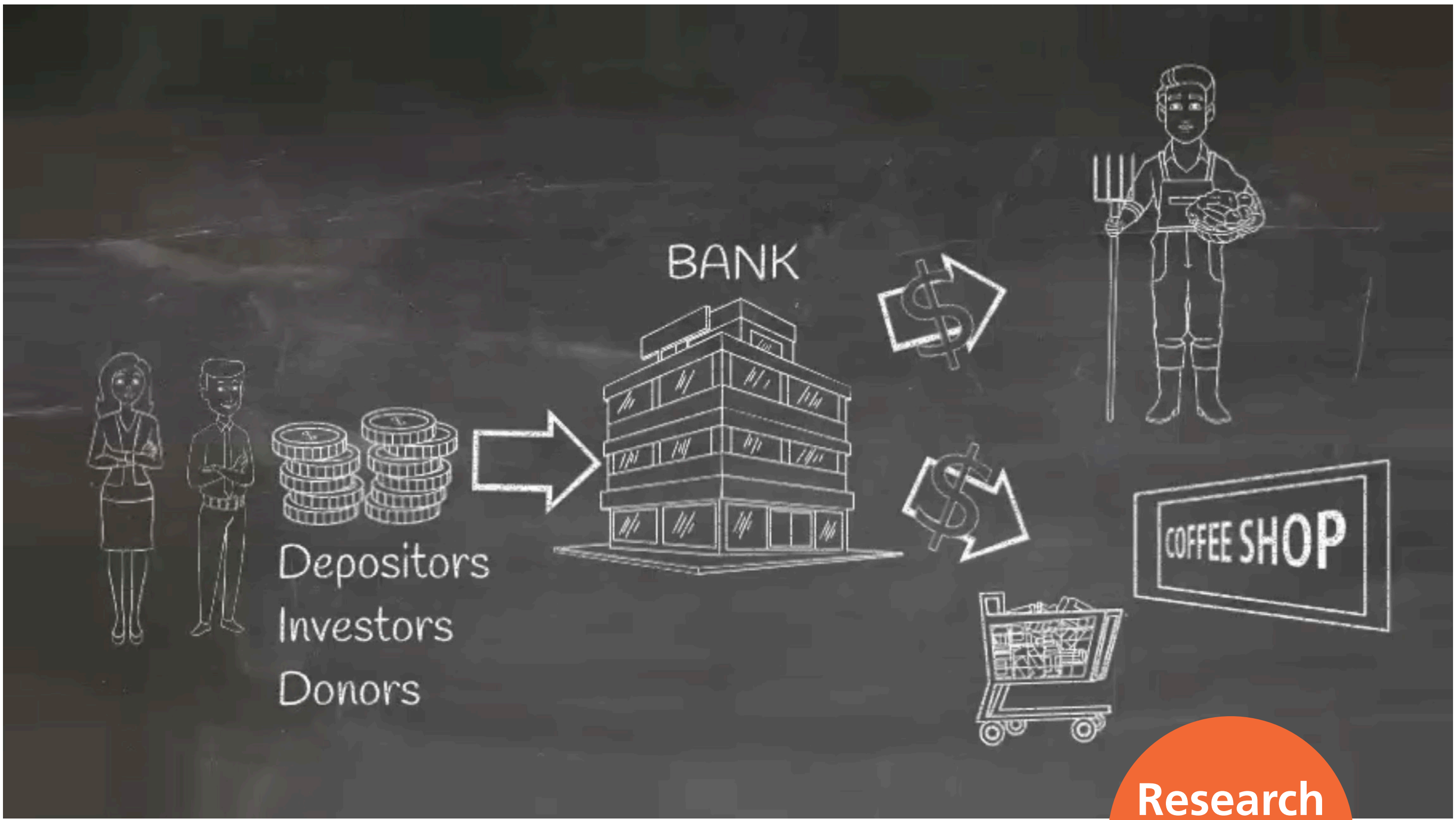

Research Digest #1

COVID-19 AND THE FINANCIAL INCLUSION VALUE CHAIN

By Davide Castellani, Max Niño-Zarazua, Valeria E. Pujia and Valentina Garofalo
in collaboration with the European Microfinance Platform (e-MFP) 'From Research to Practice and Back Again' Action Group

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EUROPEAN MICROFINANCE PLATFORM
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AG on Research

From research to practice and back again

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.

