



# Microfinance for water supply services

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## Introduction

Microfinance is topical because it can make an important contribution to the achievement of the Millennium Development Goals (MDGs). Used properly, it can help to reduce income poverty, lessen the vulnerability of the poorest and empower women. For the water sector, it can help the poor to have access to water services.

Microfinance has existed for centuries around the world, including Africa, but 2005, the UN year of microcredit, was instrumental to inform and advocate for microfinance. Mainstream banks such as Citigroup, Deutsche Bank, Credit Suisse, the Brazilian Unibanco and ICICI Indonesia have now found out that the poor, like everyone else, attach great value to being able to save and to face unexpected expenses.

Historically, microfinance has focused on other sectors (such as trade, small scale producers). As the topic of financing water supply services has moved up the policy agenda, it has received considerably more attention in recent years within the water sector.

This factsheet explores examples of microfinance for the water sector. For additional information, readers are advised to consult the WELL Factsheet on microfinance for sanitation, and the WELL Briefing Note 16 on local financing mechanisms for water.

## What is micro-finance

In most developing countries, financial services such as bank loans, insurance, and pension funds are not accessible by the poor. When some forms of credit are available, these are often limited to either community savings groups or informal money-lenders that charge very high interest rates, reflecting the lack of a formal market.

Microfinance means literally that the amount of finance provided is small, and it has been defined as the provision of diverse financial services to low-income people. However, there is not one agreed definition of the term, which can mean anything from community based revolving funds to the products offered by affluent banks to specific clients (and who are not necessarily the poorest).

The term itself is becoming obsolete and “building inclusive financial systems for the poor” is increasingly used as the financial institutions that provide financial services to the poor become more diversified and cannot be described as Microfinance institutions (MFIs)

The idea of small loans to the very poor was first explored in Bangladesh in 1976, when the Grameen Bank was created. Their strategy was to get around the problem of a lack of borrower guarantee's or collateral, by creating a solidarity group of five or so borrowers who could vouch for each others' loans. Because the borrowers all know each other, there is increased peer pressure to

repay. Grameen's experience revealed a very low rate of default on solidarity loans and repayment rates are greater than 90%.

Over the last 15 years, the microfinance market has grown despite the absence of specific financial sector policies. Nobody knows how many microfinance institutions, formal or otherwise there are now, but mainstreaming into the financial sector has taken place since the mid-1990s. Leading microfinance institutions around the world (such as FINCA, ACCION, ProCredit, Opportunity International) worked together to build performance indicators and standards for the financial services provided and many of them now have credit ratings as good as the formal finance institutions.

Historically, microfinance has not been available for financing water supply and sanitation activities, because these are not usually perceived to be sufficiently attractive. A long term is normally required for repayment and in some cases, there is no direct link with income generation. However, some microfinance institutions argue that the core blockage to increased microfinance in the sector is awareness of the business case for water supply projects (CREPA/IRC, 2006).

## **The need for Microfinance in water supply: beyond solidarity loans**

There are several examples following the Grameen Bank strategy of providing group loans for traditional micro-finance activities in the water sector. These tend to succeed in rural areas, but many argue that solidarity loans only work in rural settings or other situations where people and communities are very close with strong social networks. As businesses grow for some elements of the group, individual financing needs change. And once loans are repaid, the individual builds a credit history, so there may be no further need for collective guarantees.

The remainder of this section presents examples of how microfinance is used to support water supply services, for households, communities, independent providers/small utilities and municipalities.

### **Households and community based organisations**

As a result of cost recovery strategies and the need for community ownership of water systems, an increasing number of poor communities need to pay upfront, in cash, 10-20% of capital investments in water infrastructure. Usually, they need to save for a couple of years before they are able to pay for the required costs. Once the system is in place, funds are rarely available for paying for rehabilitations and major repairs.

To overcome the latter problem, both ASCI in Ethiopia and K-Rep in Kenya provide financial services to Community Based Organisations (CBOs) for water in rural areas. The CBOs have a separate account for community investments and make regular savings deposits which enable them to access funds for larger repairs and maintenance.

Another example where microfinance can help households to access water services is in peri-urban areas where the high lump sum costs of household connections normally have to be paid upfront to the water utility.

Microfinance can be essential in providing access to peri-urban households, as it is the case in Cote d'Ivoire where 300 households benefited from the micro credit provided by an NGO to pay the required connection costs to SODECI, the water company.

