Chapter 19

Association of African Development Finance Institutions

THE IMPACT OF COVID-19 ON AADFI MEMBERS[1]

This chapter summarizes actions taken by the Association of African Development Finance Institutions (AADFI) to combat the economic impacts of Covid-19, as of April 2020. AADFI has 60 member institutions throughout Africa.

INTRODUCTION

Covid-19 has presented great health and socio-economic challenges across the globe. Its impact will be more precarious in emerging and developing countries, particularly in Africa, given the continent's weak health infrastructure and poor development indices – high unemployment, fragility and social unrest. The Covid-19 pandemic will, therefore, constitute a big challenge towards achieving the Sustainable Development Goals (SDGs) in Africa.

Unsurprisingly, the capacity of African Development Finance Institutions, particularly the National Development Finance Institutions (NDFIs), to provide solutions to the numerous development

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challenges of the continent has been further weakened as the pandemic compounds their existing challenges.

It is on this premise that the Association of African Development Finance Institutions (AADFI) surveyed African NDFIs to ascertain the impact of the pandemic on their operation and what solutions could be provided.

CONSEQUENCES OF COVID-19 ON NATIONAL DFIS (NDFIS)

Macroeconomic effect

Most African countries will grapple with their financial positions as revenue earning nosedived in the wake of the pandemic. For instance, the crash in oil price from over $60/barrel at the beginning of the year to under $30/barrel as a result of Covid-19, and the decline in commodity prices, have both led to a huge shortfall in the revenue of commodity exporting countries. Generally, most member countries would face revenue challenges to finance their budget and fight the pandemic.

Moreover, as these countries grapple with supply and demand shocks, decline in travel, investment and remittances, inflation is likely to spike in the short term, with a fall in the value of their currencies. This may result in the high cost of funds, liquidity constraints, challenges in mobilizing suitable financing and incapacitation of National DFIs to lend or fund the completion of projects.

Furthermore, there would be a stoppage in production, and a likely tendency of most economies to slip into recession, with the disappearance of several small businesses and the emergence of high levels of corporate debt. The consequences of these will manifest in job losses and high unemployment, and worsened social unrest in most African countries.

Re-direction of funds meant for DFIs by the government

As countries contend with the huge financial resources required to fight the Covid-19 pandemic in the face of a liquidity squeeze, most African governments are redirecting resources meant for development projects to the health sector to help mitigate the pandemic. This further deprives the NDFIs of the funding that would have gone towards financing micro-, small- and medium-sized enterprise (MSME) projects and creating jobs.

Consequently, NDFIs will face higher business risks, a reduction in business opportunities and a decline in operation due to the shutdown of MSMEs' business activities, a scaling back of business growth plans and lower profit margins, if not outright operating losses for the current financial year. Furthermore, NDFIs will witness drastic shrinking in their balance sheet and pressure to redirect their existing funding portfolio towards responding to Covid-19.

Despite the above constraints, National DFIs would still be expected to play a countercyclical role and support their governments to develop effective fiscal and business stimulus packages.

CONSEQUENCES FOR NDFI'S LENDING ACTIVITIES

Lower-investment inflow

There will be a slowdown in business activities, thus reducing the level of investment inflow and leading to a contraction in NDFIs' projected earnings. Nonetheless, a greater shift in DFIs' financing priorities to agriculture, medical and pharmaceutical products is expected.

A possible decrease in the number of requests for new credit will eventually hinder DFIs' contribution to job creation. In addition, challenges related to restrictive measures, impacting directly on specific sectors funded by some national DFIs – such as catering, transport, hotels, trading and other small businesses – will all translate to massive job cuts.

Funding and liquidity challenges

It is unlikely that governments will channel funds to DFIs for financing MSMEs in the near future, as governments' priorities have shifted to fighting the pandemic. The level of funding from development partners targeting job creation in Africa may shrink.

With the challenge of a funding shortages, most DFIs will be forced to scale down lending activities (credit rationing) and funding shortages for ongoing projects leading to time and cost overruns, as well as increased risk of project failure; and lower profitability of operation due to a lower volume of lending activities and possible provisioning on classified loans.

As most businesses funded by NDFIs struggle for survival, supporting these businesses may also increase the risk on DFIs' liquidity – the prudential limit being breached with a significant constraint on the capacity to offer financial support on the scale that will likely be required to help economic recovery.

It is expected that most DFIs providing guarantees may face a certain risk of cascading calls on guarantees for projects in progress and previously approved. Also, in a context of strict limitation on granting new credits at the level of lending banks, guarantee requests addressed to guarantee institutions will be rare.

Deterioration in asset quality

As businesses and projects funded by DFIs get stressed, and in a good number of cases some projects will halt, it is envisioned that most DFIs will face the risk associated with cash flow cycle, decline in revenues and high default rates in loan re-payments in the coming months, based on business analysis and payment deferment. Thus, the anticipated surge in Non-Performing Loans is projected to be about 60% arising from the MSME difficulties in servicing their loans.

