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RESULTS FOR  
DEVELOPMENT

# INNOVATIVE FINANCIAL SERVICES FOR EDUCATION

By Claire Trainar  
with Nicholas Burnett

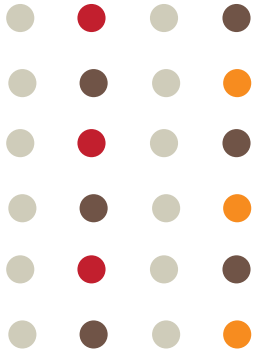




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# Foreword



The current mandate of Educate A Child (EAC) is to support out of school children (OOSC) at the primary level in accessing, participating in and completing a quality primary education. Through working with EAC partners in 38 countries it is evident that the cost of education is one of the major barriers to a quality education that learners, parents, and providers face, regardless of the level of education. Education costs are manifest at a wide range of input points. These points vary from parents and communities, to private providers, to governments.

Putting aside the debate on private vs. public provision, which is an important debate in its own right, EAC wanted to understand better some of the opportunities in and constraints to providing financial services for education, particularly in relation to providers that supplement or complement public education. Our partner Results for Development (R4D) willingly took on this challenge.

The publication addresses access to financial services by both the users and the providers of education. It also considers linkages between the public and non-public sectors in relation to financial services.

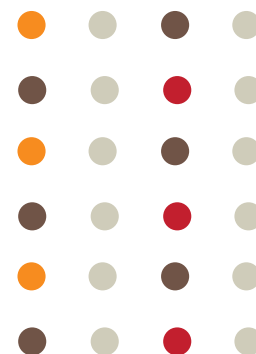
The findings of this research are both encouraging and discouraging. There are several innovative approaches available, some of which show potential. Unfortunately, few have been adapted sufficiently to make a significant difference at the primary level.

We hope that the findings and analysis contained in this publication encourage serious consideration of alternative ways to provide financial services for education—especially to those who are most disadvantaged and seeking education at the primary level.

Mary Joy Pigozzi, PhD  
Director, EAC

# List of abbreviations

<b>AFED</b>	Association for Formidable Educational Development (Nigeria)
<b>BRAC</b>	Bangladesh Rural Advancement Committee
<b>CIFF</b>	Children's Investment Fund Foundation
<b>DFI</b>	Development Finance Institution
<b>DFID</b>	Department for International Development
<b>DIB</b>	Development Impact Bond
<b>EAC</b>	Educate A Child
<b>GDP</b>	Gross Domestic Product
<b>HCC</b>	Human capital contract
<b>IFC</b>	International Finance Corporation
<b>IFFIm</b>	International Finance Facility for Immunization (GAVI)
<b>ISFC</b>	Indian School Finance Company
<b>LCPS</b>	Low cost private school
<b>MFI</b>	Microfinance institution
<b>NBFI</b>	Non-banking financial institution
<b>NGO</b>	Non-governmental organization
<b>NISA</b>	National Independent Schools Alliance (India)
<b>OOSC</b>	Out of school children
<b>ORB</b>	Order Book for Retail Bonds
<b>P2P</b>	Person-to-person
<b>PALF</b>	Pearson Affordable Learning Fund
<b>PCG</b>	Partial credit guarantees
<b>PE</b>	Private equity firm
<b>PEAS</b>	Promoting Equality in African Schools
<b>PRI</b>	Program-related investment
<b>PTA</b>	Parent Teacher Association
<b>R&amp;D</b>	Research and development
<b>RSF</b>	Risk-sharing facility
<b>SLEF</b>	School Level Enhancement Finance
<b>SIB</b>	Social impact bonds
<b>SIF</b>	School Improvement Finance
<b>SME</b>	Small and medium enterprise
<b>SPV</b>	Special-purpose vehicle
<b>UNESCO</b>	United Nations Educational, Scientific and Cultural Organization
<b>UNICEF</b>	United Nations Children's Fund
<b>VC</b>	Venture capital fund



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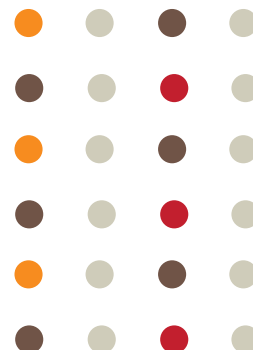
# Executive Summary

In 2012, nearly 58 million children of primary school age and 63 million adolescents between 12 and 15 years of age were not enrolled in school, primarily in South & West Asia and Sub-Saharan Africa. Financial barriers are a major cause for exclusion from basic education. Children from disadvantaged backgrounds are particularly vulnerable because the private costs of attending school are more prohibitive to the poor. In Nigeria for instance, most children from rich households start school compared to just 30% of those from the poorest households. The lack of schools, teachers, equipment and good teaching practices also contributes to the global out of school challenge. Insufficient levels of domestic public funding and aid to education have generated a US\$38 billion annual financing gap in basic and lower secondary education, thereby creating a practical need for private financial resources to support the universal right to education. Therefore, financial innovations could participate in reducing the number of out of school children (OOSC) by balancing the quantity and quality of education provided by state and non-state providers (supply side) with the demand for education from students and their parents (demand side). This review identifies three broad categories of successful initiatives in financial services targeted at students, for-profit schools and not-for profit schools. The majority of initiatives implemented in the countries where the number of OOSC is highest remain local and small-scale. Thus the question remains whether and to what extent they can be expanded or replicated in a scalable manner to enroll OOSC.

First, higher education students and their parents can benefit from a wide range of new financial services. The experience of Trustco, FINAE, Ideal Invest and Eduloan provide keys for success in higher education loans while Enzi and Lumni are beginning to implement equity-like human capital contracts<sup>1</sup>. The expansion of student financing towards the base of the income pyramid at higher education level can be spurred by crowdfunding, securitization, debt issuance on capital markets and risk mitigation strategies with the participation of governments or development finance institutions. Yet, there is so far no evidence that similar financing models could be successfully replicated at the pre-primary, primary and secondary education levels where the largest share of OOSC can be found and where the link with employment and debt repayment is less direct than in higher education.

Second, the loan products developed specifically for low-cost private schools (LCPS) can positively impact the supply side of the education equation: they can be infrastructure loans (Indian School of Finance Company in India), cash-based loans (Department for International Development [DFID] and the Kashf Foundation in Pakistan) or loans combined with school proprietor management and financial literacy training (Edify and IDP Rising School Program in Ghana). Impact investing, although currently focused on a small number of school chains, bears interesting potential for LCPS equity financing: it would not only mobilize new funding, but also help promote innovations in teaching, monitor outcomes as well as introduce and scale efficient approaches. These nascent debt and equity innovations have not been implemented on a large scale yet despite strong LCPS demand. In parallel, the creation of and support for non-state school provider federations around the world could also help improve non-state schools' inclusion in the formal educational and financial systems while giving them a united voice.

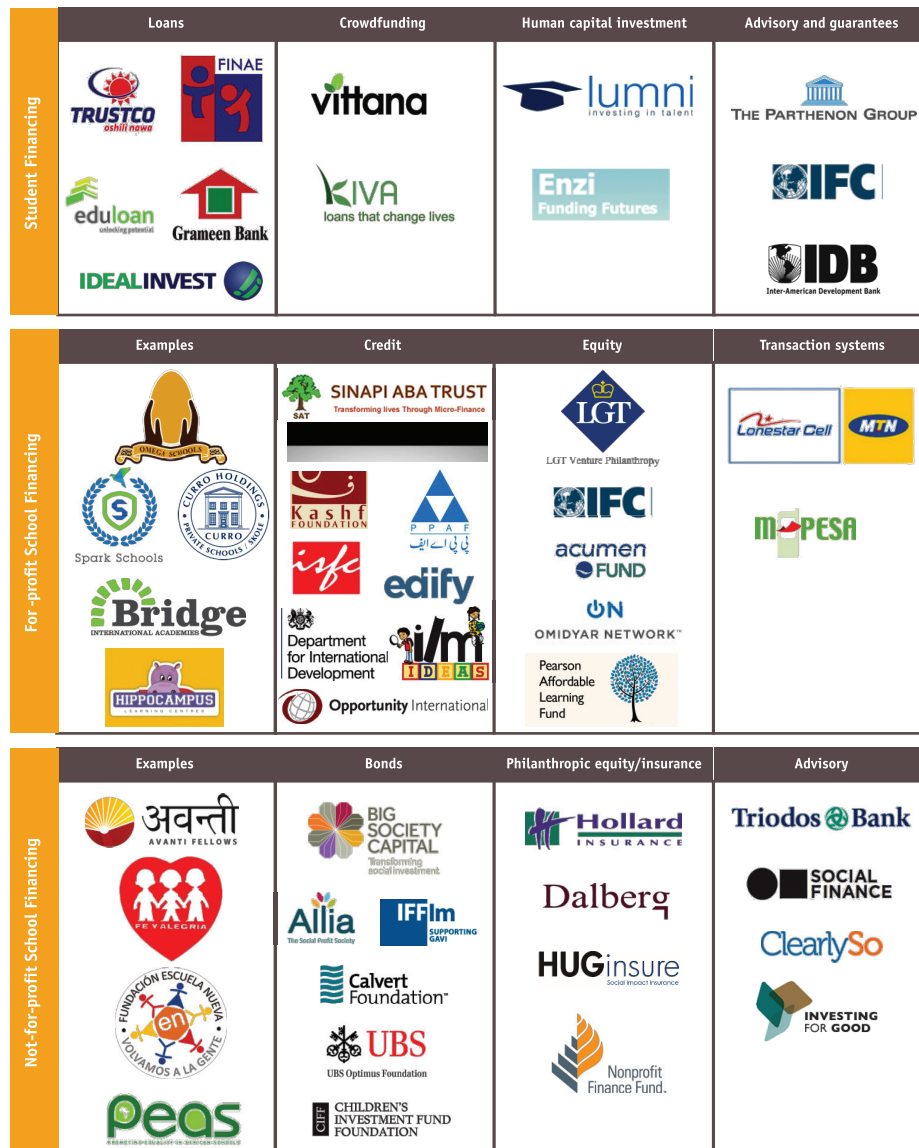
<sup>1</sup> Refer to *Financial Mechanisms* on page 46



# Executive Summary

Third, not-for profit schools' access to financial resources could be improved following the development of innovative financing mechanisms such as Social Impact Bonds (SIBs)/ Development Impact Bonds (DIBs), social impact insurance mechanisms such as HUGinsure, equity-like capital (philanthropic equity and program-related investments) and charity bond markets in developed countries. However, only a small number of these innovations have been implemented so far, catering to large international nonprofits and nonprofits headquartered in developed countries. There is no significant evidence that such mechanisms can be successfully scaled and replicated for small nonprofits in developing countries.

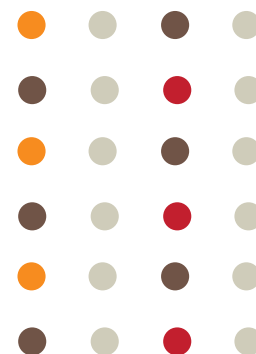
**Figure 1:** Diagram of the players involved in student, for-profit and not-for-profit school financing



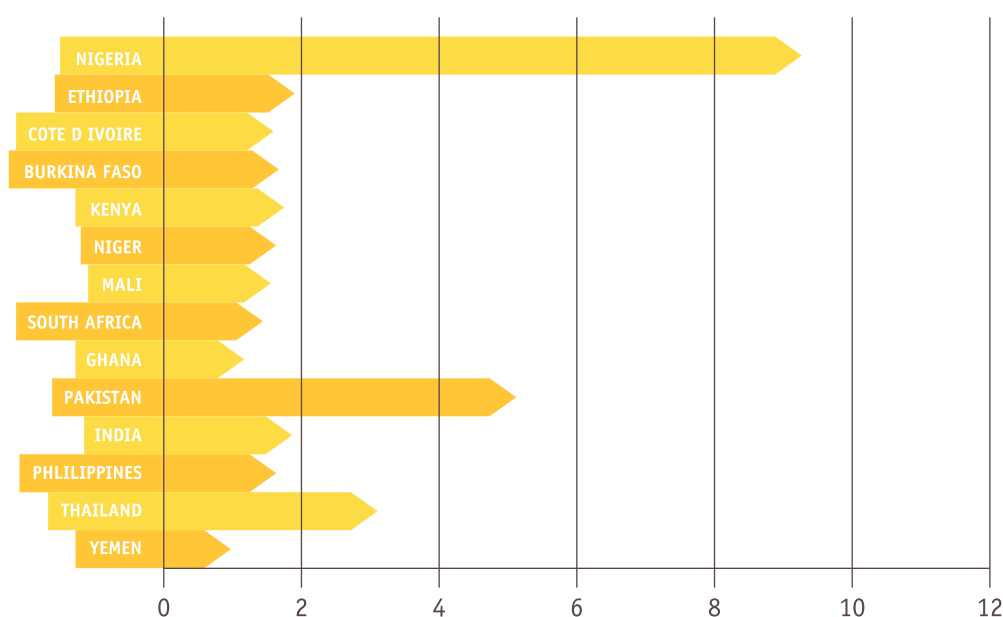


# Introduction

Despite global initiatives dedicated to achieving universal primary education, nearly 58 million children of primary school age were not enrolled in school in 2012 <sup>2</sup>. South and West Asia have dramatically reduced their numbers of OOSC since 2000, contributing more than half the total reduction in numbers out of school <sup>3</sup>. Yet the number of OOSC in Sub-Saharan Africa has stagnated since 2007. Similarly, efforts of the international community to increase enrollment in secondary education are falling short of expectations, with 63 million adolescents between 12 and 15 years of age out of school <sup>4</sup>. 26 million of them are in South & West Asia and 21 million in Sub-Saharan Africa <sup>5</sup>. As previously demonstrated by Results for Development in a study commissioned by Educate A Child (EAC) on a set of twenty countries <sup>6</sup>, “*the estimated economic gain from achieving universal primary education exceeds the estimated increase in public spending required to enroll those OOSC in primary school*”. For nine countries with high OOSC prevalence, the economic benefit associated with achieving universal primary education exceeds multiple years of economic growth: in Nigeria and Mali for instance, the projected cost of OOSC is worth over two years of average gross domestic product growth.



**Figure 2** Half of the world's OOSC at primary level are concentrated in 14 countries (in millions)



Source : UNESCO Institute for Statistics 2013

<sup>2</sup> *Progress in getting all children to school stalls but some countries show the way forward, UNESCO Policy Paper 14 / Fact Sheet 28, June 2014*

<sup>3</sup> *Education For All Global Monitoring Report 2013/14, Teaching and Learning: Achieving Quality for All, UNESCO*

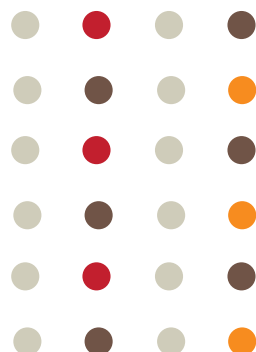
<sup>4</sup> *Progress in getting all children to school stalls but some countries show the way forward, UNESCO Policy Paper 14 / Fact Sheet 28, June 2014*

<sup>5</sup> *Ibid*

<sup>6</sup> *Exclusion from Education : The Economic Cost of Out-of-School Children in 20 Countries, Results for Development (R4D) and Educate A Child (EAC)*

## Introduction

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On the supply side, the lack of schools, teachers and equipment, as well as ineffective teaching practices leading to poor academic performance account for a large portion of the school exclusion phenomenon<sup>7</sup>. The provision of financial resources in the form of debt and equity can therefore significantly influence the creation of new schools, the expansion of existing schools, and the improvement of education quality via curriculum development and teacher training. Improving the capacity of the schooling system has been one of South Asia's most significant levers for increasing enrolment rates from 75% in 2000 to 90% in 2011<sup>8</sup>. The financing of school and classroom construction programs, boarding facilities and school transport helps improve the accessibility of schools for students in marginalized areas.

On the demand side, parents claim household economic hardship as well as direct and indirect costs of education as the main reasons for non-attendance at school in West and Central Africa<sup>9</sup>. Children from disadvantaged backgrounds are overrepresented among OOSC because the private costs of attending school are more prohibitive to the poor. Barriers to school entry or/and progression disproportionately impact the poorest children, increasing their probability to never enter the education system or to drop out before completion<sup>10</sup>. In Nigeria, most children from rich households start school compared to just 30% of those from the poorest households<sup>11</sup>. In Uganda, the majority of children (whether poor or rich) enter primary school, but while 80% of the richest reach the last grade cycle, only 49% of the poorest do<sup>12</sup>. In Indonesia, 47% of parents whose children have never attended primary school and 57% of parents whose children have dropped out named either cost or work as the primary cause<sup>13</sup>. Many countries, including Kenya, Mozambique, and Ethiopia, have taken steps to address the consequences of income inequalities for education access by abolishing school fees, and have observed an increase in enrollment. However, they have not completely removed the cost barrier to enrolment for the poorest since substantial non-fee costs apply. Access to financial services in the form of savings or debt could help overcome the consequence of income inequalities on education access and attainment by enabling students to fund their studies and parents to afford their children's educational expenditures.

