actiam
PERSPECTIVE

Financial inclusion:
investing in the engine of economic growth

Today, 1.7 billion people of a total of 7.6 billion people remain unbanked, lacking either an account at a financial institution or at a mobile money service provider (IFC, 2018). Furthermore, research estimates that there 65 million formal MSMEs face credit constraints, representing 40 percent of all enterprises in 128 reviewed countries (IFC, 2017).

Investing in Sustainable Development Goal (SDG) 1 - No poverty (end poverty in all its forms anywhere) and SDG 8 - Decent work and economic growth (Promote sustained, inclusive and sustainable economic growth, full and productive employment and decent work for all) offer enormous potential for investors to generate financial and non-financial results by promoting access to finance for micro-, small- and medium enterprises (SME).

A PROMISING INVESTMENT CATEGORY WITH ROOM FOR IMPROVEMENT

Since its start, microfinance has been a promising investment category given its potential to deliver solid returns to investors and simultaneously serve millions of low income people in developing and emerging countries who lack proper access to financial services. More and more, we witness a trend of growth into the SME segment. SMEs contribute up to 45 percent of total employment, create 4 out of 5 formal jobs and generate up to 33 percent of national income in emerging countries. However, we do need to think critically about how financial services offer value to customers. How regulation can strengthen, instead of hinder financial inclusion efforts. How financial inclusion efforts can be addressed more structurally, keeping in mind the strong population growth and hence the number of new young micro, small and medium entrepreneurs in emerging countries in the years to come. And finally, how investors can increasingly contribute to the financial inclusion of the other half of the population in emerging countries by investing responsibly in financial institutions with an attractive risk-return profile combined with strong governance and a client-centric attitude.

THE ROLE OF PRIVATE INVESTMENT FUNDS

In order to make financial inclusion investable, responsible asset managers and banks such as Responsibility, Blue Orchard, Triple Jump, Triodos, ASN Bank and ourselves pool investments in microfinance institutions (MFIs) and financial institutions (FIs) targeting SMEs via private investment funds. These funds are accessible to both a retail and an institutional target audience for over a decade. A decade that was characterised by numerous challenges such as a financial crisis and economic downturn due to which interest rates dropped and local currencies depreciated against hard currencies. But also politically motivated regulatory challenges such as interest rate caps. While these caps can have positive effects, a limit that is set too low can lead to FIs finding themselves unable to serve remote clients when costs can no longer be covered.

Challenges were also encountered at the MFI level, ranging from over-indebtedness and high interest rates to large-scale fraud that was not detected by auditors or rating agencies. Nevertheless, Dutch investors in the inclusive finance sector jointly committed around € 4 billion in 2017, showing a steady increase over the past years (NpM, 2018). The SMX – MIV Debt index, covering 7 fixed income microfinance funds, presents decent returns and at the same time display an impressive outreach to low income people worldwide. Investment funds increasingly target the SME segment and as such, support successful entrepreneurs on their growth path.

This is a publication of our Impact Investing team, consisting of 8 professionals with an average experience of 15 years in the industry.

As per end of December 2017 the team manages around €1 billion.

ACTIAM is *the* responsible asset manager for more than one million people. With over 100 staff we manage €54.1 billion (ultimo December 2017) primarily for insurance companies, pension funds, banks and intermediaries. ACTIAM invests for its clients not only to achieve an optimal financial return, but also a social return. We do this by taking into account the consequences for the environment and society and continue to develop responsible investment solutions for the general public.

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FINANCIAL INCLUSION

Financially included individuals and businesses have access to useful and affordable financial products and services that meet their needs, delivered in a responsible and sustainable way. They are better able to improve their economic situation by investing in their health, education and businesses. They can also build a buffer to smoothen their income, make payments and absorb shocks and emergencies. Digital financial services are on the rise and are an innovative time and money saver as they ease collection of money and lower transaction costs. MFIs and FIs with a specific focus on financial inclusion (such as a universal bank with a significant exposure and dedication to SMEs for example), are the enablers of financial inclusion. They are the ones who go above and beyond to serve their client's interests due to a DNA that is drenched in financial and societal advancement and is embedded throughout the organization. It is up to investors to carefully select those institutions that truly live up to that promise. A supportive enabling environment and often, financial support from international (impact) investors are key to development of these institutions.

LESSONS LEARNED

We enabled access to the microfinance sector for institutional investors, which was quite distinctive at the time of the launch (2007) as most microfinance funds were retail funds and operated on a smaller scale. Independent research[1] presents lessons learned by ACTIAM and the sector based on the above described challenges and experience in the industry.

An example is the progress that has been made in terms of responsible lending practices as depicted in the timeline below. Also in terms of fund management, several valuable lessons were learned. Looking more critical to the shareholder base of an MFI (such as the presence of international shareholders), strong governance structure in place and whether there are possibilities to further increase diversification in terms of country and currency exposures and improving client reporting.

ENHANCING INVESTMENT OPPORTUNITIES

Even though we notice that investor's appetite for private debt investments in emerging countries is increasing, risk perceptions are generally higher than the actual risk. Often, there are no standard references available and information cannot be found through a Bloomberg portal. Due to its low volatility, low loss default, low correlation with other asset classes, strong diversification, stable returns and cash flows from interest payments, financial inclusion does provide an interesting investment opportunity to investors. If we can overcome some of the remaining challenges concerning relatively high costs of most retail funds, supportive legislation, little research and data available and too little actors in the space, this will support increased investment in and development of the sector. Through sector initiatives, some of these remaining challenges are being tackled. In order to further advance sustainable development investments – and financial inclusion investments in particular – it is also a key responsibility of private investment funds to educate investors and other stakeholders about the opportunities, risks and ways to mitigate these risks.

