# CHINA CITY COMMERCIAL BANKS:

## OPPORTUNITY FOR MICROFINANCE DELIVERY?


prepared by

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## Introduction

This brief was originally prepared as an introduction to a review of Chinese City Commercial Banks (CCBs) commissioned by the Consultative Group to Assist the Poor (CGAP) in cooperation with the China Project Development Facility (CPDF) of the International Finance Corporation (IFC) in order to determine the suitability of CCBs for participation in CGAP's Retail Advisory Service (RAS) program. The RAS program seeks to promote the commercialization of microfinance through support to banks interested to provide financial services to microenterprises. It is offered here to provide introductory background regarding CCBs and consideration of their applicability for the delivery of microfinance services in China.

The review was undertaken during October of 2005 and involved the examination of external sources and interviews with staff and management of CCBs at various locations in China. The brief begins with a short look at the history of the microfinance movement in China, continues with a presentation of general information regarding the Chinese banking sector and CCBs, and closes with conclusions regarding CCBs as a possible opportunity for the delivery of microfinance services.

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## Microfinance in China

While strong economic growth in China has succeeded in significantly reducing poverty over the past quarter century, the World Bank estimates that more than 120 million people currently live on less than one dollar per day. Microfinance has been promoted and employed by government and international donor organizations in China as a means to address poverty alleviation and employment generation. Most programs have been carried out in rural areas in the poorer Western and Central areas of the country. The history of the microfinance movement in China began in 1994 and can be divided into the following three phases.[2]

1. An **experimental** phase between **1994 and 1996** characterized by projects funded by international grants and soft loans, which tested the feasibility of group lending methodologies, and were managed by non-governmental organizations (**NGOs**), mass organizations, research

[2] Du Xiaoshan, 2005

institutes, and other non-profit organizations in China. These programs involved approximately $20 million in funding, made loans of between $125 and $800, charged interest rates averaging 8%, often involved a compulsory savings component, and targeted poor households.[3]

2. An **expansion** phase from **1996 to 2000** when **government** agencies – initially funded and operated through the Poverty Alleviation Fund and later in cooperation with the Agricultural Bank of China – began to use microfinance as a tool for poverty alleviation and employment generation. With loan sizes and targeted poor similar to the first phase, these government run programs involved approximately $75 million in funding, and charged subsidized interest rates of 3% (per annum, flat).[4] Also during this period, some NGO managed programs were introduced to international microfinance best practice principles.

3. In addition to the initiatives begun in the previous phases, from the year **2000 to the present** Rural Credit Cooperatives (**RCCs**) have undergone a reform process and have been encouraged to increase access to credit in rural areas.[5] Also during this period the national government began to address regulatory issues relevant to the microfinance industry, while many of the programs established during the first two phases began to disintegrate.[6]

Still at an early stage in its development, neither the central government nor its supervisory agencies have yet to finalize a comprehensive and integrated approach for the promotion, regulation, and supervision of the microfinance industry. A certain measure of ambiguity at this stage of development may be conducive to fostering innovation. However, given the Chinese context, it will be necessary to clarify the ground rules for the emerging industry and provide a legal and regulatory framework for financial service providers to serve low-income clients. Efforts to legitimize existing best practice programs will encourage their expansion, while at the same time attracting new players to enter the field. This will be crucial if the sector is to satisfy the vast demand for microfinance services in China.

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[3] Sun Ruo Mei, 2003

[4] Ibid

[5] In December of 2001, the PBOC issued "Guidance for the Management of RCC's Micro-loan Program" which encouraged RCC's to initiate micro-loan programs at village and township level. Additional issuances regarding RCC's and microfinance including "Tempororary Provisions for Management of RCC's Micro-loan Program" (1999), and "Guidance for the Management of RC's Liability-group Loan" (2000). Sun Ruo Mei, 2003.

