

A Market-Building Approach to Financial Inclusion

For many people around the world, gaining access to basic financial services such as savings, remittances, and credit might be the key to unlock poverty. Poverty, after all, is more complex than privation; it is also characterized by precariousness. Research shows that, in developed and developing countries alike, the earnings of low-income households are not just low, they are also likely to be irregular. When households can save, access credit, get insurance, send and receive money safely, and make payments easily, they're better able to manage cash flow spikes and weather shocks that might otherwise send them back into poverty.

In the last few years, the world has made real, measurable progress on fighting poverty through financial inclusion. The World Bank reported this year, in its 2014 Findex survey, that two billion working-age adults are unbanked, down from 2.5 billion in 2011. This is a great achievement for global development, made possible mainly by harnessing the power of markets and innovative technology. Today, 62 percent of adults worldwide now have access to at least one formal financial account, compared to 51 percent just three years earlier.

At the macro level, financial inclusion is also critical to economic growth, and it advances many other development priorities such as health, education, and women's empowerment. As more people gain access to tools to manage their money, their ability to build assets and smooth consumption not only improves the welfare of their own household, it also expands possibilities for whole economies. This array of benefits is why financial inclusion is explicitly called for in several of the new Sustainable Development Goals the United Nations adopted in September 2015.

While hundreds of millions of people entering the banking the system since 2011 is a tremendous accomplishment, the work is not done. The UN's goals call for ensuring that all men and women, "particularly the poor and vulnerable," have equal access to financial services (as well as property rights, technology, and other economic resources)

Arjuna Costa is an investment partner and Tilman Ehrbeck a partner at Omidyar Network.

by 2030. Women are disproportionately affected by financial exclusion, especially in the Middle East and South Asia, where 37 percent of women own an account, compared to 55 percent of men. Access has expanded rapidly in some countries, not at all in others. In Tanzania, for example, the central bank but exceeded its 2009 goal of increasing the reach of financial services from 27 percent to 50 percent of the population two years ahead of schedule—largely through mobile money. Meanwhile, Pakistan barely increased the number of people with an account, from 10 percent to 13 percent, and participation in formal borrowing and savings are still both below 4 percent.

TECHNOLOGY LEAPS OVER PHYSICAL BARRIERS

Many different factors can hold back financial access in a given market. A whole ecosystem of necessary conditions need to be in place for access to expand: the financial and technological infrastructure, a regulatory environment that promotes innovative approaches while protecting consumers, the availability of appropriate and useful financial tools, and market incentives.

One fact is common to every market: The distribution costs for traditional financial service models are too high. The old brick-and-mortar bank branch model does not reach many low-income people, and it reaches even fewer of the world's poorest people, many of whom live in rural, sparsely populated areas, far from any traditional branch. Information costs are also prohibitive. By definition, the financially excluded have little or no access to formal credit, and therefore have no traditional credit history.

Technology has the power to overcome these physical barriers, opening new markets that include people at the base of the pyramid. For this to happen, government policies must be aligned to promote inclusion, and products and services need to be specifically designed to meet the needs of underserved segments, which often vary locally.

The best example of this is mobile money. In the most celebrated example, M-PESA has just about fully penetrated the market in its native Kenya, including the base of the pyramid. Provided by the mobile network operator (MNO) Safaricom, M-PESA reaches at least 84 percent of Kenyans living below \$2 per day. The success of mobile money has spread to many countries in sub-Saharan Africa; according to the Findex data, in Cote d'Ivoire, Somalia, Tanzania, Uganda, and Zimbabwe, more people now have access to mobile money than traditional bank accounts.

While mobile money is not in itself a solution to financial exclusion, it is an access point to formalized financial services. Of the two billion people on Earth who still do not have an account, an estimated 1.7 billion do have a mobile phone. As mobile money platforms such as M-PESA have attained scale, a rich ecosystem of businesses has emerged around them. These new businesses provide everything from savings, credit, and insurance to access to basic utilities such as water and power.

