Consultant Report
22 October 2003

Microfinance in China and Development Opportunities

Prepared by
Peter Situ

German Technical Cooperation (GTZ)
Table of Contents

Abbreviations....................................................................................................................3
1. Overview of Microfinance Sector in China.................................................................1
  1.1 Situational review.................................................................................................1
  1.2 Basic concepts and sustainability.........................................................................1
  1.3 Rural microcredit supply from the formal sector.................................................2
  1.4 Rural microcredit supply from the informal sector.............................................3
  1.5 Situation of urban small loan lending and SME financing.................................3
  1.6 Government towards microfinance......................................................................7
  1.7 NGO and microfinance.......................................................................................8
  1.8 Urban microcredit...............................................................................................9
  1.9 Regulatory framework and institutions involved.................................................10
  1.10 Main stakeholders in microfinance..................................................................12
  1.11 Challenges and Constraints............................................................................20
2. Development opportunities.......................................................................................21
  2.1 Assessment of current and foreseeable future development............................21
  2.2 Future winners....................................................................................................22
  2.3 Future losers.......................................................................................................22
  2.4 Constraints related to development cooperation projects...............................23
  2.5 Recommendations.............................................................................................23
  2.6 Proposed development paths.............................................................................24
### Abbreviations

<table>
<thead>
<tr>
<th>Abbreviation</th>
<th>Full Form</th>
</tr>
</thead>
<tbody>
<tr>
<td>ABC</td>
<td>AGRICULTURAL BANK OF CHINA</td>
</tr>
<tr>
<td>ADBC</td>
<td>AGRICULTURAL DEVELOPMENT BANK OF CHINA</td>
</tr>
<tr>
<td>ACFTU</td>
<td>ALL CHINA</td>
</tr>
<tr>
<td>AusAid</td>
<td>AUSTRALIAN GOVERNMENT’S OVERSEA AID PROGRAM</td>
</tr>
<tr>
<td>CANGO</td>
<td>CHINA ASSOCIATION FOR NGO COOPERATION</td>
</tr>
<tr>
<td>CASS</td>
<td>CHINESE ACADEMY FOR SOCIAL SCIENCES</td>
</tr>
<tr>
<td>CBRC</td>
<td>CHINA BANKING REGULATORY COMMISSION</td>
</tr>
<tr>
<td>CEFA</td>
<td>CHINA FUNDATION FOR POVERTY ALLEVIATION</td>
</tr>
<tr>
<td>CGAP</td>
<td>CONSULTATIVE GROUP TO ASSIST THE POOR</td>
</tr>
<tr>
<td>CGF</td>
<td>CREDIT GUARANTEE FUND</td>
</tr>
<tr>
<td>CIDA</td>
<td>CANADIAN INTERNATIONAL DEVELOPMENT AGENCY</td>
</tr>
<tr>
<td>DCF</td>
<td>DEPARTMENT OF COOPERATIVE FINANCE</td>
</tr>
<tr>
<td>DFID</td>
<td>DEPARTMENT FOR INTERNATIONAL DEVELOPMENT, UK</td>
</tr>
<tr>
<td>FAO</td>
<td>UN FOOD AND AGRICULTURE ORGANIZATION</td>
</tr>
<tr>
<td>GB</td>
<td>GRAMEEN BANK</td>
</tr>
<tr>
<td>GDP</td>
<td>GROSS DOMESTIC PRODUCTION</td>
</tr>
<tr>
<td>GTZ</td>
<td>GERMAN TECHNICAL COOPERATION</td>
</tr>
<tr>
<td>IFAD</td>
<td>INTERNATIONAL FUND FOR AGRICULTURAL DEVELOPMENT</td>
</tr>
<tr>
<td>IGA</td>
<td>INCOME GENERATING ACTIVITIES</td>
</tr>
<tr>
<td>ILO</td>
<td>INTERNATIONAL LABOR ORGANIZATION</td>
</tr>
<tr>
<td>JICA</td>
<td>JAPAN INTERNATIONAL COOPERATION AGENCY</td>
</tr>
<tr>
<td>MCA</td>
<td>MINISTRY OF CIVIL AFFAIRS</td>
</tr>
<tr>
<td>MFI</td>
<td>MICROFINANCE FINANCIAL INSTITUTION</td>
</tr>
<tr>
<td>MOFCOM</td>
<td>MINISTRY OF COMMERCE</td>
</tr>
<tr>
<td>MOFTEC</td>
<td>MINISTRY OF TRADE AND ECONOMIC COOPERATION</td>
</tr>
<tr>
<td>MOLSS</td>
<td>MINISTRY OF LABOR AND SOCIAL SECURITY</td>
</tr>
<tr>
<td>NGO</td>
<td>NON-GOVERNMENT ORGANIZATION</td>
</tr>
<tr>
<td>OI</td>
<td>OPPORTUNITIES INTERNATIONAL</td>
</tr>
<tr>
<td>PA</td>
<td>POVERTY ALLEVIATION</td>
</tr>
<tr>
<td>PADO</td>
<td>POVERTY ALLEVIATION DEVELOPMENT OFFICE</td>
</tr>
<tr>
<td>PBC</td>
<td>PEOPLE’S BANKD OF CHINA</td>
</tr>
<tr>
<td>RCC</td>
<td>RURAL CREDIT COOPERATIVE</td>
</tr>
<tr>
<td>RCCU</td>
<td>RURAL CREDIT COOPERATIVE UNION</td>
</tr>
<tr>
<td>RCF</td>
<td>RURAL COOPERATIVE FUND</td>
</tr>
<tr>
<td>RMB</td>
<td>REN MIN BI</td>
</tr>
<tr>
<td>SE</td>
<td>SMALL ENTERPRISE</td>
</tr>
<tr>
<td>SME</td>
<td>SMALL AND MEDIUM ENTERPRISE</td>
</tr>
<tr>
<td>SOE</td>
<td>STATE-OWNED ENTERPRISE</td>
</tr>
<tr>
<td>TA</td>
<td>TECHNICAL ASSISTANCE</td>
</tr>
<tr>
<td>UNDP</td>
<td>UNITED NATIONS DEVELOPMENT PROGRAM</td>
</tr>
<tr>
<td>UNFPA</td>
<td>UNITED NATIONS POPULATION FUND</td>
</tr>
<tr>
<td>UNICEF</td>
<td>UNITED NATIONS CHILDREN’S FUND</td>
</tr>
<tr>
<td>WF</td>
<td>WOMEN’S FEDERATION</td>
</tr>
</tbody>
</table>
Microfinance in China and Development Opportunities

