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BANKING ON GLOBAL SUSTAINABILITY:

A sustainable downscaling strategy in Latin America and the Caribbean

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Abstract

Adequate financial markets are fundamental to sustainable development. Accurate capital allocation requires return on investment incorporates the social and environmental variables impacting, negatively or positively, such investment. Values-based capital allocation relies on sound corporate governance structures guiding the decision-making process towards sustainability objectives, not only short-term returns. One where the use of natural capital preserves the stock of capital, assuring that all generations live-off the income-flow. Concurrently financial markets, especially in emerging markets, should further engage in growth and re-distribution models to create wealth for and inclusion of SMEs. Long-term financial sustainability is hence aligned with environmental sustainability and social inclusion. Enhancing the potential of formal and informal SMEs requires strengthening credit channels. With the implementation of downscaling strategies, financial institutions (FIs) contribute to address existing levels of inequality while supporting a sustainable development path. At the same time FIs have the opportunity to impact the public policy dialogue regarding SMEs` formalization. Formalized SMEs are in a better position to grow, to have higher labor and capital demand and productivity. For FIs this implies a market expansion. For society, higher productivity and more equitable growth contribute to a better income distribution and closing the inequality gap. Redefining the financial sector's role is relevant for all stakeholders. Is not a choice, is the ethical response. FIs have to acknowledge their impact on society and the environment carries great responsibility and that their legitimacy as agents of social change, depends on the realization that their role goes beyond the traditional financial intermediation.

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GLOSSARY

BOP- Bottom or Base of the Pyramid

IBE- Inclusive Business Ecosystems

IDB- Inter-American Development Bank

IFC- International Finance Corporation

E&S- Environmental & Social Issues

ESG- Environmental, Social & Governance

FI- Financial Institutions

GRI- Global Reporting Initiative

HBS- Harvard Business School

KPIs- Knowledge Performance Indicators

LAC- Latin America and the Caribbean

MIF- Multilateral Investment Fund

MSME- Micro and Small and Middle Enterprises

SME- Small and Middle Enterprises

SRI- Social Responsible Investors

I. THE SUSTAINABILITY CHALLENGE

Adequate financial markets are core to sustainable development. To make the right capital allocation decision, return on investment should incorporate the social and environmental (E&S) variables impacting, negatively or positively, such investment. The allocation of resources, the identification of risks and opportunities and the pricing of financial assets and liabilities must reflect these impacts. This values-based capital allocation relies on sound corporate governance structures that guide the decision making process towards sustainability objectives. Such objectives imply that the use of natural capital must be done while still preserving the stock of capital, and assuring that all generations live off the income-flow of such stock (Forum of the Future, 2003). At the same time financial markets should further engage in growth and re-distribution models to create wealth for and inclusion of the bottom of the pyramid (BOP[1]) (Gradl and Jenkins, 2011). Long-term financial sustainability is then aligned with environmental sustainability and social inclusion.

In this sense, given their financial intermediation role, banks and other financial intermediaries (FIs), are able to catalyze, promote and influence social change. Such influence can be exercised through their direct and indirect sustainability footprint. Banks intermediation role and high capillarity shapes their sustainability footprint. Banks have numerous stakeholders (employees, clients, regulators, shareholders, etc.), wide geographic and industry coverage, maintain multiple layers of inter-relation with the communities they serve, have a large employee base and are users of multiple buildings throughout their branch networks. Furthermore, many are global players with influence and impact throughout the globe. This capacity to have impact across industries, businesses, geographic locations, governments and society as a whole, provides for a fundamental opportunity and a social responsibility to foster the required transformation of current business models (Scharmer, 2009).

The type of social change needed to achieve this essential reconciliation between financial intermediation and sustainability is a renewed infrastructure for doing business. One that incorporates as fiduciary objectives, in addition to traditional financial and economic values, the E&S values at the core of sustainable development. This evolving business infrastructure is shaping into different models that aim to differentiate from "business as usual". Business models that range from creating new legal corporate structures such as B Corporations

[1] Four billion people living on less than US$2 per day.

(www.bcorporations.com), to ones that look at going-back to the roots of capitalism as opposed to its degradation into a "crony capitalism". One that does not fully serve the social inclusion and respect to the environment at the levels required to foster long-term sustainable development (Mackey, 2013). The discussion has evolved around the need to identify new models of economic growth, social transformation, consumption patterns and innovation trends that foster the healthy growth of business at sustainable levels and the wellbeing of society and the planet. Bill George in the foreword of Conscious Capitalism states: "I chose business because I believe that well-run, values-centered businesses can contribute to humankind in more tangible ways than any other organization in society" (Mackey, 2013). The idea being that the challenge is about improving the existing capitalist model so that society can enhance its successes and overcome its limitations or failures. This challenge is of particular relevance for the LAC region where different economic models coexist at different stages of development. There are a variety of economic models in the region, some of which cannot be fully defined as being capitalist models in any of its conventional forms of -laissez-faire capitalism, welfare capitalism, or state capitalism. These economies, similar to some other emerging economies worldwide, are yet to fully develop sound property-rights structures, have to strengthen their financial markets, have to facilitate that means of production are primarily controlled by private entities, and continue to face important challenges/limitations in their capital and labor markets. The region has a mixed track-record of economic growth, economic reforms and market liberalization, state participation/control and trade openness. Yet the existing array of models faces the challenges of sustainability, social inclusion and income inequality.

Capitalism, with its virtues and faults has led to an era of prosperity. Prosperity that has benefited many, by allowing a significant part of the world population to step out of extreme poverty, that has created jobs, that has fueled and been fueled by the innovation of free enterprises and democratic societies. Two hundred years ago 85% of the population lived in extreme poverty ($1 or less a day) compared to the current 16% (Chen &Ravallion, 2010); life expectancy has increased to 65yrs from 45yrs in 1950 (UN, Wilkipedia), and over 50% of the people live in democratic governments (Freedom House, 1999). Yet there is no doubt that these and other achievements have come with a high cost to the environment, and that inequality and low social inclusion persists in many regions. Yet the proposed premise is that capitalism continues to be the best system available and that together with democratic governments are able

to best serve the objectives of long-term sustainable growth, environmental care and social inclusion. Is a system that needs to improve and focus on value generation (economic, social and environmental value) facing the sustainability challenge and becoming part of the solution.

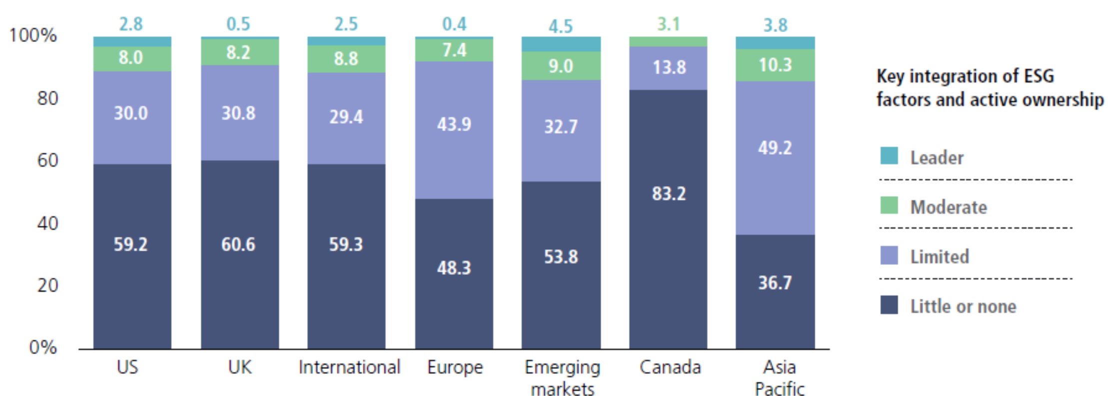
Sound financial markets are a necessary component of the improvement of the economic system. FIs have the capacity to finance the growth of values-centered businesses that promote social inclusion and respect for the environment. For this the guiding practices of capital allocation and pricing are fundamental to the creation of adequate conditions to foster the sustainable business model. Yet capital raising efforts by sustainable businesses still face important limitations either by not being able to access capital at terms that reflect their sustainability and social inclusion efforts, and/or by not accessing a wider investor's base. Anecdotic evidence indicates that even in those cases where FIs partnered with International Finance Institutions (IFIs) to implement sustainable models, the investor base did not necessarily price-in this value proposition. Thus it did not necessarily reflect in better financial terms and conditions. This pricing-in should reflect the good practices resulting from: (i) the inclusion of risk-mitigation measures linked to the financing provided by FIs (i.e.: E&S systems that fully reflect the risks associated to the different levels of financing from working capital to capital expansion and IPOs, and (ii) the financing of "good social causes" like clean energy, climate change mitigation measures or financial inclusion of the BOP, for example.

Although there is an increasing investment community that incorporates sustainability and social inclusion practices at the core of their investment decision making, it still represents a small percentage of the international community (WEF, 2013). This growing investment community is guided by somewhat different principles, although all are based on the inclusion of environmental and/or social parameters in the investment decision making process. To some, investment decisions are based on the application of "exclusion or negative list of activities" to avoid working with companies/industries that harm society or the environment. Others guide their investment decisions by selecting companies that actively pursue and measure the benefit to society and/or the environment of their business activities (i.e.: Impact Investors). It is important to highlight that impact investors do not only look for those companies that "do good", but those

that are rigorous in the measurement and monitoring of such positive impact. According to WEF impact investors manage approximately US$40 billion of cumulative capital committed[2].

