Pakistan Microfinance Network

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MicroNOTE

FINANCING LOW COST PRIVATE SCHOOLS (LCPS) THROUGH MICROFINANCE

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OBJECTIVE

This MicroNOTE highlights the prospect of a sector-led approach for financing of low cost private schools (LCPS) through microfinance. It looks at the role of various stakeholders, including microfinance providers (MFPs), low cost private schools, donors and policy makers in building a viable business case for microfinance interventions targeting the LCPS sector. It also examines whether the microfinance sector is currently positioned to serve the needs of this sector, and draws on relevant research to outline potential partnerships and opportunities for stakeholders going forward.

INTRODUCTION

Microfinance Landscape

Pakistan's microfinance sector has seen impressive growth in the past decade, with the industry moving towards greater outreach and sustainability through the maturity of existing institutions and entry of new players along with several key initiatives for market development. The sector today consists of diverse types of microfinance providers (MFPs), including Microfinance Banks (MFBs) regulated by the State Bank of Pakistan, specialized microfinance institutions (MFIs), non-government organizations (NGOs) and rural support programmes (RSPs) running multi-dimensional development programmes, including microfinance.

The sector has evolved from a single product, microcredit driven industry towards greater product diversification and today offers the low income households a range of credit, savings, insurance and remittances products. Experimentation in delivery channels using branchless banking and other technology-based services and investments in industry infrastructure such as a microfinance credit information bureau have helped moved the industry further along its maturity curve.

The sector has benefited tremendously from a progressive policy environment led by the State Bank of Pakistan, regulatory reforms aimed at fostering innovation and growth and the presence of the Pakistan Poverty Alleviation Fund (PPAF), which has not only provided liquidity for the sector's growth but also played a key role in sector

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BOX 1: Microfinance Sector Snapshot

- Active Borrowers = 2.8 million
- Percentage of active borrowers by gender = 55 pc Female : 45 pc Male
- Percentage of active borrowers by Rural/Urban = 57 pc Rural : 43 pc Urban
- Gross loan portfolio = PKR 52 billion
- Estimated potential market = 27.4 million potential clients.

- Active Savers = 5.9 million
- Value of savings = PKR 34 billion

- Insurance policy holders = 3.2 million
- Sum insured = PKR 44 billion

Source: *MicroWATCH - Quarterly Update on Microfinance Outreach in Pakistan, Issue 30: Quarter 4 (Oct-Dec 2013)*

development. These achievements have now been recognized globally by independent think tanks - for example, Pakistan has ranked in the top three countries globally in terms of its regulatory framework and business environment for microfinance for three consecutive years[1] (for some summary statistics on the sector see BOX 1).

The Next Frontier: Serving New Markets

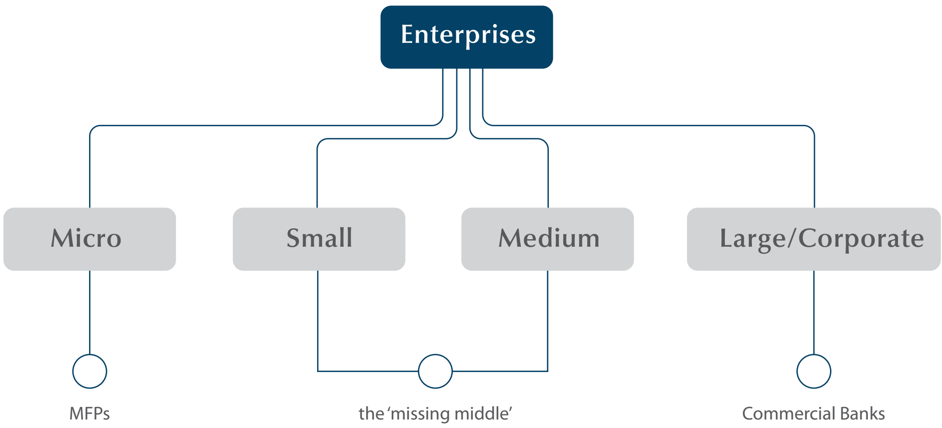
While the entry of new players and the progressive policy environment has led to innovative and experiment-led product designs and alternative service delivery models, significant challenges remain vis-à-vis expanding access to finance not just at the household but also firm level. Overall, about 90 percent of the country's population remains outside the realm of any formal financial services. Even microfinance has only served about 10.2 percent of its potential market, estimated to be close to 27 million clients. This indicates there is room for microfinance providers (MFPs) to enhance outreach to the underserved through targeted strategies that cater to specific sectors in the economy, particularly the small and medium enterprise (SME) sectors.