1. Overview of Microfinance Sector in China

1.1 Situational review

In the Mid 80s’, the Chinese Government adopted new approaches in poverty alleviation (PA) by introducing a subsidized credit program to its classic grant efforts. In the early 90s’, review of the government PA program found out that PA credit funds failed to reach the poor households and the overall repayment rate is less than 50%. It is in this context that the Chinese Government started experimenting innovative alternatives such as microfinance based on international success stories. Most pilot projects in microfinance have been supported by international donors and the Grameen Bank (GB) model seems to be the predominant reference been adopted and tested in a number of geographic areas under different economic and geographic conditions.

Microfinance experience in China is therefore project driven and most programs have been focusing on rural poverty alleviation. Urban microcredit has started catching practitioners and policy-makers’ attention when the re-employment of SOE laid-off workers has its limited market absorbing capacity, and political measures to resettle the latter have reached short-term achievements only.

There are nearly 300 microcredit projects/schemes in China and they are sponsored jointly or separately by: Government programs, NGOs, formal financial institutions and international donors. None of them have reached full sustainability, as some probably try to claim recently, and concepts of sustainability differ from one scheme to another.

1.2 Basic concepts and sustainability

In general, stakeholders and practitioners in China agree upon the basic concepts of microfinance, which can be summarized as following:

- A mean of economic development,

- Targeting low-income clienteles and/or different segments of the poor, inclusively or exclusively,
- Close link with poverty alleviation
- A financial activity,
- Savings service as an equally important part of microfinance,
- Balance to maintain between social and financial objectives.

In a simplistic manner, sustainability can be defined as following:

**Operational sustainability**: operational revenues are able to cover operational expenses;

**Financial sustainability**: Besides achieving operational sustainability, income generated is able to cover the financial cost and the imputed cost of capital;

**Social sustainability**: An important scale of operations is obtained; the outreach sustains and has a positive impact on the socioeconomic conditions of the target clienteles (mostly low-income and poor households);

**Institutional sustainability**: the organization appears to have a long-term life and it would face neither a technical bankruptcy nor an institutional collapse caused by legal or regulatory constraints. Its activities are operationally, financially and socially sustainable.

Priority given to sustainable development varies from one scheme to another, normally influenced by or inherited from a number of development philosophies and concerns introduced by different donors. Currently, operational and financial sustainabilities seem to be better understood and pursued, as most microcredit schemes formally or currently supported by international donors are facing the self-sufficiency issue after project completion; institutional and social sustainabilities have been recognized as equally important, but short-term efforts and investments tend to sacrifice the latter and concentrate on the immediate survival of reaching operational sustainability.

### 1.3 Rural microcredit supply from the formal sector

At the end of June 2003, the whole formal financial sector in China represents an approximate volume of credit of RMB 16,815 billion, of which, 1,618 billion or 10.8%
have been lent by the RCCs, the monopolistic formal financial institution active in the rural areas. RCC’s outstanding agricultural loans amount RMB 696 billion, or 83.8% of the agricultural loan portfolio lent by all the financial institutions. RMB 555 billion, or 80% of the RCC agricultural loan portfolio have been lent to individual farmers; and 80% of its portfolio lent to individual farmers is classified under the microcredit loan category.