A more general term, Socially Responsible Investment (SRI) or any known similar definitions; ethical investment, green investment, triple-bottom line investment, or sustainable investment have as commonality that of being guided by long-term value creation. That is, a value creation that refers not only to financial or economic value, but to the broader values of inclusion, sustainability and fairness. Similarly to the role of IFIs, the role of SRI investors is at the same time important and limited. A key challenge is to mainstream the view and practice that the cost of capital and therefore its allocation should also be guided by the common principles of the internalization of the social and economic externalities of the economic activities they finance In this sense, the objective is to mainstream this internalization of externalities so that the tens of trillions dollars mobilized by mainstream investors (asset managers, pension funds, money market funds, etc.) are directed to shifting current economic models towards those that are sustainable and socially inclusive (WEF, 2013). As shown in Figure 1 below, ESG variables continue to have a limited impact in SRI strategies, with Asia and Europe leading the market, but with the core of the market having little or no integration of ESG factors in their investment strategies.

Figure 1. Socially Responsible Investment Strategies by ESG Rating (per cent)



Note: Covers 5.000 strategies between 2008-11.
Source: Financial Times, April 1, 2012.

The development of such way of doing business is a complex and dynamic process that faces important challenges and potential setbacks. While many aspects have been present in

[2] According to the Monitor Institute (2009) the impact investment market could reach US$ 500 billion by 2020 (or 1% of total managed assets, estimated at US$ 50 trillion) (WEF 2013).

different societies at different times, the implementation of a comprehensive approach incorporating sustainability variables into banking business models is still to be fully formulated. There are several important sustainability initiatives for the financial sector to guide its activities. Among those worth listing are UNEP FI, Equator Principles, the Carbon Disclosure Project, Enhanced Analytics Initiative, Principles for Responsible Investment (PRI), the Carbon Principles and Climate Wise.

Years of working with FIs in LAC have provided many different opportunities to assess this concept and its practice across the region. While many institutions are in fact taking important steps towards a "better banking model", there is still much more to do. As discussed later, the region has benefited from the active role IFIs to foster sustainability and social inclusion objectives in banking. IFIs and FIs have worked towards the enhancement of sustainable banking practices to encompass more transparent corporate governance structures, stronger risk assessment and mitigation methodologies, the development of green products and downscaling strategies. At the same time, FIs in the region are actively participating in one or more of the sustainability initiatives such as Equator Principles or UNEP FI. To have impact, the proposed way of doing business must be developed in a way that reinforces competitive advantage and allows for reaching the required scale to affect social change. Some examples of what is being done in LAC can be found in the Inter-American Development Bank (IDB)'s beyondBanking (www.iadb.org/beyondbanking) initiative.

A key aspect of FIs challenge is well captured by Porter and Kramer shared value framework (Porter & Kramer, 2011). According to them, companies continue to see value creation through the prism of short-term profits, rather than on an economic value creation that also addresses the needs and challenges faced by society. This is presented as a contrasting approach to CSR initiatives, described as not being core to the business, philanthropic in nature and only as a limited response to the legitimacy crisis they face. When discussing this concept with bankers in the region, there is an array of reactions that fall everywhere along the spectrum, from true believers to those with high skepticism. At the same time, some express concerns regarding the fact that many of the sustainability parameters applied to banking are still being developed, especially in terms of determining the "true E&S costs and benefits" related to the economic activities they finance. This creates a genuine area of concern for an industry that is used to more exact forms of cost and benefits measurements. In turn, this opens the space for

many bankers to postpone any business change. Others do take the lead to move forward even in this environment of uncertainty as they look for better ways to measure newer qualitative and quantitative parameters. Likewise, the efforts made by FIs in terms of sustainability and social inclusion are also received by the public with an array of reactions. For many, it is only "green wash" and driven solely for improving public perception and not really responding to a genuine business transformation. Others perceive the change as incipient, maybe even erratic, but evolving in a positive direction. Regardless of where one stands in the opinion spectrum, much more still needs to be done. It is a systemic challenge that requires the commitment and active participation of many stakeholders.

Shared value is presented as a fix to capitalism and one that is unavoidable. A fix of the substantive obstacles of continuing doing business as usual and to the overall negative image society has of private companies. A model that is no longer viable. Companies may lead processes of bridging back together businesses and society by diminishing their short-termism. By incorporating E&S costs and benefits into the profitability function to develop new market ecosystems, and pursuing the inclusion of the BOP. Regardless of the view of the relevance of those that consider that shared value is neither new (Denning, 2011) nor "fully cooked" (Shumpeter, 2011). Or that it does not represent a real fix to capitalism as it is still based on Capitalism 2.0 instead of "Capitalism 3.0" (Hart, 2005; Denning, 2011). The merits of the core proposal stands: value has to be shared by all stakeholders not only shareholders. Value has to be broad and better distributed in our societies so that those who still live in poverty can improve their living conditions. Value has to preserve the natural capital for generations to come and for the wellbeing of other species on earth, while simultaneously maintaining positive investment returns overtime.

The sustainability challenge at stake requires revisiting some pillars of a capitalism driven by the short-term horizon, prevalence of shareholders value thinking (Stout, 2012) above any other stakeholder, and value measured solely by financial returns. It requires a capitalist system that reconciles financial performance with progress of the whole. One that impacts positively the social and environmental spheres with a view on the future value of their economic activity, and not primarily on a net present value basis. In this scenario FIs face the "substantive" sustainability challenge and a "legitimacy crisis". The aim is to act on incorporating in their core business models E&S variables that add value to the firm (long–term competitiveness) and to

society (transparent social and financial inclusion). FIs can direct their lending activities to foster sustainable development and in this way tackle their sustainability challenge and work towards reclaiming their social legitimacy. In their intermediation role they allocate capital across industries thus influencing the speed, direction and nature of economic growth and hence the social and environmental impacts.

Yet short-termism does not affect just bankers. When considering public policy, the short-term view of many politicians and legislators affects the possibility of long-term decision-making. To aim for sustainability and social inclusion, a long-term view of economic, social and environmental issues is required. This does not only or primarily affect the private sector, but pertains to society as a whole. It has a key impact on public policy as all levels of government – federal, state and municipal- have to respond to short-term party and social interests. Yet some long-term public-goods issues, such as addressing climate change, have still moved forward, although slowly, even in situations where public policy has failed to do so. In this sense some states in the Unites States have moved forward more decisively climate change policies and actions, even when the Federal Government has kept behind the international climate change agenda. Although situations like this can create complications at the regulatory level due to overlapping and in some cases contradictory public policy and regulations, it reflects the fact that society is able to push forward social change from many directions, even in situations where high level government policy falls behind.

There are of course several sustainability challenges relevant to the LAC region. In all these challenges, FIs have an important role to play both as contributor to the problem as well as potentially being part of the solution. A role that FIs should internalize at all levels of their core business, and incorporate in the financial products and services they offer. For example, the supply of financial products and services can shape the agenda of public policies and interventions regarding climate change adaptation and mitigation. Although LAC has a relatively modest carbon footprint, it is significantly weighted to land use, energy and transportation. At the same time, LAC is particularly vulnerable to the effects of climate change due to its geographic location, population and infrastructure distribution, and natural resources dependency. Studies indicate that the combination of adaptation and mitigation measures would provide the best policy mix in terms of cost-benefit analysis for the region. They indicate that the cost of adaptation investment ($17-$27bn) represents one-sixth of the estimated costs of a rise in

temperature of 2C over pre-industrial levels (approximately $100 billion annually by 2050) (IDB, 2013).

FIs also have a role to play to uphold the sustainability of the natural capital of the region which crosses geographic boundaries and has global impact. The LAC region represents only 16% of the planet's land, yet it holds 40% of the world's biological diversity, more than 30% of the earth's available freshwater, and almost 50% of the world's tropical forests (IDB, 2012). The region´s environmental resources play a key role in the global hydrology cycle and climate control while representing the largest biological repository on earth. Understanding and wisely tapping LAC natural capital in a sustainable manner (where current generation uses its "cash-flow" while protecting the "capital stock" for future generations) is a need that should be faced by both public and private sectors. At the same time, natural capital is relevant to key productive sectors -agribusiness, forestry, tourism-, to transversal needs -access to clean air and water-, and to assure the region's food security. FIs have the capacity to impact the direction of the economic growth, through its allocation of financial products and services in a manner that is aligned to the objective of a sustainable use of LAC's natural capital.

Nonetheless a core sustainability challenge FIs in LAC face is to implement a sustainable downscaling strategy that guides its small and medium enterprises (SMEs[3]) lending activity. With the implementation of this type of downscaling strategy, FIs actively contribute to address its high level of inequality[4]while backing its sustainable development path. Yet the complexity of the task ahead responds to the multi-dimension of the challenge. Let's think for example of the needs to have better transparency in the sources of capital that flow through the banking system. This requires that FIs implement comprehensive know-your customer policies that reflect international best practices so that institutions maintain a healthy correspondent-banking network. Yet, one unintended consequence is that such requirements make it even more difficult and costly for FIs to serve SMEs, especially those in the informal sector. Meanwhile, as it will be

[3] There is no single definition of SMEs. Different criteria –number of employees, asset size, sales turnover, and size range depending on each country. For the European Commission an SME has less than 250 employees; equal or less than EUR50mn turnover and of EUR43mn balance sheet. This ampledefinition also results in different measures and statistics regarding SMEs, their formality, their limited access to credit and contribution to job creation and to GDP.

