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EMERGING MARKETS DEBT

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Financial Inclusion Drives Investment Opportunities

Financial inclusion can drive economic growth, reduce poverty, and smooth inequalities. Corporate debt issuers can be active players in that process. In this paper, we explain how emerging markets (EM) debt investors can gain exposure to financial inclusion via companies with diverse geographies, business operations, and risk profiles—particularly in Mexico, Sub-Saharan Africa, and Indonesia.

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Introduction

Financial inclusion—which is the access to and use of formal financial services—is a key tool to support development. Research has shown that financial inclusion can have positive impacts on growth and income inequality by enabling greater business investment and higher spending on food and education, and by smoothing the effects of income shocks.

As such, financial inclusion is considered a pillar of eight of the United Nations' 17 sustainable developments goals (SDGs). SDGs are an urgent call for action by all countries—both developed and developing—in global partnership.

Although progress has been made to increase financial inclusion in EMs in recent years, developing nations still lag advanced economies in terms of access to basic financial services. As a result, virtually all 1.7 billion unbanked individuals in the world come from developing countries.

On the bright side, the desirability of financial inclusion offers substantial business opportunities for financial institutions operating in EMs.

Investors, too, can benefit from increasing financial inclusion. The EM corporate debt universe allows investors to gain exposure to companies whose businesses models seek to address the challenges of financial inclusion in markets where access to financial services is particularly low.

In this paper, we examine the investment opportunities in some of these corporate debt issuers—specifically, those based in Mexico, Sub-Saharan Africa, and Indonesia—and explain how we assess their risks using our proprietary analytical framework.

Financial Inclusion in EMs: Low but Improving

Increasing financial inclusion can help raise living standards by enabling households and businesses to save, access credit and insurance services, receive remittances and government transfers, and access funds during emergencies.

In EMs, financial inclusion is improving but remains lower than in developed countries. A World Bank study showed that 66% of adults aged 25 and older in developing countries have accounts, an increase of 21 percentage points since 2011, but still significantly below the 96% in high-income economies and the global average of 72%. See exhibit 1.

Moreover, because account ownership is nearly universal in high-income countries, virtually all the 1.7 billion unbanked individuals in the world come from developing countries, with seven countries making up nearly half of them: Bangladesh, China, India, Indonesia, Mexico, Nigeria, and Pakistan.[1] See exhibit 2.

EM-based small and medium enterprises (SMEs)—which are usually defined as enterprises with less than 250 employees—also lack access to adequate financial services. A recent study from the International Financial Corporation (IFC) revealed that 40% of SMEs in EMs have unmet financing needs estimated at $5.2 trillion per year, representing nearly 20% of the gross domestic product (GDP) of these countries.[2]

Financial institutions often have limited appetite to lend to the segment due to companies' smaller sizes, weaker financial buffers, and limited creditworthiness transparency. At the same time, SMEs are often a large part of their countries' private corporate sectors, making them an important source of employment and economic growth.[2]

> "Financial institutions in EMs can access the untapped potential of these markets while supporting the advancement of SDGs."

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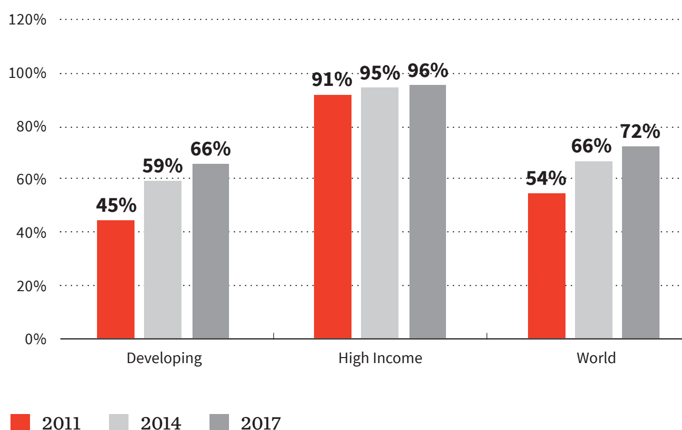
EXHIBIT 1

