Inclusive Finance:

Looking to the Future

A PERSPECTIVE FROM LUXEMBOURG

InFiNe

Inclusive Finance Network

Luxembourg

With the support of

LUXEMBOURG
AID & DEVELOPMENT

Acknowledgement

Adriana Balducci (Innpact), Mathilde Bauwin (ADA), Laurent Capolaghi (EY), Anne Contreras-Muller (Arendt & Medernach), Arnaud de Lavalette (ADA), Julie Didier (LuxFLAG), Olivier Edelman (EIB), Aurélien Hollard (Arendt & Medernach), Esther Meyer (Fondation de Luxembourg), Clara Naïdji (EY), Alessandra Nibbio (Innpact), Jean-Louis Perrier (Suricate Solutions SA), Katharine Pulvermacher (Microinsurance Network), Sachin Vankalas (LuxFLAG), Kaspar Wansleben (LMDF).

Forewords

In the light of global development challenges, such as immigration, climate change and even the growing role of digital technologies, inclusive finance is in a state of turmoil. Although the most recent Global Findex Database[1] published by the World Bank shows an increase in the number of people with access to a bank account, there is still much work to be done. One point seven billion people remain unbanked, there are many dormant accounts, women's access to financial services remains problematic in many parts of the world and, lastly, the development of digital financial products still requires an adapted and appropriate framework and regulations.

Since its creation in 2014, the Inclusive Finance Network Luxembourg (InFiNe.lu) and its members have been following these developments closely and are lending their expertise to advance financial inclusion. InFiNe.lu aims to promote the universal right to access quality and responsible financial services and products in order to strengthen financial inclusion and to combat poverty. In Luxembourg, this work has been made possible thanks to the support of the network's members and, in particular, the Luxembourg Ministry of Foreign and European Affairs – Directorate for Development Cooperation and Humanitarian Affairs.

Over more than 20 years, Luxembourg has affirmed its support for microfinance and inclusive finance as tools for empowerment and development, thus countering poverty. The country has gradually become a leading player in this area, relying in particular on a solid partnership between the private and public sectors, the financial marketplace and Luxembourg's cooperation. A real ecosystem promoting responsible and inclusive finance has developed in Luxembourg, bringing together a wide range of professions, such as consulting, technical support, training and audit. The InFiNe.lu network is a practical example of the synergies established with 30 members from civil society (both public and private sectors) reflecting this diverse expertise.

This first publication by InFiNe.lu, "Inclusive Finance: Looking to the Future. A Perspective from Luxembourg", highlights this commitment and includes the thoughts of six network members on specific areas of inclusive finance and the role played by Luxembourg. As such, these members shed light on the profile of SME (Small and Medium-sized Enterprise) entrepreneurs in sub-Saharan Africa and their needs, the use of Peer-to-Peer lending to support SMEs, the challenges of cyber security in the inclusive finance sector, and the connection with impact investment. The common thread of these articles is first and foremost to reveal the different tools, whether analytics tools or innovative financing instruments created from Luxembourg to contribute to the development of financial inclusion.

InFiNe.lu hopes these articles will provide food for thought in support of responsible and innovative inclusive finance.

Michel Maquil
Chairman
InFiNe.lu

[1] World Bank Group. 2018. "Global Findex Database 2017. Measuring Financial Inclusion and the Fintech Revolution". https://globalfindex.worldbank.org (accessed on 25.09.2018)

Table of Contents

1 **SME FINANCE**

p. 7 Small and Growing Businesses in Africa: How to Better Meet their Needs
by Mathilde Bauwin, ADA

p. 13 Lending to Entepreneurs: a Safe Bet?
by Clara Naïdji, EY Luxembourg

2 **FINTECH AND INNOVATION FOR AN INCLUSIVE FINANCE**

p. 19 Challenges of Cyber Security for Financial Inclusion
by Jean-Louis Perrier, Suricate Solutions

3 **OUTLOOK FOR INCLUSIVE FINANCE INVESTMENT FUNDS**

p. 25 Investments in Microfinance: What's in It for Investors?
by Sachin Vankalas and Julie Didier, LuxFLAG

p. 31 The Future of Inclusive Finance Investment Funds: from Traditional Microfinance Debt Funds to Broader Inclusive Finance and Thematic Funds
by Anne Contreras-Muller & Aurélien Hollard, Arendt & Medernach

4 **IMPACT INVESTING AND INCLUSIVE FINANCE**

p. 37 Impact Investing in Luxembourg
by Katharine Pulvermacher, Microinsurance Network

Inclusive Finance:

Looking to the Future

A PERSPECTIVE FROM LUXEMBOURG

Small and Growing Businesses in Africa: How to Better Meet their Needs

by Mathilde Bauwin, ADA

Small and Medium-sized Enterprises (SMEs) play a major role in the economic growth and development of most countries, especially as they are often the largest employers.

With regard to Africa, according to the International Monetary Fund's Regional Economic Outlook for sub-Saharan Africa released in April 2015, over the next 20 years, sub-Saharan Africa will become the main source of new entrants in the global labour force. Nonetheless, compared to other emerging economies, the region suffers from a lack of formal medium-sized enterprises, which are usually the ones boosting job creation. As a consequence, paying more attention to SMEs, and especially to what fosters or hampers their growth, seems crucial to ensure their viability and capacity to absorb this coming labour force.

This is the reason why ADA, a Luxembourg NGO that has been working for financial inclusion around the world for 24 years, has initiated a study to contribute to the creation of knowledge about African Small and Growing Businesses (SGBs) and their needs (ADA, 2017). Small and Growing Businesses (SGBs) are defined by Aspen Network of Development Entrepreneurs (ANDE), a network promoting entrepreneurship in emerging markets, as "commercially viable businesses with five to 250 employees that have significant potential and ambition for growth". The objective of the study was to provide new insight on this little-known segment, which could be relevant for the stakeholders seeking to foster the development of SGBs.

One of the well-known obstacles encountered by SMEs in boosting their growth is access to financing resources, either equity or debt: whereas the financial needs of SGBs are usually too low for investment funds and for banks, which are reluctant to serve this customer segment, they may be, or become too high for microfinance institutions which are sometimes constrained in terms of loan ceilings, or not used to serving such clients.

Nonetheless, some of these growth-oriented businesses start as microenterprises, and are therefore likely to be served by MFIs, at least as a first step. Thus, even though SGBs often represent a minority of clients in MFIs' portfolios, which focus more on microenterprises, referring to Microfinance Institutions (MFIs) may help better identify SGBs' profiles, understand their growth models and needs, and hence shed some light on how to bridge the missing middle in terms of financial and business development services (ADA, 2017: p. 7).

One of the well-known obstacles *encountered by SMEs in boosting their growth* ***is access to financing resources*** *[...]*

From this starting point, ADA referred to its expertise with microfinance institutions to design a study aiming at analysing a sample of SGBs. These SGBs, defined as microenterprises which turned into SMEs in the framework of the study, were retrieved from the client portfolios of five participating MFIs in three East African countries. Three local consultants conducted independent local studies in 2017 in Ethiopia, Kenya and Madagascar and carried out one-to-one interviews with 83 SGB owners. The objectives were to examine entrepreneurs' profiles and paths, identify business sectors conducive to growth, learn more about the main challenges and obstacles faced by entrepreneurs through their growing process and define their current financial and non-financial needs. These independent local studies constituted preparatory work for the African Microfinance Week 2017 organised by ADA in Addis Ababa and supported by the Grand Duchy of Luxembourg. They also served as the basis for a comparative analysis carried out by ADA. Based on the results of this synthesis, some general recommendations can be made to financial services providers, business development services providers, local and international support organisations and other stakeholders, in order to improve the way of supporting SGBs.

The recommendations made in the full study (ADA, 2017: p. 33) concern the following issues in particular:

THE ROLE OF THE GOVERNMENT AND PUBLIC AGENCIES

Despite the various measures and policies implemented in each African country under study, the efforts seem insufficient to enable SMEs to evolve and grow in a proper environment and access the services they need. The variety of definitions of Micro-, Small and Medium-sized Enterprises (MSMEs) within a country, sometimes even their inconsistency or irrelevance, could reflect the lack of attention dedicated to this segment. Even though interesting initiatives have been launched in Ethiopia, especially with regard to the provision of working spaces and premises, public support is inadequate and insufficient everywhere. The legal environment is sometimes constraining, especially in Kenya, where licenses and taxes seem too numerous, not to mention corruption, and incentives encouraging financial service providers to facilitate access to credit for SMEs are missing.