ACKNOWLEDGMENTS

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COVID-19 AND
THE FINANCIAL INCLUSION VALUE CHAIN

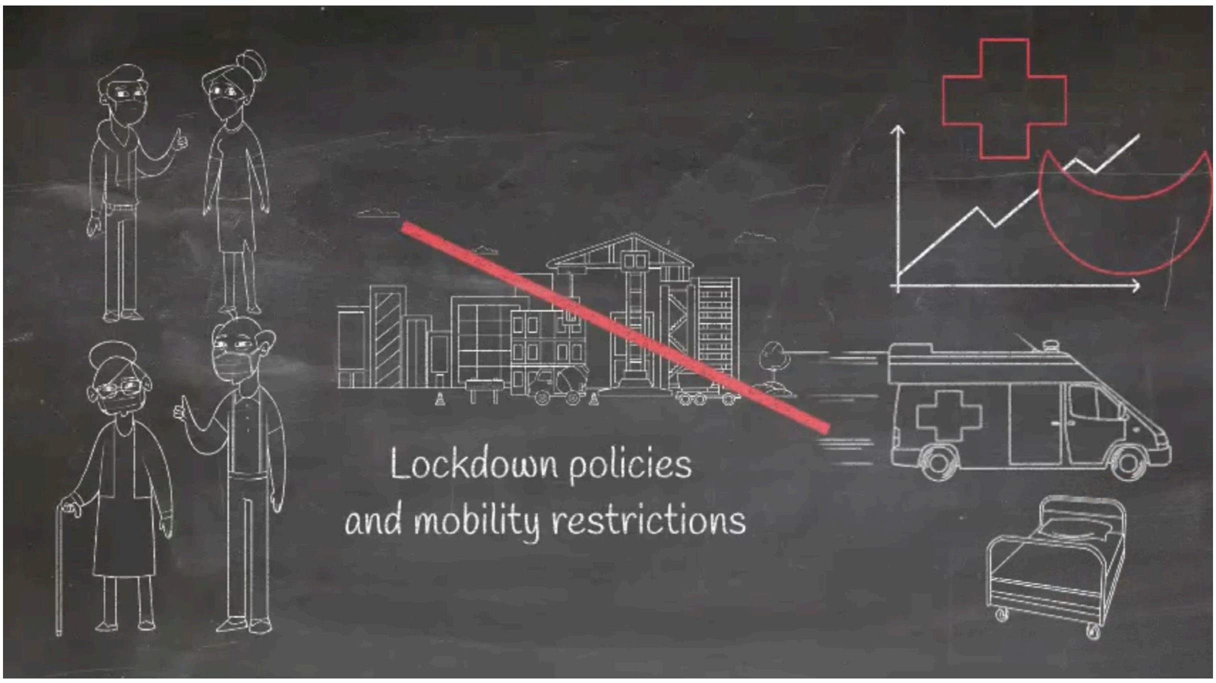
The outbreak of the COVID-19 pandemic severely affected many countries worldwide. As a result, the financial inclusion value chain has been exposed to unprecedented challenges and risks, whose effects are likely to be long-lasting. This needs to be analyzed and addressed using a comprehensive perspective.

The e-MFP 'From Research to Practice and Back Again' Action Group conducted a research project seeking to analyze the **challenges and risks** faced by the financial inclusion value chain actors during the COVID-19 pandemic. It explores the point of view of clients, Financial Service Provider (FSPs), investors, 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 issue.

The study used a **qualitative approach** based on a literature review and information collected from 25 stakeholders worldwide (10 chief executives from 9 FSPs, 9 investors, 3 regulators, and 3 other financial inclusion organizations), interviewed between July and August 2020. This publication presents the key findings of the research. For more detailed information, please refer to the full report (forthcoming), which **is rather rich in examples and reference**, with a section entirely dedicated to the literature review and another to the stakeholders' interviews, resulting in a more exhaustive and detailed enquiry.

CHALLENGES AND MEASURES TAKEN IN RESPONSE

As COVID-19 started spreading worldwide, from February 2020, **many countries applied precautionary measures** (lockdowns, curfews, quarantine and social distancing) to a more or less restrictive degree, that caused **repercussions on the broad economy**.



The impact on FSPs' clients mostly depended on the economic sector where they work and the **type of employment**. The lack of, or the limited social protection and safety nets widened the negative effects and, in some cases, the pandemic has exacerbated pre-existing vulnerabilities. In general, low-income **people rely on different coping strategies to deal with emergencies and shocks**. There are *ex-ante* measures that include savings, insurance and migration; or *ex-post* measures, such as external aids (including remittances), controlling the family budget, selling assets or borrowing from formal and informal lenders. Income reduction puts borrowers in difficulties to honor their commitments towards FSPs, and it may lead to an increase of financial demand.