At the end of 2002, 90% of the RCCs have implemented microcredit and an estimate of 43 million farmer households have accessed to RCC microcredit. RCCs claim to have reached 25% of the rural households and 59% of those eligible for borrowing.

ABC has reported RMB 3 billion disbursed in PA micro loans in 2002, reaching one million individual farmers.

1.4 Rural microcredit supply from the informal sector

Credit volume provided by informal sector has been estimated in a total of RMB 475.134 billion, of which RMB 200.1 billion of narrow-caliber and RMB 275 billion of broad-caliber in 2002. Narrow-caliber informal credit volume amounts approximately at 14.6% of the agricultural credit volume lent by formal financial institutions, while broad-caliber at 20.08% during the same period (For more details, see Estimation on the Aggregate of China’s Rural Informal Finance, GUO Pei and HE Guangwen, CEM, CRFIR, China Agricultural University).

While it is very difficult to estimate the informal sector’s market share in rural microcredit lending in China, empirical field surveys find frequently that in the Central and West poor and remote areas, 78 – 90% of the households living in visited villages have to borrow from informal credit sources such as private lenders, in loan characteristics similar to microcredit, while approximately 50% of them have access to other sources such donor-assisted schemes, RCC microcredit and/or government PA microcredit. This to some extent confirms the credit demand in the rural areas, and raising the issue of supply efficiency or targeting in rural microfinance in China.

1.5 Situation of urban small loan lending and SME financing

Presently, the Chinese banking sector has three state policy banks, four state-single-owned commercial banks (the big four), 184 foreign banks (151 branches and 16
representative offices), 11 national joint-stock commercial banks, 112 city commercial banks, 1,000 urban credit cooperatives (of which 449 operating), 31,000 post savings services, and 34,909 RCCs/RCCUs.

SME financing sources from the banking sector still relies on state-single-owned commercial banks, which have the most extensive operational network in the urban areas. Their new credit disbursements to SME during the first six months of 2003 represent 50.8% of the total disbursements to SME, while joint-stock commercial banks which are generally of medium size, share 20.6% and others financial institutions (Including City commercial banks, foreign-capital banks, rural commercial banks, urban credit cooperatives, rural credit cooperatives and rural credit cooperatives unions.) share 28.6%. However, Medium-size joint-stock commercial banks seem to give emphasis to the SME credit segment this year, as their disbursements represent 42.3% increase from the previous period, while state-single-owned banks and other FIs have experienced respectively 15.2% and 7.1% increase for the same segment and during the same period.

Table 1: FIs credit lending to SME during the first six months of 2003 (in RMB billion)

<table>
<thead>
<tr>
<th>FIs</th>
<th>New Credit Disbursement</th>
<th>% of total new disbursements</th>
<th>Growth rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>State-Single-Owned Commercial Banks</td>
<td>240.5</td>
<td>50.8%</td>
<td>15.2%</td>
</tr>
<tr>
<td>Joint-Stock Commercial Banks</td>
<td>97.6</td>
<td>20.6%</td>
<td>42.3%</td>
</tr>
<tr>
<td>Other FIs*</td>
<td>135.3</td>
<td>28.6%</td>
<td>7.1%</td>
</tr>
</tbody>
</table>

Source: PBC Survey on SME Financing
* Including City commercial banks, foreign-capital banks, rural commercial banks, urban credit cooperatives, rural credit cooperatives and rural credit cooperatives unions.

Recently, PBC undertook a survey on FIs credit lending to SMEs; 1,358 FIs and 2,438 SMEs have been investigated in 30 provinces/municipalities (except Tibet). The study indicates that up to the end of June 2003, outstanding credits to SME stand for 51.7% of the total loan amount disbursed, representing RMB 6,100 billion, with RMB 655.8 billion as new disbursements during the first six months of 2003. 62.6% of the outstanding
credits have been disbursed in the economically advanced East areas, while Central and West share respectively 18.9% and 18.5%.

According to the survey, credit has become the principal financing source of SMEs, representing 98.7% of the total SME financing during the first semester of the year. While considering credit to SMEs, FIs consider the following elements by order of importance:

- Financial situation, management quality and operational performance,
- Risk associated to loan purpose,
- Credit record and credibility of loan applicant,
- Industrial sector risk,
- Bank’s own lending capacity,
- Bank’s authorized approval limits (terms, amounts…),
- Applicant SME’s ownership.

The survey shows that SME’s satisfaction rate in borrowing stands at 71.3% for number of loans applied, 68.5% for amounts applied.

