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The Case for Responsible Investing in Digital Financial Services

By Margarete Biallas, Momina Aijazuddin and Lory Camba Opem

Together with private sector investors, IFC has been leading a global effort to develop new guidelines for responsible investing in digital finance. These guidelines leverage IFC's significant experience with the Equator Principles and responsible investing in micro, small, and medium enterprises (MSMEs) by focusing on strengthening governance, risk management, consumer protection, and financial well-being for the unbanked and underserved—as well as IFC's experience as advisor and investor in the digital finance space.

Digital Financial Services (DFS) entail a broad range of financial products accessed and delivered through digital channels, including payments, credit, savings, remittances, and insurance. The concept includes mobile financial services (MFS). The term "digital channels" includes the Internet, mobile phones (both smartphones and feature phones), ATMs, point of sale (POS) terminals, near-field communication (NFC)-enabled devices, chips, electronically enabled cards, biometric devices, tablets, and any other digital system. DFS models usually employ agents and may leverage networks of third-party intermediaries to improve accessibility and lower delivery costs.

DFS can be provided by financial institutions (banks, leasing companies, and microfinance institutions), financial technology firms (FinTechs) such as Branch or Lendable, BigTechs such as Amazon, Super Platforms such as Ant Financial, or technology firms offering financial services (TechFins) like Alibaba that leverage data they accumulate to develop financial services. FinTechs have become key to reaching financially underserved market segments.[1]

Increasingly, financial services providers themselves are digitalizing, as pressure from tech firms entering the financial services market increases. In addition, policy makers and regulators are recognizing the importance of digital financial services for financial inclusion. At its 2016 summit in Hangzhou, China, the G20 established the High-Level Principles for Digital Financial Inclusion (G20 HLPs), stating: "While tremendous gains in financial inclusion have already been achieved, digital financial services, together with effective supervision (which may be digitally enabled), are essential to close the remaining gaps in financial inclusion."[2]

What Are Investors Doing?

Investments in FinTechs have seen a steady rise in recent years, as shown in Figure 1.[3] By the end of 2018, a total of almost $112 billion was invested in FinTechs.[4] While the bulk of investments have been in the United States and other OECD countries, a similar trend can be seen in emerging markets and there has been an influx of investors who traditionally have not been engaged in either emerging markets or financial inclusion.

Initally, the focus of investors has been on firms leveraging technology to provide lower-cost payments and remittances services, an industry that grew rapidly following M-Pesa's success in Kenya. As data analytical capacities increase, data driven lending is emerging across the globe, and companies providing digital loans are quickly growing.

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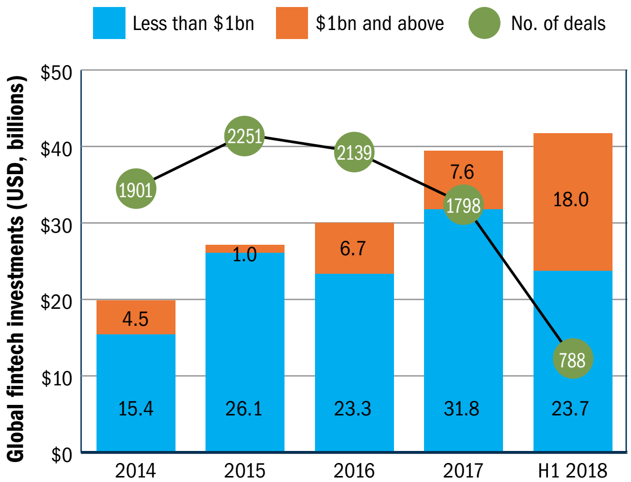

FIGURE 1 **Global Fintech Investments, 2014-2018 H1**

Source: FinTech Global

Payment platforms are critical to the growth of digital lenders as they not only facilitate cost effective means of disbursement and repayments but also provide transaction data used to assess creditworthiness. For example, the number of digital-only lenders in Kenya has seen an explosion in recent years, with over 50 lenders active in the market.[5]

These lenders are largely focused on individual lending, leveraging customer data (such as the frequency that individuals top up air time or send money) to establish creditworthiness. Digital credit providers in Kenya are able to process and disburse a loan within seconds of a customer request.