Many policymakers and regulators launched welfare initiatives for households, workers and enterprises, often through digital channels. Contextually, Central Banks adopted measures to alleviate credit pressure on borrowers or to support the FSPs, including:

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

In some cases, these measures were applied by FSPs indistinctly to all clients. In others, FSPs adopted *ad-hoc* measures depending on the loan product, the economic sector, or case by case, resulting in a **sharp increase in the deterioration of the portfolio quality**, which was defined by the surveyed FSPs as one of the most critical problems encountered. In particular, FSPs experienced major **challenges in loan collection and new loan disbursement**, due to the reasons presented below.

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

Even if at the very beginning of the pandemic there was a concern that **FSPs' liquidity** could be a serious problem, the continuous support of investors has mitigated it. In general, **lack of funding** has not been an immediate concern for FSPs, but a potential problem in the medium-term.

For FSPs who rely on funds from different investors, coordination between them appears important. In fact, investors promptly reacted to the pandemic: firstly, they **offered debt relief** instruments, and in some cases, they also **injected new capital** (in form of debt or equity) and **other kinds of support** (as financial funds for technical assistance). In exchange, investors asked for more frequent reporting (in general, on a monthly basis) to be better informed on the situation and its evolution. Secondly, they **launched initiatives at sector level to coordinate activities among them**[1].

Digitalization

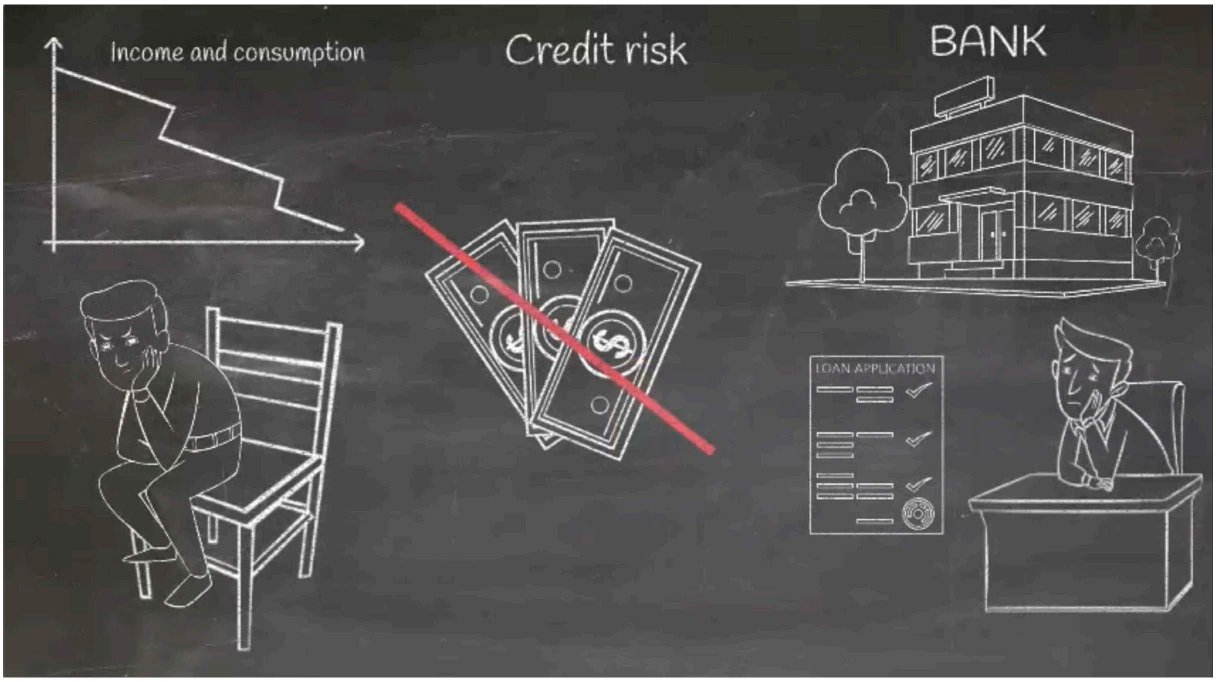
During the pandemic, Government-to-Person (G2P) transfers and social distancing have pushed households and enterprises to **increase the use of Digital Financial Services (DFS).** However, DFS encounter some **barriers** such as the lack of proper access to digital technology (i.e., infrastructure, access to technology, connectivity, adequate regulation), lack of knowledge, competency, investment and readiness on the FSPs' side, and digital readiness, financial awareness, identification documents on the part of customers, especially for some vulnerable segments, such as women and rural people. Further, gender digital divide (due to women limited digital literacy, access to mobile phone and internet connection) was expected to increase.

