Financing of Income Generation Activities in the Wake of Conflict

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These guidelines are based on experiences in Azerbaijan, Burkina Fasu, Caucasus, Georgia, Montenegro and Somalialand, working with Refugees, Internally Displaced People (IDPs) and the original inhabitants. If you are an individual or NGO thinking of starting such activities, these pages will take you through some important considerations.

CONTENT:

1. WHAT INCOME GENERATION MEANS IN A POST-CONFLICT SITUATION

In a post-conflict situation, any or all of the following may apply:

- The region where you work might be in a situation of 'no peace, no war' – front lines may be shifting all the time; security conditions may be unstable and changeable.
- There may be lasting political disagreement – despite cease-fires or peace agreements. Insecurity prevents refugees or IDPs returning home whilst their integration into the regions where they have found refuge is also discouraged.
- Victims of a conflict may be returning home but there is a huge need to rehabilitate the infrastructure – economic, physical and social. And the process will take time.
- There may have been a transition from a centralised to a market economy; in the process many people may have become impoverished and have to look for new ways to earn a living – or just survive.

The early post-emergency phase
Shortly after a conflict, humanitarian assistance may supply food, shelter or medical assistance. But, sooner or later, this assistance will come to an end or be greatly reduced. At this point, support that assists the beneficiaries to be more self-reliant becomes very important. Income generation activities can help here – to prevent a dependency syndrome, to rebuild the self-esteem of people and to facilitate their psychological recovery.

But refugees or IDPs need time to recover and adjust immediately after conflict or arrival at a new location. Grants in kind or cash can be useful, but many of the beneficiaries will not yet be ready to apply them in a planned and determined way. They might just help them to become active again – of great psychological value, but assistance that is social rather than economic.

These grants *can* lead to increased self-reliance but the results tend to be modest, partly because of the usual way the assistance is organised. Help in the early post-emergency phase is usually large-scale and guided more by urgency than good preparation. (Common approaches include the distribution of seeds, tools and animals to rural families; distribution of tools or materials to craftsmen; distribution of materials for handicrafts to women).

Because of the urgency, assistance is not usually tailored to the individual needs of the beneficiaries – no proper assessments are made of the individual capacities of the beneficiaries to use these goods for economic gain. This kind of assessment is necessary to achieve true economic results. Thus, there is a trade-off between providing assistance fast and the economic benefit that can be expected.

In ‘no peace, no war’ situations, it is expected that if people can recover their own production and capital (even on a limited scale), this will reduce their vulnerability and enable them to cope better with recurring conflicts.

Political stabilisation
Increased self-reliance is in itself a legitimate goal for income generation activities. And they can also lead to further economic development for their beneficiaries: when the security situation has stabilised, when people are psychologically ready to invest in their future, when the economic conditions are more or less favourable, then the purpose of income generation projects can shift to economic rehabilitation.

The same is true for programmes for returnees (IDPs or refugees returning to their home regions). Projects should not only aim at cushioning the immediate effects of an emergency but should be linked to future development, providing the individual beneficiaries with a sustainable source of income.

2. DECIDING WHO TO HELP AND HOW

To finance income-generation activities there is a spectrum of approaches.

At one end is **the welfare approach**, with an emphasis on directly helping poverty among the very poor. This approach tries to go deep, to reach as many as possible of the very poor.

At the other end is **the institutional approach**: this focuses on creating sustainable financial institutions for the clients who are not yet served by the existing formal financial system. It would charge interest on loans to pay salaries, cover inflation etc. It wants financial self-sufficiency for such institutions and a wide coverage, concentrating on the number of clients reached.

In between the two extremes you may be trying to achieve various goals, like:
- psychological recovery
- increased self-reliance
- self-sufficiency
- economic development

What your main purpose will be may depend on the particular post-conflict phase and the vulnerability of the target groups.

Immediately after a conflict, many of its victims will be at their most vulnerable. Farmer families will have lost their crops, animals, food reserves and seed – and face starvation. Craftsmen will have lost raw materials and equipment. Traders will be without their supplies and capital. Refugees will have left behind most of their belongings and have to start again. Former government or company employees, or farmers who have become landless, will have to look for new jobs and develop new skills. Returnees will have to rebuild their houses, clean their land, repair irrigation and drainage facilities after many years, and develop new markets for their products.

Rebuilding the economic resources of the beneficiaries (animals, seeds, tools, equipment, trade capital etc.) is of primary importance and can have a major economic impact. The purpose of such aid may be defined as assisting the start-up of new economic activities; it would be expected that a significant number will be able to develop these activities further. Then, later, the aim can shift to economic development

Grants in Kind – an example from Liberia

Same John runs a garage just outside Ganta. He used to own other garages and shops before the war. He adopted his name when he realised that the people who looted his garage were not soldiers from far away, but his neighbours. “I’m the same John that they stole from”, he says. He received a ‘Tools for Self-reliance Mechanics Kit’ from the EC and in return he signed an agreement to take on two ex-combatants as apprentices. They are now learning to weld. Same Jon has a firm manner with these two lads but he can also crack a joke, and his wife is a great cook. They do not talk with outsiders about the history of the apprentices; they might lose custom if they did.

