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Microfinance clients' awareness index: A measure of awareness and skills of microfinance clients

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Abstract The promotion of financial education for poor people in developing countries calls for work on several fronts, one of which is to develop a measure to evaluate the outcome of financial education in relation to broader development goals. This paper proposes a Microfinance Clients' Awareness Index (MCAI) to determine the level of financial awareness of microfinance clients. This index is a comprehensive measure that incorporates information on several aspects of financial awareness in one single number lying between 1 and 2, where 1 denotes complete ignorance and 2 indicates complete financial awareness of the microfinance product.

Introduction

Financial services for the poor, often referred to as microfinance, cannot solve all the problems caused by poverty but can help put resources and power into the hands of poor and low income people themselves, letting them make everyday decisions and chart their own paths out of poverty.

However, low levels of money management knowledge deter clients and potential clients of microfinance from understanding and utilising the range of products and services available. Choosing from among the growing number of microfinance products and services requires a lot of information and the skills to calculate costs, project cash flow needed to make repayments, and weigh alternatives. Field experiences suggest that financial literacy is even more important with respect to insurance contracts (Cole & Fernando, 2008).

Moreover, given the increasing commercialisation of microfinance and the entry of for-profit players in this sector, financial literacy[1] is seen as a means to enhance client protection that includes the issue of fair and transparent pricing, effective communication, sensitivity to over indebting clients, and ethical behaviour of staff. Financial literacy initiatives

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[1] Organization for Economic Co-operation and Development (OECD) has defined financial education as "the process by which financial consumers/investors improve their understanding of financial products, concepts and risks, and through information, instructions and/or objective advice, develop the skills and confidence to become more aware of (financial) risks and opportunities, to make informed choices, to know where to go for help, and to take other effective actions to improve their financial well being" (OECD (Organization for Economic Co-operation and Development), 2005).

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give clients the knowledge, skills, and confidence to understand and evaluate the information they receive and empower them to purchase the financial products and services that meet their needs and those of their families (Rutledge, Annamalai, Lester, & Symonds, 2008). Arguably, although microfinance institutions (MFIs) had been providing comprehensive group training (CGT)[2] to their clients for years to help clients understand how to calculate interest owed, repayments, or basic terms of their loans or savings products, there had been no systematic efforts or curricula based on a behaviour-change approach to promoting financial literacy for microfinance clients.

The literature review reveals that there is a need for financial literacy and that there is a paucity of research that looks at current levels of financial awareness of microfinance clients (Tiwari, Khandelwal, & Ramji, 2008). It is further noticed that various indicators while used individually can provide only partial information on the financial awareness of the microfinance clients. Moreover, in India, the unified code of conduct developed by MFIN and Sa-Dhan[3] emphasise the issue of client education and specify that MFIs must have a dedicated process to raise clients' awareness of the options, choices, and responsibilities vis-à-vis financial products and services available, and MFIs must ensure regular checks on client awareness and understanding of the key terms and conditions of the products or services offered.

Therefore, there is a pressing need to have a comprehensive measure of financial awareness which might be able to incorporate information on several aspects of financial literacy, preferably in one single number. A comprehensive measure of financial awareness is useful for the following reasons, among others: 1) to compare several MFIs with respect to their clients' level of financial awareness at a particular point of time, 2) to monitor the progress of policy initiatives for financial awareness of microfinance clients in a country over a period of time, and 3) to address questions of academic interest that have been put forward in the growing literature on financial literacy.

Against this backdrop, we propose the Microfinance Client Awareness Index (MCAI), which satisfies all the above criteria of a good measure of financial awareness index. Our proposed MCAI takes values between 1 and 2, 1 indicating complete ignorance of the product and 2 indicating complete financial awareness.

Further, this index is used to answer the following key research questions:

- What is the level of financial awareness of MFI clients?
- What are the different dimensions of financial awareness?
- How can MFIs be compared with each other on the basis of these dimensions?

In this context, this study, based on survey of 320 microfinance clients conducted in the rural area of Varanasi district of eastern Uttar Pradesh, India, is an attempt to develop a composite indicator to evaluate the outcomes and impacts of financial education programmes conducted for the microfinance clients.

The paper is structured as follows: the second section gives an overview of the literature available on the evaluation of financial literacy programmes. The third section describes the framework for creation of MCAI and discusses the sample chosen for the study, while the fourth section illustrates the empirical strategy for creation of MCAI including the set of weights used. The fifth section presents the Microfinance Clients' Awareness Index and discusses scores and ranks of MFIs. It also throws light on the association between the index and its components. The sixth section discusses, broadly, the strengths, weaknesses and potential applications of the tool developed. The seventh section provides the concluding remarks. Two appendices complement the report—detailing tables, data, statistical analysis, and sample statistics.

Literature review: evaluation of financial literacy programmes

One of the big obstacles in designing research which evaluates financial literacy programmes is determining how to measure success. Although it is clear that financial education is beneficial and has a positive impact on the lives of consumers, the kind of impact and its degree are often difficult to measure. Researchers and practitioners continue to debate the rigour of various evaluation techniques and the measures (Lyons, 2005).

Lusardi and Mitchell (2011a) agree that it is important to assess financial literacy but note that in practice, exploring how people process economic information and make informed decisions about household finances are difficult to explore. However, a set of three questions first developed by Lusardi and Mitchell (2011b) for the American Health and Retirement Study (HRS) in 2004 are commonly used to test financial literacy. These questions test the understanding of three basic financial concepts: interest rate compounding, inflation, and risk diversification. The first two questions require basic numeracy skills, while the third question requires familiarity with the definition of stocks and mutual funds.

Cole and Fernando (2008) point out that financial literacy test scores are highly correlated with math test scores, suggesting that financial literacy tests may partly measure an innate or acquired ability to solve problems in general. If this is indeed the case, then teaching financial literacy may have limited effect: the more fundamental skills of addition, multiplication, and division may matter more. However, we must look for alternative measures if financial literacy is not based simply on arithmetic skills.

Gray, Cohen, and Stack (2009) listed various indicators of financial well-being used in different research studies such as reduction in financial stress, reduced amount of time spent managing financial matters, motivation to plan ahead and set a financial goal, independent financial decisions, reduced debt,

[2] During comprehensive group training, punctuality, the necessity of paying weekly instalments on time and joint liability are emphasised. Group members also learn the "member's pledge." By repeating this pledge, members promise to come to every meeting without fail, utilise the loan for the said purpose, pay in a timely manner, take group and centre responsibilities seriously (Tiwari et al., 2008).

[3] MFIN and Sa-Dhan, the two national Self-Regulatory associations of microfinance institutions in India, have collaborated to create a unified Code of Conduct for their member institutions. The Code of Conduct seeks to ensure that microfinance services are provided in a manner that are ethical and transparent and benefit clients in a holistic manner, and lay special emphasis on client protection and good governance.