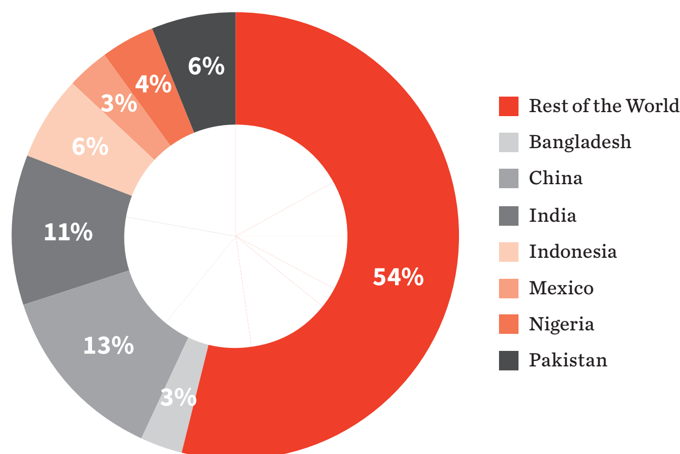
Adults (Age 25+) With Accounts



Source: World Bank Global Findex Database, as of 2017.

EXHIBIT 2

Adults Without Accounts, Breakdown by Country



Source: World Bank Global Findex Database, as of 2017.

Why Does Financial Inclusion Matter?

Studies conducted in various EMs link increased access to financial services (such as short-term credit and mobile accounts[3]) to smoother consumption patterns, higher savings rates, higher spending on food and education, and better responses to income shocks among the poor.[4]

Financial inclusion is thus considered a pillar of eight of the United Nations' 17 SDGs, including "No Poverty," "Decent Work and Economic Growth," and "Gender Equality."[5]

Research by the International Monetary Fund (IMF) associated higher levels of financial inclusion with higher economic growth (represented by SDG 8), particularly in countries with very low levels of financial depth (measured by the total volume of financial transactions in a country).[6]

There is also evidence that financial inclusion can help to reduce inequality in EMs, which in turn is highly correlated to poverty (represented by SDGs 1 and 10).[7]

Access to credit, savings, and insurance can also support SDG 2 (Zero Hunger) by allowing farmers to invest more and protect their crops.

Higher savings can also enable households to afford unexpected medical expenses, playing a role in SDG 3, Good Health and Well-Being.

Lastly, research shows evidence of the positive impacts of higher levels of financial inclusion on SDG 5, Gender Equality, through the empowerment of women.[8]

EXHIBIT 3

Unition Nations Sustainable Development Goals

Source: William Blair and United Nations, as of November 2021.

Financial Inclusion Drives Investment Opportunities

We believe the need for financial inclusion offers substantial business opportunities for financial institutions operating in EMs. These institutions can access the untapped potential of these markets while supporting the advancement of SDGs where it can have the most impact.

For investors, the EM corporate debt universe offers the opportunity to gain exposure to companies whose business models seek to address the challenges of financial inclusion in markets where access to financial services is particularly low.

Naturally, the nature of these issuers' business models often exposes them to more risks than does traditional banking. These risks include elevated asset quality risk, funding risk, and regulatory risk, among others.

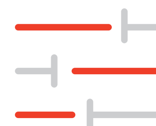
We assess these risks by using a robust analytical framework designed to help us find issuers with solid credit profiles and strong risk management that also support social development via a strategy for furthering financial inclusion. Exhibit 4 provides an overview of how we assess corporate risks through our proprietary analytical framework.

EXHIBIT 4

William Blair Emerging Markets Debt Corporate Risk Model for Financials

Financial Risk Profile
- Capitalization
- Asset Quality
- Liquidity

Business Risk
- Competitive Position
- Sector Concentration



Funding Structure
- Funding Mix
- Maturity Schedule

Management and Strategy
- Ownership Structure
- Growth Strategy

Sovereign Risk
- Sovereign Fundamentals
- Regulatory Risk

Source: William Blair, as of November 2021.

Mexico: Non-Bank Financial Institutions (NBFIs) Come Into Play

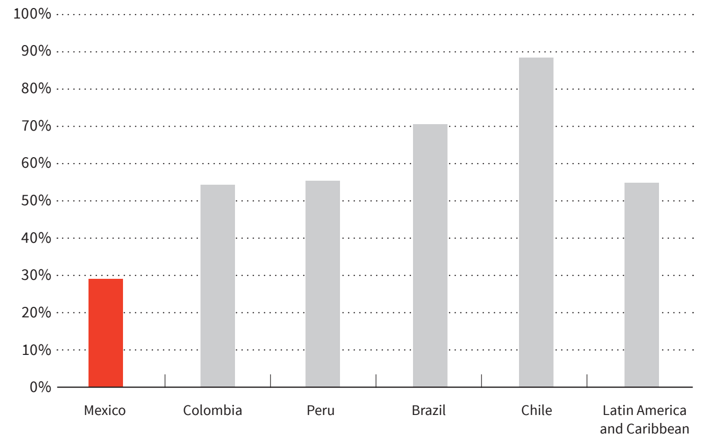
Mexico has one of the lowest levels of financial inclusion in Latin America, as measured by the private-credit-to-GDP ratio and account ownership indicators, as shown in exhibits 5 and 6.

