



International Labour Organization

IPEC

International Programme on the Elimination of Child Labour

TECHNICAL GUIDELINES

Microfinance Against Child Labour

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Geneva, February 2004

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Preface

New figures on child labour released by the ILO in 2002 reaffirmed the dire situation that millions of children are trapped in worldwide and the acute necessity to continue all endeavours to end child labour.

The International Programme on the Elimination of Child (IPEC) pursues a multi-dimensional strategy to achieve that objective. The use of income-generating activities to eliminate child labour has been a common feature of IPEC Programmes for many years. In some regions income generation is an important component of the approach, while in others links have been established with service providers allowing IPEC to focus its resources on other interventions to get children out of hazardous work and to sustain that situation.

Early on, IPEC established collaboration with units in the ILO that have contacts and expertise in the areas of employment creation, microenterprise development, and microfinance. These Guidelines are the outcome of a collaborative effort between the Social Finance Programme and IPEC on the use of microfinance to combat or prevent child labour.

Microfinance can contribute to progressively eliminate child labour in two ways:

- **Income-generation:** The most common approach is to provide microcredit to parents or guardians of child labourers to help them to start or expand an income-generating activity to replace the income formerly earned by child labourers. The effectiveness of this approach depends on whether certain preconditions—outlined in Chapter 2 of these Guidelines—are satisfied.
- **Risk-management:** Besides stimulating additional income, microfinance can also play an even more important coping role for vulnerable households. Through appropriate risk-managing financial services, such as savings, emergency loans and possibly insurance, microfinance helps poor families to weather the storms of unpredictable expenses and income droughts without having to resort to child labour.

By expanding the purpose of microfinance to include both purposes, these Guidelines mark a turning point in how IPEC can utilise this approach. This broader perspective reflects a greater emphasis on the sustainability of IPEC's interventions, since productive and protective financial services complement each other to achieve a more lasting impact on the welfare of the working poor. To enhance sustainability, these Guidelines also recommend that IPEC projects avoid using revolving loan funds, but instead partner with financial institutions that can continue to provide financial services long after the ILO's interventions are completed.

Microfinance is not a panacea. It is just one tool from a menu of interventions that can make an important contribution to eliminating child labour if it is used in an appropriate fashion under appropriate circumstances. Drawing from a recent thematic evaluation¹, these Guidelines provide valuable advice and guidance for project designers, programme managers and implementing partners.

These Guidelines remain a work in progress. Because they recommend a significant change in approach, this document intends to stimulate discussion on how to best achieve both the productive and protective role of microfinance in projects designed to eliminate child labour.

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¹ ILO-IPEC, 2003 (February). Income generation strategies for child labour elimination. Thematic Evaluation; Geneva.

Introduction

These Guidelines focus on how microfinance can help reduce child labour. Written for IPEC project designers and implementing partners, these Guidelines were drafted by the ILO's Social Finance Programme in close collaboration with IPEC staff in response to requests from the field for guidance in using microfinance more effectively in child labour programmes.

It should be clarified that this document deals with the provision of **financial services** to low-income people. In contrast, **non-financial services** such as training, mentoring and advisory services for potential entrepreneurs will not be described in these guidelines. Detailed information on non-financial services can be obtained through other ILO Programmes, in particular the InFocus Programme on Boosting Employment through Small Enterprise Development (SEED). A guide "Using Small Enterprise Development to Reduce Child Labour" has been recently published by SEED and IPEC.

In using microfinance to eliminate child labour, it is necessary to avoid a "one-size-fits-all" approach. The households of child labourers, and the contexts in which they live and work, are heterogeneous. These Guidelines provide advice, but they are not a blue-print. Instead, they should be seen as an introduction to the basics of a microfinance programme while still leaving room for adaptations to the local context.

This document is organised into six chapters. Chapter 1 defines microfinance and explains what it can and cannot do in reducing child labour. Microfinance has both a productive role, to stimulate income-generation, as well as a protective role, to provide households with an alternative to child labour as they cope with crises and economic stresses. Chapter 2 outlines the preconditions for microfinance, including issues related to the demand and supply of microfinance, as well as the external environment.

Chapter 3 presents different models for delivering microfinance to households of child labourers, or former child labourers, and strongly recommends that IPEC projects partner with existing financial service providers to enhance impact and sustainability. Chapter 4 introduces basic design issues including targeting and the key features of credit, savings and insurance products. Chapter 5 discusses how grants might be used, either as an alternative to microfinance or in combination with savings and credit. The final chapter provides basic information about monitoring and evaluation of microfinance activities.

Significant efforts have been made to keep this document concise and readable. Yet it remains both long and incomplete. To make the text more accessible, the following two pages contain a summary of "key messages". A bibliography of recommended readings is included as an annex. If readers are seeking specific technical advice, they are also welcome and encouraged to contact the ILO's Social Finance Programme.

Lastly, it is important to recognise that microfinance is not always the most appropriate answer for the needs of poor families. There are circumstances in which microfinance can cause more harm than good. Consequently, these Guidelines provide ideas on how to use microfinance to combat child labour and, if the preconditions for the provision of sustainable financial services are not in place, they suggest possible alternatives.

Key Messages

**Need
more info?
Go to....**

Financial Needs of IPEC's Target Groups

- | | |
|--|-------------------|
| 1. IPEC's target groups need financial services for both productive and protective purposes. Productive finance supports people who engage in income-generating activities (e.g. through microcredit). Risk-managing financial services—such as savings and emergency loans—helps reduce their vulnerability. To make a sustainable impact in eliminating child labour, households need access to both. | 1.2, 1.3
Ch. 4 |
| 2. For IPEC's target group, savings may be even more valuable than credit. | 1.3, 4.3 |
| 3. Borrowing money involves taking a risk. IPEC projects should never require participants to take loans. | 4.2 |
| 4. One or two loans will not help households stay out of poverty or withdraw their children permanently from work. Projects should be designed to guarantee long-term access to financial services , which includes pricing for sustainability and not disguising grants as loans. | 1.1, 3.1,
4.2 |
| 5. Targeting should not be undertaken at the cost of community integration. IPEC's target group should be the main clientele of the project, but others should also be able to access financial services. | 4.1 |

Partners and Strategy

- | | |
|--|----------|
| 6. Most of IPEC's traditional implementing partners are not able to provide a range of financial services over time. In many situations, it will be better to link with different partners for different interventions. | 3.3, 3.4 |
| 7. The revolving loan fund approach is no longer the preferred option for IPEC. | 3.2 |
| 8. The project should link up with an experienced financial service provider that is operational in the target area. If this is not possible, the project should encourage a service provider to move into this region. The project should provide incentives to encourage the partner to adapt its services to the needs of IPEC's target group. | 3.3, 3.4 |
| 9. Selection of an appropriate partner is key. The IPEC project should thoroughly assess all options, taking into account the fact that microfinance requires specific skills and a long-term perspective. | 3.4 |

-
10. Potential partners might include microfinance NGOs, credit unions, rural banks, non-bank financial institutions and microfinance banks. In general, **government agencies are not effective implementing partners** since they usually lack microfinance expertise, are often seen by beneficiaries as providing handouts rather than loans, and can be influenced to use financial services for political gain. 3.4
11. **Group methodologies are generally the most appropriate method for delivering microfinance** to IPEC's target group. Groups lower the per person delivery costs and serve as an important collateral substitute. They also play a valuable role in achieving social objectives, such as creating social pressure to keep children in school. 1.4, 4.2
12. If there are no suitable financial service providers to link up with, **the project should consider establishing member-owned and member-managed financial associations, such as credit unions or village banks.** 3.5

Microfinance: Not the Only and Not Always the Best Option

13. **It is better not to do microfinance, than to do it unsuccessfully.** 3.5, 3.6
14. **If the circumstances for microfinance are not right, other approaches should be considered.** 1.5, 3.5, 4.1
15. Microfinance should always be considered as one component within a comprehensive strategy to eliminate child labour. To enhance its impact, **microfinance should be linked to other strategic elements**, including the provision of non-financial services to families and direct services to children. 1.1
16. Grants are not microfinance. **Under specific circumstances, and for specific target groups, grants can help IPEC projects** attain goals rapidly and effectively. Their main disadvantage is that their impact is limited. Hence, they should be used primarily as a stepping stone to become eligible for proper financial services. Ch. 2, Ch. 5

1 Microfinance and Child Labour

1.1 Microfinance Defined

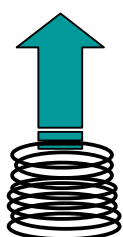
Microfinance is the provision of sustainable financial services to low-income people.² Sustainable means that those services can be accessed over the long-term, when and if people need to access them. The range of possible microfinance services is summarised in the following figure.

Microfinance Services

Credit	Savings	Insurance	Payment Services	Leasing
Income-generation	General purpose	Loan insurance	Payment services (inside country)	Financial lease
Housing	Specific purpose	Life insurance	Remittances (between countries)	Operational lease
Education	Current savings	Health insurance		Hire-purchase
Daily needs, emergencies	Term savings	Disability insurance		

Low-income households, including the most vulnerable, have the same financial service needs as anyone else. The challenge for microfinance practitioners is to design and deliver services to meet this range of needs in a cost-effective manner.

Microfinance can make a strong, positive contribution to progressively eliminate child labour, yet this is unlikely to happen when utilised in isolation. This is the reason why most of IPEC projects develop activities at several levels: some of them are “systemic” in nature, promoting structural changes that affect national institutions, policies, legislation or attitudes towards child labour. Other activities are geared towards the removal and rehabilitation of children in specific communities through direct action. Microfinance can be regarded as one important component within this comprehensive approach to effectively eliminate child labour.



Microloans to boost household income

1.2 Microfinance for Income Generation

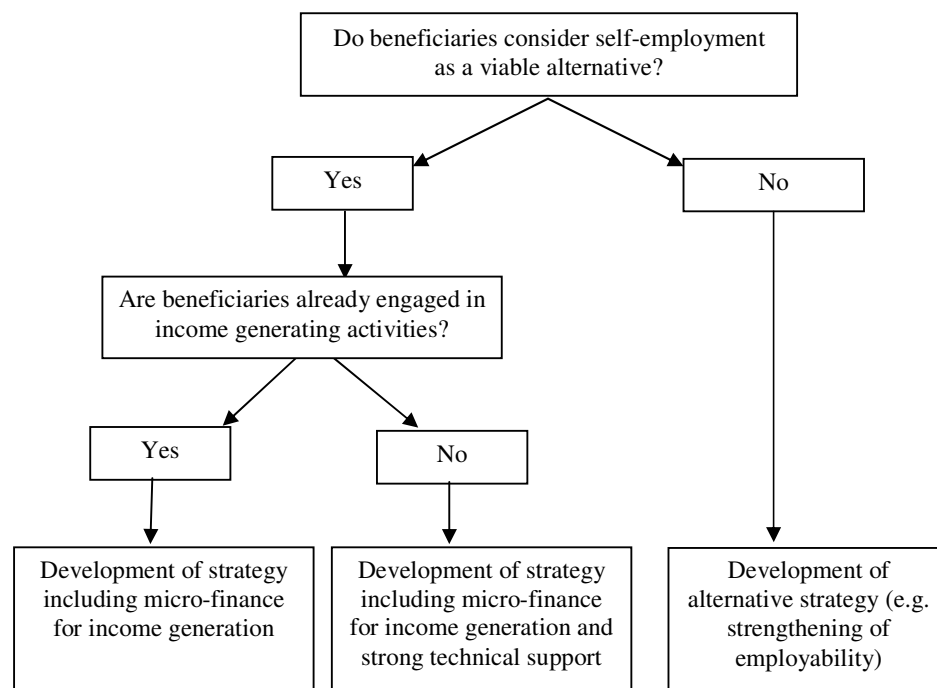
Poverty and the lack of income are generally acknowledged as root causes of child labour. IPEC’s projects and programmes therefore often include an income-generation component to address this problem. The income-generation component can be realized through, for example, the provision of small loans to assist households to start an alternative income-generating activity.