[4] Based on the Gini index (measure of inequality that takes into account the percentages of total income against the number of recipients and expressed the difference between poorest and richest -where 0 shows absolute equality and 100 is perfectly unequal), by the 2010s Latin America shows improvement since the 2000s, but is still at an average of 0.5 compared to an average of 0.30 in the European Union and 0.45 in Asia (The Economist, Oct. 13, 2012).

addressed later on, informal SMEs represent a key sector when considering the sustainable and equitable development of the LAC region.

I.1. LAC Context: placing the role of FIs

Despite the implementation of important measures towards financial liberalization in the region, with the creation of institutional frameworks and the establishment of stock exchanges and bond markets, financial markets in LAC continue to be primarily banking systems. Capital markets are widely underdeveloped, thus banks still represent the largest source of capital allocation in the region. They serve (or should serve) a vast group of enterprises (SMEs), which represent a key source of job creation and economic growth and yet have limited access to financing from formal sources. SMEs in LAC represent over 95% of total companies and around 65% of employment, but so far have a relatively small impact on GDP (OECD, ECLAC, 2013). To enhance the potential of SMEs in the region and the overall regional long-term sustainable development requires strengthening the channels that provide access to credit and general financial services. Overall, in LAC there is limited depth and liquidity in capital markets and weak bank penetration. This undermines the efficient allocation of resources, raises the cost of credit, and restricts the ability to mobilize resources to take advantage of investment and consumption opportunities. The efficient allocation of resources is vital for economic development and productivity. A competitive and sound financial sector is essential to promote economic growth, attain poverty alleviation and achieve sustainable development. Broader access to finance is crucial to gradually move towards reducing poverty and social inequality (UNDP, 2006; Beck, 2007 and 2008).

Traditionally the importance of financial systems can be assessed in at least four key dimensions; size (financial depth), efficiency, access and stability. The size of a financial system reflects the amount of financial resources available to fuel economic growth. It indicates the availability of saving and investment services of the country. The efficiency dimension of the financial system reflects its cost effectiveness. Access, the fourth dimension, measures the degree to which individuals and enterprises have access to financial products and services. Finally, the stability of the system represents the capacity of a financial system to be less prone to price instability and more resilient to shocks. More recently a fifth, the sustainability

dimension, is gaining relevance. That is the incorporation of ESG sustainability principles into the financial markets core businesses.

FIs are drivers of the required bancarization –use of financial instruments by the economically active population. This bancarization led in FIs through downscaling strategies, provide a profitable market expansion for them, contribute to generate savings platforms, access to capital, and the transactional financial services required to foster economic growth and social inclusion. One proxy to measure the level of bancarization is the credit provided by the banking sector as a percentage of GDP. In LAC the ratio is 74% compared to the global average of 168%, 205% of East Asia and the Pacific and 232% of North America (World Bank, 2012; PWC, 2013). Furthermore, within the region there are important differences. The countries with the highest ratio in the region are Brazil (110%), Chile (74.4%) and Colombia (69.6%). Although Panama also stands out as at the high end of LAC's bancarization ratio, it is mainly due to its condition of regional/international financial center. At the lower end we find countries like Uruguay (32%), Ecuador (24.3%) and Peru with 17.8%. Together with these low bancarization ratios the region also finds a relatively high weight of consumer loans (24% of total credit) in detriment of longer-term loans such as mortgages, infrastructure loans and capital investment. At the same time, it is estimated than less than 60% of SMEs' financing needs are met by formal/regulated/traditional FIs. So the regulated market offers only a partial picture of this reality. The access to credit in the region has to consider the access to financing through informal and non-regulated FIs (funds, micro-financiers, non-bank banks, etc.) that many SMEs and microenterprises (MSMEs) have. The participation of unregulated funds was also fueled by the liquidity of the pre-crisis international financial markets. This more diverse ecosystem entails other challenges that need to be addressed. For example, in terms of attaining higher levels of bancarization the cost of intermediation (difference between lending and deposit rates) continues to be too high (8 percentage points and one of the highest in the world) (WB, 2012).

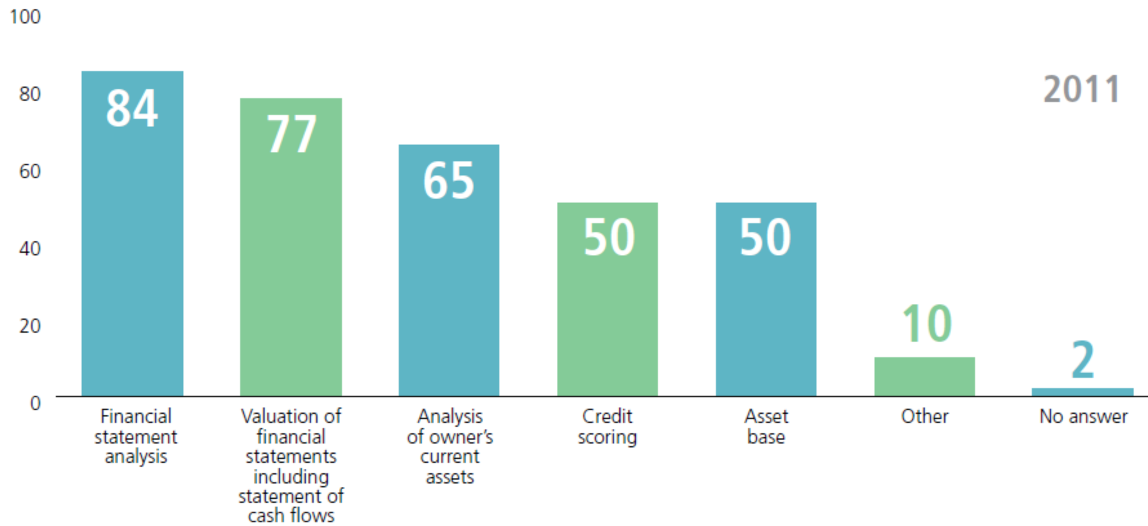
Efforts made in the region by private and public banks (with 23% of credit portfolio), domestic and international banks (with 31% of banking assets as of 2009) and non-bank banks (PWC, 2013), continue to be insufficient. There are several particularities in the region that make downscaling strategies of great importance: first, that the region has financial markets primarily driven by banks; second, that SMEs represent a not well-served market in terms of credit and other financial products and services; and; third, that the region faces the need to formalize its

economies well beyond current levels of formalization. Many hurdles need to be addressed including high operation costs, limited protection of lenders and property rights.

Barriers to scale downscaling strategies include current credit models, high transaction costs, and limited management, financial and sustainability skills of entrepreneurs in this market segment. Credit processes continue to be primarily reliant on traditional approaches. LAC banks indicate (Figure 1) that key credit aspects evalua¬ted are financial statements analysis, cash-flow and business owner's tangible assets. A 2011 regional SME survey indicates that 63% of the banks identify limited corporate management, informality and lack of financial statements as significant barriers to access credit (IDB Group, Felaban, 2011). Thus indicating that the formalization of SMEs in the region remains a challenge insofar credit approval processes are based on these formal data points. The pursuit of more suitable credit processes provides room for new models that better reflect the economic reality where SMEs function and their prevailing business structures. One example of these innovative approaches is based on the adaptation of psychometric techniques that aim to measure the willingness and ability to pay of the business owner. This is the case of the model applied by Standard Bank in Kenya (Standard Bank 2010). A model that is being adapted, tested and implemented in the LAC region as a result of the G-20 SME Finance Challenge (G-20, 2010) with the participation of IFIs.

Many LAC banks have partnered with IFIs for implementing downscaling strategies through long-term funding and technical assistance. According to the 4th Regional Survey in LAC 2011 -Banks and SME –Raising the Game Survey-, 50% of the 109 surveyed banks in 22 countries, work with the IDB Group while 40% work with the IFC. The survey also indicates that the main drivers to lend (working capital) to SMEs are higher returns (32%) from these operations and diversification (26%) (IDB Group, Felaban, 2011).

Figure 2. Tools Used for SMEs Credit Analysis



Source: IDB Group, Felaban 2011 Regional SME Survey.

Similarly, the 6th Regional Survey-Closing the Gap for Banks in the Region- (IDB Group, Felaban, 2013) shows that banks consider serving SMEs strategic for their core business. Of the 100 surveyed banks, 96% consider SMEs as strategic, 67% considered their institutions as being specialized in SMEs, and 41% responded that are seeking to expand their SME portfolio. This new survey shows that the trend is expanding and more banks are incorporating ESG parameters in their credit decision making process.

