

# Development Finance Institutions and Financial Inclusion: From Institution-Building to Market Development

**S**ignificant strides have been made in connecting the world's low-income populations and micro and small businesses to financial services. Yet, after decades, there are still large gaps in access, use, product offering, and quality of services. Several segments remain overlooked (e.g., rural populations, women, ethnic minorities, smallholder families, specific business sectors, etc.). Many countries still struggle with undeveloped financial systems—even when excluded populations gain access to financial products and services, many financial offerings are poorly designed, understood, or used. In the past, development actors assumed that access to capital was the main barrier to scaling financial inclusion, but over time, local bank financing and savings mobilization have increased, and foreign funding continues to grow (including through microfinance investment vehicles [MIVs]) (Soursourian and Dashi 2016). Other barriers that hinder financial inclusion include, among others, deficient market infrastructure, limited technological innovations, and restrictive policy and regulatory environments.

CGAP's "A Market Systems Approach to Financial Inclusion: Guidelines for Funders" (Burjorjee and Scola 2015) encourages funders to take a market systems approach to financial inclusion, arguing that only a more systemic approach can make a significant and sustainable contribution to financial inclusion (see Box 1).<sup>1</sup> Applying a market systems approach requires funders to understand the market system more deeply, taking into account the interplay of different market actors and the functions they perform (or fail to perform) in the system. Key functions in the market system for financial services include demand, supply, supporting functions, and rules and norms (see Figure 1). The shortcomings of market systems are

often deeply rooted in established practices and behavior of market actors, which are shaped by the information available to them, their capacity, and incentives. These barriers are complex, making them more difficult to address than funding gaps. They require funders to address underlying problems that prevent markets from becoming more inclusive. Rather than strengthening individual market actors (e.g., financial service providers [FSPs]), a systemic approach to financial inclusion requires funders to set the right conditions for these actors to adopt new, more inclusive behaviors and to stimulate uptake of the new behaviors beyond initial partners and the duration of a funder's intervention. Systemic change occurs when market dynamics have changed sustainably and result in a more inclusive financial services market. This approach requires being open to taking risk, being flexible, identifying new investment opportunities beyond FSPs, and having a willingness and ability to learn from failure.

## Funding for FSPs Is Not the Stumbling Point

DFIs play an invaluable role in developing financial markets and have been key to strengthening and building FSPs that serve low-income markets. As seen in Figure 1, these FSPs are a niche "supplier." DFIs' financial inclusion commitments are heavily concentrated on financing these retail FSPs (92 percent of commitments; see Figure 2), which helps to address FSPs' funding constraints. When adding capacity-building grants to FSPs (4 percent), 96 percent of DFI commitments are dedicated to financing or strengthening the supply side in the financial services market, and it is uncertain as to what extent other market barriers to financial inclusion are addressed by DFIs' interventions.

<sup>1</sup> In this paper, "market development approach," "systemic approach," and "market systems approach" are used interchangeably in referencing changes to the financial services market.

### **Box 1. What is a market systems approach to financial inclusion? And as it is applied to DFIs?**

A market systems approach aims to catalyze systemic change—change that is significant in scale and sustainable. The following are key features of a market systems approach:

- **Consideration of the whole market system (not just the supply side).** Overcoming barriers to financial inclusion requires addressing underlying constraints in the market. The lack of providers serving low-income segments is often a symptom of underlying problems that might be linked to an unconducive policy environment, a lack of understanding of excluded segments, or misaligned incentives.
- **Facilitative interventions.** DFIs—and other funders—need to think of themselves as facilitators

See Burjorjee and Scola (2015).

who encourage changes to incentives in the market system that enable a broad range of market actors to perform market functions more effectively.

- **Incentives and crowding-in.** In theory, DFIs play a temporary role in markets and should work toward crowding in market actors, including private investors. Crowding-in often requires setting the right conditions (e.g., transparency) and incentives.
- **Flexibility.** Adopting a market systems approach requires working with a broader range of market actors and responding to dynamic changes in financial markets. DFIs (and other funders) need to invest beyond prevailing business models; this requires flexibility and a higher level of risk-taking (e.g., innovator companies).

Our research suggests that DFIs can significantly increase their contribution to financial inclusion by (i) expanding their lens to thoroughly review how their interventions affect the entire financial system, (ii) growing their risk appetite to test new business models and delivery channels that help bring the poor into the financial system, and (iii) leveraging their technical credibility to facilitate market development.<sup>2</sup> Effectively, DFIs would help drive a more sustainable and dynamic market that ultimately presents them with new and more diversified investment opportunities, eventually benefitting the private investors they seek to crowd into the market. Several DFIs are considering broadening their scope of activities and realize that they may need to take more risks, but it is not clear how they will do so.

Deploying a market systems approach would help DFIs frame their investment strategy within the broader context of market change and higher DFI additionality. Cambodia provides an early DFI example that preceded and resembles the modern day “market systems development” approach. In Cambodia, a small group of coordinating DFIs and donors not only funded a promising microfinance institution (MFI) in a risky undeveloped market,

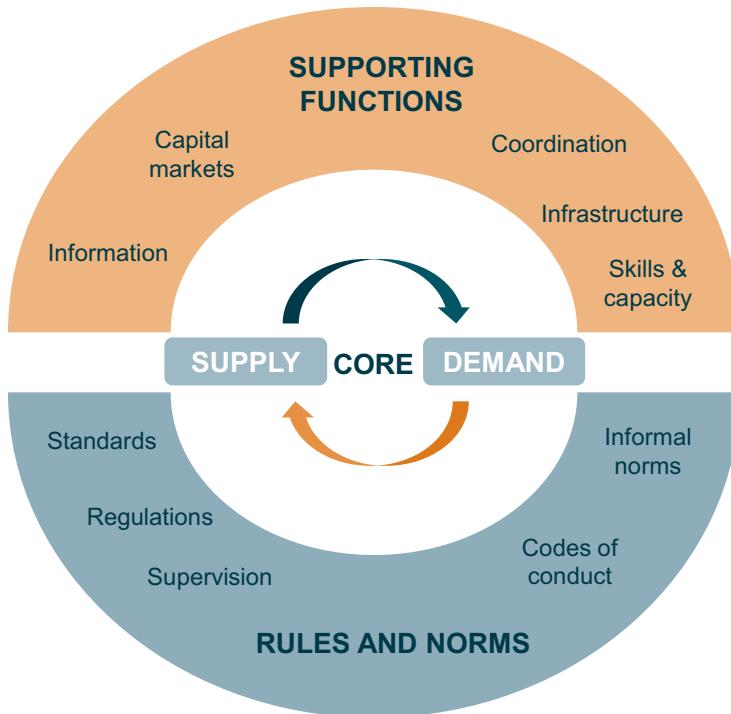
but the group also advocated for policy and regulatory changes that ultimately created a robust microfinance industry. Further, the NGO became the country’s largest commercial bank, serving many remote communities (70 percent of its portfolio is classified as rural), and expanding to two other Asian countries (see the following section, “DFIs Deploying ‘Elements’ of a Market Development Approach: Mini-Cases”).

This paper aims to show what a market systems approach could look like by highlighting cases of DFI contributions to market development and by addressing the challenges and requirements DFIs face and ways they can influence broader market change.<sup>3</sup> Interviews were an important component of our research and recommendations; more than 40 industry experts, including those working in DFIs and MFIs, consultants, and digital finance experts, were interviewed. The paper promotes the idea that DFIs can and often should play an expanded role in promoting market development beyond an investment-only approach (e.g., supporting policy and regulatory changes and providing advisory or technical assistance on critical market innovations). The market systems approach does

<sup>2</sup> “Technical credibility” refers to many DFIs’ recognized expertise on finance, banking, legal, and other private investment-related matters, including overlaps in policy and regulations.

<sup>3</sup> This paper discusses how DFIs pursued “elements” of a market development approach to address needed changes in how a particular market was functioning. It does not address how to measure the impact of market development programs. (CGAP is working on a separate market systems measurement handbook, which will go deeper on this topic.)

**Figure 1. The market system and main market functions**



Note: This diagram was adapted by CGAP from the Springfield Centre's Making Markets Work for the Poor (M4P) framework, commonly known as a market systems development approach. The framework seeks to change the way markets work by addressing systemic constraints and engaging market actors to create large-scale, lasting benefits for the poor.

not suggest that DFIs become more like donors (managing large grant programs) or that donors become more like DFIs (setting aside sizable amounts of their budget for investments). Their traditional and complementary roles remain intact, with the flexibility for different types of funders to participate in specific market initiatives where they have a comparative advantage.

## DFIs' Role in Embracing a Market Systems Approach

### Investing in development: Balancing financial and developmental returns

DFIs' mandate is to contribute to achieving development goals through investments in private-sector companies that yield market or near market financial returns. Their mandate and instruments

are complementary to bilateral and multilateral development agencies that provide predominantly grants and loans to governments, and rarely work directly with the private sector. DFIs' government shareholders expect DFI investments and interventions to have broad development impact. DFIs typically aim to deliver broader development impact beyond the direct outputs created by their investees—including economic growth, inclusive markets, and improved policy environments.<sup>4</sup> However, DFIs face difficult trade-offs between development and financial returns and have been criticized for not sufficiently prioritizing development outcomes (Savoy, Carter, and Lemma 2016). Incentivizing commercial investors to invest in projects with high potential development impact is core to achieving a DFI's mandate, and can be realized when DFIs invest early in new business models or help develop new market segments.

<sup>4</sup> See Bortes, Sunil, and Grettve (2011).

"Additionality" and "catalytic" are terms that are often used to describe the nature of DFI funding and the role it plays in market development. DFI funding is considered "additional" when funds are invested in countries, sectors, regions, capital instruments, or business models where commercial investors have not (yet) invested (Savoy, Carter, and Lemma 2016). It is considered "catalytic" if it crowds in commercial investors, particularly local investors. Yet, both descriptions refer to DFIs only as providers of funding and understate the facilitating role DFIs can play as suggested in the following.