> *It could be more relevant to consider microenterprises and start-ups* ***as a part of a value chain which also includes SMEs*** *[…]*

ACCESS TO ADEQUATE CREDIT

A high share of SGB owners face difficulties in accessing the amounts they need to keep growing. This is mostly due to collateral requirements from the financial institutions currently funding them. Even with clean credit histories, requirements remain too high and processing times too long. The conditions demanded by MFIs seem inappropriate for SMEs, while banks still refuse to serve them: this is the "missing middle" issue often referred to when talking about challenges faced by SMEs. Whereas the trend in public policies is rather to create a proper and supporting environment for start-ups and microenterprises, the same kinds of initiatives in favour of the expansion of small and medium enterprises are missing, and yet SMEs are likely to create more jobs. **It could be more relevant to consider microenterprises and start-ups as a part of a value chain which also includes SMEs, and to think about how to ensure access to financial and non-financial services for the whole chain.**

ACCESS TO DIVERSE AND SOPHISTICATED FINANCIAL SERVICES

Most SGB owners resort to diverse financial institutions in order to make up for the lack of appropriate financial services offered by the institution currently funding them. The Ethiopian case is particularly striking, with SGB owners taking credits from MFIs but all other services such as current accounts and electronic payment solutions from banks. If MFIs or banks are not able or willing to offer all the services needed by SMEs, at least synergies and collaborations between various financial service providers could be created in order to ensure that SMEs are properly served. MFIs could also innovate and scale-up their services to better meet SMEs' needs, especially by including fintech solutions, either internally or in cooperation with specialised providers.

THE BURDEN OF INFORMAL SECTOR

All surveyed SGBs are formally registered in Ethiopia and Madagascar, whereas this is not the case in Kenya, where several levels of registration exist. The Kenyan legislation does not seem to efficiently incite SMEs to register. However, more generally speaking, formalization is a key issue, not only because it facilitates access to suppliers, clients and government support for SGBs, but also because it minimises market distortions: for now, many SGBs have to face competition from other local enterprises which are not always formalised and are not submitted to the same rules and costs, which is definitely an obstacle to their growth. As a consequence, more incentives to formal registration should probably be implemented, not only for SMEs but for all economics actors whatever their size.

THE NEED FOR NON-FINANCIAL SUPPORT

Few surveyed SGB owners benefited from non-financial services. If some of them claim not to need any, others acknowledge that training, either technical or managerial, and business development services (BDS) in general could be useful for their growth. So far, the offer of such services has remained insufficient, inappropriate, and even too costly when provided by private organisations.

More coordination between providers of financial and non-financial services and/or public-private partnerships could be solutions to test in order to develop more organised, efficient and quality-driven BDS sectors.

THE NEED FOR MORE KNOWLEDGE AND INFORMATION ABOUT SGBs

The outcomes of studies of this kind may be particularly useful for several types of actors. For MFIs first, they could help them better know their clients, train loan officers, and especially give them some clues to identify SGBs in their existing portfolios but also among their possible future clients. Hence, such studies may provide MFIs with relevant information to implement specific and adapted support dedicated to SGBs, whether for the pre-launch or the post-creation phase. Second, for governments, donors, and national or international organisations willing to focus their efforts on job creation, such studies give insight on the segments to target to maximise the potential number of jobs created. As a consequence, more studies with other MFIs, in other countries and other continents should be launched in order to contribute to knowledge creation on SGBs.

These studies could also adopt a different perspective by focusing on entrepreneurs' life stories, and/or dealing with complementary issues, such as SGB owners' resilience capacities and strategies to manage risks and face shocks; this could give food for thought about the needs for other kinds of products and services, such as insurance.

Indeed, even though African SGBs have recently started benefiting from more financial support from investors (e.g. GroFin, I&P, MCE) or even some MFIs (e.g. VisionFund), a lot more needs to be done to support the sector. ADA recently joined ANDE (Aspen Network of Development Entrepreneurs) to build awareness and become more involved in the initiatives supporting entrepreneurship in Africa and in other emerging markets, a course of action that other actors keen to know more on the topic can also adopt.

Mathilde Bauwin
Project Officer
ADA

References

ADA. 2017. "Small and Growing Businesses in Africa, Successes and Challenges". https://www.ada-microfinance.org/en/our-resources/media-center?media=180

Lending to Entrepreneurs: a Safe Bet?

by Clara Naïdji, EY Luxembourg

No need to look far to see that the way Small and Medium-sized Enterprises (SMEs) raise funds has changed. Social media is a boon for anyone with a promising venture idea. Instead of knocking on investors' doors one by one, a large audience is now at ourfingertips. At the same time, it implies that investing in an SME is now open to a lay person seeking to diversify their income stream.

In Continental Europe, the main active platforms to invest in SMEs are Kickstarter, Indiegogo, and Seedrs, to name a few. The vast majority of platforms we heard of operate as reward-based or equity-based crowdfunding. This means that the crowdfunders generally receive goods and services or shares in the venture in exchange for their contribution.

But how about entrepreneurs who are looking for debt financing and don't feel like giving up control over their companies or free products to a crowd of strangers? Well, small enterprises crowdlending, or peer-to-peer lending, hasn't shared the same easy path as these other types of crowdfunding.

Peer-to-peer lending is recent, and the first platforms started to appear in 2005 in China, the United States and the United Kingdom. The market remains largely dominated by the United Kingdom, which represents over 80% of total peer-to-peer loans granted in Europe. Consumer lending remains the most widespread form (Wardrop et al., 2015).

HOW DOES PEER-TO-PEER LENDING WORK, EXACTLY?

Peer-to-peer lending is the facilitation of lending from one individual or company to another. Financing occurs when several investors transfer money to a platform and select a single loan or several loans to invest (Savarese, 2016).

The minimum ticket size may vary and can start at EUR 1,000.

Peer-to-peer lending has lower costs for loan processing and servicing as there are fewer operational expenses than in traditional lending industries. Everything, from the due diligence to the information gathering process, is done online.

Peer-to-peer lending platforms are disruptive mostly because of the way they can assess the borrower's creditworthiness in a more efficient and innovative way than the banking industry. On top of the financial statements analysis, it is not uncommon to see such platforms using the number of Facebook friends or the number of executives in your LinkedIn connections to assess whether or not you are a worthy creditor.
Everything is now done through an online form, and the information is then processed in an algorithm. The risk profiles are then classified through a grading system which corresponds to a certain interest rate (Morgan Stanley, 2015).

An initial debate in the peer-to-peer lending business model was whether to set the rate of return per risk profile or use an auction system. The auction model was progressively given up by many platforms in the US and the UK to shift towards a set rate of return. A good decision which helped significantly reduce the number of loan defaults (Snyder, 2011).

One should bear in mind that peer-to-peer lending is always a two-sided market: peer-to-peer lending has to develop an attractive offer for investors (high rates of return) and an interesting offer for borrowers (easier, cheaper access to financing).

DO INVESTORS GET MONEY OUT OF PEER-TO-PEER LENDING?

4% to 12% interest rate with a minimum investment of as little as EUR 100: this is a hard promise to hold these days, but peer-to-peer lending platforms are willing to take up the challenge.

With that promise, they mainly attract retail investors but we have seen investment funds and banks increasingly investing in peer-to-peer loans as part of an investment strategy. In 2017, the UK government revealed that the average amount of default for peer-to-peer lending platforms having received government authorisation was below 2%. A very low risk if you compare it to interest rates averaging 8% (in Continental Europe, these figures are not readily available) (Innovative Finance ISA, 2017).

The platforms have developed new techniques to mitigate risks. By default, platforms split the requested investment into several loans for diversification purposes. Some platforms even have a provision fund to repay lenders in the event of a default. However, the assessment of these platforms' creditworthiness still leaves room for improvement.

Due to current legislation, platforms are not allowed to engage in cross-border loans. Hence a platform's rate of nonperforming loans is often linked to the overall loan performance of the platform's country (Wardrop et al., 2015).

But not everything is rosy: ten peer-to-peer lending platforms failed between 2010 and 2015 in the United Kingdom alone. This is due primarily to fierce competition between platforms in the UK but also to the industry's evolution. Peer-to-peer lending platforms started by offering loans to low-risk profiles and, over time, increasingly accepted riskier borrowers due to the higher profits they generate through higher interest rates. Not to mention the fact that peer-to-peer lending platforms have limited resources to recover loan payments (Bottiglia, Pichler, 2016).

What we see is that the people who get the high returns are often those with sufficient risk management knowledge to properly diversify the loans portfolio on the platform.

