Spectrum

Financial inclusion: an economic opportunity for all

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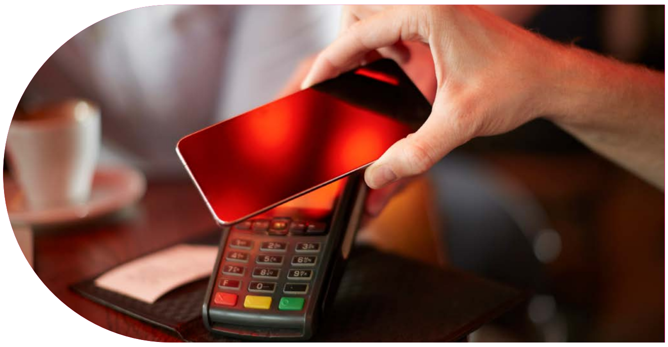
Despite considerable progress on reducing absolute global poverty over the last 20 years, worldwide, billions of people remain unbanked, uninsured and without assets or savings. In the midst of the global pandemic, those without access to formal financial services have suffered disproportionately.

This issue of *Spectrum* explores why financial inclusion should be an essential part of 'building back better', not just as a moral imperative, but as a significant economic opportunity which offers real benefits for society as a whole.

Key points

- Despite a decrease in absolute poverty, billions worldwide are financially excluded
- Access to financial services provides security and opportunity for individuals and businesses
- Financial inclusion is both socially and economically beneficial to wider society
- For investors, it offers access to significant growth opportunities in untapped markets



Part 1: What's the issue?

"Anyone who has ever struggled with poverty knows how extremely expensive it is to be poor."[1] That comment was made over half a century ago by the American writer James Baldwin (and expresses a sentiment which existed long before that). Yet it's arguably more pertinent than ever in 2021.

Having battled through a decade of real wage stagnation set against ongoing asset inflation, the world's poor now find themselves once again at the thin end of the wedge. In the developed world, the working poor – whose numbers have increased as overall poverty has gone down[2] – have been most vulnerable to job losses during the pandemic[3], at the same time as being the least well protected from the consequences.[4] Meanwhile, in the developing world, where median incomes are lower and financial inclusion an even greater issue, the vast majority of the poor are facing Covid-19 uninoculated both physically and financially. In fact, according to the World Bank, global extreme poverty worsened in 2020 for the first time in a generation, with about 120 million additional people joining the ranks of the poor worldwide.[5]

What exactly *is* financial inclusion?

Financial inclusion is commonly defined as 'access to and use of formal financial services'. More specifically, it is a situation in which everyone can access the products and services they need to manage their money effectively at reasonable cost, while having the necessary awareness and understanding to use them appropriately. It encompasses the responsible and sustainable provision of a range of financial services, including transactions, payments, savings, credit and insurance, which provide financial opportunity and security for individuals and businesses.

> **Financial Inclusion means that individuals and businesses have access to useful and affordable financial products and services that meet their needs – transactions, payments, savings, credit and insurance – delivered in a responsible and sustainable way.**
>
> **– World Bank**

[1] James Baldwin, "Fifth Avenue, Uptown: a Letter from Harlem" in Esquire (July 1960); republished in Nobody Knows My Name: More Notes of a Native Son (1961).

[2] See for example: https://www.jrf.org.uk/data/workers-poverty; https://ifs.org.uk/uploads/WP201912.pdf; https://www.bls.gov/opub/reports/working-poor/2018/home.htm

[3] See for example: https://www.ilo.org/wcmsp5/groups/public/@dgreports/@dcomm/documents/briefingnote/wcms_767028.pdf; https://www.pewresearch.org/social-trends/2020/09/24/economic-fallout-from-covid-19-continues-to-hit-lower-income-americans-the-hardest/

