Strengthening Financial Inclusion through Digitalisation in Europe

White Paper

Insights on sustainable practices of inclusive finance in Europe

Authored by Massimo Preziuso (the University of Twente, ETM group, HBE department, Faculty of Behavioural, Management and Social Sciences).

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Introduction

Background

While digital financial services have become the leading driver of financial inclusion globally, digitalisation has exposed the modern society to increased levels of inequality and new forms of exclusion. One example is in the booming numbers of the GIG or platform economy, which has grown five times in the last decade (International Labour Organisation, 2021). Many GIG workers are vulnerable and underserved by traditional financial services providers. For example, credit or income scoring based loans supplied to individuals or SMEs could be prohibitive to the freelancers without stable revenues and start-uppers without tangible assets as guarantees.

Digitalisation is also associated with a massive environmental footprint. Advancements like bitcoin for decentralised finance result in massive annual energy consumption with a carbon footprint close to the emissions generated by the entire metropolitan area of London (de Vries, 2021). Such issues have been aggravated by the pandemic crisis showing the world the complex interlinks between economic development, environmental sustainability and health.

In 2020, the European Commission decided to invest € 1.85 trillion to build 'a fairer, greener and more digital Europe' via the European Recovery Plan (European Commission, 2020). The European Central Bank has also started to consider the impact of its monetary policy on climate change to preserve its goal of price stability. The COP26 just ended has boosted the transition towards global net-zero emissions and a +1.5C environment by 2050, phasing down coal (COP26, 2021). In this occasion, all the involved parties agreed that it is time for financial institutions by and large to accelerate the decarbonisation of their portfolios.

Generally, independently by their digital advancements, inclusive finance organisations do not support environmental issues (Le et al., 2020). However, in the European Union, sooner or later, their activity will need to align with the strong climate policies of the region. Otherwise, they will see a reduction in their operations due to less funding available to their 'unsustainable' portfolios.

It is time to look at the best ways to achieve these multiple objectives by building the next generations of inclusive, digital and fully sustainable financial organisations.

The SFIDE project at a glance

Supported by an EIBURS research grant for 2019-2022, SFIDE (Strengthening Financial Inclusion through Digitalisation in Europe) aims to identify innovative practices of inclusive finance supporting the growth and resilience of underbanked/unbanked self-employed, micro, small and medium enterprises (MSMEs) across Europe, with the assistance of the European Microfinance Network. It will also conduct a detailed analysis of the Dutch Microfinance institution Qredits. Furthermore, it will look at the German and Norwegian inclusive finance markets, alongside with the supporting academic - TU Berlin (Germany) and

Nord University (Norway) and business partners - Triodos Bank, the Netherlands and Youth Business International, UK. Last but not least, the research will look at how an optimal balance is achieved between automation and face-to-face interaction to reach, advice, finance, and achieve long term impact for underbanked/unbanked individuals and entrepreneurs.

This report is part of the Work Package 1: Explorative case studies on innovative European inclusive finance organisations.

Methodology

A dataset of inclusive financial practices in the European Union has been developed to investigate their different combined approaches to digitalisation and environmental sustainability.

The research activity has started with a questionnaire sent to 50+ inclusive finance and fintech organisations operating in the European market. This analysis is based on the first 25 companies which have answered by May 2021.

The questionnaire included a total of 21 questions, divided into six areas listed below:

- (Digital) business models
- Financial inclusion and health goals
- Environmental sustainability and governance approach
- Impact measurement
- Performances
- National and EU policy developments

The selected organisations range from traditional microfinance institutions to advanced inclusive fintech passing through NGOs and service providers operating in the European Union (including the United Kingdom).

The first results of the research were presented in two webinars organised by the SFIDE project with the European Microfinance Network (EMN). They took place in November 2020 and July 2021, gathering many highly participative attendees. Inputs and feedback from practitioners were considered in the development of this report.

The 25 companies have been classified into three groups, along with the “Tech vs Human” intensity of the business, namely:

- **Traditional** (Mikrofin, BCR Social Finance, Ustoi, PerMicro, KEP Trust, Partner, EKI)
- **Hybrid** (Adie, Microbank, Microstart, Qredits, PatriaCredit, AFI, Bizkaia, Nickel)
- **Fintech** (AideXa, Buddy Payment, Kabbage, Peaks, Tink, Plaid, Crowd, Trezeo, Ecolytiq, Tred Earth)

Key findings

The results show that the interaction between digitalisation and full sustainability starts to be visible in the business models of inclusive finance organisations. Nevertheless, they put in evidence that solving the tradeoffs between environmental sustainability and inclusive development is still not central for these organisations.

