

# Financial Institutions



## Sector strategy

Investments in financial institutions make up approximately a third of CDC Group's portfolio. The following pages give an insight into why this sector matters for us and what our investment priorities are.



**The United Nation’s Sustainable Development Goals say nothing about financial services. Yet even the most fundamental of the 17 specified goals, such as eliminating hunger, cannot be achieved without a well-functioning financial sector.**

The dependency is often direct. For example, the production and distribution of food requires farmers, transport companies and shop keepers to have access to capital. But it is also indirect. The Sustainable Development Goals will not be achieved without broad-based economic growth. And this, in turn, cannot be achieved without financial institutions that facilitate payments, provide savers with somewhere safe to keep their money and direct capital to the enterprises that need it. The financial sector is as important to a country’s development as infrastructure such as roads and electricity.

Hence CDC’s investment in the financial sectors of our target countries. We aim to direct capital to enterprises that will promote financial inclusion or improve the performance of the financial sector – for example, by reducing operating costs or extending the range of services available. These broad goals are translated into five “investment themes”, to which we direct capital through a variety of products and channels.

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# 01

## The problems we are trying to solve

**Many people in South Asia and Africa are “financially excluded”. They do not have bank accounts and they cannot borrow from credit institutions, relying instead on family and friends who can typically advance only small sums to cover personal spending, not the long-term funds required for business development. Less than 30% of businesses in these countries have a bank loan or line of credit.**

The barriers to access are often infrastructural. Branch networks cannot profitably be extended into the poor and sparsely populated rural areas in which many people in these regions still live. And most of these countries lack the land registries, credit bureaus and financial reporting conventions on which lending in advanced economies depends.

Financial exclusion is not the only problem. Businesses large enough to easily access basic banking services are still hampered by an under-developed financial system. The absence or illiquidity of domestic capital markets mean they are over-reliant on bank credit. This is generally more expensive than capital provided directly by investors, but the cost is made yet higher in our target countries by a limited supply of domestic savings. Banks must instead raise funds in the wholesale markets, usually in US dollars or euros, and then lend in their local currencies, thereby incurring currency risk. This drives up banks' cost of capital, which they must pass on to their customers. Risk management products, such as insurance and derivatives, are also generally unavailable or overpriced in South Asia and Africa. Businesses in these countries therefore face a higher risk of being driven to insolvency by unexpected events than their counterparts in advanced economies do.

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Financial inclusion and financial development are related, of course. As banking practices become more advanced, cost-to-serve falls and a greater portion of the population become profitable customers for banks. But they are somewhat independent, as exemplified by the United States, which combines the world's most liquid and sophisticated capital and derivatives markets with an unbanked rate of 8% (compared to 0% in New Zealand, Canada and Denmark, among others). By contrast, Kenya has a decent level of financial inclusion, on account of widespread use of Mpesa mobile wallets, combined with unsophisticated financial markets (see Figure 1). Investments that promote one of our two goals – financial inclusion and financial development – will not necessarily promote the other.