The SME segment is particularly underfunded, with loans to the segment making up less than 2% of GDP, significantly below other middle-income countries such as Turkey, Indonesia, and Peru, as exhibit 7 shows.[9]

There are many issuers in the EM corporate debt universe whose business models focus on the unmet financial needs of companies and individuals in Mexico. In addition to commercial banks, these include NBFIs such as independent leasing companies. Examples are Unifin, Mexarrend, and Mega, and consumer finance and payroll lenders such as Credito Real and Financiera Independencia.

EXHIBIT 5

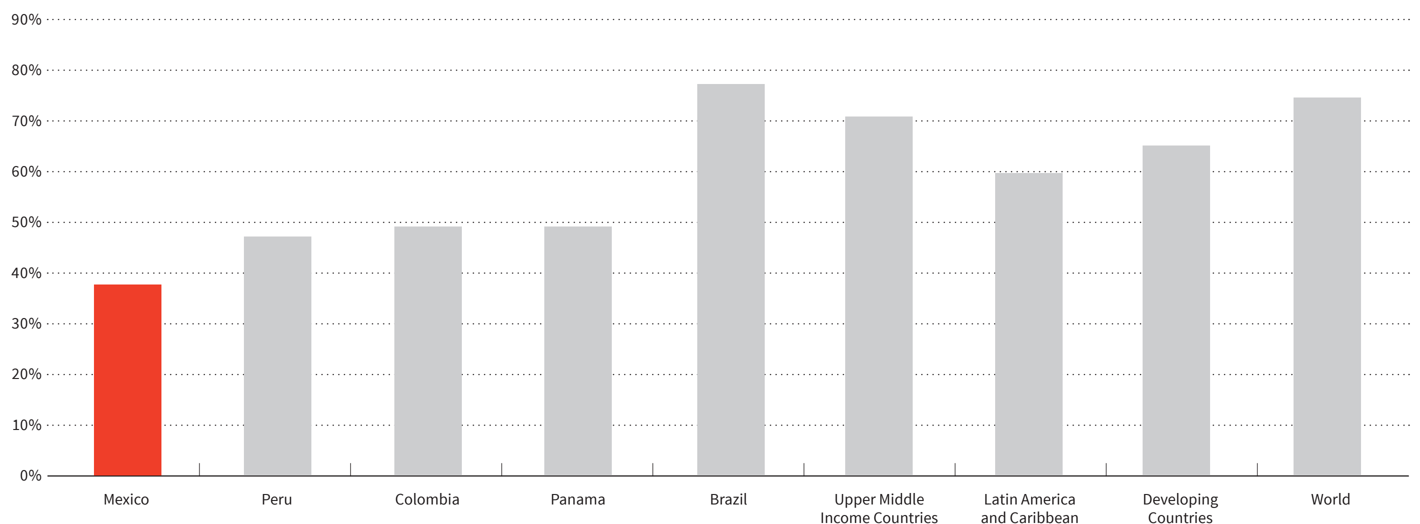
Domestic Credit to Private Sector by Banks (% of GDP)



Source: World Bank, as of 2020.

EXHIBIT 6

Financial Institution Account Ownership (% Adults aged 25+)



Source: World Bank Global Findex database, as of 2017.

Mexico: Non-Bank Financial Institutions (NBFIs) Come Into Play (continued)

When evaluating investments in NBFIs, we see regulatory risks, funding, and asset quality as key risks.

Unlike traditional banks, most NBFIs are not regulated. They are thus not subject to minimum capital or liquidity requirements or certain standard accounting practices. This increases the risk of accounting irregularities and regulatory oversight.

