EXTRAORDINARY TIMES EXTRAORDINARY MEASURES

COVID 19 #BANGLADESH #MICROFINANCE #VULNERABILITY

London,24th May, 2020

The microfinance industry in Bangladesh represents, in its essence, a national 'safety-net' infrastructure. It reaches more than ½ of Bangladesh's 160 million people - mostly low-income people, women, and the vulnerable – with financial and non-financial services with little or no public subsidy. This MFI mediated safety-net infrastructure offers the most reliable means of keeping liquidity flowing among the millions of people and businesses most impacted by COVID 19 and who will largely be left to fend for themselves given the limited size and duration of the national stimulus package. Yet, credit supply pressures are exposing large sections of the microfinance sector to an existential threat, impacting on the liquidity of low-income families and their businesses. A decade of gains will be wiped out unless there is a massive injection of liquidity through the MFIs system, and everyone acts with extraordinary imagination and speed. Are MFIs, their investors, the Government, and donors willing and able to come together, act and act fast?

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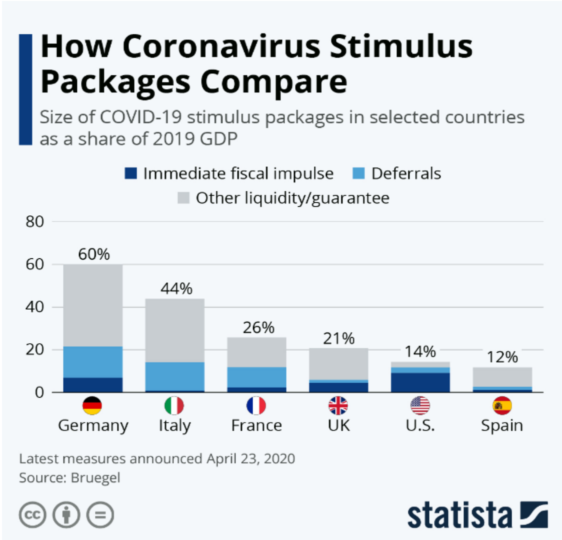
1. Context

The COVID-19 pandemic represents the biggest test for Bangladesh since 1971: The immediate concern is how Bangladesh's broken public health system will cope with unprecedented levels of infection, ill-being, and death. The pandemic also constitutes an unprecedented macro-economic shock, which has the potential to shunt the country back decades.

This year, the economy is expected to grow by 2 percent (IMF), its lowest level since 1980 – that is $20 billion less circulating in the economy. It may take more than 2-years for the economy spring back to its pre-COVID level. Nearly 1 million jobs will be lost in the formal sector alone (ADB) if the pandemic lasts for six months as production and supply-chains are disrupted, the costs of doing business goes up, and business confidence and private investment falls. Poverty will double to 40 percent (SANEM), back to the 2005 level.

Importantly, the pandemic will disrupt the livelihoods of over 85 percent of the workforce that work in the informal economy – *day labourers, maids, transport workers, part-time workers*. This informal army who power the nation's economy live on small, irregular and uncertain wages at the best of times, and even the smallest disruption can have a catastrophic impact for them and their families. Economic activities in April dropped by 71 percent in urban and 55 percent in rural areas, resulting in daily income plummeting by 76 percent (PPRC & BIGD).

The size of the policy and fiscal response lacks credibility. The scope of the Government's response is laudable, broadly involving a fiscal impulse, deferrals and other liquidity support. These cover support to expand existing safety net programmes for the most vulnerable, support for export-oriented industries,



SMEs, the agriculture sector, and health workers.

Yet, the US$ 11.5 billion stimulus package is small compared to both the scale of the pandemic and the fiscal space available to the government given a low debt to GDP ratio. To put it into perspective, the size of the stimulus package is roughly half of the projected $20 billion loss in GDP, or about 70 percent of the $16.4 billion annual remittances receipts, or the same as Amazon's annual profit for 2018.

The Government's response also fares badly in comparison to other countries. For example, Bangladesh Government's stimulus package is about 3.3 percent of 2019 GDP, compared to 10 percent in India, 60 percent in Germany and 21 percent in the UK (Statista); in Germany nearly 40 percent of GDP has been allocated for liquidity and loan guarantees alone.