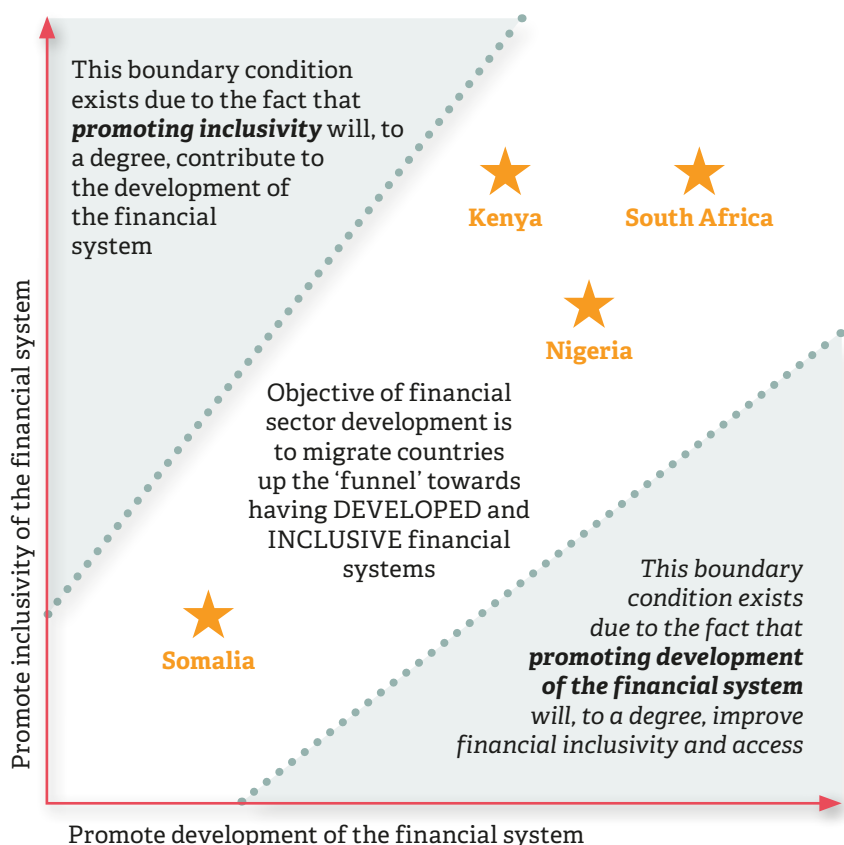


Figure 1: CDC aims to push financial sectors up the "funnel" of development and inclusion (country examples shown are illustrative)

The problems mentioned above are common across South Asia and Africa. But this fact disguises significant differences between countries within these regions. Just as GDP per person ranges from \$235 (South Sudan) to \$22,000 (Mauritius), so financial systems range from almost non-existent (Somalia) to near-Western (South Africa, in sophistication if not inclusion). Any effective investment strategy must recognise these differences.

Following analysis conducted at the Department for International Development (DfID), we assign the countries we target to five levels of financial sector development (see Figure 2). Those in Level 1 are so legally or politically insecure that investing in financial institutions is practically impossible. These more basic problems must be fixed first. Where a modicum of legal and political security is established, however, CDC can make private sector investments that advance the financial sector – those investments varying with the country's level of development.

At its most basic, the objective of the financial sector is to intermediate capital from providers to consumers. So it follows that financial sector development, at its most basic, **aims to improve ability of the financial sector to intermediate capital**

To do so, financial sector development efforts have to focus on 2 dimensions:

**1 Promoting development of the financial system**

*By this we mean actions and interventions – whether from government, from regulators, or from private sector – that improves the efficiency, stability and diversity of the financial system*

**2 Promoting inclusivity of the financial system**

*Having a somewhat developed financial system is a pre-requisite for serving marginal customers, however it's not sufficient on its own. Efforts also need to focus on capturing underserved customer segments and marginalized groups into the formal financial system*