Of the 55 banks surveyed by IDB in 2011 (IDB beyondBanking, 2011) 62% indicated that they had built-in an environmental policy for lending, while 29% were signatory of the Equator Principles, 24% of the Carbon Disclosure Project and 22% of UNEP-FI. At the same time, 62% of the 109 surveyed banks indicated to have a CSR department, while 65% produce a CSR report, of which 44% follow GRI guidelines (IDB Group, Felaban, 2011). However, fewer show the internalization of E&S considerations in the credit approval process of MSMEs loans accompanied by assistance to enhance clients' sustainability skills. Moreover, most of the internalization of E&S parameters continues to be done with a risk mitigation focus and not as a business opportunity driver as well.

Market/brand recognition of these sustainability efforts by LAC FIs is still incipient and very much related to the participation of IFIs. Further work, by FIs, IFIs, regulators and investors should be guided towards the differentiation of those FIs that are standing out and leading the

change of the banking model, and those lagging behind. This is of particular relevance for a business model that provides sound access to finance in a region where financial inclusion continues to be a key developmental challenge. Still limited collaborative arrangements with stakeholders, inadequate credit methodologies and limited information sharing continue to affect the robustness of the SME business ecosystem in the region. At the same time the potential for public policy dialogue remains to be fully developed.

I.2. The Role of IFIs in Financial Markets in LAC

IFIs actively pursue the development and strengthening of financial systems. The overall objective is to reinforce financial systems that foster sustainable economic growth and financial democratization. To do this, IFIs support public policy and public institutions as well as directly FIs, in order to foster sound competition and the deepening of banking services. Their contribution to the development of financial markets is implemented through a series of actions (projects, studies, technical assistance, evaluations, etc.) that target among others: (i) strengthening FIs balance sheets by enhancing their asset/liability management, their funding composition by providing longer tenors and/or funding diversification, and stronger capital positions to support business growth; (ii) fostering domestic and regional debt and equity markets; (iii) backing individual transactions with high demonstration effects; (iv) mobilizing private lenders and investors to invest in the region, (v) fostering the development of new financial instruments, (vi) promoting specific target financial activities (such as mortgage finance, trade finance, consumer finance, SME and microfinance) to encourage the availability and competitiveness of financial services that have high social impact; and (vii) reducing vulnerability to market disruption and systemic risk.

To face the sustainability challenge financial systems have to be well managed and well regulated. The potential negative impacts of weak financial systems in economic growth are well known in the region. In addition to the global financial crisis in 2008, over the years there have been many individual and regional or sub-regional financial crises in LAC that have affected or interrupted growth. So in order to focus on a new banking model for LAC, the core financial sustainability has to be continuously addressed. In this sense, IFIs continue to work on all the areas that are conducive to stable, secure and transparent financial systems. Consequently, over

time, their actions in areas of sustainability and social inclusion have grown and become more relevant. Working towards financial systems that combine financial return and social return: (i) Principled banking: transparent, responsible and ethical; (ii) Closer to the people: serving more people through more efficient channels; and, (iii) Responsible and aware of the environment and the society in which they work.

In this sense, IFIs have worked towards the enhancement of sustainable banking practices in the region for many years. Their interventions have been in a variety of areas to encompass concerns related to institutional capacity building and training, risk assessment and mitigation, corporate governance structures, development of green products and design and implementation of downscaling strategies, among others. Many banks in have developed E&S risk methodologies, implemented inclusion models targeting SMEs and the BOP, and strengthening corporate governance structures alongside IFIs' financing.

There are plenty of examples of projects led by institutions like the IDB Group and the World Bank Group, FMO, DEG, among others. Projects that have targeted different categories of state owned and private FIs that range from large commercial banks (both domestic and international capital), microfinance institutions, private equity funds, to mortgage providers, etc. These projects foster business structures and practices, and the offering of financial products and services aimed at building a sustainable banking practice. They require therefore the intervention of the public and private sectors as well as the civil society. Additionally, many of these institutions have projects at the regulatory level to strengthen the overall financial markets of the region.

At the same time, the work of IFIs has generated relevant data about the banking practices in the region. These data in turn contribute to the analysis and the dissemination of best practices amongst members of the banking community, and serves as a guide or a reference for those that are yet to embark in this business transformation. IFIs are working together to promote homogeneity in the industry so that is possible to create baselines and compare between players. Dissemination and homogeneity aim to influence the financial systems as a whole.

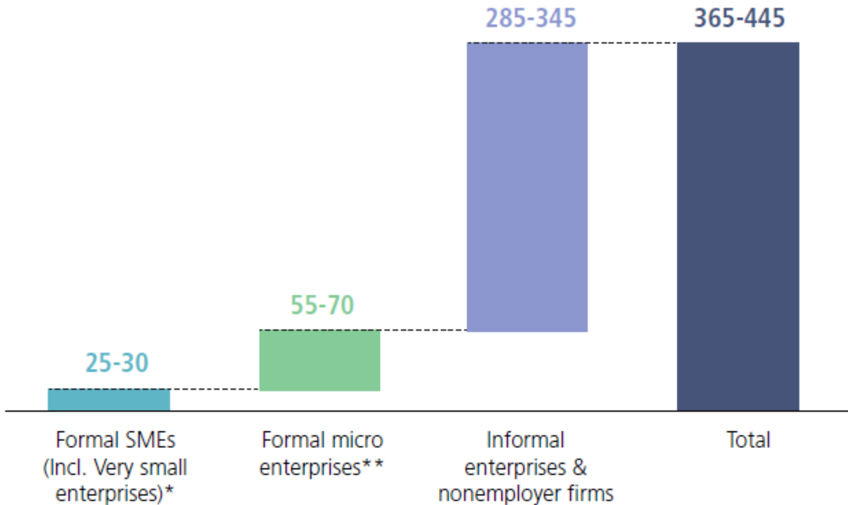
It is important to highlight that the core rationale to support FIs is to advocate and exhort FIs and other stakeholders to engage in the proposed business model. However by themselves FIs cannot make the consolidation of the business transformation, especially in regards to public policy, where Governments and regulators are the key players with important tools and

incentives to guide it. At the same time, and not less relevant, FI's clients have the ability to influence the business transformation process though their banking choices and preferences.

I.3. The need for SME financing and SME formalization

SMEs are at the core of supply chains in many industries and play a vital role in job creation, representing over 60% of GDP and 50% of employment in high-income countries (Harvard Lab, 2012). According to the OECD, SMEs represent over 65% of private sector enterprises (OECD, 2005). Although the contribution of formal SMEs in emerging economies is smaller, it is very important to consider both formal and informal enterprises.

Figure 3. Number of Enterprises by Segment and Formality in Emerging Markets (millions)



Notes: *Registered enterprises typically with 5 or more employees. **Registered enterprises typically with 1-4 employees.
Source: International Finance Corporation. World Bank Group. "Posing the Challenge on SME Finance". *SME Finance DFI Meeting. Paris. March 2011.

SMEs in LAC represent a high share of firms in all countries (around 95%) and make a significant contribution to employment (between 60% and 70%) and between 20% and 35% to GDP depending on the country (Vives, 2005; IDB and MIF, 2008). SMEs constitute then an important vehicle to improve job creation, income distribution and poverty reduction. However, SMEs continue to face limited access to adequate financing, representing only 12% of the total credit of the region, to sustain their growth, capital expansion and productivity gains. Access to

capital and technology in the region continues to be primarily available for larger firms. In LAC the gap of productivity between the large firms and SMEs is significantly high; according to OECD such gap is 6 times in the region, while in the OECD is only 1.6 times. The same OCDE study indicates that only 10% of LAC SMEs are engaged in export activities, compared to 40% of SMEs in the OECD (OCDE, CEPAL, 2013).

The value of the credit gap in formal and informal MSME financing in emerging markets globally is estimated at around US$1,300-1,600 billion, while US$125-155 billion in LAC (Stein, Goland, and Schiff, 2010). Reducing this gap requires an ample supply of funds from banking and capital markets, with innovative credit methodologies to expand financial products availability. Boosting in this way, SME financing and with it, a direct effect on social wellbeing, job creation and better income distribution.

Less than 10% of SMEs in developing countries are formal (Stein, Goland, and Schiff, 2010) and in LAC, a region that is predominantly urban[5], it is estimated that 56% of jobs in these urban areas are informal (WB, 2007). Given the relevance of the informal sector in LAC, its incorporation into the formal economy constitutes a priority to public and private sectors and civil society. There is an important economic, social and environmental value of the economic activity carried out by the informal sector. Until this sector is fully incorporated to the formal economic sector, it is not able to realize its full economic and social potential, and constitutes only a way of survival instead of a social and economic force to fully build the middle-class in LAC. Informal enterprises have very limited access to formal financing. Approximately 70% of emerging-market MSMEs do not use any formal credit (Stein, Golan, and Schiff, 2010). Similar to other emerging markets, informality in LAC refers not only to street vendors and microenterprises but to SMEs that serve niche markets or are part of supply chains across a broad array of industries.

Finding business models to tap the informal businesses and advance their transformation to economic agents of the formal economy is vital for inclusive economic growth, the long-term sustainable development of the region and the reduction of its inequality. Micro-finance models with joint liability models have been unable to expand beyond small amounts of working capital. Meanwhile corporate models seem to be too expensive if adapted to SME financing needs, as

[5] According to the United Nations LAC has the highest urbanization rate of the emerging economies at 79% compared to Africa with 40% and Asia with 45% (UN 2013).

they often do not have collateral and credit history to be assessed from a risk perspective. Given such challenges, financial intermediaries have been unable or unwilling to serve SMEs effectively and contribute to closing the missing-middle gap.