<sup>7</sup> *Global initiative on out-of-school children, All Children in School by 2015, Regional Report West and Central Africa, UNICEF, 2014*

<sup>8</sup> *Global Initiative on Out-of-School Children, South Asia Regional Study Covering Bangladesh, India, Pakistan and Sri Lanka, UNICEF, January 2014*

<sup>9</sup> *Ibid*

<sup>10</sup> *Education For All Global Monitoring Report 2012, UNESCO - Analyses from Delprato (2012), based on Demographic and Health Survey data*

<sup>11</sup> *Ibid*

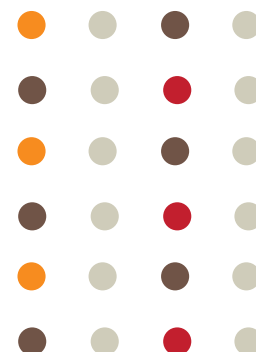
<sup>12</sup> *Ibid*

<sup>13</sup> *Ibid*

It is essential to investigate the innovations in private financial services that can positively impact education demand and/or supply. Traditional private financial institutions range from commercial banks to credit card companies, insurance companies, brokerage firms, and investment funds (such as private equity or venture capital). Non-traditional providers of financial services have emerged to provide services that are not offered by traditional institutions. They include international development financial institutions, microfinance institutions, non-bank financial institutions, peer-to-peer lending/crowdfunding service providers, and mobile money operators.

By reviewing the private financial service initiatives that have shown promise in impacting education supply and demand, we aim to identify whether and to what extent lessons and success factors could be replicated in a scalable manner to enroll OOSC.

Insufficient domestic public funding and declining levels of education aid create a role for the private financial services to impact both the supply and demand side of the education equation. Indeed, the average annual financing gaps of US\$26 billion in basic education and US\$38 billion in basic and lower secondary education<sup>14</sup> have been exacerbated by inadequate levels of development aid for education (the share of education in total aid fell from 10.2% in 2009 to 8.7% in 2012<sup>15</sup>) and insufficient and/or skewed domestic expenditure on education. For instance, the 10% most educated receive 43% of public spending on education in low income Sub-Saharan countries versus 25% of public spending on education in middle-income countries<sup>16</sup>.



<sup>14</sup> Education For All Global Monitoring Report 2013/14, *Teaching and Learning: Achieving Quality for All*, UNESCO (data for 46 low and lower middle income countries)

<sup>15</sup> Education for All Global Monitoring Report, *Aid reductions threaten education goals*, Policy Paper 13, June 2014

<sup>16</sup> Education For All Global Monitoring Report 2013/14, *Teaching and Learning: Achieving Quality for All*, UNESCO

# 1. While state and non-state education providers are confronted with different financing challenges, they both tend to charge student fees

## 1.1. The public delivery of education and its financing model

Education services have traditionally been delivered by the States and financed by taxation and education aid. While faced with surges in enrollment due to school fees abolition, many countries suffer from decreasing levels of education aid, domestic expenditures and increasing budgetary constraints. As a result, they increasingly encourage non-government providers to complement public education services.

### 1.1.1. States have traditionally provided education services for their constituents

Governments have traditionally assumed the responsibility of delivering education to their constituents. Universal access to free basic education has been recognized as a human right in numerous international treaties since the adoption of the Universal Declaration of Human Rights in 1948, which states that “Everyone has the right to education. Education shall be free, at least in the elementary and fundamental stages<sup>17</sup>.” Therefore States hold the primary responsibilities in ensuring the right to education is protected. Moreover, education is considered a “public good” with benefits not only to individuals, but also to society at large: it generates positive externalities for the entire community as it directly contributes to the accumulation of human capital, economic productivity and improved quality of life.

Many countries eliminated official school fees in line with the States’ commitment to a primary education “free of tuition and other fees” in order to be accessed by all<sup>18</sup>. Fee abolition can cause not only a sudden surge in enrollment<sup>19</sup> without a proportionate increase in state school places, but also a reduction in quality due to overcrowding and lack of textbooks or adequately trained teachers, leading eventually to falling enrolment and higher drop-out rates. Budgetary and institutional constraints plague both the coverage and quality of public education services, thereby threatening children’s right to education. Several governments have become increasingly aware that they cannot achieve universal primary education under the status quo<sup>20</sup>. In Bhutan, Cameroon, Chile, Colombia, Haiti, Swaziland, Aruba, and Trinidad and Tobago for instance governments have accepted that the non-state sector plays a complementary role to that of the public system<sup>21</sup>.

<sup>17</sup> *Universal Declaration of Human Rights, article 26 (1948)*

<sup>18</sup> *Malawi (1994), Uganda (1997), Cameroon (1999), Lesotho (2000), Tanzania (2001), Timor-Leste (2001), Cambodia (2001), Zambia (2002), Kenya (2003), Madagascar (2003), Benin (2004), Mozambique (2004), Vietnam (2004), Burundi (2005), Ghana (2005-2006) and Yemen (2007). South Africa outlawed fees for the two poorest quintiles in 2004.*

<sup>19</sup> *In Kenya, the elimination of fees resulted in 1.2 million additional students entering the school system; in Uganda, primary school enrollment grew from 3.1 million in 1996 to 5.3 million in 1997.*

<sup>20</sup> *Non-state Providers and Public-Private Partnerships in Education for the Poor, UNICEF, 2011*

<sup>21</sup> *Low cost private schools for the poor: What public policy is appropriate?, Elsevier, International Journal of Educational Development, Stephen P. Heyneman and Jonathan M.B. Stern, 2013*

### 1.1.2. Public education is financed by taxation, aid and cost-sharing

Public education is partly financed by the State, which raises revenues via taxation and pays for the capital costs, the teachers' salaries, and the recurrent costs of the schools. Yet, low-income countries still heavily rely on aid to finance their education systems. While national government expenditures provide the majority share of education financing, donor spending accounts for about two-fifths of public spending on education in countries such as Liberia, Afghanistan and Malawi<sup>22</sup>. In twelve countries<sup>23</sup>, donors fund at least a quarter of public spending on education<sup>24</sup>. However, the decreasing levels of education aid (US\$38 billion annual financing gap in basic and lower secondary education<sup>25</sup>) jeopardize the public education system's funding model in developing countries.

Consequently, cost-sharing schemes have developed whereby States require students and parents to pay for part or most of tuition costs, food costs, lodging costs, and the like. This can take the form of fee introduction where instruction was free in the past (as in many former communist countries) or increasing existing tuition fees. The shift of financing responsibility from government to households includes the introduction of fees for food, lodging and supplies that used to be provided for free or were heavily subsidized by governments. Cost-sharing takes place at all levels of education, but households shoulder a larger share of financing at university level than at primary school level as the per-student cost of education increases with the level of education<sup>26</sup>. Most countries in Sub-Saharan Africa currently spend at least ten times more on a university student than on a primary school student<sup>27</sup>.

### 1.2. The non-state delivery of education and its different financing models

Over the past decade, enrollment in non-state institutions has increased more than in the public sector. Non-state education forms a fragmented sector in which providers are not unified as their goals, forms and sizes significantly differ. Therefore non-state education providers are confronted with different short- and long-term financing challenges.

<sup>22</sup> *Education for All Global Monitoring Report, Aid reductions threaten education goals, Policy Paper 13, UNESCO, June 2014*

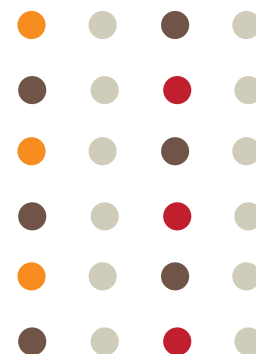
<sup>23</sup> *Liberia, Afghanistan, Malawi, Comoros, Guinea-Bissau, Gambia, Burkina Faso, C.A.R, Haiti, Mozambique, Cambodia, Sierra Leone*

<sup>24</sup> *Education for All Global Monitoring Report, Aid reductions threaten education goals, Policy Paper 13, June 2014*

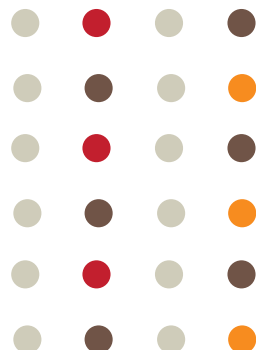
<sup>25</sup> *Education for All Global Monitoring Report, Teaching and Learning: Achieving Quality Education for All, UNESCO, 2013/14, p.41. Calculations based on EPDC and UNESCO (2009); OECD-DAC and World Economic Outlook*

<sup>26</sup> *Latest data available from the World Bank on governments' per-student expenditures (% GDP per capita) in primary, secondary and tertiary education and from UN statistics for selected countries in Sub-Sahara Africa*

<sup>27</sup> *World Bank, UN data for selected countries in Sub-Sahara Africa*



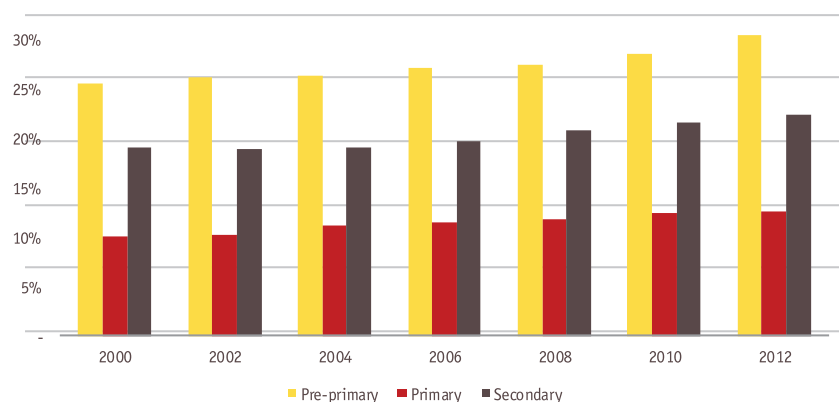
### 1.2.1. Over the past decade, enrollment in non-state institutions has increased more than in the public sector



Non-state education is loosely defined as “all formal schools that are not public, and may be founded, owned, managed and financed by actors other than the state, even in cases when the state provides most of the funding and has considerable control over these schools (teachers, curriculum, accreditations, etc.)<sup>28</sup>”. It forms a fragmented sector in which providers are not unified as their goals, forms and sizes significantly differ: “Non-state providers range from civil society organizations such as non-governmental organizations (NGOs), churches, mosques, and community organizations to profit-making companies, and in size from individual street traders to multinational corporations<sup>29</sup>.”

Non-state providers have dramatically increased in number in recent years as a result of governments’ capacity constraints and the growing population’s demand for education. According to official statistics, enrollment in non-state institutions increased more than in the public sector across all education levels between 2000 and 2012<sup>30</sup>. In 2012, 269.7 million children were in non-state schools, with 21% of them in pre-primary, 33% in primary and 46% in secondary<sup>31</sup>. Almost half of the children in non-state pre-primary schools are in East Asia & the Pacific, and half of those in primary and secondary education are in South and West Asia<sup>32</sup>.

**Figure 3:** Global enrollment in private institutions at pre-primary, primary and secondary levels (in %)



Source : UNESCO Institute for Statistics

However, non-state provision remains difficult to quantify as there is massive under-reporting. Non-state enrollment figures are significantly higher than they appear - at least double compared to official statistics in some countries<sup>33</sup> - because many non-state schools are unregistered. Informality can be explained by two main causes: some governments limit the number of non-state schools or prohibit their establishment and, even when possible, registration and certification processes tend to be complicated, time-consuming, and expensive.

<sup>28</sup> *Supporting Non-state Providers in Basic Education Service Delivery, Consortium for Research on Educational Access, Transitions and Equity, Pauline Rose, June 2007*

<sup>29</sup> *Public Interest, Oxfam International, 2006*

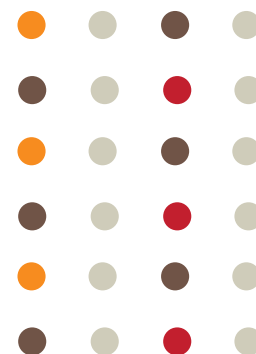
<sup>30</sup> *UNESCO Institute for Statistics*

<sup>31</sup> *Ibid*

<sup>32</sup> *Ibid*

<sup>33</sup> *E.g.: recent surveys in Lagos state (Nigeria) indicate that only 26% of private schools are government-approved*

For-profit non-state schools	
<b>Elite schools</b>	Established for the small proportion of the population that can afford their fees and to children of expatriates, they also include schools created by international bodies to provide education with internationally recognized qualifications and extra-curricular programming. They employ well-trained and experienced teachers and have modern facilities.
<b>Budget schools</b>	Catering to low-income areas and populations, budget schools have mushroomed in the past decade. Often informal (unregistered and unregulated), provision of this kind tends to be small scale as it mainly occurs through the initiatives of individual “edupreneurs”. Few chains or professionally managed schools exist. LCPSs are a complement to or substitute for public education: <ul style="list-style-type: none"> <li>- Differentiated demand: families may choose LCPSs because of a lack of accountability or adequate quality in state education services or because they want specific values and interests to be taught to their children (e.g.: religion)</li> <li>- Insufficient supply: reaching the poorest and marginalized with no or limited access to public education, LCPSs have arisen in response to state failure to deliver universal access to quality education</li> </ul>
<b>LCPSs</b>	Size and growth of LCPSs: <ul style="list-style-type: none"> <li>- Enrolment in LCPSs accounts for up to 30% of primary school places in some low income countries<sup>34</sup>.</li> <li>- LCPSs account for 30% of the total school enrolment in Pakistan<sup>35</sup>(2012) and for 40% of Bangladesh’s primary enrollments (2003)<sup>36</sup></li> <li>- LCPSs represent 75% of school enrollment in Nigeria’s Lagos State and 64% in Nigeria’s Ga District<sup>37</sup></li> <li>- 40% of basic level private schools in Ghana are low-cost (7,000 LCPS with half a million students in 2010)<sup>38</sup></li> </ul> <p>Note: LCPSs are not always for-profit, notably in countries such as India, where they have the status of “educational societies” and are not allowed to book profits.</p>



Not-for-profit non-state schools	
<b>NGOs</b>	NGOs have traditionally provided basic education where the government lacks the capacity to do so or does not consider it a priority. Focusing on reaching marginalized populations and areas, they can use both non-formal and formal approaches in delivering education services. Indeed, two types of NGO schools co-exist: those intending to integrate ultimately into the state system, and those operating as an alternative to the state system. The sector is fragmented as not-for-profit schools can range from village schools to vast systems like BRAC (formerly Bangladesh Rural Advancement Committee), Save the Children, Plan International, CARE International. Over the past two decades, the civil society movement has flourished <sup>39</sup> : the number of international NGOs increased from 6,000 in 1990 to more than 50,000 in 2006, and now to over 65,000.

