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A New View of Finance Program Evaluation

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A New View of Finance Program Evaluation

by

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THE VALUE OF FINANCIAL SERVICES TO THE ECONOMY AND TO CLIENTS

This paper addresses the evaluation of projects that offer financial services — credit and savings — to poor clients and microenterprises. The paper presents a framework for evaluating financial services programs that is in keeping with our current understanding of the role of finance in economic development and best practice in financial development programs. To show why such a framework is needed and how it differs from prevailing methods, the paper summarizes the major debate about finance programs and explains how that debate has been resolved. The paper then presents the evaluation framework itself.

During recent years, development institutions have adopted a new view of credit and finance programs. This new view replaces an older approach in which programs funnelled credit to particular economic groups, using whatever institution offered the most competent delivery mechanism. Development finance institutions, discounted lines of credit, and nongovernmental organizations were all used to reach target groups selected by governments and donors. The targets themselves ranged from major industry to small farmers to microenterprises. Though targets and mechanisms varied widely, the programs of the older approach shared an underlying set of motivations and working principles:

- They were conceived as efforts to generate economic growth in a target group designated as crucial for national development. In a sense, they were not finance programs, but sector programs that used finance as a means of reaching the target population, predicated on the notion that they could release a binding "credit constraint."

- They assumed a static view of the mainstream financial system as failing to serve target groups and consequently sought to compensate by providing an alternative source of services.

- They were financed from donor or government funds, rather than from within the financial system.

Such programs have been a mainstay of international development for decades and can be found in nearly every country.

A critique of this approach, first articulated in the early 1970s, for example, in A.I.D.'s 1972 "Spring Review of Rural Credit," has now gained widespread enough acceptance to be considered the dominant view in the field of international development finance. Among the leading proponents of this view, and responsible for much of the literature that articulates it, have been the financial economists of the Department of Agricultural Economics and Rural Sociology at Ohio State University.

This new view takes a radically different stance on each of the three points that characterize the old view. It argues first that the causal links between receipt of credit by individual borrowers and their subsequent economic growth are indirect, credit being but one factor in an extremely complex process of decision making by enterprises and households. Financial services are valued more for their general enabling effects across whole economic sectors, rather than for the direct change induced by individual loans. Secondly, the new view argues that it is far preferable to build the capacity of the financial system than to provide a substitute for its inadequacies. By providing finance directly, often on a noncommercial basis, old-view programs reduced incentives for commercial lenders to innovate in areas where donor and government efforts already operated. Finally, the new view recognizes that in the long run financial services on a national basis cannot be funded from limited donor or government coffers, but that a healthy, sustainable financial system must be based on mobilization of resources from the citizens of the country itself and through commercial sources. In short, the new view of finance emphasizes building financial intermediation systems that offer savings and credit services on a commercially sustainable basis.[1]

As a result of this shift in thinking, some of the major donors have reduced their use of development finance institutions and lines of directed credit. Many new programs are being developed using the newer principles. However, a mix of approaches remains. At present, credit and finance programs can be found throughout the spectrum from targeted subsidized credit to pure financial system development.

Because the new view of finance is increasingly accepted as correct and is increasingly used as the basis for project design, methods of evaluation need to be rethought. For the most part, evaluations of credit programs are still based on the old-view ideas about causality. They are centered on the presumption of a direct line of causality between receipt of credit by individual borrowers and a particular desired economic response, for example changed borrower income resulting directly from receipt of a particular loan. In essence, these are still sector program evaluations, rather than evaluations of financial system development.

There are two problems with the old evaluation model. First, the focus on the direct causal response to individual loans misses much of the richness of the effects of finance, which are generally diffuse, rather than strictly linear. Second, evaluations that try to measure that response are, in effect, attempting to prove that financial services are valuable, a task that is better left to more general research that explores the relationship between the presence of a healthy financial system and economic growth. On the basis of what is already known about the value of financial services, one can be confident that wider availability of credit and savings services benefits the users, their communities, and their economic sectors. Additional knowledge about the benefits of financial services is needed but is best gathered in the context of a rigorous research effort that is not necessarily focused on individual loan programs. If program evaluations can be freed from the burden of proving that finance matters, a task for which they are not well suited, they can concentrate on evaluating the quality of the services and their institutional setting.

[1] This is a highly abbreviated description of the debate on these issues. For a full elaboration of the old and new views, see Adams, Graham, and Von Pischke.

Evaluations should use as their frame of reference the existing understanding of the role of financial services, an understanding that is now briefly explained.

