



**MicroFinance
Network**

THE FUTURE OF FINANCIAL INCLUSION: A LEADERSHIP CHALLENGE

Reflections and Analysis of the 2017 Annual Meeting

THE MICROFINANCE NETWORK

LONDON, APRIL 2017

Raúl Velarde Dabrowski, Francisco Arenas Ballester, Dhruv Toshniwal

Abstract

In the 1990's and 2000's, MFIs were the driving force behind the growth of the financial inclusion industry. These organizations adapted, evolved, and grew exponentially by bringing commercial solutions to the social problems of dozens of millions of people at the bottom of the economic pyramid all over the world. Naturally, the industry has become more competitive and has matured. Furthermore, their current external environment is not only evolving gradually but also is going through radical changes that are redefining the industry. Traditional banks, telcos, multinational retailers, and fintechs are entering this market and are reconfiguring the way we understand customer needs, the value propositions that are offered, the delivery channels use, and the industry value chain configuration. This trend has potential impact on the future of the MFIs. In this context, we asked what will be required in the coming years of the MFIs so they can have the most impact, reaching more people at the bottom of the pyramid, faster, and providing integrated solutions to their problems? Given the complexity and uncertainty of the external and operational environment of the financial inclusion industry, the essential requirement will be a new kind of transformational leadership, one that will infuse these organizations with the capabilities to set direction, dynamically learn, innovate and adjust rapidly. At the same time, a leadership that is able to increase current efficiencies while managing strategic, structural, and cultural transformations.

Message from Shameran Abed, MFN Chairman

Dear MFN Members,

First of all, let me take this opportunity to sincerely thank my friend Enrique Majos for his outstanding leadership of the Microfinance Network. During his time as Chairman, Enrique has helped to regenerate the Network, creating momentum for greater sharing, learning and collaboration. In recent years the global microfinance sector has entered an exciting new phase of innovation, regulation, as well as competition. Enrique's leadership and the contribution of the Microfinance Network as a whole has been invaluable in helping members to navigate some of these new challenges and opportunities.

The 2016 meeting in Dhaka was a fantastic opportunity to learn about new digital financial models, and the role that innovative new actors in the financial space, such as mobile money providers, can play in complementing the work of microfinance institutions.

The 2017 meeting in London saw extremely constructive discussions about the tension between competition and complementarity faced by MFIs in the midst of increasing financial sector innovations that serve the bottom of the pyramid. Members welcomed the opportunity to learn directly from some of these innovators about the new ways they are serving the markets in which we operate. These rich conversations have been expertly captured by Raul Velarde Dabrowski and Francesco Arenas Ballester in this report of the London meeting. I strongly encourage everyone to review and consider the content of this report, with conclusions that are sure to have important implications for each of our work.

This note would be remiss without directly acknowledging the fantastic management of the Network by Dhruv Toshniwal over the past two years, as well as the exceptional services provided to the MFN by Raul and Francisco. I thank them sincerely. I also take this opportunity to introduce the new MFN secretariat, to be led by Isabel Whisson with support from Oishi Nawal, both from BRAC.

I cannot overstate what an immense honor it is for me personally to be taking on the Chairmanship of the MFN, following in the footsteps of some of the luminaries in our field from Maria Otero to Carlos Labarthe. I will do my best to build on the momentum created during Enrique's leadership, to regenerate and grow the Network further. Recognizing the value that each one of us brings to the Network, and that each new member can potentially bring, I also invite each of you to reach out to friends in the sector who would benefit from being part of this special group of institutions and practitioner CEOs. Between us we contain a wealth of knowledge and experience that best serves when it is shared. While each of us in our daily responsibilities encounter pressures, questions and concerns that often consume our attention, the Microfinance Network provides a rare and refreshing opportunity to take a step back, learn from peers facing similar challenges, and consider how to approach them in a spirit of collaboration that ultimately serves those to whom we are most accountable: our clients.

I greatly look forward to continuing the discussion with all of you, hopefully with the addition of some new faces, in 2018.

Until then,

Shameran

Message from Enrique Majos, Outgoing Chairman

Dear MFN members:

On repeated occasions, we have highlighted that our Network has the uniqueness of bringing together the knowledge, experience, and profound sense of purpose that comes from the foundation of each of our institutions. These set of values, represented by each of you, make our community a wonderful source of transformation and wisdom.

Our world and our industry have never evolved and transformed as fast and dramatically as they are today. As former Chairman, I am proud to present to you the work that we have all together produced during our last annual meeting in London 2017. The document that you are about to read is a great compilation of analysis and discussions, and sheds light on different contexts and perspectives, which I truly believe will be a powerful directional guide for the transformation of your institution.

I also want to express my satisfaction and excitement about having Shameran Abed leading our Network. His progressive thinking, experience, and most of all his profound vocation to serve the underserved people in our communities, will bring the MFN the leadership we need for the following years.

Warm regards,

Enrique Majos

PROLOGUE

After the Annual Meeting in London we set out to write a summary or a memory of the discussions we held in the three working days. However, as we reviewed the meetings notes we became aware of the richness of the discussions, the insights that were gained and, only after weeks of analysis, we were able to induce more profound conclusions. Therefore, we did not want to miss the opportunity and decided to write this article to share with the MFN members not only reflections and analysis but also to provide a tentative roadmap for the future leaders of this industry.

Most of the content in the article comes directly from the discussions of the meetings. We have complemented those comments with our experience and insights working with other financial institutions and central banks, and provided the article structure with well-known and tried analytical frameworks. However, the article does not include a thorough current literature review on the subject. Therefore, it is important to point out that the analysis and conclusions have limitations, and as such we hope it serves as the basis for discussion and is tested against other observations, studies and experiences.

We would like to point out that during the discussions the comments were not simple observations, on the contrary, the participating CEOs provided complete lines of thought and ideas that were robustly fleshed out. They come from decades of experience of each one of them in this industry and also as a product of the learning community MFN members have created. Therefore, we consider what they share as invaluable.

Consequently, we would like to recognize Enrique Majos and Shameran Abed for the leadership they are providing in setting direction for the MFN and for putting together the Annual Meetings. And then thank outstanding MFN participants for their trust and generosity: Youssef Bencheqroun (Al Amana), Pierre Marie Boisson (Sogesol), Hassam Faried (DABCD), Youseff Fawas (Al Majmoua), Godwin Ehigiamusoe (LAPO), Melo (Banco Mundo Mujer), Magdy Moussa (ABA), Elizabeth Rhyne (Accion).

The third day of the Annual Meeting was a special one as for the first time a group of non-members were invited to participate and engage in the discussions. We are very thankful to them for their openness, and for letting us take a peek into their entrepreneurial skills: Nick Hughes (M-Kopa), Jorge Rubio (Citybank) Fernando Cabello (Aplazame), David Kruijff (First Access), Loubna Bazine (Friendly Score), Richard Leftley (MicroEnsure), Antonio Separovic (Oradian), and Benedetta Arese Lucini (Oval Money).

Raul Velarde Dabrowski
Francisco Arenas Ballester
Consultants for the MFN

INTRODUCTION

Members of the Microfinance Network (MFN) have been leaders building the microfinance (MF) industry by allowing access to formal credit to millions to people. They have been at the forefront of the industry during all their stages: in the early nineties, they worked to consolidate their business models adapting them to their local environment, by the end of the nineties many were able to access the capital markets for funding, in the early 2000s they were scaling, and later in the decade they diversified into other financial products and services to achieve Financial Inclusion to their customers. In parallel, the growth and profitability of the microfinance institutions (MFIs) have attracted competition, consequently, fostering the development of a robust industry that provides customers and potential customers access to alternative sources of credit and other financial products and services.

