THE EARLY IMPACT OF COVID-19 ON FINANCIAL INSTITUTIONS

Insights from a survey of IFC financial institution clients

The global COVID-19 pandemic and diminished economic activity that resulted from it had a significant impact on financial institutions around the world in 2020. In order to gauge that impact and identify the areas of financial institutions' operations that felt it most acutely, IFC launched a survey of financial institution clients in October 2020. The survey asked managers to share their assessments of the pandemic's impact primarily along four dimensions: operations, strategic direction, funding, and loan portfolio. This note summarizes key findings extracted from the responses of 149 clients across 65 emerging markets, representing approximately 30 percent of IFC's outstanding portfolio in long-term finance to financial institutions.[1]

SUMMARY

Seven months from the outbreak of the COVID-19 pandemic, as most countries had begun easing the lockdown restrictions of the first months, IFC financial institution (FI) clients were still operating at about 80 percent of pre-crisis levels. The vast majority of FIs were reporting lower loan collection and disbursement levels; government moratoria and voluntary deferrals affected over half of FI portfolios. Despite the widespread restructuring of portfolios, FIs started to register significant increases in non-performing assets. Notwithstanding the unprecedented challenges, FIs managed to preserve liquidity partly aided by strong deposit levels through the first months of the crisis. The crisis led most FIs to assign even greater priority to the digital transformation of front- and back-end operations, as well as to the development of retail deposits as a key funding strategy. While demand for Micro, Small and Medium Enterprise (MSME) finance was expected to recover through 2021, FIs raised significant concerns about the increased risks for this segment. Finally, demand for investor support was strong among survey respondents, in particular demand for local currency products and medium to long-term financing, as well as technical support for digital transformation and risk management.

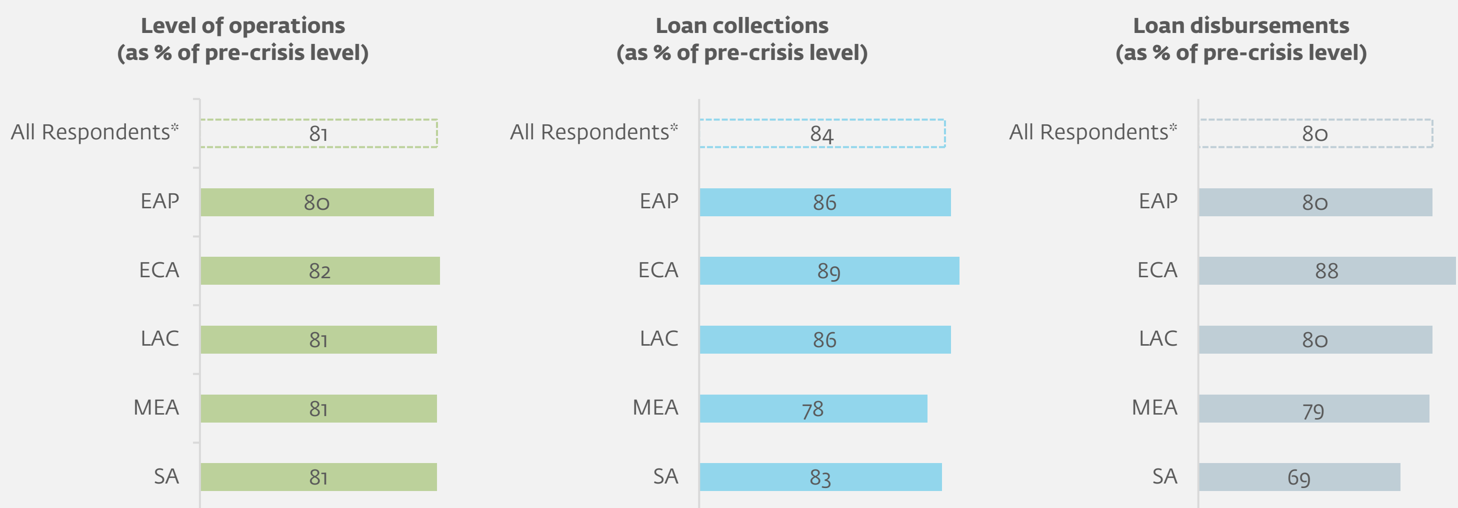
1 The research consisted of an online survey shared with 317 financial institutions in IFC's outstanding client portfolio with lending operations, excluding trade finance and fund investments. Participation was voluntary and responses were received between October 1st and November 15th, 2020.