For example, Safaricom has launched M-Shwari, a savings and loan service tied to M-PESA. Today, one in five adult Kenyans is an M-Shwari customer. Dozens of other innovative solutions are leveraging the platform of a broadly used, widely ac-

cepted electronic payments system to provide “over-the-top” (OTT) services based on microleasing, data analytics, or micropayments. For example, companies like M-KOPA in Kenya install solar panels for residents and collect frequent but small payments through M-PESA.

MARKETS NEED SOUND POLICY TO DEVELOP

Omidyar Network (ON) invests in these kinds of technology-driven startups because of their potential to dramatically lower the distribution and information costs of financial services, and their ability to scale quickly to reach people at the base of the pyramid. However, the impact investing and development sectors are all too familiar with information and communication technology for development projects that never scaled. Businesses—especially small enterprises using technology and new approaches to reach underserved segments—need safe, efficient markets in order to scale. These markets need to be built on sound regulation and government policy.

In countries where the government has made financial inclusion a top priority, such as Bangladesh, Uganda, Peru, and, more recently, India, new markets for low-cost financial services are growing fast. Other government programs, even those not focused directly on financial inclusion but otherwise targeting the poorest segments of society, can create opportunities for financial access. When government social transfer programs, such as Brazil’s Bolsa Família or Mexico’s Oportunidades, are delivered electronically, they often provide beneficiary households with their first account. India has embarked on an ambitious effort to convert social programs away from in-kind or cash payments to direct digital benefits leveraging Aadhaar, the country’s comprehensive biometric identification scheme.

Although well-aligned policies can promote access, regulations can have unintended side effects that prevent or distort the formation of markets. In the absence of a widespread identification scheme like India’s, know your customer regulations that don’t keep pace with innovation can prevent the most vulnerable citizens—such as women, who are less likely to have identification documents in some markets—from accessing formal financial services. Heavy regulations, also often have the effect of protecting incumbents, whether traditional banks, telecom operators, or state-owned enterprises. This protection hinders competition, with the effect of keeping costs high and harming poorer consumers. On the other hand, when consumer protection regulations are inadequate or don’t keep up with new technologies, the poorest citizens often suffer the most—from too much debt, too little savings, or the wrong insurance.

Just as there is an essential role for government in advancing financial inclusion, so is there a role for nonprofit organizations, the development community, and civil society. Nonprofits often provide essential industry infrastructure, such as MIX Market, a data hub for measuring and mapping the financial and social performance of microfinance institutions, and MicroSave, which offers strategic advice and training to these institutions.

Nonprofits also perform important coordinating roles. The Consultative Group to Assist the Poor (CGAP) advises government and financial institutions in serving the

needs of the poor while freely distributing information and research on financial inclusion. U.S.-based RippleWorks pairs Silicon Valley startup veterans with promising businesses in developing countries, bridging the gap between concept and scale.

STARTING FROM A SECTOR-BASED ANALYSIS

Because myriad factors—technology, policy, civil society, and industry infrastructure—are all necessary to expand financial service markets, ON has developed a sector-level framework to financial inclusion. In fact, ON applies a systems-level approach for each sector in which we invest. And because we aim to create impact at the sector level (beyond what one company or organization could deliver), we make both for-profit investments and nonprofit grants, from two separate checkbooks. A venture capital checkbook allows us to invest in innovative ideas to advance financial inclusion, and a foundation checkbook enables us to make grants focused on building the knowledge and advocacy necessary for an ecosystem in which these ideas can mature.

In financial inclusion, a sector-level analysis has led us to a market-building approach. Part of this approach involves investing in early stage, technology-driven companies that deliver financial products and services to the underserved. When successful, these startups also have a broader demonstration effect, proving that there is a viable market in serving low-income or previously underserved consumers. However, to build markets, it is just as important that we advance knowledge and activities that allow these innovative solutions to scale quickly and safely. Therefore, we also deploy capital to disseminate knowledge that will inform both policy and service design. We support regulation and policy changes that promote more inclusive financial systems.

