The Complementary Use of Loans and Grants
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Harriet Mukuba, a young widow living in the suburbs of Kampala, Uganda, tested positive for HIV after her husband died twelve years ago. She received counseling and medical care from AIDS Widows and Orphans Family Support (AWOFS). With no proven business experience, Harriet did not qualify for their loan program, so AWOFS selected her to receive a Trickle Up grant to start a clothes embroidering business. Her success at managing her business and savings later gave her access to AWOFS’ loan program, allowing her to expand her business further.

There is an ongoing debate on whether grants and loans can exist in the same environment without grants undermining microfinance institutions (MFIs). As the example of Harriet Mukuba illustrates, grants and loans can complement one another when administered and monitored properly. Grants can target individuals who are not eligible for loans and “graduate” them to be eligible for credit, thus reaching the most vulnerable populations while increasing the client base for MFIs. As microfinance products, grants and loans have the same objective – alleviating poverty and reducing vulnerability – though each address different needs of the client.

Microfinance Institutions

MFIs provide financial services through loans and savings. For those who cannot obtain commercial loans for the small amounts they need, MFIs provide an alternative source of credit to informal moneylenders who can take advantage of the poor and charge interest at rates that drive the client further into debt and increase their vulnerability. These financial services can help the poor to increase their income, build their assets, and reduce vulnerability. MFIs give loans to groups or individuals at interest rates meant to sustain the organization. They have a sense of permanence in a community, and can provide clients with long-term financial services.

Challenges of Poverty Targeting

MFIs are meant to be sustainable, so they must be selective in whom they serve and must reach a large number of clients. Hence, they may not reach the poorest of the poor who may be considered unbankable even for MFIs because they may lack collateral, business experience, and regular income, and may not be able to show the ability to repay loans. Solidarity groups may keep the extreme poor from joining for similar reasons. Several studies have found that those who use microfinance services usually fall near or above the poverty line; they generally are not the extreme poor or destitute.1,2

The poor themselves may be averse to taking out loans if they see it as potential for further debt and reduced financial stability if they are unable to repay loans. They also may not be able to justify the cost of credit to finance income-generating activities with very low profits. The poorest of the poor are generally part of the subsistence economy, so their first priority is to feed themselves and their families and provide other basic needs. They have little to no surplus, and they may be unwilling to risk not being able to feed their families to start a business. In addition

to the financial risk of loans, the poor may also suffer from loss of self-esteem, confidence, and social assets if they are unable to pay their loans.

When examining the impact of microfinance services relative to income, a study by David Hulme and Paul Mosley found that households at or above the poverty line had a higher average change in income than households below the poverty line when compared to income changes found in a control group. Higher income borrowers who are near or above the poverty line can take more risks and use loans to invest in promotional activities, where as those with lower incomes are more likely to take smaller, subsistence-protecting loans. They are averse to making risky business investments and there is often no substantial rise in income. The loans may even increase their debt if they are unable to follow the payment schedule.

The extreme poor also tend to drop out of microfinance programs at higher rates than the less poor. Poorer clients may not be able to manage the increasing size of regular loan payments. They may also drop out of joint liability groups when the amount of the loans by other members in their group increase beyond the amount they can take themselves. They may drop out rather than take the risk of guaranteeing these large loans.

Within the extreme poor, there are specific vulnerable groups that MFIs often cannot serve. It is not cost-effective and sustainable for MFIs to serve highly dispersed populations that are costly to reach, populations with high degrees of mobility or instability due to violent conflict or natural disaster, those who lack social capital or social cohesion, and people with life threatening disabilities or diseases.

**Financial Services Targeting the Most Vulnerable Groups**

Grants are a financial product that can reach those most vulnerable groups who do not have access to credit. It is a risk-free opportunity for the poor to start a business, build assets, expand an already existing business, or reestablish assets that have been lost. A grant may be the first and only access to capital a person ever has. It can contribute to the sustainability of the individual and families receiving the grant. The following examples show how grants have been used to reach vulnerable individuals or populations.

After the February 2000 floods in Mozambique, CARE Mozambique provided safety net grants through two MFIs established in the area. Clients used the grants to recover from their loss by erasing their debt, restoring their credit line, and obtaining new loans. They were a one-time, temporary solution to move people out of the immediate crisis and protect them from long-term problems.

The American Refugee Committee (ARC) provides grants, loans, and business training to Sierra Leonean refugees returning from Guinea and Liberia after the civil war in Sierra Leone. With few possessions or job prospects, these services helped returnees increase their incomes, self-confidence, improve their standard of living, and assist in reintegration.

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Harriet Mukuba’s case at the beginning of this piece is just one example of how Trickle Up works with partner agencies to provide vulnerable populations one-time grants of seed capital, business training, and monitoring of business activities to individuals who do not qualify for loans. Target groups receiving Trickle Up grants include the extreme poor, women, refugees, immigrants, people living with HIV/AIDS, people living with disabilities, and those living in extremely rural areas. Many of Trickle Up’s partners are MFIs that use the grants from Trickle Up to reach people their own program does not target. With help from Trickle Up grants, entrepreneurs can “graduate” and qualify for the partner agencies savings and loans program if they have managed their business properly and contributed to their personal savings.

Precise targeting and proper administration of grant programs can address the concern that grants cause long-term dependence, delay the transition from relief to development, and distort the market for credit. When targeted at those who do not qualify for credit, grants can be used as safety nets; and with appropriate training and monitoring, grants can be used to graduate people to credit and other services provided by MFIs. Rather than competing with or detracting from MFIs and their client base, grants can create customers for MFI services.