However, significant changes in the environment, threaten to disrupt the current structure of the industry. MFN members, in their quest to maintain their leadership position, asked themselves in this 2017 Annual Conference which kinds of organizations will lead Financial Inclusion in the next 5 to 10 years. In particular, the MFN members took a closer look at the changes brought by technology in general and at the emerging fintechs in particular. They analyzed if fintechs¹ business models are complementary and will help the MFNs evolve into the new stage of the industry or if some of these Fintechs will pose a competitive threat to the MFNs. Participants also explored the role of other environmental factors and analyzed which of them hinder their progress to fulfill their MFI's mission.

In an innovative format, the MFN invited a selected group of fintechs. They participated in the discussions and engaged in an exploratory open dialogue that provided valuable lessons for all participants. At the end of the Annual Meeting members benefited from generating a shared perspective on the possibilities to improve the way each will achieve their mission towards Financial Inclusion. However, they also shared a perception of uncertainty about the specific ways the MFNs will need to change to adapt to critical environmental trends. Therefore, participants agreed that the opportunity and challenge is innovation, collaboration with fintechs, and balancing between maintaining and improving the efficiency of the current business models while exploring and driving transformation to incorporate new tools, structures, capabilities, and talent. Members also noted that the evolution process is complex and that learning to move forward gradually but decisively is critical since incorporating and building new capabilities always takes several years.

Document outline. The document is structured in four sections: External Environment Analysis, Business Model Evolution, Industry Reconfiguration, and Conclusions. For those wanting to focus on the main transformational leadership takeaways, those are incorporated in the Conclusions section.

¹ Fintech is the new applications, processes, products or business models in the financial services industry, composed of one or more complementary financial services and provided as an end-to-end process via the Internet. Sanicola, Lenny (13 February 2017). "What is FinTech?". *Huffinton Post*. Retrieved 20 August 2017.

EXTERNAL ENVIRONMENT ANALYSIS²

The strategic challenge of the MFIs is to maintain fit between the organization and their environment by delivering a differentiated value proposition at a cost that generates long-term value. Before exploring the required capabilities for the future, we started, as in the previous two years, with an analysis of what the participants perceive are the most relevant political, economic/competitive, social, technological, environmental and legal/regulatory factors. The analysis involved describing those factors, their evolution, their expected trend and their impact on the MFIs business model.

Increasing Government Role

We observed that in many countries the government is increasing its role or level of regulation on the MFIs and their industry. The modes and degree of regulation and intervention vary significantly and they range from basic such as client protection to taking full control of the MFI.

Client Protection

Triggered in the 2000s, with events such as the micro credit crisis in India and the financial crisis of 2008, Client Protection regulation has become a basic mode to enforce practices that reduce the vulnerability of customers generated by the asymmetries in the relationship between financial product providers and customers. Incorporating Client Protection practices is also in the best interest of the MFI and many have adopted voluntarily the Smart Campaign principles that promote transparent, respectful, and prudent financial services to all clients.

However, regulators in different countries are not necessarily adopting the best practices on Client Protection suited to the bottom of the pyramid (BoP) market segment, generating diversity in its scope and requirements. For example, in Jordan, the Central Bank has just recently introduced Client Protection regulation and, even though fairness and transparency have been its primary focus, the regulation is requesting from the financial providers that their loan officers meet standards usually required from commercial banks providing large credit amounts.

Interest Rate Caps

Interest rate caps could severely stress the business model of some MFIs who would struggle to reduce their transaction costs to maintain their profitability. Based on the observations of the participants, there seems to be a trend towards imposing interest rate caps, although with a wide range of severity. In Asia, for example, Cambodia caps the credit interests at a low 18%; in Bangladesh, the cap is at 27% on lending a minimum of 6% on deposits; Myanmar similarly started with a cap of 30%. In contrast, Colombia has a 62% cap. Meanwhile, in Mexico and Nigeria the MFIs have avoided interest rate caps. Member expressed concern on the interest rate caps since, once established, it might never go away and the trend will be for the governments to continually drive it downwards.

Government as a competitor

In Nigeria, the Central Bank has launched a program to help the BoP, offering loans with low interest rates, thus competing with LAPO, who at the same time is facing competition from a large number on non-regulated institutions that the government allows to operate. In Jordan also the government is

² The external environment consists of a general environment and an operating environment. The general environment consists of the economic, political, cultural, technological, natural, demographic and international environments in which a company operates. The operating environment consists of a company's suppliers, customers, market intermediaries who link the company to its customers, competitors and the public.

intervening in the market but working collaboratively by taking charge of digitizing payments, holding the mobile money switch and trying to promote the development of small businesses. Finally, in alarming fashion, some governments have taken over the MFI, such was the case in Constanta in Georgia, Gajik in Armenia and Grameen Bank in Bangladesh.

Engaging the regulator

In general, the MFN observes a trend towards a more regulated microfinance industry and it appears that flying “under the radar” is no longer a strategy that MFIs can follow. It seems necessary to maintain some sort of engagement with the regulator, although some members perceive it as a risky strategy. Some believe that the wisdom is being able to inform politicians and decision makers but to keep a healthy distance. In any case, engaging the regulator successfully requires additional capabilities.

Competition intensity and new business models

Members agreed that the landscape is increasingly competitive, and that there is a greater number of imitators that have been entering the market to compete for the same customer. There seems to be a constant battle to obtain a lower cost of financing, and some new entrants, with high budgets, build their network by “stealing” the best loan officers. However, there was consensus on believing that competition by entrants with similar business models do not pose a competitive threat to market leaders, as these competitors face the same problems as the leaders while not benefiting from their scale economies and infrastructure.

In contrast, some members see that the real competitive threat will not come from the traditional financial institutions or from traditional MFIs but from players that can integrate solutions in platforms that allow them to better understand the customer, offer personalized end-to-end solutions with better user experience, and at the same time generating better operating performance. A good example is the growth of the peer to peer lending and crowd funding spaces in China and the tremendous growth and relevance of the Alibaba group who achieved three trillion dollars of remittances in 2016 via its Alipay subsidiary. Consequently, there was consensus on the need not only to monitor their progress but also on trying to engage Alibaba directly. Furthermore, with the mobility and ubiquity of smart phones, other members also see mobile carriers as posing a competitive threat.

Technology marches on...unstoppably

Many of the new business models are Fintechs who are sprouting everywhere fueled by the internet, the mobility provided by smart phones, new analytical tools, and cloud computing. Although many of the fintechs startups are still trying to solidify their business models, some have already entered a fast growth stage, acquired mesmerizing numbers of clients—in the dozens of millions—with profitability. Since technology is revolutionizing the Financial Inclusion industry a significant portion of the Annual Meeting was devoted to this environmental factor. Therefore, this topic is more developed in the following sections.

Deterioration of the social fabric

Terrorism, drug trafficking, delinquency, organized crime, and migration are having an impact on behaviors at the bottom of the pyramid. Trust is down, and opportunistic behavior is up hurting commitment to lending groups, increasing loan defaults, and restricting access to certain markets. Members also noted that earlier opportunities, such as providing credit to refugees, are meeting challenges due to political resistance, as in the case of Syrian refugees in Lebanon.

Over-indebtedness

During the nineties the BoP market segment customers had very limited options. The first MFIs provided micro credits with low flexibility and the customers usually got smaller loan amounts than what they needed. During the two thousands, MFIs grew exponentially and competitors came in. Consequently, customers started having more options to manage better their cash flows. However, during this decade, product design, for the most part, continued providing rigid products, and with more providers in the market—regulated and unregulated—many customers now have several loans at the same time, a significant percentage of which can have as many as seven loans and are paying loans with other loans. The general agreement was that three to four loans per client are acceptable since multiple loans have helped clients smooth their cash flow requirements throughout different periods of the year.