In view of the current frontiers of advancing financial inclusion, we pursue three investment theses:

- Reduce the distribution costs of reaching underserved populations
- Disrupt the high information costs of credit risk assessment for these consumers
- Bring innovative products and services to market that leverage this emerging lower-cost environment.

As the financial inclusion frontiers evolve, so do our investment theses. We are constantly evaluating our theses against the market to address new concepts and to support those areas in which capital is not abundant but still necessary in order to build a specific ecosystem. For example, when a large number of investors drove their funds to supporting microfinance, we shifted our investment focus to promoting the digital delivery of financial services—a critical piece of the puzzle.

DRIVING DOWN DISTRIBUTION COSTS ACROSS THE SECTOR

ON's efforts to act on the first thesis—drive down the distribution costs of financial services—illustrates how our flexible capital model allows us to invest in all the actors in the ecosystem necessary for building new markets. In a mature market based on digital delivery of financial services, four actors play key roles: traditional commercial banks, MNOs, governments, and entrepreneur-led third party providers. By leveraging technology, banks will be able to expand retail financial services to the mass market in developing countries. To support MNOs in building the digital delivery infrastructure, ON channels our grant capital through Groupe Speciale Mobile Association's (GSMA) Mobile Money for the Unbanked program.

Recognizing the critical role of governments in fostering this ecosystem, we also invest in efforts that support regulators and policymakers. Through a grant to the Alliance for Financial Inclusion (AFI), for example, ON supports the work of progressive regulators dedicated to expanding access to financial services while balancing safety and stability. One of the best examples of the alliance's financial inclusion advocacy work is the creation of the Maya Declaration, the first global and measurable set of commitments defined and signed by 80 developing and emerging country governments.

As a founding member of the Better Than Cash Alliance (BTCA), we help promote the digitization of large cash payments from governments (such as salaries, pensions, procurement, and social transfers programs), thereby driving the volume and speed-to-market of digital money. As an implementing partner of the G20's Global Partnership for Financial Inclusion, BTCA coordinates the financial inclusion work of governments, the development community, and the private sector.

All the actors in this ecosystem are interdependent. The work of regulators can ease the path to market for new technologies, and new technologies can advance the financial inclusion goals of governments. For example, through an early stage equity investment in Segovia Technology, ON is funding the software platforms needed for BTCA's advocacy efforts to be successful among its implementing countries.

In addition, many of our equity investments, whether made directly or through partnerships, fund startups building the last mile of the mobile-based digital delivery infrastructure in Latin America, Southeast Asia, and sub-Saharan Africa. These businesses are all modeled on lowering distribution costs by digitizing the retail front-end of service delivery. For example, Paga leverages mobile phones and a network of agents to simplify transactions for users in Nigeria. Zoona does the same in Zambia, and both have the potential to scale across borders, providing access points to financial inclusion in Africa.

DISRUPTING TRADITIONAL RISK ASSESSMENT

Addressing the second thesis, ON invests in companies using innovative approaches and big data analytics to assess the creditworthiness of "no file" or "thin file" borrow-

ers who are invisible to formal service providers, thus lowering information costs. For example, Cignifi provides a way for MNOs, insurers, and retailers to assess the risk of any consumer with a mobile phone, using predictive algorithms on calling data and usage patterns. Lenddo provides traditional and alternative lenders with a risk management algorithm that assesses consumer's online reputation on social networks such as Facebook, LinkedIn, and Twitter. Lenddo's founders estimate that about 1.2 billion people worldwide have no formal credit history, but they do have a digital footprint on social networks. Just as credit for hundreds of years was based on relationships and borrowers' reputations in the community, Lenddo crunches social data to help lenders judge the reliability of potential customers and their likelihood to repay a loan. We've also invested in Revolution Credit to help "thin file" borrowers gain access to products and terms they'd otherwise be denied. Users participate in online quizzes and games, which Revolution Credit turns into behavioral data, allowing users to prove to lenders they are lower-risk borrowers than their credit score would indicate.