[6] Du Xiaoshan, 2005

*NGO Microfinance*

While Chinese law prohibits non-financial institutions from providing financial services to the public, NGOs have been given rather tenuous informal permission to practice microfinance in the interests of alleviating poverty. Although the government's interest in microfinance has been increasing – as evidenced by 2005's "Document #1" of the Central Committee of the CCP and the State Department, which calls for the formulation of regulations to support the development of microfinance institutions – these institutions currently remain unlicensed and unsupervised by any government body. The uncertainty caused by this ambiguous regulatory environment constrains the development and long-term sustainability of microfinance NGOs. Because these NGOs seem to lack permanence, it becomes difficult to attract quality staff and long-term funding, as well as negatively affecting repayment behavior.[7]

Microfinance NGOs in China are prohibited from capturing deposits. Moreover, because these NGOs are not licensed, nor do they possess any legal status, commercial banks are prohibited from lending to microfinance institutions. Consequently, microfinance NGOs have been funded through grants (for loan capital and operational expenses) from international donors[8] and the government. Such grant funding has proven to be unstable and limits the sustainable development and expansion of microfinance NGOs.

Despite these limitations, microfinance NGOs have extended loans totaling over RMB[9] 1 billion (average RMB 3,000) through some 300 programs (currently managing approximately $50 million in funding) to tens of thousands of clients.[10] The most prominent programs have included the following:

- China Foundation for Poverty Alleviation (CFPA) funded by the World Bank (and others).
- Funding the Poor Cooperative (FPC) funded by the Ford Foundation, Grameen Trust and Canada Fund and administered by Rural Development Institute (RDI) of the Chinese Academy of Social Sciences (CASS).
- Sustainable Microfinance Assistance for the Poor (SMAP) funded by UNDP. Managed by CICETE, this project funded several MFIs and provided technical assistance.

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[7] Ibid

[8] See "International Groups Active in China" on the Microfinance Gateway's "Microfinance in China: Re-awakening the Dragon"

[9] Exchange Rate RMB 8.2 : $US 1

[10] Duval, Goodwin-Groen, 2004, Microfinance Gateway, 2005

- Qinghai Agricultural Bank Microfinance Program funded by Agricultural Bank of China (ABC) and supported by Ausaid.

Most Chinese microfinance NGOs employ the Grameen group lending methodology. These microfinance programs have succeeded in demonstrating that despite relatively high interest rates, loans to poor households can be expected to be repaid. In addition some microfinance programs have been able to achieve financial sustainability.[11] Unfortunately, most microfinance NGOs have been constrained by limited capital and institutional capacity, as well as a lacking legal recognition. Often, programs which are operated as experiments or projects discontinue when donor funding runs out.[12]

### *Governmental Microfinance Programs*

Microfinance programs supported by the government serve hundreds of thousands of clients and now manage over one billion dollars of fiscal funding. However, due to inadequate training, as well as a lack of appropriate incentives and oversight, these programs have performed poorly. Accordingly, it is anticipated that many of these programs will be phased out.[13]

### *Rural Credit Cooperatives*

RCC's possess an extensive branch network in China's rural areas and are the most important source of financial services for the rural and agricultural economy. At the end of 2003, China had over 34,000 RCCs with outstanding loans of RMB 842.4 billion.[14] Efforts have been made to reform recognized deficiencies in the RCC system through the clarification of ownership structures, transformation of operating mechanisms, and the write-off of historical losses. In addition, the People's Bank of China (PBOC) has issued various regulations to support RCC efforts to expand services and outreach including the extension of refinancing facilities. The PBOC has also approved the development of specialized loan products such as "**trust**" loans (uncollateralized credit loans of between $125 and $6,000)[15] which are granted based upon an evaluation of a household's credit-worthiness, and **joint liability loans** (group loans). By end 2002, RCC's had outstanding portfolios of RMB 75 billion worth of "trust" loans,

[11] Park, Ren, Wang, 2003

[12] PlanetFinance, 2004

[13] Ibid

[14] Sun Ruo Mei, 2003

[15] Ibid

and RMB 25 billion in joint liability loans.[16] In total, RCCs are reported to have provided $13 billion of microloans to millions of borrowers through more than 15,000 of its branches.[17] This represents significantly more than has been achieved by the NGOs and government supported microfinance programs.

