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Inclusive finance,

an essential channel for generating impact with sustainable finance

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For 30 years, ADA's development work in Africa, Latin America and Asia has focused on enabling vulnerable populations to improve their living conditions thanks to financial services that meet their needs.

While ADA's original focus was on supporting microfinance institutions, it now aims to contribute to the broader development of inclusive finance in a rapidly changing financial sector.

On the one hand, the microcredit projects run a few decades ago by NGOs with a main focus on women's groups have given way to diverse, professional and autonomous financial institutions capable of serving various segments of the local market, from smallholder farmers in rural areas to small and medium-sized businesses in urban areas.

On the other hand, at a time of financial crisis, climate emergency and growing socio-economic inequality worldwide, there is growing pressure for the traditional financial sector to move towards greater responsibility and sustainability.

Against this backdrop, ADA believes that inclusive finance is a segment of the financial sector in its own right. As such, it can be a particularly relevant tool for sustainable investment and for generating impact.

To better understand this idea, we need to take a look at the origins to redefine the concepts.

It started with responsible finance: excluding and minimising negative impacts

The origins of responsible finance go back several centuries, with certain religious movements defining the principles of ethical investment, which consist of avoiding investing in morally reprehensible sectors such as alcohol, tobacco or gambling. From the outset, responsible finance was therefore defined by **exclusion** criteria.

This trend gained significant momentum in the era of the anti-war and civil rights movements from the 1960s onwards, when investors shunned companies involved in the arms industry and disinvested massively from companies operating in South Africa in reaction to apartheid.

Several decades later, the creation of the Domini 400 Social Index in 1990 institutionalised the practice on a larger scale. This was the first stock market index to be based on exclusion criteria in terms of a company's environmental, social and governance performance – the familiar **ESG criteria,** not yet known by that name.

It was not until the 2000s that the ESG terminology became established with the publication of the "Who Cares Wins" report in 2004 by the UN with the support of the financial industry, which called for the consideration of ESG criteria in investment decisions, and the launch of the Principles for Responsible Investment (PRI) by the UN in 2006 to provide practical guidance to investors.

Initially, the integration of ESG criteria mainly consisted of analysing how these non-financial factors could have **negative consequences** financially, in particular on returns, but also on non-financially, notably on the social ("people") or environmental ("planet") aspects.

From responsible finance to impact finance: targeting a positive impact

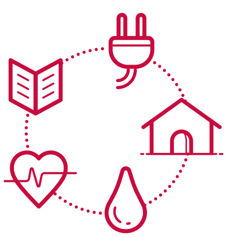
However, the need to go beyond minimising the risks of negative impact to aim more proactively for **positive non-financial impacts** is rapidly emerging. The concept of impact finance arose in 2007 at a Rockefeller Foundation conference, with the first use of the term “impact investing”, which was then taken up and formalised by the Global Impact Investing Network (GIIN) created in 2009.

GIIN defines impact investment in terms of the following four aspects:

1. **intentionality** to generate positive social and/or environmental impacts;
2. the **financial return on investment** (donations or subsidies are not impact investments);
3. a **return on investment range from below the market rate to** a risk-adjusted **market rate;**
4. **impact measurement** and reporting in the interest of transparency.

In the past, the sector used the term “social impact” to describe the non-financial impact of an investment, whether on people, communities or the environment. However, global awareness of the climate crisis and - more recently - the biodiversity crisis, has made the environmental aspect a priority. This awareness has contributed to the emergence and growth of **green finance,** a segment of impact finance that aims to generate positive environmental impact. **Climate finance** aims to adapt to and/or mitigate climate change. When the preservation of biodiversity, terrestrial or marine ecosystems is targeted, this can be called **biodiversity finance, nature finance** or **blue finance.** As all these impacts constitute different types of environmental impact, they are always sub-segments of green finance.

The **social** aspect has thus taken second place. Yet, in the past, impact finance was mainly social: a 2010 GIIN publication[1] on the potential of impact investment as a new asset class identified microfinance as one of the most developed impact investment sectors with the most opportunities at the time. One of the very first studies on impact investment carried out in the same year among 62 European impact finance institutions[2] confirmed that microfinance was indeed the leading impact investment theme, with more than 50% of funds under management dedicated to this sector.



Indeed, by promoting access to financial services for the most disadvantaged populations (“bottom of the pyramid”), microfinance aims to reduce socio-economic inequalities and improve the living conditions of these populations by enabling them to manage an income-generating activity. Investing in microfinance therefore means aiming for a positive social impact.

In addition to microfinance, affordable housing, access to water, education and health are identified in these publications as impact investment segments with a social impact.