<sup>34</sup> Lion’s Head Global Partners, *Spotlight on Education, Low cost private schools, Infocus July 2012*

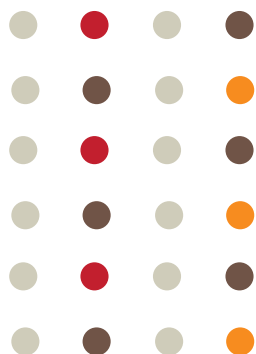
<sup>35</sup> *Access to Finance for Low-Cost Private Schools in Pakistan, IIm Ideas, 2014*

<sup>36</sup> *Non-State Providers and Public-Private-Community Partnerships in Education - Contributions towards Achieving EFA: A Critical Review of Challenges, Opportunities and Issues, Aga Khan Foundation team, 2007*

<sup>37</sup> *Ibid*

<sup>38</sup> *Final Ghana Country Report: Market Research Project on Low Income Private Schools, IFC, October 2010*

<sup>39</sup> *The Future Role of Civil Society, World Scenario Series, World Economic Forum, January 2013*



<b>Philanthropy</b>	Philanthropic schools are institutions focused on the poorest and most vulnerable members of the community. Founded by individuals, families, family trusts or corporate/private trusts, they often belong to a long tradition of giving, especially in South Asia (Pakistan and India) where they focus on primary education. Many are expressions of faith, and are the result of religious traditions such as zakat, waqf or tithing <sup>40</sup> . Two prominent Pakistani charitable foundations are Anjuman-Hamayiat-Islam (in Lahore) and Anjuman Faizul Islam (in Rawalpindi) <sup>41</sup> .
<b>Faith-Based Organizations</b>	Some schools combine secular and religious education, while others focus only on religious education. Islamic schools or Madrasas are omnipresent throughout the Muslim world and Christian mission schools are major providers of both primary and secondary education in Africa and Latin America. <ul style="list-style-type: none"> <li>- In Indonesia, madrasas account for 20% of primary enrollment (2007)<sup>42</sup></li> <li>- In Papua New Guinea, 30% of schools at secondary level are managed by churches and this proportion reaches 50% at primary level (2002)<sup>43</sup></li> <li>- Faith-based schools account for 70% of students in primary schools in the Democratic Republic of Congo<sup>44</sup></li> <li>- Churches owned about 64% of all primary schools in Malawi (2000)<sup>45</sup></li> <li>- In Lesotho, 90% of schools are still run by churches (2005)<sup>46</sup></li> <li>- About 75% of primary schools are owned and managed by faith-based organizations in Sierra Leone (2004)<sup>47</sup></li> </ul>
<b>Community-Based Schools</b>	Created and managed by communities (often in rural areas due to a lack of other service provision), community schools can either integrate the state system or constitute an alternative. Integrated village-based development projects are experiencing a renaissance, notably in Africa. Communities may be involved in construction, financing and/or oversight of school. <ul style="list-style-type: none"> <li>- Harambee schools in Kenya</li> <li>- In Mali, one third of the primary schools are community-based<sup>48</sup></li> </ul>
<b>Private Not-for-Profit Fee Paying Schools</b>	Private schools serving low-income areas with fees ranging from low to high. Aga Khan Foundation Educational Services in rural areas of Pakistan and India

### 1.2.2. LCPSs are confronted with short- and long-term financing challenges

LCPSs are market-oriented schools that are dependent on student fees to cover some or all of their capital and recurrent costs. Revenues are a function of student enrollment and fee level but often prove insufficient to enable LCPSs to expand, develop and improve the quality of teaching because they can neither cover the infrastructural investments nor the increased operating costs that come with managing a greater number of children.

<sup>40</sup> *Non-State Providers and Public-Private-Community Partnerships in Education - Contributions towards Achieving EFA: A Critical Review of Challenges, Opportunities and Issues*, Aga Khan Foundation team, 2007

<sup>41</sup> *Supporting Non-state Providers in Basic Education Service Delivery*, Consortium for Research on Educational Access, Transitions and Equity, Research Monograph No 4, Pauline Rose, June 2007 p.16

<sup>42</sup> *Non-State Providers and Public-Private Partnerships in Education for the Poor*, UNICEF, 2011

<sup>43</sup> *Ibid*

<sup>44</sup> *Faith-Based Schools in Conflict-Affected Countries*, DDVE Seminar Presentation 2009-22, World Bank, Quentin Wodon, 2009

<sup>45</sup> *Supporting Non-state Providers in Basic Education Service Delivery*, Consortium for Research on Educational Access, Transitions and Equity, Research Monograph No 4, Pauline Rose, June 2007 p.15

<sup>46</sup> *Ibid*

<sup>47</sup> *Promoting Education in Countries affected by Fragility and/or Conflict*, Sierra Leone Case Study, Alan Smith, 2011

<sup>48</sup> *Communities, gender and education: Evidence from sub-Saharan Africa*, Background paper prepared for the EFA Global Monitoring Report 2003/4, Gender and Education for All: The Leap to Equality, Pauline Rose, 2003



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Long-term resources are needed by schools to finance their growth since their revenues tend to be swallowed up by running costs: teachers' salaries and fixed costs - such as property rent, utilities and repair/maintenance - are the main cost drivers in education. Teachers' salaries account for 70-80% of schools' expenses<sup>49</sup> and for about half of revenues<sup>50</sup>. LCPSs manage to charge low fees to their students by locally hiring inexpensive young and undertrained teachers. Furthermore, some formal LCPSs are financed by governments while others solely rely on their revenue streams. Government-aided LCPSs receive state support in the form of direct or indirect support with teachers, subsidies, student vouchers, capital expenditures, curriculum, improved teaching material, assessment systems and training programs.

The cash-richest periods for school owners are at the beginning of each term once most fee payments are received: registration fees, admission fees, uniform costs, textbook charges and the like. Yet, fee payments are not always guaranteed or timely, especially in rural areas. Due to the seasonal nature of rural and agricultural labor, parents' income level greatly varies throughout the year and does not ensure regular payments for schooling. In 2008, Gray Matters Capital found that 71% of schools surveyed in Hyderabad had 25-50% of their fee payments pending<sup>51</sup>. Thus LCPSs also need working capital financing to smooth cash flows.

### 1.2.3. Nonprofit schools suffer from the unpredictable nature of donations

Nonprofits face different types of financing needs depending on the cost-recovery strategy they adopt. When pursuing full philanthropic financing, all costs need to be financed by donations grants and state subsidies, whether they are at local or headquarters level: initial capital expenditures, expansion plans, renovation works, teachers' salaries, utilities, rent, diverse supplies, administrative headquarters costs, monitoring costs, reporting costs, and fundraising costs. When not fully funded by philanthropy, nonprofits charge fees to students in order to cover part - or all - of their capital and operational expenses. Thus nonprofits' revenues suffer not only from the unpredictable nature of donor funding flows and from uncertainties pertaining to the full and timely payment of state subsidies, but also from a volatility of cash-flows similar to that of for-profit schools.

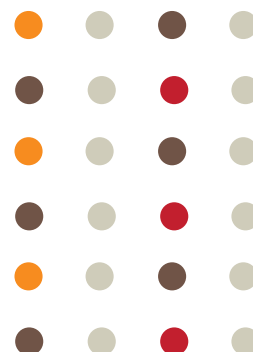
### 1.3. Education comes at a cost for students and their families in most state, for-profit and not-for-profit schools

Education is rarely free: it comes at a cost for students and their parents at all levels of education in state, for-profit and not-for-profit schools. Although tuition fees have been theoretically abolished in many countries, non-tuition fees remain very common in government schools. The amounts charged by non-state schools vary depending on the profit or cost-recovery strategy they pursue.

<sup>49</sup> *Low cost private schools, Spotlight on Education, Lion's Head Global Partners, 2012*

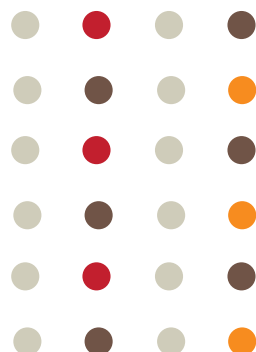
<sup>50</sup> *Access to Finance for Low-Cost Private Schools in Pakistan, IIm Ideas, 2014*

<sup>51</sup> *Low cost private schools, Spotlight on Education, Lion's Head Global Partners, 2012*



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### 1.3.1. Public education is rarely free and charges fees at all levels of education



State education is rarely free and can include a wide range of fees at all levels of education. Although theoretically abolished in many countries, fees at public primary schools are very common in reality<sup>52</sup>: out of 93 countries surveyed by the World Bank for a fee survey among public schools, only 16 countries have no user fees<sup>53</sup>. “Free primary schooling remains the exception rather than the rule”<sup>54</sup> states United Nations Educational, Scientific and Cultural Organization (UNESCO).

Common fees that parents have to pay at all levels of education in addition to tuition fees typically include transport costs, textbook charges, compulsory uniforms, Parent Teacher Association (PTA) dues, and many specific fees such as registration fees, exam fees, community contributions to district education boards, private tutoring, lodging charges at boarding schools, charges for school meals, etc. The indirect cost of sending children to school must also be taken into consideration: the time during which they attend classes at school is a time during which they do not help with household chores or work to support their families.

### 1.3.2. The amounts charged in student fees by non-state education providers can vary

Students in non-state schools may face the same tuition and school-related fees as in state schools, although the amounts they have to pay can differ depending on whether their school is for-profit or not-for-profit.

In for-profit schools, students pay for tuition fees and other school-related charges that are meant to cover operating costs, initial capital expenditures and subsequent maintenance works as well as to generate a profit for the school. LCPSs in India charge as little as 80 rupees per month (equivalent to US\$1.50)<sup>55</sup>.

Unlike for-profit schools, not-for-profit schools do not aim at generating profit from their operations. They charge students fees that can cover 0% up to 100% of recurrent local operating expenses, the remainder being financed by donors. Fundación Escuela Nueva, located in rural areas of nineteen countries in Latin America and Asia, does not charge fees and manages to cover recurrent costs with its own funds. Conversely, parents of students at Fe Y Alegría schools in Latin America are expected to provide resources in order to finance maintenance or enhancement of the infrastructure, acquisition of supplies and educational materials, and in some cases, to cover the salary of teachers<sup>56</sup>.

<sup>52</sup> *Implementation of Free Basic Education Policy*, World Bank, Raja Bentaouet Kattan, December 2006

<sup>53</sup> *Sixteen countries with no fees for primary education: Bangladesh, Cambodia, Cape Verde, Chile, Costa Rica, Guatemala, Iraq, Nepal, Peru, Senegal, Sri Lanka, St. Kitts and Nevis, Tanzania, Gambia, Tunisia, and Zambia*

<sup>54</sup> *Reaching the Marginalized: EFA Global Monitoring Report*, UNESCO, 2010

<sup>55</sup> *Private Schools for the Poor: Development, Provision, and Choice in India*, Gray Matters Capital, 2009

<sup>56</sup> *Faith-Based Schools in Latin America: Case Studies on Fe y Alegría*, World Bank, Juan Carlos Parra Osorio and Quentin Wodon, 2014

## 2. Students' access to financial services impacts the demand for education

### 2.1. Traditional student financing remains underdeveloped in developing countries

Traditional student financing remains underdeveloped in developing countries for three main reasons. First, private banks associate student-financing services with low profitability and limit their lending services to higher education's most credit-worthy students. Second, student lending is all the more complicated when the country's population is not included in the formal financial system and does not have any bank account or credit history. Third, student lending schemes sponsored by governments are intrinsically unsustainable.

#### 2.1.1. Student lending remains underdeveloped due to private banks' selection bias

Whether at the pre-primary, primary, secondary or higher education level, education comes at a cost for students in both state and non-state education institutions. Student-financing options are scarce in developing countries where student loans are considered risky and generally represent a very small portion of private banks' portfolios. Student loans are associated with low profitability due to high default rates and administrative costs.

High default rates are generated by a numbers of factors including high graduate unemployment in developing countries, mobility and emigration, underdeveloped credit cultures, lack of legal and regulatory frameworks in support of debt collection as well as the borrowers' attitude (e.g., some refuse to pay on the basis that education should be free, some mistake loans for donations)<sup>57</sup>.

At the same time, administrative costs are high due to the small size of the individual loans, the costs of tracking students through the in-school, grace, and early repayment periods, the long repayment period, and the costs of loan collection in countries where employment, tax, and credit records are insufficient and electronically inaccessible<sup>58</sup>.

Because of low profitability and students' lack of credit history, private student loans are limited to higher education's most credit-worthy students such as those whose parents have co-signed the loans and are the real borrowers or those studying in advanced professional fields.

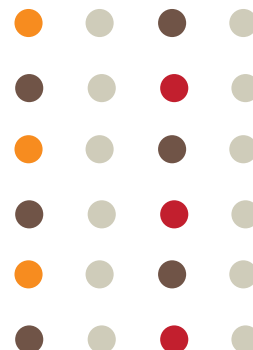
#### 2.1.2. Bank lending to students is all the more complicated when the wider population does not have a bank account

Student lending in developing countries is further hampered by the fact that individuals tend not to be included in the formal financial system and not to have any credit history. Globally, 2.5 billion individuals do not have accounts, most of them in developing countries. A recent study from Gallup and the World Bank on financial inclusion revealed a low average bank penetration in developing countries, where only 41% of adults have bank accounts and 7% have credit cards that might serve as an alternative to short-term loans compared to 89% and 51% respectively in developed countries<sup>59</sup>.

<sup>57</sup> *Making Student Loans Work in Low- and Middle-Income Countries : Enhancing Asset Values and Tapping Private Capital*, D. Bruce Johnstone and Pamela Marcucci, February 2010

<sup>58</sup> *Making Student Loans Work in Low- and Middle-Income Countries : Enhancing Asset Values and Tapping Private Capital*, D. Bruce Johnstone and Pamela Marcucci, February 2010

<sup>59</sup> *Measuring Financial Inclusion, The Global Findex Database, Policy Research Working Paper 6025*, World Bank, 2012



Among the most commonly reported barriers to having bank accounts are the lack of money to deposit, high cost due to withdrawal charges and balance fees, physical distance in rural areas, and a lack of proper documentation. Important regional divides are observed: the lowest regional account penetration rates can be found in the Middle East and North Africa (18%), Sub-Saharan Africa (24%) and South Asia (33%)<sup>60</sup>.

Microfinance institutions (MFIs) are currently not lending to the unbanked for education purposes. A few of them, such as the Grameen Bank in Pakistan and Opportunity International in Uganda, have introduced education loans for parents who are existing business customers only. This is the only way they can precisely assess default risk. In 1997, The Grameen Bank introduced a Higher Education Loan Program<sup>61</sup> meant to finance existing customers' children's education while Opportunity International developed education loans to parent groups, using the group's guarantee and the perceived value of the bank in the community to ensure low default rates.

### 2.1.3. Government-sponsored student lending schemes are not sustainable

Government-sponsored schemes have developed in many countries to allow students to choose where and what to study based on their academic abilities rather than their ability to pay. Government-sponsored schemes therefore carry an important risk associated with rendering student loans available to all. Yet the design of public student loan schemes is intrinsically unsustainable: the net present value of repayment streams is often insufficient to cover the cost of the money plus the administration and collection costs even when there is no default on repayment. The loss of asset value is explained by the low interest rates of government schemes, which include high levels of built-in subsidies and do not reflect the risk of the borrower. This strictly limits the public supply of funding.

### 2.1.4. Three types of loans exist for higher education students

Three Types of Student Loans at Higher Education Level	
<b>Conventional or mortgage-type loan</b>	This type of loan is characterized by a determined interest rate (fixed or variable), a specified repayment period and a precise repayment mode (installments can be equal or increase over time). If the duration of the repayment period is too short, payments can take too great a portion of the monthly income and lead to default.
<b>Income-contingent loan</b>	A proportion of the graduate's income has to be paid each year until the loan is repaid at the contractual rate of interest or until the graduate has repaid for a maximum number of years. This type of loan aims to achieve a balance between effective recovery of costs and minimum risk to the borrower. In developing countries, these loans are difficult to implement due to the informal nature of employment and the difficulty to verify the incomes declared by the borrower, who often does not have any formal bank account.
<b>Graduate tax</b>	Former students repay their loans through a graduated surplus income tax. Contributions by graduates with high income are larger than those by graduates with low income. The feasibility of this type of loan is challenged in its settings with underdeveloped tax systems.

<sup>60</sup> *Ibid*

<sup>61</sup> [http://www.grameen-info.org/index.php?option=com\\_content&task=view&id=539&Itemid=599](http://www.grameen-info.org/index.php?option=com_content&task=view&id=539&Itemid=599)

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Public and private student loans tend to focus on higher education because students have reached adulthood and are expected to be employed within four years upon graduation (enabling them to begin repayments). Student loans typically do not reach pre-primary, primary and secondary levels where existing loans are in the name of the parents, based on their income level and credit history, and do not take into account students' academic performance.

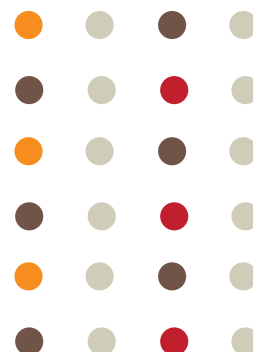
## **2.2. Non-banking financial institutions are developing innovative lending models to finance the cost of higher education**

Innovative models in student lending have recently emerged in developing countries where the rise of the middle class increases demand for higher education. Some non-banking financial institutions (NBFIs) are offering fair terms to low- and middle-low income students as well as attractive returns to investors, thereby enabling the sustainable expansion of access to debt-based student finance. The International Finance Corporation (IFC) and the Parthenon Group, a global strategy consultancy firm in education, have outlined four main keys to success<sup>62</sup> that are illustrated below by the experiences of Eduloan (NBF in South Africa), Trustco (MFI providing loans to students who in addition to a full-time job are enrolled in its in-house distance learning Institute for Open Learning in Namibia), Ideal Invest (NBF in Brazil) and FINAE (NBF in Mexico).

