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Financing the Frontier: Inclusive Financial Sector Development in Fragility-Affected States in Africa

REDUCING POVERTY
THROUGH FINANCIAL SECTOR DEVELOPMENT





Key points

01

Poverty and financial implications of fragility

Poverty rates in sub-Saharan Africa's 26 fragile states are, on average, 20% higher than countries with comparable levels of economic development. The gap is widest for countries affected by repeated cycles of violence. Access to finance plays a crucial role in poverty and conflict cycles, as lack of equitable access to financial services can lead to underdevelopment and stagnation, exacerbating social and economic unrest.

02

Link between fragility and displacement

SSA has the world's highest refugee and internally displaced population – over 19 million people in 2016 – and the numbers are rising due to new and ongoing crisis in the Central African Republic, Nigeria, South Sudan, and Burundi. In SSA, financial market imperfections – i.e. informational asymmetries, high transaction costs – can be a source of fragility, especially for poorer populations.

03

Differences and opportunities in FASA

Financial systems in FASA are shallow, especially in terms of credit depth and supporting functions for consumer and industry voice, and significantly lag behind the rest of Africa. They often face high levels of market distortion and mismatched incentives from donors and humanitarian interventions. In FASA, 80% of the population is financially excluded in Cameroon, Chad, DRC, Sierra Leone, and Sudan and over 90% in Burundi and Niger.

04

Lower levels of risk tolerance and trust

FASA have lower rates of formal salaried employment (on average 12%) equating to high informality and income insecurity, which effects household consumption and production decisions. This results in a need for a wide-range of financial services to build assets, manage risks, and smooth consumption. In fragile situations, individuals become more risk averse and invest less and private sector actors can find it difficult to find entry points.

05

Scale digital payment and remittances infrastructure

There are over 30 million African adults living outside their country of birth sending home over US\$40 billion in remittances, resulting in the largest aggregate flow to fragile states. These amounts will only increase with rising migration and forced cross-border displacement in FASA. There is an increased need and opportunity for remittances and diaspora investments to utilize remittances as financial strategies to increase savings and diversify risk.

06

Recognise and expand on promising trends

There are promising practices in FASA for donors and development actors in partnership with private sector actors. This includes the need and opportunity for increasing finance options for refugees and internally displaced populations, increase the range of Islamic finance providers and products in the market, support inclusive insurance, and increased use of liquidity facilities and partial credit guarantees.

07

Market system solutions are still relevant

While each FASA situation is unique and complex, using a market systems approach is an opportunity for donors and development actors to adjust tactics but adhere to several key principles: think long-term, do not ignore the informal sector, ensure a positive business case, carefully sequence interventions, and utilize a diverse package of smart aid instruments.

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Abbreviations

AfDB	African Development Bank
CAR	Central African Republic
DCED	Donor Committee for Economic Development
DFID	Department for International Development (U.K.)
DFS	Digital Financial Services
DRC	Democratic Republic of the Congo
FASA	Fragility-Affected States in Africa
FCAS	Fragile and Conflict-Affected States
FDI	Foreign Direct Investment
FSDA	Financial Sector Deepening Africa
FSP	Financial Service Provider
GDP	Gross Domestic Product
GIIN	Global Investment Impact Network
IDP	Internally Displaced Persons
KNOMAD	Global Knowledge Partnership on Migration and Development
ICAI	Independent Commission on Aid Impact (U.K.)
IDP	Internally Displaced Person
ILO	International Labour Organisation
KYC	Know Your Customer
M4P	Making Markets Work for the Poor
MDG	Millennium Development Goals (United Nations)
MFI	Microfinance Institution
MFW4A	Making Finance Work For Africa
MNO	Mobile Network Operator
MRM	Monitoring and Results Management
MSD	Market Systems Development
ODA	Overseas Development Assistance (World Bank)
ODI	Overseas Development Institute
OECD	Organisation for Economic Co-operation and Development
PSD	Private Sector Development
SDG	Sustainable Development Goals (United Nations)
SSA	Sub-Saharan Africa
USAID	U.S. Agency for International Development
WEF	World Economic Forum

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This Think Piece was researched and written by Thea Anderson and Diane Johnson.

Thea Anderson
Director, Financial Inclusion
Mercy Corps
tanderson@mercy Corps.org

Diane Johnson
Independent Consultant
diane@diagonal.biz

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Executive summary

‘Fragility is not a category of states, but a risk inherent in the development process itself’
 – President Ellen Johnson Sirleaf of Liberia

This think piece is a response to the recognition that inclusive financial market development in sub-Saharan Africa (SSA) faces new challenges. It argues that there is a triple justification for an increased focus on fragility-affected states in Africa (FASA). First, poverty is reducing, but the concentration of extreme poverty in fragile states is likely to increase. As SSA grows, there is a moral imperative to ensure the benefits are shared, and that no one is left behind. Second, levels of financial sector under-development in FASA are distinctly lower than non-fragile counterparts in SSA. If we believe that access to financial services and capital play a key role in poverty reduction, then this inequality must be addressed. Last, in spite of bright spots – many of which are highlighted in this paper – the response of the donor community of financial market shapers to the challenge of FASA programming has been relatively sluggish.

The theory of change that remains most powerful for supporting inclusive financial sector development is that effective access to financial services and catalytic investments will help people make their way out of poverty, or at least maintain incomes in times of crisis or economic shock by facilitating economic growth

and stability. Financial sector development in FASA can:

- 1) Reduce transaction costs
- 2) Build capital markets to facilitate capital accumulation and more productive investments
- 3) Encourage the development of entrepreneurship and business growth
- 4) Provide options for mitigating risk and responding to shocks and stresses
- 5) Contribute to overall stability-building measures

While there is no set definition for fragility, there are a number of generally accepted features. There is broad agreement that fragile states are characterised by poor governance, weak capacity and institutions, high risk of conflict and insecurity, disputed legitimacy and poverty (World Bank, 2009). As detailed by the OECD, there is no single categorisation that captures the diverse aspects of risk and vulnerability fragility is ‘an issue of universal character that can affect all countries, not only those traditionally considered “fragile” or conflict-affected’ (OECD, 2015).



Image: Liberia / S. Sheridan – Mercy Corps © 2014

This think piece is rooted in the market system or ‘M4P’ approach, which hinges on facilitation rather than direct implementation. As such, this approach represents a radical shift in how donors envision, and how development actors interact with, financial systems. Although the theoretical frameworks for this approach are well developed, there is a comparative lack of detailed analysis regarding application in the financial sector and in FASA. A market system approach conceptualises market systems as a core function of both supply-demand and the supporting functions and rules which underpin the core transaction.

The root causes of the lack of pro-poor development of financial systems are highly specific to both the target sector (i.e. inclusive insurance, SME finance, capital investment, etc.) and the specific geographic context and target population (i.e. refugees, African diaspora). To determine specific systemic constraints on developing a target financial system requires a deep diagnostic process consisting of market, political economy and conflict (if applicable) analyses. However, there are common challenges to financial sector development across FASA and market systems (i.e. those that will affect all systems regardless of the specific ‘core’ product or service). Examples of such challenges include: potential high degree of population mobility and/or recurrent humanitarian cycle of needs; weak institutions, public and private, in the formal financial sector including weak capacities and incentives for financial service providers; high prevalence of, and reliance on, informal financial mechanisms; wide-spread infrastructure deficits (particularly transport and communication systems); and

high levels of distortion from humanitarian aid or short-term investments from donors.

This document provides a justification for donor and development actors to invest in the foundations of a functioning financial sector. Specifically, *foundations* require (a) personal identification solutions and (b) fit-for-purpose regulations that encourage and allow inclusion and innovation in the financial sector. This is followed by an outline of seven 1. Market segments: Refugee/IDP finance and Islamic finance promising trends in inclusive financial sector development in FCAS, grouped in three categories:

1. *Market segments*: Refugee/IDP finance and Islamic finance
2. *Financial delivery channels*: Impact investing, and payments and remittances infrastructure
3. *Financial products and instruments*: Inclusive insurance, liquidity funds and credit guarantees, and diaspora investment platforms.

Ultimately, through the think piece the authors provide several principles for success:

- Invest in contextual understanding
- Think long term
- Build on what the industry knows
- Do not ignore the informal sector
- Ensure a positive business case
- Utilise adaptive management processes
- Carefully sequence interventions
- Think creatively about new types of partnerships
- Utilise a diversified package of smart aid instruments

Introduction: why this document?

Purpose and audience

This think piece is a response to the recognition that inclusive financial market development in SSA faces new challenges. It argues that there is a triple justification for an increased focus on FASA. First, poverty is reducing, but the concentration of extreme poverty in fragile states is likely to increase. As SSA grows, there is a moral imperative to ensure the benefits are shared, and that no one is left behind. Second, levels of financial sector under-development in FASA are distinctly lower than non-fragile counterparts in SSA. If we believe that access to financial services and capital play a key role in poverty reduction, then this inequality must be addressed. Last, in spite of bright spots – many of which are highlighted in this paper – the response of the donor community of financial market shapers to the challenge of FASA programming has been relatively sluggish.

This think piece is rooted in the market facilitation approach. This approach focuses on harnessing the power of market systems, including their full range of participants – from suppliers and consumers to rule-makers and support services providers – to deliver benefits for poor men and women on a lasting basis. It seeks to achieve and maintain a careful balance between

public and private sector interests, between the bottom-line and the bottom of the pyramid. To date, this approach has not yet been applied to FASA’s financial markets in full – an important opportunity.

Successful financial market facilitation requires a depth of relationships and market understanding that is typically achieved through country-specific programming. As a result, this think piece cannot prescribe what will work. Instead, it focuses on sets of promising practices that could be applied to particular financial market failures on the ground. It also considers cross-border issues such as remittances and refugees. Critically, it provides insights into the ‘how to’ of financial market development programming in FASA – the tactics and the trade-offs.

Taken together, it is hoped that the findings at least start a conversation among policy-makers and practitioners about the value of increased financial market development programming in FASA. At best, this think piece could help initiate, refine and strengthen efforts to reduce poverty by making financial markets work for the poor, especially in the continent’s most difficult environments.

Methodology

This think piece draws on extensive desk research of over 100 documents from recent literature on the topic; interviews with 35 key stakeholders including donors (multilateral, institutional and private), financial sector networks and think tanks, corporate and private sector actors, development actors, service providers, and financial service providers; the authors’ own experiences; good practices from development actors; and insights from direct participation in the June 2016 conference, ‘Financial Sector Development in African States Facing Fragile Situations’.¹

“Successful financial market facilitation requires a depth of relationships and market understanding that is typically achieved through country-specific programming.”

1. This regional conference took place from 28-29 June 2016 in Abidjan, Côte d’Ivoire. It was hosted by Making Finance Work for Africa (MF-W4A) and Financial Sector Deepening (FSD) Africa, with support from the African Development Bank and World Bank FIRST Initiative.

Section 1

Rationale: why does this matter?



Image: Ethiopia / S. Sheridan – Mercy Corps © 2016

Links between fragility, conflict, poverty, inequality and displacement

Fragility and conflict are self-reinforcing

According to the World Bank, ‘Fragile states are not always conflict affected countries and conflict affected countries are not always hampered by fragile institutions’ (World Bank, 2009). However, nearly all of the 28 African countries listed as ‘fragile’ on DFID’s 2016 list are conflict affected. USAID has stated that ‘Governing institutions (often) lack legitimacy and have little ability to support the peaceful resolution of societal conflicts. Illegitimate governance can entail economic institutions or financial services that are corrupt and/or exclude large segments of society, thus limiting economic opportunity. Economic (and social) disenfranchisement is a common driver of internal conflict and instability’ (USAID, 2014). In SSA, there are many instances of elite-controlled financial systems with state banking having evolved to finance private accumulation, particularly in agrarian economies or in single commodity economies. This exacerbates economic inequality and discrimination (Baddeley, 2011).

Poverty implications

The links between fragility and conflict have important implications for poverty. SSA has 483 million people living on less than US\$1.25 per day, representing a poverty gap three times the level of South Asia (ODI, 2014). Poverty rates in fragile states are, on average, 20% higher than countries with comparable levels of economic development; the gap is widest for countries affected by repeated cycles of violence (Sile, 2013). As a group, fragile countries lagged behind in reaching the Millennium Development Goals; nearly two-thirds failed

“In SSA, there are many instances of elite-controlled financial systems with state banking having evolved to finance private accumulation, particularly in agrarian economies.”

to meet the goal of halving poverty in 2015 (OECD, 2015). Today, the 50 countries and economies on OECD’s 2015 fragile states list – of which 30 are African – are home to 43% of the global population who live on less than US\$1.25 per day. By 2030, this figure could reach 62% (OECD, 2015).

Poverty and inequality

To reduce poverty in countries with high levels of inequality, much higher growth rates are required. With weak or corrupt institutions, even high rates of economic growth will not necessarily translate to reductions in extreme poverty (Addison & Cornia, 2001); (Ravallion, 2001).

In Nigeria, rapid growth has not contributed to significant poverty reduction due to an gap in access to basic services between both the poor and non-poor, and between genders (this is due to higher overall work burdens, lesser access to productive resources and fewer assets to draw on in emergencies) (USAID, 2014). Across SSA, women and girls are disproportionately affected economically and socially in situations of fragility. In addition to a lack of basic services, they are least likely to be able to access government support functions, such as birth certificates and functional identification documentation. This limits their access to formal employment and financial services. In SSA, only 44% of children have births registered (World Bank, 2016).

In FASA, and especially in those countries in a state of conflict, growth is often slowed by financial uncertainty. As a result, employment dwindles, leading to fewer economic opportunities available for the poor. This contributes to persistent poverty and inequality and generates socio-economic instability and the potential

for (ongoing) civilian unrest (Baddeley, 2011). Finance can play a crucial role in poverty and conflict cycles, as lack of equitable access to financial services can lead to underdevelopment and stagnation. This exacerbates social and economic unrest, increasing the probability of future conflicts (Baddeley, 2011).

Fragility and displacement

SSA has the world's highest refugee and internally-displaced populations (IDPs). Together, they account for over 19 million people – which equates to 26% of the global total (UNHCR, 2016). Between 2013 and 2014, there was a 29% rise in 'persons of concern'² originating

in the region (from 13 million to 16.8 million) (KNO-MAD, 2016). Furthermore, the numbers are increasing due to both ongoing and new crises in the Central African Republic, Nigeria, South Sudan and Burundi (among others) (UNHCR, 2016).

East Africa and the Horn of Africa report the largest rise of refugees at 25.5%, while Western Africa has the largest increase in asylum seekers and IDPs at 56% and 371% respectively. The DRC has experienced a 4.3% increase in IDPs in 2015. (IEP, 2016)³ More than 20% of the populations of Somalia and South Sudan are displaced in some form. After Syria, these are highest global displacement numbers.

Financial sector development and poverty reduction

On average, after access to electricity, lack of access to finance is cited as the highest business constraint in African fragile contexts (Leo, et al., 2012).

The theory of change that remains most powerful for supporting inclusive financial sector development is that effective access to financial services and catalytic investments will help people make their way out of poverty by facilitating economic growth and stability. Financial sector development in FASA can:

1) Reduce transaction costs

Financial services can make the exchange of goods and services more efficient (safer, cheaper, faster, and viable across greater distances).

2) Facilitate capital accumulation and more productive investments

Financial services are a critical function in driving economic growth in the 'real' economy (i.e. key sectors such as mining, transport and agriculture) through a variety of instruments. Capital markets offer significant potential for economic development to mobilise and channel savings at scale into long-term, productive investment that can create jobs, drive private sector-led growth and help SSA economies exit from international aid.

3) Encourage the development of entrepreneurship and business growth

Financial services support the development of new enterprises and business growth. At least 70% of jobs

globally are generated by SMEs (WEF, 2016) and these local entities often prove extremely resilient in fragile contexts. African labour markets are characterised by a very high ratio of informal-to-formal sector employment; therefore, while formal growth is essential in the long term, the informal sector has a greater capacity to absorb an expanding labour force.

4) Provide options for mitigating risk and responding to shocks and stresses

Financial services are a vehicle for households to establish, repair (post-crisis) or upgrade businesses, homes and assets as well as to assist with consumption smoothing and risk mitigation. Household stability encourages longer-term planning, investment and resilience.

5) Contribute to overall stability-building measures

A strong, transparent financial sector can contribute to economic stability, which can be both a driver and a result of overall stability. However, access and usage must be equitable along cultural and ethnic lines, religions, and gender – otherwise horizontal inequalities will be exacerbated. Financial inclusion can address income equality issues, and is a core means to tackle the vulnerability of African fragile states.

2. United Nations High Commission for Refugees terminology denoting people who fall outside the formal 'refugee' definition outlined in the 1951 Refugee Convention including asylum seekers and internally displaced people.
3. The population of DRC is 78.4 million in 2016; therefore, this represents an increase of 321,000 IDPs last year (IEP, 2016).

Financial sector fragility in FASA

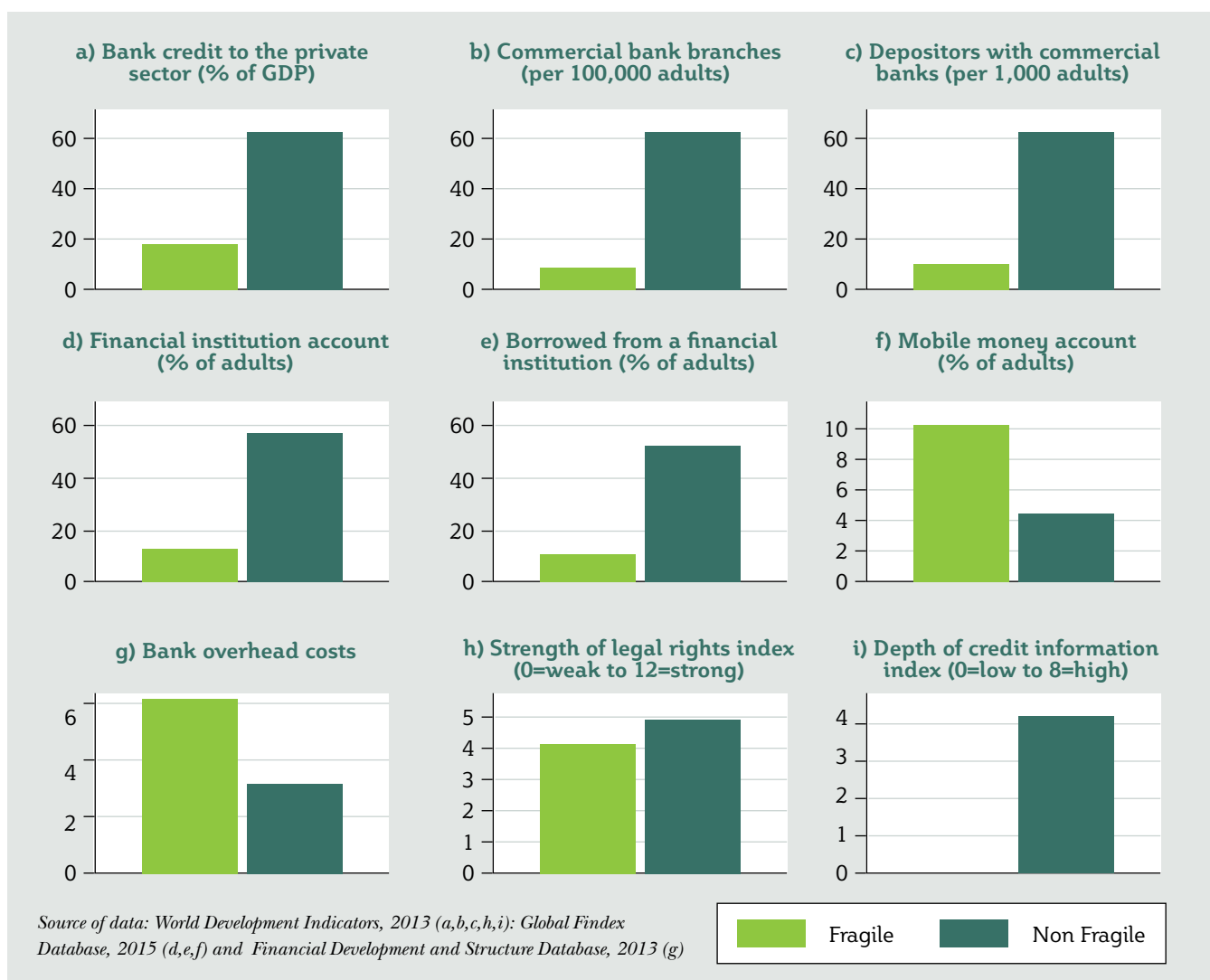
‘Conflict affects the financial sectors of developing countries at many levels: at the macroeconomic level by disrupting general economic confidence; at the meso level by destroying key financial institutions; and at the microeconomic level by disrupting the social relationships essential to financial transactions’ (Baddeley, 2011).