But some groups may be so vulnerable, and the social and economic conditions so adverse, that it cannot be hoped that they will be able to overcome poverty, Amongst them are the elderly, the handicapped, single-head households, or families living far from markets. For many, increasing their level of self-reliance is all that can be expected. They lack assets, manpower, strength, skills, or market opportunities to develop economic activities. They may also lack the financial withholding power needed to be able to save.

Income generation activities aiming at increased self-reliance for these most vulnerable groups can be justified (although if they depend on continuous re-investments from outside, this assistance is social and not economic). But remember that for some of the most vulnerable groups all they can do is manage poverty.Other social assistance programmes may be a better solution.

3. WHAT FINANCIAL SERVICES CAN AND CANNOT DO

These guidelines are about the use of financial services for income generation purposes, with as its primary aim the rehabilitation of the economic resources of the beneficiaries in a post-conflict situation, enabling them to re-start economic activities, financial services are seen as a means to this end and not ends in themselves.

Financial Services
They include credit, savings and insurance. To find out which of these services should be in your programme, first do an analysis of the financial needs of your target group.

Savings
People's incomes are usually divided unevenly over the year. Most notably in the seasonal incomes in agriculture, but it also applies to many other trades. This irregular income has to be evenly divided over the year to cover normal household expenditures, while financial reserves are also needed for irregular high expenditures such as school payments for children or purchase of materials to start production. People also may face sudden expenses due to calamities – diseases, funerals, bad harvests.

Through savings, people can keep the periodic differences between income and expenditures in balance. Poor people who lack savings or saving capacity have a higher risk of getting into debt. Some people say that what the poor need is not so much access to credit, as access to savings mobilisation. It is also argued that most poor people do in fact have saving capacity – what is needed are effective ways of making it real.

> ***Income and the yearly cycle – an example from West Africa***
> Almiras' husband was killed in the Civil War. She was able to settle near family members in a village that was relatively safe. As the rainy season approached she received a loan of land from the village, seeds and tools from ECHO and food handouts from the WFP. She and her children were able to plant, tend and harvest.
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> Most of the maize harvested was stored as food for the coming year or as seeds for the next crop, but she was able to sell a small surplus. This was now her income for the whole year. However everyone in the family needed clothes and other essentials, she had no skills in budgeting or saving and the banks had closed.
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> By the beginning of the next year's rainy season the money had gone. But the rainy season is the time of planting and crop-tending. The family had to work harder in the fields than during the rest of the year, their stored food was nearly all gone and they all suffered from diarrhoeas and malaria, with no

> money to buy medicines. To get through the rainy season she had to sell the last of her silver bangles and borrow money from an uncle against the next harvest…

Because of their marginal incomes and limited opportunities, providing credit to the poor puts them at risk of getting into debt. As savings can be used for productive investments, these can be a substitute for credit. Many of the poor also use credit firstly for consumption needs, for food when they run out of cash, for social investments such as repairing houses, school payments for their children, funerals or weddings. Such loans do not bring extra income in return, which can then be used for loan repayments – as is expected with loans for production purposes. This makes the use of savings even more appropriate than costly credit.

Informal Sources of Finance
Informal sources such as relatives, friends, shopkeepers, traders, pawnbrokers, moneylenders or traditional Savings and Credit groups like ROSCAs are the main suppliers of financial services to the poor. People borrow money from them or sometimes deposit savings. Savings are often made in kind – animals, food stock or jewellery. Establishing and maintaining social networks, is an important insurance mechanism.

Yet, it is thought, these sources and mechanisms often do not respond appropriately to all of the financial needs of the poor. There is an ongoing, undecided discussion as to whether the interest rates or loan charges calculated by shopkeepers, moneylenders etc. are exorbitant.

True or not, each of these lenders can serve only a limited number of clients. Their services depend on personal contacts and many of these lenders only have limited capital. Semi-formal or formal financial service programmes dispose of more capital and can develop into larger organisational structures. They are thus able to reach more people and give them access to financial services. They might be able to supply larger or longer-term loans, which are sometimes needed for capital investments in production or trade.

Because of the flaws in the informal financial markets, the setting up of financial service programmes by NGOs or other institutions can be valuable. But to avoid duplication, an enquiry should first be made into the existing informal sources of financial services – the type of services they provide and what is lacking.

Reaching the poor
Organisations sometimes choose to issue grants or ‘soft’ loans out of a concern that some or all of their target groups will not be able to repay a loan with a higher interest rate. On the other hand, if their long-term objective is to guarantee a supply of financial services for their target groups into the future, they should create

sustainable micro-finance programmes. But then, the financial sustainability of such programmes is likely to become an overriding concern – interest rates will need to be calculated which fully cover the costs and risks of lending. This in turn can result in the exclusion of more vulnerable groups.

Organisations have to define their primary objectives. Experience shows that the two priorities of reaching the very poor and creating sustainable financial institutions are difficult to combine.

Financial services and income generation in post-conflict situations

In these guidelines, the provision of financial services is defined as a *means* for the creation of income generation opportunities and *not an end in itself* (which is what advocates of micro-finance are inclined to think it is).

In many development programmes the mobilisation of savings is emphasised as being of primary importance for the very poor. Many programmes prefer to start with members' savings before credit is issued. However, the saving capacity of many of the target groups of humanitarian agencies just after conflict will be limited. Many victims – whether IDPs, refugees, people who remained in their houses, or returnees – will have lost a great deal of their assets, including their savings. They have to restore their belongings, land and capital before they can start saving. To emphasise savings under such conditions is often unrealistic.