In this approach, the loan is used to facilitate the self-employment of parents to replace the income previously earned by the child. As a result, the overall economic condition of the household should not decline when the child leaves

² Grants are not part of microfinance. For more information, see Chapter 5.

work and goes to school. Typically the loan is conditional—if your child goes to school, then you can have access to a loan. To be effective and sustainable, a stream of subsequent conditional loans should be made available.

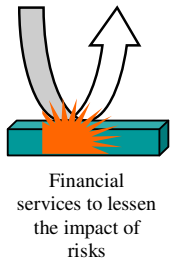
When conceptualising the role of income-generating loans in the project design process, it is important to recognise two important issues, illustrated in the diagram below. First, self-employment may not be the beneficiaries' preferred choice for income-generation. They may actually prefer wage employment. So it is necessary to ensure that self-employment is an acceptable income boosting approach. Second, unless the adults are already engaged in a microenterprise or an income-generating activity, they may need some guidance and technical support. Microenterprise loans may be the missing piece for persons with experience, but otherwise it should be coupled with technical skills and/or entrepreneurial training. Indeed, it is much harder, riskier and more costly to help people to start new economic activities than to help them expand existing enterprises.



In sum, it should right from the project start be assessed which is the appropriate alternative for households of child labourers: if self-employment or promotion of wage employment. Both strategies involve a different range of interventions and activities. The opportunity of providing credits or loans for income generation should always be considered in this context.

1.3 Microfinance for Reducing Vulnerability

These Guidelines propose that microfinance has an extremely important role to play in eliminating child labour even if it does not directly contribute to income generation. In fact, microfinance to manage risks and smooth consumption in a poor household may be more important in combating child labour than income-generating loans.



Child labourers often come from the poorest households, which are most vulnerable to risks. Unexpected income shocks—such as droughts, bad crops, floods, fires, livestock death, theft, illness, death in the family or unemployment—can cause a major setback because these households have the fewest assets and greatest difficulty in coping with risks. As a consequence, one of the primary coping strategies is for all able-bodied household members to generate income, including children. Progress that has eventually been achieved in preventing or reducing child labour can easily be reversed if these households do not have alternative coping methods.

Consequently, even if IPEC projects do not include microfinance for income generation, they should consider facilitating access to mechanisms that allow households to overcome temporary cash flow shortfalls and manage their risks. Through savings mobilisation, access to emergency loans and possibly insurance, low-income households are able to better cope with risks and make consumption less dependent on income.

By including simultaneous strategies to a) boost income and b) cope with risks, IPEC projects will be able to achieve a more sustainable impact than focussing on income generation alone.

1.4 Other Benefits of Microfinance

One of the primary methods for delivering microfinance is through a group structure, such as a solidarity group, a self-help group or a village bank. For microfinance, these groups lower the per person delivery costs, as well as the acquisition and screening costs, and serve as an important collateral substitute. By lowering the costs and the risk of default, the group makes it possible to provide financial services to persons who would otherwise not have access.

Additionally, it is important to recognise that savings and credit groups also play a valuable role in achieving social objectives that can therefore contribute to the sustainability of IPEC interventions. For instance, by grouping poor clients, microfinance can achieve the following spin-off effects:

- **Empowerment:** Bringing together low-income persons, particularly women, into a group has the additional benefit of empowering them, giving them a sense of responsibility, while freeing them from historically dependant relationships.
- **Leadership:** Groups typically have several leadership posts that can be rotated throughout the membership to allow all participants an opportunity to exercise a leadership role.
- **Skills development:** To manage the affairs of the group, members often need to learn basic skills including recordkeeping and accounting.
- **Building block:** Savings and credit groups can serve as the basis for wider association building as well as for taking collective action.
- **Vehicle for other service delivery:** Since they are already meeting on a regular basis for their savings and credit activities, these groups also provide a forum to deliver other services, such as awareness raising about the dangers of child labour (see box).

- **Peer pressure:** The peer pressure element of the group is usually used to ensure timely loan repayments—group members do not want to let each other down. But it could be used to achieve other objectives too, such as pressuring each other to keep their children in school.

However, these positive impacts are unlikely to have a lasting effect if the microfinance initiative itself is not sustainable.

There is no magic formula with respect to sequencing microfinance and other IPEC interventions. IPEC projects typically start with non-financial components, e.g. awareness-raising, so that beneficiaries can be sensitised on the programme. Yet it is also possible within an IPEC project to organize people in groups through microfinance, and then provide other, non-financial services. In any case, it is essential to plan for the implementation of the microfinance component (in relation with the other elements of the intervention) from the beginning of the project. **Sufficient time should be allocated for the execution of the microfinance activities; hence, it is not advisable to leave this element of the project to the last stages of implementation.**

Reaching out to the poor through credit unions – Freedom from Hunger

Freedom from Hunger (FFH), a US-based micro-finance support organisation, designed a programme called “*Credit with Education*”, to serve the poorer segment of the market. This programme combines group-based savings and lending services for the poor, with education sessions on health, nutrition and micro-business. Field agents provide these services to solidarity groups, in their communities.

The programme is implemented in partnership with *credit unions*, as these organisations share the social and financial mission of the programme. They can also offer a wide range of loan products. Credit union clients can graduate from a group-based loan to other credit union products, when and as the need arises. Last but not least, they can provide sustainable poverty-focussed products, because they can spread their overhead costs over a wide range of financial products. The costs of the programme are shared between FFH and the credit unions. FFH covers the technical assistance and start-up costs, whereas the credit unions finance the loan portfolio.

The project has been successful. In Mali, for example, it reached over 10,000 poor credit union clients. Impact studies in Ghana and Bolivia showed that the children of *Credit with Education* clients had improved nutrition. Women’s income, health, nutrition practices and empowerment have also improved.

Source: MicroBanking Bulletin, Sept. 2000.

1.5 When is Microfinance Appropriate in Combating Child Labour?

There are many reasons why parents send their children to work. Some of these reasons include:

- To **earn extra income** for the household: Whether it is to cope with an economic shock or because of a perpetual state of poverty, for the poorest households, the urgency of putting food on the table may be sufficient justification to send children to work.
- Due to **lack of child care (or cost of child care)**, parents may prefer to take their children with them to the workplace, and since they are there, they may as well contribute to the family’s income through work.
- Some households are unable to afford the **costs of schooling**, including stationary, uniforms, etc., so going to work is an alternative to incurring an education expense.
- Some households want to **maximise their income**; unlike “earn extra income,” which is essentially a survival strategy, a household that wants to maximise income could do without the income generated by the child, but prefers not to.
- In some cultures or in some contexts, it is **considered normal if children** work.
- **Children themselves may also desire to earn money**, for consumption or prestige.

These diverse reasons or motivations for child labour—that in specific situations can be compounded—highlight that elimination strategies also need to be diverse and customised to local conditions. Of these motivations, the need to earn a sufficient income to ensure the survival of the household can be directly addressed by a microfinance component; financial services can also assist in addressing issues linked to the cost of child care and schooling. However, microfinance is unlikely to make a significant impact if the family wishes to maximize income or if cultural reasons or consumption patterns lead children to work.

Checklist: When is microfinance appropriate for combating child labour?

Reason for Child Labour	Microfinance can be appropriate
Household needs extra income to survive	[
Lack / Cost of child care	[
Cost of schooling	[
Household wants to maximise income	-----
Cultural context: it is considered normal for children to work	-----
Children themselves desire to earn money (for consumption or prestige)	-----

2. Necessary Conditions for Successful Microfinance

In the context of an IPEC intervention, there are some basic conditions that have to be met before microfinance can be successful. If these conditions are not in place, other income-generation activities would be more appropriate.

A thorough **situation analysis** will reveal whether the necessary conditions are being met. The analysis should be done through primary data (individual interviews, surveys and focus group discussions) and through secondary data (for example, consultants reports, newspaper articles, institutional reports). It is important to cross-check and verify data from different sources, by using different methods (triangulation).

2.1 Demand Considerations

The first precondition for microfinance is whether the families actually want financial services, and if so, what services might they need. While this may seem obvious, in practice the needs and the demands of the intended beneficiaries are unfortunately often overlooked in project design.

As already mentioned, there is an important distinction between starting and expanding income-generating activities. The costs and risks associated with helping people to initiate an income-generating activity need to be taken into consideration. Another common problem is that the design of the loan product (loan size, term length, repayment frequency, etc.) may not suit the intended purpose.

2.2 Market Considerations

Even if the intended beneficiaries want access to financial services, there are three other market considerations. First, is there a sufficient **concentration** of low-income persons so that a microfinance institution can achieve sufficient economies of scale to cover its costs? If the market is not large enough, it will be very difficult to attract a Microfinance Institution (MFI) to serve this market.

The second issue is the **mobility** of the target group. Where people are very mobile, it is quite difficult for microfinance to succeed. People may literally walk away from their obligations, which puts a microfinance programme at risk. For example, high degrees of mobility threaten to undermine the formation of social capital implicit in the use of savings and credit groups and are a reason for low repayment rates in credit schemes.

The third item involves **difficult or high risk groups**. Again, if lending is involved, then the scheme needs to make appropriate loan decisions based on the prospective borrower's risk profile. Through group lending methodologies and other innovative approaches, microfinance has made significant strides in extending financial services to persons who were previously considered un-bankable. But that does not mean that everyone deserves a loan. If the project

designers or implementers believe that individual clients or specific segments of the market are unlikely to repay, then it does not make sense to give them a loan.

Mobile Populations

The following questions can be asked to determine whether a mobile group of people can be targeted:

- Is there a way to gauge how long the target group will stay in the area of (temporary) residence?
- Is the target group likely to move to one particular area, or will people spread to different regions? (If people will move to the same area, the programme could follow them, or link up with an agency in their future area of residence.)

There is no blue-print on how to assess whether a particular target group is sufficiently stable to access microfinance services. It requires both individual judgement and common sense.

Taken together, the assessment of the demand and the market analysis should provide information on potential clients. This should include information on the characteristics of the target group and the need for financial services in the target area. The following issues should be part of the demand and market assessment:

- Is there a critical mass of people who can benefit from financial services?
- In what geographical areas do they live?
- What type of financial support do they need, and what will they use it for? (e.g. for income-generation, to manage income fluctuations, to save for school fees etc.).
- What are their income and expenditure patterns (e.g., is there significant seasonality in their income and expenses, and consequently in the work of children)?
- What is their poverty level?
- Who should (not) be targeted?
- Does the target group have a credit history?
- Do they already participate in group or collective activities?

2.3 Supply Considerations

The situation analysis will also reveal the extent to which agencies are providing financial services in the region, and whether IPEC's target group can access these services. This information is useful to determine whether there is a need for *more* financial services. If the demand is being met by other agencies, it is not necessary to provide additional services.

