



INNOVATIVE FINANCE TO ADDRESS BONDED LABOR IN SUPPLY CHAINS

SOCIAL FINANCE REPORT

SOCIAL FINANCE WAS COMMISSIONED BY HUMANITY UNITED TO UNDERTAKE A SCOPING STUDY TO IDENTIFY WHAT ROLE INNOVATIVE FINANCE SOLUTIONS – PARTICULARLY, BUT NOT LIMITED TO, OUTCOMES-BASED FINANCE – COULD PLAY IN TACKLING IRRESPONSIBLE RECRUITMENT PRACTICES ALONG MAJOR SUPPLY CHAINS AND PREVENT MIGRANT WORKERS FROM FALLING INTO BONDED LABOR. IT IS BASED ON DESK RESEARCH AND INTERVIEWS UNDERTAKEN BETWEEN OCTOBER AND DECEMBER 2019.

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It should be noted that this report does not constitute first hand research, and quantitative analysis has been produced based on aggregate figures drawn from other published material, which are referenced in sources. Quotations shared by interviewees are anonymized and referenced throughout this report, but should not be considered reflective of institutional standpoints of either Humanity United or Social Finance.



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EXECUTIVE SUMMARY

Migrant worker debt bondage, caused by worker-paid recruitment fees, is a complex and intransigent problem in Malaysia's electronics sector. Workers who become indebted in order to pay recruitment fees often find themselves unable to leave their jobs, regardless of working conditions or pay. Some multinational brands have trialed different approaches to address this problem by requiring employers to implement globally established 'employer-pays' recruitment, but the problem persists.

The drivers of this problem are numerous and varied, but many are linked to the way recruitment fees are financed: the willingness to pay fees, or lack of it; poor access to credit or working capital; information asymmetry for workers, implying a risk of inflated fees; and kickbacks and 'facilitation payments'. Rather than employers paying to recruit workers, workers themselves, in effect, subsidize their own access to jobs. The employer-pays model requires a reversal in the direction the costs of recruitment typically flow.

This report centers on the economic relationships between the parties, and the question of how alternative finance solutions might help tackle the problem. We also recognize that while finance solutions are one key element to drive change, there are other levers of change including policy, regulatory, and legal levers, among others.

Financing problems exist at a number of key points in the worker's recruitment journey, both on the "supply" side (supply of workers) and the "demand" side (demand for workers

by employers), as well as with intermediary recruitment agents. Due to the entrenched practices and interests on each side, attention must be paid to both sides for solutions to have a chance of getting traction.

This report proposes an outcomes-based smart subsidy model as a new solution to complement and enhance the effectiveness of the important work that is already being done to address bonded labor. This is a **supply side solution** aimed at supporting recruiters to transition to an employer-pays model and enabling new employer-pays recruiters to enter the ethical recruitment market, by providing targeted, or 'smart' outcomes-based subsidies alongside the operating capital required to fund their business.

We believe this model, when put alongside the demand-side initiatives already undertaken by brands, offers a practical solution that can be piloted in the near-term. We recommend that brands, suppliers, foundations and donor institutions collaborate in an exploration of such a model.

The report focuses on the electronics sector and the migration corridor between Nepal and Malaysia as a demonstration case for solutions that will have wider application. Learnings from this report will be applicable to other sectors and corridors. It should also be noted that this report was produced prior to the COVID-19 pandemic, and hence does not include considerations of the significant impact of the crisis on labor migration or the employer-pays recruitment market. We believe that learnings and recommendations outlined in this report will remain applicable once markets are in recovery.

THE CHALLENGE

The International Labor Organization (ILO) estimates that there are approximately 25 million victims of forced labor globally across different sectors, including electronics, construction, agriculture, domestic work, and manufacturing.¹ Around 50% of victims of forced labor in the private economy are affected by debt bondage: when a worker is trapped in employment in order to repay a debt. This figure totals approximately eight million people worldwide.² Sustainable Development Goal 8.7 calls for global economies to “*take immediate and effective measures to eradicate forced labor, end modern slavery and human trafficking*”.³

Migrant workers are particularly vulnerable to becoming victims of bonded labor. Many rely on recruiters to connect them with employment abroad. An unscrupulous recruiter might charge high or fraudulent fees, forcing the worker into high-interest debt and increasing vulnerability to bonded labor.

Such recruiters generally operate in the informal economy, without oversight, and do not offer legally enforceable contracts or agreements regarding wages or benefits.⁴ Victims of bonded labor become vulnerable to other human rights violations such as poor working conditions, unpaid overtime and passport retention. This report focuses on the

problem of bonded labor caused by worker-pays recruitment practices but is aware that it is not the only issue affecting migrant workers.

In the context of the Malaysian electronics sector, bonded labor is especially entrenched.

In a 2014 study by Verité, it was found that 92% of all foreign workers surveyed in the electronics sector in Malaysia paid recruitment fees in order to get their jobs.⁵ 71% of migrant workers were found to be in bonded labor, defined as being indebted by recruitment fees that took at least half of them more than a year to repay.⁶

THE WORKER JOURNEY

Finance problems are two-fold along the worker journey for recruitment: not only does the burden of funding fall disproportionately on the worker (funds flow from the worker all the way to the employer, in some cases), but the worker journey to employment involves a complex ladder of intermediaries, which inflates the costs.

In practice, globally, most recruitment of migrant workers is based on a worker-pays model, where workers cover the entirety of their recruitment costs. **Yet the employer-pays principle, where all recruitment and deployment costs are paid by the employer,**

1 'Global Estimates of Modern Slavery: Forced Labor and Forced Marriage', ILO (Geneva, 2017). This figure includes people in forced sexual exploitation and forced labor imposed by state authorities.

2 'Global Estimates of Modern Slavery: Forced Labor and Forced Marriage', ILO (Geneva, 2017).

