Theory of Change for Financial Inclusion

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Contents

1 Introduction

Financial Inclusion is one of Norfund´s four investment areas. Norfund invests in commercial banks, microfinance institutions and other financial service providers, including non-deposit taking lenders, insurance and fintech under this investment area.

The focus lies on direct investments within debt and equity, while we explore opportunities within funds, platforms and partnerships. Africa is our core focus, but with significant activity in South-East Asia and Latin America.

The World Bank defines financial inclusion as the following:

"*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*."

This background note describes the foundation of our «Theory of Change» for investments in Financial Inclusion, by describing the problems we are aiming to solve, the inputs we provide, and the outputs and outcomes we expect to be realized by providing such inputs. The expected outcomes and impact are derived based on literature and knowledge of the sector. See box 1 for a description of how we are applying the Theory of Change concept and framework.

Box 1: Theory of Change concept

A theory of change is a comprehensive framework that outlines how and why a desired change is expected to happen in a particular context.

The theory starts with identifying the specific issue or challenge that needs to be addressed. Inputs are then detailed, which include the resources, activities, and interventions necessary to tackle the problem, and that Norfund is providing. These inputs might consist of funding, staff, partnerships, and specific actions or programs designed to provide a solution to the identified issues and drive change.

The theory of change then maps out the logical sequence leading from inputs to outputs, outcomes in the short and longer term, and finally, the desired impact.

Outputs are the direct results of the activities and inputs, such as the increase in staff or payment of taxes and fees by the company we have invested in. Outcomes refer to the short- and medium-term changes that result from these outputs, such as expansion of firms or establishment of new firms and increased household consumption and resilience as a result of this. Finally, the impact is the long-term, sustained change that the theory aims to achieve, such as economic growth and improved living standards.

This pathway is mapped out in a theory of change, and helps organizations and stakeholders understand the process of change, measure progress, and refine strategies to increase the likelihood that the desired impact is achieved.

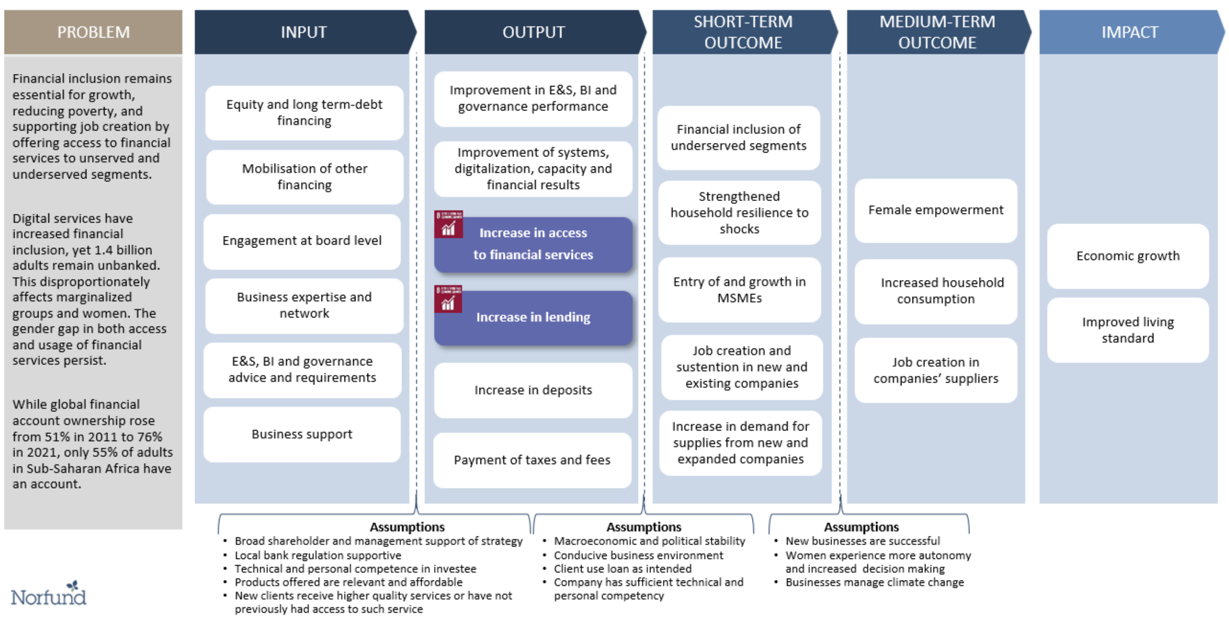
2 The Theory of Change framework

Based on literature and current knowledge of financial inclusion Norfund has developed a Theory of Change (ToC) for how we believe change happens through our investments in financial inclusion. The ToC consists of a framework of input, output, short- and medium-term outcomes and impact goals, as described in box 1.

The input is what Norfund provides as an investor, while the outputs are generally monitored during annual reporting. The outcomes are generally measured through case studies and other in-depth analysis on a case-to-case basis. The expected long-term outcomes and impacts are demonstrated through literature.

The elements visualized in the ToC are those that are probable based on literature and knowledge of the sector. However, we do not state that these happen in all cases. Central to move from input and through the steps, all the way to the final impact goals are the assumptions outlined in section 6 of this document. If these assumptions do not hold, some or all of the steps in the ToC might not be realized.

The Theory of Change for Financial Inclusion



3 The hypothesis of change

This part of the document explains our inputs translate through to outputs and outcomes that finally enable greater economic growth and improved standard of living, through increasing access to affordable and accessible financial services. The following sub-sections correspond to the different parts of the visual ToC presented in section 0.