II. SUSTAINABLE DOWNSCALING STRATEGY

Although BOP frameworks target a different market segment than the SME/missing-middle, some of its specific components and challenges are relevant when developing an SME downscaling strategy. The missing-middle market refers to the untapped SME market that falls between microenterprises and corporates (Harvard Lab, 2012), meanwhile BOP frameworks address the needs and challenges of tapping two thirds of the world population (Prahalad, 2004). One of these models, the Inclusive Business Ecosystems (IBE) framework (Gradl and Jenkins, 2011) was developed as a CSR initiative at Harvard Business School (HBS). It aims to empower companies to create sustainable and inclusive market solutions that generate economic value and improve living standards of the BOP (Figure 3). Its main focus is on three key structures (private initiatives, project based alliances and platforms) to strengthen ecosystems around inclusive business models through engagement strategies to raise awareness, build capacity and generate public policy dialogue. (Gradl and Jerkins, 2011). People living at the BOP are to be engaged as consumers, producers, entrepreneurs and citizens.

Figure 4. Strategies for Strengthening Inclusive Business Ecosystems

Barriers to scale	Players and their roles	Strengthening Strategies
Limited knowledge and skills among the BOP	Companies, specialized firms: media outlets, development agencies, and NGOs: education and training	BOP awareness-raising and capacity building
Lack of market information	Companies, specialized firms: trial-and-error learning, market research	Research
Ineffective regulation	Governements, companies: regulatory change, self-regulation	Information-sharing
Inadequate infrastructure	Governments, companies, contractors: building Infrastructure	Public policy dialogue
Limited access to finance among the BOP	Financial services companies: business model innovation	Creating new organizations

Source: Barriers to scale sourced from UNDP (2008). "Creating value for All: Strategies for Doing Business with the Poor." New York, NY: UNDP.
Gradl and Jerkins, 2011.

The challenges to tap the missing-middle are similar to that of the BOP insofar they also require scale, thus the importance of replicability and demonstration effect, for which traditional lending models are to be transformed. For such transformation the strategies for strengthening the inclusive business ecosystems for the BOP can be adapted to the specifics of the missing-middle market (Figure 4). When tackling the missing-middle, SMEs are to be engaged as producers, job generators, fiscal subjects, suppliers, retailers, distributors and as sources of innovation. Many LAC FIs are developing strategies to tap the missing-middle. The examples are particular important in smaller economies where microfinance has showed relative success, such as in Central-America and the Andean region. While the business expansion is the primary driver, many FIs have developed very comprehensive strategies that include targeted credit models accompanied with customer financial literacy and business management capacity building and even E&S risk methodologies. There are very interesting examples from Guatemala and Honduras to Ecuador and Peru, among others, and many key players have worked with IFIs.

SMEs capacity building is vital for businesses growth, innovation and sustainability. This is particularly relevant for small businesses that need to achieve a larger scale to assure viability. The transformation from single decision-maker to role specialization and with it, increase in the number of employees, has to be backed with more complex know-how, management and technology structures. One example of capacity building support is the IFC/IBM SME Toolkit (IFC). With the growth of SMEs businesses comes the demand for additional financial products and services both at an enterprise and individual (workers) levels. As these business ecosystems evolve, FIs face new challenges and market potential that require further analysis and development by FIs themselves and the relevant stakeholders.

Research and information sharing can facilitate FIs' stakeholders define their participation in these business ecosystems. FIs can become an important source of valuable information to activate such ecosystems. In order to assess the credit risk of their customer base (SMEs), FIs generate comprehensive databases that can be used not only for credit management purposes but to gather intelligence about the sustainability challenge. They can provide key information about the economic activity, and its impact on society and the environment, of its SME customer base across industries and geographic location.

Figure 5. Adaptation of Strategies for Strengthening Inclusive Business Ecosystems to the SMEs Missing Middle Market

Barriers to scale	Players and their roles	Strengthening Strategies
Limited entrepreneurship skills among SMEs	Corporates, business and industry associations, NGOs, IFIs, Development Agencies: education and traininng	Capacity building by industry clusters Research Information-sharing Public policy dialogue
Limited financial literacy among SMEs	Banks, schools and universities, NGOs, development agencies: education and training	
Ineffective credit approval models	Regulators, banks, microfinance institutions, funds, NGOs, IFIs, universities: development of new SME credit models	
High transaction costs	Banks, IT companies, governments, businesses, regulators, development agencies: business/system innovations to support large number of low amount transactions	

Source: Own elaboration.

Robust FIs' databases can be used to bolster public policy design, implementation and monitoring. Public policy dialogue is essential to build on these business ecosystems based on the formalization process of SMEs. Such formalization constitutes a key social, economic and sustainability challenge shared by the whole LAC region. Thus, the public policy dialogue benefits from the active participation of all stakeholders involved in the formalization of economic actors, including FIs as primary source of credit and other financial services to this market segment, and as potential sources of data contribution.

Credit models and scoring systems have to be transformed to tackle the specific needs of the missing-middle (i.e. lack of collateral, limitations of micro-finance cooperative models). This transformation is required to address high operational costs and the need to reach a scalable business model to matter at the core of the bank's business model (i.e. IT solutions and collaborative partnerships with stakeholder of the SMEs' formalization process), and foster cross fertilization with other FIs (banks and micro-finance institutions). It is about how to find a business solution that can be scaled up to meet the demand and provide access to those outside the formal financial system while fostering the policy dialogue to formalize businesses.

II.1. FIs –Looking from Within

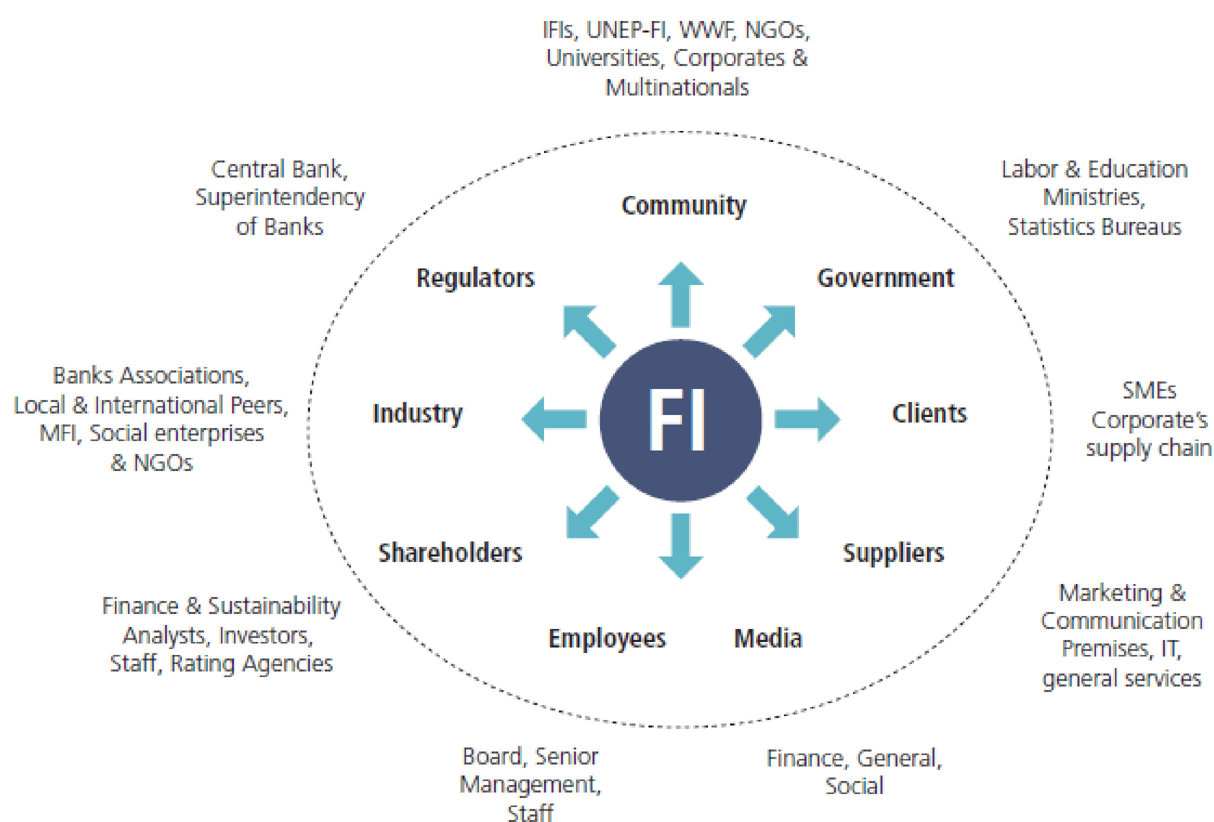
For FIs to pursue this business transformation they have to look closely inside their institutions to identify the changes needed from within, they need to build the internal commitment engaging the relevant internal stakeholders, and expanding their own vision and mission in society. Organizational change is a complex proposal where behavior, values and assumptions transform and adjust to a new reality. These processes are neither necessarily linear nor fully planned or have a predictable pace. Yet change processes can be significantly influenced at all levels of the organizations. The identification of the existing gap to meet the vision, the proposed responses to close such gap and achieve their implementation require buy-in and to overcome resistance to change. Resistance to change that can come from many stakeholders: -Internally could be from (i) shareholders due to costs of the transformation and time expectation of potential benefits (i.e.: economic contribution and policy dialogue); (ii) CSR departments as the mainstreaming of the "CSR components" into the core business may result in a declining need for a separate CSR function; and (iii) credit departments for introducing a new credit methodology. -Externally resistance may come from (i) client-SMEs for the reporting requirements to maintain relevant comprehensive databases; (ii) government agencies due to FI's attempt to further participate in the SME-formalization policy dialogue; (iii) regulators for introducing alternative credit methodologies; (iv) peers for being ahead of the pack; and (v) investors for not recognizing or pricing-in the business transformation.

