COVID19: A FRAMEWORK FOR THE MICROFINANCE SECTOR

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4-1-2020

I. INTRODUCTION

The current global crisis differs from anything in our lifetimes: it is certainly more complex, more sudden and deeper than the most recent referent, the Great Recession. First and foremost, countries need to address the health crisis, try to flatten the curve in people affected by the virus, test and treat those impacted by the virus, and figure out how to resume some kind of normalcy without triggering relapse. As of today, there is great uncertainty about this timeline, and thus about the ultimate scale of the liquidity and solvency challenges that businesses, financial institutions and individuals will face.

Governments and international financial institutions will prioritize support for the real economy— individuals and companies -- and then financial institutions that pose systemic risk. Only then *might* they turn attention to second or third-tier financial institutions, like many microfinance institutions (MFIs), notwithstanding the close connections of these institutions with many of the most vulnerable populations. So, while MFIs may indirectly benefit from support to individuals and small and medium-sized enterprises (SMEs) – collateral succor! – they are unlikely to receive direct government support in a timely fashion.

This note outlines a strategy for the rescue of the microfinance sector (MFS) due to distress caused by the twin health and economic crises. The strategy is based on the authors' experience with a wide variety of economic and financial crises over the past 30 years – East Asian countries South Korea, Thailand, Indonesia and Malaysia, as well as crises in Turkey, Mexico, Argentina, and the sovereign debt crises of the 1980s and 90s – and the efforts to address these episodes by the U.S. Treasury, Federal Reserve, World Bank, International Monetary Fund (IMF) and other official and private institutions.

Because direct official support for MFIs may not be forthcoming on a scale and timeline necessary, this rescue will need to be led by the main players dedicated to the microfinance ecosystem -- investment funds, networks, industry associations and leading MFIs -- which hopefully will be able to enlist development finance institutions (DFIs), regional development banks, supervisors and central banks to support or at least condone their efforts. There will also be a need for ad hoc institutions and coordinating committees to be created. There will be a need for fresh money and a rescheduling and restructuring of MFIs in distress. The lessons of previous crises suggest that damage can be contained, but it requires fast action, peer pressure and an intolerance for free riding and sitting on the sidelines on the pretext of bureaucratic procedure. [1]

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[1] The lessons are drawn from country experiences starting with the London Approach in the 1970s and 1980s extended thereafter in the 90s with the Bank of England using its suasion to effect workouts with large corporate debtors in distress with their lead banks and other creditors. The London Approach was adopted in the East Asian Crisis (1997-2003) by a World Bank restructuring team assisting client countries first in Korea and then in other countries in the region such as Malaysia, Indonesia and Thailand. The approach was then utilized during the Turkish Crisis (2001-2002). Ira Lieberman, a co-author of this note, led the World Bank restructuring efforts in particular in Korea and Turkey and had oversight over other East Asian support programs.

II. KEY FEATURES OF A RESPONSE

- **Time-bound processes.** Given the likely depth of the crisis and the number of MFIs in distress, resolution processes will need to be time bound. In previous successful emerging market crises, the out-of-court workout processes were targeted for completion in three months. In one case, an additional 30 days was allowed for arbitration if the parties could not agree. In another, the initial 90 days could be extended for up to three 30-day extensions. While recognizing that workouts / restructuring of a large, complex MFI might take longer, the goal should be a time- bound process of three to six months.
- **Survey.** In a crisis, information is critical. Crisis-resolution programs and institutions often work in what is known as the "fog of war" with very little real-time information. This, for example, is proving to be a critical issue in the current health crisis due to limits on testing capacity. To help lift the fog, a survey needs to be taken of leading MFIs by country, with CGAP coordinating the survey with the MIX. Investment funds, DFIs and regional development banks could assist this process initially by soliciting information from their borrowers or investees. In addition to enabling ongoing refinement of estimates of the scale and types of support required, institution-specific information could be used to "tranche" support, as is done with IMF standby facilities.