The assessment should map the financial landscape to identify existing formal and informal financial services:

- **Formal service providers:** banks, non-bank financial institutions, credit unions, microfinance institutions, specialized NGO credit schemes, donor- and government programmes.

- **Informal service providers:** Rotating Savings and Credit Associations (ROSCAs), Accumulating Savings and Credit Associations (ASCAs), moneylenders, pawnbrokers, traders, relatives.

The assessment of the supply should identify the parts of the market formal and informal service providers are currently reaching, and with what types of services. It should also reveal whether there is scope for establishing linkages or partnerships with financial service providers. When considering possible partners, it is critical that they have sufficient capacity to deliver financial services over the long term. If this is not the case, the success of the programme is at risk. As discussed in more detail in the following chapter, key areas include the institution's vision, mission, strategy, management, sustainability focus, expertise, image and reputation.

2.4 External Environment

The situation analysis should also consider the external environment which has to be conducive, or at least not hamper microfinance. Key issues to look for include:

- **Inflation:** It is very difficult to lend money in an inflationary environment unless the loans are denominated in a foreign currency. In an inflationary environment, the value of the loan capital will quickly dissipate unless the interest rate is sufficient to cover inflation, which is difficult to do unless inflation is reasonably predictable. Non-case lending is one way to overcome inflationary conditions (see box on the “Goat to School” Programme).
- **Interest Rate Ceilings:** Experience has shown that limits on the interest rates to be charged on loans have the adverse effect of reducing the supply of small loans. Consequently, well-intentioned policies to ensure that the poor do not have to pay high interest rates usually result in limiting the access to credit for the poor.
- **Contaminated Credit Culture:** Some markets have been badly corrupted through years of subsidised loan schemes. If the intended target market has been used to handouts disguised as loans, it can be quite difficult to convince market participants about what a loan really means. It may be very difficult to get the money back for a loan scheme in such an environment.
- **Savings Restrictions:** In some countries, there are significant restrictions on the type of financial institutions that are allowed to mobilise deposits. This type of regulation is implemented to protect clients against bad management of savings schemes. Often small, common-bond groups are exempted from such restrictions and are allowed to mobilise savings and on-lend those funds among themselves.

If one of the first three external conditions is in place, microfinance should probably be avoided. In the case of savings restrictions, the design of the scheme should be amended accordingly.

The “Goat-to-School” Project

The Brazilian economy has been subject to a number of bouts of hyperinflation, which in the 1980s and mid '90s created a significant challenge for microfinance activities. To overcome inflation and to avoid other problems associated with lending cash, an IPEC project in Brazil experimented with a rotating fund of goats. Families would receive three goats—one male and three female—on condition that their children would be sent to school. Successful reproduction of goats would lead to the return of the female goats, which would be allocated to other families.

Goat-keeping was chosen because it was a forgotten cultural productive activity with a relatively high chance of success in the semi-arid area. No microfinance expertise or other financial possibilities were available in the region, and it was felt that this was an appropriate non-financial, income-generating activity. The administration of the “goat-fund” was done by the Rural Workers Union. The ILO's role was to provide technical assistance and initial funding for the goats.

The Rural Workers Union was not a microfinance institution. For the union, the rotating goat fund was a tool to give families the chance to improve their lives and at the same time, while resources were scarce, to enable other families to receive goats through the revolving fund. While being inflation resistant, this scheme also corresponded well with the expertise of the implementing partner. By 1994, 30 families had been reached through the programme. By 2002, 250 families were involved. An intensive technical assistance programme secured that goats were repaid, in order for other families to receive the same package (loan in goods, technical assistance).

A limitation of the project was that there was no alternative service other than goats. The design had not foreseen the risks of being tied to one “financial” instrument, with no diversification. Not everyone wants to rear goats. Another risk was the loss of goats due to illness or accident, as well as the use of the goat for other purposes – e.g. slaughter for income. Borrowers had an obligation to use the loan in a defined way; there was no flexibility to decide how to use the loan. Furthermore, the flood of goats on the market could decrease their value.

For more information on this project, refer to the publication “Boas Práticas de Combate ao Trabalho Infantil: os 10 anos do IPEC no Brasil”, IPEC Brasília; 2003; pages 123 to 130. The document can be found on line in <http://www.ilo.org/public/portugue/region/ampro/brasil/index.htm#>

2.5. Checklist: Necessary conditions for successful microfinance

This checklist summarizes the discussion presented in this chapter concerning the opportunity of including microfinance as part of the strategy in a child labour intervention. The questions included in the checklist should be modified and completed according to the local conditions where the intervention is to be developed.

Demand Considerations	YES	NO
Do families want financial services?		
Is the financial service appropriate to families' needs?		
etc.....		
Market Considerations		
Is the target market large enough?		
Is the target population mobile?		
Regarding repayment possibilities, is the target population a high risk group?		
etc.....		
Supply Considerations		
Are there existing formal / informal service providers?		
Do existing service providers meet the potential demand?		
Do existing service providers cover IPEC target groups?		
Do existing service providers have sufficient capacity?		
etc.....		
External Environment		
Does the intervention take place in an inflationary environment?		
Are there limits (ceiling) to the interest rates that can be charged?		
Does the intervention take place in an environment with a corrupted credit culture?		
Does the intervention take place in an environment with savings restrictions?		
etc.....		

3. Choosing an Appropriate Delivery Strategy

The provision of microfinance requires specific skills. Like any tool, microfinance is designed for particular purposes. Used correctly, it can be very effective. Used improperly, it can waste resources and do great harm. Hence, it is very important that microfinance services are designed and implemented by experts.

This chapter highlights the value of sustainable microfinance and illustrates the limitations of revolving or rotating loan funds, which have been a common tool in IPEC projects. The next section explains why partnerships with microfinance institutions are a more effective means for achieving a sustainable impact and provides guidance in creating partnerships. Lastly, this chapter discusses alternatives if microfinance institutions are not available or willing to partner.

3.1 Key Components of Sustainable Microfinance

Access to sustainable financial services can make a permanent impact on people's lives. In contrast, temporary access to savings and credit will only have a limited impact. To work out of poverty, people need access to a wide range of financial services beyond the life of the project. One or two loans will not help households stay out of poverty or withdraw their children permanently from work. Ongoing access to financial services, on the other hand, can help sustain the project's achievements.

Efforts to extend financial services to the poor must plan for sustainability from the start. In designing sustainable financial services, it is important to consider the following issues:

- Appropriate interest rate
- High loan recovery
- Cost-efficiency
- Adequate size of the loan fund
- Well-trained and motivated staff
- Appropriate systems and policies to guide and oversee financial operations

The most controversial of these points is the tricky issue of **interest rates**. Can the poorest and most vulnerable households really afford to repay loans plus interest? Should the ILO require the poor to pay market rates for their loans? Wouldn't the target group be able to get out of poverty faster if the loans were cheaper? Why should the poor pay more for their money than rich people? Indeed, there are a number of strong arguments that can be used to justify subsidised interest rates. However, they are not sufficiently compelling if the project wants to achieve a significant and lasting impact. Consider the following counter-arguments:

Long term access to permanent financial services. A key objective of the microfinance component of an IPEC project should be that the target groups have access to financial services for the long-term, not just during the project period. Without such, households are likely to resort back to child labour as soon as they experience an economic stress or

crisis. It is unreasonable to assume that donors or governments will subsidise financial service providers for the long-term. Instead MFIs need to charge the full costs of service delivery to their borrowers, considering also that small loans are relatively more expensive to administer than larger loans.

Extra cost of borrowing from commercial institutions. The discussion about interest rates often overlooks the fact that, for poor people, there are often additional costs of borrowing from a commercial bank. Travel expenses and opportunity costs of one's time, for example, can be quite high. So while a loan from a bank may only be 12%, it could turn out to be a lot more expensive than a 30% interest rate charged by a microfinance institution that is more accessible and offers appropriately designed services.

Alternatives to loan provision. The comparison of microcredit to a bank loan is really a false choice in many cases, because IPEC's beneficiaries are unlikely to be eligible for a bank loan. In fact, their main alternative is likely to be the moneylender, who may charge at least 10% per month. There is a misplaced perception that the poor cannot afford "market" interest rates. In fact, they are often paying much higher rates at the informal market (see box).

Moneylenders and Interest Rate

Ms. Sakhiya Tharu, a wife of a former *kamaiya*, started vegetable farming with the support of a small loan from her group. She now can have proper meals from her income. "We had to borrow money from the local moneylender at a high interest rate, but now I can take a loan at a nominal interest rate from the group."

Source: Case Study of Families Under Debt Bondage Project, J. Acharya, ILO Office, Nepalgunj

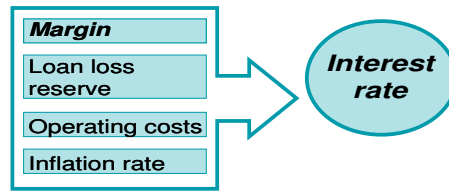
High returns on investment. Most people are better off, even after paying interest, than they would be without the loan. When loans are invested in a microenterprise or income-generating activity, they often can generate very high returns on investment because they tend to be labour- rather than capital-intensive.

Outreach to intended beneficiaries. Experience shows that where subsidised credit has been offered, it often gets hijacked by influential persons and does not reach the intended beneficiaries. Influential and wealthy persons could capture the lion's share of the subsidy.

In general, the interest rates of microfinance institutions are often set **above bank rates**, but **below the rate of informal lenders**, because microfinance institutions have higher transaction costs in handling relatively small loans, compared to banks. In IPEC programmes, the interest rate should cover at least the agency's operating costs, projected loan losses, and the inflation rate.³ It should also create a small margin that allows the financial institution to expand its services or to invest in new technologies.

³ Programmes that borrow funds for on-lending should also cover the cost of borrowing capital through their interest rate. Yet IPEC projects work with donated funds, so inflation is included in the overall project budget as a cost of capital to ensure that the organisation can retain the real value of its loan capital.

Interest Rate Components



The most effective way to make credit affordable to the poor is for MFIs to focus on the two interest rate components that they can influence, namely:

- ◆ Minimising loan losses
- ◆ Minimising operating costs

Besides the interest rate, another somewhat controversial issue is the project's attitude or approach toward **loan repayments**. There is a natural tendency not to press the poor to repay their loans, but such a soft approach can actually cause more damage than good. If the organisation does not insist on loan repayments, it is essentially undermining the credit market. Extending sustainable financial services to the poor is a challenge, and many microfinance institutions will not be able to take up this challenge if they have to compete with grants disguised as loans. Furthermore, if the MFI does not get its money back, it undermines the sustainability objective. How can it provide financial services in the long term if it is losing all of its money? If the project believes that it is unlikely that families will repay their loans, it should consider alternative approaches such as the provision of grants (see chapter 5 for further information on this).

3.2 Revolving Loan Funds – The Pitfalls

The primary way that IPEC has used microfinance is through revolving loan funds (RLF) from which the target households can borrow to start or expand income-generating activities. These RLFs are typically managed by non-specialised, multi-purpose NGOs. Experience shows that since microfinance is only one component in a large range of activities in which they are engaged, it usually does not receive the attention and focus it needs.

Although RLFs are intended to continue to revolve after the project ends, the high costs of managing a small fund often become too burdensome for an organisation that does not specialise in financial service provision, particularly since the organisation cannot achieve economies of scale. Experiences from the past confirm this: **Revolving funds in IPEC projects and in microfinance projects in general have generally achieved disappointing results.** In practice, they often become “dissolving funds.”