First, student-financing companies need to raise awareness about the basics in emerging markets where student lending is still in its infancy. While student loans account for about 6% of the gross domestic product (GDP) in the United States, they account for only 0.7% of Brazil's GDP. Accordingly, significant investments are required in sales and marketing with large teams advertising the existence of financial support at university campuses, through traditional and social media. Trustco spends millions on door-to-door sales, TV campaigns, print marketing and radio. FINAE offers an online platform for students to learn about the finance and loan products.

Second, in markets where student lending is little known, partnerships with colleges and universities turn out to be the most efficient way to reach prospective borrowers. Successful models cultivate close cooperation with universities. Ideal Invest offers a tool on partner university websites for students to automatically assess their eligibility and their expected monthly repayments. Eduloan has 37 branch offices at universities and works closely with financial aid offices. Universities partnering with FINAE are not only in charge of the marketing and loan origination efforts, but also provide FINAE sales representatives with equipped offices on university premises. Moreover, universities are incentivized to support and share risk with student-lending companies. By financing students who do not have the means to pay for higher education, MFIs and NBFIs help fill marginal seats that would otherwise have remained empty. Universities provide the resources constituting FINAE's first loss collateral fund. They offer discounts on tuitions for Eduloan and pay 100% of the interests in Ideal Invest's Zero Interest Program while students only reimburse the principal.

<sup>62</sup> *Student Finance: A New Frontier for Impact Investing? Stanford Social Innovation Review, Maryanna Abdo, Ashwin Assomul and Svava Bjarnason, June 2014*



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Third, beyond any effective marketing and partnership, the best programs design simple loan products that they iterate over time to improve their services, from origination to disbursement and collection. FINAE's initial loan product was rapidly replaced because customers could not understand the concepts of interest rates and outstanding capital to be repaid. The improved version, "Ennti", was an immediate success because monthly installments were expressed in amounts<sup>63</sup>. An incremental approach to lending minimizes lender exposure to individual risk and accommodates students whose familial cash-flows may be too uncertain to commit upfront to larger longer-term loans.

Both Ideal Invest and FINAE disburse successive small amounts for each period or semester directly to the university accounts and not via students' bank accounts, thereby forcing the student to confirm its re-enrollment regularly. While Ideal Invest's semester loans are independent from each other, repayment is coordinated and staggered so that only one installment is due each month<sup>64</sup>. Experience also taught student-lending firms that high repayment rates could be achieved provided students get accustomed to reimbursing their loan every month from the start. Keeping in touch at regular intervals with students, graduates and their co-signatories via websites and personalized messages is an important aspect of debt collection. Trustco adopted a different approach: focused on financing government employees and formal private sector employees included in the banking system, it is able to maintain control over loan collection through payroll and bank account automatic deductions<sup>65</sup>. In case of default, academic qualifications can be withheld until repayment resumes.

Finally, loan programs prove to be most successful when their risk assessment tool focuses on students' profiles instead of parents' wealth. In order to maximize their consumers' ability to repay loans on time and in full, student-lending firms need to gauge the employability and expected income related to each degree choice. Ideal Invest uses a proprietary credit-scoring technology that screens out candidates whose degree choices do not match market demand, and that sets different interest rates depending on the programs, courses and universities concerned.

### **2.3. Equity-like contracts emerge to finance higher education's costs while experiments test the correlation between savings and education financing**

Experiments have taken place beyond debt-based mechanisms to identify whether solutions could be found using equity and savings instruments. Lumni, one of the pioneers of equity-like solutions, has since 2002 financed 5,000 higher education students from low- or very-low-income backgrounds where funding recipients are the first family members to attend college. However, there is no evidence that such mechanism could be replicated at pre-primary, primary and secondary education levels in which the link with employment and reimbursement is less direct than in higher education. Moreover, there is currently no evidence of savings' direct impacts on education financing other than at the margins.

<sup>63</sup> Interview with FINAE's investor relations manager Cristina Tellez

<sup>64</sup> Ideal Invest S.A. Case Study, *Guide to the Inclusive Business Models in IFC Portfolio*, International Finance Corporation, 2012

<sup>65</sup> Trustco Finance Proprietary (Pty) Ltd Case Study, *Guide to the Inclusive Business Models in IFC Portfolio*, International Finance Corporation, 2012

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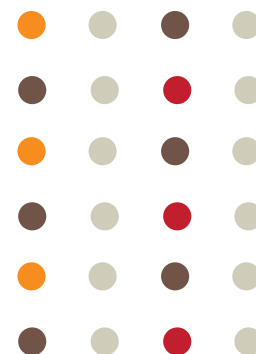
### 2.3.1. Equity-like human capital contracts have the potential to revolutionize higher education student financing

MyRichUncle, Lumni and Enzi are revolutionizing the US and Latin American higher education financing by implementing Milton Friedman's theory on equity investment in human capital. Defined as the sum of skills, abilities and knowledge available in a society, human capital drives not only individuals' potential but also economic growth and development at country level. Human capital contracts (HCCs) are equity-like financial instruments attracting private capital to finance higher education. Students receive funding in exchange for a percentage of his or her income during a fixed period of time: the investor's return therefore depends on the earnings after graduation and not on a predefined interest rate. Such contracts benefit both students and investors for three main reasons<sup>66</sup>.

First, students' uncertainty about being able to make fixed loans payments is reduced because it is transferred to investors who can decrease their exposure to individual risk by investing in a large number of students with high-income earners subsidizing losses produced by low-income earners. Lumni manages 30 funds to achieve the level of diversification required and to attract different types of investors<sup>67</sup>: some will be interested in certain fields of study, others in a certain type of students and others in specific schools or geographical areas. It can offer investors annual financial returns of 9% in addition to significant social impact.

Second, with reimbursement payments proportionate to graduates' incomes, HCCs virtually eliminate default due to financial distress.

Third, HCCs focus on students' performance rather than on their financial background while traditional higher education loans disadvantage the poorest by requiring collaterals. Lumni must fund students' whose future earnings can be accurately predicted. Its screening process is more stringent than that of student-lending firms. It uses structured application and interview processes as well as third party information to predict employment prospect and appraises the risk a student represents. Mentoring, tutoring and career counseling are provided to help students achieve the best outcomes possible. By amassing data on the financial benefits of each education track at specific institutions, Lumni will diminish information asymmetry and enable students to make informed decisions about the opportunities offered by higher education<sup>68</sup>.



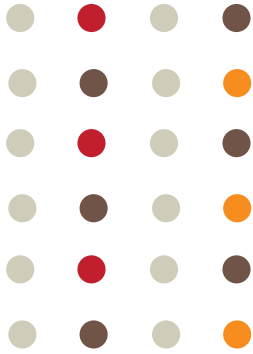
<sup>66</sup> *Human Capital Contracts, « Equity-like » Instruments for Financing Higher Education, Lumni Finance, Policy Analysis, Miguel Palacios, December 2002*

<sup>67</sup> *Phone interview with Felipe Vergara, CEO of Lumni*

<sup>68</sup> [www.sfs.ashoka.org/fellow/felipe-vergara](http://www.sfs.ashoka.org/fellow/felipe-vergara)

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### 2.3.2. Savings-related experiments have not yielded any conclusive results yet



Savings are an interesting area of experimentation for education, especially given the high percentage of adults saving money in Sub-Saharan Africa, the region most plagued by the OOSC phenomenon. 20% to 26% of adults save money in South Asia, Europe & Central Asia, Latin America & the Caribbean, Middle East & North Africa but this proportion increases to 40% of adults in Sub-Saharan Africa and East Asia & Pacific<sup>69</sup>. In some regions, a large percentage of individuals who save money choose alternatives to formal financial institutions<sup>70</sup>. Only 23% to 37% of savers save at financial institutions in Europe & Central Asia, Latin America & the Caribbean, Middle East & North Africa and Sub-Saharan Africa<sup>71</sup>. Many MFIs have implemented financial literacy programs to encourage the opening of formal savings accounts. In Mongolia, XacBank developed a youth financial education program called Aspire that aims to help teenage girls understand the importance of savings, the existence of different savings strategies and the benefits of opening formal accounts.

However, there is no empirical evidence of savings' direct impacts on education financing other than at the margins. For instance, a study by UK Plan on community-managed savings groups<sup>72</sup> showed no significant results across countries and projects. While positive correlations were found in a few cases, such as Banking on Change projects in Uganda and Ghana, where education was often financed by share-outs (annual interests paid to members according to their savings level), it is impossible to substantiate that educational expenditures increases due to savings: other uses of savings may be prioritized.

Opportunity International recently developed an innovative product linking savings to education insurance without constraining the use of the savings. It launched with MicroEnsure in 2013 in Malawi a savings-plus-insurance product called EduSave that allows savers to qualify for school fees insurance with as little as US\$15 in the bank<sup>73</sup>. It ensures that children can stay in school for one year or more after the death of their parents – an eventuality that is a leading cause for school dropout in some developing countries. The more parents save, the higher education insurance amounts in case of death. However, EduSave seems to use school fees insurance less as a mean to reduce the number of OOSC than as a marketing add-on to attract individual savings deposits<sup>74</sup>.

Further experimentation is needed to identify scalable savings models for education financing. Mobile money operators like M-Pesa are beginning to provide savings features in association with local banks while school chain Bridge International Academies is developing pre-payment plans for parents in parallel with financial literacy training on spending and budgeting.

<sup>69</sup> *Financial Inclusion Index, World Bank, 2011*

<sup>70</sup> *Financial Inclusion Index, World Bank, 2011*

<sup>71</sup> *Financial Inclusion Index, World Bank, 2011*

<sup>72</sup> *Savings Groups and Educational Investments, Plan UK, Stuart Cameron and Eric Ananga,*

<sup>73</sup> <http://opportunity.org/news/news-room/press-releases/microensure-launch-edusave-to-provide-education-safety-net-to-1-000-000-children-in-malawi-by-2014>

<sup>74</sup> *Interview with Tim Nourse, President of Making Cents*



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## 2.4. A challenge remains on how to scale up and extend these student-financing innovations to pre-primary, primary and secondary education

Three main mechanisms can be used to scale up higher education financing innovations and extend them towards students at the base of the income pyramid: crowdfunding, securitization or debt issuance on capital markets, and partial credit guarantees or risk sharing facilities. However, no evidence currently suggests that higher education student-financing innovations can be successfully replicated at pre-primary, primary and secondary education levels.

### 2.4.1. Crowdfunding widens access to student loans at the bottom of the income distribution

Not-for-profit organizations such as Vittana and Kiva are using peer-to-peer lending and crowdfunding to widen access to student loans for low-income families. Vittana is the pioneer provider of digitally crowdfunded micro-loans, mostly generated by small donations from individuals on its website, to students in the developing world with financial need and in their last two years of higher education. Vittana's impact has grown at an exponential rate since 2009: the number of loans financed grew from 167 in 2009 (equivalent to a loan value of US\$69k) to 26,600 in 2014 (equivalent to a loan value of US\$18.5m) with a 99% repayment rate<sup>75</sup>. However, Vittana is more than an intermediary that connects donors with student: it supports on-the-ground MFIs to jumpstart the market for lending innovations to low-income students. It provides its local partners with free technical assistance, student-loan specific training, and interest-free capital generated from their website. Vittana and Kiva launched a partnership in 2014 that will enable Vittana to focus on expert technical assistance and innovative product development while Kiva will be in charge of the online portal and communication with lenders.

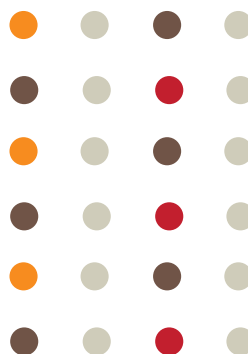
### 2.4.2. Student financing firms can use securitization or debt issuance on capital markets to scale up

Student lending and equity-like human capital investments can scale up by issuing debt or securitization.

Ideal Invest has three main sources of revenues enabling to increase the number of student loans each year: a commission fee charged to partner institutions equivalent to a percentage of the principal amount lent to students, loan repayment streams, and management and performance fees from a special purpose vehicle that the company has structured to carry loans to maturity. Ideal Invest manages to reduce its cost of funding and to make loans more affordable to students because it funds itself directly in the Brazilian debt capital markets. It issues 80% of the special-purpose vehicle (SPV) student loan assets under the form of senior notes rated AA by Standard & Poor's while it owns the remaining 20% junior notes and receives the associated capital gains<sup>76</sup>. Ideal Invest keeps interests aligned from origination to collection because it issues debt without transferring the student loans' default risk to investors.

<sup>75</sup> Interview with Kate Cochran, Director of Vittana Education Fund

<sup>76</sup> Interview with Carlos Furlan, CFO of Ideal Invest



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On the contrary, securitization and structured finance take student loans' risk off the balance sheet and transfer it to other investors. It plays an important role in financial markets because it allows investors to obtain a portion of the fund while benefitting from the whole fund's diversification. Securitization appeals to capital markets without financial intermediaries, thereby increasing the funds available and decreasing the cost of capital. Thus students can finance their studies at a lower cost. FINAE introduced in 2013 the first loan securitization scheme of the industry. It aims to issue its bonds (rated AAA and backed by a partial credit guarantee from the Inter-American Development Bank) once or twice a year to secure resources required to expand its student-lending program and provide new loans at each semester<sup>77</sup>. In a similar manner, Miguel Palacios advocates the use of securitization schemes to scale HCCs<sup>78</sup>.

#### **2.4.3. The scale-up of innovative schemes can be facilitated by governments and development finance institutions with partial credit guarantees and risk sharing facilities**

The success of student loans, equity instruments, and savings schemes depends on whether governments implement legal frameworks that protect investors and lenders. Government and development finance institutions (DFIs) can further facilitate the scale-up of innovative student financing schemes by providing partial credit guarantees (PCGs) and risk-sharing facilities (RSFs) to mitigate risk perception and attract lenders and/or investors. The success of such initiatives depends more upon the commitment of the partners involved, the intrinsic product design and the marketing and sales execution than upon the financing mechanism itself.

A PCG is a promise to pay principal and/or interest up to a pre-determined amount (e.g., the Inter-American Development Bank's partial credit guarantee to FINAE's securitization fund). It reduces the probability of default and increases recovery upon default, thereby enabling borrowers to achieve the lowest possible funding costs and investors to maximize their return given their risk tolerance. It allows the use of a triple-A credit rating to help borrowers diversify their sources of funding, extend maturities and obtain financing in their currency of choice.

The IFC implemented numerous RSFs in the student-lending market to support innovations suffering from restrictive credit conditions because of a lack of historical data to estimate future losses. RSFs are bilateral loss-sharing agreements between the IFC and an originator of assets in which the IFC reimburses the originator for a fixed percentage of incurred losses that exceed a predefined threshold (first loss). The most successful schemes are observed in Latin America, where consumer loans are widespread and where private education is more mature than in other regions. Moreover, successful RSFs tend to partner with local MFIs rather than big commercial banks. Because their portfolios have a higher share of student loans than private banks, MFIs have a stronger incentive to actively participate and innovate in student lending.

<sup>77</sup> Interview with Cristina Tellez, Investor Relations for FINAE

<sup>78</sup> Human Capital Contracts, « Equity-like » Instruments for Financing Higher Education, Lumni Finance, Policy Analysis, Miguel Palacios, December 2002

### 3. The access of for-profit schools to financial services impacts the quantity of education provision

#### 3.1. For-profit non-state schools generally lack access to financial services in developing countries

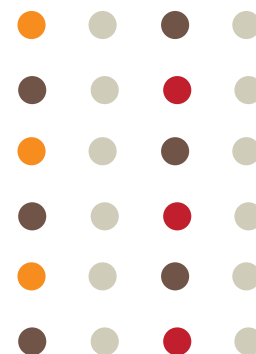
For-profit non-state schools, especially LCPSs, lack access to financial services in developing countries. First, many LCPSs are not included in the formal financial system and do not have a bank account. Second, LCPSs suffer from a “missing middle” on the financial spectrum: comparable to small and medium enterprises (SMEs), they fall between the offers developed by banks for larger groups and by microfinance institutions for very small companies. Similarly, equity financing for SMEs has not developed yet.

##### 3.1.1. Many LCPSs are not included in the formal financial system and do not have a bank account

Many LCPSs do not use banks’ financial non-lending services and do not even own a bank account because the parties it transacts with (suppliers, teachers and parents) are often unbanked.

