**Financial Intermediaries: BD Rural Water Supply, Sanitation and Hygiene for Human Capital Development Project (P169342)**

**1.Macro-economic context**

The economy of Bangladesh has demonstrated remarkable resilience in the wake of the global financial crisis and a slump in global growth, attaining an average gross domestic product (GDP) growth rate of 6.5 percent since 2010, well above the average for developing countries – with an officially projected growth of 8.13 percent in fiscal year (FY) 2019, driven by manufacturing and construction. Progress on reducing extreme poverty and boosting shared prosperity through human development and employment generation has continued with the poverty incidence[[1]](#footnote-1) declining from 48.9 percent in 2000 to 24.3 percent in 2016 (latest available poverty data) and a projected 20.5 percent in 2019. With per capita gross national income US$ US$1,751 in 2018, it is well above the lower middle-income country category threshold which it crossed in FY14. Economic growth has been accompanied by a growing labor force, rapid urbanization, and an overarching need for job creation – that has led the country through a structural shift from traditional agriculture towards industry and the service sectors. Recent economic conditions have improved further with headline inflation declining to 5.9 percent in FY16 from 7.3 percent in FY14, while the fiscal deficit was contained at around 3.1 percent of GDP in FY16.

Bank lending and savings rates have declined constantly since 2013. The average spread – the difference between the weighted average lending rate and deposit rate – has been stable between 3.90-4.50 percent since June 2018 to January 2020. As of end-January 2020, the average savings rate was 5.69 percent and the average lending rate was 9.66 percent[[2]](#footnote-2).

**2. Financial Sector Context**

Bangladesh’s financial sector consists of the banking sector, world class microfinance institutions (MFIs), nonbank financial institutions, a capital market and an insurance sector. As in most economies, banks dominate the financial sector in Bangladesh with more than 55 percent of total assets, the capital market and the insurance sectors account for 40 and 3 percent of total formal financial sector assets, respectively. These are also equivalent to their share as a percentage of GDP.

The regulation and supervision of financial institutions is undertaken by several regulators including Bangladesh Bank (the banking sector), the Securities and Exchange Commission (SEC) of Bangladesh (the stock market), the Insurance Development and Regulatory Authority (IDRA) (insurance companies), and the Microcredit Regulatory Authority (MRA) (microfinance).

The MRA was established under the Microcredit Regulatory Authority Act 2006, to ensure transparency and accountability in the microfinance sector, and promote the sustainable and inclusive development of the microfinance sector. The MRA is the central body that is responsible for licensing, monitoring and supervising the operations of non-governmental microfinance institutions (NG-MFIs). The MRA undertakes on-site and off-site supervision. To maintain their license, NG-MFIs are required to comply with MRA regulations. To this effect, NG-MFIs are required to submit annual audited reports, semi-annual MIS reports and monthly reports on selected indicators.

As of end-June 2018, there were a total of 31.2 million clients in the 702 licensed NGO-MFIs providing microfinance services through 18,196 branches. Over the past five years, total loans outstanding have more than doubled to reach BDT[[3]](#footnote-3) 673.90 billion (US$ 7.93 billion). Cumulative savings amount to BDT 262.95 billion (US$ 3.09 billion), and total loan disbursed amount to BDT 1201.91 billion (US$ 14.14 billion). The loan recovery rate was 96 percent according to the MRA. The microfinance sector is highly concentrated, dominated by four NGO-MFIs, namely ASA, BRAC, BURO, and TMSS, which with Grameen account for about 64 percent of the MFI market. Their relative share has, however, recently declined.

At the reporting time MRA has set an interest ceiling of 27 percent for general microfinance lending which is now 24 percent for general microfinance. However, in practice, over 90 percent of loans charge an interest rate of 25 percent or below, with some institutions charging rates as low as 20 percent. Hence the ceiling does not appear to be a binding constraint.