### The DFI financial inclusion approach to date: Investment driven to FSPs

DFI funding for financial inclusion has continually increased since 2007 when CGAP started collecting annual data on cross-border funding, with DFIs representing 42 percent of estimated cross-border financial inclusion commitments globally as of December 2015.<sup>5</sup> The average DFI commitment for financial inclusion is \$8.9 million and has been relatively steady since 2013. Depending on DFIs' ownership, funding sources, and organizational structure, DFIs support financial inclusion in different ways. The three predominant engagement models are as follows:<sup>6</sup>

- Investments only.
- Investments combined with technical assistance (TA).<sup>7</sup>
- Stand-alone advisory services (generally for market development purposes).<sup>8</sup>

Not surprisingly, *investments* are the predominant engagement model, with debt funding being the primary investment instrument, followed by equity, and then guarantees. (See Figure 2a. Note that the

drop in both debt and equity reflected in this figure relates mostly to foreign exchange [FX] depreciation of the Euro during the period.) Equity investments have been increasing—making up 20–40 percent of a few DFIs' investment portfolios. Equity investments have a higher prospect of driving impact and influencing market development through three leverage points of equity: entry, governance, and exit (Lahaye 2016). Nonetheless, most equity investors—private and public—are focused on the financial returns of their FSP investees and are less interested in the change they might trigger in the market.

In terms of investment targeting, nearly all of the DFI commitments reported were exclusively for FSPs (92 percent). Investments in market infrastructure, where financial returns are uncertain or lower, and other types of companies, such as FinTechs, that play an increasingly important role in financial inclusion remain marginal (Figure 2b).<sup>9</sup> Roughly a third of DFI funding to FSPs is channeled via intermediaries such as MIVs (referred to in Figure 2b as "retail financing-indirect").

TA for retail FSPs represents around 4 percent of total DFI commitments. When the *investments* are combined with TA, TA funds primarily come from grants originated from several possible sources (internal budget line item, subsidies from third parties, and increasingly from collaborating TA grants from the DFIs' sister donor agencies or private foundations, for example). To date, the majority of this TA has been focused on FSP institution building, and experience to date suggests that this "retail TA" rarely has a deliberate or pronounced spillover effect into the broader market. At one of the larger DFIs, when TA is directed at the investee level (e.g., an FSP), it charges advisory fee revenues,

<sup>5</sup> The global estimate takes into account financial inclusion commitments reported to CGAP as of December 2015 by 54 funders (namely, public funders, such as donors and DFIs, and some large private foundations) (CGAP Funder Survey, 2015 data) and financial inclusion commitments (namely from private investors in MIVs) captured in the 2016 Symbiotics MIV Survey (2015 data).

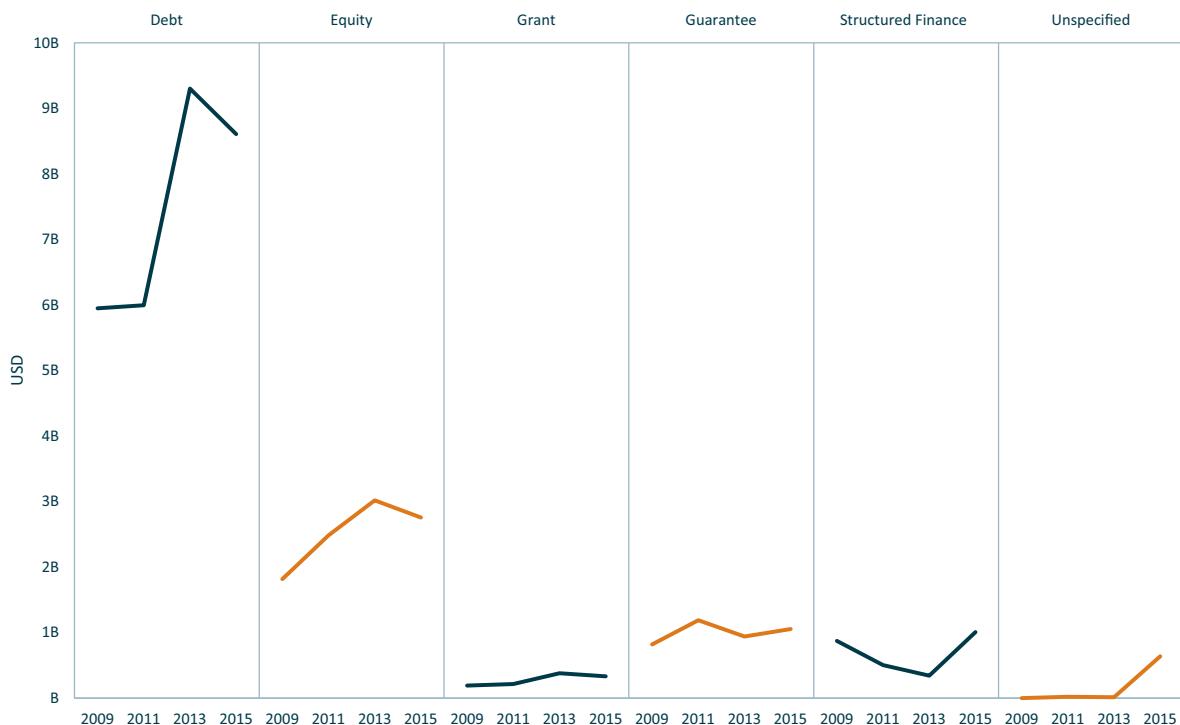
<sup>6</sup> The *investment-only approach* is the predominant DFI model (based on analysis of their funding survey responses with less than 5 percent allocated to noninvestments), since many DFIs source their funding from capital markets and need financial returns. For example, KfW raises 90 percent of its funding in capital markets and thus focuses on investments to ensure repayment of that capital (<https://www.kfw.de/KfW-Group/About-KfW/Arbeitsweise/Verantwortungsvolle-Refinanzierung/>).

<sup>7</sup> In this paper, TA refers commonly to strategic advice and other inputs, with a specific focus. Capacity building is used more generally to refer to knowledge- or skill-building efforts. TA and capacity building can be provided either directly by DFIs or contracted to third parties (more predominantly the latter). Funding for TA and capacity building can originate from various sources—internal DFI budget allocation, in conjunction with public donor programs, private foundations, and/or advisory fees charged by the DFI to the FSP or industry beneficiary.

<sup>8</sup> Occasionally, advisory services may be FSP-specific and compensated in part by the FSP.

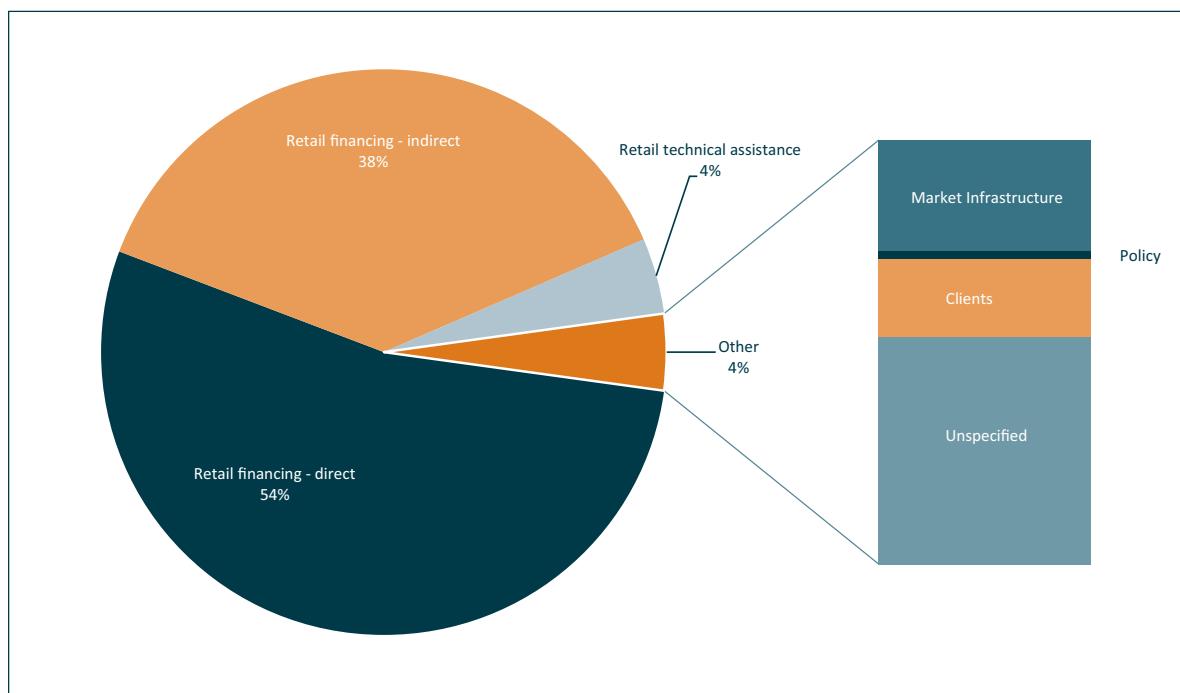
<sup>9</sup> FinTech is defined as the use of technology and innovative business models in financial services (World Economic Forum 2015). Digital financial services have often been the result of FinTech innovation.

**Figure 2a. DFI financial inclusion commitments and trends, by instrument**



Source: CGAP 2016: International Financial Inclusion Funding Data (2015 data). Based on the largest DFIs reporting since 2009 to the CGAP International Funding Survey.