RISKS

Clients

The pandemic exposed clients and non-clients to the **risk of credit crunch**, more harming for low-income people, those likely to be the most in need and vulnerable. The risk of potential liquidity shortage faced by the FSPs and the difficulties in assessing clients remotely led in many cases to the halt in loan disbursement or focusing on clients with good credit repayment history.

[1] To mention a few: Memorandum of Understanding signed by 9 MIVs on "Coordination among Microfinance Investment Vehicle - MIVs in response to Covid 19"; Common Pledge signed by 30 organizations on "Key principles to protect microfinance institutions and their clients in the COVID-19 crisis"; R3 Coalition (Response, Recovery, and Resilience Investment Coalition), collaboration across impact investing networks; and Key investing principles "COVID-19 Investor Statement - Impact investors in emerging markets" signed by 14 investors.



Clients could also be subjected to some **Client Protection (CP) risks**: aggressive loan collection practices (i.e., inappropriate tactics or irresponsible collateral seizure); fraud; non-tailored product offers; poor communication on forbearance measures, related costs and consequences; privacy breach and cyber- crime; and inadequate complaint mechanisms.

Other risks included:

- **Savings-panic**: uncertainty and need of financial resources could lead to a savings withdrawal panic with the potential risk for the client to see their savings blocked.
- **Risk of changing repayment culture:** borrowers may have taken advantage of the debt relief measures offered by the FSPs even when not particularly in need or they may change their repayment culture in the future, potentially damaging their credibility or credit history.

During the pandemic, FSPs have been exposed to a number of significant risks. Those most important to underline are:

- **Operational risk.** Branch closure or contingency policies have stopped or limited the capacity of the FSPs to carry out daily operations in a regular way.
- **Credit risk.** Clients' delay in loan repayment and use of debt relief measures could lead to the deterioration of the portfolio quality, higher probability of clients' default, with a consequent increase in loan loss provisioning, decrease in profit and lower growth.
- **Liquidity risk.** Limited loan recovery could influence the cash-flow balance.
- **Solvency risk.** In the medium-long term, loan default, combined with liquidity shortage, could have an impact on the profitability and sustainability of the institution, making FSPs riskier for their own lenders.
- **Foreign exchange risk.** In periods where local currencies depreciate, funds in hard currency may have a negative effect on the balance sheet of FSPs.
- **Mission drift and CP risk**. Lack of funding could bring FSPs to shift from the intended target towards less risky segments. FSPs could risk harming their clients (see CP risk above).

Investors

The greatest risk to which investors have been exposed concerns increasing **asymmetric information** problems with the FSPs, but also, with respect to other investors funding the same institution.

"

Information as usual would be wrong because obviously it's no longer a usual period, we are in a different context. I think that we have to acknowledge the fact that more frequent reporting is necessary, but the reporting should be more specific. And I think specifically looking at liquidity and stress-tests, and this is something that've been discussed with a lot of our partners, lenders and investors. And especially if you look at all the signatories of the Pledge, or even to the large microfinance vehicles, often we have agreed to certain template for reporting. So, when we're involving in financing a specific MFI, we discuss at that level and agree a specific reporting format "

Investor

Investors could also have faced **liquidity risk** if FSPs did not honor their commitments, and that, in turn, could transform into an increased risk of **insolvency** for their own investors.