The revolving loan fund approach has several disadvantages:

- RLFs have a short-term perspective and short-term impact;
- They only reach a small number of people;
- They are geared towards productive loans, and cannot address low-income household's need for other financial services;
- RLFs are usually provided by agencies with limited microfinance experience, who tend to be more concerned about disbursements than repayments;

- Repayment incentives are weakened by the fact that they are capitalised with “cold”, donor money (in contrast to “hot” member money), which beneficiaries often take for granted;
- If borrowers get the impression that they will not be able to access future loans (for example because the project is ending) it becomes much less likely that they will repay their current loans.⁴

In light of these disadvantages, the revolving loan fund approach is no longer IPEC’s preferred option for addressing the financial service needs of its target group.

3.3 The Preferred Strategy: A Partnership Approach

Rather than setting-up their own microfinance scheme, IPEC projects should partner with specialised financial service providers and encourage them to work with IPEC’s target group. There are some important benefits to this partnership approach:

- Through existing financial service providers, IPEC projects should be able to incorporate financial services for both productive and protective purposes;
- By encouraging MFIs to work with IPEC’s target group, the target group has better chances to continue having access to financial services after the project ends;
- As a result, the partnership approach has more potential for a long-term, positive impact in eliminating child labour;
- The project can build on the experiences, as well as the infrastructure and organisational systems of the partner, rather than building such systems from scratch;
- The project can benefit from previous investments undertaken by other donors, and may benefit from funding that is being made available through other donors;
- Financial services will be provided by experts. This will allow child labour experts to focus on their core competencies;
- The risks of fraud or mismanagement of loan capital is reduced. Such risks are high in project-funded financial schemes. Sound microfinance institutions have systems in place to check on the use of funds, and to control the risks of fraud.

Furthermore, by partnering with a microfinance institution, IPEC can forge a relationship with an organisation that may be reaching tens of thousands of households throughout the country. This might allow for expanding IPEC’s outreach into new geographic areas.

While the logic of the partnership approach is compelling, in practice it may be more difficult to implement than a revolving loan fund. As shown in the following box (describing a real example from Pakistan), this approach is possible but not simple from a programming perspective. The design of the intervention must be customised to the local conditions, and it may involve significant and perhaps technical negotiations with prospective partners. When developing a microfinance component, it is necessary to consider the following issues:

⁴ One of the primary reasons why borrowers repay microloans is so they can access another, larger loan. Consequently, whenever an MFI experiences disbursement delays or problems, it quickly causes a surge of repayment problems.

Creating Partnerships for the Provision of Microfinance, IPEC Pakistan

The project on Combating Child Labour in the Carpet Industry aims to reduce child labour through workplace monitoring and income generation for families of child labourers. The objective of the microfinance component is “to provide easy access to credit for income-generation, and savings services to the families, particularly the mothers of carpet weaving children.” For this component, IPEC is partnering with the *First Women Bank Limited* (FWBL), a financial institution with a dual status as a commercial bank and a development finance institution. The bank’s services include regular banking facilities, as well as consultancy, technical and managerial training, credit to women microentrepreneurs, computer literacy programs, display facilities, marketing support and exhibitions. Loans priced at the prevailing market interest rate are disbursed to groups or individuals.

IPEC has contributed US\$154,000 to the Bank to cover salaries of microfinance officers and support staff, as well as some operating expenses. The Bank, in turn, has contributed Rs. 7.725 million (approx. US\$ 170,473) of its own funds to the project. This money is used for on-lending, to cover salaries and to monitor the project.

The main challenge of the action programme was to clarify the project’s expectations and procedures to the Bank. Since the Bank had no experience in working with the ILO, expectations on the use of funds and on reporting requirements had to be made clear.

The partnership with the bank has been fruitful because of its microfinance experience and because its mission closely matches IPEC’s objectives.

For information on this project contact ILO-IPEC office in Lahore, Pakistan, at ilo@lhr.comsats.net.pk

- **Are MFIs willing to work with IPEC’s target group?** In most developing countries there are a range of financial service providers that reach low-income persons. Some organisations may be particularly concerned about reaching the poorest of the poor, and it may be possible to persuade them to work with the ILO.
- **What are the priorities of potential partners?** To partner with an MFI, it is necessary to understand its priorities and concerns. By the end of the project, most MFIs will want to know if they will have generated a sufficient scale of operations to achieve sustainability. MFIs will be more interested in partnering if they can see the project as an opportunity to:
a) experiment with new products, b) expand their outreach into a new geographic area, or c) develop partnerships with other service providers.
- **Do they need a subsidy to cover costs?** To open up a new branch or to expand operations into a new geographic area, MFIs may need short-term operating subsidies to cover shortfalls until operations reach a sufficient scale to cover their costs.
- **Do they need technical assistance?** While MFIs may be interested in reaching the families of child labourers, they may not have the right product menu to meet the needs of this market. The ILO could provide technical assistance to help MFIs to develop appropriate services for the poorest segments of the market.
- **What linkages can be created?** Although less compelling, another possible selling point would be to assist an MFI to link with other service providers. Microfinance institutions often pursue a minimalist approach whereby they just offer credit and perhaps savings. Some organisations recognise the limitations of this approach, but are cautious about offering additional services themselves. Since an IPEC project would bring together

different partners who provide complementary services, an MFI might be intrigued to experiment with such an arrangement.

Once the project designers better understand the priorities of potential microfinance partners, it is possible to design incentives to enlist their participation, which might include:

- Funding part of the agency's overhead costs (including staff costs) for a limited period, to enable the agency to explore a new market;
- Covering technical assistance and research expenses to develop appropriate financial services for the new target group;
- Providing staff training; or
- Creating a guarantee fund to reduce the lender's risk in serving IPEC's target group (see box below).

Credit Guarantee Funds

In some circumstances, a credit guarantee fund can facilitate access to credit. Many small and micro entrepreneurs with good business plans cannot access bank loans because they do not have suitable collateral. A guarantee fund is especially created to guarantee the loans for which entrepreneurs apply at the bank. Well-designed guarantee funds apply a risk-sharing mechanism: both the bank and the guarantee fund share part of the credit risk in case the entrepreneur cannot repay his or her loan. Credit guarantees are not for free. The entrepreneur has to pay a fee for the guarantee coverage that is offered. There are a number of reasons to be cautious with credit guarantee funds:

- **Moral hazard.** An entrepreneur, who knows that his or her loan is guaranteed, may feel less pressure to repay the loan.
- **High operational costs.** Usually both the bank and the guarantee fund have to evaluate credit applications and monitor the performance of the client.
- **Sustainability concerns.** It is not easy to create a guarantee fund that can cover its losses with the income from guarantee fees.

Whenever IPEC would decide to create a credit guarantee fund, much care should be taken that the design is adapted to the local context and that previous experiences and good practices are being taken into account.

Most experienced MFIs have access to sufficient loan capital for on-lending, or can access these funds from other sources. They usually have more difficulties covering the costs of overhead or product development. If loan capital is lacking, IPEC could consider providing some funds for on-lending. However, donor requirements need to be taken into account (see box below), and it might be simpler if ILO IPEC does not provide loan capital at all.

Specific guidance for USDOL-funded projects

The United States Department of Labor (USDOL) has no authority to provide funding for capitalizing micro-credit schemes or revolving loan funds. All IPEC projects funded by USDOL should, therefore, consider other income generation alternatives, such as facilitating access to existing financial institutions (as opposed to providing the actual capital for the RLF.)

Funds can be used for training and capacity building of microfinance staff (e.g. on how to address the needs of the projects' target group); covering research and development costs and covering costs of setting up new branches, through which the institution could reach out to the projects' target group. Non-financial services for income generation (such as skills and vocational training, start-up kits or business development services) can also be included in USDOL-funded activities.

3.4 Selecting Partners

The selection of an implementing partner is perhaps the most important aspect of a project's success. An ineffective partner can create dependency and provide disincentives for other agencies to work in the community, thereby reducing benefits to the target group. The mistake of choosing the wrong partner is costly in terms of efficiency and impact. .

One has to look carefully at available institutions and find out who is willing to work with IPEC's target group while providing sustainable and appropriate services that help a large number of families to withdraw children from work. In the microfinance industry, a range of potential partnerships have evolved over the last few years, so the scope for partnerships may be better today than just five years ago. Potential partners might include microfinance NGOs, credit unions, rural banks, non-bank financial institutions and even microfinance banks. Experience shows that, in general, government agencies are not effective implementing partners since they usually lack expertise in delivering financial services, are often seen by beneficiaries as providing handouts rather than loans, and can be influenced to use financial services for political gain.

When assessing prospective microfinance partners, it should be kept in mind that success in microfinance means providing **sustainable** financial services to a large number of poor people. The following checklist helps to determine whether an agency has the capacity to provide microfinance services over the long term.

Assessing the Capacity of a Microfinance Institution

Minimum Requirements

- *Vision and mission:* Does the organisation have a clear vision and mission? Is this in line with the vision of the programme? Does it combine social and financial goals? Is it willing to work with IPEC's target group?
- *Strategy:* What is the organisation's strategy for its microfinance programme?
- *Sustainability focus:* Does the organisation have a long-term view? Does it plan for sustainability? Is it looking ahead, beyond one particular funding opportunity?
- *Management:* How is the agency's capacity to manage a microfinance programme? Does management support the agency's vision, mission and strategy?

- *Expertise:* Does the agency have microfinance expertise? Has it maintained low levels of delinquency (e.g., less than 10% portfolio at risk after 30 days)?
- *Image and reputation:* Is the reputation of the agency compatible with microfinance, or does it generate expectations that it will provide services for free, or at a subsidised rate?

Preferred Requirements

Ideally, the partner should also meet the following preferred requirements (yet these can also be built through capacity building support):

- *Depth of financial services:* Does the agency provide a variety of financial services (including savings and credit)? Are these services appropriate to IPEC's target group?
- *Staffing:* What are the skills of the staff, and how much emphasis is placed on skills development? What is the productivity and turnover of staff? Are staff members well-motivated?
- *Familiarity with child labour issues:* To what extent is the agency familiar with child labour issues, and with appropriate interventions to withdraw children from work?
- *Performance:* What has the agency achieved through its past operations (in terms of outreach, impact, sustainability and efficiency)? If past performance has been low, how does the agency justify this? How does it track its performance?
- *Internal controls:* How does the agency protect itself against fraud?
- *Multi-donor support:* How many donors support the agency, and for what purposes? Support from more than one donor is preferred, yet support from too many donors is counter-productive. Donor requirements should also be compatible.

An IPEC project should clarify the scope of involvement with the local partner right from the start. It should highlight the importance of services that will be available after the project has terminated. It should underline that IPEC's financial investment and involvement is comparably short in nature, and that it depends on the partner's commitment to sustain working with this particular target group. Specific benchmarks should be defined in the achievement of this long-term strategy. Occasionally, IPEC should seek to establish multiple partnerships to cover the specific needs of its target groups (see box below for an example in from Nepal).

Balancing Partnerships to Leverage Expertise

In Nepal, the ILO's Prevention of Debt Bondage project works with two partners. MUM, a small, local NGO is responsible for forming groups that include former Kamaiyas, or bonded labourers, and providing them with social awareness, literacy and skill training. As a local organisation, MUM has the confidence of the people and is able to work closely with them. The project also partners with Nirdhan Bank, Ltd., a microfinance bank that has an extensive network throughout the country. Nirdhan is responsible for lending to the self-help groups that MUM has formed, once the groups can demonstrate their discipline and maturity. In this way, by working with two partners who have complementary responsibilities, the ILO leverages their expertise while not pushing them beyond their core competencies.