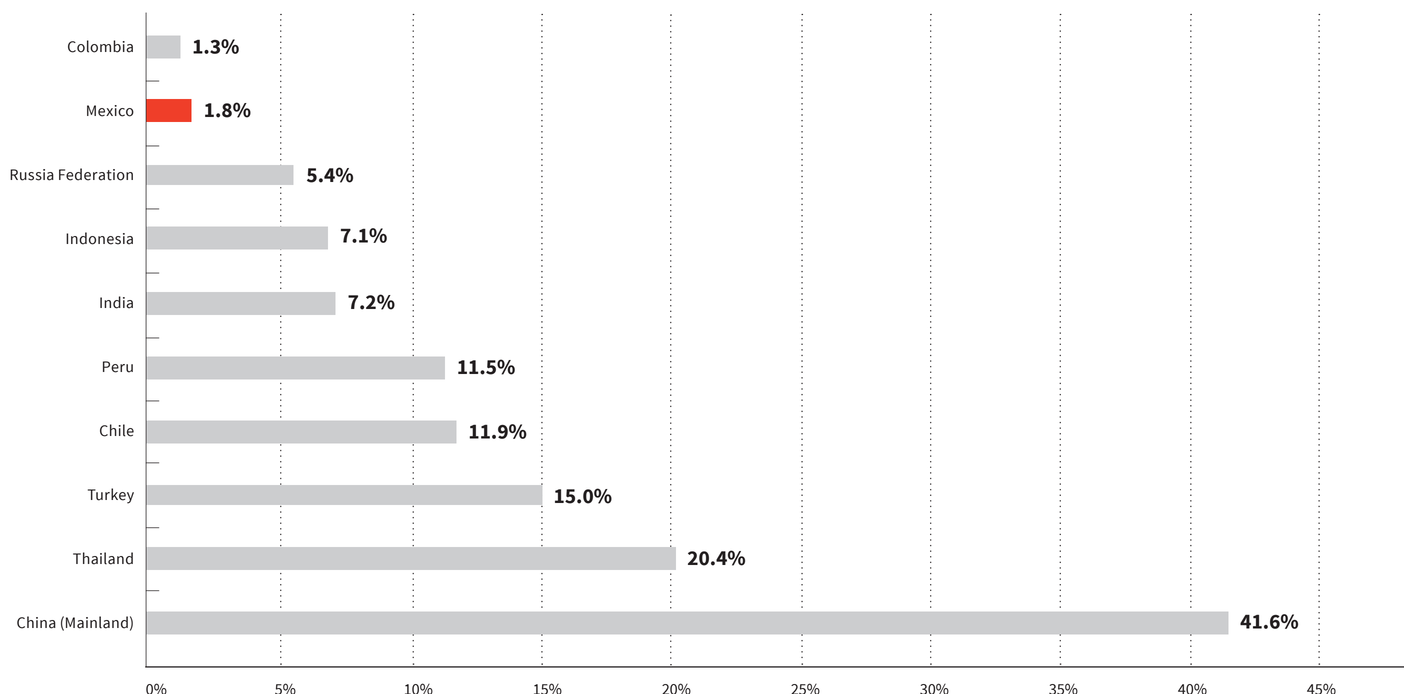
In terms of funding, NBFIs differ from traditional banks in that they are not funded by customers deposits, and therefore must rely on wholesale sources of funding, including commercial and development bank loans, the securitization market, and debt capital markets. Funding risks could arise because their funding is restricted to a certain group of counterparties, putting them at the mercy of credit appetite and broader market conditions.

Asset quality is also a key risk given the borrower's risk profile, which comprises mainly of smaller companies and lower-income individuals. This makes borrowers more vulnerable to economic shocks and hence more prone to miss repayments.

Using our multifactor risk analysis framework, we seek to uncover issuers with strong underwriting track records, healthy capitalization ratios, diversified funding bases, and comfortable maturity schedules. While audit risk events are by nature hard to predict, we seek to mitigate these risks by selecting issuers that apply best practices, such as regular auditor rotation and consistent accounting practices.

EXHIBIT 7

Outstanding SME Loans From Commercial Banks (% of GDP)



Source: Financial Access Survey, The International Monetary Fund, as of 2020.

Sub-Saharan Africa: Riding the Digital Wave

Sub-Saharan Africa has one of the lowest levels of financial inclusion in the world, particularly when looking at the level of financial institution account ownership. Financial institution account ownership among adults in the region is 36%, 29 percentage points lower than the developing country average, as exhibit 8 shows.