From an economy-wide perspective, financial economists agree that financial institutions contribute to economic growth by performing three crucial functions:[2]

- Mobilizing a society's resources and allocating them to efficient uses (intermediation).
- Helping the economy to manage risk by diversifying it.
- Facilitating transactions — providing axle grease to the economy.

Financial services do not directly create economic opportunities. Rather, they help people and enterprises position themselves to take advantage of opportunities. In general, goals for finance programs should be specified in terms of improving the ability of financial systems to perform these three functions, or extending them to new areas or client groups. Evaluations should focus on indicators that reveal whether assisted institutions perform these basic financial functions well.

From the individual's perspective, access to financial services enables the clients to perform the following functions:

- Protect themselves and their families against bad times, by building a stock of assets or by borrowing during emergencies;
- Manage their enterprises and other activities more efficiently, for example by purchasing inventory or inputs at advantageous times and prices; and
- Obtain capital for investment.

Several further implications that are crucial for understanding how finance works. First, clients can use savings as well as credit to carry out these three functions.[3] Many people prefer to save rather than to borrow. Thus, there should be a presumption that a good finance project will involve both credit and savings (or will at least fit into a system that involves both). Secondly, any given transaction is only one event in an ongoing series of financial decisions that the client manages. Evaluators focusing on individual transactions will miss much of the real story. Thirdly, financial services are used for important functions other than growth-oriented investment, such as special family events, home improvement, or purchase of consumer durables. Planners and evaluators should understand these functions before specifying their own

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[2] World Bank, 1989, p. 25.

[3] "An Evaluation of the Institutional Aspects of Financial Institutions Development Project, Phase 1, in Indonesia," John F. Gadway, Tantri M.H. Gadway, and Jacob Sardi. GEMINI Technical Report No. 15. March 1991.

stated objectives, in order to avoid specifying objectives that do not adequately match client behavior.

Let us examine how an evaluation might be organized to build upon this understanding of the functions of financial services for individuals and for the economy.

A FRAMEWORK FOR EVALUATING FINANCE PROGRAMS

The evaluation framework described here has two levels, that of the client and that of the institution (see the box on the following page).[4] Before moving to an item-by-item discussion of the issues evaluations should examine, a few general comments are needed on the characteristics of the proposed approach.

In keeping with the emphasis on building healthy financial institutions, the new view would submit to market discipline as one of the most reliable and relevant indicators of performance. Each of the two evaluation levels is associated with a strong commercial test. The service-client relationship is best measured by a market test of demand, or willingness of clients to pay. If people pay full cost for a service on an ongoing basis, then evaluators can be sure that the service is valued at least as highly as its price. By their actions clients reveal information on the value of benefits that is more credible than verbal responses to questionnaires.

The market demand test is less valid when services are underpriced or subsidized, because the price to clients does not include the cost of the subsidy. By buying the service, clients show that they value it as much as its price, not whether they value it as much as it costs. This factor becomes more problematic the greater the subsidy.

At the level of the institution, the strong commercial test is financial self-sufficiency, the ability to cover all costs from program revenues. These two tests, which are interdependent, make finance programs "self-evaluating."[5] The tests are easily verified, and if both are passed, evaluators can be confident that the program is successful.

[4] Similarly, Yaron proposes two measures for evaluation: outreach (clients) and profitability (institutions).

[5] A term originally applied to finance programs by Henry Jackelen (Jackelen, 1989).

A Framework for Evaluating Finance Programs

I. The Client-Service Relationship

1. Number of clients, market penetration indicators

2. Characteristics of clients: gender, location, income status, sector of enterprise

B. Quality of service and alternatives

1. Market test: willingness to pay

2. Client transaction costs: convenience and timeliness

3. Service terms: price, loan sizes, maturity, collateral, access to deposits, and eligibility requirements

C. Enlarging clients' decision-making options: How the service fits into the client's financial management process: liquidity, consumption smoothing, and investment

II. Institutional Viability

A. Financial self-sufficiency of service

B. Financial condition of institution

1. Profitability or ability to break even

2. Portfolio quality

3. Liquidity

4. Capital adequacy

C. Institutional strength and context

A strict free-market evaluation might stop there, concluding that a market-based service need bear no further burden of proof than showing that it yields a solvent commercial operation. More is needed, however, whenever a government or a donor becomes involved in supporting financial programs that serve marginal clients. The fundamental purpose for their involvement is to extend the frontier of the financial sector into sustainable, profitable activities, through innovation and demonstration effects.[6] Innovation means introducing a new type of service or instrument to existing clients, introducing a new type of client to existing instruments, or both. This frontier orientation requires that evaluations concern themselves with the nature of the innovation. An evaluation should determine whether the frontiers have, in fact, shifted. This area of inquiry requires examination of the client group and the specifics of the services it receives.

