

2009 Financial Sector Symposium:

# **Preserving Access to Finance during the Global Crisis**

A Joint Initiative by BMZ, FMO, and KfW

Hosted by KfW

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## **1 Overview**

The 2009 Financial Sector Development Symposium, “Preserving Access to Finance during the Global Crisis” is timely to discuss issues and solutions as the crisis unfolds and challenges our efforts to protect achievements in access to finance for the poor in developing countries. After nearly a decade of buoyant growth of developing and transformation economies, benefiting from high demand and increasing globalization, the global financial crisis that originated in the West has reached the developing and transition countries. The crisis risks to reverse the massive achievements in broadening and deepening access to finance for the poor. The intensity of contagion and severity of the impact that is now unfolding poses challenging questions as to the benefits of globalization, and the ability of governments, financial institutions (FIs) and individuals to manage risks associated with it. The crisis also mirrors structural weaknesses of financial markets and FIs and reveals their high exposure to foreign exchange risk and maturity mismatch in the absence of long term funding in local currency. This challenge is at the heart of development finance and requires reflection on the achievements of market based financial systems and our ability to maintain outreach, while effectively addressing problems and keeping the risks in check.

The symposium will

- (i) share lessons of crisis vulnerability and resilience from the perspective of governments and FIs;
- (ii) blend professional experience from public and private sources; and
- (iii) provide a platform for reflecting issues and developing solutions that contribute to restoring stability and confidence in the markets and maintaining access to finance for the poor.

Public private partnerships are essential where the general public has lost trust in the markets. The symposium is set to contribute to boost confidence in market based development finance and explore how to maintain sustainable outreach of finance to the poor, while enhancing the resilience of financial systems, institutions, and people in mastering the crisis and returning to growth.

This event is jointly organised by the German Federal Ministry for Economic Cooperation and Development, FMO, and KfW. It will be held on December 3-4, 2009, at KfW, Berlin and limited to about 70 international participants composed of policy makers, practitioners and financiers.

## **2 Financial Markets under Stress**

With its origin in advanced economies, the first round effect of the ongoing financial and economic crisis has spilled over to emerging markets in October 2008 in the wake of the liquidity crunch generated by the bankruptcy of Lehman Brothers, a systematically important investment bank in the US. Among developing countries, emerging market countries were first hit by the crisis given their significant exposure to international financial markets. During 2008, private capital flows to developing countries witnessed a nearly 40 percent drop from their USD 716 billion peak in 2007 and are likely to be negative in 2009.

FIs in low-income countries were so far somewhat shielded from the crisis through factors such as stable funding in domestic savings, high liquidity reserve requirements, small interbank markets, and tight capital transfer controls. The resulting limited attractiveness to foreign capital in these countries has thus shielded them from the benefits and risks of international market access. However, as the global real demand weakens nonperforming loans in those markets will rise as well. As a result of weakening labour markets in advanced economies, remittance flows to developing countries have dropped since October 2008. Remittances are projected to further fall significantly over 2009 and to adversely affect demand in developing countries.

World GDP will decline in 2009 for the first time since World War II. Developing countries' GDP growth is estimated by the IMF to drop from 6.1% over 2008 to 1.6 % over 2009 and will be associated with declining real per capita income in more than 50 developing countries. The World Bank and IMF estimate that the crisis will push another 90 million people into extreme poverty over 2009, challenging the path for achieving the Millennium Development Goals.

As a result of the liquidity crunch banks and investors in developed economies have sharply reduced their credit exposure to emerging markets and developing countries. The global re-assessment and re-pricing of risk and the subsequent de-leveraging process in developed economies have led to sharp drops in funding for the private sector and steep increases in interest margins. Emerging market currencies witnessed sharp devaluations since October 2008, and some have lost large foreign exchange reserves in an attempt to stem pressure on their currency. With their relatively open capital accounts countries like Brazil, South Africa, and Eastern Europe, who experienced short-term capital inflows from carry trades in the past, are now witnessing extremely volatile and illiquid foreign exchange markets.

Primary goods exporting developing countries have been hit by both declining demand and prices and subsequently reduced creditworthiness. As a result countries like Angola and Nigeria have suffered from diminishing revenues and access to international financial markets.

Even low risk trade finance in developing countries has been massively affected through the ongoing deleveraging process that led to a reduction of banks' risk limits and a liquidity crunch in early 2009.

Low income countries (LIC) suffered less from the first round effects but are exposed to sharp reductions in worker remittances, reduced commodity export revenues, reduction in creditworthiness and access to finance.