For information on the project for the sustainable elimination of bonded labour in Nepal, contact the InFocus Programme on Promoting the Declaration (declaration@ilo.org)

3.5 When Partnerships Do Not Work

The partnership approach is by far the best means of achieving a sustainable impact in the area of support to households' income. Even though it may be difficult to set up, the benefits justify a significant investment in trying to make it happen. But this will not always be possible. The following are some of the alternatives to consider when partnerships do not work.

Savings-based approaches. If experienced service providers are not available, or not willing to team up with IPEC, the project can promote the development of member-owned and – managed associations—such as credit unions or village banks—which tend to be more focused on savings mobilisation than lending. This approach is somewhat less attractive than partnering with an MFI because it requires building something from scratch instead of leveraging the existing infrastructure of an MFI. It therefore requires more resources. This strategy, however, has better chances of success than a revolving loan fund. Savings-based approaches have the following advantages:

- They can provide both savings and credit, including emergency loans;
- They work with “hot” member money, rather than “cold” donor money. This acts as an incentive for people to be serious about loan repayments, which, in turn, will affect the long-term availability of funds.
- A savings-based approach creates both literal and figurative ownership.

The promotion of savings groups can be done in two ways. The first approach, which is the preferred option in many cases, is to contract a national credit union association or village bank network to provide technical support to create a local organisation that is run and managed by the target group. The credit union association or village bank network would be responsible for building the capacity of the local organisation, and should provide ongoing institutional support such as technical assistance, liquidity management, internal control and performance monitoring.

If such an association or network does not exist, then it is still possible to promote a stand-alone village bank. Although without institutional backing its chance of long-term success may not be much better than that of a revolving loan fund, it is still a possible option since it would be member-owned and managed and because (unlike an RLF), the ILO would not be capitalising it.

A criticism of the savings-based approach is that the mobilisation of savings from the poor often does not raise sufficient funds for on-lending for income-generating activities, or it takes too long for those funds to be raised. This concern is legitimate. It could be addressed in two ways. The donor could include a matching grant (a subsidy to the fund equivalent to the total amount of mobilised savings) to essentially double the available capital. Alternatively, in the self-help group approach, once the groups have sufficient savings and can demonstrate their discipline (e.g., through attendance records and good repayments on internal loans), the group can borrow money from a bank and on-lend it to individual members for income-generating activities. IPEC has some experience with this approach in India.

Not including microfinance. If the above-mentioned strategies are not an option, the project should not engage in microfinance. It is better not to do microfinance, than to do it unsuccessfully. Ineffective initiatives waste resources and can result in over-indebtedness of

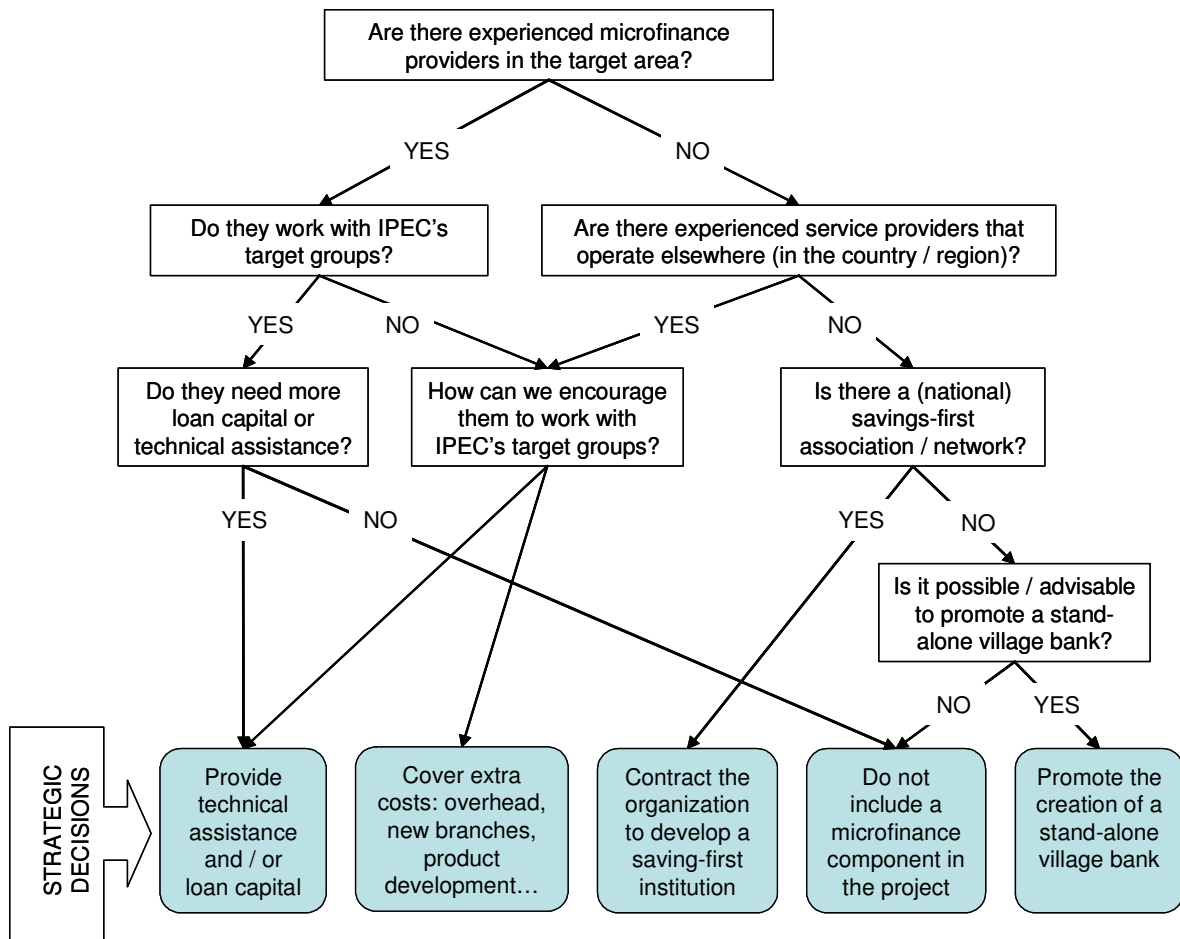
the target group. This can discourage other microfinance providers to enter into the region, or to work with the target group. Poorly done microfinance is worse than not doing microfinance at all.

3.6 Conclusion

Wherever possible, to maximise their effectiveness, the microfinance components of IPEC projects should be done in partnership with financial institutions. Since partnerships are not always possible, other alternatives should be considered, including the possibility of not doing microfinance. **Consider at all time possible restrictions for programming the available resources, such as specific indications in project documents or donor requirements.**

The following flow chart helps to guide a project’s microfinance strategy.

Decision Tree: Establishing Partnerships for Microfinance and Child Labour



4. Microfinance Design Issues

Even if IPEC works with an experienced financial service provider, programme managers should still have a basic understanding about financial products to ensure that the partner designs services to meet the target group's needs. This chapter highlights key microfinance design features, including targeting and specific issues for savings, credit and insurance.

4.1 Targeting

Different people have different needs. Entrepreneurial people should be treated differently from people who will not engage in income-generating activities. The reasons why families send children to work are numerous, and so are the ways in which they can overcome constraints. Hence, the project's interventions should also be multi-faceted.

The target group could be divided into the following sub-groups:

- People who can benefit from an income-generation or microenterprise loan;
- People who can benefit from other financial services to reduce their vulnerability (e.g., emergency loans, savings, etc.);
- People who live in the same community as IPEC's target group.

Targeting should not be undertaken at the cost of community integration. If a programme excludes community members, it runs the risk of creating tensions and jealousy in the community. IPEC's target group should be the main clientele of the programme, yet others should also be able to access financial services. A more inclusive approach has the extra benefit of generating greater economies of scale and enhancing the likelihood of sustainability.

Women's Empowerment

Programmes trying to target the lowest income groups often focus on women. Women tend to spend a larger share of their income on the household. Yet a complicating factor is that some women merely act as an intermediary. Women apply for a loan, but in fact serve as an entry point to the loan scheme for male borrowers. The institution should therefore ask itself whether women have control over the use of the funds they borrow. They may be worse off, since they bear the burden (a debt), but not the benefits of the loan (financial control). There may also be negative social costs to providing preferential treatment to women, such as decision-making processes within the household.

But microfinance is not appropriate for everyone. Who should not be targeted? There are a number of market segments where microfinance may not be appropriate, including:

- **People who will not benefit from financial services.** Examples include persons who are too vulnerable to be able to repay a loan, such as the bed-ridden or chronically ill. By building the capacity and resources of their helpers or extended family, extremely

vulnerable people may become indirect beneficiaries of a microfinance programme. They may also be reached through a (welfare) grants programme. See chapter 5 (grants) for further details on this.

Dependency

Ms. Bhadia Tharu, 45, is a widow. She does not work, so she is unable to save money. She is totally dependent of her son, so she does not get a regular amount for savings, and can not spend her money independently. She is not able to make regular deposits into a mandatory savings scheme.

Source: Case Study of Families Under Debt Bondage Project, J. Acharya, ILO Office, Nepalgunj

- **People who live in remote areas.** The concentration of people in the targeted area should be sufficient to keep the operational costs of the programme manageable. It would be quite difficult to attract a microfinance partner to work in remote areas because that particular branch or retail outlet would be unlikely to cover its costs by the end of the project (or ever). In remote areas, the member-owned and –managed approach may work, especially if the village bank is inclusive and the community has skills and interest in maintaining a financial association.
- **People who are very mobile.** Mobile people, such as demobilised soldiers (see box), are likely to move away from the microfinance scheme. However, if migration is seasonal and predictable, microfinance could possibly work if services are designed to accommodate migration patterns.

Demobilised Soldiers

Former boy-soldiers in Liberia lacked basic skills to run businesses, and their “fighting skills” influenced their behaviour in a group. After the conflict World Relief decided not to target them for their microfinance programme. The agency found that the boys first needed social skills before they could access business support services and microcredit.

Similarly, ACLEDA, a Cambodian microfinance institution supported by the ILO, did not serve demobilised soldiers. Many of the soldiers lacked business skills and preferred to return to the army. They were not a stable population and considered a loan as a reward for their services to the country.

More information on ACLEDA can be found in <http://www.gdrc.org/icm/country/acleda-base.html>

4.2 Loans

Borrowing money involves taking a risk. If it is a well calculated risk —i.e., if the borrower’s future income is sufficient to repay the debt— then the loan can be very useful for poor families. **But IPEC projects should never force participants to take loans.** It should always be remembered that a loan (or credit) is debt and that debt can ruin the livelihood of those who already live in poverty. If IPEC target groups are not aware already, they should be warned about the risks associated with borrowing.