The micro-enterprise market is relatively homogenous in terms of its financing needs, with most MFPs catering to this market through small loan sizes (generally starting at PKR 10-15K for first time borrowers), based on a group lending methodology that relies on social collateral (cross guarantors) in lieu of hard collateral (gold, term deposits etc). On the other hand, small and medium enterprises (SMEs) represent a heterogeneous set of business sectors with a diverse range microfinance needs. These sectors have largely remained under-served and are sometimes labeled as the 'missing middle' in the firm financing spectrum. Due to recent revisions in microfinance regulations several MFPs are starting to recognize the opportunity that lies in this under-served market and have started looking into developing capacities and more sector-specific products to cater to the growing number of enterprises that fall within the 'small' business category[2] (see FIGURE 1).

[1] Source: Global Microscope on the Microfinance Business Environment 2013; The Economist Intelligence Unit Limited, 2013; *www.eiu.com/microscope2013*

[2] For more on this development, please refer to PMN's study "Moving Towards Micro and Small Enterprise Lending: Opportunities and Challenges"; Pakistan Microfinance Network, 2013; *http://www.pmn.org.pk/articles/MovingTowardsMSELOpportunitiesandChallenges.pdf*

FIGURE 1: Financing Entrepreneurship in the Economy: The Continuum



Financing Low Cost Private Schools (LCPS): An Opportunity for Microfinance?

One sector that has recently come into focus is low cost private schools (LCPS), a business that falls within the SME sector given its characteristics. There has been a significant increase in the number of low cost private schools operating in the country, in both rural and urban locations, over the past few years. The financing of these schools has important implications not only for access to finance indicators, but also on the matter of access to education for the poor and low income households.

It is estimated that Pakistan has close to 5.1 million children out of school, while government spending on the sector has been limited – 2.3 percent of GNP in 2011[3]. This indicates the need for greater private sector interventions, including the provision of grants, loans and technical assistance to low cost private schools, to build their capacity to address the weak education/enrollment indicators in the country.

A research study recently commissioned by the United Kingdom's Department for International Development (DFID) looks at access to finance for low cost private schools in Pakistan, estimating that the sector's funding appetite exceeds PKR 77 billion for over 70,000 low cost private schools currently operating in the country. The amount and sources of initial investment for these existing schools are typical of the SME sector, with a substantial number of low cost private schools having initial investments of less than PKR 300K sourced usually from personal savings and loans from family and friends[4]. This amount falls within the range of enterprise lending guidelines set by SBP, which allow MFBs to lend up to PKR 500K for this sector (see below: regulators).

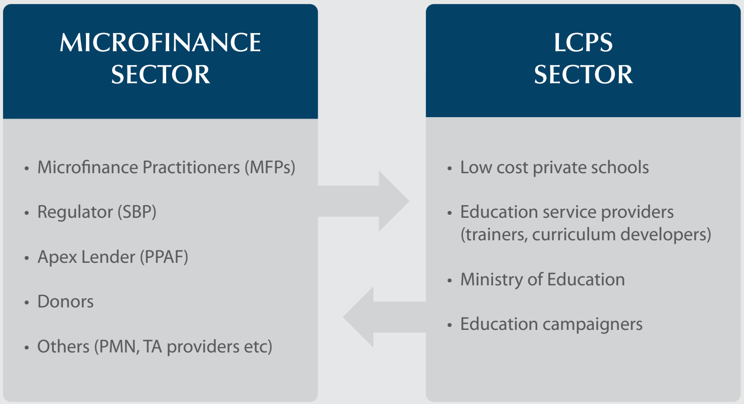
PARTNERSHIPS BETWEEN MF AND LCPS SECTORS - RATIONALE

The rationale behind targeting the LCPS sector for financial access is based largely on market demand principles, potential for project expansions and alignment to existing developments in the microfinance and LCPS sectors. More specifically, the rationale according to the relevant stakeholders is shown in BOX 2.