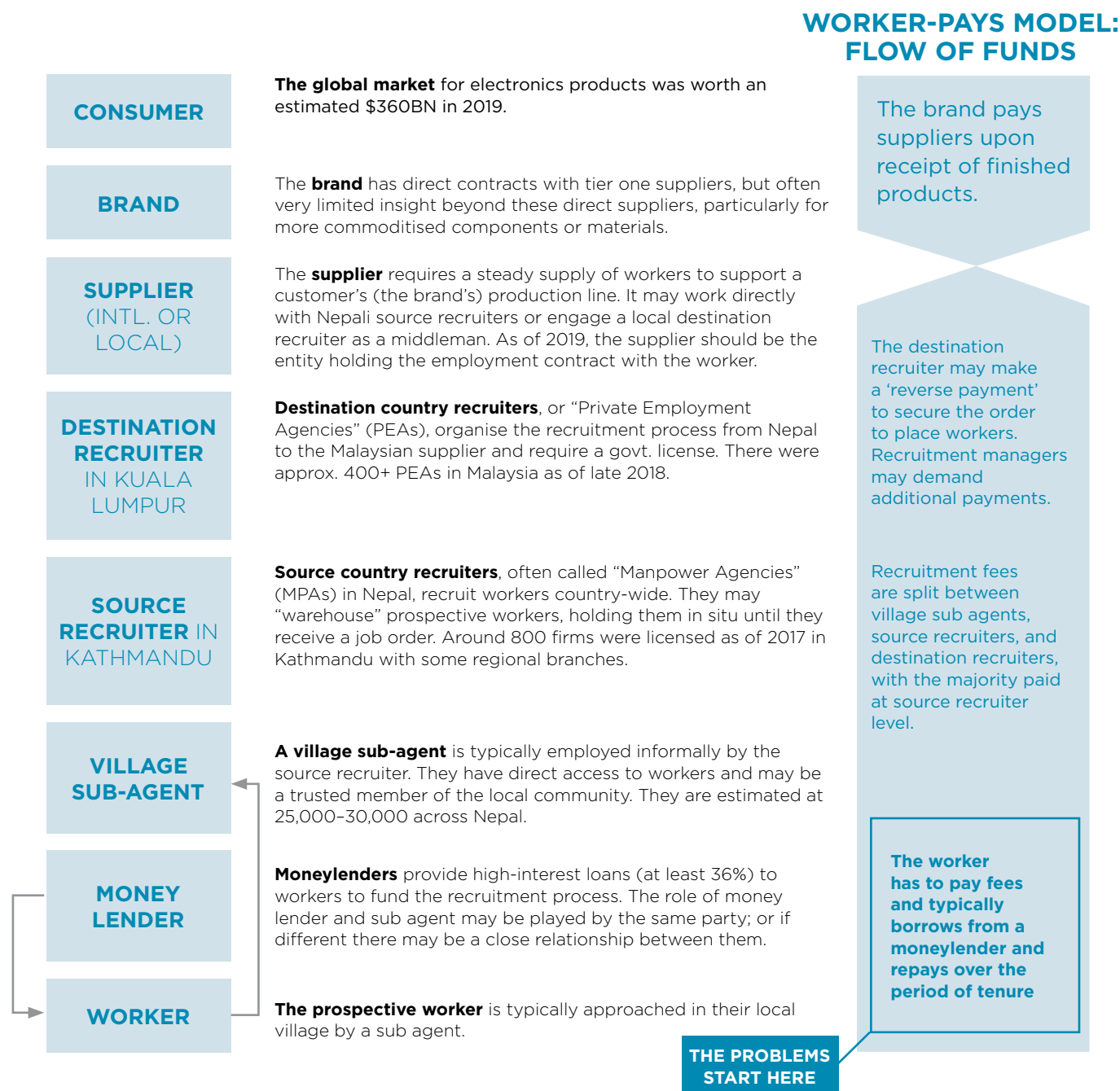
3 United Nations Sustainable Development Goals, <https://sustainabledevelopment.un.org/sdg8>. Accessed December 2019.

4 'Responsible Recruitment: Collaborative Remediation in Garment and Footwear Supply Chains', OECD (February 2019).

5 These statistics were obtained from a survey of 501 workers in the electronics sector, for more details see 'Forced Labor in the Production of Electronic Goods in Malaysia: A Comprehensive Study of Scope and Characteristics', Verité (2014).

6 *Ibid.*

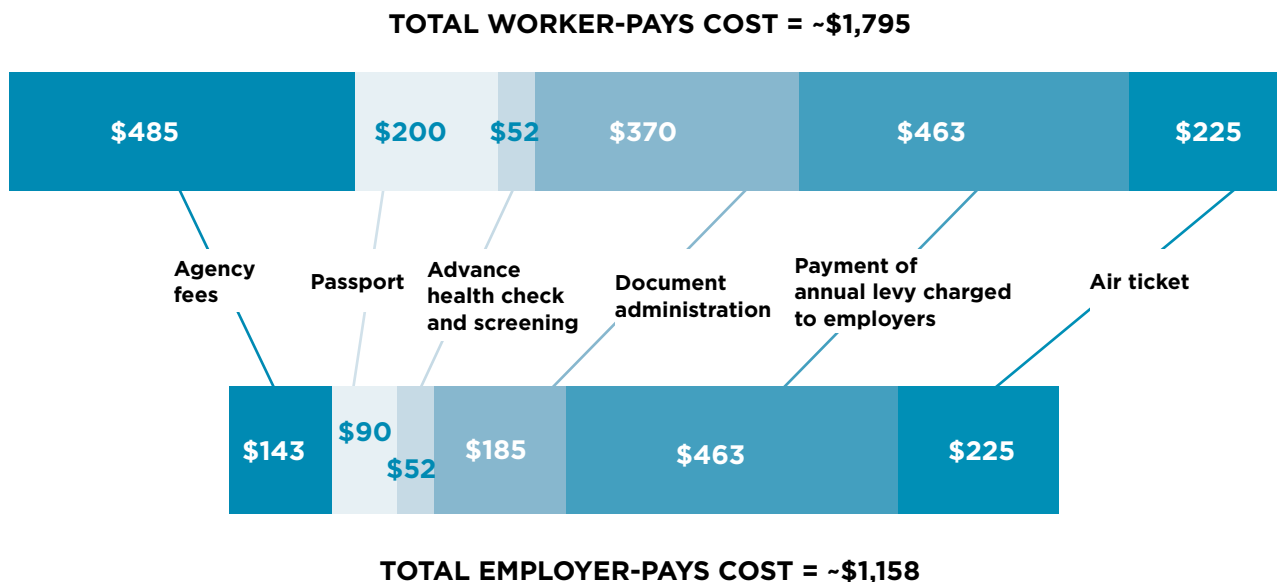
FIGURE 1: HIGH-LEVEL OVERVIEW OF WORKER JOURNEY, INDICATING ROLES OF DIFFERENT ACTORS AND FLOW OF FUNDS.



