

Workshop Report

A Glimpse at the Microfinance Industry in China

This paper was written by the China Association of Microfinance (CAM) team and is based upon input papers, presentations and discussions from the workshop “Inclusive Access to Financial Services in China: Challenges and Opportunities”.

Since the 2006 Nobel Peace Prize was awarded to a large microfinance bank, the Grameen Bank of Bangladesh, and its founder, Prof. Muhammad Yunus, microfinance has gained recognition as being an effective tool in the fight against poverty. However, although the microfinance industry is flourishing in South Asia, Latin America, Eastern Europe and Africa, it is still in an embryonic stage in China, which accounts for approximately one-fifth of the global population and, after India, has the second largest number of people living in poverty in the world.

As a result, a number of questions with regard to the current microfinance climate in China must be considered:

- Why has the microfinance industry in China thus far failed to enjoy the success and rapid growth that it has had in other countries?
- What is the potential size of the Chinese microfinance market?
- What are the challenges encountered by Chinese microfinance practitioners?
- What opportunities are available to microfinance suppliers?
- How can inclusive access to financial services be facilitated?
- What are the obstacles that international investors need to overcome?

On the 27th of February 2008, a workshop entitled “*Inclusive Access to Financial Services in China: Challenges and Opportunities*” was held in the Jianguo Garden Hotel in Beijing. The workshop was jointly sponsored by the World Microfinance Forum Geneva (WMFG) and the United Nations Development Program (UNDP), and was organized in collaboration with the China International Center for Economic and Technical Exchanges (CICETE) and the China Association of Microfinance (CAM). The event attracted approximately 100 microfinance operators, regulators, international microfinance investors, foreign and domestic financial institution representatives, and microfinance researchers and experts.

The workshop addressed the history of microfinance development, microfinance demand and supply, the general financial and legal framework in China, the function of microfinance networks, and the possible impact of new technology on microfinance growth - thus drawing a comprehensive picture of the current state of the Chinese microfinance industry. During the workshop, participants discussed and analyzed all of the above areas and reached a common understanding on important aspects of Chinese microfinance practice and the industry's prospects.

Within the Chinese microfinance industry, the principal financial product offered to clients, typically based in unbanked and underbanked rural areas, is microcredit, as opposed to microsavings, microinsurance and remittances – services which are well developed in other microfinance markets. How to define microcredit was one of the key discussion points among workshop participants. Professor Du Xiaoshan of the China Academy of Social Sciences (CASS), regarded as the “Father of Microcredit in China”, proposed to consider as microcredit all loans up to 100,000 RMB Yuan (equivalent to US\$ 14,000), provided to unbanked or underbanked clients.

1 Overview of the Microfinance Environment

1.1 The General Financial System

The current general framework of the Chinese financial system comprises banking, insurance, and securities operators, together with the relevant regulatory authorities. Such regulatory bodies include: the Central Bank (People's Bank of China - PBOC), the China Banking Regulatory Commission (CBRC), the China Insurance Regulatory Commission (CIRC), and the China Securities Regulatory Commission (CSRC).

- **Banking System:** China's banking system has total assets of US\$7.5 trillion (December 2007) and comprises: 3 policy banks (China Development Bank, Export-Import Bank of China, and the Agricultural Development Bank of China), 5 state-owned commercial banks (Bank of China, Industrial and Commercial Bank of China, China Construction Bank, Agricultural Bank of China, and Communication Bank of China), 12 shareholding commercial banks, 113 urban commercial banks, 13 rural commercial banks, 244 foreign-funded banks, 80 rural cooperative banks, 19,348 rural credit cooperatives (RCC), and 31 recently created rural financial institutions (CBRC pilot project, Village Banks, Lending Companies, and Rural Mutual Credit Cooperatives).
- **Insurance Sector:** China's insurance sector has total assets of US\$400 billion (December 2007) and comprises: 62 insurance companies, 6 insurance groups, 2 insurance asset management companies, and 1,142 professional insurance intermediary agencies.

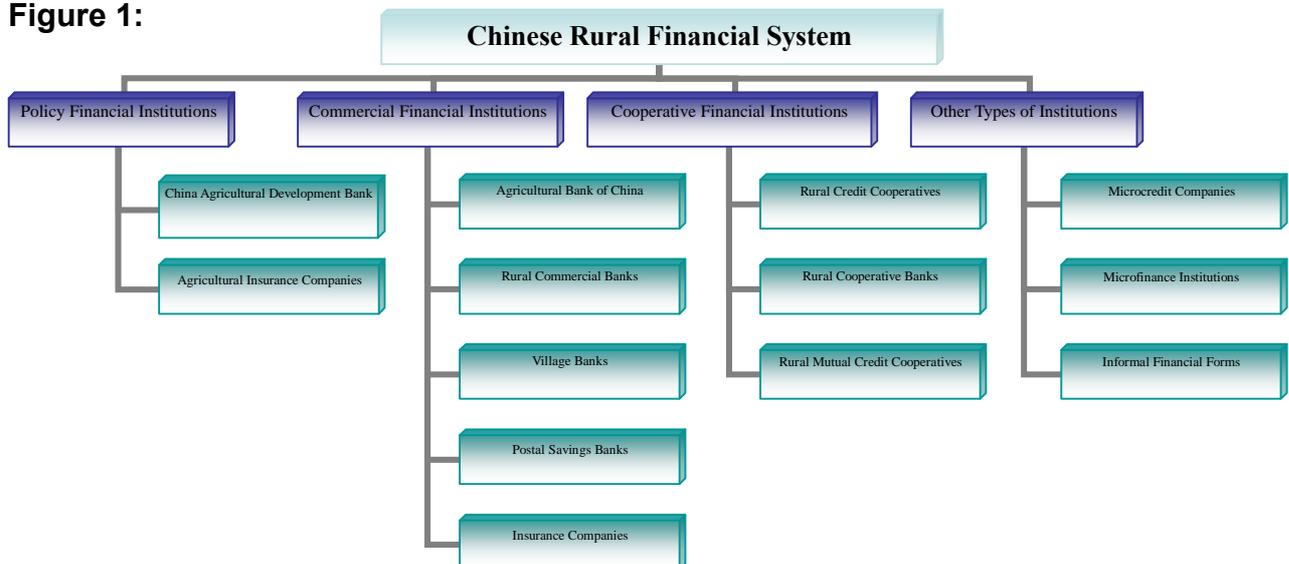
- **Securities Industry:** China’s securities industry has total assets of US\$1.1 trillion (December 2007) and comprises: 130 security companies, 42 fund management companies, 2 security exchanges, and 1 futures exchange.

In addition, the Chinese financial markets include money market, bond market, stock market, insurance market and foreign exchange market operations.

1.2 The Current Rural Financial System

According to Jiao Jinpu, the PBOC’s Deputy Director of Research, China’s current rural financial system can be illustrated in the following chart.

Figure 1:



As advocated by the United Nations in its Blue Book, the Chinese government has committed itself to continuing financial reform and the construction of an inclusive financial sector. The government has identified the current rural financial system as being fatally flawed and as a hindrance to the country’s efforts to create a harmonious society.