### *Commercial Banks*

While the overall effectiveness of initiatives to meet demand for microfinance has been limited, it is only recently that banks have begun to consider this market. Although the government has encouraged commercial banks to diversify into microfinance, these financial institutions are overwhelmingly oriented toward serving larger Small and Medium Enterprises (SMEs) and state owned enterprises (SOEs). Despite the shortcomings of the banking sector in general (see below), commercial banks possess significant resources which could be mobilized to the benefit of the microfinance industry. Unfortunately, government subsidization of microfinance has created the perception among commercial bankers that microfinance is merely a poverty alleviation tool, rather than a commercially viable market opportunity. However, it is notable that a number of initiatives have served to link microfinance programs with CCBs. For example, **Tianjin City Commercial Bank** extends loans to borrowers which have been pre-selected and guaranteed by the Tianjin Women's Federation, and **Jilin City Commercial Bank** extends loans to laid-off workers which have been screened and trained by the local Ministry of Labour and Social Security as part of a program promoted by the International Labour Organisation (ILO) and funded by the Japanese. Continued financial sector liberalisation is anticipated to support the commercialization of the microfinance sector and introduction of internationally accepted best practice including the introduction of market interest rates (see below). It has been suggested that commercialisation of the microfinance sector could involve on the one hand, increased engagement of RCCs, and on the other, urban commercial banks moving downstream to serve microenterprises and poor clients.[18]

### *Focus on SMEs*

Government authorities have paid increasing attention to the SME sector. This includes the encouragement of banks to provide financial services to these firms, especially in the case of CCBs. Earlier this year the China Bank

[16] Ibid

[17] PlanetFinance, 2004

[18] Ibid

Regulatory Commission (CBRC) issued the Guidelines on Banks’ Lending to Small Enterprises which seeks to promote lending to SMEs as a means of increasing portfolio diversification and revenue. This enlightened document promotes “best practice” in a number of areas with recommendations including:

- SME lending programs should be commercially viable and pricing should be market-based, it is recommended that banks should take advantage of liberalized interest rates.
- SME lending programs should be managed by specialized departments, policies and procedures, systems and staff.
- Remuneration of loan officers should include incentive systems based on commercial performance in accordance with business volume, profit and portfolio quality.
- SME lending programs should promote product innovation and diversified products and services.
- Credit analysis should be based on cash flow and character of the borrower; specialized information collection methods are recommended in recognition of the special characteristics of target group.
- SME lending programs should focus on the standardization of products, simplification of procedures, streamlined approval processes, and decreased processing time in order to increase efficiency and minimize costs.
- SME lending programs should employ appropriate management information systems to appropriately track loan portfolios and manage risk.

The CBRC guidelines provide the following definitions of SMEs:

**Table 1: Interim Measures for Statistical Definitions of Small Enterprises**

| Industry | Category | Unit | Below |
|---|---|---|---|
| Industrial Enterprises | Number of employees | Persons | 300 |
| | Annual sales | M RMB | 30 |
| | Total assets | M RMB | 40 |
| Construction Enterprises | Number of employees | Persons | 600 |
| | Annual sales | M RMB | 30 |
| | Total assets | M RMB | 40 |
| Wholesale | Number of employees | Persons | 100 |
| | Annual sales | MRMB | 30 |
| Retail | Number of employees | Persons | 100 |
| | Annual sales | M RMB | 10 |
| Transportation | Number of employees | Persons | 500 |
| | Annual sales | M RMB | 30 |

| | | | |
|---|---|---|---|
| Postal | Number of employees | Persons | 400 |
| | Annual sales | M RMB | 30 |
| Hotel and Restaurant | Number of employees | Persons | 400 |
| | Annual sales | M RMB | 30 |

Source: China Banking Regulatory Commission

While these parameters might be considered to be well over the threshold of most definitions of microfinance, it is nevertheless encouraging that banking authorities are promoting industry "best practice" principles for SME products while banks begin the process of "scaling down". Each bank is required to prepare its own respective strategy document for the development of financial products and services to SMEs for submission to CBRC.

### *Interest Rate Policy*

Until only recently interest rates have been restricted to a narrow range of just 30% above and below the central bank determined base rate (approximately 5.6%). This has severely constrained the ability of microfinance institutions and banks to provider microfinance services on a sustainable and commercially viable basis. However, some NGOs and quasi-government organizations have informally charged much higher effective interest rates on loans, and the RCC's have been allowed to charge as much as 50% over the base rate. While interest rates charged by theses types of programs are on average 8%, payment schedules which require installments beginning immediately after disbursement can actually double effective interest rates to as much as 16%.[19] Nevertheless, it has been estimated that effective interest rates of at least 30% per annum are required for microfinance to be fully sustainable. Since October 2004, most interest rates have been liberalised in urban areas, although rates are still capped in rural areas. Due to liquidity and competitive factors, however, banks are only slowly beginning to increase the rates they charge to their customers.