In addition, evaluations should produce information that enables the financial institution to improve performance, by reaching new customers, offering better services, and operating more efficiently. Meeting this objective requires detailed information on clients — along the lines of market research — and on internal operations.

Use of such a framework blurs the traditional distinction between "management" evaluation and "impact" evaluation. Information about clients can be significant for management decisions, and indicators of institutional performance, such as cost recovery, reveal a great deal about achievement of ultimate objectives. Within the proposed framework, it does not make sense to carry out management-only evaluations, confined to operations and administration, nor to allow evaluations of the impact on clients to stray very far from the interaction between client and service.

These principles become clearer as the following sections move point by point along the organizing framework shown in the box, describing the relevant indicators and their uses at each stage.

THE CLIENT-SERVICE RELATIONSHIP

At the level of clients, evaluations should substantially resemble market research. The main point of the research would be to understand the needs, preferences, and alternatives of the clients as they relate to the use of financial services generally, and the offered services in particular. Such research should be highly useful to the institutions in refining current services and designing new ones.

6 von Pischke.

Client Outreach

Indicators of outreach include numbers of clients, together with information on their basic characteristics, such as gender, location, or type of business. Assessment of outreach responds to the strong interest that both donors and sponsors and financial institutions should have in understanding clients. If donors and sponsors want to know whether frontiers have shifted, and if institutions want to improve services, both can learn by adopting a marketing point of view that emphasizes knowing as much as possible about customers and focuses on certain customer groups. Good finance projects adopt such a perspective from the planning stage and use it throughout, just as private financial institutions survive by selecting target groups that they have a comparative advantage in serving. Knowledge of and focus on certain groups enable institutions to craft more attractive services.

Very basic outreach information (such as client location, gender, or category of business) can be incorporated into ongoing monitoring information systems, whereas more complex data is best gathered periodically through sample surveys. Two types of analysis should be performed on the outreach information to yield performance indicators. First, information on clients should be sorted to determine which categories of clients use specific types of services and which categories repay promptly and save regularly.

Second, information on clients should be compared to information about the general population of the area covered by the program, so that the program can be assessed in context. Market penetration ratios, for example, indicate whether a service is well accepted and how much growth potential it has. Estimates of the percentage of female clients relative to the percentage of women in the service area can tell a program whether it needs to make a minor adjustment or start a completely new service in order to reach women.

Quality of Service

Evaluators should judge finance programs on the quality of services they provide. This emphasis on service quality is one of the clearest departures of the evaluation approach described here from the evaluation methods most often applied to donor-assisted finance programs. Quality should be judged in a way that respects the clients' preferences and decision-making positions. The strongest and simplest test of service quality, as stated above, is willingness of clients to pay, which serves as a basic indicator of the value or benefit of the service.

This market test should be supplemented with assessments of specific service features. This line of investigation is again very close to market research, and of similar value. The starting point should be the terms of the services. These terms — loan size, maturity, collateral, group guarantees, grace period, liquidity of deposits, and the like — should each be examined in light of the preferences of the clients. For example, the length of the loan and the repayment schedule should reflect the timing of income from clients' businesses — perhaps longer for agricultural enterprises and shorter for retail establishments. Evaluators should ask whether the program has developed the right product or whether other products might have greater demand.

Another aspect of quality of service concerns transaction costs borne by clients, under the general headings of convenience and timeliness. Because transaction costs can be a high proportion of total costs of financial services, particularly for poor clients and informal enterprises, the ability to minimize them is a crucial feature of good services. Transaction costs include both out-of-pocket costs involved in obtaining services such as transport costs or legal fees and the cost of time that must be diverted from the business in order to obtain services. For example, minimizing the time between loan application and loan disbursement greatly increases the service value to clients, as the opportunities for which clients borrow are frequently very time-sensitive. Thus, time from application to disbursement is an important performance measure.

An additional concern, for both evaluators and clients, is the trade-off between service features and cost. Clients will be willing to pay more for services with desirable attributes such as low transactions costs. However, where there is limited competition, clients may be paying unnecessarily high rates, in effect subsidizing the inefficiency of the program. This appears to be the case in several well-known microenterprise credit programs.

