



# Small-scale finance for water and sanitation



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Formed in 2003, the EU Water Initiative – Finance Working Group (EUWI-FWG) helps shape the financial strategy of the EUWI. The FWG encourages innovation, the development of institutional and regulatory frameworks and capacity building. It also encourages using development funding as a catalyst to leverage other forms of finance – including national budgets, donors and users. The EUWI-FWG is hosted by the Global Water Partnership (GWP), which provides secretariat and administrative support.

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## ABBREVIATIONS AND ACRONYMS

AFD .....	Agence Française de Développement (France)
CBO.....	Community based organisation
CLIFF .....	Community-led Infrastructure Facility
DFI .....	Domestic financial institution
DFID .....	Department for International Development (United Kingdom)
DGIS.....	Directoraat Generaal Internationale Samenwerking (Netherlands)
EIB .....	European Investment Bank
ESA .....	External support agency
EU .....	European Union
EUWI-FWG .....	European Union Water Initiative – Finance Working Group
FINISH .....	Financial Inclusion Improves Sanitation and Health
GIZ .....	Deutsche Gesellschaft für Internationale Zusammenarbeit (Germany)
IFI.....	International financial institution
JLG .....	Joint liability group
KfW .....	Kreditanstalt für Wiederaufbau (Germany)
MDG.....	Millennium Development Goal
MIV .....	Microfinance investment vehicle
MFI.....	Microfinance institution
NABARD .....	National Bank for Agriculture and Rural Development
NGO .....	Non-governmental organisation
NSDF.....	National Slum Dwellers Federation
RCB .....	Rural Community Bank (Ghana)
ROSCA .....	Revolving Savings and Credit Association
SACCO .....	Savings and Credit Cooperative
SDI.....	Slum Dwellers International
SHARE.....	Sanitation and Hygiene Applied Research for Equity
SHG.....	Self-help group
Sida .....	Swedish International Development Cooperation Agency
SLC .....	Savings and Loan Cooperative
SME .....	Small and medium enterprise
SPARC .....	Society for the Promotion of Area Resource Centres
SSF.....	Small-scale finance
SSIP .....	Small-scale independent provider
WATSAN .....	Water and sanitation
3Ts .....	Tariffs, taxes and transfers

# Executive summary

## Key findings

**Households in developing countries invest more than donors or governments in water and sanitation (WATSAN) services, but these investments are often 'sub-optimal'**, because of limited access to finance. WATSAN entrepreneurs, although they provide critical services particularly for the poor, often find that their financing needs fall in the 'missing middle' (estimated roughly at between USD 2000 and USD 100,000). The issues related to financing WATSAN small and medium enterprises (SMEs) are little understood at present.

**Limited access to financing is a key obstacle for small-scale finance (SSF) recipients to deliver sustainable services.** This is, of course, not the only constraint, but it is a significant one, alongside informality, lack of business skills and affordability constraints.

**Few domestic financial institutions (DFIs) are currently involved in financing small-scale WATSAN providers.** In some countries, such as Kenya, India and Vietnam, the markets for micro and mesofinance for WATSAN are growing with the development of lending products such as 'toilet loans' or 'water tank loans'. Some countries, such as Vietnam (which has mandated the Vietnam Bank for Social Policy to offer WATSAN specific loan products) and Ghana (which has a stated policy to roll out sanitation revolving funds [SRFs], although not yet implemented), have defined sanitation microfinance as a key pillar of their strategy for reducing the sanitation access deficit. In many other countries, DFIs are not very aware of the financial needs of the sector. There is, therefore, a need to build their capacity and awareness of financing needs in the WATSAN sector.

**SSF is, in theory, not limited to microcredit.** There is a tendency to focus exclusively on microcredit, even though SSF can include many other financial instruments, such as

savings, insurance, leasing, working capital loans, etc. Microcredit is somewhat easier to grasp and has been much better documented. In practice, however, most of the SSF that has been provided for WATSAN to date tends to relate to credit. The combination of savings and loans (credit) holds great promise for facilitating access to WATSAN providers.

**Using microfinance for WATSAN is sometimes criticised on the grounds that access to water or sanitation is not directly income generating** and thus it is difficult for poor people to obtain a loan to access such basic services. However, a microloan for WATSAN is clearly income enhancing as it improves health and well-being and saves time for revenue earning activities. Besides microcredit, other financial instruments can play an important role in increasing access to WATSAN and therefore would warrant further analysis and documentation.

**A survey of EU donors showed their interest in, but limited experience of, supporting SSF for WATSAN.** Public funding can be used in a variety of ways to support small-scale WATSAN providers, such as grants for market research and assisting microfinance institutions (MFIs) to help catalyse private finance. Donors can improve the market and help overcome 'misunderstandings' between lending institutions and community-based organisations (CBOs) by bridging the divide between their different approaches. They can also help to improve overall governance in the country to make conditions more conducive for investment.

**Donors can use a variety of financing instruments and channels to transfer finance to SSF recipients.** These instruments may include grants (in various forms), concessionary loans, guarantees and equity investments. Overall, no single financial instrument can be used to trigger a market response from private finance providers to get them to start offering SSF services for WATSAN. A combination of such instruments would need to be used, in order to address the various market failures identified, although it would be necessary to keep the overall financing structure as simple as

possible. Some financing institutions may be more willing to take one type of instrument vs. another (e.g., NGOs can accept grants, but seldom can they accept equity investments). On the supply side, some donors (such as philanthropic organisations or social investors) may be more willing to take risks than traditional donors. Blending funds from various donors, therefore, may be the way to develop a financing package with an optimal risk profile.

**Grants can lever other forms of funding and should be provided based on performance.** They should avoid promoting 'incompetence', which means that if there is no adequate business plan, there should be no grant. Grants must avoid distorting the market and interfering with the business of the banks/microfinance institutions (MFIs) (e.g. by introducing subsidies that distort the market). In all cases, it is important to pay attention to the 'soft elements', so as to ensure that financial institutions or their NGO counterparts also provide technical and managerial support to SSF recipients.

**A key issue is 'getting funds from A to B', given the great number of SSF recipients and the physical distance between external support agencies (or governments) and the recipients on the ground.** A number of financing channels can be considered to that effect. Intermediary institutions are critical and include Apex institutions, NGOs, microfinance investment vehicles (MIVs), trust funds or local commercial banks – these are not necessarily mutually exclusive.

**Experience shows that supporting MFIs and commercial banks to expand their services into WATSAN can be more effective than attempting to impart business and financial management skills to existing WATSAN NGOs.** Building the capacity of financial institutions to get involved in providing WATSAN products is critical, as financial institutions have a certain level of rigour and can be better trusted to collect payments. Building successful partnerships between financial institutions, NGOs and other supporting organisations (such as consultants) is key, however, as NGOs would still be needed for 'soft components', such as hygiene education, demand

creation, community organisation, capacity building or training. They can also help small-scale entrepreneurs develop business plans in order to be in a better position to access funding. Once partnerships have been successfully built, there is likely to be more demand than can be met by the supply. There is a role for donors and support agencies in building the capacities of both MFIs and NGOs and helping to provide an enabling environment for SSF.

**Channelling financing via multi-donor trust funds and Apex institutions (i.e. national-level agencies) may also be a good way to reduce transaction costs and leverage the expertise of these institutions.** There are considerable numbers of Apex institutions and microfinance investment vehicles (MIVs) already in existence that are not specialised in water, but which could be informed about the financial needs of the sector and serve as very useful financial channels.

**Both microfinance and mesofinance present market potential to provide services to the poor. Sanitation is potentially the sub-sector where needs are greatest and holds great potential for the application of microfinance.** Domestic water services also require micro and particularly mesofinance, but there are substantial differences in the financing needs between the two sectors. Households are the main investors in sanitation (which usually consists principally of 'on-site sanitation' in most countries) and, therefore, need access to funding in order to spread the initial cash outlay required over time. Investment needs for water systems tend to be more substantial and this is where CBOs and small-scale independent providers (SSIPs) would need to access mesofinance, which could also take the form of leasing large equipment.

**Supporting SSF is only one instrument among many others and it is not a panacea.** SSF is best suited to fill the 'missing middle gap' and to meet the needs of poor households, although not those of the extremely poor and destitute. Given that microcredit usually carries fairly high rates of interest, these would usually prove too high for the extremely poor who also tend to be excluded from formal financial markets

(although this is rapidly changing in some countries such as Kenya with innovative services such as mobile banking). For the latter, other types of approaches may be needed as part of a package. One promising approach consists of combining savings and loans so as to mobilise the necessary funding at the level of the community itself and leave the community to be in control of its own savings. This requires that MFIs are able to take deposits (which is not the case in all countries) or that savings are done through village savings groups (or similar structures), which are inherently limited in scale. The model, developed by Slum Dwellers International (SDI), is an interesting alternative that allows scaling up. Donors could help develop this by supporting more research and development.

## What more could external support agencies do?

**Before designing a small-scale financial support scheme for WATSAN, external support agencies (ESAs) should assess the organisation of the domestic financial sector as well as that of the water sector.** The financial sector, including microfinance, is organised differently in each and every country. Hence it is critical to better understand the organisation of the financial sector before designing a financial support scheme for WATSAN entrepreneurs. Questions to consider include:

- What is the regulatory environment and overall 'financial system' structure? Are MFIs allowed to take deposits? Is there a credit bureau in place?
- What is the structure of the 'financial sector'? Who are the main actors providing microfinance services, commercial banks/MFIs/NGOs? What is the degree of 'financial inclusion' (i.e. access to formal financial services)? Do Apex bodies or MIVs exist?
- What is the depth and breadth of the microfinance sector? What is the overall size of the microfinance sector? What range of financial products do they offer?

- What is the level of 'awareness' of the WATSAN sector amongst financial institutions?

**ESAs should draw on existing experiences with general micro and mesofinance, including in-house and from other organisations.** Many donors have considerable experience in supporting SSF for other sectors, such as income-generation activities, clean energy and agriculture. There is often little communication between professionals working in microfinance within the donor organisations themselves or between them and their counterparts in the WATSAN sector. Learning from these experiences would help with structuring WATSAN projects and programmes that incorporate elements to support SSF recipients. It would also help with using existing financial channels that have been set up for various sectors rather than create new ones specifically for WATSAN.

**Existing innovative programmes to support SSF for WATSAN could be built upon and expanded.** Some of the programmes reviewed in this report, such as the Microfinance Water Sector Activity in Kenya, the Financial Inclusion Improves Sanitation and Health (FINISH) project in India and water and sanitation CLIFF (in both India and Kenya), have proven successful at channelling substantial amounts of funding to SSF recipients. Much can be learned from the architecture of these programmes for potential replication. Making incentive payments to MFIs for boosting sanitation coverage in their areas of operation under the FINISH programme is particularly innovative and could provide lessons. Channelling additional funding to these programmes could be considered by other EU donors, as these programmes are already in place and there would be economies of scale in using them as platforms to pull in financing. The EUWI could act as a mechanism to build alliances between EU donors to scale up such programmes.

**In supporting SSF for WATSAN, ESAs and governments can use a broad range of instruments and financial channels.** The use of guarantees should be encouraged, under the appropriate circumstances, and the creation of domestic facilities that can provide local guarantees should be fostered.

**Subsidies and regulation need to be improved so as to eliminate contradictory policies and practices that could limit the use of SSF where appropriate.** For example, microfinance for sanitation is only likely to be viable if hardware subsidies are simultaneously discontinued.

**DFIs should be encouraged to 'mainstream' WATSAN SSF.** At present, many MFIs and commercial banks deal with WATSAN activities as 'pilot projects' managed by a specific department (this was the case of K-Rep's handling of the Kenya Microfinance for Water Projects Activity). Instead, these activities should be mainstreamed into the main activities of the financial organisations.

## Which concerted actions could be initiated?

**Much still remains to be done in order to increase the level of penetration of SSF in the WATSAN sector, which means that concerted actions between ESAs may need to be initiated.**

**In order to design better actions, it could be important to start by improving the level of knowledge, particularly on the specific needs for mesofinance,** as this tends to be less documented than microfinance. Some financing instruments, such as leasing, have found marginal use in the WATSAN sector although their potential appears to be large. It would also be crucial to more systematically monitor the

microfinance market for WATSAN and its impact on beneficiaries. Existing resources on micro and mesofinance for WATSAN could be pulled together on a web platform (on a similar model to that for rural finance) to increase their accessibility. The ultimate objective would be to stimulate interest from funders to provide more micro and mesofinance for WATSAN.

**Given that domestic financial intermediaries are essential for channelling finance, concerted actions to develop national Apex institutions, for example, could be undertaken.**

Establishing or developing an Apex institution can take time and effort and there would be economies of scale in developing this concurrently with other activities.

**Attention should also be paid to improving the overall business environment and strengthening the financial systems.** 'Macro' interventions, linked to improving the overall regulatory environment, are essential and are as important as developing specific financial products for WATSAN or establishing dedicated financial channels. Improving regulation and monitoring can help prevent the types of crises that have marred the microfinance sector in India (following a period of extremely rapid growth). The strengthening of regulatory regimes for micro and mesofinance is taking place in a number of countries throughout the world and donors could do more to support such processes where they are ongoing or about to be undertaken.

# 1. Introduction

## 1.1 Report objectives

The objective of this report is to identify ways in which governments and external support agencies (ESAs) can increase access to finance for small-scale WATSAN providers, by channelling public funding to support the market and leverage private sector financing. The ultimate objective in doing so is to increase access to services for poor households, who either invest in the services themselves or rely on small-scale providers.

This report has been developed as part of a component of the work programme of the European Union Water Initiative – Finance Working Group (EUWI-FWG), which looks at enhancing the role of the private sector in WATSAN and how EU donors can provide strategic support.

**Rationale for the report.** At present, there is little awareness or cohesion among ESAs (including EU donors) on the best way to increase financing for small-scale providers. It is not easy to get an idea of what their policies are or what they are doing and

how they could collaborate to add more value. Given the importance of these types of providers for the sector and of reaching the Millennium Development Goals (MDGs), members of the EUWI-FWG identified the need for a study on this issue from two perspectives – that of ESAs (also referred to as donors) and that of DFIs (including MFIs and local banks).

**Target audience.** This report is principally aimed at ESAs, including bilateral donors, multilateral institutions, NGOs and philanthropic organisations. It would also be of interest to government officials and local agencies looking to incorporate microfinance and mesofinance elements into the designs of their programmes. One objective of the report is to convince agencies, which have not previously considered increasing financing to that segment, of the importance of doing so and that it can be done in a cost-effective manner.

**Geographic focus.** The report draws from examples from a diverse range of geographies, including urban, peri-urban and rural areas. Many examples are drawn from East Africa and India. This is where fieldwork was conducted as part of the project funded by the EUWI-FWG (Kenya) and as part of a parallel project funded by DFID via the SHARE research project (Tanzania and India).

### Box 1. Definitions used in the report<sup>1</sup>

**WATSAN services** refer to all water services provided through manmade capital that deal with the supply of drinking WATSAN services. This includes piped and non-piped water services, as well as on-site and networked sanitation.

**Small-scale finance (SSF)** is defined as financing below approximately USD 100,000. It covers both microfinance services (including small loans below a few thousand USD) and mesofinance services (below approximately USD 100,000) to small and medium enterprises (SMEs).

**SSF recipients** include small-scale WATSAN service providers, ranging from households, SSIPs, small and medium sized enterprises, equipment providers, CBOs, non-governmental organisations (NGOs), user committees and local governments. These may also include small utilities when those do not have access to standard financial channels.

<sup>1</sup> A glossary of terms relative to small-scale finance is provided in Annex C to this report. For a broader glossary of financial terms applicable to the WATSAN sector, refer to Winpenny (2011).

## 1.2 Background to the report

In many developing countries, a substantial segment of the population is served by small-scale WATSAN providers, which may include households themselves as well as small-scale private operators, NGOs or CBOs. These providers often face a number of difficulties to provide adequate services, including limited access to finance from either private or public sources.

Small-scale service providers often find themselves in a 'financing availability gap', for funding roughly below USD 100,000. Domestic entities which can, at least theoretically, provide financing to fill this gap include MFIs (for small funding amounts, typically of a few hundred Euros) or local commercial banks (for what is commonly referred to as 'mesofinance' as opposed to microfinance). These two forms of finance are referred to as SSF in this report.

At present, however, local commercial banks and MFIs rarely provide this finance as they are unfamiliar with the WATSAN sector and perceive it to be high risk. Thus there is inadequate financing to households and small-scale service providers for WATSAN investments. Consequently, an opportunity to improve service coverage for the poor is lost, when the demand and the needs are substantial. This can be referred to as a 'market failure'.

Public funding, either from domestic governments or international donors, could potentially be used to correct this market failure and leverage additional financing for small-scale WATSAN providers. International donors can rarely support these providers, however, as there are very few channels to transfer donor financing to small-scale providers. Many ESAs (bilateral or multilateral) tend to finance WATSAN via central governments or utilities operating at the national level. More rarely, some donors also support sub-sovereign entities (such as utilities or local governments), either through grants or loans (generally with a national government guarantee, but also without in some cases) or in the context of support provided to national programmes.

Overall, ESAs lack guidance as to how they can channel financing to small-scale WATSAN providers and leverage additional financing (from private sources) in the process. The objective of this report is, therefore, to help fill that gap.

## 1.3 Methodology

This study is based on three streams, as described below.

**Literature review and methodological development.** The study started with a review of existing literature on the role of donors for leveraging small-scale financing at the local level, for SMEs, in general, and for a range of infrastructure sectors (including WATSAN, but also renewable energy). This review examined what a range of donors are currently doing in this area (i.e. going beyond EU donors). Information came mostly from web-based searches and interviews with key informants. The findings informed the development of all subsequent study streams.

**Survey of EU donors' policies and practices.** A survey of EU donors was undertaken to find out what they are doing in terms of leveraging local small-scale financing for providers of WATSAN to the poor. The survey identified the specific support provided by EU donors which could inform the study. The survey also solicited the views of donors on the role that they can play to support SSF to the sector and on potential initiatives that could be undertaken to develop a coordinated approach to these issues.

**Survey of local domestic finance providers and their interest in funding the WATSAN sector in Kenya.** MicroSave, a Kenya-based consultancy specialising in microfinance and promoting financial inclusion for the poor, conducted a survey of local financial institutions in Kenya (including commercial banks and MFIs). The purpose of the survey was to identify which institutions are currently providing financing to small-scale operators of WATSAN in Kenya and the types of services that they are providing. The survey explored the constraints faced by these financial institutions in reaching

this target group and asked them how they thought donor financing could be used to alleviate such constraints. Similar surveys were conducted in Tanzania and India which focused exclusively on microfinance for sanitation.

**In addition, a seminar on 'SSF for WATSAN' was held at the World Water Week, in Stockholm in August 2011.** The seminar was co-chaired by the EUWI-FWG and SHARE research programme. Preliminary findings of the work were presented at this seminar and discussed by an eminent panel of experts, including Meera Mehta (CEPT University, India), April Rinne (Water.org), Monica Scatasta (European Investment Bank) and Vijay Athreye (FINISH programme). The comments and insights of all participants at the seminar contributed to the outcomes of the study. The strength of the debate showed that the issue of SSF for WATSAN is generating increasing interest.

## 1.4 Report structure

The remainder of the report is structured as follows:

- **Section 2** examines the types of financing needs faced by small-scale providers of WATSAN;
- **Section 3** looks into the types of repayable financing to which SSF recipients can potentially have access;
- **Section 4** evaluates whether this is an area where donor financing can be used to help expand the market, how this can be done and what EU donors are doing in this area;
- **Section 5** examines in more detail the type of financial instruments that donors can use to support small-scale WATSAN providers;
- **Section 6** evaluates alternative options for channelling large funding packages to SSF recipients.

In addition:

- **Annex A** contains summary findings from the field work conducted in Kenya;
- **Annex B** consists of a glossary of key terms relevant to SSF;
- **Annex C** includes a list of useful websites and references.

The full results of the survey of EU donors and of the India, Tanzania and Kenya field work are available as separate documents on the following websites, [www.euwi.net](http://www.euwi.net), [www.gwp.org](http://www.gwp.org), [www.sharereseach.org](http://www.sharereseach.org) and [www.watercredit.org](http://www.watercredit.org).

## 2. Understanding the market

This section sets out a typology of small-scale WATSAN providers operating in the sector and outlines their financing needs. It then examines the type of financing they can typically access to meet those needs and the common challenges and constraints they face in doing so.

### 2.1 Who are the small-scale service providers in the WATSAN sector?

Small-scale providers of WATSAN are extremely diverse, ranging from households to SSIPs (such as water carriers or people who manually empty latrines), SMEs, equipment providers, CBOs, NGOs, user committees and local governments. Households are considered to be 'service providers' when they either 'self-provide' the service (e.g., by building and operating a pit latrine or digging a well) or provide services to others (e.g., when households who have a tap connection sell water to their neighbours).

Small-scale WATSAN providers serve a substantial portion of the market, particularly for the poor. In many developing countries where coverage by 'formal' services is low, households can be the primary investors in WATSAN infrastructure, particularly in on-site sanitation solutions or domestic water resources. This finding was underlined by the Africa Infrastructure Country Diagnostic report, prepared under the leadership of the World Bank. This report found that households in sub-Saharan Africa contributed to almost half the total capital investments in the WATSAN sector, mostly through their investments in on-site sanitation facilities. Small-scale independent providers (SSIPs), which include informal water vendors or people who empty pit latrines, often serve a high percentage of the population – up to 90% in some cases according to World Bank estimates.

With respect to sanitation, which is one of the most 'lagging' MDGs, governments often expect households to finance the majority of the necessary investments in the next decade. This is particularly the case in countries that have stopped providing hardware subsidies for on-site sanitation and focus on financing behaviour change campaigns, such as in Ghana and Tanzania. In Ghana, for example, the Country Status Overview led by the Water and Sanitation Programme (WSP) estimated that the total capital expenditure requirements to meet the MDG target stand at USD 402 million per year. With the adoption of community-led total sanitation (CLTS) as the government's main policy direction with respect to sanitation, households are expected to meet the full costs of sanitation hardware.