Consequently, over-indebtedness is rising and the MFIs seem to be in a bind: although some manage it with discipline and working with loan officers, many others seem to struggle between achieving their goals and trying to adhere to client protection principles, why? First, it is hard to know if the customer has contracted more loans than he or she can manage. Second, with so many credit providers, MFIs don't believe they are responsible of managing the customer's debt level. Finally, loan portfolio goals and loan officer's compensation provide incentives that make it hard for them to say no to providing credit.

Conclusion: Significant challenges but huge prospects for Financial Inclusion and the MFIs

The environmental analysis provided us with a big picture of the industry. The participants identified significant challenges from the environment but at the same time big opportunities to reach more customers, with products more suited to their needs at lower costs. These characteristics highlight the need to transform MFIs in the upcoming years. Members also noted that although the microfinance industry is mature there is still a lot of growth potential. In the late 90s, the seminal work "The Fortune at the Bottom of the Pyramid" estimated the unbanked population segment at four billion people. Therefore, although the industry has matured in some aspects there is still an almost limitless market potential for the MFIs that build the right new business models.

BUSSINES MODEL EVOLUTION

After the environmental analysis, the discussions then explored how these factors are impacting the evolution of the MFI's business model. Following the same methodology as the last two years, the analysis covered: changes in clients' needs and behaviors, the MFI's value proposition, changes in the service delivery channels, evolution on organizational capabilities and testing the mission.

Market/Client Evolution

In this session, members asked themselves how clients have evolved over the past years, and how they think the client will continue to evolve based on different parameters. Members were encouraged to discuss clients' profiles, needs, behaviors, degree of financial and technological inclusion, and changes in their decision-making processes.

The empowerment of clients

With the growth of the industry and more choices, the majority of clients have had the opportunity to experience financial products. Through these experiences they have "learned while doing", becoming more knowledgeable about the products and services. And with more choices, many asymmetries in the relationship have been neutralized resulting in clients who are more empowered, more sophisticated and

Business Model Framework

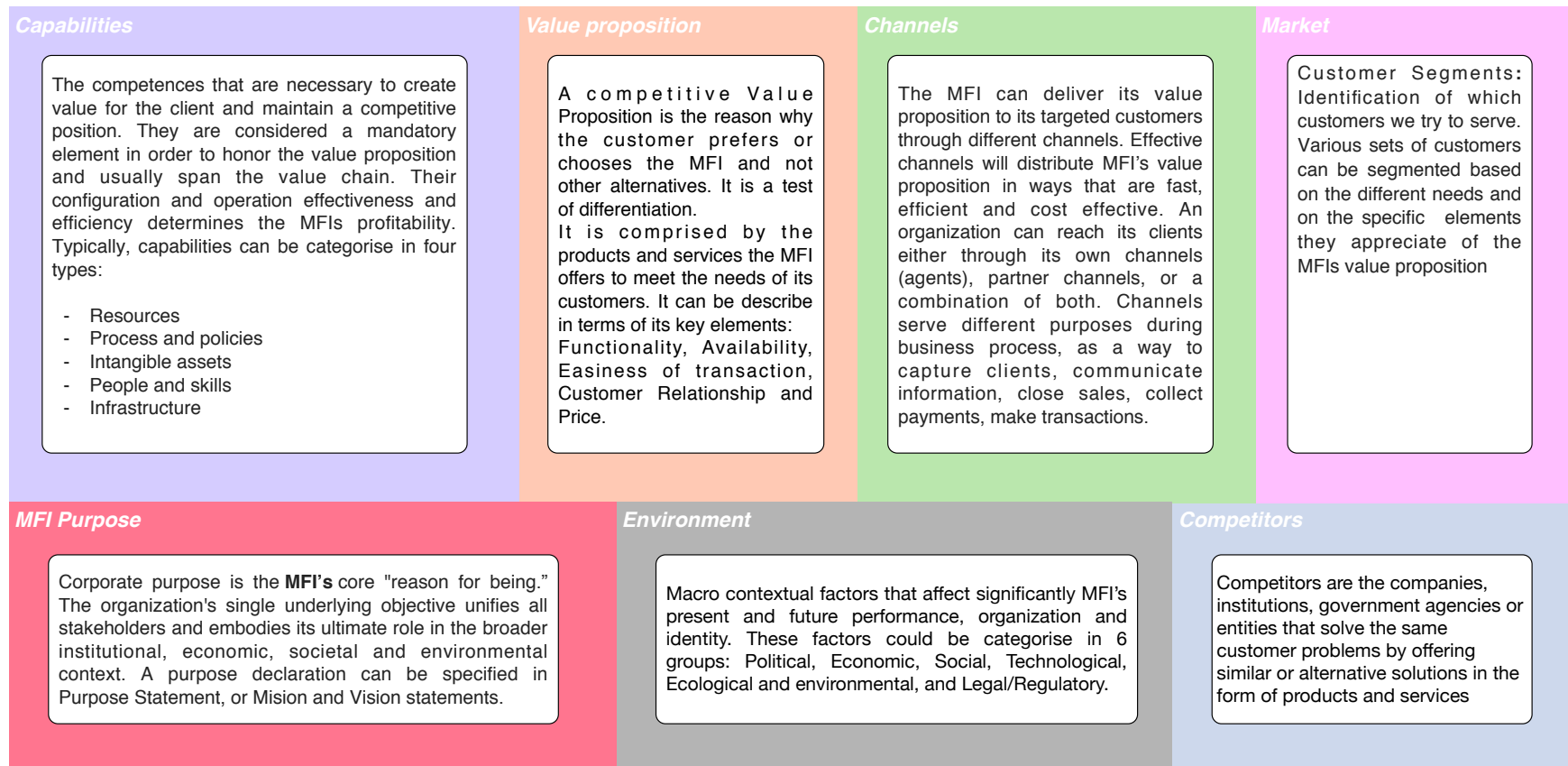


Figure 1. Business Model Analytical Framework

more demanding. Therefore, although the fundamental needs of the customers are still present, MFI's need to invest in developing a better experience for them.

The expertise gained through experience in credit products is also bringing up the need for a package of services and the willingness to try them. For example, connectivity has led to an increase in the need to do money transfers more often and travel large distances more frequently. Also, migration of children of MFI clients to universities in big cities and the need for inter-city and inter-country remittances have grown due to an increasing number of family members working abroad.

Changes in Demographics

Particularly in respect to traditional group lending, members noted a larger participation of younger people in the client base. These younger members are more active participants that ask more questions, are more likely to compare interest rates and demand better service. The younger generations tend to expect more direct and informative communication and in general appear to be less loyal to the MFI. In Egypt specifically, natural evolution of family practices, as well as the different profile of female heads of households are important characteristics of the generational shift.

Also, the new generations face an increasing pressure to lead an "upgraded lifestyle" which leads to more consumption, fueling their need for credit. Therefore, younger people are more open to trying new solutions, particularly those that are technologically driven. Members also noted that while earlier generations of clients gave particular importance to the first institution that reached them, younger clients tend to be less loyal and more likely to compare across a range of providers. Finally, some participants pointed out that there is an increasing number of men in the borrowing groups.

Customer segmentation

Throughout the session, members raised several questions regarding current segmentation methods and proposed new ideas for segmentation. The main conclusion from this session was that MFIs need to build more sophisticated tools to segment customers and understand their underserved needs. One suggestion was to construct an end-goal or activity based segmentation scheme, highlighting three distinct types of small businesses with three different objectives: pursuing growth, maintaining the family, or diversifying risk: "Poor and unbanked, is very different from poor, unbanked and *entrepreneurial*. It is important to look for entrepreneurial potential."

Similarly, members recognized that the correct mix of products and services that the customer needs at a certain point in time could vary based on the customer's objective, stage in their economic growth, and their context. A finer segmentation will require structuring decision-making processes differently for delivering successfully the product being offered.