Renaud Meyer, Deputy Country Director of UNDP, emphasized in his workshop speech that building an inclusive financial sector is not only necessary to revitalize rural areas and to create more balanced growth in China, but is also a vital component of a well-off society and fundamental to achieving the country’s Millennium Development Goals.

1.3 The Policy and Legal Framework for Microfinance

In 2005, Prof. Du Xiaoshan of CASS gave the following summary of the development of the policy and legal framework for microfinance in China:^①

'In September 1996, the Central Committee of the Chinese Communist Party (CCP) and the State Council convened a 'high-level' meeting in order to discuss the national poverty alleviation strategy. In the meeting, an increase in poverty alleviation funds and the availability of such funds for individual villages and households was emphasized.

In February 1998, Chen Junsheng, the head of the national poverty alleviation project, stated in a national-level meeting that: "Microfinance is an effective tool to reduce poverty. We should experiment with microfinance projects in some areas and then spread these projects to other areas. The key characteristic of microfinance operations is that funds directly reach the poorest rural households and that the rate of repayment is high." As a result of the meeting it was decided to give support to provinces in order to allow the commencement, or expansion of, pilot microfinance projects.

On October 14, 1998, the 'Central Committee of the CCP on Agriculture and Rural Areas' identified the emerging necessity of ensuring that the rural poor received sufficient food and clothing. As a result it was decided to advocate the expansion of effective microfinance projects in order to ensure that poverty alleviation funds reached the hands of the rural poor. This was the first time that the effectiveness of microfinance operations in achieving these goals was recognized by the Central Committee of the CCP. The belief was reiterated during the '1999 central poverty alleviation meeting' and in the 'Ten-Year Rural Poverty Alleviation Plan (2001- 2010)'.

In July 1999, the PBOC published its 'Temporary Management Methods for RCC Microcredit Loans'. These guidelines cover loans without collateral that target individual farmers.

In January 2000, the managers responsible for overseeing the 'RCC Joint-guarantee Loan Project' examined the institutional structure of NGOs and quasi-government organizations that had implemented microfinance projects and encouraged the undertaking of practices such as: joint guarantees, forced deposits, group savings funds, installment repayments, and continuous loans.

In December 2001, the PBOC published its: 'Management Guidelines for RCC Microcredit Loans and requirements for implementing microfinance.'

In April 2004, the policy paper entitled: 'Improvement in Granting Microfinance Loans and Serving the Rural Poor', further strengthened the management, systemization, and support of RCC microfinance.'

Dr. Sun Tongquan, Deputy Director of the Citi-China Microfinance Training Center, pointed out that since 2004, consecutive Communist Party of China (CPC) No.1 policy papers have emphasized rural financial reform and innovation in financial services. The most recent changes in policy and the microfinance legal environment started to occur in 2005. The PBOC launched credit-only Microcredit Companies (MCC) pilot projects in five provinces and seven MCCs were established under the administration and supervision of local authorities. Subsequently, the PBOC published its '*Guidelines for MCCs*' in 2006, which encouraged private investors, at home and abroad, to engage in credit-only lending activities, serving unbanked and underbanked regions. However, current foreign exchange control policy impedes the inflow of foreign capital in either equity or debt form.

According to the PBOC's Jiao Jinpu, the problem regarding international investment in MCCs can be solved on a case by case basis.

In December 2006, CBRC published its '*Opinion Regarding Easing Market Access for Banking Financial Institutions in Rural Areas in order to better Support the Construction of a Socialist New Countryside*' and granted permission for the establishment of three new types of rural financial institutions: Village Banks (VB), Lending Companies (LC), and Rural Mutual Credit Cooperatives (RMCC). RMCC's are fully-licensed financial institutions and although they are regulated and prudentially supervised by the CBRC, they do not enjoy preferential policies on taxation and savings reserves, nor do they have access to the subsidies that RCCs receive.

In January 2007, the CBRC published '*Provisional Rules for the Administration of Village Banks*', '*Provisional Rules for the Administration of Lending Companies*', and '*Provisional Rules for the Administration of Rural Mutual Credit Cooperatives*'.^② In December 2006, the CBRC started pilot projects in 6 provinces before expanding the experiment to a total of 31 provinces, autonomous regions and municipalities in October 2007. To date, 31 such rural financial institutions have been created.

1.4 Policy and Legal Environment for Public-Interest Microfinance

1.4.1 Legal Status

Non-Profit Organizations

Public-interest MFIs take four different organizational forms: societal organizations, foundations, privately-run non-profit enterprises, and institutions. By law, none of these organizational forms is allowed to engage in activities that could generate a profit .

^② Rules are available on CBRC official website (www.cbrc.gov.cn)

Basis of Legality

However, public-interest MFIs are a reality and have been developing for more than ten years. The legality of their operations stems from the following three aspects:

- National policies
- International cooperative agreements
- Official approval of experiments for poverty alleviation and financial innovation

1.4.2 Financing

Equity Financing

The providers of funds to Non-Profit Organizations (NPOs) are prohibited from receiving any economic returns on their investments and from obtaining ownership of the organization. As a result, unless public-interest MFIs transform into other types of organizations, they cannot receive equity financing.

Liability Financing

There are two main types of liability financing: public savings, and loans from commercial banks. Unfortunately, these options are not feasible for public-interest MFIs.

Foreign Investment

There are two kinds of foreign investment: direct investment and indirect investment. Direct investment refers to equity investment whereas indirect investment is received in the form of loans.

As detailed above, there are legal barriers with regard to equity investment. It is possible to receive foreign loans, as long as strict guidelines are adhered to. However, the process can be extremely long and complicated.

Wholesale Funds

There is no specialized wholesale fund for microfinance in China.

Monitoring and Supervision

The China Association of Microfinance (CAM) has tried to construct a regulatory framework for public-interest MFIs. However, due to their unregistered status, CAM's guidelines have no binding power over any MFI without authorization from the government. In many ways, the poor performance of public-interest MFIs in China can be attributed to the lack of any effective and appropriate supervision.

1.5 Policy and Legal Environment for Commercial Microfinance

Ownership

The main problem with regard to ownership is connected to the limitations placed on Village Banks. The controlling shareholder, or sole shareholder, of a Village Bank is obliged to be a banking institution, and must hold at least 20 per cent of the Village Bank's total equity. This limitation on ownership prevents domestic and international non-financial institutions from investing in Village Banks.

Funding Sources

MCCs can only acquire funds, donations or wholesale funds from one source, and are not allowed to receive bank loans or to mobilize public savings.

Business Region

RCCs, VBs, LCs and MCCs are not allowed to operate outside their registered administrative region. Moreover, Village Banks can only be registered in rural areas. Although such a limitation is good for controlling financial risk within a small region, it restricts these institutions from expanding and obtaining economies of scale.

1.6 Policy and Legal Environment for Mutual Funds

RMCCs can be defined as licensed mutual funds or credit cooperatives. Mutual funds supported by governments, or created by farmers, do not have the legal status of financial institutions. Theoretically, they can apply to register as RMCCs. However, in practice, the high cost of RMCC prudential supervision prevents them from doing so. Some Mutual Funds take the form of societal or specialized cooperatives.