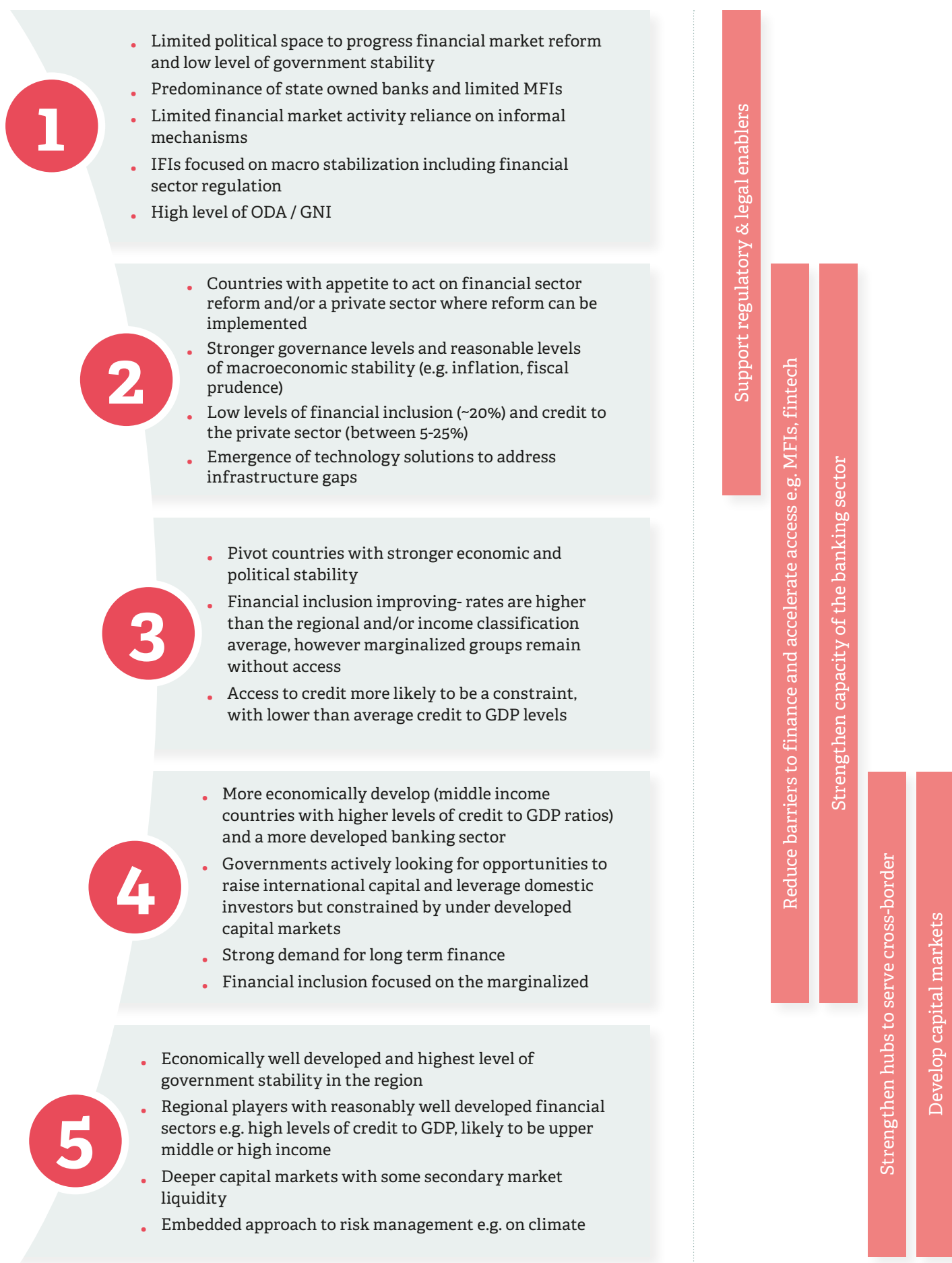


Figure 2: Five levels of financial sector among developing economies. Source: DFID financial sector development team



## 02

### **Our Investment Themes**

The development needs of the financial sectors in our target countries give rise to our five investment “themes” – that is, to the specific aims of our investments:

- 2.1. Increase bank sector capacity**
- 2.2. Develop capital markets**
- 2.3. Help intermediaries serve SMEs**
- 2.4. Support firms financing the delivery of basic needs**
- 2.5. Harness the power digital financial services**



## Case study: HBL

The Pakistan government has been receiving support from the IMF for many decades. A condition for this support is a programme of privatizations of state-owned enterprises. Habib Bank (HBL) was brought to market in 2016.

Investments in politically and economically unstable countries such as Pakistan present considerable risk, driving down valuations and, hence, the proceeds of asset sales. To provide reassurance to the market, CDC played the role of an “anchor investor”, buying 5% of HBL for US\$122 million. The privatization ultimately delivered about US\$ 1 billion for the government, an unprecedented sum in Pakistan. The Privatisation Minister stated that the offering would have not have been successful without CDC’s involvement.

Completing the transaction was an important milestone in satisfying the IMF’s conditions for continued support. And its success will help to reassure investors considering participation in the roughly 70 state-owned enterprises yet to be privatized.