MFI members have identified new client segments based on emerging and unattended needs such as those related to providing health insurance, serving clients educational needs, and building solutions tailored to housing and rent requirements. MFIs seem to have focused on serving needs of very small companies and segments slightly above the traditional microfinance segment. However, members noted the opportunity to serve underserved segments, situated at socioeconomic strata lower than the traditional microfinance client.

Value Proposition

In this session, members were asked how their value proposition has evolved, and how it was likely to continue to evolve in the future. They were invited to dissect the value proposition in terms of availability, functionality, easiness of transaction, relationship and total cost of service.

Functionality

MFIs have been responding to changing needs by developing new product offerings with increased flexibility and offering products for financial inclusion: credit, savings, insurance, transactions. MFIs have also diversified their products tailoring them to meet better customer needs such as healthcare, education, affordable housing, and rent. LAPO, for example, has developed an affordable housing product and is focused on same day disbursement for loan renewals. SogeSol has developed a specific consumption loan product to enable clients to pay rent twice a year because that is how rent is typically paid in Haiti. Gentera has begun experiments with digitized group lending and a digital ROSCA product (rotating savings association), among other innovative solutions to meet the emerging needs of clients. For some, health insurance was noted as an important aspect for our clients, even more important than credit insurance.

Availability and ease of transaction

Clients are increasingly expecting same day disbursement, increased presence in the field, and availability for assistance via remote channels. These service characteristics will demand integrated platforms and several tools to accomplish efficiency and productivity during transactions. Tamweelcom, for instance, focuses on the service part of their business and to facilitate transactions it offers Western Union to deliver the loan to the customers.

Relationship

Participants emphasized that the MFIs business model revolves around trust and the depth of relationships with the customer as a differentiating factor. An increased emphasis on loan productivity metrics might be a threat to this relationship. There is a need to align incentives of loan officers with customer service metrics and have more touch points with the client. Members continued to emphasize the need to continue building confidence and trust with clients as a differentiating factor. To achieve this goal, BRAC started using a separate staff with separate incentive structures to deal with this different group of customers based on product preferences and needs. BRAC also noted that having more information on inflows and outflows of client's money can be used to start giving the client more information about how they are spending money. LAPO, for example, decided to make it a priority to give preference to children of clients who have a university education. These are some of the things that can be done to increase familiarity with clients, making them feel like the MFE is their organization and is interested in their development.

Service Delivery Channels

The objective of this session was to analyze how transaction channels are changing, and how they are taking up an increasingly important role in transforming service offerings. Participants analyzed how technology is impacting different phases of the delivery channels: attraction, analysis, sales, post-sale service and renewal. A strategic aspect of this analysis is the future role of microfinance.

From payment platforms to financial products platform

In the early stages, the MFIs goal was to provide credit to help customers enhance their revenue. Then MFIs increased their product and service portfolio to help achieve financial inclusion for their customers. More recently, as in the case of m-Pesa and b-Kash, the Agent Banking Model has appeared as an alternative channel. The question discussed was whether this business model is transforming the landscape. B-Kash, for example, is trying to go beyond being a payment platform by becoming a more open platform for financial products and services, such as for an insurance company that could have access to millions of potential customers through it, allowing b-Kash to charge for the access. The general agreement was that the transaction channels are still evolving, and there is a need to closely scan where it

is heading. Particularly, Africa provides good examples of new and radical solutions being tested and is worthwhile to follow.

From agent based channels to hybrid channels

This discussion focused on the future of the traditional channel. There were two sides to the argument: one, the agent and his/her personal relationship with the customer are essential and cannot be removed from the equation, and the other argument is that the channel will become completely digital. Digging deeper, participants shared their experiences and analysis of the channel's different phases: attraction, analysis, decision, disbursement, operation, post-sale service, and renewal. We arrived at the following three conclusions.

First, digital channels and social media platforms, such as Facebook, are proving to be very efficient for acquiring new customers and for generating leads. Genera's experience with this type of channel is that productivity is approximately five times higher than through agents. It was highlighted that potential customers are more willing to provide information to Genera via Facebook than through "door to door selling". Some of the efficiencies are derived from the fact that through Facebook potential customers initiate contact with Genera, therefore there is no time wasted in engaging someone that is not looking for credit.

Second, in the analysis phase of the traditional model, the agent acquires the information from the customer; in contrast, dozens of emerging fintechs are testing an all-digital business model. For example, Mexico's Konfio's business model is based on developing algorithms that learn from the experience of providing loans. So far, these models seem to work for nano loans, but the participants have not observed a successful and scalable solution yet. The cash burn rate vs. learning process of the algorithm has not made it economically viable yet. Participants argued that it is very difficult to acquire relevant information about the willingness to pay without having direct contact with the customer, unless you have a system that generates a reliable memory of the customer's behavior and there are clear consequences for defaulting customers.

Finally, disbursing and operating the loan seems to be a potential phase for high digitization, although human contact is still necessary for providing high levels of service and also for reinforcing the context for willingness to pay (social cost). Nevertheless, renewal could benefit from digitization if the MFI has a good institutional memory of the client's behavior.

The conclusion is that, although many new models are trying to find an all-digital solution, none have been successful and scalable so far. In contrast, the observations show that the evolution of the channels will reflect efficiencies that optimize the benefits of digitization and the human touch at different phases.

Digital channels and community relationships

Leading into the discussion of the mission of MFIs, members recognized the role of the institution in the society, where group-lending focused MFIs are part of the local culture with actual relationships with the community and contribute to a stronger societal culture and growth. By switching to digital, organizations would be re-orienting themselves outside the community, and while possibly good for business, it would diminish the historical value to the community provided by the MFIs. In person visits by loan officers improve the social fabric; substituting them with m-wallets for example would mostly destroy this social value.

Organizational Capabilities: Evolution and Revolution required

In this session participants discussed the evolution of capabilities that have allowed them to differentiate themselves in the market and gain competitive advantage to achieve their mission. The goal was to understand how those capabilities have evolved in the last 15 years, analyze how they have been impacted by changes in the environment and, lastly, evaluate which capabilities will be required now and in the upcoming years in order to deliver value to the BoP efficiently. The comments showed that, for the most part, MFIs have been developing capabilities that help them maintain or improve the efficiency of the traditional business model. However, radical changes in the environment are pushing them, each at their own pace, into a transformational era in which new talent, structures, processes, infrastructure and leadership/management skills will be required to maintain relevance in the financial inclusion space.

MFI's Capabilities in the 2000s: Scaling with control

Members recalled how, during the 2000s, as their organizations solidified their business model the demand for micro credit grew. During those years, growth was fueled by the capability to replicate and scale the organization. Building structures, processes, and people allowed them to develop their agent network and deliver a consistent product by adhering to processes and values. During this time, MFIs developed access to funding in the capital markets, and at the same time they were able to grow with control. As a result, some went from NGOs to financial institutions, developed strong governance practices, and began complying with regulations. In that untapped market, they grew by focusing on one product for several years. Towards the late 2000s, to assist clients' financial inclusion, many MFIs started to diversify into savings, loans and later into transaction systems. These capabilities led the MFIs to greater profitability and, naturally, attracted competition. Consequently, the industry as a whole has grown and matured.

In that same period, MFI's have faced significant new challenges from the environment. As was summarized above, the environmental factors session analyzed in depth the main factors generating challenges for the MFIs. We found that there were two very distinct set of responses. A first category is an organizational response where a competitive business model is maintained. The second category is composed of emerging transformational responses to the radical changes occurring in the external environment.

Organizational capabilities have been evolving in the past ten years

The competition in the 2000s started with business model copycats. Customers became more experienced, were offered more choices and increased their market power, which exposed the inefficiencies of the MFIs value proposition. A one-product strategy no longer was sufficient. In addition, as MFIs grew, they faced political and regulatory challenges. Furthermore, whereas in the early 2000s these organizations were small and could go unnoticed, as they became larger, and some became public, MFIs realized it was no longer possible to "fly under the radar". Now, some MFN members have even become political targets.