For the past 15 years, Chinese microfinance policy has been shaped by ad-hoc agreements and exceptions. However, the period of minimal regulation is now starting to come to an end. Dr. Sun Tongquan suggested that, if the central government wished to achieve the goal of an inclusive financial sector, it would need to build a more supportive environment for microfinance growth, including more favorable laws and regulations.^③ In this context, it was most encouraging to hear from Jiao Jinpu of the PBOC that new MCC legislation is being drafted jointly by the PBOC and CBRC, and is expected to be passed in the near future.

2 The Demand for Microfinance

In order to understand current microfinance demand in China we must consider the following questions:

- Is there demand for microfinance services in China?
- What is the potential size of this demand?
- How much of this potential demand is not currently being met?
- What sectors of the population are most lacking in access to financial services?

^③ For more information on the policy and legal environment, please refer to Sun Tongquan's workshop input paper entitled "Policy and Legal Framework for Microfinance in China".

Prof. He Guangwen discussed the questions above.

2.1 Analysis of the Potential Size of the Market

To get a first impression of the market for microfinance, it is useful to look at the number of people living in poverty. Based on the definition of living on less than one US dollar per day, there are currently approximately 130 million people living in poverty in China. If the definition of two US dollars per day is applied, this figure rises to approximately 400 million people.

An indication of the size of the market for microcredit in China can be given by looking at the number of rural households, urban laid-off workers, SMEs and microenterprises.

2.1.1 Massive rural population

At the end of 2006, there were a total of 37 thousand townships, 624 thousand villages, 4.5 million sub-villages, 740 million village dwellers, and 249 million rural households in China.

2.1.2 Huge urban registered unemployed population^④

During the reform of State Owned Enterprises (SOEs) and collective corporations, many Chinese workers were made redundant. In addition, the population of unemployed college graduates is growing and unemployment figures become even higher when also considering disabled workers and decommissioned soldiers.

The unemployment rate in China increased by 1.0% between 2005 and 2006, with the total number of unemployed increasing from 8.4 million to 8.5 million. At the end of 2006, the official unemployment rate was 4.1% (State Statistics Bureau, 2006).

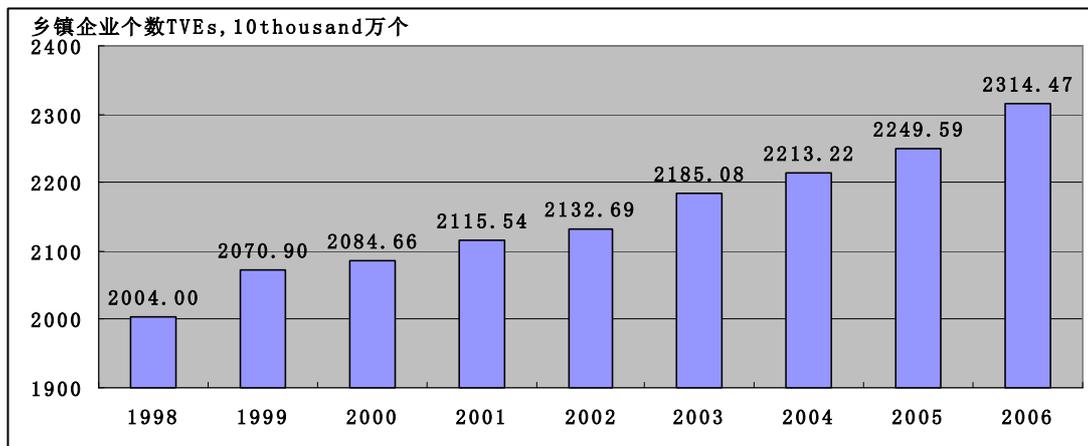
2.1.3 Large number of SMEs and microenterprises

As of the end of June, 2007, more than 42 million SMEs and microenterprises were registered with the Administration of Industry and Commerce (AIC), accounting for 99.8% of the total number of enterprises in China. Of these, 4.6 million belonged to SME proprietors and almost 38 million belonged to individual proprietors (SME Department of the National Development and Reform Commission [NDRC], 2008)

Another category to be considered is township and village enterprises (TVE), of which there were 23.1 million, employing a total of 147 million workers at the end of 2006. Some 99% of TVEs are SMEs or microenterprises.

^④ According to Chinese labor statistics, the term 'urban registered unemployed population' refers to people who are not rural residents, have laboring capacity, and who are within a certain age group (16-50 yrs for men and 16-45 yrs for women). In addition they must be unemployed, searching employment, and have registered at a local employment agency.

Figure 2: Increase in number of TVEs in China (1998-2006)



2.2 Analysis of Current Access to Financial Services

A number of case studies have helped to reveal the current situation with regard to the access of rural household and SMEs to financial services in China. From these studies the size of the unserved microfinance market can be indirectly derived.

2.2.1 Significant Rural Household Demand for Microcredit

The studies show first of all that rural households have a significant demand for funds. According to a 2003 survey conducted by a research team at the China Agricultural University via interviews with 291 rural households in Zhejiang and Ningxia provinces, the credit demand of rural households was substantial with some 64% of surveyed households expressing interest in obtaining credit and 63% of households showing interest in obtaining credit over the next two years. This figure rose to 78% of households when appropriate technical training was also included in the credit package. (He Guangwen, Li Lili, 2005a).

A 2005 survey of 502 rural households in four counties/cities in Guizhou Province, Tongren, Jiangkou, Shiqian, and Yuping, indicated that 89% of rural households expressed interest in obtaining credit. (He Guangwen, Li Lili, 2005b). Research also showed that 84% of 720 surveyed households, located in 6 counties in Tongren Prefecture (including Wanshan and Songtao), expressed interest in bank and RCC loans. Farm household loan demand did not rely on interest rates; such households would be prepared to pay high interest rates in order to receive loans. (He Guangwen, Li Lili, 2005c).

Secondly, research shows that the market share of Rural Credit Cooperatives (RCCs) is still relatively small and the remaining potential market is huge. Since early 2002, RCCs have promoted rural household microlending operations throughout the country. Based on the statistics of the People's Bank of China (PBOC), in September 2007, the number of loan clients exceeded 77 million, representing 33% of the country's 230 million rural households (PBOC, 2007). These numbers serve to illustrate that there is a large potential microfinance market.

In 2005, a survey was undertaken by a research team from the China Agricultural University in order to calculate the total number of loans disbursed by 11 township RCCs to rural households in 20 villages in Guizhou Province's Tongren, Jiangkou, Shiqian, and Yuping. The statistics from the survey show that, as of June 30th 2005, the average loan size for rural households was only 4,612 Yuan, approximately 80% of China's per capita GDP, and that only a small portion of total demand was being met. The figures also show that RCC loan supply remains limited in rural areas, with a lowest coverage rate of 17% in HX village, and confirm that there is still significant unmet demand. (He Guangwen, Li Lili, 2005b)

Thirdly, some well-executed case studies have shown that informal lending in rural areas is extremely common, indirectly illustrating the potential size of the rural microcredit market.