Small-scale WATSAN providers face a number of constraints for providing services, in addition to limited access to finance. A major hurdle is that they usually lack legal recognition, as these providers tend to operate in the informal sector and do not have formal land ownership titles (which may be an issue

when they build and manage networks). They often have insufficient institutional capacity and limited business skills and have received little training. They have limited access to cash and often do not have the required collateral in order to take out a loan.

## 2.2 What are their financing needs?

Even though they often operate informally, the types of costs that small-scale WATSAN service providers need to cover are similar to those of other types of service providers operating at a larger scale. They need to invest in hardware and associated equipment (investment costs), operate and maintain the facilities (operation and maintenance [O&M] costs, such as salaries, fuel, electricity, chemicals and spare parts) and set aside funding for large maintenance expenses, such as renewing major pieces of equipment (capital maintenance costs)<sup>2</sup>. If they have borrowed capital to make investments, associated financial costs would also need to be covered. Even though the unit investment costs may be substantially lower than for large utilities, they nevertheless represent a significant financial burden when compared to the levels of disposable income for households or small-scale providers.

Estimating which costs need to be covered and how much financing is required to cover them are critical steps towards mobilising adequate financing. To cover their costs, small-scale service providers can draw from a mix of financing sources, commonly referred to as 'the 3Ts' – tariffs, taxes and transfers (Figure 1). Reducing costs through efficiency gains can also be an important means of freeing up financial resources.

These three sources represent the 'bedrock' for financing WATSAN and form the basis for 'sustainable cost recovery' (SCR). SCR entails securing future cash flows from a

<sup>2</sup> See [www.washcost.info](http://www.washcost.info) for more information on available methods for estimating life-cycle costs faced by small-scale service providers, particularly in rural areas.

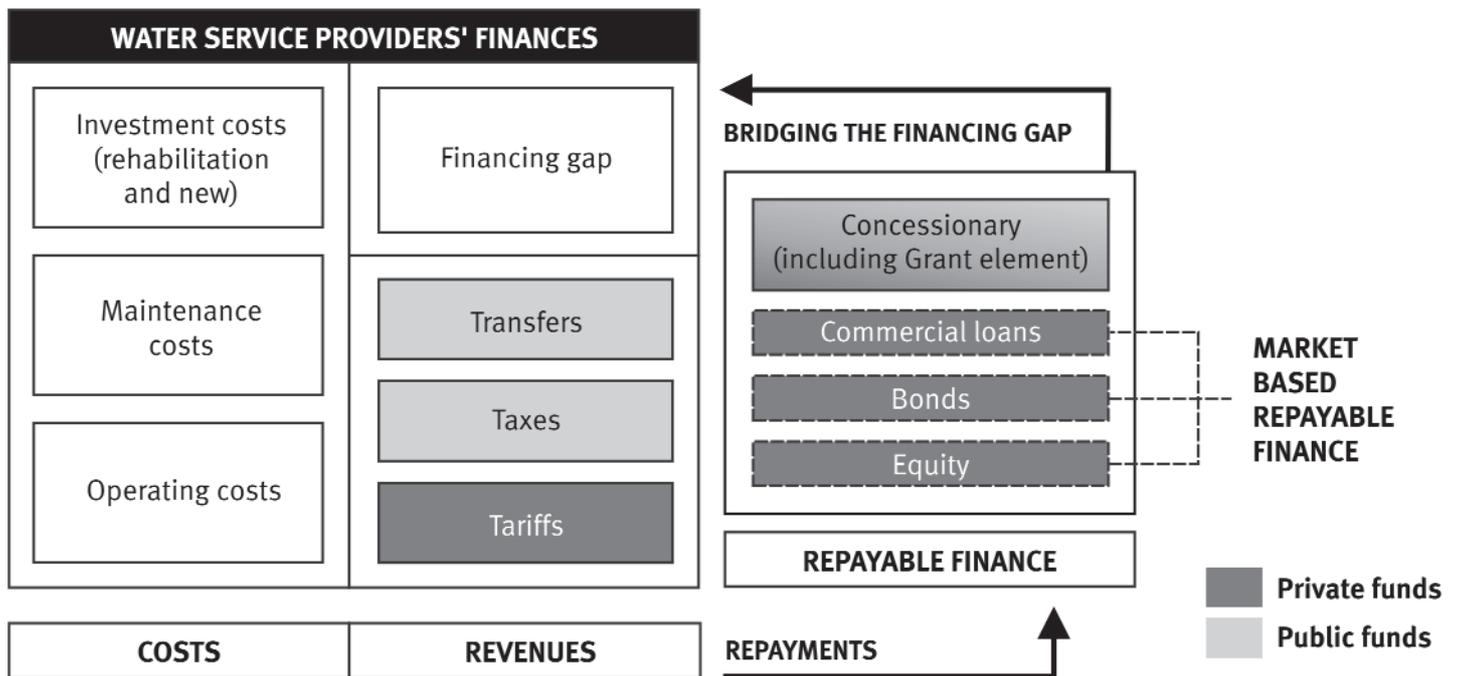


Figure 1. The overall 'financing equation' for WATSAN providers

Source: Adapted from OECD (2010)

combination of the 3Ts, and using this revenue stream as the basis for attracting repayable sources of finance, such as equity, commercial loans and bonds (depending on the size of the service provider and on the local situation). While investment costs may be partly covered through grants (taxes and transfers), the operating costs, at least, should be covered through tariffs. As WATSAN investments are typically substantial and lumpy, mobilising repayable finance is often needed to bridge a temporary financing gap and help smooth the burden of these investments over a longer period.

Although the same financing equation applies to small-scale providers as it does to large-scale providers, their ability to draw on different sources of revenues is much more limited. Small-scale WATSAN providers need to invest in a range of areas, as shown on Table 1. To meet these investment needs, they can mobilise funds from a range of sources. Small-scale WATSAN providers rarely receive subsidies from the

government (what the 3Ts refer to as 'taxes') or from international donors (referred to as 'transfers'). In order to mobilise sufficient cash for up-front investments, they tend to draw from friends and family or resort to money-lenders. In some cases, still rare in the WATSAN sector, they can also access microfinance or mesofinance from DFIs, such as MFIs or commercial banks (see Section 3 for more information). Service providers can then refund this initial investment through tariffs charged to their customers.

Table 1 shows that small-scale WATSAN providers need financing for different types of investments depending on the nature of the investment. To cover the financing needs that they cannot address from their own revenues or savings, they can, in theory, access financing from a variety of sources as shown in the right-hand column. Whether or not such financing is readily provided by domestic financial markets will depend on national circumstances.

Table 1. Types of small-scale WATSAN providers and their financing needs

Type of small-scale WATSAN providers	Type of infrastructure for which they need finance		Potential financing instruments
	WATER	SANITATION	
<b>Households</b>			
	Household connections or water tanks	On-site sanitation facilities	Microfinance mechanisms such as: <ul style="list-style-type: none"> <li>■ Micro loans</li> <li>■ Savings and loans combined</li> <li>■ Group lending and solidarity mechanisms</li> </ul>
<b>Community based organisations</b>			
CBOs, user committees, cooperatives, neighbourhood organisations and self-help groups	Upgrading, rehabilitation and extension of small piped networks/ point source operators	Management of of community and public toilets e.g. latrine cleaners and O&M	Micro and mesofinance: <ul style="list-style-type: none"> <li>■ Medium-term loans (for the community contribution to the investment and O&amp;M)</li> <li>■ Savings accounts, current accounts, short-term loans for repair</li> </ul>
<b>Private enterprise</b>			
<i>Small-scale providers</i> <ul style="list-style-type: none"> <li>■ Water kiosk operators and carters</li> <li>■ People who empty latrines</li> <li>■ Masons, small construction companies</li> </ul> <i>SME private operators</i> <ul style="list-style-type: none"> <li>■ Equipment suppliers</li> <li>■ Small water network operators (e.g. Aguateros)</li> <li>■ Small sewerage network operators</li> <li>■ Private land and housing developers</li> </ul>	<ul style="list-style-type: none"> <li>■ Small-scale equipment e.g. gloves, carts, protective clothing</li> <li>■ Building materials</li> </ul> <ul style="list-style-type: none"> <li>■ Water tankers</li> <li>■ Vacuum tankers</li> </ul> <ul style="list-style-type: none"> <li>■ Larger scale investments for equipment (as above)</li> <li>■ Distribution networks e.g. building small bore sewer network</li> </ul>		Micro and mesofinance: <ul style="list-style-type: none"> <li>■ Short-term loans (working capital)</li> <li>■ Capital investment loans</li> <li>■ Leasing of expensive assets</li> <li>■ Savings instruments</li> <li>■ Current accounts</li> <li>■ Overdraft facilities</li> </ul>

Source: Authors' compilation

### 3. What type of repayable financing is available to SSF recipients?

Small-scale WATSAN providers currently have access to a limited range of repayable financing to cover the up-front financing needs that they cannot cover themselves. In this section, we identify what types of repayable financing SSF

recipients have access to, distinguishing between microfinance for households and mesofinance for WATSAN providers, including SSIPs, CBOs and SMEs.

These SSF recipients all face substantial constraints in accessing financing, as shown in Figure 2. As a result, their financing needs are seldom covered and their ability to expand their coverage is low. Public sector intervention may be required in order to trigger a market response and increase the supply of financing accessible by them (see Section 4).

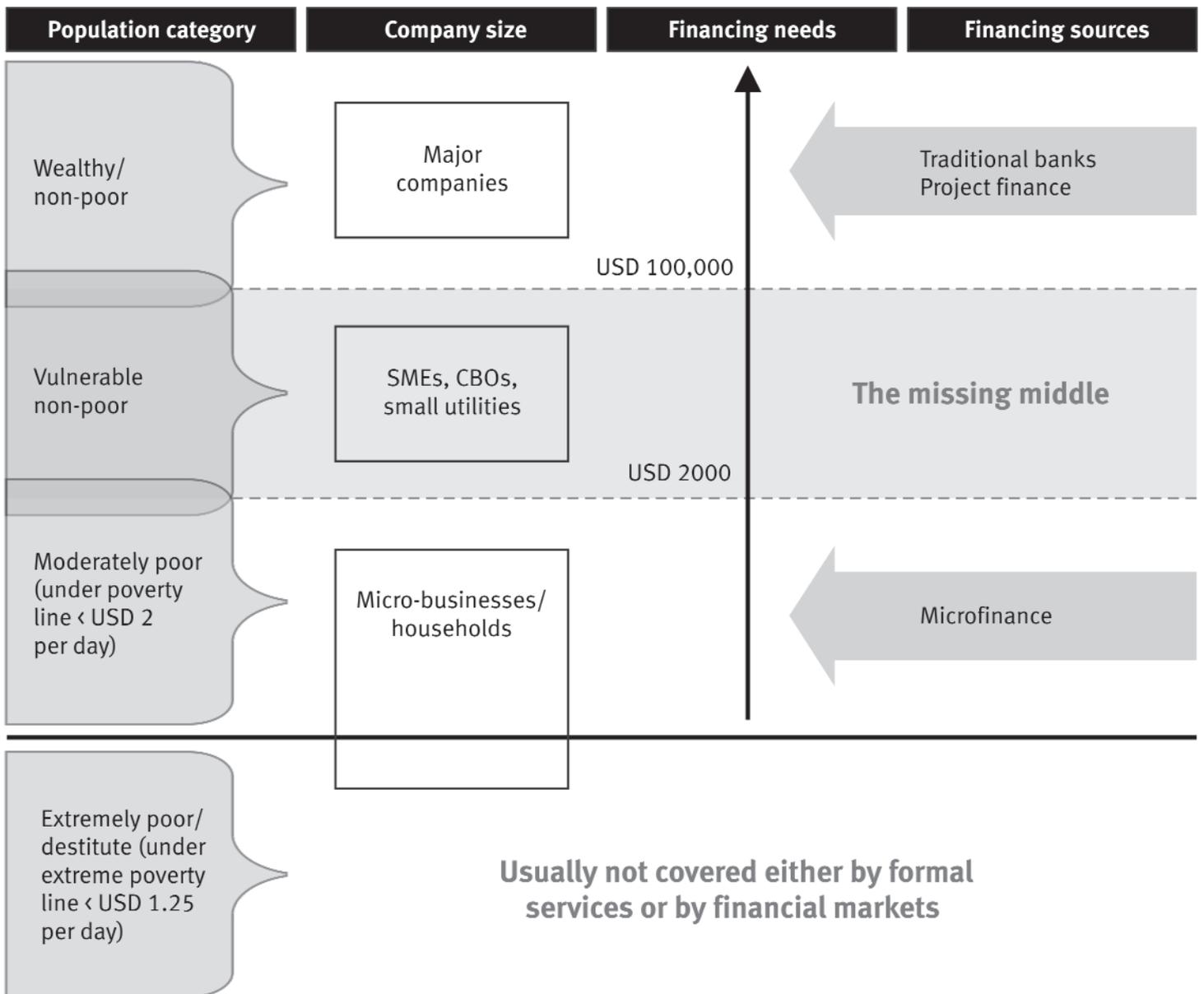


Figure 2. Access to finance: the uncovered segments

### 3.1 Microfinance for households

This section focuses on the microfinance provided to households for investing in their own WATSAN facilities (what can be qualified as 'home improvement' investments).

#### What is microfinance?

Microfinance has been practiced for many years in different forms. It first became prominent in development circles in the 1970s in Bangladesh, with the provision of small loans for income-generating activities with only minimal collateral requirements. The most well-known microfinance model that originated at the time was that of the Grameen Bank.

The microfinance sector has grown considerably in the last 20 years and now encompasses a whole range of financial services that are provided to low-income clients who traditionally lack access to banking and related services. These financial services may include credit products as well as savings, insurance, fund transfers (for remittances) or a combination of these. In the case of credit, the loan size varies considerably from very small loans for household investments (in the range of a few hundred USD) to larger loans for micro-business development (several thousand USD). The funding of small projects with loan sizes that are above microfinance levels, but are less than USD 100,000, would usually be classified as 'mesofinance', discussed in the next sub-section.

The entities providing such services can include MFIs, commercial banks, non-banking financial institutions, NGOs, credit cooperatives or solidarity lending groups. Typically, an MFI would be well established in the community, which gives it an edge in terms of assessing a borrower's ability to repay and enables the MFI to rely on peer pressure and community cohesion to obtain repayment. In addition, NGOs and microfinance specialists can provide support services to

incorporate microfinance products into the design of broader development interventions, which may include the development of tailored financial products and/or brokering with financial institutions as well as training.

A popular form of micro-lending, referred to as 'group lending', consists of requiring borrowers to form a small group and to guarantee each other's borrowing. In some countries (such as India), these groups are made up of women who share strong community ties. In this case, peer pressure replaces the need for collateral, which is often lacking for WATSAN investments as they are not 'moveable'. Group lending can either work as a revolving fund (whereby each group member has the ability to borrow in turn, provided the others have repaid) or as a mutual guarantee, to minimise the risk of non-payment. From a lender's point of view, extending a loan to a group of borrowers provides a higher guarantee of being reimbursed than if it had lent to an individual.

#### How is microfinance used in WATSAN?

In the WATSAN sector, microfinance can be used to provide access to finance to those who would otherwise be excluded, such as households, SSIPs, CBOs and NGOs. Even though microfinance as a financing model is now well established with a solid track record, its application to the financing of WATSAN has remained somewhat limited and MFIs rarely offer tailored products for WATSAN.

According to a study conducted by Mehta (2008) for the Gates Foundation, only a few large MFIs in Asia had achieved significant scale in these areas. These MFIs include BRAC, Grameen Bank and ASA in Bangladesh,<sup>3</sup> Self Employed Women's Association in India and the Vietnam Bank for Social Policy in Vietnam (VBSP) (see Box 2). As Mehta indicated at the time, "Experiences so far suggest that although several pilots are available to study, the sustainability and scalability of the market is still unknown."

<sup>3</sup> Since then, for example, Grameen has stopped offering specific water and sanitation loans and merged these with housing loans.

## Box 2. The Sanitation Revolving Fund (SRF) in Vietnam: a successful pilot and scaling up

In 2001, a SRF component was incorporated in the World Bank-financed, Three Cities Sanitation Project in Vietnam to provide loans to low-income households to build on-site sanitation facilities. The SRF provided small loans (USD 145) at partially subsidised rates to low-income and poor households to build a septic tank, a urine diverting/composting latrine or a sewer connection. To access the loans, households needed to join a Savings and Credit group, which brought together from 12 to 20 people who must live close to each other to ensure community control. The loans covered approximately 65% of the cost and enabled the household to spread the costs over two years. The loans acted as a catalyst for household investment although households needed to find other sources of finance to cover total investment costs, such as borrowing from friends and family.

The initial working capital for the revolving funds (USD 3 million) was provided as a grant by the World Bank, Denmark and Finland. The SRF was managed by the Women's Union, a countrywide organisation representing the rights and interests of women, which has a long experience in running microfinance schemes. The initial working capital was turned over more than twice during the first phase of the project (2001 to 2004) and was then transferred to subsequent phases to be revolved further. Combined with demand generation and hygiene promotion activities, the SRF helped around 200,000 households build sanitation facilities over the course of seven years. The revolving fund mechanism allowed leveraging household investment by a factor of up to 25 times the amount of public funds spent. Repayment rates have been extremely high (almost 100%). This revolving fund programme in Vietnam compared very favourably with other forms of public support for sanitation, including indicators such as leveraging and effectiveness (Trémolet et al., 2010).

Since 2004 this pilot approach has since been scaled up via other World Bank-funded projects and through the Vietnam Bank for Social Policies (VBSP). As of the end of 2011, VBSP had extended 3.5 million loans for water supply and sanitation and 3.1 million facilities had been built. The share of WATSAN loans as a percentage of the overall portfolio has been steadily growing year on year, from 0.86% in 2004 to 7.56% in 2009. Growth in WATSAN loan products is now a key driver of overall portfolio growth – 16% growth in 2011.

Source: OECD (2010) and VBSP's annual reports.

In the last five to ten years, the market for WATSAN microfinance products has started to take off in some countries, but has remained modest overall. The boxes below refer to examples in India and Kenya where microfinance for WATSAN has been scaled up beyond single pilot projects. Much remains to be done to take these examples fully to scale.

It is impossible to track with precision the growth of this market, however, as the majority of microfinance service providers does not track WATSAN financial products separately from other products e.g., purchasing a solar panel). General purpose loans may be used for WATSAN investments without this being recorded as such.

### Box 3. Growth of the 'toilet loan' market in India

Historically sanitation activities in India have been carried out using a grant-based model either by the government (e.g. the Total Sanitation Campaign) or NGOs (e.g. Gram Vikas).

The development of the microfinance model, which offers sustainable financial services on a large scale, has led a number of organisations to support local MFIs, such as BASIX, to offer loans for building toilets and getting water connections. This endeavour has been supported by both an initial strong demand for 'toilet loans' among the population itself and an awareness of microfinance as a potential support to public services activities. Even though these micro loans are not income generating as traditionally required by a MFI, they are income enhancing and can be provided to households based on evidence of their revenues and their abilities to repay the loans. The market for 'toilet loans' is growing in India, particularly in rural areas, triggered by these different factors.

Many different financial institutions have expanded their scope to get involved in the 'toilet loan' market. Some NGOs with WATSAN experience have developed their microfinance activities. This has, in some cases, resulted in a split between the NGO and a dedicated microfinance institution, as was the case for GUARDIAN (see Box 16). In other cases, well-established MFIs have developed their WATSAN financing activities. Some of the MFIs providing loans for sanitation are also looking into acquiring Non-banking Financial Corporation status, which would give them the possibility to take deposits.

As of late 2011, there had been an estimated 150,000 toilet loans covering the sanitation needs of more than 750,000 people in India, from institutions such as the Bharat Integrated Social Welfare Agency (BISWA), GUARDIAN, Bihar Women Development Corporation (BWDC), Evangelical Social Action Forum, and Grameen Koota. This is just a sample based on the information available; there may be many others. Many have received support from Water.org (see Box 20) or the FINISH programme (see Box 19).

Microfinance is not the only solution for financing access to sanitation. For example, the MFI GUARDIAN believes that it would be able to reach between 30 and 40% of the population in a given village. This offers good prospects for improving the quality of life of a substantial group of the population in India.

Source: Trémolet and Kumar (2012).

From these examples, it appears that microfinance can help households make WATSAN investments, such as obtaining a connection to the water or the sewerage network, purchasing a water tank or building an on-site sanitation facility.

Obtaining a small loan can help households overcome affordability constraints, as it enables them to spread the cost of the investment over a longer period of time, which reduces the burden of the initial cash outlay. Households can

#### Box 4. Growth of the 'water tank loan' market in Kenya

In Kenya, 43% of the population still do not have access to safe drinking water. Women have to travel long distances in search of water at the expense of any income-generating activity. In areas with heavy rainfall, water tanks are an opportunity to harvest or store rainwater and use it during dry spells. Water tanks can also be a solution in urban areas as an alternative to piped water or water from tankers (which is usually expensive).

Water tank loans have become one of the most popular products offered by banks (such as K-Rep Bank Ltd. or Equity Bank Ltd.) and MFIs (such as the Small and Micro Enterprise Programme (SMEP) and Kenya Women Finance Trust (KWFT) Ltd.) in Kenya. Financial institutions have entered into partnership agreements with water tank suppliers in order to facilitate access to the tanks and reduce the purchase costs. For example, KWFT (the oldest affiliate of Women's World Banking, which caters for the financial needs of women-headed households) has entered into agreements with three water tank manufacturers and obtained a 50% reduction in cost as well as free delivery to rural households.

Banks and MFIs promote and market water tank loans to their clients. If the latter cannot purchase the tanks from their savings, the MFI pays for it up front on presentation of a pro forma invoice. Water tank manufacturers deliver the tank (sometimes to the bank branch) and the customer makes a regular payment to the financial institution spread over a period of from 3 to 12 months, depending on the MFI. Delivery of the tank is turned into a public event with various stakeholders invited.

Water tank loans are usually small loans in the range of KES 5000 to KES 100,000 (between USD 60 and USD 1200). They are offered at an interest rate of around 20% with an application and insurance fee of 1.5% on average. Typically, the loan duration is for about one year. For some MFIs, the customer is required to contribute a margin of from 10 to 15% of the loan or the value of the tank to qualify for a loan. In case of default, the water tank serves as collateral. So far, the repayment rate has been close to 100%. The demand for this specific product keeps increasing given such factors as water scarcity and the high cost of purchasing water either from a network or from tankers.