Many African countries have undergone a series of financial sector reforms aimed at modernising and bolstering the performance of financial systems in the past two decades. While these reforms have resulted in substantial improvements, African financial systems in fragility-affected states are still shallow, especially in terms of credit depth, with ratios of private credit-to-GDP among the world’s lowest (Sile, 2013). SSA’s average credit-to-GDP ratio is 48.1 with an average 66% of SSA still considered financial excluded from the formal financial sector (World Bank, 2014). In FASA, the percentage of financially excluded is over 80% in Cameroon, Chad, DRC, Sierra Leone and Sudan, and over 90% in Burundi and Niger. The primary outlier is Kenya

with only 25% of the population not accessing formal financial services. In Ethiopia, a country of 91 million people, only 7.1 million have deposit accounts (ODI, 2014).

The gaps are particularly important in economies in fragile situations. The figure below shows that the financial sector performance of FASA is significantly lagging behind the rest of Africa. The exception is the percentage of adults having a mobile money account, which is higher on average in fragile countries at around 12% (AfDB, MFW4A, FIRST, FSDA, 2016) (with an extremely wide range including only 1.8% in Cameroon and up to 58.4% in Kenya).

Figure 1: African fragile Vs. non fragile states



As demonstrated in the case of a highly fragile state like South Sudan, the financial sector is often dominated by a few banks in the capital with limited or no non-bank financial institutions (such as leasing and insurance), microfinance or other financing alternatives. Financial institutions are liquid due to lack of investments or limited risk appetite, or nascent or non-existent capital markets (Yak, 2016). Financial institutions suffer from low cost-to-income ratios linked to high costs of doing business: high electricity prices (extensive use of generators), small market size preventing economies of scale, no hard infrastructure (roads, telecommunications – only 2% of the roads are paved) and low efficiency of contractual agreements which are cost inductive (Arvanitis, 2014); (Yak, 2016).

“In FASAs like South Sudan, the financial sector is dominated by a few banks in the capital with limited or no non-bank financial institutions, microfinance or other financing alternatives.

The examples of South Sudan and Guinea-Bissau represent the situation of many highly fragile states with vulnerable financial sectors driven by unstable political and economic environments and economies overly reliant on a single commodity (cashews in Guinea-Bissau and oil in South Sudan). The financial sectors in both countries are underdeveloped, with financial sector intermediation accounting for only 4% GDP in Guinea-Bissau and banking penetration below 1% (Arvanitis, 2014). The underlying fragility of political volatility undermines the countries’ institutions and ability to diversify their economies. NGOs dominate the microfinance sector with limited capital, minimal sustainability to scale and often poor portfolio quality (M-Cril, 2015). In South Sudan, trade finance within value chains and community-based microfinance through NGOs (national/international) are often the only financial options during active conflict, especially in the northern area where fighting is the heaviest (Yak, 2016); (M-Cril, 2015).



Image: Financial inclusion / MasterCard Foundation © 2009

Mixed story of mobile money in highly fragile states (Katakam, 2016) (Mohamud, 2016)

The development of mobile money in FASA is a mixed story even in countries with seemingly similar levels of infrastructure and potential demand due to protracted crises. Obstacles range from inadequate infrastructure (hardware, software or both) and weak institutional frameworks that discourage private investment, to unstable economic conditions that reduce demand for financial services (Claessens & Rojas-Suarez, 2016). First, in Somalia and Zimbabwe, persistent lack of infrastructure has been an enabler of the growth and scale of mobile money (mobile money usage is 37% in Somalia and 22% in Zimbabwe, compared with a 12% average user rate across sub-Saharan Africa) (World Bank, 2014). In markets where, due to economic, political and social instability, movement of cash within countries and across borders is a challenge, mobile money has thrived. In Somalia, internal regulations are non-existent, allowing mobile money operators and clients to manoeuvre in an environment based on 'trust' rather than through legal agreements (Mohamud, 2016). Both countries have seen strong investments in mobile money infrastructure by the private sector and respective diaspora populations.

There is a similar situation in Cote d'Ivoire, where mobile operators have pointed out that mobile money solved a massive pain point during the 2011 crisis as payments could continue to move even when people could not due to insecurity (Penicaud, 2014). However, in DRC, which has similar security constraints, mobile money is still nascent with only 9% of a population of 78.5 million holding a mobile account (World Bank, 2014). While there are active mobile operators, weak public infrastructure and limited government influence outside the capital a lack of private investors in the mobile money space makes scale difficult and not yet an attractive alternative to cash.

A third scenario is that of South Sudan and CAR, the most volatile and poorest countries in Africa and markets operating in active conflict where there is no noticeable mobile money uptake (although there are mobile operators present in urban areas). The only exceptions are some government payments using mobile money in South Sudan. There is a dearth of public infrastructure and agents, and a lack of ability to handle liquidity rebalancing at any scale. In South Sudan, the lack of regulatory environment has been a barrier to growth as mobile operators and other potential operators have no incentive to resolve 'support sector' barriers without the potential of legal recourse (Yak, 2016).

Section 2

What and where are fragility-affected states in Africa



‘Much like Tolstoy’s quip that each ‘unhappy family is unhappy in its own way’, a fragile state is fragile in its own way. It is too often unhelpful to reduce the definition of fragility to standardized, static lists or indicators. It seems more helpful to think about understanding, rather than defining, fragility’.

– World Bank ‘Let’s Talk Development’ Blog, 27 March 2015

What do we mean by fragile?

The Organisation for Economic Cooperation and Development (OECD) has published a report every year since 2005 to monitor aid to a list of countries considered the most fragile. In 2015, rather than focusing purely on a list, the report charts out an understanding of fragility as ‘an issue of universal character that can affect all countries, not only those traditionally considered “fragile” or “conflict-affected” (OECD, 2015). This approach, visualised in the following diagram, moves beyond a single categorisation toward indicators that capture diverse aspects of risk and including⁴, including: 1) violence i.e. ‘peaceful societies’; 2) access to justice for all; 3) effective, accountable and inclusive institutions;

4) economic foundations (inclusion and stability) and 5) capacities to prevent and adapt to social, economic and environmental shocks and disasters.

Other relevant definitions:

Fragile states and regions are those that suffer external and social stresses that are likely to result in violence; lack the capacity to manage conflict over violence; and neighbour states that are especially susceptible to instability (DFID, 2016).

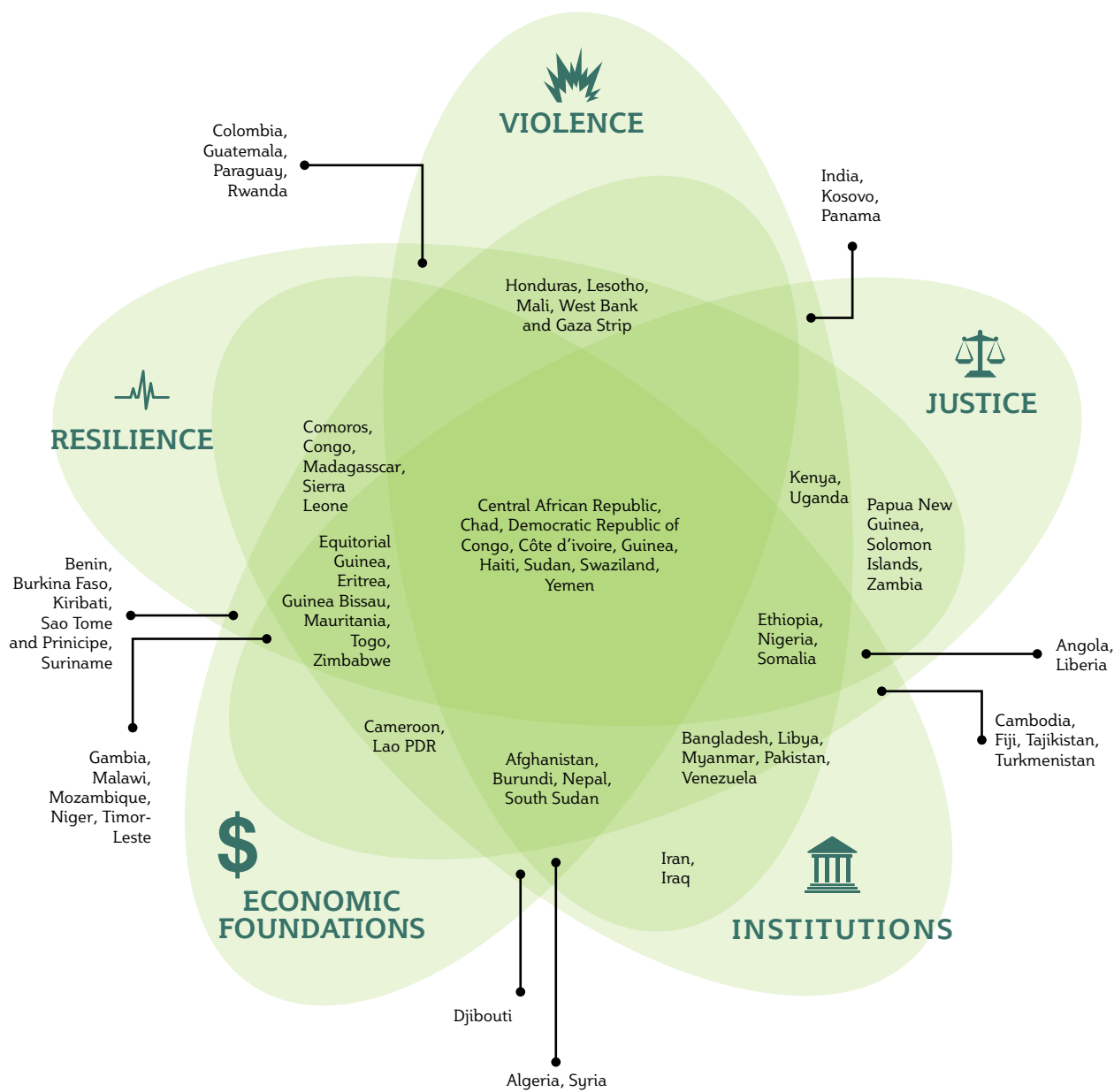
Fragility is a condition of elevated risk of institutional breakdown, societal collapse or violent conflict (AfDB, 2014).



Image: Lower Nyando/ Kelvin Trautman – CGIAR © 2013

4. Includes three related to Sustainable Development Goals (SDG) 16, ‘promoting peaceful and inclusive societies’, and two from the wider SDG Framework.

Figure 2: Venn diagram representing fragility clusters across states and economies



Violence
Reduce all forms of violence and violent deaths elsewhere



Resilience
Reduce exposure and vulnerability to climate related extreme events and other economic, social and environmental shocks and disasters; build adaptive capacity



Justice
Promote rule of law at national and international levels, and ensure equal access to justice for all



Institutions
Develop effective, accountable and transparent institutions at all levels; reduce illicit financial flows and combat organised crime



Economic Foundations
Reduce youth unemployment: Promote economic, social and political inclusion

Source: http://www.keepeek.com/Digital-Asset-Management/occd/development/states-of-fragility-2015_9789264227699-en#.WDJBPbIrL3g#page22

In the absence of a clear definition of fragility, development actors often coalesce around its antithesis, resilience, which can be defined as ‘the ability of countries, communities and households to manage change, by maintaining or transforming living standards in the face of shocks or stresses without compromising their long-term prospects’ (DFID, 2011). The African

Development Bank (AfDB) utilises a framework of ‘transition and resilience’ and has replaced the term ‘fragile’ with the language of ‘transition’, applying a lens which goes beyond conflict and violence and recognises the multi-faceted dimensions and diversity of states and economies in transition.

In June 2014, AfDB approved the bank strategy for ‘addressing Fragility and Building Resilience in Africa’ (2014-2019). It marks a shift in the bank’s approach to addressing fragility, as it moves away from the narrow approach of categorising states into a set of ‘fragile states’ to a new approach in favour of referring to ‘fragile situations’. The bank acknowledges that all countries and regions, both on the African continent, and globally, face issues of fragility in varying degrees. Financial Sector Development in African States Facing Fragile Situation; Abidjan Conference Concept Note, May 2016.

While there is no set definition for fragility, there are a number of generally accepted features, with broad agreement that fragile states are characterised by poor

governance, weak capacity and institutions, high risk of conflict and insecurity, disputed legitimacy, and poverty (World Bank, 2009).

Drivers and typologies of fragility

‘Fragility is not a stigma, if you are in a state of fragility, you can get out of it.’
Dr. Sibry Tapsoba, Director Transition Support, AfDB (AFDB, 2016).

Causes of fragility may be multiple and dynamic, and co-exist at various points in time. Common drivers of fragility include:

- Injustice
- Inequality (including inequities in access to, and ability to use, the financial system)
- Ethnic tensions
- Religious radicalisation
- Terrorism
- Climate change
- Environmental disasters
- Pandemic diseases
- Migration patterns and labour markets

The lines between conflict and non-conflict zones are increasingly blurred; as are the boundaries between criminal, intercommunal and politically motivated violence. States of fragility may be exacerbated by many different factors, including global and regional competition among great powers, political and ethnic tension within countries, organised crime and terrorist networks, lack of access to justice, weak rule of law and legal institutions, and limited trust between citizens and their governments.

Financial market imperfections – including informational asymmetries, high transactions costs and limited contract costs – can be a source of fragility. This is especially the case for poorer populations, and limits

their access to capital, thereby reducing the efficiency of capital allocation and intensifying income inequality (Beck, et al., 2004).

In many fragile contexts, the youth bulge can be an additional destabilising factor in the absence of economic opportunities and productive activity. If there are limited legitimate opportunities for earning money, and if population pressures are high, then high opportunity exists for insurgent groups to have the critical mass to provoke conflict (Baddeley, 2011). As the world population increasingly concentrates in urban environments, cities are especially vulnerable to increased fragility (WEF, 2016).

“The lines between conflict and non-conflict zones are increasingly blurred; as are the boundaries between criminal, intercommunal and politically motivated violence.”

Even in countries that fall under typologies of extreme fragility there are opportunities for financial sector development, such as in the DRC and Somalia. The DRC – using various typologies and definitions – can be considered a fragile state, a state with constrained access, a country facing internal conflict and one facing regional instability. The DFID-funded ÉLAN RDC uses finance as a direct intervention, as well as a supporting sector for other sector interventions including transport, household energy access and agriculture, with a clear strategy to work in areas with higher potential for conflict and instability. From a direct financial sector perspective, the programme builds the market system for mobile money as a support function to the greater economy. This includes industry-wide support, and direct support to MNOs to offer appropriate products and service and expand mobile agent networks. Once in place, the mobile money (payments) infrastructure can support ease of business across other sectors. However, due to the nature of FASA, ÉLAN RDC has fewer options for partnerships to demonstrate innovative models, and requires more direct involvement than would be found in a traditional M4P approach (ASI, 2016).

Somalia, which fluctuates between a failed state and a ‘recovering fragile country’ (Guardian, 2015), offers development actors clear entry points with remittances and diaspora investment platforms. The estimated GDP per capita of Somalia is US\$435, the fifth lowest in the world, with 40% of Somalia’s population relying on immediate remittances to meet basic daily needs (IFAD, 2015). However, of the US\$1.4 billion sent to Somalia annually from its global diaspora, a significant and growing portion is in diaspora-funded business investments.⁵ While some diaspora members are likely to prefer investments in a known business or in family members, recent research indicates significant opportunities for aggregating investments from diaspora members, especially in the agriculture, education and finance sectors in co-investment and mutual fund vehicles. Development actors can provide investment information and due diligence support to develop a pipeline of investments to tap into the diaspora funds.

Situations of fragility do not follow clean patterns. While the field of development previously tried to focus on phases of intervention such as ‘pre-crisis, active crisis, recovery and post-crisis’, current thinking recognises the reality that countries facing situations of fragility do not experience clear-cut phases and often exist in a ‘complex crisis’ situation for protracted periods of time.⁶

as those that experience a low level of transactions (i.e. supply-demand coming together); and weak markets as those that face low competitive and cooperative pressures (i.e. supply-demand exists but there is a lack of players engaged in supply). These typologies may co-exist and all scenarios typically experience a low level of supporting services and weak regulatory systems.⁷

FASA countries are often in constant transition and flux from war (i.e. Democratic Republic of Congo and the Central African Republic), or in the midst of major economic, political or social transformation (i.e. South Sudan, Mali and Nigeria). In addition to conflict, they may have suffered acute natural disasters or epidemics (Sierra Leone and Liberia) or experience recurring drought and economic shocks (i.e. countries in the Horn of Africa, such as Ethiopia and parts of Kenya and Uganda).

There is also a development dialogue on ‘nascent, thin and/or weak markets’ which can be applicable to countries facing fragile situations. While these definitions are not exact, one can think of nascent markets as those where there are new opportunities (i.e. in a product/service or delivery channel); thin markets

The Somali region is one of Ethiopia’s leading regions in livestock sales, especially of sheep, goat, and camel. These sales are primarily to the Middle East, where there is a constant sizeable demand. However, the market can be considered ‘weak’, as its growth is inhibited by a lack of financial services, infrastructure, transportation, animal health services and other inputs. In comparison, the market system for fish in Borena, in Ethiopia’s Oromia region, in addition to support system issues, has serious supply issues – which in the near/medium term will not change. It can therefore be considered thin. While there are multiple benefits to livestock insurance for pastoralists, it is a ‘nascent’ market, with supply-demand and support systems and regulations not yet in place (Mercy Corps, 2016).

5. Investments range from US\$5,000 and US\$100,000 (IFAD, 2015).

6. See Mercy Corps (2016), ‘Cracking the Code: Enhancing Emergency Response & Resilience in Complex Crises’, www.mercycorps.org/research-resources/cracking-code-enhancing-emergency-response-resilience-complex-crises

7. For more information, see Mercy Corps (2015), ‘Facilitative Approach in Nascent Markets’, available at https://usaidlearninglab.org/sites/default/files/resource/files/prime_-_facilitative_approach_in_nascent_markets.pdf

Where are the fragility-affected states in Africa?

There are regions on every continent facing the prospect of fragility recognizing that political and social instability is not the preserve of low-income countries but also includes middle and upper-income countries tackling corruption, failures in inclusive government, and inequality gaps (WEF, 2016).

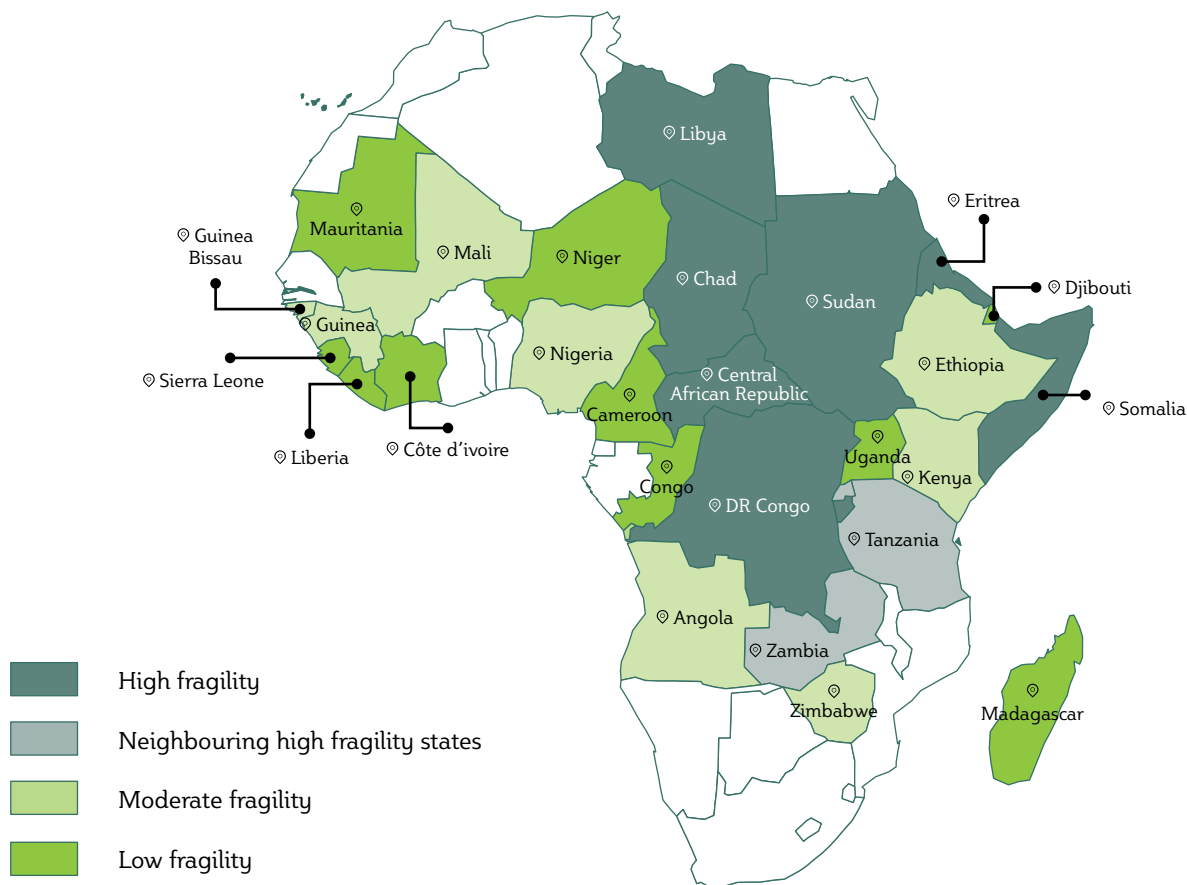
From 2004 to 2014, Africa experienced unprecedented growth rates with seven of the 10 fastest growing economies located in SSA (World Bank, 2016). In 2014, SSA's growth rate was 4.5%; higher than the developing country average of 3.9%. SSA growth decelerated to 3% in 2015, driven by low commodity prices, weak global growth, rising borrowing costs and adverse domestic developments in several countries. It should be noted this rate is still higher than global emerging market growth rates of 2.4% in 2015 (World Bank, 2016).