Indeed, in rural and marginalized areas where some LCPSs are set up in response to the inadequacy of public education, bank account penetration rates tend to be much lower than in urban areas: the difference can range from 6 to 19 percentage points depending on the region<sup>79</sup>. Moreover, when individuals have a bank account, they tend not to use it for business purposes. 88% of individuals<sup>80</sup> in developing countries declare using banks for personal purposes solely. In Sub-Saharan Africa, for instance, bank accounts serve mostly to receive remittance payments. In developing countries, 25% to 30% of formal SMEs have no access to bank<sup>81</sup>.

As a consequence of the local population’s low utilization and access to formal financial services, the LCPS sector predominantly uses cash transactions to collect school fees from parents at the school premises and to pay teachers’ salaries or vendors. In Pakistan, 90% of LCPSs were found to resort to cash transactions instead of bank transfers and one third of schools had no bank account<sup>82</sup>.



<sup>79</sup> <http://www.economist.com/blogs/feastandfamine/2012/04/banking-developing-world>

<sup>80</sup> *Ibid*

<sup>81</sup> *Scaling-Up SME Access to Financial Services in the Developing World, IFC, October 2010*

<sup>82</sup> *Access to Finance for Low-Cost Private Schools in Pakistan, IIm Ideas, 2014*

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### 3.1.2. LCPSs suffer from a “missing middle” on the financial spectrum in developing countries

LCPSs suffer from a “missing middle” on the financial spectrum in developing countries and find it difficult to obtain loans from banks or MFIs, even when they already have a bank account. Thus edupreneurs’ limited personal savings and/or informal borrowings predominantly finance the LCPS sector growth.

Most LCPSs belong to the SME category as they are born through isolated initiatives of local edupreneurs and remain small-scale. Banks incur high administrative costs by lending to SMEs: loan sizes are small while the per-loan transaction costs are relatively constant. In countries with immature financial systems where they face little competition and are not threatened by new entrants, banks have therefore no incentive to take risk and offer lower-yielding debt to SMEs when they can earn handsome returns by lending to large public and private players. The absence of general market data on the SME market, and specifically on the education sector that is traditionally seen as the responsibility of the government, limits banks’ potential for lending based on financial statements. 80% of banks admit they have difficulty in establishing SME credit-worthiness<sup>83</sup>. Because of information asymmetry and lack of reliable data, loan officers cannot understand business models and make effective credit appraisals on the basis of cash-flow statements.

Consequently, commercial banks primarily engage in relationship-based or collateral-based lending with quite unfavorable conditions for SMEs: interest rates and collateral requirements are much higher than for large firms and can be unsustainable for LCPSs. Indeed, banks can charge more than 150% of the loan amount in collateral, as well as interest rates 5% to 6% higher than in the rest of the world<sup>84</sup>. Yet, the lack of collateral (property titles and LCPSs themselves are often informal) and the absence of clear recourse legislation or insolvency regime in developing countries can deter banks from offering collateral-based lending to LCPSs.

MFIs provide small loans to the informal sector and the smallest formal enterprises. Although they can be an option for schools’ small-scale development, they have limited ability to accompany them as they grow and lack the ability to offer additional critical non-lending products for expansion. Moreover, microcredit loans are not adapted to LCPS characteristics. LCPS capital requirements are those of a SME rather than a microenterprise, and microloans’ interest rates are very high and repayment periods very short (from 3 to 6 months in Lagos<sup>85</sup>), which puts pressure on schools.

LCPS owners’ lack of managerial, business and financial literacy is an additional obstacle to credit. Edupreneurs, typically small micro-enterprise owners with multiple businesses, often implement unsophisticated management structures lacking formal documented financial reports or operational policies. The low prevalence of manuals and policies related to the quality of education, teachers’ performance, administration, business planning and budgeting impedes loan officers to access formal accounts and financial records and assess schools’ risk.

<sup>83</sup> *Scaling-Up SME Access to Financial Services in the Developing World*, IFC, October 2010

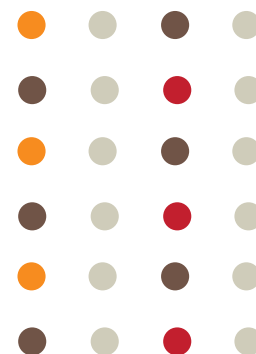
<sup>84</sup> *Support to SMEs in developing countries through financial intermediaries*, Dalberg, November 2011

<sup>85</sup> *Private Schools for the Poor*, Endeava, Working Paper 3, April 2014

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### 3.1.3. Limited SME outreach of equity financing in developing countries

Equity financing is often necessary to enable growth at scale, to invest in fixed assets, and to support increased levels of leverage<sup>86</sup>. It can constitute an important financing source for SMEs especially during their early lifecycle stages, when cash flow is not yet stabilized and contracting debt is not possible. Yet, equity funds have a limited SME outreach, as the current lack of competition enables them to focus on the largest firms with high-growth potential. Indeed, individual small-scale LCPSs serving marginalized populations in rural areas have little growth perspective, which translates into rather unattractive financial returns for investment banks, private equity firms (PEs), venture capital funds (VCs) and pension funds. Additionally, the cost of raising capital is higher for SMEs than large firms as many of the compliance costs associated with accessing capital markets are fixed (e.g., listing and rating agency charges, legal fees, prospectus preparation costs, etc.).



### 3.2. Non-bank initiatives emerge to improve for-profit schools' access to financial services

Non-bank initiatives are emerging to improve for-profit schools' access to financial services in three major areas: transaction platforms, debt instruments and equity solutions. First, mobile money services promote greater financial transparency between schools and parents and enable more efficient school management. Second, the introduction of loans addressed to LCPSs in India and Pakistan and the development of impact investing bear significant potential for for-profit school financing. However, LCPS loans are developed on a small-scale and impact investing focuses only on a few school chains. There is currently no hard evidence that these solutions can be replicated successfully on a larger scale.

#### 3.2.1. The emergence of mobile money payments in developing countries

While developing countries account for most of the 2.5 billion unbanked, they account for 5 out of the 6 billion mobile phone owners worldwide<sup>87</sup>. Only 15-20% of Africans have bank accounts but 60-70% of them have a mobile phone<sup>88</sup>. Mobile money plays a critical role in financial inclusion as it enables all individuals with a mobile phone to access stored value accounts and a growing range of financial services, including top-ups, person-to-person (P2P) transfers, transaction systems, bill payments, bulk payments and even basic lending services and interest bearing accounts. The mobile money industry is rapidly expanding, with Sub-Saharan Africa accounting for 56% of active mobile money services and 43% of planned mobile money services. Out of the current 30 million active users of mobile money services, 9.7 million are in East Africa and 3.8 million in South Asia<sup>89</sup>. In Kenya, 68% of cell phone owners regularly use their mobiles to send or receive payments and the ratio reaches 50% in Uganda, 29% in South Africa or 24% in Senegal<sup>90</sup>.

Where mobile money payments are widespread, LCPSs can use mobile money-based fee

<sup>86</sup> When a company has a leverage ratio considered too high (too much debt versus equity), it may experience a reluctance from creditors to lend more money and a decrease in profitability due to elevated interest costs

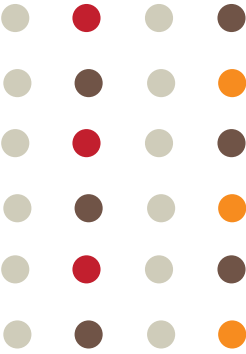
<sup>87</sup> <http://www.worldbank.org/en/news/press-release/2012/07/17/mobile-phone-access-reaches-three-quarters-planets-population>

<sup>88</sup> <http://www.economist.com/news/finance-and-economics/21586309-paul-edwards-took-pay-tv-and-mobile-phones-africa-now-its-e-payments-cash-be>

<sup>89</sup> State of the Industry: Results from the 2012 Global Mobile Money Adoption Survey, GSMA - Mobile Money for the Unbanked, Claire Pénicaud

<sup>90</sup> Pew Research, Global Attitudes Project, Emerging Nations Embrace Internet, Mobile Technology, February 2014

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collections, teachers' salaries and vendor payments to decrease the time spent by the staff on "cash registry" issues, to improve transparency, to diminish embezzlement risks and to increase efficiency. Security and safety increase when no cash is handled on the school premises. Quite a few initiatives have been developed for schools, especially in Kenya and other Sub-Saharan African countries. Bridge International Academies partnered with Equity Bank in Kenya and negotiated a preferred rate with mobile money operator M-Pesa for parents to pay school fees from their M-Pesa account or via an M-Pesa agent<sup>91</sup>. Mobile money services, combined with Bridge International Academies' custom software, enable personalized SMS bills and receipts to be sent to parents with regards to their children fees. Kenyan mobile school fees payment service M-Karo was launched to enable enables parents and guardians to make fee payments (deposits) directly to school accounts at Co-op Bank provided they are account holders at Co-Op Bank's M-Banking or as users of M-Pesa systems<sup>92</sup>. In Liberia, Ecobank and Lonestar Cell MTN introduced a mobile money school fees payment service to which many schools already subscribed<sup>93</sup>: available on mobile phones or internet, it puts an end to the long queues for school fees payment.

### 3.2.2. Loans for formal and informal LCPSs have been developed in India and Pakistan

Non-bank financial institutions, such as Indian School Finance Company (ISFC) in India and DFID/MFIs in Pakistan are developing loans catering to formal and informal LCPSs.

ISFC is a non-bank financial institution exclusively engaged in the business of lending to schools and vocational institutes for capacity building and quality improvements: purchase of school land and building, construction and renovation of school building, furniture and equipment purchase, purchase of school buses and other transportation vehicles, and refinancing of existing loans for cash flow management. ISFC has a better turn-around than banks since the latter are not interested in financing schools: Indian schools' status of "educational societies" prevents them from booking profits and makes it difficult for them to repay loans ISFC lends bigger amounts than MFIs and at lower costs: tickets are on average US\$260,000 with a 19%-25% interest rate at ISFC while they are limited to US\$200-US\$900 with a 46% interest rate at MFIs. ISFC provides secured (up to 5 years) and unsecured loans (up to 3 years) to registered schools which can provide their last six months bank statements and already generate profit, thereby ensuring timely and full repayment of capital and interests.

In Pakistan, DFID is piloting two cash-flow-based loans catering to LCPSs, which are characterized by a lack of formal registration, the absence of tangible collateral and the unavailability of documented financial information on the enterprise: School Improvement Finance (SIF) finances infrastructure expansion and improvement while School Level Enhancement Finance (SLEF) finances the acquisition of education quality enhancement products and services. Both are limited at US\$5,000. LCPS characteristics, combined with financial institutions' lack of knowledge on the education sector, generate an opacity that usually prevents them from getting credit based on cash flows or collaterals. DFID tried to tackle this lack of transparency by developing a financial model (informed by survey data from 305 schools) that averages sector values and normalizes to an extent the risk of lending to unusual clients from the education sector. Based on enrollment and fee level, it provides loan agents with LCPS free cash-flows and the maximum loan amount eligibility. The cash-flows generated by student fee payments will serve as collaterals in addition

<sup>91</sup> Interview with Shannon May, co-Founder of Bridge International Academies

<sup>92</sup> <http://www.co-opbank.co.ke/index.php/payments/37-payments/payments-diaspora>

<sup>93</sup> <http://allafrica.com/stories/201306040630.html>

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to the edupreneur's personal guarantee. LCPSs willing to contract a cash-flow based loan will be required to open a bank account to enable loan agents to verify actual cash-flow information and follow up on loan repayment. DFID is currently talking with banks to see whether LCPS cash-flow-based lending model could be adopted by financial institutions providing higher tickets than MFIs.

### 3.2.3. Impact investing is still in its infancy, focusing on the scale-up of school chains

Impact investing is still in its infancy, with a share of only US\$3 billion out of the US\$2.5 trillion annually spent on education<sup>94</sup>. This investment approach uses the means of commercial capital to improve social and environmental wellbeing, on a spectrum ranging from impact-first to finance-first investment. While impact-first investments remain the realm of foundations (small-scale schools targeting the bottom of the pyramid present limited potential for short-term financial returns), finance-first investments attract large private funds and institutional investors with quick and attractive financial returns.

Finance-first investments target school chains/franchises or medium-scale schools whose students come from higher-income backgrounds and have greater spending power. They aim to scale up already proven concepts, thereby intervening at a stage where profit generation and financial returns are more stable and transaction costs proportionally lower. Chains such as Curro, Bridge International Academies, Omega Schools, e-Advance & Spark Schools and Hippocampus Learning Centers were able to secure investments from the IFC, LGT Venture Philanthropy, Omidyar Network Fund, Pearson Affordable Learning Fund and Acumen Fund because they create economies of scale through standardization, amortization of centralized business functions, curriculum development costs or new technologies over a significant number of students. However, the number of school chains providing education to the most marginalized children remains small.

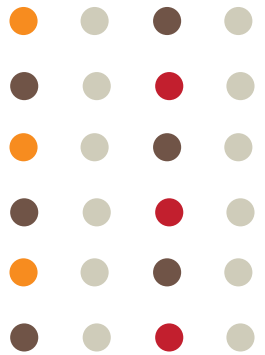
#### Box 1: Bridge International Academies

Bridge International Academies charges a per-pupil fee of US\$5 a month, which is 70% lower than that of other low-cost private schools operating in the same communities, because of its "Academy in a box" model. "Our biggest challenge," co-founder Jay Kimmelman explained, "is that we need to ensure we standardize everything. If we want to be able to operate like McDonald's we need to be sure that we systematize every process, every tool - everything we do!"

#### Box 2: Spark Schools

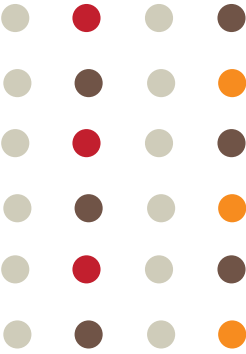
Spark schools combine classroom teaching and online educational technology designed to meet the specific needs of each student in order to improve education quality while at the same time diminishing teachers' related costs which can represent up to 80% of traditional schools' costs: "We believe that technology should not add to the total cost to educate, but should rather increase efficiency and effectiveness in schools. The SPARK Schools blended learning model decreases our cost to educate, allows for individualized learning for our students, and lowers tuition fees for our families. It allows teachers to maximize their planning and instructional time and streamlines operations with costs similar to, or less than, traditional schools!"

<sup>94</sup> Impact Investing in Education Landscape, Open Society Foundation, 2013



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### 3.3. Civil society organizations can significantly improve low-cost private schools' inclusion in formal education and financial systems



Civil society organizations can help improve LCPS' inclusion in the formal education and financial systems. A few nonprofits, such as Edify, IDP Rising School Program and the Kashf Foundation have combined school proprietor training with school loans. The creation and support for federations of non-state education providers can help give non-state schools a unified voice to address concerns about hostile government regulations, facilitate their access to financing via partnerships with MFIs, and create an ecosystem for education quality improvement.

#### 3.3.1. LCPS loans combined with proprietor training have been developed by nonprofits

Civil society organizations such as the IDP Foundation, Edify and the Pakistan Poverty Alleviation Fund have developed, in partnership with MFIs, programs combining loans with school owner managerial, financial literacy training and even in some cases with education quality elements. They invest in school proprietors to ensure a better management of LCPSs. Inclusion in formal systems, both educational (via State recognition) and financial (via the adoption of formal financial and operational documents necessary for loan officers to estimate creditworthiness), is a necessary condition for LCPS growth to be sustainable.

In 2009, the IDP Foundation launched in partnership with microfinance institution Sinapi Aba Trust the IDP Rising School Program to cater to LCPSs in poor areas not adequately reached by the public Ghanaian education system. While the IDP Foundation provides the funds for the loan portfolio, Sinapi Aba Trust loan officers develop/conduct targeted training sessions and distribute loans (97% for capital/infrastructure) at below-market interest rates to school owners who have or are in the process of getting a formal bank account in the name of their school. The training modules range from determining the frequency of fee collection to creating financial documents, developing financial literacy and resolving school management issues such as engaging parent-teacher associations, managing community relations, working with district officials and registering with Ghana Education Services as schools and businesses. Significant improvements in management have been observed after the trainings: the average quiz score increase from 46% before the training to 77% after the training, 20% of owners abandon their dual role as head teacher and owner, 85% register with Ghana Education Services and 33% take multiple loans<sup>95</sup>.

In 2013, the Pakistan Poverty Alleviation Fund supported the provision of “Kashf School Sarmaya”, a loan program for LCPSs in urban areas, through partner organization Kashf Foundation, the premier wealth management company for low-income households. Loans are tied to technical support in the form of curriculum development/improvement, capacity building workshops for school-owners, teacher trainings and other monitoring support to ensure improvements in quality of education<sup>96</sup>. After working in collaboration with school management to assess the LCPS financial needs and the quality of teaching and curriculum, Kashf loan agents undertake a consultative process to determine the most important capital needs: either infrastructure capital or working capital financing<sup>97</sup>.