Innovative technologies and new entrants are radically altering the financial services industry in emerging markets, forcing traditional financial services providers to adapt while changing the economics of delivery to benefit the unserved and underserved.

Disruptive innovations are breaking down barriers across sectors. Also, innovations in technology are giving rise to new business models and partnerships, and are vastly expanding the scope, reach, and sophistication of services.

Everyday objects are increasingly enabled to send and receive data, connecting and communicating directly with one another and through user interfaces in smartphone applications. While this is primarily a developed country phenomenon, there are examples from the developing world. In East Africa, solar devices can be located via GPS and produce information on unit usage and repayments made by the owner. This data is then used to perform instant credit assessments that drive new business. As a result, new products such as PayGo solar and PayGo gas are emerging. These provide financial institutions with

Financial Services Provider	Loan Range in KSH*	Fee/Nominal Interest Rate	Tenure in days	APR**
CBA M-Shwari	100–50,000	7.5% monthly	30	91.50%
KCB-MPESA	50–100,000	2.5% fee plus 1.086% daily, 4.08% monthly	30, 90 or 180	40.8%–132%
Equity Eazzy Loan	a) 1,000 - 200,000 b) 1,000 - 3,000,000	1.01% fee plus 6.12% monthly	30, 365	79%
Tala	3,000–50,000	5%–15% monthly	30	195%
Branch	1,000–70,000	1%–14% monthly	30–485	10%–180%
Jumo/Airtel Kopa Cash	500–20,000	13.5%, 17%	7, 14	121%–185%%
Kopa Chapaa	500–100,000	0.85%–0.98% daily	10	310%
M-Coop Cash	1,000–100,000	8% fee plus 3.9% monthly	30	50%
Pesa na Pesa	500–10,000	10% fee	10	304%
Pesa Pata Peer Lending	2,000–20,000	5%–10% monthly	28	365%

*Kenyan shilling **Annual percentage rate

TABLE 1 **Digital Credit Projects in Kenya**

Source: IFC.

new asset classes to finance and can be used as additional collateral, enabling additional lending.

As Table 1 illustrates, digital credit in Kenya comes in a variety of models, including those that use mobile phone apps, mobile money wallets, and payroll lending, as well as through a range of provider types, including banks, mobile network operators, and even savings and credit cooperative organizations (SACCOs). Many of these lenders are lending outside the purview of current regulation.

The services generally offer (relatively) small-value, short-term loans. Most use the customer's mobile phone-based data—including call and SMS records, mobile money transaction history, and social media data—to determine a credit score and loan amount. Customers can borrow as little as KSh 100 (approximately US $1) and up to KSh 1 million (US$ 10,000). No collateral or paperwork are needed, and loan limits and access to larger amounts increase each time a previous loan is repaid on time. The processing fee for these apps is lower than banks. Most important, cash is sent instantly and directly to the borrower's mobile phone.

Why Did the Need for the Guidelines Emerge?

As a result of the rapid growth of digital credit in the market and the ease of applying for these loans, over 8.2 million Kenyans had digital loans as of May, 2018.[6] Many of these borrowers may not have fully understood the terms and conditions of the digital credit they received. Instead of building positive credit histories, half of all digital borrowers in the country are now 'negatively listed,' meaning they are officially considered as defaulters and are ineligible for additional formal credit. At the same time, these loans are clearly meeting a need.

Therefore, investments in digital financial services, and first and foremost digital credit, are expected to continue to gain momentum, as international funders continue to increase their commitments. An example is in the energy access industry. A 2018 IFC study showed dramatic growth of off-grid solar since 2010, which saw diverse investors entering the market by 2014, with more than $500 million raised through 2017 from commercial debt and equity investors.[7]

By 2018, figures showed rapid growth for small-scale solar home systems, including solar panels, batteries, inverters, and a distribution board. More than 80 percent are in African markets, with providers including M-Kopa, Off-Grid Electric, d.Light, Bboxx, Mobisol, and Nova Lumos. In total, these companies have raised over $360 million in financing and currently provide energy services to over 700,000 customers in East and West Africa.[8] The key to their success has been an innovative financing model that uses the latest innovations in mobile payment systems.