Table 1 summarises the levels achieved on the single metrics by the three types of organisations analysed:

Table 1

	Using Digital Models	Measuring Financial Inclusion	Environmental & governance policy	Measuring Impact	Performance	Impact of Policy
T						
H						
F						

LEGEND:

Types of organisations: T = traditional, **H** = hybrid, **F** = fintech

Achieved level: Red = very low, **Orange** = low, **Yellow** = intermediate, **Green** = high

In the following part, we briefly discuss highlights along the various metrics analysed with the interviewees.

<u>(Digital) business models</u>

Traditional companies use digital tools for online application, communication, clients acquisition. They don't use open banking services. The next step for many of them is represented by the digital signature and online microloans

Hybrid organisations use automated solutions together with human activities. In some cases, they build customised products and customer journeys. Some of them are also running pilots of open banking.

Fintechs use digital tools for 100% automated underwriting, multichannel acquisition (via API), actionable insights, Personal Finance Management services, simplified KYC (no IDs), risk scoring and matching activities.

<u>Financial inclusion and health goals</u>

Traditional companies measure the quality of their activity in terms of numbers of loans, created jobs, or by measuring avoided indebtedness of individuals and families. They also consider the realisation of financial health via coaching/training programs.

Hybrid organisations look at the number of loans, the number of women entrepreneurs supported, jobs creation, digital and human coach, PFM solutions, and the number of Point of Sales developed.

Fintechs have financial health & stability goals through instruments like multi-platform dashboards, customised products for GIG / flexible workers, and online coaching. Last but not least, in some cases, they consider their clients' environmental footprint as a goal.

Environmental sustainability & governance

Traditional companies sometimes use exclusion lists or think to design green loans. But, in general, they believe that small loans cannot impact the environmental strategies of their clients. Additionally, they don't have governance policies, both internally and for their clients.

Hybrid organisations work on internal environmental / governance strategies. They still don't focus on the environmental footprint or governance policies of their clients

Fintechs focus only on internal environmental strategies, governance policy, and testing protocols (A/B) to avoid disparate impact (bias). In some cases, they use ESG scoring/carbon offset once sustainable investors require it. They can also support the carbon neutrality of consumers or perform real-time environmental impact assessment in payment transactions

Impact measurement

Traditional companies write impact reports, even if they realise that a long term impact of their activity is hard to verify.

Hybrid organisations use CSR / Impact reports. Social Return on Investment (SROI) is an emerging topic. To measure the impact, they can use data on repayment rates, type of clients, long term impact, jobs created.

Fintechs usually don't publish impact reports. Instead, they tend to supply aggregated data for clients only.

Performances

Traditional companies tend to have good customers and revenue growth (except for 2020). But, at the same time, banks guaranteed loans represent a crucial factor determining their financial results.

Hybrid organisations which banks own tend to be bigger and more risk-averse than the independent ones and, at the same time, profitable. In general, MFIs tend to be subsidised by public grants. Instead, SME finance companies work without subsidies.

Fintechs tend to have high customer growth with a slow path to profitability.

National and EU policy developments

For traditional companies, the main problem is that **r**egulation differs by country. At the same time, microfinance needs distinct rules for issues like AML, KYC, proof of income. Current laws are not in line with the fast and growing digital opportunities. Covid – 19 boosts digitalisation but also risks adversity. Due to green policies at the EU level, there is a tendency towards designing green & tech for impact financial products.

For the hybrid organisations, the role of international organisations and European financial instruments like InvestEU is essential. They share with the traditional organisations the critic to the national regulations and approaches of microfinance. They also realise that digitalisation goes along with discrimination. Next-generation EU is an opportunity for investments in digital innovation (digital ID) and to get scale within underserved areas. Covid 19 has brought the emergence of flexible products

For Fintechs, the EU Digital Finance strategy is critical. They consider Open Banking / PSD2 a more powerful enabler of financial inclusion more than its regulation. Covid 19 represents an accelerator for their business. At the same time, they think that higher inequality means more protection and more digital tools. Looking at the Green policies of the EU, they believe that standardisation of sustainability data is needed.

Conclusions

MFIs and SME finance organisations operate differently. MFIs still tend to be low digital – high touch, while SME finance companies tend to be high digital – low touch.

Open Banking (PSD2) and API aggregators are essential to building collaborative, scalable and inclusive finance ecosystems at the national and regional level.

Adopting green investments strategies depends on investors more than on a proactive approach of inclusive finance organisations.

Governance approaches of clients are not taken into consideration.

To improve their impact, traditional and hybrid companies need to give more attention to governance policies (AI bias, diversity, gender equality).

Full green and inclusive digital financial solutions have still not emerged. Uniform and simplified EU regulations are needed, for instance, in the portability of digital identity, microfinance rules, and sustainability data disclosure.

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