1 JPMorgan Chase & Co., The Rockefeller Foundation and Global Impact Investing Network, Inc, 2010. Impact investments: *An emerging asset class.*
2 AlphaMundi Group for Impact Financing Luxembourg, 2010, *Impact Finance Survey 2010.*

Sustainable finance: an evolving concept that now includes responsible finance and impact finance

The various crises that have shaken the world in recent years, from the 2008 financial crisis to the climate crisis, from growing socio-economic inequalities to geopolitical tensions, show that these recent developments have had only marginal consequences. At a time when there is a growing perception of the risk of "green washing" or "impact washing", the pressure on the financial sector remains considerable, leading regulators to take up the issue. A case in point is the European Union's sustainable finance plan as part of its Green Deal, comprising a number of regulations that define what the EU now considers to be **sustainable finance.**

In short, European legislation, in particular SFDR (Sustainable Finance Disclosure Regulation), defines several levels of sustainability in finance:

"Grey" finance

or funds covered by Article 6 of the regulation, do not declare specific sustainability objectives but must disclose the way in which sustainability-related risks are taken into account in investment decisions. Put simply, this is **traditional finance** for which a minimum consideration of non-financial risks is now required.

"Light green" finance

or funds covered by Article 8 of the regulations, promote the social and environmental characteristics of their investments without making them their main objectives and must disclose these characteristics and the way in which the potential negative impacts of the investments are measured. In simple terms, this segment can be considered to correspond to **responsible finance** or **ESG finance** as described above.

"Dark green" finance

or funds covered by Article 9 of the regulations, declare specific social and/or environmental sustainability objectives and must disclose how they are measured, the progress made towards achieving these objectives and how the potential negative impacts of investments are measured. For simplicity's sake, this segment is supposed to correspond to **impact finance** as described above, even though recent studies show that it is not the case yet.[3]

European rules therefore indirectly define the scope of sustainable finance, which includes both responsible finance and impact finance, representing increasing levels of sustainability.

While the use of the term "green" can be confusing, particularly as the rules currently only contain a taxonomy of activities considered to be environmentally sustainable, the notion of sustainability defined by these rules does correspond to the concept of sustainable development and therefore incorporates both social and environmental aspects.

The European Union is not the only organisation that stives to better define and frame what is meant by sustainable finance: the Global Responsible Investment study 2022 published by GSIA (Global Sustainable Investment Alliance)[4] reveals that the sector is maturing in many countries, resulting in stricter definitions and labelling of what can be considered sustainable investment, whether in the United States, Canada, Australia or New Zealand.

This trend towards standardisation and regulation reflects the desire to accelerate the shift of financial flows towards a sustainable economy on a larger scale.

3 Scheitza L., Busch T., 2024. SFDR Article 9: Is it all about impact?, Finance Research Letters, Volume 62, Part A, 105179, ISSN 1544-6123, https://doi.org/10.1016/j.frl.2024.105179.
4 GSIA, 2022, Global Sustainable Investment Review 2022.

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However, in a context in which the issues and their consequences are global and affect all levels of society - particularly the most vulnerable - limiting financial flows to developed countries and large companies seems difficult to reconcile with the concept of sustainable finance.

While the markets of developing countries have long been - and may still seem - risky, the financial sectors of these countries have also evolved, especially when it comes to serving segments of the population that traditionally face constraints in accessing financial services, be they individuals or small enterprises. As mentioned above, community microcredit has given way to inclusive finance, i.e. a panoply of financial services tailored to the needs of these diverse customer segments. The services are offered by financial institutions that are just as diverse, ranging from savings and credit cooperatives to banks, FinTechs, InsurTechs or companies offering credit, leasing or advance payments.

Nowadays, thanks to this diversity of services, providers and customers, inclusive finance contributes to much more than financial inclusion and reducing inequalities. For example, by financing various stakeholders in the agricultural sector, household sanitation facilities and school fees or small businesses providing products and services to communities, inclusive finance contributes to a number of sustainable development goals, including food security (SDG 2), access to water (SDG 6), health (SDG 3), education (SDG 4) and employment and growth (SDG 8), to name but a few.

Lastly, in addition to the professionalisation of the sector and its potential for positive social impact, its development included the integration of a “triple bottom line”, i.e. taking account of the risks and opportunities represented by climate and environmental issues. As these issues particularly affect developing countries and their populations, the inclusive finance sector is increasingly taking them into account by offering a range of financial services that enable households and small businesses to adapt to climate change and/or contribute to the ecological transition.