#### *Market Potential*

While an estimated 10 million poor families receive microfinance services in China,[20] the PBOC estimates that only 25% of rural households have access to formal credit.[21] Given China's huge population, and its rural concentration numbering some 900 million people, combined with the limited penetration of

[19] Park, Ren, Wang, 2003

[20] PlanetFinance, 2004

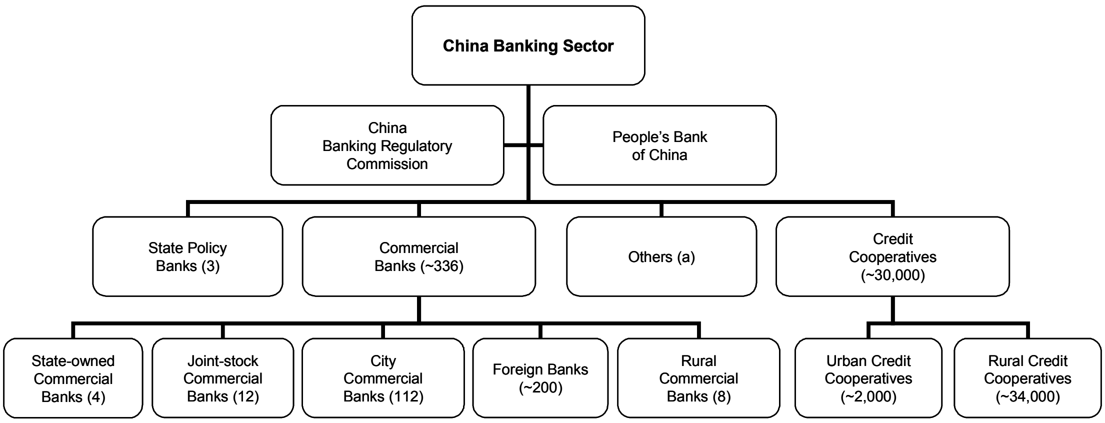
[21] CGAP, August 2005

efforts to date, the character of demand is vast. With an improved regulatory environment and the engagement of commercial banks, the microfinance industry is set for significant growth over the coming years, estimated by some to reach tens of millions of clients.[22]

## The Chinese Banking Sector

The banking sector in China is regulated by the PBOC which oversees monetary policy, clearing and settlement systems, foreign exchange and gold reserves; while the CBRC formulates and enforces regulations governing banks, asset management companies, trust and investment companies and other deposit-taking financial institutions.

**Figure 1: Chinese Banking Sector**




Source: KMPG, 2005

China's banking sector, with end 2004 assets at $3.8 trillion and $1.5 trillion in domestic savings, is considerable and has been growing at compound annual growth rates of 13% since 2000.[23] The sector is dominated by four major state-owned banks, (Agricultural Bank of China, Bank of China, China Construction Bank, and Industrial and Commercial Bank of China) which boast some 80,000 branches and hold over half of China's banking assets. The sector also includes some twelve joint-stock commercial banks which hold about fifteen percent of total assets. China's 112 CCBs together account for just five percent of total sector assets.

The problems of China's banking system are well known and include such issues as opaque ownership and governance, the dominance and influence of state-owned firms, fraud and corruption, poorly developed credit standards, and large volumes of non-performing loans. To complicate matters, low interest

[22] PlanetFinance, 2004

[23] KPMG, 2005

rates, under-developed capital markets, and easy credit during recent years have resulted in over-leveraged enterprises, particularly SMEs and SOEs. Additionally, there are concerns regarding the affects of a possible economic slowdown and pricing and valuation bubbles in the mortgage market. Motivated by the opening of the banking sector to foreign competition in 2007 (in accordance with WTO requirements), authorities have implemented measures to increase the clarity of ownership structures, governance standards, and the quality of management, as well as increasing the effectiveness of regulatory agencies. In 2001 bank asset management companies were established by the government, helping to remove some RMB 169 billion in non-performing loans from the balance sheets of the banks.