While it is difficult to categorise countries given the multi-dimensional and fluid nature of fragility, the following map depicts DFID's categorization of fragile, conflict-affected states (DFID, 2016). This places states and regions spread across five categories: 'high fragility' (nine in Africa); 'moderate fragility' (nine in Africa);

'low fragility' (10 in Africa); and 'neighbouring "high fragility" states' – (five in Africa). This also includes three regions, including north and south of the Sahara. From this list, it is evident there has been a shift away from conflicts between nations to conflict within nations. As internal conflict becomes more prominent, external parties are more likely to become involved, or suffer from the consequences of violence as local conflicts turn into regional crisis (IEP, 2016).

A fragile situation can exist within an otherwise stable state, or can exist regionally – affecting one or more states (i.e. eastern Kenya and north-eastern Nigeria). There is a high spill-over effect as conflict and fragility do not often remain in discrete geographic locations (i.e. Sahel, South Sudan into fragile northern Uganda; Nigeria into Cameroon; and DRC into Rwanda).

Figure 3: Fragile states in Africa



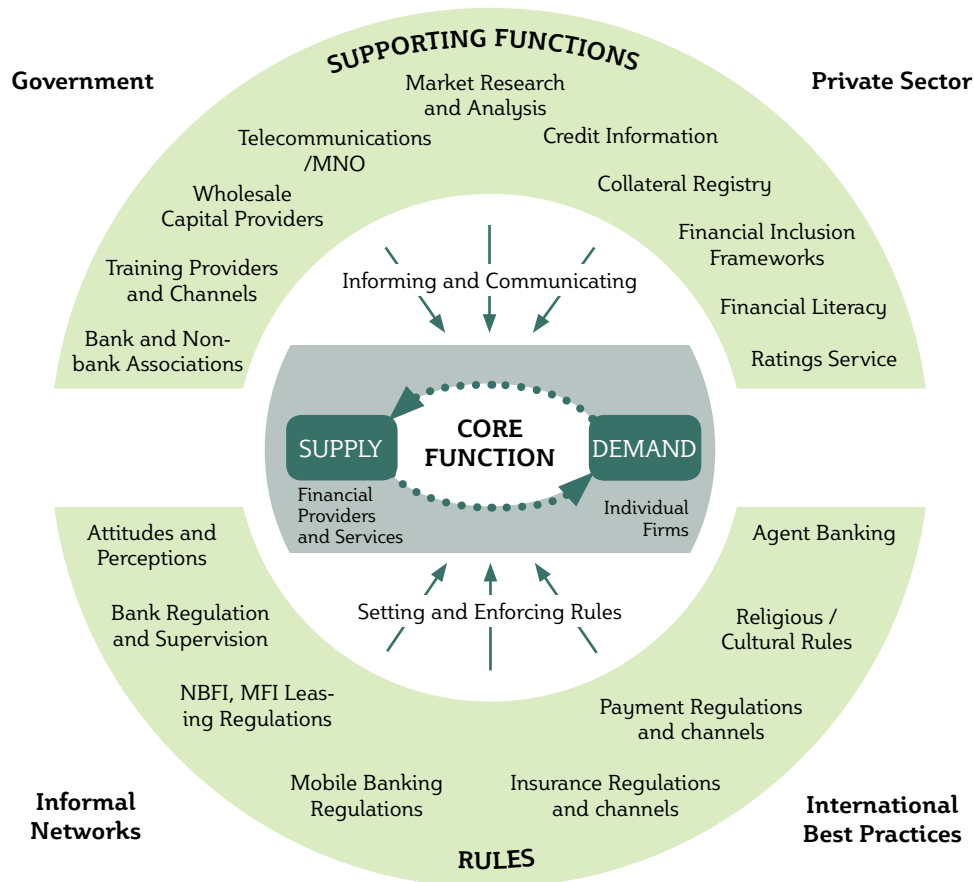
Source: Adapted by FSD Africa from the Department for International Development's (DFID)

Section 3

Financial market systems in FASA: what is distinctive?



Figure 4: Financial market system



Source: This is adapted by Mercy Corps from Springfield Centre, 2016

Structure of financial market systems in FASA

A market development approach conceptualises market systems as a core function of supply-demand and the supporting functions and rules which underpin the core transaction. This is visually depicted for a functional financial market system (non-context specific) in the adjacent visual.

Consumer demand

In FASA, only 14% of adults have access to a bank account, compared with 23% in Africa and 24% in SSA (Sile, 2013). Also, in FASA, women are 32% less likely than men to have a formal account (19% in other developing economies) and those aged 15-24 are 39% less likely than those aged 25-64 to have a formal account (World Bank, 2013).

Employment: Countries facing situations of fragility have low rates of formal salaried employment (on average 12%), resulting in high informality, where people are consuming households and self-employed firms simultaneously. This equates to the reality that

consumption and production decisions are intertwined, resulting in the need for a wide range of financial services to build assets, manage risks and smooth consumption (Cull, et al., 2014). Those working full-time for an employer are more than twice as likely as other adults to have a formal account (World Bank, 2013).

Risk tolerance and trust: In fragile situations, individuals and enterprises become more risk averse and tend to invest less. They choose low-risk investment activities and withhold their savings from the formal financial system, even where financial products and services are available. As fragility increases, individuals and enterprises rely more on social and business networks due to increased levels of trust, proximity and lower administrative requirements. Costs may or may not be comparable to formal providers depending on the specific product, provider and context. With over 22 million people born in Africa living outside their country, and two-thirds living in other African countries, the idea of migration, and resulting remittances, as a financial strategy to

diversity is central to both the formal and informal financial sectors in FASA (ODI, 2014).

Consumer profile: Consumers in fragile contexts tend to have lower financial literacy and capabilities due to a lack of experience with products and services and overall lower literacy levels resulting from ineffective education systems. Depending on the context, some population segments face additional constraints to accessing financial services based on their religion, ethnicity, gender, age or other factors (CGAP, 2015), which can be amplified in fragile contexts (i.e. women requiring a husband's signature for transactions, women not able to travel alone or meet with men outside the family) (Grassi, 2015). Ten percent of adults in these contexts cite religious reasons as an obstacle to having a formal account (World Bank, 2013).

Products and services

- Remittances and government payments: High demand for these services; 25% of adults in fragile contexts report using their account to receive remittances from family members living elsewhere compared with 14% in the rest of the developing world (World Bank, 2014).
- Savings: People are more likely to save at a community-based institution or store cash at home. They are less than half as likely as those in the rest of the developing world to save at a formal financial institution and more than 50% more likely to save using a community-based method (World Bank, 2014).
- Mobile money: There is a higher use of mobile money (though this is very country-specific as per the previous text box); 11% of adults in fragile contexts report having used a mobile phone to pay bills or send/receive money in the past 12 months, compared with 4% in the rest of the developing world (World Bank, 2014).
- Credit: There is a high demand for credit; 48% of adults in fragile contexts report some form of borrowing in the past year, while this figure is 34% in the rest of the developing world (AfDB, MFW4A, FIRST, FSDA, 2016). Only 6% report having borrowed from a formal financial institution; significantly larger shares report having borrowed from family or friends (34%), a retailer using instalments or store credit (12%) or from an informal lender (9%). The use of credit largely relates to emergency or health reasons (22% of adults in fragile contexts, twice the average in the rest of the developing world) (World Bank, 2014).

Supply of financial services

Types of providers: Fragility affects the sustainability of financial institutions; in the DRC and Zimbabwe, financial institutions collapsed because of a lack of product uptake (Sile, 2013). There are fewer numbers of formal financial service providers in FASA (i.e. banks, microfinance institutions, credit unions, insurance companies, pension funds, capital markets), which results in lower levels of competition and a higher prevalence of informal providers. Informal providers may be viable value propositions but may be insufficient, unreliable, and often expensive. Capital markets can be an important complement to bank finance for companies to develop and governments to invest productively. However, in FASA, they are either nascent or non-existent (especially in 'failed states' such as South Sudan and Somalia), or limited (in countries such as the DRC and Mali). There is often low financial intermediation among banks representing inefficient investing in the private sector – often a mixture of supply and demand-side constraints (Arvanitis, 2014). Banks suffer from low cost-to-income ratios linked to the high cost of doing business: high electricity prices (due to extensive use of generators), small market size preventing economies of scale, and low efficiency of contractual agreements which are cost inductive.

Product offerings: Financial institutions struggle to offer affordable and appropriate products when macroeconomic indicators are unfavourable, as they often are in fragile contexts (i.e. high inflation rates, slow growth and high unemployment rates). As fragility increases, suppliers of finance are likely to become excessively risk-averse and target their services towards a limited customer base. As a result, long-term financial transactions are replaced by short-term credit, relation-based credit and cash transactions (Sile, 2013). There is limited innovation in financial product options with an over-reliance on debt, rather than savings and insurance. Likewise, there are limited incentives to innovate when information about the potential consumer base is lacking, levels of trust and coordination are low, informality is high and formal institutions may be making profits from 'business as usual' (Arvanitis, 2014).

Delivery channels: The financial services sector in fragile contexts suffers from underdeveloped delivery channels, particularly for reaching consumers in rural areas where infrastructure is often absent (Sile, 2013). Financial service providers in these environments often have weak capacity (i.e. technical, physical, financial, managerial, personal/cultural). This is related, but not limited to a lack of competition, non-existent or low-quality resources for building capacity, low operating capital, out-migration, and lack of a conducive regulatory environment. One of the primary challenges in financial

services in fragile contexts is the lack of a workforce with required skills and experience. This applies to both senior management as well as boards of directors for institutions (Leo, et al., 2012). It is common that senior management in financial institutions are expatriate (both from the region or international) and non-permanent, and require extensive leave throughout the year from their positions. They also often lack succession planning (M-Cril, 2015).

Supporting functions

Supporting functions are those which are the most important functions that enable the supply and demand of a specific product or service to come together and result in beneficial transactions. In general, FASA countries experience a lower level of well-developed supporting functions; they may be absent, inadequate or mismatched (i.e. the wrong type of player is performing a function). Of particular note is the lack of infrastructure in fragile contexts; both hard infrastructure (i.e. transport and communications) as well as 'soft' infrastructure (i.e. specialised intermediaries or industry bodies). These 'institutional voids' hamper the development of the financial sector and limit incentives for market entrance (Khanna, et al., 2005). Several areas critical to building financial markets that work for the poor are: information and capacity building, industry-level coordination, and retail payments infrastructure (El-Zoghbi & Lauer, 2014).

Information: A well-functioning financial system will produce and process information that promotes (i) the efficient allocation of capital to firms that provide necessary and desired products and services to consumers and (ii) effective regulation and supervision of such firms, their products and their services. (Zoghbi & Lauer, 2013). Information enables consumers to understand the providers and their various products and services and to assess their value and pricing. It helps providers to understand consumers and their needs. It also enables both consumers and providers to

understand their respective rights and responsibilities. Providers, as well as funders, regulators and other policy makers, need information on other providers for competition and benchmarking purposes. The lack of information and unequal access to information (when comparing consumers with providers) is a particular problem in financial markets (Zoghbi & Lauer, 2013) and is magnified in fragile contexts.

Capacity-building services: Lack of capacity manifests in many ways: consumers may not understand the benefits or risks of different financial products and services, providers may not have the staff capacity to design and develop products relevant for poor segments, and regulators may not have the capacity to regulate and supervise new innovations that serve the poor or the types of institution that serve them. (Zoghbi & Lauer, 2013). Capacity can also be a constraint of other market actors, such as credit bureaus or collateral registries (Zoghbi & Lauer, 2013). In fragile contexts, there is a noticeable lack of quality provision of skills-building services for institutions and individuals (Arvanitis, 2014).

Industry-level coordination: Fewer numbers of providers, lack of trust, and lack of well-developed markets affect the existence, and quality, of industry-level coordination bodies. Coordination could be informal, or institutionalized. It serves the purposes of exchange of information, establishing standards, lobbying for conducive policies or regulations, or developing a strategy, particularly for a new area of practice, such as digital financial services which has potential to reach consumers in fragile contexts.

Retail payments infrastructure: Payment systems are the backbone of a financial system and can serve as the basis for introduction of other financial products and services. There are large differences among countries regarding the volumes and value of transactions being handled by retail payment systems (CGAP, 2015). Fragile states are more prone to lack the infrastructure (and regulations) required for payments.

Few fragile states are actually in the digital readiness stage, according to the Digital Evolution Index.⁸ Out of the top 50 countries positioned to capitalise on digital readiness, only three (Nigeria, Egypt and Kenya) overlap with the 50 most fragile states listed in the Fund for Peace's Fragile States Index. Even if they have internet access, there remains widespread lack of access to basic electronic payments services which precludes the possibility of paying for services or being paid for providing services.

8. The Digital Evolution Index, developed by MasterCard Corporation and Tufts University, ranks 50 countries' readiness to engage in the digital economy: http://insights.mastercard.com/digitalevolution/Digital_Evolution_Index_Key_Findings.pdf

Rules

Rules include specific laws, regulations and ‘standards’ relevant to a core market. Rules are themselves a

system and consist of the processes by which these laws, regulations and standards are set.

African states in transition lag far behind their higher income and non-African fragile counterparts on nearly every World Bank ‘Doing Business’ measure, with eight of the bottom 10 countries from Africa in 2016.⁹ On average, African fragile states have an ease of doing business ranking of 171 (of 182 countries) (Leo, et al., 2012) compared with an average ranking of 143¹⁰ for other SSA countries. For example, importing a standardised container of goods costs three times more in an African fragile state than in a middle-income country, and starting a new business costs over three times more in African fragile states than in other low-income countries (Leo, et al., 2012). High operating costs have a profound impact on businesses’ ability to generate profits, expand, and compete regionally and internationally.

Regulatory frameworks: FASA countries typically have restrictive, outdated and unresponsive regulations, including an absence of policies that encourage inclusion (i.e. tiered KYC, flexible collateral requirements). Draft policies often become outdated even before passed due to long approval periods within various government offices.

In South Sudan, a microfinance bill that would allow MFIs to accept deposits, originated by the Ministry of Finance and developed in 2010, sat for several years with a separate ministry. There is a high turnover in the Central Bank, especially from the microfinance department. In other cases, regulations were not passed due to the Central Bank’s concerns that it could not properly regulate as it was overwhelmed by the regulation of existing policies already passed by the traditional banking sector (Yak, 2016).

Supervision and enforcement: The loss of qualified human resources contributes to weak regulation and limited supervision and enforcement capacity. (Sile, 2013); (Leo, et al., 2012). Weak supervisory capacity for those regulations which do exist undermines clients’ trust in financial institutions and creates uncertainty among market actors. Macroeconomic issues facing fragile states negatively affect the performance of central banks, resulting in a lack of enforcement of legal and regulatory rules (if there are regulations in place at all).

Consumer and industry voice: In FASA, there is often weak representation of consumer and industry voices in policy-making and regulatory processes. This absence

of the interests of consumers (or poor organisation of their representation), and institutions providing financial services to the low-income market, can result in regulations that are not balanced and do not adequately address their concerns. Extremely fragile contexts experience low levels of industry self-regulating standards, due to the absence of industry associations. The absence of industry and consumer voices reduces the ability to address several core consumer protection issues, such as transparency, dispute resolution and complaint channels, responsible lending, and fair treatment (CGAP, 2015). An example is the case of Africa’s ‘remittances super tax’ (ODI, 2014). Money sent to Africa and within Africa faces a ‘super tax’ in fees at least double the global average, regardless of the African country or market, costing Africa at least US\$1.4 billion annually (ODI, 2014). To date, there has been limited industry voice to force government regulatory changes on money transfer operators and exclusivity agreements with agents to lower costs.

Limited trust in the formal financial system is often amplified by this lack of consumer recourse – the ability to raise grievances and have them heard and resolved or redressed (Chapman & Mazer, 2013).

Political economy issues: Politically motivated policy-making and government interventions are still common in all financial markets (CGAP, 2015) and may be more prevalent in fragile contexts. Such interventions (i.e. government institutions lending at subsidised rates, unsustainable interest rate caps) can distort markets and create disincentives for the private sector. Weak state-society relations in FASA can result in a higher prevalence of traditional, religious and customary law, making financial services harder to regulate.

9. In the bottom 10: Liberia, Equatorial Guinea, CAR, Chad, DRC, South Sudan, Libya and Eritrea. See World Bank’s ‘Doing Business Report 2016’, which compares regulations for domestic firms across 189 countries and is available at www.doingbusiness.org

10. www.doingbusiness.org

Contextual factors

All 'systems' are surrounded by a set of contextual factors which affect the structure, and functioning, of the system. Two key factors are particularly important for financial market systems in FASA:

1) Economic growth trends

Large prosperity deficits and higher systemic risks are seen in monolithic, commodity-dependent economies (Legathum, 2016). Countries that have best delivered prosperity tend to have more complex economies (i.e. they produce, and may export, a wide variety of different products). Despite the relative complexity of some African economies, SSA is still the least economically complex region in the world and several countries in the region suffer from the 'curse of commodities' (Legathum, 2016). An economy is complex not only when it exports highly complex products, but also when it exports a wide variety of different products. Countries like Zambia are highly dependent on commodities. Its relatively complex economy is still dominated by copper, though mainly processed in some form and highly vulnerable to falling commodity prices.

Despite the relative complexity of some African economies, SSA is still the least economically complex region in the world, even behind the oil-rich Middle East (Legathum, 2016). Economic diversification is happening, though unevenly and not along the right lines.

Oil-heavy economies like Angola, Nigeria, Congo and Sudan are noted for their large deficits in economic growth and growing inequalities within the general population. The same can be said for other commodities, such as rubber in Liberia and the cashew sector in Guinea-Bissau. Zambia's relatively complex economy is dominated by copper and highly vulnerable to global commodity prices.

A dependency on commodities is transitioning into a concentration of low skilled, low-productivity services, rather than necessary manufacturing industries (Legathum, 2016). SSA's services sector has expanded more than in any other part of the developing world since 2000, accounting for 58% of GDP (up from 49%). Nigeria has seen the biggest increase in its service sector of any country in the world. In 2000, services accounted for 21.8% of GDP. By 2014, that had risen to over half

the economy at 55.5% (World Bank, 2016).

2) Financial resource flows

Domestic revenues: There are significant data deficits on flows of non-official development assistance (ODA) and domestic sources of finance in countries considered fragile. Overall, these countries have lower domestic revenues than other developing countries, including the inability to gather taxes, which significantly reduces the state's operating budget for productive investment.

Foreign Direct Investment: Factors attracting investment in SSA include high urban growth, 'functioning free markets, large potential markets with large populations, raw materials, and abundant and inexpensive labour forces' (KPMG, 2015); (World Bank, 2016). While the economy in fragile situations can be remarkably dynamic and resilient, these countries struggle to attract foreign investment. Only 6% of FDI to developing countries in 2012 went to FASA, concentrated in just 10 resource-rich countries (OECD, 2015).

Currency risk is major risk for investors. For example, investors would have lost 70% recently in Zambia due to currency depreciation; in Nigeria, it is difficult now to remit money offshore since there are limited U.S. dollars in the financial system (McCammon, 2016).

Overseas Development Assistance: ODA fills a significant finance gap in those countries considered fragile. Since 2007, 53% of total ODA has been allocated to countries that are currently on the 2015 fragile states list. ODA to fragile states peaked in 2013, and is projected to stabilise at higher levels than ODA to non-fragile developing countries into 2017.