Consequently, MFIs have made evolutionary adaptations by generating more efficient projects and developing an integrated value chain. These adaptations involved: a better understanding of their customers, varying their core products for better market segmentation, reinforcing the post-sale service, incorporating client protection principles, and developing an IT infrastructure, a banking core and strong HR practices to better attract, develop and retain agents. In addition, some MFN members are now able to engage systematically with the government and regulators in order to promote a healthy external context for financial inclusion.

Revolutionary changes in the environment require organizational transformation

Until now, all of these improvements in the business model have permitted the MFIs to maintain leadership in their respective markets. However, the MFN participants concluded that in the future those evolutionary improvements might not be enough, why?

The explosion of digital technologies has made us aware of a myriad of possible futures. These new tools and business models have arrived. However, they are at an early stage of maturity, and there was consensus on how there is still significant uncertainty about them, and it is hard to predict which will be the correct strategic moves for each MFI. With this context it was very clear for the participants that transformational capabilities will be required to understand, evaluate and integrate these varied digital technologies. Here are a few of them:

Leadership skills. Strong leadership skills capable of creating an atmosphere where high operating performance is maintained, while at the same time encouraging the development and implementation of entrepreneurial ideas. Additionally, the participants observed that responding with a vertical organization structure to material external changes that impact different areas of the organization fails to provide solutions because departments tend to work in isolation. In contrast, integration will be required — integration that is comprised of increased collaboration among different areas with different structures, member's goals, time priorities and interpersonal orientations. Managers will face the challenge of choosing and implementing new coordination and collaboration mechanisms. Therefore, organizational structures, decision-making and managerial processes will require significant changes.

Generating a vision that will be refined constantly. Leaders must provide constant refinement of strategic vision in a world of frequent, radical changes and consequent diminishment of personal industry expertise. Managers will need to understand and accept this new reality in order to generate a vision of how the pieces of the business model will fit together. With high uncertainty, the end point is not well-defined, only a general direction, and the end point will likely change. As a result, one of the most important skills will be the ability to make decisions in such as was as to allow the MFIs to be agile in pursuing those goals, while constantly correcting course to meet a moving target.

Understanding complex things. In order to generate a new vision and lead the organization, MFI leaders will need to be able to acquire new knowledge and engage with individuals and organizations that will allow them to understand and evaluate complicated things in order to incorporate or discard them. For example, participants mentioned the importance of understanding behavioral economics, big data, machine learning, and artificial intelligence in order to assess better credit risk, attain deeper customer segmentation, and solve also local/community challenges. Some members described this as a process of self-education, looking into value adding proposals, learning to differentiate between competitors and complementors, and selecting the right partners.

Multidisciplinary teams. Understanding is only a first step. Solutions—new products and services—will not come from individuals or from specialized departments. The large variety of new skills and business solutions available will require the MFIs not only to attract new talent with varied knowledge and skills but also to be able to develop teams of multidisciplinary people working together to innovate and bring into the market new products and services that better serve the people at the BoP. Some members described how they are already in the first stages of developing this capability.

Recent and Future changes in «traditional» MF/FI Business Model (an internal view)

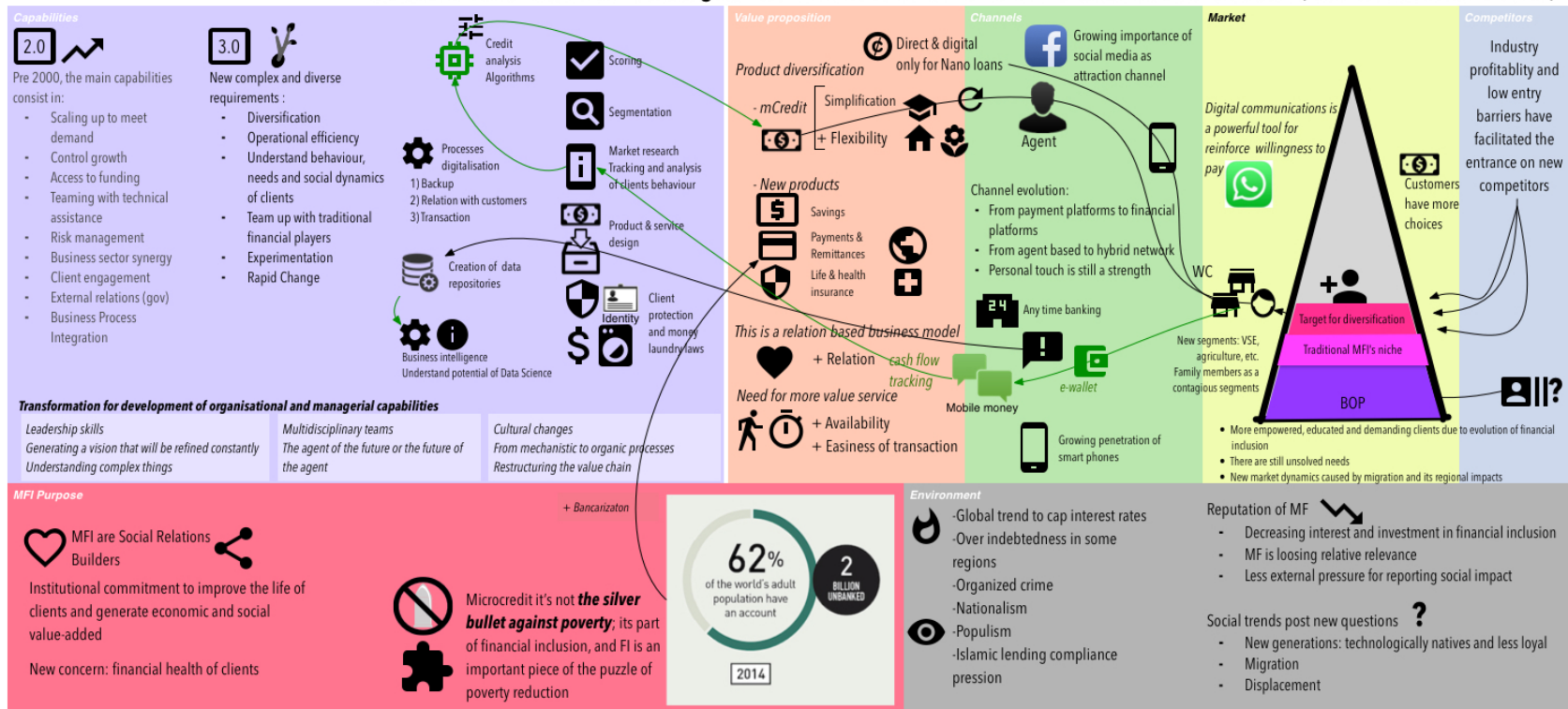


Figure 2. Changes to the MFIs business model

Restructuring the value chain. Participants agreed that in the past, when you looked at the big companies and how they were built (e.g., retailers), the objective was to build an integrated value chain. However, the analysis led the group to believe that the new business models will be more about collaboration, such as with fintechs, and about adding pieces to the value chain. The process, they predicted, is going to be gradual, and it is going to be a mix of digital and human contact, alliances and collaboration. Thus, successful business models will be those that are able to put together pieces from traditional MFIs, fintechs, and other kinds of players. These new models will require building trusting relationships and new modes of contracting.

From mechanistic to organic processes. In another significant challenge, MFIs will need to go “backwards” in the natural evolution of processes. This means making choices based on figuring out which parts of the organization will be required to change rigid mechanistic processes—that were efficient in the past—to more organic, flexible and less structured processes that will allow them to deal with uncertainty, adapt, and learn fast to deliver new and improved solutions for the customer.