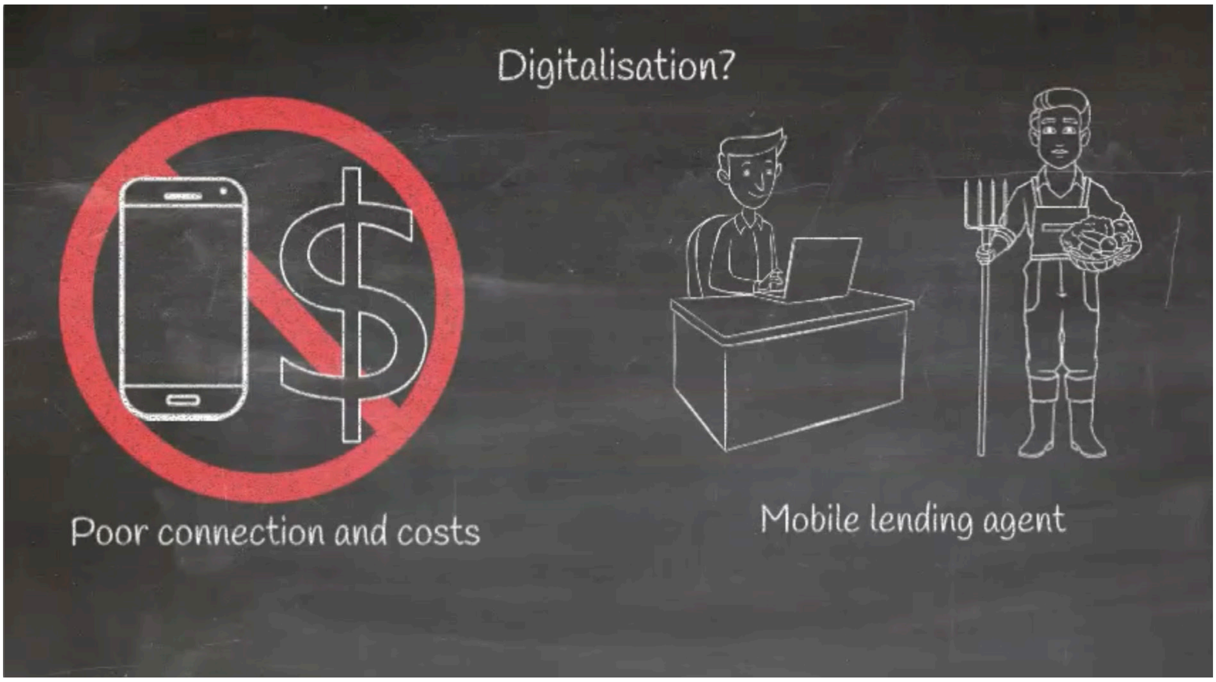
Similar to FSPs, investors could, and can, also be exposed to a risk of **mission drift** if their risk appetite changes and they invest in institutions that are not their usual targets but are less risky.

OPPORTUNITIES

In the middle of a crisis, an institution can weather it by taking advantage of the arising opportunities and learning from the difficulties encountered.

The pandemic served as a **catalyst for digital finance** fostered by many factors: the massive use of G2P digital social transfers, the increased use of DFS from FSPs, and the digital or contactless payments used to reduce social/physical movements triggered behavioral changes among people, who gained familiarity with digital transactions.

FSPs can take this momentum and further deploy DFS in line with their country readiness in terms of infrastructure, digital culture, mobile phone and internet ownership, but also in relation with their own knowledge and competencies. The financial sector needs first to identify the main gaps and barriers to digitalization, so it can then invest in innovation. FSPs can further exploit digitalization to:

