FINANCIAL INCLUSION

Approach and Principles

Markets, Economic Recovery and Growth Technical Unit

Overview

There are over two billion people excluded from, or underserved by financial services. Of them, one billion live on less than US$1.25 a day relying on cash for everyday transactions and long-term use. [1] Although financial inclusion is not an end to itself, but rather a means to an end - it is an essential ingredient in reducing poverty and achieving inclusive economic growth.[2] Studies show that when people can access a range of financial services, they are better able to absorb financial shocks, manage risks, and start and expand businesses.[3]

It is very expensive to be poor; yet poor and underserved populations frequently have limited financial options and perceived to be high risk, with low potential for earning lenders a profit. The result is not enough financial service providers (FSP)[4] offer the needed range of flexible financial products for those that need it most, including smallholder farmers, pastoralists, and micro, small, and medium enterprises (MSME). FSP often fail to meet the actual demand for financial products by strictly operating on supply-led models that do not address the core financial needs and behaviors of poorer market segments.[5]

At the same time, poorer clients may have limited ability to meet institutional or legal requirements. This is especially true for vulnerable populations, the unserved or chronically underserved, who may lack legal documentation, consistent cash flow or credit histories. Culture also plays a role, including gender-based or religious restrictions that limit access to financial products not tailored to their particular needs and interests. This mismatch leaves poor households and businesses, especially those in countries plagued by frequent disaster or crisis, without access to the stepping-stones that could help lead them out of generations of poverty.

APPROACH TO FINANCIAL INCLUSION

- Respond to short-term needs –including in emergencies - while remaining focused on the long-term by leveraging the commercial sector as part of the initial early recovery response, minimizing market distortions and promote the re-emergence of FSP.
- Improve access to and more importantly – actual usage of financial products, both formal and informal products. This includes payments, savings, credit, remittances, leasing, insurance, and other risk mitigation products.
- Strengthen financial systems that include and serve low-income clients, beginning with an insider's understanding as to how and why the financial market does not currently work.

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[1] IFAD, Smallholders, food security, and the environment, 2013
[2] World Bank, The Global Findex Database 2014, April 2015
[3] Aker, J., R. Boumnijel, A. McClelland, and N. Tierney. 2013. "How Do Electronic Transfers Compare? Evidence from a Mobile Money Cash Transfer Experiment in Niger." Tufts University
[4] Financial service providers (FSP) is used throughout this document – unless otherwise indicated – to include banks (commercial and public), microfinance institutions, credit unions, savings and credit cooperatives (SACCO), mobile network operators (MNO), leasing companies, insurance providers, post offices, savings groups, and other financial providers.
[5] Addressing Customer Needs for Full Financial Inclusion (September 2013). Center for Financial Inclusion, Accion

Theory of Change

Mercy Corps' financial inclusion theory of change states that within inclusive financial systems, participants are able to access, use, and afford a range of financial services and products. In doing so, they will better manage economic assets to cope with shocks and stresses, adapt to changing circumstances, and transform their lives.

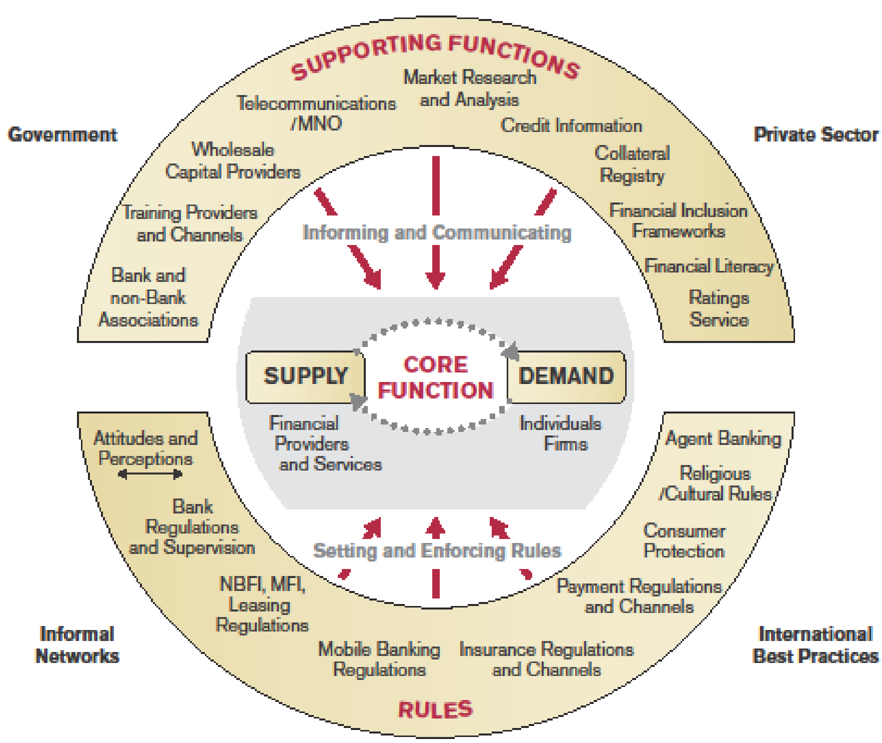
Definition

Mercy Corps' financial inclusion approach is evidence-based and adheres to market development principles. It builds systems that include and serve poor clients, beginning in each market where Mercy Corps works with an understanding how and why the financial market does not currently work for low-income or vulnerable populations.

