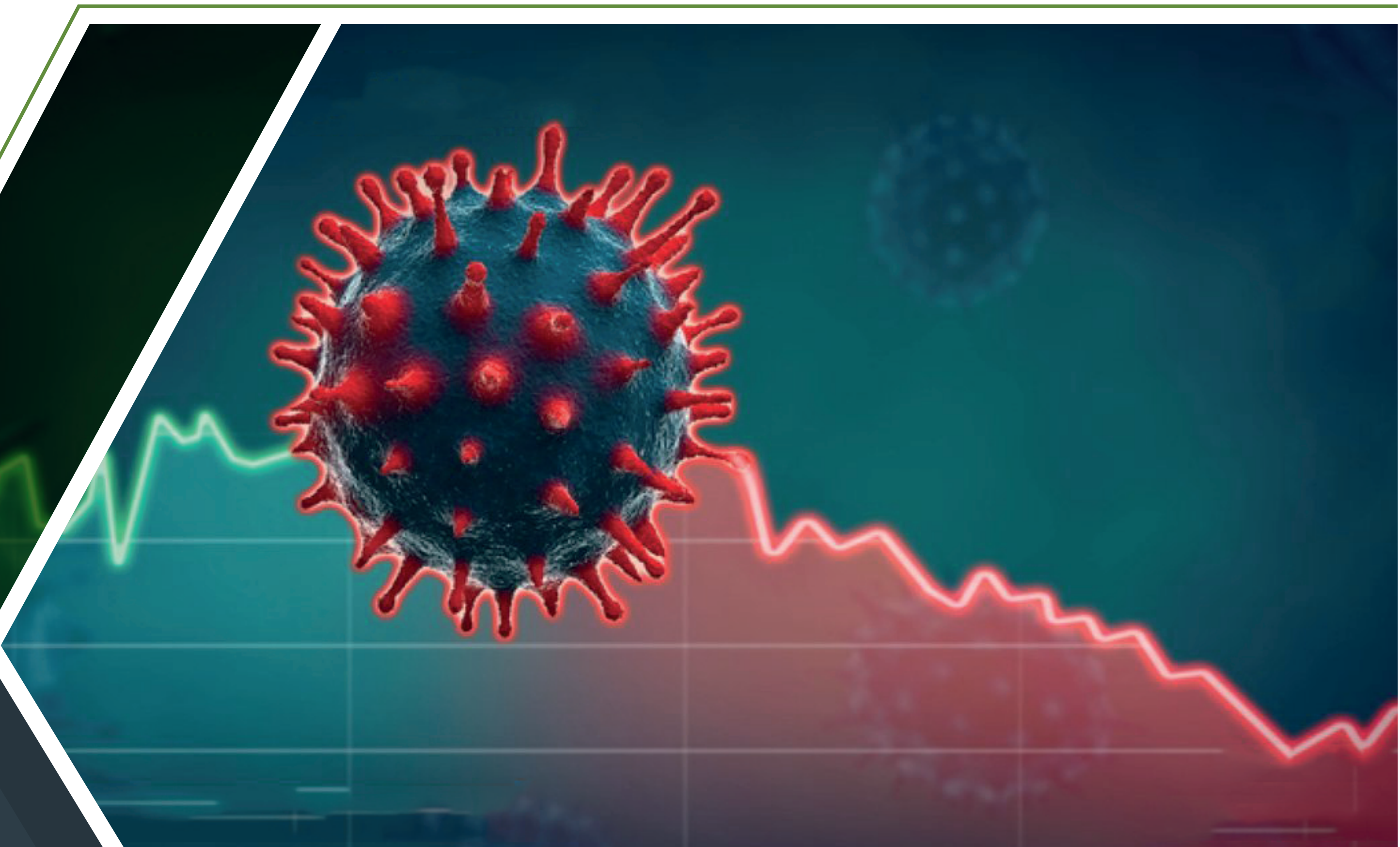
IMPACT OF COVID-19 ON BUSINESS MODELS OF IDFC MEMBERS



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Contents

1 ACKNOWLEDGMENTS

This report represents the findings and conclusions from a study by IDFC sub Working group on business models co-led by CDG, BNDES and Bancoldex carried out from April until September 2020. We wish to thank the other members of the sub-working group from VEB, ICD, DBSA, AFD, for their critical guidance and support. We also wish to thank the 15 IDFC institutions which took part in the survey: CDG, HBOR, PTSMI, DBSA, Bancoldex, AFD, KfW, JICA, CAF, TSKB, BICE, ICD, VEB, CDP and BNDES.