As of early 2016, 43% of all AfDB resources were channelled into fragile situations, compared to 17% under ADF-12 (AFDB, 2016).

However, while ODA to fragile states has almost doubled since 2000, it is largely distributed to countries deemed as high global security risks.¹¹ Sixteen of the top 20 most aid-dependent countries have been on the fragile states list since 2007, when it was first compiled, and the eight most aid-dependent countries in the world are fragile states (OECD, 2015).

11. Afghanistan and Iraq received significant flows in the MDG era – 22% of all ODA to fragile states and economies.

12. *Note: all statistics in this paragraph are taken from the two citations at the close of the paragraph unless otherwise noted.

*Remittances*¹²: Today's African diaspora consists of approximately 30 million adults, sending approximately US\$40 billion back home annually (ODI, 2014). Although remittances are the largest aggregate flow to fragile states (US\$87.8 billion in 2012), they primarily benefit a small number of middle-income countries with large diaspora populations. In 2013, 2% of African GDP was due to remittances (ODI, 2014). Though this can vary by country, there are nine SSA countries with remittances representing over 5% of GDP, and as high as 20% of GDP for Lesotho and Liberia (ODI, 2014).

For the region as a whole, this represents 50% more than net ODA from all sources. For most countries, the amount exceeds FDI and in several fragile states, remittances are estimated to exceed 50% of GDP. SSA saw a growth of 1% in remittances in 2015 and an increase of 3.4% to US\$36 billion is expected in 2016 (KNOMAD, 2016); (OECD, 2015). Nigeria accounts for 68% of all remittances within Africa (US\$20 billion) and is the world's fifth largest recipient in absolute terms (ODI, 2014). After Nigeria, the other three African countries with transfers in excess of US\$1 billion are Senegal, Kenya and Sudan (ODI, 2014).

Although most remittances are used for daily necessities, up to 20-25% are available for uses other than immediate consumption (MFW4A, 2016). Remittances are often used to start small businesses, particularly in countries or areas where credit markets are not well developed (KNOMAD, 2016). Remittance inflows bolster the economic stability of poor countries by shoring up their balance of payments, allowing them to finance imports and improving their credit ratings. Remittances are frequently a lifeline in situations of forced displacement, helping households cope with insecurity and helping people escape conflict (KNOMAD, 2016).

Defining the 'cost' of remittances is not straight-forward; fees are involved and in most cases remittances involve transactions in at least two different currencies with a profit placed on the currency conversion. Despite a 2% decline in the average cost of sending US\$200 over the course of 2015 (11.5% in the fourth quarter of 2014 to 9.5% in the fourth quarter of 2015), SSA is the highest-cost region globally (average is 9.5%) for sending and receiving transfers (KNOMAD, 2016). Costs vary substantially across the region, ranging from 4–5% in the lowest-cost corridors, to 18–20% in the highest (outflows from South Africa to nearby countries) (KNOMAD, 2016); (OECD, 2015). Reducing the barriers and costs of remittances is now an objective (10.c) of the SDGs. Due to the high costs of traditional commercial money transfer operators, hawalas and regional money operators are commonly used; however, fluctuating foreign exchange rates can limit commercial movement of money across borders¹³ (Yak, 2016).

Fixed exchange rates and capital controls are having an impact on foreign exchange markets and channels of remittance flows. Nigeria is witnessing a large black market premium on foreign exchange. For example, on 22 February 2016, in the Lagos black market, the dollar was being bought at 367 naira and sold for 372 naira, while the official exchange rate was around 195. Similarly, despite a 25% devaluation of the official rate, the Angolan kwanza trades at around 270–280 to the dollar in the black market while the official rate is around 135. Such large differences between official and black market rates tend to drive remittances to informal channels (KNOMAD, 2016).

Challenges to financial sector development in FASA

The root causes of the lack of pro-poor development of financial systems are highly specific to both the target sector (i.e. inclusive insurance, SME finance, capital investment, etc.) and the specific geographic context. To determine specific systemic constraints to developing a target financial system requires a deep diagnostic process consisting of market, political economy and conflict (if applicable) analyses. However, some

common challenges to financial sector development across FASA and market systems (i.e. those that will affect all systems regardless of the specific 'core' product or service) include:

- Regularly changing and unpredictable political contexts
- High risk of security challenges
- Constrained access to markets and populations

13. For example, a significant amount of money (especially from salaried employees) is sent from South Sudan to Kenya and Uganda through national and regional operators.

- High potential for illicit markets to thrive
- Potential high degree of population mobility and/or recurrent humanitarian cycle of needs
- Weak institutions, public and private, in the formal financial sector including weak capacities and incentives of financial service providers
- Foreign exchange and parallel currency markets
- High prevalence and reliance on informal financial mechanisms (i.e. family and friends, rotating savings schemes, pawn brokers, moneylenders, savings 'under the mattress')
- Widespread infrastructure deficits (particularly transport and communication systems)
- High levels of distortion (aid interventions with limited long-term investment strategies)

In the post-conflict setting, the presence of donor-funded NGOs can make it difficult or impossible for the private sector to compete in an otherwise attractive market system. Examples include the improved cook stove and seed markets in the DRC. In North and South Kivu both are heavily subsidised by donors. This provides a sharp contrast to the private-sector led cook stove markets in Kinshasa and Lubumbashi (ASI, 2016).

As a result of all these factors, private sector actors can find it difficult to find entry points, and stakeholders have higher perceived and actual risks for investments. Financial services markets in these contexts experience

higher transaction costs for consumers and providers. They are less likely to be responsive to the needs and demands of the population and experience low levels of trust between individuals, groups and institutions.



Image: Financial inclusion / Jack Lyell – Alamy Stock © 2016

Section 4

FASA: what is different?



What does facilitation mean in FASA?

Facilitators play a catalytic role to incentivise and enable market actors to perform their functions more effectively, driving substantial and beneficial change in the 'core' market, i.e. supply-demand. A market systems approach defines facilitation as 'working with system actors to catalyse the desired systemic change processes'. This means that the facilitator does not play key roles in the market system in the long term, but works with stakeholders to align their capacities and incentives to play these roles sustainably, i.e. without aid-funding.

While there is a dearth of documented evidence

on the application of a market systems approach in FASA, experience from donors, governments and implementing agencies points to some key learnings. How we implement in fragile contexts is as, or more, important as what we implement. For this reason, specific programmes, or interventions, cannot be recommended on a broad level; rather a process needs to be undertaken to determine what is most appropriate for the specific context and strategic goal of the aid-funded initiative.

More and more of our work is in fragile and conflict-affected states, and we need processes that allow us to rapidly and flexibly respond to changing contexts. We know that we need to put as much emphasis on implementation and delivery as on allocation and design. *Peter Vowels, DFID Adaptive Management Programming. (DFID, 2016)*

What is adaptive management?

Adaptive management is a programming approach that combines appropriate analysis, structured flexibility, and iterative improvements in the face of contextual and causal complexity. Adaptive management is evolving and multi-faceted; it includes a variety of specific techniques and approaches, whose usefulness depends on a given context, the problems being addressed, and the capabilities or constraints of the program in question (Mercy Corps and IRC, 2016). Adaptive management processes are well suited to FASA given the complex and fluid nature of these contexts. The market development approach is an adaptive management process although to date, literature and practice have not tied these two concepts together.

DFID has recently undertaken a study to look at their programming 'incentives, capabilities and processes', and found the following:

- **DFID's conventional approach to programme management has served us well but will need to evolve further.** DFID has already reduced administration budgets considerably, but we need to continue to strip

back our processes, reduce the paperwork and focus our energy on real-world delivery.

- **Our programmes need to be flexible and responsive to changing political realities and conflict dynamics on the ground.** To achieve this, we need to improve our ability to commission and manage adaptive, flexible programmes.
- **Programme excellence requires collective responsibility and clear accountabilities.** This means enabling our staff to make decisions that are contextually aware, being confident in the application of professional judgement to ensure proportionality, and being rigorous in ensuring a clear audit trail and value for money.
- **Streamlining our process will only get us so far.** Culture and behaviour are in practice more important than the fine print of the rules. Our processes and procedures need to provide an overall framework to assure value for UK taxpayers, whilst making sure decisions are made by those closest to the point of delivery.

Peter Vowels and Tim Wingfield, DFID Adaptive Management Programming.¹⁴

14. See dfid.blog.gov.uk/2013/10/21/adaptive-programming

Market development project cycle

‘The more challenging the situation, the better our systems and approaches need to be to be effective. Many adaptations focus on strengthening and improving elements present in most programs such as monitoring and evaluation systems, team capacity building and situational understanding’ (Mercy Corps, 2015).

Throughout steps of a project cycle, a market development approach uses frameworks, appropriate to any context or sector, to break down the complexity of implementing systemic change. While it is practical to discuss these steps as distinct, in practice there is overlap and constant interaction between the steps (for example, diagnosis and monitoring and results measurement are closely linked and create a virtuous circle). For this paper, the following steps of a project cycle will be utilised:

- Setting a high-level strategy

- Diagnosis
- Setting a future vision
- Facilitating systemic change
- Monitoring and Results Measurement (MRM)

1) Setting a high-level strategy

All development interventions should ‘Do No Harm’; this means understanding the context in which they operate, understanding the interaction between their activities and the context, and acting upon this understanding to avoid negative impacts.¹⁵

A financial sector development programme can create or exacerbate conflict in various ways:

- Real or perceived bias in the distribution of project resources, support or employment
- Resource transfers to parties to the conflict
- Enabling a diversion of resources to conflict
- Contributing to inflation
- Changing existing power structures, for example by increasing competition in a market.
- Reducing the capacity of local structures. For example, recruiting local government staff or activists (either formally or through payment of per diems for project work), or setting up parallel bodies. (Anderson, et al., 2003)

While all programmes in FASA should adopt basic Do No Harm and conflict sensitivity principles, it is a strategic choice if the development intervention is intended to have explicit peace or stability-building goals, in addition to other stated goals (i.e. poverty or vulnerability reduction). While peace-building and economic objectives may overlap in practice, there is also a need to carefully consider potential trade-offs between scalable economic development strategies and peace-building needs. For example, interventions focused on benefitting vulnerable groups or establishing economic linkages between conflict parties may be unlikely to achieve the same economic impacts as interventions focusing on economic growth potential (DCED, 2015).

The following are key questions to setting a high-level strategy in FASA:

What is the expected pro-poor impact?

Target groups: A review of financial sector development

programming shows that the majority have either a goal of reducing the poverty, and/or vulnerability, of the target group through economic growth and/or increased financial inclusion (i.e. an ‘inclusive financial sector’). Clarifying the target group is an essential first step of setting a high-level strategy. In fragile contexts, this may include refugee or IDP populations, or a specific affected population such as women or youth.

Geography: Clarifying the geographic focus is critical for strategic clarity. The focus may be regions, or ‘corridors’ within a country context that exhibit characteristics of fragility not present in other parts of the country. Depending on the flexibility of the programme, a regional or specific cross-border perspective can be beneficial, as fragility often crosses boundaries and there are potential opportunities to be found in regional dynamics and structure. However, drivers of change and stakeholders continue to operate on a national and local level.

15. This approach is well developed and many resources exist for agencies wanting to apply its frameworks. The text box information is adapted from ‘private sector development programming’. See <http://cdacollaborative.org/programs/do-no-harm>

We've been working on a regional level for four years and are coming to the conclusion that even though there is a regional central bank, developments are really happening at a country level. The eight countries in the region are very different; financial inclusion/access is quite different, private sector actors, context and histories are so different, that now we are focused in one country (Cote d'Ivoire) intensively'. Interview with Estelle Lahaye, CGAP West Africa, 8 July 2016.

How will the target group benefit? Clarifying objectives is important. The objective may be driving economic growth that benefits the target segment, improving access to (and use and quality of) financial goods and services that increase financial inclusion for the benefit of the target segment, or both. It is important to ensure that the assumptions behind a theory of change take into consideration the causes of fragility in a specific context.

What is the financial system change envisaged? It is important to clarify what the expected financial system change is (i.e. changed incentives, increased capacity, adapted practices, new relationships that result in inclusivity or increased economic growth).

This high-level strategy can be thought of as a 'theory of change' which sets broad strategic parameters, but is flexible enough to allow for adaptation. The high-level strategy may need to be revisited regularly as fragile contexts are fluid and dynamic. Establishing a clear theory of change helps focus the diagnostic process by identifying the scope of the additional information needed.

2) Diagnosis

Africa has for long mortgaged development policy and programming to external agencies with limited and at times unsustainable results. There is a strong need for development agencies to develop a strong contextual understanding of the environments in which they work. Harrison Manyumwa, 21 October 2013 (DFID, 2016).

The diagnostic process is the backbone of a market systems approach. It is a continuous process that not only serves program design, but also allows programme management to adapt interventions and informs market facilitation. Because of the diversity and complexity of fragile contexts, an understanding of the political economy – and conflict dynamics if applicable – is required in addition to an understanding of the structure and dynamics of the targeted financial services

sector (CGAP, 2015). The specifics of conducting political economy or conflict analyses are beyond the scope of this paper, which will focus on the diagnosis of a financial service market, taking fragility into consideration.

Generic conflict analyses are too broad to help them tailor their private sector development programmes to the specific context. They can also be extremely resource and time consuming. It can consequently be more useful to conduct a conflict analysis into a particular economic sector, rather than the overall conflict (DFID, 2014).

The diagnostic process in FASA asks key questions which correspond to the high-level strategy:

What products/services have high pro-poor potential (or stability-increasing potential)?

Sector selection in a fragile context may prioritise products/services with a higher relevance for the specific fragility. These may include infectious diseases (i.e. hospital cash, health insurance); climate change (i.e. index-based insurance); political instability (i.e. savings); or recovery from conflict (i.e. business loans or capital investment). An assessment of the feasibility of catalysing pro-poor systemic change in the selected 'sector' will need to take into consideration the context-specific factors contributing to fragility, particularly political economy issues and the timeframe of the programme vis-à-vis strategic objectives recognising that change in a fragile setting can take longer.

What is the current level of access for the target group?

This level of diagnosis looks at supply-demand. In fragile contexts, this may be at the informal level given the high prevalence for informality. At the formal level, it may be weak/thin due to a lower level of providers. There are likely to be lower levels of innovation in a fragile context and a lower level of consumer experience with the product/service.

What does the system look like – how is it working for the target group?

Supporting functions may be absent or weak in fragile contexts and the regulatory environment is often weak, and may be corrupt or seen as illegitimate by different market segments. Aligning functions with players (i.e. market actors) in a fragile context may reveal that there is a dearth of actors available to undertake key functions/rules. If the driver of fragility is a crisis

(either man-made, such as conflict, or natural, such as drought), it is important to understand how the market system functioned pre-crisis and what has changed as a result of the crisis.

What are the underlying constraints (and priority intervention areas)?

The informal norms and economic dimensions to fragility greatly play into our understanding of underlying causes and feasibility of interventions. Capacities and incentives are of even greater importance in fragile contexts where capacities are weaker, and incentives may be skewed depending on the nature of fragility.

There are challenges to gathering data in fragile contexts which are applicable to both the diagnostic process and monitoring and results measurement (adapted from (DCED, 2015):

- *Limited access:* Risks of harm may limit the ability to access programme sites and meet with the target group. Political institutions may also not allow access, or restrict the questions that can be asked.
- *Weak capacity:* It is often challenging to find and retain effective results measurement staff, while low capacity and high costs among third parties (universities, survey firms, consultants) may reduce the ability to outsource the collection of data.
- *Limited secondary data:* Government institutions may not collect or publish accurate data owing to limited capacity and resources. In particular, there may be limited data on populations, which reduces the validity of sampling techniques. This may necessitate an increased amount of primary data collection.
- *Greater monitoring costs:* A lack of infrastructure (e.g. roads, telecommunications networks), security costs and recruitment challenges will typically require higher spending on data gathering. More frequent analysis may be necessary as circumstances change rapidly in fragile contexts.
- *Sensitivity of data:* Consumers and partners may be put at risk if project data is accessed by some parties. This may also cause unwillingness among stakeholders to share information.
- *Data interference:* Local staff or partners may be biased in their reporting.
- *Qualitative information:* In fragile settings, perceptions, beliefs and opinions are particularly essential to the success of interventions. Qualitative information requires more time to collect and analyse.

A collaborative diagnostic process can lay the groundwork for future coordination, is an entry point for building relationships and provides access and insights which may be more difficult to obtain in a fragile context.

3) Setting a future vision

A future vision should be ambitious, but realistic according to the dynamics of FASA. This requires an additional focus on what is feasible. Applying the framework for setting a future vision is thinking through ‘who will do’ and ‘who will pay’ for key functions in the system. This holds true in fragile contexts with a recognition that there may be a longer timeframe during which the development actors are ‘doing’, or ‘paying’ for, a function. Subsidies may be used more extensively to buy-down risk, which is higher in fragile contexts.

4) Facilitating systemic change

In a typical programme, only a small proportion of interventions reach scale. Programmes therefore need to experiment with a wide variety of innovations early on, then double-down on those showing most promise. Donors and practitioners also need a high tolerance for risk and failure (ASI, 2016).

Facilitating systemic change relates to how development actors play a catalytic role to incentivise and enable market actors to perform their functions more effectively and sustainably (CGAP, 2015). There is little existing evidence on how financial sector interventions can/should be implemented, or how to adapt based on timing (in a fragile context) (McIntosh & Buckley, 2015). Financial sector development is not a linear process. This is particularly the case in fragile contexts where situations are dynamic and circumstances can change rapidly, i.e. there is potential for recurring cycles of fragility including humanitarian crisis or mass population movements (e.g. northeast Nigeria, Sudan). Good facilitation principles and practices hold true in FASA, although tactics will differ depending on the context.

Good facilitation principles:

- *Relationships:* Reinforce relationships between system actors.
- *Ownership:* Ensure partner owns, and is committed to, the change process.
- *Intensity:* Right-size the level and type of support to the change process.

Good facilitation practices:

Testing the business model makes sense

When introducing a new product, service or delivery channel, it is important to ‘run the numbers’ and ensure the business case makes sense for all stakeholders. The

“When introducing a new product, service or delivery channel, it is important to ‘run the numbers’ and ensure the business case makes sense for all stakeholders.”

desire to introduce change in a fragile context can lead to unrealistic expectations about what is feasible and the potential for players to be able to continue to ‘do’, or ‘pay’ for, a needed function without donor subsidies in the long run.

Thinking through systemic change (designing results chains)

In fragile contexts, stakeholders often take longer to gain trust and learn new ways of working. This should be reflected in the timelines between steps in the logic of a results chain. Testing the logic of systemic change and uncovering assumptions behind how change will happen is critical in FASA.

Selecting partnerships

Fragile contexts may have fewer ‘innovators’, as their environments aren’t supportive of risk taking. It is likely there will be more intensive engagement with a smaller number of actors (because there are often fewer actors present and capacity may be limited). It will also mean engaging with the informal sector more intensively than may be the case in non-fragile contexts.

Due to the thin nature of markets in DRC, many sectors experience a lack of strong actors ready to take on new roles in a market system. To address this, the programme must continue identifying new entrants (foreign companies), but also identify strong actors from other market systems that can move into the role needed to bring about market system change (ASI, 2016).

It is essential to engage the public sector in systemic change efforts. In fragile contexts, the public sector

may be in transition, overwhelmed, or lacking resources (such as skills). That means we may spend more time understanding and influencing the regulatory system and capacity either to develop new regulations or to adapt old regulations that are constraining the market (i.e. outdated laws on deposit-taking institutions, or lack of mobile money regulation limiting mobile operators’ willingness to enter the market) (Hinton, 2016).

‘My argument is that, in FASA, we need to modify our traditional ways of building financial markets (supporting policy and regulatory reform) because governments in those places are unreliable counterparties, and traditional market-building processes can be too slow. So, whilst continuing to do what’s possible building the enabling environment, we also need to work more intensively with private investors and better understand what we can do to make it easier for them to do their business – albeit sharing, rather than removing, risk.’ Mark Napier, Director, Financial Sector Deepening Africa, 2016.

Designing activities – making offers

Although institutions may be fewer in number or operating at less than optimum capacity in FASA, it is important to keep a focus on ‘what is working’ and avoid the introduction of unrealistic formation of new institutions. Higher risks (real and perceived) in fragile contexts may result in an increased use of subsidies (a greater number, or for a longer time period, or both). There is often a higher degree of direct interventions by the facilitator (i.e. taking on information gathering or capacity building). However, this should be done with a view to how the development agency will exit, i.e. who WILL do and who WILL pay in the future, even if those timeframes are longer due to the context. Low degrees of trust are common in fragile settings and require deeper ‘negotiation’ skills of the facilitator to bring different stakeholders together. Encouraging stakeholder dialogue as an ‘honest’ broker in situations where trust is lacking can be key. There is a high value of conducting pilots to see what works before investing in scale-up.