The wide variance across these countries begs the question:

> *if much larger economies with sparse populations, reasonably well-functioning public health and welfare systems are allocating an unprecedented share of their GDP, is it reasonable to assume that Bangladesh can equally manage the consequences of COVID by spending a fraction of the others?*

State aid bridges only a limited period and immediate relief-thinking needs to very quickly, transition to thinking about medium-term recovery: besides the limited size of the Bangladesh Government's response, it is also fairly limited in duration. If the pandemic lingers beyond September and economic activity constrained, it could trigger a full-blown recession, causing widespread defaults, mass migration back into poverty for those who had moved out over the last decade, severe loss of life. Under this scenario, the relief and stimulus funds would fail to revitalise the economy and even larger amounts will be needed in future. Medium-term, recovery-centred thinking needs to be built into the current immediate response.

2. Stabilising the Financial System

Maintaining liquidity flow to businesses and families should be the central focus if Bangladesh is to avoid a prolonged crisis. Simply put, a company's liquidity comes from sales, while a family's liquidity comes from income. Liquidity can be boosted by drawing on reserves, cashing in time-deposits or selling surplus assets, as well as by borrowing from financial institutions or from family and friends. The pandemic directly disrupts the circulation of liquidity, because businesses and individuals have little or no income; asset sales are difficult either because of few buyers or the discount rate is too high; and it is difficult to secure liquidity from friends and family as they seek to maintain reserves for themselves.

A well-functioning financial system is essential for the country to recover quickly from the economic consequences of the pandemic and avoid full-blown recession. Though banks are not being hit by COVID as directly as other retail institutions, they are at the heart of the economy, provide funding to corporates and individuals. Their stability is crucial to keeping the economy running by continuing to intermediate between savers and investors, and accelerate recovery.

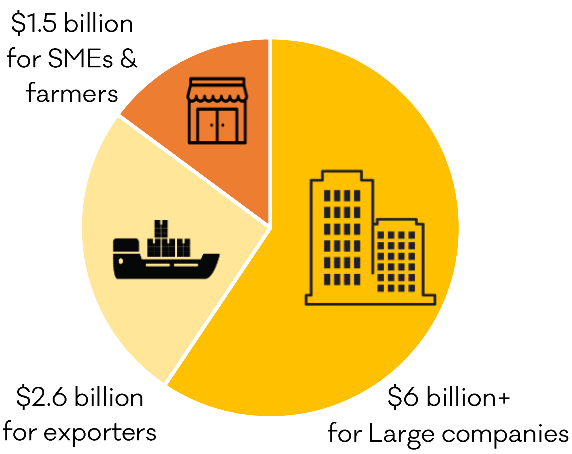
Pressures on the supply of credit to the real economy have placed the financial system under incredible stress. Despite the considerable size of the financial system with over $250 billion in assets, liquidity strains have grown as depositors withdraw funds, credit quality deteriorates, defaults increase, regulators impose price restrictions, and operational costs increase with social distancing. Current liquidity buffers should sustain most banks' funding so that they can withstand the temporary closure of conventional liability markets for up to a quarter or two at a stretch.

Government's prioritization of liquidity support is a good response but very limited in size. Over 80 percent of the stimulus package deals with liquidity in the economy. Specifically, Bangladesh Bank has injected about $10 billion liquidity in the financial system by cutting the cash-reserve-ratio, increasing the advances-to-deposit ratio, reducing the repo rate, and creating small low-cost refinancing funds targeting farmers, micro-entrepreneurs, and SMEs.

Impact of Government actions will be limited, accruing largely to formal corporates, leaving SMEs and the informal economy to fend for themselves. Liquidity measures are unlikely to trigger credit growth as most sectors will see credit losses, deposits squeezed as banks are priced out by the Government's savings certificate rates, higher interbank rates will increase cost of finance, and imposed narrow spreads and deferrals will compressed margins.

Conditionalities (e.g. delaying repayments for non-performing loans by six months) accompanying the liquidity stimulus package will likely lead to adverse selection of troubled corporate.