### 2.1 Increase bank sector capacity

*Banks are the cornerstone of the financial sector in our markets*

By legal definition, only banks can take call deposits and lend these funds on at longer maturities. This means that, for the foreseeable future, banks will be the main conduits for transferring money from savers to borrowers. Economic development in our target markets therefore requires a healthy banking sector with the capacity to lend to new and growing businesses.

Yet banks in these regions are severely constrained in their lending. Following the financial crisis, regulators have required banks to hold much more capital and liquidity, and to undertake more rigorous procedures to prevent money laundering. Global banks have responded by withdrawing from many countries in our regions, and domestic banks find it difficult to raise the extra regulatory capital required to maintain and expand their lending. The effects have been especially pronounced in trade finance. According to the Asia Development Bank, the gap between the demand for trade finance and the amount actually extended by banks – the “trade finance gap” – amounted to \$1.5 trillion in 2018.

To address these capacity constraints, CDC provides banks with regulatory capital and medium-to-long term debt for on-lending. We advance these funds when there are simply no other providers or when none can commit funds for sufficiently long periods. This can sometimes mean acting as a “cornerstone investor” in privatization (see Box 1). We also provide risk sharing facilities (which free up banks’ capital resources) and lines of credit for short-term trade finance exposures. At the start of 2020, we had extended trade lines of credit to over 380 banks across Africa and South Asia either directly or indirectly, through bank partners such as ABSA Bank (South Africa), Standard Chartered and Sumitomo Mitsui Bank.



## 2.2 Develop capital markets

*Capital markets are key to unlocking longer-term and size-able funding*

Capital markets allow governments and companies to source capital directly from investors (such as pension funds, insurers and asset managers) without the intermediation of banks. They have an increasingly important role to play now that regulation is driving up the costs of bank intermediation and restricting the supply of bank credit. They also improve economic stability by reducing the concentration of risk in the banking sector. The governments of several of the more economically advanced countries in our regions are rightly keen to promote them.

However, most lack the required market infrastructure for clearing, settling and recording transactions. And they lack institutional investors, such as insurers and pension funds, of the combined scale required for market liquidity.

CDC's investments are directed at solving these problems. We will invest in providers of market infrastructure such as exchanges, central clearing platforms, custodians and credit data bureaus. And we will invest to expand the institutional investor base, especially pension providers and insurance companies. The products offered by these institutions make domestic pools of long-term capital available for investment while helping households and firms to save and manage risk.

CDC also offers Risk Sharing Facilities (RSFs) to FIs. In markets where legal or other institutional constraints mean the securitization of bank assets is not yet feasible, RSFs provide an alternative means of freeing up bank's capital and thereby increasing its lending capacity. Indeed, RSFs can act as a step towards future securitizations because they allow originators to build the required asset performance track record and internal monitoring systems. We currently have RSF programmes with Standard Chartered Bank in Sierra Leone and Zimbabwe.



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## Case study: Equitas

CDC began its relationship with Equitas in 2013, then a micro-finance institution (MFI) based in Chennai, India. Equitas makes loans to the owners of small businesses to buy assets required for their operations – vans, sewing machines, power tools, etc. – and to support the education and healthcare of their families. As so often with MFIs, however, Equitas was highly constrained in its access to capital and, hence, in the number of small business owners it could help.

Since 2013 CDC has invested \$40 million in Equitas (in equity and debt), helping it to expand from 3,000 employees to more than 13,000. Equitas now has three million customers and operates in 12 Indian states.

CDC is not merely a passive investor. On top of capital, we provide Equitas with strategic advice, encouraging them to list on the National Stock Exchange (NSE) in 2016 and thereby diversify their sources of equity capital. We also helped them become one of the few MFIs to receive a small finance bank licence from the Reserve Bank of India. This means Equitas can take deposits, diversifying its sources of debt capital. In short, Equitas is not only larger than it was when CDC began working with it in 2013 but better positioned to keep growing.