Sources: Global market for electronics products: Market directory for worldwide consumer electronics industry 2019, <https://www.statista.com/outlook/251/100/consumer-electronics/worldwide> (accessed December 2019). Contractual requirements between supplier and worker: This is due to changes to Private Employment Agency Law: see 'Pusma welcomes amendments to Private Employment Agencies Act', *The Star*, July 2018, <https://www.thestar.com.my/news/nation/2018/07/11/pusma-welcomes-amendments-to-private-employment-agencies-act/> (accessed December 2019) for more detail. Number of PEAs in Malaysia: 2018 Labor Department Statement, <https://www.ajobthing.com/blog/only-453-private-employment-agencies-left-in-malaysia> (accessed December 2019). Number of recruiters in Nepal: 'The Migrant Recruitment Industry: Profitability and unethical business practices in Nepal, Paraguay and Kenya', ILO (2017) Number of sub agents in Nepal: 'Labor Brokerage and Trafficking of Nepali Migrant Workers', Verité (2016) Moneylender interest rates: Interview with Humanity United staff.

Note: Supply chains are highly complex, with hundreds or thousands of suppliers of components and raw materials for each electronic product. The different components are brought together in an electronic product or component by a first-tier supplier to the brand owner, but typically rely on multiple sub-supply tiers for components and materials. **This diagram illustrates a highly simplified picture of a product's actual supply chain.**

FIGURE 2: BREAKDOWN OF INITIAL RECRUITMENT COSTS OF THE NEPAL-MALAYSIA RECRUITMENT CORRIDOR, IN WORKER-PAYS MODELS AND EMPLOYER-PAYS MODELS, PER WORKER.⁷



is considered best practice and is promoted by leading business alliances and industry groups.⁸

Multiple studies show that when workers pay for recruitment, they pay more in initial recruitment costs than an employer would pay to recruit someone for an equivalent position. There are various explanations for why an employer-pays model is less costly:

- Employers have market power, whereas workers have none: an employer can negotiate pricing and bring volume, while in contrast an individual worker has little choice but to accept the terms and fees demanded and can often be desperate.

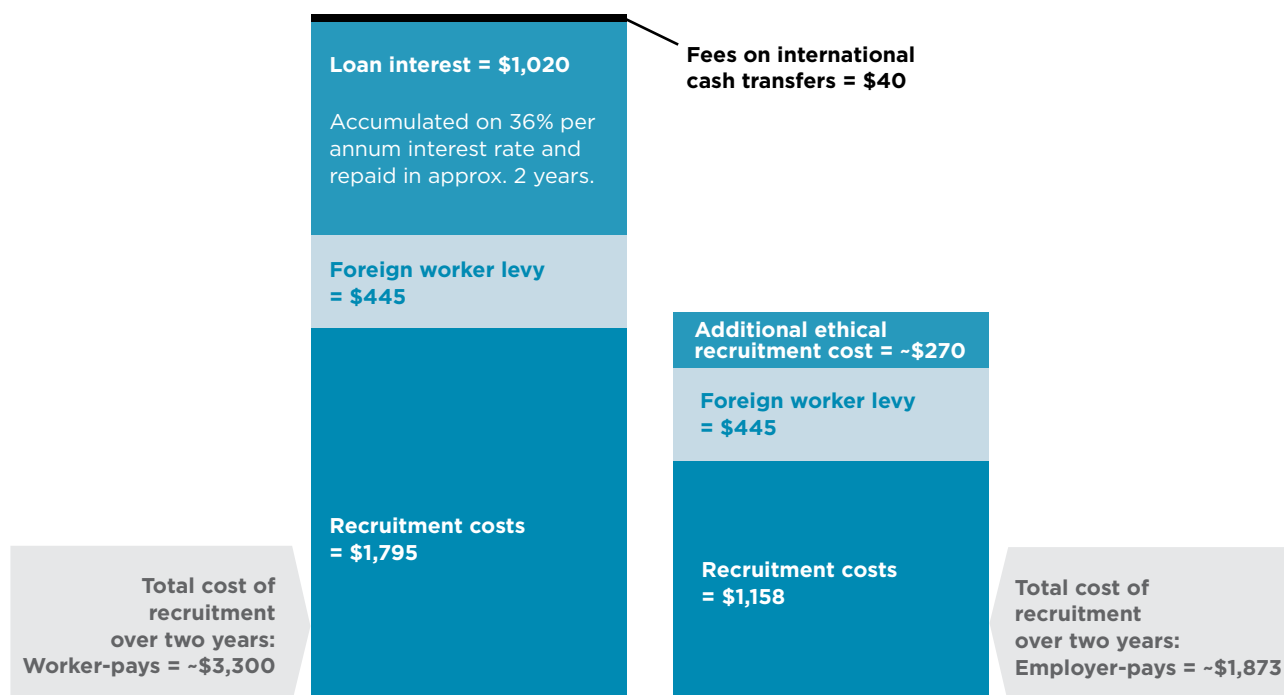
- Employer payments are clear, formal, and documented, while worker payments are informal, opaque, and rarely documented via receipts. This makes worker payments susceptible to inflated fees and bribes, a problem exacerbated by the ladder of intermediaries a worker must climb in order to access work.

While some costs are consistent across both models, such as the advance health check and training, others vary greatly due to these factors. One example is document administration, which includes visa, work permit, and immigration security clearance costs, together costing

⁷ The costs in Figure 2 are aggregated and evaluated to an estimated figure for each cost from a range of sources including 'Labor Brokerage and Trafficking of Nepali Migrant Workers', Verité (2016): 'Financial and Contractual Approaches to Mitigating Foreign Worker Recruitment-Related Risks', Verité (October 2019): R. Jureidini, 'Transnational Culture of Corruption in Migrant Labour Recruitment', IOM (2017) and the Official Portal of Immigration Department of Malaysia (Ministry of Home Affairs, <https://www.imi.gov.my/index.php/en/main-services/visa/security-bond-bank-guarantee-rates.html> (accessed December 2019). Each of these costs are informed by at least two sources but are estimates valued for 2019/2020 and are not directly attributable to the costs of recruitment which vary between different recruiters, suppliers and brands in the Malaysian electronics sector.

⁸ There is ongoing debate as to whether responsible recruitment should constitute an employer only pays model, or if it is reasonable to expect workers to pay for some costs. For the purposes of this report, we have focused on an entirely employer-pays model, to understand the impact of worker-pays and the potential for an ethical recruitment market. We understand that in practice, a transition to employer-pays recruitment might take a more stepped approach where workers might pay for some of the costs, for example passports and transport from initial point of departure to Kathmandu.

FIGURE 3: BREAKDOWN OF REAL COSTS OF RECRUITMENT OVER TYPICAL TWO YEAR EMPLOYMENT PERIOD, PER WORKER.