Varying levels of competition are one reason for the requirement not to judge programs in isolation. Attributes of a service can be interpreted only when they are compared with available alternatives. Many standard finance project evaluations implicitly assume that clients have no alternative source of finance. In fact, this assumption is likely to be mistaken. As more is learned about informal financial arrangements, it is clear that alternatives are widely available. Evaluators should learn about the terms and the transaction costs associated with these alternative arrangements and should understand why and when clients select one option or another. The requirement to assess other sources of finance places a significant burden of information-gathering on evaluators, but it is an essential requirement if conclusions are to be useful.

Generally speaking, information from clients regarding their views on service attributes and alternative services will be credible, especially when compared with standard impact information such as changes in income. Clients have relatively little incentive to distort their responses. However, at present, few evaluators are familiar with techniques to elicit such information, particularly from poorer clients.

Effects on Clients' Range of Decisions

Donors and sponsors of finance programs are always intensely interested in the effect their efforts have on clients. Donors' ultimate motivation for becoming involved in finance, the new view of finance notwithstanding, remains a desire to increase the economic activity or improve the quality of life for direct clients and their families, employees, or customers. Evaluators are under great pressure to demonstrate such changes. However, the path from financial service to changed economic performance or quality of life is full of curves, bumps, forks, and even dead ends. It cannot be easily traced. The path is best understood not by examining the end points, but by taking the perspective of the client as he or she negotiates it.

Evaluators must recognize three things that appear obvious to clients. First, economic and quality-of-life decisions are affected by a wide range of factors, of which finance is one. Competition, markets, health, weather, and many other factors can all have an overwhelming direct effect. The effect of finance is not likely to be as clear-cut as the effect of these other factors. Second, clients use finance for a variety of purposes, as described above: protection against bad times, facilitating efficient business operations (liquidity), and financing investment. Third, use of financial services is not a single event, but an ongoing process involving a series of decisions and a range of alternative sources. Tracing the effect of a finance program through all of these processes will be difficult for any evaluation. Therefore, when attempting to measure the effect of finance programs on clients, evaluations must recognize the limited role of finance, and particularly of specific transactions.

It is, of course possible to distinguish the effects of any given variable, such as finance, from among a variety of contributing factors. Statistical techniques have been designed explicitly for that purpose. However, these techniques must be rigorously applied if they are to yield reliable results. Their application requires collection of data at two or more points in time, as well as the use of control groups. For the vast majority of donor-assisted finance programs, such data is too expensive to collect, and evaluators fall back on measurement of subjective responses of clients and reliance on client memories. Such subjective responses, assuming they are positive, are of value for little more than public relations purposes.

More importantly, techniques designed to control for other factors are of little value if the ultimate indicators being examined are not the most relevant ones. This happens when evaluations employ a model of the role of finance that does not reflect the way clients actually use it. Typically, the evaluation assumes that financial transactions will be used for investment, and it therefore measures changes in return on investment. All other uses of finance tend in such cases to be overlooked.

In order to avoid these pitfalls while still examining the effect of finance on clients, evaluations should stay close to the direct uses of finance. The basic question to pose is, "How has the availability of this financial service changed the clients' decisions?" In other words, "What can clients do now that was not possible without the service?" The aim is to explain how the service changed the strategies and options available to the client, and how changed financial decisions affected other economic decisions. Questions should elicit the direct and immediate uses of the services, and also determine how the stated use was filled before the service was available. Examples might focus on such changes as ability to purchase raw materials at cheaper prices or accumulation of enough savings to survive a drought year. The line of questioning may have to be as open-ended as the strategies are open to clients.[7] Rather than providing definitive "impact" results on predetermined indicators, such a line of questioning will produce results that are indicative of the nature of the effect. Although they may seem less precise, such results are more likely to be accurate reflections of what the provision of financial services actually accomplishes.

[7] See the example of Mrs. Kariuki in Von Pischke, p. 84.

INSTITUTIONAL VIABILITY

The new approach to evaluation is most novel in its client-level questions — outreach, service quality, and client options. However, a shift in perspective is needed for the institutional portion of the evaluation, away from a donor-centric examination of the use of donor funds, which is in essence an audit, to the institution and the service, particularly its financial self-sufficiency. Moreover, whereas standard financial analysis techniques can be used, they need to be adapted to the special attributes of the service, especially when the service differs significantly from standard commercial bank services.

Self-Sufficiency of the Service

The basic question at issue here is whether the service really works from a commercial point of view. Does the service have the potential to survive and expand? The answer to this question is yes only if the income from the service covers its associated costs, both direct administrative costs and financing costs. It is important to examine the service separately before turning to the question of the viability of the sponsoring institution (except when the service is the only activity of the institution). The key indicators at this level are profitability of the service and, for credit, portfolio quality. In each of these areas, an overall assessment must be made, supplemented by a more detailed analysis using ratios and other tools, to ensure that reported findings are robust and to pinpoint the sources of problems. Some of these ratios will be strictly financial, such as the ratio of loans outstanding to total assets; others will be indicators of operational efficiency, such as the average number of clients per loan officer.