In any case, if it comes to the provision of loans, the microfinance partner should design loan product(s) based on the demand of the target group. The agency should make sure that the following parameters meet people's needs:

- **Loan purpose.** People may want to use loans to stimulate income generation or to help manage risks and smooth income. It is important that the target families have access to both types of loans.
- **Repayment schedule.** For income-generating loans, the term and repayment schedule should be tailored to the expected cash flow of the investment. For example, if the loan is for pig raising, then loan principal should be paid when the pigs are sold and the interests could be paid weekly. If the loan is for a petty trader with a daily cash flow, then daily or weekly repayments could be possible. For emergency loans, the repayment schedule should be based on the household's cash flow. In all cases, it is strongly recommended that frequent repayments be included in the design so that the lender can maintain a close relationship with the borrower and can react quickly if repayments are late.
- **Loan size.** A loan is both an opportunity and a liability. A loan has to be large enough to be useful, but small enough to be repayable. The loan size should also be appropriate to the purpose for which it will be used. Loan sizes depend on the regional economy. In Africa and Asia, as little as \$100 can make a big difference. Yet in other economies, including Eastern Europe, such amounts do not make any impact.
- **Loan duration.** The duration of a loan should be closely linked to the loan purpose. If a loan is used for productive purposes, the duration of the loan should match the productive cycle. People generally prefer long-term loans. Yet the longer the term, the higher the interest costs. Long-term loans are also more risky for both borrowers and lenders since the further in the future one looks, the more difficult it is to predict one's economic circumstances. Therefore longer term loans are not necessarily better.
- **Collateral.** If an agency disburses a loan, it needs some security that this loan will be repaid. Examples include houses, land or other tangible assets. Some lenders may revert to non-traditional collateral, such as jewellery or other items that contain a personal value. Yet IPEC's target group may not be able to provide such assets. This is why for most IPEC projects, group-based lending is the preferred option. In this system, group members act as guarantors for each other's loan. Through peer pressure, the agency has better chances of getting the loan back.
- **Incentives and penalties.** It is crucial that the implementing partner is serious about loan repayments. To make sure that people keep their promises to repay, microfinance programmes need incentives for repayment (carrots) and penalties for non-repayment (sticks)—see box. Choosing the right incentives and penalties is different for each community.

Repayment Incentives and Penalties

Examples of incentives:

- rebates on interest;
- faster processing of applications;
- the opportunity for a client to qualify for another, larger loan;
- the opportunity for a client to qualify for other financial products.

Examples of penalties:

- a charge for each day that a loan is late;
- disqualifying clients from new loans if their initial loans have not been fully repaid;
- giving out information about the unreliability of the client to the community;
- sharing a client's bad credit record with other microfinance programmes.

- **Interest and fees.** As discussed in Chapter 3, interest rates should be sufficient to cover costs once operations reach a certain scale and maturity. Microfinance programmes charge their clients in several ways. Besides interest, some programmes charge an upfront fee, which is deducted from the loan. Cultural aspects have to be taken into account as well. For instance, microfinance in traditional Muslim societies is often a challenge since many Muslims believe that charging interest is “haram” or a sin. Yet Islamic Banking (see Annex 1) allows for other ways to recover the costs of lending. Annex 1 suggests several ways for lenders to cover their costs in an Islamic Banking context.

Which Lending Methodology to Choose?

There are two main categories of lending methodologies: individual and group lending. Within the group lending approach there are numerous variations. Annex 2 contains more information on lending methodologies. In the context of child labour programmes, group lending is recommended because:

- Collateral is not required;
- Groups can act as a forum for communicating child labour messages;
- Groups can create peer pressure against child labour;
- Groups build social capital, which is a valuable safety net.

With IPEC's target groups, a village bank or self-help group (SHG) model would be most appropriate because it is savings-driven (see box), allowing people to get bank services which they may otherwise not have access to. Another advantage is that the internal or group account could be used for emergency loans. Finally, it does not require any loan capital from the ILO or other donors.

The Indian Self-help Group Approach

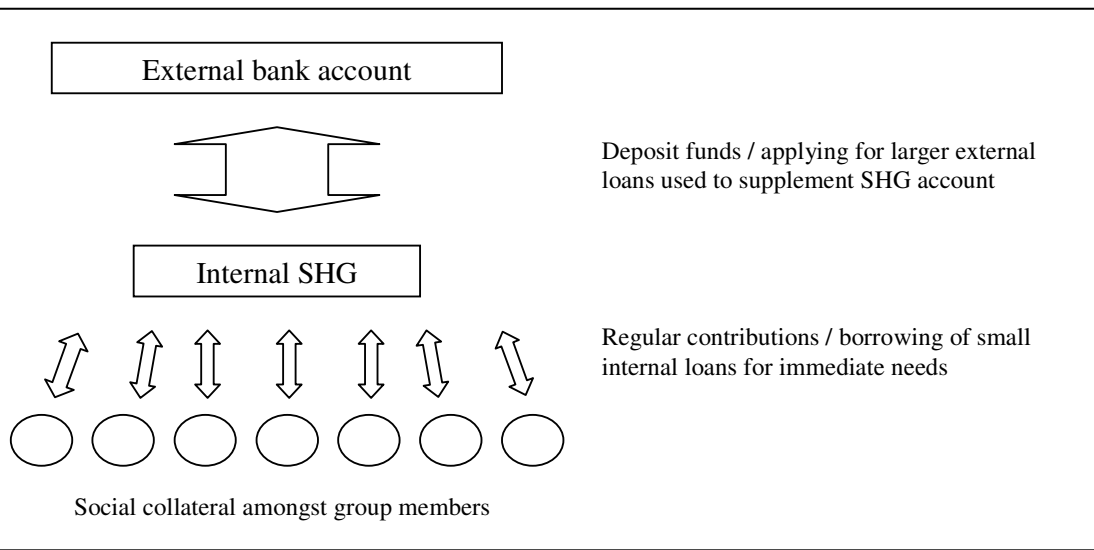
An IPEC project based in Hyderabad, India uses the self-help group (SHG) approach for extending financial services to target families. The SHG model, the most common microfinance approach in India, has several valuable features that make it a particularly effective means for progressively eliminating bonded labour.

Also known as the bank-linkage model, the SHG approach typically involves two institutions, an NGO promoter and a bank. For a fee, NGOs form and train groups of rural women, and assist them to qualify for a bank loan. In this way, the NGO can specialise in social mobilisation, group formation and training, but does not have to get involved in providing financial services. Members have their accounts with the SHG, not the bank; the bank does not deal with individual members. To qualify for a bank loan, a self-help group of twenty or so members follow certain steps, including:

- The SHG members decide to make regular savings contributions, which are managed by the group.
- Members can then borrow individually from the SHG—internal loans—for purposes, on terms and at interest rates decided by the group.
- The SHG opens a group savings account in the bank and deposits funds that are not loaned out to group members. The deposit allows the group to qualify for a bank loan—an external loan.
- The SHG maintains meticulous records of the group’s attendance, savings and internal lending activities. The discipline shown in these records, and the corresponding balances in the group’s savings account, can after six months make the SHG eligible for a bank loan, which it uses to supplement its own funds for on-lending to its members.

The SHG is effectively a micro-bank carrying out all the intermediation tasks associated with taking savings and then lending it out, and can be more responsive to member’s needs than a bank. Internal loans are typically small and used primarily for consumption purposes. Income-generating investments are more likely to occur after the SHG gets an external loan from the bank.

Since India has a fairly extensive banking infrastructure, this methodology is reasonably effective in reaching out to rural areas. However, some groups, particularly in sparsely populated regions, do not link with a bank at all, but rather gradually build up their own capital. A crucial feature of the SHG, like other group methodologies, is that it provides social capital. Members trust each other, and this trust is carried into other areas of cooperation, such as initiating civic projects in villages as well as monitoring child labour.



4.3 Savings⁵

In the context of IPEC's operations, micro-savings are probably at least as important as microcredit. This was confirmed by the thematic evaluation: "the demand for savings services by poor households and micro enterprises is as strong as or stronger than the demand for credit. Expansion of the outreach of savings services can have a potentially significant impact on both sustainability and poverty eradication." Indeed, building up one's assets through savings can be more empowering than putting a household in debt through a loan.

The Importance of Savings

Mrs. Baijayanti Mala Chaudhary, 45, sends her daughter to work because the family did not have enough land, and she could not feed the family properly. She is an active member of the project's self-help group. She is pleased with the project, since it enables her to borrow money to meet her *immediate needs* at an *acceptable interest rate*. "I learned many things from the project (group). I can discuss my problem with other members in the group. I can consult my colleagues about the problems faced. Through group we have learnt about *the importance of savings* and curtailing unnecessary expenses, which are the most crucial aspects to the poor like us." She expects that through the project, she will be able to start a business, so that she would be able to take her working daughter out of child labour.

Source: Case Study of Families Under Debt Bondage Project, J. Acharya, ILO Office, Nepalgunj

This conclusion is in line with experiences from other microfinance programmes. People use savings for **life cycle events** (e.g., for birth, education, marriage or funeral), **investment opportunities** (e.g., productive investments or home improvement) and **emergencies** (e.g., to cope with sickness, injury or theft). The latter is particularly relevant for IPEC's target group. If people can save money to cope with emergencies, this reduces their vulnerability to income shocks, which reduces their reliance on child labour.

Even though the need for savings among poor people is high, access to formal savings is still limited. If savings services exist, they are often mandatory and illiquid (difficult to withdraw), and do not meet people's needs. As a consequence, poor people usually resort to informal savings systems: they hide their money at home, invest it in kind (e.g., in livestock or jewellery), or participate in Rotating Savings and Credit Associations (ROSCAs) or Accumulating Savings and Credit Associations (ASCAs).

These informal systems are accessible and they meet certain needs. Yet they also involve some disadvantages. Savings in kind are illiquid, and subject to price fluctuations. Hiding savings at home is prone to theft, prone to demands by relatives, and trivial spending. Savings through community groups (ROSCAs and ASCAs) typically require that people deposit a predetermined amount, biweekly or so. Yet this requirement is often too rigid for the poorest households, which may only be able to deposit savings infrequently.

What do Poor People Want from Deposit Services?

In many cases, poor people have the following priorities for their savings services:

⁵ Main source: *Savings are as Important as Credit*, CGAP Donor Information Resource Centre.

- *Security*: With limited resources, they need to know that their money is safe.
- *Low transaction costs*: People need to have easy access to savings (in terms of proximity and office opening hours). Savings services should also be simple (minimal paperwork);
- *Appropriate design*: Savings products should allow for frequent deposits of small, variable amounts;
- *Positive returns*: People want to make an adequate return (interest rate) on their savings. Yet returns are a much lower priority than the other three criteria as evidenced by the fact that some poor people even pay money collectors or money holders a fee for savings services to assure the safety of their deposits.

How Poor People Save: Lessons from ILO Debt Bondage Project

In South Asia, the ILO's "*Prevention of Debt Bondage*" project relies heavily on the use of financial services. This project has generated the following preliminary lessons on appropriate savings products for the poor:

- Poor people need savings products through which they can make deposits whenever they have money at their disposal, rather than being required to make mandatory, weekly or bi-weekly deposits.
- The "saving first" obligation, which is common in many microfinance programmes, can act as an obstacle to reach the poorest
- Group members may want to include other family members in making deposits.
- The institution must demonstrate to group members that their savings are safe.

Some implementing partners have experimented with daily savings by providing a small "piggy bank" to each client. This container has a lock that clients open at each group meeting to deposit money into the group account. This lockbox helps group members to set aside savings whenever they have a little extra money, and other family members can contribute as well. The piggy bank allows people to deposit savings throughout the month, not just in the couple of days before the group meeting. Since the introduction of the lockboxes, some groups have experienced more than a 100 percent increase in their monthly savings.