**Figure 2b. DFI financial inclusion commitments and trends, by purpose**



Source: CGAP 2016 International Financial Inclusion Funding Data (2015 data); data from 15 DFIs as of December 2015. "Retail finance" refers to financing to FSPs for their loan portfolio. Funders can finance these retail institutions directly or indirectly by channeling funds through intermediaries or wholesale institutions, such as apexes, investment funds, and holdings. "Technical Assistance" refers to efforts to strengthen retail providers to become more sustainable and deliver better and more responsible products (e.g., management and governance, IT systems, support to operations [e.g., training, transformation, etc.], responsible finance, product development, and research). TA can be provided directly to retail institutions or indirectly through networks or holdings. Not all DFI TA for financial inclusion is reported to the funder survey.

which at least minimizes the risk of crowding-out local TA service providers.

*Standalone advisory services* tend to focus on specific market development goals without an investment component. This is the least common engagement, since generally there is no direct financial return or link to DFI investments. Advisory may include TA (e.g., strategic advice) and capacity building (e.g., knowledge building through trainings, workshops, or exchanges). DFIs may also play an important coordinating role for developing financial services markets (see the Tanzanian digital finance case that follows). Advisory services can be targeted to strengthening a diverse range of market functions and actors, such as policies, regulations, and industry standards; market infrastructure (e.g., payment systems); capital markets; credit information systems; industry associations; etc. Advisory services are funded by donors or occasionally from the DFIs' profits or budget allocations. When market development becomes a measured DFI goal backed by senior management commitment, funding advisory services from the DFIs' resources is a rational proposition. It is worth highlighting that there is an important public-private interplay to consider on such advisory services. If DFIs opt to abandon such work because of the lack of financial returns, development and private sector investments that view the market as too underdeveloped or risky for their capital could be hampered. To date, DFI funding allocations for market building interventions at the policy, market infrastructure, and client levels have been small, representing approximately 2 percent of consolidated DFIs' funding commitments.<sup>10</sup> Two DFIs had grant allocations representing 12–32 percent of their total funding and, not coincidentally, exhibited more active market development approaches.

In summary, there are different engagement models used by DFIs, and these models have changed

over time, especially during DFI organizational restructurings. DFIs often get drawn into advisory services by their strong credibility in local markets, staff expertise, and a natural extension of their investees' needs. Yet, when DFIs participate in policy and regulatory change advisory services, there is a natural conflict of interest that they need to manage—this advocacy work will help expand financial inclusion, but some will also perceive it as work to benefit the DFIs' investments. Given other pressures—constrained DFI funding sources for TA or overlap with their bilateral agencies that historically managed TA—they may revert back to their investment-only focus and curtail important market development activities.<sup>11</sup> While the prevailing DFI model for financial inclusion is investment only, each of the DFI investment cases featured in this paper for their market development contribution had an important TA component that was often directed at market facilitation. Understandably, DFIs will continue to have a concentration of funding in investments, and rather than suggest that DFIs need a major reallocation of their funding to TA and advisory services, the key is to ensure that DFI investments are used to catalyze systemic change in a market. Lastly, DFIs provide other important nonfunding support for financial inclusion, such as leveraging their convening powers to bring market actors together, advocating for best practices, enabling policies and regulations, and promoting knowledge sharing.

### **Adjusting the DFI approach to more fully promote market development**

When market functions work more effectively, more low-income populations and businesses will be linked to the financial system, and DFIs will have more long-term investment opportunities in a broader range of companies in a more diverse and inclusive financial services market. These desirable outcomes motivate DFIs to be more attentive to market development needs and opportunities.

<sup>10</sup> Even when considering DFIs' support for investee-level TA (4 percent of funding) with estimated market-building advisory support (2 percent), the total commitment allocation of 6 percent for TA and advisory remains small.

<sup>11</sup> For example, IFC advisory services, which were usually funded internally, switched to a more revenue-driven model, yet the sustainability of this model and services are under review again.

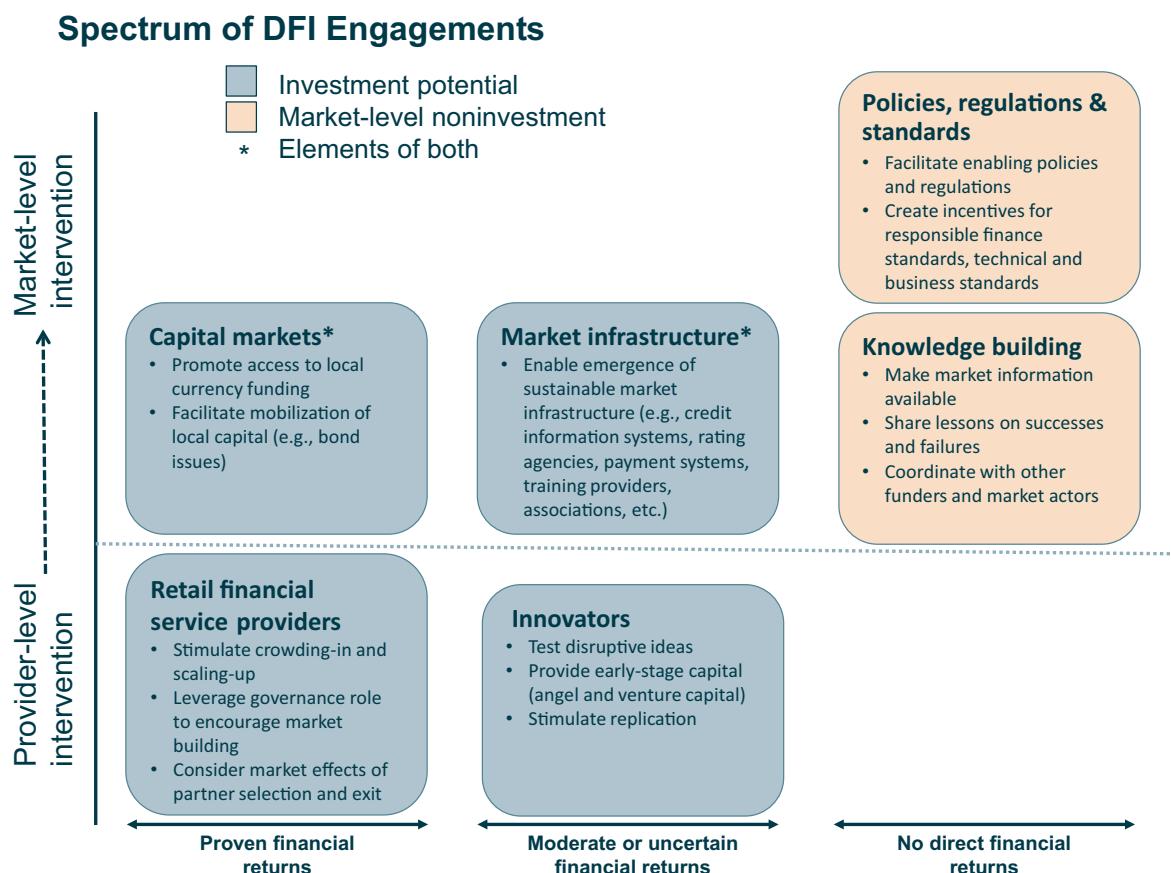
Figure 3 provides a high-level framework to help DFIs apply a market-systems lens and consider other engagements that move beyond an investment-only approach. The framework analyzes DFIs' engagements on two dimensions: (i) the level of the intervention (i.e., provider or market level) and (ii) the level of financial returns. The ultimate goal is for each type of intervention to lead to market change.

As evidenced earlier, DFIs' engagements are presently concentrated in the lower left corner of Figure 3—FSP investments yielding proven financial returns. To maximize their contributions to market development, DFIs should pursue the following strategies relative to their three engagement models:

- Review and identify how each of their investments will affect the financial system and contribute to needed market changes (screen and structure all investments with this market lens).

- Take more risk to broaden the scope of their investments. DFIs should test and invest in innovators (new business models and delivery channels) and market infrastructure companies that help bring the poor into the financial system. TA should be prioritized for investments that have a high potential spillover effect on the rest of the market. "Market infrastructure" and "innovators" are largely ignored despite the fact that these engagement areas might yield moderate financial returns and are important to market development.
- Leverage their technical credibility to facilitate market development. DFIs' role is about more than investments. For example, DFIs can be instrumental to creating an enabling regulatory and investment environment for financial inclusion. They can play an active role in market development that is complementary to the role of donors, by leveraging their technical credibility, their access to high-level decision makers, and their collective influence

**Figure 3. A two-level analysis of DFI engagements in financial inclusion**



Note: FSP innovators, like ACLEDA Bank., fall under retail FSPs, and the goal is to help them generate a market spillover effect for change. "Innovators" refers to new business models or companies that may change or disrupt current market dynamics.

**Table 1. Integrating market development into current DFI engagement models**

DFI Engagement Model	Adjusted for Market Development
Investments	Review each to maximize contribution to market development.
Investments and TA	Take more risks and diversify the DFIs' portfolio with investments in innovators and market infrastructure companies that need valuable TA.
Advisory	Use DFI technical credibility to facilitate market development.

and power on market stakeholders to incentivize and drive change. DFIs can connect investees to a network of resources that strengthen their institutions and growth. While donors (such as bilateral and multilateral development agencies with grant funding as their main instrument) might be more inclined and better equipped to play a broader market facilitation role, DFIs are well-positioned to play an active role in the areas of "policies, regulations and standards" and "knowledge building" highlighted in Figure 3.