The outlined elements of the ToC and the below hypothesis of change builds on literature and knowledge of the financial sector, that is further described in section 5.

3.1 Input

Norfund invests equity or debt in the financial institution, including FinTechs and MFIs. In some cases, we also mobilise financing from other investors. Norfund provides advice and requirements to strengthen the FI's corporate governance and ensure that it has appropriate systems in place to identify environmental and social risks and we may use grant funding to support the development of training programmes or systems to help the institution strengthen its performance.

When we hold equity, we may take a board position to, amongst other things, promote sustainable practices and financial inclusion. When we invest equity we provide capital, which is often scarce in the markets we operate in. This helps businesses sustain or scale operations. By attracting equity businesses might be able to undertake projects or initiatives that are too risky to conduct based solely on debt financing, like expansions of operations. Furthermore, equity increases the capital adequacy of the financial institution, which enables the bank to attract and take on more dept.

For investments within Financial Inclusion debt financing is most common, also for Norfund. When we provide loans, we can set out terms and conditions the Financial Service Provider (FSP) must comply to for the loan to be disbursed. For instance, we provide Environmental and Social Action Plans (ESAP) and Business Integrity Action Plans (BIAP) based on areas we would like the FSP to improve. If the items in the action plans is not fulfilled within the set timeframe this could be considered an event of default. Thus, debt financing allows the possibility to affect the operations of the FSP and can in some instances be more effective than having a board position in a large board, as could be the case when we provide equity.

Providing loans typically allows for a shorter investment horizon than equity, enabling more frequent recycling of capital. Thus, by providing loans more businesses can be reached within shorter time. Hence, both equity and loan investments are useful tools to create the desired impacts. The preferred instrument depends on the circumstances and the type of investment.

3.2 Output

Provision of equity increases the capital adequacy of the FI, which allows the FI to borrow more and take on more deposits through a multiplier effect. Providing loans to the FI is also important as it increases the FIs lending capacity but does not affect the capital adequacy.

Funding from DFIs like Norfund also gives the FSP a “stamp of approval” which may attract other investors, mobilizing more capital towards the business. The investments in the FSP enable the entity to expand their lending activities, both in terms of volume and number of clients, which are Norfund's strategic impact objectives for the sector.

FinTechs provide innovative solutions that can lower the cost of accessing finance, enabling increased financial inclusion. MFI institutions enable small firms and households' access to loans, while we encourage the traditional banks to increase their lending to SMEs. In this way, the different types of FSPs serve different segments that we aim to reach.

In addition to increased lending from the FIs we expect the deposits to increase, reflecting increased access and usage of financial services. For investments within insurance, we expect the uptake of insurance to increase[1]. If households and businesses can increase deposits and access insurance schemes this is beneficial as it increases their resilience towards shocks, meaning they can better deal with unexpected events that require larger amounts of money.

Business support (grant), ESG requirements and active ownership contributes to improved governance and systems in the institution. Together with the growing loan book, this contributes to improved financial results and increased taxes and fees to the government from the FSP.

3.3 Outcome

The increased availability of loans and financial services contributes to formation of new firms and the expansion of existing ones. This contributes to both sustaining existing jobs and creation of new jobs.

As firms grow, they increase their demand from suppliers, enabling these to grow, hire more people and pay more taxes, inducing a multiplier effect. Households use loans to increase consumption, investment and to confront shocks, contributing to better living standards. Increased lending to women and underserved segments through MFIs and FinTech's results in improved financial inclusion, through a larger outreach and lower cost of services. Furthermore, enabling women with better access to finance can increase female empowerment, by enabling them to start firms, save for education or home improvements, that can increase independence and greater autonomy.

3.4 Impact

Access to financial services is a catalyst for economic growth and improved living standards. It empowers small and medium enterprises to expand through increasing their access to lending, which in turn leads to new job opportunities. Increased consumer spending, fuelled by improved access to credit, stimulates economic activity. Furthermore, in rural areas, better access to finance can yield higher agricultural productivity, which acts as a significant economic driver. Easier access to affordable lending also fosters entrepreneurship, which can lead to innovative businesses and further job creation.

As businesses grow and profits rise, employees often enjoy higher wages and improved job security, which in turn enhances their standard of living. Additionally, increased financial stability through higher wages allows households to invest in education and healthcare, resulting in a more skilled workforce and higher productivity in the longer run. These interconnected effects of increasing the access to finance contribute significantly to economic development and overall improvement in living standards.

4 Rationale for investment

This part gives an outline of the problem we are aiming to solve with investments in financial inclusion. Financial inclusion is critical to support growth, job creation and to reduce poverty and vulnerability. Inclusive financial systems provide individuals and firms with greater access to resources to meet their financial needs, such as capitalizing on business opportunities, investing in home construction or education and confronting shocks. Financial services deliver value to customers in various ways, primarily by enhancing their resilience and creating new opportunities.

[1] Per 2024 Norfund has one investment within insurance

4.1 Individual access

In recent years, financial inclusion in developing countries has seen significant progress, yet challenges remain. Approximately 1.4 billion adults worldwide still do not have a financial account. The percentage of adults with a financial account globally increased from 51% in 2011 to 76% in 2021, with developing economies witnessing a notable rise to 71% account ownership[2]. However, for sub-Saharan Africa the corresponding figure is still only 55 % (World Bank, 2023). Digital financial services, including mobile money and e-wallets, have played a crucial role in this growth, particularly in Sub-Saharan Africa (World Bank, 2021).