Source: EUWI-FWG report, Muruka and Mugweru (2012) - see a summary in Annex A.

either borrow on an individual basis (which is relatively rare) or through a group. Loans are usually provided for less than three years (with 12 months being a commonly encountered tenor for MFIs, although longer-term loans are provided as well). The loan amount ranges from approximately USD 30 to USD 250 (sanitation loans tend to be smaller), at interest rates in the range of 20 to 25% (or at standard local market rates).

As microfinance borrowing rates can prove to be high for some households, microfinance schemes that combine saving schemes with group lending can help overcome affordability constraints where MFIs are allowed to take deposits. A number of savings and loan group schemes can be put in place to allow combining micro savings with micro-lending. There is a whole range of group savings and loan

## Box 5. Community based initiatives in Tanzania

SDI is a network of CBOs of the urban poor in 33 countries in Africa, Asia and Latin America. SDI's mission is to link urban poor communities from cities across the South to share problem solving strategies. The organisation's focus is slum dwellers' needs and, particularly, their right to access basic services such as water.

SDI groups use grassroots savings and credit schemes as ways of mobilising urban poor communities as agents of their own development. The process starts by establishing a crisis credit fund from the small change available in most households. Women in charge of treasury management of the fund collect these small amounts of money during daily visits. This in turn creates the opportunities to access grants and loans at favourable interest rates from a wide range of agencies (local authorities, national government, bilateral development agencies, etc). Some of these resources are channelled through revolving funds; the initial supply of lending capital comes from donors and only repayments of early loans are used to finance later loans.

SDI provides sanitation under the umbrella of housing upgrading. Participants are first encouraged to form credit schemes and apply collectively for loans rather than construct a sanitation block individually. By using a revolving fund, they benefit from cheaper labour, better materials and more organised construction. The fund encourages donations from donors and governments to be placed beyond their immediate control with the explicit responsibility for decision making being in the hands of the communities. SDI tackles mobilisation and sustainability issues by establishing communities as project drivers. Thus most of the SDI groups work closely with an NGO that provides technical support and ensures that lenders follow community priorities rather than dictating them. In other words, SDI federations collectivise and scale up the financial and social resources of poor households, making it possible for a collective organisation to achieve what individual households could not.

An example of this approach can be found as applied by the Centre for Community Initiatives (CCI), an NGO working in Tanzania on improving the quality of lives of informal settlements. CCI encourages slum dwellers to form groups (between 20 to 100 members) and start saving schemes.

To date, CCI has supported the establishment of 52 saving schemes in most of the main Tanzanian cities. Members contribute anything they can spare to these local saving schemes and, after 2 to 3 months, they are able to access a small loan for their own housing and sanitation needs.

Each local saving scheme was then encouraged to join together to form a federation at the city level. By grouping these city level federations, CCI formed the Tanzania 'Jenga fund'. This fund mobilises savings from the federations, combines them with other sources of funding (NGOs/donors) and gives loans to a variety of large-scale projects, such as water connections for a whole community.

### **Box 5. Community based initiatives in Tanzania *Continued...***

According to CCI, the potential of these savings schemes for WATSAN projects is huge. Firstly, they are offering more competitive interest rates compared to other MFI institutions. They are suited to sanitation projects, given that triggering sanitation investment requires a 'social process' in which a development minded organisation, such as CCI, needs to be involved. Without this involvement, mainstream financial institutions or even MFIs could potentially fail. Hence these saving schemes offer huge potential for water and, most of all, sanitation where the needs are urgent and remain largely under-funded.

Source: Trémolet and Muruka (2012).

schemes, starting with the village banking model that relies on cooperatives and associations. In village banking both share capital and savings deposits are mobilised from members (sometimes with a match from ESAs). Loans are made to groups of ten members, benefiting only half of them at a time and reaching the second half only after repayment of the initial loans.

There are only a few examples where such schemes have been used to finance WATSAN investments. One example where this is currently being attempted is the Jenga Fund, developed by the Centre for Community Initiatives (CCI) in Tanzania, which pools savings from its members to finance housing as well as WATSAN investments.

### **What constraints limit the use of microfinance for WATSAN?**

There are numerous potential advantages to using microfinance to support development, as highlighted in Table 2 below. A number of constraints make it difficult for WATSAN microfinance to really scale up, although many of these constraints can be addressed through an adequate design of the micro-credit scheme and improved communication.

Accessing a loan for a WATSAN investment can be difficult for poor households given that such loans would not be considered as income generating. Microfinance providers are seldom familiar with the WATSAN sectors and they would usually prefer lending for productive activities. This may reflect simply a lack of familiarity with the sector rather than a deliberate policy of not lending to the sector. For example, in Tanzania, a survey of microfinance institutions (including MFIs and commercial banks) conducted for the SHARE research consortium showed that few financial institutions had considered lending for WATSAN investments and that even fewer were aware of the magnitude of the investment needs at the household level and of the potential benefits from such investment.

In fact, experience indicates that helping households invest in WATSAN facilities can generate a stream of benefits for those households and can be significantly 'income enhancing'. Income can be achieved through a reduction in the number of days lost to illness, in lower medical expenses and an increase in productivity. This in turn boosts revenues and enables loan repayment (in the case of microcredit). Such ability to repay was confirmed in the Vietnam and Indian cases, where a growing number of women are willingly taking on loans to build toilets and repayment rates are high.

Table 2. Microcredit for WATSAN: the case for and against

Potential advantages	Potential constraints
<b>For households (HH)</b>	
<ul style="list-style-type: none"> <li>■ Enables HH to spread the cost of their investment, thereby alleviating capacity-to-pay constraints</li> <li>■ Income enhancing: generates benefits for HH from accessing WATSAN, some of which can be monetised, including:               <ul style="list-style-type: none"> <li>■ Time savings</li> <li>■ Reduction in waterborne diseases</li> <li>■ Increased labour productivity</li> <li>■ Increased school enrolment</li> <li>■ Increase in housing value</li> </ul> </li> </ul>	<ul style="list-style-type: none"> <li>■ WATSAN investments do not directly generate income that can be monetised: HH may not be willing to borrow</li> </ul>
<b>For microfinance providers</b>	
<ul style="list-style-type: none"> <li>■ Could prove a substantial market, given the high needs and donors' support, which could then help them reach additional clients</li> <li>■ Aligns well with the social mission of microfinance</li> </ul>	<ul style="list-style-type: none"> <li>■ There is not necessarily a direct revenue stream to guarantee repayment: higher risk for microfinance providers</li> <li>■ Microfinance providers may not be aware of the needs of the WATSAN market and be unwilling to lend as they perceive it to be too risky</li> </ul>
<b>For governments and external support agencies</b>	
<ul style="list-style-type: none"> <li>■ Efficient use of funds and high leverage ratios (i.e. the amount of private funding leveraged for each USD of public funding provided): this may, therefore, help free up scarce public resources to target the poorest</li> </ul>	<ul style="list-style-type: none"> <li>■ Pro-poor targeting: microfinance (microcredit) may not lift affordability constraints for the poorest: it may only be applicable to a segment of the population (which would vary in size depending on the country) and is not the only means of increasing access</li> </ul>

Source: Adapted from Trémolet (2011).

Households taking on a water or sanitation loan need to demonstrate their ability to repay the loan from existing sources of income. As a result, a water or sanitation loan would typically not be the first loan that a household would subscribe to, but the second or third loan. From the point of view of a microfinance institution, this might be a good way to remain 'engaged' with their customer base and to provide a mix of financial services on an ongoing basis.

To limit lending risks, many MFIs require customers to have repaid an initial loan before offering a new one, in order to ensure that borrowers are not over-indebted and can maintain their ability to repay. The risk would increase when

customers take on several loans simultaneously from several MFIs. There are several ways of mitigating such a risk, for example through group lending providing a guarantee. In urban and peri-urban environments where community links may be weaker, this type of guarantee might not be sufficient. To overcome this problem, some countries, such as Kenya, have established credit bureaus which are able to provide a centralised system for checking a borrower's credit history.

Broader constraints may be more difficult to address through actions in the WATSAN sector. For example, many households may not have access to any financial services, let alone finance water or sanitation investments. Households that are

extremely poor or destitute (i.e. with a daily income below USD 1 a day) seldom have access to microfinance services as shown on Figure 2 above. People may also be deprived of financial services because they live in remote areas.

The expansion of mobile phone technology applied to mobile banking has the potential to change this in some countries. As the costs of mobile phone technology have fallen and the mobile technology has been adapted to support financial services, mobile banking innovation has begun to spread across and within poor countries. In Kenya, the leading cell phone company, Safaricom, has realised this potential by launching M-PESA, an SMS based money transfer system that allows individuals to deposit, send and withdraw funds using their cell phone. The system is low cost and does not require any other registration requirements than a Kenyan passport. Hence with no limited amount for deposits and no obligations to have already been through a previous lending scheme, this mobile phone banking system is able to reach poorer communities. By January 2010, after a little more than two years of operation, M-PESA had 9 million customers, accounting for approximately 40% of Kenya's adult population. Thus a money-banking system, such as the example of M-PESA, holds great transformative potential and might represent a real driver to overcome the barriers to the expansion of microfinance services. Kenya is the country where mobile banking is most developed, but such services are also developing fast in Uganda, Tanzania and Pakistan.

ESAs, therefore, have a role to play in raising awareness and making the sector more attractive, so as to increase SSF for WATSAN.

### 3.2 Mesofinance for WATSAN service providers

In this section, we examine the provision of mesofinance services to WATSAN providers, such as SSIPs, CBOs and SMEs.

### What is mesofinance?

The term 'mesofinance' refers to the financing requirements of small businesses that are not typically covered by the banking system. This is a segment of corporate financing that is generally not very developed or covered either by MFIs or banks. The segment can be defined as being situated between the upper credit limit for microfinance loans and the minimum amount required for traditional bank financing; we have placed these roughly at USD 2000 and USD 100,000. There is a missing link between these two limits that means SMEs lack access to financing and, consequently, cannot develop.

SMEs are one of the main drivers of economic growth in developing countries. They often account for the major part of these economies and play a key role in job creation, investments and innovation. Moreover, their light structure and flexibility also means that they can make economies more resilient to crisis. Few of the financial needs of these small businesses are adequately covered, however.

The mesofinance sector is still underdeveloped and SMEs remain on the edge of traditional financial circuits. If the need to develop this market is high, it might offer a window of opportunity for banks and other financial institutions seeking to diversify their offerings. For financial institutions, the business model is substantially different from microfinance. Compared to the relatively fast and standardised operations for microfinance, SME financing requires due diligence of the business proposal and higher transaction costs per client.

### How is mesofinance used for WATSAN?

The use of mesofinance for WATSAN, although no less important than that of microfinance, is much less documented. It is also very difficult to track because mesofinance providers usually consider this type of financing

as standard 'SME loans', without recording the nature of the business. The size of the loan would depend on the size of the business itself (for very small businesses, such as the manual emptying of pit latrine, loan sizes may be closer to microfinance than to mesofinance).

There are a few examples where mesofinance has been used for WATSAN. The example of the Kenya Microfinance for Water Projects Activity, developed by the WSP, GPOBA (Global Partnership on Output-based Aid) and K-Rep, is one that is frequently put forward as an example of how mesofinance can be leveraged through the targeted use of donor funds (see Box 9 for more details). In that case, the maximum loan amount was just over USD 100,000 although the average loan size was about USD 50,000.

Other examples can be found in the literature. For example, in Kampala, Uganda's capital, the local authorities tried to

improve the sanitation situation in the slums by constructing highly subsidised public toilets. Most of these have been closed down because of the lack of ownership and collective responsibility. Therefore, many people were still practicing open defecation, worsening cholera and diarrhoea outbreaks. To overcome this, a public-private partnership was established as described in Box 6 below.

In Tanzania, WaterAid has been working for some years now to support the adoption of a 'gulper technology' for emptying latrines in Dar es Salaam. Most recently, they have assisted small entrepreneurs and CBOs to access mesofinance. This has been difficult (as detailed in Box 7 below) and has not achieved scale so far.

A specific type of financing that could smooth out the investment costs for the service providers is leasing, as described in Box 8 below. WATSAN providers are usually

### **Box 6. Public-private partnership (PPP) for sanitation in Kampala**

To improve sanitation in some of the most affected informal settlements in Kampala City, the City Council/Uganda Government, with support from German Technical Cooperation (GTZ now GIZ), established a PPP with two local private companies engaged in the production of modular plastic toilets (Crestanks and Polifibres). This partnership facilitated production and distribution of sanitation products that are designed especially for the urban poor population. At the community level, a two year pilot project took place based on a practical intervention which was designed to create a demand through smart sanitation marketing. The stakeholders, including beneficiaries, suppliers, the Kampala City Council, MFIs and local NGOs, were mobilised to work together during the sanitation marketing campaign. The people then had the opportunity to ask for a meso-credit to buy a pay and use toilet and become entrepreneurs. They made informed choices based on investments and O&M costs and their own ability to pay, without subsidies, the manufacturer's price, which is about 15% lower than the retail value. After two years, the project appears to have been a success; new local sanitation entrepreneurs have recovered their investments and continue to expand their business by adding showers and laundry services.

Source: Nuwagaba (2010).

### **Box 7. A revolving fund to enable CBOs to purchase gulper equipment in Tanzania**

In Dar es Salaam, Tanzania's biggest city, only 10% of the city is connected to the central sewage system. The pit latrines often over- flow and latrine emptying is infrequent, dangerous and unhygienic. To solve this problem, WaterAid Tanzania, an NGO, is pioneering a low cost pump attached to tricycles that empties up to six latrines a day in unplanned urban settlements. Once the latrine has been emptied using the 'gulper pump', a specially designed vehicle called a Piki-Piki is used to transport the waste to the city treatment plant for safe disposal. This equipment, tailored to the needs of poor communities in densely populated areas, is helping to reduce diseases such as cholera and typhoid.

In order to finance acquisition of the gulper pumps and tricycles, WaterAid Tanzania sought to link the CBOs they were working with to commercial banks and/or MFIs. This approach had only limited success. Most of the CBOs have not met the banks' requirements, in terms of presenting a viable business proposal and evidence of strong and stable management. These factors led to delays and prompted WaterAid Tanzania to develop an alternative funding approach to deploy the gulper pumps involving the setting up of a revolving fund.

WaterAid Tanzania could not directly fund the CBOs, but placed an initial supply of lending capital (TZS 10 million or USD 7407) with a local manufacturer in charge of developing the gulper pump and supplying the tricycle trucks. The CBO borrows 100% of the cost of the total equipment from the local manufacturer. As each set of equipment costs TZS 5 million, the initial amount allocated by WaterAid Tanzania enabled only two CBOs to access the funds to purchase gulper pumps. These two CBOs now provide sanitation services in Temeke district in Dar es Salaam. The repayment of the loans by the CBOs to the local manufacturer will be used to produce new gulper pumps and tricycle trucks for other CBOs, based on the concept of a revolving fund.

Source: Trémolet and Muruka (2012).

unlikely to access standard medium-term loans to finance expensive equipment. Usually, the upper credit limit amount of MFIs is too low while the formal bank requirements, especially collateral, are too stringent. In order to overcome this financial barrier, leasing might be expanded as an alternative instrument for solving the initial investment hurdle. Although leasing could help WATSAN entrepreneurs smooth out the cost of their investments and reduce the need for initial capital outlays, its use has remained very limited in the sector so far.

### **What constraints limit the use of mesofinance for WATSAN?**

WATSAN providers are looking for financing to help them run their services more efficiently and generate income. As a result, lending to this type of provider is comparable in nature to lending to other types of income-generating activities. Financial institutions, which are used to lending for income-generating activities, would, therefore, be more comfortable with this type of activity.

### **Box 8. Leasing, a solution to overcome the initial investment hurdle?**

Leasing is a contract which enables one party (the lessee) to have the right to use equipment by paying small instalments to the party that owns the equipment (the lessor). This type of contractual arrangement benefits both parties as the lessee generates cash flow from the use of the equipment whilst the lessor receives income from leasing the equipment without losing the right to own it. Leasing is also a form of financing which has no, or very few, collateral requirements (as the leased asset serves as collateral) and, therefore, can provide a launch pad for many potentially successful SMEs whose loan applications are often rejected because of a lack of collateral.

Leasing can take pressure off the SME's as the cash flow is spread evenly over the lease period, allowing the lessee to save cash. Leasing can provide a solution to the financing of machinery, land and equipment for SMEs, which can include water tankers or gulpers. The lessor (the public authority or the financial institutions) owns the water or sanitary equipment until it has been fully paid for by the instalments of the lessee (the WATSAN provider). The WATSAN provider generates cash flows from the use of the equipment. A part of its benefits is paid to the lessor through small instalments. Once the full cost of the equipment has been repaid, the WATSAN provider is the full owner.

Kenya has acquired experience with leasing water tankers to small entrepreneurs. In Nairobi, the water ministry is reviving eight water schemes to ease the pressure on water resources in the city, but many peripheral areas will remain underserved. In this context, the government is leasing water tankers to small-scale water providers in order to provide water services in remote areas. This arrangement is a win-win arrangement for both the public authorities and the WATSAN providers. The government ensures the provision of water in these remote areas and, by providing filling points, encourage water tankers to use only authorised water sources. It also provides the means for WATSAN providers to acquire tankers. They are then able to deliver water at a lower price. Hence leasing can be an attractive form of financing for WATSAN providers which warrants further expansion.

Source: Katongole (2007).

There is frequently a gap in domestic financial markets, however, which is referred to as 'the missing middle'. The small-scale WATSAN providers and SMEs looking to develop services would usually be unable to access domestic lending markets as their financing needs would typically fall into such a 'missing middle' category.

In addition, the small-scale WATSAN service providers are often operating in the informal sector and are small and

poorly run. Managers have not been trained in basic business practices and would be unaware of the basic requirements of financial institutions when they review a loan application and enter into an agreement. Financial institutions are usually unaware of the financing needs of the WATSAN entrepreneurs and are likely to perceive them as very risky. The lending terms that they offer may not be appropriate. Interest rates may be too high or maturities too short and not match the life of the WATSAN investments.

## 4. How can public funds be used to increase finance to SSF recipients?

As discussed above, domestic financial markets are often inadequate for covering the financing needs of SSF recipients in the WATSAN sector. Public funding is also limited, but it could be used more effectively to unlock SSF for WATSAN.

This section examines the rationale for using public funds to foster increased financing flows to SSF recipients and presents the experience of EU donors in this area. It is based on the results of a survey of EU donors conducted for the purpose of this study between April and June 2011. A full write-up of results from the survey is presented in a separate report. The objectives of the survey were to understand what EU donors are doing in the area of SSF, in general, and whether they are providing/supporting SSF for WATSAN, in particular. This survey was limited to donors originating from the EU – mostly bilateral donors – and the two European multilateral donors, the European Commission and the European Investment Bank (EIB).

### 4.1 Should public sector support be provided to leverage SSF?

There are a number of factors that justify the use of public funds to support the development of SSF for WATSAN. Overall, EU donors, who were consulted as part of the survey, agreed that SSF would help the poor, even though lack of finance is not necessarily the main obstacle (other factors, such as lack of formal business practices, can be a very significant barrier).

The main rationale for calling on public funds to support the expansion of financing to SSF recipients is that we are in the presence of a classic case of market failure. As set out in

Section 2.1, SSF recipients are serving a large part of the market, but their access to financing is very limited. Addressing these market failures may require initial public funding in order to 'kick-start' the development of financial markets that meet their needs.

Previous analysis has shown that supporting this type of intervention can be very cost-effective compared to subsidised approaches (Trémolet et al., 2010). Scarce public funds can be used to leverage commercial funding, resulting in high leverage ratios (defined as the amount of private funding leveraged from commercial sources through public funding). In initial phases, leverage ratios may remain modest, but can increase over time.

Microfinance may be particularly useful for sanitation, as most governments (and their development partners) have moved away from a policy of providing hardware subsidies (i.e. constructing latrines that end up never being used) to one of supporting behaviour change, demand creation and supply side responses (see Box 10 for more details). A number of governments (such as Ghana) are pinning their hopes on the use of microfinance to help households get access to the services (particularly for sanitation) as well as to help small-scale entrepreneurs develop their offerings. There are several models, each with their pros and cons, and no one-size-fits-all. More work is needed to develop those models that are found to suit local conditions so that they can be expanded.

Some opponents of using public funds to support small-scale providers argue that the latter are only a 'temporary solution' and that financing them would mean endorsing their informality. However, a 'temporary solution' and 'informality' may be what is needed initially, as they can evolve to more formal mechanisms over time. It can be argued that providing SSF recipients with adequate financing could, therefore, help them formalise their operations and reach more customers in a manner that only they can.

Another common argument against supporting micro and mesofinancing is that these initiatives may not be the appropriate instruments for reaching the extremely poor and destitute. However, SSF can make a substantial contribution for the poor and vulnerable non-poor, especially in rural and peri-urban areas that are not reached by utilities. As a result it can help free up resources for targeted interventions to reach the poorest and hardest to reach, such as through direct support, hardware subsidies (preferably *ex post*), conditional cash transfers, etc.

A limiting factor is that it is very difficult for European donors or even central government representatives to assess the risks associated with SSF recipients at a local level. This means that the monitoring and transaction costs for ESAs of funding such a multiplicity of actors is, potentially, very high.

#### 4.2 What experience do EU donors currently have in this area?

This section presents a summary of EU donor activities and experiences in channelling SSF to WATSAN. A more extensive presentation of findings has been prepared as a companion report.

According to the survey, EU donors have limited experience of either providing SSF directly to WATSAN providers or catalysing its provision by other financiers. Most EU donors are focused on lending at the national level to public actors (including ministries and public utilities) and more rarely deal with local governments. None of the donors consulted have financed SSF recipients directly, for obvious reasons. Indeed, it is almost impossible for an EU-based donor to finance a multiplicity of SSF recipients in developing countries and they would need to use a variety of financing channels in order to reach them (see Section 6).

Given the multiplicity of financial channels and the decentralised nature of many EU donor institutions,

information is difficult to track and no EU donor was able to provide aggregated data on how much of the financing they provide ends up going to WATSAN SSF recipients. Instead, they were able to provide examples of cases and activities that benefited those recipients.