About sources of funding, savings represent the largest source of funding, with a stable share of 35.4 percent. The share of funding represented by cumulative surpluses (34.8%) and bank loans (20.5%) has steadily increased, as the role of Palli Karma Sahayak Foundation (PKSF, the apex organization) and donors (as major funders) has progressively diminished.

**3. Project Summary**

The project development objective is to (i) improve access to ‘safely-managed’ water supply and sanitation in selected areas of rural Bangladesh; and (ii) strengthen sector institutional capacity for water and sanitation.

The focus would be on strengthening of sector institutions to help implement the national WASH policies, investing in WASH infrastructures that meet the ‘safely-managed’ services in line with SDG 6.1 and 6.2 in selected rural areas, and changing hygiene behaviors so that WASH infrastructures are properly used.

Department for Public Health and Engineering (DPHE) and Palli Karma-Sahayak Foundation (PKSF) will be the implementing agencies of the project.

To achieve the objectives, the project will support six components, financed by the Government of Bangladesh (GoB), Asian Infrastructure Investment Bank (AIIB), and World Bank. Pursuant to a Project Co-lenders’ Agreement with the AIIB, the World Bank will supervise the project and administer both IDA and AIIB loans in accordance with the World Bank’s policies and procedures. The total cost of the project is US$ 550.5 million; IDA finance US$200 million, Asian Infrastructure Investment Bank (AIIB), US$200 million. The AIIB and World Bank will jointly finance the project in equal shares, with all components financed jointly. The GoB will provide US$150.5 million in counterpart funding. Items not eligible for financing under the country financing parameter—such as vehicle, fuel, salaries, allowances to civil servants, and expenditures such as land acquisition, and resettlement (under Component 4)—as well as MFI loans to LEs (under Subcomponents 1.4 and 2.3) will also be financed from the counterpart funding which will flow to the project as parallel financing.

**Project Components:**

1. **Component 1: Investments in water supply**
2. **Subcomponent 1.1** will carry out investments in large piped water schemes to support safe water scarce communities through the build-operate (BO) model.
3. **Subcomponent 1.2** will carry out investments in small piped water schemes to support safe water scarce communities through the design-build-operate (DBO) model.
4. **Subcomponent 1.3** will provide MFI loans to households for their water facility improvements.
5. **Subcomponent 1.4** will provide MFI loans to local water entrepreneurs to respond to the household demand for certified water facilities and expand their business.[[4]](#footnote-4)
6. **Subcomponent 1.5** will carry out feasibility studies in high climate risk regions.
7. **Component 2: Investments in sanitation and hygiene**
8. **Subcomponent 2.1** will provide public sanitation and hygiene facilities in high pedestrian traffic locations (such as markets, bus stations) and community health clinics.
9. **Subcomponent 2.2** will provide ‘safely managed’ sanitation and hygiene facilities for households through MFI loans or sanitation grants.
10. **Subcomponent 2.3** will provide MFI loans to LEs to respond to the household demand for certified sanitation facilities and expand their businesses[[5]](#footnote-5) and provide training for MFIs on WASH loans and LEs on climate-smart design and proper installation and maintenance of ‘safely managed’ WASH facility products.
11. **Subcomponent 2.4** will promote innovation to localize innovative water, sanitation and hygiene (WASH) technologies, especially in fecal sludge management (FSM).
12. **Subcomponent 2.5** will support a behavioral change communication (BCC) campaign to raise WASH awareness.
13. **Component 3: Institutional strengthening**
14. **Subcomponent 3.1** will provide technical assistance (TA) for the strengthening of policies necessary to support the implementation of the NSWSS.
15. **Subcomponent 3.2** will carry out capacity-building activities through trainings to central and local government officials working in the WASH and converging sectors who are responsible for implementation of the NSWSS and investments in information technology (IT) hardware and software to support the sector institutions.
16. **Component 4: Project implementation and management**
17. **Subcomponent 4.1** will support the DPHE’s capacity for project implementation and monitoring.
18. **Subcomponent 4.2** will support the PKSF’s capacity for the project implementation and monitoring.
19. **Component 5: COVID-19 emergency response.** This component will provide quick, just-in-time WASH services where needed in the COVID-19 pandemic hotspots, to cope with the fast-changing COVID-19 situation.
20. **Component 6: Contingent emergency response component (CERC).** This component will provide immediate response to an eligible crisis or emergency as needed.