In Latin America account ownership increased from 40 % to 73 % between 2011 and 2021, making the region almost reach the global average (World Bank, 2023). Looking to some of our core countries in Asia, adults that had a bank account or access through mobile money in 2021 varies greatly, with 89 % in Sri Lanka and only 37 % and 33 % in Laos and Cambodia respectively, showing the large differences in access between countries (World Bank, 2023). It is worth noting that more than half of the worlds´ unbanked adults live in only seven countries[3], showing the inequalities between countries (World Bank, 2021).

Despite advancements in access to financial services, disparities in account ownership still exist, also within countries. Especially along gender, income, and educational lines we observe large differences (World Bank, 2021). For instance, regulatory and technical issues disproportionately affect women's access to financial and digital services. Findings from the Global Findex Database in 2021 indicate that Sub-Saharan Africa reported a 12 %-point gender gap in access to financial services in 2021. This is twice as large a gap as the developing economy average and three times larger than the global average. By contrast, the gender gap in account ownership in East Asia and Pacific is insignificant at 3 %-points. In Latin America and the Caribbean, women are 7 %-points less likely than men to have an account.

Microfinance institutions can aid in addressing this gender gap in access and usage of financial services, by targeting women in their operational structure. This can, if done in a way that ensures affordable and relevant services are provided, lead to women's empowerment by positively influencing women's decision-making power and enhancing their overall socio-economic status.

Further to the gender gap in account ownership differences are also seen to vary with length of education, income level and whether one lives in a rural compared to urban area (World Bank, 2021). The report finds that less educated adults are less likely to own an account. Individuals with only primary education in developing countries are 14 percentage points less likely to own an account than adults with at least secondary education. Less educated individuals are also more likely to have lower income, which might explain parts of the difference and the difference between income groups in account ownership.

[2] Adjusting for inactive accounts, the percentage of globally banked individuals decreased to 66 % in 2021

[3] This is much due to the size of these countries. In order of level of adults without access to banking services (high to low): India, China, Pakistan, Indonesia, Nigeria, Egypt and Bangladesh. These make up 740 million unbanked adults all together.

The report does not quantify the extent of the gap in account ownership between rural and urban areas, due to differences in definition of such areas. The report does, however, state that rural populations are less likely to hold an account (World Bank, 2021).

Further to account ownership several reports highlight the quality and underusage of financial services as significant obstacles to financial inclusion. One key issue is the mismatch between the financial products available and the needs of the underserved populations. This misalignment can lead to low usage rates, as people may find the services too expensive, irrelevant, or complicated to use (UNSGSA, 2020).

These statistics and findings show that differences do still exist, and that work to ensure further financial inclusion across gender, educational levels, regions and income levels is still needed.

4.2 Business access

Increasing access to finance is not only important to ensure individual access. Access to finance remains pivotal in achieving growth of businesses and is especially important for SMEs wishing to scale or maintain operations. SMEs are pivotal in most economies, especially in developing countries, representing the majority of businesses and contributing significantly to employment and GDP (International Finance Corporation, 2017). However, lack of access to finance is among the main constraints for these businesses. It is estimated that micro, small, and medium enterprises (MSMEs) in developing countries have an annual unmet financing need of $5 trillion which is 1.3 times the level of global MSME lending in 2023 (SME Finance Forum, 2023). This illustrates the importance of ensuring reliable and affordable access to finance for such businesses in developing countries.

The challenges facing MSMEs include informality, information asymmetry, and lack of collateral, making it difficult for them to obtain bank loans. Consequently, they often rely on internal funds or informal sources. Approximately 400 million MSMEs in emerging economies lack adequate financing instruments, highlighting the critical need for more accessible and innovative financing solutions (International Finance Corporation, 2017). Efforts to address these challenges include leveraging fintech platforms and digital tools to mitigate the adverse impacts of informality and information asymmetry.

4.3 Changing requirements and the lack of long-term financing

Stricter regulations have gradually been imposed on banks through the Basel Accords over the last decades. These regulations have required that the banks, among other things, strengthen their capital adequacy and long-term stable funding base. This has posed a challenge for banks operating in Norfund´s markets due to the lack of well-functioning capital markets where they can raise equity or issue bonds at reasonable prices and cost. Therefore, DFIs providing long-term financing and capital to these institutions play an important role in filling this gap.

The Basel framework requires banks to hold a certain amount of capital (Tier 1 and 2 capital) over their risk-weighted assets to be able to better absorb losses and protect customer deposits. This requirement acts as a restriction on how much lending a bank can undertake. Banks can strengthen their Tier I capital through retained earnings or by issuing new shares or Additional Tier I (AT1) instruments. Tier 2 capital can be strengthened through raising subordinated debt. Thus, when Norfund invest equity or provide loans that qualify as Tier I or Tier II capital this results in a multiplier effect on the amount of lending that the bank can offer to their clients. The banks can utilize existing deposits or loans, as well as take up new senior loans, for on-lending to new and existing clients.

The lack of long-term financing poses challenges for banks, as well as MFIs, NBFIs and FinTechs, primarily by increasing these institutions' vulnerability to liquidity, refinancing and interest rate risks. A mismatch between short-term liabilities and long-term assets can lead to liquidity problems, affecting the stability and solvency of banks (e.g. in a bank-run). Furthermore, reliance on short-term funding tends to be more volatile (except customer deposits), reducing profitability and limiting the banks' ability to offer competitive loan rates, thereby limiting the banks outreach and contribution to financial inclusion. Ultimately, the absence of a stable long-term funding base for banks can undermine the banks' capacity for strategic planning and hamper the offer of services and outreach to underserved segments. This makes Norfund, offering long-term and reliable financing (e.g. through senior loans) even more important in these markets, which often do not have well-functioning capital markets where institutions can issue bonds and institutions struggle to receive other sources of local funding.