Rehabilitation of the economic resources of the beneficiaries is therefore very important in a post-conflict situation. The process can be financed with grants or soft loans, or, if the long-term objective is the establishment of sustainable micro-finance programmes, with high interest loans. Initially, the priority may have to be on relieving poverty rather than institutional development. Such a welfare approach is justified in rehabilitation programmes where the primary objective is to recreate the conditions before the human disaster. Once this has been achieved, development can take off.

But, as soon as possible, appropriate income generation assistance for individual beneficiaries should be combined with the longer-term objective of developing sustainable micro-finance institutions. This means a shift from grants or soft loans to proper micro-finance instruments. Nevertheless, different approaches can be pursued at the same time – an institutional approach for less vulnerable groups; individual poverty alleviation for the more vulnerable groups.

Humanitarian assistance programmes should avoid doing harm to future development. Granting assistance for too long can create a dependency syndrome. So can offering soft loan terms to beneficiaries who are able to meet commercial terms. It creates undue competition for other micro-finance programmes, harming their development.

Grants, soft loans and micro-finance:

Some definitions:

Grants, as distinct from loans, are provided without an obligation to repay either in kind or cash to the giver, although other obligations can be imposed.

Soft loans are loans on which no interest is charged, or a low interest (below the rate required to cover all the expenses and risks of the lending agency).

Micro-finance refers to the provision of financial services, that can include credit, savings and insurance services. Micro-finance suppliers can be one of three types:
- **Informal** suppliers: such as relatives, friends, shopkeepers, traders, pawnbrokers, moneylenders or traditional saving and credit groups (e.g. ROSCAs).
- **Semi-formal** suppliers: in recent decades many non-specialised NGOs have started micro-finance programmes – either with credit made available through revolving funds, or through more broadly-defined micro-finance programmes, including savings and credit services or even insurance.
- **Formal** suppliers*:* these are the specialised micro-finance organisations, banks or other institutions registered under bank law and officially licensed to provide financial services.

ROSCAs (rotating savings and credit associations) are traditional saving and credit groups existing in large parts of Africa, Asia and Latin America. Other names are merry-go-rounds, hagbads and tontines. People contribute to each at periodic intervals (for example once per month) an equal amount of money, which may be very small. Each time, when all donations have been collected, the total amount is paid out to one of the group members. The cycle continues until all participants have recieved the total once. After that, the group can break up or start a new cycle with the same members or (some) new members. Thus the members commit themselves to a form of savings. If it is someone’s turn to receive the lum sum, he/she can afford to make one expenditure larger than normal. It is a system most popular among women, but also used by traders, civil servants and others.

4. DECISION TREE: WHEN TO USE GRANTS, SOFT LOANS OR SUSTAINABLE MICRO-FINANCE PROGRAMMES.

Ask the following:

- What is the post-conflict phase?
- How vulnerable are the beneficiaries?
- Do you have – or can you get – the capital?
- What are the general objectives of your programme?
- How strong organisationally are you?
- What are the economic conditions/infrastructure like in this region?

What is the post-conflict phase?

Early rehabilitation: Grants are the favourite tool
We have seen in chapter 1 that in the immediate aftermath of a conflict, seeds, tools, or other materials are usually granted to programme beneficiaries. Assistance is urgently required but the preparation time for the organisation is short. There is often little time for proper targeting or proper assessment of individual skills and opportunities, or for a tailor-made distribution of tools appropriate to the needs of each individual. The economic results of such assistance will be marginal for many of the beneficiaries. Also, the beneficiaries have to recover from their traumatic experiences and adjust to their new conditions before they can plan for their future and properly consider a far-reaching decision like taking a loan for a business investment. Organisations should probably not start loan programmes under such conditions.

As long as the security conditions are uncertain, as in many of the ‘no peace, no war’ situations, lending might also be too risky: the lending organisation risks its capital and the borrowers risk indebtedness.

In the early rehabilitation phase, most beneficiaries have numerous needs besides the start-up of economic activities – such as repairing their houses or renewing furniture and other household equipment – and so often have a limited capacity to repay a loan. Assistance through grants is often preferred.

Later phases: the shift from grants to loans
If an organisation wants to act in a development-oriented way, a shift from grants to loans and an approach focusing on more durable solutions should be considered at some point in time. This can mean soft loans or establishing a sustainable micro-finance programme. Both can significantly increase the programme impact. Shifting from grants to loans, establishing a revolving fund, means that the total capital available for loan distributions will, in due course, get bigger. Loan repayments can be used for new beneficiaries or to issue one loan after another to borrowers.

If the choice is for soft loans, the capital of the revolving fund will shrink over time and eventually disappear, since the repayments do not cover the organisational costs, non-repayment and inflation. A sustainable access to credit can only be assured by charging interest to cover these costs and risks.

When deciding between grants, soft loans or sustainable micro-finance, one should however consider the likelihood of a trade-off between broader development goals and the objective of reaching the most vulnerable amongst the target groups. The broader objectives of the programme or organisation, its organisational capacity and the regional and general economic conditions all have to be taken into consideration.

Cultural factors – will the borrowers repay?