Note: Ethical recruitment costs include initial sourcing and auditing of potential ethical recruiters, annual monitoring and auditing costs, and supplier personnel overheads to monitor worker fees paid to an intermediary.⁹

anywhere between \$185 and \$370 per worker. Illegal kick-back commissions and bribes to government officials have been recorded in some labor channels as inflating actual costs by up to five times.¹⁰

When a two-year view of costs over the worker's tenure is considered, worker-pays recruitment can be up to 75% more costly than employer-pays recruitment. This reflects the inflationary effect of high loan interest rates over that period – the typical duration of a migrant worker's contract.¹¹

EXISTING SOLUTIONS

Multiple industry-led frameworks, such as the Responsible Labor Initiative and the Institute for Human Rights and Business (IHRB)'s Dhaka Principles, have been designed to facilitate companies' progression towards an employer-pays recruitment model, and align with international regulations to prevent forced labor. Certifications for the different supply chain stakeholders have also been developed to recognize step-progression towards employer-pays recruitment practices for recruiters and suppliers, and to establish supply chain-wide standards (see the Appendix to the main report document for more).

⁹ These estimates have been informed by figures from ethical recruitment pilots. Pilots which have informed the majority of our assumptions are 'Ethical Recruitment: Translating Policy into Practice', Impactt (2019); and 'Less than One Percent: Low-Cost, Responsible Recruitment in Qatar's Construction Sector' NYU, STERN Centre for Business and Human Rights (2019). It should be noted that these estimates are derived from programs operating at reasonable scale; recruiters working with lower volumes may have higher monitoring costs per worker.

¹⁰ R. Jureidini, 'Transnational Culture of Corruption in Migrant Labor Recruitment', IOM (2017).

¹¹ Please see footnote 7 for the sources for Figures 2 and 3.

THE VALUE-FOR-MONEY CASE FOR EMPLOYER-PAYS RECRUITMENT

The employer-pays model has been tested by brands in various industries and corridors. While more testing and analysis is required to develop a robust cost-benefit case for investing in employer-pays models, two recent examples highlight certain advantages and begin to establish an evidence base:

- **Thai Union** (TU), a global seafood conglomerate based in Bangkok, implemented a major overhaul of their recruitment and labor policies after a 2015 report exposed bonded labor, including among children, among their suppliers. The new policy sought to establish a low-cost to workers, rather than a no-cost to workers, model. Under the new policy, workers reported 9% higher job satisfaction levels; were 39% more likely to save each month; and worker turnover fell by 93.6%. TU also reported growth in the volume of workers and some growth in earnings, although these have not been quantified.¹²
- After finding that 93% of workers had paid recruitment fees, **QDVC**, a construction company in Qatar, implemented an employer-pays policy in 2015. QDVC found not only that the total cost of recruitment to them was equal to less than 1% of the overall cost of the construction project, but that worker motivation and retention had improved. In its June 2019 evaluation, it was reported that QDVC had not needed to make further recruitment drives since 2015-16, and that the average worker employment length had risen by a year.¹³

As brands strive to implement such frameworks, a range of approaches are being taken to encourage a change from worker-pays to employer-pays recruitment. The scale and complexity of the recruitment corridor means there are multiple points to intervene: on both the demand side and the supply side of the problem.

Demand side solutions focus on ensuring that supplier demand for workers is based on an employer-pays recruitment model. These approaches are important, but they face significant obstacles to their long-term efficacy. They include:

- **Purely compliance-driven models:** in these models, brands contract with suppliers on terms which require adherence to Codes of Conduct under which they must commit to employer-pays recruitment and to cascade the

obligations down to sub-tier suppliers. They are usually supported by compliance audits.

- **However, enforcing compliance relies on the power of the brand as customer.** Even a major brand might represent only a small proportion of a supplier's business. Unless enough customers implement employer-pays approaches, suppliers may simply move workers from one brand's production line which requires compliance to another's, which does not. Equally, penalties must have "teeth" to impact on supplier practices, including willingness by brands to end supplier relationships where needed. This will be simpler for some brand-supplier relationships than others, where the supplier is deeply embedded in a complex supply chain.

¹² 'Ethical Recruitment: Translating Policy into Practice', Impactt, (2019).

¹³ 'Less than One Percent: Low-Cost, Responsible Recruitment in Qatar's Construction Sector', NYU Stern Center for Business and Human Rights (June 2019).

- **Willingness on the part of brands to share the costs of employer-pays recruitment with suppliers, and to shoulder the additional costs of audit, varies significantly.** The success of tools which can be leveraged on the demand side relies on the willingness-to-pay, at least in part, of brands: it is clear that cascading employer-pays requirements without recognizing the impact on a supplier's cost structure is ineffective. This is true at first tier supplier levels, and even more so at sub- and sub-sub-supply tiers. However, those brands who are willing to pay also face additional compliance audit costs such that even committed brands are not able to cover their entire supply chain.¹⁴
 - **Compliance and remediation:** This builds on the purely compliance-driven model, with contract terms providing explicitly that where workers are found to have paid fees, suppliers must repay the worker in full. The model offers “teeth” but faces challenges.
 - **Remediation is operationally challenging,** as workers typically lack receipts for payment, meaning suppliers must reimburse based on reported payments alone. Workers might be tempted to invent or inflate fees paid, or conversely, may be afraid to report payments for fear of retribution.
 - **Moreover, such models are a “band aid”, not a catch-all solution.** They do not address the root cause of the issue and are curative, not preventative, in nature. They also likely have the effect of subsidizing inflated fees and corrupt payments demanded along the worker's journey, rather than providing any incentive for intermediaries or middlemen to change their practices. Rather, they may well cause suppliers to be less transparent and to cover up where workers have paid fees.
 - **Capacity building models:** Some brands focus on working closely with suppliers to build their capacity to assess supply chain risks and identify appropriate recruiters.
 - **Capacity building is a potentially important tool to build stronger relationships and trust between brand and supplier, and takes a longer-term view of the issue,** influencing suppliers to act on cascading changes down to lower tiers in the supply chain.
 - **However, it is not sufficient, if employed alone.** Capacity building must work alongside an enforcement mechanism, such as compliance, and is also a higher-cost solution which is also unlikely to be scalable across a brand's entire supply chain, or even the majority of first-tier suppliers.
- Supply side solutions** focus on ensuring that recruitment agencies offer services on an employer-pays basis, or other approaches that aim to minimize the risk of a worker paying fees or incurring debt. For instance:
- **Awareness-raising among workers** to inform them of their rights and connect them to employer-pays recruiters.
 - These models focus on transparency and addressing information asymmetry, to develop the pipeline of workers and build trust in employer-pays recruitment. Models which seek to educate workers about labor rights, such as the Responsible Business Alliance's Responsible Workplace and Recruiter Programs, the CSO-NET initiative and The Issara Institute's Golden Dreams smartphone app provide useful precedent.¹⁵
 - Although this report is focused on the economic relationships between parties

14 'Supplier Responsibility 2015 Progress Report', Apple (2015).