<sup>95</sup> IDP Rising School Program in Ghana PowerPoint Presentation and phone interview with IDP Foundation team (Irene Pritzker, Allison Rohner and Alison Ehlke)

<sup>96</sup> Financing Low Cost Private Schools (LCPS) through Microfinance, Pakistan Microfinance Network, MicroNote No 21, Aban Haq and Khadija Ali, March 2014

<sup>97</sup> [http://kashf.org/?page\\_id=255](http://kashf.org/?page_id=255)



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Similarly, Edify partners with MFIs in Latin America and Africa to finance recognized Christ-centered<sup>98</sup> LCPSs' expansion at or below market rates while improving school proprietors' financial literacy, Christian curriculums' content and teachers' approach to teaching. Since September 2013, Edify has also been piloting a new program in the Dominican Republic that focuses on the 40 most committed schools it worked with<sup>99</sup>. This cohort is provided with intensive training on school governance, operations, strategic planning, leadership, finance and Christian teaching during one year.

### 3.3.2. Federations of non-state schools can help with formalization and access to financial services

The Association for Formidable Educational Development (AFED) in Nigeria, National Independent Schools Alliance (NISA) in India, Liberia Private Schools Association, the Independent Private School Association in Sierra Leone and the South Sudan Association of Private Schools are platforms that bring together non-state schools and give them a unified voice to address concerns about government regulations, facilitate their access to financing via partnerships with MFIs, and create an ecosystem for education quality improvement.

AFED is the only association in Lagos State that develops its members so that they can meet the approval standard stipulated by the Ministry of Education<sup>100</sup>. It has become so important that the government amended policies to automatically recognize AFED's new members as certified schools. Federations can partner with different organizations working in the education space and, like school chains, are able to amortize the heavy curriculum development and teacher training costs that cannot be individually afforded by non-state schools over all their member schools.

NISA conducts workshops and trainings on leadership management, classroom teaching techniques and other quality education modules for its member schools. It partners with organizations developing curriculums and scaling-up teachers led micro-innovations (e.g.: Educational Innovations and STIR Education)<sup>101</sup>.

Because it can take up to ten years for students in developing countries to be graded on a national common test allowing for comparisons between schools, AFED submits its members in Lagos State to annual unified examinations. As test results are not the only proxy taken into account by parents to gauge the quality of education, AFED also conducts site visits at member schools, monitors them, and gives them recommendations for performance improvement. It encourages them to open bank accounts and, after conducting due diligence and quality audit, links suitable loan recipients with financial institutions providing short-term loans (e.g., Olive Micro Finance Bank, Citiserve Micro Finance Bank, VCL Micro Finance Banks Ikorodu Division Micro Finance Bank and Seed Capital Micro Finance Bank).

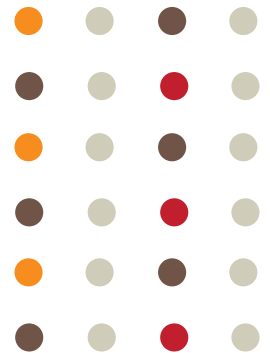
Professor James Tooley, Director of the E. G. West Centre at Newcastle University and renowned for his work on low-cost private education in developing countries (he co-founded Omega Schools in Ghana and Empathy Learning Systems in Hyderabad, India), strongly supports the federation

<sup>98</sup> Additional eligibility criteria apply: LCPSs have to already be up and running, close to profitability, able to document their financials and operations. Where owned property is formal, it is used as collateral; elsewhere Edify requires edupreneurs' personal responsibility.

<sup>99</sup> Phone interview with Edify Director of Education Partnerships (Gates Bryant)

<sup>100</sup> <http://edumations.blogspot.fr/p/afed-and-lagos-state-nigeria.html>

<sup>101</sup> <http://nisaindia.org/partnership-programs>



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of non-state schools and envisions a global coalition regrouping national and local associations. According to him, linking these federations with third party education service providers for quality or infrastructure purposes, potentially partially owned by federations themselves, would pave the way for scalable delivery and financing.

### 3.4. States' responsibility in creating a favorable ecosystem for LCPS to access financial services

Governments are responsible for creating a favorable ecosystem for formal, informal, banked and unbanked LCPS to access financial services. They could focus on three main courses of action: implementing a solid financial infrastructure and collateral regimes to improve lending conditions, promoting mobile money services to achieve greater financial inclusion of the unbanked and unlocking existing local capital and savings to provide long-term financing for education.

First, States could help improve the reach and the lending conditions at formal financial institutions. Fostering competition among financial sector players would reduce established banks' margins in traditional business lines (large firms) and incentivize them to expand to marginalized areas, reduce balance and withdrawal fees and lend to lower-margin riskier clients such as SMEs and LCPSs. Establishing a solid financial infrastructure would in addition improve transparency and dramatically diminish the current problems of opacity, legal uncertainties and information asymmetry that increase SMEs' perceived risk and limit the financing supply. Strong accounting and auditing standards would encourage lending based on financial and cash-flow statements rather than on relationships. Public credit registries and private credit bureaus could provide information on borrower creditworthiness, thereby expanding access to credit and reducing lending costs. Effective collateral regimes allowing movable assets to be used as collaterals, rather than only fixed assets, would reduce the risks and losses of lenders while modern insolvency regimes should be developed and implemented to enable "fast-track" and expedited bankruptcy provisions for corporate SMEs and personal insolvency issues in the case of non-corporate SMEs. Legislation should promote leasing and factoring, two financial services that prove very useful to finance SMEs' working capital needs.

Second, States can help the unbanked access transparent and secure financial services by promoting non-bank mobile money services that enable to electronically store value and transfer it from person to person. Introducing new mobile money-friendly regulations in Sri Lanka in 2012 to enable rapid adoption proved very successful while the introduction of M-Pesa in South Africa was slowed down by cumbersome transaction reporting requirements<sup>102</sup>.

Finally, government can take measures to unlock existing local capital and savings to provide long-term financing for education. Indeed, restrictive regulations and low risk tolerance tend to restrict pension funds to safe but low return yielding investments such as government bonds. The US\$6 trillion of assets controlled by institutional investors in developing countries<sup>103</sup> are therefore not available to fund local LCPS programs. Local currency education bonds, issued and guaranteed by governments, could help redirect a portion of the savings to non-state education.

<sup>102</sup> *Smartphones for the Unbanked: How Mobile Money Will Drive Digital Inclusion in Developing Countries*, Brookings Center for Technology Innovation, Issue 25, John Villasenor, September 2013

<sup>103</sup> <http://norrag.wordpress.com/2013/04/08/the-future-of-education-financing-a-role-for-debt-conversion-development-bonds/>

## 4. The access of not-for-profit schools to financial services impacts the quantity and quality of education provision

In a context of diminishing traditional grants, donations, aid to education and government subsidies, not-for-profit schools struggle to raise funds to cover their costs. Innovative financial services for nonprofits have been introduced that attract private sector resources in the form of debt or equity such as the charity bond markets, social insurance mechanisms, philanthropic equity and program-related investments, Education Bonds and SIBs. Such innovations are mostly targeted at not-for-profit schools run by international NGOs or by charities based in developed countries. Therefore the section will focus on these two types of nonprofit organizations.

### 4.1. In a context of diminishing traditional grants, donations, aid to education and government subsidies, not-for-profit schools struggle to raise funds to cover their costs

International not-for-profit organizations are confronted with reductions in government subsidies and in aid to education as well as with low levels of private contributions to education. Furthermore, they suffer from the unpredictability and the restrictions on uses of traditional grants and donations. As a result, they increasingly struggle to cover their costs with traditional sources of financing.

#### 4.1.1. Traditional grants, donations, aid to education and government subsidies are becoming scarce

Current private contributions to education in developing countries focus on higher education instead of primary education<sup>104</sup> and total only US\$683 million a year, which is equivalent to 5% of all aid to education and less than 0.1% of the profits of the world's two biggest oil companies, Exxon and Shell<sup>105</sup>.

Although individuals are the largest source of giving, they prove costly to cultivate for a nonprofit and they only generate small individual returns. A few successful individuals such as Carlos Slim (Mexico), Liliane Bettencourt (France), Lakshmi Mittal (India) and Li Ka-shing (Hong Kong) donate to education. Yet, Pauline Rose, director of the EFA Global Monitoring Report, warns that "education doesn't have a high-profile supporter like Bill Gates encouraging other private organizations to contribute. The private sector shouldn't need to be told the importance of investing in education, but it does need someone to champion its cause and remind it that it is one of the first to benefit from an educated, skilled workforce"<sup>106</sup>.

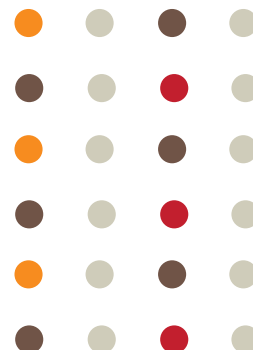
Access to funding from foundations, large companies, international NGOs and governments is more difficult and characterized by lengthy procedures, bureaucratic application processes, and one-off grants that leave nonprofits responsible for finding replacement funding sources. Additionally, education is not the main focus of foundations: while 53% of US foundations' grants are allocated to health, only 8% go to education. Five corporations – Banco Santander, Cisco, Intel, Coca Cola and Exxon – account for the majority (60%) of the private sector contributions to education<sup>107</sup>.

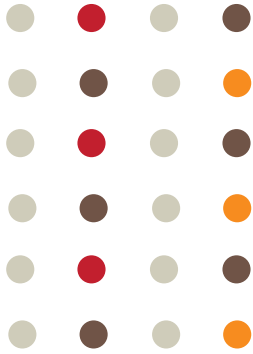
<sup>104</sup> EFA Brief, *Private Sector contributions to education are less than 0.1% of profits of two of the world's biggest oil companies, 2011*

<sup>105</sup> *Ibid*

<sup>106</sup> *Ibid*

<sup>107</sup> *Ibid*





Local government support of recognized not-for-profit schools can take a wide variety of forms but varies with changes in political leadership and public policy. Local government traditional funding arrangements can be direct or indirect and typically include: tax subsidies or incentives, subsidies (funds sent directly to the education provider for teacher salaries or textbook purchase), student loans, vouchers, grants and scholarships, curriculum, improved teaching material, assessment systems, training programs and teachers. Not-for-profit schools' operations and sustainability can be jeopardized if governments do not honor the financial support originally agreed on. For instance, the Ugandan government is currently not providing in-country Promoting Equality in African Schools (PEAS) schools with the per student subsidy initially determined.

Many nonprofit schools run by international non-governmental organizations are also supported by bilateral grants and multilateral donors such as the World Bank, UNESCO, United Nations Children's Fund (UNICEF), Asian Development Bank, or Inter-American Bank. Yet, annual aid to education has declined by over US\$1.3 billion (10%) since 2010 and is expected to stagnate until 2015, despite a US\$26 billion annual financing gap<sup>108</sup>. The share of education in total aid fell from 10.2% in 2009 to 8.7% in 2012<sup>109</sup>. The largest decrease in aid to basic education was suffered by South and West Asia, with disbursements falling by 26% between 2010 and 2012. India and Pakistan suffered from the largest reductions in aid to basic education with falls of respectively US\$278 million and US\$60 million despite their high numbers of OOSC.

#### 4.1.2. Traditional grants and donations are unpredictable and have their use limited by restrictions

Raising funds and maintaining that fund base prove both time- and cost-consuming for nonprofits: it requires time, staff and skills that pull resources away from pure service delivery. Donor funding may sometimes not be available when needed. Timing issues include the unpredictability of donations and grants as well as the lack of immediacy in disbursement.

The existence of donor-imposed legal restrictions on the use of the funds adds further complexity: it can render cash illiquid, non-fungible, and difficult to use or move around. Indeed, when donor funds are earmarked or tied to specific activities for a specific period of time, nonprofits are prevented from optimally spending the funds for maximal impact. Donors tightly control how their donations are spent, often not allowing more than 10% fluctuation on budget line items and requiring lengthy processes for approval of any adjustment. Aside from a few large nonprofits with well-established grassroots fundraising capabilities, most nonprofits struggle to maintain or grow their pool of unrestricted reserve funding, therefore lacking the flexibility they need to create maximal impact.

<sup>108</sup> Education for All Global Monitoring Report, *Aid reductions threaten education goals, Policy Paper 13, June 2014*

<sup>109</sup> Education for All Global Monitoring Report, *Aid reductions threaten education goals, Policy Paper 13, June 2014*

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General administration costs such as travel, marketing, fundraising, salaries, insurance and office rent are associated by many donors with inefficiencies and lack of direct social impact: thus they tend not to be (fully) funded by grants and endowments, which jeopardizes the sustainability and existence of the nonprofit organizations. Most nonprofits experience situations of underinvestment that drive their demand for drawdown on unrestricted cash<sup>110</sup>, notably when restricted grants for new or expanded programs do not provide for the additional staff and operational costs that accompany a program's growth.

#### **4.2. Not-for-profit schools mainly use non-lending financial services and focus on sustainability to make up for the rarefaction of grants**

Not-for profit schools run by international organizations and by charities headquartered in developed countries tend to be included in the formal financial system as they need formal bank accounts to receive donations, subsidies and grants. However, nonprofits increasingly attempt to achieve self-reliance and build up reserves to diminish their dependency on unpredictable donor funding rather than resort to bank financing.

##### **4.2.1. Not-for-profit schools are included in the formal financial system**

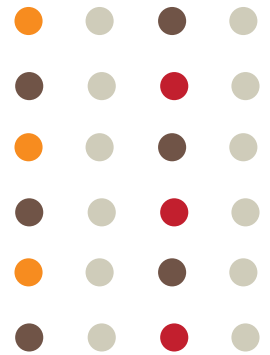
Not-for-profit schools are included in the formal financial system. They have formal bank accounts enabling them to receive government grants and subsidies, bilateral and multilateral grants as well as donations from private contributors. They widely use banks' non-lending financial services, notably:

- Banks' financial transaction systems allow for payment and reception of funds.
- Checking accounts, also called transactional accounts or current accounts, are deposit accounts held at a financial institution that allow for easy withdrawals and deposits through checks and automated cash machines and electronic debits among other methods.
- Custodial accounts are trust accounts set up for the benefit of the nonprofit and administered by a responsible person (the custodian) who has a fiduciary obligation to the beneficiary. They contain all the restricted and unrestricted endowments pledged and wired by donors.
- Foreign exchange services, provided by banks or brokers, exchange donor currency into the currency used in local operations. For instance, PEAS uses foreign exchange specialist Monex International to convert donor funds from British pounds into Ugandan shillings.

##### **4.2.2. Not-for-profit schools prefer building up reserves to using debt or equity**

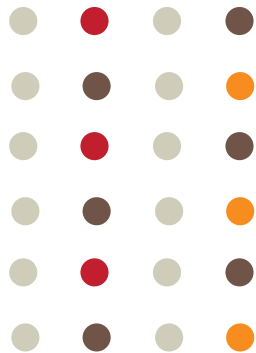
Despite the rarefaction of their traditional funding sources, not-for-profit schools tend not to contract loans or investments. Used to defining themselves as grant-dependent organizations rather than social enterprises, they have long been – and remain – uncomfortable with the concept of borrowing money and financially rewarding investors.

<sup>110</sup> *Hidden in Plain Sight, Understanding Nonprofit Capital Structure, Clara Miller*



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Although private capital could provide them with greater flexibility than donor-restricted funds with regards to how and when money can be spent, nonprofits have a limited understanding of how to use it to increase impact. Indeed, it fundamentally differs from traditional donor funding as it requires from nonprofits the payment of principal and interests in the case of a loan, or of investor returns in the case of an equity investment.



Yet it also differs from the for-profit sector: nonprofits have technically no owner and raising equity-like capital by selling shares is thus not possible. Moreover, nonprofits are faced with control and governance issues related to the legal entities created to capture financial returns, thereby generating potential trade-offs between social impact and investor/creditor returns. Nonprofits tend to prefer keeping three months' to three years' worth of reserves on their balance sheets to ensure they can manage grant delays, honor their commitments and ensure the smooth running of local operations. Yet, it means that cash sitting idle is not being used to educate children.

Similarly, there is little guidance for private sector investors on the unique challenges that nonprofits face and the opportunities that exist for increasing social impact. Investors fear the position where they could be forced to seize the assets of a not-for-profit school that defaults or fails to meet expectations because of the bad publicity it would generate.

