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Demand-side Financing of Education
What role for microfinance?

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1. Introduction

In the past two decades, the number of microfinance institutions (MFIs) offering microcredit has grown markedly. At the same time NGOs and governments have augmented efforts to increase literacy rates and to reduce drop out rates in schools. However, traditionally, microcredit and education programs have not worked with each other—government programs relating to education have focused on increasing the number of schools and teachers, while microfinance programs have focused on providing credit for the acquisition of working capital in micro-enterprises. Microfinance and education can and should integrate. This report will show cases in which this is starting to be the case.

It is not out of chance that the provision of microcredit has focused on loans to acquire physical working capital and not to accumulate human capital. It is inherently harder to provide credit to build human capital as compared to credit for investment in physical capital because the former is irreversible in the sense that it can not be bought or sold and only yields returns in the long term (Flug et al, 1998). However, there are also strong reasons to think that developing credit markets for education, thus removing important demand-side constraints on its acquisition, is very important to help families get out of the vicious circle of poverty. Low and variable incomes lead to deficient levels of educational attainment, thus leading to the intergenerational transmission of poverty.

There are also institutional reasons why most MFI programs have developed a single-product credit delivery mechanism: standardization of products together with economies of scale helps to reduce transaction costs. However, such programs can hardly reduce poverty on a large scale and on a long-term basis. Poverty is caused by many factors, including lack of skills, entrepreneurship and human capital. If microcredit is used for investing in education, it can have a deeper and longer impact through the creation of virtuous cycles out of poverty by making the younger generation in a family have more skills than their parents did, and so greater opportunities in terms of access to more and better jobs in the future. The challenge in this respect, however, lies in finding out how to design microfinance products that are effective in removing the financial constraints that poor families face in sending their children to school, but at the same time making sure that the outcome is not just greater indebtedness for the client and that it is sustainable for the MFI.

This report will document three case studies of innovative products in microfinance institutions which help parents finance their children's education. They are derived from primary research done during the months of July and August 2006, through interviews with MFI clients and staff. This is an exploratory study so there are no statistically significant conclusions. Rather, its aim is to provide an initial overview of the ways in which microfinance can play a role in solving demand-side financial constraints for educational attainment and act the preliminary basis for future research.

2. The Pervasive Effects of High Drop Out Rates in India

According to the UNESCO report on education statistics 2006, in India, the survival rate to grade 5 is about 80% (pp. 92). This means that about 18 million children start first grade but do not make it to fifth

grade. Thus, drop out rates are very important, especially considering that the net enrolment rate in primary education is already very high, nearly 90% (pp. 83). This situation is even worse in the case of secondary education where only 19% of students who start it actually finish it (pp. 126). All in all, only 15% of students who start first grade in India make it all the way through to the end of secondary . As similar patterns are observed in most developing countries, it comes as no surprise that the UNDP Task Force on Education has identified the issue of retention, in other words, reducing drop-out rates, as the most important factor to be addressed to achieve the millennium development goal of universal primary education (Birdsall et al, 2005, pp. 54).

3. Some Characteristics of the School System in India

The main characteristic of the school system in India is that it is highly segregated. There is a strong dividing line between private and public school with the former being preferred by everyone even though they are more expensive. The reason for this is that private schools teach English and computers, and parents (rightly) believe that these are the main skills that are in demand in the market. The segregation between the two systems is intensified by language barriers because government school teach using the local language (for example, they use Tamil in Tamil Nadu and Telugu in Andhra Pradesh), thus when a child starts his or her education in one of the two systems it is very hard to change to the other because they are not proficient enough in the other language. One of the most pervasive consequences of this is that if a child starts his education in a private English school and parents reach a point where they can not pay the fees anymore, the child just drops out indefinitely instead of moving to a government school. Moreover, the likelihood of this happening increases as the child moves up the educational attainment ladder because the school fees increase with the class (sometimes 10th grade can cost twice the amount that 1st grade costs).

4. What are Parent's Constraints in Financing Education?

I will concentrate my analysis on two main types of problems that parents face. The first one is a cash management problem. Parents often have trouble accumulating the lump-sum that is needed to pay for tuition fees and other expenses at the beginning of the school year. This is because, despite their small incomes, poor people very often encounter expenditure needs which are very large in relation to the sums of money that are immediately available to them (even if they can easily handle day-to-day expenses such as food using their income).