Examples of Savings Products

People have different savings needs, so institutions should look into these needs and fine-tune their savings products accordingly. Savings products differ in terms of liquidity, flexibility, convenience and rate of return. They can be divided into the following categories:

- **Compulsory savings.** Many microfinance institutions require clients to save a fixed percentage of the loan amount or a fixed amount, prior to disbursing a loan. Common reasons for such requirements are that clients need to build up a savings mentality and show commitment to loan repayment. Such savings also act as additional collateral against default. In fact, *compulsory savings are not savings as such, but a component of the lending methodology.*
- **Voluntary savings.** For a client, voluntary savings are more useful than compulsory savings, provided that these savings are well-managed by the institution. For the

institution, voluntary savings are more complicated, partly because withdrawals are not predictable. If the regulatory framework permits, the institution can use voluntary savings to on-lend, but it must ensure that there are sufficient reserves for withdrawals.

Voluntary savings can be liquid or time-bound. The former allows for frequent, small deposits and withdrawals, whereas the latter allows people to save for specific purposes.

a. *Demand deposits*

This savings product provides the most liquidity to the client. People can access their savings freely and frequently, for example when they need money to cover unexpected expenses. Demand deposit accounts tend to be the most popular savings service. But they are also the most difficult to offer and beyond the capacity of many MFIs because of the heavy demands on information systems, liquidity management, and internal control.

b. *Contractual savings*

Through contractual savings, people make regular deposits over a pre-determined period of time, in return for which they get a premium interest rate. Depositors are not allowed to withdraw their savings before the maturation date, or can only do so at the cost of a higher charge. This savings product enables people to save money for expected needs (such as school fees or weddings), or to earn interest on money that they can store in a safe place. A combination of contractual savings and quick access emergency loans may be a demand deposit-like service for MFIs that are not able to offer fully liquid facilities.

Savings and Credit - An Integrated Approach

The ILO's Gender Promotion Programme (GENPROM) implements a project on "promoting the linkages between women's employment and a reduction in child labour" in Tanzania. This project targets poor women in precarious situations, who take their children with them to the workplace, or send their children to work so that the household earns some income. The project has undertaken the following initiatives: (i) awareness raising and group formation; (ii) group training (on group dynamics, child labour issues, reproductive health, legal rights, occupational safety and health and gender issues); (iii) community awareness seminars for Government officials, community leaders and spouses of group members (to get "buy-in" from other community members); and (iv) the provision of savings and credit services (through a guarantee fund with a commercial bank).

The importance of savings. The project has achieved some interesting results in helping poor people to save. Through an awareness raising campaign, group members were sensitised on the importance of savings. It was quite a challenge to get people to understand the importance of savings. Yet once this was achieved, the results were very positive. People started saving in very small amounts of about 100 Shillings (approx. 10 US dollar cents), yet eventually they made deposits of up to 1000 Shillings.

Achievements. Within one year, the project has organised 1,000 women in groups, of which 283 have received a loan from the bank. Loans range from US\$ 50 to US\$ 500, and are disbursed at an interest rate of 23% per year. Some groups have managed to save up to US\$ 100. These savings can be withdrawn freely, for example in case of emergencies, on the condition that the group approves. The default rate of the loan scheme is zero.

For more information, refer to <http://www.ilo.org/public/english/employment/gems/action/tanz.htm>.

c. *Time deposits*

Through a time deposit, people save a lump sum of money under an agreement that they will not access these funds for a specific time. This savings product is mostly applicable in agricultural settings, where people have surplus funds available after a harvest or the sale of animals. They deposit these funds in a time deposit, to make sure that they will not spend it. This savings product is mainly used as a secure and relatively profitable way of storing savings. This is the easiest savings product for an MFI because there are only two transactions, one deposit and one withdrawal. However, this product is the least likely to address the needs of IPEC's target group.

4.4 Insurance

Insurance is another financial service that may help IPEC households to manage risks. However, insurance is a complicated service, quite unique from savings and credit. Ideally a formal insurance company offers a group insurance policy to a microfinance institution, which then extends insurance to individual or client groups. In this way, the company with the technical expertise keeps the risk, and the microfinance institution is responsible for the sales and service functions.

When choosing a microfinance partner, it might be useful to determine if it offers insurance, and if so, in partnership with whom. This criterion, however, should not carry too much weight because the demand for insurance among IPEC families is probably quite low, at least in comparison to savings and credit. Unless the insurance policy accumulates value (i.e., endowment or whole life), if poor policyholders do not need to make a claim, they tend to feel that they have wasted the little money they have.

Savings and credit are much more versatile than insurance. A life insurance policy, for example, will not help someone who is robbed or whose house burns down. Insurance is most relevant for large losses that are unlikely to occur, and which do not affect many people at once. For expected expenses, such as weddings or school fees, savings is the most appropriate intervention. For small, unexpected expenses, if the household has not built up a sufficient savings buffer, emergency loans are most appropriate. For large losses that affect many people at once, it is necessary to think about relief, donations and grants.

5. Grants

5.1 What are Grants?

In development programmes, grants are typically provided at two levels: a donor can provide a grant to a partner (microfinance) institution or development institutions (usually NGOs) can provide “micro-grants” to their beneficiaries.⁶

Grants to Microfinance Institutions

Providing a grant to a partner institution can be a useful tool to help the institution become sustainable, or to experiment with new products and in new markets. However, the effectiveness of grants for microfinance institutions is being debated quite prominently today. Microfinance practitioners have been very critical about providing grants, arguing that microfinance institutions can become sustainable within five years. Yet lessons from the past have shown that there are only a handful of microfinance institutions that have managed to do so. One of the lessons learned is that grants should be temporary in nature, and they should have clear objectives and criteria to assess whether the agency has achieved certain targets.

Grants to the Target Group

Micro-grants are small amounts of money or materials given to poor people. They can provide a safety net to poor households, and can be a stepping stone towards microfinance and self-reliance. Micro-grants are not considered part of microfinance for the following reasons:

- Unlike microfinance, grants do not entail any mechanism for recycling or sustainability. Micro-grants are not returned to the agency, and hence the impact of a micro-grants scheme is limited in both time and scope.
- Grants schemes are based on an unequal relationship between the supplier and the beneficiary. In contrast, in a microfinance scheme, the client pays for a service, and hence, s/he can make some demands on the way in which the service is delivered.
- Since grants usually represent a one-time injection, they cannot help households address their ongoing need for financial services.
- Grants entail the risk of making people dependent.

In sum, grants may be an mechanism to make a quick impact in a short-term project with a limited number of beneficiaries, but by themselves they rarely result in sustainable development. For IPEC projects, grants may be a relevant intervention in environments where sustainable microfinance is not possible, where microfinance partners are unavailable, or for target groups for whom microfinance is not appropriate.

The next section provides advice on the implementation of micro-grant schemes.

⁶ The terms “grants” and “micro-grants” are used interchangeably.

5.2 Implementing Grant Schemes

When implementing a grant scheme, consider the following issues:

- **Targeting.** Grants require careful targeting. Grant programmes will attract both needy and less needy people. The programme should ensure that grants reach those people who need it most, which requires a careful analysis of people’s actual needs and profiles.
- **Stepping stone.** To maximise their effectiveness, grants should be part of an economic empowerment process. They should be used as a stepping stone through which people can eventually access financial services. A grant should enable beneficiaries, for example, to engage in productive activities and meet the conditions to enter into a savings and credit programme (see box).
- **Differentiation.** The organisation or personnel providing the grant should not be the same as the one providing microfinance. Borrowers may not feel obliged to repay a loan to an organisation that also hands out grants. Microfinance staff may also not be able to distinguish between lending and granting.

The design of a grant scheme also needs to take into consideration the delivery mechanism, its purpose and conditions.

Delivery mechanism. Grants can either be provided in cash or in kind. **Cash grants** allow people to use the money for whatever they want—money is fungible. This arrangement could be empowering, but it could also be abused; for example, the money could be spent for undesirable purposes, such as on alcohol or gambling. With **In-kind grants**, beneficiaries

Grants as a Stepping Stone to Self-reliance, BRAC, Bangladesh

BRAC, Bangladesh has implemented the “Income Generation for Vulnerable Groups Development (IGVGD) Programme. This programme enables vulnerable groups to graduate from a grant to a loan. It begins with an 18-month commitment of free food (with the support of the World Food Programme and the government) to people at greatest immediate risk. The programme engages participants in skills-training programmes in income-generating activities such as poultry and silkworm rearing. The IGVGD programme also provides the hardcore poor participants with access to BRAC’s Essential Health Care service, which addresses the link between productivity and health.

During 18 month introductory period, BRAC helps participants to learn to save, building up an economic “nest egg” for future investment and protection. Most participants then progress to individual income-earning activities within the same sectors. Within two years of starting the process, roughly 80% had made the transition – with their small income-earning activities and accumulated savings – into BRAC’s mainstream microfinance programme as borrowers.

This progression of support services – from grants to training to savings to self-employment – appears to be sufficient to break down the barriers of extreme poverty, social isolation, lack of productive skills and poor self-confidence that previously kept this population from self-employment.

Source: “*Microfinance, Grants and Non-financial Responses To Poverty Reduction : Where Does Microcredit Fit?*”, CGAP Focus Note 20.

typically choose among selected items, which may or may not match their needs. In-kind grants may be useful if people have difficulty accessing certain goods. The fungibility problem of cash grants is not entirely overcome by in-kind grants. There are many examples where people have sold the in-kind grant to use the money for something else. In-kind grants may also experience logistical problems with procurement, storage and distribution. Food-for-work programmes are an interesting example of a grant scheme that combines cash and in-kind grants.

Purpose. Grants are typically used for three different purposes: welfare, reconstruction, and economic development. **Welfare** grants provide immediate relief for people in distress. Examples include (donations for) food, shelter, clothing and health care. **Reconstruction** grants help victims of disasters and crises to rebuild their assets, so that they can eventually engage in economic activities. Examples of asset reconstruction grants include (donations for) agricultural and livestock inputs (such as seeds, cows, chickens, goats), production tools and equipment. **Economic development** grants are essentially the same as reconstruction grants except that they are targeted at disadvantaged persons rather than disaster victims.

Conditions. Grants can either be offered on a conditional or unconditional basis. In a conditional grants scheme, (part of) the grant is typically awarded after the recipient has fulfilled a predefined requirement, such as the commitment to take children out of work, and / or place them in school (see box). **Unconditional grants** are provided without any stipulations.

Trickle Up Programme - Conditional Grants

The Trickle Up Programme extends conditional grants of up to US\$ 100 in two instalments. To gain access to the second instalment, recipients have to meet the following requirements:

- Promise to commit 250 hours to the business within the first three months
- Save or reinvest at least 20 percent of the profit in the business
- Secure local approvals or licences required to run the business
- Anticipate the prospect of continued business growth and self-employment
- Demonstrate accountability by reporting regularly on business progress

For more information, <http://www.trickleup.org/>

6. Monitoring and Evaluation

As part of regular project **monitoring**, IPEC should track the efficiency and effectiveness of the microfinance component. There is abundant literature on process and impact indicators for microfinance: some of them are depth of outreach, breadth of outreach, portfolio quality or operational and institutional sustainability. Annex 3 provides definitions of microfinance indicators and a sample reporting format. However, experienced financial service providers may already have a set of indicators and a reporting format, and it would be better to build on what they are already doing instead of requiring unique reporting system only for the ILO.