‘We see pilots as the way to learn – we pilot for on average six months and we pilot things that we believe have scale-up potential. But we only scale-up what works and we plan the timelines based on the potential after doing the pilot’. Interview with (Teshome, 2016).

Crowding-in

Crowding-in will not happen automatically as a result of simple pilot testing; replication often requires additional interventions before it is institutionalised (CGAP, 2015). This is heightened in fragile contexts, where information flows and infrastructure are often inadequate and industry coordination is often lacking. The facilitation of crowding-in can be embedded in project design with supplementary interventions to raise awareness and interest in outcomes resulting from a pilot.

A commonly cited strategy for getting to scale is through the demonstration effect. However, the conditions in the DRC under which the demonstration effect works are quite stringent. Consequently, we could find relatively few examples of it working in practice. Programmes cannot therefore lazily assume that the demonstration effect will automatically hold (ASI, 2016).

Managing and exiting partnerships

The thin and underdeveloped nature of (DRC's) markets makes it more difficult at times to take a lighter approach, as market actors are required to take more substantive risks to take on new roles in market systems. At times, this requires the programme to take on comparatively more risk than in other market development programmes, which can lead to expectations of continued support from partners. To avoid this, clear exit strategies and careful communication with partners are required (ASI, 2016).

Monitoring and Results Measurement (MRM)

MRM is a process of assessing change, at different levels of the theory of change, to prove the contribution of interventions to the impact for the target group, as well as improve the facilitation process. Adhering to Do No Harm standards requires an additional set of standards to those used in market development programmes (DCED) including the use of indicators to monitor negative impacts of interventions.

DFID recognises that working in fragile contexts requires robust approaches to managing risks. They refer to the use of third party monitoring processes for inaccessible areas, the use of technologies such as geocoding and the use of mobile phones in monitoring service delivery (DFID, 2016).

Three principles underlie the application of the DCED Standard in fragile contexts (DCED, 2015):
Simplicity: Personnel are often overworked and under-resourced, with little training in results measurement. High staff turnover may reduce familiarity with the project and context. An overly complex results measurement system will not be successfully implemented, wasting project resources and reducing the willingness of staff to use it.

Flexibility: Fragile contexts are unpredictable, complicated and fast-changing. An inflexible results measurement system may monitor irrelevant indicators, fail to capture the positive impact of the project, and put staff and project clients at risk by ignoring negative consequences. Results measurement systems should be flexible. A results chain can never capture the full complexity of the situation, and may become rapidly outdated if not regularly reviewed. Be alert for positive and negative changes not captured by your indicators, and be prepared to modify the monitoring system accordingly.

Sensitivity. Inappropriate interventions in fragile contexts can endanger staff, partners and project clients while worsening the conflict. Private sector development (PSD) projects must be particularly aware of potential negative impacts because conflicts are frequently driven by economic factors, which PSD interventions can either reinforce or reduce.

Data gathering and triangulation: Keep an eye on the context and surrounding systems, by leveraging multiple forms of data through multiple channels. Adaptive management requires mechanisms for building and maintaining an understanding of context. This enables a project to refine its approach, as more is learned about the context and the project's impacts on it. It also means the project approach can be shifted as the context shifts, including as new needs or opportunities arise. The same challenges of gathering data as described in diagnosis will apply to the MRM process.

Quantitative 'soft data': Practically, traditional M&E systems (focused on tracking activities, outputs and outcomes) often fail to provide sufficient contextual awareness or feedback to inform programming. Adaptive programs deliberately build large networks of external informants, including partner organisations and community leaders, which contribute data back to the program. 'Soft' data sources, such as field staff observations, are also valued for the insights they bring, especially when combined with 'hard' data and structured assessments.

Connect decision-making to MRM: To be useful, appropriate data and reflective analysis cannot be isolated. They must feed into decision making and action. Accomplishing this requires cross-team integration and structured processes, such as: integrating M&E or other

analytical functions into program teams, as mentioned above; building response capacity (i.e. funding and/or staff) that will be ready to address opportunities and needs identified over the course of the program; and allowing for extended inception periods for research and design that shapes program budget, staffing and strategies (Mercy Corps and IRC, 2016).

Donors need to incentivise programs – what we count, what we measure. There is a chance that we are measuring the wrong things in fragile states with too much focus on individual activities rather than changes in systems and structures – current DFID performance measures may not work in FASA (Vowels, 2016).

Operational tactics

A growing body of evidence indicates that aid agencies are most successful when able to operate flexibly, particularly in fragile environments. Yet our systems and tools are often too rigid to effectively address complex problems, and program incentives frequently undermine adaptation instead of supporting it. To drive improvements in impact we need to be better able to analyse the dynamics of a given situation, anticipate how these might evolve, and be sufficiently agile to adapt to changes in context and need. (Mercy Corps and IRC, 2016)

For each context in FASA, an operational profile (including security, logistics, human resources (national/ international), administration, financial and information technology systems) is required to determine the specific operational challenges and opportunities.

Processes

Bridge the gap between programs, operations and finance teams. Programmatic adaptation has ripple effects across an organisation. Operations and finance teams that would otherwise default to standardised procedures – which typically are designed for a stable context and pre-designed programme – must find ways to adapt accordingly. These support teams are better placed to facilitate adaptation if they work closely with the programme team, so that they better understand why they are being asked to take new approaches. Likewise, programme teams that understand existing operational and financial procedures are more likely to understand the flexibility they have (Mercy Corps and IRC, 2016).

Security: Security protocols will depend on the donor requirements applied to the facilitator, particularly when it comes to expatriate presence. The use of armed guards can increase risk to staff and may act as a deterrent for gathering the 'close' information needed to gain insights for good market facilitation.

In FASA, donors need to find a different delivery model and need partners that can move around more freely. Currently programs are often working in parallel, versus vertically, with no incentive to look across programs. There is an opportunity for us to look up from the 'county perspective' versus the current focus looking from the country level down. DFID needs incentives for partners to talk to each other (Vowels, 2016).

Budgets: Flexibility in budgets is necessary in fragile contexts where dynamics change rapidly. Budgets can be loosened by allocating funding in broad categories, with the opportunity for: flexibility within each category; holding a reserve of funding for learning and adaptation; or ensuring that budget changes receive rapid approvals from donors (Mercy Corps and IRC, 2016). Market development budgets are typically constructed as overhead (i.e. administration), staffing (programme staff considered as 'programme' costs), intervention funds (often constructed as cost-share or 'challenge funds'), and research.

Salaries will be agency and context-specific. They may be higher if the living situation is considered difficult or if qualified staff (national or expatriate) are hard to find. Frequent travel may be required if there is not a

consistent on-the-ground presence (which will depend on an operational assessment as mentioned). If the programme requires an external auditor, the costs of having an auditor visit the fragile country or region must be factored into the budget. If the programme deals primarily in cash, or is at a large scale, quarterly or bi-annual external audits should be considered to ensure both external and internal transparency.

Timelines: Systemic change takes time. Market-based solutions take 5-10 years to reach significant scale (Koh, et al., 2014). In FASA, it can take longer due to the lack of institutions, lower capacities, fewer counterparts, weak governance, and difficulty in hiring and retaining teams (among other factors). Development actors must recognise that other actors will likely not be able to sustain their involvement for the entire duration (Koh, et al., 2014).

‘Working in FASA requires longer-term due diligence procedures and always takes longer at the front-end compared to non-fragile states. This includes significant time to ensure strong Do No Harm and conflict sensitivity analysis.’ (Onajin, 2016)

People

The role of facilitator requires entrepreneurial instincts, critical analytical skills and the ability to process complex information in large amounts, flexibility, good interpersonal skills, and political economy skills. This is a combination that is difficult to find (and retain), particularly in fragile contexts where capacities are limited for a variety of reasons.

Hire local and hire for an adaptive mindset: Though hiring local staff has long been important for working in FASA, cases of adaptive management add further evidence for the value of the local networks, contextual knowledge, and personal investment of staff hired from the communities being served. In addition, hiring practices should seek staff with ‘adaptive mindsets’: inquisitive by nature, able to ask the right questions and bringing broad, flexible competencies and skillsets (Mercy Corps and IRC, 2016).

In Mercy Corps’ Uganda RAIN programme, which had a strong financial sector component, recruitment interviews included problem-solving scenarios or trips to the market to see how candidates analysed context in real time. The contextual knowledge and analytical skills of these team members were invaluable in several program pivots (Mercy Corps and IRC, 2016).

Team composition: Whether teams are expatriate or national will depend on context and access issues, resources, and recruiting potential. The security requirements of the donor, or operational considerations, may require a reduced presence of expatriate staff and consultants. It may be difficult, and more expensive, to place expatriate staff in fragile contexts, and it can be challenging to find appropriate consultants willing to work in these contexts.

It is important that your context analysis carefully considers the different profiles of different groups and contexts. In a Mercy Corps programme example, removing foreign staff from the environment reduced the risk to them, but at the same time, it made the local staff feel safer because they were not subject to increased scrutiny and suspicion due to them being seen with the foreigners. It is important to note that this is not always true; sometimes the presence of expatriate staff can increase safety (Mercy Corps, 2015).

The DRC government tightened its visa procedures in the beginning of Q4 2015, resulting in visa processing times of up to six weeks. This has had an impact on the programme’s ability to mobilise international consultants and staff to join the programme (ASI, 2016).

Multi-sectoral teams: Given the complex nature of fragile contexts, facilitation teams should come with a variety of skillsets.

The programme piloted a novel approach to gathering information on political economy and conflict issues to inform interventions and programming. A Conflict Advisory Group (CAG) was formed, comprising five advisors from different areas of expertise, including conflict resolution, human rights and gender (ASI, 2016).

Provide mentorship and coaching. The behaviours and competencies needed for adaptive management (and market development) are quite different from those instilled by traditional management approaches. Staff need supportive criticism and advice to help them adopt these behaviours and steer their work appropriately. This can occur through formalised mentorship and coaching, perhaps as part of supervisors’ roles, or through more informal channels (Mercy Corps and IRC, 2016).

Proximity

Implementation arrangements: Different types of organisations can facilitate systemic change, as long as they are seen as independent and have the capacity to adapt to change and opportunities that inevitably arise in dynamic market systems (CGAP, 2015). Whether a facilitating agency operates in a country directly, or chooses to contract out the facilitation role (i.e. to an international or national NGO/contractor, or local stakeholder(s)) will depend heavily on ‘access’ issues. AGIS Consultants describes the options as: partial coverage with no staff on the ground, semi-coverage through a hub model, or full-time staff on the ground (2016). It is extremely difficult to be a good facilitator of systemic change without having consistent on-the-ground knowledge and presence.

Several market development programmes have found that unless a facilitator partner has a deep understanding of the approach of facilitation, and knowledge of the target sector (i.e. financial services, tourism, agriculture), the time and energy it takes to train, support and oversee the sub-facilitator can be too resource-intensive to be worthwhile. Through both direct experience and interviews, the authors have found that the provision of only short-term in-country support by international staff is often not effective, though may be a model for donors or non-implementing development actors.

Place decision-making authority as close to front-line staff and partners as possible. Those who are closer to a problem usually understand it more thoroughly and are better positioned to quickly try new things, see whether they are working, and iterate accordingly. This is critically important in complex aid and development efforts, where difficulty understanding context reduces the value of initial plans and where shifts in that context can make current activities irrelevant. Centralised decisions often take too long and are made without nuanced understanding of on-the-ground realities. Adaptive programmes allow significant field-staff and partner autonomy. Where oversight is needed, short decision making chains can support informed and rapid decisions (Mercy Corps and IRC, 2016).

Programming culture

Foster open communications and a collaborative culture. Successful adaptation is more likely when teammates build trust, communicate openly, and support one another in taking risks. The habits and norms of organisational culture are important. Program leaders can set the tone in how they interact with staff, including actively seeking input from field staff and demonstrating commitment to act on it. Relationships and common identity built across the team, including outside work hours, can facilitate collaboration. Quarterly reviews, weekly staff meetings and even daily briefings provide further opportunities to reinforce this culture. (Mercy Corps and IRC, 2016)

However, what probably underlines the process and causes it to succeed is the attitude and approach of the individual colleagues from DFID who have taken a very collaborative, learning-centred approach that results in a jointly agreed process and implementation plan throughout (Hopkins/DFID, 2016).

Think about strategy, not projects: It is important to ensure programme timeframes are realistic vis-à-vis strategic objectives and interventions, and programmes are sequenced to reflect the iterative, and dynamic, pace of change.

‘What we need is fewer “project-based approaches”. Even if a project is a success, that’s it, because the project comes to an end. We need funding, but also cover for the implementing agencies’ backs, letting people get on with implementation and learning and using a bottom-up approach to see what works’ (Makin, 2016).

Section 5

Promising practices: towards a set of priorities



Foundations for inclusive finance: what is essential?

Adapted regulatory approaches

In a highly underdeveloped financial market, regulation has the ability to promote innovation. Over-regulation has the opposite effect. Badly designed regulatory frameworks, especially those that lack private sector input, can have adverse effects, hindering investments, economic growth and job creation (World Bank, 2014). Regulators can play a role in building markets or delaying markets. This is especially true in fragile contexts. Regulators alone are often not in a position to reset policy appropriately. Development actors can expand regulators' understanding of how financial services can have a positive impact on poverty rates and stability. Regulations are required to enable the successful adoption and adaptation of financial services, to encourage their use, and to increase competition among providers (Claessens & Rojas-Suarez, 2016) in the core market and supporting functions. However, if designed poorly, regulations can be a barrier. For example, bureaucratic and costly KYC regulations can limit the uptake of mobile money services and incentives of mobile network operators to market to low-income populations. In fragile states, development actors need to work 'ahead of the curve' of the actual regulations to head off the risk of inhibitory or inappropriate regulation, which will be more difficult to change once in place (Koh, et al., 2014). Development actors have a distinct role to play to reconcile the often deep mistrust between the government and the private sector in fragile contexts. This distrust often results in cronyism and lack of legitimacy (Nelson, 2014). Three principles for adapted regulatory approaches include similar regulation for similar functions, regulations based on risk, and a balance between ex-ante and ex-post regulation (Claessens & Rojas-Suarez, 2016). In fragile states, and those in transition, there is an opportunity to focus on different types of regulatory areas: competition policy, KYC rules, and levelling the playing field (Claessens & Rojas-Suarez, 2016) and how the regulations impact the core market.

Key opportunities:

- Competition matters, as it leads to greater variety of products and services, higher efficiencies and

lower costs (Claessens & Rojas-Suarez, 2016) and can address the causes of inefficiency in the core market. However, the main goal for competition policies is ultimately to allow and encourage new providers to enter the market, which is a key barrier in African fragile states (Arvanitis, 2014).

- Creating or adapting KYC rules can ensure they are adequate for maintaining financial integrity, but don't create unnecessary barriers to inclusion (rather, they work to enhance inclusion proportionate to the risk) (Claessens & Rojas-Suarez, 2016). Tiered KYC is line with a risk-based approach, and recognises minimal risks posed by small transactions by allowing for restricted and graduated accounts (Claessens & Rojas-Suarez, 2016). SIM card registration is increasingly serving as a minimal and equivalent KYC. This is especially important for payment services which are less risky activities than deposits or credit.
- 'Levelling the playing field' in financial services is enabled by when regulations for similar services are treated equally with a focus on requiring consumer protection across service providers. This should include disclosure of fees charged, and the provision of customer recourse and dispute resolution mechanisms (Chapman & Mazer, 2013); (Claessens & Rojas-Suarez, 2016).
- Reducing Africa's 'remittance super tax' through regulatory reforms and ending exclusivity agreements with specific mobile transfer operators and banks (ODI, 2014).

What development actors can do:

- Advocate and support a risk-based approach to tiered KYC regulations, to allow a different level of financial transactions and as an entry point into formal finance (especially important for remittances, payments and mobile money).^{16, 17}
- Prioritise consumer protection regulations for customer recourse to build trust in the formal finance system.¹⁸
- Include inclusive Islamic banking policies, including regulatory and supervisory frameworks, as stand-alone financial institutions and windows within conventional institutions (Gelbard, et al., 2014).

16. Tiered KYC regulations exist in South Africa, Peru and India. See Gelb, Alan (February 2016), Center for Global Development (CDG), 'Balancing Financial Integrity with Financial Inclusion: The Risk-Based Approach to Know Your Customer', available at www.cgdev.org/sites/default/files/CGD-Policy-Paper-Gelb-KYC-Financial-Incl.pdf

17. The Central Bank of Nigeria introduced a three-tiered set of KYC requirements in 2013 for opening formal and mobile accounts with balances below certain thresholds. In 2014, though, only 2.3% of Nigerians had a mobile money account (World Bank, 2014), demonstrating a slow start to the tiered systems. See Alliance for Financial Inclusion (May 2016), www.aifi-global.org/sites/default/files/publications/2016-casestudy-btg-nigeria.pdf

18. See Chapman, Megan (December 2013), CGAP, 'Making Recourse Work at the Base of the Pyramid', available at www.cgap.org/sites/default/files/Focus-Note-Making-Recourse-Work-for-Base-of-the-Pyramid-Financial-Consumer-Dec-2013_1.pdf and Mazer, Rafe (February 2016), CGAP, 'Recourse of Digital Financial Services' available at www.cgap.org/publications/recourse-digital-financial-services

(See Annex A).

- Encourage short-term land usage to secure capital for working capital and housing upgrading post-conflict.

Identification solutions

Proof of identity through a functional identification (ID) is the foundation for financial inclusion and a fundamental right for all people. An ID, in its most basic form, is a prerequisite to access education, services, information, jobs, and financial services and is typically required to facilitate KYC. In its more advanced forms, an ID, especially on digital channels, allows individuals to build authentic and verifiable information, such as a credit history, and unlock access to a wider range of financial products and providers.

Establishing a formally recognised identity can be a major hurdle, especially in fragile contexts which often lack a national ID scheme in any form and may be years away from having a digitised or biometric ID scheme. Fifty-six percent of the SSA population does not receive a formal ID at birth (UNICEF, 2013). Due to movement

within or across borders (such as IDP and refugee populations), people often require a new ID. Formal identification can be a government or community-issued ID, third-party document, biometric registration, and increasingly a SIM card or phone number unique to an individual. However, even accessing a SIM card may carry a prerequisite of a functional ID (GSMA, 2016). The recognition and authentication of an individual's identity, together with associated rights, is becoming a priority for governments around the world and is included as Sustainable Development Goal target 16.9: 'free and universal legal identity, including birth registration by 2030.'

Key opportunities:

What is needed is a system that lets the issue of identity be resolved in the first instance within the communities where poor people live, shop and work (e.g. through attestation by known local figures) and draws people into seeking and improving their digital identities over time. (Mas & Porteous, 2015)

This is the notion of social identity. Let people with meagre resources help each other overcome their limitations: each may have very little voice, but collectively they represent a potentially vast information system for official identification purposes. That is hard to reconcile with the way governments and formal institutions tend to handle identity verification: in silos, contained within databases and cards. We need more flexible notions of identity, which build layers of identity information and verification through social networks – as well as bureaucratized ID-seeking processes (Mas & Porteous, 2015).

There is scope for a dual approach of sponsorship and biometrics. There are two applications for biometrics: (i) identification or 'de-duplication' (has this person registered before?) and (ii) authentication (checking that this person is the same person you saw last time). There are pros and cons of various biometrics (iris, finger vein, facial) which are beyond the scope of this

paper (see additional resources for more information). While there are signs of innovations, such as IRIS guard – a mobile app for use in developing countries – the existing standards for biometrics are currently proprietary. The cost of the technology for biometrics adds to the cost to the transfer procedure.

We are not yet at the stage where we are seeing practices (in biometrics) that are linked that are cost-effective. And no matter the technology; if the enabling environment isn't right, the type of technology doesn't matter (Leon, 2016).

What development actors can do:

Development actors, in partnership with the private sector and DFIs¹⁹ should prioritise building systems and structures to ensure everyone has a functional ID as the foundation for access to financial services. Without this focus, development actors risk excluding large portions of the population. This includes working with actors for

government-issued IDs, where feasible, and increasing levels of mobile phone access to create stronger digital footprints. However, in parallel, development actors must apply a Do No Harm lens and strongly consider options that are 'privacy enhancing identity systems rather than privacy threatening', especially in FASA.²⁰

19. See the World Bank's Identification for Development initiative, available at www.worldbank.org/en/programs/id4d and [ID2020](http://www.id2020.org), and the [UN private sector partnership ID2020](http://www.id2020.org) at www.id2020.org

20. See Consult Hyperion, 'Digital Identity: Issue Analysis' (June 2016), available at www.chyp.com/wp-content/uploads/2016/07/PR-11578-Omidyar-Network-Digital-Identity-Issue-Analysis-Executive-Summary-v1_2-1.pdf

Practice trends: what is showing promise?