### 2.3 Help intermediaries serve SMEs

*SMEs are the growth engines of the economy in our geographies*

Small and medium enterprises (SMEs) are responsible for 33% of GDP in our regions and, when informal businesses are taken into account, as much as 90% of jobs. SMEs serve consumers in rural communities and impoverished urban areas that lack the infrastructure needed for large business or public-sector activity. And they are an important source of innovation and industrialization.

SMEs report that their greatest challenge is accessing the finance they need to grow and create more jobs. Banks see SMEs as high risk and costly to serve; venture capital and private equity investors do not see the potential for large absolute returns; and SMEs may at times be too large to be served by microfinance institutions. As a result, according to the World Bank, SMEs in low- and lower-middle-income countries face a \$930 billion financing gap.

CDC therefore invests in the non-bank financial companies so that alternatives to traditional bank financing become available to SMEs. For example, in 2017 we made an equity investment in Vertitas, an Indian non-bank lender focused on small businesses. We also support micro-finance institutions (MFIs) looking to extend their lending to SMEs – investing, for example, in the Indian MFIs Utkarsh and Equitas (see Box 2).

And we work with our bank investees to increase the finance they provide to SMEs. This can mean funding work to develop products and operations better suited to SME clients, as we have done with Habib Bank (Pakistan), Ratnaker Bank (India) and I&M Bank (Kenya). Or it can mean entering into risk-sharing agreements, which reduce banks' capital cost of lending to SMEs. For example, under a recently launched Supply Chain Finance program, CDC provides risk sharing facilities to banks serving end clients. Early results are promising, with the program reaching SMEs for purchases as small as \$5.74.



## 2.4 Support firms financing the delivery of basic needs

*Ensuring basic needs of people are met is highly developmental*

CDC is committed to the UN's sustainable Development Goals. The first four aim to ensure that basic needs for food, shelter, energy, education and healthcare are met. These basic needs do not include financial services, yet financial services can be vital for delivering them. Many people in our regions do not have the savings to pay upfront for medical treatment, education or housing. Financial firms can help by supplying the insurance, mortgage or other credit products that allow lump-sum payments to be converted into smaller regular payments over an extended period. They can also improve access to energy and food by extending credit and risk management products to providers, thereby expanding supply and reducing prices.

Through a combination of capital and technical assistance, CDC is encouraging traditional banks to lend to basic needs-related segments. For example, we invest in the REFFA fund which lends to banks, MFIs & non-bank FIs for on-lending to private education providers and to their customers. And following the investment in IIFL, our investment professionals worked with management to develop an affordable housing finance strategy.

We are also investing in specialist lenders. We have already provided capital to a firm financing off-grid solar energy, and we plan to invest in suppliers of affordable housing finance and agricultural lenders. (Only 7% of African farmers now access finance from traditional banks or MFIs).

Ideally, we would also invest in companies providing health insurance and crop insurance. However, the insurance industry is not yet sufficiently developed in many of our regions to make this feasible, and it must remain a long-term ambition.



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## 2.5 Harness the power of digital financial services

*Digital financial services reduces operating and risk costs in the financial system, and promotes inclusivity*

Digital technology is disrupting the financial services industry all around the world. This presents a challenge for traditional banks with their expensive operating models. But it is good news for consumers, especially in poor countries. New digital technologies – not just mobile banking but operations employing machine learning and robotic process automation – allow banking services to be delivered at a substantially reduced cost to people who were previously physically or economically inaccessible.

The McKinsey Global Institute estimates that such digital financial services (DFS) could spur growth that adds \$3.7 trillion to the GDP of emerging economies within a decade. The UN has launched the Taskforce on Digital Financing “to harness the potential of financial technology to advance the Sustainable Development Goals”.

CDC aims to make direct equity investments in DFS providers. Some investees will provide DFS to end-users: digital lending platforms, e-wallets, remittance firms and the like. Others will be companies that provide services to other parts of the financial system – cloud-based banking platforms, credit scoring model providers, payment processors, electronic trading platforms – promoting development and inclusion by reducing system-wide costs.

