THE BANKING ASSOCIATION SOUTH AFRICA

UN CDF Impact Capital for Development

EXPLANATORY NOTE:

FINANCIAL INCLUSION CONSIDERATIONS IN SUSTAINABLE FINANCE POLICY FRAMEWORKS

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Background and motivation

Sustainable finance and financial inclusion are two key developmental topics relating to the financial sector, which demonstrates potential to contribute to pressing and contemporary social and environmental issues that countries are grappling with. As such, many countries are considering prioritising financial inclusion within their national sustainable finance policy or voluntary industry principles and to include financial inclusion as a top priority for their sustainable finance committees, working groups, and institutional roadmaps.

There is no universally agreed-upon definition of sustainable finance; however, it is commonly understood as the integration of environmental, social, and governance considerations into the financial decision-making processes. Over time, sustainable finance has undergone a series of significant evolutions, shifting from a risk-based approach to focus on products and deeper sustainability integration. Presently, sustainable finance has moved mostly beyond a risk-based approach to a more holistic one, with the goal of using finance to solve social and environmental problems. This means that [sustainable] finance must not only avoid causing harm, but it must also actively contribute to a more sustainable future. Merely assessing these issues through a risk lens is no longer sufficient; the goal is to foster sustainability. Therefore, by embracing this progressive definition of sustainable finance, one could argue that financial inclusion is an essential element of sustainable finance. In order for finance to effectively tackle social issues such as inequality and poverty, it is imperative to broaden the scope of financial services to the low-income market. However, to address the low-income market, sustainable finance must not only finance social infrastructure, but also

increase access to this infrastructure (which is crucial to reach the sustainable development goals) through finance.

Based on over a decade's work in financial inclusion and incorporating extensive livelihoods data, this explanatory note aims to convey the key findings of UNCDF's research on the linkages between financial inclusion and sustainable finance, to provide the underlying rationale to acknowledge financial inclusion within sustainable finance, as well as practical guidance to decision makers (whether public or private) responsible for the development, maintenance and implementation of national sustainable finance frameworks or policies as an evolution in the financing agenda towards **PEOPLE** and **PLANET**. The note aims also to serve as input to the development of a draft check list for decision makers, which will be used for consultation and input from relevant stakeholders.

Financial inclusion as an essential element of sustainable finance

At its core, financial inclusion is an objective which aims to reduce poverty and income inequality, by aiming to ensure the accessibility, affordability and reachability of formal financial products and services for every individual, that meets their needs, across the income spectrum. This stems from the widely agreed benefits of having access to formal financial services, which smooths income and consumption, reduces transaction costs, covers against risks, allows for asset building over time and investment into productive opportunities. These financial products and services are at the retail level, and include payments/transactions, insurance, savings, remittances, credit schemes and loans for households and small businesses. Financial inclusion originated from a strong social objective to focus on the low-income market, and to some degree is more established than the sustainable finance development discourse. Thus, it is not traditionally seen as an element of sustainable finance, but rather, viewed as a separate area of work by most stakeholders.

In recent years, the intended impact of financial inclusion has also been articulated in terms of its potential to contribute to broader development objectives. Households – including the low-income - consistently prioritise four real economic needs within their monthly expenditure, and they use retail financial services (both formal and informal) to meet these expenditures (See UNCDF MAP, 2020. Insights Series Volume 3, Note 2). These four needs are healthcare, education, access to basic services (like access to energy) and entrepreneurship, and the realisation of these needs directly supports the achievement of specific Sustainable Development Goals (SDGs). In addition to reducing poverty and income inequality, financial inclusion's support of these additional SDGs results in a strong emphasis on the social SDGs – those SDGs related to **PEOPLE** and thus the social element of sustainable finance.

While financial inclusion also supports the climate agenda through making access to clean or cleaner energy sources available to households and small businesses, the bulk of this work has focused on access to energy in the first instance – as a poverty reduction mechanism. More recently though, there has also been an increasing focus on the clean (environmental) aspect of this. This further highlights the interconnectedness between financial inclusion and sustainable finance.

By contrast, *sustainable finance* despite its broad definition which aims to make an impact in terms of both *social* and *environmental* objectives (see for instance

definition of sustainable finance by the South African National Treasury), is dominated by environmental aspect of the sustainability agenda, as the bulk of sustainable finance is deployed to initiatives of the environmental objective – which is relevant for those SDGs related to the **PLANET**.[1]

*"Sustainable finance encompasses financial models, services, products, markets and ethical practices to deliver resilience and long-term value in each of the economic, environmental and social aspects and thereby contributing to the delivery of the **sustainable development goals** and climate resilience."* (South African National Treasury, 2021[2]).