2 EXECUTIVE SUMMARY

The covid-19 crisis has been described as the deepest global recession in decades, despite the extraordinary efforts of governments to mitigate its effects with fiscal and monetary policy measures.

This report surveys 15 IDFC member institutions to identify how the Covid-19 crisis affected their business models. As the pandemic has hurt millions of people and has brought economic activity to a near-standstill, and its effects are still being experienced in a large number of countries, IDFC members were challenged to provide a prompt response to the crisis and this required a business model shift involving changes in strategies, funding sources, financial instruments and channels.

Through quantitative and qualitative inputs, and case studies, the report reveals that IDFC members were able to quickly came up with solutions to address the short-term economic damage and the health crisis by mobilizing private resources and blending them with their own capital, and by designing new financial instruments, fast track approval processes and digital tools. A new approach to risk management is being developed with a focus on integrating ESG and climate risks in the credit appraisal. Most relevant to the question of cooperation, the survey indicates that the covid-19 crisis has accelerated the partnership with all stakeholders mainly with the state and regional state authorities, other development banks, commercial banks, the private sector and NGOs.

Over the longer horizon, there is a risk that the pandemic leaves lasting scars through lower investment, an erosion of human capital and fragmentation of global trade and supply linkages, leading to a future in which IDFC members could be instrumental to improve fundamental drivers of economic growth while safeguarding the planet and people's lives. Members should also consider the degree to which they wish to accelerate private sector mobilization as their lending capacity may reach its limit. As the pandemic taught us the fragility of human beings, it is also a wake-up call urging development banks to join forces in order to design innovative schemes for recovery.

3 IMPACT OF COVID-19 ON BUSINESS MODELS OF IDFC MEMBERS

3.1 A stronger alignment with beneficiaries' needs

3.1.1 Expected impacts

The COVID-19 pandemic has hurt millions of people and has brought economic activity to a near-standstill as countries imposed tight restrictions on movement to halt the spread of the virus. In addition to the health crisis, the economic damage is strong and represents the largest economic shock the world has experienced in decades. As a consequence, maintaining employment, ensuring survival of companies, accelerating equitable transition, strengthening health systems and supporting province/municipal governments are in order, the main expected impacts of the actions carried out by surveyed IDFC members.

For instance, by mid-August 2020, BNDES reported that the emergency measures that reached USD 12 billion approvals, kept about 5 million jobs in Brazil while benefiting more than 171,000 companies, 99.7% of them being micro-, small- or medium-sized (MSME).

3.1.2 Priority SDGs

According to the survey, we find that SDGs 8 (Decent Work and Economic Growth)/ 3 (Health and well-being)/ 1 (No poverty)/ 9-(Industry, Innovation and Infrastructure)/ 17 (Partnership for the Goals)/ 2 (Zero Hunger) are in the ones IDFC members have picked in priority in the light of the pandemic.

A closer look at CAF Covid-19 rescue package shows it is mainly structured around 3 SDGs:

8 DECENT WORK AND ECONOMIC GROWTH

SDG 8: Decent Work and Economic growth

- Financial assistance for micro, and small and medium-sized enterprises, particularly those in sectors most impacted by the pandemic (such as hospitality, tourism, retail and transport).

3 GOOD HEALTH AND WELL-BEING

SDG 3: Health and well-being

- Medical supplies and equipment, virus testing and healthcare infrastructure construction and expansion.
- Research and development for vaccines and treatments, as well as other costs related to preventative care, education and mental health support in relation to Covid-19.

1 NO POVERTY

SDG 1: No poverty

- Other economic recovery initiatives geared at underserved populations including poverty alleviation and employment programmes.

3.1.3 Priority Sectors

According to the survey, renewable energy, healthcare equipment and service, utilities, pharmaceuticals, bio-technology and life science are on the top of the agenda of IDFC members, as a consequence of Covid-19.

For instance, the "COVID-19 – Health in Common" Initiative led by AFD is an initial response to the health crisis and its immediate economic and social consequences. The plan includes the following measures: (i) €150 million in the form of donations and (ii) €1 billion in the form of loans to address short-term challenges facing partner countries and development banks in the 19 priority countries in Africa, the ocean basins (Madagascar, Comoros and Haiti) and the Middle East.

