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Performance Valuation of Credit Unions Having Social and Self-sustaining Aim

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Abstract

Credit unions (CUs) as finance institutions are valued by financial ratios, although they have a social aim as well. Moreover, the cooperative nature of activities should be taken into account. The paper aims to discuss the methodology for performance valuation of CUs and carry out the valuation on Lithuanian CUs example. Cost effectiveness estimated by data envelopment analysis is compared to different performance and outreach measures. The main results suggest that more cost effective credit unions are the larger ones, but efficiency is not described by other outreach measures.

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Keywords: Credit union; Microfinance institutions; Performance valuation; Outreach; Social aim; Self-sustaining aim; Lithuania.

Introduction

Credit unions (CUs) are treated as microfinance institutions (MFI) that provide microfinancial services to members, including the ones that are unbanked and may have irregular or low income. Although CUs have to satisfy the regulations in order to act as finance institutions, as liquidity, reserve capital, accountability. The concept of CU as well as MFI is changing from serving the poor to self-sustaining finance institution acting as competent market participant. Here the conception of *quality credit union* appears, although the main services involve serving lower income groups with professional financial services offering quality products. With professional services MFIs become more attractive to middle-income earners (Jones, 2008). It could be predicted that target audience would not be reached if better financial state is achieved (Cull *et al*, 2009; Hermes *et al*, 2011), but certain studies as Gutierrez-

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Nieto *et al* (2005), Louis *et al* (2013) advocate the positive relationship between social efficiency (outreach) and financial performance. Beside this, the dual target of CUs as cooperative unions should be taken into account: lower lending rates and higher deposit rates for members limit the ability to earn from interest payments. In this context the valuation of CUs as MFIs activities requires to clarify the methodology for valuation of financial self-sustainability and outreach.

Lithuanian credit unions compound slightly more than 2% of financial assets and only 5,55% of economically active population are involved in CUs (valuation of 63 CUs out of 75 by ENCU). The market width and penetration rate are low but gives the potential to CUs to balance the provision of financial services to poorly banked population and small businesses. It could be also assumed that regulatory environment and technological advances should help CUs to develop. There are still limited number of studies related to Lithuanian CUs, their activities, performance measurement and development possibilities. The main could be outlined as discussion on valuation of CUs major changes with introduction of new regulations (Levisauskaite & Rackauskas, 2013), risk management in CUs (Kaupelyte & Levisauskaite, 2005), risk valuation of CUs applying different statistical methods (Kedaitis & Zilinskas, 2013), clustering of CUs by performance (Balezentis et al, 2014) and non-parametric analysis of CUs performance (Balezentis et al, 2013). Thus the further research and recommendations would be of value for Lithuanian CUs performance improvement and clarification of CUs functions as reaching the target clients.

The main purpose of the paper is to discuss the methodology for performance valuation of CUs as microfinance institutions that have dual aims and make a sample valuation based on Lithuanian CUs. The problem for valuation is because MFIs have aims that face in different directions: social aim – to provide financial services for lower income communities, and self-sustaining aim – to be able to perform without outside assistance. Thus valuation is related to testing the efficiency of financial activities and outreach. The research was executed in three stages, the first estimates efficiency scores of CUs using data envelopment analysis (DEA), the second investigates the weight of importance of the main performance variables on CUs efficiency using regression analysis, and the third investigates the relationship of other performance and outreach measures with CUs efficiency using Spearman correlation analysis.

1. Literature review

The aim of CUs as cooperative organizations differ from other financial institutions as the shareholder and the customer are in one position. Thus there are no conflicts between depositors and borrowers as customers and owners, but the conflict between borrowing members and saving members exists (McKillop, Wilson, 2011). If decisions in typical financial institution are aimed to rise the shareholder value, in CUs the shareholder aims have to be matched with economic and social goals of customers (members). The return to members is in form of financial services at more favorable or acceptable conditions. There are limited possibilities of CU members to use their shareholder rights, except to use CUs financial services with more favorable conditions or to exit the CU. The broader discussion on ownership rights in CUs, owner involvement, participation and power may be found in Hoel (2011) report and on value proposition in Byrne & McCarthy (2014) paper. Moreover, in order to grow, CUs have one way of rising capital – attracting more members. Thus the CUs have to balance between charity to members and performance efficiency, generally paying much attention to cost effectiveness. The viability-social role conflict in CUs is addressed not only in cost and profit perspective, but also in valuation of lending conditions in order to minimize risk of default (Ralston & Wright, 2015). The sound lending practices should be applied when lending to members, but financially constrained members fall under highest risk and conditions larger write offs.

The debates of politicians as grouped by Hermes *et al* (2011) are the ones of welfarists that propagate the dominance of outreach and institutionalists that stress the importance of sustainability, but the most important are studies in fact measuring the performance and outreach as in Cull *et al* (2007), Louis *et al* (2013). More in-depth discussion on early studies of negative and positive relationship between outreach and performance may be found in Hermes *et al* (2011). In general the studies may be grouped to the ones measuring the relationship between profitability and outreach, and the ones stressing on cost effectiveness and then outreach. The most common performance ratios used are grouped in table 1 and used in further research (see more in Sollenberger, 2008). Outreach indicators used in studies differ, but the most explicit could be stressed: average loan size (per borrower; compared to GNP per capita; compared to GNP per capita of the poorest 20%), part of small loans to total portfolio,