- **Institutional capacity.** In all crises, institutional capacity is key to timely crisis resolution. While microfinance banks would fall under the purview of bank regulators – possibly a mixed blessing – only a few countries have microfinance-specific supervisory functions for non-bank MFIs. Industry leaders – leading investment managers, networks and associations – should move expeditiously to build institutional capacity to address restructuring and workout needs. Such institutions should include:
  - **A Steering Committee.** Senior representatives of large network groups, large investment funds and ideally, the regional development banks and the DFIs, (the "Major Players").
  - **Appoint CGAP as the Coordinating Secretariat** for the sector and have CGAP appoint a team dedicated to crisis support.
  - **A Creditor/Shareholder Committee** for each workout representing major creditors and shareholders, with at least 50% (ideally more like 75%) of each credit and shareholding group; typically the largest creditor or shareholder chairs the committee. If the workouts are voluntary and out of court, the Creditor Committee cannot "cram down" on minority or recalcitrant creditors (that is, force them to agree to the workout agreement). If the Steering Committee or Restructuring Commission can convince regulatory authorities to support legalization of the process, then the workout could be treated as an out-of-court process, legally able to cram down. [2]

[2] Normally that would be done through the bankruptcy system with bankruptcy judges approving the workout. This process is known as pre-packaged bankruptcies, frequently used in the USA. But we doubt whether many of

- **Restructuring Commission/Arbitration Panel.** In each of the countries where the Steering Committee decides to undertake workouts, a Restructuring Commission should be established with an Arbitration Panel to oversee these workouts. The Commission and the Arbitration Panel can provide guidance to creditor/shareholder committees in the event they cannot reach agreement on particular workout provisions, or at the end of 90 days cannot reach a comprehensive agreement. The arbitration panel should provide a decision within 30 days of a case being presented to them.

- **Lender of Last Resort / Emergency Liquidity Facility.** In virtually all emerging market and developing country crises the IMF, supported by the World Bank and various regional development banks and backed by the G7, has served as lender of last resort to countries in distress. Central banks are most frequently the lender of last resort to the banking sector. The industry should advocate for central banks to, at a minimum, extend support to MFIs that are banks and other depository MFIs. But the microfinance sector will need a lender of last resort for the large number of MFIs that are unlikely to receive direct support from central banks. This could be a consortium of regional development banks with backup support from DFIs, the IMF and World Bank. There is precedent for such a facility, albeit not at the scale currently required. In the aftermath of Hurricane Mitch, which devastated several Central American countries in 1998, it was recognized that quick and agile liquidity support for the sector was lacking. The Inter-American Development Bank Multilateral Investment Fund (IADB/ MIF), with support from other institutions and investors, created the Emergency Liquidity Facility (ELF) for Latin America to quickly provide short-term liquidity to institutions facing a systemic crisis, natural or man-made. A second facility (HELP) was created specifically for Haiti following the 2010 earthquake, both taking bad loans off the books of the leading MFIs and injecting new funds to shore up balance sheets and provide liquidity.[3]

III. IMPLEMENTATION/ SEQUENCING

The sequencing and timely implementation of the rescue process is critical to its success. We recommend the following steps:

1. **An immediate standstill.** The Steering Committee in coordination with Major Players should coordinate efforts to put an informal 90-day standstill in place as soon as possible with the possibility to extend for three 30-day periods. This standstill should be coordinated with

the countries involved will have adequate bankruptcy capacity and during a crisis, such as the present one, the bankruptcy system to the extent it exists will be quickly overrun (see diagram in Appendix of Workout Process).

[3] Both ELF and HELP were managed by Omtrix. Ira Lieberman was the Chairman of the Board of both ELF and HELP. Paul DiLeo was an investor, Board member and investment committee member of ELF and the companion Short Term Liquidity Facility, which addressed institution specific liquidity issues.

banking supervisors in countries where workouts are likely to take place and MFIs operating as banks are involved. (Timing: immediate).

2. **Communication of a Rescue Strategy**. In a crisis, communications are critical. We suggest that a document laying out the process and framework for the rescue be disseminated widely throughout the industry as soon as possible, with feedback solicited for a limited period. We recommend that CGAP execute this and at least initially serve as the de facto secretariat for coordinating the rescue effort. (Timing: next 30 days).
3. **A Steering Committee** with representatives of leading institutions in the industry be appointed quickly to discuss and confirm the framework and guiding principles of the rescue strategy. (Timing: next 30 days).
4. **Leading creditors and investors form crisis units.** The leading institutions—regional development banks, DFIs, large networks, and investment funds ("Major Players") - should each quickly form crisis units, headed by a senior member of management, to oversee crisis interventions. (Timing: next 30 days).
5. **A Crisis Survey of leading MFIs** by region and country take place, coordinated by CGAP and the MIX. It could be self-reported by the MFIs, or their creditors/shareholders. MFIs should be informed that financial support, including a continued standstill, is dependent on ongoing, timely reporting. (Timing: begin within next 45 days).
6. **Lender(s) of Last Resort.** The Steering Committee should seek commitments for Lenders of Last Resort. This could be in the form of grant funds, equity or long-term loans with grace periods to stabilize balance sheets. (Timing: 45-90 days). These funds could be supplemented by permanent Emergency Liquidity Facilities, as described above over the medium term.
7. **Workouts begin.** With the situation likely to remain fluid for some time in most countries as the duration, severity and possible recurrence of the health crisis remain uncertain, it may be difficult to advance coherent workouts in the near term. However, we recommend that workouts for a select set of MFIs begin well before the end of the initial standstill to confirm processes, mobilize resources and demonstrate viability. Any Major Player can propose a workout, or any MFI can request one, with CGAP in consultation with the Steering Committee to confirm. (Timing: next 60-90 days).