Hence, while there has been notable progress in financial inclusion in developing countries, significant gaps and obstacles persist, underscoring the vital need for continued investment and innovation in financial services to achieve inclusive growth and poverty reduction across all segments of the population in developing countries.

5 Literature review

This section of the document lies the foundation for why investments in financial services are needed and contributes to improved living standards and economic growth, by describing some of the literature that exists on the topic.

5.1 Investing in financial services- in general and traditional banks

Financial inclusion is recognized for its substantial positive impacts on various economic aspects such as growth, entrepreneurship, employment, income inequality, and poverty alleviation (Dixit & Ghosh, 2013; Fadun, 2014).

A study from 2022 focusing on sub-Saharan Africa breaks down financial inclusion into several dimensions including its availability, penetration, and usage. Each dimension contributes differently to economic growth, with availability and penetration showing significant positive impacts on the economy. The usage dimension improves growth but is not found to be statistically significant (Ifediora, Onochie, Eze, & Samuel, 2022). This study emphasizes the importance of financial education policies in Africa, which can help individuals understand and leverage the benefits of banking services. They find that such policies could enhance the impact of financial inclusion on economic growth.

Another study examining 33 African countries between 2004 and 2019 found a significant and positive correlation between financial inclusion and economic growth in the countries studied. The study noted that particularly in low-income countries, the level of financial exclusion is negatively associated with investment, economic growth, and savings, emphasizing the important role of financial inclusion for economic growth (Ezzahid & Elouaourti, 2022).

A broader study analyzing the impact of financial inclusion in 104 developing countries from 2004 to 2019 concludes that financial inclusion is positively correlated with economic growth, primarily by expanding opportunities for lower-income individuals, thereby facilitating broader economic growth in regions with many underbanked individuals (Kumar, Qin, & Inaba, 2023).

Hence, literature suggests that financial inclusion plays a vital role in fostering economic growth in developing countries. However, the relationship is nuanced, affected by the various dimensions of financial inclusion, and influenced by institutional and educational factors in different countries and populations.

5.2 Investing in Financial Technologies

This part of the document describes some of the impacts of FinTechs on development, focusing on their contribution to financial inclusion, and the challenges they face, including the persistent gender gap in usage and access to financial services.

The emergence of FinTechs (Financial Technologies) has revolutionized the landscape of financial services, especially in developing countries. The Global Findex Database 2021 reveals that technology-enabled accounts and the COVID-19 pandemic have accelerated the use of digital payments. Mobile money, particularly in Sub-Saharan Africa, has seen a substantial increase in usage in the last years (World Bank, 2021).

A study from 2022 finds that FinTechs contribute more to digital financial inclusion than traditional financial institutions. They also find that the use of FinTech is significantly contributing to narrowing the class and rural divides in access and use of financial services (Tok & Heng, 2022). This is corroborated with the findings from the Financial Access Survey from 2023 which highlights the critical role of mobile money in reaching underserved populations (IMF, 2023). However, the study from 2022 shows that FinTechs have no impact on bridging the gender divide, underscoring a crucial area for future focus (Tok & Heng, 2022).

FinTech innovations hold significant potential to address barriers to financial inclusion (Bhattacharya & Sarker, 2020). These barriers include the lack of physical access to financial institutions, high costs, and complex requirements associated with traditional financial services. The main message is that mobile money has accelerated access to financial services in low-income regions, but a gender gap persists, in line with findings from other studies.

FinTechs have undoubtedly made a profound impact on financial inclusion in developing countries, particularly by addressing accessibility and cost barriers. While they have successfully narrowed the class and rural divides, the gender gap in financial access remains a challenge. Continued innovation and targeted policies are essential to leverage the full potential of FinTechs in driving equitable development.

5.3 Investing in microfinance institutions

Microfinance Institutions (MFIs) have emerged as pivotal players in promoting financial inclusion and development, especially among underserved populations and women. This subchapter provides an overview of some of the literature on MFIs, with a special focus on women's empowerment and some of the challenges associated with microfinance.

Several studies highlight the empowering effects of microfinance on women. In rural Bangladesh, microcredit has shown positive impacts on various indicators of women's empowerment (Rahman, Khanam, & Nghiem, 2017). The study uses data collected from household surveys in four districts, revealing significant improvements in women's empowerment due to microfinance participation.

Similarly, in Malaysia, a study of a microcredit institution, shows that microfinance has empowered women through access to financial capital and the ability to start small businesses. The researchers find that these women have gained more control over household decisions and resources, enhancing their autonomy (Samer, Razali, & Rashid, 2018).

This is corroborated by a meta study reviewing 54 previous articles on the link between the use of microfinance and women's empowerment. This study finds that the majority of the 54 research articles concluded with a positive relationship between microfinance and women's empowerment (Khurseheed, Khan, & Mustafa, 2022). In several of the studies, results varied due to the measure of empowerment applied or socio-political differences in the contexts of the studies.

However, despite the many positive impacts, microfinance is not without its challenges. A systematic review of the impacts of micro-credit and micro-savings in sub-Saharan Africa highlights that microfinance can have harmful effects on the poor. This study indicates that while microfinance can improve livelihoods, it can also lead to over indebtedness and exacerbate poverty in some cases (Rooyen, Stewart, & Wet, 2012).