While interventions are highly context specific, the research process for this paper revealed some programming trends which show promise across fragile contexts. These ‘trends’ can be conceived of as those which benefit a particular market segment (i.e. target group), those that are financial products or instruments, and those that are a delivery channel mechanism. Promising practices are briefly described here, with a deeper look at six promising practices (denoted in parentheses) in Annex A.

Market segments

1) Refugee and IDP finance (See Annex A)

As of July 2016, SSA hosts the world’s largest refugee, IDP, and ‘persons of concern’ populations – over 19 million people.²¹ Refugees and IDP displacement is increasingly urban, dispersed and self-settled, with managed camps becoming the exception. With extensive displacement, these populations must have opportunities to access finance for productive and consumption needs.

2) Islamic finance (See Annex A)

Globally, religious self-exclusion from formal financial institutions is highest in SSA (Gelbard, et al., 2014); (Naceur, et al., 2015). Islamic finance is still nascent in SSA but has a formal and growing presence with increasing demand in 21 African countries. The expansion of Islamic finance, and especially microfinance, has the potential to offer more effective tools for improving financial inclusion than conventional finance in certain SSA countries (Naceur, et al., 2015); (Anderson & Byrne, 2015); (Karim, et al., 2008).

Financial delivery channels

3) Impact investing (See Annex A)

Impact investing is an investment approach that intentionally seeks to create both financial return and measurable social or environment impact (WEF, 2013). By leveraging the private sector, these investments can provide solutions at a scale that purely philanthropic or development interventions usually cannot reach. East Africa has become a global hub for impact investing, though the focus is primarily on Kenya (with over half of the investments), with little to no investments in more transitional contexts (i.e. Somalia and Burundi). The impact investment market in West Africa is comparably

smaller than in East Africa, with the majority of impact investing capital concentrated in four countries and deployed by DFIs through the use of debt.

4) Payments and remittances infrastructure (See Annex A)

Payments are the ‘connective tissue of an economic system’ (BMGF, 2013); they serve as an optimal entry point into the formal economy as well as a means to access remittances. For cross-border remittances to flow, there has to be a strong payment system in place in-country. Digital payment systems allow movement from high-touch to low-touch, however current levels of access and usage for digital payments are mixed due to lack of infrastructure and dependency on cash – both prevalent factors in fragile contexts.

Financial products and instruments

5) Inclusive insurance²²(See Annex A)

The risks facing low-income populations and businesses, and financial providers serving these segments in fragile contexts, are vast and complex, and uninsured losses can lock them into vicious debt cycles. Challenges to developing inclusive insurance markets are exacerbated in fragile contexts; particularly due to ineffective, ill-enforced legal frameworks, poor infrastructure and limited knowledge of, and trust in, insurance products. However, there are several emerging insurance schemes relevant for FASA, including, at the micro-level, loyalty-based mobile insurance and index insurance and at the meso-level, catastrophic insurance.



East Africa has become a global hub for impact investing, though the focus is primarily on Kenya

21. UNHCR, 2016.

22. The term ‘inclusive insurance’ is increasingly replacing ‘microinsurance’. The term ‘digital insurance’ is used to encompass the role of digital mechanisms to support the delivery of inclusive insurance; it is generally broader and more encompassing than the term ‘mobile microinsurance’.



Image: Ethiopia / S. Sheridan – Mercy Corps © 2016

6) Liquidity and partial credit guarantees facilities (See Annex A)

There are significant opportunities for development actors to use both liquidity and partial risk guarantee facilities either as stand-alone or combined interventions in FASA, adapting learnings from existing programmes in non-fragile environments. Liquidity facilities are used by development actors primarily in natural disasters. Though they must be established pre-disaster (or conflict), they serve an immediate need to stabilise, reduce losses, and ensure the resiliency of financial providers. Partial credit guarantee facilities are already commonly used by various types of donors to mitigate partial risk, to allow financial institutions to lend to unserved and underserved MSMEs. These donor and blended finance investments can provide a demonstration effect for other investors in higher-risk contexts.

7) Diaspora investment platforms

Diaspora communities contribute to the socioeconomic

development of their home countries through remittances, human capital transfer, trade facilitation, philanthropy and investment. In the African context, the opportunities for diaspora investment growth are vast, with almost 140 million Africans living outside of the continent. With an estimated US\$40 billion of funds held globally in diaspora savings, governments, companies and community groups are increasingly turning to the diaspora as a potential source of longer-term investment (DMA & IOM, 2015). Diasporas tend to have a higher risk appetite for investments in home countries (Hinton, 2016). Investment may be direct, into a single business, or may take the form of co-investment with other diaspora members or mutual funds. There is also the potential for shared-risk development impact bonds – especially for low-to-medium fragile states. Diaspora funding platforms, typically set up as online portals, provide effective and efficient avenues to connect diasporas to investment opportunities, providing a structured, transparent and reliable way for diasporas to invest in ventures back home.

Homestrings²³ is an African-focused crowdfunding platform that offers bonds, funds and projects for diaspora investments in infrastructure, healthcare, education, transportation, and small and medium-sized enterprise finance. Homestrings is active in Cameroon, Cote d'Ivoire, Nigeria and Somalia. An example of a project is the YooMee Internet Bond, which supports the growth of a company that provides high-speed internet access in sub-Saharan Africa. 'I get access to early-stage investments, backing great entrepreneurs so I can be part of the next big thing in Africa'. Ade B, Homestrings Investor.

Renew Strategies²⁴ is an impact investment and advisory firm that manages and supports the largest U.S. based Impact Angel Network focused of Africa, a global network of diaspora investors that seeks to make both social impact and financial returns on their investments in SSA (specifically Ethiopia and East Africa). Sector focuses include clean energy, agro-processing, manufacturing and healthcare. Individual investments range from US\$100,000 to US\$3 million, for expansion or growth of capital in high-growth, domestic firms, with a full exit in three to seven years via a management buyback with a target IRR greater than 25%.

23. www.homestrings.com

24. www.renewstrategies.com

Section 6

Donor landscape: who is doing what?



This section provides a brief snapshot of highlighted institutional and private donors investing in financial sector development in FASA.

Institutional donors

The majority of institutional donors invest in financial sector development as a supporting sector for larger impact goals (i.e. private sector development, energy access, education, stability, climate resilience, and agricultural growth). In addition to the below, the Agence Française de Développement (AFD) and the Swiss Agency for Development and Cooperation (SDC) have growing portfolios in this sector.

The European Commission (EC) committed €77 million to assist Kenya, Somalia and Ethiopia address 1.7 million refugees. At the 2015 Valletta Summit, the EC committed to address migration from Africa to Europe, including the need to “promote cheaper, safer, legally-compliant and faster transfers of remittances and facilitate productive domestic investment.” In addition, the EC agreed to operationalize the African Institute on Remittances in 2016 and contribute to a Trust Fund of up to €1.8 billion.²⁵

Swedish International Investment Agency (SIDA)²⁶ works globally with investments in East Africa and a growing West African presence (Onajin, 2015). SIDA is dedicated to diaspora financing platforms (especially for Somalia) and already works in FASA but, as with other donors, requires strong partners on the ground for due diligence and to conduct Do No Harm and conflict sensitivity analysis (Onajin, 2015). SIDA dedicates ‘financial systems’ funding under their global market development portfolio²⁷ and through partial-credit guarantee mechanisms. This includes a portfolio with UNHCR and partnership with the World Bank’s Multilateral Investment Guarantee Agency (MIGA)²⁸ that covers all countries considered fragile by the World Bank, including non-commercial risks such as political risks (extortion, civil unrest, and civil war) (Onajin, 2015).

The UK Government’s programming approach to inclusive financial sector development in fragile states is led by the Department for International Development’s (DFID) Finance Team, which forms part of DFID’s Private Sector Development Department. The approach



“The majority of institutional donors invest in financial sector development as a supporting sector for larger impact goals”

is nascent but developing and is framed by two recent policy documents. The UK Aid Strategy (2015) prescribes an increase in DFID programming spend in fragile states to 50% of total programming spend. DFID also published a ‘Building Stability Framework’ in 2016, which foregrounds the role of inclusive economic development.

More specifically, in Africa alone, DFID funds ten financial sector development programmes. A number of these programmes focus explicitly on fragile states, including, for example, finance teams within ELAN RDC (Democratic Republic of Congo) and PEPE (Ethiopia) and so-called ‘FSDs’ in Kenya and Nigeria. DFID also funds FSD Africa, which is leading a fragile states strategy focused on three countries: DRC, Sierra Leone and Zimbabwe; and two thematic: forcibly displaced people finance and remittances.

U.S. Agency for International Development (USAID) has committed to international efforts to assist one billion people move out of extreme poverty by 2030 with a strong Africa focus (USAID, 2014). This includes supporting financial sector development under in its Africa Bureau, Power Africa²⁹, economic growth and trade portfolio, and the U.S. Global Development Lab. One of the primary initiatives is the USAID Development Credit Authority (DCA). The DCA seeks to prove the commercial viability of underserved markets through credit guarantees and bonds backed by the U.S. Treasury. Through DCA, USD\$3.7 billion in private financing has been made available for entrepreneurs, including in the DRC, Ethiopia, Liberia, and Zimbabwe.³⁰

25. See http://ec.europa.eu/dgs/home-affairs/what-we-do/policies/international-affairs/africa/index_en.htm

26. www.sida.se

27. www.sida.se/English/how-we-work/our-fields-of-work/market-development/financial-systems/

28. www.miga.org – note MIGA does not cover Somalia

29. www.usaid.gov/powerafrica

30. See country-specific overview here: <http://storymaps.esri.com/stories/usaaidcredit>



Image: Ouallam, Niger / S. Sheridan – Mercy Corps © 2014

Bi-lateral donors

The African Development Bank Group (AfDB) approaches fragility from a multi-dimensional risk perspective recognizing the private sector as a strategic partner in fragile situations. The AfDB develops efficient and inclusive financial systems to facilitate transactions and mobilize savings for investment, especially for SMEs. The AfDB applies financial instruments to promote private sector growth, including partial risk and credit guarantees, private equity investments, and trade finance. In 2015, the AfDB launched a credit enhancement initiative to increase private financing in fragile situations with the capacity to cover US\$700 million in credit default exposures to further boost private investments.

The International Finance Company (IFC), a member of the World Bank Group, provides financial and advisory support in FASA, increasing as part of larger financial inclusion initiatives and digital finance partnerships.

The United Nations, through the U.N. Capital Development Fund (UNCDF) provides investment capital and technical support to the financial sector and has several commitments in FASA including: Burundi, CAR, DRC, Guinea Bissau, Liberia, and Sierra Leone. UNCDF works extensively in Africa as the host of the Better than Cash Alliance (BTCA) and through its Mobile Money for the Poor initiatives across SSA.³¹ UNCDF played a large role in the development of emergency payments infrastructure during and post-Ebola crisis in Guinea, Liberia, and Sierra Leone.³²

Private foundations and companies

The Bill and Melinda Gates Foundation (BMGF) is a global leader in financial sector development through its Financial Services for the Poor Initiatives with a focus

on digital financial services. The BMGF does not have a specific focus on FASA, though works in countries that have fragile regions or border fragility-affected

31. See www.betterthancash.org

32. See www.uncdf.org/en/digital-financial-services-diagnostics-west-african-fragile-states-guinea-liberia-and-sierra-leone

countries. The BMGF focuses on several African countries – Kenya, Nigeria, Tanzania, and Zambia, and increasingly Ethiopia to extend the reach of digital payment systems and minimize barriers to payments to spur economic activity. This includes the Level One Project³³ focused on building payments infrastructure and a partnership with Swedish technology company Ericsson on mobile wallets.

The MasterCard Corporation has a goal to have 500 million financially included by 2020, including 100 million people across Africa. In 2015, MasterCard launched the Nairobi-based MasterCard Labs for Financial Inclusion in partnership with the BMGF

to ‘generate new ideas with local entrepreneurs, governments and other stakeholders across East Africa, and rapidly move from concept to reality.’³⁴ MasterCard partnered with the Nigerian government on a National Identity Smart Card to reach 120 million Nigerians. Further MasterCard, through its Center for Inclusive Growth, supports electronic transfers in humanitarian response through the Electronic Cash Transfers Learning Action Network (ELAN)³⁵ to provide the use of humanitarian aid through digital channels including research on pathways to financial inclusion in humanitarian response.



Image: Goma, DRC / G.Ellis – Mercy Corps © 2015

33. <https://leveloneproject.org/about-us>

34. www.mastercard.com

35. <http://www.cashlearning.org/elan/elan>

Section 7

The next decade for financial market facilitation in FASA: what next?



Although the theoretical frameworks for a market systems approach are well developed, the process undertaken for this document showed a comparative lack of detailed analysis regarding application in the financial sector. Significant questions remain about how to apply these frameworks, and adaptive management processes, to fragile situations. This think piece attempted to address these gaps given the evidence base available at the time of writing. However, the real learning will come when donors and practitioners apply these frameworks to financial sector development in FASA. An open learning agenda and well-designed monitoring and results measurement systems, which take the dynamism of the contexts into consideration, will be required to fill the gaps in current knowledge. Development actors can help make a valuable connection between business, government and local communities and ensure accountability of business and government partners to adhere to international norms, goals and commitments. Donors can provide the flexibility needed to take risks, and allow development actors to pivot as the fragile state changes and adjusts. Donors can also crowd-in legitimate market actors. Undertakings are more likely to succeed when the international donors can provide the necessary financial guarantees and political confidence required for business to mobilise in volatile settings, including investment in national institutional and local authorities (CSIS, 2013).

Principles for success

- *Invest in contextual understanding.* Every FASA situation is unique and complex with differing financial demands.
- *Think long term.* Market-based solutions can take up to five to 10 years to reach significant scale. In FASA, it can take longer due to the lack of institutions, lower capacities, fewer counterparts, weak governance and difficulty in hiring and retaining teams (among other factors).
- *Build on what the industry knows.* Financial sector development in FASA needs to build on what we already know works and does not work in financial services, and adapt accordingly (i.e. liquidity, customer preferences and push versus pull financial products).
- *Do not ignore the informal sector.* Pursue two-track approaches to increase productivity in the informal sector while simultaneously improving the operating environment for formal enterprises (Leo, et al., 2012).
- *Ensure a positive business case.* Investments need to have bottom-line returns.
- *Utilise adaptive management processes.* Utilise pilot approaches embedded within locally-owned systems. Ensure constant diagnosis and feedback loops so programming takes advantage of windows of opportunity – new products, actors or market segments. Agility and a high degree of flexibility is key; windows of opportunity can close as quickly as they open and FASA can experience shocks and returns to violence.
- *Carefully sequence interventions.* The development of legislation and the build-up of capacity of national institutions overseeing and promoting financial regulation.
- *Think creatively about new types of partnerships,* including private-public partnerships.
- *Utilise a diversified package of smart aid instruments* that can stimulate private resources but are currently underutilised, i.e. risk guarantees, new debt instruments and equity investments. Donor and blended finance investments in the financial sector can provide a demonstration effect for other investors in higher-risk contexts (McIntosh & Buckley, 2015).

Donors can provide the flexibility needed to take risks, and allow development actors to pivot as the fragile state changes and adjusts.

Annex A

Promising practices

Market segments

Finance for refugees and Internally Displaced Populations (IDP)

Introduction

As of July 2016, SSA hosts the world's largest refugee, IDP, and 'persons of concern' populations – over 19 million people.³⁶ It is unlikely these populations will return to their original homes, recognising that 80% of global refugee crises last at least 10 years while two in five refugee crises last at least 20 years (Crawford, et al., 2015). Once displaced for six months, both refugees and IDPs have a high probability of being displaced for a minimum of three years (Crawford, et al., 2015) and an average of 17 years (Hansen, 2016). This is referred to as 'protracted displacement'.³⁷ Globally, ODA is invested in supporting refugee and IDP populations. In 2014, 50% of total global humanitarian spending (US\$12.2 billion) was spent on displacement crises (Crawford, et al., 2015). However, as displacement becomes more protracted, donor support drops off even as refugee and IDP numbers may increase (Easton-Calabria & Omata, 2016). For example, while five SSA countries received high levels of international funding in 2013 (Sudan, South Sudan, Mali, CAR and Somalia), by 2015 this figure had dropped to two: South Sudan and Sudan (Crawford, et al., 2015).

More than 20% of each of the populations of Somalia and South Sudan are displaced in some form. After Syria, these are the highest global displacement numbers. In 2015, 57 million people were IDPs or formal refugees (IEP, 2016). State failure, conflict and terrorism were the major drivers of the increase in refugees and IDPs, with the largest increases coming in countries engaged in protracted civil conflict, including the DRC with a 4.3% increase in IDPs in 2015 (IEP, 2016).³⁸

People have their own strategies for self-reliance to settle and build livelihoods (with mixed outcomes) as they cannot rely on international assistance, which is unpredictable and insufficient.

Somalia has almost equal numbers of people internally displaced within the country and externally displaced in other countries as refugees (Crawford, et al., 2015). Four of the world's eight countries with the highest levels of IDPs and refugees are in SSA: DRC, Somalia, Sudan and South Sudan.

Opportunities for investment

Refugee and IDP displacement are increasingly urban, dispersed and self-settled, with managed camps becoming the exception. With extensive displacement, these populations must have opportunities to access finance for production and consumption needs. However, as with any potential financial market segment (and sub-segment), there are significant cashflow differences and product preferences. Each situation is unique and complex, including 'new' and 'old' refugees, IDPs and host communities with differing demands. At present, most financial services available for refugees and IDPs are informal, small-scale and fractured, and structured by domestic and international humanitarian agencies using a mix of grants and short-term credit (Easton-Calabria & Omata, 2016); (Betts, et al., 2014); (M-Cril, 2015) with only a small number of formal financial service providers lending to refugees (Hansen, 2016).

- Several countries with long-standing refugee and IDP populations (i.e. Uganda, Kenya, Sudan, Mali and Niger) have enacted legislation for refugee

36. UNHCR, 2016.

37. Forced displacement refers to people forcibly displaced as a result of armed conflict, situations of generalised violence, violations of human rights or natural or man-made disasters. It includes refugees, IDPs and other 'persons of concern' to UNHCR, such as asylum seekers and stateless people (UNHCR, 2012); (Crawford, et al., 2015).

38. The population of DRC is 78.4 million in 2016. This, therefore, represents an increase of 321,000 IDPs in 2015.

and displaced populations permitting freedom of movement and right to work,³⁹ though with limited ‘implementation, compliance, and monitoring’ (Crawford, et al., 2015). Directly linked to the concept of functional IDs and tiered KYC, development actors can support the strengthening of the implementation and roll-out of this legislation.

- Often the real obstacles for finance are linked to misconceptions by financial providers of refugees and IDPs. Subsidising and sharing the costs of market analysis for financial providers directly (often starting with microfinance providers), and larger industry associations (as they exist), should be prioritised. This includes the design of segmentation tools⁴⁰ for IDP and refugee populations, to understand who financial providers can and should serve, and with which products, recognising that the financial needs of these populations are as varied as the financial provider’s existing clientele. This may include credit, but more likely will include payments, formal savings and ideally insurance as entry points.

To demonstrate the viability of lending specifically to refugee populations, the UNHCR, with financial and technical support from the Swedish International Development Cooperation Agency (Sida), will launch a global partial credit guarantee facility for financial institutions in late 2016 targeting refugees as clients (Ayoubi, 2016). This facility is an attempt to incentivise financial providers (Onajin, 2015) to work with refugees and IDPs, recognising that even in ‘crisis, displacement, and fragility there are systems’ and even ‘humanitarian actors need an exit strategy rather than [to] create parallel systems’ (Ayoubi, 2016).

- Several INGOs, in partnership with CGAP and the Ford Foundation, have utilised the Graduation Approach⁴¹ for vulnerable populations. They have also done so with the UNHCR, to adapt components of the model for urban-based refugees in Egypt, with demonstrable success.⁴² They are expanding the model for refugees in ‘rural, urban and camp

settings’, and in both emergency and protracted situations in Egypt, Costa Rica, Ecuador, Burkina Faso and Zambia, with an emphasis on building social capital and networks for integration into local economies. This is important in ensuring that development actors recognise it is not always about ‘money, knowledge and skills’ (Koh, et al., 2014). Instead, what individuals, smaller businesses and those in protracted displacement often lack most are relationships, networks and influence.