[3] Source: Education for All (EFA) Global Monitoring Report 2011: Youth and Skills - Putting Education to Work, United National Educational, Scientific and Cultural Organization (UNESCO), 2012.

[4] Source: Draft Report: 'Access to Finance for Low Cost Private Schools in Pakistan', 2014.

BOX 2: Key Stakeholders in the Partnership



Microfinance Providers (MFPs)

As the microfinance sector moves towards achieving growth and sustainability through greater market segmentation and product diversification, enterprise lending has become an increasingly important segment for microfinance providers (MFPs). There has been a significant increase in the disbursement of individual loans over the past few years, which indicates the growing need for customized, demand-driven microfinance products that go beyond the standard group loan model. The provision of microcredit has advanced from the generic product features of small loan amounts in groups, to need-based product features and loan amounts that can make a significant contribution to the income-generating capacity of clients, including micro- and more recently small-entrepreneurs.

There is great potential in creating access to microfinance services for owners of low cost private schools as a specific sub-set of the MSME sector in the country. Several MFPs, especially the microfinance banks, have already begun taking steps that will enable them to reach out to the higher end of the microfinance market (the MSMEs) by creating enterprise loan products and employing the individual lending methodology for higher loan amounts. However, given the size of the potential microfinance market within the LCPS sector, there is scope for MFPs to introduce a sector-specific microcredit product or modify their existing micro-enterprise loans, to effectively engage with the low cost private schools.

Findings of the DFID study on financing low cost private schools indicate that returns are projected to be fairly high given the increasing growth trends for enrolment and low-cost strategies of this sector. Moreover, the sector represents a rapidly growing market, with the number of private schools having increased 10 fold in the past decade, and an estimated 70 thousand low cost private schools currently operating in the country already. A majority of these schools have found a market in the Punjab and Sindh provinces, which also hold the highest concentration of microfinance service providers in the country.

Low Cost Private Schools (LCPS)

Existing trends in the LCPS sector in Pakistan indicate that these are largely unregistered, privately owned and managed by sole proprietors, catering to low income households. The primary source of funding (other than initial personal savings or loans from family or friends for set-up) is the low, affordable fees charged to students – which averages less than PKR 1,200 per month. While returns demonstrate progressive and profitable business, a majority of these schools face

BOX 3: Increasing Gender Equality in Education through LCPS

One of the many challenges affecting enrollment rates in Pakistan is the lack of a gender focus in both public and private sector-led policies for education. Support for the LCPS sector through microfinance presents an opportunity for stakeholders to address this challenge, by financing interventions that not only improve overall access and quality, but take an active stance on improving the gender parity in school enrollment.

In Punjab and KPK, female enrolment in areas where private schools are located is approximately 20 percent higher compared to areas without such schools*. This demonstrates the viability of the LCPS sector to identify and meet the needs of the local communities in a way that the public sector has not. According to recent literature, there are several explanations for relatively more gender equity in LCPS in Pakistan, including**:

- Close proximity of the LCPS to homes, which means shorter commute times for girls.
- Families feel more comfortable sending their daughters to LCPS where the majority of teaching staff is female.
- Where presence of LCPS has resulted in overall improved access and more children enrolled, girls are less likely to drop out to look after younger siblings.
- Demonstrating good test results of girls may elicit interest from competitive school owners to enroll more girls.

Many MFPs in the country have a strong gender empowerment and inclusion focus, including microfinance banks (MFBs), partner organizations of the Pakistan Poverty Alleviation Fund (PPAF) and Rural Support Programs (RSPs). Overall, 56 percent of active borrowers in the sector are female, with some MFPs exclusively targeting women for microfinance interventions. It would be in line with their current social objectives to finance more female-focused LCPS which could, in turn, also create greater female enrolment in the schools.