One problem facing evaluators, particularly for nonbank programs, is a lack of standards for services aimed at marginal groups. Programs tend to be evaluated without reference to "industry" norms or to the achievements of well-performing institutions. Indicators such as arrears, charge-offs, and operating margins vary extremely widely from top institutions to mediocre ones, and evaluators have little guidance to determine what levels might be considered standard. For example, administrative costs as a percentage of loan portfolio can vary by a factor of two or even three among well-performing institutions serving microenterprises in different countries, because the cost structures these institutions face are so varied.

Moreover, information is often kept in a form that prevents both accurate assessment and comparison across programs, especially in the area of portfolio quality. Evaluators should expect institutions to maintain portfolio quality information that shows arrears categorized by degree of delinquency, so that they can assess accurately the proportion of the portfolio at risk. Frequently, such information is not available.

Development of industry norms can be particularly useful where competition is low. Clients should be served at prices that reflect the full cost of providing a service, but should not have to bear the consequences of inefficient service delivery. Competition can ensure that inefficient services are driven out of the marketplace, but financial services offered on the frontier typically lack competition. In the short and medium term, industry norms become crucial benchmarks of efficiency.

Financial Condition of the Institution

Just as important as knowing whether the service is viable is knowing whether it has a secure institutional base, and that requires a look at the financial condition of the institution. Methods for assessing financial condition are well established and widely known. They involve analysis of income statement and balance sheet information.

The indicators of financial condition used most often are profitability, which measures the excess of income over expenses, both on an absolute scale and in terms of return on equity; portfolio quality, which measures exposure of the institution to the risk of default; liquidity — the percentage of total assets held in liquid forms such as cash or demand deposits — which measures the ability of the institution to avoid interruption of lending due to lack of available funds, or inability to meet demand for withdrawal of deposits; and capital adequacy, which measures equity as a percentage of total assets. Financial institutions must have enough capital to ensure that investors will manage resources prudently and that the institution can weather unexpected risks.

Profitability must be assessed taking both actual costs and subsidies into account. When grants or cheap capital make an operation appear more profitable, the subsidy must be corrected for in an assessment of financial self-sufficiency. In addition, the equity (or quasi-equity for a nonprofit) of an institution must bear a cost at least equal to the rate of inflation, in order to assess whether the operation can maintain its value. Jacob Yaron has constructed what he calls the subsidy dependency index, a tool that allows comparison with other institutions.[8]

Evaluations must recognize stages in the pursuit of self-sufficiency, described in Chapter One, including a start-up stage during which the goal is for income to cover operating costs, followed by a second stage when income covers the real costs of capital at unsubsidized rates. One task is to examine which current subsidies are start-up subsidies and which are chronic. A program may be acceptable even if it has not reached viability, if it shows a convincing trend toward smaller subsidies and eventual commercial operations.

Institutional Strength and Context

Although strong financial performance indicates a strong institution, qualitative assessment must supplement the quantitative indicators, in order to gauge the institution's ability to sustain and expand achievements in the future, or adapt to challenges and changing circumstances. Internal issues such as leadership, vision, and management must be examined. For example, do the board, management, and staff share the same organizational vision? Is

[8] Yaron.

there good information flow among all levels of the organization? Are there problems of staff turnover? Does the board play an appropriate policy-making and oversight role?

External issues are also important. These issues include the image of the institution among clients, the business community, and political leaders, with analysis of potential political forces that may push the institution in various directions. They also include regulatory issues and the relation of the institution to the financial system. Examination of these qualitative questions informs decisions about future directions for the institution and its services.

SUMMARY AND CHALLENGE

Evaluations of finance programs based on the two-level framework described here will provide a clear picture of program achievements, and a useful market and service analysis for the assisted financial institution. Evaluations will conform to an appropriate vision of what finance does and how finance programs should be conceived and implemented.

Implementation of this framework faces several challenges. For example, some may argue that this framework is appropriate only for programs conceived under the new view of finance, and old view programs should be evaluated using a more traditional framework in keeping with original goals. This argument has some merit because it is unfair to program implementors to change standards midstream. However, evaluations based on the framework provided here can pave the way for a move of old-style programs toward a sounder future, if they are applied in a way that acknowledges performance vis-à-vis original goals even as they rate the program against the new goals.

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