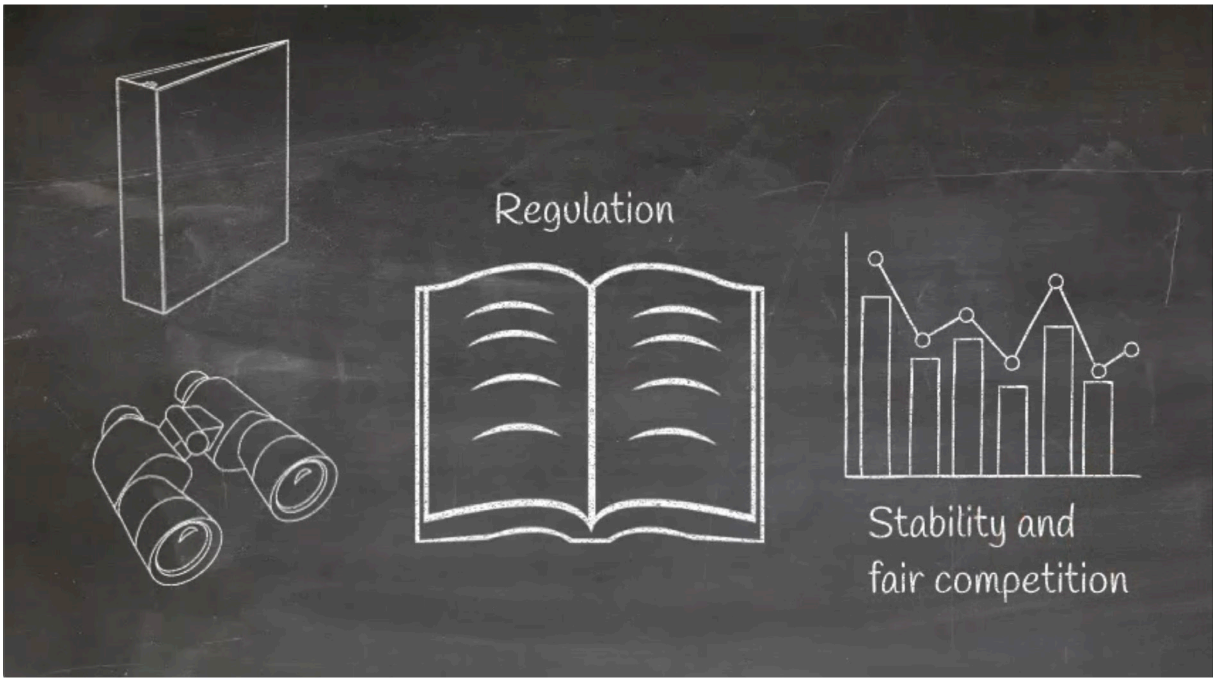


- deliver financial services, namely for loan disbursement and loan collection, or for other services (money transfer, bill payments, etc.)
- improve the efficiency and cost-effectiveness of the loan process through paperless procedures, a mix of remote and field visits, digital signatures and digital onboarding[2], etc.
- communicate with clients (e.g., conveying important messages, reminders, balances, etc.) to manage relationships and monitor clients' activities.
- deliver training and financial education programs to staff and/or clients.

From the regulatory perspective, regulators can take the opportunity to strengthen the regulation/supervision around DFS; and investors, in a better regulated environment may be encouraged to invest in the digital innovation.

> *"The COVID-19 crisis has put a spotlight on the need for TC's work to help build stable, resilient, and inclusive financial systems and to better prepare financial supervisors and regulators to manage a crisis. Financial supervisors and regulators have been playing a critical role during the pandemic to ensure financial markets continue to function effectively."*
>
> **Toronto Centre**

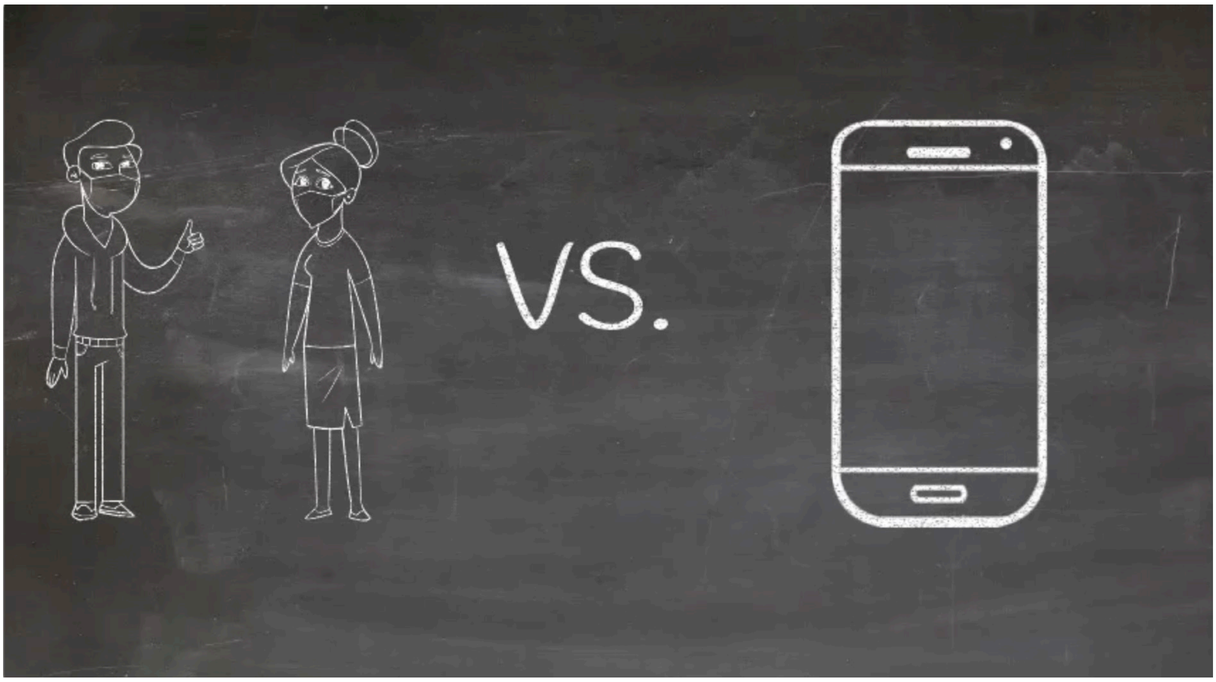
[2] Digital onboarding enables significant cost reduction for financial organisations as processes can be automated. Customers are able to self-serve by simply using their phone/tablet or computer instead of calling or going to a branch. Some advantages of digital onboarding include clients' identification, due diligence processes, Know Your Client (KYC), data validation and account activation and sign-off.