Moreover, given the link between household income and education, MFPs are considered to have a positive impact on children's education through targeted microcredit programs which aim to increase household income among clients. While the exact impact on student enrollment would perhaps be difficult to measure, the MFPs serious about this particular social impact can look at financing of LCPS as a more specific move towards meeting such social objectives. Moreover, the LCPS financed through these MFPs can be accessed on the basis on enhanced enrollment, particularly that of girls, as a means of quantifying program success.

** **Source:** Andrabi T, Das J, Khwaja A, Zajonc T, Religious School Enrollment in Pakistan: A Look at the Data. Comparative Education Review 50 (3), 2006.*

*** **Source:** Wheeler K, Egerton-Warburton C, Spotlight on Education: Low Cost Private Schools, Lion's Head, INFOCUS, July 2012*

financial constraints in terms of expanding enrollment and improving teaching quality. These outcomes would require funds to develop and/or improve the physical infrastructure of the school property, purchase equipment and material for classrooms, and take part in technical assistance trainings on teaching and learning techniques. Revenue generated through school fees is primarily used to cover the cost of teachers' salaries, rent of school property (in some cases), utilities and repair and management of the schools. With this existing revenue and cost model, the only feasible way for LCPS to grow – to expand outreach to a greater number of students – and improve quality, is through external funding. The availability of loan products, with appropriate loan amounts and terms and conditions that address the specific needs of this sector would allow school owners to achieve the type of growth their enterprise has the potential to achieve.

There is also a substantial role to be played by education service providers to improve the quality of teaching and learning outcomes for private education providers in the country. While donors and MFPs can address the investment and funding needs of the low cost private schools, it is also important to build linkages with experienced players in the private education sector for quality control, curriculum development, teacher trainings and other value-added services that could influence the quality of education provision. More efforts need to be made for linkage creation between the service providers and LCPS based on the fulfillment of mutual objectives vis-à-vis improved learning outcomes and higher enrollment.

Regulators

While in most countries, the financing needs of LCPS fall outside the ambit of microfinance providers, the regulatory environment in Pakistan allows – and continues to support – the delivery of financial services to a growing number of MSME sectors through microfinance. This support is in line the SBP's continued efforts for financial inclusion in the country, particularly through expanding access to formal financial services for the poor. In 2012, SBP revised ***loan limits*** for MFBs from PKR 150K to PKR 500K to allow for the microfinance sector to address the growing market demands of the MSME market.[5]

BOX 4: Defining 'Low Cost Private Schools' within the Scope of Microfinance

In lieu of sector-specific definitions, microfinance providers tend to view their target market as belonging to either the micro-, small- or medium-enterprise (MSME) categories. As such, the owners of low cost private schools are seen as potential clients within the generic enterprise lending programs currently offered by MFPs. In devising a strategy for supporting the LCPS sector through microfinance, it is important to define where these schools fit within the current MSME definitions used by stakeholders.

The definition of MSME varies not only across different countries, but also across different institutions. According to the State Bank of Pakistan, the definition of MSME entails the following criteria:

MICRO-ENTERPRISE	SMALL-ENTERPRISE	MEDIUM-ENTERPRISE
Up to 10 workers	Up to 20 workers	Up to 250 workers
Turnover: not specified*	Turnover: PKR 75 million	Turnover: Up to PKR 400 million
* Often not differentiated from Small-Enterprises		

*** Source:** *Moving Towards Micro and Small Enterprise Lending: Opportunities and Challenges, Pakistan Microfinance Network (PMN), 2013.*

Donors

Donors and social investors have been working with different stakeholders within the microfinance realm, including regulators and MFPs, to support the financial inclusion agenda in the country. International interest from donors and investors has led to the emergence of new players in the field, particularly regulated micro-finance banks (MFBs), which have more recently started to target micro-, small- and medium-enterprises (MSMEs) through individual, higher-ticket loans. Enhanced support from donors for MSME sector lending is in line with current interventions aimed at up-scaling microfinance to reach the underserved, and establishing an entrepreneurship culture among the working poor in the country.