Who Benefits from Government's Stimulus

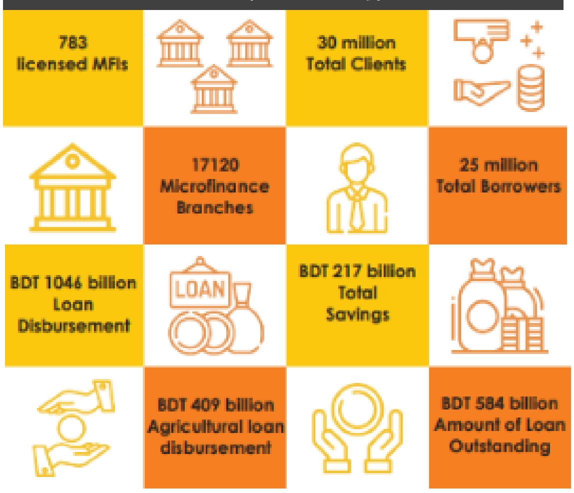


More than $6 billion will flow to large companies while an additional $2.6 billion will flow to exporters (PRI), leaving about $1.5 billion for SMEs, farmers, micro-entrepreneurs.

3. Managing the Existential Crisis for MFIs and Averting Consequences for low income people and enterprises

MFIs are omnipresent in lives of most Bangladeshis. Largely outside of the formal commercial banking system, more than 30 million micro-enterprises and low-income people rely on MFIs to push and pull liquidity between them and the larger financial system, storing more than $3 billion in deposits, and lending more than $14 billion to invest in business and manage personal and business liquidity.

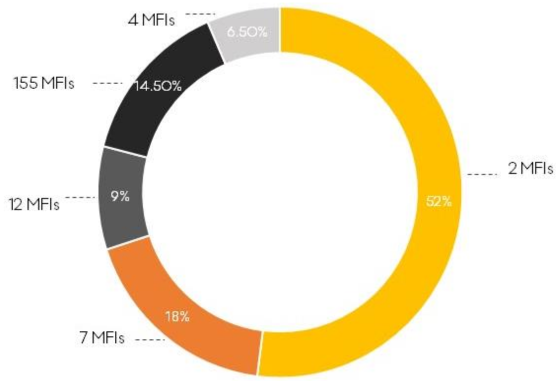
MFI landscape of Bangladesh



In reality though, ***MFIs benefit more than ½ of all Bangladeshis*** given that one client acts as a channel for intra-family distribution of resources (even after discounting multiple accounts with other MFIs).

The Bangladesh microfinance industry is large, diverse and varying in size, performance, and asset quality. Over 780 licensed MFIs manage about $7.9 billion in financial assets, though 28 MFIs manage nearly 90 percent of the assets. This includes two Tier 1 MFIs managing 52 percent of the industry assets, seven Tier 2 MFIs managing 18 percent, 12 Tier 3 MFIs managing 9 percent, and 7 Tier 4 MFIs managing 6.5 percent. Distressed assets are low, below 5 percent.

Distribution of Assets across MFIs



MFIs are also important sources of non-financial support, especially at times of stress. Social development origins of MFIs and their high-touch, relationship-based business model have shaped their role as more than just provider of financial services. This is most visible and pronounced at times of stress.

They act as channels for relief during emergencies, as mediators in settling disputes and negotiating with local elites and state institutions, and as trusted providers of information and advice on health and wellbeing.

Credit supply pressures are exposing large sections of the microfinance sector to an existential threat. The best case estimate from interviews with the regulator and leading MFIs is that the industry will need at least an additional $2.2 billion in liquidity to manage the crisis. This is equivalent to about a ¼ of the industry's assets.

Central to this threat are the:

i. *Capital structures* of most MFIs, which over the last decade have seen increasingly reliance on expensive, commercial bank debt to fuel their growth.

ii. *Core low-margin business model of MFIs* whose characteristics include credit secured through social contracts, high transaction costs, low delinquency rates, frequent collections and disbursements, and repayment instalments small enough to be always serviceable under all but the most exceptional of circumstances.

Any one disruption – *an increase in the cost of funds, a reduced line of credit, a sudden income loss of borrower, a delay in the frequency of collections, a slip in repayment rates from 95 percent to 80 percent* – can render many MFIs insolvent in less than a year.

With COVID, MFIs face a "perfect storm" where everything that can go wrong, is going wrong. Branches are closed, collections and disbursements not taking place, delinquencies increasing, revenues lost, credit from wholesale lenders squeezed, and wholesale prices raised. As one of the highly respected, moderately leveraged, top 10 MFIs in Bangladesh reported:

> *"between April to June, we will not be able to disburse $530 million loans as planned. We will not have been collecting $90 million in savings, and we will be losing $65 million in interest revenue."*

The largest MFI in Bangladesh confirms this general condition across its operation as well.

