Spotlight 3.1

Supporting microfinance to sustain small businesses

Micro, small, and medium enterprises (MSMEs) and the informal sector will play a critical role in the long-term recovery from the COVID-19 (coronavirus) crisis. In low- and middle-income countries, small firms are vital for job creation, economic growth, provision of goods and services, and poverty alleviation. Formal and informal MSMEs make up over 90 percent of all firms and account, on average, for 60–70 percent of total employment and 50 percent of GDP worldwide.[1] Yet despite their important economic role, these businesses struggle to access formal financial services. About 130 million, or 41 percent, of formal MSMEs in low- and middle-income countries faced credit constraints before the COVID-19 pandemic, and the MSME finance gap (the difference between current supply and potential demand, which can potentially be addressed by financial institutions) was estimated at $5 trillion.[2] The demand for finance from informal enterprises was an estimated $2.8 trillion, equivalent to 11 percent of GDP in these countries.

Policies to support the continuity of financial services to MSMEs and the informal sector and protect these clients through restructuring processes are essential to avoid a delayed recovery. Although microfinance institutions (MFIs) are often small and may seem unimportant in balance sheet terms, they serve a segment of an economy that is macroeconomically significant. MFIs typically have detailed operational knowledge of local business conditions and the skills and abilities of individual entrepreneurs, which enables them to direct funds from recapitalized institutions to productive lending opportunities. Globally, the formal microfinance sector provides over 140 million low-income clients with credit and savings services.[3] The sector's reach is much larger when nongovernmental organizations (NGOs), cooperatives, and informal savings and loan groups are included. In 2018 the global microfinance sector oversaw $124 billion in outstanding loans and $80 billion in savings. Specialized microfinance investors had a $17 billion portfolio in MFIs.[4]

The state of MFIs during COVID-19 and the policy response

During the pandemic, several governments took important steps to protect MFIs when borrowers

began to default on their loans. The differences between MFIs and conventional banking institutions required a tailored approach. Whereas most banks rely on asset-based lending, MFIs maintain close relationships with their clients to assess and ensure each client's willingness and ability to repay. Microfinance lending is typically high-touch, with frequent, even weekly, in-person meetings with borrowers. But such meetings became difficult, if not impossible, under lockdowns. Moreover, MFI balance sheets are highly granular and may consist of hundreds of thousands of borrowers with relatively small short-term loans. Thus the sheer volume and varying circumstances of individual borrowers can make blanket moratoria on loans and formal loan rescheduling difficult to organize and implement—and borrowers may not even want them. Finally, with their links to the informal sector and their deep knowledge of local economies and communities, MFIs are important channels for payments (such as government-to-person transfers) that regulators and policy makers can leverage to support recovery.

As the lockdowns and decline in economic activity precipitated by the COVID-19 pandemic took hold, experts anticipated that MFIs would face swift deterioration of their performance metrics, especially liquidity and asset quality. But based on a global assessment of MFIs in July 2021,[5] the overall impacts of the pandemic on MFI balance sheets seem to have been mixed based on MFI characteristics, government assistance, and specific market dynamics, among other things (also see spotlight 2.1 on MFIs). Key factors in MFI resilience during the pandemic are national government and regulatory responses (box S3.1.1), the nature and type of institution (such as whether deposit-taking or credit only), the prepandemic financial and operational strength of individual institutions (box S3.1.2), and how individual

Box S3.1.1 How Pakistani MFIs and regulators managed the crisis

As the economic crisis arising from the COVID-19 pandemic unfolded in Pakistan, MFI operations became severely restricted, and some MFIs were forced to close temporarily. Many MFIs acted quickly, however, to initiate business continuity plans to ensure the health and safety of staff and clients and work around lockdowns. Digital financial services and branchless banking surged. In the first year of the pandemic, the number of active branchless banking accounts increased by 53.7 percent, from 27.7 million to 42.6 million.[a] Meanwhile, from March 2020 to March 2021 regulators enacted a debt moratorium to ease the financial crunch on borrowers caused by lockdowns and the decline in economic activity. In addition, nonbank microfinance companies (NBMFCs) were shielded by federal guidelines asking commercial banks and other lenders to MFIs, such as the Pakistan Microfinance Investment Company, to reschedule wholesale lending to the sector. Anecdotal reports also suggest that handshake agreements with other MFI lenders to extend repayment terms, as well as the continued availability of wholesale funding for creditworthy MFIs, helped buoy the sector.