Some EU donors have supported the establishment of specific programmes that channel funding to SSF recipients. For example, the Netherlands Directorate-General for International Cooperation (DGIS) is funding the FINISH programme in India. This is a multi-partner programme that finances and provides technical support to MFIs in Indian states to facilitate access to sanitation by one million people (see Box 18 for more details). DFID and the Swedish International Development Cooperation Agency (Sida) are the key funders of the Community-led Infrastructure Finance Facility (CLIFF). CLIFF acts as a funnel for channelling financing to small-scale slum upgrading projects, including affordable housing, WATSAN (see Box 11 for more details). They have recently extended the programme and roughly doubled their combined participation.

A number of EU donors (such as Sida, DFID and DGIS) have chosen to channel funding to multi-donor trust funds that have experience in SSF, such as WSP or GPOBA. The activities of these trust funds are presented in more detail in Sections 5 and 6. They provide block grant funding to these programmes, however, and are not involved on a day-to-day basis with the details of their operations.

Other EU donors, such as the EIB and l'Agence Française de Développement (AFD), have limited experience of SSF to date, but have expressed strong interest in developing their activities in that area, as they recognise the importance of financing this market segment in order to reach the poor. Both organisations have extensive micro and mesofinance activities in other economic sectors, but there are limited internal linkages between the departments dealing with those activities and those dealing with WATSAN. In fact,

almost all EU donors have in-house expertise on micro and mesofinance, but are not necessarily using it to inform the design of WATSAN projects. This could be seen as a key area for improvement.

A few donors have looked into expanding their activities in this area but subsequently decided against it. Deutsche Gesellschaft für Internationale Zusammenarbeit (GIZ) conducted studies in Kenya and Uganda to evaluate the extent to which domestic financial markets were serving the financing needs of WATSAN SSF recipients and how they could provide funding to address potential market gaps. However, they decided not to take a pilot project forward, but instead focused on building formal financial systems and strengthening utilities.

The survey also asked EU donors for their views on whether or not SSF for WATSAN was a suitable strategy. Most EU donors agreed that improving access to SSF can enhance poor people's access to WATSAN and that donors have an important role to play in doing so (although GIZ was more circumspect). Donors agreed that SSF for WATSAN can be a tool to help the poor, but, in general, not the ultra-poor. Most of them agreed that the lack of revenue generation associated with water investments (for households) should not be seen as a constraint limiting the potential of SSF and that, in any case, revenue generation exists in financing for SSIPs, masons, etc.

There was less agreement on the types of financing tools and channels that can be used to support SSF. The survey results helped highlight the fact that EU donors use a broad variety of financial instruments and channels and that there is, therefore, a need to draw out more systematically what the advantages and disadvantages of these methods might be.

Finally, EU donors felt that there was scope for cooperation in taking ideas further towards joint implementation. These could include conducting joint projects to:

- Establish public facilities at the national level to channel small-scale financing (e.g. guarantee funds, revolving funds, domestic development banks, etc.);
- Establish or strengthen Apex institutions to channel financing (see glossary for a definition);
- Work jointly on improving the business/regulatory environment for WATSAN SSF providers;
- Establish a website/web-based network to coordinate learning on small-scale financing for WATSAN;
- Prepare a guidance document on 'how' donor finance can be channelled and used to catalyse other sources of finance for non-utility WATSAN service providers.

## 5. Potential financial instruments to support SSF

Public support for expanding the financial services market for SSF can be provided in several ways. Initially, donors focused on creating special revolving funds, often with guarantees (Honduras, Lesotho, Philippines and Vietnam). Though these programmes did achieve some success, there were questions over their sustainability once donor funding stops. More recently, donor efforts have focused on creating linkages with local MFIs and banks. Though these are still at very initial stages, they do seem to focus both on scaling up and ensuring sustainability.

This section examines the types of financial instruments that can be used to support access to SSF. Choosing between those instruments should be driven by an identification of the issues (or 'market failures') preventing an adequate supply of financing to those agents, as shown in Table 3 below.

This section provides examples of donors using those financing instruments. These examples are drawn from the three study pillars underlying the present report, i.e. including the literature review, the survey of EU donors and surveys of DFIs in Kenya, Tanzania and India. It also draws on

Table 3. Role of public funding to support SSF services to WATSAN

Issue to be addressed	Role of public funding	Potential financing instruments
MFIs/commercial banks are not familiar with WATSAN and vice versa	Improve knowledge and exposure to WATSAN in financial institutions	<ul style="list-style-type: none"> <li>■ Grants for market studies</li> <li>■ Grants for new product development</li> <li>■ Grants for training and dissemination</li> </ul>
Existing finance terms are inadequate: interest rates are too high for SSF recipients, loan tenor is too short	Improve lending terms and reduce borrowing costs	<ul style="list-style-type: none"> <li>■ Guarantees</li> <li>■ Blending of grants and loans</li> <li>■ Funding for credit bureaux to lower perceived 'credit risk'</li> </ul>
Limited capital available	Provide access to capital	<ul style="list-style-type: none"> <li>■ Seed financing for revolving funds (grant or loan)</li> <li>■ Guarantees</li> </ul>
SSF recipients lack the necessary skills to 'access' financing	Develop SSF recipients' professional and business skills	<ul style="list-style-type: none"> <li>■ Grants for training in business skills for SMEs, including WATSAN</li> <li>■ Technical assistance grants</li> <li>■ Equity investments with associated business support ('angel investors')</li> </ul>

a broader range of 'donor experiences', including donor agencies from outside the EU, international NGOs or social venture funds. Where applicable, lessons from the use of these financing instruments to support small-scale financing in other sectors are also included.

### 5.1 Grant funding

This section focuses on grants that can be used to increase access to SSF for WATSAN in order to increase access to services. Public subsidies, if successful, can help leverage other sources of finance, such as deposits (in the case of savings and loan schemes) or commercial financing.

#### How to make the best use of grants

The basic principle behind a grant (also referred to as a 'subsidy') is that it is public funding that does not have to be repaid. Grants (or subsidies) can be very useful to address 'market failures', where the functioning of the market does not yield an outcome that maximises benefits for society as a whole.

Grant funds can be provided to cover various needs, as presented in generic terms below:

- A 'capital grant', also referred to as a 'hardware subsidy' supports the purchase of property, the construction of a facility or the purchase of equipment;
- An 'operating grant' provides support for the day-to-day costs of running an organisation. Funds provided for 'soft activities', such as market research or capacity building, can be referred to as 'software support' or a 'software subsidy';
- A grant provided as 'seed financing' can provide initial capital for a revolving fund or help with the launch of a new organisation.

In the past, grants have often been provided without any performance requirements. This has contributed to the lack of financial sustainability and overall poor performance and to a negative view of subsidies.

In recent years, there has been a clear move away from direct project-based grants by some of the EU bilateral donors

towards budgetary support on the one hand and performance-based financing and 'smart subsidies' on the other. The move towards budget support is based on the idea that poverty reduction can best be met by strengthening public sector institutions so that they take greater ownership and responsibility, enabling them to address development issues themselves. Budget support may lead to increasing support to SSF recipients, for example when it is used as grants to rural CBOs to expand services. But it is difficult to assess this specifically given that budget support by definition is not earmarked.

'Smart subsidies', however, can be used very effectively to leverage domestic funding for SSF recipients. As Jonathan Morduch puts it on the [www.financialaccess.org](http://www.financialaccess.org) blog, "The idea behind a smart subsidy is that subsidies are neither inherently useful nor inherently flawed. Their effectiveness depends on how they are designed and deployed."

There are several concrete ways in which subsidies can help increase the availability of SSF and open access to commercial funds. Subsidies can help by demonstrating and testing innovations. Research and development (R&D) is often challenging to self-fund if future returns are not expected to be very high; the benefits of R&D are enjoyed widely by the sector as a whole while the costs are borne by the innovator alone. External subsidies provide important support that allows organisations to experiment with new models and products. Given that micro and mesofinance for WATSAN have yet to be scaled up, there is still a need to support financial institutions in the development of new products tailored to the needs of WATSAN SSF recipients. Subsidies can also help institutions reach costlier, harder-to-reach customers.

Grants can either be provided *ex ante* (before the service they support has been effectively delivered) or *ex post* (after pre-specified outputs have been delivered and verified). Providing a grant *ex post* can provide a stronger guarantee

that the service is delivered to the right people, as it allows targeting specific poverty groups if needed.

Typically, *ex ante* grants to leverage SSF can be provided for a number of purposes:

- To support the providers of finance, i.e. financial institutions, to help them provide targeted services (by funding market research, financial product development, capacity building, internal system development, training, etc.) or to give them access to capital at a cheaper rate (e.g., seed financing for revolving funds). This was provided by the World Bank, Finland and Denmark in Vietnam for the establishment of a SRF, (see Box 1 above);
- To strengthen the capacity of finance recipients, i.e. small-scale providers of WATSAN services, by supporting the formalisation of their services and preparing them to access financing, for example, by funding the formalisation of their services, acquisition of business and management skills, preparation of business plans and financial projections;
- To strengthen the financial system as a whole, for example, by funding the establishment of a credit bureau to assess borrowers' credit histories or a rating system to evaluate the solidity of financial institutions.

Alternatively, grants can be provided *ex post*. Results-based grants could support the development of microfinance products for sanitation entrepreneurs, by providing financial institutions with a subsidy for each new loan extended to a WATSAN entrepreneur. The FINISH programme in India has been experimenting with this type of output-based subsidy for financial institutions, to give them incentives to expand sanitation services at the community level in various ways (see Box 18 for more details). *Ex post* subsidies or grants can also be used to leverage commercial financing from commercial banks or MFIs, resulting in the blending of both types of financial instruments. This is what was tested in the 'K-Rep' project in Kenya, described in Box 9 below. Following

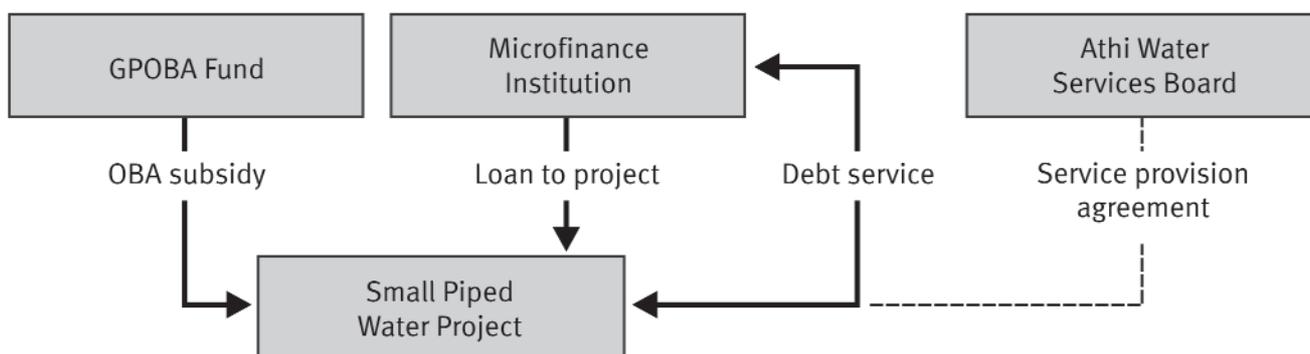
### Box 9. Using output-based grants to leverage mesofinance in Kenya

The WSP and K-Rep Bank Ltd<sup>4</sup> developed a pilot project for supporting local water service providers in Kenya that combines mesofinance with output-based subsidies to ensure an appropriate focus on network extensions.

The Kenya Microfinance for Water Projects Activity was launched in 2007. Funding for implementation of the project's pilot phase, approximately USD 1.1 million, was provided by the World Bank's GPOBA. The objective of the pilot project was to increase access to, and efficiency in, water supply services by the poor in the rural and peri-urban areas of Kenya and particularly in the Athi Water Services Board region. Following the Kenyan Water Act of 2002, the Community Water Project (CWP) signs a service provision agreement with the Water Service Board in whose jurisdiction it falls. The WSP chose to focus the project on addressing the needs of CWPs in Kenya, which are numerous and represent a large market.

Under the project, GPOBA provides capital subsidies to the CWPs selected through a transparent and demand responsive approach. Each CWP sub-project is pre-financed through a combination of its own resources as equity, accounting for 20% of the investment needed, and a loan from K-Rep Bank for the remaining 80%. K-Rep Bank follows its normal due diligence process for providing this loan. Upon successful implementation of the sub-project and certification of the outputs by an independent programme audit consultant, a subsidy, reflecting 40% of the total eligible project costs, is provided to the CWP, allowing the CWP to prepay part of the loan from K-Rep Bank and helping to keep debt service payments affordable.

This provides better risk management from the lender's perspective and increases the incentives for the CWP to complete the project, as the full subsidy is only transferred upon delivery of the agreed outputs (including an increase in the number of connections and in revenues collected). After the release of the subsidy, the MFI remains responsible for collecting the remainder of the loan that is to be covered from water revenues. Technical assistance grants are also provided to assist with project development. Each community project receives a grant for management assistance during project implementation and during the first year of operations. Those arrangements are summarised in the following Figure.



<sup>4</sup> K-Rep Bank Limited (<http://www.k-repbank.com/>) was officially established in Kenya in 1999, with a focus on microfinance, SMEs, poor households and development-oriented enterprises. See Box 17 for more information on the institution itself as opposed to the pilot project.

### **Box 9. Using output-based grants to leverage mesofinance in Kenya *Continued...***

**Loan product characteristics.** The maximum loan value is KES 10 million (USD 107,526). The CWP (borrower) has to deposit 20% of the loan amount as cash collateral. The loan attracts an interest of 16% per annum on a declining balance basis (the effective interest is estimated to be +/- 9%). The loan term is a maximum of 5 years (60 months) with equal annuity payments and a 12 months grace period. To secure the loan, K-Rep has established a number of arrangements and purchased a partial credit guarantee from the USAID Development Credit Authority that covers 50% of the loan loss in the event of a default happening within the first two years for each sub-project.

**Donor support received.** In December 2007, GPOBA signed a grant agreement with the EU Water Facility for an additional EUR 1.5 million to expand the number of target projects to 55 throughout the country. In addition, a Public-Private Infrastructure Advisory Facility granted the Water Services Trust Fund another USD 523,000 to pilot a matching grant system to support communities in engaging consultants to assist with the preparation of loan applications.

**Project results and scaling up.** Initially the project screened 42 community systems and conducted pre-feasibility studies for 21 sub-projects from communities within the Athi Water Services Board area. This screening familiarised the stakeholders with the capacity of WATSAN organisations. Although initially slow, the project showed much progress between 2008 and 2009, with the identification of in excess of 13 eligible sub-projects for financing, approved lending of more than KES 56,670,423 (USD 717,000) and receipt by K-Rep Bank of 19 unsolicited proposals.

**Lessons learned.** The pilot project was designed to address some of the constraints weighing on water service providers in reaching communities through mesofinance, which included the limited exposure of MFIs to the water sector and/or project finance, interest rates and tenors beyond what is affordable and a lack of up-front collateral for small piped water systems.

From K-Rep's point of view, the motivating factors for taking part in the project included i) the return on the loan capital and ii) the potential for increasing customer outreach and related business (see Box 16 for more details on the nature of the institution). For example, K-Rep Bank plans to market financial products to the users of the water systems that it finances, such as a specialised cow leasing product for customers involved in dairy farming. The pilot established a simple project financing cycle that exposes both the bank and community water projects to each other. The pre-financing engagement exposed the community project management to the requirements of the financing institutions and exposed the bank to the dynamics of community water projects.

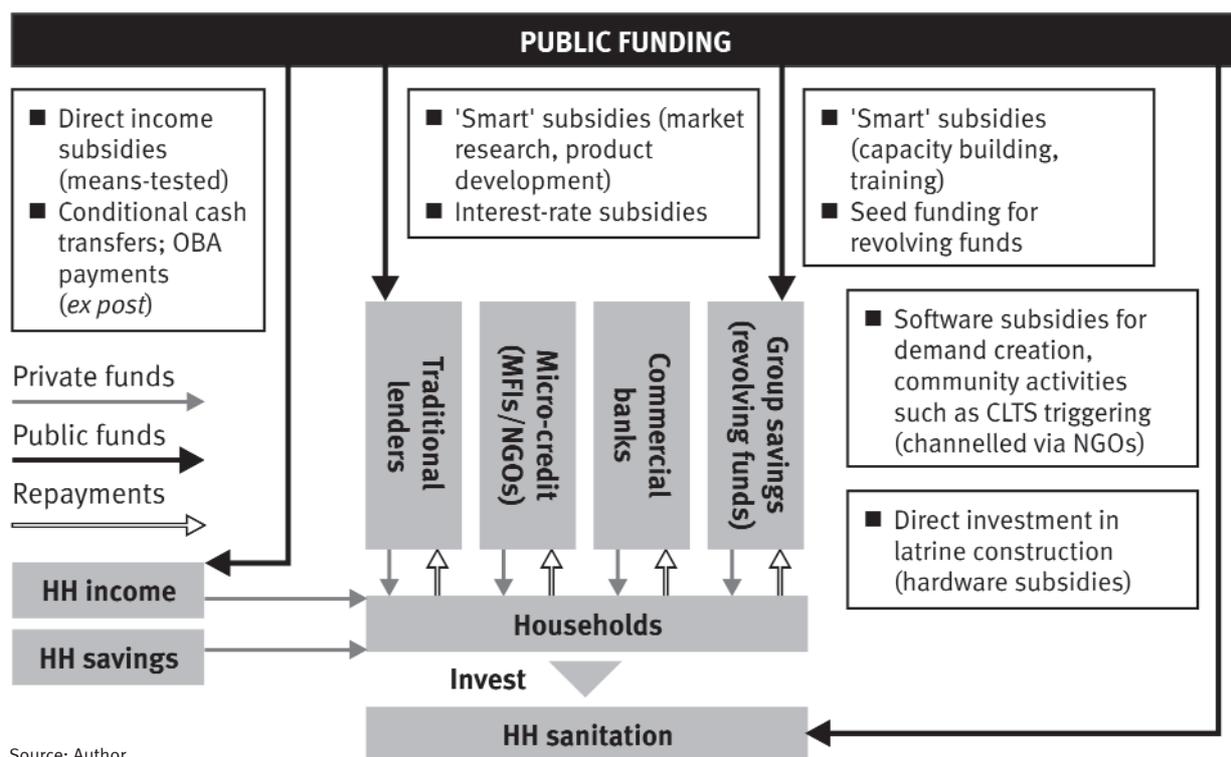
Source: Mehta et al., 2007, quoted in OECD (2010) and Muruka and Mugweru, 2011.

### Box 10. Using public sector grants to support improved access to on-site sanitation

So-called 'hardware subsidies', whereby governments and donors invest directly in building latrines and handing them out for free to beneficiary populations are gradually being phased out. This is based on the experience that 'handed-out' latrines do not get used if they are not preceded by behaviour change and demand promotion campaigns. Many countries are, therefore, changing their sanitation policy to emphasise behaviour change campaigns (using methods such as CLTS) and sanitation marketing (to train latrine builders and instil in them a marketing and commercial approach).

With this type of policy, households become the main investors in on-site sanitation. Some households might be able to invest from their own funds (income or savings) whilst others would need to borrow from a variety of sources in order to mobilise the funds necessary to cover the initial capital costs.

Public funders looking to support access to sanitation, therefore, have to diversify the types of subsidies to boost sanitation coverage. They will need to include software subsidies for demand creation, smart subsidies to microfinance organisations and direct income subsidies (means-tested) to support those households who cannot afford to invest in on-site sanitation, either from their own funds or from borrowed funds. These alternative uses of public funding to support on-site sanitation are shown on the figure below.



### **Box 10. Using public sector grants to support improved access to on-site sanitation *Continued...***

Analysis of alternative financing mechanisms for on-site sanitation (see Trémolet et. al. 2010) found that providing seed financing to a revolving fund in Vietnam, for example, was a much more effective use of public funds (in terms of leverage ratio and reach of the project) than providing hardware subsidies as was the case in Senegal or Ecuador.

a successful pilot supported by the WSP, the local commercial bank, K-Rep, has received a number of unsolicited applications demonstrating the interest generated by the scheme.

Different types of subsidies can be combined to support certain interventions, such as households building on-site sanitation facilities, as detailed in Box 10 below. As many donors and governments have abandoned policies based on high levels of hardware subsidies, they are looking for alternative ways of funding sanitation. Households are now considered to be the main investors in on-site sanitation and subsidies are needed in order to improve on the lack of progress in meeting the MDG sanitation target.

#### **What are the pros and cons of using grants?**

There are several arguments for using grants that support improved access to SSF. Grants are particularly well-suited to address some of the key constraints affecting SSF recipients, which relate to capacity and information availability rather than a genuine lack of capital. No other type of financial instrument can be used to provide 'software support' (such as for training or capacity building). In addition, grants can have a 'systemic impact' when used to improve the conditions needed for developing an SME finance market, such as the business climate, regulation, market information, business support or legal frameworks. Following extensive research in Kenya and Uganda, GIZ indicated a strong preference for supporting the development of SSF through these types of more general activities, without necessarily

investing in specific activities to support the SSF recipients. A key risk when using grants, however, is that the actions that are being supported can stop when the grant itself stops. This might not be an issue for *ex ante* grants that are used to kick-start a market, as the presumption is that the grants would no longer be needed once the market has developed sustainably (although developing such a market can take time). But *ex ante* grants are seldom sufficient to kick-start a market in a sustainable and scalable manner. A way of mitigating this issue for *ex post* grants is to ensure that a sustainable and predictable source of grant funding is identified within the country itself, rather than relying on funds from abroad.

This is particularly important given that grant funding from bilateral donors has tended to decline (partly as a reflection of the economic crisis and its negative effects on public budgets in Western countries). For example, the AFD has been phasing out grant funding to the water sector and is now almost exclusively providing concessional loans.