IV. Standstill Agreement

A critical component of this approach is an immediate and universal standstill; if some creditors are able to exit precipitously, the principle of equitable burden sharing is violated and agreement among the remaining creditors becomes much more difficult. Key features of an effective standstill include:

- A willingness by the main creditors to initially commit to a non-statutory (voluntary) resolution to the MFI's financial difficulties, rather than resort to a formal insolvency procedure (declarations of default, liquidation, administration), and forego recourse to other enforcement procedures, such as receivership or bankruptcy.
- During the period of the review, the MFIs primary creditors agree to maintain their facilities, effectively operating at an informal standstill (for 90 days to be extended as necessary) sufficient to preserve the confidence of depositors, clients, investors and supervisors by enabling the MFI to continue to meet obligations as normally as possible, subject to the timely preparation of cash budgets and relevant

- operational and financial data, and approval and monitoring by the relevant Restructuring Commission.
- In addition to the maintenance of existing facilities, it may be necessary to allow the MFIs to supplement their existing borrowing with new money, in case of an immediate liquidity shortfall. New money should be provided on a pro rata basis by all existing lenders and shareholders, or by specific lenders with preferential arrangements.

V. WORK OUT / RESTRUCTURING

With a standstill in place, the institution and its investors have the breathing room to restructure and recapitalize the balance sheet, as and if appropriate.

- As part of this consideration, the creditors can commission an independent review of the MFIs' viability, drawing on comprehensive information made available by, and shared between, all parties to any workout.
- Drawing on the independent review, the company's main creditors work together to reach a joint view on whether, and on what terms, a company can be supported.
- To facilitate these discussions, a coordinating or lead funder -- a DFI or investment fund -- should be designated, and a steering committee of major creditors and shareholders formed[4].
- Adoption of some of the basic principles and guidelines that have been developed in previous restructuring exercises – for example, the recognition of seniority of claims and equitable burden sharing between creditors in a single category[5] – will be very helpful in facilitating timely deliberations among the parties.

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[4] The lead creditor or steering committee is typically composed of those institutions with the largest credit exposure to the borrower. In cases where the MFI group is unusually diverse, members may be designated to ensure that the divergent interests are represented.

[5] Other examples and questions to consider include:

- Should a standstill apply to all payments, or are some imminent payments exempt?
- How will loan covenants, cross default, negative pledge provisions be neutralized?
- How are preferred creditors defined? All new money? What if it was previously committed? Is emergency liquidity a preferred credit? Does debt equity swap qualify other exposure of the swapper as preferred? Is new equity protected from dilution?
- What is the composition of the creditor committee, how does it operate and what are its authorities? How does it communicate with non-member creditors? Is there a separate shareholders committee and if so, how do the two relate?
- What are information/reporting requirements of the MFI? What if they are not met?
- Is there conditionality on support? If so, how is tranching determined?
- Is there a provision for arbitration?
- What is the reaction to free-riders?
- What is the treatment of bonds and other securities?

- If, on the basis of the review, there is an agreement among creditors that the company is indeed viable in the medium to long term, the creditors will move to consider more lasting forms of financial support through debt rescheduling or restructuring, e.g. an interest holiday, extension of loan maturities, provision of subordinate loans, capitalizing interest in arrears, further lending of new money and/or conversion of debt into equity.
- Such longer term financial changes will need to be conditional and tranched against implementation of an agreed business plan.