Despite significant risks, foreign banks are anxious to enter what is viewed as one of the most lucrative markets in the world. Currently foreign investors are limited to a total of 25% ownership in any bank, with a 20% limit for any single investor. While these restrictions may be relaxed over time in order to attract investment in weaker banks, “third-tier” CCBs have also become interesting targets for foreign investors.

**Table 2: Foreign Investment in Chinese Commercial Banks**

| | | Share | Inv. $m | Year |
|---|---|---|---|---|
| China Everbright Bank | ADB | 3.0% | - | 1996 |
| Shanghai Pudong Deve. Bank | Citigroup | 5.0% | 73 | 2003 |
| Industrial Bank | Hang Seng Bank | 16.0% | 208 | 2003 |
| Minsheng Bank | IFC | 1.2% | 24 | 2003 |
| Minsheng Bank | Hang Seng Bank | 8.0% | - | 2003 |
| Minsheng Bank | Temasek | - | - | 2003 |
| Bank of Communications | HSBC | 19.9% | 2,225 | 2005 |
| Shenzhen Development Bank | Newbridge Capital | 17.9% | 149 | 2004 |
| Bohai Bank | Standard Charter | 19.9% | 120 | 2005 |
| CCB | Bank of America | 9.1% | 3,000 | 2005 |
| CCB | Temasek | 5.1% | 1,400 | 2005 |
| BOC | UBS | - | 500 | 2005 |
| BOC | Royal Bank of Scotland | 10.0% | 2,500 | 2005 |
| BOC | Morgan Chase | - | - | 2005 |
| BOC | Deutsche Bank | - | - | 2005 |

| | | | | |
|---|---|---|---|---|
| BOC | Temasek | - | 1,000 | 200 5 |
| ICBC | Goldman Sachs & Allianz | - | 1,000 | 200 5 |

Source: Peter Bottelier, Associate Professor, Johns Hopkins University-SAIS, Hearing before US-China Economic and Security Review Commission, August, 2005

## China City Commercial Banks

CCBs were formed during the 1990's through the merging and restructuring of over 5,000 Urban Credit Cooperatives (UCCs). Beginning with Shenzhen CCB in 1995, some 112 CCBs have been established to date.[24] Given that UCCs were originally part of each city government's economic planning apparatus, CCBs maintain strong ties to their respective city governments which in many cases still hold large stakes (averaging 75 percent).[25] No CCB is as yet publicly listed and private investment is still limited. CCBs are mandated to serve SMEs considered to be an increasingly important sector of the economy. Consequently, CBRC figures indicate that 70% of CCB loans go to state-owned and private SMEs.

The geographic area of operations of CCBs is currently restricted to its municipal boundaries. However, CCBs are allowed to expand their activities into other geographic areas through investment in local entities in those areas, and it has been suggested that authorities will consider relaxation of these restrictions as the health of the sector improves.[26] CCBs are subject to minimal capital requirements of RMB 100 million (as compared to RMB 1 billion for joint-stock commercial banks and RMB 50 million for RCCs) and a capital adequacy ratio of 8%. Beginning in January 2006, CCBs will be required to disclose financial statements and provide relevant information regarding risk management and corporate governance to the CRBC. With branch networks averaging fifty units per CCB (although some have over 200), CCBs are frequently some of the larger banks in their markets often ranking among the top five. CCBs produce rates of return on assets averaging around one half of one percent (with few reaching one percent), still higher than the average Chinese commercial bank. CCBs over the coming years are anticipated to grow

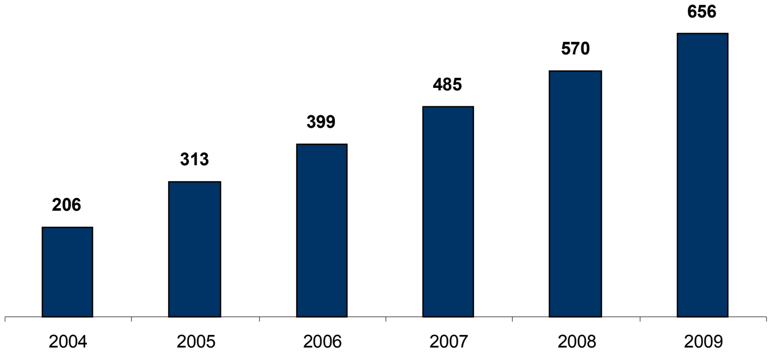
[24] KPMG, 2005 (China Business Review, December 1999, *Banking in China*,: Asian Wall Street Journal, February 2005, *City Lenders Offer Foothold For International Investors in Fast-Growing Market*)