15 'Developing a Financially Viable Ethical Recruitment Model: Prospects for the Myanmar-Thailand Recruitment Channel', Issara Institute (2018): CSO-NET consists of approximately 25 Myanmar NGOs working together to support jobseekers and returned exploited migrants from Thailand, and is enabled by Walmart Foundation's support to the Issara Empowerment Incubator.

and how alternative finance solutions might help tackle the problem, it nonetheless recognizes the importance of awareness-raising and other such approaches, and **recommends building on existing precedent to develop worker awareness programs among local populations in their home country.**

- **Investment in or capacity-building of ethical Microfinance Institutions (MFIs),** which charge affordable rates of interest to workers and may also provide end to end support, such as BRAC's Probashbandhu Ltd.

- Low cost loans are a valuable part of the recruitment landscape, but while they reduce the debt burden of migrant workers, they do not eliminate it. Perhaps more importantly, they offer no incentive to employers to assume responsibility for recruitment costs.

- **Investing in new social enterprise recruiters** who are committed exclusively to employer-pays models or **providing grant finance to capacity-build existing recruiters** and catalyze their transition to employer-pays models.
- **Interviewees who contributed to this report highlighted the need to develop a market of ethical recruiters to respond to growing demand for employer-pays recruitment.** Opportunities also exist to test the viability of and demand for employer-pays recruitment agencies, given the reported successes of existing employer-pays recruiters who have proven the model's sustainability. As a result, **the model proposed in this report revolves around methods of building and scaling the ethical recruitment market, while ensuring a focus on quality.**

TACKLING THE PROBLEM FROM THE SUPPLY-SIDE: INVESTING TO BUILD THE MARKET OF ETHICAL RECRUITERS

THE OPPORTUNITY FOR ETHICAL RECRUITMENT

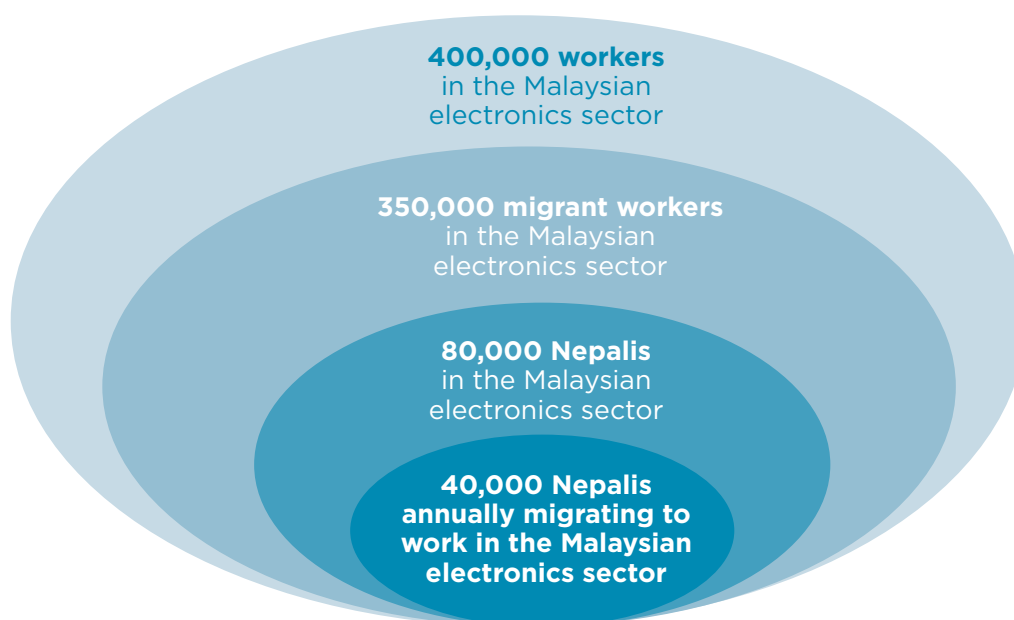
The recruiter market in the Malaysia-Nepal channel is characterized by fragmentation, dominance of entrenched, long-established firms, and high barriers to entry. Recruiters committed to employer-pays models remain a small, but important, part of the market: estimates of the total number of such firms from interviewees participating in this research project ranged from 10–20 globally. In comparison, interviewees reported that each Southeast Asian country is typically home to 500–1500 recruitment agencies operating a worker-pays model.

However, there is a significant potential market for employer-pays recruitment, based around a long-term, sustainable model:

research findings from this report indicate that an ethical recruitment model would not require long-term grant financing. What is needed instead is a medium-term method of subsidizing ethical recruitment companies, supporting their ability to reach scale and sustainability.

Further, there is useful precedent: namely, the Responsible Business Alliance and ELEVATE's Responsible Workplace and Recruitment Program,¹⁶ which focuses on capacity-building to mature the ethical recruiter market within specific corridors, and The Global Fund to End

FIGURE 4: ESTIMATE OF MARKET SIZE FOR ETHICAL RECRUITMENT OF ~\$46M ANNUALLY, BASED ON THE NEPAL-MALAYSIA MIGRATION CHANNEL FOR ELECTRONICS ALONE.¹⁷



¹⁶ RBA Foundation: Responsible Workplace and Recruiter Programs: <http://www.responsiblebusiness.org/rba-foundation/>. Accessed in December 2019

¹⁷ Assumes average direct employer-pays recruitment costs of \$1,158 and two-year tenure. Sources used for calculations: 'Forced labor in the production of electronic goods in Malaysia', Verité, (2016); <https://www.thestar.com.my/business/business-news/2019/07/13/ee-industry--the-----golden-goose-of-Malaysia>; https://www.miti.gov.my/miti/resources/6._Electrical_and_Electronics_Industry_.pdf; Department of Statistics for Malaysia (2016)

Modern Slavery's experience in providing seed finance to new recruiters. The former reports being oversubscribed with high levels of interest from recruiters.

