments.
Savings-panic	Clients	Uncertainty and need of financial resources may lead to a savings withdrawal panic with potential liquidity problems at deposit taking level
Risk of changing repayment culture and moral hazard	Clients	Borrowers may have taken advantage of the debt relief measures even if not needed
CP-related risks	Clients	Aggressive loan collection practices; offer of non-tailored products; poor communication of forbearance

		measures; breaches of privacy; malfunctioning of complaint mechanisms. DFS: Irresponsible lending and over-indebtedness, low levels of transparency, privacy breaches, cyber-crime and frauds. *FSPs to adopt a CP lens.*
Operational risk	FSPs	Branch closure or contingency policies have stopped or limited the capacity of the FSPs to carry out daily operations. *FSPs to adopt safety measures, business continuity plans and flexible processes*
Credit risk	FSPs	Clients' delay in loan repayment and use of debt relief measures leading to the deterioration of portfolio quality, increase loan loss provisioning and loss of income with an impact on the profitability and sustainability of the institution. *FSPs to organize clients' follow up to better understand their situation and closely monitor its portfolio to take informed decisions.*
Liquidity risk	FSPs and investors	Impaired cash-flow balance. *FSPs can rationalize costs (cut expenses), or ask for restructuring their debts or additional funding. Monitoring and stress tests can better guide FSPs.*
Foreign exchange risk	FSPs and investors	In periods where local currencies depreciate, funds in hard currency may have a negative effect on the FSPs portfolio. *FSPs and investors to protect investments with hedging arrangements (in general this risk is taken by the investors)*
Solvency risk	FSPs and investors	In case of persistent portfolio deterioration, FSPs may encounter difficulties in repaying their lenders. And consequently, also investors may have the same problems with their own lenders. *FSPs to manage credit and liquidity risks*
Mission drift	FSPs and investors	Shift from the intended target towards upper segments changing their risk appetite.

		FSPs and investors to adhere to their own social mission to ensure keep targeting the same segments as before.
Asymmetry information	Investors	Investors may not have reliable and updated information on the FSPs performance. *FSPs to communicate truthful, regular, and updated information*

Opportunities

DFS demonstrated to have a great potential of expansion. FSPs can invest in new technologies depending on the country readiness in terms of infrastructure, digital culture, mobile phone and internet ownership, but also in relation with their own knowledge and competencies. Regulators and investors can support them with favorable regulations and financial support.

FSPs can further exploit digitalization to:

- deliver financial services, namely for loan disbursement and loan collection, or for other services (money transfer, bill payments, etc.)
- improve the efficiency and cost-effectiveness of the loan process through paperless procedures, mix of remote and field visits, digital signatures, etc.
- communicate with clients to convey important messages, reminders, balances, etc.
- deliver training to staff and/or clients.

FSPs can take advantage of the lessons learned from this crisis to improve their resilience to cope with potential other emergencies. They can improve their risk management systems, business continuity plans, and client protection practices.

Cross cutting issues

Social Performance Management

To address the challenges and risks that FSPs are encountering, adopting SP and CP lens can be useful to mitigate some of them. Accordingly, key practitioners (such as SPTF or CFI-Acción) shared studies, best practices and lessons learned, as well as tools in line with the SPM standards and CP principles.

It would be worthwhile to study whether having in place a sound SPM system and CP practices could have led to a better response to the crisis.

Vulnerable segments and gender lens

The COVID-19 pandemic has led to an increase of existing inequalities for the most vulnerable segments, including women, youth, migrants, refugees or people with disabilities.

Women and youth, with more fragile job employment, lower social protection, and higher rate of financial exclusion, are less resilient in recovering from a shock. The promotion of DFS may

widen the gender gap of financial inclusion as women register lower rates of mobile ownership and digital literacy.

When dealing with this pandemic, all actors in the value chain should give more attention towards those segments **where exclusion barriers are still relevant and amplified by the consequences of the crisis.**

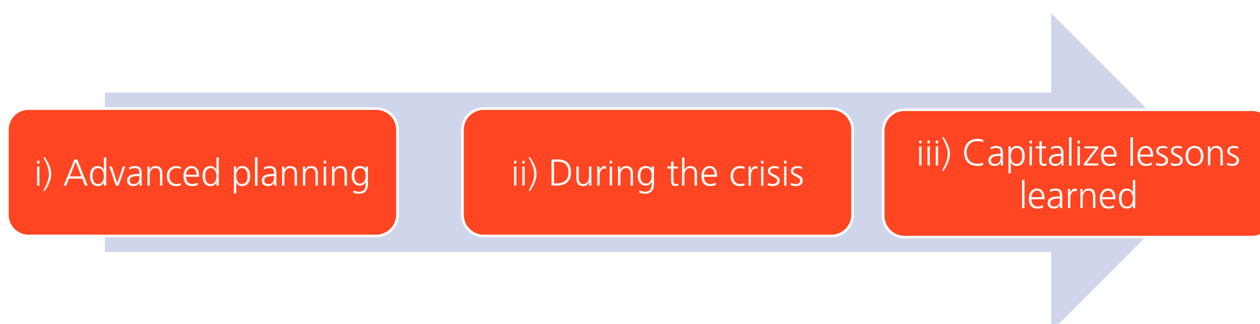
Lessons learned

This research tried to bring some light on the key challenges and risks faced by the financial inclusion value chain, and the opportunities that this crisis has brought.