To counter this potential decline in grant funding, a growing source of grants to the sector is charitable foundations. Such a source of funding can bring its own benefits, as described below. The foundations that provide grant funding have significant endowments and have shown an interest in using innovative financing methods, such as microfinance. The decision making process tends to be quicker for foundations than for public agencies, which have long project approval cycles. Therefore, grant-making foundations can be more

flexible and responsive to market opportunities without being bound by specific requirements in terms of the choice of country where they work, for example. Some of the foundations active in the sector have been using 'challenge funds' or 'awards' mechanisms, whereby they award pre-defined grant amounts to innovative approaches and projects in the sector. This type of 'prize' can be very useful to stimulate innovation and competition among small-scale WATSAN providers. For example, the Stone Family Foundation (based in the UK) has recently launched the 'Stone Prize for Innovation and Entrepreneurship in Water' through which they are looking to support new initiatives in the water sector that are innovative, entrepreneurial and potentially scalable<sup>5</sup>.

Another type of risk associated with using grants is that they can lead to over-reliance on subsidies and end up distorting local markets. For example, switching from hardware subsidies to the provision of seed funding for revolving funds may generate confusion in the minds of recipients. As a result, they may not necessarily consider it an 'obligation' to repay the funds, and the latter may dwindle over the years. Subsidising financial institutions can also distort the sizes of the firms and create economic inefficiencies. This means that, although grants are likely to be a critical component of any financing strategy to support SSF for WATSAN providers, particularly at the point of entry, they would need to be complemented by other types of financial instruments, such as concessional loans, guarantees or equity investments, as detailed in the following sections.

## 5.2 Concessional loans

### How to make the best use of concessional loans

A concessional (or 'soft') loan is one provided on concessional lending terms, which may include lower interest rates, longer repayment periods or a grace period. This means that the terms of the loan are more favourable to the borrower than what they could otherwise access in the commercial banking system.

ESAs and domestic banks (such as commercial banks or MFIs) can offer soft loans to providers of SSF to soften the final lending terms and facilitate access to capital for SSF recipients. For example, a national bank in India, the National Bank for Agriculture and Rural Development (NABARD), established with a development mandate, initiated a scheme in the late 1980s that later led to the establishment of the 'Self-help Group (SHG) Bank linkage' programme. In that scheme, NABARD makes concessionary loans to commercial banks that are lending to women's SHGs formed with the support of NGOs. This model has been used to fund all sorts of development activities including access to WATSAN (see Boxes 11 and 15 for more details).

### What are the pros and cons of using concessional loans?

According to Latortue (2006), "Debt is the main instrument used by international financing institutions (IFIs) to support MFIs, comprising 74% of the funds that they deploy."

The use of concessional loans to support WATSAN SSF appears much more limited than for microfinance as a whole. This is probably because the market is at a very early stage of development, which means that using grants may still be justified. One recurrent issue with concessional loans from ESAs is that they are usually denominated in foreign currency. In the WATSAN sector, where all revenues are in local currency, this exposes the borrower to a significant foreign currency risk.

This means that loans to support SSF may be provided only to financial institutions that have the ability to carry or hedge the risk and are sufficiently secure to repay the loans. Lending terms may need to be further softened through the provision of guarantees (see next section). Identifying when a financial institution is 'ready to stand on its feet' and can access loans rather than pure grants is often a difficult judgment to make, which may lead to distortions (particularly if grant support is prolonged more than necessary).

<sup>5</sup> See <http://www.thesff.com/> for more details.

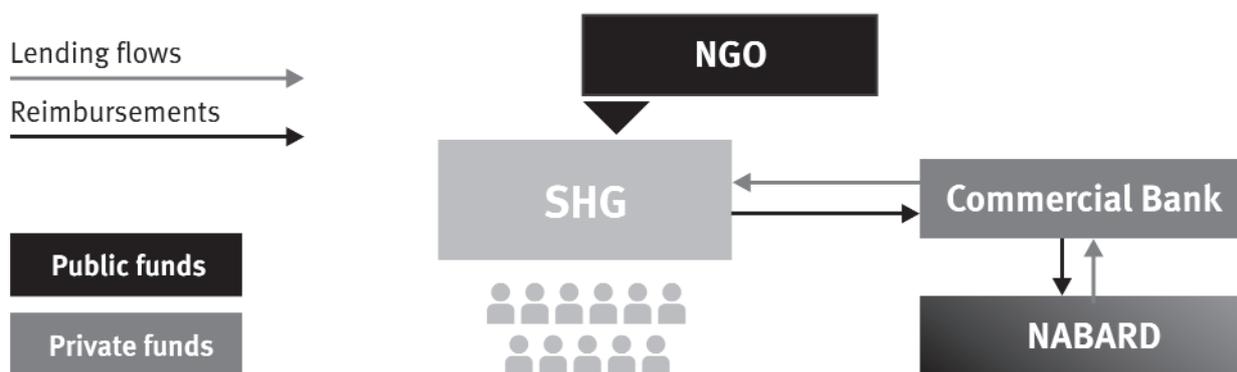
### Box 11. The SHG Bank linkage programme supported by NABARD in India

The SHG Bank linkage model is supported through concessional loans from NABARD, an Apex bank created in 1981 with a mandate to facilitate credit flows for the promotion and development of agriculture, small-scale industries, and other allied economic activities in rural areas. In this model, NABARD refinances commercial banks for the loans given to SHGs.

SHGs are informal associations of up to 20 women (their average size is between 11 and 14) who meet regularly, usually once a month, to save small amounts (typically INR 50 to INR 100 a month). While they are formed with the encouragement of NGOs and other self-help promoting agencies, such as government agencies and banks, they are expected to select their own members. They receive basic training in financial management skills and book-keeping. After saving regularly for a minimum of six months and satisfactorily maintaining prescribed records and accounts, they can use the funds to lend small amounts to each other for interest, which is ploughed back into the group funds. They then become eligible to be 'linked' with the local bank branch under a NABARD-sponsored 'SHG Bank linkage programme' (SBLP).

The SBLP, is represented in the figure below. NGOs are involved in mobilising members to form groups, providing capacity building to members on various issues, like book-keeping, leadership and governance, and conflict resolution within the groups. The NGOs are remunerated for the groups formed and linked with banks.

The SHG model was the first mover and all the major NGOs started forming SHGs across the country (Professional Assistance for Development Action [PRADAN], Development of Humane Action [DHAN] Foundation, etc.). The model was also considered to be an empowering model for women as they are expected to perform a number of activities, like keeping books of accounts, transacting with banks for the deposit and withdrawal of money and taking loans. All these functions were hitherto handled by men. The programme received a big push when in 2000 Andhra Pradesh state, supported by the World Bank, started a programme to create SHGs across the state. As of March 2010, around 60 million clients were linked with banks under the SBLP.



### **Box 11. The SHG Bank linkage programme supported by NABARD in India *Continued...***

In contrast, in the MFI model (which is explained in more detail in Box 15), the MFIs lend directly to small groups (either joint liability groups (JLGs) or SHGs) and have to seek financing from a variety of sources, including from commercial banks. NABARD has been providing indirect support to MFIs offering loans for sanitation through the FINISH programme (see Box 18).

Source: Trémolet and Kumar (2012). For more information, see: <http://www.nabard.org/index.asp>.

## 5.3 Guarantees

### **How to make the best use of guarantees**

A guarantee is a contract by a third party (C) to underwrite a financial commitment entered into by two parties (A and B). At the national scale, guarantees can be used by national governments to reduce the risks of borrowing and bond issues by their sub-sovereign bodies. They can also be used by international agencies to increase the creditworthiness of developing country institutions. At the micro level, guarantees can be provided by a variety of institutions (including donors) to providers of SSF in order to improve lending terms, by extending the maturity of the loan or reducing interest rates (through a reduction in the associated risk premium).

The use of guarantees to support SSF, in general, is on the rise, albeit from a fairly low base. Several IFIs and development agencies are showing increasing interest in using guarantees to support MFIs. For example, the USAID Development Credit Authority had provided USD 78 million in guarantees to microfinance by 2006 (Latortue, 2006). Investors and donors believe that guarantees facilitate the MFIs' access to local lenders, leverage scarce socially-motivated financing and protect MFIs from currency risk.

However, too often guarantees seem to be poorly designed and may end up increasing the cost of a commercial bank loan. A Consultative Group to Assist the Poor (CGAP) study found that, "The all-in cost of a guarantee backed retail bank loan can be more expensive for MFIs than other funding sources: MFIs pay annual fees ranging from 0 to 4.5% of the guarantee amount on top of the bank interest rate." Despite these guarantee fees paid by the MFIs, the study suggested that most guarantor institutions were not covering their costs of providing guarantees. The CGAP study also showed that guarantees do not, in fact, consistently lead to subsequent direct lending by domestic banks without additional collateral. This was the case in a number of WATSAN projects guaranteed by donor institutions, such as in the 'gulper project' (see Box 6), in which the DFI was reluctant to lend over and above the guaranteed amount, thereby limiting the leveraging effect of the guarantee.

In other cases, the use of guarantees can help leverage private financing. Through CLIFF, jointly supported by DFID and Sida, through Homeless International and in partnership with the Cities Alliance, the provision of guarantees (combined with capital and operational grants) has leveraged significant amounts of private financing and helped scale up the programme, as described in Box 12 below.

## Box 12. Grants and guarantees via CLIFF

**Background.** The British based charity, Homeless International, with the support of DFID and Sida, started the CLIFF programme in 2002. CLIFF is a venture capital facility which enables organisations of the urban poor to access greater public, private and civil society sector resources. These resources are used for sustainable housing and basic services projects for slum dwellers (including sanitation), which have the potential to be scaled up to benefit even more people. In addition, they can be used to influence the policies and practices of banks, governments, international development agencies and others. The programme was initially piloted in India in 2002 and later expanded to Kenya and the Philippines.

**Channelling financial resources to ultimate beneficiaries.** Donors provide financing to CLIFF in the form of grants. These grants are received by Homeless International and channelled into a revolving fund in the form of operational and capital grants. With support from this fund, implementing partners and organisations of the urban poor (such as the Indian Alliance organisation and the Society for the Promotion of Area Resource Centres [SPARC], Mahila Milan and NSDF) take out loans through local financial institutions – increasingly commercial banks such as the Bank of India or UTI Bank (now Axis Bank). If the implementing partner lacks the collateral to take out a loan, Homeless International provides support in the form of the guarantee provision.

In sum, CLIFF provides:

- The bulk of the funding (75%) as capital grants to enable local partners to provide loans to the projects (these funds are later revolved to finance new projects)
- Operational grants to cover the costs of project preparation and management
- Loan guarantees through the Homeless International guarantee fund.

Sanitation is included in CLIFF partners' projects, either indirectly as part of housing upgrade schemes (which always include household sanitation facilities) or directly, as part of projects to build community sanitation facilities. During Phase 1 (2002-2010), CLIFF implemented about 29 projects, of which about four had a sanitation component.

Donor support received. During the first phase of the programme (2002–2010), DFID provided about USD 11.2 million and Sida provided about USD 4.6 million. These grants were used as seed funding for revolving funds and leveraging commercial funding. CLIFF estimated that these donor funds leveraged about USD 87 million in commercial funding, which gives a leverage ratio of about 5. Both DFID and Sida have raised their contributions for the second phase of CLIFF (2010–2015), to USD 24 million and USD 6.15 million, respectively. During that second phase, CLIFF is looking to expand the range of implementing partners and the number of countries where it is active.

Source: Trémolet and Kumar (2012).

### **Box 13. Softening lending terms with guarantees: the TAFSUS example in Tanzania**

TAFSUS is a Tanzanian not-for-profit company, set up in 2010, whose main aim is to raise domestic capital, provide credit enhancement and technical assistance for the local financing of slum upgrading and affordable low-income housing. TAFSUS is registered under the Tanzania Company Act 2002 as a company limited by guarantee. TAFSUS was set up as a non-banking financial institution with the support of UN-Habitat (as part of their Slum Upgrading Facility project). A number of donors were involved in setting up of the credit enhancement facility, including Sida and DFID. TAFSUS is governed by a Board of Directors with members from the private sector, civil society, ministries and academia.

TAFSUS is mandated to work with local actors to make slum upgrading projects 'bankable' – that is, attractive to retail banks, property developers, housing finance institutions, service providers, MFIs and utility companies. TAFSUS helps communities to prepare project documents and negotiate with the bank. Where necessary, they can provide a guarantee to soften lending terms. TAFSUS seeks to blend a combination of community savings, government subsidy and local domestic commercial bank lending.

TAFSUS initially identified between 10 and 12 potential projects, with about half of them related to sanitation, including public toilets, emptying cesspits, pit latrine construction or sewer construction. In one of the first projects considered relative to sanitation, TAFSUS is planning to facilitate the acquisition of two gulper units (based on the model promoted by WaterAid) by a local CBO, the Ukonga Development Trust Fund. TAFSUS is helping the CBO develop a bankable project, provide entrepreneurship training and will provide a guarantee for the bank loan. The CBO leaders will also need to pledge their own personal assets to guarantee the loan.

Source: Trémolet and Muruka (2012).

In Tanzania, a project supported by UN-Habitat led to the establishment of the Tanzania Financial Services for Underserved Settlements (TAFSUS) which identifies slum upgrading projects, assists with project preparation and facilitates access to finance for those projects. One of the key tools is the provision of cash guarantees to soften lending terms (see Box 13).

#### **What are the pros and cons of using guarantees?**

DFIs frequently ask for guarantees before extending loans to WATSAN borrowers, largely because they are not familiar with

the sector and perceive it as risky. Although guarantees can help with softening the lending terms, the project that is being guaranteed needs to be financially viable, with clear financing revenues (coming either from tariffs or predictable taxes and transfers, in the case of a project that receives external subsidies). The provision of guarantees, therefore, needs to be associated with support for project preparation and strengthening of financial management skills (as planned in the case of the TAFSUS vehicle in Tanzania). The entities receiving the guarantees would also need to be formally established, in order to limit the risk to the public donor providing the guarantee.

## 5.4 Equity investments

### How to make the best use of equity investments

Equity investments are a form of finance in which investors take an 'equity stake' by purchasing shares in a given entity. This enables them to share the risk of that entity (through fluctuations in the share price or the risk of bankruptcy) in return for the prospect of sharing its profits (through dividend payments and an increase in the share price). The higher the investment risk, the higher the expected level of return.

Equity investments are based on a more commercial approach than other types of development aid (loans, grants, etc.) and may be injected either into the capital of a WATSAN service provider or that of a DFI, such as an MFI or commercial bank. The example of the AfriCap Microfinance

Fund, funded by the EIB, although not a WATSAN example, shows the value of equity investments to support the development of local financial institutions.

Regarding WATSAN SSF, equity investments can be made by ESAs and social venture funds. Given that return prospects are unlikely to be immediate or very high, these institutions may be willing to be involved as 'patient investors', which means that they are not looking for market rates of return on equity and are prepared to wait longer than private investors for any type of return to materialise.

Equity investments are the preferred financing instrument for some international institutions, such as the International Finance Corporation (IFC), or social venture funds, such as the Acumen Fund, which are increasingly looking at potential participation in small-scale enterprises in the WATSAN sector.

#### Box 14. Equity investments by the AfriCap Microfinance Fund

In 2001, the EIB invested USD 1.8 million in AfriCap Microfinance Fund (AfriCap), the first commercial microfinance equity fund dedicated to Africa. AfriCap has been very successful in investing its capital and fair value estimates of its portfolio are showing above expectation financial returns and significant socio-economic impacts.

In 2005, AfriCap sold its shares in Equity Bank Ltd. (Kenya) to an employee fund, realising its first partial exit in favour of local investors. This gave employees an opportunity to participate in the rapid growth of their bank and provided appropriate commercial rewards to AfriCap and its shareholders. This exit has become a landmark and was recognised in November 2006 when AfriCap received Africa's Venture Capital Deal of the Year award. Less than half a year later, AfriCap had negotiated its second exit by agreeing to the sale of its shares in First Allied Savings and Loans (Ghana). Both exits have had a powerful demonstration effect by signalling that the microfinance industry is emerging as a commercially viable and attractive investment opportunity both for development-oriented and commercial investors.

In 2007, the EIB increased its equity investment in AfriCap by another EUR 5 million, as part of the transformation of AfriCap into AfriCap Microfinance Investment Company.

Source: EIB (2008).

Whereas privately-held funds had previously been examining the WATSAN sector (such as the SNS-REAAL microfinance fund), private sector interest has been seriously dampened by the global financial and economic crisis which has reduced their appetite for risky investments.

However, these funds seldom reach the smallest entrepreneurs. This is true of all sectors and of the WATSAN sector, in particular. According to Sanders (2006), "The IFC has invested in approximately 100 private equity funds, which have together funded over 1000 companies. Of these, about 500 are SMEs with an enterprise value of below USD 4 million. 100 SMEs have enterprise values below USD 500,000. Therefore, only 10% of their investments target the 'missing middle' segment."

### **What are the pros and cons of using equity investments?**

Equity investment can foster a more commercial approach by the recipient organisation as they need to be focused on generating a return on investment. Equity investments can help 'strengthen the balance sheet' of these organisations, which means that they make them able to take on more debt and increase their financial capacity. This is particularly beneficial to MFIs and commercial banks extending loans to SSF recipients, as these are likely to be increasingly submitted to scrutiny in terms of the capital adequacy ratio. As a result, there is a limit on how much an MFI can extend in loans if it has limited equity. Therefore, receiving an 'equity injection' would enable an MFI to grow its lending portfolio whilst respecting banking regulations.

However, there are often restrictions on the ability of certain DFIs to receive equity investments, particularly if the institution has a charitable status. This is because 'equity investments' are expected to generate a return and NGOs are usually not allowed to operate for-profit. This is the case for GUARDIAN in India, for example, which is supposed to be the

only MFI in the world that focuses specifically on offering loans for WATSAN investments (see Box 15). A study by the Council of Microfinance Equity Funds revealed that, "...of the thousands of the MFIs in operation..." only 115 are legally structured to take equity investments. The rest are, for example, NGOs and cooperatives (Latortue, 2006).

There might also be restrictions for ESAs to take equity participations, as these would be deemed more risky than extending a concessional loan, for example. In those cases, these agencies may need to rely on their 'private sector arm' to take such participation (e.g., the IFC for the World Bank or PROPARGO for AFD).

## **6. The 'channelling' challenge: getting funds from A to B**

This section examines in more detail the institutional issues of channelling large funding packages from public funding sources (A) to SSF recipients (B). This is particularly challenging because of the fragmented nature of the WATSAN market and the large number of SSF recipients that need to be financed.

Unlike global commercial banks, donor agencies and development banks do not have extensive retail banking networks on which they can rely to reach the finance recipients (such as the borrowers in the case of a loan). As a result, such 'fund channelling' issues are not specific to the WATSAN sector and emerge in all sectors where there is a mismatch between the scale of the finance providers and that of the recipients. The issue is even more complicated when the potential finance recipients are outside of the 'formal financial market'. Identifying the most appropriate 'financial channelling' approach is essential to minimise transaction costs and take pilot projects to scale.

As Figure 3 outlines, a number of financing channels can be used to get funds from A to B<sup>6</sup>. In this section, we examine each of the potential financing channels, including:

- The 'straight line' approach, whereby donors/public financiers finance DFIs and NGOs directly;
- The 'Apex approach', whereby donors identify an institution at the national level (also referred to as an Apex institution) that can disperse the funds to DFIs;
- The 'funnel approach', whereby donors provide funding to an institution operating in several countries (such as a multi-donor trust fund or MIVs) and let it allocate the funds based on previously agreed principles.

The 'Apex' and the 'funnel' approaches can also be combined, when a multi-country institution (the 'funnel') decides to channel financing via Apex institutions in each of its country of operations.

The rest of this section gives more information about what the alternative financing channels are and outlines the pros and cons of using these different channels, drawing from existing experience in the WATSAN sector as well as from other sectors.

### 6.1 The 'straight line approach' (through DFIs)

Some donors, particularly when they are new to SSF and want to experiment with an approach, may choose to channel funds directly via a specific DFI in a given country. The scale of the programme undertaken in such a way will be driven by the scale and geographical coverage of the selected organisation, which in turn will determine the potential for scaling up.

There are three main types of direct local intermediaries that can be relied upon, NGOs (which traditionally have been favoured by donors in the WATSAN sector), MFIs and commercial banks. The distinction between these categories

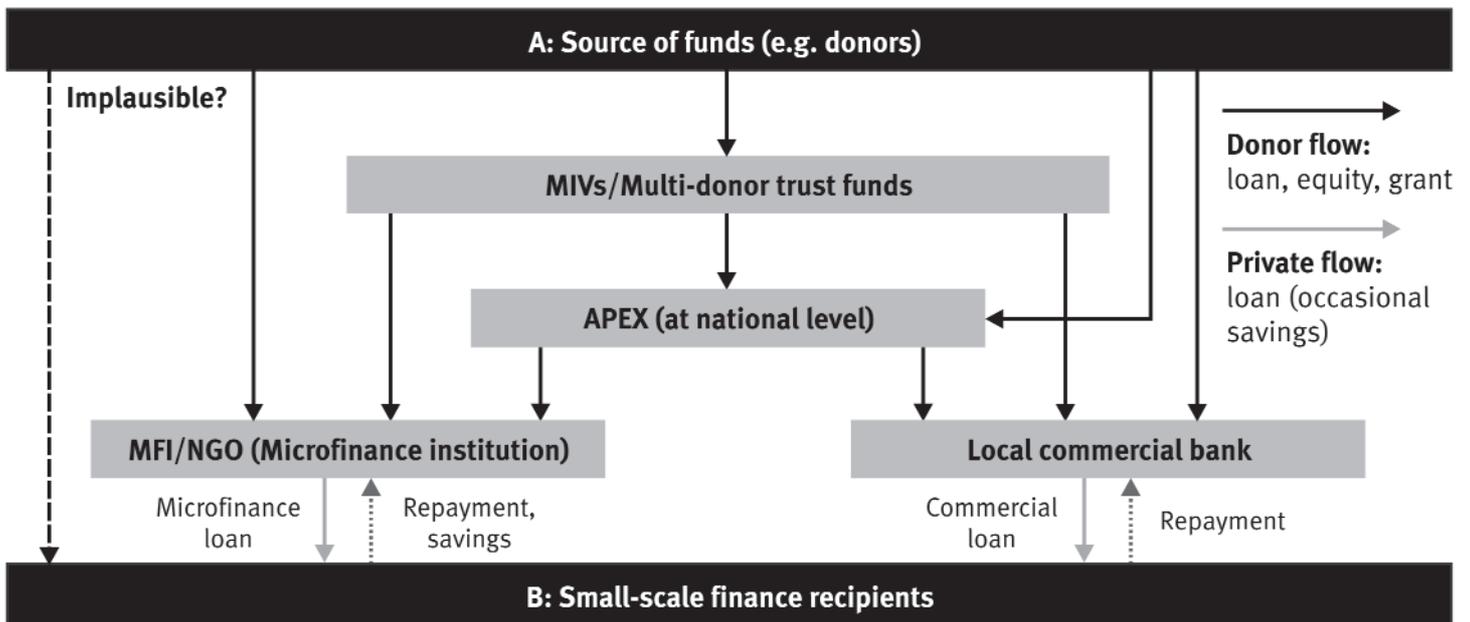


Figure 3. Alternative channels to get funds from A to B

Source: Author.