JICA launched "JICA's Initiative for Global Health and Medicine" to strengthen JICA's work in protecting people's lives while supporting Japan's development policy and international efforts to achieve the pledge of "leaving no one's health behind." Under this initiative, JICA will support efforts to achieve Universal Health Coverage (UHC) through a focus on prevention, precaution and treatment. A more ambitious resource mobilization.

87% of IDFC surveyed members will seek greater capitalization or other forms of funding in the light of Covid-19, mainly from capital markets, international funds, institutional resources and crowdfunding.

For instance, on April 2020, AFD issued two Covid-19 bonds, one of € 1.5 billion over 10 years and a second one of an amount of US$ 2 billion over 3 years. On May 2020, CAF issued Latin America's first Covid-19 response Bond, a €700 million five-year social bond to support its member countries' Covid-19 related relief and recovery costs.

3.2 A new approach to risk management

In order to mitigate the impacts of the pandemic on their expected returns, IDFC surveyed members intend to closely monitor the following risks in the light to the pandemic: (i) liquidity risks, (ii) foreign exchange risks, and (iii) impacted sectors such as tourism and transport.

In addition, we find a strong awareness among members of the importance of taking into account ESG and climate risks in their credit assessment. Indeed, 80% of surveyed participants intend to integrate climate risks while 73% of surveyed participants intend to integrate ESG risks.

3.3 More innovation in tools and processes

3.3.1 Accelerating the decision making process

Covid-19 created a sense of emergency and pushed institutions to accelerate their decision making process. For instance, AFD put together a fast-track appraisal of operations by teams at its headquarters in France and at field office. In order to place the USD 250 M Covid-19 emergency package, ICD put together a fast track appraisal process, which has been cleared by the ICD executive committee and approved by the board of directors. Eventually, KfW offered a fast track loan for the companies with more than 10 employees.

3.3.2 Using innovative financial instruments

3.3.2.1 Synthetic securitisation

Synthetic securitisation is a credit-risk hedging transaction – i.e. an insurance, which enables regulatory capital relief while fully keeping the legal ownership of the selected assets and, therefore, all related business relationships. In other words, it is a mechanism by which a bank pays a premium to the securitization fund to protect a percentage of its corporate portfolio against defaults. There are two main benefits for the banks. On the one hand, it is lowering the bank risk exposure.

On the other hand, it is enabling the bank to free up equity to support new lending. This mechanism is all the more relevant as the pandemic strongly hit SMEs.

As a consequence, some IDFC members are considering offering this instrument to its customers in the light of the pandemic.

3.3.2.2 Guarantees

Guarantees are a strong contra-cyclical tool. We find that the Covid-19 crisis accelerated the use of state guarantees channeled by IDFC members.
CDP offered medium to long term loans targeting medium and large Italian companies to support staff costs, investments or working capital in production facilities and business activities, with a guarantee scheme covering from 70% to 90% of the loans, depending on the size of the companies.

KfW launched a package of different instruments, the "KfW Special Program 2020", where all instruments include a 90% guarantee scheme from the State.

VEB.RF supported small and medium-sized enterprises by issuing guarantees totaling USD 1.3 billion to commercial banks that give salary loans with an interest rate of 0%. In addition, it supported loans for the sectors most affected by the crisis and for social NGOs through guarantees worth $5.6 billion, which covered 85% of the loan amount. Finally, VEB initiated another anti-crisis guarantee program worth $3 billion for working capital loans to strategic enterprises.

3.3.3 Leveraging non-financial instruments

Surveyed IDFC members intend to focus more in the light of Covid-19 on research activities, advisory services, project preparation and technical assistance and capacity building to the private sector.

3.3.3.1 Research activities

CDG group set up a series of webinars to discuss the impact of covid-19 on the energy and the health sectors. In addition, CAF contributed with a series of webinars in order to analyze Latin America's economic situation and its impact on SMEs. It also sought to disseminate the strategies governments and companies may carry out to mitigate COVID-19 adverse effects.

3.3.3.2 Project preparation

In the light of Covid-19, VEB.RF Group partnered with National PPP Development Center in Russia to support local governments with project preparation. Indeed, it offered to (i) conduct a strategic audit of infrastructural plans (government programmes, targeted investment programmes); (ii) make recommendations on whether it is practicable to use PPP mechanisms for their implementation; (iii) provide access to remote training in the application of concession agreements and PPP agreements; and (iv) conduct instant due diligence for projects and offer assistance in setting up projects.