Historically, financial institutions predominantly provided sustainable finance for environmental objectives. This is more commonly known as green financing. However, as the area evolved from green financing, and more so since the COVID-19 pandemic, there has been a notable shift towards incorporating broader sustainability issues into the sustainable finance agenda. An illustrative example of this shift can be observed in South Africa through the establishment of the JSE's sustainable segment, which has replaced the previous green segment. This development signifies a broader recognition within the financial industry of the importance of addressing social aspects alongside environmental considerations in the pursuit of sustainable finance. However, while green financing is arguably much easier for the industry to implement, given that it is not too different from traditional asset financing, financing for social objectives is more complex, and deviates more from traditional financing. Therefore, social financing remains a nascent, although an emerging area of focus.

As the once-separate technical areas of sustainable finance and financial inclusion increasingly overlaps within their shared commitment to sustainable development objectives, the mutually supportive and complementary role the two imperatives play in terms of its impact on environmental and social objectives points to opportunities for the financial sector and policymakers to leverage both in a more complementary manner, to accelerate progress on the SDGs. This does not necessarily advocate that stakeholders in either areas should start working in the other, but rather, that they should be cognisant of each other and ensure a degree of communication and collaboration, towards enhanced impact in both areas. This can be visually summarised as shown in Figure 1, and provides the basic rationale to integrate financial inclusion within any sustainable finance approach or policy.

Left unchanged, the two areas still compliment a country's impact and progress towards achieving the SDGs – based on existing work in the two areas and the distinction between their main areas of impact. However, with no integration between the two areas, it is unlikely to leverage and compound impact to the sustainable finance agenda towards areas of growth focused on the low-income. We therefore argue for a more deliberate integration between the two areas, which has the potential to accelerate the evolution of sustainable finance by fostering a more comprehensive approach. By offering products and services to the retail market, sustainable finance becomes more inclusive and accessible to a broader range of individuals.

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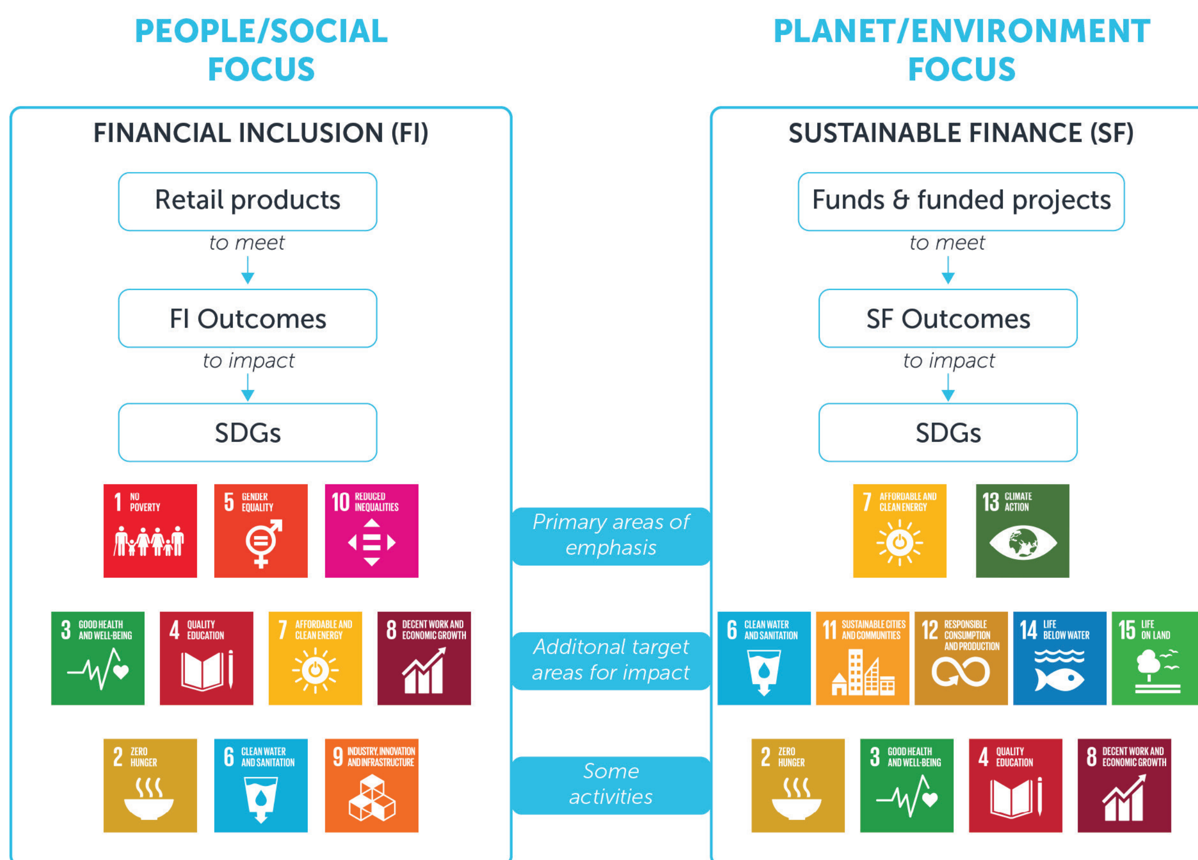
[1] It should be noted though that sustainable finance did not originate from the SDGs specifically, and in fact predates the SDGs. Therefore, sustainable finance is not primarily anchored in the SDGs, although the vast majority of sustainable finance activities can be directly linked towards contribution to specific SGDs.