<sup>6</sup> It would be implausible for donors to channel funding directly to SSF recipients and this is, therefore, not dealt with as a realistic *modus operandi* here.

is sometimes blurred as some MFIs can in fact have an NGO (or charitable) status, whilst other MFIs evolve over time to become full-blown commercial banks. If a donor chooses to channel financing directly through a DFI, care should be taken to select this local intermediary, as each institution (and each type of institution) would have its own strengths and weaknesses.

### **Channelling funding through WATSAN NGOs**

Many donors that have experimented with SSF for WATSAN have chosen to channel funding through existing WATSAN NGOs. There are advantages in this approach as such NGOs have prior knowledge of the sector, good connections at the local level and are genuinely motivated to increase access to WATSAN. Some have well-established relationships with local small businesses, to which they are able to provide technical support for the development of locally-suitable technologies (e.g., WaterAid played this role in the case of the gulper project described in Box 6).

However, NGOs are not financing institutions and using them as financial intermediaries has been part of the reason why the performance of existing WATSAN microfinance programmes has often been unsatisfactory. Initial seed financing for revolving funds has been gradually depleted over time, for example, with low repayment rates for credit schemes.

It is often difficult for an NGO to operate simultaneously as a traditional NGO (handing out hardware subsidies or providing software support) and as a quasi-MFI. This can create confusion in the minds of the SSF recipients, who may think that the 'loan' they have subscribed to does not 'really' need to be repaid. In addition, the staff of WATSAN NGOs typically are not trained to handle micro or mesofinance and these organisations have no internal systems in place to assess borrowers' credit histories or repayment capacities and collect payments. All of these factors compounded may lead to poor repayment rates. In addition, the type of support services they can provide to borrowers are largely related to their core expertise (WATSAN), but they may struggle to

impart business or financial management skills. When they do, this is done using hired specialist firms, whose incentives may not be closely aligned as they are not risking their own capital in the process.

WATSAN NGOs can, nevertheless, play a very important role in identifying the needs for financing amongst SSF recipients and provide complementary services e.g., by conducting behaviour change campaigns or training masons). As a result, WATSAN NGOs can be considered as points of entry into the sector and ongoing partners of MFIs or commercial banks. If they want to engage in delivering microfinance, they would need to create a separate dedicated entity, as was done in the case of Gramalaya/GUARDIAN in India (see Box 16) or K-Rep Bank in Kenya (see Box 17).

### **Channelling funding via MFIs**

MFIs are organisations that provide financial services to clients who are poorer and more vulnerable than traditional bank clients. Most MFIs started as not-for-profit organisations, like NGOs, credit unions and other financial cooperatives, and state owned development and postal savings banks. An increasing number of MFIs are now organised as for-profit entities, often because it is a requirement for obtaining a license from banking authorities to offer savings (deposit taking) services.

Often there are important distinctions between MFIs according to their legal status, as this drives their ability to provide different types of financial services. Such legal and regulatory provisions vary from country to country. However, a typical distinction is between licensed and unlicensed MFIs. Licensed MFIs are usually commercial banks, state owned development banks and post office banks. Unlicensed MFIs are commonly NGOs or community based MFIs that usually have less access to commercial funding and are more likely to need assistance to access capital. The unlicensed operators can also include a range of cooperative models such as the Savings and Credit Cooperatives (SACCOs) and Savings and

### **Box 15. The microfinance situation in India: a brief history**

The different legal forms under which MFIs are registered in India are Societies, Trusts, Section 25 (not-for-profit) companies, Non-banking Finance Companies (NBFCs), Cooperative Societies and SHG Federations. Of these, only the NBFCs are for-profit.

Initially, most of the MFIs were registered as societies or trusts and worked as not-for-profit MFIs. As the MFIs grew, the banks asked for more capital to secure their loans. Societies and trusts, being non-profit entities, could not raise capital from investors who were eager to cash in on the profits available in the sector. This led to the transformation of the large NGO-MFIs into for-profit NBFCs. The share of NBFCs in the portfolio outstanding grew from 50.5% in 2005 to 76.0% in 2009.

The transformation of the sector led to the entrance of private equity to mobilise capital. Initially, this was considered a welcome trend by all as it helped MFIs to leverage more bank capital and in turn increase their outreach. This also helped to drastically reduce dependence on donor funds. However, private equity also came with demands for a high return on equity (in excess of 30%). This pushed MFIs to pursue a high growth strategy, which, essentially, was to offer a single standardised loan product to all the clients with ever increasing loan cycles that had no connection with the business or household cash flows of clients. The focus was no longer on building client relationships, but on just lending and recovering the money. This led to neglect on important issues of client protection and political risk.

SKS microfinance, the biggest MFI in the country, issued an initial public offering in March 2010. It was a major success, although many critical voices raised concerns about this commercialisation of microfinance. Soon after, in Andhra Pradesh (the state that has the maximum penetration of microfinance in the country), a large number of cases of inappropriate behaviour of MFI staff for loan collection surfaced and a number of suicides in the state were attributed to the excessive pressure for repayments and usurious interest rates charged by MFIs. This led to a clampdown on microfinance activities by the state government. Legislation was introduced that greatly restricted the operations of MFIs in the state. The overall loan disbursements reduced significantly across the country with Andhra Pradesh taking the maximum hit. The repayment rates also reduced drastically for MFIs with portfolios in Andhra Pradesh, with most of the MFIs reporting only a 10 to 15% repayment rate, although the repayment rates in other parts of the country remained unaffected.

The situation also led to a scarcity of funds for the sector as banks stopped lending to MFIs because of the overall uncertainty of the legal status of the sector. The overall sector shrunk in size during the last quarter of fiscal year 2010/11 with all the major MFIs reporting a reduction in portfolio size.

Following this, the Reserve Bank of India (RBI) set up a committee (known as the Malegam Committee) to look into the charges of misbehaviour by MFIs and excessive interest rates. This led to the publication of a draft Microfinance

### **Box 15. The microfinance situation in India: a brief history *Continued...***

Regulation Bill in July 2011, in order to strengthen and harmonise the regulation of the microfinance sector in India. The RBI guidelines, soon to be turned into law, have provided a breather to the MFI sector and a number of banks have started lending again to MFIs. The future of the sector seems to be secure for now, though there may be some fundamental changes in the operations of the MFIs. This demonstrates the need for regulation of the MFI industry as for any other banking sector.

Source: Trémolet and Kumar (2012).

Loan Cooperatives (SLCs) common in Benin, Ghana or Tanzania and the Rural/Community Banks (RCBs) in Ghana.

Licensed MFIs are usually subject to more stringent prudential regulation and transparency requirements and are supervised by government financial authorities. Licensing would usually bring with it the authorisation to accept savings deposits, the added facility to mobilise resources from domestic capital and financial markets, the capacity to receive liquidity support from the central bank and increased banking skills. Having access to a deposit base means access to cheaper and more reliable capital, and a lesser need to rely on either expensive commercial lending or scarce donor funding. For clients, the possibility to save in MFIs (rather than commercial banks) means increased accessibility and reduced travel time.

In Kenya, for example, the Microfinance Act 2006 clustered existing MFIs into three Tiers. Tier I – deposit taking institutions. Tier II – credit only, non-deposit taking institutions. Tier III – other organisations supervised by an external agency (such as Rotating Savings Societies or ROSCAs). This Act harmonised previously fragmented legislation and enabled some MFIs to accept deposits in exchange for increased regulation.

Another key distinction is between MFIs that have a 'for-profit' status and those which are not-for-profit. This

distinction leads to different approaches to lending, recovery and the associated support provided to their borrowers. In short, some MFIs are more 'socially-minded' whereas others are more 'commercially-orientated'. An increased commercial focus is at the heart of what has commonly been referred to as the 'crisis' of the Indian microfinance market, as explained in Box 15 below. Such increased commercial focus has also been at play in other countries, such as in Mexico, and, in some cases, has resulted in very high lending rates and harsh methods used for loan recovery.

Given these different types of MFIs, it is essential to survey the market before identifying a suitable MFI to channel funding to SSF recipients.<sup>7</sup> Given the low level of awareness in most MFIs of the needs of the water sector and that (in the case of household loans) financing is not directly for income-generating activities, but serves a broader purpose, the 'socially-minded' MFIs would typically be more receptive and appropriate. Other MFIs may want to add this type of product to their portfolios in order to increase their social performances, given the increased level of emphasis coming from the microfinance sector as a whole on evaluating social performance (see Annex C.1.).

In many cases, such 'socially-minded' MFIs would be those that have evolved from an NGO. For example, when Water.org, decided to pilot projects to support microcredit for WATSAN in

<sup>7</sup> Donors or other types of external funders who are considering channelling funding through MFIs or commercial banks can obtain information on existing actors from a specialised website, [themixmarket.org](http://themixmarket.org) (see Annex C.1. for more guidance on useful web-based resources).

India, they identified an existing WATSAN NGO, Gramalaya, operating in Tamil Nadu as the potential recipient for their support. However, a decision was quickly taken to spin-off

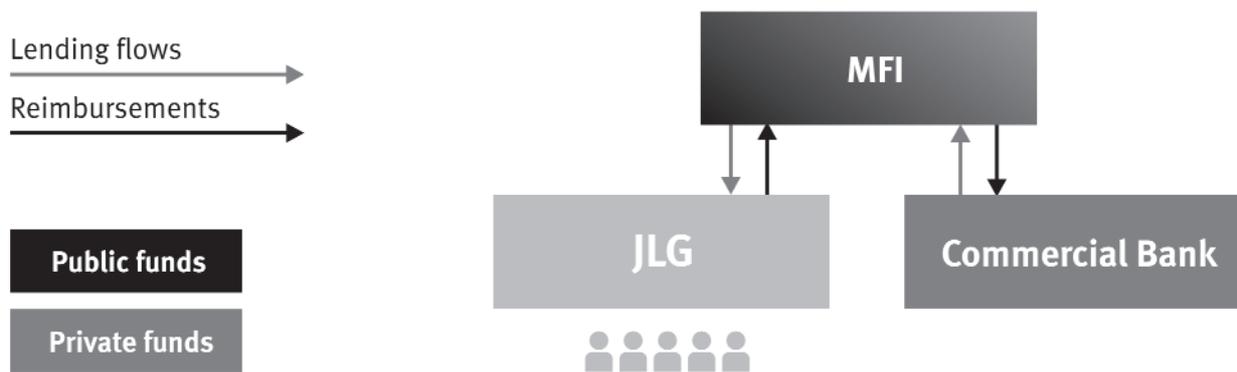
GUARDIAN as a separate MFI in order to offer microfinance services. Box 16 below reviews this experience, which is rather unique.

**Box 16. GUARDIAN, an MFI spun out of the NGO Gramalaya, Tamil Nadu, India**

GUARDIAN is the first water-and-sanitation-only microfinance institution in India (and probably in the world). As such, they have placed a strong emphasis on 'toilet loans' targeted at poor households, mostly in rural villages and some slums. These represent the bulk of their portfolio. Although they are still relatively small, they have been rapidly developing over the last three years and demonstrate a potential for further growth, backed by a strong operational and financial record. During their first three years of operation, they disbursed 20,000 loans to households (60% of which were for sanitation) which attracted a 100% repayment rate.

GUARDIAN ([www.guardianmfi.org](http://www.guardianmfi.org)) was formally established in November 2007 by the board members of an NGO operating in Tamil Nadu, called Gramalaya. This NGO had a long history of working in WATSAN, beginning with the installation of hand pumps in 1986. On the sanitation side, they conduct hygiene education campaigns and have also helped with the establishment of community-run toilet blocks, in the urban slums of Trichy, which are working remarkably well.

Gramalaya was early in the pioneering of the WaterCredit concept with the aid of Water.org (formerly known as Water Partners International). In March 2005, Gramalaya decided it did not want to continue with lending activities, but preferred to maintain its status as a trust and establish a separate, but related organisation, GUARDIAN, to be in **16**.



**Box 16. GUARDIAN, an MFI spun out of the NGO Gramalaya, Tamil Nadu, India *Continued...***

charge of micro-lending operations for WATSAN. Some of Gramalaya's board members and long-standing staff were deputed to create GUARDIAN, bringing with them technical expertise in the WATSAN sector.

GUARDIAN was registered as a Section 25 company under the Indian Companies Act 1956, which means that it is a not-for-profit MFI. As such, it is able to borrow directly from commercial banks (something that Gramalaya, as a charity, is not able to do). GUARDIAN uses the MFI model, which was developed in India based on the experience of the Grameen Bank in Bangladesh. In this model, represented in the Figure below, MFIs borrow from commercial banks

to on-lend directly to SHGs or JLGs. JLGs are made up of fewer members (up to five members) than SHGs and are formed solely for the purpose of taking out a loan. Neither SHGs nor JLGs require collateral. Instead, the group lending model substitutes for the need for collateral by requiring that if one of the members of the SHG or JLG defaults on a payment, the rest of the group will pay on his/her behalf.

To date, GUARDIAN has received commercial loans from the local branch of the Indian Overseas Bank (IOB) for a total of approximately USD 1.6 million. Other banks have not been willing to fund them as they deemed GUARDIAN's rating insufficient. Gramalaya also provided GUARDIAN with a guarantee, which means that if they default on a loan to IOB, the amount will be taken from Gramalaya without affecting GUARDIAN's borrowers.

GUARDIAN received initial grant support from Water.org, an NGO based in the USA that focuses on supporting WATSAN through its WaterCredit initiative, for a total of approximately USD 165,000. Until May 2011, GUARDIAN received grant support for its operational costs (predominantly salaries and administration expenses) from Water.org. Grant support also covered the costs of the technical and institutional support provided by BASIX IGS (Indian Grameen Services), the Institutional Development Services branch of a leading Indian MFI based in Hyderabad, as well as from ASA, based in Bangladesh. Support from BASIX IGS was provided over the course of six months and covered activities such as initial training, research, product design and development, preparation of operational policies and definition of collection systems. The MFI is now able to stand on its own feet and operational grants have been phased out.

Each USD 1 invested by Water.org in GUARDIAN's activities leveraged approximately USD 16 in commercial funding (including so-called 'patient capital' from social investors, such as the Acumen Fund and Milaap). GUARDIAN has more recently approached social investors in an attempt to diversify their funding sources. They have also obtained funding from Milaap (a small NGO based in Bangalore which functions on the Kiva model) and the Acumen Fund, which invests in social enterprises throughout the world and is willing to accept lower (and slower) returns on its investment than private investors.

Source: Trémolet and Kumar (2012).

MFI can act as useful financial intermediaries as they would typically have strong networks at the local level and know their customer base well. For microfinance, the group lending mechanism allows reducing or waiving collateral requirements. Compared with NGOs, they would have already established systems for assessing repayment capacity and collecting revenues, with a network of credit officers who are accustomed to extend financing for a variety of purposes and are incentivised to collect their dues. However, many MFIs may lack the business skills to assess larger projects associated with mesofinance. Compared with the fast and standardised operations for microfinance, SME financing requires higher transaction costs per client. The capacity to take on this type of transaction may be higher, at the level of commercial banks, as described below.

### **Channelling funds through a local commercial bank**

Commercial banks are financial institutions that provide banking services, such as accepting deposits and providing credit facilities and loans. They differ from retail banks as they execute transactions not only with individuals, but also with small businesses and corporations. Commercial banking activities also differ from investment banking activities, which include underwriting, facilitating mergers, etc. Commercial banks are usually not supported by donors and are accountable to their shareholders for the profits they make.

Commercial banks that operate in micro and mesofinance can either come 'from above' or 'from below'. As the microfinance sector has grown substantially over the last decade, many 'traditional' commercial banks have diversified their services to enter this segment of the market, such as Citigroup, for example. At the other end of the spectrum, former non-profit NGOs or MFIs may have made the transition towards becoming profit-making entities whilst remaining in the business of microfinance lending. This has been the case of K-Rep Bank, a leading provider of microfinance services in Kenya, as described in Box 17 below.

Commercial banks can be an appropriate channel for microfinance (particularly in urban and peri-urban areas) or mesofinance/SME loans. Large commercial banks may have better access to capital than small MFIs and a stronger network of bank specialists. In order to keep their corporate risk profiles to acceptable levels, commercial banks may choose to co-finance small businesses and share risks with a second party. However, some commercial banks may have minimum loan sizes (in order to reduce transaction costs), meaning that their participation would be more forthcoming in larger projects, possibly following a first round financed by MFIs.

### **Overall assessment**

When selecting a single institution at the domestic level, experience has shown that it is preferable to channel funding through an established financial institution (preferably a 'socially-minded' MFI with an extensive retail network and a substantial customer base) rather than through a WATSAN NGO. This is because it is more difficult (and therefore costly) to 'transform' a sector NGO into a financial institution than to help an existing financial institution develop specialised products for WATSAN investments. Going through a commercial bank may be the favoured route for larger projects involving mesofinance. However, it might lead to unattractive lending terms for the borrowers, unless this commercial bank is 'socially-minded' and the cost of borrowing can be lowered (through the provision of guarantees, for example).

### **6.2 The 'Apex approach'**

For international donors, the plethora of MFIs and commercial banks that exist can be an inhibitor in deciding who to fund. As a result, donor institutions often rely on financial intermediaries in the form of Apex institutions to channel funds to DFIs, who will then on-lend to small-scale agents, including in the WATSAN sector.

### **Box 17. Moving from CBO to commercial bank status: K-Rep Bank in Kenya**

Kenya Rural Enterprise Programme (K-Rep) was founded as a CBO in 1984 to support the development of small and micro enterprises in Nairobi. It was a project of the US based NGO World Education Incorporated. Its banking arm has since become a successful, commercial, microfinance bank. Despite its transition to commercial status, it works to balance its social and profit-orientated mission by maintaining a focus on the provision of financial services to the poor. As of 2010, K-Rep Bank had 65,000 borrowers and 170,000 depositors with a portfolio of USD 61 million and customer deposits worth almost USD 67 million.

In 1987, the project was incorporated as a local NGO. In 1989, it changed its original strategy of supporting NGOs with grants and technical assistance to that of providing them with loans. In the same year, K-Rep established a microcredit lending programme as its core business and growth area. It also expanded activities to include research and product development and changed its technical assistance (TA) activities to a for-a-fee capacity building service. In 1999, K-Rep's microcredit section was converted into a commercial microfinance bank. Two other entities were established, including K-Rep Development Agency (to carry on R&D work) and K-Rep Advisory Services (to serve as a consulting company).

As a microfinance institution, K-Rep Bank provides loans, savings and banking services with the objective of building up the assets of low-income groups and individuals in shelter, health and education. K-Rep Bank took an early lead in financing water services in Kenya following their involvement with the Kenya Microfinance for Water Projects Activity (see Box 9). In parallel with that project, the microcredit department has been providing small loans to its clients to purchase water tanks for rain water harvesting and water storage (see Box 4).

The water project is an anchor programme within its health mission and, more importantly, a frontier financial product managed by the Special Projects Department. It is recognised within the Bank as generating other financial services that add value to the bank's target clients, by giving access to cash deposit services to customers of water service providers, water services boards and government grant agencies. It was reported that deposits received from water-related customers was about KES 18 million (USD 225,000) during the Microfinance for Water Projects Activity. In addition, the bank has also extended services to farmers in the area of the project for the financing of dairy cows and other farm inputs.

Source: Muruka and Mugweru (2012).

## What is an Apex institution?

An Apex institution is an institutional mechanism operating within a single country or integrated market to channel funds, with or without TA or other supporting services, to a significant number of retail MFIs that, in turn, disburse loans to low-income people. Apex institutions are usually funded with public money, but they take various institutional forms, such as development banks, NGOs, donor programmes, private commercial banks and special government or donor programmes. They may otherwise be known as second tier banks or national funds. Apex institutions permit donors to

pass the difficult and time-consuming task of MFI selection to a local institution that has the requisite skills and is deemed politically independent. Funding is redistributed to MFIs as concessional loans (or more rarely, grants) with or without TA for improving operations.

CGAP 2010 identified 76 Apex institutions in operation around the world. They found that Apex institutions are especially prevalent in Latin America and south Asia (69% and 29% respectively of the total Apex disbursements in 2007). The number of Apex institutions in Africa has grown in recent years, with eight Apex institutions being created

### Box 18. ARB Apex Bank Limited, Ghana

The ARB Apex Bank Limited of Ghana started operating in 2002. Its shareholders are the Rural/Community Banks. There are a total of 136 rural banks throughout Ghana with 700 branches in total. The first rural banks in Ghana were set up in the late 1970s, although many of them have taken time to get established. These banks are owned by local people and can only operate within a radius of 40 kilometres around their headquarters.

They offer a broad range of financial services and can take deposits (they can only lend up to 57% of their deposit amounts). They offer loans for income generation (trading, agriculture, cottage industries) and also for housing, school fees or home improvement. Their mission is to encourage local development.

The mission of the ARB Apex Bank is to provide banking as well as non-banking support services to the Rural/Community Banks to help them improve their operational efficiency, and thereby, transform them into efficient and credible financial institutions, which can effectively address the banking needs of the communities in which they operate.

The ARB Apex Bank functions as a 'mini' central bank for the Rural/Community Banks under the supervision of the Bank of Ghana. ARB Apex Bank has outlets in all the 10 regional capitals. The Apex Bank ensures effective supervision of Rural/Community Banks with regular regulatory inspections, to insure that internal control measures and good book-keeping practices are observed. It also provides services such as cheque clearing, fund management, technical support, joint product development and training. Although such rural banks have yet to provide financing for WATSAN investments, the ARB Apex Bank has expressed strong interest in developing this type of product in the context of a WATSAN programme funded by EIB/AFD in small towns and rural areas.