4. **Palli Karma-Sahayak Foundation (PKSF), financial intermediary**

PKSF was established in 1990 by the Government of Bangladesh and registered under the Companies Act as a “not-for-profit” organization. PKSF’s vision is to alleviate poverty and improve the quality of life of the poor – the landless and the asset less people – by providing them with resources to create employment and enhance economic conditions. Since its inception, it has been working as an apex (wholesale) microcredit funding, providing capital to its Partner Organizations (POs) to provide microcredit to the poor households, also build the capacity of POs and monitor the disbursement and collection of loan repayments at the field level.

The PKSF has considerable experience in managing Bank projects in various sectors, will play the main role in the development of private assets under the project. Under this project, the PKSF will be responsible for offering wholesale capital to around 60 retail MFIs as financial intermediary, which in turn will give loans to households to upgrade the WASH facilities at their residence in the project areas. In addition, PKSF will extend capacity building support to retail MFIs and local entrepreneurs for creating demand and installing SDG 6 compliant WASH facilities.

**PKSF Partners (microfinance Institution) since 2015**

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
|  | 2015 | **2016** | **2017** | **2018** | **2019** |
|  MFI partner organizations of PKSF  | 274 | 275 | 277 | 277 | 278 |
| Total Members (Million) | 11.12 | 11.98 | 12.71 | 13.24 | 13.91 |
| Total borrowers (Million) | 8.55 | 9.39 | 9.97 | 10.38 | 10.78 |
| \*Loan Disbursement (US$ Billion) | 25.31 | 28.62 | 32.42 | 36.58 | 42.24 |
| \*Loan Outstanding (US$ Billion) | 1.65 | 2.07 | 2.62 | 2.99 | 3.53 |
| \*Savings (US$ Billion) | 0.64 | 0.77 | 0.94 | 1.10 | 1.34 |

**5. Assessment of PKSF**

A review of its financial performance indicates that PKSF is a viable financial institution (a) with good performance in terms of financial efficiency (return on assets, 4 percent), (b) strong capital adequacy (52 percent), (c) acceptable credit quality (NPL levels below 4 percent), (d) solid funding sources and diversification, and, (e) adequate institutional capacity and systems. It is the view of the appraisal team that PKSF is qualified to act as wholesale organization for on-lending IDA funds to the microfinance sector. There are already multiple precedents of PKSF performing this role utilizing IDA funds – dating back almost 20 years. PKSF also continues to enjoy the support of the Government of Bangladesh.