Continuous monitoring of the microfinance-specific indicators should be ensured by the partner MFI in charge of implementing the microfinance activities. However, IPEC staff need to make sure that monitoring and evaluation of the microfinance components be in line and consistent with the overall monitoring and evaluation system of the project.

One specific aspect of monitoring of microfinance interventions is that, because money is involved, careful attention should be given to mismanagement and fraud, which might be indicated by unrealistic figures or abysmal portfolio quality.

Concerning **evaluation**, it is important to remember that the core objective of microfinance within the context of an IPEC project is to contribute to the reduction and prevention of child labour, and to sustain such results over time. Therefore, the evaluation of the microfinance component would normally be part of the overall project evaluation, aiming to assess to what extent the microfinance activities contribute to achieving IPEC's overall objective.

The microfinance partner agency should assess whether its services have a positive impact on people's lives, collecting and analyzing data on selected variables⁷ with each ensuing loan cycle to build an understanding of how the clients' conditions are changing while using the services. For IPEC, this implies that they should assess whether services reduce poverty and vulnerability, and whether they are increasing income among IPEC's target groups. It is, however, IPEC's responsibility to assess to what extent child labour has been prevented or reduced, and whether their programmes have contributed to placement of children in schools.

In microfinance, the discussion on how to assess impact has been quite controversial. There are several opinions on how to measure impact. The first school of thought claims that client satisfaction is a sufficient indicator for impact. This group equates satisfaction with impact. The other school of thought suggests that satisfaction and impact are two different things. The analogy would be eating a lot of candy. This is something that some people enjoy a lot, although they know that it is not good for their health. This group concludes that client satisfaction provides important information, but it does not provide sufficient information to determine the impact of the programme. More aspects must be taken into account, to find out how a microfinance programme affects the lives of its clients. Annex 4 (recommended reading) provides further information on key tools for assessing and evaluating microfinance services, such as **AIMS** (Assessing the Impact of Microenterprise Services) and **MicroSave**.

⁷ These variables might include:

- For **enterprises**: monthly sales, value of assets, number of employees (paid, unpaid, by gender), registration status
- For **households**: assets, expenditures on food, monthly income, value of savings

Annex 1: Islamic Banking

Although Islamic Banking does not charge interest explicitly, it allows several ways for lenders to cover costs. These include:

Murabaha: This is the sale of a commodity at a price that includes a stated profit known to both the vendor and the purchaser. It is the equivalent of a cost plus profit contract.

Mudaraba: This is a contract between two parties whereby the one party (the lender) entrusts money to the other party who manages the funds (the borrower). The borrower uses the funds in an agreed manner and then returns to the owner the principal and the pre-agreed share of the profit, while s/he keeps the remainder of the profits. The division of profits between the two parties must be on a proportional basis and cannot be a lump-sum or guaranteed return. Also, the lender is not liable for losses beyond the capital he has contributed and the borrower does not share in the losses except for the loss of his time and efforts.

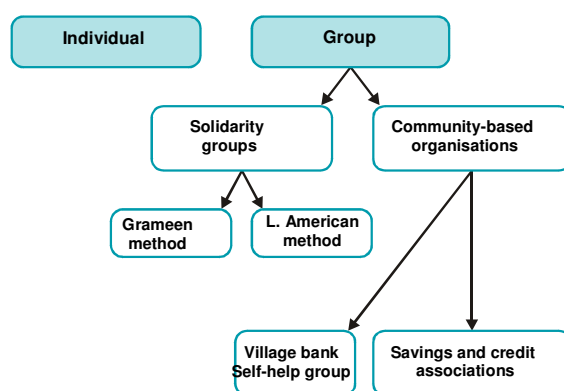
Musharaka: This is a partnership, normally of limited duration, formed to carry out a specific project, similar to a western-style joint venture. It is regarded by some as the purest form of Islamic financial instrument, since it conforms to the underlying partnership principles of sharing in, and benefiting from, risk. Participation in a musharaka can either be for a new project, or for providing additional funds for an existing project. Profits are divided on a pre-determined basis, and losses are shared in proportion to the capital contribution.

Ijara Wa Iktina: This is equivalent to the leasing and instalment-loan, hire-purchase, practices of the kind used to finance vehicles in western economies. Ijara wa iktina as applied by Islamic banks includes the requirement that the leased items be used productively and in ways permitted by Islamic law.

Muqarada: This technique allows a bank to float what are effectively Islamic bonds to finance a specific project. Investors who buy muqaradah bonds take a share of the profits of the project being financed, but also share the risk of unexpectedly low profits, or even losses. They have no say in the management of the project, but act as non-voting shareholders.

Salam: Here a buyer pays in advance for a specified quantity and quality of a commodity, deliverable on a specific date, at an agreed price. This financing technique, similar to a futures or forward-purchase contract, is used mainly for seasonal agricultural purchases. It can also be used to buy goods in situations where the seller needs working capital before s/he can deliver.

Annex 2: Lending Methodologies



- *Individual lending*
Individual lending is the most bank-like approach to microfinance. It involves relatively large loans with standard collateral. Individual loans tend to target more established businesses, which have sufficient assets to secure a loan.
- *Group lending*
Group lending was designed to address the lack of collateral, that is common among poor households. Group lending uses social collateral. This means that people who trust each other, can come together and form a group to guarantee each other's loan. Group lending can be divided into two kinds: the solidarity group approach and the community-based organisation approach. The latter consists of the village banking approach and the savings and credit (or credit union) approach.
 - a. *Solidarity groups* are small groups, usually 4 to 6 members, who guarantee each other's loans. Groups collect repayments, issue new loans and deposit saving. Some solidarity groups also support each other in other social ways (e.g. the Grameen Bank approach), whereas others focus more on the development of client businesses (e.g. the Latin American approach).
 - b. *Village banking* evolved from a strong vision to create stand-alone village institutions. In the classic model, a village bank has an external account (in which a donor deposits its grant or loan), and an internal account (in which the bank accumulates its earnings and members' savings). Each village bank has its own president and treasurer who manage the bank and the internal account. Many versions of this model exist. Village banking is often favoured by the very poor, who prefer to work under the protection of a large group of individuals.
 - c. *Savings and credit associations* (or credit unions) are similar to village banks. The main difference is that savings and credit associations generate all funds through internal savings mobilisation and interest earnings. These associations are often called "savings-first" organisations. Members can access a loan, yet this loan is conditional on the person's savings.

Annex 3: Microfinance Indicators

The following indicators provide insight in the operations of IPEC's partners. These indicators can be used in the design stage (to select partners, by assessing their existing microfinance programme) and in the implementation stage (to track the performance of the microfinance partner). IPEC staff should collect data from the partner institution according to the table on the next page. These data are the inputs for the indicators, which should be calculated by IPEC staff. As such, it will be possible to compare indicators across institutions. (If the institutions calculate the indicators, and deliver the results to IPEC, one cannot be sure that the calculation methods are similar.)

Breadth of outreach

Average loan size = Value of loans disbursed / number of loans disbursed (7/6)

Depth of outreach

Average loan balance = Value of loans outstanding / number of active borrowers (4 / 1a) or (4 / 1b)

Depth = Average loan balance / GNP per capita⁸

Institutional sustainability

Portfolio yield = Income from lending activities / average loan portfolio outstanding (15 / 5b)

Operational sustainability = Operating income / (operating expenses + provision for loan losses) (10 / 11+12)

Financial sustainability = Operating income / (operating expenses + provision for loan losses + financing costs + cost of capital)⁹ = (10 / 11 + 12 + 13 + 14)

Portfolio quality

On-time repayment rate = Amount of repayments made (this period) / amount of repayments due (this period) (16 / 17)¹⁰

Portfolio at risk (> 30 days) = Balance of loans in arrears (> 30 days) / value of loans outstanding at end of period (19 / 4)

Loan loss ratio = Amount written off / average loan portfolio outstanding (18 / 5b)

Institutional efficiency

Administrative expenses ratio = Administrative expenses / average outstanding loan portfolio (20 / 5b)

Borrowers per staff = Number of active borrowers / Number of staff (1a / 3) or (1b / 3)

⁸ The average loan balance is calculated in Ratio B. Information on GNP per capita can be found in development reports, e.g. UNDP Human Development Report.

⁹ This definition does not look at subsidy adjustments, but was chosen for the sake of simplicity.

¹⁰ This indicator does not take into account the fact that borrowers can repay instalments before they become due. Hence, it does not give the full picture on repayments. Yet for the sake of simplicity, this indicator is used.

Microfinance Indicators - Data Collection Form

Period covered: _____ Currency: _____

	During the period (flow)	End of the period	
Breadth of outreach <i>Is the programme meeting a broad segment of the potential client population?</i>			
1a. Number of active borrowers with working children, or with children at risk ¹¹			
1b. % female borrowers (active) with working children, or with children at risk			
2a. Number of active savers			
2b. % female savers (active)			
2c. Amount of total savings			
2d. Voluntary or compulsory savings?		Voluntary Compulsory	
3. Number of staff			
4. Value of loans outstanding ¹²			
5b. Average loan portfolio outstanding ¹³			
6. Number of loans disbursed during the period			
7. Value of loans disbursed during the period			
Sustainability <i>Is the institution moving toward full cost recovery?</i>			
8. Annual interest rate			
9. Flat rate or declining rate?	Flat rate Declining rate		
10. Operating income			
11. Operating expenses			
12. Provision for loan losses			
13. Financing costs			
14. Cost of capital			
15. Income from lending activities			
Portfolio quality <i>Is the institution maintaining a good portfolio?</i>			
16. Amount of repayments made			
17. Amount of repayments due			
18. Amount written off			
19. Balance of loans in arrears (>30 days) ¹⁴			
Efficiency <i>Is the institution efficient in its delivery of services?</i>			
20. Administrative expenses			

¹¹ Borrowers with an outstanding loan

¹² At the end of the period

¹³ i.e. (portfolio outstanding at beginning of period) / (portfolio outstanding at end of period)

¹⁴ At the end of the period

Annex 4: Recommended Reading

Specific Publications on Micro-Finance and Child Labour

ILO-IPEC, 2003 (February). *Income generation strategies for child labour elimination*. Thematic Evaluation; Geneva.

International Centre for Entrepreneurship and Career Development (1999). *Manual for Supplementing Mothers Income. A Solution to Child Labour*. ICECD-IPEC India. New Delhi.

Kelly, Paula Francis (2002). *Micro-finance Interventions: Tools to Combat the Worst Forms of Child Labour, including Trafficking*. ILO Mekong Sub-regional Project to Combat Trafficking in Children and Women in collaboration with ILO-IPEC projects to combat child labour in the deep-sea fishing and footwear sectors in south-east Asia. Bangkok.

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Berenbach, Shari and Diego Guzmán. 1992. *The Solidarity Group Experience Worldwide*. Washington, DC: ACCION International. www.accion.org.

Churchill, Craig. 1999. *Client-focused Lending: The Art of Individual Microlending*. Toronto: Calmeadow. www.accion.org

Churchill, C., M. Hirschland and J. Painter, 2002. "New Directions in Poverty Finance: Village Banking Revisited," Washington DC: SEEP Network, www.seepnetwork.org and www.pactpub.com.

Nelson, Candace, et al. 1996. *Village Banking: The State of the Practice*. New York: SEEP Network, www.seepnetwork.org and www.pactpub.com.

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