#### **4.2.3. Not-for-profit schools develop a sustainable mindset and attempt to achieve self-reliance**

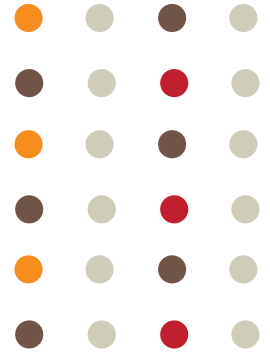
Nonprofits increasingly attempt to achieve self-reliance and build up reserves to diminish their dependency on unpredictable donor funding rather than resort to bank financing. Many are currently shifting towards the adoption of social enterprise models to better serve their communities in the long run. They are developing “for-profit” business skills, capacities and organizational culture to generate the additional revenue streams, and the cost-recovery needed to operate sustainable business models. According to Devang Vussonji, Head of Education at Dalberg, “one third of the NGOs have a sustainable mindset.”

A social enterprise is a business owned by a nonprofit or for-profit organization with primarily social objectives, whose surpluses are principally reinvested for that purpose in the business or in the community rather than being driven by the need to maximize profit for shareholders and owners. A wide range of transformations is possible for nonprofits to become social enterprises: ramping up the selling of branded products services, introducing fees for service for beneficiaries, creating distinct commercial for-profit ventures consistent with the organization’s mission and generating profits by selling products and services to unrelated parties, building a hybrid social enterprise, or transitioning from a nonprofit to a for-profit business.

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Box 3: Promoting Equality in African Schools (PEAS)

PEAS, a nonprofit active in Zambia, Uganda and Rwanda, is evolving towards the concept of social enterprise with three different cost-recovery stages. The schools have achieved the first stage, “cash-flow sufficiency”. They do not depend on UK fundraising to continue their operations because fees, income-generating activities, and government contracts cover local operational costs. The second stage, “operating expense self-sufficiency”, will be reached when the schools will be able to cover the recurring expenses currently funded by donors such as inspection, monitoring and training. At last, “full-scale commercialization” will be ensured when schools can finance capital expenditures by drawing money on their cash reserves.



Some education providers, such as Avanti Learning Centers and Empathy Learning System/ Beautiful Tree Trust, have developed hybrid models with two independent and legally distinct entities. Avanti Learning Centers provides underserved high-school students across India with a science and mathematics after-school program based on a blended learning program<sup>111</sup> that enables significant cost-savings. Originally structured as a nonprofit for students at the bottom of the income pyramid, it created a for-profit arm to cater to lower middle-income families. The for-profit entity benefits the not-for-profit entity: the former owns the program content and raises equity to develop and implement it in five stand-alone centers; the latter implements it for free in eight government schools with a mix of donor and government funding to cover overhead and operational costs.

**4.3. Innovative initiatives are emerging to mobilize private sector capital into social purpose organizations in the form of debt and equity**

Four major initiatives have recently been introduced that can mobilize private sector capital into international not-for profit organizations or charities based in developed countries in the form of debt or equity. Charity bond markets and HUGInsure, the first social impact insurance, are still in their infancy. Philanthropic equity and program-related investments are forms of capital that can be used by not-for-profit schools. No evidence exists so far that such mechanisms could be replicated on a larger scale and for smaller nonprofit organizations.

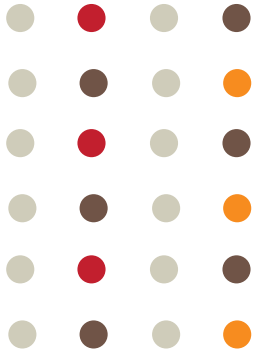
**4.3.1. The charity bond market could become a scalable source of funding for not-for-profit schools**

Still in its infancy, the UK charity bond market could become a scalable source of funding by opening up social investment to a mass investor market. It enables regulated charities and social enterprises to issue specific fixed-income instruments on debt capital markets and get unrestricted cash upfront if they have a viable underlying source of revenue with which to repay bondholders' principal and interest.

<sup>111</sup> Recorded videos and books to be studied at home cover the basics, online problem sets to be solved in class are discussed with peers and as a result while tutors only intervene one day a week to clarify notes and bring final touches

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Allia's Charitable Bonds are ethical savings bonds that allow investors to bring forward future interest in an upfront donation to their chosen charity while the capital is lent at a fixed rate to a social housing provider with interest and principal repayment at maturity. Allia has raised about £30m of investments in charitable bonds.



Similarly, in the US, the Calvert Social Investment Foundation created a Community Investment Note whose mechanism mirrors that of traditional banks' certificate of deposit<sup>112</sup>. Investors buy a note for a determined length of time between 1 and 10 years after which they are paid back the principal and a below-market fixed rate of interest between 0% and 3%. The capital raised from the community investment notes is loaned to a diversified portfolio of social change organizations selected after a screening and due diligence process: examples include nonprofits, microfinance institutions, education, fair trade and affordable housing<sup>113</sup>. More than US\$1bn notes have been purchased so far with diversification enabling to lower individual risk: investor repayment rate stands at 100%.

Allia's Retail Charity Bonds provide a light alternative to bank debt for established charities with strong credit worthiness and attract a new group of investors. The London Stock Exchange introduced in 2010 the electronic Order Book for Retail Bonds (ORB) in response to growing private investor demand for greater accessibility to fixed-income securities. Yet, issue sizes of retail bonds on the ORB have historically ranged from £20m to £300m, thereby excluding the majority of charities and social enterprises from debt capital markets due to the smaller scale of their financing requirements (£3m-£20m) combined with the significant fixed cost and complexity of directly selling bonds to investors. Thus charity bonds were mostly unlisted or under mini-bond format with limited if any transferability. Charity bonds have become easier and less expensive to issue following three important developments: the creation of Retail Charity Bonds plc, the launch of the Charity Bond Support Fund, and the multiplication of advisory firms specialized in capital-raising for charities. Retail Charity Bonds plc, launched by Allia and Cannacord Genuity in June 2014, is a platform through which UK charities can issue small publicly listed bonds to retail and wholesale investors while benefitting from simplified bond issuance procedures, improved price transparency, lower transaction costs and better liquidity (expected to be admitted to trading on the ORB, they can be bought or sold on the secondary market as easily as shares<sup>114</sup>).

Capital-raising advisory firms such as Triodos, ClearlySo, Social Finance and Investing for Good have developed an expertise in advising charities and social enterprises on their capital raising needs: Investing for Good assisted UK disability charity Scope in issuing a three-year listed charity bond in 2012. Although investment is currently largely limited to wealthy philanthropic investors and charities, it is hoped that well-established track records will allow more widespread investment from the general public in the near future, notably through pension funds<sup>115</sup>. In the meantime, the Big Society Capital's £10m Charity Bond Support Fund helps charity bond issuers raise capital while investor demand is still constrained given the market's early stage of development<sup>116</sup>.

<sup>112</sup> *Investing in Change : Calvert Community Investment Notes Take Social Investing Mainstream, Stanford Social Innovation Review, Vinay Jain, Spring 2006*

<sup>113</sup> *Calvert Foundation's Community Investment Note Fact Sheet and website*

<sup>114</sup> [www.retailcharitybonds.co.uk](http://www.retailcharitybonds.co.uk)

<sup>115</sup> [www.bbc.co.uk/news/business-16267298](http://www.bbc.co.uk/news/business-16267298)

<sup>116</sup> *Social Investment Insights Series, Growing the Market for Charity Bonds, Big Society Capital, Alex Goodenough, July 2014*



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#### 4.3.2. The first social impact insurance has been created to facilitate bank lending to nonprofits

The creation of the first social impact insurance mechanism aims to better match funding needs with available funding capacity by facilitating bank lending to nonprofits. “With more than \$500 billion in capital allocated in the coming years to fund businesses and organizations that create positive social impact, money is not necessarily a problem. But getting it into the projects where it is needed is a challenge. There is often a gap between securing funding for a project or concept and bringing that funding to the table,”<sup>117</sup> explains Ian Ross, MD of Hollard International.

Impact investing has the potential to grow to about 1% of total managed assets, which would result in US\$500 billion to US\$1 trillion of capital released for social impact projects<sup>118</sup>. Yet, it is estimated that only 15% to 40% of this capital has been deployed and that the remaining US\$300 billion to US\$850 billion are in-waiting<sup>119</sup>. Because nonprofits’ creditworthiness is difficult to assess, risk misperception across the social capital value spectrum prevents the efficient and timely deployment of capital required to enable maximum social impact. This untapped capital represents the market opportunity for HUGinsure, the world’s first social impact insurance entity which will take the lending risk from financial institutions, thereby enabling them to fund unproven social impact projects.

Created by Dalberg’s impact investment arm (D. Capital) and Hollard Insurance in association with Aon and the Lloyd’s market, HUGinsure can help organizations immediately access funding that might otherwise be tied up in institutional processes or delayed because the risks of development work are not widely understood. Underwritten in the Lloyd’s market and based on specialized risk assessment methodologies, the policies will enable not-for-profit organizations to accelerate funding quickly in time sensitive situations and access more working capital financing thereby scaling operations at a faster pace, in exchange for a small upfront payment. HUGinsure is expected to accelerate the release of over \$400 million for global development by 2018<sup>120</sup>: initially focused on providing trade credit insurance policies, it will in the long run develop insurance offerings for a variety of project risks, including performance risks.

#### 4.3.3. Philanthropic equity and program-related investments are forms of capital that can be used by not-for-profit schools

The Nonprofit Finance Fund strongly encourages nonprofits to distinguish between revenues and different forms of capital to create greater clarity for the organization and the funder community on what they can achieve together<sup>121</sup>: philanthropic equity and program-related investments constitute two promising areas of cooperation.

Revenues – earned, contributed, restricted or unrestricted – pay for recurrent operating expenses while capital – generated through surpluses, accessed through debt or provided as a multi-year contributed investment – builds liquidity, adaptive capacity and sustainability. Many nonprofits rely on contributed revenues from funders and donors to subsidize their operations and deliver

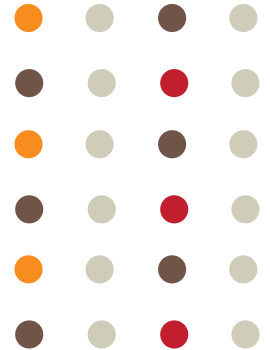
<sup>117</sup> <http://www.risksa.com/new-insurance-initiative-to-enable-ngo-relief-funding/>

<sup>118</sup> <http://www.huginsure.com/problem/index.html?&re=1>

<sup>119</sup> *Ibid*

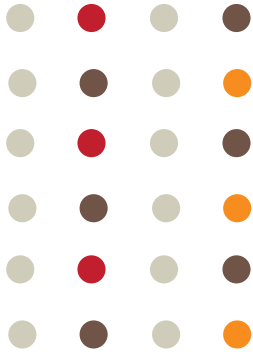
<sup>120</sup> [https://alumni.mckinsey.com/public\\_content/500170373](https://alumni.mckinsey.com/public_content/500170373)

<sup>121</sup> *All Flexible Funding is not Created Equal : GOS, Capacity Building Grants and Change Capital, Nonprofit Finance Fund blog, Rebecca Thomas and Rodney Christopher, May 2011*



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their products and services: called “ordinary revenues” or “buy money”, these funds purchase programs that nonprofits deliver to their clients<sup>122</sup>. If nonprofits intend for “buy money” to cover pay for a program’s costs on a local scale, they do not expect it to be sufficient to finance program expansion in a scalable manner or the testing of innovative business models.



Charitable donors and social investors can make a major contribution by providing philanthropic equity, also called “change capital”<sup>123</sup>, a form of high-risk growth capital similar to early stage equity investment in the for-profit world. Change capital is a flexible form of capital of limited duration that allows for one-time infusions of capital to fund improvements in programs’ quality and efficiency or adjustments to the size and scope of the organization. The injected capital can be compared to risk capital or research and development (R&D) investment: it shall be used to take risk, innovate, renew, refine and further the nonprofit’s business model to pursue new revenue opportunities, improve effectiveness, cost-recovery and social impact. Called “build money”<sup>124</sup>, it differs from general operating revenues in the sense that it is an extraordinary investment meant to amend the organizational structure, not to pay for business as usual or to serve existing constituents. It differs from capacity-building revenues since it is not earmarked for a specific use. It is spent on any number of program-related activities or infrastructure building priorities with the explicit expectation it will lead to a healthier business model with improved social and financial results.

Program-related investments<sup>125</sup> (PRIs) are investments made to significantly further foundations’ exempt activities with a potential return of capital to the grant-maker within an established timeframe. They bring private sector discipline and efficiency to social ventures, often enabling recipient organizations to attract scale-up capital from commercial sources. They can take many forms, including loans, equity investments, lines of credit, linked deposits, guarantees etc. In 2007, education has risen to the number one PRI-attracting program area<sup>126</sup>.

#### **4.4. States could attract additional private capital for nonprofits’ initiatives by developing Education Bonds and Social Impact Bonds**

States could attract additional private capital for nonprofits’ initiatives by introducing a mechanism similar to GAVI’s International Finance Facility for Immunization (IFFIm) to finance education and by participating in SIBs or DIBs. However, difficulties lie in determining precisely which variables can be isolated to orientate action and measure quality impact in low-cost implementation settings.

##### **4.4.1. States could use a mechanism similar to GAVI’s IFFIm to finance education**

Replicating a finance mechanism similar to GAVI’s IFFIm in the education sector would enable the issuance of Education Bonds with sovereign government donors’ pledges used as collaterals.

<sup>122</sup> *Philanthropic Equity: Promising Early Returns, The Nonprofit Quarterly, Craig C. Reigel*

<sup>123</sup> *All Flexible Funding is not Created Equal : GOS, Capacity Building Grants and Change Capital, Nonprofit Finance Fund blog, Rebecca Thomas and Rodney Christopher, May 2011*

<sup>124</sup> <http://opinionator.blogs.nytimes.com/2012/06/27/fixes/>

<sup>125</sup> *The spectrum of core support: funding mechanisms and approaches, Social Investors, Fall 2013*

<sup>126</sup> *Why Program-Related Investments Are Not Risky Business, Ashoka, Forbes website, February 2013*

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Indeed, IFFIm uses long-term government commitments to healthcare as collaterals to issue Vaccine Bonds on the global capital markets and converts them into immediately available cash resources for the Alliance's programs. Cash receipts from sovereign donors are then used to repay IFFIm bonds.

Created in 2006 to accelerate the availability and predictability of funds for the Alliance's immunization program, IFFIm is backed by the governments of the United Kingdom, France, Italy, Norway, Australia, Spain, the Netherlands, Sweden and South Africa, which together have pledged to contribute more than US\$6 billion over 24 years.

Because the education sector is less clear cut than healthcare, the main difficulty may not be in building a finance mechanism similar to IFFIm to increase the supply of capital, but in identifying the most relevant and effective way to use this capital. Vaccines have scientifically and empirically demonstrated their ability to improve health, which explains the success of Vaccines Bonds. Yet in the education sector it is still unclear whether an isolated variable – and if so, which variable – could yield significant improvement: for instance, focusing resources on textbooks only without associated teacher training (or vice-versa) would not constitute an efficient use of available capital.

#### 4.4.2. States could fund education by issuing Social Impact Bonds and Development Impact Bonds

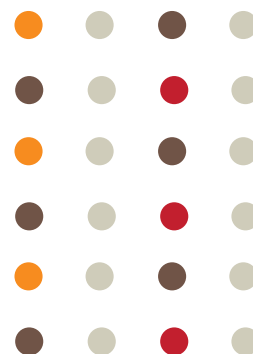
The public sector could play an important role in developing payment-for-result mechanisms such as SIBs and DIBs to attract new funding to finance early-stage interventions or to accelerate the scale-up and adoption of specific programs.