A 1998 study, performed by a team from the China Agricultural University, of 365 rural households in 21 counties in Zhejiang, Jiangsu, Hebei, Henan, and Shaanxi provinces, discovered that 38.4% of all loans taken-on by rural households were from formal lending channels (RCC, ABC, other banks, and non-banking financial institutions) whilst 61.6% were from informal channels (cooperative funds – 0.6%, informal lenders – 60.96%) (He Guangwen, 1999).

According to recent research, rural household and SME financing still faces major problems. Analysis of a 2003 survey, performed by the Ministry of Agriculture's 'Agricultural Economic Research Center', of 217 rural households in 18 villages of 6 counties in Anhui Province (Zhu Shouyin, 2003) revealed that, not one loan, from a total of 524, was from a commercial bank. Some 84 loans (16%) were from RCCs, whilst informal loans accounted for 79% of all loans. Informal lending accounted for 80% of the total value of loans made, while RCCs only accounted for 15%. Guo Xiaoming's 2005 survey of 243 rural households in 17 villages of 4 counties in Sichuan Province found that the proportion of loans provided by RCCs and informal lenders was 33.5% and 66.5% respectively, highlighting that the informal sector was still the main source of loan funding for rural households.

2.2.2 Enormous Market for SME Finance

Based on a 2005 survey undertaken by Zhejiang Province's SME Bureau (Wu Jiayi, 2006), only 28.7% of 592 small enterprises (at the business start-up phase and with annual sales volumes of 5 million Yuan or below) had taken loans from banks. Some 14.7% of enterprises obtained a portion of their start-up funds from informal lenders whilst 29.4% of them received funds from friends/relatives. The survey also revealed that 65.2% of the enterprises invested their own funds in their businesses, on average accounting for 50% of start up funds.

The survey indicated that, on average, loans from friends/relatives and informal lenders, banks, and private capital, accounted for 38%, 14.1% and 46.1% of small enterprise start-up capital respectively.

SMEs also have a severe shortage of funding sources to fuel business growth.

2.2.3 Huge Financing Gap for the Unemployed

Unemployed people have no stable income source and it is difficult for them to offer loan guarantees. As a result, it is extremely difficult for them to start a business or to gain reemployment. Urban commercial banks in many cities, such as the Bank of Beijing and Tianjin Commercial Bank, have initiated micro guarantee loans for unemployed workers. Local government financial departments have also set up microcredit guarantee funds through which microcredit guarantees can be provided to unemployed workers.

However, during the implementation of the project, some difficulties have been experienced. Firstly, when commercial banks offer loans, they require that borrowers provide up-front guarantees and 50% of the working capital. Secondly, the maximum loan limit is very low; normally, an individual loan, secured by the guarantee fund, does not exceed 20,000 Yuan.

2.3 Conclusions

- There is a huge demand for microfinance services in China.
- The demand varies for different sectors of the population.
- The current fulfillment of microfinance demand in China is very low. As a result a huge underserved market exists.
- The Chinese government's policy of opening-up the microfinance industry will provide excellent opportunities for investors.^⑤

3 The Supply of Microfinance

3.1 History of Microfinance Development

The development of China's microfinance industry can be divided into four phases. The first, or experimental, phase lasted from the beginning of 1994 until October 1996 and was characterized by the fact that most projects (initiated by international donors such as UNDP, UNICEF, UNFPA and implemented by organizations such as CASS and CICETE) relied on international grants and soft loans, with almost no government funds. During this phase, practitioners mainly tested the feasibility of the Grameen Bank methodology, and operated through quasi-official organizations or NGOs.

The second phase is known as the replication phase. It lasted from October 1996 to 2000. In addition to NGOs, local and national governments also started to promote microfinance, supplying financial, human and organizational resources in order to achieve the goal of poverty alleviation. At the same time, practitioners also paid attention to bringing microfinance practice in line with international best practice standards. Urban microfinance experiments, targeted towards the unemployed, were also launched during this period. However, the scale of such operations remained limited.

^⑤ For more information on the demand for microfinance, please refer to Prof. He Guangwen's workshop input paper entitled "An Analysis of the Demand for Microfinance in China"

The third phase of Chinese microfinance development, known as the expansion phase, lasted from 2000 until 2005 and began when formal rural financial institutions became involved in microfinance and the national government started to show interest in the regulatory environment. On the advice of the central bank, the People's Bank of China (PBOC), China's Rural Credit Cooperatives (RCC) launched microfinance activities, quickly expanding them and proving their ability to become the main Chinese microfinance player in the future. Meanwhile, the microfinance projects of the first two phases started to disintegrate.

The fourth phase, of commercialization, (2005-present) started when central regulatory departments encouraged non-governmental and overseas funds to engage in the experimental activities of commercial MFIs. As mentioned previously, 7 MCCs and 31 new-type rural financial institutions have been set up in accordance with PBOC and CBRC guidelines. One of the phase's characteristic features was the regulatory authorities' efforts to issue regulations to facilitate the investment of private and international funds in underdeveloped regions, in order to address financial insufficiency and inadequate competition.

The central government and the regulatory authorities have paid increasing attention to microfinance and are currently studying the relevant policy implications.

3.2 Types of Microfinance Providers

3.2.1 Comparison of Microfinance Providers

Since the first microfinance seed was planted in China, a vast number of different types of microfinance operators have appeared within the Chinese market including: NGO MFIs, the Agricultural Bank of China (ABC) and the Agricultural Development Bank of China (ADBC), RCCs, Urban Commercial Banks and Guarantee Companies (UCB & GC), Rural Financial Institutions (RFI), China Development Bank (CDB) and Harbin Commercial Bank (HCB), Microcredit Companies (MCC), Village Banks (VB), RMCCs, Lending Companies (LC), and Postal Savings Banks. These providers are described in tables 1 and 2.

Table 1. Comparison of Microcredit Providers – Clients and Products

	Type of Institution	Since	Regions	Target Clients	Traditional Collateral	Average Loan Size	Annual Interest Rate*	Savings	Remittances
1.	NGO MFIs	1993	Country-wide	Mid/ low income and poor clients	No	Several thousand	3-18%	No	No
2.	ABC	1997	Country-wide	Mid/low income and poor clients	No	Several thousand	2-3%	No	No
3.	RCCs	2000	Country-wide	All kinds of farm households	No, but yes for large loans	Several thousand – ten thousand	0.9-2.3 times basic rate	Yes	Yes
4.	Urban Commercial Banks	2002	Urban Areas	Laid-off workers	Guarantee companies	Several thousand – several tens of thousands	Basic rate but subsidized by government	Yes	Yes
5.	MCCs	2005	5 provinces	Farmers and micro-enterprises	Yes	Several thousand – hundred thousand	Around 20%	No	No
6.	Village Banks	2006	6 provinces	Farmers and micro-enterprises	Yes	Several thousand – hundred thousand	0.9-2.3 times basic rate	Yes	No
7.	RMCCs	2006	6 provinces	Member farmers and enterprises	No	Several thousand	0.9-2.3 times basic rate	Yes	No
8.	Lending companies	2006	6 provinces	Farmers and micro-enterprises	Yes	Several thousand – hundred thousand	0.9-2.3 times basic rate	No	No
9.	Poverty Alleviation Loans	2004	Country-wide	Mid/ low income and poor clients	No	Several thousand	Less than basic rate	Yes	Yes
10.	Postal Savings Banks	2007	Country-wide	All kinds of farm households	Yes	Several thousand – hundred thousand	0.9-2.3 times basic rate	Yes	Yes
11.	Microcredit Pilot Project of Commercial Banks	2005	More than 10 regions	Micro-enterprises and disadvantaged people	No	Several tens of thousands	Around 20%	Yes	Yes