WHAT'S THE ADVANTAGE FOR ENTREPRENEURS?

The financial crisis has severely affected confidence in bank lending. Therefore, demand for loans has decreased due to fear of rejection, too stringent conditions or high interest rates.

> ***Peer-to-peer lending platforms*** *emerged at just the right time.*

These platforms were able to provide lower interest rates to borrowers and higher return on investments to investors. Also, on peer-to-peer lending platforms, the loan approval delay is approximately one week. This was a revolution compared with the bank lending process, which can take up to six months for SMEs. Furthermore, peer-to-peer platforms reach out to creditworthy SMEs that are excluded from the traditional lending system.

ARE THE REGULATIONS FAVOURABLE FOR THE SOUND DEVELOPMENT OF AN EFFECTIVE PEER-TO-PEER LENDING INDUSTRY?

The European Commission released the Capital Markets Union initiative (CMU) in 2015, the aim of which is to diversify sources of capital for SMEs by complementing bank financing (Council of the European Union, 2015). The reflexion on how to protect financial institutions without preventing the apparition of innovations that could improve the efficiency of lending or deposits activities is nothing new.

In the United Kingdom, the regulatory sandbox offers the opportunity for peer-to-peer lending to experiment with innovative ideas without having to obtain a license. The sandbox (or interim) permission allows platforms to receive advice from regulators on the application and other potential legal issues to avoid infringement (FCA, 2014).

European governments have enacted different policies regarding potential losses by investors on peer-to-peer lending platforms. On the one hand, we have friendly regulation, such as the French government offering a tax rebate for investors on peer-to-peer lending platforms having suffered a loss due to a defaulted loan. On the other hand, many countries, including France, are limiting the amounts that an individual can invest in peer-to-peer loans.

Another aspect of regulation is investor information. Any platform offering financial return investments to retail investors has to inform about the risk, and peer-to-peer lending is not an exception.

In many countries, the platforms are at least obliged to provide an information sheet and sometimes even a whole prospectus for each loan offered.

In the UK, no regulation on information requirements exists, and standards that emerged through market practices are Peer-to-Peer Finance Association (P2PFA) which then influenced UK regulations. The UK P2PFA was founded in 2011 and brings together more than three-quarters of peer-to-peer lending platforms in the UK into a common consortium. This association quickly recognised the need to standardise the information provided to investors in order to preserve reputations and therefore investments in the industry (P2PFA, 2011).

The European regulatory landscape on crowdfunding is fragmented for the time being. However, we observe a determination of the European authorities to have a common framework. The most recent attempt is the Proposal for a Regulation on European Crowdfunding Service Providers (ECSP) for Business.

The direction taken by the European Commission is to improve access to this innovative form of finance for small investors and businesses in need of funding, particularly SMEs. The regulators aim to do so by giving investors better protection and a higher level of guarantees, based on clear rules on information disclosures, new rules on governance and risk management and a coherent approach on the supervision of these platforms.

WHAT IS THE OUTLOOK OF THE PEER-TO-PEER LENDING MARKET?

The initial purpose of peer-to-peer lending was to be able to perform lending activities without the intervention of traditional banks. In line with the alternative finance trend, these platforms wanted to bring financial activities back to the level of the community of peers. **However, we observe an increasing number of partnerships between banks and peer-to-peer lending platforms and growing investments by banks in peer-to-peer lending platforms (Milne and Parbooteah, 2016).**

Another surprising trend is also observable; the securitisation of these loans (Asian Development Bank, 2015, vi). Some platforms started to pool loans into interest-bearing securities, either as a way to counter regulations or so as to be able to lend larger amounts.

In 2015, Morgan Stanley mentioned that the global market for peer-to-peer lending would reach USD 290 billion in 2020. According to these forecasts, 2020 could see the market reach maturity and its growth rate could start to decline (Morgan Stanley, 2015).

Peer-to-peer lending is certainly enjoying strong momentum, but the industry still has to adapt to competition and regulations. Hopefully, initiatives such as the UK P2PFA will emerge throughout Continental Europe and make SME crowdlending a viable financing alternative for SMEs.

WHAT ABOUT LUXEMBOURG?

Luxembourg has a vivid investment fund and private banking sectors which are supporting the development of fintechs through investments and infrastructure. To date, no solid actor could emerge as a Luxembourg reference for peer-to-peer lending. One should keep in mind that the development of a peer-to-peer lending industry rests upon the dynamism of the startup scene.

According to a report by the Idea Foundation, the number of new companies grew steadily in Luxembourg from 2003 to 2014. In recent years, Luxembourg has adopted various strategies in its bid to become a "nation of start-ups": Digital Tech Fund in 2016, Luxinnovation, Fit4Start programme.

It might be only a matter of time before Luxembourg SMEs start looking for peer-to-peer financing options (.lu, 2017).

Clara Naïdji
Financial Auditor
Private Equity
EY Luxembourg

References

Asian Development Bank. 2015. "Making Money Work: Financing a Sustainable Future in Asia and the Pacific". Asian Development Bank. http://hdl.handle.net/11540/4030. License: CC BY 3.0 IGO, IV

Bottiglia, R., Pichler, F. 2016. "Crowdfunding for SMEs: A European Perspective", Palgrave Macmillan UK, London, 93-210

Council of the European Union. 2015. "Conclusions on the Commission action plan on building a Capital Markets" Union, adopted on 10th November 2015, Brussels, 13922/15

Financial Conduct Authority. 2014. "Regulatory sandbox". https://www.fca.org.uk/firms/innovate-innovation-hub/regulatory-sandbox (accessed on 23.12.2016)

Innovative Finance ISA. 2017. "The Innovative Finance ISA". https://innovativefinanceisa.org.uk/the-isa/ (accessed on 23.12.2016)

.lu. 2017. "Luxembourg, a great place for startups". http://www.luxembourg.public.lu/en/actualites/2017/07/12-startup/index.html

Milne, A., Parboteeah, P. 2016. "The Business Models and Economics of Peer-to-Peer Lending", European Credit Research Institute, 17/2016

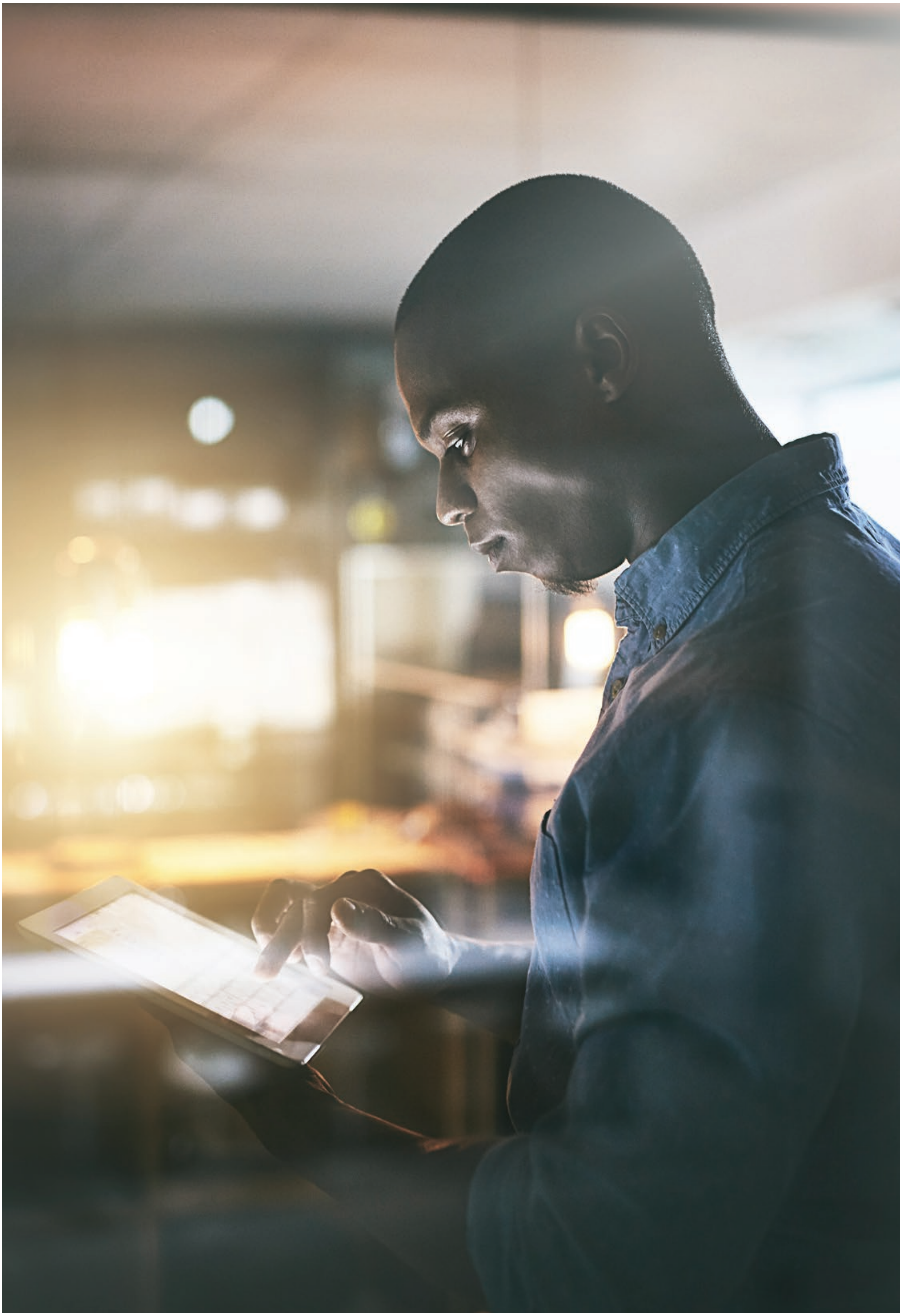
Morgan Stanley. 2015. "Global Marketplace Lending Disruptive Innovation in Financials", Morgan Stanley Blue Paper, May 2015, 24 – 57