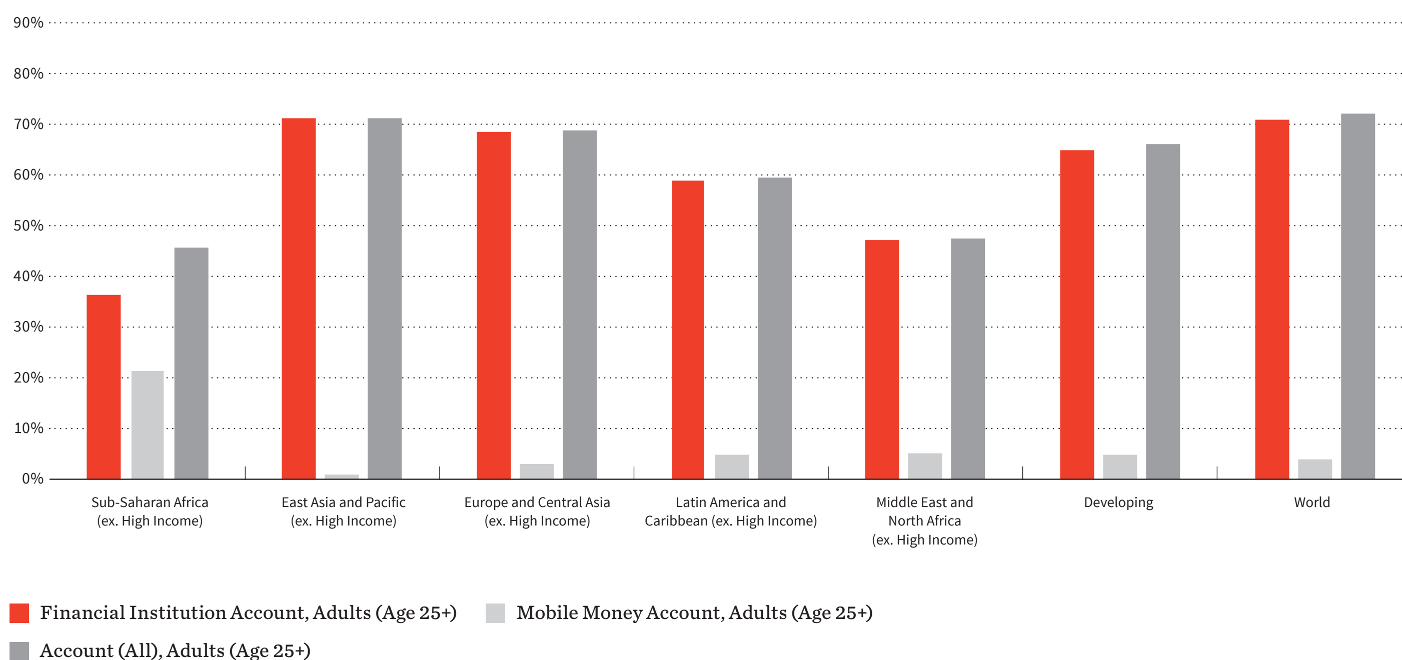
At the same time, the region is home to an interesting phenomenon: the remarkable growth in mobile accounts. When mobile accounts are considered, the level of account ownership in Sub-Saharan Africa increases by 10 percentage points to 46%. Some of the factors that explain this phenomenon are the young average age in the region (under 20 years) and the high level of mobile internet connectivity in Sub-Saharan Africa (close to 80%).[10]

This remarkable penetration of mobile accounts underscores the importance of developing digital solutions to address the financial needs of a large and young unbanked population.

Currently, Sub-Saharan Africa is home to a number EM corporate issuers that have developed solutions to take advantage of the market opportunity offered by the region. The issuers include Ecobank (based in Togo), Access (based in Nigeria), and Standard Bank (based in South Africa). The solutions developed by these issuers include mobile apps, payment systems, and cash management systems.

EXHIBIT 8

Emerging Markets Account Ownership by Region and Type, Adults Age 25+



Source: World Bank Global Findex database, as of 2017.

While these issuers' product offerings vary significantly depending on the issuer's size, geographical footprint, and regulatory framework, we see common elements in their strategies. At the most basic level, services offered include payment solutions, which enable, for example, transfers between family and friends and receipt of remittances. From there, the product range usually expands into broader offerings, including credit and trade financing.

A number of factors are helping drive these offerings. Partnerships with fintechs and local telecom companies are common, with 200 fintechs in Nigeria alone; this supports the development of targeted products. The COVID-19 pandemic also accelerated the adoption and usage of digital banking in Sub-Saharan Africa, with transaction volumes in digital channels significantly outpacing traditional channels.