Overall, these measures appear to have averted a liquidity crisis among Pakistan's MFIs in the short term, particularly those regulated, deposit-taking, and digitally enabled.[b] Indeed, during 2020 loans totaling approximately $635 million in the sector were deferred or rescheduled. Some MFIs even experienced an increase in business. Microfinance banks (MFBs) saw a net increase in deposits in 2020 of 29 percent, and gross loan portfolios increased from $1.97 billion to $2.02 billion during 2020.[c] However, results were mixed across the sector. The largest MFBs

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Box S3.1.1 How Pakistani MFIs and regulators managed the crisis *(continued)*

saw growth continue, while the smaller players, including the vast majority of NBMFCs, saw declines in their portfolios and asset quality. By the end of 2020, many Pakistani MFIs had temporarily suspended their lending operations, and the demand for credit declined slightly as people suffered income losses.[d]

Whether some consolidation and solvency support, particularly for smaller institutions, are needed in the sector remains to be seen. Going forward, it will be important to distinguish viable MFIs from those likely to fail. MFIs, especially those unable to restart lending and return to prepandemic levels of growth, may find that their weaker balance sheets no longer meet prudential requirements once temporary regulatory forbearance is lifted. Recapitalization of institutions focused on MSME lending, especially MFIs, may be necessary and critical to restoring the viability of private sector MSMEs. The government's Kamyab Pakistan Programme, rolled out in September 2021 to provide subsidized or interest-free loans to SMEs and agricultural workers, could also have mixed impacts on the stability and future growth potential of the microfinance sector by distorting the price of credit and increasing the moral hazard of strategic future default.

a. Compare the relevant data in SBP (2020) and SBP (2021).
b. A study of 31 economies found that firms with an online presence were more likely to stay in business during the pandemic than those with no online presence, suggesting that digital technology helps small firms innovate and adapt to changing market conditions (Muzi et al. 2021).
c. See Basharat, Sheikh, and Fatima (2021).
d. The number of active borrowers in Pakistan dropped from 7.25 million to 7 million.

Box S3.1.2 Case study: A compounded crisis in Lebanon

The Lebanese economy entered a recession in 2019, pressured by fiscal and trade balance deficits, declining capital inflows, and dwindling foreign exchange reserves. Acute political and financial crises ensued, leading to a run on banks, default by the government on debt obligations, and a proliferation of exchange rates in a historically dollarized market. Alongside the COVID-19 pandemic and the catastrophic explosion at the Port of Beirut, the compounded political and financial crises have had devastating effects on MFIs and their clients.

A survey conducted by the Consultative Group to Assist the Poor (CGAP) and the Lebanese Micro-Finance Association of almost 1,000 microfinance borrowers in Lebanon found that their situation deteriorated sharply between mid-2019 and the last quarter of 2020. Half of the respondents had stopped working or had a less stable income. Entrepreneurs, who account for the majority of MFI clients, saw a 94 percent decrease in sales and faced challenges arising from exchange rate fluctuations and loss of customers. Fifty percent of those employed experienced salary

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Box S3.1.2 Case study: A compounded crisis in Lebanon *(continued)*

cuts, and 20 percent lost their jobs. Women, who make up half of borrowers and are generally self-employed, were the most affected, with three times as many women as men reporting they had stopped working, and most saying they had to handle family care alone during the pandemic.

Purchasing power declined dramatically in Lebanon from mid-2019 to mid-2020 as the pound's exchange rate deteriorated and inflation rose. In mid-2019, spending by a typical borrower's household was more than $1,000 a month for 4.5 members, or $7.90 per person per day. A year later, inflation-adjusted spending had dropped by more than half, to $3.40, indicating that the 35 percent real contraction in GDP had hit the poorest more severely. With curtailed income, 40 percent of microfinance clients were no longer able to meet their basic needs. Sixty percent cut consumption, including of meat or fruit; 50 percent of households were forced to tap into savings; and 43 percent sold movable assets, primarily gold. In the face of impoverished clients and lower levels of economic activity, MFIs saw their nonperforming loans (NPLs) rise from 2 percent in mid-2019 to over 20 percent in 2020.[a]

In 2019, prior to the crisis, the microfinance sector had roughly 1,000 staff members and an aggregate outreach of about 150,000 clients for a loan portfolio of $220 million. However, activity rates dropped as the crisis deepened, and the sector began downsizing. By 2021, portfolios stood at $150 million for some 100,000 loans. But NPLs in the newly disbursed portfolio were still manageable at 8–10 percent.