OPERATIONS

1. **Operations averaged about 80 percent of pre-crisis levels**. As Figure 1 shows, the impact of the pandemic on operations as of October-November 2020 was consistent across all regions. Roughly one in five respondents reported operating at pre-crisis levels, and the majority of these FIs were in upper middle-income countries. Among those still feeling the effects of the crisis on operations in Q3 2020, 32 percent expected it to take more than one year to return to pre-crisis levels. While FIs in Asia expect a quicker, v-shaped recovery, the curve was flatter among FIs in Europe and Central Asia and Latin America and the Caribbean, where more than 40 percent of institutions expect a full recovery after a year or more.

2. **The impact of the pandemic on new loan disbursements was largest for the riskier micro, small, and medium sized enterprise (MSME) and retail segments.** At the time of the survey, IFC clients on average reported that loan disbursements decelerated due to the crisis, at about 80 percent of pre-crisis levels. FIs in South Asia recorded the lowest disbursement levels as of October-November 2020. Microfinance institutions (MFIs) and nonbank financial institutions (NBFIs) were disbursing just over three quarters of pre-crisis loan volumes. Commercial banks were more likely to have access to credit enhancements to support lending operations; in the first months of the crisis nearly 60 percent of banks leveraged government guarantees and risk-sharing facilities to support lending, compared to just under 20 percent of non-banks. Government support is associated with higher levels of loan disbursements to corporates and housing, while levels of MSME and retail lending were relatively unaffected by government support. Figure 1 shows that decreased business activity due to pandemic containment measures reduced collection rates to 84 percent of pre-crisis levels on average, with small regional differences.

FIGURE 1: *Impact on operations, collections and disbursements*



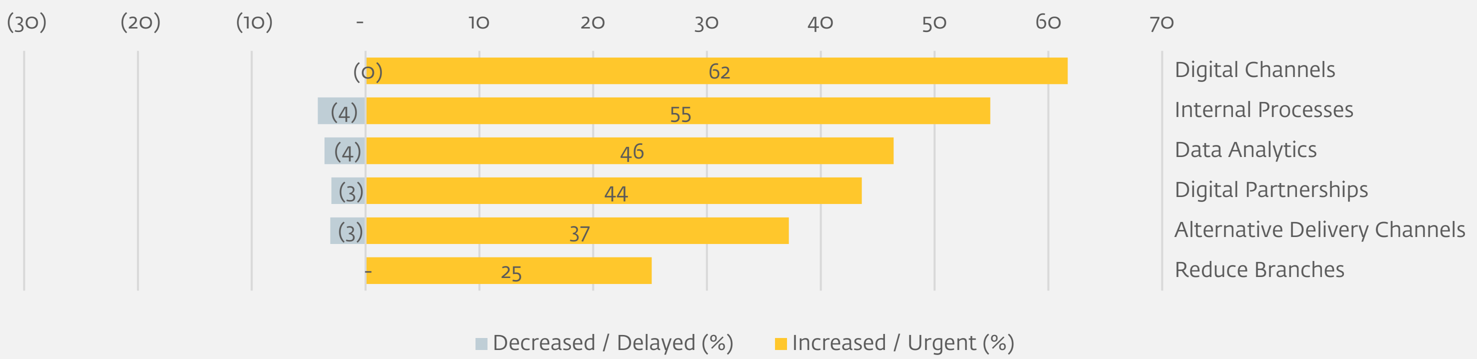
** Aggregate average*

ECA = Europe and Central Asia, LAC = Latin America and the Caribbean, MEA = Middle East and Africa, SA = South Asia, EAP = East Asia and the Pacific