When evaluating investments in Sub-Saharan African financials, we pay special attention to sovereign risk. These risks include political instability, currency volatility, and countries' external positions. Regulatory risk is also an important factor. Because the regulatory framework in some of these jurisdictions lags those of other EMs, this could result in vulnerabilities in banks' capital and liquidity positions and insufficient buffers for credit losses. Also, as new regulatory requirements are introduced over time, we could see pressure on banks' balance sheets as they seek to adapt to new regulations.

Sovereign risks are not the only risks these financials face, however. In terms of business model risk, we watch the size of foreign exchange loans in the banks' loan books, as high exposure to such loans can translate into vulnerabilities when currencies depreciate. In terms of financial risk, we focus on asset quality, as some of these issuers are expanding into new, riskier market segments. Lastly, as part of our environmental, social, and governance (ESG) analysis, we consider cybersecurity risks, given that these issuers are expanding in digital solutions, and customer protection issues given the growth in retail products.

"The COVID-19 pandemic accelerated the adoption and usage of digital banking in Sub-Saharan Africa, with transaction volumes in digital channels significantly outpacing traditional channels."

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Indonesia: Policy Drives Initiatives

According to the World Bank Findex survey, Indonesia ranked poorly in terms of financial inclusion compared to regional peers such as India and Thailand. With account ownership at 49% in 2017,[11] it also ranked lower than the average of lower middle-income countries, and lower than the East Asia and Pacific[12] (EAP) region, at 61% and 71%, respectively. Indonesia also has one of the lowest rates of domestic credit to GDP among its peers (33%) as exhibit 9 shows.

In order to improve financial inclusion, the Indonesian government established the National Financial Inclusion Strategy (SNKI) program in 2016. This program includes credit guarantee schemes for SME lending, subsidized micro loans (KUR), simplified bank accounts, and initiatives to support women and rural areas. More broadly, the program seeks to strengthen the regulatory framework to protect customers and improve the system's financial stability.

Given the strong presence of state-owned banks in the Indonesian banking system (42% market share, compared to the median of 27% for select EMs[13]), these institutions are instrumental in implementing the government's financial inclusion policy.

Our investment universe includes some of the largest government-owned banks in Indonesia, including Bank Rakyat and Bank Mandiri. Both banks are active in lending under government-sponsored programs supporting financial inclusion, with KUR loans representing between 6% and 14% of their total loans and almost 40% of their total microlending. (KUR is a partial credit guarantee program that helps fulfil the collateral requirement hindering SMEs from accessing credit; through KUR, Indonesia's commercial banks can provide working capital at lower interest rates compared to most other micro loans).

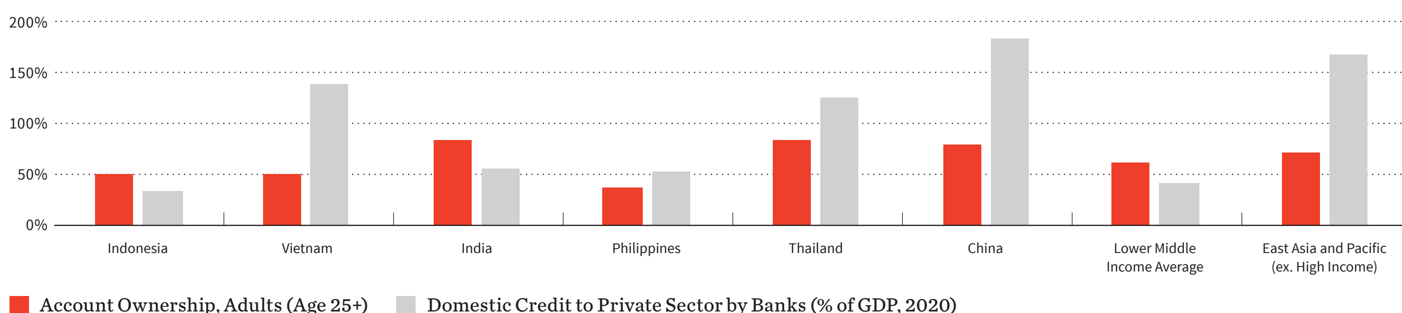
Lending under such programs can be positive for banks to the extent that it is profitable and does not lead to excessive risk taking. To ensure such risk-taking does not occur, we continually monitor asset quality, particularly in directed lending products.