The second problem relates to the lack of liquidity that parents face during crises, emergencies or shocks, making it tempting for them to withdraw children from school as a consumption smoothing device. This has been empirically documented by many researchers. For example, the cross-country study by Ersado (2002) showed that, for credit-constrained households, it is the variability of a household's available income, rather than the average level of poverty of the household, that has the greatest impact on the likelihood that a child is in school. Additionally, in a study of six Chinese provinces Brown and Park (2002) conclude that

“controlling for expenditures per capita, children from households that are both poor and credit constrained are three times more likely to drop out of school” (pp. 537).

Based on this typology of problems I will label my case studies as Product Type #1 if they solve the first problem, and Product Type #2 if they solve the second problem.

5. Case Studies

This section will look in detail at three different products provided by three different MFIs: an educational loan at Mahasemam Trust, a family needs loan at Ujjivan and an emergency loan at Grameen Koota. I will highlight what makes each product special and possible ways in which they might be improved.

5.1 Case Studies of Product Type #1

5.1.1 Educational Loan at Mahasemam Trust

The Mahasemam Trust started in 1999 in the city of Madurai, in the Southern Indian state of Tamil Nadu. It later expanded its activities to the state capital, Chennai (formerly called Madras). As of May 2006, Mahasemam Trust had 110,571 members and 89,272 active borrowers, all of whom are women. The total amount in loans disbursed was Rs 980 million (\$22 million) and the total amount disbursed in educational loans is Rs 60 million (\$1.5 million). The rest of their portfolio is mostly comprised of income-generating loans which are disbursed using the Grameen model.

The educational loan at Mahasemam is Rs 3,000 (\$60) per child and each client can apply for loans for a maximum of two of her children (Rs 6,000 in total). The interest rate is 10% per year flat and there is also a flat fee of Rs 100. The loan has to be paid back in 50 weekly instalments (approx. one year). To be eligible for an educational loan, the client must already have an Income Generation Loan with Mahasemam and thus already be accumulating the mandatory savings of Rs 10 (\$0.2) per week, which is a pre-requisite for the Income Generation Loan. Additionally, the client must show a written proof that the child is enrolled in school and has been promoted to the next grade. Based on this document the loan is approved.

The product was launched for the first time this year and had very high demand, seen by the fact that about 90% of clients applied for it. Only those clients who do not have children or whose children are older than the school age did not apply for the educational loan. However, only 20% of these applications resulted in actual disbursed loans, because the MFI was not able to disburse so many loans in the short period of May-June, which is the period when the yearly school fees need to be paid in India.

From the MFI point of view, it is interesting to note that the creation of this new product does not increase their transaction costs or operational costs because the product is offered to the same client base that is already using the income-generating loan. Thus, contrary to the usual prediction that the creation of new products, rather than having single homogenous products is more expensive for the MFI, Mahasemam is rather reducing the transaction costs as a percentage of their total lending, since using the same network of people more money is being lent.

Clients repeatedly say that they use the income they get from the business that they started with the Income Generating Loan to pay for the educational loan. Additionally, most clients say their husbands also

contribute some of their income towards the weekly repayment of the educational loan. Thus, given that clients do have an ability to pay for the loan in small instalments, but they find it much more difficult to have the lump-sum that is needed at the beginning of the school year, this loan is effective in solving the cash management problem poor families face at the beginning of each school year. Clients report that in previous years they would handle this situation by going to local moneylenders, who would charge an interest rate of about 10% per month (120% per year).

My first reaction to this product, given that its whole purpose is to help parents accumulate a lump sum for the payment of yearly school fees through small instalments, was that there is an opportunity to reverse the cycle and make it a savings product. This is because what clients are confronted with is just a cash management problem. Thus, saving through weekly instalments to accumulate a lump-sum for the beginning of the school year, entails the same effort for the client as repaying a loan that was given at the beginning of the school year through weekly instalments thereafter; plus it prevents the client from having to pay for the cost of the interest that is attached to credit products.

However, the biggest constraint for achieving this is to actually be able to reverse the process, given that savings need to be done one year in advance and clients are already indebted during the current school year. Additionally, the one advantage of it being a credit rather than a savings product is that, because the lump-sum is given to the client at the beginning of the school year, this assures that the child is enrolled and later repayment is a problem to be dealt with later and. Thus, the child's education is not compromised, even if later on parents have to struggle to pay back the loan. On the contrary, it is much harder to make sure that a lump-sum is accumulated through savings because there is no way that the MFI can force the clients to save. Rather, the MFI can exert a greater leverage in pressing the clients to pay back the loan once it has been disbursed. Thus, even though a savings product would make the whole process cheaper for clients since it avoids the interest paid on credit, it might not be as effective in keeping children in school as the credit product.