Box 1: The Rationale for Investor Guidelines

Over 100 leading organizations have worked to develop a set of investor guidelines for funders of Digital Financial Services (DFS), based on the G20 High Level Principles for Digital Financial Inclusion (G20 HLPs). DFS are uniquely positioned to bring financial inclusion to millions of people, creating powerful opportunities to improve access, usage, and customer-centricity. DFS come with risks for both customers and the financial system, which investors, innovators and policy makers need to be aware of. At the same time, DFS providers have become an increasingly attractive asset class with billions flowing to this emerging industry, mainly in the form of equity. As the circle of investors is far larger than just development finance institutions, there is a critical need to broaden institutional commitment to generating development impact and protecting consumers of digital financial services. Lessons from significant inflows into potentially vulnerable asset classes in emerging markets sectors such as agri-finance, solar, micro and small business enterprises are less known.

What Are the Risks?

While the inflow of funding presents tremendous opportunities for emerging markets, with it come increased risks.[9] One factor holding back investors in emerging asset classes in inclusive digital financial services is the lack of a framework to help them evaluate risks. Risks arise at the level of the industry, and more importantly, as the Kenya example illustrates, at the level of the consumer as user of digital financial services.[10]

These risks include unfair pricing, push-marketing, and non-transparent disclosures; weak financial awareness and capability; overindebtedness; lack of customer recourse; loss of customer funds or access due to fraud, data breach, or blacklisting; and system errors due to weak DFS infrastructure, among others. These risks are more significant for the poor and vulnerable (rural individuals, women, the elderly, youth, migrants, and forcibly displaced persons), as well as people in nascent or fragile and conflict-affected markets. Traditionally, these customer segments have been considered too risky and too poor to be of interest to banks and insurance companies. Mobile wallets and mobile money transfers, peer-to-peer and other alternative lending platforms, pay-as-you-go asset finance, and digital credit are examples of recent innovations that are reaching hundreds of millions of consumers and small businesses.

The risks among the poor and persistently underserved are more pertinent in digital lending than in savings and payments. These include consumer risks such as over-pricing, over-borrowing, and over-lending (Figure 2), and are similar to those the microfinance sector experienced as the sector rapidly expanded and commercialized.[11] Considering the greater numbers of digital lenders entering markets and an increasing focus by investors on similar digital models, it is urgent and prudent to develop actionable guidelines for responsible investing in digital finance.

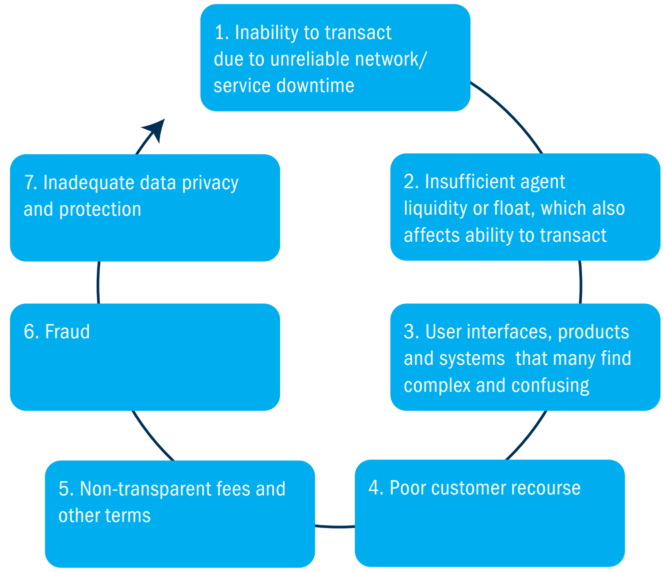

FIGURE 2 **Consumer Risks in Digital Finance**

Source: CGAP; Responsible Finance Forum (2015–2019)

How to Deal with These Risks?