Another opportunity for the sector is to address the weaknesses which emerged during the crisis to be better prepared to face future emergency situations in terms of sound risk management system, business continuity planning, and client protection practices. Where needed, FSPs must improve their internal systems **or adapt their products and services** to the clients' new needs. In this regard, the pandemic showed the importance of offering credit bundled with **health or life insurance** (even though in case of systemic risks, there is no guarantee that they can be activated).

> *When COVID-19 broke out initially, we used WhatsApp groups for all our group customers... if our loan officer had 20 or 30 groups, we expected that LO to form the same number of WA groups for all those members to be able to chat, discuss matters affecting the group, matters affecting individual customers, look at those customers who require a loans, or require to be supported to make repayments and that really played a major role in supporting our operations. But then we also introduced something different because our co-guarantee mechanism hasn't been really digital, it has been physical and paper list. So, we did introduce a mobile-based co-guarantee solution...*

FSP



Having a broad understanding of the problem and acting in a cooperative way (such as the initiatives taken by the investors) proved to be important. However, it needs to be brought at sector level involving all stakeholders to adopt different and comprehensive perspectives.

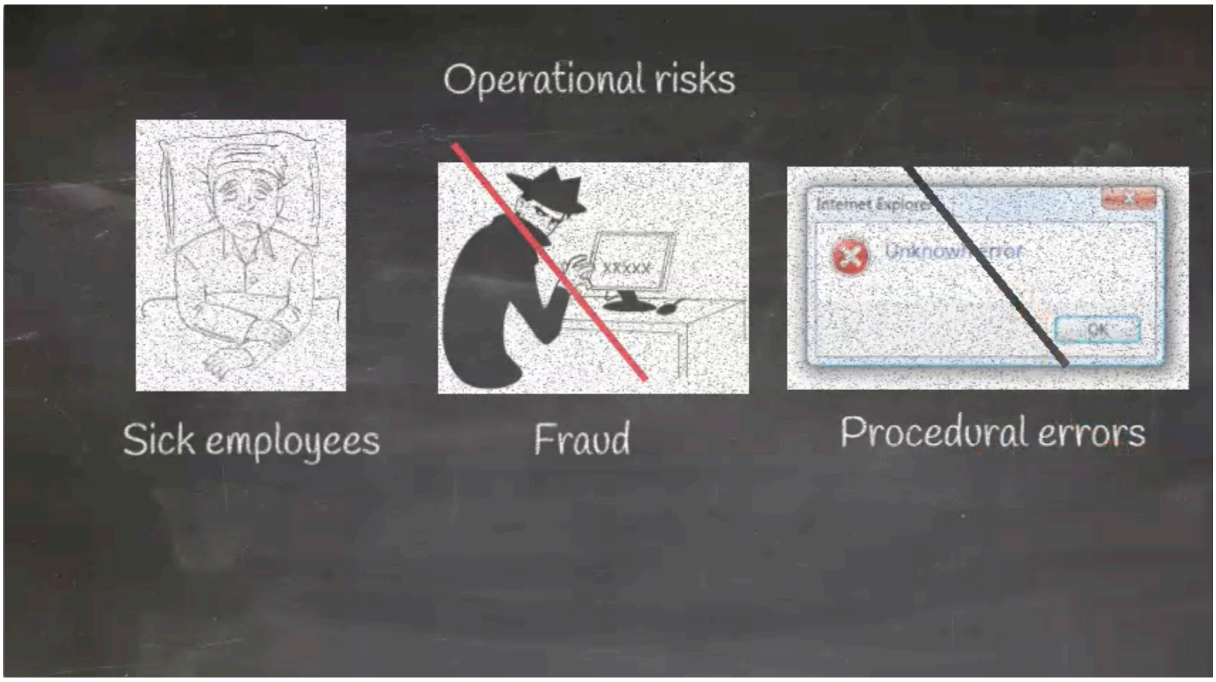
CROSS CUTTING ISSUES

Throughout the report, two macro cross-cutting areas were identified. One is related to Social Performance Management (SPM) and CP; the second is associated with vulnerable segments.

First, although the main challenges and risks encountered by FSPs are mostly related to financial performance (credit, liquidity risks, etc.), adopting **SPM and CP lens** can be useful to mitigate some of those risks. For instance, regular client monitoring and understanding of their situation can support the timely decision-taking process of the FSPs. Further, it would be useful to conduct empirical studies to investigate which are the best SPM and CP practices and FSPs' strategies that have prevented risks and negative effects of this crisis.

Second, the COVID-19 pandemic has put at higher risk **the most vulnerable segments**, **including women, youth, migrants, refugees or people with disabilities,** increasing existing inequalities and financial exclusion**.** Their fragile employment situations and lower social protection prevents them from promptly accessing available resources and recovering from shocks.