Additionally, there also exists the issue in legal terms that MFIs are not allowed to collect savings, so a savings product could only be provided whenever there exists a comprehensive regulatory framework for MFIs in India. Thus, this is an example of the fact that new product development needs to go hand in hand with MFI regulation. Furthermore, even if Mahasemam were to be legally able to collect savings, it is not clear that they would have an incentive to turn their educational loan into a savings product, since they would not be making money out of it; it wouldn't be as profitable as a credit product.

5.1.2 Family Needs Loan at Ujjivan

Ujjivan is a non-bank financial company (NBFC) based in Bangalore, with the mission of providing financial services (loans, life and health insurance, bank accounts, etc.) to poor working women. Its focus is on the urban poor, specifically women living in and around Bangalore. They include salaried workers in garment factories, hotels, government offices, house maids, etc. and those who are self-employed, for example vegetable and fruit vendors, saree makers and petty shop owners. Given that most MFIs in India have concentrated their operations in rural areas, Ujjivan views the urban context as an untapped market where it can expand rapidly, achieve economies of scale and ultimately profit.

Ujjivan started only a year ago and is piloting an urban model of microfinance over an 18-month period

(October 2005 - March 2007). They have four branches in Bangalore with a total of 5,000 clients at present, and plan to have twelve branches across the city by March 2007 with a customer base of 25,000. Following this, they plan to refine the model and launch it in a new Indian city every six months. Their ultimate target is to achieve national scale and reach 600,000 customers in five years.

From the MFI perspective an educational loan is like any other consumption loan because it is a non-productive loan in the short-term. Thus, Ujjivan decided to not have a loan specifically for education, but rather a loan with that would allow clients to use it for anything that is not designed for income-generating purposes. Thus, they developed the Family Needs Loan, which is a generic consumption loan of a sum between Rs 3,000 and Rs 7,000 (\$60-140) at 18% per year flat.

Ujjivan also has a business loan, but only 22% of its clients have it (the rest have Family Needs Loans). The reason why Ujjivan (as opposed to the majority of MFIs) started providing a product that is not necessarily the standard income-generating loan is because their market research yielded that the majority of their potential urban clients are salaried employed women with neither skills nor interest in starting their own business. This is very important, because one of the big criticisms that MFIs and the microcredit movement in general has received is the assumption that all poor people can and want to start a micro-enterprise, which is not the case at all. This is especially true in the urban context where many poor people are employed by large businesses and institutions. Thus, by conducting thorough market research and developing a product that is less supply-driven and more sensitive to client needs, Ujjivan has created a product that prevents women from having to take credit under the false pretense that it is going to be used for working business capital.

The most interesting aspect of this product is the fact that it is a loan that can be used for a whole variety of purposes because it makes it much easier for clients' group formation. Imagine, as it happens with the Mahasemam Trust product mentioned earlier, that a client has to search for four other women who also need an educational loan and form a group with them to be able to get it. This is much harder than finding four other women who need a loan for any non-productive purpose, including house repair expenses, expenses for festivals and weddings, and the repayment of other debts. Of the 3,500 family needs loan that Ujjivan had disbursed by August 2006, 7% of them had been used to pay for education fees and other education-related expenses. The loan use is verified by loan officers one week after the loan is disbursed; the client provides a receipt from the school stating the amount paid.

Additionally, after completing its pilot phase, Ujjivan is thinking of providing two other very interesting products. The first is a Combination Loan of Rs 7,000 where Rs 3,000 would go to family needs and the Rs 4,000 would go for business purposes. The second is a higher education loan given on an individual basis (rather than group-based) amounting between Rs 15,000 and Rs 30,000 (\$300-600) per year, for five consecutive years, to pay for university education. The client would only begin to repay the loan once the student has completed his degree, so this is a long-term loan which entails a greater risk for the MFI. However, Ujjivan believes that it can work with clients that have a good proven repayment track record with the MFI for at least two years. At the moment, no MFI in India has ever provided a higher educational loan of this nature.