Table 2. Comparison of Microcredit Providers – Performance

	Type of Institution	Number of Active Clients	Gender of Clients	Value of Loans Disbursed in Yuan	Portfolio Quality	Ability to Achieve Sustainability
1.	NGO MFIs	150 thousand	No gender limitation or mainly female clients	Billion	Uneven	A few can
2.	ABC	No information	Mainly male clients	Several tens of billions	Poor in general	Cannot
3.	RCCs	70 million	Mainly male clients	Several hundred billion	Uneven	Uneven
4.	Urban Commercial Banks	Several hundred thousand	Mainly male clients	Nearly ten billion	Uneven	Relying on subsidy
5.	MCCs	Several thousand	Mainly male clients	Several hundred millions	Good	Yes
6.	Village Banks	Several thousand	Mainly male clients	Over one hundred million	Good	Good tendency
7.	RMCCs	Several thousand	Mainly male clients	Several millions	Good in general	No
8.	Lending companies	Several thousand	Mainly male clients	Several millions	No information	No information
9.	Poverty Alleviation Loans	Several ten thousand	Mainly male clients	No figure	Mostly good	Relying on subsidy
10.	Postal Savings Banks	Several thousand	Mainly male clients	A hundred million	Good in general	Good tendency
11.	Microcredit Pilot Project of Commercial Banks	No information	Mainly male clients	Billion	Good	Yes

Of the different microfinance suppliers listed above, only NGO MFIs and MCCs are non-financial institutions and consequently not allowed to work with savings or receive funding from commercial banks – thus preventing them from enjoying economies of scale. In addition, the three newly created rural financial institution types (VBs, LCs, and RMCCs) as well as MCCs are subject to strict geographical restrictions.

3.2.2 Current Challenges Faced by Microfinance Suppliers

With regards to the challenges faced by microfinance in China, the following three types of projects will not be discussed in any detail:

- Subsidized microcredit projects for poverty alleviation developed by state-owned banks such as the Agricultural Bank of China (ABC) and the Agricultural Development Bank of China (ADBC),
- Microcredit projects implemented by urban commercial banks and guarantee companies,
- Subsidized microcredit projects for poverty alleviation implemented by rural financial institutions.

The reason for the exclusion of the above types of projects is that they rely on government subsidies and are unable to achieve financial sustainability.

This section will now discuss the problems faced by other microfinance supplier types.[®]

NGO MFIs

NGO MFIs face three major challenges:

- Lack of legal status.
- Sources of funding (insufficient funds and no normal financing channels).
- Lack of human resource capacity.

In addition, there are a number of other issues to be faced, such as: ownership and governance, internal control mechanisms, cohesion, fund management, and external supervision.

RCC Farmer Microcredit Project

RCC Farmer Microcredit projects face a number of challenges:

- Loan interest rates are set in accordance with PBOC requirements, typically 0.9-2.3 times the basic interest rate, and should be lower than the general interest rate set by PBOC.
- Repayment and operational sustainability rates vary greatly among RCCs, and include good, mediocre, and poor performers.
- Lack of desire among RCCs and their staff to implement such projects.
- Limited relevant business knowledge and management capability.
- Lack of personnel and outlets.

MCCs

MCCs face the following challenges:

- No recognized legal status (PBOC and CBRC have yet to issue an official document to recognize MCCs as financial institutions).
- No innovation or advancement in terms of loan products and methodology.
- No standard loan guidelines (some MCCs have offered loans to their own shareholders).
- Tendency towards large loan sizes .
- Conflicts among shareholders.
- No source of funding which would allow a growth in scale.

Village Banks

VBs face the following challenges:

- Control by large shareholders or traditional commercial banks.
- Large loan size.
- Loan disbursement only in region of registration.
- Difficulty in collecting deposits.
- Limited capital funds (with the exception of village banks which have CDB as controlling shareholder).

[®] For a more detailed analysis of different types of microfinance providers, please refer to Prof. Du Xiaoshan's workshop input paper entitled "The Current Supply of Microfinance in China".

Questions to be considered include:

- Is it necessary for village banks to be controlled by commercial banks?
- Can the scale of operations be expanded from counties to cities after a certain level of performance is achieved?
- Should a settlement channel for remittances be offered?
- Should effective supervision be in place?

RMCCs

The following challenges and problems are currently being faced by RMCCs and unregistered MFIs adopting village banking methodologies:

- Higher operational costs after registering.
- No preferential treatment.
- Strict requirements to meet prudential regulations (not necessary as non-prudential regulations could be adopted instead).
- Difficulty in financing (even though policy allows for the mobilization of funds).
- Poor management capacity and staff quality.
- High possibility of being controlled by privileged investors.
- Weak internal control mechanisms.
- Low internal cohesion.
- Poor operational and financial management.
- Ineffective external supervision.

Postal Savings Banks

Postal savings banks face the following challenges:

- Lack of microcredit business knowledge and management capacity.
- Poor staff quality and lack of talented employees at all levels.
- Difficulties with regard to guaranteeing loan portfolio quality.

Commercial Bank Microcredit Pilot Project

Commercial banks face the following challenges:

- Difficulty for leaders and staff to adapt their ideas in order to successfully carry out the project.
- Lack of equipment and training for qualified staff.
- Obstacles to the learning of relevant skills and knowledge in order to guarantee the success of the project.
- Doubts about the potential for microcredit projects to be expanded, and to become a leading product and major income source for commercial banks.

3.3 Dilemma in Microfinance Supply

The existence of a large number of different types of microfinance providers would seem to suggest that current microfinance supply could match the enormous demand that exists in the countryside and a number of cities. However, as stated by Professor Cheng Enjiang of ACCION International, microfinance development in China is stagnant. According to Professor Du Xiaoshan, there are two principal reasons for this. On the one hand, formal financial institutions, which have the potential to rapidly increase their number of microfinance clients, are unwilling to serve the poor and low-income population - based on 2007 CBRB statistics, there are over 8,000 townships with only one rural financial institution and over 3,000 townships without any financial institution at all. On the other hand, NGO MFIs, equipped with a social mission and great enthusiasm, encounter major bottlenecks related to their legal status, funding sources and management capacity.

At this point in the workshop, Bold Magvan, President of Xac Bank, described the transformation process of his bank from an original UNDP project to a commercial microfinance bank in Mongolia. He emphasized that the Mongolian microfinance industry as a whole experienced rapid growth due to three important factors: strong government support, active donor assistance, and favorable regulatory changes. Subsequently, workshop participants, especially microfinance practitioners, expressed their desire for more favorable regulations being issued in terms of equity and debt financing.