Similarly, India's crisis in Andhra Pradesh a decade ago, which nearly put an end to the microfinance sector there, stemmed from allegedly coercive practices, lack of transparency, over-lending, high interest rates, and aggressive growth to capture the market with high profits, and it shook the industry as banks and investors retreated to avoid reputational risks (Box 2).

The successful initial public offerings (IPOs) of microfinance institutions in India and other markets such as Mexico prompted contentious discussions about balanced return, the role of purely commercial investors in microfinance, and the need for social performance management, client protection, and corporate governance.[12]

IFC's own investment and advisory experience[13] (Box 2) in India after the Andhra Pradesh crisis as well as 20 years of global microfinance revealed that a

Box 2: IFC in India: An Overview and Case Study

In Andhra Pradesh, rapid growth in India's microfinance industry led to an overemphasis on the supply side, resulting in a repayment crisis that drove the central bank to introduce regulations that essentially shut down the industry. Microfinance operations came to a standstill, and only $835 million was invested in the sector in 2012, compared to $2.4 billion the year before. IFC however took a strategic perspective and invested a total of $564 million in both equity and debt over the last decade. Today IFC partner institutions account for a significant share of lending.

Responsible Finance and Risk Management

IFC focused on implementing client protection, risk management systems for a dozen institutions, and complementing its own advisory services. IFC partnered with the Smart Campaign to pilot the development of client protection indicators, implementing these for 18 portfolio companies, and supported the development of client certification indicators for Smart Certification. Among the first institutions certified were IFC microfinance investees in India and Bosnia-Herzegovina. Today, over 100 microfinance institutions are certified globally, two-thirds of which are IFC investees.

Utkarsh—Transformation from Greenfield MFI to Digital Bank: Investor Guidelines 1, 2, 6–10

Utkarsh was the first greenfield microfinance institution to be established in Varanasi, the poorest region in India. In 2010 IFC supported Utkarsh in establishing a Code of Conduct, designing its financial products to meet the needs of women (who make up 97 percent of Utkarsh's borrowers), training and hiring staff, as well as supporting risk governance. Utkarsh combined this with other non-financial products such as education and health care. Utkarsh offers a range of services—from financial-literacy, to skills and vocational training for over 450,000 women, and connections to nearby marketplaces—to help women maximize the impact of their loans and improve their livelihoods. In 2017, Utkarsh transformed to a small finance bank and digitalized its operations. It now also delivers critical funding to small and medium-sized companies. As a bank, Utkarsh can now offer savings accounts, issue bank cards, and provide loans at lower interest rates by leveraging technology.

comprehensive risk governance framework that assesses both the institution and its customers' well-being is critical to better position itself on a successful path toward digital transformation.[14]

Lessons learned from these events—including the need for fair and transparent pricing, customer education, and customer recourse—have been recognized by social and impact investors and the broader international investment community. Customer trust is a fundamental building block for scaling digital inclusion. Increased access, reliability, convenience, and cost-effectiveness build this customer trust.

Trust enables customers to increase the use of digital financial services, to gradually improve their lives with diversified products, and to potentially contribute to economic growth.

While ultimately the providers of financial services need to build a relationship of trust with their clients, investors are recognizing that they too can play a critical role. Seeing these potential risks to the digital financial services industry, IFC leveraged its experience in establishing the IFC Performance Standards, which laid the earliest foundations for responsible investments that today are embodied in the Equator Principles, Global Corporate Governance Forum, UN Principles for Responsible Investment (UNPRI), and Principles for Investor in Inclusive Finance (PIIF).

IFC and a group of like-minded investors set out to develop Guidelines for Responsible Investing in Digital Financial Services (Investor Guidelines). The primary objective of the Investor Guidelines is to catalyze broad awareness and mobilize action for best practice standards for investors and for innovators in digital finance (Box 3).