Whatever the DFI engagement model, each of the strategies shown in Table 1 requires DFIs to ensure that all their interventions/investments apply a "market lens" upfront.<sup>12</sup> Systemic change to a market should become the grounding point for all their financial inclusion engagements. DFI investments, TA, and advisory services would respond to the market's barriers, needs, and opportunities. DFIs do not have to fundamentally change their engagement models, but how they design and deploy these will be different under a market systems approach. DFIs will need a more thorough understanding of the underlying constraints that prevent financial inclusion. Market diagnostics need to be adapted to analyze all the critical market functions and the market actors performing those functions (e.g., suppliers, end users, policy makers and regulators, capital markets, etc.), including the capacity and incentives of market actors. Based on the market diagnostic, DFIs identify market gaps and their underlying causes, and then design a Theory of Change (ToC)—a plan that maps out how the DFI's interventions will address those constraints and make the market function in a more inclusive way. DFIs should conduct such studies preferably in conjunction with other development actors—donors and DFIs.

In addition to coordinating the upfront market studies and ToC, collaborating is key throughout a market development approach, as many DFIs may be limited in the range of roles and funding they can provide. By collaborating closely with peers, donors, and market facilitators, such as Financial Sector Deepening (FSD) Trusts, DFIs can pursue a market systems approach collectively that will lead to change (coordinating their individual strengths/roles to address market functions and needs; see Figure 1). Collaboration was a key ingredient to several of the DFI market development cases presented later in this paper.

DFIs can enhance their market development value-add by supporting several of the market-level interventions noted in Table 1 and by identifying upfront how each provider-level intervention will be translated into meaningful market-level changes. By extending their investments to a broader array of partners or contributing to many of the aforementioned capacity-building efforts that would help develop these markets (either as part or separate from investments), DFIs can promote more efficient development and scaling of financial markets.

### Key challenges DFIs face in adopting a market systems approach

A market systems approach requires DFIs to make decisions based on how they define success: What is the balance between financial returns and development outcomes on their investments? How should these be measured at the investee and market level? DFIs' systems typically are not aligned with achieving the market impact expected by government shareholders (e.g., their systems often lack metrics and accountability for

<sup>12</sup> Many DFI investment proposals include a question on how the investment will have a market impact or create additionality. While this is good, it tends to be more of a one-off question or brief detail in these proposals (i.e., a check box verification). Under a market systems approach, market change would be the driver, and the focus of the investment proposals would be on how that investment will contribute to market change.

market development). The need for financial returns often discourages many DFIs from making small investments, such as in market infrastructure companies where financial returns are often less attractive. A market systems approach would strengthen DFIs' market focus and help them set up the supporting systems needed. It requires a more intensive and broad sweeping market diagnostic upfront and the flexibility to engage with multiple market actors. While the long-term market development benefits might be huge (including a larger number and diversification of investment opportunities, overlapping with DFIs' investment mandates), DFIs are often not as equipped as donors are to deploy this approach. Several DFI challenges were identified during the interviews:

- Low risk appetite, especially in the wake of the 2008 global financial crisis that limited DFI investments and market development impact.
- Limited or no access to grant funding that could complement investments or be used to support market-development initiatives.
- Internal structural rigidities. The push to make large, low-risk deals limits the ability to invest in newer, smaller, and more innovative companies and untested business models. Tenors may be too short for investments that require patient capital, and collateral might be an issue. Staff incentives are not aligned with market development, as they can't experiment with investments or take adequate risks, and in most organizations, failure is considered highly negative and has consequences.
- Organizational silos. Several DFIs lack cross-cutting teams or internal coordination that would allow for more comprehensive investments across sectors, including innovative or technology-driven business models that defy the traditional financial sector category used by most development organizations.<sup>13</sup>
- Pressure for financial returns. DFIs that raise funding in capital markets require sufficient financial returns to repay this funding. Realizing such returns is challenged by small deal size and

low financial returns on some financial market investments, the current low-rate environment, and currency volatility.

- Discomfort with new business models and technology. Most DFIs acknowledge the potential of technology as a driver of financial inclusion, but hesitate investing in FinTech companies or innovators because they fear the unknown.<sup>14</sup> Even in areas where DFIs played an instrumental role developing market infrastructure, they face challenges investing in companies that formed from their efforts.<sup>15</sup>
- Lack of local presence. Some DFIs lack country-level teams that intimately understand market needs and challenges and can more easily build relationships with local stakeholders, which is required for market facilitation. Highly centralized organizations where decision-making mostly takes place at headquarters find it more difficult to adapt to a market development approach.

By examining DFI cases that integrate some elements of a market system approach, we highlight the requirements and recommendations for DFIs to confront or work around these challenges.

## DFIs Deploying “Elements” of a Market Development Approach: Mini-Cases

The cases that follow briefly profile how DFIs played a critical role in bringing about market change beyond a specific FSP investment. The five cases are grouped by effective market-development themes.

### Creating an enabling environment through market facilitation and coordination

#### ACLEDA Bank: An FSP investment driving market change

During the mid-1990s, three DFIs (FMO, KfW, and IFC) engaged with ACLEDA, a promising Cambodian

<sup>13</sup> For example, there are often separate teams for traditional financial institutions, financial inclusion, FinTech, and payments.

<sup>14</sup> Some DFIs have dedicated FinTech departments, but these specialized teams tend to invest only in large, lower risk commercial deals that don't necessarily overlap with serving low-income communities.

<sup>15</sup> IFC has been the leader in developing credit rating services or credit bureaus globally, yet it made only one investment in such companies. The challenges to such investments are small deal size and burdensome DFI processes and procedures that tend to complicate decision-making and create delays at these start-up companies.

**Table 2. ACLEDA's innovations and impact on the Cambodian market**

ACLEDA's Innovations	Market Impact
NGO transformation into a regulated financial institution with a license to mobilize deposits from the public (2000) <sup>a</sup>	Opened path for the creation of other regulated MFIs and adjustments to existing regulatory requirements and licensing. The National Bank of Cambodia eventually created a new legal structure, Microfinance Deposit Taking Institution, for regulated MFIs.
Introduction of SME lending	Picked up later by other MFIs.
Introduction of ATMs (2010)	Other MFIs later added ATMs.
Fund transfers (domestic and international)	Using ACLEDA accounts, remittance pricing came down.
Housing loans	Only home improvement loans existed prior; housing loans replicated by other MFIs.
Electronic banking (ACLEDA Unity)	Payments and mobile banking services later picked up by other MFIs.
Cash management and payroll services	Other MFIs began offering such services.
Customer service biometrics (efficient, accommodate client special needs, security)	Not yet picked up by other players.
Accredited banking and finance training center (AIB); providing Bachelor's and Master's degrees	AIB and its predecessor (ACT) have been training microfinance and banking professionals in Cambodia and regionally since 2011 with nearly 400,000 professionals trained.

a. With the support from the National Bank of Cambodia (NBC), ACLEDA transformed initially into a specialized bank that had relatively low minimal capital requirements. This was essentially a trial period for ACLEDA and NBC to experience MFI regulation, before ACLEDA later transformed into a commercial bank.

MFI NGO operating in a weak financial system that lacked data transparency but in a country context of entrepreneurial and development potential. These DFIs worked together, especially during the early investment period, with ACLEDA to advocate for policy and regulatory changes with local officials and to lay the groundwork to crowd in private investment. They successfully supported ACLEDA's transformation to a regulated specialized bank and eventually to a commercial bank. Over time, private commercial investors aligned with ACLEDA's mission were identified, and the DFIs exited ACLEDA Bank Plc., with some deploying their capital in other regional ACLEDA partners in underserved markets (e.g., Myanmar and Laos). Ultimately, ACLEDA became a global industry leader reputed for its strong social commitment, innovative products and services, institutional strength with best practice governance and risk management systems, collaborative leadership shaping the Cambodian and other microfinance markets, and a successful NGO-to-bank transformation that achieved impressive scale (with nearly \$4 billion in assets, 1.6 million depositors, and 408,000 borrowers as of December 2015).

Backed by the DFIs' investments, TA, and advocacy support (grant funded), ACLEDA went on to influence the broader market by continuously introducing product innovations that industry peers replicated (often guided by ACLEDA), actively leading the microfinance industry association and promoting industry coordination on needed policy and regulatory changes, and serving as a best practice institution (Table 2). ACLEDA has also institutionalized its influence on knowledge and capacity building for the broader market, by building a training institute (ACLEDA Institute of Banking [AIB]) for banking and business professionals nationally, regionally, and even globally. Beyond managing Associate's, Bachelor's, and Master's degree programs, AIB hosts lateral learning visits leveraging ACLEDA's microfinance expertise for national, regional, and international visitors.<sup>16</sup>

In short, DFIs took on a sizeable amount of risk to invest in an unstable country with a weak financial system and nascent microfinance sector. They recognized ACLEDA as an MFI with a visionary, innovative, and collaborative leader who engaged with his peers and policy makers to significantly contribute to market development. They provided

<sup>16</sup> FMO and KfW provided funding support for the formation of AIB's training predecessor (ACT) and for its industry capacity building. In 2015, AIB's income fully covered expenses for the first time (ACLEDA entities who send staff to AIB for training account for the majority of demand/revenues at present, with an anticipation for increased income from other third-party entities going forward since AIB received its license as a Higher Education Institute in early 2016).

**Box 2. The DFIs' reputation and credibility in the local market was critical to their influence**

DFIs provided ACLEDA with sizable financing for its growth, transformation, capacity building, and product development plans, but what was arguably equally important to ACLEDA's success was how the DFIs engaged with policy makers and regulators to construct an enabling environment for microfinance transformation, product diversification, and scaling.

debt initially and ultimately equity financing to support ACLEDA's transformation into the largest Cambodian commercial bank with a diverse product offering and broad client base that had a spillover effect into Cambodian and other regional Asian markets. The DFIs played a critical role in advocating with ACLEDA to policy makers and regulators for a new legal framework that would support the commercialization and scaling of microfinance in Cambodia. This led to a new legal framework that later benefitted other MFI transformations. Their interactions with local policy makers and regulators continued on a regular basis throughout their ACLEDA investments and helped improve the industry's governance capacity (see Box 2).