Because DFS can reshape all areas of financial services, our investments here will also promote the goals of our other four investment themes. For example, digital trade and supply chain finance platforms can be used to distribute small ticket funding to a greater number of SMEs than would be possible through bank partnerships alone. In 2019, CDC made an equity investment of USD 21 million in Indifi, an Indian online lending platform that makes loans to small businesses such as shops and restaurants.



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## How CDC invests in the financial sector

**Having decided on which businesses to invest in, we must decide how to invest in them. Should we take an equity position or simply lend? Should we invest directly or through a fund that invests in our targets? Should we be a passive investor or should we seek to guide our investee by taking board positions or providing technical advice?**

The answers depend on the purpose of our investment and the maturity of the investee. For example, where we aim to cut the cost to serve customers by investing in a fintech with an unproven business model, we are likely to do so by a direct equity investment of “catalyst capital”. These are high-risk investments in firms whose business model does not depend on leverage and debt. At the other end of the spectrum, if we seek to increase lending capacity in a market where banks are adequately capitalised but face a paucity of long-term debt funding or have exceeded single borrower limits, we are likely to advance them long-term credit for on-lending.

We will be most hands-on, taking board positions and offering technical advice, when our goal is to advance the business models or operational efficiency of our investees. And we will be most hands-off, investing through funds, when our goal is better achieved by the local knowledge of the managers of those funds than by our own.

The return to direct investing since 2012 and the expansion of our engagement options (see Figure 3) mean that we can always find a way of helping the companies that we think will advance the financial sector in our regions.

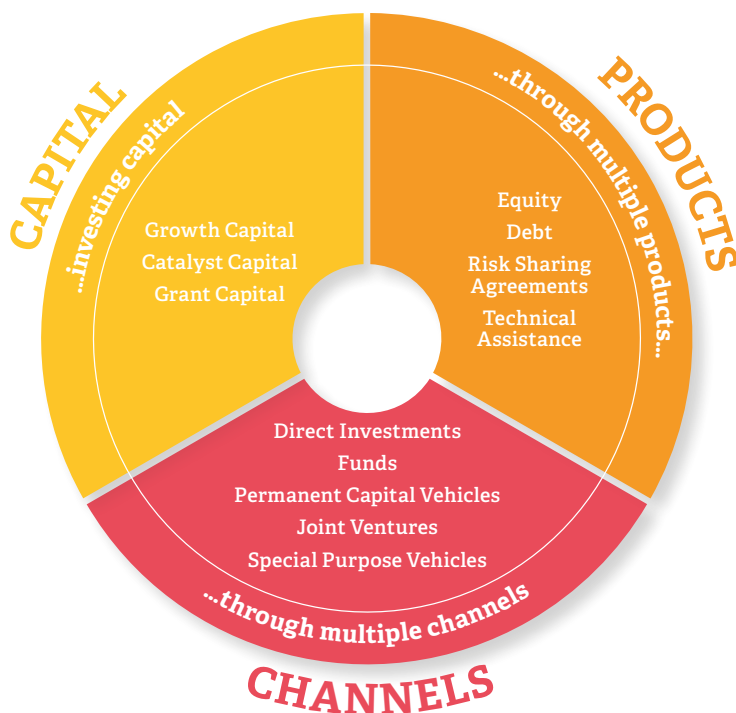


Figure 3: How CDC invests

Through these investment themes and methods, we help financial firms in South Asia and Africa improve their operational efficiency, design products suited to excluded groups, manage risk better and expand their lending capacity. Each of these advances, in turn, helps to reduce financial exclusion and to provide businesses with the capital they need to increase output and employment. Incomes rise and poverty is alleviated.