The Investor Guidelines also aim to develop actionable tools for investors to recognize and manage risks, catalyze private sector awareness, and share knowledge among industry practitioners.

Regulators are likewise adopting the High-Level Principles for Digital Inclusion developed by the G20 through regulatory sandboxes, innovation hubs, reg-tech, and other platforms to deepen public-private sector partnerships in scaling digital financial services. Evolving industry and regulatory standards are critical to support the objectives of the Investor Guidelines, and to maintain a more agile engagement with signatories striving to refine what works and how to adapt more effectively with DFS consumer needs, business models, or market realities.

About the Investor Guidelines

The Investor Guidelines are anchored by the G20 High Level Principles for Digital Financial Inclusion, which was launched in 2016 with China as holder of the G20 Presidency.[15] The G20 HLPs were developed by a team of leading policy experts and industry practitioners, in the context of increased opportunities and evolving risks emerging in digital financial services for customers, sectors, and markets across the globe. The G20 HLPs represent the most comprehensive standards that are being implemented at national policy levels to advance the growth of digital financial inclusion. The Investor Guidelines aim to promote responsible investments in DFS and to contribute to broader financial inclusion and sustainable development goals. Signatories sign a statement:

> "As investors or fund managers investing in inclusive digital financial services, we commit to adhering to, and promoting the Guidelines for Responsible Investing in Digital Finance."

As such, Signatories of the Investor Guidelines publicly commit to: (1) **transforming the G20 High Level Principles into actionable steps** that are aligned with investors' due diligence; (2) **catalyzing investments in responsible digital financial inclusion** models for resilient growth and creating markets and opportunities for underserved; and (3) **accelerating private-public DFS innovation** through dynamic learning from responsible investments, sharing lessons learned from evolving innovations to achieve Sustainable Development Goals by 2030 and beyond.

As a Signatory, implementing the Investor Guidelines is a voluntary commitment on two levels: as an individual institution, and as a collective group of partners or co-investors. There is no reporting, compliance, or review requirement as signatory, though proposed actions may include certain verification or certification measures as part of managing risks. This approach is based on experiences IFC has had as a standard setter, which show that organizations will more likely demonstrate their commitment if they have control over how to implement standards that are aligned with their institutional mandates.

Why Should Investors Become Signatories and Operators or Providers Endorsers?

Each signatory is an individual owner of the Investor Guidelines, adapting them to myriad risks and opportunities. Signatories are also collective owners of the Investor Guidelines. This entails engaging within and across investors, with current or potential investees, industry networks or associations, as well as regulator. One objective of such engagement is to address evolving risks and opportunities. As signatories working together in a given market, they can accelerate responsible investments in DFS to create value-add for digital customers and broader ecosystems. Signatories also catalyze investments in responsible product innovation and collaborate with industry and tech as partners to fine-tune emerging evidence and business models for inclusive growth.

The Investor Guidelines are relevant for a broad range of DFS investors and investees. They are designed to be

Box 3: Investor Guidelines for "Responsible Investing in Digital Financial Services"

Guideline 1: Promote Responsible Investment in Digital Finance. We embrace digital financial services as a priority to drive development of inclusive financial systems. We will actively support responsible DFS providers to innovate and expand the range of financial services available to underserved groups to help them reduce their vulnerability, build assets, and mitigate their risks for an inclusive digital economy. We as investors commit to make responsible investment choices. We commit to supporting improved board governance and management commitment such that access to finance generates resilient, sustainable and value-added growth towards creating markets and opportunities for broader Sustainable Development Goals.

Guideline 2: Manage Risks Comprehensively with Growth of Digital Inclusion. We acknowledge that investors play a role in ensuring that the risks that emerge from innovation are borne by those that are equipped to absorb them, i.e., not by end customers. Investors will identify and assess risks during their due diligence process and manage these during investment. We encourage our investees to incorporate risks for customers or consumers into their business models and operations for a more comprehensive risk management framework.