**Tanzania's mobile market interoperability: Effecting market change as a trusted facilitator**

Digital finance is a well-recognized path for scaling financial inclusion and serving remote communities and populations while possibly lowering transaction costs. With four major mobile network operators (MNOs) in Tanzania and a functioning mobile money market, the country was ripe for developing an interoperable platform that would allow clients with mobile wallets from different MNOs to send and receive payments more conveniently.<sup>17</sup> For participating MNOs, the promise of owning their destiny in terms of shaping the design of interoperability (as opposed to being told how it would be done by regulators or vendors)

was attractive. Each of them also had other business motivations for collaborating on an interoperable system (e.g., the potential for increased transaction volumes across an integrated platform with standard rules). The initial planning and buy-in process included introducing the concept, setting up the project, and securing stakeholder buy-in, central bank support, and donor funding. The first person-to person (P2P) transactions became operational for the first two participating MNOs five months after this planning period. From February 2016, when all four MNOs had interoperability agreements in place, to September 2016, monthly mobile wallet transaction amounts have nearly tripled to US\$72million.<sup>18</sup>

IFC facilitated the interoperability process, acting as a critical and neutral market facilitator between the key market stakeholders (namely MNOs, banks, the Bank of Tanzania, and other regulators being kept abreast of developments). The success of this program is attributed to several factors:

- The engagement of a neutral broker (IFC) that had no commercial interest and strong market credibility to facilitate the industry discussion on interoperability.
- The recruitment of payment systems experts from the cards, banking, and telecommunications industries.
- The design of a clear plan, beginning with an in-depth market study accompanied by a highly consultative process that maintained strong communications with key market stakeholders throughout the process.
- Strong funding support and collaboration with the Bill & Melinda Gates Foundation and FSD Trust.<sup>19</sup>

The end result is that P2P interoperability is fully functional, with all four MNOs participating since February 2016.

IFC's facilitating role covered several key responsibilities, including the following:

- *In-depth market analysis on interoperability.* Considerable time was dedicated to consulting with key market stakeholders, conducting a market

<sup>17</sup> There are only a handful of countries with interoperable mobile financial services, thus this was a true market innovation with the potential to scale such services.

<sup>18</sup> Number of transactions rose by 239 percent and volume amount of transactions by 277 percent from February to September 2016, according to the Bank of Tanzania.

<sup>19</sup> This case draws largely from IFC (2015) and interviews with members of the IFC Advisory Services team.

### Box 3. Key take-aways from the ACLEDA and Tanzania interoperability cases

There are quite a few important overlaps from the ACLEDA and Tanzania interoperability cases:

- In both the ACLEDA and Tanzanian interoperability cases, DFIs' credibility and power with local regulators and market stakeholders helped them to influence if not drive the market changes.
  - In both cases, DFIs displayed how strong market collaboration with DFI peers and key market players can lead to more effective industry buy-in and change.
- a. Despite the success of IFC's facilitating role, it should be noted that as this paper was written, IFC's Advisory Services strategy was under review as part of the overall World Bank and IFC restructurings. At this time, it is unknown to what extent IFC will continue playing a crucial role in facilitating the development of digital financial services beyond its investment portfolio.

- DFI TA and advisory services played important roles in building institutional and industry capacity, and such DFI support was funded in various ways.<sup>a</sup>
- In both cases, there was a clear work plan designed with the key market actors' inputs and leadership that guided the process and the DFI's work (e.g., in ACLEDA's case, the transformation feasibility study identified key areas of needed DFI engagement, such as regulatory reform).

demand study, reviewing the business model and its legal and regulatory implications, and sharing these findings with market players (this data transparency ultimately helped align the various parties around the value of interoperability).

- *Numerous workshops and trainings.* IFC provided capacity-building support around interoperability for market players (including agent networks), to ensure there was common industry understanding and consensus around the terminology and implications.
- *Consultations on demand and design* with all key stakeholder groups played an important role in building consensus. Throughout, IFC applied a business perspective to the consultations—ensuring that the business model design and critical sharing of transaction fees made economic sense to the key actors who actually led the conversations (thus stimulating project ownership and authorship of the final plan).
- *Drafting the rules and standards for interoperability.* IFC mobilized a team of regulatory, payments, legal, and financial experts to advise local actors who were developing the standards and rules for interoperability. The IFC team also conducted the financial modeling behind the design of an interoperable system. Throughout, IFC engaged as the central facilitator to a process driven by the MNOs and two banks, which sought consensus based on core business incentives.

The Tanzania interoperability case will influence other markets. IFC is developing a series of templates and toolkits for developing interoperability solutions that leverage the lessons learned in Tanzania to inform market facilitation elsewhere. No IFC investments were made as part of this market development initiative, mostly because IFC's interoperability work centered on creating rules, governance, business models, and other intellectual property, as opposed to materializing market infrastructure or new companies.<sup>20</sup> The Tanzania interoperability case underscores that DFIs can lead as important market catalysts without immediate investments, especially when third-party funding is available to finance their advisory, broker role, and expenses (see Box 3). Nonetheless, the case raises some questions:

- Do DFIs have the right incentives in place organizationally to support a noninvestment approach (no investments and financial returns in the near term)?
- In which cases are they better placed than other funders to play a facilitator role?
- Should such engagements be considered on an opportunistic basis (e.g., IFC had strong local presence, expertise, and relationships with key market actors and companies) or become a more standardized intervention, and if so, on what basis—when there is transformational market impact?

<sup>20</sup> As part of the funding arrangement with Gates Foundation, others would have open access to this intellectual property.

## Sharing risks by co-investing with DFI peers: Addressing foreign exchange risk

### TCX: DFIs joining forces to build an innovative market solution

Increasing amounts of foreign capital from international social investors (DFIs and private investors) began pouring into the microfinance industry after 2000. This much-needed capital helped scale industry outreach globally but created serious FX risk for the FSPs who borrowed U.S. dollar and Euro capital (accounting for over 70 percent of these international loans). There was a serious market gap for available and viable FX risk mitigating tools called hedges. In 2007, an innovative FX hedging fund called The Currency Exchange (TCX) was created under FMO's leadership and with the investment support of more than 10 DFIs and a guarantee. TCX provides its international investors long-term FX hedges in illiquid emerging capital markets by managing a large diversified pool of global currency exposures. TCX effectively converts investors' hard currency loans into local currency funding for FSPs, thus reducing FSPs' vulnerability to market volatility. DFIs were crucial to this solution, with FMO hiring a specialized team to structure the fund, conduct an initial market feasibility analysis, and model TCX. Other DFIs quickly recognized TCX's merit in addressing a mounting risk in the industry, and they worked effectively as a group to finalize the investment terms for TCX and to secure sizable investment approvals.<sup>21</sup> Later, a specialized facility for accessing TCX FX hedges was created for the microfinance industry through MFX Solutions, a viable structure supported by guarantees from OPIC and the Omidyar Network.<sup>22</sup> Both TCX and MFX benefitted from TA grants provided by donors to support FX capacity building and tool development, trainings, market research, and advisory services—both at the industry and FSP levels.

TCX provides an interesting example of DFIs addressing a serious market gap and demonstrating a willingness to take risk on an innovative and complex fund that not only helps DFIs hedge their portfolio of local currency exposures but provides an important mechanism for MIVs and private investors to make effective local currency loans to FSPs and other sectors. TCX has reached significant scale, providing hedges for 1,733 transactions in over 50 frontier market currencies and covering \$4.1 billion in underlying investment transactions as of May 2016. In the past 18 months, TCX provided important hedging that made 10 local bond issues feasible (including three in Africa). By providing long-term hedges in illiquid markets, TCX is helping to reduce the volatility in these markets, establish expectations for future FX movements based on economic models (thus, establishing early benchmarks for FX hedges), and build local capacity among central bankers and finance officials with regard to these economic models (a positive side effect of TCX's work). Overall demand for TCX's hedges is growing, especially for larger and longer hedges from the infrastructure and renewable energy industries. Per TCX's CEO, it needs to grow sizably to meet increased market demand, requiring a near doubling of TCX's initial capital to \$1 billion.

In terms of market development, the TCX case highlights the following:

- **DFI collaboration and group deals.** DFIs are more comfortable and more efficient in deals where their peers are co-investing and creating an effective risk-sharing mechanism.<sup>23</sup>
- **Size matters to DFIs.** Most market-level projects like TCX require significant capital and are attractive to DFIs looking for market-changing opportunities that absorb large amounts of capital.<sup>24</sup>
- **Global structures can help resolve local market issues.** Creating a global fund was a good option that matched the DFIs' "need for size" while responding to local market gaps for FX hedging products. The alternative of DFIs making individual unhedged direct local currency loans to investees is more risky.

<sup>21</sup> TCX not only provides FX mitigating instruments for the financial inclusion industry, but also for other development finance sectors. DFIs use TCX to hedge local currency assets that they have on their balance sheet.

<sup>22</sup> MFX has closed hedges exceeding \$1 billion of underlying notional investments.

<sup>23</sup> Additional examples of DFI group deals and risk sharing include ACLEDA and MFI greenfield investments.

<sup>24</sup> Size was also critical to make TCX's business model viable, by diversifying large volumes of local currency exposures.

- *Innovative investments are feasible for DFIs.* The risk appetite and incentive structures at DFIs do not encourage direct investments in market infrastructure and innovators. TCX is an innovative business model that attracted DFI support because of its structure of diversifying the underlying FX business risks and providing valuable hedging services to DFIs and the private fund managers and investors they seek to attract to financial inclusion.