Lending to SME has substantially contributed to the latter’s development. During the first semester of 2003, each RMB 100 lent to SME has generated RMB 263 in GDP, RMB 890 in sales revenues and RMB 74 in tax revenues.

There are currently 29.3 millions SMEs registered in China, or 95% of the total number of enterprises. Of GDP generated by enterprises, 51% is made by SMEs, whose export contribution amounts for more than 60% of the total export value, tax contribution amounts for more than 43.2% of the national tax income in 2002. SMEs provide 60% of the employment in the country.

Where addressing loan size, banks generally consider RMB 100,000 as small loan and there is less or little commercial interest in lending below this amount. Start-up and working capital for urban self-employment and micro-enterprise typically expect external financing between RMB 5,000 to 30,000 as rule of thumb. Apart from the small amount considered as insignificant by most commercial banks, low capacity of providing evidence as first and second payback sources curtail a number of SMEs in their credit
access from formal FIs, particularly those are in their pre-start-up, start-up and early growth stages.

However, definition of small enterprise (SE) varies in China compared to some other countries and SE development may not include micro-enterprises, which a number of donors’ programs promote to deal with SOE reform and re-employment of laid-off workers. Enterprises registered with less than seven employees are classified as micro-enterprises in China, and there are presently 25.7 million, which are mostly private businesses active in urban and township areas. Their access to credit provided by the formal banking sector is difficult and insignificant either in numbers or in volumes.

The urban registered unemployment rate has increased to 4% (7.7 million persons) at the end of 2002 and is expected to grow further to some 5% within the next five years. In addition, another 1.7% of the urban labor force (4.1 million workers) were laid-off from SOEs and seeking re-employment. Estimated underemployment (surplus labor) in rural areas is 150 million workers and many of them come to urban areas to seek employment, often in the informal economy (ILO).

At the end of June 2003, there are 525 million of laid-off workers and 395.8 million unemployed registered with the Ministry of Civil Affairs (MCA). Although the Government has issue “Guidelines on Microcredit Guarantee for Laid-Off Workers” in January 2003, and makes direct intervention in promoting urban microcredit lending to laid-off workers, the banking sector is reluctant to lend and current credit analysis process of commercial banks operating in urban areas systematically excludes this policy segment. Therefore, its is reasonable to conclude that urban “microcredit” is not yet significant in terms of number and volume disbursed by the formal banking sector. Their external sources of financing rely on interest-free and self-arranged-interest loans between friends and family relatives. Therefore, it is reasonably assumed that the microcredit financing from the formal banking sector is not yet significant in China.

There are only few urban microcredit schemes operating in China, primarily supported by international donors and directly linked to self-employment of formal SOE laid-off workers. This is in conformity with the social concerns of the Government, which recently instructed governments of provincial and prefecture levels to establish microcredit guarantee funds (CGF), or use the existing SME credit guarantee
organizations/funds to provide credit guarantee for laid-off workers, and urged the banking sector to join the support efforts for the latter.

Present urban microcredit schemes are primarily social outreach-driven and politically oriented; attention has not yet been paid to the financial viability, which is the prime interest of commercial banks for their possible involvements.

1.6 Government towards microfinance

Early skepticism of the Government on microfinance can be interpreted by its reluctance to take strong ownership in microfinance experimentation in the 90s; this was mainly linked to its philosophy of direct intervention with subsidized interest rate to support the poor, instead of considering sustainability and market rules. However, as the Government’s P.A. program was proven unsuccessful in terms of sustainability and targeting, the Government was interested in efficient alternatives, and a number of donor-supported microcredit schemes were experimented, under the close framework of government and para-government agencies.

At the end of the 90s’, the Government started officially recognizing that microcredit is an efficient alternative to reach the poor by providing credit service to the rural population, especially in remote and mountainous areas where market efficiency and formal FIs interventions fall. However, the Government was less flexible in promoting multi-forms of organization for related institutional setup, sticking to the notions of “illegal activity” once the donor-supported projects reached their completion, although it tolerated the continuation of credit operations, as far as no savings mobilization involved. This is probably due to the bitter experience and negative impact of the once booming Rural Cooperative Funds (RCF), which had stirred some non-negligible social and financial turmoil in the rural areas, and which was forcibly taken over by RCC in 2000 by an order issued by PBC.

In 1998, PBC/RCC started experimenting microcredit operating by RCC with some international assistance. Based on the results of the experimentation, PBC issued related guidelines to provide managerial and operational framework to RCC in 2000 and nationwide promotion has started since, as replicability is based on an existing institutional network. The Government clearly spelled its preference on promoting RCC microcredit,
injecting additional funds under the form of PBC discount-rate agricultural re-lending to RCCs.