Under such circumstances, developing countries' FIs and entrepreneurs operate under increasingly challenging conditions. Lenders, especially those with limited or no access to domestic deposits, have to scale back their business and simultaneously deal with open currency positions on their balance sheets and loan quality issues in the context of devaluation. Borrowers who have taken substantial open currency positions are facing liquidity and solvency problems after the appreciation of the U.S. dollar since mid 2008 and refinancing may be hard to obtain in such an environment. The pernicious impact of reduced access to external financing is exacerbated by the tightening of domestic inter-bank credit reflecting mistrust among market participants. Risks for financial institutions are rising, especially those dependent on foreign funding

in the wholesale markets and limited access to deposits. The crisis is also testing the FIs' management ability in containing such risk through effective asset-liability management. This downward spiral risks to prevail for some time. The crisis has put financial systems and FIs in developing countries under severe stress and raises questions as to how development finance can further preserve access to finance for the poor. It also raises the issue of appropriate resolution mechanisms for the ongoing crisis and future preventive measures that improve the robustness of financial markets, FIs and their clients in withstanding the impact of crisis.

### **3 Objective of the 2009 Symposium**

The 2009 Symposium aims to enhance the understanding of key vulnerability and resilience factors for different country types, the options for FIs in preserving access to finance for their clients and improving their crisis management, and opportunities for strengthening the resilience of markets.

The Symposium is also a platform to expand partnerships between donors, policy makers, managers, and private investors engaged in development finance to restore and expand the outreach and range of services that financial institutions offer to low-income clients.

An introductory panel will shed light on macro issues in the real economy and financial sectors that limit the choices of policy makers, financial institutions and the target beneficiaries in responding to weaknesses highlighted by the crisis. The subsequent three panels explore approaches and strategies of:

- (i) FIs in preserving access to finance to the target group,
- (ii) FIs in enhancing internal crisis resilience through management capabilities, and
- (iii) Strengthening the crisis resilience of financial markets in developing countries.

Based on that debate the subsequent panel will review external support for development finance and explore options for improving relevance and effectiveness in addressing the needs of crisis and financial systems development. A concluding panel will discuss the key findings, open issues and recommendations. For each topic a keynote speaker will present a research paper to be followed by a panel discussion among four panellists.

## **4 Symposium Topics**

### **4.1 Crisis Resilience and Access to Finance- The Macro Perspective**

Developing and transition economies have been hit by three macro effects of the crisis: (i) the credit crunch caused by the withdrawal of international investors and financiers from emerging markets, (ii) the collapse of global real sector demand illustrated by sharply reducing trade of developed with developing countries, and (iii) the subsequent drop of domestic demand employment and profitability of businesses in developing countries. However the vulnerability and resilience has shown remarkable differences across the globe

The crisis has also shattered international trust in the global financial system built on current account imbalances caused by the large US deficits and surpluses of China, Japan and Germany. The role of developing countries in the world economy and their level of integration into it results in a variety of severity

and types of impacts and affects the policy options of a country in addressing the crisis. The panel will discuss country specific vulnerability and policies affecting access to finance and explore choices and limitation for financial sector policy makers and FIs to respond to the crisis. The panel will discuss the following issues:

**Global issues:** Is the global economy likely to return to the export led growth that was generated by the large current account deficits in the US? Can developing countries “export themselves out of the crisis? Who will substitute for the private investment shortfall to kick-start the economies? What can governments and external financiers contribute to stimulate the markets? What is needed to end the vicious cycle of deleveraging of financial institutions?

**Real economy issues:**

**Emerging Market Economies (EMEs):** How have liberal capital account and foreign ownership policies in local financial systems affected system stability during crisis? How has the global competitive position been affected? How well is fiscal strength and risk management to meet the cost of the crisis in the banking system and public stimulus to bridge period of market failure? What are benefits and cost of liberal versus more conservative market policies? Eastern Europe including new EU members, Asian and Latin American EME may be cases for illustration.

**Developing country primary product exporters:** How can exporters of primary products enhance their resilience against high volatility of demand and prices? What are suitable buffers against external shocks? How can income streams be diversified? African and Middle Eastern raw material exporters may serve as examples.

**Low income countries (LIC) and EME low income market segments:** How well are less integrated markets and market segments shielded from the crisis? What is the impact of weakening global demand on LICs? Do food producing LICs and rural EME segments benefit or suffer from the weakening global demand? Should LICs open their markets or stay isolated from the global markets? How has the demand in labour importing countries affected worker remittances to low income countries? What are appropriate strategies for growth and risk taking for LICs? Given their different market size and environments African Latin American and Asian LICs may provide a variety of options.

**Financial Sector issues:**

**Savings markets:** How do domestic private savings affect crisis resilience? Are domestic resources sufficient to develop the economy? Does the public trust the banking system? What are essential policies stimulating confidence in local markets? Eastern Europe and emerging Asia may illustrate the differences.