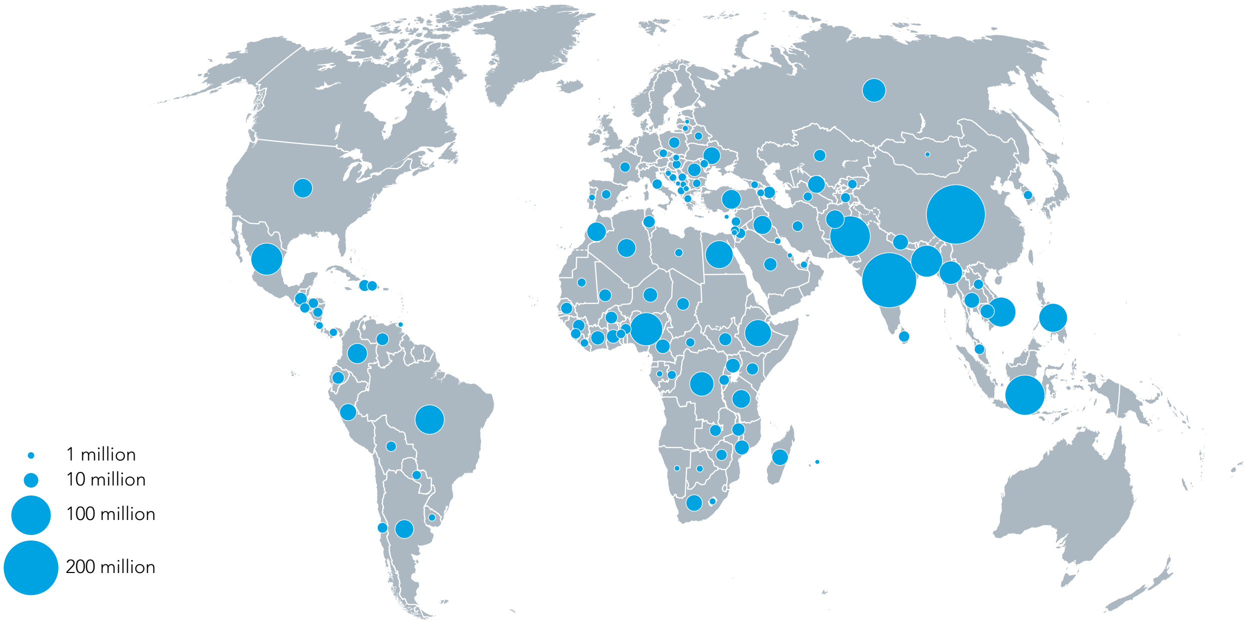
[4] See for example: https://www.ons.gov.uk/peoplepopulationandcommunity/personalandhouseholdfinances/incomeandwealth/articles/financialresilienceofhouseholdstheextenttowhichfinancialassetscancoveranincomeshock/2020-04-02.

[5] https://www.ons.gov.uk/peoplepopulationandcommunity/personalandhouseholdfinances/incomeandwealth/articles/financialresilienceofhouseholdstheextenttowhichfinancialassetscancoveranincomeshock/2020-04-02.

Why is financial inclusion so important now?

It is increasingly understood that absolute levels of poverty are far from the only issue affecting the world's poor. Almost a third of adults globally (about 1.7 billion people) remain unbanked, half of whom are from the poorest 40% of the world population.[6] Many more are unable to access financial services like loans which are taken for granted in the developed world. Being excluded from the formal financial economy, or at least from access to credit facilities which could be deemed 'reasonable and fair' often creates a vicious circle, trapping people in a cycle of debt.

Figure 1: Unbanked adults by country in 2017
Globally, 1.7 billion adults lack a bank account



Source: Global Findex database.
Note: Data is not displayed for economies where the share of adults without an account is 5% or less.

Insurance is another financial product which most of us take for granted but is out of reach for a significant proportion of the global population. The uninsured portion of natural disaster losses are around 60%, and these are primarily located in developing countries which also bear the brunt of the increase in adverse weather events associated with climate change.[7]

There is also huge 'leakage' in the system in terms of remittances and aid provision. Migrant workers sending their earnings back home can pay as much as 10% in transaction fees[8], while financial aid sent by governments and charities is often siphoned off through corruption, never reaching those who need it most.