STRATEGIC DIRECTION

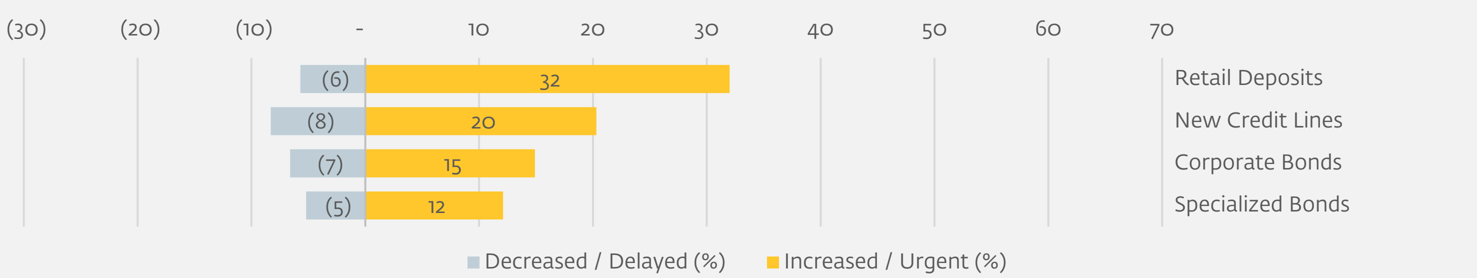
3. Digital transformation gained priority for more than half of IFC clients. While digital transformation was already a corporate priority for nearly all IFC clients, 62 percent of respondents (Figure 2a) stated that investments in digital channels such as mobile and Internet banking had become an increased or urgent priority as a result of the crisis. Other aspects, including the digitization of internal processes and the development of data analytics and alternative credit scoring capabilities, grew in importance for about one in two clients.

FIGURE 2a: *Impact on strategic priorities—Digital transformation*



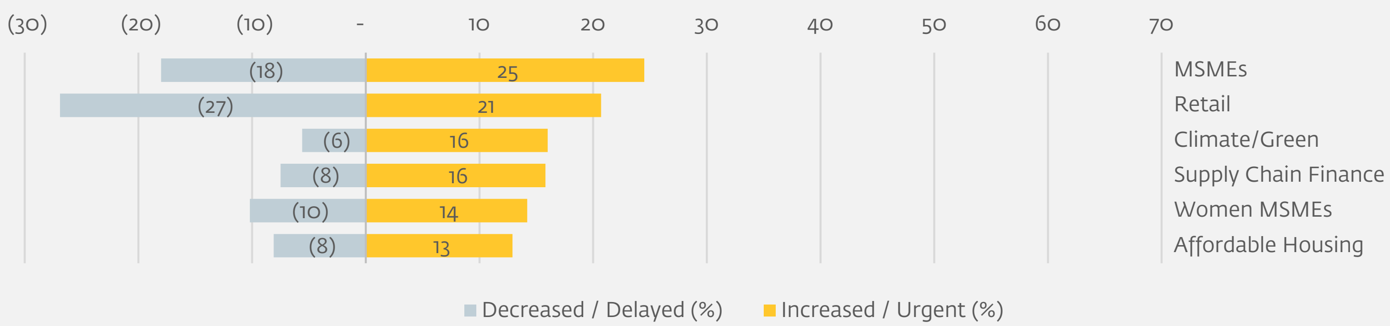
4. Diversification of funding sources is a strategic priority for the majority of IFC clients. In particular, the development of retail deposits (Figure 2b) increased in importance for one in three respondents. Considering their resilience through the crisis, retail deposits are considered an important priority for strengthening financial positions. While corporate and specialized bond issuances were considered priorities by a minority of respondents, survey data indicated that these funding strategies have gained importance since the crisis.