**Domestic or foreign currency financing:** Has the leapfrogging strategy through capital imports worked? What were the benefits and risks of external capital inflows? Can countries afford the common use of foreign currency in their economies? How does the public perceive benefits and risks of holding foreign and domestic currency assets and liabilities? What can Governments do to build trust in the local financial system its currency? Dollarized markets in Eastern Europe and Latin America may be cases for illustration.

Panellists: Professionals representing various regions of the world with a central banking, domestic and international financial institutions background.

#### **4.2 Preserving Access to Finance of Financial Institutions and its Clients**

Long term client relationships are critical for the success and stability of FIs' business models and the clients' ability to survive the crisis. A long term vision on that client potential is essential for both. However, FIs' responses differ widely by institutional type, and the culture of the organizations. Client orientation, ownership (domestic, foreign, or state owned), sources of funding (customer deposits versus external lenders and investors), subsume in different business models.

The panel will discuss FIs' responses to the crisis and illustrate the impact of their business model and strategy on the resilience vis-à-vis its clients. It will explore the diversity of FI choices to improve resilience and preserve access to finance in discussing the following issues

Importance of MSME, households and corporate customers in the business model: How important are MSME customers as a source of funding and as customers for other financial services (loans and payments)? Are individuals and SMEs customers recognized as pillars for income generation and funding stability? How are policies and incentives defined to support stable provision of services to that segment? How are small business and corporate client relationships anchored in the business model? To what extent do FIs maintain a long term vision on their client relationships and market orientation?

Loan origination and know your customer policies: Quantitative and credit scoring and branchless banking models have been advocated as cost effective models to develop mass retail markets. Have these models proven effective in assessing the financial needs and risks of individual customers? Do banks operating under such models know their customers? Or do these models impose undue risk to the FI and its customers? How is customer financial literacy developed?

Loan recovery. The crisis may prompt different loan recovery and management strategies ranging from forbearance to strict imposition of foreclosure. Is foreclosure an effective strategy in the short and long run? What are the merits of a cost intensive restructuring of affected customer loans for the long term relationship and profitability of the FI? Where are the limitations for keeping customers whose income and profitability weakened during crisis?

Pricing. Which are appropriate FI risk provisioning and pricing policies that compensate for compressed lending margins and increased risk? What are acceptable pricing and fee levels that support debt servicing abilities and livelihood of customers? How can risks of customers be mitigated during crisis?

Product selection. Can savings products serve as sufficient safety nets? What is the potential market for such services in different income segments? How can these products be offered by the FIs?

#### **Institutional type Issues:**

Deposit taking banks. Are banks with a large deposit base more resilient to external shocks? What are appropriate strategies to respond to bank runs? Are state owned banks perceived to be more reliable for

the public? Are cooperative and savings banks and banks in rural areas more robust compared to their commercial bank peers that focus on urban areas?

What are strategies for non deposit taking institutions to preserve access to funding and lending to clients?

How do responsible finance policies support trust in the public?

Panellists: Banking and NBFIs professionals from various developing countries, with different institutional FI backgrounds (commercial, rural, cooperative, microfinance, funds and financing companies) supplemented by supervisory experts, will discuss their experience.

#### **4.3. Enhancing Crisis Resilience of FIs and its Management**

Tightening liquidity, rising Non Performing Loans (NPL) and capital requirements, decreasing net margins, asset-liability mismatches require superior management and systems to keep risks in check. FIs' board oversight and management capabilities are essential in weathering the crisis. The panel will discuss the potential and limitations of FIs' to improve management and systems to defend against adverse impacts of crisis and preserve access to finance through their continued presence in the market.

The panel will discuss FIs' responses to the crisis and illustrate the impact of their managements, systems, and oversight mechanisms to prepare for and weather crises. The following issues will be discussed:

Managing liquidity. What can banks do to prepare for a liquidity crunch in the market in the absence of Government support? What are appropriate FI strategies to maintain confidence in the safety of deposits?

Managing open currency positions. What can banks do to prepare for massive devaluation? Which strategies work that limit foreign exchange risk exposure? How can open currency positions be hedged? What can be done by the Government in the absence of a cross currency swap market? How can FIs hedge against massive devaluation?

Managing maturity mismatch. What can banks do to prepare for a collapse of term financing? Which strategies allow proper management of the term structure of assets and liabilities?

Managing repricing risk. Under volatile markets, which strategies allow FIs to manage re-pricing risk and adaptation to changing funding cost and risk margins? Which solutions do exist without interest rate swaps?

Asset liability management (ALM). How can board ALM committee members be made fit to understand the content of stress tests and its implications for the solvency and profitability of the FI?

Provisioning policies. Do FIs' business plans and strategies provide for adequate risk buffers through conservative valuation and risk provisioning and capital need estimates. What are effective strategies to mobilize equity at short notice?