Guideline 3: Foster a Proportionate Legal and Regulatory Framework. We support a prudent and proportionate legal and regulatory framework. As responsible investors, we commit to ensure compliance to existing regulations (including, by our investee companies) and to engage productively with policymakers so that the regulatory framework reflects both customer protection concerns and commercial concerns.

Guideline 4: Facilitate Interoperability and Infrastructures for DFS Ecosystems. We recognize the need for an ecosystem of enabling infrastructure for DFS and encourage interoperability, where appropriate, within that ecosystem. We encourage investee companies to take responsibility for the actions of agents, employees, and third-party service providers across the value chain. We will support investees to implement appropriate mechanisms for responsible provision of services along the value chain, and encourage investees that provide infrastructure services to providers of DFS to apply these Guidelines along the chain.

Guideline 5: Establish Customer Identity, Data Privacy and Security Standards. We encourage the development, use and implementation, as relevant to market standards and in accordance with applicable laws and regulations, of customer identity and authentication systems by DFS providers. We promote the responsible use of data and practice of data management, including back-end technology infrastructure and/or other mechanisms to protect the privacy and security of customer data and help strengthen approaches for informed customer consent. We encourage the assessment of risk to both customers and providers in adopting various approaches and technologies.

Guideline 6: Promote Fair and Transparent Pricing. We encourage and support investees to apply fair, risk-based and transparent pricing for all financial products and services, that is affordable to consumers while allowing for investees to be sustainable and provide adequate returns to investors. For savings products, investors encourage and support investees to provide real returns on the deposits of customers.

Guideline 7: Improve Disclosure of Terms and Conditions for Customers. We will promote and support investees to improve disclosure of terms, conditions and pertinent information to customers through transparent and clear communication that is easily accessible. This includes transparency in pricing, appropriate product design and delivery, and key supporting facts that enables customers to make informed decisions.

Guideline 8: Enhance Customer Services for Problem Resolution and Product Innovation. We will encourage and support investees to enhance customer services for feedback, problem or complaints resolution in a timely and responsive manner (including redress mechanisms) to build and sustain customer trust and improve the design and delivery of products and services.

Guideline 9: Prevent Over-indebtedness, Strengthen Digital Literacy and Financial Awareness. We promote and support proactive, ongoing approaches that deliver innovative digital literacy & financial literacy and awareness initiatives for consumer protection, to help prevent over-indebtedness and support financial capability throughout the customer relationship.

Guideline 10: Track Progress to Mitigate Risks and Expand DFS Opportunities. We encourage use of impact measurement industry standards for measuring and reporting lessons on responsible and sustainable performance by DFS providers.

The complete Investor Guidelines can be found at the Responsible Finance Forum's website, with examples of "Proposed Actions" for Signatories: https://responsiblefinanceforum.org/investor-guidelines inclusive. Signatories include Investors and Endorsers that have expressed their commitment to accelerate progress toward responsible digital inclusion as shown in Box 4, namely to:

- Mitigate digital risks with investment opportunities and tools;
- Network with strategic investors and business leaders;
- Engage with global industry, policy makers, and thought leaders;
- And drive growth with digital resilience and customer loyalty.

Investors who are Signatories may include funds and fund managers focused on financial technology or fintech, digital financial services, or broader financial inclusion; private equity and venture capital funds; public equity and debt funds; development finance institutions and international finance institutions; and family offices and foundations. They may also include indirect investors and asset owners such as pension funds, fund-of-fund managers, sovereign wealth funds, and endowments.

Endorsers who are Signatories are investees such as:

- Providers of DFS including multi-channel providers (for example, banks, microfinance institutions (MFIs), insurance companies);
- Operators providing DFS as their primary product or as part of a larger offering (such as mobile wallets offered by telecom operators, payment products offered by e-commerce platforms, money transfer services and remittances offered by retailers, social media companies, and technology companies);
- Pay-as-you-go providers and other products-as-a- service delivery models with an embedded financial service (such as vendors of PayGo solar systems providing financing to buyers or rent-to-own finance); and
- Those providing infrastructure services that support a broader digital ecosystem (payment systems or transaction platforms and data analytics companies, for example).