Moreover, a decrease in return on DFIs' assets, an increase in counterparty risk, an increase in the level of provisions induced by the outstanding payments recorded, resource scarcity (fewer opportunities to access resources at moderate cost) and poor project financing capacity will be evident. The impact of these will weaken the viability of projects under implementation, and negatively affect most DFIs' profitability and financial sustainability.

Business operation and business continuity

The risk of exposure of staff to Covid-19 and the need to adopt protective measures in line with the established protocol will redefine the way DFIs operate henceforth. Already, as in most institutions, there is a re-configuration of the approach to working in terms of flexibility and teleworking.

The situation will also result in a change in client and staff engagement models and possible delays in project evaluations and diligences due to travel restrictions, especially for national DFIs with cross-border projects.

AFRICAN NATIONAL DFIS RESPONDING TO COVID-19

Therefore, African DFIs should take their response to the pandemic as a measure of their strengths and weaknesses in designing innovative development products.

Business strategies and processes are being revised in most national DFIs in the wake of the disruptions brought by the pandemic. This includes a review of the contingency plan and re-engaging with stakeholders, including existing clients, to understand the expected impact of the pandemic on their activities. The result in most cases indicated that at least 40% of clients expect the current challenges to impact their ability to meet upcoming debt obligations. Thus, NDFIs are reviewing their clients' liquidity position and evolving a payment deferment for up to six months and above.

Some institutions have incorporated the impact of Covid-19 into their short- and medium-term strategy. They have created a dedicated fund for Covid-19 to support the financing of business in the health industry and to facilitate the procurement of essential supplies and finished goods specifically geared toward mitigating Covid-19.

Protection of employees

All member DFIs took proactive measures to keep employees safe and have implemented a business continuity plan, as work is now mostly done remotely.

Downward revision of budget

The cut in business activities and expected negative impact on cash inflow have compelled most NDFIs to review their operating budget downward, with up to a 30% slash across the board; and to reduce their total expenditures by up to 25% in the first instance, with a view to adopt further cuts in other non-critical expenses depending on macroeconomic outlook over the next three to six months.

Portfolio review

Portfolios have also been revised to establish anticipated credit risks per sector and per client to devise survival strategy, activate contingency funding plans and explore the possibility of getting funds to absorb the effects of Covid-19.

Besides, projects are being prioritized with an emphasis on strong financial viability and, in some cases, on a less risky asset to optimize limited financial resources. Some projects may have to be sold off, according to some DFIs, to reduce financial stress and create the capacity to complete the most viable projects.

Review of credit term

Most institutions have revised credits terms to about a 180-day moratorium on existing credit facilities for households (extendable to 360 days) and other loan conditions relaxed to ease affordability challenges as a proactive measure to avoid loans going bad.

NDFIs are reengineering their balance sheet projections while also requesting their lenders to grant a moratorium to cushion the liquidity impact.

DFIs are, however, expected to apply the instruments of debt relief selectively to reward their historically well performing clients and thus to reduce the impact of the pandemic on the present and future NPL Ratios. As bad as the situation is, stronger DFIs may also be shaken, but the pandemic should *not* lead to the demise of DFIs.

The pandemic creates an opportunity for DFIs to prove their relevance to governments in Africa through strategic planning and the introduction of innovative approaches to the delivery of their mandates.

SUPPORT REQUIRED BY NDFIS IN ADDRESSING COVID-19 CHALLENGES

- Concessional debt funding, grants, provision of credit guarantee, liquidity support and a downward review of the term for credit lines obtained from multilateral banks in order to rescue businesses, support projects in the agricultural (transport, production, storage, energy, seed distribution, road maintenance) and pharmaceutical sectors to save existing businesses and jobs.
- The need to engage with governments for capital injections into national DFIs, channel development funds and funds provided by development partners through the national DFIs to be directed to appropriate sectors to stimulate economic activities.
- A waiver on limitations to the restructuring of credit facilities that may be at risk; temporary capital and liquidity relief to provide DFIs with enough time to build up capital buffers; and a postponement of compliance requirements such as single obligor limits for one year.
- The need for relevant technical assistance and capacity building in the following areas, among others, are required to reinforce capacity in member institutions:
  - Business Continuity Plan (BCP).
  - Stress testing framework covering finance, technology,

risk management etc.
  - Crisis management and risk assessment during crisis for DFIs.
  - Fintech, digital banking and management of remote teams.
- The need to share knowledge across institutions, during and after the crisis, on how DFIs are responding to ensure the survival of the funded MSMEs and institutions.
- National governments should take their DFIs into confidence by involving them in development policy formation, passing special financial support to businesses through them as part of measures to institutionalize such support and equip DFIs for future response to emergencies.