The agent of the future or the future of the agent. The core asset of the MFIs, the agent, will be required to change. Technological and social changes will drive deep changes in the agent’s roles, skills and knowledge. The participants visualized the agents as supported by technologies and processes that will allow him or her to add value in new ways to assure that closeness to customer—understanding customer’s problems, needs, and assessing risk—and relationship with the community is not lost but enhanced.

Cultural changes. Transformations that require behavioral and cultural changes will be more challenging. For example, for many years MFIs have trained their agents to follow a process in order to support their operational capabilities. However, understanding the new world, innovating and becoming more entrepreneurial will require more analytical skills, critical thinking and fact based decision making, a huge organizational transformation challenge. Gentera for example, has set up Finlab, a different organization, to integrate people with the right knowledge, skills and motivations in search for a refined culture for the future.

The Industry and the Mission of the MFIs

With all the changes occurring in the industry, participants explored the question if the mission of the MFIs needed revision. They agreed that while organizations have monetary goals, the real thrust of microfinance has been to build financial organizations that contribute to real economic growth. However, members agreed that seeing the MFI’s as the silver bullet to solve poverty in the world was an unrealistic statement, studies have shown that microfinance is not a sufficient condition to reduce poverty. Still, MFIs are a necessary element of the ecosystem for the development of the BoP population. These shortcomings might be a reason why the industry has lost support from strong champions (i.e. Gates Foundation, USAID). Today, more interest is shown in those initiatives that have more of an ecosystem perspective and on *impact investment*.

Consequently, some members argued for a Mission stretch of the MFIs by going further and providing the BoP non-financial services and helping them develop. Members agreed on the importance of taking an ecosystem perspective and working along other institutions and the government in order to reach the MFIs mission. Also, Accion posed a stretch as to the desired resulting behavior and condition of customers by supporting them to achieve financial health (balancing income and expenses, building reserves, planning, and using a range of financial tools).

INDUSTRY RECONFIGURATION

One of the main objectives of the Annual Conference was to explore the future of Financial Inclusion. In the first two days, the discussions focused on how changes in the external environment are impacting the MFIs, how the MFIs are evolving in the different elements of their business model, and explored the capabilities required for the future. Thus, the discussion was set for the third day. MFN members wanted to have direct contact with some of the new innovative players in the market. Therefore, in a first for the MFN, new relevant players were invited to the third day of the Yearly Meeting: First, Nick Hughes, CEO of M-Kopa delivered the keynote speech. Then, Jorge Rubio from Citibank shared his experiences on how multinational consumer goods retailers are doing financial inclusion. Finally, a group of Fintechs CEOs presented their business models. An energetic, collaborative discussion ensued among MFI CEOs and Fintechs CEOs, exploring the way these two worlds will connect.

The first observation is that the Financial Inclusion industry is opening dramatically and the industry boundaries have disappeared. Whereas in the 2000s microfinance was the realm of the MFIs, now the industry barriers are erasing with multiple categories of players participating and vying for the same customer. Figure 3 illustrates how these categories intersect to reach the traditional customers of the MFN.

The general idea of the diagram is that the BOP services ecosystem is being repopulated rapidly. On one hand, MFIs are no longer the only financial provider to the market segment, both, traditional banks and B2C fintechs, are targeting the same market. For the former (traditional banks), the lack of growth in natural markets has made them identify opportunities in previously considered unattractive segments; for the latter (B2C Fintechs), their new business models demand accelerated growth under the promise low-cost coverage.

In a second category, we see the incipient but threatening convergence of non-financial services providers. International consumer products companies, who have always sought the largest scale, scope and market penetration, are looking to increase their capillarity and closeness to their customers by creating new ways of distribution and relationship at the base of the pyramid. In such initiatives, credit is just one of the value proposition elements. The high frequency of consumption of many of the products they provide justifies commercial models of continuous contact, so the use of technologies for monitoring and analysis is of enormous information volume. A third group, discussed in depth during previous MFN meetings, is based on new transaction and payment platforms based on TIC. Typically, these business models are the product of the synergy between entrepreneurs and large telecommunications companies, who have experienced great penetration at the BOP. The exponential penetration of smartphones facilitates the entry of new financial services offerings.

The fourth group is composed of entrepreneurial initiatives focused on solving different problems in the BOP. These initiatives are based on the identification basic problems (energy, health services, food, education, etc.), which require different solutions from those employed in the upper segment markets. Their fundamental distinctiveness consists in their integrality (taking care of the different elements of each problem) and evolutionary (improving their functionality quickly) character. Again, financial services are an important element in these integral solutions. To the extent that problems of first necessity are solved, these solutions become powerful relationship platforms on which companies can deliver their offer portfolio. Finally, there is a very wide group of B2B Fintechs, whose offer is not only oriented to the end customer but to the different types of companies (MFIs, traditional banking, consumer companies, transaction channels, etc.). The ecosystem of Fintechs has populated the whole value chain of the industry with a complete set of solutions, products and functions. While many are entrepreneurial ventures in their early stages, others have scaled and matured to millions of customers and have become profitable. For example, Alibaba has developed a large-scale support platform for all kinds of businesses.

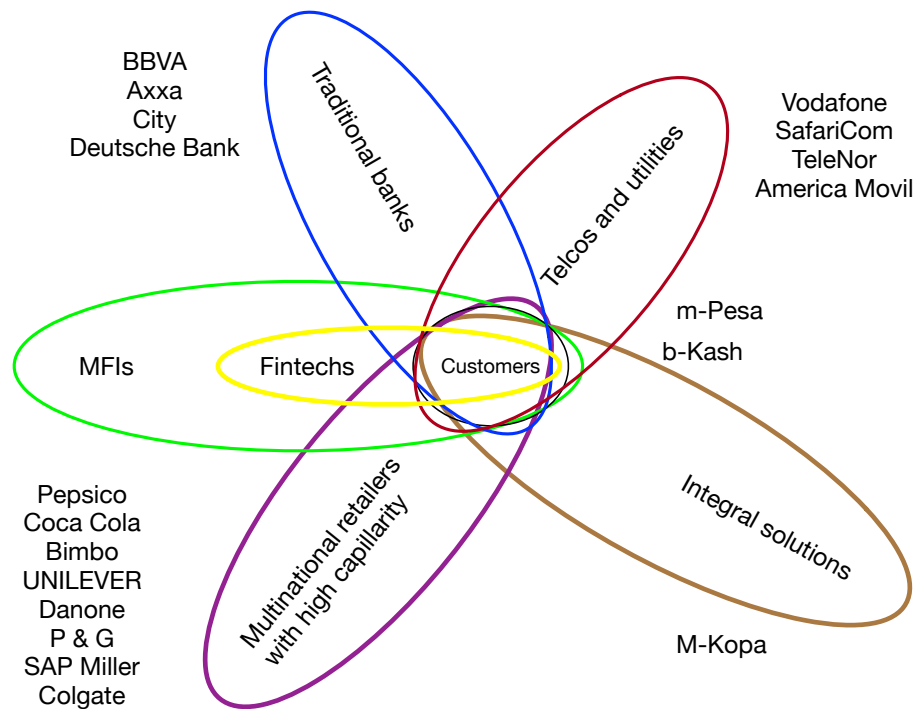


Figure 3. Intersection of financial inclusion categories of players

Keynote speech: Nick Hughes from M-Kopa

The keynote speaker was a pioneer at Vodafone’s m-Pesa, the innovator in peer-to-peer digital remittances and payment system for the BoP and co-founder of M-Kopa, a Kenyan solar energy company. M-Kopa was launched commercially in 2012 and currently has connected over 500,000 homes in East Africa to solar power. The company sells home solar systems in Kenya and Tanzania to off-grid customers who pay a deposit, take the system home, and then pay a daily fee through M-Pesa for a year to own the solar system. In addition to getting solar power, customers also slowly offset the cost of the device by saving on the use of kerosene lamps and reducing phone charging costs. Nick described his entrepreneurial process with M-Kopa:

After M-Pesa's experience, Nick, with the certainty that the model would experience rapid commoditization, focused his energy on a different question: what real and relevant problem could be solved at the BoP? He identified the immense need for clean energy. In Kenya, there are more than six million people using kerosene as a source of energy, spending on average 50 cents per day.