For more information, see: <http://www.arbapexbank.com/abtapex.htm>

### **Box 19. The FINISH programme in India: channelling funding to MFIs for 'toilet loans'**

The FINISH programme was set up as a five year programme in 2008. Its main objective is to expand sanitation infrastructure to rural India to cover 1 million households by 2013. They intend to do this not just through the building of toilets, but by promoting an overall 'sanitation system' that takes a holistic look at the process. There is a strong emphasis on hygiene promotion and awareness-raising through to the safe treatment and disposal of excreta. As of July 2011, FINISH had contributed to the extension of 132,000 'toilet loans' throughout seven Indian states, with the highest number being provided by BISWA in Orissa.

FINISH functions as a partnership between seven organisations that each brings very different expertise. It was initiated by SNS-REAAAL (a Dutch Bank) and BISWA (an Indian NGO and MFI), with others joining later, including TATA-AIG (an Indian insurance company), WASTE (a Dutch NGO specialised in sanitation and solid waste), NABARD, the National Housing Bank and the United Nations University.

On the ground, FINISH works through about eight implementing partners who are based in seven states around India. These are well-established NGOs/MFIs with prior experience in microfinance and sanitation, who are willing to commit 10% of their microfinance portfolio for work in sanitation. The organisations that were selected mainly operate in rural areas because this is where sanitation coverage is lowest (in some rural areas, it is as low as 5% although average coverage is around 25%).

Given that FINISH operates with a number of different NGO partners, the terms of the loan products on offer vary according to the capacity of each MFI/NGO. For example, BISWA gives smaller loans of INR 4000 (USD 80) over one year with an interest rate of 20% reducing to 10%. In contrast, BWDC gives larger loans of up to INR 350,000 (USD 7000) for a package of a septic tank, latrine and bathroom.

Once it has selected its implementing partners, FINISH provides them with small grants and technical support for awareness-raising. For awareness-raising, they have included some aspects of CLTS and have also made their own media to promote sanitation.

Their strategy is to achieve 100% sanitation coverage in a few villages before moving to the next ones. One innovative aspect of the programme is the provision of incentive payments to MFIs and their credit officers to improve sanitation coverage. Achieving total sanitation in a village can be a difficult task because the coverage lingers at relatively high levels and never reaches 100%. In order to achieve full coverage, FINISH grants incentive payments to MFI staff, as they play the joint roles of animators and loan officers. Through the MFIs, FINISH channels INR 600 per month (USD 12) to staff members, which is raised to INR 1200 per month (USD 24) once their initial target is reached. In addition to this, the organisations are granted INR 75 (USD 1.5) for each toilet built using a loan which exceeds the 50% coverage target. This is raised to INR 150 (USD 3) when the village coverage reaches 70% and is then raised again at

### **Box 19. The FINISH programme in India: channelling funding to MFIs for 'toilet loans' *Continued...***

90% coverage. This incentive payment is paid by FINISH to the relevant partner organisation. In some cases, these organisations will choose to share it with their field workers and in others, to add it to the revenue of the organisation as a whole. Currently, 41% of the total FINISH budget has been earmarked for incentive payments (referred to as 'output-based aid').

FINISH is financed only partly from donor grants, the vast majority of the funds (90%) are leveraged from commercial banks. The grant portion of the programme, estimated at about 9% of the total funding, has been provided by DGIS of the Netherlands.

Source: Trémolet and Kumar (2012); <http://www.finishsociety.com/>.

between 2003 and 2008. In 2008/2009, Apex institutions disbursed approximately USD 2 billion of public money to MFIs, which is almost as much as the total disbursements by donors and investors to the entire microfinance sector in 2007. A majority of Apex institutions are funded both by international donors and domestic governments. CGAP 2010 found that the top five international funders of Apex institutions are KfW, the World Bank, the Inter-American Development Bank, the International Fund for Agricultural Development and the EU.

Examples of established institutions serving as Apex institutions include La Financiera de Desarrollo Territorial S.A. (FINDETER) in Colombia (an Apex institution established in 1989 to facilitate access to commercial bank financing for local governments in Colombia)<sup>8</sup>, NABARD in India (the largest Apex institution in the world, described in Box 11) or the ARB Apex Bank Limited in Ghana (see Box 18). Most existing Apex institution funds were established in the 1990s and 2000s.

The role of Apex agencies vary from country to country, as they can be used to channel funds, but they would also offer a variety of financial and support services to the DFIs with which they interact. As these institutions tend to operate at a multi-sector level, their degree of familiarity with the WATSAN sector also varies quite substantially. For example, 25% of

the loans to municipal governments and local corporations facilitated by FINDETER were for WATSAN investments. The ARB Apex Bank in Ghana has indicated a strong interest in supporting rural banks to develop WATSAN lending products.

In addition, specially established programmes, such as FINISH, can be used as an Apex-type channel for funding. This type of approach allows much more targeted support to MFIs and commercial banks looking to extend SSF services to WATSAN. The FINISH project combines a mix of incentives and support services that makes it innovative and scalable to other parts of India and with potential for other countries.

### **The pros and cons of channelling funding through an Apex institution**

Throughout the microfinance sector, donors are increasingly choosing to channel funding through Apex institutions. They have often been used as a funding channel of choice to keep MFIs going in Cambodia, Malaysia and India following the global financial crisis (CGAP 2010).

There are many good reasons for international donors and domestic governments to channel public funding through Apex institutions which can explain their popularity. Apex

<sup>8</sup> See OECD (2010) for more information.

institutions can serve as useful intermediaries for donors, investors and governments because they cut down on transaction costs. They take on the responsibility for selecting MFIs and channelling funds to them in a context where there are too many for donors to choose from and the transaction costs (and associated risks) of selecting MFIs can be very high. As a result, they can be a useful channel for large amounts of finance. They can assist donor coordination through centralisation and thereby help to shield MFIs from donor pressures and diversity of standards, reporting requirements, etc. They can also be a coordinating body for MFIs.

Levy (2002) argued that Apex institutions are better informed than governments or international donors and are, therefore, in "...a much stronger position ... to select the best potential candidate for viability and to provide the necessary hands-on guidance and supervision." They can provide TA at a lower cost than individual MFIs. Apex institutions can also take on other functions beyond loans, such as acting as guarantors for MFIs, although many Apex institutions would not necessarily be able to extend guarantees. Such instruments enable MFIs to gradually access national and international financial and capital markets and build bridges between MFIs and commercial, retail systems. As specialised institutions, they can provide an oversight function on sound microfinance, although this can sometimes generate a conflict of interest with their lending and TA activities.

Apex institutions are also able to provide funding in local currency as opposed to international investors who offer two-thirds of their debt in a hard currency and expose the borrower to international exchange risks.

The fact that they are useful from a donors' perspective means that Apex institutions can often be created as a result of funding supply rather than demand. As a result, they may end up as storing facilities for unused donor money. Although they are supposed to be useful organisations for selecting MFIs to fund, some Apex institutions do not have the

necessary expertise to perform such selection or risk being subject to political pressure in doing so.

Apex institutions can be hard to reach on the MFI side, however, because their procedures can be as complicated as those of the donors. In sectors where MFIs are too small and unable to use Apex funds appropriately, funding should be focused on building up MFIs institutionally through grants, rather than on creating intermediaries. For example, K-Rep tried to start off as an Apex institution, but in the end opted to be a stand-alone microfinance retailer because there was not a sufficient nucleus of viable MFIs for them to support (Levy, 2002). In cases where there are stronger MFIs in existence, Apex institutions can crowd out commercial funding for those strong MFIs who no longer need to be reliant on them. Given that Apex institutions are often lending at below market rate terms, they may weaken the incentives for the sector as a whole to reach sustainable financing.

Overall, Apex institutions can provide a very useful financial channel for donors to transfer substantial amounts of funding to MFI-type institutions in developing countries. Their ability to play a useful role varies substantially from country to country and some countries may not have viable Apex institutions in place. In the latter cases, donors may need to start by supporting the establishment of a sound Apex institution.

In addition, given that most Apex institutions are generalist financial institutions, they would usually be unaware of the specific needs of the WATSAN sector. Donors looking to support micro and mesofinance for WATSAN would, therefore, need to build the awareness of Apex institutions and use them to develop financial products that meet those needs.

### 6.3 The 'funnel approach'

As an alternative or complement to the previous models, donors may look at channelling funding through an intermediary active in multiple countries, which would,

## Box 20. The WaterCredit initiative

As part of a diverse portfolio of WATSAN activities, Water.org started a microcredit programme for WATSAN in Bangladesh in 2003. They saw this as a way of leveraging additional sources of finance, over and above the limited amounts of donor funding. They then expanded to South India in 2004 and to Kenya in 2005. In each country, they entered into partnerships with local MFIs and supporting organisations, including for example Dushtha Shasthya Kendra in Bangladesh, BASIX, Gramalaya and GUARDIAN in India, and Equity Bank and KWFT in Kenya.

The WaterCredit model has evolved over time. Early on, Water.org would provide seed financing for a revolving loan programme. They would make a grant to the partner NGO at the national level which was intended to cover all costs, i.e. the costs of product development as well as seed financing for the revolving loan programme. The main limitation of this model was that it could only provide limited funding, which naturally reduced the degree of scale possible.

Water.org also pursued partnerships with MFIs and found that this model worked well. In the MFI-led model, Water.org does not provide financing for the loans themselves, but rather provides assistance to the MFI to develop financial products suitable for the WATSAN needs of their clients. Each MFI is responsible for mobilising loan capital through existing channels (e.g. internal savings, commercial banks and social investors). This is the model that they have used to support the establishment and subsequent operations of GUARDIAN in Tamil Nadu, South India (see Box 16).

This approach has enabled them to implement much larger programmes. The WaterCredit network now includes 23 partners. The latest programme in India, with the support of the PepsiCo Foundation, had a total budget of USD 8 million of grant funding, which is expected to mobilise an additional USD 26 million in commercial and social investments and USD 1 million of in-kind and community contributions.

Overall, Water.org estimates that, "...after 10 years of loan cycles, five times as many people have water with WaterCredit than with a similar amount of grant funding." Since 2007, the global WaterCredit repayment rate by partner MFIs has been between 97 and 98%.

Source: Trémolet (2011).

in turn, look to transfer funds through domestic Apex institutions directly to MFIs or even directly to SSF recipients.

Various types of intermediaries can be considered for these purposes, including international NGOs, multi-donor trust funds, or finally, MIVs, which are commonly used in the microfinance sector to channel both public and private funds. The following sections examine each of these potential intermediaries in turn.

## International NGOs

International NGOs can serve as intermediaries for ESAs in order to channel funding. For example, the Dutch Ministry of Foreign Affairs stated in their response to the survey conducted for this study that 25% of their total overseas development assistance flows are channelled through NGOs. They indicated their extensive experience in providing funding for micro and mesofinance, in general, and to

## Box 21. REGMIFA – Regional MSME Investment Fund for sub-Saharan Africa

REGMIFA is a debt fund which focuses on refinancing regulated and/or non-regulated MFIs, local commercial banks and/or other financial institutions (referred to as partner lending institutions or PLIs) that are established in sub-Saharan African countries and provide funding to MSMEs. It provides its partner lending institutions with longer-term senior loans, subordinated debt and guarantee schemes, the majority of which are in local currency.

REGMIFA was created as an initiative arising from the G8 summit that took place in Germany in 2007. The G8 endorsed the idea of establishing an investment fund for the promotion of MSMEs in the sub-Saharan region. KfW, supported by the German Ministry for Economic Cooperation and Development, took the lead in developing this initiative in close collaboration with a group of 10 other development finance institutions from Spain, Belgium, Austria, France, and Norway as well as the EIB and the IFC.

REGMIFA was launched in May 2010 and is based in Luxemburg. Its mission is to build a unique PPP between donors, development finance institutions, private investors and African stakeholders to provide financing to qualified and PLIs serving MSMEs. In pursuing its development goal, the Fund observes the principles of sustainability and additionality, combining public mandate and market orientation.

REGMIFA has a unique capital structure (with three types of shares available to investors, each with its own risk structure) which embodies the principle of PPP through the leveraging of public funds as a risk cushion to attract significant private sector capital to sub-Saharan Africa. In addition to the investment fund, a dedicated TA facility focuses on practical implementation assistance to client institutions and on capacity building.

Source: <http://www.regmifa.com/presentation/strategy>

WATSAN, in particular. This they always do through partner organisations (e.g., by establishing revolving funds). In the WATSAN sector, they have a long-standing relationship with BRAC in Bangladesh and are also the main funders of the FINISH partnership, developed with the support of WASTE, a Dutch NGO with expertise in designing WATSAN programmes using micro and mesofinance (see Box 20).

International NGOs are also used extensively by foundations (such as the Bill & Melinda Gates Foundation, the Michael and Susan Dell Foundation and the PepsiCo Foundation) for channelling funding to MFIs. For example, the PepsiCo Foundation has channelled funding through Water.org, the

only WATSAN NGO that has developed a specific initiative, WaterCredit, expressly focused on supporting MFIs to develop their WATSAN lending activities.

Channelling funding through an international NGO or charity can be attractive as many international donors have already established links with such organisations. However, still relatively few existing international NGOs have extensive successful experience with running microfinance and mesofinance schemes for WATSAN. There would, therefore, be a need to build their expertise in this area, develop and pilot-test successful models before channelling substantial amounts of funding for these purposes. Many NGOs with

good credentials in WATSAN lack financing expertise, whilst international NGOs involved in microfinance have limited knowledge of the water sector. A few, such as CARE, have tried to combine both based on their experience with village savings and loans schemes.

### **Multi-donor trust funds**

Another channel at the international level consists of multi-donor trust funds. Many respondents to the survey of EU donors referred to the WSP or the GPOBA as their channels of choice for reaching WATSAN SSF recipients. For example, WSP is currently running a multi-year programme supporting the development of the domestic private sector. This organisation can be used to fund the soft side of facilitation support as well as *ex post* subsidies (such as output-based subsidies to service providers in the case of GPOBA).

However, such funds are usually not specialised in micro or mesofinance nor focused on WATSAN, but have other objectives. As a result, they would themselves need to identify either international or domestic intermediaries in order to provide funding to WATSAN SSF recipients (e.g., channelling funding to local MFIs).

### **Microfinance investment vehicles (MIVs)**

MIVs are private entities which act as intermediaries between investors and MFIs. MIVs receive investments generally from IFIs by issuing shares, units, bonds, grants, equity investments or other financial instruments. These resources are then pooled and sometimes blended to provide efficient and targeted financial support to MFIs, such as debt, equity or guarantees (not grants, in general, as such MIVs are commercial investment vehicles). The diversity of MIVs (self-managed or not, profit seeking or not, investing in individual MFIs or in other MIVs) makes it possible for many different types of investors to become involved in the SSF sector. As for the recipients of their funding, they range from direct investment in individual MFIs to investments in other MIVs.

According to Latortue (2006), Profund, created in 1995, was the first microfinance investment fund. It was joined in the following years by a handful of others, such as Dexia, Oikokredit and Unitus. The number of such funds rose to 60 in 2006, with the creation of many such MIVs being supported by international donors. The total amount of funds that they manage stood at USD 1.5 billion in 2006 and has been growing over the last few years.

MIVs operate at the international level across different countries. They make use of different currencies and are profit seeking, although with varying expectations in terms of their return on investment. In this role as an intermediary investment vehicle, MIVs are growing rapidly in nearly every aspect including total assets, assets devoted strictly to microfinance, and regional funding. MIVs differ from Apex institutions in a variety of ways. MIVs are a means of pooling finance flows from various types of investors who are looking to invest in microfinance, but are not set on a specific country. In contrast, Apex institutions are on the receiving end of financial flows; they do not provide finance directly, but instead channel the funds they receive to MFIs in a given country.

Depending on the type of MIV, the investments they provide to MFIs can be as debt, equity or guarantees. An example of an MIV recently set up with European donor support is REGMIFA, a regional investment fund supporting the development of micro, small and medium enterprises (MSMEs) in sub-Saharan Africa. Although it could act as a very useful channel for mesofinance to WATSAN entrepreneurs, it has yet to be used for this purpose.

### **Overall assessment**

Even though some of the financial channels presented above are not currently much in use in the WATSAN sector (such as MIVs), their use could be expanded in the context of an expansion of the financial offerings to the WATSAN sector. Such development is likely to require initiatives at the level of individual ESAs as well as concerted actions.

## Annex A. Overview of the SSF market in Kenya

A supporting study was carried out in order to understand the extent to which local financial institutions provide financing to small-scale WATSAN providers in the specific case of Kenya. This study updates and expands on an earlier study conducted for GIZ in 2007 (Biesinger and Ritcher, 2007) which examined similar issues.

Using largely a qualitative research approach, MicroSave Consulting Ltd (based in Nairobi), identified and surveyed financial institutions including MFIs and commercial banks actively involved in financing the WATSAN sector. The full study contains the following components:

- An overview of the WATSAN sector in Kenya;
- An analysis of what financial services DFIs provide to the WATSAN sector and how such services fit in the broader range of products the financial institutions offer to their customers;
- An analysis of the extent to which donor support might be required in order to encourage these financing institutions to offer their services to WATSAN SSF recipients.

### The WATSAN situation in Kenya

With a population of 48.6 million people, the majority of which live in rural areas, Kenya faces challenges to meet the MDGs with regard to access to clean water and improved sanitation. In 2007, approximately 62% of Kenyans had access to water; compared to the less than one-half (48%) who had access to improved sanitation services.

As Kenya is a water scarce country, there is a need for an effective water management regime, hence the enactment of the Water Act 2002 which provides for regulation and management of water and sewerage service provision. The regulatory regime has encouraged the participation of small

water service companies and community based water groups. It is estimated that 60% of the population in Nairobi (the majority living in unplanned settlements) relies on water services from small-scale providers (Mehta et al., 2007). Overall, in excess of 77% of the households in the country rely on streams or water from boreholes. UNICEF (WHO/UNICEF, 2008) estimated that a total of 16 million Kenyans used unimproved water sources.

### Financial services in Kenya: development and outreach

Kenya has a fairly vibrant financial sector. Kenya is considered to be the financial hub of the east and central Africa region, with a stable banking sector (43 banks and one mortgage company) and a long history of SACCOs, MFIs and informal savings mechanisms. In the last decade, the government has made concerted efforts to attract investments through tourism promotion, tight banking regulations (e.g. gradual increase of capital requirements) and privatisation of public enterprises e.g. sale of public shares in the telecommunications and energy parastatals.

However, access to formal financial services remains low. A study by the Financial Sector Deepening Trust, supported by DFID, showed that only about 40.5% of the adult population has access to formal financial services in Kenya. Access to financial services has been on the rise, however, with rapid expansion of a bank branch network, improved regulation of MFIs and provision of services through mobile phones. This is especially true of the M-PESA money transfer services offered by Safaricom – a mobile telephone service provider partially owned by the Vodafone group, which has grown extremely fast in recent years.

## Financial institutions and products on offer to the WATSAN market

There is a disproportionate emphasis on financing water services as opposed to sanitation in Kenya. The study found that financial institutions have developed financial products for water both for individual customers and community based groups. The financial institutions interviewed for this study offer small loans for water-related enterprises and irrigated agriculture. Few financial institutions had specific financial products targeting the sanitation sector, however. It appears that financial institutions find it easier to provide financing for water-related assets compared to sanitation. In addition, there are many donor funded projects, for example, Kenya Water and Health Organisation, focusing on water which financial institutions can partner with to deliver services.

MFIs are offering small loans for plastic water tanks. Pioneering MFIs in this segment included Faulu Kenya DTM Ltd, Kenya Women DTM Ltd, SMEP DTM Ltd and ECLOF Kenya, among others. Nowadays, commercial banks focusing on low-income households, including Equity Bank, Family Bank and K-Rep Bank, also provide small loans to their customers to purchase water tanks. The water tanks are generally used to harvest rain water and/or water storage for those accessing piped water. The financial institutions facilitate access to these tanks in partnership with tank manufacturers and/or distributors. Since the financial institutions provide an opportunity for bulk purchase, water tank manufacturers offer as much as 40% discount to financial institution customers.

The second financial product on offer in the market is project finance. Financial institutions finance individual or community based WATSAN projects. While the main financial institutions in Kenya offer project financing in some form, few offer project financing to WATSAN projects. In the K-Rep Bank, water projects, and in the Family Bank, sanitation projects are managed under special project departments. In the Equity Bank, water-related projects are financed across a range of different products, for example, asset finance to purchase

trucks or agriculture financing to purchase irrigation equipment. There is a perceived need to mainstream such special projects into the overall activities of the financial institutions, as many of these types of financing were initially developed as pilot projects.

Overall, the financial institutions interviewed indicated that they provide financial products for WATSAN in some form. However, these are spread across different products and the financial institutions do not particularly monitor the size of their WATSAN portfolio. Going forward, it would be important to support financial institutions to separate out and monitor their interventions in the WATSAN sector. Such support could help financial institutions with their product development and marketing activities, in order to measure the performance of the WATSAN portfolio, collect client feedback and assess the outcomes of interventions to facilitate the country's progress toward meeting the MDG targets.

## Key WATSAN financing programmes in Kenya

The study identified two key financial institutions involved in WATSAN projects.

K-Rep Bank Ltd has developed a financing model in partnership with GPOBA and WSP. The K-Rep Bank model pilots and demonstrates the viability of leveraging microfinance to improve access to a water supply for low-income people in Kenya. The project involves the identification of CWPs and financing of up to 80% of the cost of infrastructure development following a market driven project assessment and lending appraisal process. The model includes an output-based subsidy arrangement whereby up to 40% of the loan amount is paid to the project upon meeting specific targets. The subsidy component seeks to increase the sustainability of the community managed water supply project. The subsidy is used to offset part of the loan.

Starting with an initial US 1.1 million for the pilot, the bank has since committed USD 4 million to scale up the project

nationwide to meet increasing demand, as confirmed by more than 19 unsolicited project proposals from community based water projects across Kenya.

On a smaller scale, Family Bank Ltd, in partnership with Practical Action, is implementing a project in one district to provide loans to owners of rented houses to improve toilets and solid waste management.