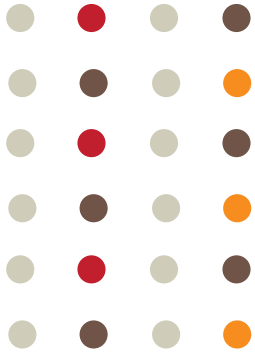
The principles are the same for SIBs and DIBs: partners who can be governments, donors, investors, firms or civil society organizations agree on a common goal and a way to measure success. Private investors finance upfront a program aimed at achieving these outcomes. They work with service delivery partners who can consist in any combination of public agencies, for-profit companies and nonprofits. If the program is deemed successful by an independent assessor, then the outcome funder (usually the government), reimburses the investors. Over the past four years, 25 SIBs have been commissioned worldwide<sup>127</sup> to tackle social issues and thirteen of them are education-specific with a strong emphasis on vocational and childhood education<sup>128</sup>. DIBs are a variation of SIBs where the outcome funder is a foundation or a donor agency instead of a government. The more successful the program, the greater the return on capital invested for investors: they get their capital back plus a premium for taking the risk that the program might have failed. SIB returns are generally between 2% and 6%<sup>129</sup>. Even if a few universal success factors can be identified (e.g.; quality of the service provider, scalability of the underlying innovation, or other metrics used to measure the impact of SIBs and DIBs), no unique scalable approach to SIBs and DIBs exists. They need to be structured on a case-by-case

<sup>127</sup> *The Global Social Impact Bond Market, Factsheet, Social Finance, August 2014*

<sup>128</sup> *Social Impact Bonds & Education in Latin America, Global Education and Skills Forum 2014, Multilateral Investment Fund of the Inter-American Development Bank Group and GEMS Education Solutions*

<sup>129</sup> *Interview with Amie Patel, Principal and Director Emerging Markets at Imprint Capital*





basis in order to satisfy the many participants' differing sensibilities and risk-reward appetites. Moreover, the small number of SIBs and DIBs currently implemented is not enough to prove their effectiveness and scalability.

Recently, a DIB to improve the quality of girls' basic education has been launched by the Children's Investment Fund Foundation (CIFF) and UBS Optimus Foundation in India. The UBS Optimus Foundation will invest US\$238,000 in Educate Girls, an NGO that operates in government-run schools in Rajasthan and partners with EAC, to enroll and retain girls as well as to improve learning outcomes for all while CIFF will be responsible for paying for the social outcomes achieved by the program. While nonprofit Instiglio will help design the results-based financing program, an independent evaluator will measure impact, and an external advisory board will promote transparency and good governance. This DIB aims to become a proof of concept for replication and scale-up in the education sector and beyond<sup>130</sup>.

Social Finance has developed several case studies in partnership with PEAS and Lion's Head Partners to highlight the benefits that could be derived from implementing DIBs for providers of secondary education in Uganda and low-cost primary schools in Pakistan<sup>131</sup>.

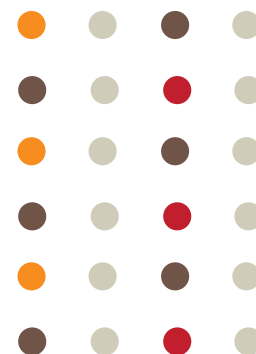
<sup>130</sup> <http://educategirls.in/blog/childrens-investment-fund-foundation-and-ubs-optimus-foundation-launch-the-first-development-impact-bond-in-education-with-the-ngo-educate-girls/>

<sup>131</sup> *Investing in Social Outcomes: Development Impact Bonds: The Report of the Development Impact Bond Working Group, center for Global Development and Social Finance, October 2013*

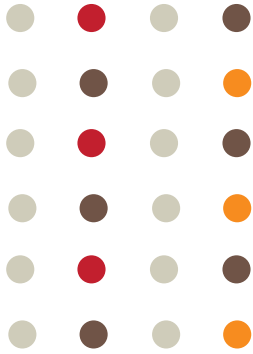
## 5. Focus on the main out of school children countries

Most of the innovations in financial services for education are being developed in countries plagued by high numbers of OOSC such as Pakistan, India, Ghana, South Africa and Kenya<sup>132</sup>. However, little or no information was gathered on financial innovations for education in other countries faced with the same OOSC challenge such as Nigeria, Ethiopia, Niger, Yemen, Burkina Faso, Mozambique, Philippines and Mali. The table below summarizes for each of the top ranking countries in terms of numbers of OOSC the specific key private financial services innovations that have been developed.

A clear geographical segmentation of the different types of financial service innovations can be observed. Impact investing in for-profit schools mainly takes place in India, South Africa and to a lesser extent in Kenya. Cash-flow-based loans and innovative infrastructure loans for LCPSs are being developed in Pakistan and in India. Not-for-profit initiatives combining for-profit school loan and proprietor managerial and financial literacy training are concentrated in Ghana. Innovations in financial services for nonprofits are still in their infancy in developed countries such as the UK and the US. Lastly, most innovations in secondary and higher education student financing (loans and human capital investing) take place in Latin America where the private education sector and the use of consumer loans are widespread among the population.



<sup>132</sup> UNESCO Institute for Statistics 2013



**Figure 4:** Financial innovations for education for the countries most plagued by the OOSC phenomenon

Countries	# 00S children		Financial services innovations	
	Primary	Lower Secondary	Types	Details
Nigeria	8.65 million	n.a.	Other	<ul style="list-style-type: none"> <li>Association for Formidable Educational Development (AFED) helps non-state schools access to finance and become formal</li> </ul>
Pakistan	7.26 million	6.46 million	Debt	<ul style="list-style-type: none"> <li>Cash-flow based loans to for-profit schools: DFID and Ilm Ideas, PPAF and the Kashf Foundation</li> </ul>
India	5.56 million	16.4 million	Debt	<ul style="list-style-type: none"> <li>Indian School Finance Company (ISFC) infrastructure loans to for-profit schools</li> <li>IFC provided a mezzanine guarantee to Citibank and NIIT, an IT school</li> </ul>
			Equity	<ul style="list-style-type: none"> <li>SONG Investment Management funded K12 Techno Services/Gowtham Model Schools</li> <li>Pearson Affordable Learning Fund (PALF) funded Avanti Learning Centers, Zaya and Sudiksha</li> <li>Omidyar Network Fund funded Teach For India, Akshara and Anudip Foundations</li> <li>LGT Venture Philanthropy funded Varthana</li> <li>Acumen Fund financed Hippocampus Learning Centers, Edubridge and Labournet</li> <li>IFC invested in Avanse, a company providing finance to higher education students</li> </ul>
			Other	<ul style="list-style-type: none"> <li>Development Impact Bond launched by CIFF / UBS for NGO Educate Girls</li> <li>National Independent Schools Alliance (NISA) helps non-state schools access to finance and become formal</li> </ul>
Ethiopia	2.73 million	3.23 million	All	No information
Niger	1.21 million	1.13 million	All	No information
Kenya	1.09 million	0.03 million	Debt	<ul style="list-style-type: none"> <li>Risk sharing facility involving IFC and K-Rep Bank to build a portfolio of school loans</li> </ul>
			Equity	<ul style="list-style-type: none"> <li>IFC, LGT Venture Philanthropy, Learn Capital and PALF financed Bridge International Academies</li> </ul>
			Other	<ul style="list-style-type: none"> <li>Mobile money transaction services (M-Pesa) and savings accounts (M-Karo)</li> </ul>
Yemen	1.04 million	0.67 million	All	No information
Philippines	0.96 million	0.35 million	Equity	<ul style="list-style-type: none"> <li>Omidyar Network Fund financed Kalibr</li> <li>PALF invested with Ayala Corporation in APEC, a low cost secondary school chain</li> </ul>
Burkina Faso	0.92 million	0.78 million	All	No information
Mozambique	0.86 million	0.65 million	Debt	<ul style="list-style-type: none"> <li>Microfinance institution Opportunity International</li> </ul>
Ghana	0.79 million	0.13 million	Debt & Guarantee	<ul style="list-style-type: none"> <li>School loans combined with school owner managerial and financial literacy training (Edify and IDP Rising School program in partnership with MFIs such as Sinapi Aba Trust and Opportunity International)</li> <li>IFC provided a partial credit guarantee to the Trust Bank to fund private K-12 schools and made a loan to Ashesi University College</li> </ul>
			Equity	<ul style="list-style-type: none"> <li>PALF financed school chain Omega Schools</li> </ul>
			Other	<ul style="list-style-type: none"> <li>MicroEnsure and Opportunity International launched EduSave to link savings with education insurance</li> </ul>
Brazil	0.68 million	n.a.	Debt	<ul style="list-style-type: none"> <li>Ideal Invest provides students with innovative loans</li> </ul>
Mali	0.51 million	0.44 million	All	No information
South Africa	0.50 million	0.01 million	Debt	<ul style="list-style-type: none"> <li>Eduloan provides students with innovative student loans, supported by the IFC</li> </ul>
			Equity	<ul style="list-style-type: none"> <li>PALF funded school chain e-Advance &amp; Spark Schools and created the Village Capital incubator programme for Edupreneurs</li> <li>Curro Schools is listed on the Johannesburg Stock Exchange</li> </ul>
			Other	<ul style="list-style-type: none"> <li>Mobile money transaction services</li> <li>Risk sharing facility (Strathmore University in Nairobi, IFC and Commercial Bank of Africa)</li> </ul>

Source : UNESCO Institute for Statistics 2013 (latest data available indicated for each country)

## Conclusion

While governments remain responsible for creating a financial ecosystem and regulatory framework beneficial to all – education providers, students and their parents – resource constraints in developing countries and donor funds create a practical need for private resources to support the universal right to education. This review discussed the financial innovations targeted at students and their parents (demand side) as well as at LCPS and not-for profit schools run by international NGOs and charities headquartered in developed countries (supply side).

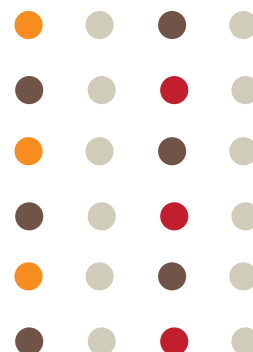
First, higher education students and their parents can benefit from a wide range of new financial services. The experience of Trustco, FINA, Ideal Invest and Eduloan provide keys for success in higher education loans while Enzi and Lumni are beginning to implement equity-like human capital contracts<sup>133</sup>. The expansion of student financing towards the base of the income pyramid at higher education level can be spurred by crowdfunding, securitization, debt issuance on capital markets and risk mitigation strategies with the participation of governments or development finance institutions. Yet, there is so far no evidence that similar financing models could be successfully replicated at the pre-primary, primary and secondary education levels where the largest share of OOSC can be found and where the link with employment and debt repayment is less direct than in higher education.

Second, the loan products developed specifically for LCPSs can positively impact the supply side of the education equation: they can be infrastructure loans (ISFC), cash-based loans (DFID and the Kashf Foundation in Pakistan) or loans combined with school proprietor management and financial literacy training (Edify and IDP Rising School Program in Ghana). Impact investing is currently focused on a small number of school chains but bears interesting potential for LCPS equity financing. These nascent debt and equity innovations have not been implemented on a large scale yet despite strong LCPS demand. In parallel, the creation of and support for non-state school provider federations around the world could also help improve non-state schools' inclusion in the formal educational and financial systems while giving them a united voice.

Third, not-for profit schools' access to financial resources could be improved following the development of innovative financing mechanisms such as SIBs/DIBs, social impact insurance mechanisms such as HUGInsure, equity-like capital (philanthropic equity and program-related investments) and charity bond markets in developed countries. However, only a small number of these innovations have been implemented so far, mostly catering to large international not-for-profit organizations and not-for-profit organizations headquartered in developed countries. There is no significant evidence that such mechanisms can be successfully scaled and replicated for small nonprofits in developing countries.

Additional research in association with the actors identified in this review, funders, researchers and policymakers would help precise in which cases and to what extent scale-up, expansion towards pre-primary, primary or secondary education and replication are possible to reduce the numbers of OOSC in South & West Asia and Sub-Saharan Africa.

<sup>133</sup> Refer to List of Financial Mechanisms



## List of Financial Mechanisms

Asset-based loan (also called mortgage-type loan and asset-backed loan)	A business loan is secured by collaterals such as inventory, accounts receivables, machinery and equipment, real estate, and/or other balance sheet assets. A legal mechanism allows the lender to take possession and sell the secured property ("repossession") to pay off the loan in the event that the borrower defaults on the loan.
Cash-flow based loan	Type of debt financing, in which a bank lends funds, using the expected cash flows that the borrowing company generates as collateral for the loan
Cash-flow sufficiency	Commercial income covers the below market-rate operating expenses of a nonprofit organization that benefits from reduced rates because of direct access to philanthropic investment
Charity bond	Fixed-income instrument that charities and social enterprises can issue on debt capital markets in exchange for unrestricted cash upfront provided they have a viable underlying source of revenue with which to repay bondholders' principal and interest
Collateral	Borrower's pledge of specific property to a lender, to secure repayment of a loan
Community Investment Note	Like for a certificate of deposit, investors purchase a note for a set period of time after which they are paid back the principal plus interests. But in community investment notes, the capital raised is loaned exclusively to organizations creating social change
Cost-sharing	States require students and parents to pay for a portion of tuition costs, food costs, lodging costs (especially at higher education level) that were previously borne predominantly or exclusively by governments or taxpayers
Crowdfunding	Practice of funding a project or venture by raising monetary contributions from a large number of people, typically via the internet
Development Impact Bond	As with SIBs, investors provide external financing for interventions in developing countries and receive a return if pre-agreed outcomes are achieved. Funds to remunerate investors come from donors and/or the host country and are commensurate with the level of success
Full-scale commercialization	Revenues cover all market-rate costs, including the cost of capital, and nonprofits do not need donor funding anymore
Grace period	Time after graduation when payments are not required and, in some cases, interest does not accrue
Graduate tax	Former students repay their loans through a graduated surplus income tax: . Contributions by graduates with high income are larger than those by graduates with low income
Human capital contract	Equity-like financial instruments attracting private capital to finance higher education. Students receive funding in exchange for a percentage of his or her income during a fixed period of time
Hybrid model of schools	Hybrid models have a for-profit arm and a not-for-profit arm (commercial for-profit venture)
Impact investing	Impact capital differs from commercial private capital in that it seeks to reach the most vulnerable beneficiaries; it differs from private philanthropic capital in that it seeks to apply market-based innovations to ensure financial sustainability, if not financial profit
Income-contingent loan	A proportion of the graduate's income has to be paid each year until the loan is repaid at the contractual rate of interest or until the graduate has repaid for a maximum number of years
Junior debt	Debt that is lower in repayment priority than other debts in the event of the issuer's default. Junior debt is usually an unsecured form of debt
Mobile money	Mobile money uses the mobile phone to transfer money and make payments to the underserved ( P2P transfer, bill payment, bulk payment, merchant payment, and international remittance)
Net present value	Value in the present of a sum of money, in contrast to some future value it will have when it has been invested at compound interest
Operating expense self-sufficiency	Only capital expenditures and headquarters costs still depend upon donations and grants, all the other expenses are covered by the revenues generated
Partial credit guarantee	Promise to pay principal and/or interest up to a pre-determined amount



Philanthropic equity	Also called “change capital” or “build money”, it is a flexible form of capital of limited duration that allows for one-time infusions of capital to fund improvements in programs’ quality and efficiency or adjustments to the size and scope of the organization
Program-related investments	Investments made to significantly further foundations’ exempt activities with a potential return of capital to the grant-maker within an established timeframe
Recurring expenses	Regular cost incurred repeatedly, or for each item produced or each service performed
Return on capital	Profitability ratio that measures the return an investment generates for capital contributors, i.e. bondholders and stockholders. Return on capital indicates how effective a company is at turning capital into profits.
Risk sharing facility	Bilateral loss-sharing agreements between the IFC and an originator of assets in which the IFC reimburses the originator for a fixed percentage of incurred losses that exceed a predefined threshold (first loss)
Securitization	Financial practice of pooling various types of contractual debt and selling the obtained consolidated debt as bonds, pass-through securities, or collateralized mortgage obligation to various investors
Senior debt	Borrowed money that a company must repay first in the event of default
Social Impact Bond	Also known as Pay for Success Bonds or Social Benefit Bonds, SIBs are based on a commitment from government to use a proportion of the savings that result from improved social outcomes to reward non-government investors that fund the early intervention activities
Working capital	Financial metric which represents operating liquidity available to a business or organization. The management of working capital involves inventories, accounts receivable and payable, and cash



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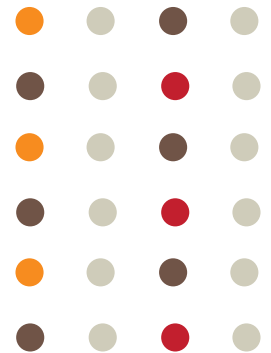
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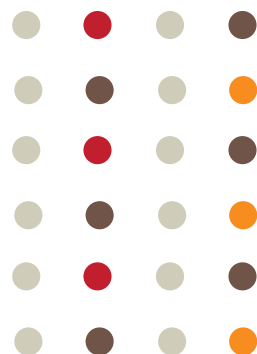
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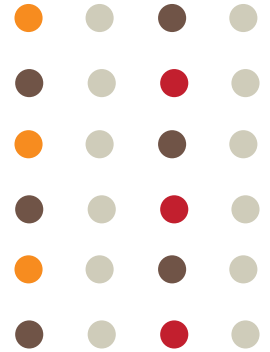
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