We strive for full financial inclusion for the unserved and chronically underserved and in areas affected by conflict, natural disasters, and economic and political crisis. Mercy Corps embraces a broad definition of financial inclusion, seeking to improve access, ensure quality and actual usage of financial products and services, including credit, insurance, leasing, payments, remittances, and savings.

Mercy Corps works with market stakeholders at all levels – in both the formal and informal sector - to ensure financial products and services are accessible and affordable; age-, gender- and context-appropriate; and delivered in a scalable manner. We introduce new, or expand existing, financing mechanisms and products through a diverse range of delivery models to strengthen access and uptake of financial services.

Financial Market System



Approach to Financial Inclusion

When engaging with the financial market, Mercy Corps strives to play the role of a facilitator by designing and promoting incentives to spur financial market participation by a wide array of actors, including formal and informal FSP, clients, regulators, and market infrastructure actors.

Our role in a developed or mature financial system will differ than in a nascent financial system.

- In well-functioning markets, Mercy Corps works with existing FSP to improve market efficiencies, support innovation in existing products and services, expand the range of products, and extend the reach of the product base to 'last mile' clients.
- In nascent markets, there are often few existing formal or informal FSPs. Mercy Corps may take a more active – albeit temporary – role to include research; develop a business case; catalyze new products through smart subsidies; incentivize FSP or value chain players to enter the market; and advocate for enabling regulation.

In both scenarios, we encourage FSP to make their investment decisions on the needs of the market. Through our interventions, we strive for sustainable service delivery beyond the period of Mercy Corps short-term support or investment. We plan our exit at the point of entry and put in place benchmarks or identifying market signals to direct Mercy Corps' exit.

Key Strategies for Financial Inclusion

Use of Smart Subsidies and Financing

Mercy Corps stimulates and expands financial systems. This includes 'buying down the risk' of new business models or products for a limited time to test or prove their business viability (e.g. introduce a new financial product or delivery channel). Any subsidy should be short-term, have a clear objective and exit strategy, and create the space and opportunity to 'crowd-in' more players. This could include feasibility studies; cost-share to develop, pilot, or market a new product; or subsidize costs for new services to limit the risk to the FSP. Mercy Corps does not subsidize interest rates or collateral requirements, to avoid distorting the market.

Appropriate Products and Services

Mercy Corps promotes market segmentation of clients to understand the demand of current and potential clients and their ability to engage with FSP (formal and informal). This includes market segment profiles to understand which interventions are appropriate or applicable to different clients based on various factors (age, gender, income levels, type of employment, collateral available, repayment capacities, and religious considerations).[6] This includes understanding the literacy and numeracy levels of the potential clients as that can influence how they interact with FSP and the design of consumer education delivery.

Increase Client-Level Financial Capability

Financial capability is the combination of financial skills, knowledge and behaviors that clients require to make informed and effective financial decisions at the individual, household or business level. Increased financial capability results in increased understanding of and ability to mitigate risk, make choices on appropriate financial products, and negotiate with FSP. Financial capability is not static and must adapt based on age and life circumstances.

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[6] We also look at different types of employment – formal salaried, informal salaried, seasonal, and entrepreneurs.

Mercy Corps employs a wide-range of approaches through a diverse range of actors to deliver and reinforce financial capability. This includes a range of digital and classroom channels at the client and FSP level, and advocacy or information campaigns. We work with FSP to understand the role of financial capability in client acquisition and retention. There are opportunities to influence regulatory frameworks as countries adopt financial inclusion regulations.

Integration of Technology and Digital Finance

Technology provides an opportunity to increase financial inclusion at scale through diverse platforms that reach wider audiences. It can reduce transaction costs through electronic payments and bundled services, especially for populations segments with limited freedom of movement due to transportation costs or social norms. We encourage the use of mobile money and digital financial services at the client and institutional level. This includes by governments for social safety net payments and the use of e-payments when appropriate in humanitarian response.

Mercy Corps works in partnership with FSP to ensure mobile technology reaches target clients in more rural areas and there are adequate agent networks for clients to cash-in and cash-out. We ensure technology is appropriate based on the literacy and numeracy of the targeted market segment incorporating digital literacy training as required. Increased technology allows individuals and businesses in the informal economy to build a credit history and track transactional data.