**Summary of assessment**

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| **1. License** | The PKSF is a government institution founded in May 1990. Legally, it is a not-for-profit company registered under the Companies Act. The PKSF is not regulated by a financial regulator but falls under the purview of the FID at the MoF. |
| **2. Governance**  | The PKSF is governed as a PPP, through a 3-tier structure, consisting of (a) the management team, (b) the General Body, which approves the annual budget and audited accounts, with strong private sector representation; and (c) the Governing Body consisting of seven members that appoints the managing director. The General Body, composed of 21 members with strong private sector representation, meets twice a year. The chairman must not be a government official. |
| **3. External audit standing** | The PKSF’s external audit for FY2018/19 is unqualified. |
| **4. Capital adequacy** | The PKSF’s capital fund is BDT 47.7 billion (US$561.7 million), which represents a capital adequacy ratio of 85.3 percent. |
| **5. Liquidity** | The current liquidity ratio is 7.1, higher than the legal minimum of 2.5, and debt-to-equity ratio is 0.3, lower than the legal maximum of 4.5.The PKSF’s mandate authorizes its management to mobilize funds in the form of grants, loans, and contributions from a wide variety of sources, including the GoB, private individuals and organizations, foreign governments, international donors and lending agencies, and capital markets. To date, the PKSF has received funds from the GoB, IDA/World Bank, US Agency for International Development, Asian Development Bank, and International Fund for Agricultural Development. |
| **6. Profitability** | At the PKSF level, net surplus to average equity ratio is 4.8 percent, and the return on average total assets is 3.4 percent. |
| **7. Policies and risk management functions** | The PKSF represents, on average, 18.0 percent of PO’s funding. All POs funded by the PKSF are in compliance with the MRA regulations. They undergo a stringent selection process before they can become one of the PKSF’s PO, based on criteria that are stricter than the MRA’s minimum requirements. The PKSF’s risk management is found to be strong, and POs are adequately supervised both by the MRA and PKSF. The PKSF has developed a comprehensive rating system to annually assess the performance of POs along the following nine dimensions: (a) financial efficiency, (b) economic efficiency, (c) operational efficiency, (d) financial strength and risk management, (e) growth, (f) accounting and internal control system, (g) social performance, (h) human capacity, and (i) governance. A six-scale rating system has been developed, using letter designation corresponding to scores of up to 1,000. The full list of 144 indicators has been shared by the PKSF and is on file. |
| **8. Asset quality**  | The nonperforming loans ratio is at 3.5 percent. The overall loan collection rate is at 99.5 percent. |
| **9. Internal audit and controls** | The Audit Division is responsible for internal and external audit for both the PKSF and its POs, including fraud detection, internal controls, and monitoring compliance. The internal audit/control systems are of adequate quality. Audits are carried out in accordance with the Bangladesh Standards on Auditing, which are very close to the International Accounting Standards. |
| **10. Adequate MIS** | The IT and MIS system is of adequate quality and meets the PKSF’s current need. |

*Note:* All financial statement figures in this table are based on FY2018/19.

**6. Project Implementation**

Under this project, the PKSF will use IDA and AIIB financing to onlend to retail MFIs, which in turn will provide loans to households to upgrade the WASH facilities at their residence in the project areas (Subcomponents 1.3 and 2.2.a). In addition, the PKSF will extend capacity-building support to retail MFIs, credit group members and LEs for creating demand and installing SDG 6-compliant WASH facilities (Subcomponents 2.3 and 2.5). The PMU will comprise a full-time project coordinator, deputy project coordinator, and personnel with specialization in FM, procurement, M&E, E&S, and others, posted from within the PKSF and recruited from the open market.

For the purposes of the Credit Line, the IDA and AIIB loan funds will be channeled through the Economic Relations Division of the Ministry of Finance (MOF) as the Borrower’s representative and passed on to PKSF in local currency (BDT). A Corresponding Designated account will be opened at the Bangladesh Bank. PKSF will sign a Subsidiary Loan Agreement with the Government of Bangladesh – and it will, in turn, sign agreements with each qualified POs for the purposes of implementing the project’s credit line. Separate Operational Procedures for the Credit Line will be outlined in detail in the Project Operations Manual (POM) – which will determine the eligible institutional criteria, eligible activities, detailed withdrawal procedures, and responsibilities of all parties implementing the Credit Line. The POs, in turn, will on-lend the Credit Line funds to eligible households and local entrepreneurs in accordance with the Operational Procedures and their financial considerations.

The PKSF will implement the project by leveraging about 60 MFI partner organizations (POs). WASH loans will be made available to the POs against their progress targets at an interest rate of 5 percent with a grace period of six months (that is, the first installment due after nine months) and a loan repayment period of three years (that is, 10 installments in total).[[6]](#footnote-6) Training will be organized for PO staff on national WASH policies strategies and the quality of service issues as they relate to SDGs 6.1 and 6.2.

**7. Eligibility Criteria**

***Potential POs****:* PKSF has an existing rigorous appraisal of NG-MFIs to become PKSF-POs. The project has appraised these criteria and deemed that they meet the standards of Financial Intermediaries. The Project will therefore rely on PKSF’s existing system for PO appraisal. Once qualified, a PO is always expected to continue meeting the eligibility criteria. Compliance will be reviewed annually.