## More than capital

CDC aims to make its investees not only better funded enterprises, but better managed. In some cases, we take positions on the boards and offer broad strategic guidance from this position. The HBL and Equitas case studies are examples of this (see pages 7 and 9). But we also provide more tactical or operational guidance, sometimes recruiting external suppliers and providing grants to pay for them. Three examples:

- CDC invested in the Kenyan bank I&M in 2016. The investment was followed by a strategy refresh that included establishing I&M as a digital leader across East Africa. We helped set up a dedicated digital unit to implement initiatives in automation, advanced analytics and front-end solutions, hiring the unit's leader and data scientists. CDC's Digital Financial Services advisor joined the bank as a member of its transformation committee.
- At Veritas, an Indian non-bank lender, we funded a \$150k project to digitize their paper-based loan origination systems of. The work was led by an IT consultancy brought on-board to integrate, automate and optimize workflows and train staff.
- A gender diagnostic at our Pakistan investee HBL identified a need to increase the number of senior managers who are women. We worked with our strategic partner, The Boardroom Africa, to search for a female board member, helped identify promising female employees for leadership training, and supported the creation of a mentoring programme.



## Case Study: Sierra Leone Ebola banking facility

An Ebola outbreak in 2014 caused a severe economic slowdown in Sierra Leone. Production from the mining sector declined, supply chains were disrupted, and basic commodities were in short supply. CDC responded by entering into a risk participation agreement with Standard Chartered Bank in December 2014, supporting up to \$50 million of new working capital lending to Sierra Leone businesses.

This joint facility helped companies to mitigate the effects of the Ebola crisis by scaling up operations to supply affected zones with hygiene products, building materials and staples such as rice, flour, cooking oil and sugar.

The facility also helped to keep people in work. For example, Shankerdas & Sons is a manufacturer based in Freetown, founded in 1939 and (in 2014) employing around 1,000 people at its three factories. As Ebola hit, falling revenues threatened the staff with layoffs, until the Shankerdas received a loan from our facility and could continue operating at full capacity through the crisis. They have since received a second loan to fund the construction of a bottled drinks factory that will provide a further 250 jobs.

# 04

## Our strategy in COVID times

**The COVID-19 pandemic and the lockdown imposed by many governments are causing a global economic shock. The governments of economically advanced countries are offering extraordinary levels of support to help companies and workers survive the temporary cessation of business – both with direct payments and by guaranteeing commercial bank loans to struggling firms.**

Governments in Africa and South Asia, however, lack the fiscal and monetary headroom to do the same. This makes the resilience and capacity of their banking sectors critically important. By supporting the banking sectors of African and South Asian countries, CDC can help to minimise the pain the crisis imposes on their populations, as we did during the 2014 Ebola outbreak (see case study).

Although this crisis support will entail some short-term reprioritization, it requires no revision of our broad strategy. Insofar as we achieve our five investment themes discussed in Section 2, the populations of our target countries will be better able to get through the crisis. Themes 1, 3 and 4 – namely, increasing lending capacity, directing capital to SMEs, and supporting specialists in financing the provision of basic needs – will help to keep people and businesses alive while their earnings are suspended. Social distancing is aided by digital banking technology (theme 5). And post-COVID economic growth will be accelerated by deeper and more liquid capital markets (theme 2).

We can make the most immediate and easily executed interventions through our investee financial institutions, helping them to increase the credit available in our markets. By expanding our pre-existing trade finance programmes, we can inject liquidity quickly and accurately, supporting SMEs and basic needs industries. Other liquidity instruments at our disposal include risk sharing agreements and senior debt. And we are on-hand to provide extra regulatory capital via equity and tier II debt, should our investees need it.

Find out more about how we're responding to the coronavirus crisis at [cdccgroup.com/covid-19](https://cdccgroup.com/covid-19)

~\$1.6bn invested in financial institutions across Africa and South Asia  
40+ investment and impact professionals dedicated to the sector  
5+ subsectors supported, including digital financial services and insurance

This strategy encompasses the activities, motivations and ambitions of a large group of people at CDC. They include our investment professionals, which span four product teams dedicated to working with financial institutions (FI Equity, FI Debt, Intermediated Credit and Trade & Supply Chain Finance), and our impact professionals, who are thought leaders on the topics of E&S, Business Integrity, Development Impact, Gender and Climate Change.

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