FIGURE 2b: *Impact on strategic priorities—Funding*



5. Mixed impacts on lending priorities are consistent with high levels of uncertainty and reduced lending activities, as shown in Figure 2c. Retail and MSME lending decreased or ceased to be a priority for 27 percent and 18 percent of respondents, respectively. However, 21 percent of FIs stated a new importance for retail lending and 25 percent reported a higher priority for lending to MSMEs. For other lending segments such as women-owned MSMEs, supply chain finance, affordable housing, and climate/green finance, the survey results were mixed: between 13 and 16 percent of FIs declared that these areas had gained priority as a result of the crisis, while between 6 and 10 percent of clients deprioritized lending operations for these segments and objectives.

FIGURE 2c: *Impact on strategic priorities—Lending*

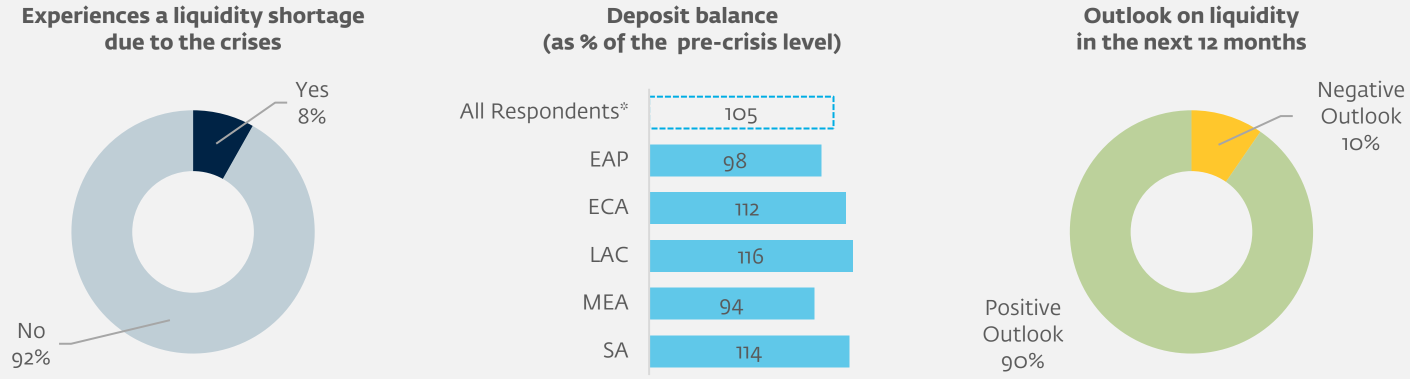


FUNDING

6. Client liquidity has substantially held across the portfolio. Only 12 FIs (8 percent of respondents) reported having experienced a liquidity shortage since the onset of the crisis (Figure 3).[2] The outlook is generally optimistic as only 14 clients (10 percent) expected liquidity problems within 12 months, with low loan collection levels and challenges in raising wholesale funding emerging as key pressure points. Liquidity positions were supported by reduced disbursements (see Figure 1), and by a strong performance from deposits, which increased on average during the first months of the crisis, while wholesale funding showed signs of volatility.

2 The appetite for IFC's Working Capital Solutions, which provides short-term loans to emerging market banks, was high during the initial months of the crisis, most likely due to concerns of possible liquidity problems caused by the pandemic and its economic impact. By the time of the survey, this precautionary demand for liquidity had declined, which shifted funding demand to the long term.