In Somalia, Saraphatou, the manager of a project providing interest-free loans explained why they only loan to women: "the men here used loans to buy khat and cigarettes and then came with sad faces and said they couldn't repay. Women use the money to start growing vegetables or set up little tea-shops. They're busy looking after the children and making money but they pay their loans back. We may consider men in the future if they have a tribal Elder to stand guarantor for them".

How vulnerable are the beneficiaries?

It has been pointed out that in the immediate aftermath of a conflict, many of its victims are extremely vulnerable. But somehow a majority of them succeed in re-establishing a living. Therefore at some point it should be possible to shift from grants to loans in order to finance income generation activities.

To define the precise point in time for such a shift is difficult. It depends on the social and economic conditions of the beneficiaries as well as the political situation. Have the beneficiaries had enough time to recover and resettle? Has security returned? Are economic conditions favourable enough to successfully take up income generation activities?

The repayment capacity of beneficiaries is sometimes misjudged. Even under adverse conditions, some activities enable people to earn incomes that will allow for loans. Trade is one such activity. Going into trade is relatively easy: the business cycle is short so investments give a quick return, and profit margins are relatively high. In contrast, agriculture often has long business cycles and relatively low profit margins. So loans for trade may be safe while loans for agriculture need to be made with caution.

Although improved conditions allow for a shift from grants to loans for a majority of the target groups, there may be certain groups who remain extremely vulnerable. It may be necessary to continue with grant programmes for such groups, while shifting to loan programmes for the large majority of the target group.

Do you have – or can you get – the Capital ?
It is often said that to reach sustainability, a formal micro-finance organisation should have a total loan capital of several hundred thousand US dollars, and that to reach full operational and financial sustainability takes about three to five years. Other kinds of projects (grants, soft loans) can be started with however much capital is available and, since the money will melt, the project runs until the capital is used up.

What are the general objectives of your programme?

Community Development?
Many NGOs have more broadly defined programme objectives, such as community development, community rehabilitation or solidarity with more vulnerable groups. Income generation programmes specifically assist individuals to improve their economic situation. Some community members will benefit from it more than others. The community might indirectly benefit from the economic progress some individuals make, because others are employed, relatives or friends are helped or the general economic progress is strengthened. But such community benefits are not the result of a deliberate programme design.

Yet income generation programmes can be linked directly with broader community development objectives:

- There may be a need for investments in the social infrastructure – repairing the schools, clinics, water sources – or in the economic infrastructure, through funding irrigation schemes or providing transport to and from markets. These investments are essential if IDPs and refugees are to go home are restart their lives successfully. Those who receive a loan can be asked to pay a community fee, instead of interest, to be used for such investments. Individual gains from the income generation programme are thereby funneled to the whole community.

- In grant programmes, beneficiaries have been asked to distribute part of their harvest or, for craftsmen, give hours of free service to more vulnerable people. This introduces a solidarity aspect into the programme. Similarly, in loan programmes, social fund fees can be paid by borrowers instead of interest. This could be used to support the most vulnerable.

Such linkages would be difficult to make if an organisation wants to develop a sustainable micro-finance programme. First, loan beneficiaries can hardly be asked to pay a community fee or social fund fee on top of a high interest fee.

Secondly, organisations that want to develop into a micro-finance organisation tend to concentrate fully on this, often resulting in narrowing their original, often broader, defined objectives. Although such a development is not inevitable, it is very difficult to combine the determination, rigour and business orientation required for establishing a successful micro-finance programme with the attitudes and orientation of a broader defined social programme.

So it is important for any organisation considering micro-finance to look at how it relates to its original objectives and the possible consequences.

Community-Based Approaches…
In Africa and Asia many NGO programmes have a community-based approach: programme. Interventions take place at the lowest community level (villages) and ownership of the programmes is delegated to this level. If associated tasks and responsibilities are handed over to committees of a community organisation, it can result in a substantial reduction of the overhead costs for programme management. Interest fees for micro-finance programmes can be kept low.

Programmes can also be linked more easily to traditional Savings and Credit systems at this lowest level. Local capacity will be strengthened, thus incorporating community development objectives in what might primarily be an income generation or micro-finance programme.

An example from Somalialand
This was an income generation programme managed at community level by women's groups. The basic concept of the programme was derived from the widespread, traditional rotating saving and credit system, or ROSCAS, known in Somalia as Hagbads. Most of the women in the programme had used these for years.

The programme received capital from Denmark, and an initial sum could be given to various women's groups. Each group decides itself on its maximum membership, mostly between thirty to fifty women. Then it decides on the members who will receive the first loans –five to ten people. Each receives a loan. Repayment is in equal monthly instalments. The group then meets monthly for repayments and other business.

As the first loans are repaid, the money is paid out immediately to one or more other members, depending on the total amount collected. Once every member has received and repaid their first loan, the whole cycle can start again, with second or more loans to its members.

The funders have agreed that the revolving fund can be used for loans as long as the women see a need for it or want it to continue. The revolving fund could, however, be handed over to the village community to be used for communal investments such as schools, health structures, grinding mills etc. To guarantee their commitment, clan elders participate at the women's meetings.