Stakeholder Mapping

As highlighted before, for IBE-inclusive model working with stakeholders is vital for a holistic approach. Stakeholder mapping is a useful framework to analyze the legitimacy, influence and contribution of stakeholders. It's a tool used to identify level of complexity of the issues being faced, to determine who to engage, and their relationship and their influence over the institution (FI) based on their expertise, willingness and value-added (Johnson & Scholes, 2002). Stakeholder engagement is fundamental for the long-term success of the transformation strategy and the resiliency of the new business model. Resiliency understood as the ability of the FI to successfully adjust its business model to the changing conditions (Janisch, 2011). By incorporating stakeholders' views, FIs can foster their engagement and improve the quality of the

process, outputs and outcomes. By frequently assessing these engagements and communicating with stakeholders, FIs facilitate the understanding of the strategy and anticipate potential reactions, legitimizing their participation and transforming the role of FIs in sustainable development. An assessment of FI's stakeholder map (Example-Figure 6) can guide the process of identification of the most influential stakeholders to push the organizational change needed to pursue the sustainable downscaling strategy.

Figure 6. FI Stakeholder Map



Source: Own elaboration.

Stakeholder mapping can also guide the determination of the potential appropriate collaborative arrangements that can be used to engage with the different stakeholders in the identification and implementation of the sustainable downscaling strategy. Setting continuous feedback processes allows for adjustments overtime to rearrange the stakeholder map and adjust the collaborative arrangements when and as necessary. At the same time, feedback processes would be an integral part of the assessment of the (i) identification of quality of the financial and

non-financial services offered to the SMEs; (ii) access to untapped SME-needs; and (iii) quality, integrity and relevance of the gathered data points (economic contribution).

II.2. Collaborative Arrangements

The combination of the three IBE-structures provides a working framework that allows FIs to implement the components of an action plan simultaneously or in a phased approach, while the focus on long-term profitability provides the guiding principle for the SME-lending and FI's contribution to sustainable development.

In order to do this, FIs have to tackle some organizational challenges; (i) the focus on short-term financial performance instead of long-term profitability, (ii) the perception that sustainability objectives are a CSR matter or a risk-mitigation objective; (iii) that the extra-mile step to create a comprehensive sustainable SME-downscaling strategy is not necessary nor feasible, and (iv) to map and engage key stakeholders to partner in the different IBE-structures. Overall it requires FIs to transform their view of the purpose of its own business from solely financial intermediation to a broader scope of co-responsible contributor to sustainable development. To guide and measure its downscaling strategy FIs would build a roadmap guided by a combination of existing and new KPIs that would set the long-term goals. The proposed KPIs would allow FIs to measure the increase in their share of the productive sector served by the bank, its contribution to the formalization of the economy, job-creation and retention and to closing the gap of inequality in the country. Thus contributing to measure the unlocked assets in the communities FIs serve, in the form of unlocked production, consumption and citizenry power.

Table 1. Proposed KPIs

FIs Strategic KPIs - Example		
	By 2020	Baseline (2013)
SME Portfolio (existing KPIs)	1. SME portofolio growth (USD Amount) by (X% yearly avg.) 2. Number of clients - SMEs 3. Number of products used by SMEs: at least X. 4. Tenor of SME loan products for capital investment: at least X years	1. SME portofolio USD amount Baseline: US$XX mn. 2. Number of clients - SMEs Baseline: XX 3. Number of products used by SMEs. Baseline: X 4. Tenor of SME loan products for capital investment. Baseline: X years
NON-Financial SME Products (new KPIs)	At least X% of clients-SMEs received FI's 1. Financial Literacy and/or 2. Entrepreneurship training	The existence of a baseline will depend on the type, if any, programs the FI has in place and how it is measured
Long-Term Profitability (new KPIs)	At least two years of Triple-Bottom Line or Integrated Reporting	Most LAC FIs only do traditional financial reporting
Economic Contribution (new KPIs)	At least three consecutive years reporting: 1. Contribution to GDP growth 2. Contribution to job creation and retention.	N/A. Most FIs do not have this data available, nor have the methodology to gather, aggregate and validate it.
SME- Formalization (new KPIs)	Contribute to formalize least X% of clients-SMEs served during the period that prior were informal	N/A. This data is not gathered, nor is there any formal, process to support SME formalization

Source: Own elaboration.

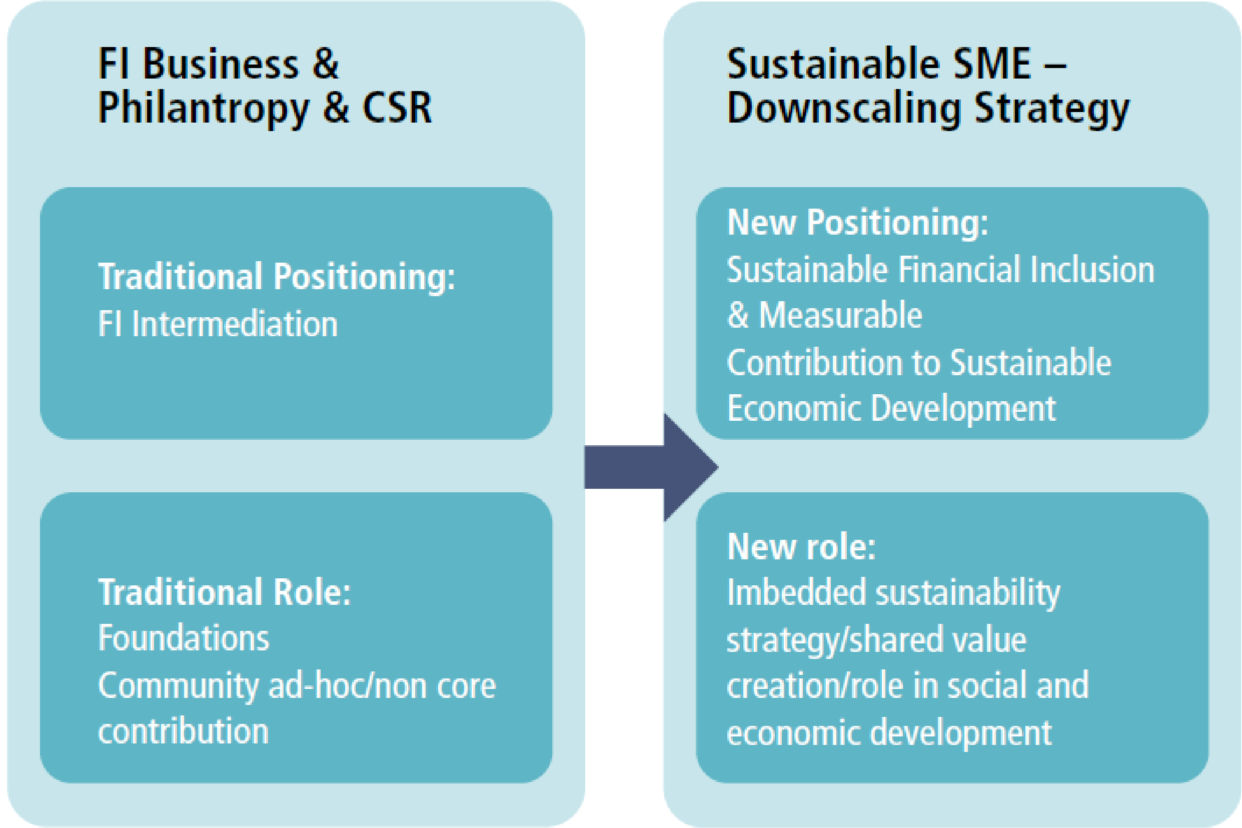
Although it is still not possible to comprehensively substantiate any potential direct immediate impact on FI's profitability if the sustainability challenge is not tackled, it represents at least a missed opportunity of potential leadership, forward thinking and innovation. FIs have the opportunity to lead markets towards higher levels of contribution to sustainable development and place themselves as active contributors to sustainability goals, with a clear "social license" to operate (Gunningham, Kagan& Thornton, 2004) and enhance their competitive advantage.

As highlighted by Peter Sands, Standard Chartered CEO “Banks enable people in their everyday lives to buy goods and services, to save and invest, to buy homes and grow their

wealth. We help businesses to set up, to expand and to trade internationally. We help economies to prosper, to build infrastructure and to lift their citizens out of poverty. By doing these things in the right way, banks can be an extraordinarily powerful force for good throughout the economy." (Kapstein& Kim, 2010, p2).