FIGURE 3: *Impact on liquidity*



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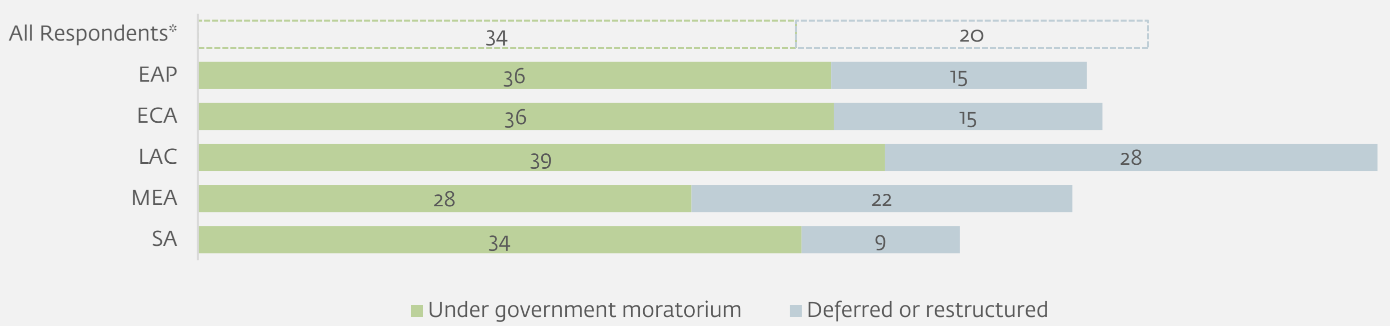
PORTFOLIO

7. Outstanding loan portfolios remained at pre-crisis levels with over 50 percent of portfolios interested by moratoria and deferrals. Government moratoria on loan repayments, in addition to voluntary deferral and restructuring efforts, affected over half of client portfolios, on average. There are significant regional differences, as the share of portfolio affected by any type of deferral or restructuring for a respondent ranged from an average of 67 percent in Latin American and the Caribbean to 43 percent in South Asia. Middle East and Africa recorded the lowest impact from government mandated initiatives. At the time of the survey, government moratoria were still active in over 40 percent of countries represented in the survey.

FIGURE 4: *Portfolio under government moratorium*



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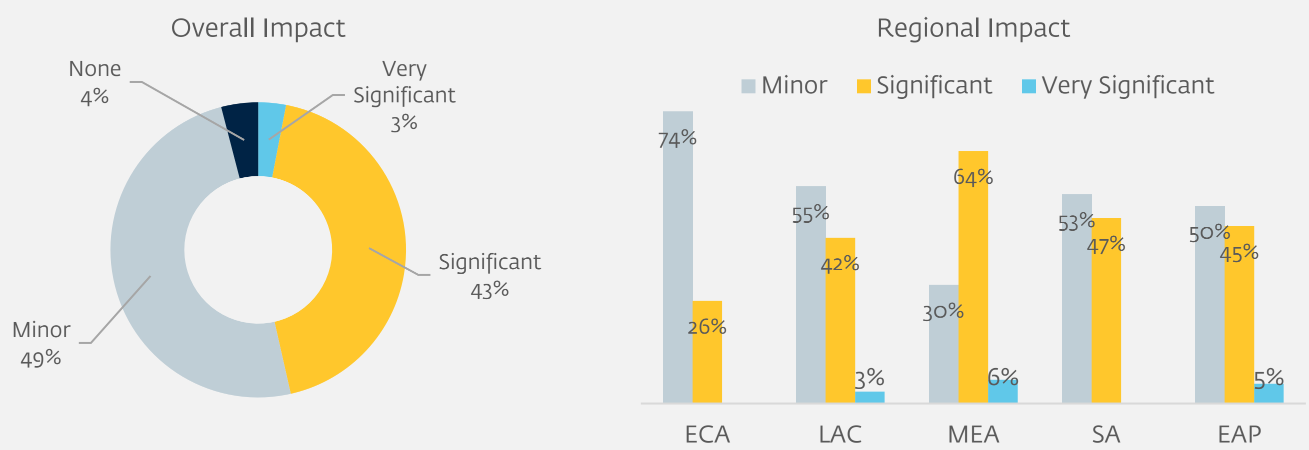
ASSET QUALITY