In the system described above, loan capital was provided to a community to enable them to (re-)start income generation activities. Building on the traditional Hagbad, the principles of the new system, such as the organisation and the contractual obligations to which loan takers committed themselves, were easily understood and kept. The final objective of the programme was not necessarily to establish a sustainable community-based micro-finance system. It could be the outcome of the programme, but after the most urgent economic rehabilitation needs had been addressed or the women's group broke up, the revolving fund could also be used for other aims.

How strong organisationally are you?
The organisational capacities that are needed for massive distribution programmes in the earliest rehabilitation phase, for a tailored grants programme, for community-based revolving fund programmes, for soft loan programmes, or for operating regional micro-finance programmes, all differ greatly.

The main requirements for a massive distribution programme are the capacity to assess the needs and to identify the tools required to help economic or social recovery. In addition, it needs good logistics and proper organisation and monitoring of the distribution process.

A tailored approach requires the capacity to assess an individual's ability to start and develop a new activity and how likely it is to succeed. Then, proper monitoring is necessary to make sure that the beneficiary uses the grant for the agreed purpose, and to follow the impact for the beneficiaries.

A community-based savings and/or credit programme requires the following abilities: to analyse social relations in a community, to facilitate groups, to mobilise community skills, to be rigorous regarding repayment discipline and financial integrity, and some basic bookkeeping skills. The management skills required are relatively small, and the other activities are mainly delegated to the community. However the outside agency starting such a programme should provide training, assistance for problem resolution and monitoring of the programme's progress and impact. Credit or grant officers can carry out most of this if they have the basic skills. Training, group mobilisation and problem resolution can also be delegated to other specialised programme staff. Financial management and financial monitoring systems for such programmes are relatively simple.

To develop a formal or semi-informal micro-finance programme which is sustainable, and operates on a regional scale, is a different matter. Credit officers will require more competence in assessing loan applicants and their business proposals. But the requirements for middle or senior management are of a different order: there should be high standards in loan portfolio management (to ensure minimal non-repayments/arrears) and capital management (to ensure a high proportion of the capital is active and in outstanding loans rather than dormant). The cost-effectiveness of the operations has to be watched closely: economies in salaries (high client-to-staff ratios), transport costs etc. Proper planning and monitoring systems for loan portfolio and financial management should be used. This requires business-oriented staff in middle and senior management positions who are properly trained in micro-finance.

Humanitarian and small organisations should consider whether they have the capacity, the determination and the long-term commitment needed from themselves and their donors to establish a micro-finance organisation.

What are the economic conditions/infrastructure like in this region?
Since a high client-to-staff (or credit per credit officer) ratio is crucial, in regions with a low population density – such as many parts of Africa – it will be difficult to establish a sustainable formal micro-finance programme. High ratios cannot be realised because transport costs are high, loan amounts per client are too low and the risks of non-repayment or arrears are too high.

So, many financial institutions restrict their operations to urban or semi-urban areas. The agricultural sector is often avoided because the profit margins are too small and the target group too poor. If a drought or other natural disaster hits a region, all farmers may be hit. If a financial institution puts a large share of its loans in one sector only, or in a region heavily dependent on agriculture, it risks repayment problems with a large part of its clients at one time.

Community-based approaches have the advantage that organisational costs, and the interest charged to cover these costs, can be kept low. They offer a good alternative to formal micro-finance under these kinds of conditions. Community-based programmes are better able to overcome problems from natural hazards or temporary economic adversities. In the face of serious default problems, a community-based programme will not be under such heavy pressure to solve them quickly. It can wait for better times, rescheduling the loans or rebuilding part of the lost capital with new savings or other members' payments.

5. INTEREST & ISLAM

An important Islamic principle is that usury – i.e. the lending of money at exorbitant interest rates – is bad. However, there is no agreement as to whether interest is wrong only when money is lent at exorbitant rates that exploit the borrower, or whether it should be forbidden completely.

Islam does allow gain from a financial activity if the financial capital is, at the same time, at risk of potential losses. Profit-making, too, is acceptable in Islamic societies.

Alternatives exist to charging interest and the following practices exist in Islamic banking:

- Profit-and-loss-sharing schemes. The bank provides capital needed for a project while the entrepreneur provides its labour and expertise. The profits (or losses) from the activity are shared between the bank and the entrepreneur at a fixed ratio determined in advance. Profit-sharing rates must be set as a percentage of the profit.

- The Koran encourages Muslims to make loans with zero return to 'those who need them'. Banks are allowed to charge a service fee to cover the administrative and transaction costs of the loans as long as such costs are not related to the maturity or the amount of the loan.

- The bank buys capital or trade goods and resells them to the entrepreneur for the costs of the goods plus a fixed increase for the administration costs. The bank owns the goods until the last instalments have been paid. It is very similar to trade financing or leasing.

So there are acceptable ways of providing money or building formal micro-finance systems. To know more, you need to get informed about the practices of other financial programmes in your region, before starting an appropriate micro-credit or micro-finance programme.

6. BEST PRACTICE

– Economic viability
– Market opportunities
– Vulnerability
– Selection criteria
– Enforcement of repayments
– Collateral, individual guarantor and group or community-based loan systems
– Adoption of basic principles from traditional systems
– Size of loans or grants
– Successive loans
– Grace periods
– Training and consultation
– Bank accounts
– Monitoring and evaluation

Economic viability
Earlier, the different purposes of income generation projects were looked at – psychological recovery, increased self-reliance, self-sufficiency or economic development. The economic activities should be sustainable. It is not increasing self-reliance if grants are necessary for each round of production. The economic capability of the beneficiaries and the new activities have to be properly assessed, whether for grants or loans.