Theory suggests that access to microfinance has different effects depending on region, population density, attitudes to debt and financial literacy of the clients, to mention some (Rooyen, Stewart, & Wet, 2012). Different effects due to region are usually due to different circumstances affecting the clients, while population density often affects the operational costs of the MFI leading to differing interest rates offered to clients. Attitudes towards debt on the other hand are important in determining uptake of the service, and financial literacy is crucial in determining how the clients understand the potential usage and repayment agreements. Considering these elements can therefore be crucial in determining the success of MFIs in reaching clients and ensuring that the funds are used as intended.

While there exist certain challenges, it is observed through several studies that women, in general, have a better understanding of loan terms and conditions compared to men. This makes them less likely to experience the possible adverse effects of microfinance lending. A comprehensive study involving interviews with 50,000 clients, 66% of whom were women, suggests that lending to women not only empowers them but also leads to better financial management and decision-making. Women reported more significant household improvements and a better grasp of financial terms, making microfinance a potentially effective tool for female empowerment and poverty reduction (60 decibels, 2023). This leads to an increased spending on health, education and meals for the household. Women in this survey also report that they have fewer options for financial services compared to the men in the survey, underscoring the importance of offering such services to women.

Hence, MFIs can play a crucial role in driving development, particularly through women's empowerment in developing countries. While they have significant positive impacts, challenges such as overindebtedness need to be addressed. The evidence suggests that focusing on women not only advances their empowerment but also leads to more sustainable and responsible use of microfinance services.

6 Assumptions

Investing in financial inclusion is important to facilitate job growth and economic development, but for our inputs to translate to outputs, further to outcomes and in the end the desired impact there are many elements that should be in place. This section outlines some of the assumptions we have underpinning our theory of change.

Not all assumptions must hold for the desired outcomes to be realized, as several of the outlined assumptions are difficult to achieve in the markets Norfund operates in. However, if the desired outcomes and impacts are not realized as a result of the investment the lack of one or several of the elements mapped out might be part of the reason.

6.1 From inputs to outputs

The key assumptions in order to be able to transition from our inputs to our desired outputs include:

- The business has a robust strategy
- The business has support from the local community
- There exists conducive regulatory framework
- The business has adequate competence
- The products that are offered are relevant and affordable
- The new clients receive services of higher quality or have not previously had access to such services

That the shareholders and management agree on the strategy is crucial for the successful implementation of any investment. This ensures that there is a coherent approach to decision-making and resource allocation, aligning the company's activities with common goals. In the context of financial services in developing countries, this alignment is especially important, as it can influence the organization's commitment to cater to underserved markets, and maintain a focus on long-term sustainability and impact, rather than short-term profits.

Regulatory frameworks play a significant role in the financial sector. Supportive, stable and predictable local bank regulations can facilitate the introduction of innovative financial products, ensure the protection of consumers, and maintain the stability of the financial system. Regulations that encourage financial inclusion can lower barriers to entry for new players and promote competition, leading to more diverse services and potentially better terms for consumers.

The capacity of the investee to effectively deploy technical resources and demonstrate personal competence is pivotal for success. Skilled management and staff can navigate local challenges, adapt to market demands, and efficiently utilize investments to generate impact. In developing countries, where systems may be less mature, the competence of the investee is even more critical to ensure that services provided are not only innovative but also stable and reliable for the customers.

The relevance and affordability of financial products are essential to ensure uptake and sustained use. In developing countries, where some may use financial services for the first time, it is crucial that these products address the specific needs and are affordable. This encourages widespread adoption and can have a significant impact on financial empowerment and economic development.

The assumption that new clients receive services of higher quality, more tailored products or that they have not had prior access to financial services is an important assumption in order to claim we are contributing to the goal of increasing financial inclusion. Should this not hold we could merely be substituting the services offered by local FSPs. By targeting individuals or enterprises who are in need of better quality services, or that have not previously had access, financial service providers can make a significant social impact by offering more tailored products, or by bringing them into the formal financial system. This can lead to improved livelihoods through better access to savings, credit, loans, and insurance products. The assumption underscores the potential for transformative change in the community by enabling financial growth and resilience among new clients.

6.2 From outputs to short term outcomes

For investments in FSPs to translate to our desired short-term outcomes there are a number of conditions that must be in place. The central assumptions include:

- There is macroeconomic and political stability
- There is conducive business environment,
- The clients use the financial services as intended
- The companies who are offered loans or financial services have sufficient technical and personal competency

A fundamental prerequisite for the success of almost any investment is the presence of macroeconomic and political stability. Stable economic conditions, characterized by stable inflation, sustainable debt levels, and predictable fiscal and monetary policies, are crucial for the long-term viability of financial investments. Political stability, on the other hand, ensures that there are consistent and predictable regulations and a lower risk of conflict or drastic policy shifts. Together, these factors are part of creating a predictable environment that encourages households and businesses to make investments, allowing for reliable financial planning.

A conducive business environment is a critical assumption for businesses to expand or be formed as consequence of better access and more uptake of financial services. This includes a legal and regulatory framework that supports the establishment and growth of businesses, including elements such as clear property rights, enforceable contracts, and a competitive market free from undue monopolies or barriers to entry. Additionally, infrastructure such as reliable internet, electricity, and transportation, as well as access to markets and a skilled workforce, are essential components in a business´ viability. When these elements are in place the increased lending or equity to FSPs can result in our desired outputs.

The assumption that clients will use loans or other financial services as intended is pivotal for the FIs product offering to result in household resilience, entry of new firms and expansion of existing ones, with job creation as a result. The effectiveness of financial services hinges on borrowers utilizing the capital for productive purposes such as starting or expanding businesses, investing in education, or health improvements, rather than for unproductive purposes. The productive use of loans leads to an increase in income or assets, enabling clients to repay their loans and potentially take out further loans for additional growth. Misuse of funds, on the other hand, can lead to high default rates and undermine the sustainability of the FIs as well as creating debt traps for individuals. Therefore, ensuring that clients are educated about the purpose of the loans or financial services, and what happens if repayments stop is fundamental. There should therefore be systems in place to monitor and encourage the intended use of funds.