### **Status and role of donor support to financial institutions**

Few financial institutions interviewed indicated that they received any donor support to extend financial services to the WATSAN sector. Where such support was provided, for example, in the cases of K-Rep Bank and Family Bank, the financial institutions viewed these as special projects or pilots.

Donor organisations do not seem to show a particular preference for supporting the financial institutions to expand services to the WATSAN sector. The donor organisations have used a mix of approaches, including a combination of grants and guarantee schemes in the case of the K-Rep Bank/GPOBA project, a guarantee scheme in the case of the Family Bank/Practical Action project and capital grants and guarantees in the case of Homeless International and the CLIFF projects.

It is clear that for projects that have received some donor support, this has contributed to expanding their outreach by designing the project as community based. This seems to have a better potential to reach many households as compared to small loans provided to individual clients by MFIs and microfinance banks, especially for water tanks. Donor support is clearly very important for MFIs and microfinance banks to scale up financing to the WATSAN sector.

Donor support is needed for market development and improvement of the financial institutions' capacities to engage with the water sector actors. MFIs have tight cash flows hence they need to access loan funds to expand their operations in the WATSAN sectors. Banks, on the other hand, do have capital, but need to manage risks related to lending to new market segments; hence the need for guarantees and appropriate collateral arrangements with borrowers.

While the K-Rep Bank–GPOBA project has demonstrated the viability of leveraging mesofinance to finance water service infrastructure, it remains unclear how the model may be used in promoting improved sanitation services in Kenya. Nonetheless, the project is an important example that both financial institutions and donors can learn from. Donors should be encouraged to establish such inclusive partnerships to improve funding to the WATSAN sector.

## Annex B. Glossary: financial terms relative to SSF

The companion EUWI-FWG publication *Financing for Water and Sanitation: a Primer for Practitioners and Students in Developing Countries* includes an extensive glossary of financial terms. The glossary below complements this and focuses on terms particularly relevant to small-scale financing.

**Angel investors.** Angel investors are individuals who invest in businesses looking for a higher return than they would expect from more traditional investments. Many are successful entrepreneurs who want to help other entrepreneurs get their businesses off the ground. Usually they provide a bridge between the self-funded stage of the business to the point where the business needs a level of funding that a venture capitalist would offer.

**Apex institution.** An Apex institution is an institutional mechanism operating within a single country or integrated market to channel funds, with or without TA or other supporting services, to a significant number of retail MFIs that, in turn, disburse loans to low-income people. Apex institutions are usually funded with public money, but they take various institutional forms, such as development banks, NGOs, donor programmes, private commercial banks and special government or donor programmes. They may otherwise be known as second tier banks or national funds. Apex institutions permit donors to pass the difficult and time-consuming task of MFI selection to a local institution that is assumed to have the requisite skills and to be politically independent. Funding is redistributed to MFIs with or without TA for improving operations.

**Blending finance.** Blending grant and loan financing is often useful to soften the overall terms of a financing package. This financial mechanism can make water infrastructure projects

with a delayed or drawn-out financial return more viable. A number of blending platforms exist in which grant and loan funds from various sources can be combined.

**Capital adequacy ratio (CAR).** The ratio of a bank's capital to its risk. National regulators track a bank's CAR to ensure that it can absorb a reasonable amount of loss and complies with statutory capital requirements.

**Collateral.** Collateral refers to any type of assets pledged by a borrower that may be seized by the lender to recover the value of a loan if the borrower fails to meet the required interest charges or repayments. It is a protection for a lender against a borrower's default.

**Commercial bank.** A financial institution that provides banking services, such as taking deposits and providing credit facilities and loans. Commercial banks differ from retail banks as they execute transactions not only with individuals, but also with small businesses and corporations. Commercial banking activities also differ from investment banking activities, which include underwriting, facilitating mergers, etc.

**Commercial loan.** A loan extended by commercial banks or development finance agencies at commercial rates, i.e. interest rates that reflect market conditions.

**Community based organisation (CBO).** CBOs are non-profit societies created by communities to address local needs. They are governed by volunteer boards of directors and staffed by paid personnel. Some CBOs are also supported by volunteers. If some CBOs are self-funded, many of them receive funding from a variety of sources, including grants, donations, fees, fundraising and government subsidies.

**Concessional loan (or 'soft' loan).** A loan provided on concessional lending terms, which may include a lower interest rate (than the market rate), a longer repayment period or a grace period. The IFIs providing soft loans can do so either because they benefit from direct subsidies or are able to access market finance at better conditions than traditional banks (thanks to a high credit rating).

**Equity investments.** Equity investments are a form of finance in which investors take an 'equity stake', which means that they purchase shares in an entity. This enables them to share the risk of that entity (through fluctuations in the share price) in return for the prospect of sharing its profits (through dividend payments). The higher the investment risk, the higher the expected level of return.

**Foundations.** Foundations are non-profit public or private organisations addressing development issues. They provide grants to support specific development research or projects in developing countries. They would often select the types of areas and challenges they are targeting. For example, the Bill & Melinda Gates Foundation has recently announced that it will focus on the sanitation sector, whilst the Stone Family Foundation is launching a competition for innovative water projects.

**Grace period.** A period during which no interest payment is due on a loan. This period usually takes place immediately after the loan has been received. Such a grace period can be particularly useful for WATSAN investments which are usually made up front and only generate a stream of revenues (necessary to repay the loan) over time.

**Grant.** A grant is a form of development aid without repayment obligations. Grants might be untied or carry explicit or implied political and commercial obligations. Grants are usually provided by IFIs, governments, foundations and specific funds with different policies, procedures and technical products. A grant can be blended with other kinds

of finance to produce a suitable financing package for a particular project.

**Guarantee.** A guarantee is a contract by a third party (C) to underwrite a financial commitment entered into by two parties (A and B). Guarantees can be used by national governments to reduce the risks of borrowing and bond issues by their sub-sovereign bodies and by international agencies to increase the creditworthiness of developing country institutions and support specific projects within them. Common types of guarantees for large projects are Political Risk Insurance, Partial Credit Guarantee and Partial Risk Guarantee. Those types of guarantees would not typically be used for SSF recipient however.

**Informal sector.** Economic activities that are not recorded by the state, regulated by labour or taxation laws or monitored for inclusion in gross domestic product estimates. The informal sector may include, for example, water sellers, street vendors, buskers, shoe-shiners, etc.

**Institutional investor.** Institutions, such as an insurance company holding the savings of others, which are able to invest in bulk in suitable outlets.

**Leasing.** Leasing is a contract, which enables one party (the lessee) to have the right to use equipment by paying small instalments to the party that owns the equipment (the lessor).

**Leveraging.** Using an injection of finance to induce other contributions and thereby generating a multiple of the original amount. It can also refer to the ratio of debt to equity in a company's capital structure.

**Mesofinance.** Mesofinance deals with the financing requirements of small businesses (e. g. small-scale WATSAN providers) that are not covered by large or international banks. These needs can range between USD 2000 and USD 100,000.

**Microcredit.** Microcredit refers to small loans for borrowers (up to roughly USD 2000, but more frequently in the range USD 50 to USD 250) with little or no collateral. Microcredit is typically provided to micro entrepreneurs for income-generating activities, but can also be provided to households for home improvement.

**Microfinance.** Microfinance typically refers to schemes for extending credit, savings, insurance, money transfers and other financial products to small-business, farmers and other low-income borrowers who cannot get access to normal bank loans.

**Microfinance institution (MFI).** An MFI is an organisation that provides financial services to clients who are poorer and more vulnerable than traditional bank clients. Most MFIs started as not-for-profit organisation, like NGOs, credit unions and other financial cooperatives, and state owned development and postal savings banks. An increasing number of MFIs are now organised as for-profit entities, often because it is a requirement for obtaining a license from banking authorities to offer savings services.

**Micro investment vehicle (MIV).** MIVs are private entities which act as intermediaries between investors and MFIs. MIVs receive investments generally from IFIs by issuing shares, units, bonds, grants, equity investments or other financial instruments. These resources are then pooled and sometimes blended to provide efficient and targeted financial support to MFIs, in such forms as debt, equity or guarantees. The diversity of MIVs (self-managed or not, profit seeking or not, investing in individual MFIs or in other MIVs) makes it possible for many different types of investors to become involved in the SSF sector.

**'Missing middle'.** This expression refers to a market segment made up by small-scale entrepreneurs who cannot access the traditional commercial market funding and whose financial needs are above the lending capacity of MFIs.

**Multi-donor trust fund (MDTF).** A MDTF pools donors' resources in a single trust fund account for a developing country, region or sector. Generally a trust fund committee composed of representatives from all contributing donors and sometimes national authorities oversees the use of the MDTF's resources. For donors, the MDTF is a funding channel for countries or projects in which they would not otherwise have become engaged. For water projects, MDTF can enhance aid effectiveness by reducing transaction costs and mitigating and managing the high risk levels inherent in SSF.

**Output-based aid (OBA).** OBA is grant aid offered for specific projects or programmes, which is not disbursed until the recipient can demonstrate that the project is successfully completed and the ongoing provision of services is independently verified. These types of results-based subsidies have been used extensively in the telecommunications or energy sectors, and to a lesser extent in the WATSAN sector.

**Repayable finance.** Repayable finance refers to sources of finance that ultimately need to be repaid, such as loans, microfinance, bonds or equity.

**Revolving fund.** A revolving fund mechanism is one where funds are revolved, i.e. loan repayments and interest earned are used to provide new loans. The interest covers administrative costs and helps prevent the fund from being depleted as a result of such factors as inflation, non-payments and the cost to the lender of getting outside finance. The initial supply of lending capital usually comes from the public sector (IFIs, development banks, national governments, etc) and the funds might be used to extend small loans to households or entrepreneurs. The repayment of the loan, together with interest, is used to replenish the fund and make further loans. In this way, the fund revolves in that borrowers' repayments are used to finance later loans.

**Savings group schemes.** A savings group scheme enables members of the group to save small amounts and rotate the available funds to group members for investment. There are several types of savings group schemes, depending on the number of people served, the amounts of savings and the credit options available to their members, as described below.

- **Rotating savings and credit association (ROSCA).** The ROSCA method is the simplest and most widely used type of savings group. An informal association of 8–15 participants makes daily contributions to a common fund which is given, in whole or in part, to each contributor in turn. Given that the money is redistributed at the same time that it is collected, no record keeping skills and money storage facility are needed. Once a member has received the funds, they must continue to contribute, but will not receive the lump sum again until all the members have had a chance of receiving it once. ROSCAs serve both loan and savings needs for small investments.
- **Accumulating savings and credit association (ASCA).** The ASCA is a more flexible form of informal savings group. The contributions collected at each group meeting are accumulated rather than redistributed at the end of each meeting (as in a ROSCA). With the large amount of savings accumulated over time, the group can lend to its members free of interest or with interest. Interest earned on loans can become income earned for savers (stakeholders of the loans) adding an incentive for a member to maintain their savings with the group. ASCAs serve both savings and credit needs in a flexible way. Credits are used for expected expenses (marriage, education), unexpected emergencies (accident, fire) and investment (such as for a water tank or buying a cow).
- **Savings and credit cooperatives (SACCO) or Credit unions.** A credit union operates like an ASCA, but serves a much larger membership (from a low of 100 to several thousand) and offers a wider range of savings and credit services to its members, who are not reached by local commercial banks. Credit unions are formal institutions and usually chartered under the cooperative or credit union law of the respective

country. Credit union funds are also normally kept in a bank for safekeeping. Members are free to come to the credit union office anytime during office hours and no regular attendance at meetings is required. They can operate individual accounts, make savings deposits and withdrawals, earn interest on their savings and pay interest on loans they take from the credit union.

**Seed financing.** Seed financing refers to the injection of the initial equity capital provided to start a new enterprise or as a basis for attracting commercial finance. It can also refer to the initial funding provided to a revolving fund or a lending scheme. Money used for initial investment in a project or start-up company, for proof-of-concept, market research, or initial product development is also called seed financing or seed money.

**Self-help group (SHG).** A SHG is a locally-based financial intermediary usually composed of 10 to 20 local women. Members come together on a voluntary basis to regularly save small sums of money, contributing to a common fund. When there is enough capital in the group, funds are then lent back to members to meet their consumption or business needs. The group members use collective wisdom and peer pressure to ensure proper end-use of credit and timely repayment. SHGs are widely used by MFIs and commercial banks as intermediaries for the delivery of microcredit. Unlike ROSCAs, SHGs receive loans from formal banking institutions to supplement their resources.

**Small-scale finance (SSF).** SSF is defined as financing below approximately USD 100,000. It covers both microfinance (including small loans below a few thousand Euros) and mesofinance, particularly to SMEs.

**Small-scale finance (SSF) recipient.** SSF recipients include small-scale WATSAN service providers, ranging from households, small-scale independent providers (SSIPs), SMEs, to equipment providers, CBOs, NGO user committees and local governments. These may also include small utilities when those do not have access to standard financial channels.

**Small-scale independent providers (SSIPs).** SSIPs are typically self-employed entrepreneurs who provide water supply and/or sanitation services to a segment of the population. SSIPs often play a key role in low-income neighbourhoods not serviced by municipal networks as well as in smaller towns where municipalities are not providing adequate water supply and sanitation services.

**Smart subsidies.** Smart subsidies are subsidies that are transparent, rule-bound and time-limited. With respect to microfinance, smart subsidies refer to subsidies provided to financial institutions to develop financial products that target the poor, through soft funding for market research, product development or staff training.

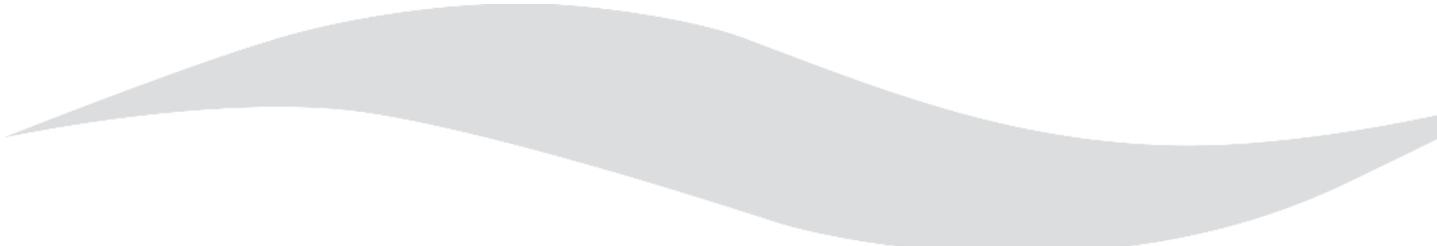
**Social performance.** Social performance is defined by the Social Performance Task Force as, "The effective translation of an institution's mission into practice in line with accepted social values." Commonly accepted social values include providing financial and/or non-financial services to greater numbers of poor and excluded people, improving the quality and relevance of services already being offered, reducing poverty, creating certain benefits for clients (e.g. increased revenue from their businesses, greater sense of empowerment, decreased vulnerability), and improving an MFI's impact on the environment or the community.

**Subsidies.** A subsidy is a grant given generally by the government to economic actors in various forms, such as a cash transfer, a tax reduction or inputs at lower prices (such as free land). A subsidy can be given to economic actors as

an incentive to deliver goods and/or services that benefit society. A subsidy can also be provided to households below the poverty line to enable them to access basic goods and services. Subsidies are sometimes provided to support utility infrastructure projects and may include 'hardware subsidies' (to reduce the initial capital investment costs), 'operating subsidies' (to cover losses incurred during service operation) or 'software subsidies' (to cover the software costs associated with infrastructure development, such as for project preparation, capacity building and training).

**Sub-sovereign financing.** Financing provided to sub-sovereign levels of administration, including regional and state governments, municipalities, and specialised infrastructure financing agencies (such as utilities). The financial standing of these sub-sovereign institutions is crucial to enable them to attract loan financing. They may need a central government guarantee in order to do so at affordable lending rates.

**Tariffs.** Tariffs are payments made by users of WATSAN services for access to and use of the services. A number of additional charges may be payable to the service provider, such as meter rental, penalty charges (for late payment or tampering with the meter), etc. Cross-subsidies, i.e. tariffs paid by other user groups or users of other services (e.g., users of electricity services when the two services are combined) are included in 'tariffs'. When the service is self-provided (e.g., when a household builds and operates their household latrine), the equity invested by the household (in the form of cash, material or time – 'sweat equity') would also fall under 'tariffs' as defined by the OECD.



**Taxes.** Taxes refer to funds originating from domestic taxes which are channelled to the sector through transfers from all levels of government, national, regional or local. Such funds would typically be provided as subsidies for capital investment or operations. 'Hidden' forms of subsidies may include tax rebates, soft loans (i.e. at a subsidised interest rate), transfers from local government, housing taxes, donations, subsidised services (such as subsidised electricity) or 'dormant' equity investments.

**Transfers.** Transfers refer to funds from international donors and charitable foundations (including NGOs, decentralised cooperation or local civil society organisations) that typically come from sources external to the country, i.e. are contributed by tax payers or individual donors in other

countries. These funds can be contributed either in the form of grants, concessionary loans (i.e. loans that include a 'grant' element in the form of a subsidised interest rate or a grace period) or guarantees.

**Utilities.** Utilities are agencies that are responsible for providing networked public services, such as water, sewerage or electricity. They may be either public or private.

**Water and sanitation (WATSAN) services.** Refer to all water services provided through manmade capital that deal with the supply of drinking WATSAN services. This includes piped and non-piped water services, as well as on-site and networked sanitation.

## Annex C. Useful resources

### C.1. Useful websites

#### On microfinance

**<http://www.cgap.org>** – CGAP is an independent policy and research centre dedicated to advancing financial access for the world's poor. It is supported by over 30 development agencies and private foundations who share a common mission to alleviate poverty. Housed at the World Bank, CGAP provides market intelligence, promotes standards, develops innovative solutions and offers advisory services to governments, financial service providers, donors, and investors.

**[www.microfinancegateway.org](http://www.microfinancegateway.org)** – A service of CGAP, the Microfinance Gateway is possibly the most comprehensive online resource for the global community dedicated to advancing financial services for the poor.

**[www.themix.org](http://www.themix.org)** – The Microfinance Information Exchange (MIX) is a non-profit organisation established in Washington DC in 2002 with regional offices in Azerbaijan, India, Morocco and Peru. It is the leading business information provider dedicated to strengthening the microfinance sector. The organisation's core focus is to provide objective data and analysis on microfinance providers and, more specifically, financial and social performance information. Services include collection and analysis of data, creation of best practice and standards for the microfinance industry. The MIX has a social performance assessment tool.

**[www.mixmarket.org](http://www.mixmarket.org)** – This website is managed by MIX and supported by international organisations and charitable foundations interested in microfinance. MIX provides objective, qualified and relevant performance information on MFIs, funders, networks and service providers dedicated to serving the financial sector needs for low-income clients. MIX

market provides instant access to financial and social performance information covering approximately 2000 MFIs around the world. It is an informative and user-friendly website which provides an instant picture of which MFIs are active in a given country.

**<http://www.sptf.info>** – The Social Performance Task Force (SPTF) consists of over 1000 members from all over the world and from every microfinance stakeholder group. It includes practitioners, donors and investors (multilateral, bilateral and private), global, national and regional associations, TA providers, rating agencies, academics, researchers and others. The SPTF's mission is to engage with microfinance stakeholders to develop, disseminate and promote standards and good practices for social performance management and reporting. It will achieve this by:

- Providing a platform for dialogue, learning and collaboration;
- Working toward setting industry standards for social performance management, measurement, monitoring, reporting and training;
- Promoting good practices and the demonstrated successes of MFIs engaged in social performance management;
- Gathering quality evidence and research to demonstrate the business case for social performance management.

**<http://www.e-mfp.eu>** – The European Microfinance Platform (E-MFP) is a network of European MFIs promoting cooperation between members working in developing countries, by facilitating exchange of information and capacity building. It organises an annual conference and supports research initiatives, including research on issues such as sustainability and targeting the poor.

**<http://www.ruralfinance.org>** – The Rural Finance Learning Centre is a website assisting organisations in developing countries to build their capacity to deliver improved financial services which meet the needs of rural households and businesses.

**<http://watercredit.org>** – WaterCredit is an initiative of Water.org that puts microfinance tools to use in the WATSAN sector. The WaterCredit.org website has been designed with different types of stakeholders in mind; MFIs, sector experts, catalytic philanthropists, social investors and commercial banks. It provides information on the WaterCredit programme as well as background on how microfinance can be used to boost access to WATSAN.

**<http://financialaccess.org>** – The Financial Access Initiative is a consortium of leading development economists focused on substantially expanding access to quality financial services for low-income individuals. Launched with a USD 5 million grant from the Bill & Melinda Gates Foundation in late 2006, the Initiative is housed at the Wagner Graduate School of Public Service, New York University. The website contains a wealth of articles and publications on increasing access to financial services for poor people.

#### **On WATSAN**

**[www.euwi.net/wg/finance](http://www.euwi.net/wg/finance)** – The European Union Water Initiative (EUWI) was launched at the Johannesburg Summit in 2002 to create the conditions for mobilising all available EU resources (human and financial) and to coordinate them to achieve the water-related MDGs in partner countries. The website presents EUWI's activities and contains an extensive library of water-related resources prepared with EUWI support, including the activities of the FWG.

**[www.gwp.org](http://www.gwp.org)** – The Global Water Partnership (GWP) was founded in 1996 by the World Bank, the United Nations Development Programme, and the Swedish International Development Cooperation Agency (Sida) to foster integrated water resource management. The website presents GWP's activities and contains all GWP supported publications.

**[www.sharesearch.org](http://www.sharesearch.org)** – SHARE is a consortium of five organisations which have come together to generate rigorous and relevant research for use in the field of sanitation and hygiene. SHARE is a five year initiative (2010–2015) funded by DFID. The website contains sanitation sector news and reports relative to research supported by SHARE.

**[www.wsp.org](http://www.wsp.org)** – WSP is a multi-donor partnership created in 1978 and administered by the World Bank to support poor people in obtaining affordable, safe, and sustainable access to WATSAN. The website contains a wealth of research reports and technical notes on programmes conducted by WSP, including for example on the K-Rep experience.

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