PKSF will rely on the following criteria to select PKSF-POs that will be participating financial intermediaries (PFIs) for this credit line:

1. Broad eligibility criteria, as per PKSF general guidelines
* Adequate profitability, capital adequacy, asset quality, and liquidity in accordance with accounting and auditing principles acceptable to the Bank;
* Audited annual accounts;
* Acceptable levels of loan collections;
* Appropriate capacity, including for carrying out sub-loan/subproject appraisal, and for supervision of the use of funds and implementation;
* Adequate managerial autonomy and commercially oriented governance. Must create required LLP as per PKSF guidelines;
* Capacity to mobilize domestic resources;
* Appropriate prudential policies, administrative structure, and business procedures. In addition, have a maximum debt-to-equity of 9:1;
* Adequate accounting and book-keeping and MIS system, with adequate internal controls;
1. **Additional project-specific criteria**
2. Have existing operations in the selected project areas
3. Have previous track record, efficient manpower, and financial and infrastructural capabilities
4. Have implemented a number of development projects with the PKSF
5. Have experience in implementing programs related with WASH, specially implementing experience of the GPOBA sanitation microfinance project
6. Have been involved in health-related programs.

During implementation, POs’ compliance with the eligibility criteria will be closely monitored by PKSF and tracked on an on-going basis. As indicated, POs will also be required to report to PKSF on their sub-loan portfolio and on key financial and performance indicators on a quarterly and annual basis, as relevant, and in line with the results framework. The financial performance of the POs will also be monitored through independent auditors’ reports.

**8. Lending terms**

The POs will offer WASH loans to poor and non-poor households through their credit groups, 90 percent of whose members are women (Subcomponents 1.3 and 2.2.a).Technical support will be extended to PO staff to enhance their skills in carrying out the BCC campaign (see paragraph 9), mobilizing LEs, ensuring quality of WASH facility construction, and mobile-app based reporting. The loans will comply with the following conditions:

1. **Loan interest rate:** About 18 percent per year (including fees and other charges)
2. **Grace period:** 2 weeks (as per Microcredit Regulatory Authority [MRA] policy)
3. **Repayment tenure:** 1–1.5 years (60 weekly installment or 15 monthly installments)
4. **Loan size.** Credit group members will be entitled to receive loans up to a maximum of BDT 50,000 for both water and sanitation at a time. The loan size for respective loans is as follows:
	1. **Water loans:** BDT 15,000–50,000 (BDT 25,000 on average)
	2. **Sanitation loans:** BDT 15,000–30,000 (BDT 20,000 on average), not to exceed the costs of facilities less the subsidy
	3. **Renovation loans for sanitation:** BDT 5,000–10,000 (maximum 10 percent of sanitation loans in total), not to exceed the costs of facilities less the subsidy

***Local Entrepreneurs Loan:***

The loan facilities will be followed as per PKSF Microenterprise Loan Component which is being revised. Currently the loan ceiling is from BDT 30,000 to BDT 10,00,000 and the duration of loan repayment period is maximum 2 years. The type of repayment is flexible as weekly, monthly, quarterly, half yearly, yearly etc. and the rate of interest is maximum around 24 percent per annum.

1. based on the Household Income and Expenditure Survey 2016 (HIES 2016), BBS [↑](#footnote-ref-1)
2. Source Bangladesh Bank, January 2020 <https://www.bb.org.bd/econdata/w_avg_interest.php> [↑](#footnote-ref-2)
3. Bangladeshi Taka (BDT). Throughout the annex, the exchange rate used was 1US$=85 BDT. [↑](#footnote-ref-3)
4. Contributed solely by the Palli Karma-Sahayak Foundation (PKSF). [↑](#footnote-ref-4)
5. Contributed solely by the PKSF. [↑](#footnote-ref-5)
6. The interest rate and repayment period will be finalized by the PKSF Board according to the agreement with the FID. [↑](#footnote-ref-6)