Nonetheless, the financial crisis exposed some of Lebanon's large top-tier MFIs—representing 75 percent of the market—to potential solvency issues stemming from their significant assets, liabilities, and currency mismatches. On the liabilities side, because of the previous ease of borrowing from foreign lenders, MFIs had accumulated outstanding foreign debt totaling $80 million, but capital controls imposed by local banks on external transfers prevented them from servicing it. On the assets side, MFIs' loan values fell to about 10 percent of precrisis values as the exchange rate depreciated, including the US dollar–denominated loans that clients were repaying in pounds at the officially pegged rate. The future value of MFIs' $45 million in local deposits is uncertain. They could be written off in whole or in part, stretched out, or mandatorily converted into local currency, depending on how the banking sector is restructured. These MFIs are at a de facto standstill with their creditors. Clearly recapitalization, together with debt restructuring and relief, will be needed. Left unaddressed, this need could result in less access to finance, with disproportionate impacts on a significant portion of low-income borrowers in a context of rising poverty and unemployment.

Source: Chehade (2021).

a. CGAP, Lebanese Micro-Finance Association, and Consultation and Research Institute (2020).

MFIs responded as market conditions changed. Borrower profiles undoubtedly play a role in MFI experiences as well. For example, World Bank phone surveys in Sub-Saharan Africa suggest that, although female-led MSMEs experienced a greater drop in sales than male-led firms between March and July 2020, they did not face greater problems in repaying their loans.[6] Meanwhile, a survey of 225 microfinance institutions of different sizes and in different regions in the early months of the pandemic found that although liquidity problems among MFIs were not severer than they were

prior to COVID-19, small MFIs were nearly twice as likely as medium-size ones to face liquidity constraints.[7] In Latin America and the Caribbean and Sub-Saharan Africa, problems were worse than in other regions. However, by the first quarter of 2021 liquidity problems were receding. As for asset quality, in the early months of the pandemic there was a spike in restructured portfolios and portfolio-at-risk levels. A year later, a strong recovery was under way in all regions except Africa, where portfolio growth rates remained negative.[8]

Looking ahead

As moratoria are lifted, questions linger about the asset quality of MFI portfolios. Questions also remain about the ongoing solvency of the smaller MFIs that do not take deposits, especially those that at the onset of the pandemic had weak financial positions, including limited capital buffers. Identifying those MFIs viable in the new environment will be a challenge. A restructuring and consolidation exercise could effectively clean up the sector by closing or consolidating weak and poorly governed institutions. Past MFI crises have demonstrated that out-of-court restructuring or workout processes and the use of distressed asset facilities that specialize at the sector level are the best practice. In addition, markets for distressed assets could enable microfinance providers to better manage their balance sheets by shedding nonperforming assets to focus on building sound portfolios of productive loans. However, success in exercising these options is not guaranteed: distressed MFI loan assets are typically difficult to collect because of the inherent characteristics of microlending, which involves uncollateralized, high-touch loans, often based on the relationship between the MFI agent and the borrower. Furthermore, distressed asset purchases are especially risky in the microlending context because of the relatively large numbers of loans involved and the associated due diligence requirements, which are rendered even more complex and uncertain in the context of government support such as loan moratoria.

Nonetheless, policy makers should pursue measures that support the provision of financial services to MSMEs and the informal sector. Encouraging the emergence of markets for secured transactions and better credit information sharing could enable a broader range of funding and lending instruments and help manage MFI lending risks going forward. Digital transformation of MFI operations and service delivery should also be encouraged—successful MFIs will draw on new technologies for better risk management, develop new business models that leverage their infrastructure and client positioning, and offer products that are more accessible to the informal sector and micro and small businesses. A lesson from the Lebanese experience is that it may be prudent for future microfinance models to limit currency risks. There, blended finance options could be explored to allow renewed investments by development finance institutions and microfinance investment vehicles, but all of them require, first and foremost, macroeconomic stabilization.

Notes

1. For more information on MSMEs in emerging economies, see Department of Economic and Social Affairs, United Nations, "Micro-, Small, and Medium-Sized Enterprises (MSMEs)," https://sdgs.un.org/topics/capacity-development/msmes; World Bank, "Small and Medium Enterprises (SMEs) Finance," https://www.worldbank.org/en/topic/smefinance.
2. For more information on the MSME finance gap, see the International Finance Corporation, IFC MSME Finance Gap database (updated October 2018), https://www.smefinanceforum.org/data-sites/msme-finance-gap, and the associated report (IFC 2017).
3. Convergences (2018).
4. Symbiotics (2019).
5. CGAP and Symbiotics (2021).
6. IFC (2021).
7. Spaggiari (2021).
8. CGAP (2021).

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