FINANCIAL INCLUSION PRINCIPLES

- Clients value reliable and quick access to loans as much as, or even more than, the cost.
- Access to, and usage of, formal and informal financial services are needed for vulnerable households and businesses.
- FSPs charge cost-covering interest rates and fees in order to grow and provide services in a sustainable manner.
- Market-driven competition between FSP will stimulate product innovations and a gradual expansion of financial services into new areas and institutionally riskier products.
- Insurance, leasing, remittances, and savings are as important as credit.
- Deposit mobilization is an important source of funds for FSP and long-term household security and should be encouraged within all Mercy Corps interventions.
- Integration of new technologies drives demand and decreases transaction costs for clients and providers.
- Ensure financial literacy is available at the point financial decisions are made for the greatest impact.

Strengthen the Institutional and Regulatory Level

Mercy Corps often supports a few select FSP as a market entry point, while simultaneously facilitating the overall financial market system and moves from direct to indirect support in a specified timeframe. This may include the need to address constraints in the regulatory or legal environment of the overall market.[7]
At the regulatory level, we encourage moveable asset registries, alternative collateral and flexible know your customer (KYC) regulations and opportunities for poor clients to obtain a legally recognized ID.

[7] For example, FSP often try to protect themselves against the risks inherent to financing the poor through excessive credit rationing and over-reliance on traditional collateral, thus limiting access to the intended clients. Mercy Corps must address at the FSP level and within the regulatory environment.

At the institutional level, Mercy Corps works with FSP to avoid a 'one size fits all' approach. This includes recognizing that traditional business loans are often not appropriate for agribusinesses, which require grace periods or balloon[8] payments to synchronize with agriculture cycles, or required term-savings accounts.

Appropriate Financing Mechanisms

Mercy Corps facilitates relationships between market actors to build trust in long-term financing mechanisms and new delivery methods. This should increase financial mechanisms between actors in supply chains for short-term, direct financing.

- Supply chain finance (i.e. value chain or trade finance) can move actors from informal to formal finance providers. Supply chain finance is by nature transactional (often at the input stage or directly post-harvest in agriculture chains). Thus, Mercy Corps also links actors to formal financial providers for longer-term credit and savings services. Supply chain finance allows documentation of payments received and cash transferred to build cash flow histories for clients. It allows clients to use buyer contracts as a source of collateral for a formal financial provider.
- Alternative products (i.e. leasing, energy efficient technology and warehouse financing) increase the options available and bring new actors into the financial system.

FINANCIAL INCLUSION 101: SAVINGS

- *Asset creation* – savings allow for the purchase of economic assets, including tangible assets like jewelry for collateral or land to rent for additional income. Intangible assets include school fees, health expenses or life events (weddings, funerals, births).
- *Cash flow management* – savings manage regular expenditures for planned and unplanned needs and protect clients from taking a loan for this purpose.
- *Risk management* – cash savings (or assets to sell or trade) can mitigate the risk of unplanned emergencies. For example to repair a house after a flood, replant after a crop failure, replace stolen business inventory, pay for a family illness. This is 'saving up' before an event to have sufficient savings balance to cover unforeseen expenditures and 'saving down' after the event by using saving reserves to cover income that has been lost.

Research and Iterative Analysis

When strengthening financial systems, Mercy Corps understands research must go beyond questioning why transactions are not happening at the core market between clients (demand) and financial providers (supply) (see Figure 1[9]). Mercy Corps must identify the underlying causes that contribute to the underperformance of the finance market and understand potential incentives and capacities for growth. Information is continually required to understand changing contexts, market actors' roles, market adaptation, and impacts of Mercy Corps financial interventions.

We use iterative market analysis to adapt financial and non-financial products. This often includes:

- Human-centered product design, marketing, and delivery mechanisms
- Train staff and upgrade operations
- Introduce appropriate risk management systems.
- Advocate and pilot alternative forms of collateral, such as purchase orders or supply-chain contracts[10]
- Develop alternative credit-history and credit-reporting models
- Apply and integrate client protection mechanisms

[8] Holding back most of a debt and paying it near the end of the agreement.
[9] www CGAP.org
[10] This can also include working with banks and MNOs to apply microfinance best practices (cash-flow and character-based lending), reinforced with prescription of collateral-substitutes

Additional Resources

Mercy Corps Financial Inclusion Capacity Statement
Mercy Corps Financial Inclusion Sector Priorities

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About Mercy Corps
Mercy Corps is a leading global organization powered by the belief that a better world is possible. In disaster, in hardship, in more than 40 countries around the world, we partner to put bold solutions into action — helping people triumph over adversity and build stronger communities from within.
Now, and for the future.

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