The situation has evolved recently, from skepticism or passivity to some degree of enthusiasm towards non-FI microcredit. This can be seen through recent contacts and discussions with some bilateral programs by MOFCOM representing the Government; donors are encouraged to invest in the sector, and MOFCOM has showed more flexibility in pilot areas’ selection, methodologies and implementing structures to be introduced. This could be seen as a prelude to gradually open the door for developing a more competitive microcredit sector, or at least to allow conversion of de facto no-FI microcredit schemes into formal FIs specialized in microfinance. However, it is clear that the Government’s emphasis is in reforming and supporting the RCCs by allowing the latter to maintain a quasi-monopolistic market position, including for microcredit business in the rural areas.

1.7 NGO and microfinance

Genuine NGO development was not really encouraged in the 90s’, probably due to immature stage of political reform and to concerns on such organizations for any political claims or mandates destabilizing the Chinese social and political situation. With recent governmental structure rationalization and pilot democratic reform at village level, the Government has perceived the benefits of grassroots NGOs dedicated to social economic development. NGOs undoubtedly feel some important gaps of government services, or complement the latter either in quality or in quantity. It is in this context that the Chinese Government has reviewed its position toward NGO development, and it has showed some encouragement in theory, and more flexibility in application in this regard.

A number of formal donor-supported projects in microcredit have converted themselves into local development associations, firstly for fundraising concerns rather than institutional development. As banking regulator, PBC before and now CBRC are aware of those credit schemes still considered illegal or at least irregular after the donors’ pilot umbrella is no longer provided. However, CBRC has expressed its tolerance, if not yet flexibility towards such operations, as far as no savings mobilization is involved. This is partly as result of longtime lobbying by the donors’ community and the Chinese microcredit practitioners, but also because of the ongoing but gradual interest rate liberalization that will leave the financial sector more market-oriented, therefore possible
distortion effect from non-FI credit schemes is less significant in the views of the regulators.

NGO development is a relatively new phenomenon in China. A number of nation-wide organizations claiming to be converted into NGOs are still somehow acting as government’s extension, or even under the government’s payroll.

### 1.8 Urban microcredit

If some lights have been seen at the end of the tunnel in the rural areas, the Government has showed more cautions regarding urban microfinance development. There are only 5-6 pilot urban microcredit mainly supported by the international donors, mostly with links to credit support to laid-off workers. This reluctance reflects some sensitivity in the urban areas, where laid-off has become a thorny issue and where most banks have been established and operating.

Even though the Government has established a guarantee fund for urban microcredit to laid-off workers, or using the existing SME guarantee fund for this purpose, and it keeps urging the banking sector to lend to unemployed people desirous to start a self-employment venture, banks so far haven’t showed great enthusiasm. This is probably a natural reaction to any instructions of policy nature from the commercial sector, also because the credit market is in its full growth stage in the urban areas; as far as the market is not saturated, banks will concentrate their efforts on the more lucrative segments and leave behind the more costly microcredit lending. There are some exceptions, for example in Hefei, where Opportunity International (OI) has convinced the city commercial bank to function as its disbursement and recovery channel of the credits to laid-off workers. In the ILO/PEP project, commercial banks are also involved in managing and operating small credits to target borrowers.

In summary, the Government has three major concerns towards microfinance development: conformity in interest rate, institutional setup and savings mobilization. With the gradual interest rate liberalization and needs for grassroots development entities, there are more understandings and opening towards market rate application, as well as for setting up associations of social economic development nature operating microcredit in the rural areas. However, savings mobilization remains strictly the business of formal financial institutions and the Government will unlikely relax this in the short-term.
1.9 Regulatory framework and institutions involved

At the policy and central level, three important ministerial agencies providing the regulatory framework regarding microfinance: the People’s Bank of China (PBC) whose current intervention is mainly in monetary policy and interest rate regulation; the China Banking Regulatory Commission (CBRC) as supervisor of the banking sector and related activities; the Ministry of Civil Affairs (MCA) that is mandated to regulate and administrate the areas of non-government organizations.

**PBC**

PBC’s monetary policy instruments can be defined by the law as: reserve requirements; fixing base interest rates; refinancing; short-term lending to commercial banks; and open market operations in government bonds and in foreign exchange. The State Council may approve any other instruments. The law thus allows for a monetary policy implementation through indirect instruments. However, in practice, the interest rates, both for deposits and lending are set by PBC. Lending rates can be established by banks within a band, defined as the PBC base rate plus a margin. For RCCs, the margin at present is 50%, for commercial banks 20%. It is considered that these rates are below market clearing levels, and their main effect is the provision of relatively cheap resources to the State enterprise sector, the banking sector’s traditional clientele.

PBC has been instrumental in a number of innovations, which at present are being tested on a pilot scale. In the rural financial sector, these include: the liberalization of the lending interest rate, the introduction of microcredit and joint liability group lending by RCCs. For each of these, pilot counties are being selected where the new policies are applied. The first outcomes seem to be positive and they are under application on a larger scale, especially since June 2003.