P2PFA. 2011. "Peer-to-Peer Finance Association Operating Principles". http://p2pfa.info/wp-content/uploads/2016/06/Operating-Principals-vupdate2016.pdf (accessed on 16.01.2016)

Savarese, C. 2015. "Crowdfunding and P2P lending: which opportunities for Microfinance? EMN Magazine". https://www.european-microfinance.org/docs/emn_publications/emn_magazines/magazine_crowdfunding_7.pdf (accessed on 13.01.2017)

Snyder, B. 2011. "Exploring Auction Models for Peer-to-Peer Lending, Insights by Stanford Business", April 1, 2011. https://www.gsb.stanford.edu/insights/exploring-auction-models-peer-peerlending (accessed on 24.01.2017)

Wardrop, R., Zhang, B., Rau, R., Gray, M. 2015. "Moving Mainstream, The European Alternative Finance Benchmarking report", February 2015. https://www.jbs.cam.ac.uk/fileadmin/user_upload/research/centres/alternative-finance/downloads/2015-ukalternative-finance-benchmarking-report.pdf (accessed on 01.12.2016)



Challenges of Cyber Security for Financial Inclusion

by Jean-Louis Perrier, Suricate Solutions

Not a day goes by without news of a major cyber security attack or vulnerability discovery. Many, if not most large retail, Information Communication Technology (ICT), financial, industrial companies, central banks or public services around the world have suffered breaches, including military and intelligence agencies.

What about financial inclusion? There seem to be few breach disclosures in the sector; is there really no risk? What are the threats and consequences? What can be done rapidly in resource-scarce environments? We will seek to open some lines of thought to mitigate a rapidly rising operational risk, taking advantage of the opportunities offered by Luxembourg's recognised presence in the fields of ICT and cyber security as well as a financial centre.

ARE THERE REALLY CYBER SECURITY ISSUES FOR FINANCIAL INCLUSION?

In the last two years, we noted that institutions were reluctant to admit any breaches but far more expansive about those suffered by competitors. It soon became obvious that the whole sector had been hit.
In recent months alone, several central bankers and regulators worldwide, including the International Monetary Fund (IMF) (Lagarde, 2018), as well as

throughout Africa, have also acknowledged the issue. A recent report on cyber security in the continent states: "In 2017, the number of successful attacks launched against financial services doubled" (Serianu Limited, 2018).

OUR RESEARCH IN WEST AFRICA REVEALS SEVERAL LARGE-SCALE INCIDENTS AFFECTING ALL TYPES OF ACTORS:

- The former country leader of money transfers has almost disappeared after significant incidents,
- One of the largest Microfinance Institutions (MFIs) in another country has had its outstanding amounts reduced by approximately 80%,
- A well, long-established MFI has suffered losses of several tens of thousands of euros in two months, with net profit turning red,
- A very large investor has had several of its investments in one country of the region suffer substantial losses,
- A major bank and a national post have each suffered losses exceeding EUR 1.5 million due to a combination of external attacks and internal fraud,
- Operations at a very large Digital Financial Services (DFS) provider were stopped for several days at the end of December 2017, officially for "maintenance purposes", unofficially after a cyber attack from Eastern Europe.

In March 2018, the perpetrators of one of the largest cyber attacks in Europe and probably in the world were arrested (Reuters, 2018). Losses estimated at USD 1 billion were incurred by 100 financial institutions in 40 countries over five years. The criminals had developed highly sophisticated weapons and set up a complex international criminal organisation. It took close cooperation steered by Europol between the United States, Asia and Europe to lead to the criminals' arrest.

So threats are real and financial inclusion may well be on the verge of major cyber security incidents. It is of crucial importance to develop management awareness and security intelligence sharing.

ARE THESE CYBER SECURITY INCIDENTS REPORTED?

In most cases, victims do not disclose incidents as they fear loss of reputation, and there is a lack of disclosure obligations and trusted bodies to handle disclosures confidentially. Hence, modus operandi, originating actors and relevant information are not made available for mutual protection.

At the international level, a network of public and private organisations, known as Computer Emergency Response Team (CERT) and Cyber Security Incident Response Team (CSIRT), elaborates and shares security intelligence. These teams have the methodology and expertise to investigate and report threats, disseminate security intelligence and best practices, and assist organisations for incident response. Unfortunately, only a few CERTs are really operational on the continent.

Besides, few research institutes include Africa in their reports, and data from local media are of poor quality. Notable exceptions provide some insights:

- **Africa Cyber Security Report 2017 (Serianu Limited, 2018) estimates the total cost of cyber crime in Africa at USD 3.5 billion, of which USD**

1 billion for Nigeria, Kenya, Ghana, Uganda, and Tanzania. These countries give some enlightening trends: insider threats are significant with 33% of costs, USD 185 million was paid in compensation to victims of breaches, and another USD 185 million was withdrawn from victims' accounts. Financial institutions were the first victims with losses of about USD 248 million, followed by governments, USD 204 million, and mobile transactions, USD 140 million.

- Norton Cyber Security Insights Report 2016 states that "67% of South Africans have experienced online crime — compared with 48% globally" (Norton, 2017).
- The November 2016 Cyber Crime & Cyber Security Trends in Africa report lists 1.9 million attacks with 378 different attack signatures targeting Africa in 2016 (Symantec - African Union Commission - Global Forum for Cyber Expertise (2016).

Cybercriminal organisations strengthen their focus and expertise to improve their Return On Investment (ROI).

Two trends are observed at the global level:

- Financial institutions are more and more targeted by increasingly well-organised criminal networks, money being the motivation,
- Small and medium-sized institutions are easier targets than larger ones, which spend hundreds of millions of dollars per year on cyber security: four US banks spend USD 1.5 billion a year, i.e. approximately the size of the cyber security market in 2018 for the whole of Africa! (Morgan, 2015).

"Ethical hackers" performing penetration tests in sophisticated contexts acquire full administrative rights in about 10 days in 95% of cases; this shows that no institution is "hacker proof" and reveals the performance of actual hacking toolkits and the limitations of standard security tools and methods. By way of illustration, the average detection time for cyber security incidents is around 200 days in international benchmarks (Ponemon Institute, 2017).

WHAT ARE THE THREATS AND CONSEQUENCES?

While financial institutions are already facing a rapid expansion of critical cyber security threats, the consequences may be more severe for financial inclusion, with often fragile institutions that could struggle to recover from serious incidents.

The first consequence typically cited after a cyber attack is customer data loss. Customer Data Protection is a real concern as many financial inclusion institutions have several hundred thousand customers, while others deal with several tens of thousands of SMEs.

Far worse is the theft of customers' or institutions' money, and as we have seen above, this is already frequently the case. There are usually no or limited guarantee funds for deposits, nor are there cyber insurances, so customers and institutions risk incurring substantial losses. Moreover, it could prove difficult to manage numerous claims for refund, and trust in Digital Financial Systems would be endangered, in turn slowing down the progress of financial inclusion.

An even grimmer threat is that severe financial attacks could undermine the sustainability of some institutions and the assets of all depositors.