The technological alternative was a small solar generator whose cost per kw is lower than kerosene and the device would be purchased in installments. The business model largely depended on the ability to attract and convince users to adopt this new solution. Thus, the first business problem involved technical

and distribution issues: small-scale solar power generation and the development of a deep capillarity marketing network with an important educational component.

After the client's adoption stage, the business model continued in an incremental problem-solving cycle. Lowering the cost of energy released money for other needs, such as entertainment. On the other hand, the client has adopted the hardware-as-a-service model. This allows equipment up-scaling via refinancing to cover new energy needs (phone charging), and the acquisition of consumer goods (TV sets). Thus, the solution of a problem leads to the identification of a new one and such evolution allows incremental business with strong social impact. In a third stage, this same asset acquisition platform can be used for services such as Internet access. Providing such access allows M-Kopa data collection at an unparalleled scale at the base of the pyramid.

M-Kopa's experience presents several reflections³:

- First, it is a model built from the understanding and is focused on solving customer relevant problems. This customer centrality is intentional and methodological, as it entails strong learning and experimentation skills.
- Second, the client's condition improves as his/her problems are solved, and such development releases resources that can be used for new needs. It can be said that the model is a clear example of technological and financial inclusion.
- Third, establishing a frequent business relationship (hardware-as-a-service base) creates a business platform in which credit is part of the value proposition but not is core offering. The economics of the model allow competitive rates to the extent that there is an incremental margin, both in the commercialization of goods and services.
- Fourth, physical and primary needs (electricity) serve as a bridge to other necessities (internet access). This keeps the organization in a permanent state of entrepreneurial problem solving.
- Fifth, transaction digitization becomes a powerful method of capturing customer behavior information, which in turn would allow the identification of new problems to be solved.

Jorge Rubio: Financial Inclusion in large multinational consumer goods value chains

Jorge Rubio is a founding member of the Citi's Global Inclusive Finance Group based in London, UK, which was created in 2005 to spearhead the group's commercial efforts to support social and financial inclusion around the world. The group is responsible for Citi's financial inclusion strategy and to develop partnerships with clients across Citi's businesses in over 40 countries.

In the seminal article of "Value at the Bottom of the Pyramid", Prahalad and Hart anticipated that, as their traditional markets stagnated, corporate firms would look towards the lower segments of the socio-demographic pyramid. The authors thought that the difficulties of access, information and credit would be the main strategic challenges for these companies.

Jorge Rubio's trajectory in corporate banking has allowed him to observe this same picture, the renewed and growing interest of multinational companies in emerging market segments. He categorized such corporations into three groups:

Telecommunication companies. As a result of their great penetration in these segments they are interested in making telecommunications profitable by providing services of greater margin and

³ As a separate note, for those interested in this integral solution approach, learning about the work of Bunker Roy and the Barefoot College can be extremely insightful. https://www.ted.com/talks/bunker_roy

added value. Typically, they offer transaction platforms and credit to their mobile prepaid customers. Some of these companies have sought some kind of acquisition or association with financial entities - traditional or MFI - although others have penetrated directly to the market. An important trend, which strengthens their entrance into financial services, is the replacement of traditional mobile phones by smartphones. Some of the companies are SafariCom, TeleNor, and America Movil.

Consumer products companies. The focus of these companies is dual, as they pursue increased profitability upstream and downstream of their value chains. While the rationale is to increase performance in their traditional business, they are seeking to boost their presence through financial solutions that allow them to develop and certify alternative suppliers, ensure the quality and continuity of supply of key raw materials, increase the penetration of their products, strengthen their relationship with traditional BOP channels, and capture customer behavior in these segments. They lean on their financial leverage with corporate banking, although they have also tightened ties with some MFIs. Some of these companies are UNILEVER, Starbucks, Bimbo, Danone, P & G, SAP Miller, Colgate.

Traditional financial firms. Banks and insurance companies are attracted by the development of the BOP. Jorge pointed out three reasons for this attraction: the increased size of the segment; the cross-selling opportunity derived from financial inclusion and the potential of their own FinTech initiatives that with lower cost of access would allow them to reach the segment. Thus, the dreaded interest of the great financial actors has begun to become a reality, materializing in alliances, acquisitions, joint ventures or Finlabs. Among others are Axxa, City, BBVA, and Deutsche Bank.

Such convergence of actors shows how the ecosystem of financial inclusion is changing rapidly, after decades of steady MFIs dominance. The diversity of business goals, platforms, resources and technologies suggests the need for new strategies, hybrid business models and the interoperability of financial institutions.

This reconfiguration brings new considerations on the role, active or passive, that different institutions will assume. Since the capacity for influence will depend on factors such as the commitment of economic resources, the ability to test and choose different technologies, the linkage with other entities and the institutional orientation.

A more integrated and digital ecosystem also pledges to remedy one of BoP's large gaps, lack of information. Unlike other segments, where customer behavior can be tracked, captured, analyzed, and forecasted, there is a lack of transactional traceability in the BOP. The MFIs have reached a high level of knowledge about the clients. However, the explosion of social networks, the internet and digitization is allowing new players to capture an exponential volume of customer behavior and trading information.

Fintechs: Competitors or Complementors

In exploring the future of financial inclusion, MFN members asked themselves which kind of organization will reach more people, with more and better products, faster and more efficiently: Revamped traditional MFIs, Fintechs, or organizations that combine the assets and capabilities of each.

On one hand the MFIs have been building an infrastructure for financial inclusion. For the past twenty-five years, they have accumulated a wealth of knowledge working with people from the BoP, and have built invisible assets—one on one relationships with customers, their communities and regulators. However, strong held beliefs, negative incentives, decision-making rules, risk aversion, and strong cultures pose a huge transformation challenge for them. On the other hand, innovations by Fintechs have the potential to reach the same market via leading edge technologies and solutions, agile processes, adaptable structures, an experimental attitude, and failing fast and iterating. However, Fintechs' frequent

hypothesis is that theirs is the best new solution and that a mostly digital organization, on its own, with very limited face-to-face interaction with customers, can deliver a differentiated value proposition and win the market. Thus, with these contrasting business models as context, the Fintechs CEOs that were invited, shared with the rest of the group the characteristics of their business model, the stage of development they were in, the challenges they are facing, and how they see their relationship with traditional MFIs.



Figure 4. Fintech Venture Funding

Fintechs participants suggested that MFIs could lever their own capabilities with Fintech solutions. However, in their experience engaging the MFIs, they find that the MFIs want to own everything needed by the organization. Therefore, they suggest that MFIs will need to adjust their mindset in order to capture these opportunities. There was consensus among participants that, in order to continue scaling and attain significant cost efficiencies, MFIs need to incorporate the power of digital technologies. However, MFIs and Fintechs would need to share assets and expertise—data in exchange for technology—such as payment and transactional information, to uncap the value of digital. By analyzing the changes brought about by the Fintechs we are not only looking at the competitive environment (competitors) but also to the significant changes to the operating environment (complementors). The following is a brief description of Fintechs that participated in the Annual Conference:

Aplazame is a consumer credit company that offers a payment system that can be used by online buyers to receive funding for their purchases. Aplazame aims to simplify financing and offer more flexible payment options through a simple, safe and fast platform.

Enclude is a specialist intermediary in “impact” or “inclusive” investing, mobilizing capital from a broad range of investors to financial investment vehicles and companies that address underserved markets around the world.