The assumption that the companies who get increased access to financial services through the FSPs possess sufficient technical and personnel competency is vital for the translation to the outcomes we desire. Technical competency involves having the right technology, systems, and processes in place to efficiently and securely manage operations that are needed for a successful business. Personnel competency involves having an adequately skilled and motivated workforce capable of making informed decisions, providing quality services, and possibly innovative solutions in response to market needs. The combination of these competencies ensures that the businesses that we wish to see started or expanded as a result of the FSPs product offering can effectively manage risks, adapt to changing market conditions, and meet the needs of their clients, thereby ensuring that the outputs of our investments are translated into meaningful and sustainable outcomes.

6.3 From short term outcomes to medium-term outcomes

For the short-term outcomes to result in the medium-term outcomes there are at least three central assumptions that should be made.

- The businesses that are formed or expanded must be successful
- For women to be empowered the increased access to finance must affect their autonomy
- The businesses are able to mitigate the adverse effects of climate change

The success of the businesses is crucial for economic expansion and societal development to happen. Successful enterprises create jobs, increase incomes, and stimulate local economies, leading to improved living standards and poverty reduction. As businesses grow, they demand more goods and services, fostering a cycle of economic activity and innovation. This success attracts more investment, both domestic and international, further enhancing economic stability and growth. Moreover, successful businesses contribute significantly to the tax base, enabling governments to invest in infrastructure, education, and healthcare, which are vital for sustainable development. In essence, the prosperity of businesses that get access to lending is pivotal for medium term outcomes and the impact goals to be realized.

Enhancing women's autonomy and decision-making power is fundamental for achieving equitable and sustainable development. When women have greater autonomy, they are able to make better choices about their health, education, and employment, leading to better outcomes for themselves and their families. According to the literature MFIs can contribute to this. That this happens is an important assumption in order for the households to increase their consumption and for female empowerment to be realized.

The ability of businesses to manage the effects of climate change is an assumption that speaks to the resilience and adaptability of enterprises. In the context of many of the regions in Africa and southeast Asia, where climate change poses significant risks, this assumption suggests that businesses are expected to adopt practices that allow them to mitigate the adverse effects. This could mean investing in adaptive technologies, and develop further strategies to mitigate environmental risks to for instance crops and produce, if that is what the business produces. The successful management of adverse climate impacts is becoming increasingly important for the success of any business in regions that feel the effects of climate change.

Additionality in investments

In addition to the above assumptions, we assume that Norfund is additional in the investments that are being made. This entails that the investment would not otherwise have been made and is a prerequisite for investments conducted by Norfund to be realize. This central underpinning of any investment is therefore not further discussed in this background note, as it lies a step ahead of the theory of change.

7 Impact risks

The investments in financial inclusion holds large potential for economic growth and development. However, there are risks to any such investment that must be acknowledged. Assessing the impact risks means assessing the likelihood that impact will be different than expected. This section will outline some of the risks we must acknowledge as we invest in financial service providers.

Market, regulatory and political risks

When investing in financial service providers the different market risks are especially important to account for. A fluctuating economic environment, characterized by changes in inflation rates, currency value changes, and interest rates can significantly influence the sustainability and success of financial inclusion initiatives. If these market dynamics change significantly and unexpectedly during our investment span this can greatly affect the effectiveness and intended outcomes of the investment.

Evolving governmental landscapes, including policy shifts, regulatory changes, and political instability, can alter the markets for financial service providers. These changes create difficulties for new financial entities seeking to operate, as well as for existing ones looking to expand, thereby impacting their role in job creation and economic development. The political landscape in developing countries can be volatile, with changes in leadership or policy potentially affecting the stability and viability of financial service initiatives.

Customer risks

Expanding credit access to underserved populations is inherently risky. The lack of traditional credit history and collateral among these groups may lead to higher default rates, resulting in financial losses for institutions and a diminished impact on economic development. The effectiveness of financial inclusion initiatives is partly dependent on the financial literacy of the target population. Inadequate understanding of financial products can lead to their underutilization or misuse, potentially causing financial distress.

On the other hand, there is a risk of fostering a misuse of financial services, particularly credit products, resulting in over-indebtedness among users. This can undermine the benefits of financial inclusion, adversely affecting living standards and economic stability of the clients.

In addition, social norms and cultural practices can be considered as a risk, as they can influence the adoption and usage of financial services. In certain communities, skepticism about formal banking or credit systems can limit the effectiveness of financial inclusion initiatives.

Furthermore, new users of financial services are susceptible to scams and fraudulent activities, highlighting the need for enhanced consumer protection measures among these groups.

Technology and climate risk

In an age where digital platforms are central to expanding financial inclusion, technological systems are vulnerable to various technological risks, including cybersecurity threats, data breaches, and operational failures. Such risks can erode trust in the financial system and hinder the widespread adoption of financial services.

In many of the developing countries where we invest the effects of climate change can pose a risk to economic stability and the success of financial services. Climate-related events can disrupt markets, affect agricultural outputs, and lead to increased vulnerability among the populations these services aim to support.

As we provide due diligence of investments a lot of these possible risks are assessed, and when providing equity and engaging in active ownership allows us to participate on board level and thus implement measures to mitigate such risks. Nevertheless, it is important to keep in mind that any investment carry the risk of realizing unintended impacts.