The problem isn't limited to the developing world. In the US, it is estimated that "financially vulnerable" households spend c13% of their income on unnecessary fees and interest vs c1% for those classified as "financially healthy".[9] In the UK the situation is little better with an estimated 11 million struggling to access affordable credit.[10] Social, geographic and racial rifts persist over time, making it harder to escape poverty and further perpetuating the issue.

Given all these issues, the Covid-19 pandemic is having a disproportionate impact on small businesses and low-income households, for whom the lack of a financial safety net compounds the impact of the crisis.

[6] World Bank Group – Findex report – https://globalfindex.worldbank.org/sites/globalfindex/files/chapters/2017%20Findex%20full%20report_chapter2.pdf
[7] https://www.theactuary.com/2021/01/13/insured-losses-natural-disasters-rise-2020
[8] World Bank Group – https://remittanceprices.worldbank.org/sites/default/files/rpw_main_report_and_annex_q121_final.pdf
[9] FinHealth Spend Report 2021.pdf
[10] Source: fair4allfinance

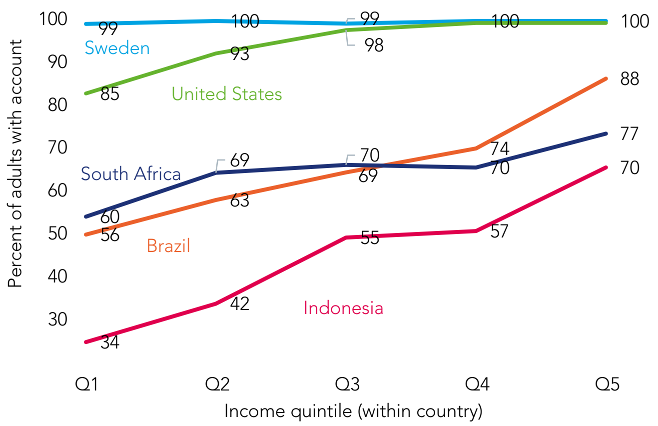
The high cost of financial exclusion

- Globally, an estimated 1.7 billion people are unbanked.[11]
- More than 40% of global assets are uninsured.[12]
- Foreign workers sending money home lose on average approximately 7% in remittance fees.[13]
- 1 in 5 people in the UK have less than £100 in savings.[14]
- 11 million British people struggle to access affordable credit.[15]
- Levels of home ownership within different racial groups in the US has barely moved in 50 years.[16]
- The median black family has a net worth of less than 1/10th of the median white family.[17]
- In the UK, black people are nearly four times more likely to be denied a loan.[18]

The benefits of financial inclusion

International Monetary Fund (IMF) studies show a strong association between extending traditional financial services to low-income households and small businesses operating in the informal economy and reducing income inequality (see Figure 2). The data also showed that while both men and women gain from inclusion, the largest reduction in income inequality comes when women are given increased access to finance[19].

Figure 2: Financial Inclusion and Income Inequality, IMF[20]



Source: IMF – Finance and Inequality (imf.org) – January 2020

Reducing income inequality is important, but it is far from the only benefit of giving people access to the formal financial system. Financial inclusion is an almost uniquely powerful theme in terms of the number of areas it touches. In fact, the UN has linked financial inclusion to progress in relation to 13 of its 17 Sustainable Development Goals (SDGs). As well as more obvious impacts like reducing inequalities, eliminating hunger and improving wellbeing, access to formal financial services can in turn improve access to clean water and sanitation, affordable energy and quality education. It can indirectly impact issues such as gender equality and help build stronger institutions which improve political stability, minimising conflict and creating more just societies.

Financial inclusion also represents a significant economic opportunity. As well as bringing up to 1.7 billion people into the financial system, it has the potential to generate 95 million jobs and boost global GDP by a massive $3.7 trillion by 2025.[21]

Figure 3: UN SDGs positively impacted by financial inclusion

Part 2: What is being done about it?

While the pandemic has exacerbated social inequalities and plunged tens of millions of people back into extreme poverty, the last twelve months have also been a time of positive change. Unprecedented technological adoption in banking has seen digital payments emerge as a strong force for financial inclusion. Governments have seen the benefits of collaborating with banks and payments companies to quickly and effectively distribute financial aid, such as the Paycheck Protection Program (PPP) in the US.