From an operational point of view, in a recent attack against Bank of Chile (Seals, 2018), USD 10 million was stolen through the Swift network; 9,000 PCs and 500 servers were also disabled by the hackers. One can easily imagine the difficulties this posed for business continuity.

The latest PwC Global Investor Survey ranked cyber attacks as the "biggest threat to business" (PwC, 2018). The reason for this is quite simply the certainty that cyber threats can or will happen, with potentially extreme damages. A number of impact investors we contacted already have serious cyber security and fraud concerns about present investments; due diligence will be strengthened in the future so as to integrate a more comprehensive cyber security assessment, which may reduce the sector's funding.

Lastly, the AFI (Alliance for Financial Inclusion)[1] recently qualified cyber threat as a potentially systemic risk. If an average hacker can take control of an institution's IT infrastructure in just a few days, a couple of weeks could be all it takes to breach the defences of the dozen or so institutions that deliver financial services to the majority of a country's unbanked population.

CONCLUSION, RESULTS OBTAINED AND NEXT STEPS

Given the potentially critical consequences in terms of losses, customer data privacy, business continuity, and also sustainability of financial inclusion, it is clear that cyber security has not yet received proper attention from most institutions and their partners. This is due to a lack of resources, skills, and intelligence sharing, but also to the complexity of an ever-evolving subject which requires huge awareness efforts for stakeholders, including customers, management, employees, investors, regulators, central banks, and technical partners.

Suricate Solutions has developed and tested a practical approach to offer financial inclusion (microfinance, microinsurance, DFS providers, fintechs, Mobile Network Operators. etc.) efficient and cost-effective security operations:

- mutualised managed security services,
- a comprehensive security intelligence sharing network,
- a global risk-based approach to cover prevention, efficient detection through 24/7 security supervision, which is at the heart of the system, and remediation to cyber attacks, capacity building and awareness programmes.

The first-of-its-kind regional cyber security operation centre for inclusive finance launched in Dakar (Senegal) in 2017 is already improving cyber security for 40 institutions and 600,000 customers, with a rapid outreach as one million customers are expected to be protected by the end of 2018. **The commitment and support of our Luxembourg partners has been decisive for key aspects:**

- Technical: Suricate can mobilise as many as 200 high-level cyber security experts with invaluable experience from the Government Cyber Security Competence Centre, the University of Luxembourg SnT cyber security research centre, and from Excellium Services - the country's leader in cyber security - to support our local teams,
- Funding: Suricate have been supported by Luxembourg Development Cooperation and the EIB (European Investment Bank),
- Mobilising: the active presence of Luxembourg in ICT and Inclusive Finance with InFiNe.lu, ADA,

e-MFP, and contributions to development cooperation and with major institutions like the World Bank's CGAP, UNCDF, AFI, African Development Bank and several development agencies, among others, were key assets.

Suricate is planning to leverage this ecosystem and extend its coalition of technical and financial partners to scale up in West, Central and Eastern Africa.

Jean-Louis Perrier
Partner
Suricate Solutions

[1] Alliance for Financial Inclusion is a group of central banks and regulators from 90 emerging countries https://www.afi-global.org/

References

Lagarde, Christine. 2018. "Estimating cyber-risk for the financial sector." https://blogs.imf.org/. 22 06 2018. https://blogs.imf.org/2018/06/22/estimating-cyber-risk-for-the-financial-sector/#more-23816 (accessed on 27.06.2018)

Morgan, Steve. 2015. "j-p-morgan-boa-citi-wells-spending-1-5-billion-battle-cyber-crime." https://inhomelandsecurity.com. 14 12 2015. https://inhomelandsecurity.com/j-p-morgan-boa-citi-wells-spending-1-5-billion-battle-cyber-crime/ (accessed on 28.06.2018)

Norton. 2017. "cyber-security-insights-2016." https://us.norton.com. 2017. https://us.norton.com/cyber-security-insights-2016 (accessed on 28.06.2017)

Ponemon Institute. 2017. "2017 Cost of Data Breach Study." https://www.ibm.com/. 06 2017. https://www.ibm.com/security/data-breach (accessed 28.06.2018)

PwC. 2018. "2018-global-investor-survey." https://www.pwc.com. 26 03 2018. https://www.pwc.com/gx/en/ceo-agenda/ceosurvey/2018/gx/deep-dives/2018-global-investor-survey.html (accessed on 28.06.2018)

Reuters. 2018. "Spanish police arrest suspected mastermind of $1 billion bank hacks." www.reuters.com. 26 03 2018. https://www.reuters.com/article/us-cyber-banks-spain/spanish-police-arrest-suspected-mastermind-of-1-billion-bank-hacks-idUSKBN1H21H3 (accessed on 28.03.2018)

Seals, Tara. 2018. "banco-de-chile-wiper-attack-just-a-cover-for-10m-swift-heist/132796/." https://threatpost.com. https://threatpost.com/banco-de-chile-wiper-attack-just-a-cover-for-10m-swift-heist/132796/ (accessed on 28.03.2018)

Serianu Limited. 2018. "Africa Cyber Security Report 2017." www.serianu.com. 2018. http://www.serianu.com/resources.html (accessed on 20.02.2018)

Symantec ; African Union Commission ; Global Forum for Cyber Expertise (GFCE). 2016. "africa-cybercrime-and-cybersecurity-trends." https://www.sbs.ox.ac.uk. 11 2016. https://www.sbs.ox.ac.uk/cybersecurity-capacity/content/africa-cybercrime-and-cybersecurity-trends (accessed on 28.06.2018)

Investments in Microfinance: What's in It for Investors?

by Sachin Vankalas and Julie Didier, LuxFLAG

Over the last two decades, microfinance has moved from a niche investment theme, promoted by specialised investors targeting social development, to an attractive asset class providing diversification opportunities for both public and private investors.

This led to the emergence and growth of specialised investments widely known as Microfinance Investment Vehicles (MIVs), which at present count about 115 vehicles globally, with the MIV universe estimated at USD 15.8 billion in Assets under Management (AUM) at the end of December 2017 (Symbiotics, 2018). While the MIV market remains highly concentrated (Symbiotics, 2018), the total amount of investments in microfinance exceeds these figures as Microfinance Institutions (MFIs) also attract investments from International Financial Institutions (IFIs) and local financial providers directly.

Whereas the Central Asia and South America regions have driven substantial growth in the past, they slowed down in 2017. However, markets in South East Asia and Asia Pacific and Africa are set to register above average growth in the short- to mid-term. **Luxembourg has set a strong example as a country of incorporation for MIVs, managing to increase its presence as a domicile from 44% of AUM in 2006 to 61% in 2015 (CGAP and Symbiotics, 2016: p. 36).** This showcases the country's long-standing attractiveness and its capability in having built a unique ecosystem for such structures.

***Besides evaluating social impact,** analysing the market's overall profitability remains a complex task […]*

The microfinance industry is facing challenges but also opportunities that will affect MIVs in the future. The industry has set itself a larger scope with the emergence of impact investing as an investment strategy. In general, impact investors are very committed to measuring and managing impact, using a combination of tools, e.g. proprietary metrics and standard frameworks (GIIN, 2018: p. 37). Measurement and reporting on social impact through metrics such as women's empowerment (percentage of female borrowers), average size of microloans, job creation or rural development are a defining factor of the microfinance industry. MFIs as well as MIVs investing in the institutions are required by investors to show evidence on how they contribute to reducing worldwide poverty rates. The timely emergence of the Social Performance Task Force (SPTF) helped the industry federate different tools and initiatives in this regard. The vast majority of MIVs are largely improving their tools for measuring and monitoring social impact and reporting on it, as far as we can observe in analysing the microfinance funds labelled by LuxFLAG. In 2017, **LuxFLAG-labelled MIVs with over EUR 7.6 billion in Assets under Management financed more than 600 MFIs in 92 countries, with an average loan amount of EUR 2,130 to micro-entrepreneurs, encompassing on average 65% female and 53% rural borrowers (LuxFLAG, 2018).** Transparency is a key requirement these days, therefore accountable reporting and disclosure are needed to remain foremost in the minds of investors who are ready to support financial inclusion.

Besides evaluating social impact, analysing the market's overall profitability remains a complex task as information on the financial performance of MIVs is seldom publicly available. From a diversification perspective, however, microfinance is perceived as having a low negative correlation with conventional asset classes (Fanconi and Scheurle, 2015: p. 226). Recent empirical research confirms past experiences of the viability of microfinance and can build valid arguments for future investments. Building on data of 68 microfinance funds over the period from January 2008 to June 2017 and constructing a portfolio of 19 MIVs, Le Saout (2017: p. 50) concludes in his analysis that the integration of microfinance assets in a portfolio improves the efficient frontier and provides a diversification opportunity despite currency risks. Postelnicu and Hermes (2016: p. 16) suggest, based on empirical analysis of a sample of 100 countries, that microfinance is more successful in terms of financial and social aims in societies that facilitate the development of social capital built through trust, social ties or shared norms.