Making a first selection on the basis of vulnerability criteria can target the most vulnerable groups. This should be followed however by proper assessment to select among them only those who can sustain their businesses.

Market opportunities
Sometimes, managers overlook the question as to whether there will be sufficient demand for the products of new economic activities. The problems include the following:

- Beneficiaries who have a business and are applying for a loan to expand or diversify, usually have a good notion of the market demand. But beneficiaries starting new economic activities can be too optimistic, can forget to make a market assessment, or do not know how to. They need time to learn about their markets and to develop them. So first loans should be kept small. Later on, if their businesses develop successfully, the amounts can be increased for follow-up loans.

- If loans are issued to many applicants for many different trades, there is usually no problem with demand. But if borrowers all start the same type of business in a small market – e.g. all opening small shops selling the same products – the market can quickly become saturated.

- If programmes develop just one economic activity – such as a large number of farmer families going into cattle production, which depends on external markets – then the enterprise is very vulnerable (to falling markets, for example).

Vulnerability
Because humanitarian agencies consider the most vulnerable groups as a main target group, they are tempted to give grants or loans without a business-like assessment. But economic criteria should not be sacrificed to vulnerability criteria, especially if long-term sustainability is pursued. Loans issued to beneficiaries who are unable to repay will result in high default rates, jeopardising the programme's continuance, while the beneficiaries risk indebtedness.

To reconcile the humanitarian concern for the most vulnerable groups with a concern for long-term impact, complementary programme components of grants and loans can be a solution. Grants are given to those who are able to start up an activity and sustain it, but cannot yet repay a loan. Those who have repayment capacity have to rely on loans. An example of economic activity for the most vulnerable is small-scale agricultural production. It can be an appropriate means for increased self-reliance but the returns, perhaps in kind, are often insufficient, with income growth realised too slowly. Repaying a loan would be difficult.

It is often said that grant and loan programmes should not be implemented by the same organisation. Loan applicants might feel the different treatment between them and grant beneficiaries is unfair, affecting their willingness to repay the loans. However there are examples of programmes where the two components were combined without any problems. It is possible if there are clear vulnerability criteria which distinguish between the two groups of beneficiaries, and these criteria are accepted by the communities.

Selection criteria
The use of social categories, such as the elderly, the disabled, single-headed families, war veterans etc. is widely practised in former socialist countries for targeting social benefit programmes.

This approach is attractive since these groups can be easily distinguished and selection on the basis of such criteria is socially accepted. The disadvantage is that all the people in these groups are not necessarily among the most vulnerable. In contrast, long-term unemployment, as the result of a lasting economic or political crisis, can make others even more vulnerable.

Selection criteria should therefore be based on the real financial situation of the beneficiaries, however difficult it may be to get reliable information. An alternative is to rely on the communities to identify the most vulnerable families themselves

Enforcement of repayments
A major weakness of many NGO loan programmes is a lack of follow-up on non-repayments. Experience has shown that a lack of enforcement will result in declining repayment figures and finally the loss of the revolving fund. It means that beneficiaries expect no pressure to repay with future programmes.

A reason for this lack of follow-up of loan defaulters is often that the programme officers are not convinced that borrowers have the capacity to repay. If this is the case, loan projects should not be started. If it is called a loan, it should be treated as a loan, to avoid harmful effects for other (future) programmes.

Collateral, individual guarantor and group or community-based loan systems
Collateral requirements are often used to guarantee repayment of loans. In countries with weak court systems their effectiveness may be limited if the courts, or the community leaders, are unwilling to confiscate the collateral after default. So, before starting such a system, the co-operation of the courts or community leaders should be assured. In some programmes, the items used for collateral – e.g. second-hand furniture or electronic appliances – are overvalued, especially when times are hard. Items that keep their value, such as cattle, or gold and jewellery, are better alternatives.

A major weakness of collateral systems is that it excludes more vulnerable groups who have nothing. The so-called *guarantor system* is a good alternative. Personal guarantors can guarantee security for the loans with their properties, or with their salaries, with proper contracts signed before the court and/or with the employers of the guarantors. The guarantor system can be very effective since defaulters want to avoid bringing their guarantors into trouble.

While the guarantor system is linked to individual loan systems, another alternative are group or community-based loans. In *group loans* – where each has some 5-15 members – responsibility for repayment of the loans is transferred to the groups. If one member defaults, other group members should make a repayment for them or new loans are not issued to the group. In c*ommunity-based systems* – village banks, for example – other community members may be denied new loans when individuals have not made repayments. If the community is involved in the selection of loan applicants, in collecting repayments or through being the future owners of the revolving fund, there should be great peer pressure on beneficiaries to repay.

The replacement of collateral by peer pressure, through the individual guarantor or group guarantee system, or through community-based systems, is an effective means of making access to loans for more vulnerable groups possible. But this can only be effective if beneficiaries and loan committees are willing to comply with their obligations. A feeling of ownership of the revolving funds is a necessary condition. This is built by giving members real responsibilities and proper training.