Nevertheless, as mentioned by Thorsten Giehler of GTZ, the regulatory environment in China has improved to some extent. Microfinance institutions have been able to create a successful microfinance model under the existing framework by strengthening their management capacity and operational innovation.

It was concluded that in order to resolve the current dilemma in microfinance supply, microfinance growth in China should be facilitated at three levels: macro, meso and micro⁷.

4 Domestic Networks and International Cooperation

International organizations and domestic microfinance networks of all kinds have an important role to play in helping the Chinese microfinance industry realize rapid and healthy development. These organizations and networks operate at the meso level, helping to bridge the gap between the macro and micro levels.

⁷ Macro level refers to policy makers and regulators, such as the PBOC, CBRC, State Council etc...; Meso level refers to networks such as CAM and wholesale funds such as CDB; Micro level refers to microfinance practitioners such as NGO MFIs, MCCs, RCCs, VBs, RMCCs, LCs, Postal Savings Banks etc...

4.1 Industry Level Network

4.1.1 History

In 2003, representatives from more than 100 domestic MFIs (mostly NGO-MFIs) attended the China Microfinance Summit, sponsored by the Ford and Citi foundations. The participants appealed for the establishment of an association of microfinance organizations in China. After the Summit, the Rural Development Institute (RDI) of the China Academy of Social Sciences (CASS, the first institution devoted to the introduction of microfinance in China), together with the China International Center for Economic & Technical Exchanges (CICETE, the manager of the largest Microfinance program in China), the Women Development Department of the All-China Women's Federation (ACWF) and the China Foundation for Poverty Alleviation (CFPA), decided to jointly initiate and create the China Association of Microfinance. CAM's principal function would be to focus on five aspects of policy: dialogue & coordination, self-regulation, communication & advocacy, training & technical assistance, and fundraising services.

According to Chinese regulations regarding the management of NGOs, each association should be subordinate to a government department. The Ministry of Commerce (MOFCOM) gave its support for the project, agreed to be the responsible government department, and to uphold the creation of the association. Later on, CICETE, the Rural Development Institute of CASS and the Women Development Department of ACWF, organized the preparation committee for the association and submitted the application to the Ministry of Civil Affairs (MOCA), via the Ministry of Commerce.

In 2004, Citi Foundation provided a five-year grant to CASS, to support the establishment of CAM.

In November 2005, CAM was created at the China Microfinance Development Conference in Beijing, with more than 100 MFIs unanimously passing the resolution to create the association and its new constitution. They also elected the administrative and standing committees and appointed the association's Secretary-General. Representatives from the People's Bank of China (PBOC) (the central bank) and the Ministry of Commerce attended the conference to show their support. After the conference, the CAM secretariat's first official action involved accepting the offer to use the facilities of CICETE and CASS. The main part of the secretariat is now based in CICETE's buildings.

4.1.2 Performance of CAM

At present CAM is the only industry level microfinance network. The network has 109 members from 24 different provinces and municipalities, including 93 NGO MFIs, 3 research institutions, 7 sub-networks, 5 financial institutions and 1 MCC. However, owing to the absence of regulations concerning the legalization of its members' credit activities, CAM has not yet been legally registered, even though PBOC and CBRC have recognized the function and activities of the network.

Since its establishment, CAM has already hosted three annual assemblies, in 2005, 2006 and 2007, and convened regular Administrative Committee meetings. In particular, the October 2006 conference created wide spread enthusiasm all over China due to the presence of Prof. Muhammad Yunus, just after he won the 2006 Nobel Peace Prize. During his three-day stay in Beijing, Professor Muhammad Yunus attended meetings with Madam Wu Xiaoling (Vice Governor of PBOC), Mr. Wang Zhaoxing (Assistant Chairman of the CBRC), Mr. Liu Jian (Director General of the State Council's Leading Group Office for Poverty Alleviation), Mr. Li Zhaoxing (Minister of Foreign Affairs - MFA), and Mr. Yi Xiaozhun (Vice Minister of Commerce - MOFCOM). Dr. Yunus' talks with senior officials proved fruitful and ended positively, with the issuing of new CBRC regulations two months later - a remarkable breakthrough with regard to the microfinance regulatory framework.

Thanks to the meetings described above, the regulatory environment has become much more friendly with regard to microfinance development, and public consciousness regarding the effectiveness of microfinance in poverty alleviation has been significantly increased – a development which will help the microfinance industry to grow in the future.

In addition, CAM has conducted other service activities for its members, including the creation of self-regulation guidelines, technical assistance and training, communication and lobbying, and fundraising services.

4.1.3 Challenges

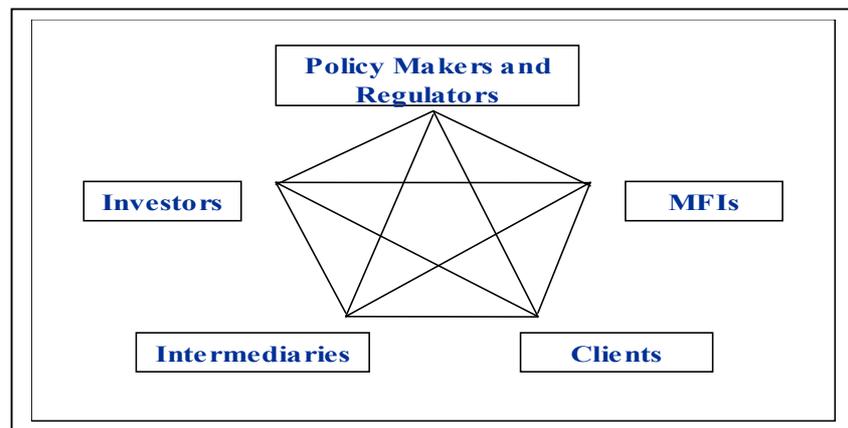
- **Legal status:** CAM has not yet been legally registered due to the fact that the majority of its members provide credit illegally.
- **Ownership:** Members are not obliged to pay membership fees due to the fact that CAM has not yet been registered.
- **Governance:** Although CAM has its own administrative committee, in reality CASS and CICETE are the association's real governing bodies.
- **Sources of funds:** CAM is dependent upon a grant from Citi Foundation.
- **Capacity:** Constrained by the above problems, CAM cannot provide all of the services requested by its members. The association's contributions to the microfinance industry as a whole are also limited.

In addition to CAM, a number of other sub-networks are also functioning. These networks are based on projects by, among others, CASS, CICETE/UNDP, CFPA, MOFCOM/UNICEF/UNFPA, ACWF, Trade Union, Hope International, Plan International, CDB and PBOC MCCs. Some of these projects have joined CAM as member institutions.

4.2 New Cooperation Patterns for an Inclusive Financial Sector

At the end of his workshop presentation, Bai Chengyu, Secretary General of CAM,[®] gave an overview of all stakeholders in an inclusive financial sector (Figure 3).