[2] https://www.treasury.gov.za/comm_media/press/2021/2021101501%20Financing%20a%20Sustainable%20Economy.pdf

Figure 1 | *Mutually complimentary areas of impact for sustainable finance and financial inclusion*



Given the current evolution of sustainable finance to focus on deeper sustainability integration, there are encouraging signs that social objectives are gaining increasing attention. For instance, South Africa's Green Finance Taxonomy explicitly recognise elements of social objectives. However, financial inclusion itself, and linking to its potential to elevate impact on social objectives, does not yet receive the same attention. Clear direction from policy makers is therefore required, to foster an enabling policy and regulatory environment for finance to become more sustainable, by also leveraging financial inclusion. That means identifying the policy mechanisms that can clearly link financial inclusion to sustainability to further financing for the low-income. The resultant financial services and market growth can only come once the underpinning framework and supporting structures are in place.

Enhancing impact through direct and deliberate integration

At a more practical level, private sector decision makers who are looking to enhance the impact of their sustainable finance investments (and taking direction from imperatives set by national sustainable finance frameworks), can also take a more deliberate approach to integrating sustainable finance and financial inclusion, to enhance impact in both areas. This can be done by supporting sustainable finance investments or projects with a deliberate strategy to make formal

financial products available to the users of the resultant basic services. Given that people use financial services to manage their cashflows to meet specific needs[3], the proportion of the population in a catchment area that can access the resultant services can be increased.

Example of financial inclusion and sustainable finance in practice: When using the proceeds of sustainable finance to build a hospital, the addressable market that can access the resultant services can be increased by deliberately focusing on access to financial products that support usage of the hospitals' services. This strategy can also increase the amount of viable sustainable finance investment opportunities on the ground. Financial inclusion, therefore, can ultimately increase the impact on the ground of sustainable finance investments, particularly those related to asset and infrastructure finance.

The private sector can also leverage financial inclusion's unique ability to reach ground level economic activity. Given financial inclusion's very strong links to livelihoods, engagement with household and small businesses are at the micro-level and in the real economy, through retail products and services, financial inclusion can be used to expand the reach of sustainable finance to the retail level. Sustainable finance, for the most part operates at the macro level through directing targeted investment flows into the overall economy - in the form of large financing instruments like bonds, debt or equity. Thus, it is most often located within/focused on the corporate/ investment areas of the financial sector for the placement of capital. Thus, both are critical and necessary working in tandem to achieve complementary ends.

To reach the required scale and impact, sustainable finance requires increased reach and impact at the retail level, within the real economy. This means being able to reach

Figure 2 | *Financial inclusion increases access to services, required for the SDGs*

[3] Practically, low-income households especially prioritise expenditure on basic services like education, access to water and energy and healthcare, but they use (higher cost) informal financial services to do so, or they forego these services if their cashflow and financial mechanisms does not allow it (See UNCDF MAP, 2020. Insights Series Volume 3, Note 1 for the quantified – mostly informal expenditure on these basic services

the mass market at scale, working within the boundaries of consumer realities. Financial inclusion allows for aggregation of micro level activity through identifying market sectors and segments that require financing and can therefore provide the corporate financial sector (at the macro level) a unique channel to reach the ground where financing is most needed by aligning products and services to the needs of society.

If sustainable finance fails to include this retail aspect, it risks losing out on the opportunity to broaden societal access to not just formal financial services, but also potentially participation in the formal economy, thereby undermining growth and inclusivity in the markets that it operates.