These developments and shifts in perspective bring us to an inflection point where we have both the societal desire and the technological capability to build back better, not just from an environmental perspective but from a social perspective as well.

[11] Source: IMF. [12] Source: World Bank Group.
[13] Source: World Bank Group.
[14, 15, 16, 17, 18] Source: fair4allfinance.
[19] Source: IMF – Women in Finance: A Case for Closing Gaps (imf.org) – September 2018.
[20] Source: IMF – Finance and Inequality (imf.org) – January 2020.
[21] Source: McKinsey Global Institute.

Digitalisation & financial inclusion

Fintechs are playing a major role in improving access to financial services. An IMF study found that between 2014 and 2017 digitalisation raised financial inclusion even where traditional banking services were contracting.[22] In the wake of Covid-19, that trend is accelerating.[23] Mobile distribution is particularly relevant for reaching the under-served, since two-thirds of unbanked adults globally own a mobile phone.

Traditional banking will remain part of the equation and can have its advantages for certain underserved sectors of the population, particularly those for whom financial and/or technological literacy are an issue. However, in many contexts where financial inclusion is most important it can result in negative outcomes – for example in rural areas of the developing world where people may have to travel significant distances to access bricks-and-mortar banking. As well as convenience, mobile payment has the advantage, not only, of offering security but of providing a track record, which is important in terms of the ability to access credit.

Digital technology is starting to break down financial barriers in a material and accelerating way. Data analytics, artificial intelligence and open banking are allowing lenders to assess the prospective ability of individuals or small businesses to pay in innovative ways. This is undoubtedly widening access beyond the incumbent beneficiaries of financial services. At the same time, it gives people further down the socio-economic spectrum access to goods and services at far more reasonable rates than has historically been the case.

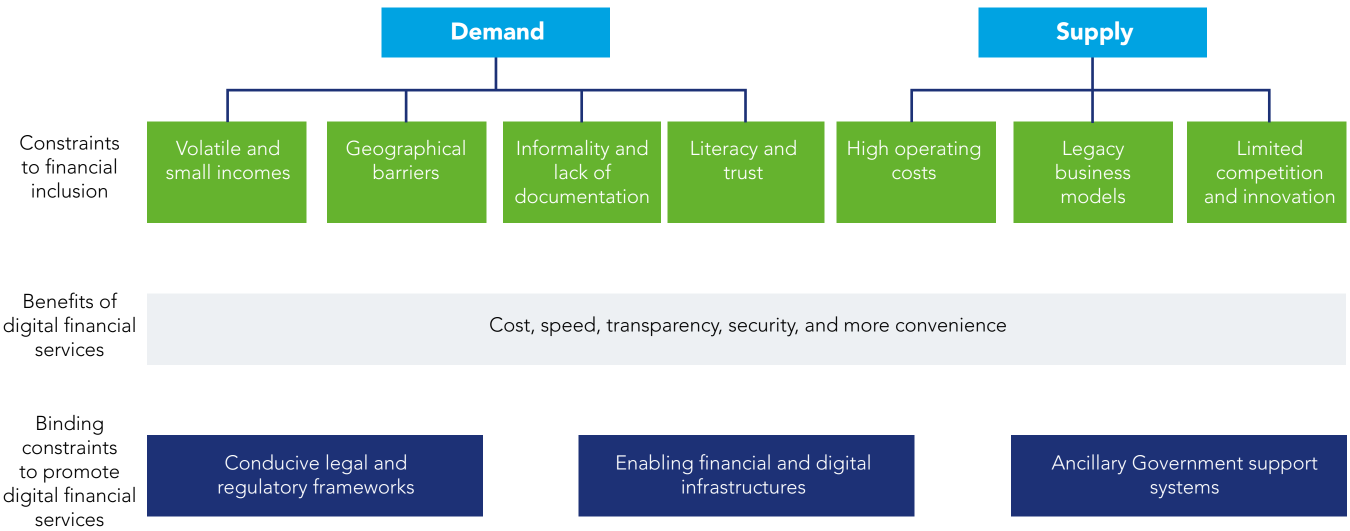
Barriers to financial inclusion

While the appetite to increase financial inclusion exists, there are a number of barriers which digital financial services has to overcome.