Figure 3: Stakeholders in an Inclusive Financial Sector



Furthermore, he described three cooperation patterns, each involving a subset of these stakeholders:

- Upgrading of NGO MFIs,
- Downscaling of commercial banks,
- Building of green-field microfinance institutions.

Mr. Bai Chengyu then proposed that a national committee for an inclusive financial sector, consisting of all stakeholders, be created in order to promote the improvement of the regulatory environment through dialogue and research. At the same time, wholesale or apex funds should be established in order to deal with microfinance practitioners' shortage of funding.

As NGO MFIs have taken a lead in microfinance operations and have encountered significant obstacles in China, the creation of new cooperation patterns should be to their advantage. For instance, cooperation should encourage commercial banks to work with NGO MFIs, which typically possess valuable experience and branch networks. Commercial banks should be encouraged to entrust NGO MFIs as retail partners with regard to loan delivery and collection. Such cooperation should lead to the commercialization or take-over of well performing NGO MFIs.

In fact, UNDP and its Chinese partners are about to launch a new program to develop commercially viable microfinance institutions which serve lower market segments in a sustainable way, with the aim of eventually creating a more inclusive Chinese financial sector. Two components of this program are very similar to Bai Chengyu's proposal, mentioned above: the formation of a national committee with

[®] For more information on networks and cooperation patterns, please refer to "Networks and Cooperation Patterns of Microfinance in China" by Bai Chengyu.

the objective of making a national strategic plan for an inclusive financial sector in China, and the establishment of a competitive fund to catalyze the growth of promising MFIs via a comprehensive package of support.

During the workshop, Bold Magvan of Xac Bank shared Mongolia's success in taking full advantage of such a national committee and of international cooperation to accelerate the healthy and rapid growth of the country's microfinance industry. In addition, representatives of ASA (Bangladesh) and GTZ said that what is most important for Chinese microfinance operators, in terms of international cooperation, is how to convert available international experience and resources into reality, so that various types of microfinance products and services can be delivered on the ground. In conclusion, Bai Chengyu pointed out how international organizations planted the first microfinance seeds in China and made a great contribution to the development of the industry. With the support of international cooperation, domestic networks can bear more responsibility and play a more important role in building an inclusive Chinese financial sector[®].

5 Possible Impact of New Technology

With continuous financial innovation and new technological development in countries with a relatively mature microfinance industry, mobile banking has become a key force in increasing the efficiency and enlarging the coverage of the microfinance industry. However, the following questions remain unanswered:

- What implications will such new technology have in China?
- What is the possible impact of mobile banking on microfinance?
- Are there any obstacles?

5.1 Potential of Mobile Banking in China

Reform and the opening up of the economy in 1978 meant that, by 2000, China had achieved rapid economic growth. However, rural development lagged behind in terms of infrastructure, education, financial services, medical care, and telecommunications. In order to improve the livelihoods of the rural population, significant government support and aid was required in the form of a series of measures, including the modernization of the agricultural industry and countryside. Compared with urban areas, telecommunication infrastructure was almost non-existent in China's vast rural regions, resulting in communication difficulties for the rural population. Therefore, six telecom operators started a village-connect program in January 2004. By 2007, 99.5% of Chinese villages had access to telecom services, and 98.8% of villages (97% of the rural population) were connected to the mobile phone network, thereby ensuring a solid basis for mobile banking delivery.

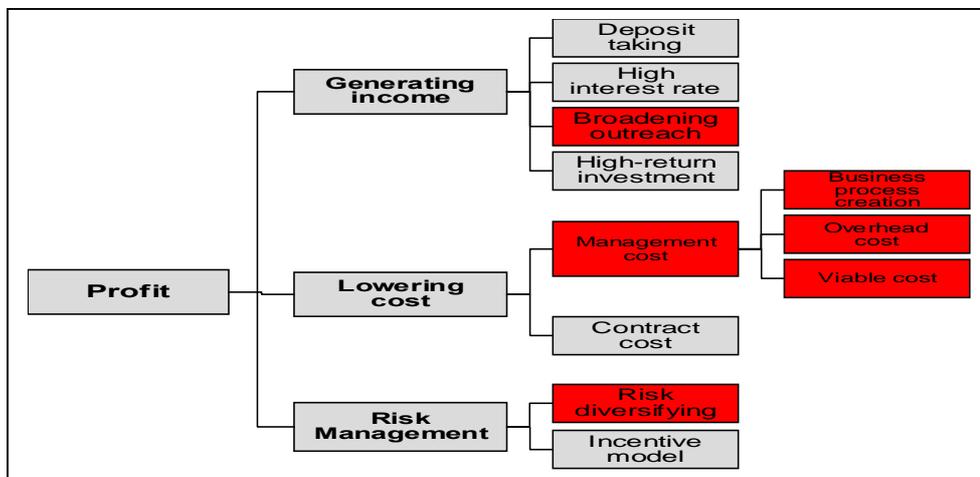
[®] For more information, please refer to Bai Chengyu's workshop input paper entitled "Networks and Cooperation Patterns in Microfinance in China".

China has now become the world's largest mobile telecom market in terms of subscriber base, thereby creating great potential for the delivery of mobile banking in rural areas. There were over 150 million rural subscribers in 2007 and this figure is projected to increase to over 200 million in 2009 - an average of one mobile phone per house hold.

5.2 Impact & Challenges of Mobile Banking

If the rich distribution channels and existing information platform of telecom operators can be employed by MFIs, they will be able to enhance operational efficiency, reduce management costs, increase outreach, and achieve sustainability by renewing their profit model.

Figure 4: Profit Model Improved by New Technology



According to Tao Yong, Director of SDR, new technology such as mobile banking will help to ensure that the microfinance industry will be flourishing in the near future and will enable MFIs to take a significant step towards sustainability in China.

However, Xu Weichang of IFC pointed out that, although mobile banking has successfully been adopted by some African countries with sparsely-located populations and a wide coverage of mobile networks, it may take some time to find solutions to a number of problems in China. Also, many MFIs in China are restricted to operating within a certain region and would therefore be unable to profit from the dramatic expansion in outreach that mobile banking would offer.

The realization of the significant effect that mobile banking could have on the development of the Chinese microfinance industry generated lively debate amongst all workshop participants.

6 Foreign Investor Perspective

According to the CBRC website, there are an average of 55 banking financial institution branches in each county in China, 30% of which are concentrated in urban areas. Although there is an average of 3.69 branches in each town, some 3,306 towns have no branch at all. Moreover, there are 2 counties and 8,213 towns with only one branch. Based on PBOC data, approximately 33% of farming households have access to loans from formal financial institutions. However, in some areas, only 5% have such access (Jiao Jinpu, Yang Jun 2006). Loans granted by RCCs to farming households account for 90% of all loans from financial institutions. In addition, it should be mentioned that there is a huge difference between supply and demand side statistics. According to supplier statistics (i.e. statistics from the banking system), between 2000-2003, the average loan size of farmers was 227 Yuan. However, demand side statistics, collected by a national countryside social and economic investigation team, shows that, between 2000-2003, each farmer borrowed an average of only 65 Yuan from banks and RCCs each year. Even considering factors such as delinquent loans, the farmer loan size reported by RCCs is almost three times as high as that reported by farmers. In 2004, the average farmer loan size was reported as being only 14 Yuan in poor counties (Wu Guobao 2006).