5.2 Case Study of Product Type #2

5.2.1 Emergency Loan at Grameen Koota

Grameen Koota started its operations in May 1999 as a Grameen Bank Replication Program with the help of seed capital funding from Grameen Trust. As of July 2006 they had 62,000 members and 50,000 active borrowers. Their 36 branches are all located in the state of Karnataka with a strong concentration around the villages just outside and near Bangalore. They provide Income Generation Loans of Rs. 7,000 with an interest rate of 18% flat per year, to be repaid in a year through weekly instalments. Additionally, and more important for this investigation, they have an emergency loan product of up to Rs. 1,000 (\$20) which is disbursed immediately after the client applies (this is to say, in the same group meeting when the application for the loan is made). It is an interest free loan with only a documentation fee of Rs. 15, and has flexible repayment with clients (together with their group's approval) choosing the number of weeks that they want to pay it back in (max. 50 weeks). It is observed that most clients choose a repayment period of 10 weeks.

For clients in their older branches (more or less at least four years of operation) clients actually do not pay any fees at all because they borrow the emergency loan from the money accumulated in the group savings fund. Grameen Koota, just as all MFIs do, require clients to start making compulsory savings of Rs 10 per week, even before the first loan is disbursed. With time, the savings can represent a considerable amount that has been accumulated, but most MFIs allow clients to withdraw their savings only when they decide to drop out of the MFI definitely. On the contrary, Grameen Koota is allowing clients to get their emergency loan from these savings, making it an interesting model to be replicated, since savings are effectively acting as a safety net for when households face a crisis or need a lump-sum quickly. This is a best practice idea that should be used more by other MFIs. It encourages the transparent use of clients' savings, which currently is not always the case. It is often found that MFIs are not too clear, even in their own books, about where exactly they are putting their clients savings.

Around 10% of clients who have taken emergency loans claim that it is used to pay for school fees. Actually, the majority of emergency loans taken out during May and June (the time when the school year in India starts) are used to pay for education-related expenses such as tuition fees, but also uniforms, materials and transport fees. Additionally, it is interesting to note that in the three states I surveyed (Andhra Pradesh, Karnataka and Tamil Nadu) private schools that charge monthly fees allow for parents to get behind in paying the fees for a maximum of two months, after that the child is not allowed to attend class. Therefore an emergency loan like this is perfect for solving this situation as the accumulated amount of two months fees is generally between Rs 500- 1,000.

Moreover, even in the cases when the emergency loan is not directly used to pay for education-related expenses, one can argue that it helps in preventing households from taking children out of school in times of crises, by helping them stabilize and smooth their consumption. In my interviews with clients, most crisis or emergencies come about when a working family member falls ill and so can not contribute his income to the household for a couple of weeks. Thus, the emergency loan in these situations act as a cushion in the meantime while this person recovers and goes back to work (consecutively helping out the family to pay back the loan within the next 10 weeks).

6. What Constraints do MFIs face in providing these Products?

Microfinance institutions face three different types of constraints in developing these new products: financing constraints, organizational constraints and ideological constraints. The first come about because educational loans are seasonal in nature. This is to say, for them to work effectively, educational loans must be disbursed at a specific time in the year, namely, between May and June (just before the school year starts in India). Thus, as was seen in the case of Mahasemam Trust, it might be very hard to obtain a level of financing during these two months which is much higher than the general average that the MFI needs throughout the year. However, this should not be an issue through the ICICI partnership model using the overdraft facility. Using the overdraft facility entails an extra 1% cost for the MFI, but this will happen in all cases (not just for educational loans). Additionally, if this is regarded by the MFI as a problem, the cost could be passed on to the clients through an application fee to be charged at the moment they apply for the loan. Another financing constraint is present in the case of emergency loans because these are loans that, by their nature, have to be disbursed very quickly. However, given that it is not a very high amount, loan officers can carry the sum to the group meetings in case somebody applies (as is done in Grameen Koota).

Organizational constraints can also arise because of the seasonal nature of educational loans, especially during the first year that the loans are offered. This is because the MFI may be working at full capacity generally throughout the year and so they might not be able to cope with an extra disproportionate number of loans to be disbursed during May and June. Additionally, there are other issues that relate to the development of new products in general, such as those that arise because the computer system that the MFI uses can only handle a certain number of products and so adding a new one may entail updating or re-engineering the whole computer system that the MFI uses (a relatively large fixed cost).