The limits of this new category have yet to be explored, and clear concerns around consumer privacy need to be properly addressed. But if these companies succeed, they will significantly alter the economics of providing credit to financially underserved customers around the world.

BRINGING INNOVATIVE SOLUTIONS TO MARKET

Enabled by lower-cost payment platforms and credit assessment infrastructure, new financial products and services can reach customers at the base of the pyramid. This expanded reach is evidenced by the proliferation of OTT services that provide savings, loans, and insurance, as well as basic utilities, riding on the underlying success of mobile money in countries where it thrives. The business model of these services is therefore premised on the success of digitization and lower transaction costs.

ON has made investments in OTT services such as MicroEnsure, which builds partnerships between MNOs and insurance carriers to provide free or low-premium insurance to mobile subscribers in Africa and Asia. It's a mutually beneficial partnership: MNOs often have difficulty winning customers' loyalty; switching between networks is a real challenge in emerging markets, where it is common to find users carrying more than one SIM card. MicroEnsure gives free insurance to mobile subscribers in exchange for their loyalty, and with this approach it has provided insurance to millions of people for the first time. The success of MicroEnsure, which this year received the Kalahari Award for "Best Low Income Group Product" among mobile financial services across Africa and the FT/IFC Award for "Excellence in Transitional Business," demonstrates that financial inclusion must be about more than providing access. It requires understanding of what low-income consumers need and tailoring products and services to meet those needs.

Indeed, providing access is just the beginning. Financial services are a means to an end, a tool people use to secure their future and pursue opportunities. The possibilities

opened by access to the broad range financial tools is only limited by the imagination.

The OTT services that have seen the strongest uptake have been in solar power. In Tanzania, many households rely on kerosene for lighting, which is expensive and toxic. There, ON has invested in Off.Grid:Electric, which provides pay-as-you-go solar power to low-income customers, most of whom could not afford the upfront cost of traditional solar installations. With next-generation lithium batteries and hyper-efficient appliances, the solar power company is able to efficiently deliver solar infrastructure to rural communities. It provides customers with 50 times more light for less money than they would spend on kerosene. In Kenya, M-KOPA similarly performs solar installations that customers can pay for over time from their M-PESA accounts. The financial and social opportunities OTT solar has indirectly created are exciting to consider. Children can study later in the evenings, and some households with the solar devices have started small side business by letting their neighbors charge their mobile phones.

M-KOPA and Off.Grid:Electric represent a kind of micro-asset-based finance, and their business model would not be viable—or profitable—without an ubiquitous digital retail payment system. The cost of collecting micropayments from customers would be too high.

REINFORCING APPROACHES, ONE GOAL

ON pursues all three of our investment theses simultaneously. Together they create virtuous cycles: as digital payment platforms scale, they allow financial service providers to reach millions of new customers. Disrupting information costs allows providers to offer these new customers a broader range of services. As services tied to digital payment platforms proliferate, the value proposition of the payment platforms increases and thus, scales further. Greater scale creates a broad customer base for yet more innovative services tailored to the needs of people previously unbanked.

The underlying principle of our market-building approach is to attack these factors on all fronts. Our multifaceted approach aims to push the entire market forward. Although many investors do not have the resources to make grants and support market development as extensively as ON, our work is one concrete example of how to apply a larger framework, with an eye to the entire ecosystem, when investing in financial inclusion. When all the actors in the financial service ecosystem work together, full inclusion—built on technology and scaled by expanding markets—can empower the remaining two billion unbanked people, while also growing economies and promoting broader development.