By funnelling sustainable finance investments through providers of retail financial services, like banks, microfinance institutions (MFIs), these providers in turn can provide retail financial products that directly contribute to sustainable finance outcomes. Examples include the provision of:

- SME finance
- Micro insurance mitigating the impact of climate change
- Affordable insurance for access to healthcare
- Affordable housing finance
- Educational loans or savings products

Considerations for policy makers – unpacking the risks

Failing to properly consider the intersect between sustainable finance and financial inclusion can have negative unintended consequences for sustainable development at best and at worst hamper efforts at inclusive growth. Furthermore, it could also negatively impact the outcomes pursued by sustainable finance and financial inclusion respectively. Understanding these risks should therefore inform decision making.

Failure to synergise reduces impact. Financial inclusion and sustainable finance have mutually complimentary areas of impact in terms of sustainable development, but failure to proactively and more deliberately leverage these complementarities might result in missed synergies between the two areas. Merging sustainable finance and financial inclusion is about creating financial products that are both inclusive and impactful.

Failing to broaden financial sector participation. Sustainable finance involves high level, aggregated capital flows often remaining in the corporate sector. Failing to more deliberately integrate financial inclusion in support of larger scale investments might result in a more concentrated financial sector, as opposed to an opportunity to broaden access to and participation in the financial sector by a broader segment of a country's population.

Increasing the size of the financial sector through increased participation in the low-income market. A well-functioning financial sector can unlock economic opportunities by means of intermediation, investment and de-risking markets. Improved financial sector performance in turn leads to additional jobs in the financial sector. The financial system, therefore, is simultaneously an enabler and beneficiary of real economic growth. Thus, by not growing the financial system through increased opportunities, risks hampering growth in general.

Winning big but failing small – investments not hitting the ground. People require financial services to access the services that result from sustainable finance investments. Failing to deliberately integrate access to financial services in specific catchment areas that will benefit from sustainable finance investments runs the risk of decreasing the impact of those investments in terms of the number of households and small businesses that can be reached.

Missed opportunities for job creation. SME's present an avenue for income generation for the majority of residents of lower income and less developed countries. Sustainable finance investments are often funnelled to high technology, capital intensive products, that only contribute to employment at the margin. By leveraging financial inclusion as a way to reach SMEs, and deliberately including SME development within sustainable finance initiatives, an increased emphasis on job creation or maintenance is achieved. As a minimum, the potential negative impact on SMEs should be considered, but actively developing SME suppliers could also help.

Financial sector stability. Financial inclusion contributes to broader participation in the financial sector, which contributes to deepening the financial sector. A deliberate and planned approach to including financial inclusion in sustainable finance can contribute to financial sector development and stability by ensuring that the introduction of risky new segments to financing is well managed with policy and regulatory oversight.

The climate crisis and the just transition. Financial inclusion can play a crucial role to advance climate adaption for the low-income market but also in the concept of a Just Transition in the global effort to tackle the climate crisis and facilitate the transition towards a low-carbon economy. It is widely acknowledged that this transition must be equitable, taking into account the social implications that are just as significant as the environmental aspects. This entails considering how the transition will impact workers and communities affected by the shift.

Practical guidance is therefore required for decision makers to take account of the identified linkages and synergies between financial inclusion and sustainable finance. By taking a deliberate approach to including these considerations within sustainable finance frameworks, these systemic risks can likely be avoided through careful and considered approach.

Embedding financial inclusion in sustainable finance policy and regulatory frameworks

The linkages between financial inclusion and sustainable finance, as explained in this note, provide the rational for acknowledgment of financial inclusion considerations within sustainable finance frameworks at a policy level. However, practical guidance for decision makers on how to achieve this is provided below, which can also serve as a basis for the development of a draft check list for decision makers. The guidance below can be used for consultation with and input from relevant stakeholders in this space.

Considerations for incorporation of financial inclusion into National Sustainable Finance Frameworks

Within the context of the Sustainable Finance Roadmap, Vision, Strategy or supporting guidance documentation:

1. make reference to financial inclusion and acknowledge a specific role for financial inclusion within sustainable finance;

2. make reference and linkages to the National Financial Inclusion Policy in addition to specific national development objectives, plans, policies, goals, or targets;

3. outline cooperation between agencies or between the regulator and industry association with respect to policy design and/or implementation related to the National Financial Inclusion Strategy;

4. acknowledge financial inclusion as an additional mechanism to increase domestic finance/capital (e.gunder the Integrated National Financing Framework) to enable the achievement of stated national objectives in line with national sustainable development priorities, strategies, targets, and the size of sustainable investment needs.