On the demand side, geographical barriers may exist for remote communities, while the necessary level of digital and economic literacy to be able to understand, use and trust the products can be an issue. Lack of documentation can also be a problem, and income levels for many people existing below the poverty line are not only low but volatile, presenting challenges in assessing the suitability of products.

Looking at the supply side, high operating costs can have an impact, while legacy business models can create an inherent bias against underserved parts of the population. In the past, limited competition and innovation have been an issue in financial services, although as discussed, more recently the fintech revolution has been driving rapid change in the sector.

Figure 4: Constraints to financial inclusion and the development of digital financial services



Source: World Bank Group

As barriers are broken down, countries will tend to pass through various stages of development in transitioning from a predominantly cash-based economy to a fully digital one (see Figure 5). However, that's not to say that the process has to be painstakingly slow: Kenya's embrace of mobile payments, and in particular the M-Pesa branchless banking system[24], has driven rapid penetration of digital financial services and brought millions into the formal financial system. It should serve as an inspiration to countries currently still relying on cash. Overall, though, it is vital that governments, corporates and the third sector all play a constructive part in addressing these barriers, an idea the pandemic has only reinforced.

[22] Source: IMF – The Promise of Fintech : Financial Inclusion in the Post COVID-19 Era (imf.org) – July 2020.

[23] Source: Deloitte/Institute of International Finance (IFF) – Realizing the Digital Promise: COVID-19 Catalyzes and Accelerates Transformation | Deloitte | Financial Services – 2020.

[24] M-Pesa is owned by Vodafone but was started as a public/private initiative driven by the UK Government's Department for International Development. As well as Kenya, it operates in Tanzania, Afghanistan, South Africa, India and Eastern Europe. M-PESA (vodafone.com).