8 Annex

8.1 Operating structures of the investees

This section considers the characteristics of the different types of companies Norfund invests in.

8.1.1 Microfinance institutions (MFIs)

This section outlines how MFIs typically differ from traditional lenders.

MFIs typically focus on underserved populations who do not have access to traditional banking services. This includes people in rural areas, low-income groups, and small-scale entrepreneurs. MFIs often do much of their lending to women. Traditional banks, on the other hand, often target more established, financially stable customers.

MFIs provide small loans tailored for micro-entrepreneurs and individuals. These loans usually have shorter repayment periods, and the MFI might charge higher interest rates. The shorter repayment terms can help mitigate risk and ensure regular cash flow to the institution, which is crucial for the sustainability of these institutions. The higher interest rates can be attributed to the higher operational costs associated with servicing smaller loans, especially in rural or underserved areas. Additionally, the risk profile of MFI clients, who often lack collateral and have limited credit history, can also contribute to higher rates. Furthermore, many MFI institutions cannot take. This means that the capital we provide for them comes at a higher cost. All this contributes to higher interest rates of MFI loans to the end clients compared to that of traditional loans. However, it has been pointed out that this might lead to debt traps and overindebtedness among clients who are not able to repay the loans.

At the same time, the loans offered by MFIs are designed to be more accessible than loans offered through traditional banks, if disregarding the higher interest rates and shorter repayment time. Traditional banks offer larger loans with more complex terms, often requiring collateral and a credit history. Again, it is important to acknowledge that this too is some of what MFIs have been criticized for, namely that the simple structures and lending to underserved segments can be assisting factors in putting the clients into debt traps.

Investing in MFIs involves a different risk profile than investing in the traditional banking sector. The focus on low-income clients with limited credit history can result in higher default rates, but usually MFIs mitigate this with group lending models and other strategies.

In addition, MFIs often operate under different regulatory frameworks, which can be less comprehensive and difficult than those governing traditional banks. This can affect the risk and operational aspects of the investment.

MFIs usually have a closer relation to their customer, with a more hands-on, community-based operational approach, with loan officers working closely with clients. Traditional banks operate on a larger scale with more automated processes.

8.1.2 Financial Technologies

This section outlines how FinTech's typically differ from traditional lenders. Not all points are relevant for all FinTech's or banks, but the section sets out to outline the most common differences between the two types of lenders. FinTech’s and traditional banks represent distinct approaches to financial services, each with unique characteristics.

FinTech’s are built using modern technology, using software and digital platforms to offer financial services. This technology first approach allows for rapid deployment and scaling of services, expanding the operations quickly. Traditional banks, while increasingly adopting technology, are often burdened by legacy systems that need updating.

Often the FinTech’s emphasize user experience, leveraging design and technology to create intuitive, accessible interfaces. Their services are primarily digital, offering convenience and speed. Traditional banks have historically been less focused on digital user experience, though this is also rapidly changing.

FinTech’s often target underserved demographics, offering services to those who may not have access to traditional banking. By using alternative data for credit scoring, they can also often serve customers with limited credit history.

Operating predominantly online, FinTech’s generally incur lower overhead costs compared to traditional banks, which maintain physical branches. This often translates into lower fees and more competitive pricing for customers, making the financial services more accessible for a larger segment of the population. This is especially important in low-income regions. However, the agile way of operating might also lead to difficulty in pricing the services and thus unpredictable pricing for the customers. This might also lead to variations in the availability of finance for the customers.

The ability of a FinTech to take deposits largely depends on its business model, regulatory status, and the specific financial services it offers. Many FinTechs are not able to take deposits, making the capital we invest more important for operations, and therefore the funding costs for the services are higher than for deposit-taking institutions.

FinTech’s may operate under different regulatory standards than traditional banks, which can lead to more innovative but also riskier financial products, that have been less tested. This means customers nor the FinTech might fully understand the implications of the product offering. This consideration of the balance between the need for innovation and the need for customer protection. Banks are typically subject to more stringent regulatory requirements, impacting their product offerings in a way that might limit innovation.

Many FinTech’s focus on niche areas, such as mobile payments, peer-to-peer lending, or personal finance management. This often means they can specialize and offer more tailored products. In contrast, banks usually offer a wide range of financial services, from deposits to loans and investment products.

These differences underscore the complementary roles of FinTech’s and traditional banks in the financial system. FinTech’s introduce innovation and accessibility, while banks in general offer stability and a broad range of services, at least for the time being.

8.1.3 Traditional lenders/bank institutions

Traditional lenders in developing countries are characterized by their more conventional approach to banking and finance, compared to MFIs and FinTechs. These institutions, typically larger and more established, often focus on serving clients with an accessible financial history and the ability to provide collateral.

This traditional model often leans towards risk aversion, which can lead to a lack of financial services for lower-income or unbanked populations. This is where we fully see the potential of MFIs and FinTech's within our portfolio. However, the traditional banks are crucial as lenders to SMEs, which make up a large share of businesses in low-income regions.

These banks usually offer a broader range of financial products, including savings accounts, personal and business loans, and investment services. However, they often operate through physical branches, leading to higher operational costs, which can be reflected in their service fees and interest rates. Their processes can be more bureaucratic and slower compared to newer financial models like MFIs and FinTech's, potentially leading to longer waiting times for loan approvals and other services. Traditional lenders also tend to be heavily regulated, which provides a level of security and trust but can also limit their flexibility in offering innovative financial products, as described in the section above about FinTech's.