- Though documentation is limited, the concepts of transferable credit histories for refugees across borders and IDPs within the same country show strong promise for development actors and financial actors.⁴³
- Development actors and the private sector can fill gaps left by humanitarian agencies by investing in applied research into what works, and the point at which formal finance is appropriate and actually desired by refugee and IDP populations. Due to the nature of this population, and humanitarian aid funding cycles, applied research is limited and often linked to short-term outputs (i.e. numbers trained, grants disbursed) rather than actual impact or behavioural change on the supply and demands of the financial core market and prescribing barriers in the rules and supporting functions.

Next steps

There is limited documentation on development interventions that have successfully integrated refugees and IDPs into financial sector development initiatives sustainably or at scale. It is clear from research, though, that this is a market segment that can and should be integrated into the formal financial sector. Below are four lessons to apply moving forward:

1. Misconceptions and stereotypes not based in reality: There are significant misconceptions from financial providers that refugees and IDPs are a flight risk. However, this is not based in reality (Hansen, 2016), with recent studies finding several urban refugee populations with high levels of social capital possessing economic resilience and the ability to integrate within the economies where they settled.⁴⁴

39. Though often subject to severe restrictions.

40. Segmentation criteria should mirror those already used by the financial provider with further criteria including, but not limited to: migratory phase, time in country or the area, existing links to social capital, and business networks (Hansen, 2016).

41. See resources and technical guides at www.cgap.org/topics/graduation-sustainable-livelihoods

42. See details at www.cgap.org/blog/pathways-self-reliance-urban-refugees-egypt

43. See details at <http://tinyurl.com/zb6r5rl>

44. See details of a pilot in West Africa by Nourse, T (2004), USAID, ‘Refuge to Return: Operational Lessons for Serving Mobile Populations in Conflict-Affected Environments’ available at www.microlinks.org

2. **Avoid mismatched incentives:** In blended finance opportunities between humanitarian actors and financial providers, there are often mismatched incentives. Development actors tend to refer or link the most vulnerable refugees and IDPs to financial providers (Hansen, 2016); populations not viewed as strong potential clients exacerbate assumptions and biases. While most SSA countries do not explicitly have legislation banning financial services to refugees and IDPs, limited market incentives exist to promote sustainable or private financial services to these populations outside of short-term humanitarian aid and unsustainable structures.
3. **Market distortion:** In the Sahel, though common in highly fragile countries and regions across SSA, the World Bank has found development actors, as well as private and public agencies, are inexperienced in dealing with large influxes of displaced populations (from both conflict and chronic instability). Many agencies are only recently operational, are temporary, or have had a traditional focus on food security and humanitarian assistance related to food crises (Harild, 2013). Development actors resort to direct interventions such as one-off vocational training, grants or 'soft' loans for enterprise start-up, and 'small-scale uncoordinated and unsustainable interventions' with poor or no market links and short-term funding and strategies (Crawford, et al., 2015). Though short-term grants, and cash transfers, may be appropriate for those with very minimal assets, this is not sustainable, nor does it recognise the varying market segments/potential clients within these populations and those that could actively engage with market actors and financial providers.
4. **Mitigate further tensions:** With refugee and IDP finance, there is potential to exacerbate conflict or tensions between host and displaced communities and within members of displaced communities. Linked to Do No Harm, development actors must avoid targeting specific market segments based on ethnicity, livelihood or even displacement experience, and engage host communities. This will likely include, especially for recent refugees and IDPs, undertaking additional analysis of asset loss, challenges of land access, economic marginalisation, loss of skills and fragmented social capital and understanding where there are opportunities for exposure to new markets, livelihood opportunities, skills and social networks (Harild, 2013).

Islamic finance

Total Islamic finance assets are estimated at around US\$2 trillion, a ten-fold increase from a decade ago, and are outperforming the growth of conventional finance in many places ... with the potential to contribute to higher and more inclusive growth ... and, in principle, the potential to promote financial stability (IMF, 2015).

Introduction

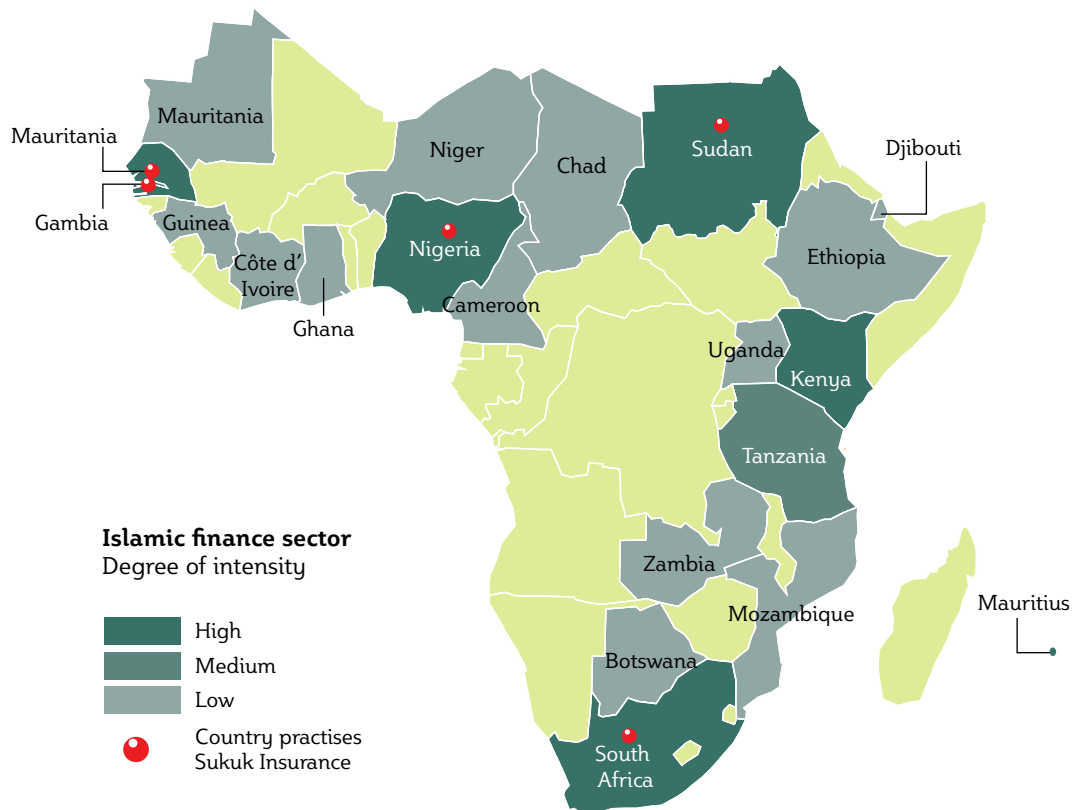
Islamic banking and investing (also referred to as Sharia-compliant finance) is a form of financial intermediation achieved through the sharing of risk between parties. It involves the avoidance of interest rates and contracts that entail excessive risks or debt accumulation, and of financial activities prohibited under Islamic principals (Gelbard, et al., 2014). Islamic finance must be used for productive activities, trade, and real assets. Globally, religious self-exclusion from formal financial institutions is highest in SSA (Gelbard, et al., 2014); (Naceur, et al., 2015). Islamic finance is still nascent in SSA but has a formal and growing presence with increasing demand in 21 African countries. Sudan is the most established, followed by advanced systems in Nigeria, Senegal and Kenya, and nascent markets in Uganda and Ethiopia (Economist, 2015). Islamic finance is the norm in Somalia, though is often unregulated or minimally regulated (Owur, 2013). The expansion of Islamic microfinance has the potential to offer more effective tools for improving financial inclusion than conventional finance in certain SSA countries (Naceur, et al., 2015); (Anderson & Byrne, 2015); (Karim, et al., 2008).

The SSA Muslim population is currently 250 million. It is projected to reach 386 million in 2030, with financial activities expected to rise as a share of GDP (Gelbard, et al., 2014). Islamic banking is found to be positively related to financial inclusion and to lower shares of firms citing finance as a significant obstacle (Naceur, et al., 2015). Interest in Islamic finance is not dependent on a majority or even large Muslim population. For example, over 80% of savings clients in the UK-based Al Rayan Bank, the fifth largest Islamic bank in the world, are non-Muslims attracted by the concept of ethical financial products⁴⁵ which is a similar finding for Islamic microfinance in East Africa.⁴⁶

45. For example, in Uganda, Somali refugees have significantly stronger social capital and networks compared to Congolese and Burundian refugees. See Betts et al (2014), 'Refugee Economics: Rethinking Popular Assumptions', University of Oxford Refugee Studies Centre, available at www.rsc.ox.ac.uk/refugeeeconomics and Women's Refugee Commission (2011) www.womensrefugeecommission.org.

46. www.alrayanbank.co.uk

Figure 5: Map of Islamic finance activity in Africa



Source: *Economist*, 2015

Intervention and impact

Although a growing industry globally, within Ethiopia, Islamic banking is in its infancy. Around a third of Ethiopians identify as Muslim, making the country's Muslim population larger than that of Saudi Arabia, Syria or Yemen. Access to finance in Ethiopia is generally very low. Nationally, only 14% of the adult population has access to formal credit and savings products, but this rate drops to 1% in rural areas (World Bank, 2014). And, until recently, there were limited financial institutions catering to the large population requiring Islamic-compliant products. The idea of creating an infrastructure to support Islamic banking in Ethiopia has gained support in recent years though, and in 2008, a proclamation by the National Bank of Ethiopia (NBE), Ethiopia's financial regulator, introduced Islamic banking in Ethiopia, and then in 2011, the bank issued formal directives on Islamic-compliant finance. This context provided an opening for Mercy Corps to counter traditional NGO behaviour by focusing on ways of developing the market system for Islamic finance using a market facilitation approach.

In partnership with USAID, Mercy Corps implements the Pastoral Areas Resilience Improvement through Market Expansion (PRIME)⁴⁷ initiative, which is focused on pastoralists and those transitioning out of pastoralism in the Somali region of the country. Mercy Corps, under PRIME, has been key to advocating for policy changes within the Ethiopian government for both Islamic finance and mobile banking. Even prior to PRIME, Mercy Corps used a facilitation approach and worked with the national and regional Somali government to launch the first Islamic-compliant microfinance institution (the Somali MFI) – which now has 16 branches – to serve the region's pastoralist market system actors that required Islamic-compliant financial products and services.

In 2014, Mercy Corps further partnered with the Somali MFI and facilitated a relationship with BeCash Technology Solutions, an Ethiopian subsidiary of a Dutch mobile technology company, to establish mobile and agent banking services in the region. Mobile and agent banking presents a huge opportunity in Ethiopia as rural Ethiopia has a 125,000:1 person-to-bank-

47. Mercy Corps' findings under the USAID-funded Pastoralist Areas Resilience Improvement through Market Expansion (PRIME) initiative in the Somali region of Ethiopia (www.prime-ethiopia.org).

branch ratio.⁴⁸ Mercy Corps' interventions included a US\$350,000 innovation grant⁴⁹ to the parties to subsidise the risk for BelCash to launch operations in the Somali region. Mercy Corps also provided significant technical assistance to develop a partnership strategy between the MFI and BelCash that allowed rapid scaling and support to the local government to upgrade and facilitate the issuing of government identification cards to register for mobile accounts. The technology platform⁵⁰ used does not require a smartphone or the internet for use, since merchants serving as agents can register users, open mobile bank accounts on their behalf, and serve as 'cash in-cash out' points.

As part of this process, the Somali MFI received the first license to act as a microfinance mobile banking agent in Ethiopia in late 2015, therefore legalising mobile banking in the country. This was due to ongoing technical assistance, including international study tours, between Mercy Corps and the NBE to understand the opportunities for Islamic finance within the country. The impact is strong with over 67,000 mobile accounts quickly opened in under a year (as of May 2016), with as many as 900 new accounts registered daily as the technology and agent network scaled. This will allow the Somali MFI to reach five times the number of clients they were reaching through their traditional branch structure. By early 2018, at least 300,000 Ethiopians will have registered and will be actively using the mobile banking platform. Mercy Corps continues to support the partnership as well the national government to expand Islamic finance, including the design financial products, legal structures for disputes, how to evaluate the market, to establish an Islamic finance advisory board that will assist the industry to navigate regulations.

Opportunities for investment:

There are several opportunities for development actor investments in Islamic finance from Ethiopia and throughout SSA:

Opportunities in the core market:

- Create and expand stand-alone Islamic financial institutions and Islamic finance windows within existing conventional financial institutions as already occurring in Ethiopia, Nigeria and Kenya.

- Expansion of Islamic-compliant SACCO and savings groups using Islamic finance principles, including for internally displaced and refugee populations, as an entry point for formal Islamic finance and to build assets and social and business networks.⁵¹
- Opportunities to develop new instruments 'inspired by Islamic financial principles', but not Sharia-certified, for a wider audience.

Opportunities as supporting functions:

- Islamic finance is closely linked to opportunities for social capital building (especially within value chains) and the strong potential to partner with private equity funds, venture capitalists and Islamic-compliant partial credit guarantees (all are well suited to the Islamic finance business model) (Naceur, et al., 2015).
- Expand the number of experts in SSA, recognising that one of the distinct barriers to the expansion of Islamic financing is the very small number of experts in Islamic finance. There is currently a very low level of SSA-based technical capacity-building and skills experts. There are significant opportunities for collaboration and exchanges for skills transfers for practices and standards (Gelbard, et al., 2014); (Anderson & Byrne, 2015).
- Islamic finance is asset-backed, serving as the collateral (similar to leasing) and based on principals of risk sharing. It offers strong potential for SMEs, as well as large-scale infrastructure projects (IMF, 2015).

In the rules and regulations:

- Innovation in Islamic banking is constrained due to the nascent regulatory environment limiting the capacity of Islamic financial institutions to offer products that meet individual and SME needs (Naceur, et al., 2015); (WEF, 2016). There is significant demand for development actors to invest in the development of government policies and supervisory frameworks. For example, FSD Uganda provided significant technical assistance in Uganda. This resulted, in January 2016, in Uganda's Parliament passing the Financial Inclusion Act Amendment Bill which includes, among other regulation, the country's first Islamic banking regulations.⁵²

48. www.prime-ethiopia.org

49. www.agrifnfacility.org

50. www.prime-ethiopia.org/wp-content/uploads/2016/02/MC_Ethiopia_Casestudy%20IIF.pdf

51. <https://smfi.hellocash.net/do/login>

52. See www.vsl.net for savings group manuals and 'IDP Islamic Compliant Savings Groups in an Emergency Response: Lessons and Opportunities from Northeast Nigeria', Mercy Corps, March 2016 (internal).

Financial products and instruments

Inclusive insurance⁵³

The risks facing low-income populations, businesses, and financial providers serving these segments in fragile contexts are vast and complex, and uninsured losses can lock them into vicious debt cycles. Challenges to developing inclusive insurance markets are exacerbated in fragile contexts; particularly due to ineffective, ill-enforced legal frameworks, poor infrastructure, and limited knowledge of, and trust in, insurance products. Distribution is also a particularly important issue. In FASA, mobile phones hold potential to reduce the costs associated with enrolling and collecting insurance payments. However, mobile insurance is still a young and experimental industry; over half of all offerings launched in the past three years have business models that are still being tested (GSMA, 2014).

While a digital sales model may be the cheapest, it may limit the market trust that can be developed through face-to-face interaction. Agent-based sales may be costly yet necessary. Thus, a hybrid model may be considered when seeking to balance the cost of reaching the market and gaining trust, and facilitating positive market discovery (CGAP, 2014).

South Africa-based think tank the Centre for Financial Regulation and Inclusion (Cenfri)⁵⁸ discusses two emerging types of insurance schemes (which may, or may not, be administered through digital channels) appropriate for fragile contexts, and notes the changing face of insurance will in the future mean bundling insurance with other financial products and services.

Loyalty-based mobile insurance: Loyal telecom subscribers receive a certain amount of ‘free’ insurance cover from their MNO, typically life, and are able to upgrade to a premium offering (i.e. additional life cover or hospitalisation add-on) through a ‘freemium’ option. Illustrative initiatives include MicroEnsure West Africa⁵⁵ programmes and TIGO Senegal.⁵⁶ These models can achieve scale in customer uptake very quickly, but due to the nature of the business model, can create new risks that pose threats to underdeveloped insurance markets. Leach notes that ‘These models can both scale rapidly

and collapse overnight as demonstrated by EcoLife Zimbabwe’ (Leach, 2013). However, it should be noted that EcoLife has recently issued a new insurance product without significant pushback, so the effects of the initial product failure may not be permanent.

EcoLife was a partnership between an MNO, an insurer and a third-party technical service provider in Zimbabwe. 1.2 million people (20% of the adult population) subscribed to the product within seven months of its launch.

Following a dispute between two of the non-insurance entities, the scheme was terminated overnight. Customers were left with nothing but the experience of insurance being an unreliable service. This dramatic failure shows the need for markets to develop hand in hand with the supervisory and regulatory environment that protects the consumer (Leach & Nacube, 2014).

With mobile insurance still in its infancy, it is unclear whether the loyalty-based freemium model will ultimately be able to achieve commercial sustainability and scale across geographies. However, early evidence suggests a confluence of customer demand and a workable initial business model (GSMA, 2014).

Index insurance (agricultural/livestock): Index insurance pays out benefits on the basis of a pre-determined index (e.g. rainfall level, seismic activity, livestock mortality rates) for loss of assets and investments resulting from weather and catastrophic events, without requiring the traditional services of insurance claims assessors. This allows a quicker claims settlement process. Despite requiring high quality weather and yield data, a strong enabling environment and extensive awareness raising and education, there are promising examples in more fragile contexts: PlaNet Guarantee⁵⁷ has multi-stakeholder partnerships in Burkina Faso, Mali and Senegal for drought index-based agricultural insurance, and the Index-Based Livestock Insurance⁵⁸ partnership in Ethiopia and Northern Kenya.

53. See Bold, Chris (10 March 2016), ‘New Bill, Big Changes in Digital Financial Services in Uganda’, available at www.cgap.org/blog/new-bill-big-changes-digital-financial-services-uganda

54. The term ‘inclusive insurance’ is increasingly replacing ‘microinsurance’. The term ‘digital insurance’ is used to encompass the role of digital mechanisms to support the delivery of inclusive insurance; it is generally broader and more encompassing than the term ‘mobile microinsurance’.

55. Adapted from email exchange with David Saunders at Cenfri and www.cenfri.org

56. www.microensure.com

57. See ‘Promising Starts in Mobile Insurance’, available at www.gsma.com/mobilefordevelopment/wp-content/uploads/2014/02/Promising-Starts-in-Mobile-Microinsurance.pdf

58. See www.planetguarantee.com

Catastrophic loss meso and macro-level insurance: These are also promising, appropriate products in some fragile environments. Financial providers carrying these forms of insurance can write off loans made to business owners whose homes and businesses are destroyed or damaged as a result of natural catastrophes and ensure their own liquidity. Global examples are the re-insurance company, Microinsurance Catastrophe Risk Organization (MiCRO), based in Guatemala, Central America,⁵⁹ and owned by re-insurer Swiss RE, Sida, and Mercy Corps and the ILO Impact Insurance facility in Mali. Catastrophic loss could also be held by a government, in particular a regional government, as a means to provide safety-net payments to citizens, in lieu of repeated humanitarian aid cycles.⁶⁰

Liquidity and partial credit guarantee facilities

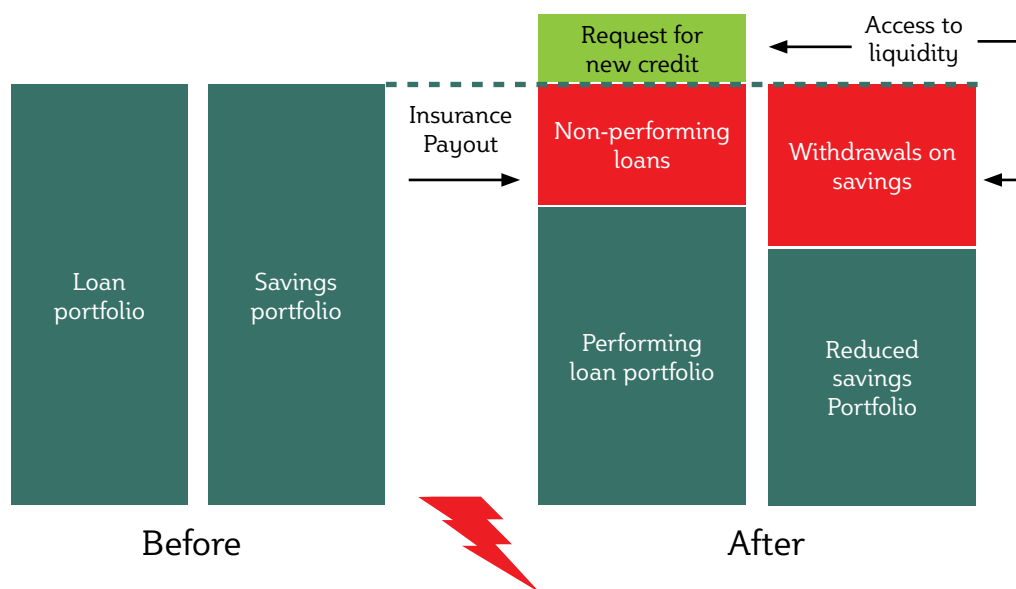
There are significant opportunities for development actors to use both liquidity and partial risk guarantee facilities (either as stand-alone or combined interventions in FASA), adapting learnings from existing programmes in non-fragile environments. Liquidity facilities are used by development actors primarily in natural disasters – both acute disasters such as earthquakes (Mercy Corps in Indonesia),⁶¹ and protracted disasters, such as drought

and climate shocks. Though they must be established pre-disaster (or conflict), they serve an immediate need to stabilise, reduce losses and ensure the resiliency of financial providers. VisionFund International has developed a ‘disaster resilient lending model’,⁶² using liquidity as a tool to rebuild livelihoods and ensure operational capacities of financial providers during times of stress and shock (McCulloch, 2016).