The key challenge FIs face is the need to align sustainable development and business success. To do so, they must address what is their ultimate institutional role. Traditionally FIs are identified with their financial intermediation and capital allocation capacity. Yet FIs impact across industries, geographies, governments, societies and the environment, place them in a key position of influence and responsibility to transform the current business model. In order to advance towards sustainable business models, FIs should respond to this higher purpose social role, rather than solely to financial intermediation, and address the E&S demands of long-term sustainable development (European Commission, 1997; UN, 2011).

Figure 7. FIs Business Transformation



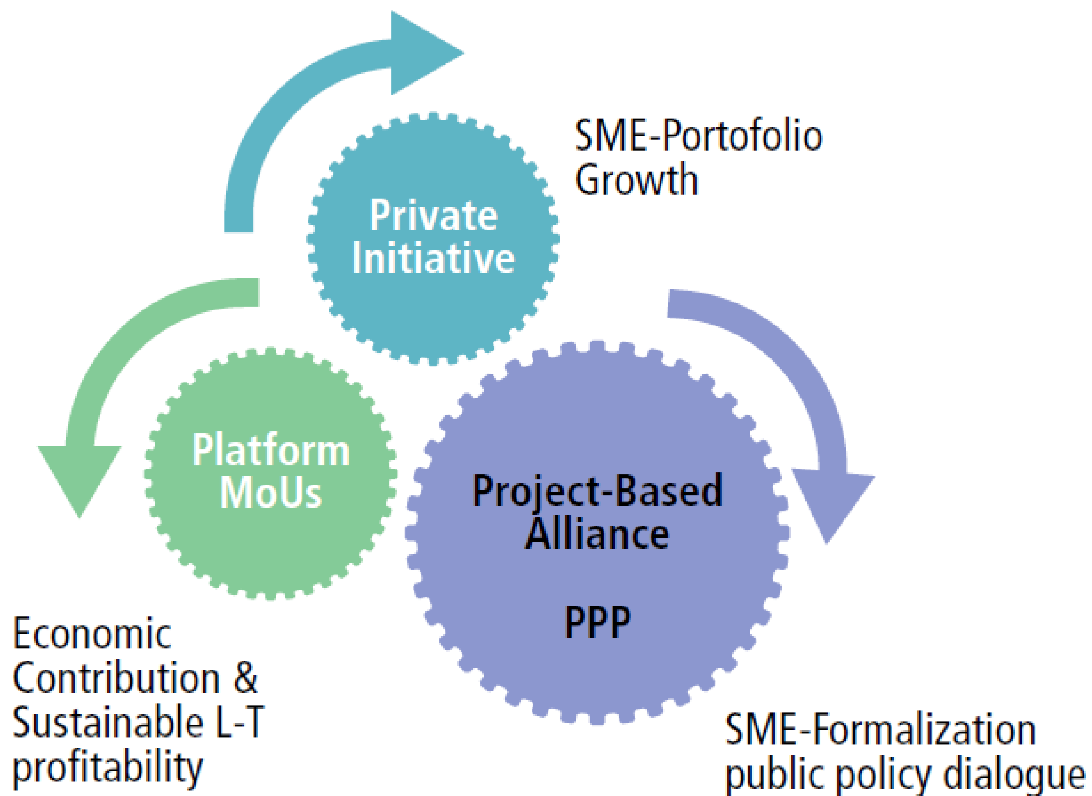
Source: Own elaboration.

In doing so, FIs address the substantive sustainability challenge and the legitimacy crises (Porter & Kramer, 2011) by incorporating in its core business model the E&S variables that add value to the firm (competitiveness) and to society (financial inclusion, economic growth and SME-formalization), while being accountable for the E&S footprint (risks and opportunities) of their lending activities.

A proposal of Collaborative Agreements for FIs.

FIs could direct their efforts through a combination of the three IBE-structures: Private Initiative, Project-based Alliances and Platforms. This combination of engagement structures allow for an encompassing approach as it relies on tapping on internal and external resources and relevant stakeholders based on the dimension of the sustainability challenge being faced. This is of primary importance, as any collaborative arrangement is to be adapted to the tasks that are being undertaken so as to reach an efficient use of resources, timely response, greater impact, and assure cooperation and collaboration.

Figure 8. FI Stakeholders Engagement Scope



Source: Own elaboration.

1) Private Initiative:

The core of the business case is to be initially developed internally and has as main component the downscaling-SME market and the alignment of the business model towards sustainability. It requires FIs to build upon the existing objective of growth of the SME portfolio by; (i) mapping and profiling of the existing and potential SME customer universe (composition by type, industry sector, profitability, job creation, size, credit experience, resource/energy efficiency, fiscal contribution etc.); (ii) identifying the financial and non-financial needs (entrepreneurship skills, financial literacy, etc.) that can be served by existing products and the innovations that should be contemplated; (iii) implementing a new credit methodology that tackles the specifics of the SMEs (i.e. lack of collateral, limited financial statements, etc.) (IDB Group, Felaban, 2011); (iv) targeting E&S business opportunities (i.e. energy efficiency, recycling, etc.) to complement the existing E&S risk classification/mitigation standards (IFC Performance Standards, 2012), and (v) documenting the SME-downscaling strategy guided by the key milestones and KPIs (Table 1).

To address the typical incentives impediments of this type of collaborative structure, the new value proposition ought to align the interests of the SMEs-customers, so they use FI's financial services and are able to enhance the business scale. However, differently than in the typical IBE-structure, the main service/product provider (FI) works in a regulated market, thus some of typical IBE incentive challenges (payment systems, product certification, etc.) are not as relevant. To implement the organizational change it is required to develop and implement an SME-targeted credit methodology, an IT and management information system (IT/MIS platform) to support the business model and the integration of E&S variables to the core business model to substitute the current model of FI business + CSR approach.

2) Project-Based Alliances:

Beyond the internal arrangements, FIs may look to engage with external stakeholders to further develop project specific alliances that contribute to the development of their sustainable business models. By creating these specific alliances FIs can work with external stakeholders to define parameters, data components and methodologies to provide reliable and comparable sustainability indicators. In particular this type of alliances incorporates peer institutions, regulators and researchers; thus improving its replicability, comparability and business scale

potential. Two main aspects can be developed through project-based alliances; measurement of FI's economic contribution and measurement of sustainable long-term profitability

A. Contribution of the FI’s SME-business to the country’s economic development: This is a less developed area of work for the industry. Previous experiences include that of Standard Chartered that commissioned a report in 2010 to better understand its economic impact in Ghana. The contribution is measured based on a selection of financial products and services identified as relevant to the creation of value to the economy (Kapstein& Kim, 2010). The applied methodology allowed for an estimation of the contribution of Standard Chartered selected product and services as percentage of Ghana GDP. Particularly important are the selection of the indicators and the metrics to be used to measure contribution to economic development (GDP growth and job creation), as well as the integrity of the methodology and the data points. In this sense, the goal is to quantify the “direct, indirect and induced impact” (Kapstein& Kim, 2010) of the FI SME-lending activity in the relevant economy. This requires the development and implementation of an IT and MIS platform, to have the capacity to create baselines, feed databases overtime and assure its integrity and to enable access to timely and reliant official economic data.

B. Development and implementation of long-term profitability measurement: Although this also represents a relatively new area of work for many FIs, there are important advances at the industry level. A key component of long-term profitability is to incorporate relevant E&S variables in financial reporting and provide systematic, reliable and transparent information on economic, environmental, social and governance performance. GRI reporting standards (triple bottom line or integrated reporting), for example, provide international best practices that allow for transparency, comparison and independent valuation.

While the IBE ecosystems provide a sound framework to address inclusive businesses and reaching scale, it does not explicitly address a core demand for FIs to incorporate E&S costs into the profitability function. This requires that FIs move away from short-term profits and allocate capital with a longer-term view; a timeframe that is consistent with the sustainability challenge we face. The role of markets and capital allocation and the sustainability challenges should respond to a broader definition of the value at risk, which should contemplate the cost of externalities. Figure 8 shows an indication of the estimated costs of global externalities

Table 2. The Cost of Externalities Trucost Study for PRO/UNEP FI Report on Universal Ownership

US$ 6.6 trillion:

The estimated annual environmental costs from global human activity equating to 11% of global GDP in 2008.

US$ 2.15 trillion:

The cost of environmental damage caused by the world's 3,000 largest publicly-listed companies in 2008.