From an investment perspective, high or low rates of trust in societies may therefore affect which countries investors are targeting. Reaching the poorest people while guaranteeing an MFI's financial sustainability are often difficult to align and must therefore be adequately evaluated and balanced (Amin et al., 2017: p. 357). Dorfleitner, Röhe and Renier (2017: p. 12-13) conclude in their empirical analysis of over 5,000 debt transactions between MIVs and MFIs that MIVs are more favourable to the ability of an MFI not to default on debt securities than to it being highly profitable. This underlines the prevalence among investors of seeking social impact creation and might reduce pressure on MFIs to deliver high financial performance and incentivize them to remain more focused on reaching and supporting poor clients.

Considering that the investment industry as a whole is facing a generational shift, **it is worth noting that social responsibility is a rising concern for the younger generation of investors and that many Millennials are willing to accept lower returns in exchange for positive impact creation (ALFI and Deloitte, 2016: p. 12).** This might create new opportunities and bring a future boost to the microfinance industry if the needs of the technology-affine future generation are adequately taken into account. Over many years, one of the triggers for growth in financial inclusion has been Financial Technology (fintech). Fintech has created opportunities for microfinance providers, opening up possibilities of improving the efficiency and scale of their current business models and their mission to serve populations which have no access to the traditional banking system. Some well-known examples of how MFIs are using fintech are cashless mobile payments, money transfers, credit scores and local currency exchange facilities. The rise of fintech has also allowed Telecom and IT companies to enter the financial inclusion space. Mobile money is currently available in three out of four low- and lower-middle income countries and still enjoying strong growth rates, with a 25% increase from 2016 to 2017 (GSMA, 2017: p. 8). Since Telecom companies are not subject to supervision or regulation by competent financial authorities,

Global challenges for future Microfinance *investments remain political risks, conflicts and wars, climate change and natural disasters.*

as opposed to MFIs and banks, certain mandatory reporting requirements such as on the social impact of services offered could be overlooked by new entrants in the financial inclusion space. In a Luxembourg perspective, ADA has been setting examples through its Digital Finance Initiative targeting sub-Saharan African countries to support new digital finance projects in the field and organising training sessions for MFIs, to state one case (ADA, 2017). The creation of the Luxembourg House of Financial Technology, attracting fintech companies active in inclusive finance in Luxembourg, as well as extensive public sector commitment, help build up the strength of Luxembourg's microfinance ecosystem and attract new investors to Luxembourg.

Global challenges for future microfinance investments remain political risks, conflicts and wars, climate change and natural disasters. Microfinance clients are among the most affected and most vulnerable to such situations, resulting not only in physical displacement but also in a serious impact on their businesses, e.g. due to harvest shortfalls. Chirambo (2017) shows that microfinance is able to help mobilise resources for climate change mitigation and adaptation and inclusive growth at the same time. Adequate planning on the side of MFIs could help to mitigate and adapt to climate change, e.g. helping through targeted training in climate-resilient farming techniques to support food security (Budiman et al., 2016: p. 57). Microfinance therefore presents opportunities for investors to factor in both environmental and social impacts at the same time.

Although these challenges and opportunities are valid in a global perspective, **the Luxembourg financial centre is proving its strength in innovating and expanding its ecosystem, bringing in new actors and building on existing initiatives to support the market. This is likely to even further enhance Luxembourg's attractiveness as a leading hub for microfinance and to continue building a strong investment and impact case for international investors.**

Sachin Vankalas
Director,
Operations & Sustainability
LuxFLAG

Julie Didier
Manager,
Marketing & Communications
LuxFLAG

References

ADA. 2017. “The Digital Finance Initiative”. https://www.ada-microfinance.org/en/our-projects/fintech-digital-finance (accessed on 07.06.2018)

ALFI, and Deloitte. 2016. “How can FinTech facilitate fund distribution”. ALFI website http://www.alfi.lu/sites/alfi.lu/files/files/Publications_Statements/Surveys/How-can-fintech-facilitate-fund-distribution-final.pdf (accessed on 24.05.2018)

Amin, Waqas, Fengming Qin, Abdul Rauf, and Farid Ahmad. 2017. “Impact of MFIs Outreach on Profitability. The Case of Latin America”. Public Finance Quarterly 62(3): 348-361

Budiman, Ibnu, Takeshi Takama, Laksmi Pratiwi, and Erwin Soeprastowo. 2016. “Role of microfinance to support agricultural climate change adaptations in Indonesia: Encouraging private sector participation in climate finance”. Future of Food: Journal on Food, Agriculture and Society 4(3): 55-68

CGAP, and Symbiotics. 2016. “Microfinance Funds 10 Years of Research and Practice. A review and analysis of CGAP & Symbiotics’ Microfinance Investment Vehicles Surveys”. Symbiotics website http://symbioticsgroup.com/wp-content/uploads/2016/12/Symbiotics_10yMIV_whitepaper2.pdf (accessed on 07.06.2018)

Chirambo, Dumisani. 2017. “Enhancing Climate Change Resilience Through Microfinance: Redefining the Climate Finance Paradigm to Promote Inclusive Growth in Africa”. Journal of Developing Societies 33(1): 150-173

Dorfleitner, Gregor, Röhe, Michaela and Noémie Renier. 2017. “The access of microfinance institutions to debt capital: An empirical investigation of microfinance investment vehicles”. The Quarterly Review of Economics and Finance 65: 1-15

GIIN. 2018. “Annual Impact Investor Survey 2018”. GIIN website https://thegiin.org/assets/2018_GIIN_Annual_Impact_Investor_Survey_webfile.pdf (accessed on 04.06.2018)

GSMA. 2017. “2017 State of the Industry Report on Mobile Money”. GSMA website https://www.gsma.com/mobilefordevelopment/wp-content/uploads/2018/05/GSMA_2017_State_of_the_Industry_Report_on_Mobile_Money_Full_Report.pdf (accessed on 06.06.2018)

Le Saout, Erwan. 2017. “Performance of the Microfinance Investment Vehicles”. Applied Economics and Finance 4(6): 42-52

LuxFLAG. 2018. “Annual report 2017”. https://www.luxflag.org/media/pdf/LuxFLAG_Annual_Report_2017.pdf (accessed on 15.06.2018)

Postelnicu, Luminita, and Niels Hermes. 2016. “Microfinance Performance and Social Capital: A Cross-Country Analysis”. Journal of Business Ethics: 1-19

Symbiotics. 2018. “2018 Symbiotics MIV Survey. A Study of Global Microfinance Investment Funds. 12th Edition” September 2018 http://symbioticsgroup.com/wp-content/uploads/2018/09/Symbiotics-2018-MIV-Survey-Abstract.pdf (accessed on 25.09.2018)

3 OUTLOOK FOR INCLUSIVE FINANCE INVESTMENT FUNDS

The Future of Inclusive Finance Investment Funds:

from Traditional Microfinance Debt Funds to Broader Inclusive Finance and Thematic Funds

by Anne Contreras-Muller & Aurélien Hollard, Arendt & Medernach

Through its unrivalled range of investment products as well as a profound local understanding of the financial inclusion sector's specificities, the Luxembourg investment fund sector has been able to adapt to the evolutions and expanded needs of financial inclusion and has become one of the most important domiciles in social impact finance.

According to an ALFI survey (ALFI - KPMG - LuxFLAG, 2017), at the end of 2016 Luxembourg was domicile to 57% of the assets under management of European social funds, including microfinance, social and solidarity funds and social impact funds.

The landscape of investment funds which pursue a social goal in addition to purely financial performance objectives has evolved greatly since the early 90s when the first Luxembourg microfinance investment fund was set up in the form of a debt fund. Since then, the social investment fund industry has been inspired by mainstream evolutions and developments, notably in the private equity investment fund sector but has also developed its own tools in order to increase its outreach in terms of investors and assets under management.

IMPACT FUNDS ADAPTING MAINSTREAM TRENDS

Debt investments, which were the traditional investments made by early microfinance investment funds and brought financial resources to microfinance institutions through loans, have been supplemented over the years by equity or quasi-equity investments in a much wider range of entities and sectors. SMEs financing and thematic investments in various social areas such as healthcare, solar energy, education, housing, etc. have become an important part of the investment programmes of social impact investment funds. An increasing number of these funds have been set up as private equity investment funds and are exploring techniques of mainstream private equity structures while at the same being dedicated to a social purpose.