As donors continue to support interventions that create greater access to finance for the working poor, there is a need to understand a more sector-specific approach to achieving scale. Given the increasing prominence of LCPS in the last decade, there is a clear market demand for alternatives forms of education in the country. On the supply side, this is partly driven by the rapid increase in number

[5] **Note:** The provision of lending up to PKR 500K is granted by SBP on a case-by-case basis following the formal application from an MFB. There are limitations on how much the MFB's portfolio can be in these loans.

of school-age children and insufficient government resources allocated to the public school sector. On the demand side, the alarming figure for out-of-school (OOS) children indicates a growing demand, even among low income households for more and better quality education. The opportunity here for donors is a dual achievement of objectives – increased access to finance for a growing segment of the market (i.e. the LCPS) and improved education indicators for the country.

MICROFINANCE FOR LCPS SECTOR: STATUS TODAY

Regulatory Environment

The current microfinance landscape allows for the provision of funds to LCPS under the general terms and conditions for enterprise lending within the MSME sector. In terms of an enabling environment for market-demand lending, the SBP currently manages a DFID-supported guarantee scheme of around USD 20M for microfinance, which is aimed at ensuring that MFBs have access to capital for onward lending. An additional credit guarantee scheme is also managed by the SBP to support lending to small businesses, primarily on a collateral free basis.

The prudential regulations issued by the State Bank of Pakistan for microfinance (2007 and revised in 2011) aim to support the industry and encourage innovative products and services, rather than setting stringent restrictions on microfinance providers. While MFBs have the leeway to devise products for a diverse range of sectors, the regulations are in place to ensure that the loan amounts provided by MFBs are appropriate for the business requirements and repayment capacity of borrowers.

In financing the MSME sector, MFBs have to ensure that the potential borrowers/enterprise owners fall under the prescribed target market for microfinance. In lieu of detailed and verified documentation on annual turnover, asset ownership and other characteristics of micro- and small-enterprises, a basic identifiable indicator is used in the form of ***number of employees***. For micro-enterprises, the maximum number of employees is 10, while for small enterprises it is 20. Currently, only a handful of microfinance banks (MFBs) have SBP's approval to lend up to small enterprises, while the majority of the industry is catering to micro-entrepreneurs[6].

Overall, the limit on number of employees is in line with existing MSME structures, though given the expansion trends and heterogeneous nature of the LCPS sector, it is possible that certain education providers would require a revision of the employee limit. Recognizing the labour intensive profile of certain sectors (including the LCPS sector), the SBP would be willing to allow case-by-case exceptions on the number of staff limit, based on the feasibility and scope of the proposed lending model. The underlying purpose of SBP's generic definition of micro-, small- and medium-enterprises is that MFBs are given the opportunity to experiment with different sectors, be innovative in product design and focus on a gradual up-scaling of the product.

From a supervisory perspective, the SBP would need to see that lending products for the LCPS sector have the potential to reach scale, be sustainable in the long-run, and add value to the industry. In building a case for LCPS sector-specific lending, MFBs would need to demonstrate a certain level of due diligence prior to scaling up the product, demonstrating an action plan that highlights potential for up-scaling as well as generation of revenue against initial expenses – such as on product development, marketing, capacity building of staff and others.

[6] **Note:** Approvals for small enterprise lending have been granted to Tameer Microfinance Bank Ltd (TMFB), Khushhali Bank Ltd (KBL) and Advans Microfinance Bank Ltd (AMFB); while MFBs pending approvals include First Microfinance Bank Ltd (FMFB) and NRSP Bank.

In the product development phase, MFBs would need to address the possible risks, systemic and social, associated with this particular sector. Being dependent on monthly cash flows (school fees charged to students) entails a certain level of risk for school owners, as various externalities could affect attendance rates (and therefore fees collection). This would ultimately mean difficulties in making timely repayments and affect the school's ability to stay open in the face of such systemic risks. MFBs would also need to recognize the possible risks of targeting this particular client profile; compared to the typical microfinance client, school owners are more educated and have a strong voice in their local community - which calls for building strong client relationships with these individuals. As with all other innovative products proposed in the past, MFBs would have to demonstrate the potential for scaling up against some of the possible risks mentioned above.