CHALLENGES TO BUILDING THE MARKET

Despite these efforts, the market of employer-pays recruiters remains subscale. It faces significant barriers to scale, both for existing and new players:

- **Incentives:**

As noted, worker-pays recruitment is significantly more profitable for recruiters than employer-pays models. It is a high volume, low margin business and recruiters are incentivized to turn over workers as quickly as possible and at volume, which can lead to workers being placed in jobs poorly suited to their skills. Strong incentives are needed to shift from the status quo and move to a less profitable model.

Currently, when adequate pressure is applied by suppliers, existing recruitment agencies *do* provide services on an employer-pays basis for a particular work order, also passing on this requirement to agencies in source countries, and in turn village sub-agents. For other suppliers, these agencies continue to use a worker pays model. There is as yet insufficient demand or incentive to shift to a model *entirely* based on ethical principles.

- **Additional costs of ethical recruitment:**

Ethical recruiters in the destination country must cover additional costs compared to worker-pays recruiters, such as the cost of identifying and engaging an ethical partner organization in the source country. This might involve establishing its own source country recruiter or setting up an ethical recruitment supply chain with ongoing compliance and audit processes.

- **Working capital:**

Interviewees reported that ethical recruiters typically charge a portion of the employer fee up front (between 40–60%) with the balance on placement. Large work orders may cause cashflow problems. As a consequence, where employers have placed bulk orders, they have struggled to engage ethical recruiters who can handle them.

On the other hand, they report that the low margin nature of the business means that recruiters need a pipeline of approximately 1000 workers to be sustainable. A new ethical recruiter would need to ramp up at speed and have access to finance that enables them to do so.

- **Demand and competition:**

The total market size for the Nepal-Malaysia electronics sector migration channel is estimated at ~\$46m annually (*Fig. 4*). However, interviewees reported differences in opinion about the scale of the current demand for employer-pays recruitment. The cost of an employer-pays model to suppliers is not insignificant: interviewees estimated an increase of between 15–30% in labor costs. The impact of this on supplier profitability and/or cost to be passed on to a brand depends on the proportion that labor costs represent of the overall contract value.

Further, worker-pays recruiters often make reverse payments to suppliers or kickbacks to their recruitment managers to win work orders. Such factors further exacerbate the significant vested interests in maintaining the current system. It is notable that ethical recruiters have chosen to compete with existing recruiters on worker quality, rather than economics.

- **Certification standards:**

Interviewees consistently noted that standards required for ethical recruitment certifications (for instance, IOM's CREST) are unrealistic to achieve, and that consequently, very

few employer-pays recruiters are currently certified, instead relying on word of mouth and the support of influential stakeholders for new business. Some also questioned the market value of these certifications.

- **Barriers to entry for new entrants:**

The recruiter market in Malaysia is well-protected and there are high barriers to entry for new firms. Financial barriers in Malaysia include licensing fees and regulations around minimum paid-in capital. This can total up to \$60,000 for migrant worker recruiters serving lower-volume clients (License B) and up to \$144,000 for those serving high-volume clients (License C).¹⁸

- Interviewees also reported that in some markets, a minimum scale is required in order to maintain a license after year one. Other barriers include burdensome regulation and entrenched corruption throughout the licensing system. In the World Bank's Doing Business Index 2020, Malaysia ranks 126/190 for ease of starting a business, despite a high ranking overall (12/160: higher than Australia or Taiwan).¹⁹

THE ETHICAL RECRUITMENT BUSINESS MODEL

Ethical recruitment agencies take different approaches to the employer-pays concept: some have a zero-fees approach for the worker, while others advocate a low-fees approach to ensure worker buy-in and guard against higher turnover. In such cases, a worker may pay for travel costs such as flights and a visa.

Charges to employers vary across sectors and geographies; it was reported that that in high-volume industries ethical recruiters typically charge a minimum of approximately \$1,000 per worker.

Some partner with recruiters directly in the source country (e.g. Nepal), while others have a direct presence in source countries or staff who sit alongside partner organizations. To avoid networks of sub-agents, the model in source countries may involve “roving agents” who visit local villages.

USING AN OUTCOMES-BASED SMART SUBSIDY TO BUILD AND SCALE THE ETHICAL RECRUITMENT MARKET

A “smart subsidy” model, that combines an outcomes-based approach with enterprise finance has promise to help build and scale the ethical recruitment market.

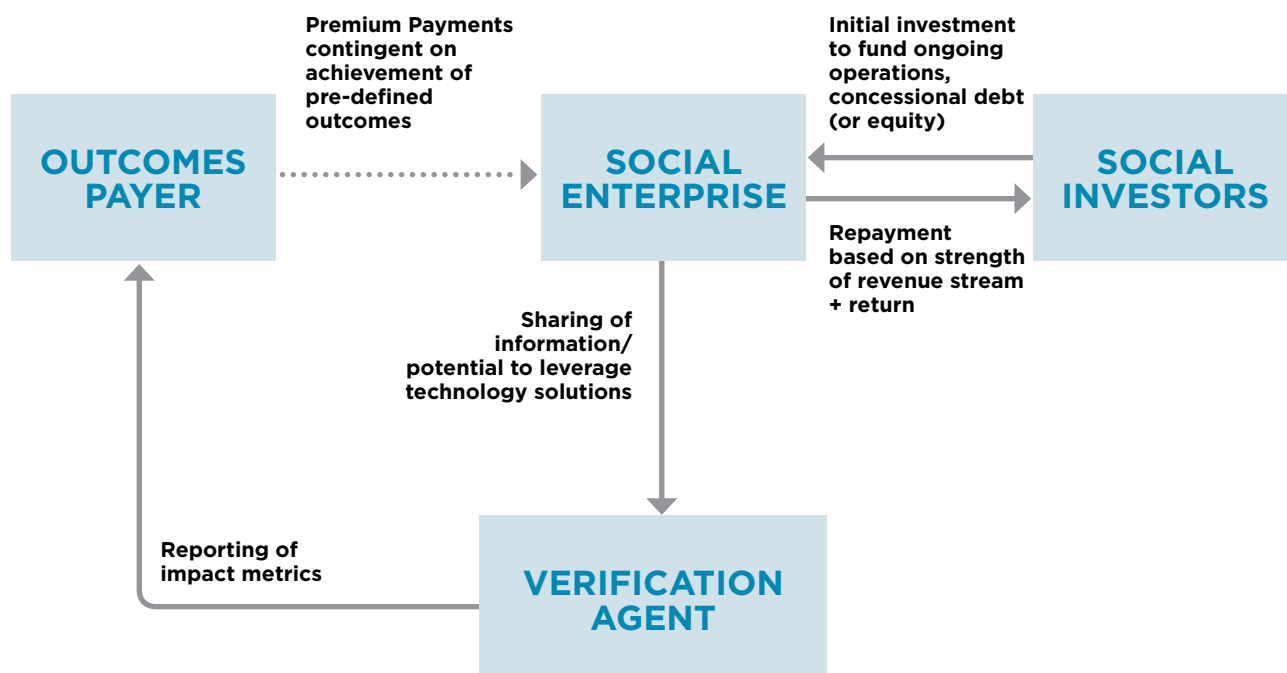
A smart subsidy model would combine two forms of finance: social investment and outcomes funding:

- Social investment is investment that purposely seeks and measures positive social impact. It can take different forms (e.g. debt/equity/hybrid) and has a range of risk/return profiles.
- Outcomes funding is conditional grant funding disbursed on the basis of results: it is a relatively flexible form of funding which in an investment context has historically been applied to a range of outcomes-based finance instruments, including social impact bonds, development impact bonds, and outcomes funds.