In late 1999, the People’s Bank of China (PBC) started formulating its policy guidelines on microcredit by Rural Credit Cooperatives (RCC). Afterward, the guidelines on group-lending methodology by RCCs were introduced and disseminated through the RCC network to further promote RCC microcredit lending to the rural households. As the Guidelines stipulate, *these Guidelines are formulated in accordance with such laws and regulations as “Law of the People's Republic of China on the People's Bank of China”, “the Commercial Banking Law”, and “General Rules on Lending”, for the purpose of*
 supporting rural and agricultural development, promoting credit service quality of RCCs, improving access to financial services and streamlining lending procedures.

In December 2001, PBC reviewed the RCC microcredit practices and published a revised version of the Guidelines.

PBC’s implication in microfinance remains in interest rate regulation and policy researches, after its banking regulation and supervision functions were split and handed over to CBRC.

CBRC In April 2003, the banking supervision function of PBC was split and handed over officially to a new banking regulatory body: China Banking Regulatory Commission (CBRC). The paramount goal of this landmark reform is to improve the efficiency of bank supervision and PBC as central bank, will focus on monetary policy making. CBRC is expected to introduce some innovation in the areas of regulatory methodology, systems and technologies to modernize financial supervision and make it more professional. Department of Financial Cooperatives (DCF) formally under PBC, has been transferred to CBRC and it continues to play its leading role in RCC reform and ensure the supervision function of CBRC on all the RCCs. As well, all regulatory issues related to rural financial sector, including microfinance development through non-FI organizations, have to be consulted with DCF.

DCF under CBRC is responsible for cooperative financial institutions for rural and urban saving business. It will standardize the management of cooperative financial institutions, study and promote the reform of cooperative financial institutions, draft regulations of supervision for cooperative financial institutions in their management of ratio of assets and liabilities, quality of assets, risks control, interest rate, supervise the risks, urge and supervise cooperative financial institutions in their internal supervision and restrictions. It will draft management measures on the establishment, business scope and qualification of legal person of cooperative financial institutions and organize the execution of the measures. It will also investigate and punish those of unlawful behaviors.

MCA MCA is mandated to be responsible for NGO registration, supervision, guidance provision, and promotion. Its current relevant interventions are mainly in the field of NGO registration. Main related regulations issued are “Regulations on Social
Organization Registration” by the State Council in 1998 and “Provisionary Regulations on Social Organization-Established Fund Administration” by MCA in 1999.

According to the State Council’s “Regulation on Social Organization Registration”, Social organization formed by individual members should have a membership of more than 30, by organizational members a membership of more than 50, by mix individual and organizations members a membership of not less than 50. The organization should have a standard name and related organizational structure, fixed office, employees relevant to its business scope, lawful sources of funding, with working capital not less than RMB30,000, been able to assume civil responsibilities, no mention of “China”, “All China” and “National” in the name of social organization. Once the application filled, it normally takes 30 days to receive the approval or rejection.

MOFCOM SME and micro-enterprise development has been under the mandate of MOFTEC presently renamed as MOFCOM. However, recent trends show that the real dynamics are somehow in the hands of local governments of different levels, depending on their understanding and needs in the sector.

In January 2003, PBC, MOF, MOFTEC, MCA jointly issued the “Administrative Guidance on Guarantee Fund for Microcredit to Laid-Off Workers”, and governments at provincial and prefecture levels are urged to established the fund to support microcredit lending to laid-off people.

According to the Guidance, loan amount of RMB20,000 could be obtained by laid-off workers from the local commercial banks with the guarantee provided by the local government’s fund. Loan term should not exceed 12 months, repayment modality is subject to the negations between lender and borrower, and related interest rate should be fixed by the central bank’s based rate without any floatation. The difference in interest income should be fully subsidized by the central government’s financing through reimbursement claims by the lending banks.

1.10 Main stakeholders in microfinance

The Chinese Government plays an important role in microfinance. The main input is its PA program under PADO distributed through the network of local Agricultural Development Bank of China (ADBC) and Agricultural Bank of China (ABC). As ADBC
and ABC have no distribution network in the rural areas, especially at the township and village levels, microcredit of government’s PA program mainly relies on local government structures for implementation. While this approach has gained merit for massive funding and wide geographic coverage, it still struggles to solve the problem of effectively reaching the real poor. Moreover, governments at all levels lack knowledge, capacities and resources to efficiently manage and operate either directly or indirectly a microcredit program. Typical practice is individual loans of average amounts ranged from RMB1,000 to 3,000 lent to either individual borrowers or borrowers’ groups, at an APR of 2.88%. Loan terms can be within 12 months, or ranging from 1 to 3 years, with either balloon or installment repayments. Local poverty alleviation offices, governments, and in some areas WFs are mobilized to disburse the loans. Recovery is not satisfactory, although some recent improvements have been reported, mainly because of lack of performance-oriented knowledge in credit management.