The inclusive finance sector is becoming a prime channel for sustainable finance: by channelling financial flows through inclusive finance organisations in developing countries, it is possible to generate a positive environmental and social impact and contribute to sustainable development goals.

Nevertheless, in order to generate significant impact, financial flows must be substantial. Only then will there be an additional incentive for inclusive finance players to direct their own financing flows towards the most sustainable activities on a massive scale.

To facilitate this channelling of financial flows at all these levels, ADA now intends to play a pivotal role in the development and growth of inclusive finance, especially of green inclusive finance. Drawing on its extensive experience in supporting the microfinance sector in its move towards inclusive finance, and its increasingly close relationships with impact investors, ADA is in a unique position to help make inclusive finance a key channel for sustainable finance.

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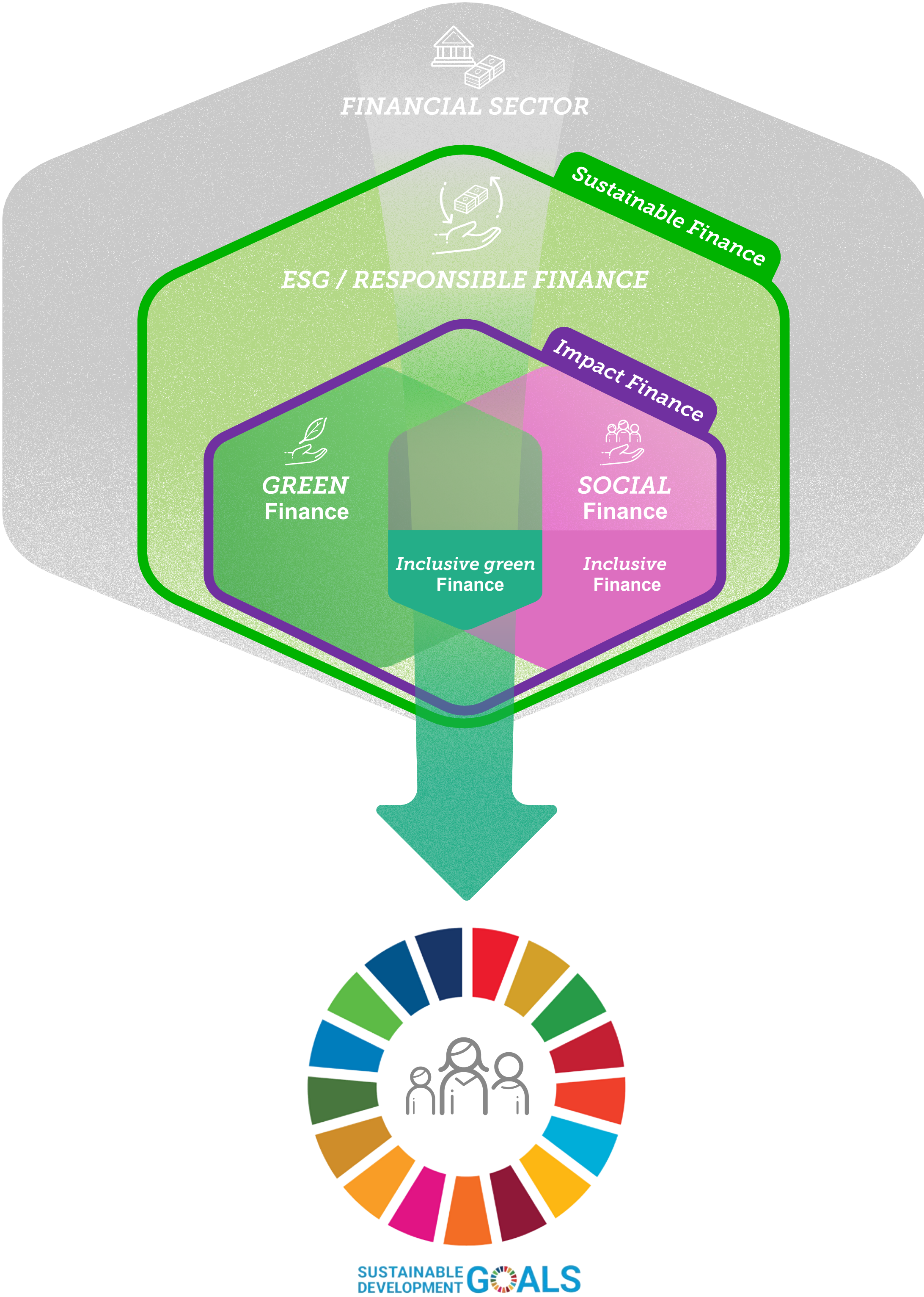

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