A number of examples could be named in this regard, but the most remarkable example, or the most unexpected one, is in our view the implementation of carried interest principles in social impact funds.

In traditional private equity, carried interest is used to incentivize fund managers to reach financial performance objectives. A portion of their remuneration is directly linked and conditional upon attaining a certain level of returns on investments.

Some microfinance and social impact funds have, often on the requirement of DFIs (Development Finance Institutions), introduced the same remuneration principles. Although the priority of such projects is not financial returns, the need to align the interests between the investors in the fund and the fund manager has been considered important enough to link the manager's remuneration to the financial performance of the fund. Whether this creates a risk of mission drift is still an open debate amongst players.

> ***The social impact industry knows how challenging it is*** *to develop generally accepted standards or key performance indicators [...]*

Some investors, and especially EIF (European Investment Fund) in the framework of its Social Impact Accelerator (SIA), have recently gone a step further. In order to emphasise the social mission of impact funds and avoid mission drift, the idea has been put forward that the remuneration of the managers should be measured not only in light of the financial performance of the investments, but also in light of their social performance. Instead of being paid upon reaching a certain level of financial returns, carried interest is paid if and when, in addition thereto, social objectives are met. This certainly incentivizes fund managers to measure, track and attain social objectives although it raises certain questions as well. Such remuneration mechanisms are still in their pilot phase. Obviously determining social objectives and how to measure them is a tricky exercise. **The social impact industry knows how challenging it is to develop generally accepted standards or key performance indicators,** given in particular the variety of sectors tackled by social impact investment funds and the multiple externalities social performance is dependent upon. International initiatives such as EVPA (European Venture Philanthropy Association), GIIN (Global Impact Investing Network) and SPTF (Social Performance Task Force) are working on developing such standards, but as of today, social performance continues to be measured based on tailor-made models which are proprietary to the individual impact managers.

IMPACT FUNDS DEVELOPING THEIR OWN TOOLS

Besides using and adapting mainstream techniques, the impact fund industry has further been able to develop its own tools, especially around the set-up of financial partnerships. One of the credos of the impact sector has been the need to attract private investors alongside public subsidies or philanthropic endowments. It has been written and stated that public or philanthropic monies alone are not able to tackle social issues but have a catalytic role to play. **Over the past few years the impact investment fund industry has allowed for the implementation of this catalytic role of the public and philanthropic funding through blended finance models.** Many investment funds indeed foster public/private partnerships at different levels. **First by bringing together investors with a different risk/return appetite under the same investment vehicles:** public investors or philanthropists invest in classes of shares bearing a greater risk and/or a lower return, thereby attracting private investors to classes of shares with lower risk and/or higher returns.

The access to retail investors for impact investment funds ***is another "hot topic"*** *[…]*

Second, by developing technical assistance facilities alongside the investment funds. These facilities, financed by philanthropic donors, aim at reinforcing capacity building at investment target level.

IMPACT FUNDS TOWARD MORE IMPACT: HOT TOPIC OF THE INDUSTRY

Looking into the future, some areas would need to be examined to make investment funds an even more efficient tool for impact investing.

At regulatory level, the impact funds sector would deserve its own EU regulation. The Alternative Investment Fund Managers (AIFM) regulation, which applies to impact funds, is a serious hurdle for such funds, the size of which generally ranges between EUR 20 million and EUR 50 million. On the one hand, it is a regulation that allows for an easy distribution of funds to professional investors across Europe through the benefit of a marketing passport. On the other hand however, the requirements of such regulation in terms of internal organisation and capitalisation entail significant costs, which, for many players in the impact sector, are excessive. Only a handful of impact managers have been able to adopt the status of AIFM. The European Venture Capital (EuVECA) and European Social Enterprise (EuSEF) regulations are an attempt to address this hurdle. However these funds are in practice limited to investments in Europe and in entities which must be in line with relatively strict definitions of venture capital or social enterprise. Here again only a limited number of EuVECA funds active in the impact sector or EuSEF funds are registered with the European Securities and Market Authority (ESMA).

All efforts to reach out to professional investors and to develop the public/private partnerships referred to above on a large scale for international impact projects, especially in emerging or developing countries, are limited by the non-availability of a marketing passport in Europe and, worse still, by the increasingly limited possibilities of private placement in Europe.

The access to retail investors for impact investment funds is another "hot topic" which should be facilitated. Currently only very few EU countries have taken advantage of the possibility offered by the AIFM regulation to allow retail investors to invest in impact funds. In a large number of EU countries, impact funds, like any other alternative investment funds, are reserved to professional investors. In that respect, the modest success of the EuVECA and EuSEF regulations which aim at enlarging the investor basis to the broader public is regrettable. The interest of retail investors in impact investments is indeed a given.
Solutions should be rapidly developed at EU level, on the basis of regulations that some EU countries such as France have individually adopted relating to crowdfunding, ensuring the access of retail investors to impact finance, in a reasonably protected environment.

***Efforts should continue to be made with respect** to the definition of the impact investment sector.*

LAST BUT NOT LEAST

Efforts should continue to be made with respect to the definition of the impact investment sector. The European Commission very recently adopted an action plan on Financing Sustainable Growth (COM, 2018) which aims inter alia at ensuring the progressive development of an EU taxonomy for climate change and environmentally and socially sustainable activities. Although initially focussing essentially on climate change and other environmental activities during 2019, it is expected that a broader EU sustainability taxonomy will be adopted in a second step.

OUTLOOK FOR INCLUSIVE FINANCE INVESTMENT FUNDS

ESG (Environmental, Social and Governance), responsible investment, sustainable finance, social impact, environmental impact, financial inclusion, inclusive finance, microfinance… all these terms need indeed to be clearly defined and categorised and must moreover be easily understandable if this sector which is putting extra-financial performance at the forefront and claiming to effectively reach social performance objectives wishes to continue to expand alongside the Sustainable Development Goals.

Anne Contreras-Muller
Of Counsel
Arendt & Medernach

Aurélien Hollard
Of Counsel
Arendt & Medernach

References

ALFI – KPMG – LuxFLAG April 2017. "European Responsible Investing Fund market 2016"

European Commission 2018. COM (2018) 97 Communication from the Commission – "Action Plan: Financing Sustainable Growth"

Impact Investing in Luxembourg

by Katharine Pulvermacher, Microinsurance Network

Around the world, microfinance has been the engine that has driven impact investing since its inception. Public and private donors, non-governmental organisations (NGOs) and microfinance practitioners worked together to develop the microfinance sector, ensuring that sustainable business models existed to attract investors to the segment.

The availability of comparable performance indicators —from Bangladesh to Brazil, Cambodia to Colombia, from the Philippines to Peru, and from Vietnam to Venezuela—made it easier for investors to analyse opportunities and evaluate results. The scale of the microfinance sector, which has reached maturity, has also underpinned its position as an anchor for impact investing, since microfinance is able to absorb amounts of capital that are large enough to make institutional attention viable. In essence, microfinance investments provided the opportunity to substantiate the concept of impact investing.

PURPOSE BEFORE PROFIT

Unlike mainstream traditional investment, impact investment begins with the intention to achieve a specific development outcome and uses the investment primarily for that purpose. The intention is therefore the key driver of the investment decision. This differentiates impact investing from responsible or ethical investment, where obtaining financial returns is the primary motive for investment, albeit within a framework that respects governance, environmental and social responsibilities (ESG). The Global Impact Investing Network (GIIN), established in 2009, has sought to clarify the distinction, and defines impact investing as "investments made into companies, organisations, and funds with the intention to generate social and environmental impact alongside a financial return" (GIIN, 2018), a definition that does not obviously place the impact intention ahead of the desire to achieve financial returns.

IMPACT INVESTING NEEDS GARDENER AND GREENHOUSE

Over the last decade, impact investors have begun to explore new themes, the most significant of which is climate finance. Climate finance encompasses renewable energy, sustainable agriculture, reforestation and water management, amongst other sub-themes. Investment solutions are now actively being sought to help achieve sustainable development targets such as access to healthcare, education and affordable housing, but impact investment funds in these areas have yet to reach scale. For this to happen, the market for impact investing needs to be developed, requiring dedicated, influential champions and a supportive ecosystem to bring the approach to maturity.