The analysis from a sector perspective seeks to underline the **importance of adopting a comprehensive standpoint** as actions taken by a single stakeholder may affect actors along the entire value chain. In this regard, to better prepare for potential future shocks, independently from their nature and causes, the sector needs to enhance the collaboration and communication among actors to balance all benefits and losses along the value chain. Regulators must balance the relief of measures between the clients and FSPs, acting in concert with the FSPs and the national microfinance networks; investors have to coordinate among them; FSPs have to protect the clients.

Further, considering that it is too early to study which are the key factors that may have accelerated or hampered the recovery, it is still worthwhile mentioning which steps an FSP can take to address future crises. Some of these actions can be enforced or recommended by regulators, local microfinance associations, international networks, or investors in the framework of their agreements. These actors can also provide technical or financial support to implement them. In this regard, three phases are foreseen.

Figure 2. Steps to address crises



A first one, "**advanced planning**", requires FSPs to be equipped with a **sound risk management system** that includes at least mapping risks and regular monitoring. FSPs indeed need to put in place a process to identify, assess and prioritize risks in terms of likelihood of occurrence and magnitude of the damage, identify potential mitigation measures (if any), and design a system

for monitoring and reporting risks. FSPs should also have a business continuity plan to be better equipped in case of emergency.

Despite that it was impossible to predict this pandemic, some FSPs may have used risk mitigation tools related to similar events, such as natural disasters, that helped them better respond to the COVID-19 crisis, particularly dealing with clients.

Further, FSPs should **have SPM and CP policies** in place to ensure alignment with their social mission and avoid harming the clients. This would allow first to clarify what is the desired target to achieve and avoid potential mission drift, offering quality products and services, and being oriented towards the creation of social impact for the final beneficiaries. CP practices would rather support the FSPs in protecting the customer. For instance, with proper systems in place to prevent over-indebtedness, in periods of crisis clients may not suffer, or they may struggle less, in case of income reduction. The promotion of financial education initiatives may also increase the chance for clients to better cope with shocks and make informed decisions in their households and businesses.

The second phase, "**during the crisis**" is related to how effectively FSPs manage a period of crisis. The following steps highlight some of the most important actions to be taken (they are not exhaustive):

- *Monitoring and client segmentation*
  FSPs need to closely and regularly monitor the performance of their portfolio (credit risk and financial indicators) by segments, including sex- and age-disaggregated data, region, context (rural vs urban), seasonality, etc., to take more informed decisions
- *Problem identification*
  FSPs need to clearly understand the evolution of the context and the life cycle events of clients. They can use customer centric approaches to understand clients' needs (above all for the most vulnerable segments as women or youth), life cycles and financial demand, how clients have been impacted and how they are likely to be impacted by crisis to potentially anticipate and mitigate future problems and offer tailored solutions
- *Adopt a flexible approach*
  Define (if not available) and implement financial emergency instruments and revise/adapt policy and procedures (such as revising/defining debt relief measures, setting new processes for debt collection and disbursement, new alert on portfolio quality or liquidity, etc.)
- *Avoid asymmetry of information*
  Promptly communicate with investors and shareholders to provide them with a good understanding of the fundamentals of the institution
- *Monitor progress*
  Follow up activities, make sure the strategy is working and be flexible and responsive to adjust systems and procedures in case of unexpected results associated with identified problems
- *Promote cooperation between different stakeholders along the MF value chain*
  Adopt an industry approach, avoiding duplicating efforts but creating synergies and sharing experiences.

The third phase "**capitalize lessons learned**" aims to accompany the FSPs in the transition from the crisis to the recovery phase, taking advantage of the lessons of the past and the raised opportunities.

In this regard, FSPs should adopt key best practices implemented during the crisis with a longer-term approach to ensure they are embedded in their strategy. The key factors that may have accelerated or hampered the recovery need to be clearly identified along with the leading resilience best practices to put in place. In this context, FSPs need to maintain the momentum, taking advantage of the lessons of the past and the emerging opportunities.

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About the European Microfinance Platform (e-MFP)

The European Microfinance Platform (e-MFP) is the leading network of organisations and individuals active in the financial inclusion sector in developing countries. It numbers over 130 members from all geographic regions and specialisations of the microfinance community, including consultants & support service providers, investors, FSPs, multilateral & national development agencies, NGOs and researchers. Up to two billion people remain financially excluded. To address this, the Platform seeks to promote co-operation, dialogue and innovation among these diverse stakeholders working in developing countries. e-MFP fosters activities which increase global access to affordable, quality sustainable and inclusive financial services for the un(der)banked by driving knowledge-sharing, partnership development and innovation. The Platform achieves this through its numerous year-round expert Action Groups, the annual European Microfinance Week which attracts over 400 top stakeholders representing dozens of countries from the sector, the prestigious annual European Microfinance Award and its many and regular publications.

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