MFP Experiences to date

While Pakistan has witnessed a widespread increase in the presence of low cost private schools in the past decade, there have been limitations in terms of the level and type of support (both financial and technical) available to these schools. With most low cost private schools being unregistered, and therefore unrepresented in any formal structure, the individual needs of these schools are not being met through a market-wide support strategy. Having said that, the microfinance sector is beginning to see the scope in this sector, and several initiatives have been launched recently in this regard.

In 2013, the Pakistan Poverty Alleviation Fund (PPAF) supported the provision of a microcredit product for low cost private schools through one of its partner organisations - Kashf Foundation. While this pilot was centered in urban areas, the PPAF plans to up-scale the product to more rural areas, particularly in South Punjab, through multiple partner organisations. In the case of the initial PPAF pilot with Kashf Foundation, the loans were also tied to technical support in the form of curriculum development, capacity building workshops for school-owners, teacher trainings and other monitoring support to ensure improvements in overall quality of education provided by these schools. Tameer Microfinance Bank Ltd. (TMFB) recently piloted a specific

BOX 5: International experience in financing LCPS – IDP Rising Schools Program, Ghana

The IDP Rising Schools Program was launched in 2009 in collaboration between the IDP Foundation and Sinapi Aba Trust, a Microfinance Institution based in Ghana with the aim of addressing the underserved market for providing microfinance loans to low-cost private schools in the country.

The program targets existing low-cost private schools with microfinance loans as well as capacity building services in financial management, school administration and techniques for effecting teaching training. The key microfinance loan features include:

- Loan amounts = approx. USD 1,000-7,500
- Interest on loans = 30 percent per annum, 3 percent of loan amount for processing fee and USD 5 application fee.
- Mandatory pre-loan training for school proprietors on best practices for school operations and management, and teacher training in best practices for child-friendly teaching and learning.

As of March 2013, the program has financed 125 school loans through 23 Sinapi Aba Trust branches in Rural, Urban and Peri-Urban areas. Most schools financed through the program charge tuition of approx. USD 15 and are either unregistered or ranked 'C' or 'D' on a 'A-D' scale of quality by the Ghanaian private school rating system. The program monitors these schools in terms of the following indicators of success:

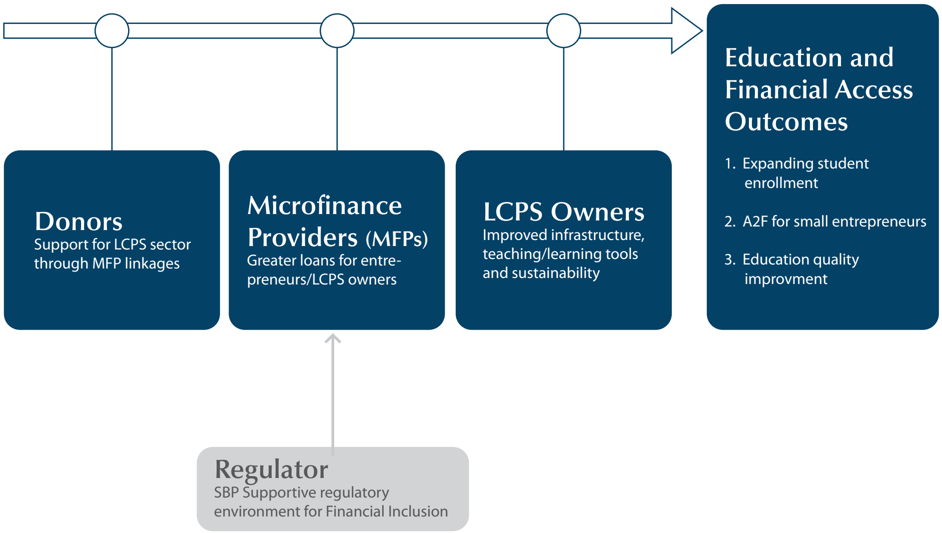
- Student attendance
- Teacher retention/attendance
- Increased enrollment

Source: *http://www.educationinnovations.org/program/idp-rising-schools#sthash.u3i41ljl.dpuf* product for LCPS, which includes product parameters for 'clean' loans as well as collateral-backed loans of up to PKR 150K for LCPS owners with relevant asset ownership (school property, gold, term deposit certificates etc). While efforts on the part of MFPs are relatively new in the LCPS sector, there is a clear interest to make positive contributions to sectors that have the potential to generate social impact.