**NGO** development is a relatively new phenomenon in China. A number of nation-wide organizations claiming to be converted into NGOs are still somehow acting as government’s extension, or even under the government’s payroll. A number of national NGOs of this nature are active in microcredit operations, and they have showed some strategic interest in promoting the sector development. CFPA, CANGO and WF could be classified under this category. Their involvement in microfinance is, in one way or another, part of the government’s decision; and political interference is present from design to execution. Their current practices tend to focus more on fundraising, which is vital for the organization’s survival, or at least for the microcredit schemes’. There is a lack of strategic planning to ensure step-by-step movements towards future institutional and financial independences.

CASS, as a government-funded research extension is the first Chinese organization to introduce GB microcredit model in China. It has received substantial amounts of TA and funds from various donors to promote microfinance in China. Its own pilot model has claimed operational sustainability and recently financial sustainability. However, the price tag of longtime and continuous donors’ supports may not be included in the calculations. CASS staffs involved in microfinance research and field monitoring have started providing consultancy to a number of donor-assisted projects, especially in the fields of advocacy and project management supports. Their consultancy seems to be financially supported by the donors that either have a close cooperation with CASS in microfinance researches, or by donors that are supporting the service users. Core
competence in financial management is one of the areas that need improvement for CASS provision of technical supports.

Three years ago, CASS has entered in a collaboration with Ford Foundation and CGAP that provide funding to set up a training center and a technical support platform. This well-thought initiative, therefore should meet the strategic needs of microfinance development in China, lacks in-depth market analysis to adequately develop and position related products and services. Current services are not yet competitive and they need to be adapted to the market needs.

Some regional-based social economic development associations or NGOs have demonstrated a better independence in governance, management and operations but their quasi-legal status and limited networking capacity make the replication difficult, should experimentation be proven successful. Another thorny issue in provision of microcredit through NGO is savings mobilization, which is stipulated in related banking laws and regulations as exclusive business for formal financial institutions. However, a number of examples show that savings have been collected and managed by borrowers’ groups and the funds have been used primarily for internal lending among group members and occasionally lent to outsiders.

Strong commitments to the local social economic development, targeting and reaching the poor, gender development are among the credits paid to NGO microcredit schemes.

**Financial institutions**

**Agricultural Development Bank of China (ADBC)** is a state policy bank with the mandate of supporting state-planned development projects. It has headquarters in Beijing, provincial branches in the capitals of provinces and branches at prefecture and county levels. ADBC has a sub-branch in the proposed project county but without any sub-branches. It will not set up sub-branches or units at township level.

**Agricultural Bank of China (ABC)** is a nation-wide institution and is managed at four levels, i.e. at national, provincial, prefecture and county. ABC has a sub-branch in the proposed project county but without sub-branches at township level.

ADBC was initially mandated by the State Council to manage and channel the Government’s poverty alleviation program of which microcredit capital is budgeted every year. As most ADBC has no distribution network at the grassroots level, ABC is asked to act as either as ADBC’s agent or PADO’s to channel the state PA program.
ABC has been ordered to manage and operate the government PA microcredit program, under the guidance of PADO, either by channeling the subsidized credit portfolio budgeted by and transferred from the Ministry of Finance, or by contributing in part or in total the budgeted funds with ABC’s mobilized savings. In the latter case, ABC should receive compensations on losses in interest income for low-interest lending only, and it has to absorb its losses in loan capital, primarily from sources of customers’ savings. As ABC has no longer grassroots sub-branch network to operate and monitor the PA microcredit lending, and low-interest rate and larger-size loans lead to targeting deviation, default and delinquency have driven to severe loan losses up to more than 50% of the disbursed portfolio in some areas. More ABC lends, more it is exposed to losses. ABC has no incentive to play an active role in the subsidized PA microcredit program.

As ABC has no distribution network, it has to mobilizes its own staffs and township government employees each year to collect due repayments. So far, loan recovery remains the major challenge for this state PA program and the rate is reported at less than 50% in many areas.

ABC targets mostly households with some valuable assets, which are believed to enjoy a certain degree of credibility in their production projects and in future repayment, and which demonstrate some capacity for loan management. Low-income and poor households are mentioned in the lending policy but excluded in the targeting criteria.

At the end of 2002, ABC was reported to have provided more than RMB 90 billion as PA funds of which 10.8 billion as new disbursements of the year. ABC claims to have disbursed RMB 3 billion in microcredits to 1 million poor households.

The Rural Credit Cooperative (RCC) has an extensive network in the rural area and it claims to cover all the townships in China. As the only formal financial institution with operating capacity in the rural area, RCC is mandated to support local agricultural and rural development. More than 50% of its portfolio should be lent for agricultural purposes and to farmers. However, as formal financial institution, RCC faces restrictions to downscale its products and services to target the low-income and poor households. RCC serves primarily better-off and rich segments, and its current notion of creditworthiness excludes the low-income and poor households.