3.3.3.3 Capacity building to the private sector

Virtual training services for supporting MSMEs have been designed by Bancóldex in the context of the current economic downturn caused by the Covid-19 pandemic. Online webinars such as "surviving in the current market to thrive tomorrow", "preparing to access financing during a crisis", "how communicating with stakeholders during crises", "cash flow improvement", "digital transformation", and "biosafety protocols", amongst others, have been specially created to complement the financial offer and help entrepreneurs boost their businesses and regain productivity. Companies from 305 cities and municipalities have studied these online courses, and the Colombian Bank has made alliances with 34 Chambers of Commerce of the country that have seen in "Bancóldex Virtual Campus", a strengthening tool for the companies in their regions.

3.4 Digitalization tools for better customer service

According to the survey, Covid-19 has accelerated the use of technology (VPN, robot advisor, crowdfunding platforms etc) for different purposes: home working, easier access of services to beneficiaries and financial intermediaries. Fintechs are also being used for easier resource mobilization, customer advisory services, and better efficiency in operations. For instance, KFW introduced a Blockchain technology that makes it possible to ensure that donor funds are used transparently and reliably. As a consequence, monitoring processes with high transaction costs are eliminated. In Russia, ROSINFRA is a platform designed together with VEB.RF to support infrastructure projects to provide access to the largest database of projects and off-the-shelf solutions, along with online advice from leading market experts, which will greatly reduce project costs and enhance the quality of project preparation. In Brazil, BNDES relied on a crowdfunding platform (Matchfunding Saving Lives), to finance the supplying of materials, medication and equipment for philanthropic hospitals, responsible for serving an important portion of the public health system.

3.5 Increased partnership

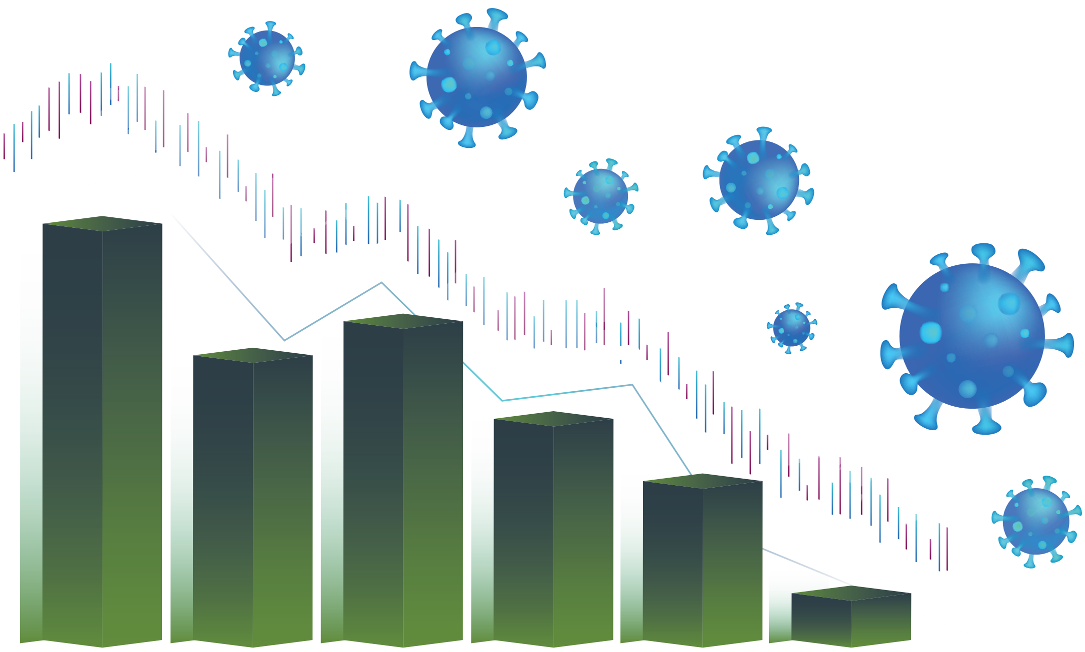
According to the survey, Covid-19 has accelerated the partnership with all stakeholders mainly with the state and regional state authorities, other development banks, commercial banks, the private sector and NGOs.

For instance, CDP has been involved into the European Commission initiative "Team Europe" aimed at coordinating European Development Banks' response to COVID-19 pandemic in partner countries. Through a re-orientation of the existing programs, Team Europe have mobilized € 15.6 billion to face the Covid-19 emergency in two priority areas of intervention: health and economy.