Consequence of an existential threat to MFIs will be particularly severe for low-income enterprises and families most affected by the economic consequences of the pandemic. If the risk is allowed to materialise, millions of poor people will lose access to non-financial services from MFIs at this time of stress. They will also face greater challenges in recovering if financial services are not readily available to resume economic activities. The scale and duration of the Government's stimulus package means there will be no substitutes to MFIs for most low income enterprises and people.

Most microfinance institutions will be able to limit the haemorrhage if lessons from earlier crisis are acted on and liquidity positions stabilised. Microfinance institutions have faced earlier crisis, particularly triggered by natural calamities. Adoption of some core strategies during that time enabled MFIs operations to recover within 6-months:

i. *Maintaining contact with clients throughout*, facilitating safety net transfers and sending a *"we have your back"* message to clients, enabling more frictionless collection of dues.

ii. *Making disbursement as soon as possible*, enabling clients to resume economic activity quickly.

iii. *Ensuring liquidity is allocated to meet demand during seasonal cropping patterns* where financing needs to be timely to catch small windows of opportunity. Stabilising liquidity is an essential underlying condition to adopt these rapid recovery strategies.

COVID is different from earlier crisis and the scale of the challenge is dawning on most MFIs. Earlier crisis tended to impact a proportion of MFI operations, enabling more vibrant areas to cross-subsidise those negatively impacted. The duration of the impact was also much better anticipated, enabling plans to be prepared and fundraised. These flexibilities are not present with COVID as it is a universal disaster.

MFIs have been frantically engaging with funders. Those with credibility and a diversified funding base are beginning to see some commitments coming through but these are primarily restricted to the top 3- 6 MFIs. The rest are just hoping to 'somehow survive'. The national association of MFIs – *Credit and Development Forum* – has put forward an ambitious $2.6 billion MFI stimulus proposal to the Prime Minister's Office, which is unlikely to fully materialise given current political-economy and competition for scarce resources.

Far more collaborative and joined-up strategies will be needed with all the key actors in the microfinance ecosystem in addition to getting the basics right internally. If the recommendations outlined in the following box are implemented, there is hope MFIs and their clients can recover in a couple of years and be much stronger in dealing with another COVID-like hazard.

RECOMMENDATIONS

i. **Rapidly assess and revise cash flow forecasts and liquidity model** assumptions, and provide support to revise business plans where necessary.

ii. **Proactively share liquidity positions and plans with the regulator, creditors and investors.**

iii. **Negotiate service agreements with MFS operators and MNOs to execute social-distancing compliant collection, disbursement, and customer services models.**

iv. **Develop a microfinance industry assessment and recovery strategy**, securing buy-in of ecosystem players for its execution, especially the Government and the regulator.

v. **Negotiate agreement with banks to act as a 'spare tyre' with temporary liquidity support** to kick-start resumption of microfinance operations. This will not be easy given banks' own liquidity constraints, but support should be leveraged from funders, market facilitators and investors.

vi. **Negotiate with regulators agreement to remove artificial and market distorting ceilings on price of foreign currency loans** adjusted for currency and country risk.

vii. **Explore with existing wholesale banks, together with interested investors and donors, potential for a large-scale blended securitization, under the leadership of a leading MIV or DFI,** of:

a. **wholesale microfinance assets** managed by domestic commercial banks, and
b. **remittance streams** (to secure better rates).

This will be likely be the most bold and transformative action, but also the most complex. Complexity however should not be an excuse to not act.

viii. **Once this crisis abates, the Credit and Development Forum together with regulators and policy makers will need to fundamentally restructure the MFI sector:**

- *Managing and incentivising consolidation* as it makes no sense to have more than 780 MFIs in the country with many operating as risky and ineffective 'mom and pop' operations'. Indeed, the COVID crisis will likely see the natural demise of many. This needs to be properly managed through, for example, liquidation under a voluntary-administration type of scheme. For the rest that do somehow survive but are essentially too small, some form of franchise model needs to be developed to enable small MFIs to work under a franchise model of a larger 'franchisor' MFI, ensuring standards and better risk management while maintaining operational autonomy;
- *Establishing a tiered regulatory structure*, enabling risk-based regulation of MFIs;
- *Steering transformation of the larger MFIs* into more specialised banks, regulated by the central bank. This will have the benefit of enabling the largest and most efficient to improve its capital structure, be subject to higher regulatory standards, become better governed, and provide keener prices to its customers.

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