Adoption of basic principles from traditional systems
See the example in chapter 5 of a credit programme developed in Somaliland which derives its basic principles from the traditional saving and credit system, the Hagbad. Basing new programme approaches on traditional systems will greatly enhance their chances of success. The beneficiaries know and understand the basic principles, accept the procedures and commitments, and will be able to manage such systems.

Size of loans or grants
The size of the loans can be decisive for ensuring economic impact and its future sustainability. For example, in one country, one programme issued loans to refugees for cattle breeding while another programme provided grants for pig and chicken production at half the loan size. It turned out that cattle breeding had given most beneficiaries a basis for further sustainable development, while many pig- or chicken-breeders had not been able to make enough profit to buy new animals to replace those slaughtered after the first production cycle.

On the other hand, it is generally recognised that initial loans for new beneficiaries should be kept small to enable the lending institution to get to know the clients and their capacities. There are many examples of programmes starting off with loans too large for many of their clients, who then fail to utilise these appropriately and develop default problems. For beneficiaries capable of managing more capital, the loan amounts can be increased later in successive loan cycles.

Successive loans
The prospect of receiving a new loan following repayment of the former one(s) gives beneficiaries a permanent interest in the system functioning well. Successive loans can thus be an important instrument. The disadvantage of issuing new loans to old clients is that it keeps the number of new beneficiaries low. If the programme's purpose is to establish a sustainable micro-finance organisation, a system of successive loans should be used since the programme aims at providing permanent access to credit for its clients. But if a programme wants to cover as many potential beneficiaries as possible, and does not aim at developing into a micro-finance organisation, they can choose to offer just one loan cycle to give each beneficiary the opportunity to get started. For further development of their businesses they could then be referred to other organisations.

Grace periods
Usually the repayment of loans starts only after the beneficiary has made his first money. The period from when the loan was issued to the time of the first repayment is called the grace period. The thinking is that without the extra income the beneficiary will not be able to repay. Thus, reimbursement of agricultural loans often starts after the first harvest. But there are good reasons to argue against

grace periods and instead to start repayments soon after the loans have been issued. If first repayments cannot be made from alternative income but have to be paid from 'savings', i.e. money withheld from other consumption needs, it helps the beneficiaries develop a saving habit. When starting repayments early, the first amounts can be kept small, while the programme stays in touch with the clients and is quickly aware of defaulter problems. And spreading repayments over a longer period allows each to be a small amount, which is easier for the beneficiaries.

Training and consultation
In some programmes, loan applicants have to follow a business training – subjects such as profit calculations, financial record-keeping, and business assessments, or a technical skills training for their particular craft. The need for this depends on the complexity of their new businesses and their previous experience. For small agricultural loans, a business training is usually unnecessary while technical training or short courses might only be necessary to teach new techniques. A business consultation with loan clients can be an alternative to training. As a basis for such a consultation, loan applicants can be asked to fill in application forms with information on their planned business.

Besides training for individual beneficiaries, it is also essential to train communities and their representatives in the principles and procedures of the (saving and) loan systems, the proper management of revolving funds and in organisational principles and group dynamics.

Bank accounts
The risks of fraud will be greatly reduced if loan officers and other staff or community members do not have to handle cash. If banks are within easy reach of the beneficiaries, a best practice is to pass all loan disbursements and repayments through a bank account.

Monitoring and evaluation
Repayments and defaults should be closely monitored so that shortcomings will be quickly traced and appropriate action taken. Formal micro-finance programmes require the adoption of proper management information systems including the monitoring of the quality of the loan portfolio, projections of portfolio growth and financial and organisational sustainability and balance sheet statements. Smaller informal financial programmes, not aiming at developing into sustainable micro-finance programmes, can use less sophisticated systems, emphasising the proper monitoring of repayments and defaults.

Although not widely practised, monitoring and evaluation of the social and economic impact of an income generation programme is also essential. Is a programme reaching its target groups? What is the social and economic impact of the project on the target groups? Is the impact in accordance with its objectives? Depending on the information available, policies and strategies can be adjusted when necessary.

7. EXIT STRATEGIES

– Exits for grant programmes
– Exit by moving into micro-finance
– Exit by merging with another micro-finance programme
– Exits for community-based programmes
– Open-ended exit strategies

Donor funding for humanitarian assistance programmes is usually made available for relatively short time periods, so programmes have to work out an exit strategy. The necessary programme adjustments can then be made in good time without harmful effects on the target groups, programme staff or other agencies. What are not wanted are the non-fulfillment of promises or contractual obligations at programme closure, confusion about the future ownership of revolving funds or collection of outstanding loans, or poor preparation of local staff or the target group for the final handing over of a programme.

Exits for grant programmes
Grant programmes can easily be closed once all the promises made have been met. To be on the safe side, if there is no assurance of long-term funding, organisations could choose to carry out only grant programmes. Allowing for a monitoring period to assess the appropriate use of the grants – whether the grants have been used for the designed purpose and the expected economic and social impact have been achieved – a grant programme can be closed down the moment all available capital has been distributed.

But it is important to determine the right exit-point for grant programmes. They should not be continued for too long, so that dependency of beneficiaries on free assistance or harmful effects for other loan programmes is avoided. If the grant programme is partly continued because distribution of grants to most vulnerable groups is considered necessary, it should be ensured that only those groups who depend on grant assistance be helped, requiring a clear definition of the vulnerability criteria.