In an outcomes-based smart subsidy model that supports the market for ethical recruitment, the outcomes funding would constitute premiums that are paid only in the event of the recruitment firms achieving pre-defined outcomes that are aligned to employer-pays recruitment objectives (see *Fig. 5 overleaf*).

¹⁸ 'Malaysia, Amendments to the Private Employment Agencies Act', Conventus Law, <http://www.conventuslaw.com/report/malaysia-amendments-to-the-private-employment/>. Accessed December 2019.

¹⁹ World Bank Doing Business Index 2020. <https://www.worldbank.org/en/news/feature/2019/10/24/doing-business-2020-sustaining-the-pace-of-reforms/>. Accessed December 2019.

FIGURE 5: THE OUTCOMES-BASED SMART SUBSIDY MODEL, IN THE CONTEXT OF ETHICAL RECRUITMENT

In this structure:

- **An outcomes payer** provides a “smart subsidy”. These are targeted success premiums, based on the achievement of specific outcomes. They provide an additional revenue stream alongside the funding that the recruiter needs for its operations.²⁰ Access to the smart subsidy directly improves the enterprise’s financial position and investability. An outcomes payer might be a bilateral or multilateral institution, a government entity, or a large philanthropic or corporate foundation.
- **A social investor** provides funding for the enterprise’s operations, setting a return in line with its standard mandate. The smart subsidy revenue stream improves the risk/return profile of the investment for the social investor. A social investor might be

a social impact fund or a Development Finance Institution.

- **The enterprises in receipt of funding** are able to maintain or accelerate a focus on impact, while also servicing investment. In this case, enterprises in receipt of funding would be recruitment agencies.

A smart subsidy model for employer-pays recruitment would likely **work with existing recruiters looking to transition to a fully employer-pays model**. The model could **also support new ethical recruitment firms**, who would also need access to start-up capital, such as very patient equity (equity with no expectation of a quick return). However, due to the high barriers to entry for new recruitment firms, the solution should ideally target both existing and new recruiters.

²⁰ The outcomes-based smart subsidy should be contrasted with other outcomes-based instruments, such as social (or development) impact bonds (SIBs or DIBs). Unlike these instruments, the subsidy complements enterprise finance that is not hypothecated to a particular intervention. In a SIB or DIB, outcome funding is typically linked to a specific project and intervention group and repays investors their up-front finance of the project costs (plus a return) if the project meets pre-agreed objectives.

Outcomes metrics that set the behavior that the smart subsidy is designed to incentivize would need careful design:

- One approach might be to base the metric on the proportion of workers recruited ethically by a particular recruiter, to incentivize a fundamental shift in business models.
- The overall aim in designing metrics would be for the outcomes-based subsidy to aim at shifting the market in a more fundamental manner towards normalizing employer-pays models, rather than focus on a line to a particular supplier, factory or brand. Brand support will be necessary, but the intended benefit will accrue more widely than to individual supporting brands.

The pricing of outcomes would need to provide sufficient incentive to shift business models. One approach might be for pricing to be designed to mitigate revenue loss inherent in a recruiter transitioning from worker-pays to employer-pays models.

A source of outcomes funding must be identified in order to take this concept forward.

- This might come from brands or suppliers with a committed interest in employer-pays models; foundations; donor agencies or intergovernmental organizations.
- Recruitment orders would need to be at scale to allow recruiters line of sight to volume before agreeing to achieve certain outcomes targets. Outcomes funding will need to be sufficient to support these volumes

WHY A SMART SUBSIDY MODEL?

Smart subsidies offer a blended finance solution to support the development of a market in ethical recruitment, recognising that employer-pays is more costly than worker-pays recruitment, and that there are costs of transitioning to an ethical model. As noted, there is a functioning market for recruitment, but subsidy and incentive are

needed for it to transition to an employer-pays model. It complements existing demand side solutions and helps overcome challenges they face:

- **New source of growth capital.** Interviewees reported that a ready market of recruiters interested in programs supporting them to shift business models already exists. However, most lack the resources to self-fund the shift to a lower-margin model with significant working capital requirements, and grant finance programs are inherently limited in scale.
- **Growth matched by quality delivery.** Outcomes-based finance would enable scaling while simultaneously incentivizing quality, driving a focus on successful implementation of employer-pays models. They could act as a subsidy for the transition from worker-pays to employer-pays recruitment, representing a premium for employer-pays recruitment versus the status quo. Building on the successes of programs like the RBA's grant-funded capacity-building program, this form of funding would leverage social impact funding to build a sustainable market for ethical recruitment.
- **Sustainable shift in business models.** Rather than structuring outcomes around workers supplied to a particular brand or supplier, which might only cover a small proportion of a recruiter's business, the model contemplates that the entirety of a recruiter's business model is taken into account in order to trigger the incentive payment. Likewise, as its whole client base will be captured, this will likely include lower tier sub-suppliers who are extremely difficult to reach by traditional demand-side models.
- **Preventative and cost-effective.** Employer-pays recruitment is less costly than worker-pays, and also less costly than "band aid" solutions like remediation.

- **Linking up the supply and demand sides of the problem.** Such a model could create active incentives for brands to ensure compliance throughout the supply chain. Brands might act as outcomes payers or investors in this model, but either way, will have a vested interest in the success of the supply-side model.
- **Built-in accreditation could support compliance and audit.** Rather than having to audit recruiters individually, involvement in such a program would create a useful signaling effect, allowing suppliers to gauge readily whether a recruiter is committed to employer-pays models.
- Committed effort to align and coordinate brand requirements on employer-pays would give brands greater leverage in supplier relationships. While suppliers are unlikely to change their entire hiring practice for a customer that represents ~5% of production, if a majority of customers are demanding changes, it may be unavoidable.
- Further, evidence of increased demand for ethical recruitment would provide an incentive for recruiters to change practices, whether within the program or without. It could lead to a market response if brands require suppliers to place orders for workers through named/pre-accredited recruiters.