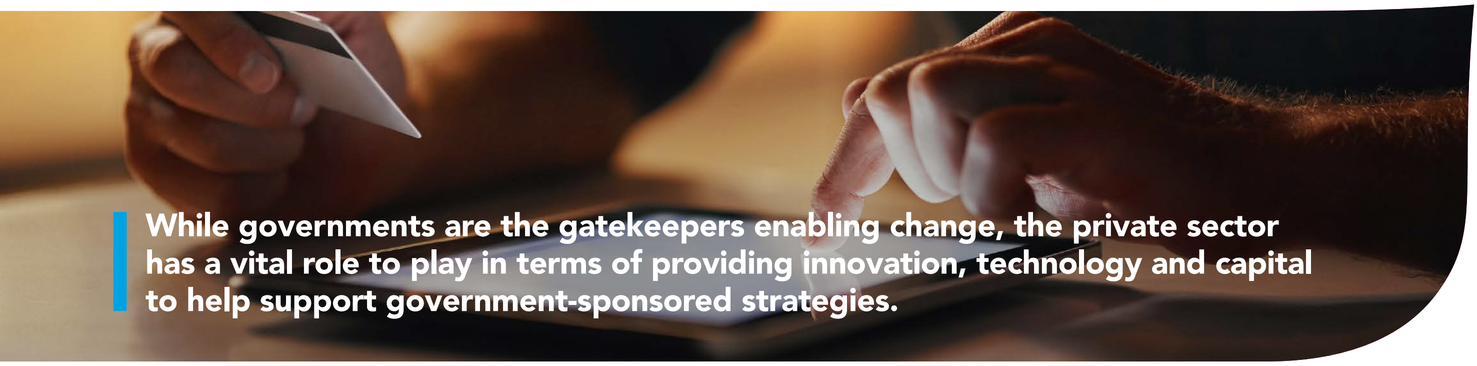
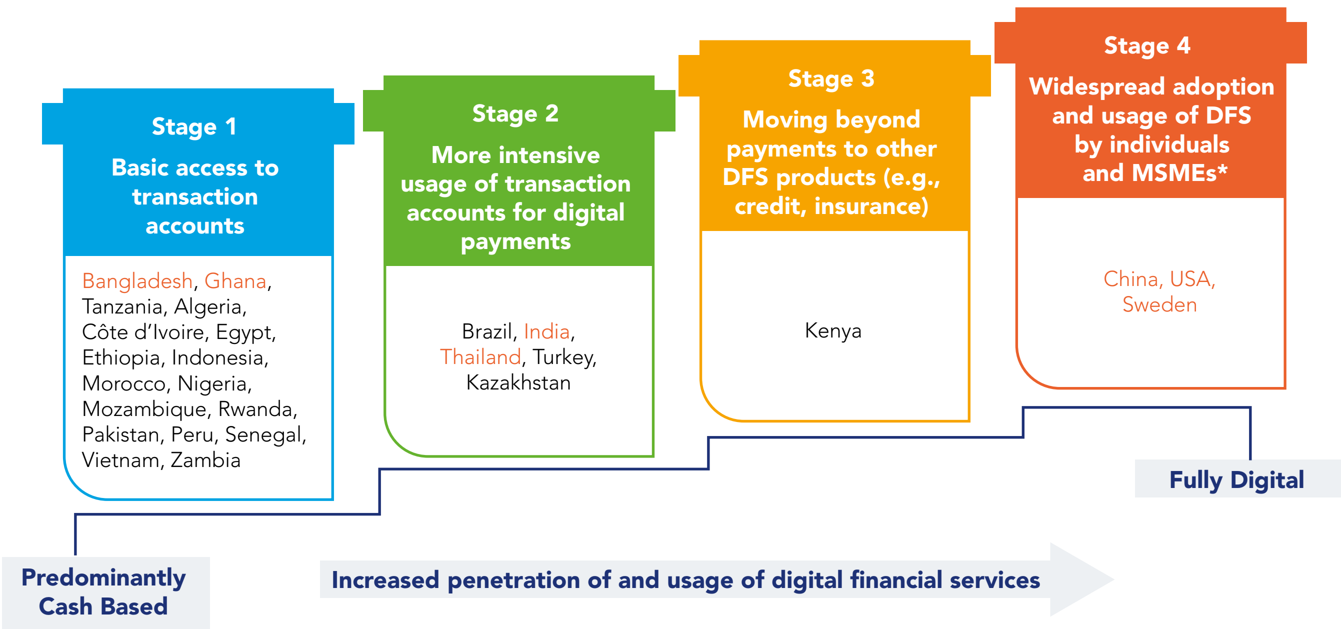


Figure 5 Development stages of digital financial services (DFS)



Source: World Bank Group

The role of government

Governments can underpin change in a number of ways: supporting financial education and legislating to ensure more transparent information is available to consumers is one. Subsidising rural broadband and enabling internet access is another: this improves gender equality and democratic stability as well as driving economic growth, while financial inclusion goes hand in hand with these outcomes as a key benefit.

Lowering the regulatory requirements for bank accounts and opening accounts for all children at birth can act as a launchpad for their financial future and also helps to bring mothers into the formal financial system. Ensuring every citizen has official government identification is also vital, since individuals need to have a legal identity in order to be lent to.

Clearly defined national financial inclusion strategies that are tailored to a country's geography and population can drive transformational change. For example, in Brazil, the loosening of regulation and introduction of banking agents has had a very positive effect on financial inclusion, while in Indonesia pioneering microfinance initiatives have been hugely successful.

The role of the private sector

While governments are the gatekeepers enabling change, the private sector has a vital role to play in terms of providing innovation, technology and capital to help support government-sponsored strategies. Corporates also possess a wealth of data and expertise from their operations in developed countries which they can apply to emerging markets.

There are big wins for businesses who are ready to challenge and diversify their own business models to capture emerging market growth. Reorienting your strategy to help drive inclusive growth can have significant long-term benefits. The payment companies are a good example of an industry that has understood that investment in inclusive growth improves diversification, lowers the cost of capital and allows access to unsaturated markets.

At the same time, innovation can improve access to a firm's products and services both in their home markets and elsewhere. Peer-to-peer payments, crowdfunding, virtual currencies, AI-assisted credit modelling, robo-advisers, auto-underwriting and blockchain bonds are just some examples of financial innovation which are both increasing inclusion and driving growth.