Practically bringing these elements together - Coordination and Governance at a policy level

During the development, implementation and/or maintenance process of the Sustainable Finance Framework and its underlying components, there are some specific steps that can be taken to ensure that financial inclusion remains an integrated component:

- financial inclusion criteria should be embedded as part of the objectives of the framework development from the start;
- during the design process, financial inclusion should be one of the criteria, and stakeholder engagement with financial inclusion stakeholders, to provide input on the design, should be included;
- once the framework is launched, governance structures for implementation should include perspectives, expertise and possibly metrics from financial inclusion stakeholders;
- when updating the framework, or during ongoing development, ensure participation of the relevant experts relating to financial inclusion;
- metrics for monitoring of implementation should consider the impact of activities on financial inclusion, to determine whether financial inclusion targets are met, and flag any negative impacts on financial inclusion.

Recommended Actions

Furthermore, there are specific actions that decision makers can take to strengthen both the social and environmental focus and potential of their sustainable finance activities at a policy level. Embed financial inclusion's potential to specifically support social sustainable development objectives by aligning with the following:

1. the regulator or industry association could undertake a market assessment to identify systemic social risks/pressing social issues, through analysis of the portfolios of supervised entities/members and publish the results on a regular basis;
2. such a market assessment can consider the role of financial inclusion and developing low-income markets for more inclusive growth, supported by sustainable finance in addressing these systemic social risks and/or issues;
3. the framework could actively require, encourage or engage financial providers to make it more attractive to place an emphasis on social risks and to leverage financial inclusion in addressing these;
4. the framework can include technical guidance or tools to support implementation in addressing social risks and/or issues through the use of sustainable finance and financial inclusion;
5. the framework can list specific retail level financial products (not limited to credit) and specific recipient target groups of those products, which is considered to support the social objectives of sustainable finance/sustainable development;
6. the framework can consider key stakeholders in the financing landscape, including development finance institutions like the World Bank Group, and investment funds so that there is a collaborative attempt at cohesively addressing the low-income and by extension risky markets.

Embed financial inclusion’s potential to specifically support environmental sustainable development objectives by considering the following:

1. the regulator or industry association can undertake research on the use of different sources of energy for different needs at a household level, and how formal and informal financial services are used to meet those needs;

2. the relevant regulator or industry association can publish guidance for leveraging financial inclusion to address climate risks at a household level, including facilitating the transition to cleaner energy sources at a household level, through the use of inclusive finance retail products;

3. the regulator can develop a methodology to incentivise financial institutions to fund household level climate-risk management interventions and to establish a strategy to increase access to inclusive financial products that could facilitate transition to cleaner energy products at a household level;

4. the framework can list specific retail level financial products (not limited to credit) and specific recipient target groups of those products, which is considered to support the environmental objectives of sustainable finance/sustainable development.

Going forward, further engagement with decision makers at the national level, as well as at the SADC level, will leverage the above suggested guidance, to inform development of a draft check list for decision makers who recognise the need for financial inclusion as a component of sustainable finance considerations.

ABOUT UNCDF

The United Nations Capital Development Fund (UNCDF) is the United Nations' flagship catalytic financing entity for the world's 46 Least Developed Countries (LDCs). With its unique capital mandate and focus on the LDCs, UNCDF works to invest and catalyse capital to support these countries in achieving the sustainable growth and inclusiveness envisioned by the 2030 Agenda for Sustainable Development and the Doha Programme of Action for the least developed countries, 2022–2031.

UNCDF builds partnerships with other UN organizations, as well as private and public sector actors, to achieve greater impact in development; specifically by unlocking additional resources and strengthening financing mechanisms and systems contributing to transformation pathways, focusing on such development themes as green economy, digitalization, urbanization, inclusive economies, gender equality and women's economic empowerment.

A hybrid development finance institution and development agency, UNCDF uses a combination of capital instruments (deployment, financial & business advisory and catalysation) and development instruments (technical assistance, capacity development, policy advice, advocacy, thought leadership, and market analysis and scoping) which are applied across five priority areas (inclusive digital economies, local transformative finance, women's economic empowerment, climate, energy & biodiversity finance, and sustainable food systems finance).

ABOUT UNCDF'S FINANCIAL INCLUSION WORK

UNCDF's Making Access Possible (MAP) programme has conducted research and extensive stakeholder engagement to identify the linkages and complementarities between sustainable finance and financial inclusion, to inform sustainable finance decision makers on the rationale to integrate financial inclusion and by extension the low-income market, within sustainable finance considerations. This work is supported by a larger body of technical work, see:

For more on MAP see: https://www.uncdf.org/map/homepage

UNCDF 2022: Sustainable Finance and Financial Inclusion – Summary Synthesis note. Available online.

UNCDF 2022: Social, environmental and financial in synch – an integrative framework for better outcomes. [Available on request]

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