As mentioned above, DFID recently commissioned a research study to identify the financing needs of LCPS, in an effort to address the existing shortfalls of education provision in the country. Based on the research findings, a financial model was proposed with sector-specific product features based on key variables, including school fees, student teacher ratio (STR) and status of school building ownership. Currently, this product is set to be piloted by three MFPs in early 2014, followed by the possibility of up-scaling with more LCPS's as well as with more MFPs.

The prevalent product features include loan tenures of 12 to 24 months, a grace period of three months to allow the school to acquire relevant equipment/skills/staff and other input for expansion/improvement, and an effective interest rate (IR) of 27 percent. While the model features comply with existing SBP regulations, they also call for the potential for greater investments from the MFBs and perhaps flexibility on the number of employees – particularly for experienced enterprise owners with the capacity and willingness to expand.

FIGURE 2: Projected Outcomes of Microfinance for LCPS Sector



CHALLENGES AND WAY FORWARD

While the recent DFID study on financing LCPS in Pakistan shows a clear potential for MFPs to reach product scale and profitability though a sector-specific approach, there are still some challenges that need to be addressed along the way. The biggest challenge relates to the capacity and willingness of MFPs to lend to a sector that has thus far remained largely outside the scope of microfinance, given the average loan amounts required by LCPS owners. As mentioned above, the regulation on loan size has already been revised from PKR 150,000 to PKR 500,000, to allow for microenterprises such as LCPS owners to benefit from microfinance services. While some MFBs have begun to pilot new higher-ticket loans, it will take some time for the sector to build its confidence in introducing loans for the MSME sectors.

From the MFP perspective, financing low cost private schools represents a particular set of challenges in product roll-out. In most cases, these schools do not record financial statements and are unable to demonstrate financial sustainability in the long run. A second challenge is the lack of capacity of field staff to identify potential clients and assess their business cash-flows and potential for expansion. Lastly, there is a lack of tailor-made products for the LCPS sector based on market demand. The implementation of a need-based lending program, such as that proposed in the DFID study, would allow MFPs to create a substantial client base in the LCPS sector (see section above: proposed product features).

In terms of the regulatory framework, there have been some important developments, such as the revision of loan amount ceilings, which allow for MFBs to be innovative in reaching out to new sectors. At the same time, guarantee schemes have been set up to encourage MFBs for onward lending, particularly to micro- and small-enterprises. The burgeoning low-cost private school sector in Pakistan holds enormous opportunities in this regard. Falling within the MSME definitions set by the regulatory body, these LCPS represent the target market for MFBs looking to move toward the higher end of the microfinance market. Moreover, financing LCPS would mean as not only creating financial access to an important sector within the MSME framework, but also addresses the social objectives of creating access to education for the poor in Pakistan.

While donors can support low cost private schools through direct grants, the scale of such interventions would most likely be limited, particularly given challenges on the ground with regards to access to sufficient information and ability to assess the sustainability of schools. At the same time, there is potential for donors to support a market based approach in which school owners are vested in improving the quality and scale of education provision tied to microfinance loans. In particular, donors can play an important role in resolving the liquidity constraints faced by MFPs to lend at higher loan amounts to this target group.

As mentioned above, literacy and enrollment rates in Pakistan are some of the lowest in the world and public schools are not reaching the necessary targets to improve 'access to education' indicators. Alternative, market-driven solutions such as low cost private schools are increasingly being considered the most viable option for low income households. Give the growth of the microfinance sector and the progressive regulatory environment for MFPs in Pakistan, this sector represents an important channel for building the financial and technical capacity of low cost private schools through effective partnerships.

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