Non-performing loans (NPLs) in the micro segment for government-owned banks have been particularly resilient, with the ratio of NPLs to total loans ranging from 1.0% to 1.6% as of June 2021. We do, however, note that current NPL ratios might not show the full extent of asset-quality deterioration because a substantial portion of these loans were restructured under COVID-19 relief programs.

Our analysis of these issuers also focuses on management and strategy, particularly ownership structure. In our view, government ownership may have positive and negative credit implications. On one hand, government ownership usually translates into a high level of political influence on an issuer's strategic decisions, such as participation in directed lending initiatives; this may turn out to be creditor unfriendly. On the other hand, government ownership can also have a positive effect, such as providing a high likelihood of government support in case of financial stress.

EXHIBIT 9

Account Ownership (% of Population) and Domestic Credit (% of GDP)



Sources: World Bank Global Findex database, as of 2017; World Bank, as of 2020.

Conclusion

In EMs, we believe there is significant room for improvement in financial inclusion, and corporate debt issuers in these markets can be active players in that process. For investors, this translates into numerous opportunities to gain exposure to financial inclusion via companies with diverse geographies, business operations, and risk profiles. But there are key risks, including asset quality, access to funding, regulation, and ESG shortcomings. We use our corporate risk model for financials to thoroughly analyze these risks as we seek to generate value for our clients.

Footnotes

1 Demirgüç-Kunt, Asli, Leora Klapper, Dorothe Singer, Saniya Ansar, and Jake Hess. 2018. The Global Findex Database 2017: Measuring Financial Inclusion and the Fintech Revolution. Washington, DC: World Bank. doi:10.1596/978-1-4648-1259-0. License: Creative Commons Attribution CC BY 3.0 IGO.

2 Miriam Bruhn, Martin Hommes, Mahima Khanna, Sandeep Singh, Aksinya Sorokina and Joshua Seth Wimpey MSME FINANCE GAP: Assessment of the Shortfalls and Opportunities in Financing Micro, Small and Medium Enterprises in Emerging Markets.

3 Mobile accounts include "mobile-phone-based services, not linked to a financial institution, that are used to pay bills or to send or receive money. Mobile money accounts allow people to store money and to send and receive electronic payments."

4 Dean Karlan, Jake Kendall, Rebecca Mann, Rohini Pande, Tavneet Suri, and Jonathan Zinman. 2016. Research and Impacts of Digital Financial Services. NBER Working Paper No. 22633. JEL No. G21,O12.

5 Leora Klapper, Mayada El-Zoghbi, and Jake Hess. 2016. Achieving the Sustainable Development Goals the Role of Financial Inclusion.

6 Ratna Sahay, Martin Čihák, Papa N'Diaye, Adolfo Barajas, Srobona Mitra, Annette Kyobe, Yen Nian Mooi, and Seyed Reza Yousefi. 2015. IMF Staff Discussion Note. Financial Inclusion: Can It Meet Multiple Macroeconomic Goals?

7 Mostak Ahamed and Roxana Gutiérrez-Romero. 2020. COVID-19 Response Needs to Broaden Financial Inclusion to Curb the Rise in Poverty.

8 Asli Demirguc-Kunt, Leora Klapper, and Dorothe Singer. 2017. Policy Research Working Paper: Financial Inclusion and Inclusive Growth: A Review of Recent Empirical Evidence.

9 The World Bank assigns the world's economies to four income groups: low, lower-middle, upper-middle, and high-income countries. The classifications are updated each year on July 1 and are based on GNI per capita in current U.S. dollars of the previous year. The classifications mentioned in this paper refer to countries' current income groups (FY22, based on GNI per capita as of 2020).

10 GSMA: The State of Mobile Internet Connectivity Report 2021

11 Based on the World Bank's Global Findex Database 2017. A survey conducted by the Financial Inclusion Insights (FII) program from Kantar, implemented in collaboration with the National Council for Inclusive Finance (DNKI), shows account ownership in Indonesia stood at 61.7% as of 2020. We chose to use the World Bank's data in this paper for comparability purposes.

12 Excluding high-income countries.

13 Includes Brazil, Chile, China, Colombia, Hong Kong, India, Indonesia, Malaysia, Mexico, Peru, Philippines, Russia, Singapore, South Africa, South Korea, Taiwan, Thailand, and Vietnam.

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