Presently, DFIs own 95 percent of TCX, which might raise questions regarding its long-term sustainability (while DFIs are currently TCX's largest users and will continue to need TCX in the future if they make local currency investments). TCX requires scale and diversification to function well, and its projected returns are positive but low and sometimes volatile.<sup>25</sup> Thus, TCX is most attractive to foreign investors that actively transact in these developing markets and will benefit from access to TCX's FX coverage—prominently, DFIs are the largest users today. DFIs' ongoing TCX support is likely a long-term proposition (and protection for the DFIs' portfolio). Many private entities benefit from TCX/MFX hedging access, too (MIVs, FSPs, and other borrowers and lenders), and TCX plays a unique match-making role for parties seeking local currency risk exposures in many of these nascent markets. While the hope is that local capital markets will become more liquid and deepen, so that long-term local currency financing becomes available to FSPs, the reality is that local capital markets are slow to develop. In the interim, TCX plays a critical role in helping private and public investors transact in these illiquid markets, and building local market knowledge of its model and pricing.<sup>26</sup>

## Building data transparency: Leading to market standards and cost efficiencies

### Remittances: Transparency and reducing remittance costs in LAC<sup>27</sup>

In 2000, the Multilateral Investment Fund (MIF), a private investing arm of the Inter-American Development Bank, launched a 10-year initiative on remittances to Latin America and the Caribbean (LAC).<sup>28</sup> Remittances were commonly recognized as a large and growing source of income and development for LAC. However, there was limited clarity and data available on remittances, and their potential was tempered by high remittance costs. A standard definition of the term "remittances" did not even exist, and LAC central banks were not accurately tracking these flows. There were no studies that analyzed either the costs of remittance transfers or the impact of remittances once received. MIF developed a ToC based on assumptions that transparency could be transformational and that remittances could be used to help recipients become banked. MIF's strategy based on this ToC set two goals to be achieved by 2010: (i) reduce the average cost of remittances to LAC by 50 percent through increased competition and (ii) increase the number of families receiving remittances through the financial system (with the implicit goal of linking them to other financial products and services) by 50 percent. The first goal was surpassed, with remittance costs falling 75 percent over the period; LAC now has the lowest regional remittance costs globally.<sup>29</sup> MIF's second goal remains a work in progress; remittances as a lever to pull recipients into the formal financial system proved to be more complex than initially expected.<sup>30</sup>

<sup>25</sup> TCX has yielded a positive internal rate of return to date. By its nature, TCX incurs FX gains and losses, and while it realized significant FX losses in 2015 (related to large emerging markets commodity and FX volatility), TCX has already recouped 70 percent of these losses. It also provided crucial FX protection to its DFI clients and others against this volatility, thus protecting their assets from losses.

<sup>26</sup> In fact, in certain markets like Kyrgyzstan, there is anecdotal evidence being examined more closely by TCX consultants demonstrating that local banks began providing short-term hedges once they knew that TCX was in the market providing long-term transactions.

<sup>27</sup> This information pulls from the 10-year program assessment (Hall 2010).

<sup>28</sup> MIF is referred to as the innovation lab of the Inter-American Development Bank and the leading provider of TA to the private sector in LAC ([www.fomin.org](http://www.fomin.org)). It is an independent fund that can pursue high-risk investments and provides TA to its partners (<http://www.iadb.org/en/resources-for-businesses/multilateral-investment-fund,5763.html>).

<sup>29</sup> While MIF's role in creating market transparency was recognized by many as contributing to lowering costs (increasing agent competition on the pay-out side and encouraging direct deposits into bank accounts), other factors likely played a role, too (such as competition on the sending side and lower cost technologies).

<sup>30</sup> According to MIF staff, there are a few successful cases nonetheless under this second goal, namely, a collaboration that propelled Bancolombia into the remittance market via its partnership with a Colombian housing cooperative COMFAMA. Bancolombia went on to refine its remittance product and become the market leader (roughly 50 percent of Colombian remittances) and more than half of the remittances they manage are now transferred into client accounts where they have a greater possibility of being deployed for other productive use (e.g., collateral for housing loans).

Some of MIF's activities that ultimately led to a better functioning market included the following:

- Conducting a thorough market diagnostic upfront.
- Addressing policy and regulations by engaging with central bankers on a common definition of remittances and standardizing its calculation.
- Piloting remittance-linked products with FSP partners.
- Engaging in knowledge and capacity building (organized over 45 conferences and roundtables).
- Conducting ongoing research and monitoring on local remittance markets.

Having a long-term perspective from the start for this project was important for MIF as it focused on addressing fundamental constraints in the market. Given the broad transparency and capacity building focus of this program, roughly half of the program funding was in the form of grants and the other half was in the form of investments in MIF's FSP partners, where remittance pilot learnings were leveraged with other industry players, including in-country and regional FSPs and other market stakeholders through MIF's annual conference. This case shows how data transparency can be transformational, by changing providers' incentives with credible information about the size and opportunity of the remittance market in LAC. This case also demonstrates how DFIs can work at different levels in a market (e.g., on policy and with FSPs) to spur change.

## Tackling multiple market gaps: Policy, infrastructure, innovators, the capital market . . .

### China: A DFI's multipronged and long-term commitment to market development

It may be hard to imagine today, but in the 1990s, China was weak on financial inclusion, with gaps at all levels—policy and regulations, regional access issues, weak institutions (FSPs), and a lack of basic market

infrastructure. Led by the Advisory Services team at its local country office, IFC established microfinance development programs that focused on policy and regulatory changes, institution building, access to rural populations, and the provision of not only micro- but also small- and medium-enterprise (SME) loans. In parallel, IFC focused on building needed market infrastructure (namely, a collateral registry and credit bureaus). Benefiting from approximately 20 years of long-term IFC support, China's financial system is now more inclusive,<sup>31</sup> the SME market has been developed, and its micro and SME FSPs (namely, microcredit companies [MCCs]) are now better funded. Today, IFC's investments are increasingly focusing on market innovator companies, including Ant Financial Services Group (an affiliate of the leading e-commerce player Alibaba Group Holding), and IFC is working with larger players in the financial inclusion space, such as Postal Savings Bank China, to focus on last-mile access in rural areas.

In brief, IFC's long-term strategic commitment and structured work plans contributed to jump starting the Chinese microfinance sector, which now embraces new business models and investments in market innovators. IFC's financial inclusion portfolio as of the end of fiscal year 2015 amounts to over US\$1 billion in investments in microcredit companies, village and township banks, rural and commercial banks, nonbank financial institutions, and a mobile payment company.

According to IFC's development effectiveness team report summing up the program:

"Intervening simultaneously at the regulatory and policy levels, sector level, and institutional level was a key factor for IFC's success in promoting access to finance in China, and it enabled IFC to have systemic impact. . . . A study by CDI [the Development Impact Department of IFC] in fiscal year 2011 found that linking advisory and investment services increases the probability of development success" (IFC 2013).<sup>32</sup>

<sup>31</sup> China has made significant progress in financial access. Sixty-four percent of the population has an active account at a formal financial institution but it remains the second largest unbanked population in the world (12 percent of the Chinese population); access has been uneven, with 234 million people still excluded, particularly in rural areas (World Bank 2016).

<sup>32</sup> IFC went on to separate its investments and advisory teams (investees continue to receive a combination of investments and TA when needed), and more recently, some advisory staff who were focused on policy and regulation moved to the World Bank while others who were focused on the private sector remained (and some staff seem to have responsibilities straddling both investments and advisory).

IFC's contributions to transforming the Chinese financial system spanned all market levels and included a combination of advisory services and investments:

- **Market facilitation.** Assumed a critical market facilitator role by supporting market research (client and market studies on the use of financial services), data sharing, coordinating policy priorities, managing workshops, and supporting the development of new business models and product innovations.
- **Policy and regulations.** Advocated for commercially oriented MFIs; advised the central bank on developing regulations for "non-deposit-taking lending institutions," which ultimately contributed to the formation of MCCs—now the prevalent Chinese MFI model; and provided support and advice on secured transaction reforms under the Property Law and feedback to the Chinese Central Bank on draft regulations allowing foreign investments in Chinese banks.<sup>33</sup>
- **Capacity building/advisory services for the industry.** Strengthened management, risk management systems,<sup>34</sup> governance, SME lending, and knowledge building through exchanges with best practice Cambodian MFIs.<sup>35</sup>
- **Market infrastructure.** Advised on collateral registry and credit bureau development.
- **FSP institution building investments.** Supported several greenfield MFIs and invested in several MFI types (as of June 2016, IFC had 12 MFI investments of \$187 million).<sup>36</sup>
- **Capital markets development.** Directly engaged in the development of China's capital markets, including issuing IFC bonds in China in 2005 and providing a partial guarantee on Ant Financial's MCC's asset-based securities in late 2015 to spur market interest in other capital market financings for MCCs.
- **Innovations.** Helped develop FinTech for China through investing in innovative technology companies.
- **Agent banking knowledge building.** Conducted workshops with emerging payment companies and large telecoms to explore new business models in agent banking. It organized study tours for People's Bank of China (PBOC) staff to Brazil to study Brazil's advanced agent-banking network, and it hosted innovative payment companies and agent banking networks from India to demonstrate how other private companies penetrated rural markets.
- **Consumer protection/responsible finance.** Conducted workshops with leading financial institutions and government entities to promote client protection.
- **Rural cooperatives.** Engaged global experts to conduct field visits and diagnostics in collaboration with PBOC and rural commercial banks with the aim to develop rural cooperatives.
- **Postal Savings Bank of China.** Made a \$268 million investment commitment to promote greater financial access, especially in rural areas.
- **Women SMEs.** In 2015, collaborated with Ant Financial Services Group and Goldman Sachs' 10,000 Women project to launch the first internet-based, gender-finance lending program in China.<sup>37</sup>

Overall, IFC's early advisory efforts to create a viable microfinance industry helped build investment opportunities for IFC beginning in 2005. By allowing the local advisory team to drive the building of the microfinance market, it is well-recognized that market development happened quickly. (See Box 4.) The combination of a strong local team with good government relations and a team of international experts was critical to the pace of this market development. While many market infrastructure companies developed over the period (such as data-mining companies and risk management companies that sell their information to banks to help them make client decisions),

<sup>33</sup> The China advisory work may be considered by some as an example of the potential DFI "conflict of interest" raised earlier in the paper, where advising on policy issues later resulted in sizable DFI/IFC investments.