[25] KPMG, 2005 (Development Research Center of State Council Network, February 2005, *Findings City Commercial Bank Survey*)

[26] KPMG, 2005 (China Business Weekly, July 2004, *Foreign Banks Eye Up Local Lenders*)

at a consolidated aggregate growth rate of 26% to reach total assets of $656 million by 2009.[27]

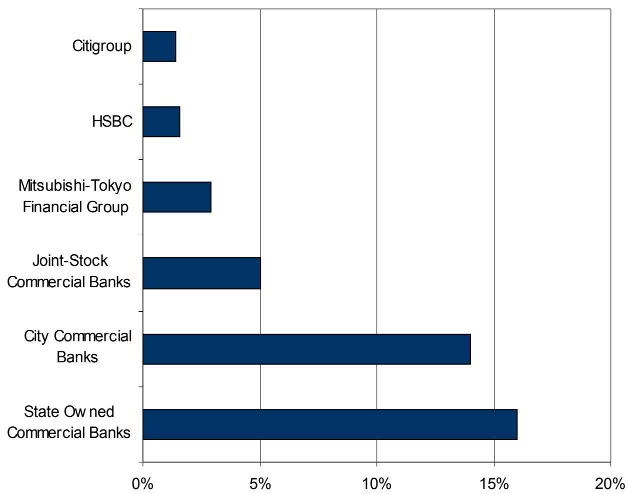
**Figure 2: Total Assets of China City Commercial Banks (US$ billion)**




Source: KPMG; CCID Consulting, "2004-2005 China City Commercial Banks Research Report" April 2005

CCBs are faced with many of the same problems which challenge the overall banking sector. Moreover, significant influence on the part of local government can have an adverse affect on lending decisions and bank management. Non-performing loan ratios for CCBs are among the highest in the industry. While some CCBs are estimated to have NPL ratios over 50%(!),[28] government pressure requiring CCBs to reduce their NPL ratios to below 15% by 2005 have resulted in a decline in average NPL ratios to 14%, down from 25% four years ago. This has been achieved through asset replacement programs, the improvement of risk management systems, and reduced government interference in loan granting decisions.

**Figure 3: NPL of Chinese Banking Sector (% of total assets)**

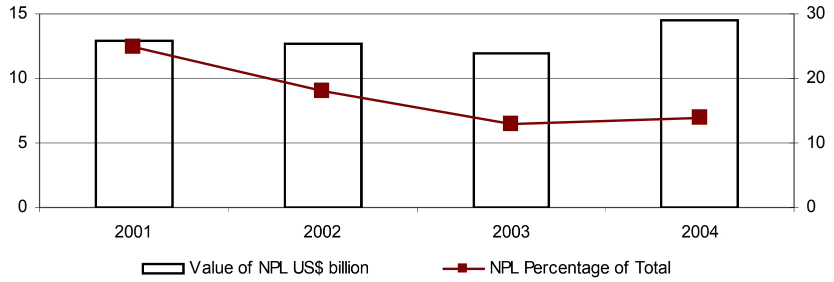



[27] KPMG, 2005 (CCID Consulting, April 2005, *City Commercial Banks Research Report*)

[28] Economist Intelligence Unit, "China financial services background," May 2005.

Source: KPMG; China Banking Regulatory Commission Website May 2005; Mitsubishi-Tokyo Financial Group Annual Report 2004; HSBC Annual Report 2004; CIBC World Markets "CitiGroup" March 2005.

**Figure 4: NPL of China City Commercial Banks (US$ billion/% of total assets)**




Source: KPMG; CCID Consulting "2004-2005 China City Commercial Banks Research Report" "April 2005

Low capital adequacy ratios and the need for capital injection are motivating CCBs to link up with foreign investors (see table above). These strategic partnerships provide CCBs not only with additional capital, but also valuable technical assistance in the development of products and the improvement of bank management and systems.