LUXEMBOURG IS AN ESTABLISHED GLOBAL LEADER IN SUSTAINABLE FINANCE

Luxembourg is well placed to act as such a champion. It is the second-largest investment fund centre in the world after the United States. As of 2017, assets under management of funds domiciled in the Grand Duchy were valued at EUR 3.9 trillion (Luxembourg for Finance, 2017). Its market share of the European fund industry is 26.3% — worth close to the combined shares of Ireland (14.3%) and Germany (13%) (ALFI, 2018). The country owes this ability to punch so high above its weight to the generally supportive infrastructure it has established, including the regulatory and legal framework, institutions and expertise.

When it comes to microfinance funds, Luxembourg is the clear global leader, with 61% of global assets under management (AUM) domiciled in the jurisdiction as of 2015 (Luxembourg for Finance, 2017). In parallel, 31% of European responsible investment funds are domiciled in Luxembourg, representing a 39% share in terms of AUM (Luxembourg for Finance, 2017). Although the GIIN puts the total value of impact investment funds at more than USD 114 billion (Abhilash – Schiff – Bass – Dithrich, 2017)[1], experts interviewed in Luxembourg say that the true size of the market is not known, due to discrepancies in the criteria applied to measurement. For example, the GIIN 2017 Survey included 209 impact investors who self-reported on assets in their portfolios that they considered eligible based on the GIIN definition of impact investing. This definition does not explicitly require the impact of the investment to be prioritised ahead of financial returns. Equally, the value of impact investments domiciled in Luxembourg also depends on what type of investments are included in the definition. Interviewees suggested that the scale of Luxembourg-domiciled funds could be anything from EUR 5 billion to EUR 15 billion, excluding investments such as green bonds.

When it comes to microfinance funds, ***Luxembourg is the clear global leader, with 61% of global assets under management*** *(AUM) domiciled in the jurisdiction [...]*

POSITIONING FOR GROWTH

Several initiatives are in place that could help Luxembourg consolidate a greater share of the impact investment market. The Climate Finance Task Force, a public-private, multi-stakeholder and pluri-disciplinary initiative, began its work in April 2015, building on six pillars: consolidation; strategic partnerships; quality control; innovation; legal and regulatory environment; and promotion and communication (Climate Finance Task Force, 2018). This initiative demonstrates the Grand Duchy's ability to mobilise existing resources and institutions, in this case focusing specifically on climate finance.

The Luxembourg Finance Labelling Agency (LuxFLAG) is a non-profit association that promotes sustainable investing in the financial industry by awarding an independent, transparent label to investment vehicles in Microfinance, Environment, ESG (Environment, Social and Governance), Climate Finance and Green Bonds that qualify as responsible (LuxFLAG, 2017). With the launch of the Luxembourg Green Exchange (LGX) in September 2016, the Luxembourg Stock Exchange became the first in the world to restrict listings to environmentally-friendly investment products, based on strict criteria (.lu, 2016). In October 2016, in an innovative partnership with the European Investment Bank (EIB), the Grand Duchy launched the Luxembourg-EIB Climate Finance Platform, intended to crowd in private sector investment into high-impact projects contributing to the mitigation of climate change (EIB, 2016). Building on this momentum to further its ambition of seeing Luxembourg become a global leader in green finance, the government announced the launch of a Climate Finance Accelerator in June 2017. The Accelerator is a public-private partnership that aims to create "the structures required to support climate financing, by offering assistance to new and innovative investment fund managers that want to invest in projects with a measurable impact in the fight against climate change" (.lu, 2017).

Luxembourg is well positioned to expand the role that it plays ***in developing the market for other areas of impact investment, such as housing and education, amongst other themes*** *[...]*

WHAT NEXT?

With its focus on becoming a hub for green investments, Luxembourg is well positioned to expand the role that it plays in developing the market for other areas of impact investment, such as housing and education, amongst other themes that are now inextricably associated with the UN Sustainable Development Goals. However, experts interviewed suggested that more can be done with respect to supporting communication about impact investment so as to develop a better understanding of what it entails and overcoming the perception that the trade-off between financial returns and impact—doing well or doing good—is ineluctable.

Creating a development finance institution with a focus on impact investment could help to crowd in private sector investment by seeding impact investment funds, and also help to expand the sector beyond microfinance and climate finance into areas such as housing and manufacturing, which are attracting the interest of impact investors in sub-Saharan Africa. There is also scope to use impact investment as a mechanism for the prevention of social and environmental ills. A concrete example could be using impact investment solutions, such as social impact bonds, to address the retraining needs arising from job losses linked to technological change, particularly given the likely effect of artificial intelligence solutions in financial services, which are a main feature in the Grand Duchy's landscape.

More flexible legal forms could be introduced. For example, although the Sociétés d'Impact Sociétal - SIS (social impact companies) regime was introduced in 2017 (ULESS, 2018) to provide a structure more appropriate for social enterprises, some interviewees felt that the new structure does not go far enough. By the same token, the cost structure for financial services in Luxembourg is felt to be relatively cumbersome and does not distinguish sufficiently between small-scale and large-scale asset managers. Since most impact investment funds are fairly small (between EUR 10 and EUR 50 million), they are disadvantaged by the absence of proportionality, which could possibly be applied at national levels within the European Union to funds that are not at a stage where they wish to passport into other EU member states. Due to their nature, impact investments are available to qualified (professional or institutional) investors only, supporting the case for lighter touch regulation to facilitate innovation and the incubation of impact investment solutions, perhaps by taking more of a “sandbox” approach. Governments should provide specific incentives to qualified investors to invest in this type of funds.

The creation of a platform to bring stakeholders across the impact investment value chain together could help to support the development of the market, and Luxembourg, with its expertise in blended finance and ecosystem of financial services, legal and development finance professionals, is well placed to provide such a platform. As the growth of impact investment around the world picks up pace, though, it is a space to be claimed before the opportunity is diluted.

Katharine Pulvermacher
Executive Director
Microinsurance Network

[1] Refers to capital committed plus capital deployed.

Acknowledgements

The author would like to thank the individuals who generously contributed their time and insights to facilitate the development of this article.

Kaspar Wansleben, Executive Director, Investing for Development SICAV - Luxembourg Microfinance and Development Fund

Ulrich Grabenwarter, Head of Strategic Development, Equity and Head of Venture Capital, European Investment Fund

Jean-Philippe de Schrevel, Founder and CEO, Bamboo Capital Partners

Patrick Goodman, Partner, Innpact

Arnaud Gillin, Partner, Innpact

References

Global Impact Investing Network website. 2018. “What is impact investing?”. https://thegiin.org/impact-investing/need-to-know/#what-is-impact-investing

Luxembourg for Finance. September 2017. “Sustainable Finance”

Association of the Luxembourg Fund Industry (ALFI) website, “Statistics: Luxembourg a Global Player”. http://rapport.alfi.lu/en/statistics-luxembourg-global-player

Mudaliar, Abhilash, Hannah Schiff, Rachel Bass, and Hannah Dithrich. 2017. “2017 Annual Impact Investor Survey”. New York: The Global Impact Investing Network https://thegiin.org/knowledge/publication/annualsurvey2017

Climate Finance Task Force (Luxembourg) website. http://www.climatefinancetaskforce.lu/435829813 (accessed on 18.06.2018)

LuxFLAG fact sheet 2017. http://www.luxflag.org/media/pdf/fact_sheets/LuxFLAG_Factsheet_2017_English.pdf

.lu website “The Luxembourg Stock Exchange goes green, with the Luxembourg Green Exchange”. http://www.luxembourg.public.lu/en/actualites/2016/09/27-lgx/index.html (accessed on 07.04.2018)

European Investment Bank press release 2016-249-EN, 20 October 2016. “Luxembourg and the EIB pioneering in the field of innovative climate finance to support high impact climate action projects”. http://www.eib.org/infocentre/press/releases/all/2016/2016-249-luxembourg-and-the-eib-pioneering-in-the-field-of-innovative-climate-finance-to-support-high-impact-climate-action-projects.htm

ULESS website. https://www.uless.lu/en/activities/defend/societes-d-impact-societales-sis (accessed on 18.06.2018)

InFiNe
Inclusive Finance Network
Luxembourg

InFiNe.lu asbl
39 rue Glesener
L-1631 Luxembourg
T. +352 28 37 15 09
contact@infine.lu
www.infine.lu

Editorial design: InFiNe.lu
Graphic design: gianmarco.design
Printing: PrintSolutions.lu

100% Recycled Paper

EU Ecolabel
www.ecolabel.eu

Follow us

@InFiNe.lu

Inclusive Finance Network Luxembourg InFiNe.lu