NPL Management. How effective are strategies of debt collection and loan restructuring?

Profitability and Capital adequacy. Are highly profitable and profit oriented institutions more exposed to financial stress? What are appropriate strategies for banks and NBFIs to secure capital adequacy and

business growth? How are appropriate strategies including asset liability management policies, systems and controls designed?

#### **4.4. Enhancing Crisis Resilience of Financial Markets**

Under tight budget limits and high indebtedness many developing countries face constraints in providing additional liquidity or guarantees to restore market confidence and support bank liquidity, recapitalization and asset resolution needs. Cost effective strategies are critical to support the turn around of insolvent FIs.

Some developing countries, especially in Eastern Europe have followed an aggressive path of development inviting foreign capital, while large economies in Asia have pursued a more cautious domestic oriented approach. This raises the issue of a country's capacity to manage open capital flows and associated risks.

Financial systems with a strong local currency funding base through savings and bond markets may be less exposed to international contagion compared to those who rely largely on international capital. Developing countries show diverse scale and depth of savings mobilization. A strong domestic currency savings culture normally reflects banking systems in stable political and macroeconomic (low inflation) environments, while countries with many bank crises and concurrent low public confidence in the banking system lead to capital flight, savings in real assets and cash under the mattress. The effectiveness of public bailout and Government letters of support and deposit insurance has produced mixed results.

Deposit mobilization is usually associated with short maturities, does normally leave a large gap for funding long term investments. Developing local currency bond markets has been recognized as useful in tapping long term resources and providing stable funding to FIs. However, high level government support over an extended period is necessary to develop the market.

In addition to these long term aspects the crisis requires a review on effective asset resolution and work out strategies and the pros and cons of in-house work out and specialized asset management companies or bad banks need to be discussed. This needs discussion of the policies and implementation experience for bad debt restructuring, as well as the broader regulatory and governance framework that needs to be put in place through laws, regulations, operating policies and appropriate systems, management, and oversight.

The panel will explore the potential for enhancing the use of local currency for savings mobilization and capital market development as well as the scope and limitations of prudential frameworks in enhancing markets' crisis resilience and preserving access to finance. by discussing the following issues:

How can local deposits be mobilized at a large scale? Has deposit insurance helped to improve confidence in the public? How are effective consumer literacy programs designed and executed? Are existing bank licensing policies sufficient and which role plays consumer protection?

How can government support developing the bond market? How can FIs and provident funds benefit from bond market development? Do savings/investment products respond to the needs of the market?

How effective are national programs to enhance liquidity and capital adequacy? Can liquidity and equity enhancement programs focusing on individual FIs be effective in the absence of market stability?

What are effective strategies for banks' bad debt resolution? Does temporary regulatory forbearance work to address capital shortage or does this constitute moral hazard for banks. Do asset management corporations work? Should financial institutions retain their assets? Which financial institutions merit public support and how are fiscal contingent liabilities held in check? What are the implications of the recent coordinated regulatory response to the crisis on the presentation of risks in financial statements and capital adequacy of FIs?

Panellists: Professionals from various regions of the world with a strong central banking and capital market development background.

#### **4.5. Preserving Access to Finance – Improving Development Finance Effectiveness**

The unprecedented depth of the ongoing global crisis requires massive stimulus and structural support packages to restore confidence in the markets. Since October 2008 rapid deterioration of the situation emphasized the need for a very fast response, challenging to the development finance institutions' normal modus operandi. Structural weakness of financial sectors came into the open highlighting the need for structural reform. The crisis merits a review as to whether development finance interventions respond adequately and timely to meet urgent needs, and support structural reform.

The panel will discuss the relevance and effectiveness of conventional DFI interventions through the following issues:

Relevance and effectiveness of existing operations. Have established interventions supporting small business finance through funds, equity investments, loans, guarantees and securitization supported crisis resilience of beneficiary FIs? Which enhancements are necessary to support crisis resilience? Which are limitations for donor support and where do governments need to extend their support? Mitigation of foreign currency risk exposure to target group and FIs is an example.

Specific crisis interventions. How are strategic liquidity interventions designed, key beneficiaries selected and their performance monitored under very tight time schedules? What is the use of trade liquidity and trade guarantee programs and what is the time horizon for such programs? How can such programs be effectively targeted?

Maximizing resources. What is the use of donor and private resources for example through funds and what are applications on national, regional and global scale? How can different donors enhance their effectiveness and collaboration?

New Instruments. How can fiscal stimulus and structural financial sector reforms be effectively supported? In which cases are policy based lending programs adequate to support structural reform and recapitalization of the banking system? How can income stability of the target group be enhanced? How can these programs be effectively designed and monitored?