**Table 3: Foreign Investment in Chinese City Commercial Banks**

| CCB | Investor | Share | Inv. $m | Year |
|---|---|---|---|---|
| Bank of Shangai | IFC | 7.0% | 50 | 1999 |
| Bank of Shangai | HSBC | 8.0% | 63 | 2001 |
| Nanjing City Commercial Bank | IFC | 15.0% | 27 | 2002 |
| Xian City Commercial Bank | IFC | 12.5% | 20 | 2003 |
| Xian City Commercial Bank | Bank of Nova Scotia | 2.5% | 3 | 2004 |
| Jinan City Commercial Bank | Commonwealth Bank of Australia | 11.0% | 17 | 2005 |
| Hangzhou City Commercial Bank | Commonwealth Bank of Australia | 19.9% | 76 | 2005 |
| Bank of Beijing | ING | 19.9% | 215 | 2005 |
| Nanchong City Commercial Bank | DEG | 10.0% | 4 | 2005 |
| Nanchong City Commercial Bank | Sparkasse Foundation | 3.3% | 1.3 | 2005 |
| Nanjing City Commercial Bank | BNP Paribas (transfer from IFC) | 10.0% | 18 | 2005 |

Source: KPMG analysis of media reports and press releases

**Table 4: Top 20 City Commercial Banks (rating out of 100)**

| | CCB | Overall Rating | Market Share Rating | Capital Adequacy Rating | Profitability Rating | Asset Quality Rating |
|---|---|---|---|---|---|---|

| | | | | | | |
|---|---|---|---|---|---|---|
| 1 | Bank of Shaghai | 89 | 100 | 84 | 75 | 94 |
| 2 | Tianjin City Commercial Bank | 87 | 95 | 85 | 85 | 80 |
| 3 | Hangzhou City Commercial Bank | 84 | 85 | 84 | 79 | 88 |
| 4 | Bank of Beijing | 83 | 100 | 73 | 66 | 81 |
| 5 | Nanjing City Commercial Bank | 82 | 74 | 91 | 77 | 86 |
| 6 | Zhenzhen City Commercial Bank | 77 | 97 | 59 | 58 | 88 |
| 7 | Dongguan City Commercial Bank | 75 | 72 | 77 | 72 | 80 |
| 8 | Changsha City Commercial Bank | 74 | 70 | 73 | 82 | 76 |
| 9 | Xi'an City Commercial Bank | 73 | 68 | 78 | 59 | 80 |
| 10 | Hefei City Commercial Bank | 73 | 52 | 83 | 80 | 83 |
| 11 | Jinan City Commercial Bank | 73 | 61 | 79 | 55 | 92 |
| 12 | Taizhou City Commercial Bank | 72 | 47 | 77 | 84 | 87 |
| 13 | Wuxi City Commercial Bank | 70 | 68 | 74 | - | 79 |
| 14 | Shaoxing City Commercial Bank | 70 | 47 | 75 | 72 | 92 |
| 15 | Ningbo City Comercail Bank | 70 | 76 | 64 | - | 79 |
| 16 | Panzhihau City Commercial Bank | 69 | - | 90 | 87 | 77 |
| 17 | Dalian City Commercial Bank | 67 | 80 | - | 77 | 77 |
| 18 | Jiaozuo City Commercial Bank | 67 | - | 100 | 62 | 74 |
| 19 | Nanchong City Commercial Bank | 67 | - | 89 | 61 | 87 |
| 20 | Nantong City Commercial Bank | 67 | 46 | 76 | 61 | 83 |

Source: KPMG; China Financial News, "China City Commercial Banks Competitiveness Ranking: Media Release" March 2005

### CCBs: Opportunity for Microfinance Delivery?

In the scramble to position themselves in an increasingly competitive environment as the opening of the banking sector to the foreign competition fast approaches, some CCBs are currently considering the addition of microfinance services to their product offering. On the face of it, CCBs would seem to be ideal candidates for the development of microfinance programs which serve the needs of microenterprises, middle-income clients, and low-income clients while generating a healthy profit for their shareholders. CCBs offer the following advantages in support of such a proposition:

- **Local focus:** Currently (and historically) restricted to operating within their municipal boundaries, CCBs are most familiar with the characteristics of their local markets and clients, and are often the only "local" bank in their respective markets.
- **SME focus:** Mandated to serve SMEs, CCBs often possess experience, systems, and human resources which could potentially be leveraged to "downscale" its products and services to reach additional markets (microenterprises and middle- and low-income clients). Recently introduced CBRC Guidelines should strengthen CCBs' SME operations as they require the establishment of specialized departments and capacity to serve SMEs with the recognition that small firms are in fact quite different from their larger customers and therefore require a special approach (see above). A similar logical framework could feasibly be applied toward the development of viable microfinance programs.