Finally, ideological constraints were those that I observed very subtly in the form of biases or prejudices within MFI staff and even microfinance researchers against loans that are not productive. In general, it is believed that it is safer and best to not provide loans that are for consumption purposes. Note that money spent in education is an investment, it is not consumption, but because it does not yield returns in the short term, it is paralleled to a consumption loan in the eyes of the MFI.

7. Conclusions and Recommendations

MFIs have a long way to go in terms of creative new product development. The few products that I documented in this study tend to be outliers within the broader population of MFIs in the sense that they have expanded their product range. But in general, MFIs in India do not provide such loans (and India is one of the countries in the world where the microfinance market has matured the most). Moreover, the products that I document in my case studies are still relatively simple. For example, there is nothing like a business loan with earnings earmarked for education or a credit-and-savings product like the one I described earlier in the product design brainstorm section. Yet, some of the lack of innovation, especially with respect to products that involve MFIs taking savings from clients, is understandable since a proper regulatory environment is not

in place. Thus, new product development in microfinance has to go hand in hand with improved regulation of MFIs.

My first general conclusion is that the role of microfinance in helping poor families to keep their children in school is not limited to the provision of educational loans. Emergency loans have a big positive impact relating to educational attainment since they help to stabilize families after a crisis and thus prevent the use of a child's schooling as a consumption smoothing device. My second conclusion is that to provide a loan to be used to pay for education, MFIs do not have to restrict themselves to an educational loan product specifically. They can also provide a general consumption loan where one of the categories for its use is education.

During my field work I also realized that realities on the ground are much more subtle than the way models depict them. For example, models that illustrate the way in which children's schooling is used as a consumption smoothing device, predict that in the face of a crisis parents will withdraw children from school. However, when I talked to MFI clients about this, they said that in the face of a crisis, before making the decision to take a child out of school, they try to get the necessary money from local moneylender, friends and family, pawn their jewellery or use part of their income-generation loan from the MFI. Only if all these possibilities are exhausted will they actually make the child stop studying and start working. This is more so in urban areas where parents give a very strong importance to their children's human capital attainment. Thus, there are many grey areas in between the black-and-white scenario of children schooling as a consumption smoothing device. So, models are useful in simplifying complex realities, but it is interesting to see the details of how things actually work in practice.

In terms of recommendations, there is a very important need for a regulatory framework for MFIs to be set by the Indian government, if the industry is to grow and develop new creative products. This is especially with regards to products that entail MFIs collecting savings from clients. There is a strong potential for cash-management products that have the goal of helping parents finance children's schooling to be savings products as opposed to credit products. However, MFIs are reluctant to consider savings products seriously because with an NGO status it is illegal to do so. What is more remarkable, though, is that they do, informally, collect compulsory savings but only in very small quantities and the government has not taken action to stop this from happening.

A second recommendation is that microfinance practitioners should be more aware of their own biases and prejudices. During my interviews with MFI staff in general I noticed that there is an ideological bias against loans that are of a non productive nature in the short term. Even educational loans, which we know are productive in the long term since they increase people's human capital formation, are regarded as more risky because they are not "productive". However, as I saw during my interviews with clients, poor people are not a homogeneous category in the sense that not all are interested or have the skills to set up a business. People that are employed by someone else and receive regular salaries are also in need of financial products, especially products that allow them to have lump-sums of money at specific points in time when they need it (the beginning of a child's school year being just one example). Thus MFIs should not limit themselves to Income Generation or Business Loans only.

Additionally, I want to stress that the role that microfinance can play in helping families to finance children's education is limited to clients that are not the poorest of the poor, specifically not those that are the

destitute poor. If a family does not have enough food to eat and pay for a minimum shelter, there is no credit or savings product that will make a difference. My estimate is that for a family of four, there needs to be an average daily income of at least Rs 100 (\$2), for the parents to qualify as potential clients.

To end, I must admit that the provision of microfinance in the context of primary and secondary education is a second best solution. Ideally, parents in poor countries should not be struggling to give their children access to basic education. Governments should increase their efforts in providing schools and improving the quality of existing schools. The latter is especially important since, as seen repeatedly during my field work, poor families go through great sacrifices in order to keep their children in private schools because government schools don't teach the skills required to get jobs (especially English and computers). As established in the UN Convention on the Rights of the Child, all children under the age of eighteen should have access to education, regardless of their parents' financial situation. However, we live in a non-ideal world, thus microfinance has a huge role to play in demand-side education financing. The examples that I have reported in this dissertation are probably just the beginning.

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