Following the Covid-19 crisis, AFD approved a first loan to the Federal Government of Brazil and entered into a policy dialogue with it.

DBSA engagement with SADC (Southern African Development Community) has resulted in a coordinated support to provide immediate humanitarian assistance with personal protective equipment (PPE) and other emergency medical items as a strategic response to Covid-19 to support countries immediately affected, such as Mozambique, Zimbabwe, Zambia and Eswatini.

Bancóldex joined efforts with several local authorities to launch specific credit lines, benefiting 20 regions and cities with a total envelope of about USD 200 million.



4 The Agenda Ahead: Considerations and Recommendations

4.1 Setting up new investment strategies with relevant tools

Over the longer horizon, there is a risk that the pandemic leaves lasting scars through lower investment, an erosion of human capital through lost work and schooling, and fragmentation of global trade and supply linkages.

It is important that IDFC members contribute to setting the stage for a lasting recovery in developing countries. It is critical to set up new strategies with relevant tools to improve fundamental drivers of economic growth while safeguarding the planet and people's lives.

4.1.1 Strengtheting national/regional value chains

Developed countries are planning to readjust their supply chains bringing some links closer to home for shorter delivery time. As a consequence, some opportunities may arise from this move. For instance, if we look at the car industry, we could argue public transport mobility may become less popular since the crisis, with personal cars regaining interest for households. In this regard, Morocco is planning to strengthen its position to become a hub in the car industry by (i) improving its competitiveness through deep local integration and (ii) decarbonizing the ecosystem so that it is energy efficient and in synch with European climate targets. On September 2020, CDG Invest, the investment branch of Caisse de Depot et de Gestion, took an equity stake in Socafix by investing about a USD 11 million. SOCAFIX is a tier 1 and tier 2 automotive supplier serving Renault, PSA, Lear and Faurecia.

4.1.2 Financing the energy transition and biodiversity conservation

The current crisis calls for building more resilient portfolios to guard against future crises such as climate change. In addition, according to scientists, some of the main causes of the emergence and spread of the Covid-19 pandemic are related to biodiversity degradation and biodiversity imbalance. One of the issues is about waste management, which is exacerbated by coronavirus waste, which has become a new form of pollution, as single-use personal protective equipment (PPE) floods our oceans.

When VEB launched a green national standard to encourage financing projects in energy production, waste management, forestry, landscape and biodiversity and adaptation to climate change, it set the tone to a root transformation in the country. Indeed, Russia has an ambitious ecological program, which will cost about € 50 billion over a 6 year period. And while the government will support about 20% of it, the remaining will have to be found on the private market, both domestic and foreign. That is why the national standard will also come up with incentives such as coupon subsidies, tax breaks, verification process subsidies and other measures to draw investment.

4.1.3 Private sector mobilization

Although 86% of surveyed IDFC participants think the Covid-19-crisis will help catalyze private sector mobilization for impact investment, there are many challenges reported among which we find poor project preparation, difficulty in finding the right balance between expected profitability and risk appetite, internal capacity building and lack of market and regulatory frameworks.

In the longer term recovery, it is critical to partner with the private sector through PPPs and blended finance mechanisms. Indeed, when asked about the existing instruments that will likely be used in the post Covid-19 world in their institution, IDFC surveyed members picked PPP as the second on the list of financial instruments, after long term loans.

IDFC members may act as arrangers and minority lenders to rescue a sector such as the airline industry.

4.2 Systematically joining forces with multiple stakeholders for recovery

Although most IDFC members have sound equity ratios well above regulatory requirements, allowing them to raise additional resources on markets, there is a risk that in the long run, the additional lending volume coupled with lower cash flow collection due to possible defaults, may threaten their ability to play a countercyclical role. Indeed, their performance is constantly monitored by credit rating agencies. Moreover, states may not be in a position to increase their commitments towards IDFC members.

It is critical to create alliances between IDFC members and with other national and multilateral development banks. This approach has the main benefits: resources pooling, risk sharing and better execution if roles and responsibilities are clearly defined. For instance, as mentioned above, JICA has launched "JICA's Initiative for Global Health and Medicine" to strengthen health systems with a holistic approach including supplying material equipment for hospitals, and calls for mutual cooperation between bilateral and multilateral development partners and emphasizes the need to mobilize private sector resources as well.

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