‘In many cases they (MFIs) are compelled to withdraw from the affected market, and risk ending up in a vicious circle of spiralling credit losses, reduced capital, and less liquidity as depositors remove their funds to cope with the emergency’ (VisionFund, 2015).

There are opportunities to adapt these models in more fragile contexts. Liquidity is critical, as on the demand side (during and post-crisis) there may be a run on savings as clients want to withdraw funds immediately to purchase necessities and start rebuilding or replenishing assets. Existing clients may also demand new loans, either to rebuild or for short-term consumption while new clients request loans.

Figure 6: Disaster resilient lending model



Source: Mercy Corps, 2016.

59. www.ibli.ilri.org

60. www.microrisk.org

61. www.impactinsurance.org

62. See Talbot, T. and Barder, O., ‘Payouts for Perils: Why Disaster Aid is Broken, and How Catastrophe Insurance Can Help Fix it’ (July 2016), available at www.cgdev.org/publication/payouts-perils-why-disaster-aid-broken-and-how-catastrophe-insurance-can-help-fix-it

On the supply side, financial institutions are affected similarly by conflict and disasters – damage to buildings and infrastructure, staff and operations. Liquidity and loan portfolios often suffer as (i) savings balances are reduced at the exact time clients have new credit demands; (ii) clients may struggle to repay loans due to more urgent needs (often requiring a loan repayment grace period); and (iii) there may be higher non-performing loans than pre-conflict, reducing the financial institution’s assets (See Figure 6 above). Development actors have a role to play, providing the liquidity but also technical assistance to the financial institutions pre-crisis, including operational stress tests, staff capacity building, product development for savings and post-disaster credit products, and links to insurance companies for microinsurance at the client level and meso-level portfolio insurance for the financial institution to bundle with liquidity funds (recognising access to insurance products is still

extremely low in FASA).

Partial credit guarantee facilities are already commonly used by various types of donors to mitigate partial risk for financial institutions to lend to unserved and underserved MSMEs. These donor and blended finance investments can provide a demonstration effect for other investors in higher-risk contexts (McIntosh & Buckley, 2015). Guarantees typically are placed with financial institutions to lend to new market segments, new sectors, or in a new location within a country. However, in countries – or more commonly regions within countries – where functional financial providers are scarce or non-existent (or the financial providers only serve a limited market segment), there is an opportunity to use non-bank financial providers as the point of entry (i.e. leasing companies, insurance companies, agriculture input sellers and output aggregators) (Hinton, 2016).

‘Credit guarantees can help build the credit origination and risk management capacity of lenders, provide countercyclical financing to SMEs during a downward economic cycle when risk aversion is high but it is important to mitigate the risk of perverse incentives’ (Rusagara, 2016).⁶³

At the multi-national level, there are the African Development Bank’s Private Sector Credit Enhancement Facility,⁶⁴ World Bank’s Multilateral Investment Guarantee Agency (MIGA), and the World Bank First Initiative.⁶⁵ At the institutional level, leaders are DFID, Sida and USAID (through its Development Credit Authority (DCA)⁶⁶ mechanism). At present, the trend is for guarantees to absorb losses between 50 and 80%

on a single portfolio for five to seven years, though this varies by donor, implementing development actor and financial provider. As noted by DFID Zimbabwe, ideally a guarantee creates systemic change in the banking sector (Mollat, 2016); however, the number of businesses with the ability to absorb and scale is limited, often minimising the impact of guarantees in more fragile contexts.

In Zimbabwe, DFID, Sida and USAID have partnered to implement a seven-year partial credit guarantee through Barclays, focused on mitigating the potential risk for the bank to lend to women-owned and youth-owned MSMEs. A portion of the guarantee can also be used for wholesale capital to microfinance institutions targeting these market segments. While the Zimbabwe banking sector has changed significantly in the past 10-15 years, previously only lending to corporations or large companies, the donors felt the bank required a guarantee to be willing to explore other market segments and expand lending further to MSMEs. However, as with other market segments, finding MSMEs with a strong track record that meet the bank’s minimum requirements has been difficult (Mollat, 2016).

Lessons for adapting partial risk guarantees to fragile contexts include:

- In many countries, there is too much risk and not enough ‘bankable’ businesses with the ability to absorb capital or scale, requiring development actors to bundle business-level technical assistance and capacity building to any guarantee structure.⁶⁷

Ideally, help them ‘build a track record’, even before the credit guarantee, to mitigate high default rates which will not attract other financial institutions to the targeted market segments.

- The use of guarantees, especially post-conflict, are especially important for the manufacturing, construction and agriculture sectors – this can

63. See www.cgap.org/blog/vulnerable-households-need-resilient-institutions-disasters

64. See <http://visionfundmedia.org/DisasterResilience/Disaster-Resilience-full-report.pdf>

65. Presentation at the Financial Sector Development in Fragile Situations conference (29 June 2016) see <http://www.mfw4a.org/financial-sector-fragile-situations-conference-2016/presentations.html>

66. See www.afdb.org and www3.weforum.org/docs/GAC16_Responsible_Investment_Fragile_Context.pdf

67. <https://www.miga.org>

- include lending against purchase agreements between buyers and suppliers and to replace assets.
- Institutional donors and direct development actors should not only partner with financial providers, but also with private companies or third-party service providers to support potential borrower capacities and build a pipeline of potential borrowers for financial providers.⁶⁸ This will often require a push strategy to attract borrowers.
- To avoid potential market distortion with guarantees – which is a credible threat – development actors must understand if there is room on the private market for commercial viable credit products and actual bank engagement.

Financial delivery channels

Impact investing in fragile states

Introduction

Impact investing is an investment approach that intentionally seeks to create both financial return and measurable social or environment impact (WEF, 2013). By leveraging the private sector, these investments can provide solutions at a scale that purely philanthropic or development interventions usually cannot reach. Investors in impact investment funds include high-net-worth individuals, institutional investors, DFIs, corporations or foundations, who invest in a wide range of asset classes. In the impact investing world, countries or regions within countries of higher risk in emerging markets (i.e. northeast Nigeria or the DRC) are typically referred to as ‘frontier markets’.⁶⁹ The impact investment market brings together sets of investors, each characterised by individual risk, return, and impact expectations. This allows for providers to structure innovative, tailored and often hybrid investments.

Development actors, foundations, and corporate social responsibility (CSR) departments within corporations still often are the primary investors in the traditional ‘social enterprise’ space, while impact investing can fill the gap between the intersection of aid and investment for MSME. Moving forward, development actors, through blended finance models (see below) can address the ‘gap’ between early-stage grant funding and later-stage commercial investments, especially to help build and strengthen pipelines of SMEs ready for investment. The state of practice of impact investing in East and West Africa is below:

- East Africa has become a global hub for impact investing. The focus, though, is primarily on Kenya, which accounts for over half of the investments. It

- is followed by Uganda, Tanzania and Rwanda, and there is little to no investment in more transitional contexts (i.e. Somalia and Burundi) (Koh & Meir, 2016). Investors are a mix of non-DFIs and DFIs, with DFIs conducting a higher percentage of deals and taking a sector approach focused on investments in the financial services, energy and agriculture sectors (GIIN, 2015).
- The West African impact investment market is comparably smaller than the East African market, with the majority of impact investing capital concentrated in four countries and deployed by DFIs through the use of debt. To date, Nigeria has received the highest amount of investments, closely followed by Ghana, trailed by Senegal and Cote d’Ivoire. DFIs have focused investments in energy, manufacturing, infrastructure and financial services, while non-DFIs have invested primarily in financial services, with most of this capital invested in microfinance (GIIN, 2015).

Opportunities for investment

Blended finance⁷⁰ models allow shared risk and financing between impact investors and development actors in extremely fragile countries. For example, impact investors the CDC Group manage the DFID-funded Impact Fund⁷¹ and Impact Acceleration Facility. These vehicles have allowed the CDC to make higher-risk investments than in their traditional portfolio. For example, in Sierra Leone this has included a US\$50 million risk participation facility⁷² for SMEs in partnership with Standard Chartered Bank post-Ebola, and an investment in a mobile payments aggregator to activate mobile payments during and after the Ebola crisis.⁷³ Though CDC has existing investments in the

68. www.frstinitiative.org

69. www.usaid.gov/what-we-do/economic-growth-and-trade/development-credit-authority-putting-local-wealth-work; USAID DCA also provides guarantees on bonds.

70. Interview with Dave Mollat, DFID Zimbabwe (July 2016) and USAID DCA interview (June 2016)

71. Interview with USAID DCA (June 2016).

72. See the Omidyar Network and the CDC Group.

73. Blended finance is defined as the strategic use of development finance and philanthropic funds to mobilise private capital flows to emerging and frontier markets Invalid source specified. www.theimpactprogramme.org.uk

country, the facility decreased their investment risk during and immediately post-crisis when the market most needed investment funds and loan capital.

Typically, the same due diligence process must be calibrated so the level of risk of a specific country is reflected in the deal structure and return expectations. However, when in a blended finance relationship with development actors there is a stronger opportunity to potentially take a higher risk for higher ‘development returns’. There is a gap in the risk-return spectrum, resulting in a ‘missing middle’ of capacity availability for investments between US\$200,000 and US\$5 million (GIIN, 2015). In Zimbabwe, the ‘missing middle’ range is US\$500,000 to US\$3 million, with a focus towards longer-term equity with bundled technical assistance, rather than just debt which is the current trend in the country (Mollat, 2016).

Though impact investing is on the rise in SSA, there are significant market-based limitations in FASA:⁷⁴

- Limited legal protection for investors; often no applicable regulations, or outdated regulations seen as too risky by investors (Hinton, 2016).
- Few service providers (as supporting functions) to support the investment deal flow (in the core market), including limited intermediaries or third parties to support primary research, feasibility studies and deal structuring (Koh & Meir, 2016).
- Low existing HR recruitment and human capacity with prerequisite skills in management and investing;

‘Post-conflict or after political upheaval there is a “perverse” investment with a temporary surge in investments—investors think they may get assets cheaper as investments are usually deferred during active conflict (McCammon, 2016).

- Temporary surge post-conflict – deferred decisions to get clarity on the political situation or feel the asset-priced may be cheaper (i.e. Zimbabwe post the currency crisis) – but within a year usually goes back to a slightly depressed investment state.
- In FASA, it makes sense to take a ‘layered approach’, with investments leveraging existing donor investments rather than stand-alone investments. However, investors have to be realistic; even with a layered approach, risks may be too high. Some investors have taken the perspective that in high-risk environments, the risk of failure is too high and rather investments can be funnelled towards

minimum or no training support functions available in the market.

- Minimal foreign exchange controls.
- High political uncertainty.
- Limited businesses and local investments vehicles with the technical and management capacity to scale or directly manage an investment of any significant size.
- Too difficult to manage one-off investments in a single country – a portfolio-level approach needed.

Next steps

A sectoral approach should be taken in FASA – often investments in the financial sector⁷⁵ and in SMEs that support vital sectors (i.e. education, health, agriculture) as entry points, recognising that these sectors underlie growth in all other sectors. In especially fragile environments, non-bank financial institutions (i.e. leasing companies) can serve as investment counterparts as well as with sector actors (i.e. agriculture companies). Below are next steps for development actors to engage with the impact investment community:

- In fragile (rather than conflict) environments, such as Zimbabwe, the perception of political risk and inconsistently applied regulations are the primary barrier to investment as calculating potential return is extremely difficult (Mollat, 2016). In these situations, diaspora populations tend to have a higher-risk appetite and can be a starting point (Hinton, 2016).

growth sectors in countries that still have low levels of poverty (i.e. investing in the solar sector in Tanzania) (Rothenbusch, 2016).

- Rather than pre-select fragile countries for investments, several impact investors recommend that development actors find companies that have an appetite for high risk, and an interest in development returns. An example is the Central Africa SME Fund managed by XSM Capital,⁷⁶ which focuses exclusively on investments in Central Africa (specifically the DRC and Central African Republic) and partners with the DFID-funded ELAN which uses an MSD approach to spur private sector development in the DRC.⁷⁷

74. [www.cdccgroup.com/Media/News/CDC-and-Standard-Chartered-Bank-commit-to-support-increased-lending-to-businesses-in-Sierra-Le-one/](http://www.cdccgroup.com/Media/News/CDC-and-Standard-Chartered-Bank-commit-to-support-increased-lending-to-businesses-in-Sierra-Leone/); www.gov.uk/government/news/new-deal-to-help-businesses-bounce-back-from-ebola-in-sierra-leone

75. <http://blogs.ft.com/beyond-brics/2015/06/18/what-can-business-do-in-the-face-of-a-public-health-crisis>

76. Adapted from interviews from P. Hinton (May 2016) and H. Rothenbusch (June 2016); (Koh & Meir, 2016).

77. However, it was also noted in interviews that the African commercial microfinance market is fractured, with many investors looking at the same institutions to invest.

Payments and remittances infrastructure

Introduction

Payments are the ideal initial entry point to build financial inclusion, including international and domestic remittances, as well as an optimal entry point for inflows and outflows as a business proposition for mobile network operators (MasterCard, 2014). Further, the Bill and Melinda Gates Foundation refers to payments as the ‘connective tissue of an economic system’, as payments

allow movement of cash and financial products (BMGF, 2013) from ‘high-touch to low-touch’ in FASA (a reality due to conflict). Payments infrastructure, including opportunities to engage the African diaspora through direct remittances, are ripe for donor-matched funding to lower risk for MNOs’ investment in product and agent development. However, development actor efforts will need to include significant push and pull strategies for market uptake as current levels of access and usage are mixed.

Many interventions today around digital financial services (payments) are based on pushing consumers to adopt digital payment systems, instead of pulling consumers through meeting real demand leading to wasted resources and disappointed consumers (Mas & Buckley, 2015). It is not enough to lower the costs to consumers – there need to be complementary pull approaches that attract excluded or underserved customers to seek out payments and become known by financial service providers – financial services are rarely desired for their own sake so pull propositions must be orientated towards solving daily problems as consumers go through their daily lives and conduct business (Mas & Buckley, 2015).

In FASA, this is primarily due to lack of infrastructure (especially in rural areas), mobile phone ownership, lack of trust, and traditional dependency on cash. Only 12% of the SSA population use mobile money today, and only 33% of mobile money accounts were active on a 90-day basis (Omidiyar Network, 2016).

Bank accounts for remittances have come under increasing scrutiny given concerns about the financing of terrorism and illegal activities. Accurate identification of recipients and meticulous monitoring of transactions is necessary to counter money laundering and the potential funding of terrorist activity. Particular attention is often paid to countries in conflict without functioning governments which are the same countries that often have a large refugee diaspora who send remittances (i.e. Somalia).

Opportunities for investment

Payment aggregators: One of the primary opportunities in investment is in payment aggregators, which allow payment instrument providers (i.e. MNOs offering

mobile money services or banks offering mobile banking) to easily integrate with entities that want to send money to or receive money from end customers. These entities can be utility companies who want to receive payments; businesses who want to pay salaries or donors who want to pay recipients; or payments from output buyers to smallholder farmers. Aggregators mostly work in the background, and although millions of transactions pass through their systems every day, most customers (and even other actors in the ecosystem) do not even realise an aggregator is part of a transaction (CGAP, 2016). Payment aggregator companies provide a combination of services and technologies which reduce the costs and complications of sending money, and provide a compliance framework for regulatory requirements. At a basic level, all aggregators do two things – integration, where they connect the systems of payment instrument providers to third-party systems, and value-added service, like notification of successful payments, reconciliation and receipts (CGAP, 2016).

In Zimbabwe, the MNOs are far ahead of the regulators, resulting in the MNOs being ‘regulated’ by their competition. Payments, especially domestic and international remittances, are almost immediately ‘cashed out’, as there is little incentive to hold value in a mobile wallet. This is a mixture of the need for consumer education and the reality that in Zimbabwe there is a ‘parallel market’ between cash and mobile money, with an average 15% increase in prices if mobile money is used versus cash (Mollat, 2016).

They can also reduce transaction costs, recognising that Africa has the world’s highest costs for internal and international transfers (ODI, 2014). By lowering transaction costs, this could free up resources (the equivalent of US\$1.4 billion annually) for more

productive uses and consumer spending, making the economy more efficient (Le Sar & Porteous, 2013).

Remittances aggregators: Most African countries restrict the payment of remittances to banks, which, in turn, typically enter into exclusive arrangements with

large money transfer operators, who operate on their behalf. This increases costs for consumers (ODI, 2014). Formal remittance channels (i.e. Western Union, MoneyGram) have gained popularity, but informal channels such as *Hawala* and regional operators are still preferred. Some payment aggregators operate at a national level for payments (i.e. Selcom Wireless in Tanzania, Pivot in Rwanda), while others act globally and

can serve both the national payments and international remittance markets (i.e. WorldRemit and Transfer To), specifically within Africa (Jumo and MSF Africa) and within specific remittance corridors like Zimbabwe (i.e. MamaMoney, EcoNet/EcoCash, and Mukuru). The remittance channel is strongly linked to availability, as well as the financial literacy of the individual.

Mobile wallets can be the starting point for accessing a wider range of financial services. However, in reality, most do not store value on the mobile wallet – instead they immediately cash out, as the ecosystem is not in place to transact using the wallet. There is a strong narrative in the humanitarian space on mobile as a delivery channel to distribute humanitarian cash disbursements to bring populations into formal financial delivery channels; however, there is little evidence that those recipients hold value on the accounts.

People receiving remittances are often outside the formal financial system, lacking avenues for savings and investment which could leverage their remittance. Availability of infrastructure and regulation around

remittances, especially AML/FCT, have to be addressed before anything else for international remittances (regulation and enforcement), but cannot be so strict as to be over-engineered to stop money flowing formally.

Annex B:

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Annex C:

Further resources

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Refugee and IDP finance

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Identification

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About FSD Africa

FSD Africa is a non-profit company funded by the UK Government which aims to increase prosperity, create jobs and reduce poverty by bringing about a transformation in financial markets in SSA and in the economies they serve. It provides know-how and capital to champions of change whose ideas, influence and actions will make finance more useful to African businesses and households.

Through access to finance initiatives, it seeks to build financial inclusion. Through capital market development, it looks to promote economic growth and increase investment. As a regional programme, it seeks to encourage collaboration, knowledge transfer and market-building activities – especially in fragile states.

Where there are opportunities to drive financial market transformation more quickly and intensively through capital investment, FSD Africa will deploy equity, loans or guarantees as the situation requires.

FSD Network

The FSD Network is an alliance of organisations or ‘FSDs’ that reduce poverty through financial sector development in sub-Saharan Africa.

Today, the FSD Network:

- Comprises two regional FSDs in South Africa (est. 2002) and Kenya (est. 2013) and seven national FSDs in Kenya (est. 2005), Mozambique (est. 2014), Nigeria (est. 2007), Rwanda (est. 2010), Tanzania (est. 2005), Uganda (est. 2014) and Zambia (est. 2013).
- Is a world-leading proponent of the ‘making markets work for the poor’ approach
- Specialises in a number of themes from agriculture finance and savings groups to payments, SME finance and capital market development.
- Represents a collective investment of \$450+ million by DFID; Bill & Melinda Gates Foundation; SIDA; DANIDA; Foreign Affairs, Trade and Development Canada; RNE (Netherlands) and World Bank.
- Spends \$55+ million per year, predominantly through grant instruments
- Employs over 120 full time members of staff and a uses wide range of consultants



FSD Africa, Nairobi, Kenya
info@fsdafrica.org
@fsdafrica

www.fsdafrica.org



Edinburgh, UK
programmesdesk@mercy Corps.org
@mercy Corps_uk

www.mercycorps.org.uk



Department for International Development
enquiry@dfid.gov.uk
@DFID_UK

www.gov.uk