Next Steps

The Investor Guidelines are an ongoing, "live" process for signatories. By definition, DFS technology is constantly innovating, and in certain markets such as those we have observed in East Africa or Asia, digital finance economies are shifting at a rapid pace. There are several lessons to be learned from traditional financial institutions in terms of consumer protection and financial well-being. These need to be considered to ensure that digital finance does not perpetuate a digital divide or further exclusion, particularly for those individuals at the base of the pyramid who are unbanked or persistently underserved. And responsible players in this space are taking proactive measures to ensure that data privacy and consumer protection are an integral part of their product offering.

Box 4. Investors and Signatories Taking Action for Responsible Digital Financial Services

The Responsible Finance Forum (RFF) hosts the Investor Guidelines, and regularly features signatories who wish to share their latest efforts among the broader international community. Below are examples of how signatories, are stepping up to take action:

CDC and FMO are supporting GOGLA to develop a Consumer Protection Code for the off-grid solar sector industry, which includes developing a measurement framework to enable in-depth and systematic company assessments in 2019.

DEG developed an Investor Briefing Note, which focused on promoting fair and transparent pricing as part of its investment process and negotiations with a potential investee, particularly for fintech investing.

FMO and Lendable led the first workshop on consumer data privacy and data protection in Nairobi and Lagos, convening local industry players and FinTech's to discuss potential solutions to improve customer consent, including challenges going forward.

IFC drafted the first comprehensive DFS risk matrix for investors and is working with industry and signatories to further refine the tool; it may be adapted by signatories as part of their investment due diligence and monitoring processes.

IFC and AfDB's Making Finance Work for Africa co-organized the Responsible Finance Forum in Tanzania, convening participants from Africa region's leaders from consumer, industry, investor, policy-makers and regulators in DFS.

SME Finance Forum and RFF collaborated to launch the First Annual Responsible Digital Innovator of the Year Award, for which the selection criteria and supporting evidence were based on proposed actions within the Investor Guidelines.

Source: Signatory investors and endorsers as shared with Investor Working Group or as provided for the Responsible Finance Forum platform.

Digital transformation is magnifying risks that are increasingly intertwined among all players in the digital ecosystem, posing potentially systemic or unforeseen challenges for regulators, industry, and consumers.

The Investor Guidelines are not intended for "negatively screening" investments in digital financial services, nor are they meant to be overly prescriptive. Rather, the Guidelines are intended to be used as a practical compass to build broader industry awareness, enhance due diligence for consumer risks, and catalyze innovative solutions to address or mitigate consumer DFS risks. And it is critical for investors and industry leaders to partner for a more open and dynamic process of evidence-building.

Going forward, the Investor Guidelines will continue to promote sharing and learning among signatories to harness more timely evidence, build robust benchmarks, and develop analytical tools to determine standards of performance and responsible investing. This process is just beginning to take shape in the impact investment community. It is a new opportunity—particularly for impact investors that are refining portfolio allocation strategies—to incorporate digital financial inclusion as an asset class for investing toward the United Nation's Sustainable Development Goals.[16]

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Please see the following additional EM Compass Notes about digital financial services in emerging markets: *How a Know-Your-Customer Utility Could Increase Access to Financial Services in Emerging Markets* (Note 59); *Modelo Peru: A Mobile Money Platform Offering Interoperability Towards Financial Inclusion* (Note 54); *Blockchain in Financial Services in Emerging Markets—Part II: Selected Regional Developments* (Note 44); *Blockchain in Financial Services in Emerging Markets—Part I: Current Trends* (Note 43); *Digital Financial Services: Challenges and Opportunities for Emerging Market Banks* (Note 42); *Can Blockchain Technology Address De-Risking in Emerging Markets?* (Note 38); *How Fintech is Reaching the Poor in Africa and Asia: A Start-Up Perspective* (Note 34).

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