8. Portfolios had begun to show signs of deterioration at the time of the survey, despite the masking effect of government moratoria and deferrals. Figure 5 shows that approximately 96 percent of institutions reported that their portfolios were negatively affected by the crisis. Nearly half of respondents to the survey stated that impact on portfolio quality was significant or very significant. Among clients reporting September 2020 portfolio data, nonperforming loans had increased by 2.4 percentage points year-on-year, on average, with more pronounced deterioration for MSME and retail portfolios. Yet, despite widespread uncertainty, respondents were optimistic in their portfolio quality outlooks. When asked about their expectations for the 12 months following the survey, 48 percent of IFC clients said they expected asset quality to improve or remain stable, while 39 percent expected minor deterioration. Only 14 percent (17 institutions) expected a significant or very significant decline in portfolio quality. It is important to note, however, that 86 percent of respondents expressed some degree of uncertainty when making these projections.

FIGURE 5: *Impact on asset quality*



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9. Portfolio quality trends differed significantly across regions. While Latin America and the Caribbean was among the regions that recorded one of the lowest increases in nonperforming loans (+1.3 percentage points) as of September 2020, this was partly due to a relatively larger share of portfolios deferred or under moratorium. Roughly 70 percent of institutions in the region expected a deterioration in portfolio quality in 2021. The Middle East and North Africa region recorded the largest impact on portfolio quality as of September 2020, with a 3.9 percentage point increase in nonperforming loans. South Asia, which recorded the lowest average portfolio share under government moratoriums or restructurings, reported the most optimistic outlook on portfolio quality, with over 50 percent of respondents expecting improvements in 2021.

LENDING OUTLOOK

10. The pandemic and associated economic crisis led to a short-term drop in demand for credit. Across segments, respondents reported a decrease in loan demand ranging between 12 and 14 percent of pre-crisis levels. The decrease was consistent across retail, MSME, corporate, and mortgage operations. Despite this consistent decline, the majority of institutions were investing more in digital channels and faster processing to support client demand, perhaps in anticipation of faster recovery in loan demand. On average, clients expected demand to return to pre-crisis levels within a year, with significant variations across markets and products.

11. Micro, small, and medium enterprises are expected to demand medium to long-term products. Demand by MSMEs for medium to long-term financing is expected to rise above pre-crisis levels in 2021, while demand for short-term liquidity is expected to recover only partially. This trend is more prevalent among clients in the microfinance portfolio. Most respondents identified the increased riskiness and the deterioration of financial position of MSMEs as key challenges for MSME lending by 70 and 60 percent of respondents respectively. Furthermore, nearly one in five portfolio clients have deprioritized MSMEs as part of their lending strategy (Figure 2c).

DEMAND FOR SUPPORT

12. Survey respondents expressed robust demand for local currency products and medium to long-term financing. Local currency products ranked highest on the list of priorities for IFC clients, followed by credit enhancements and equity. Preferences for other forms of investment support varied widely across regions; for example there is notably stronger demand for sale of nonperforming loans in the Middle East and North Africa region, whereas in Asia there is strong demand for equity. Clients in Latin America and the Caribbean differed somewhat in their product and currency preferences, with a strong demand for hard currency and working capital products.

13. Support for digital transformation and risk management are in high demand. Consistent with statements on strategic priorities, most clients indicated a strong demand for external support on digital transformation. Similarly, over half of clients expressed interest in external advice on risk management practices to support crisis response and recovery efforts.

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ABOUT IFC

IFC—a member of the World Bank Group—is the largest global development institution focused on the private sector in emerging markets. We work in more than 100 countries, using our capital, expertise, and influence to create markets and opportunities in developing countries. In fiscal year 2020, we invested $22 billion in private companies and financial institutions in developing countries, leveraging the power of the private sector to end extreme poverty and boost shared prosperity. For more information, visit www.ifc.org.

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