Humanitarian programmes that started with grants in the early rehabilitation phase may often, in the absence of other development agencies, continue their assistance in a later phase, shifting to loans. A long-term strategy then becomes essential.

Exit by moving into micro-finance
Developing into a micro-finance programme is appealing because it can help local development, it offers a clear long-term strategy and, last but not least, job security for local staff.

The chance of a programme developing into a successful micro-finance programme depends on:
- whether local staff are determined and of high quality;
- whether long-term funding can be assured, either by the direct support of the humanitarian agency, or by it actively helping to find additional donors;
- whether the capability of the programme staff is good enough to attract new donors;
- whether proper technical training, capacity building and institutional training has been provided. This requires guidance from the humanitarian organisation, or expertise hired from outside. It also requires in-house capacity to recognise the needs for training and assistance.

The development of a micro-finance programme can be long and sometimes difficult. Often humanitarian agencies do not have the expertise, determination, financial means and long-term commitment to make it happen. Before committing to it, the consequences and the requirements on any organisation should be well thought through.

The primary aim of your agency might have been to set up an income generation programme that responded to the rehabilitation needs of your target groups. The establishment of a financial programme was a means to achieve this end, not an end in itself. Loans were started to increase the potential impact of the programme, through recycling of the capital fund, or to avoid potential harm for future development programmes due to prolonging grant assistance for too long. But loan programmes do not necessarily have to develop into independent (non-)formal micro-finance programmes.

Exit by merging with another micro-finance programme
A merger will only be possible if the beneficiaries of the programme are already prepared to comply with the contractual obligations applied by the micro-finance programme. No major problems should be expected if the principal best practices of micro-credit are already adhered to in the loan programme, i.e. the selection of beneficiaries on the basis of economic criteria; repayment on time; proper monitoring of repayments; and enforcement of repayment obligations. A merger will also mean harmonising the two administrative systems.

Harmonisation of interest rates does not appear to be necessary. Programmes have shifted over time from grants to soft loans to cost-recovering interest rates without causing major problems. It can be explained to beneficiaries that, by upgrading from zero- or low interest rates to higher interest rates, they can be seen to have greater financial strength. In the end, the role of a soft loan programme is to bridge the gap with micro-finance; it can help beneficiaries who are too poor to apply for commercial micro-loans. But after starting with help and becoming successful, they need to be referred to micro-finance programmes for further capital needs.

Thus a soft loans programme with its revolving fund does not have to be sustainable. Its mission ends when the target groups are strong enough to use the services of micro-finance programmes. The remaining funds can be merged with those programmes.

Exits for community-based programmes
With community-based programmes, a local organisation can be identified, management of the programme delegated and the revolving funds handed over.

Alternatively, the programme can be closed; the loan capital can be handed over to the local communities for investment in communal services or infrastructure. With this exit strategy, management can be kept simple and overhead costs low. In countries or regions with a low population density, a poor economy and a poor road infrastructure, there may be no other option. The field travels required for monitoring the programme and the repayments of small loans would be too costly if they depended on salaried loan officers. With a community-based approach it is easier to build in other development objectives, for example capacity building or linking the revolving fund with a community development fund.

A main task for the supporting agency is to make sure that funds are used appropriately after it withdraws. This requires community mobilisation, and capacity building of the CBOs and its members. The accountability of community leaders should also be assured.

Open-ended exit strategy
The choice of exit strategy can be left open. The best strategy for a humanitarian agency seems at first to comply with best practices for micro-credit. It means that grants should be abolished as soon as conditions allow for loans, only continuing grants for clearly identifiable vulnerable groups. Best practices for loan programmes include the selection of beneficiaries on the basis of economic criteria, enforcement of repayments and proper monitoring of repayments.

All this prepares beneficiaries and programme staff for the requirements of future micro-finance. Interest rates can be introduced as soon as the economic conditions of the beneficiaries allow. But a decision to start a micro-finance organisation can wait for a proper assessment of the capacity of the staff and the organisation, an assessment of the conditions for development of micro-finance in the region, and whether the humanitarian agency could support such step. To avoid unnecessary delays in programme development, it is important to monitor closely any changes in the situation which might allow for shifts in the programme approach. This will ensure that the necessary decisions for programme shifts are taken as soon as conditions allow.

The Example of one Programme

A humanitarian agency initially started an income generation programme as an extension of its community services programme. Grants were issued to larger groups to ensure broad coverage and the democratic management of activities.

This approach, however, proved not to be successful as a tool for income generation. With time, and recovery from the civil war, the purely economic aims of the programme gained precedence; group grants were replaced by individual grants, and proper assessments were made of beneficiaries and their business proposals.

Later, a subsidised loan programme was introduced, followed again by a proper collateral/guarantor system and interest-bearing loans. The programme developed into two components: a grant component for the most vulnerable beneficiaries and for displaced people who had recently arrived; and a micro-credit component for economically capable groups.

Separate criteria and implementation procedures were applied to each component. This parallel approach proved successful, and beneficiaries and local counterparts were extremely supportive.

Recently, the micro-credit component was handed over to a local in-house NGO founded by local staff of the humanitarian agency, registered as a micro-finance organisation.

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