In three neighbourhoods of Abidjan CREPA Côte d'Ivoire, an NGO, partnered with SODECI, the public water utility, to enable poor households to connect to the network.

With grant funding from UNDP, CREPA first pre-financed the full amount (US\$36 each) of connection fees as a loan for all 300 households. At the same time, CREPA provided a capacity building program aimed at mobilizing household savings to repay the loan and ongoing water bills.

The micro loans were paid back in 17 months. This example is now being replicated in Ouagadougou but the credit is being managed by a microfinance institution

*Source: Kouassi-Komlan, E. and T. Gnagne, 2005.*

### Independent providers

Small-scale providers tend to lack access to credit, which would for example enable them to buy water storage facilities, or to buy and repair water tankers for transport. Borehole operators need finance to drill boreholes or build small water networks. Without such access, most operators rely on family or informal loans, limiting their potential for growth.

PAPME, a microfinance institution (MFI) from Benin, provides credit to clients who borrow money for buying pipes, taps and hoses. Likewise, CMFL, a Ugandan MFI, offers loans for the construction of wells both for households and urban entrepreneurs which resell water. CMFL considers the entrepreneurial activities of independent water providers as a business venture.

In Cambodia, GRET (an international NGO) provides guarantees on commercial loans for piped water systems in rural areas, in case of default of the investor. With a guarantee, the commercial bank can provide medium-term (3-5 year) loans for water supply, with lower collateral requirements and to entrepreneurs whose risk profile becomes lower with the guarantee.

### Municipalities and small utilities

Many municipalities are not allowed to access credit because of the legal framework or because they cannot obtain a credit rating (an independent assessment of the creditworthiness of a borrower) either because they are bankrupt or they do not have the resources to pay for the rating. This is a major constraint on their ability to provide water supply services.

As a result there is increasing interest from International Finance Institutions and bilaterals to support sub-sovereign lending and guarantees for the water sector. These need to be adapted to the local realities of countries with weak or non-existent financial markets.

There are a number of risks which constrain sub-sovereign lending, including those with relatively weak accounting and financial skills within utilities. Foreign exchange risks are also high, as tariffs are collected in local currency while the loan is all too often in foreign currency. Most IFIs and donors are unable to provide funding in local currency. Furthermore, capital requirements, even for smaller utilities, are more intensive than for independent or community service provision and the reliance on user fees for recovering costs is high. There is also the possibility for political interference in price setting as water tariffs is such a sensitive issue.

The Butwal municipality in Nepal, has adopted a cost sharing approach for water supply, whereby 80% of capital costs are paid by the users and 20% is provided as a grant from the municipality. However, the users pay their 80% on an instalment basis (1US\$ per month per household), over a period of time, agreed by the users themselves.

The municipality manages a Drinking Water Management Fund in which the loan paid back by the community is deposited. Transparency in the management of the fund proved to be critical for its sustainability.

*Source: WaterAid Nepal, 2005*

## Limitations of Microfinance in water supply

Many argue that making profits from the poorest is ethically wrong, even if the interest rates provided by MFIs are lower than those offered by informal money-lenders. However, for many donors, foundations and private investors, it is the notion of fairness that is appealing: the poor deserve to have access to financial services as much as those who have money.

However, there are several challenges to be addressed before microfinance can realise its potential, both in general, and in the water sector specifically.

In Kenya, only 10% of the population is estimated to have access to financial services. K-Rep bank (which was initially an NGO) has a portfolio of 90,000 borrowers and savers. The bank works with a range of poor individuals, community based organisations and non-poor clients.

Recently, K-Rep has started to develop a program to support low-interest loans for water sector investments, based on the following commercially-driven principle: if microfinance mechanisms can be used to support water sector investments, then individuals and communities – many of whom are already clients – will soon be able to use K-Rep for more banking services, which will have both commercial and poverty impacts.

*Source: ERM, 2005*

## Limited outreach of microfinance

In 2000, there were an estimated 30 million families worldwide with access to microfinance, of which 19 million were identified as very poor. Only 9% of the poorest families had access to micro credit in Asia and in Sub-Saharan Africa this number was around 6% (Daley-Harris, 2002).

The limited outreach of microfinance Institutions to the poorest in Sub-Saharan Africa can be partly explained by the fact that MFIs are relatively new here compared with Asia and Latin America. There are some exceptions, such as in Kenya, where MFIs are estimated to reach about 30% of the poor (1.8 million clients) mainly due to the cooperative credit sector. There remains a huge challenge therefore to scale up access to microfinance.