Timeline of some of the key responsible sector initiatives with regards to promoting financial inclusion

the smart campaign	Social Performance Task Force	PRI Principles for Responsible Investment	Sustainable Development Goals	GIIN / PRI
2008	2011	2012	2015	2018
Smart Campagne	Responsible covenants	PRI-led PIIF	Sustainable Development Goals	GIIN Navigating Impact
Client Protection Principles	Set of guidelines	Principles for Investors in Inclusive Finance	UN-led global initiative	Financial Inclusion launch
Sector initiative to keep clients the driving force of the industry	*Lender's initiative facilitated by the Social Performance Task Force to align responsible covenants*	*Framework for responsible investment in inclusive finance*	*Global sustainable development agenda for 2030*	*Help select imoact strategies and adopt core sets of metrics that track performance*
	Universal Standard for Social Performance Management			UN PRI Market Map
	Comprehensive manual of best practices			Step-by-step process
				Resource to help identify and differntaate impact investment opportunities

17 PARTNERSHIPS FOR THE GOALS

[1] In order to mark the close of ACTIAM's first two institutional microfinance funds, Mr. Lambrechtsen performed an independent review on a decade of microfinance activity. https://www.actiam.nl/nl/documenten/fondsen/Documents/impact-investing-fondsen/Independent_Review.pdf

During a study trip to Cambodia in September in 2017, investors witnessed first handed how the financial sector transformed from donor dependent to commercially viable institutions. Interest rates in Cambodia had dropped significantly already, annual portfolio growth was high and Cambodian MFIs were among the top winners of international awards for excellence. The instalment of the Credit Bureau Cambodia and continuous development of environmental and social standards were part of the country's journey to improve financial products and services for low-income people.

Unfortunately, progress can be fragile, as in December 2016, the Cambodian government set a ceiling of interest rates charged to microfinance clients. This ceiling was set at a level whereby most MFIs cannot cover their cost-base and it becomes loss-making to serve remote clients. These are exactly the clients that generally face the most severe constraints to become financially included. This can result in MFIs not being able to reach out to those clients, leaving low-income borrowers no choice but to revert to unregulated options such as loan sharks. Such events can undo the progress made in the past decades in terms of professionalization, transparency and client protection. At the same time, it poses an inequality threat as urban micro enterprises continue to grow and are becoming small and medium enterprises. Advancing financial inclusion is a cautious dance between all the actors involved and continued support by regulators, credit bureaus and investors as well as even further professionalisation of MFIs and FIs targeting the SME segment are key to overcome this aspect of fragility.

COOPERATION IS KEY TO TRIGGER SPILL-OVER EFFECTS TO OTHER BENEFICIAL AREAS

Investments in financial inclusion efforts increasingly recognise and target spill-over effects to other socially, environmentally and economically beneficial areas. Financial inclusion is not a goal in itself, but a crucial means to an end. Therefore it is not recognised as an individual SDG but is reflected in the sub-goals of 7 of the in total 17 SDGs. Examples include the development of a green leasing product, with technical assistance from FMO, targeting SMEs that not only provides deprived small businesses with capital expansion opportunities but also targets a country's CO_2 footprint (SDG 13 – Climate action). Or take the example of Oikocredit's efforts in providing financial products and services to refugees (SDG 10 – Reduced inequalities). As one of the founding members of FINISH, we contributed to sanitation improvements over the past 9 years (SDG 6 – Clean water & sanitation).

This led to the development of 700,000 safe sanitation systems, over 10,000 additional jobs and awareness raising of the importance of sanitation among 14 million people. FINISH developed into a professional organisation, called Finish Society cooperating with specialised partners such as WASTE, AMREF, Unicef, Amul, WSSCC, UNU and Aqua for All. Finish Society now hires 100 employees and expanded into 4 other countries besides its country of origin, India. Key to this success was the willingness of a handful of microfinance institutions that saw an opportunity to improve sanitation and health by fostering access to finance.

INCREASING ENGAGEMENT BY INSTITUTIONAL INVESTORS

The inclusive finance sector witnessed a steep professionalisation curve in the past decade. As a result, this sub-sector of impact investing market becomes increasingly better accessible and a more attractive investment category for institutional investors. The average fund size is increasing further as the sector moves increasingly towards the SME segment and investment opportunities become more scalable. Furthermore, a decent track record has been set by finance-first funds, loss rates are low and reporting requirements can be met. Hence, from a supply perspective, investment opportunities are apparent as a maturing sector can be matched to increased interest for institutional investors to engage in impactful solutions.

From a demand perspective, the finance gap for micro-, small-, and medium enterprises (MSMEs) in developing countries amounts to US $ 5.2 trillion, 1.4 times the current level of MSME lending. Great opportunities to include the unbanked while simultaneously advancing the SDGs by reducing inequalities and by creating decent jobs are for grabs. In order to close the SDG finance gap, Sustainable Development Investments[2] into listed companies while not suffice, upscaling private investments are key in realising the SDGs and have the potential to fill up to 72% of the annual financing gap (UNDP, 2017).The potential for both retail and institutional investors to generate attractive returns while diversifying their portfolio and investing in a proven and ever-developing sector that has the potential to catalyse global sustainable development is enormous.

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[2] Investing in solutions that contribute to the UN Sustainable Development Goals. These investments meet the financial risk and return requirements of pension funds and support the generation of positive social and/or environmental impact through their products and services, or at times through acknowledged transformational leadership.