As the financial inclusion sector succeeded in connecting vulnerable and underserved segments to financial services, **more attention should now be put on those segments where exclusion barriers are still present and have been amplified by the crisis**. It is crucial to first identify the key needs of these segments, considering client behavioral insights; then, leverage a multi-stakeholder approach, engaging organizations that represent different categories, including regulators that can provide a level playing field; and offer tailored support.



LESSONS LEARNED

Based on the analysis presented so far, the research highlights some key steps that the sector, particularly FSPs, can take to better prepare for future emergencies, independently from their nature and causes. The following actions can be recommended or enforced by regulators, microfinance associations, international networks, or investors, who can also provide technical assistance and financial support to implement them.

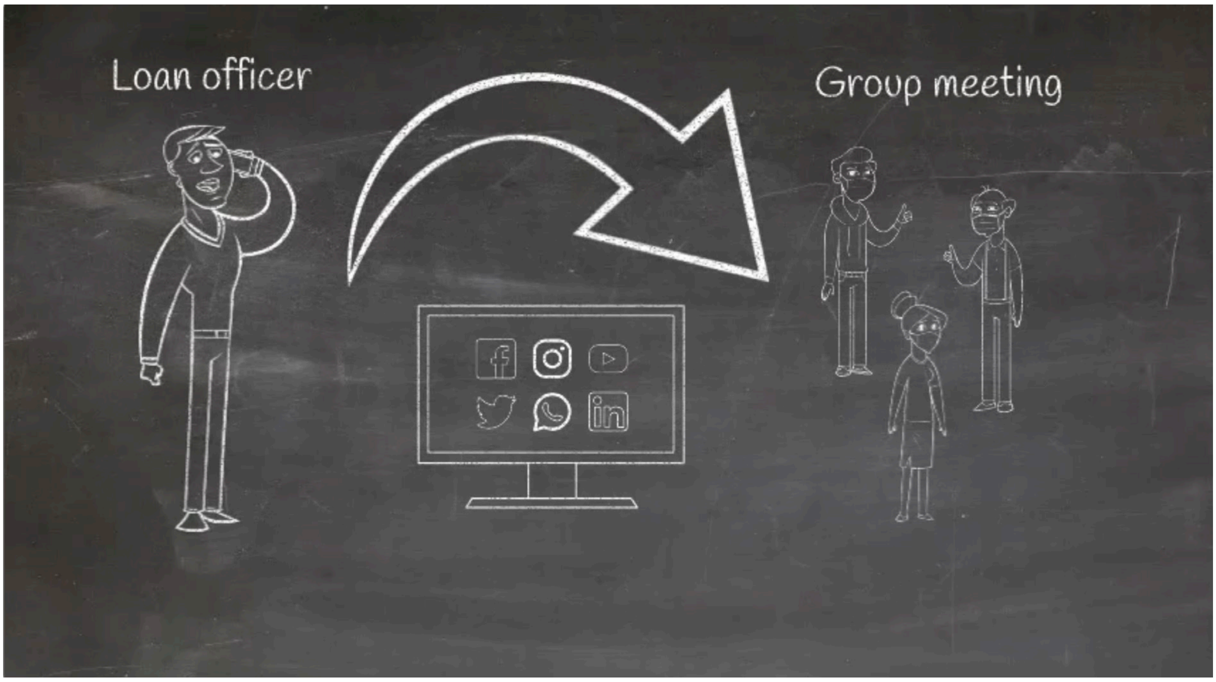
Advanced planning: FSPs should develop a sound risk management system, jointly with a business continuity plan, and SPM and CP policies to be better equipped in case of emergency and enhance their resilience.

A general risk management system should comprise the following steps:

- Identify risks
- Assess and prioritize risks (probability of occurrence and magnitude of losses)
- Identify potential mitigation measures (if any)
- Monitor and report risks

During the crisis: FSPs can take one or more of the following steps (that are not exhaustive):

- Monitor strictly the financial performance by segment to take more informed decisions
- Identify problems to better understand the evolution of the situation, with the support of client-centric studies
- Adopt a flexible approach (if needed revise internal policies and procedures)
- Avoid asymmetric information problems and the interruption of communication with all stakeholders, above all investors and shareholders



- Monitor progress of operational, financial, and social performance
- Promote cooperation between different stakeholders along the financial inclusion value chain

Capitalize on lessons learned: The financial inclusion sector as a whole must capitalize the efforts made by all stakeholders to act globally and jointly in order to balance benefits and losses along the value chain, embed different perspectives and interests and avoid that the weakest actor pays the highest cost of the crisis.

The key factors that may have accelerate or hamper 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.

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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