And finally, the model also has the potential to facilitate **learning and sharing of best practice**, and overcome some of the constraints caused by a lack of information and transparency:

- Currently, there is little literature available on the market for firms looking to shift models; a funding program made available to multiple recruiters at once would also act as a data hub, capturing evidence around the achievability of outcomes and best practice.
- Due to commercial confidentiality and regulatory constraints resulting from collective action, a trusted intermediary organization in the marketplace might play the “data hub” role. It could act as a clearing house, isolating vital but sensitive information and producing aggregate benchmarks to brands. An organization like the Responsible Business Alliance is potentially well-placed to build on the crucial role it currently plays to host or incubate such an entity.

FURTHER CONSIDERATIONS

In order for this model to drive a transformative shift in the market, we believe concerted commitment from a group of brands and first tier suppliers will be required, to harness their collective market power.

- Sensitivity around a collective approach might be mitigated by supporting, as above, the establishment of a trusted third party intermediary to ensure transparency while holding sensitive data and supporting compliance with regulatory requirements of brands.

We also believe that the proposed model is likely to be of added relevance for certain supplier relationships. The deep complexity of each supply chain, and the myriad actors involved, means that brands’ relationships with suppliers differ depending on the type and degree of specialization of the product supplied, and the sector in question.

- **Brands have deeper relationships with suppliers, often at the first tier, that provide more specialized components,** often built over many years, where co-development of components may occur or where the supplier is deeply embedded in the supply chain. These relationships are highly valued and guarded on both sides; a mutual dependency means risk of termination is low, but consequences are very high. Consequently, there is greater leverage on both sides, with brands more able to enforce employer-pays recruitment (including through capacity-building and remediation)

and suppliers more able to demand brands shoulder some of the cost.

- **Suppliers providing non-specialist or commoditized parts and materials typically have a more transactional relationship with the brand**, with neither party reliant on the other. Relationships may be more opaque, with suppliers expected to adhere to Codes of Conduct and pay recruitment costs, but these are rarely included as line items in pricing schedules. There may be a lack of clarity/agreement on where employer-pays costs fall, and suppliers may be less willing to be transparent about business operations and recruitment practices, instead preferring these to be opaque to maintain competitive advantage. In these relationships, brands are likely to have less leverage to enforce employer-pays models, and suppliers may be more resistant to audits or sharing information on recruiters.

It is likely that the smart subsidy approach, which requires significant transparency and cooperation between brands and suppliers, is best suited to specialized suppliers.

The approach is also relevant for non-specialist suppliers. However, as brands have less leverage, here it is potentially most effective if it works alongside other demand side strategies, such as remediation. HP and Verité's recent report lays out a proposal for a surety bond to enhance remediation as a means of enforcing employer-pays models.²¹ Under this model, the supplier pays premiums to a surety to insure the risk of non-compliance; if workers are found to have paid fees, the surety will reimburse the worker and then recover against the supplier. The model has similarities to the government security bond that suppliers are required to deposit when they employ a migrant worker, which can also be satisfied by guarantee product.

Although this surety bond model could be applicable to both specialist and non-specialist supplier relationship types, it may be have most use for non-specialist suppliers where there is less trust between brand and supplier and more effective enforcement tools are needed.

We recommend that the surety bond concept should be piloted in order to test its feasibility and value, although until a track record and claims history is established, it may be difficult for insurers to price premiums. If there is difficulty in setting affordable terms, it would be worth exploring whether donor or concessional funds (including CSR) could subsidize premiums or co-insure, to develop the evidence base and demand for such a product to work on a commercial basis.

²¹ 'Financial and Contractual Approaches to Mitigating Foreign Migrant Worker Recruitment-Related Risks', Verité (October 2019).

CONCLUSION AND NEXT STEPS

There are multiple brands, suppliers, foundations, intergovernmental organizations, and industry bodies who are committed to seeking solutions that support employer-pays recruitment. We believe that the smart subsidy model has value and ought to be tested, and we recommend that these parties build on their existing programs by joining together to assess its potential for effecting a sustainable shift in recruitment business practices. Still in its early stages, some questions to resolve in the next stage of work would include:

- Would recruiters have a strong interest in taking part in such a program? Would it be best to work with existing or new recruiters, or a combination of both?
- How much outcomes funding would be required, and for how long, to help recruiters make the sustainable shift to employer-pays recruitment?
- Is the Malaysian electronics sector the appropriate sector to focus on? Might the model be better suited elsewhere?
- How would we define and measure outcomes? How might we leverage technology solutions in order to do so?
- What are some of the key risks and contingencies to consider?

ACKNOWLEDGEMENTS

Social Finance is a not for profit organization that partners with the government, social sector and financial community in the UK and beyond to find better ways of tackling social problems.

We are grateful to the following individuals for their time and contribution to this work:

- Alex Silberman, *Head of Programs at Seefar and The Ethical Recruitment Agency (TERA)*.
- Anna Platonova, *formerly Head of Labor Mobility and Human Development Unit at IOM Bangkok*.
- Bob Mitchell, *Vice President at the Responsible Business Alliance (RBA)*.
- Dan Viederman, *Managing Director, at Working Capital Fund*.
- Declan Croucher, *Senior Director of Advisory Services at Verité*.
- Elaine Sim (*Co-Founder*), Zenna Law (*Co-Founder*), and Sophia Aliza Jamal (*General Manager*) at *Pink Collar Employment Agency*.
- Jay Celorie, *Global Program Manager at HP*.
- Jeff Bond, *Program and Investment Officer at the Global Fund to End Modern Slavery (GFEMS)*.
- Katrina Gordon (*Program Manager*), Mahendra Pandey (*Investments Manager*) and Sandy Tesch Wilkins (*Director, Forced Labor and Human Trafficking*) at *Humanity United*.
- Marc Capistrano, *Managing Director at Staffhouse*.
- Mike McDonnell, *Senior Manager of Supply Chain Sustainability at Intel*.
- Neill Wilkins, *Head of Migrant Workers Program at the Institute for Human Rights and Business (IHRB)*.
- Scott Stiles, *Co-Founder and CEO, at Honest Jobs*.



Social Finance is a not-for-profit organisation that partners with government, the social sector and impact investors to find better ways of tackling social problems and improving the lives of people in need.

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