- **Infrastructure:** CCBs possess substantial infrastructure in the form of existing branch networks, systems and human resources which could be utilized as a platform from which to offer microfinance products and services.
- **Financial resources:** Many CCBs possess excess liquidity in the form of deposits which are often invested in government securities.

Moreover, the introduction of microfinance products and services may offer the following opportunities to CCBs:

- **Market demand:** Interviews with CCB staff suggest significant unmet demand for microfinance products and services particularly in light of current restructuring of the economy in favor of large and growing numbers of private small and micro enterprises which are expected to provide increasing contributions to (and proportion of) economic activity, employment, and tax revenue. Estimates suggest that over half of getihu's (small family owned businesses) lack access to formal financial services.[29]
- **Limited competition:** While RCC's have been increasingly active in the provision of microfinance services in rural areas, practically no formal banking institutions currently serve the microfinance market in urban areas. It is estimated that over half of getihu's fund their activities through family networks and informal rotating savings arrangements.
- **Increased profitability:** Given limited competition, microenterprises and middle- and low-income clients are typically more concerned about access to (and the quality and speed of) financial services than they are regarding price. High margins and turnover allow these enterprises to justify paying the higher interest rates required for banks to not only cover their costs, but also to turn a profit.

On the other hand, interviews with the management of some CCBs also revealed a skepticism that has traditionally been displayed by formal financial institutions toward microfinance. Many CCBs have had the opportunity to "experiment" with microfinance on a very limited basis usually in response to the "encouragement" of local governments[30]. Unfortunately, these programs were not only disappointing financially (due to the imposition of subsidized interest rates), but often exhibited low repayment rates. Additional factors

[29] Interviews suggest a large demand for working capital loans averaging RMB 40 to 50 thousand, and a willingness on the part of microenterprises to pay interest at rates of 12 to 15 percent in equal installments.

[30] Each of the CCBs interviewed had taken part in government-supported (and subsidized) credit programs to extend loans to laid-off workers. Loans extended number in the dozens, the highest being two hundred.

which limit CCBs' ability to serve microenterprises (and correspondingly temper their interest) include the following:

- **Perceived high risk:** Many CCBs perceive microenteprises to be to risky.
- **High transaction costs:** Many CCBs believe that it is too costly to serve and monitor microenteprise clients.
- **Lack of expertise:** CCBs do not possess the experience and best practice methodologies required to address risk and cost issues associated with serving very large numbers of very small clients.
- **Lack of trained staff:** CCBs do not possess specially trained staff to serve microenterprises.
- **Contradictory ambitions:** Many CCBs are actually moving "upmarket" anticipating that the size of the clients served and loans offered will in fact increase as they grow.
- **Low profitability:** Reluctance to charge "market" interest rates above previously capped levels limits the ability of microfinance products to turn a profit.
- **Lack of collateral:** Microenterprises are unable to provide traditional forms of collateral and China currently lacks systems to provide quality credit information.

Indeed, in the absence of specialized technical assistance, overcoming these formidable obstacles poses a significant challenge to any CCB considering the introduction of microfinance products and services.

## Conclusion

As discussed, CCBs possess the institutional compatibility, branch infrastructure, and financial resources to support the development of microfinance programs. Large relatively untapped market potential and the opportunity to increase profit margins make microfinance an attractive proposition for CCBs. However, the management of many of these banks are reluctant to offer microfinance services citing false perceptions regarding the high levels of risk and costs associated with serving microenterprises and middle- and low-income clients. This is due in large part to a lack of exposure to internationally accepted approaches and methodologies which have been successfully applied at banks around the world to address these important issues. While managers at more ambitious CCBs prepare to develop microfinance programs, they can view cooperation with foreign shareholders and technical assistance providers as an opportunity to save time and improve quality through the application of best practice technologies from abroad.  Such banks need much assistance with the design of microfinance programs across a broad range of topics.  It is advised to support such initiatives in the interests of catalyzing the great potential of CCBs to deliver microfinance services to local communities across China.

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