*Micro, Small, and Medium Enterprises.

Part 3: Investing in financial inclusion

Why invest in financial inclusion?

From an investment perspective, financial inclusion is attractive for a number of reasons, some obvious, some less so.

Clearly it delivers hugely positive outcomes for multiple stakeholders, helping to address a wide range of societal and economic issues which are becoming increasingly acute. From a less altruistic perspective, it offers a huge and varied opportunity set for investors. The types of businesses which can form part of a financial inclusion-focused portfolio include banks, insurers, homebuilders providing affordable housing, credit bureaus and of course fintech, which is providing innovative solutions to some extremely entrenched issues.

Financial inclusion also represents the opportunity to unlock unsaturated economies and access cheap, accelerating growth while building long-lasting relationships with consumers and communities.

Within a broader portfolio, financial inclusion offers a great complement to broader "sustainable" themes. While many healthcare and environmental names sit on lofty multiples acknowledging the significant total accessible market ahead of them, banks and insurers exposed to emerging market growth often trade on low teen multiples and are less susceptible to valuation risk in an inflationary or rising rate environment. While the payment companies sit on higher multiples they have very high returns on equity, generate significant cash flow and tend to hold up well in market drawdowns.

What to consider

There is no single approach to investing in financial inclusion, however, there are various factors which should be taken into account when considering a possible investment in this theme. Is it materially inclusive? Can it offer sustainable growth? Does it have the margins to be able to invest in its business? If it's a case of providing capital, has that capital been tested historically against the cohort? And importantly, is the valuation attractive?

Driving inclusive growth: Equities

Bank Rakyat

- Leading Indonesian bank.
- Solid financial track record, having compounded book value at mid-teens over the last decade.
- Bringing millions into the financial system through microfinance loans and basic bank accounts.