<sup>34</sup> IFC worked with the old MCC association (CMIA) to create risk management modules for the Chinese market.

<sup>35</sup> Including trainings with ATC/AIB and meetings with the Cambodian National Bank regulation and supervision division.

<sup>36</sup> According to IFC Financial Institutions Group, China team (September 2016).

<sup>37</sup> This program is expected to help grow women's small businesses online through a RMB 500 million loan.

#### **Box 4. DFIs leading with advisory work**

An interesting take-away from the Chinese and Tanzanian cases is that DFIs can lead with advisory services without investments (if they have the funding for it, as they did), and that such advisory services can lead to a future portfolio of investments (e.g., China case). IFC began advisory services in China years before it made its first FSP investment, including advisory services on policy and legislation changes needed to ensure an enabling environment for financial inclusion and a flow of investments from both private and public investors. It is apparent from its current investment portfolio that this advisory work proved instrumental in helping to develop the Chinese market. In Tanzania, it remains to be seen whether IFC will eventually seek to translate its advisory work into new investments.

IFC investments were concentrated at the FSP level. Investing in some of these companies has been a challenge since many are young and in a nascent stage of development, and yet, private Chinese investors are readily investing in them (IFC's capital is no longer needed). Currently, the team is focused on expanding the agent-banking network and developing the digital financial

services market, to more easily reach rural areas. From a funding standpoint, IFC's advisory services were initially supported by donations and internal IFC investment profits, while more recently, such advisory services are funded by a combination of advisory fees and investment income.

Beyond the cases highlighted in this paper, there are many other examples of DFI investments and influence that contributed to financial market changes and that demonstrate the range of projects and market influence that DFIs can have (see Box 5).

#### **Pursuing a market systems approach and opening up new investments**

Interviews with industry players indicated that they feel there are ample opportunities for DFIs to incorporate a more systemic approach into their activities and investments. Shifting their focus beyond the concentration on traditional FSPs to a broader range of actors (e.g., market infrastructure,

#### **Box 5. Additional examples of DFI contributions to market development**

- *Bosnian savings market.* KfW promoted the creation of deposit insurance (market infrastructure), which dramatically increased savings mobilization in Bosnia and Herzegovina.
- *Capital markets (policy and regulation).* Several DFIs influenced the government of Bulgaria to create a securitization law and a new financial instrument.
- *Venture capital ecosystem.* MIF provided financing for a Brazilian program—INOVAR—that built the capacity of early-stage companies, fund managers, and investors; built a venture capital association; and engaged institutional investors in their first private equity investments.<sup>a</sup>
- *Market scaling (microfinance holding companies and greenfields).* IFC and other DFIs promoted greenfield MFIs in underserved markets—building

industry capacity and commercial viability and scale and expanding product offerings.

- *Market diagnostic.* FMO funded UNCDF's Shaping Inclusive Financial Transformation (SHIFT) program, for a comprehensive market diagnostic in Malaysia. Such market diagnostics are critical to mapping out a market systems approach.
- *African capital markets.* KfW spearheaded the African Local Currency Bond Fund to promote the issuance of bonds and other market notes by FSPs and to equip them with long-term local currency funding. The fund invests in the issuances and provides important TA to first-time issuers.<sup>b</sup>
- *Rural market gap and risk.* FMO manages MASSIF. The fund allows FMO to make riskier investments to support rural financial inclusion without incurring risk on its balance sheet.

a. FINEP, the Brazilian Government's Agency for Innovation, was MIF's collaborator and INOVAR's sponsor. INOVAR helped mobilize over \$2 billion in investments over 12 years (<http://hbswk.hbs.edu/item/creating-a-venture-ecosystem-in-brazil-fineps-inovar-project> ).  
b. More recently, the fund is investing in other sectors, too, including housing, renewable energy, and agriculture finance.

### **Box 6. Key requirements for adopting a market systems approach**

- Deep market understanding (e.g., market diagnostics should analyze underlying constraints).
- Reframing of approach. Making market development the center of DFI interventions.
- Risk taking. Market development is about change; change can be risky and unpredictable.
- Long-term vision and commitment because changing a system is a long-term endeavor.
- Flexibility in funding a diverse set of companies.
- Close coordination with other funders to reinforce collective impact.
- Investment turn-around. Approval and closing processes need to be efficient and agile to meet fast-evolving market opportunities, especially for innovators (some DFIs are taking a harder look at this processing risk).

innovators) and new business models would help financial markets modernize and become more efficient. As DFIs explore adoption of a market systems approach, there are some key requirements to note (see Box 6).

From our DFI case reviews and interviews, the themes and recommendations that repeatedly emerged include the following:

**1. Commitment and accountability to a market Theory of Change.** Establishing a roadmap or ToC for market development that is founded on an upfront market assessment (ideally shared and coordinated with other DFIs and market actors) will help DFIs to focus on the critical financial inclusion gaps in a country; identify, through a ToC, how their interventions will lead to market change; and establish metrics at the provider and market levels. These metrics will help to create team commitment and investment officer accountability for deploying DFI capital that contributes to long-term changes needed in local markets (e.g., FSP investments must be linked to some type of measurable market change metric; the DFI's monitoring and evaluation teams should be engaged in designing and reviewing the market metrics). The DFI's strategic thinking around its ToC should seek to create systemic change in the long run—attacking the underlying barriers to financial inclusion in conjunction with other development partners.

**2. Introduction of DFI structures that allow more flexibility and risk.** Various stakeholders (including several DFIs) interviewed consistently called for DFIs to develop a window of reprieve from their risk-adverse culture and systems to invest in promising financial innovation and infrastructure companies. This would require permission for smaller transaction sizes and higher risk in the context of supporting innovations that address financial market barriers, disrupt the market, and improve the access and design of financial services. Ideally, these DFI investments would also crowd in private-sector investment for such companies. DFIs should create dedicated pockets of money that license investment officers to support industry innovators and to take more risks.<sup>38</sup> Some DFIs have developed special structures or off balance sheet capacities for supporting higher-risk market niche opportunities in underserved markets (e.g., FMO's management of the MASSIF facility that focused on rural finance was funded by the Dutch government; Proparco's management of the Africa-focused Investment and Support Fund for Business in Africa [FISEA], which includes programs for rural finance and social business funds, and was funded by AFD). Both of these funds have the ability to make small- and higher-risk investments, and each includes significant TA to address investee capacity-building needs.

Several donors and DFIs participate in external investment structures that provide funding to

<sup>38</sup> Ideally with market risk returns to help attract DFI attention.

emerging or frontier markets, by blending private and public capital to enhance fund returns and lower investment risk to attract private investors to new areas. These types of investment structures are commonly referred to as “blended financing” and have become a popular tool for attracting private investors.<sup>39</sup> In fact, many MIVs have used this catalytic funding in their multitranche capital structures and have successfully engaged private investors into the lower-risk tranches.

It is more challenging to find cases of DFI investments for innovative FinTech funds and innovative companies. To date, a few DFIs have expressed interest but had difficulty getting comfortable with alternative FinTech models and risks. Long delays often ensued given cumbersome internal processes and investment requirements.<sup>40</sup> Ultimately, and ironically, private investors completely funded the first close of one industry pioneering FinTech fund in the absence of any DFIs who had been approached.<sup>41</sup> Progress is happening though, and the fund’s second close included two DFIs. FinTech fund managers view the DFIs’ investment role as instrumental to driving greater scale by attracting more private investors to FinTech funds in emerging countries and reinforcing the social mission of these investments.

- **3. Enabling the market environment for innovation and change.** In the past, the financial industry focus on an “enabling environment” helped to ensure that core financial systems and regulations allowed FSPs to provide basic financial products and services on a sustainable basis to low-income communities. Fast forward to today to the industry’s multitude of innovations, technology advances, and new players and business models in many financial markets. On one hand, there

are several significant new market opportunities for bridging the gap of financial inclusion. On the other hand, local policy makers and regulators are overwhelmed with the increasingly complex financial landscape, the need to keep pace and understand the features, and the opportunities and risks of these innovations. The enabling environment for financial services now cuts across multiple sectors or industries—finance, telecommunications, and retail, for example—when considering recent market innovations (e.g., retailers offering financial services, payment platforms opening ways to digital finance). DFIs have strong credibility in local markets and can use it to help integrate policy and regulatory dialogue across these cross-cutting sectors and between policy makers and FSPs, innovators, and other relevant actors—thus allowing innovations and promoting market changes more efficiently.<sup>42</sup> Shifting some resources from investments to more enabling policy and regulatory change activities will facilitate such market changes. (See Box 7.)

Market assessments are a critical tool for informing this dialogue and analyzing the current market state in relation to the opportunities to expand financial services and identify the challenges to promoting these market innovations. DFIs and their sister donor institutions should support market assessments that will help prioritize areas of needed reform, so that important policy and regulatory changes can be anticipated, including for new market entrants and models. As in Tanzania and Cambodia, DFIs can leverage their credibility and global expertise to help guide regulators in these new areas. In the Tanzanian case, DFIs played a valuable facilitator role in several market situations. Yet, other parties might also be well-suited and considered (e.g., donors, FSD trust-type entities).<sup>43</sup> The Tanzanian case shows that for

<sup>39</sup> In these cases, DFIs themselves need risk mitigating capital for their investments in high-risk/high-reward projects. For example, IFC has a Blended Finance Unit that combines donor funds with IFC funds, providing a risk cushion and allowing IFC to combine concessional money alongside its investments for advisory projects (e.g., climate change, agribusiness, some SME deals).