First Access aims to turn data into financial opportunity. First Access offers a customizable credit-scoring platform for lending institutions in emerging markets to credit score anyone.

FriendlyScore's goal is to give more people access to financial products by using variables from existing online social profiles to generate a more holistic view of creditworthiness.

MicroEnsure is dedicated to creating, distributing and operating products that help uninsured people in emerging markets to mitigate the risks they face each day. MicroEnsure offers innovative insurance products and services aimed at low- and middle-income individuals covering a range of risks related to health, assets, accidents and political violence.

Oradian aims to empower the delivery of financial services to the underserved and unbanked by providing a cloud based core microfinance system and platform to MFIs in developing markets. Instafin - Oradian's flagship product - aims to remove complexity, empower users and enable growth.

Oval Money. Oval's mission is to create a simple financial solution for the new generation of independents, with flexible income, variable expenses and limited access to financial products. Oval for savers is a new, transparent marketplace for alternative financial products.

Village Capital. Village capital aims to build communities of entrepreneurs solving specific social problems – from energy efficiency to the health-wealth gap. They invest in entrepreneurs through a peer-selected model to provide capital for growth and success.

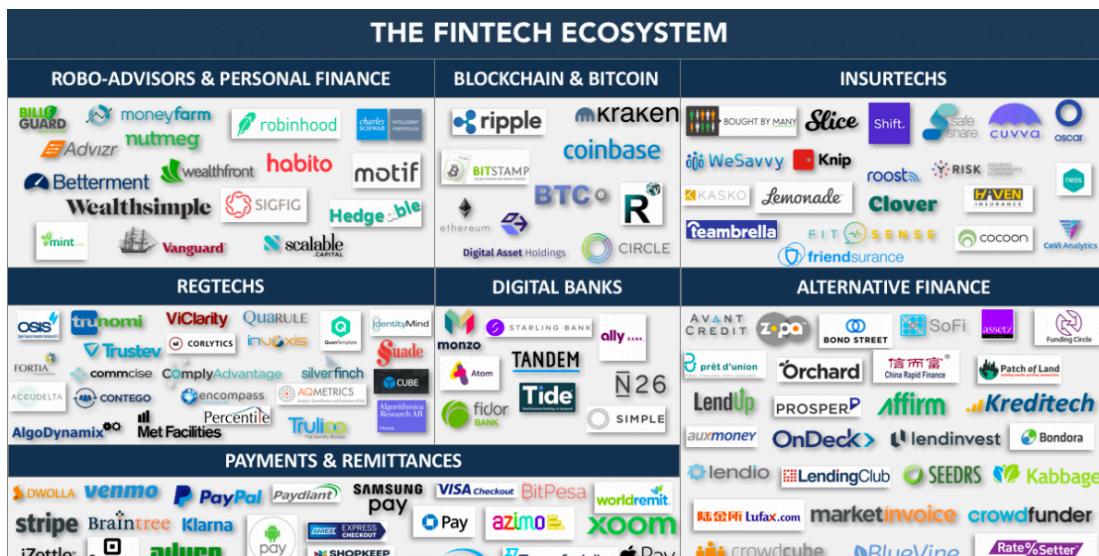


Figure 5. The Fintech ecosystem

CONCLUSIONS: A LEADERSHIP CHALLENGE

The annual meeting provided the participating CEOs with a vast number of insights into the current state and trends of financial inclusion. We have developed a better understanding of the most relevant changes in the external environment, the customers, the distribution channels, the impact on the organizational capabilities, and we reflected on the scope of the mission of the MFIs. The analysis demonstrates the complexity and uncertainty of the external environment and how the financial inclusion ecosystem is being reconfigured. Understanding that the successful MFIs will be significantly different in the future and that getting there will require transformational changes, leads us to a fundamental conclusion: the MFIs will face a leadership challenge. Based on the different contexts of each MFI, the speed rate for this change will vary significantly among them. Whereas some MFIs are in countries exposed to more competition, availability of technological infrastructure, and lower entry barriers, other MFIs are in countries where their context has contrasting traits that make them more isolated. Consequently, there was significant variance among participants as to the degree of urgency about embarking on transformational initiatives. We see three types of transformational challenges: intrapersonal, business/organization and ecosystem.

First, a sound strategy cannot be developed without a profound understanding of the relevant environment. In an environment that is dynamic, evolutionary and revolutionary, complex and uncertain, leaders face the challenge of gathering deep information, interpreting that information, and then setting direction. In a dynamic industry, this cycle must be permanent. These radical changes challenge the beliefs and personal theories of senior management about what works in the industry. Therefore, at its core, this first type of transformation is intrapersonal, without which—the dissatisfaction with the status quo—organizational transformation cannot occur. This transformation requires profound changes in mindset: from managing a professional, established, standardized institution to including a learning, innovative, entrepreneurial mindset. With uncertainty not all solutions will work, therefore, leaders will also need to develop tolerance to ambiguity and frustration so they can try, fail, and try again.

The second type of transformational challenge is at the organizational level. It involves leading the efforts to rethink the business model, identifying the new sources of differentiation, and then realigning the strategy with structures, processes, technologies and people. These changes are not a mere reshuffling of people and structures or creating new departments; on the contrary, they will entail new levels of organizational integration that require creating new structures and processes that facilitate higher collaboration and horizontal coordination of key multidisciplinary projects. With the level of uncertainty about technology, building a flexible organization and with a certain degree of slack will be critical. Furthermore, this type of transformation will require cultural changes, without which it will be almost impossible to build the new organization, as Peter Drucker once said: “culture eats strategy for lunch”.

Finally, the third type of transformational leadership will be inter-organizational. Given all the types of organizations that now reach the BoP, leaders will have to decide on how to insert the MFI in the emerging ecosystem. It will involve making the strategic decisions about what role they will play and how they will deliver value. Additionally, decisions as to how will MFIs be more effective, either by continuing to operate as integrated end to end players or by transforming and establishing different kind of relationships in the value chain, including coordinating different business models. Furthermore, the sessions highlighted profound questions as to the scope of the MFIs, where it might need to be expanded to address problems at the BoP with integral solutions. With the new ecosystem, new stakeholders are appearing and new relationships might need to be built: chambers, academic institutions, capital providers and innovation hotspots are a few of them.

MFN's transformational role

In 1993 the MFN was founded to help MFI members understand, in a collaborative context, the reasons and implications of transformation. At that time, we were referring to, through communication and collaboration, the transformation of its members into profitable, sustainable, commercial, financial institutions to serve those excluded from the financial system. The MFN members have accomplished that mission. Fast forward to the present and in this new changing environment, MFN members will face a second kind of transformation: the revolution of the financial inclusion ecosystem. The MFN seems to be a privileged space for dialogue and learning, insofar as it can congregate the main actors of this transformation, and maintain a climate of trust, dialogue and collaboration between the leaders of such institutions.

Reflections on the dynamic of the MFN sessions

In the closing session of the Yearly Meeting, members expressed their satisfaction as to how the MFN is in transition by embracing the challenges of the industry. Other members were impressed by how the group has renewed its learning dynamic, has shown how it is a peer support group, and has developed real camaraderie among members. Through the discussion, members renewed their commitment to improve the lives of the people at the BoP and to maintain its character as a social builder. Members feel that the Yearly Meeting has been a huge turning point for the Network as compared to the analogy, posed in the Yearly Meeting held in Alexandria, comparing the MFIs to “the walking dead”. The MFN has turned around the in-depth nature of the content, has improved each year the quality of the discussions, and has achieved strong engagement in the group. The MFN has been a fertile ground to develop and dive into the deep questions surrounding the mission of the MFIs, therefore, the members are already looking forward to the next Yearly Meeting to tackle their leadership challenges.