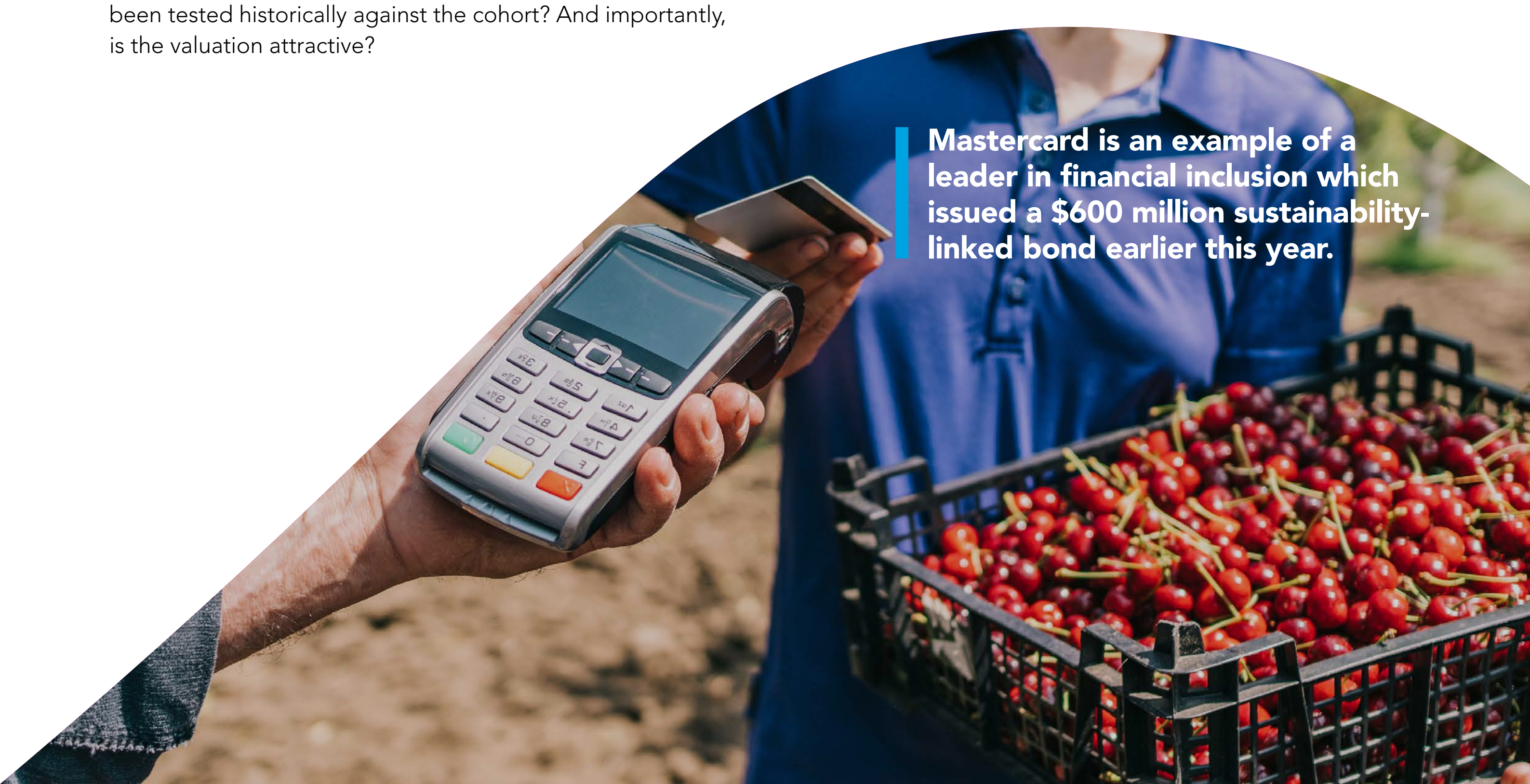
Prudential PLC

- Health and Life insurer with leading market position in high growth Asian markets.
- Pulse platform providing differentiated access to consumers.

Mastercard

- High return business in an attractive duopoly.
- Management have made financial inclusion central to the business' purpose.
- Committed to bringing 1bn individuals into the digital economy and to helping 50m small and micro merchants by 2025.

Opportunities for investing in financial inclusion exist across both equity and fixed income markets, although it is more challenging to find pure 'financial inclusion plays' in the corporate bond markets. Mastercard is an example of a leader in financial inclusion which issued a $600 million sustainability-linked bond earlier this year. We also see suitable opportunities in the US high-yield bond market, although these are harder to fit into the investing framework outlined above. We refer to them as specialised lenders and typically, but not exclusively, they are non-banks, i.e. they are not regulated by the US Federal Reserve.



Driving inclusive growth: Fixed income

Ally Financial Inc

- A leading auto and consumer loans franchise.
- It has invested in financial education through its Ally Grants and Ally Wallet Wise programmes.
- Has been able to capitalise on opportunities for providing finance to underserved consumers.
- Not categorised as high grade by the ratings agencies, but it is recognised as being in the top decile in terms of financial inclusion.
- Ally is on positive watch at Moody's to become 'high grade' which would lower its cost of funding.

Prudential PLC

- Leading life and health insurer has a strong position in at least 15 regional markets in Asia.
- Strengthening financial inclusion credentials gives access to an immense growth opportunity.

OneMain Holdings, Inc. (OMF)

- OMF is a responsible lender for non-prime customers which benefits from strong scale.
- Well-positioned to tackle the issue of financial inclusion using a data-driven approach.
- The company has originated $145 billion of business from the underserved customer base since 2006.
- In 2020 OMF contributed $2 million to supporting financial literacy, community and economic development, pandemic relief, and racial and social justice initiatives.
- In June 2021, OMF issued its first $750m bond out of its Social Bond Framework. OMF framework aligns with the ICMA 2020 Social Bond Principles (SBP).

Conclusion

The pandemic has shone a strong light on continuing financial inequality and at the same time offered a real opportunity to pivot towards investing in a fairer and more inclusive global economy. The rewards for doing so go way beyond those directly affected, from increasing political stability to helping address climate change, and from driving global GDP growth in global GDP to contributing to strong returns from a well-balanced portfolio. Ultimately, financial inclusion can pay dividends all round.

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