VI. Heterogeneous mix of financial instruments.

In prior restructuring cases, creditors have found it necessary to utilize a wide range of financial instruments and processes:

- **Debt rescheduling,** with periods of grace sufficient to allow recovery, capitalization of interest in arrears and, in some cases, reduction of interest rates on the rescheduled debt;
- **Debt restructuring** replacing term loans with other instruments to strengthen capital, such as subordinated loans or debt equity swaps;
- **New Capital.** Above all, restructurings will require injection of fresh capital to support revival from the crisis. This will include working capital facilities, and equity or quasi equity. Fresh capital has proven hardest to obtain in crisis resolution, but in this crisis will be critical to enabling MFIs to recover necessary capital ratios.
- **Interest rates**. Given that global interest rates are at or near zero, rescheduled and restructured loans and new capital should be provided at low and, if need be, subsidized rates. This will require lenders to carefully review their fiduciary responsibilities.

VII. Prioritizing resources

Invariably, restructuring of MFIs during crises will need to be segmented. There will be an understandable inclination to prioritize attention and resources on the largest MFIs, those "too big to fail" and perhaps most likely to recover quickly -- those, for example with hundreds of thousands of clients or more, a widespread branch network and large-scale savings mobilization. Because of their complexity, these MFIs will need to be handled on a case-by- case basis and require substantial effort and resources. Mid-sized MFIs can ideally be handled in a systemic way, conserving the institution-specific effort required. Small MFIs, particularly rural institutions, may require a liquidity injection and debt re-scheduling, but they may not receive much in the way of restructuring support unless a lead investor or sponsor is able to step up. These institutions play a critical role, but there are simply too many to address specifically in any meaningful way. Industry leaders should consider mobilizing a grant facility, or a highly subsidized medium-term loan facility, to simply inject liquidity into these institutions with a minimum of due diligence.

There is simply too little advisory and institutional capacity in the microfinance sector to support more than a select number of institutions in each country with bespoke treatment. Nevertheless, effort is warranted to ensure that the "rescue" does not sacrifice outreach and support to more vulnerable populations. While digital services will come to the forefront, there remains a need to preserve the elements of "high touch" that are so central to many client relationships. This is the worst possible moment for investors and funders to increase the pressure on MFIs to abandon their distinguishing social ambitions to ensure financial performance and, indeed, survival. "Solutions" cannot sacrifice lower density rural populations, or smaller ticket women borrowers. In all these and other areas, the industry has a critical role to play in ensuring that the "rescue" preserves the core distinguishing features of the industry.

VIII. Conclusion

It is important to note three key elements of this approach to workouts of MFIs:

- First, it does not guarantee the survival of an MFI in difficulty. In many cases, the due diligence reveals that the company cannot be restructured, at which point creditors may deem it appropriate to initiate formal insolvency and/or liquidation proceedings.[6]
- Second and regrettably, not all creditors may necessarily participate in the workouts in the absence of cram downs. Instead the framework is designed around the major creditors: DFIs, regional development institutions and investment funds which have no ability to bind non-participating creditors. It is for this reason that restructurings done under this approach usually provide continued funding of working capital needs.
- Third, regulatory authorities, such as banking supervisors, do not intervene at any point in the process so long as public deposits are secure. Instead the decisions are made directly by the parties at risk, the debtor and its primary creditors. Because of its voluntary nature, this approach to MFI workouts can only be effective as long as both the development community, investment funds and the MFIs are supportive and believe that the outcome is no worse than the treatment they would have received in an insolvency proceeding. If leading players in the MFI community can convince governments, and in particular the banking supervisory agency, to formalize and legalize the workout process for MFIs, then minority creditors could be crammed down.

[6] During financial/ economic crises the country's bankruptcy system is quickly overwhelmed. In many developing countries experience has shown that the bankruptcy laws are inadequate, and bankruptcy courts and judges lacked the capacity to handle the number of cases which quickly emerged. For example, important emerging market countries such as Mexico, Indonesia, Turkey and Argentina had weak bankruptcy systems which adversely affected the crisis resolution process.

Understandably, government efforts in this crisis will focus first and foremost on the immediate health impact. Only when this is addressed, and lockdowns and social distancing have been relaxed, can comprehensive, coherent efforts to address the economic damage take center stage. But even in the best of such rescue programs, many MFI clients -- the core clients in a sense, who work in informal and seasonal businesses, in home-based business, or as smallholder farmers -- will be bypassed by national efforts. These clients often cannot access or will be overlooked by many of the measures governments are employing to give relief and stability to individuals and families: mortgage and debt relief, cash grants through provident fund systems, wage and salary support to formal businesses.