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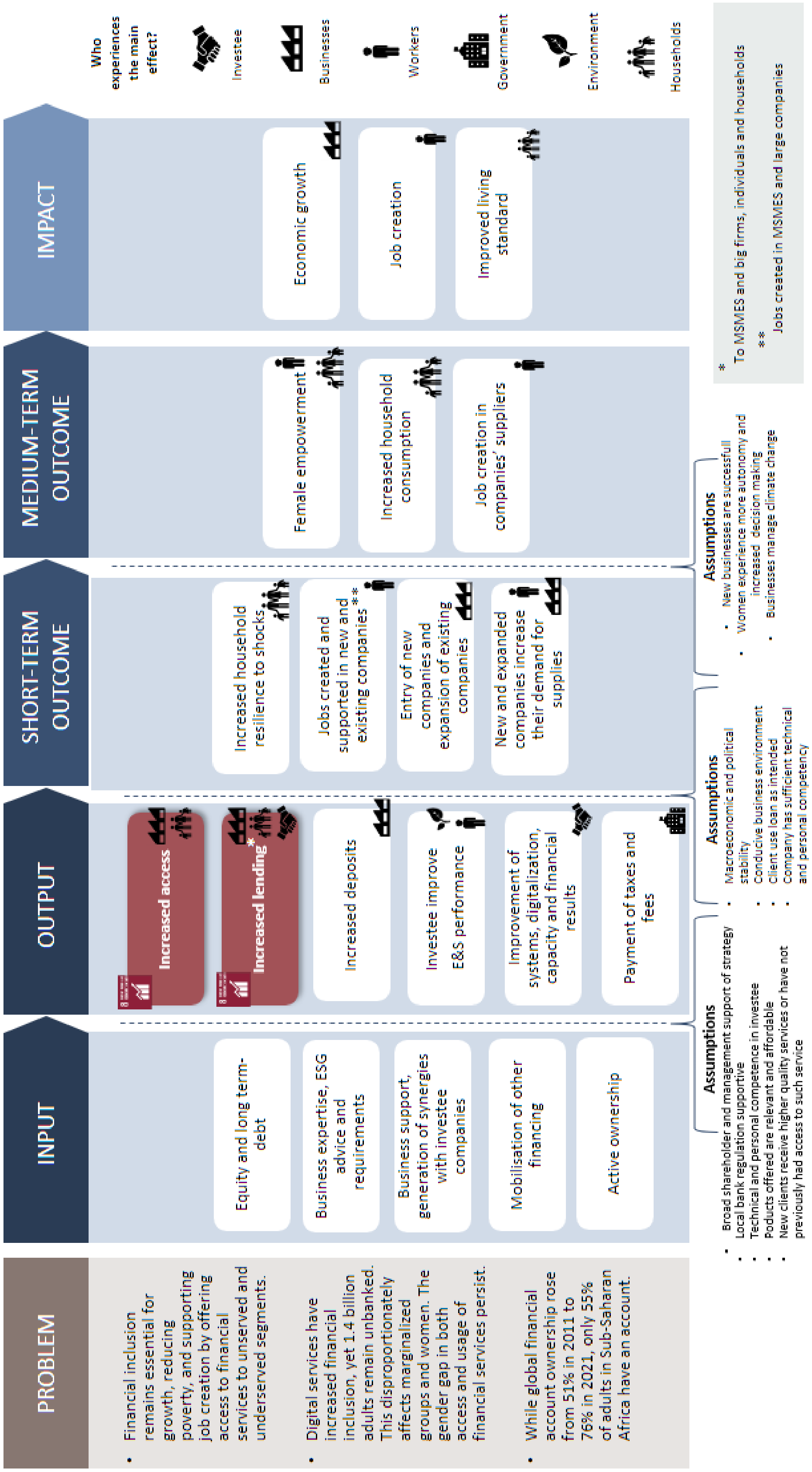
PROBLEM
• Financial inclusion remains essential for growth, reducing poverty, and supporting job creation by offering access to financial services to unserved and underserved segments.
• Digital services have increased financial inclusion, yet 1.4 billion adults remain unbanked. This disproportionately affects marginalized groups and women. The gender gap in both access and usage of financial services persist.
• While global financial account ownership rose from 51% in 2011 to 76% in 2021, only 55% of adults in Sub-Saharan Africa have an account.
INPUT
Equity and long term-debt
Business expertise, ESG advice and requirements
Business support, generation of synergies with investee companies
Mobilisation of other financing
Active ownership
OUTPUT
Increased access
Increased lending*
Increased deposits
Investee improve E&S performance
Improvement of systems, digitalization, capacity and financial results
Payment of taxes and fees
SHORT-TERM OUTCOME
Increased household resilience to shocks
Jobs created and supported in new and existing companies**
Entry of new companies and expansion of existing companies
New and expanded companies increase their demand for supplies
MEDIUM-TERM OUTCOME
Female empowerment
Increased household consumption
Job creation in companies' suppliers
IMPACT
Economic growth
Job creation
Improved living standard
Who experiences the main effect?
Investee
Businesses
Workers
Government
Environment
Households
Assumptions
• Broad shareholder and management support of strategy
• Local bank regulation supportive
• Technical and personal competence in investee
• Poducts offered are relevant and affordable
• New clients receive higher quality services or have not previously had access to such service
Assumptions
• Macroeconomic and political stability
• Conducive business environment
• Client use loan as intended
• Company has sufficient technical and personal competency
Assumptions
• New businesses are successfull
• Women experience more autonomy and increased decision making
• Businesses manage climate change
* To MSMES and big firms, individuals and households
** Jobs created in MSMES and large companies