## Limited product diversification

Limited outreach is also linked with weak product development for the poorest clients. Most loans are designed for income generating activities. When loans are extended to other areas such as housing or education, the loan is expanded in use but there are not usually changes to the initial conditions of the loans (i.e. adapting loan cycles).

Microfinance provides an opportunity for more coordination of development services given its potential in combining health, nutrition, housing improvement and educational services. Water and sanitation is sometimes included in “improved housing” type products, but microfinance organisations do not have much information or are not aware on how to develop specific products for the water sector. Exceptions include loans for infrastructure, which are limited to capital investment (such as water storage facilities) with a certain short-term return.

MFI's have capacities and experience in managing credit, but many have limited capacities for understanding the nature of demand for water sector-related finance, or helping poor communities prepare projects that do not have a straightforward income generation component. Closely monitoring loan use and impact is also not part of a typical MFI's core competencies.

## Financial sustainability

The costs of providing microfinance are not cheap, given the small size of the financing demands, the increased need for follow-up during the loan cycles, and the resulting higher overhead costs. These costs are sometimes included in the loan, making interest rates too high.

A recent study on 163 Sub-Saharan MFIs (Lafourcade et. al, 2005) found that African MFIs are among the most productive globally measured by the number of borrowers and savers per staff member. Women represented 61% of borrowers among the reporting MFIs. The cost per borrower is higher than in other regions but the costs per saver are among the lowest. The average savings balance is USD 137 per client, lower than MFIs in other regions.

While many microfinance institutions claim they are sustainable and that loan losses are lower than the rate of defaults of big banks, many of these are non-governmental or not for profit organisations lacking transparent monitoring systems and with overheads that are highly subsidised by donors.

From a survey of 1,000 providers of microfinance and other initiatives in Sub-Saharan Africa, only 20 were estimated to be financially sustainable (Daley-Harris, 2002). Some of these organisations took five years to reach the break-even point. They survived with donor support, including soft loans or grants. But donors are calling for greater effectiveness, which means they will only fund loans and not all of the upstream work required to ensure the quality of the loans.

Another constraint relates to the regulatory frameworks within countries. These don't seem to accommodate more flexible financial frameworks that help poor people get access to financial services. Even if MFIs are efficient, good banking cannot do much with bad government. This limits the growth of MFIs by preventing private investors to explore the market.

## Recent trends

### From charity to business

An increasing number of new microfinance institutions are not the result of charities or NGOs created to serve the poor. Rather existing institutions are seeking new clients amongst the low-income segments that were previously seen as un-bankable and not credit worthy.

Because of its success and low default rate, the microfinance sector has become more diverse, with the entrance of several private commercial banks, finance companies, insurance companies, and many NGOs that have become regulated MFIs. Other changes have included modifications in banking regulations to better fit the needs of microfinance, such as the replacement of collateral requirements by demonstrating the credit worthiness of clients and simplifying reporting requirements.

### Increased competition

The increasing number of MFIs and other institutions providing microfinance is stimulating competition and leading to innovation, which increases the number of clients reached. While some MFIs complain that their best clients are now moving to formal banks who also provide microfinance, there is also an increased opportunity for other sectors which have been traditionally neglected in this sector, to advocate for and educate for, increased access to MFI. These include renewable energy and water and sanitation.

### Attracting private finance

Most formal banks in developed countries rely on rating agencies to attract investors. Rating agencies provide an “objective” credit benchmark that enables others to check and compare the performance, value, risk, etc. of a lending organisation.

Specialist rating agencies have recently emerged to meet the need for rating MFIs and quite a number of microfinance institutions have been rated ([www.mixmarket.org](http://www.mixmarket.org)). MicroRate, which was set up in 1996, has already rated 45 microfinance organisations (Economist, 2005). It is the MFI who pays for the rating, passing on the costs to the borrower. This trend reflects recognition from private investors that microfinance can be a profitable business.

### Diversification

In areas where group loans are maximized, a growing trend is to move away from group to individual loans to allow for more and faster borrowing. Instead of group peer pressure, a client’s credit worthiness is built up over time, with lenders then loaning larger amounts over longer periods.

Expanding lending to include savings schemes and micro-insurances also allows smaller MFIs to take deposits, build its capitalization, and lower the cost as well as increase the potential to access even more finance from larger institutions interested in microfinance. These include banks such as ABN Amro, Deutsche Bank and Citigroup.