Currently, foreign investors keen to invest in microfinance in China can consider a number of potential institutions, including NGO MFIs, MCCs, RCCs, and Village Banks etc. There are fewer opportunities for foreign investment in microfinance projects subsidized by government funds, microcredit operations developed by the Agricultural Bank of China, Postal Savings Banks, and Urban Commercial Banks, because they do not lack access to funds. Nevertheless, foreign organizations can become strategic partners of these banks. Another option for foreign investors is to establish solely-funded microfinance banks or MCCs.

6.1 Investment in NGO MFIs

Government, NGOs, international organizations, and academia are all potential investors in NGO MFIs. In terms of legal regulations, there is no problem for foreign investors to make equity investments in, merge with or acquire NGO MFIs. However, according to the present provisions of the Chinese government, NGOs are officially prohibited from receiving loans. Despite this fact, some commercial banks have provided loans to associations. Another option for providing funds to NGO MFIs is to create a public interest trust fund and entrust NGO MFIs to disburse loans.

Advantages of investing in NGO MFIs include the fact that access is relatively easy. NGO MFIs tend to target the lowest market segments and through them investors can extend the outreach of their operations.

Disadvantages include the lack of clarity concerning the ownership and governance of NGO MFIs, and the potential conflict in objectives and institutional vision. In addition, NGO MFI staff quality and management capacity can often be poor, the transfer of assets and liabilities may be difficult, and if NGO MFIs receive fixed income investments, they cannot accept high interest rates.

6.2 Investment in MCCs

Enterprises, individuals and international organizations are all involved in investment in MCCs. In pilot provinces such as Inner Mongolia and Guizhou, foreign investors have been allowed to engage in setting up solely-funded or joint-venture MCCs, and one foreign-funded MCC has been established in Sichuan. However, laws and regulations regarding foreign investment in other provinces are unclear. There is no specific provision for fixed income investment in MCCs and the CBRC and PBOC are currently working on how best to solve the MCC funding issue. However, so far they have produced no accurate information or guidelines. Based on available information, MCCs can comprise individuals, enterprises and other civil society organizations. By law, any investment cannot exceed 50% of the institution's registered capital.

Advantages with regard to investing in MCCs include the fact that such investments are often easier to make because many MCCs have already been established. In addition, the profit margin of MCCs is often larger than that of NGO MFIs; many MCCs register a profit in their first year of operations.

Disadvantages include the fact that it is difficult to have a controlling equity stake as investors are restricted to being ordinary shareholders. In addition, the scope of the business is limited to credit services rather than a full range of products.

6.3 Investment in RCCs

Government, financial institutions and international organizations are all involved in RCC investment. Although current regulations allow equity and fixed income investments in RCCs, such investments can only be made upon the approval of the provincial RCC Union and the provincial CBRC. Individual organizations cannot hold more than 20% of total capital, and shares of multiple investors should not exceed 25% in total.

Advantages with regard to investing in RCCs include the fact that RCCs are allowed to undertake all kinds of banking business.

Disadvantages include the fact that there is no precedent of foreign investment in RCCs. Investors should select RCCs with a compatible vision, acceptable operational principles and good performance.

6.4 Investment in Village Banks

Financial institutions, enterprises and individuals are involved in investment in Village Banks. With regard to laws and regulations, registered foreign banks in China can set up solely-funded or joint-venture village banks and non-banking foreign organizations can take stakes in the form of equity or debt. However, the equity stake of a foreign investor must not exceed 10%.

Advantages with regard to investing in Village Banks include the fact that all kinds of banking business are allowed, and the profit margin is potentially large. Some reports suggest that a number of Village Banks are already profitable.

Disadvantages include the fact that Village Banks are restricted to only operating within the county in which they are registered, thereby preventing the expansion and the possibility of realizing economies of scale.

6.5 Establishment of Solely-funded Village Banks and MCCs

International organizations and financial institutions are involved in the establishment of solely-funded Village Banks and MCCs. Examples of such investments include HSBC Zengdu Village Bank, created by HSBC in Suizhou, Hubei Province, and Microcred Nanchong, jointly created by Microcred France, IFC, KFW and AGI in Sichuan Province.

The establishment of Village Banks depends on the regulatory framework in place. The establishment of MCCs requires the approval of the provincial governor in charge of finance, the provincial finance office or the provincial PBOC. Due to the nature of foreign-funded companies, investors should obtain the approval of the local Ministry of Commerce (MOFCOM) for investments of less than 50 million Yuan or the provincial MOFCOM and the foreign exchange bureau for investments involving sums over 50 million Yuan.

Advantages with regard to establishing a solely-funded Village Bank or MCC include the fact that there is a legal framework in place to enable such investments and the cost of collaboration with local government is low. In return, Village Banks and MCCs can profit from the expertise and the resources of a foreign-funded group.

Disadvantages include the fact that it is difficult for foreign investors to adapt to doing business in China and that it is difficult to compete with local institutions.

6.6 Future Development of Microfinance in China

It can be expected that new policies and regulations, favorable to MFIs, will be implemented in the near future, thus increasing the likelihood of success. Examples of such changes include:

- New MFIs being able to operate outside the region in which they are registered,
- Commercial banks not being obliged to be controlling shareholders of Village Banks,
- Microcredit businesses being allowed to collaborate with microinsurance companies.

In addition, it is likely that policies which support public-interest MFIs, such as the establishment of a special wholesale fund, will be implemented. Also, it is possible that a Management Ordinance for Lenders will be issued. Such a development would enable private funds to access the financial sector and become new lenders or microfinance suppliers. It is also possible that controlling equity groups may be established in future.

Currently, the main microfinance providers in China are RCCs, Postal Savings Banks and the Agricultural Bank of China. These institutions owe their leading positions to the support they have received in the form of national policies, laws and regulations. However, with the expected increase in support and implementation of favorable policies and regulations, other MFIs, such as MCCs, VBs and NGO MFIs, will also have good prospects.

In addition, the CBRC is said to be considering a further loosening of rules governing investment in rural financial institutions in underdeveloped areas. More specifically, changes would be made to the current limitations in three particular areas:

- Maximum stake each investor may hold (present limit is 20%),
- Area in which MFIs may operate (beyond the present region),
- Funding channels (allowing local government, initiators and shareholders to invest).

7 Conclusion

Although the Chinese microfinance industry has been developing for the last fifteen years, few microfinance institutions have achieved sustainability. However, as discussed during the workshop, there is a huge demand for microfinance services within China. Current supply does not even begin to meet this demand and as a result, policy makers and regulators, in collaboration with domestic networks and international organizations, are making significant efforts to improve microfinance supply at the macro, meso and micro levels.

As stated by Renaud Meyer in his opening speech and numerous microfinance stakeholders, we believe that a few trailblazers can fundamentally change how the Chinese financial market is perceived both at home and abroad, and usher in a prosperous new era for the sector and its clients, leading to the formation of an inclusive financial sector in China.

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