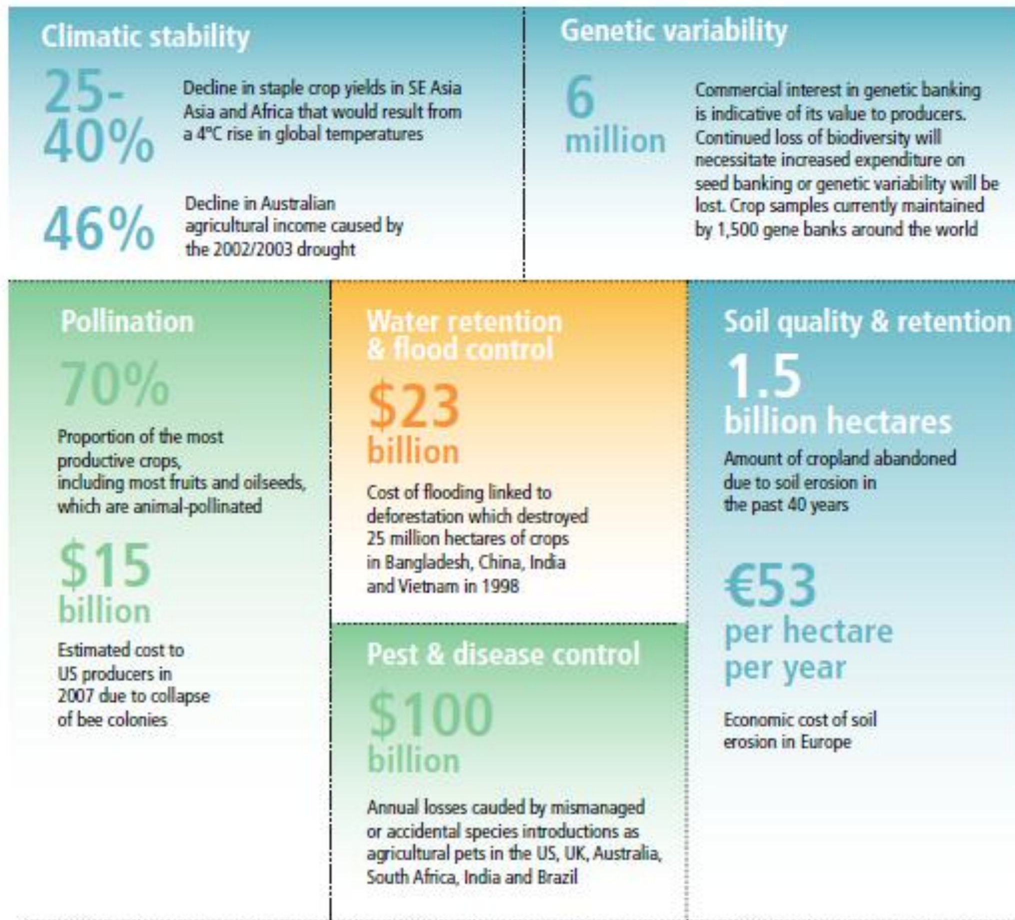
>50%:

The proportion of company earnings that could be at risk from environmental costs in an equity portfollio weighted according to the MSCI all country world index.

Source: PRI/UNEP.

Companies, FIs and investors should value the potential cost of externalities they are exposed to through their portfolios and balance sheets. In order to reduce the potential financial and reputational risks associated to such externalities, financial markets have to incorporate adequate account of them, thus protecting the value and growth potential of their portfolios. This implies a carefully assessment of the potential impact of climate change for example, in those industries they finance. This is particularly the case for FIs that are active in agribusiness, where the impact of climate change and use of scarce natural resources has clear implications in the credit stand of the agribusiness supply-chain. A creditor or investor in this economic activity should have knowledge of the potential negative impacts of climate change in this industry, as well as the new opportunities that arise. Furthermore, this impact is potentially transmittable not only through the credits granted but also through reduction of transactional services or deposits taken by cash-strapped companies reacting to the negative impact of natural disasters, for example.

Table 3. Climate Change Impacts Agribusiness



Source: Biodiversity & risk. World Economic Forum.

This type of alliances depends on clear alignment of interests and trust among the participants to assure active contribution and accomplishments. FIs can formalize them through formal agreements establishing the working frameworks: objectives and responsibilities of individual partners (FIs, NGOs, academia, etc.), and appropriate evaluation and monitoring mechanisms.

3) Platform:

To create the framework required for influencing public-policy dialogue regarding SME-formalization. The objective would be to have the capacity to mobilize relevant stakeholders to trigger the dialogue and form a public-private arrangement to structure the public-policy dialogue process. Typically public-goods face free-rider problems as key barriers, so given the

scope of this public good, where significant resources are required to research and test potential public-policy instruments, a shared effort/cost through a PPP type arrangement (with clear distribution of costs, risks and benefits) could provide an appropriate incentive arrangement. They type of the proposed public policy dialogue would be similar to the existing dialogue to tackle certain social and environmental challenges in areas of health, education and climate change among others. Ever more frequently, societies realize that the magnitude and complexity of the social and environmental challenges ahead require knowledge and resources from all sectors: public, private and civil society. Furthermore, the closer public and private sectors work, the more cross-fertilization opportunities could arise. Much has been studied about the merits of the public sector in incorporating the way of thinking, the management style and the metrics of management for results in the private sector. However, less has been done regarding the importance of the public sector engaging the private sector in terms of pursuing public goods. A Platform work arrangement, as the one proposed here, could foster a substantial discussion regarding the need to combine public and private sectors in the protection and promotion of public goods.

Potential participants in a Platform arrangement would fall into the following categories and they would engage based on their resources, expertise and leadership: private sector (FIs, MFIs and law firms), civil society (NGOs, social enterprises, academia) and public sector (local and federal authorities, relevant ministries, development institutions, tax authorities, etc.). The dialogue would encompass various subjects including incentives to reduce informality and become a formal enterprise, taxation, social security, productivity, labor conditions and the prevailing vulnerability of access to finance (Dalberg, 2011). It encompasses a dialogue process to design, implement and monitor public-policy instruments that enhance and assure the attractiveness of the formal economy versus the informal one. In this way, the value to society increases through growth, higher taxation (both through the formalized SMEs and the FIs), job creation, higher productivity, higher bancarization and heightened market coverage, competitiveness and profits for FIs.

It is a new way of doing business and therefore not without risk. There could be potential risks of (i) high implementation costs of non-financial products; (ii) alliances with stakeholders can be resource intensive, with longer implementation phases and long-term unclear potential impact on the business; (iii) data integrity and confidentiality protection, (iv) low -or limited

measurability- of the impact on the core business, and (v) the potential increase in NPLs and deterioration of asset quality with the introduction of the new credit methodologies, among others. Yet such risks have to be weighted against the potential benefits to the participants and to society. For FIs benefits could include the profitability resulting from taping the missing-middle market, diversification, growth of the loan portfolio, cross-selling opportunities, the contribution to economic growth and job creation by providing access to finance to SMEs, and leading industry change and reputational recognition. In contrast, not changing the business model could also encompass risks and require measures of adaptation and mitigation. The sustainability challenge ahead seems to indicate that the proposed business transformation will place FIs in a more robust and competitive position to tackle such challenge and contribute proactively to solve it. For the public sector the benefits could include reduction of informality, higher taxes and stronger buy-in in public policy, among others. Society as a whole benefits from higher social inclusion and equity, higher productivity and more participatory and equitable public policies.

III. FINAL COMMENTS

FIs in LAC are pursuing downscaling strategies -providing access to financial products and services to tap the missing-middle. Their growth/downscaling strategy is driven by the relevance for their commercial portfolio. Surveys indicate that this trend is increasing and consolidating across the region. IFIs and many FIs have consistently undertaken the challenge and have shown significant advances serving the SMEs market. But much more needs to be done, measured and communicated. To tap this market in a sustainable manner FIs should further pursue banking models based on the creation of social, economic and environmental value: a model that promotes financial inclusion, positive environmental and social footprint and sound corporate governance. By being market based and profitable, the expectation is that they can reach the required size to tackle the scale challenge of IBE frameworks. It is, however, a growth model to create wealth and financial inclusion, but one that looks to incorporate its impact (positive or negative) in society and the environment.

Concurrently, with further development of these downscaling strategies FIs have the opportunity to impact the public policy dialogue towards SMEs formalization. In turn, such participation would not only contribute to redefine their role in society but to further grow their

businesses. This redefinition of the role of FIs in society is strategic for long-term sustainable development. Formalized SMEs are in a better position to grow, to have higher labor and capital demand, and productivity. For the business this implies an increase in demand for more sophisticated financial products and services. For society, higher productivity and a more equitable growth contribute to a better income distribution and the closing of the inequality gap in the region. Redefining the financial sector's role is relevant for all stakeholders.

Governments require the participation of the private sector to address social challenges as they face cash constraints to cope with rising demands. Concurrently civil society's growing role as proxy for public interest and concerns claims for a social legitimization of FIs and the overall private sector. As LAC's private sector grows, so do expectations about its responsibilities in the delivery of a sustainable development. As the middle-class grows in LAC, so do their demands for more and better public services. This represents both an opportunity and a responsibility for FIs to proactively engage in consolidating this middle-class.

Globalization, innovation and new technologies offer greener and more inclusive alternatives that make for better businesses models while providing value to society and the environment. The recent global financial crisis demonstrated long-lasting consequences of business models that failed to properly align incentives, implement effective management structures, and balance the consumption of current economic, social and environmental capital with future needs. There are still few proved answers and many open questions to guide the change in the business model, yet many are working on different ideas and approaches to improve FIs working models.

Is not a choice, is the ethical response. To aim for sustainable societies implies to aim for a society based on a sound distribution of wealth, on a growth model that responds proactively to the environment and where its citizens are empowered by their participation in the decision making process through robust democratic channels. FIs have to acknowledge that their impact on the society and the environment carries great responsibility and that their legitimacy as agents of social change, depends on the realization that their role goes beyond the traditional financial intermediation.

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