This situation casts into sharp relief both the unique capabilities and vulnerability of microfinance. For many of their clients, MFIs are the best available channel for support, with established, trusted relationships, last-mile infrastructure and decades of experience in innovating solutions for poor and otherwise excluded populations. The role that MFIs play in normal times – smoothing income through loans and savings, providing emergency funds, disseminating relevant information and guidance – now mean the difference between life and death for many families.

But many MFIs -- particularly smaller companies in rural areas, with a larger proportion of small, informal and women borrowers -- are themselves in danger of being overlooked as rescue efforts focus on larger institutions with greater linkages to the financial system and macroeconomy. Just as governments are likely to focus their attention on the most visible participants in the real economy -- large corporations, state or privately owned, which are "too big to fail", and to a more limited extent SMEs -- the microfinance sector will most likely get little formal attention and support. Banking supervisory agencies and central banks are likely, as always, to focus their attention on bigger institutions, those that pose a systemic risk and are likewise "too big to fail".

This is the moment that the industry's networks, associations and lead investors exist for, even if it was unanticipated and unprepared for. Leaders in the microfinance sector will need to engage one another and develop a strategy for crisis resolution and rescue of MFIs in distress, putting aside business as usual. And they will need to resist the understandable impulse to free ride and instead step up to collectively act as lenders of last resort to inject liquidity into the sector to assist their clients during this most difficult time. The decades of work and accomplishment embodied in the microfinance industry today places it in a unique and critical position: to ensure that the world's most vulnerable are not left to fend for themselves, as has so often been the case.

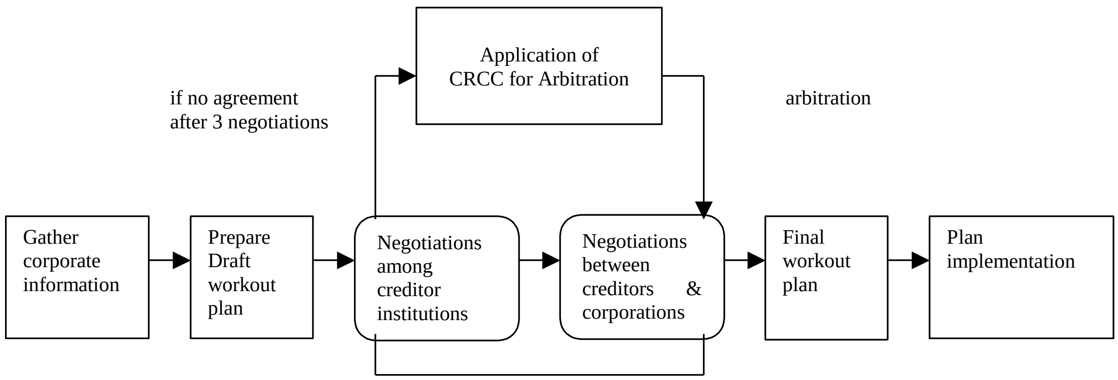
About the authors:

Ira Lieberman started the CGAP Secretariat at the World Bank and managed that facility from 1995-1999. He also served as the World Bank Group Director for SMEs. In addition to his work on MSMEs, Ira led crisis resolution efforts at the request of the U.S. Treasury for the World Bank and IMF during the East Asian Crisis (1997-2001). In Korea he and his team developed, in cooperation with the Korean banking supervisor, a systemic out of court workout program for chaebol (large conglomerate groups) and other large non-chaebol corporations. That program provided some US $100 billion in debt restructuring for some 80 different companies during the course of 1998-99. Ira also worked on crises in Mexico, Turkey and Argentina from 1995-2003. After retirement from the World Bank, Ira served as a senior economic advisor to George Soros for his MSME fund and on the Board of several microfinance funds and NGOs financing microfinance, including the Emergency Liquidity Fund for Latin America managed by OMTRIX, the Calvert Foundation and PAMIGA. Ira has written extensively on microfinance with much of his work focused on governance for MFIs.

Paul DiLeo is the founder and Managing Director of Grassroots Capital Management, PBC, and has led investments in dozens of microfinance institutions and MIVs as early as the late 1990s. As a Board member and shareholder representative Paul has directly engaged microfinance crises in Latin America and South Asia. Paul began his career in the early 1980s at the U.S. Treasury and Federal Reserve, where he focused on sovereign debt crises, including Paris Club reschedulings, IMF stand-by facilities and World Bank structural adjustment programs, Exchange Stabilization Fund support, and commercial bank reschedulings.

APPENDIX

Appendix I: Organizational structure and process for MFI workouts



Approach: London Principles focus on out-of-court restructuring of debt.