BASIX, a microfinance institution in India provides basic life insurance as well as insurance against drought and loss of cattle. These products help to reduce vulnerability in case of a catastrophic loss, where previously, the poor would have been left with no safety net or recourse for rebuilding their livelihoods.

*Source: The Economist, 2005*

## Strategic partnerships to develop scalable solutions

Given increasing competition and a need to build new markets and expand a client base, some MFIs have sought strategic alliances with NGOs and other financial intermediaries. These offer the possibility of complementary skills to reach these markets, with lower running costs for the MFIs since these are supported by the financial intermediaries.

Institutions in the water sector such as NGOs and Resource Centres are not generally experts in credit provision, but are able to provide important inputs in support of finance. They can become financial intermediaries between MFIs and households or CBOs by: mobilising start-up funds for water and sanitation credit schemes, bringing in technical support for feasibility studies, training staff in participatory tools and helping in monitoring and improving processes and results.

Larger or regional NGOs are also able to reach and promote different finance mechanisms at rural level, through their networks but also to Associations of CBOs, increasing the potential outreach of MFIs.

Water Partners International (WPI) focuses on Strategic Partnerships to help bridge the MFIs and the traditional water sector NGOs. WPI provides financial support to MFIs to conduct pilot projects in the water sector and partners with them to equip them with expertise in the sector. WPI also provides NGOs with operations and credit training (by teaming them up with leading MFI banks in their region) in order for them to launch and manage microfinance operations.

WPI has started a pilot water micro-credit project with Basix Bank (a MFI) in India, providing a grant and a loan on soft terms so that Basix Bank can conduct market research and develop its own water and sanitation credit products, and then micro loan in a few test sites. There is a potential for 900 households to benefit from this specific pilot project. The short-term objective is to test whether or not water and sanitation projects are a bankable lending product for Basix. If the pilot is financially successful, then the ultimate goal of WPI's support is to enable Basix Bank to get commercial market funding to build its water and sanitation loan portfolio. This may come through credit guarantees from WPI or other financial methods to support Basix's lending in this sector. The goal for any MFI would be to achieve financial self sustainability in their water and sanitation portfolio. WPI also provides grants to NGOs to create the infrastructure to manage a revolving microfinance fund, and provides loans to these NGOs for on-lending to CBOs and individual households.

WPI believes that grants may be necessary for initial product development and capacity building, but eventually risk mitigation, credit enhancements and other bridge financing techniques will be employed to connect the formal private capital market to MFIs (and possibly to NGOs) to fund their WSS loan portfolios on commercial financing terms.

*Source: WPI, 2005*

## Conclusions

Microfinance has existed for some time as an add-on to water projects e.g. watershed development programmes in India where a revolving fund for various activities is usually a first step to generate social buy-in, and for the productive uses such as backyard gardening and livestock. But now, linked to cost recovery policies aiming to increase user's contributions, microfinance is being used to help pay for capital costs and to cover operation and maintenance costs.

Just as traditional finance mechanisms contributed to high debt levels in developing countries without substantial poverty reduction, microfinance for the water sector should not be considered a

panacea. Microfinance loans will need to be repaid, with interest. If an effective collection system is not in place, their effectiveness is doomed from the start.

Microfinance cannot transform a poorly planned or managed project into a good one. It can, however, help to address some of the different types of constraints of access to finance from households, CBOs, SSIP and municipalities.

Although microfinance may be one means to increase finance to the sector, non-financial measures are many times more critical than merely increasing finance. For instance, the illegal status of some peri-urban areas is a barrier for SSIPs to obtain credit and improve their services. Likewise, the requirement by most utilities for connection costs to be paid in one lump-sum remains a key barrier for increasing coverage to the poorest in urban areas.

Financial allocations need to be linked with empowerment and people's involvement. A few case studies have demonstrated that linking water and sanitation projects with productive activities and social marketing decreases the risk of non reimbursement of loans.

Linking microfinance with aid to leverage local resources has the potential to increase the outreach of aid. For example, donors can provide guarantees to enable small banks or cooperatives to provide microfinance to the water sector which otherwise would be considered too risky.

Financial intermediaries can pool together existing saving schemes from CBOs to aggregate small projects for possible economies of scale and to access more interesting microfinance products which can then be used for different needs of the communities.

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