<sup>40</sup> Eventually, some DFIs were able to digest the risks and were more constrained by their internal approval and closing processes that layered in complicating risk management rules and other restrictions, where flexibility was needed.

<sup>41</sup> It is possible that several of these private investors took some comfort from the fact that the DFIs were close to completing their long internal investment processes, and thus felt comfortable investing earlier, according to one fund manager.

<sup>42</sup> Depending on the situation, it might make sense for DFIs to consider close partnerships with local players in the policy space that are better positioned to conduct detailed and expert advisory services (e.g., the World Bank, a regional development bank, or other expert agency).

<sup>43</sup> FSD trusts coordinate and manage various aspects and stakeholders of financial inclusion at a country or regional level. They have been structured in several African countries, for example.

### Box 7. DFIs supporting innovative financing structures

**Social impact bonds (SIBs).** DFIs are supporting innovative financing structures in several markets. SIBs or “pay for success” contracts are financial instruments that link investor returns to successful social outcomes. The transactions are often intermediated by NGOs contracted to achieve the social targets, and the results-based repayment derives from a government or public finance source (which reaps savings from these improved social outcomes). Originally more common in England and the United States, international SIBs are now under construction in several countries and are often referred to as development impact bonds (DIBs). The Inter-American Development Bank is supporting the development of a SIB underway in Mexico to help single mothers increase their resilience and income to break out of poverty. SIBs may become an effective model for attracting private capital to tackle societal issues, by placing a financial value on social outcomes and raising funding for preventive engagements.<sup>a</sup>

**Revenue-sharing.** In South Africa, a long-term growth capital model often referred to as a royalty or revenue-sharing model was developed by Business

Partners Ltd. (BPL), a financial institution that invests in promising young South African SMEs that need capital but not necessarily equity investments. The structure fixes preferential or minimum repayments during an initial period and recoups the difference or deferred amounts over the later years via a mechanism linked to the SME’s revenues (or other company variable). This model has opened up SME financing, and IFC and other DFIs (Norfund and Proparco) have helped replicate the model in three other African countries. These debt and quasi-equity instruments are designed to allow investors to reap the upside of their investments without the exit risk and to allow borrowers to enjoy low initial payments on financing.<sup>b</sup>

Both SIBs and the revenue-sharing model are attracting private capital to fill market gaps—financing shortfalls in capital access to SMEs—and creating a potential source of sustainable financing to combat community issues. From a market systems approach, it will be important to link these transactions to broader market needs and explore the potential for replication in other markets.

- a. A few examples of SIBs have been structured on recidivism, employment, foster care, and health-related issues.
- b. BPL, a financial intermediary in South Africa, developed the model. The precise structure varies and is flexible to the SME’s needs—debt, quasi-equity, or equity. Over time, IFC has made an equity investment directly in BPL. See [https://www.pacificcommunityventures.org/wp-content/uploads/sites/6/2016/03/casestudy\\_bpl\\_v3FINAL.pdf](https://www.pacificcommunityventures.org/wp-content/uploads/sites/6/2016/03/casestudy_bpl_v3FINAL.pdf) and <http://www.fomin.org/ens/Home/News/PressReleases/ArtMID/3819/ArticleID/3317/New-fund-to-innovate-the-way-SMEs-are-financed-in-the-region.aspx>.

facilitation to be done effectively, DFIs must be seen as neutral and must have technical credibility, local knowledge, long-term engagement, strong relationships, and local presence.

4. **Combining or linking DFI financial inclusion and FinTech teams.** As noted, there is huge potential to improve financial inclusion and accelerate systemic market changes with FinTech innovators. Yet, the financial inclusion and the FinTech teams at some DFIs often do not collaborate, and opportunities for financially excluded populations may be overlooked. Introducing processes that link, or combine, these two teams should accelerate DFIs’ market-changing financial inclusion investments. At present, industry opportunities that fall between these two groups have a difficult time engaging DFIs in productive dialogue. Efforts should be made to create or strengthen the links between the financial inclusion team and other cross-cutting teams (e.g., payment team) or related sector teams (e.g., climate finance or agriculture) to

more intentionally leverage financial inclusion as an enabler of other development goals.

5. **Incentives to pursue market development and create accountability.** At a high level, DFI government stakeholders need to more effectively implement their development mission and ensure that DFI senior management incorporates processes and structures that target market development: setting goals, measuring impact, and extracting lessons from engagements, for example. DFI investment teams need incentives to adjust their current engagement models on financial inclusion to ensure that all of the DFI’s investments are put through a market development screening process and later monitored for market development metrics; establish portfolio allocations for innovators and market infrastructure companies that address gaps in market development (e.g., transparency and more efficient processing); and employ DFI technical credibility to facilitate market development (either in an advisory capacity or by leveraging its abilities to convene

### Box 8. Creating accountability for market development: MIF's investment approach

To shift toward a market development approach to their investments, DFIs need to ensure that investment processes, staff incentives, and accountability mechanisms are aligned with this approach. MIF's system has some of these accountability mechanisms:

- **"Systemic impact" requirement.** Requires that the investment or project influences other market players (e.g., being adopted by others, creating scale beyond the investee, or creating change in the market ecosystem or regulatory framework).

- **Investment proposals.** Early in the process, proposals must address how a market development need is met by the investment. Investment officers should propose metrics for measuring the investment's market impact.
- **Development effectiveness department.** Screens and ensures impact (it reviews the proposals and metrics proposed by investment officers).
- **Monitoring Systems.** MIF has a periodic impact monitoring report that assesses progress against the market impact metrics established at the investment origination.

market actors). The DFI "potential" for more market-level impact is not realized in most cases, as investment officers often operate with a short-sighted deal-making logic that may not look beyond the end of the next fiscal year. Investment officers should be fairly incentivized, compensated, and held accountable for reaching market development objectives (and not for volume and return alone). Investments should be monitored for their market impact. For example, at MIF, investment officers' proposals must address how each investment will add value to the market (see Box 8). Another measure that DFI senior managers might consider is placing incentives to encourage financial inclusion portfolio investments in other and innovative areas outside the FSP concentration. Also, as DFIs exit their FSP investments, care should be taken in terms of "responsible exits" that analyze any potential damage to the FSP or market.<sup>44</sup>

6. **Access to TA funding can enhance DFI market impact.** When DFIs had access to a TA and advisory budget that could be used for market development or when they had a technical advisory team, they were able to promote valuable market studies, data transparency, standard-setting, policy and regulatory work, capacity building, and infrastructure market development (e.g., LAC remittances, Chinese financial infrastructure, interoperability in Tanzania). It is worthwhile for DFIs to consider setting aside some TA funding that is targeted at specific market development needs and that will

benefit a larger group of market stakeholders. If DFI TA funds are restrictive, DFIs should coordinate with partner donor agencies to fund these identified areas for market development. DFIs can also tap into the expanded access to private, third-party funding, especially from large private foundations focused on market-level interventions (e.g., the Bill & Melinda Gates Foundation and the MasterCard Foundation).

Our research showed that DFIs with access to capacity-building grants were more engaged in market-level interventions. This was true for each of the featured cases (e.g., MIF through an allocated budget and IFC through donor support for digital finance). These DFIs also tended to have more accountable market impact goals designed at the onset of the program and monitored throughout (e.g., MIF's impact framework and IFC's Advisory Services Plan).

7. **Stakeholder collaboration: A critical ingredient to market change.** DFIs will make better investments and maximize their market influence when they collaborate with key market actors (FSPs, policy makers and regulators, market infrastructure companies, and innovators) and their development partners (donors and peer DFIs). Beginning with a shared market assessment and dialogue on market gaps and strategies for coordinated investments and/or other support, the prospects for market change will be greater when there is a shared vision and coordinated

<sup>44</sup> See Lahaye (2016) and Rozas (2014).

execution for investments and other support, such as the creation of benchmarks for investments in emerging business models. The TCX and ACLEDA cases are examples of DFI coordination and collaboration.

As DFIs attempt to apply the recommendations outlined in this paper, they need to address some internal issues—namely, clear directives from DFI senior management to pursue dual goals of concrete market development alongside financial returns and the development of more accountable monitoring and evaluation systems to ensure staff alignment around market development objectives.

## Conclusion

The rise of a market systems approach to financial inclusion comes at a time when many DFIs are reviewing their market additionality and considering how to adapt to quickly evolving market challenges and opportunities (e.g., FinTech, mobile banking). The market systems approach aligns closely with the overriding DFI mandate—to develop markets and attract private sustainable capital. Further, this market approach will encourage DFIs to more actively take into account the dynamics of local markets and to broaden their investments across a wide pool of financial inclusion actors, thus diversifying their risks and attracting private investors to a more diverse and inclusive market.

To optimize a market systems approach, governments need to coordinate their country-level funding with DFIs, donor agencies, and other institutions that carry out their development agenda, to ensure that these actors are held accountable for coordinating their country-level work to achieve enhanced market change. There appears to be much room for improvement in this area.

DFIs could make local financial markets more inclusive by deeply understanding the market and laying out market-level goals upfront—expanding their lens to thoroughly review how their interventions will affect the entire financial system, leveraging their technical credibility to facilitate market development, and growing their risk appetite to test new business models and

delivery channels that disrupt markets and help bring the poor into the financial system. Promoting this market systems approach does not require expanding the DFIs' "instruments," but rather focusing on the *how* these instruments are used to maximize DFIs' contributions to catalyzing systemic change in a particular market. As shown by the cases presented, DFIs' investments and intermediations overlap with a market systems development approach, and the results clearly suggest the potential for DFIs to play a more active role in applying this approach and realizing optimal "development returns."

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