By the end of June 2003, there are 34,909 independent RCC legal persons, of which 32,397 RCCs, 2,441 county RCCUs, 65 prefecture/municipal RCCUs and six provincial
RCCUS. The whole RCC network has 62,800 employees working at different levels. It has RMB 1,618 billion in loans outstanding (10.8% of the total banking sector) and RMB 2,233 billion in deposits (11.5% of total).

Since 1999, RCC has started implementing its own microcredit service, based on results of a RCC microfinance pilot project in Hebei supported by Canadian expertise. The RCC microcredit scheme adopts the group lending methodology but also includes individual lending. Small-size and short-term loans are well accepted by both RCC and farmers, but providing microcredit to the real poor, especially poor women, remains an issue to be solved with continuous efforts.

While fairly different from the Grameen model, the main characteristics of the RCC microcredit lending are:

- There are no individual collateral or guarantees required; individual loans with group guarantee are not excluded;

- Households are screened on their overall creditworthiness, related to their income level and stability of income sources and their previous repayment performance, by an assessment group which include RCC staff, representatives of households, the Village Committee and the Village Party Branch. Assessments are Reviewed every two years;

- Based on the assessments, households receive a credit line booklet, which entitles them to draw loans any time up to a ceiling amount. Loan terms usually do not exceed 12 months. Loan purposes are defined as related to agriculture or consumption;

- Loans can be disbursed in the RCC office or by credit officers in the village;

- There is some flexibility in interest rate setting, and the rate is subject to RCC’s decision;

- Interest should be paid quarterly, and bullet repayment for loan principal at the end of maturity;

- Incentive is set and based on performance to encourage staff to better monitor the loan repayment and ensure its full recovery.

Since 1996 and especially after its start of microcredit and joint-liability lending in 1999, RCC has lent to support individual farmers, rural and agricultural development. Up to the end of June 2003, RCC’s outstanding agricultural loans amount RMB 696 billion, or 83.8% of the agricultural loan portfolio lent by all the financial institutions. RMB 555
billion, or 80% of the RCC agricultural loan portfolio have been lent to individual farmers.

In June 2003, the State Council released its RCC reform plan. Provinces/provincial-level municipalities of Zhejiang, Shangdong, Jiangxi, Guizhou, Jilin, Chongqing, Shaanxi and Jiangsu have been chosen to pilot the reform. The main objectives are to restructure and define ownerships and governances of current RCCs of different categories and performances, improve a better administration system on RCC by the provincial and municipal governments, and enhance RCCs services quality and efficiency.

**International donors** started supporting microcredit experimentation in China in the early 90s’ primarily for two purposes: a) introduce international best practices and build showcases to encourage the Chinese Government’s actions in poverty alleviation through microfinance; b) provide policy advisory service to enhance the legal and regulatory framework for the emerging microfinance sector. Lack of desirable institutional distribution channels, almost all the donors have chosen the project approach and at least 300 donor-supported microfinance projects/schemes have been started during the last ten years, mostly in rural and remote areas.

Multinational agencies seem to be advised or pushed to cover an unreasonable large territory and disperse funding for an unreasonably long list of provinces and counties. Bilateral programs appear to be more focusing by implementing their pilot projects in a limited number of counties, but nearly automatically in the most remote and harsh areas where natural and economic conditions do not favor a success story building within the project terms of 3 to 5 years. To date, international donors are still facing the sustainability issue when their projects reach the completion and lack convincing results to shoulder their policy advisory services to the Chinese Government.

As internationally funded pilot projects are mostly managed and executed in collaboration with governmental departments and agencies, they are influenced to achieve outreach rather than sustainability, which only started catching stakeholders and practitioners’ attention in 1998, where a number of donor-assisted pilot projects were reaching their maturity, and termination of pilot projects tended to carry away results achieved during the project life. Little efforts have been paid to enhance institutional sustainability either by creating new microcredit financial institutions (MFI) or downscaling services of existing financial institutions to reach the real poor. Objectives
were set for short-term, as project programming does not facilitate medium and long term development planning.

A number of previously or currently donor-supported projects/schemes are trying to convert themselves into NGOs, by registering themselves as local economic development organizations to carry out microcredit when donor’s support program/project ends. All of them keep the donors’ revolving funds as main funding resource and some have succeeded to have access to commercial funds provided by local financial institutions.

Recently, IFAD has shifted its credit program implementation from project approach to institutional one, by using RCCs as its credit channeling agency and providing technical capacity building and other supports to the involved RCCs.

There are no comprehensive accounts on total funds invested by the international donors in microfinance in China, neither in TA nor in loan capital provision. However, Multinational organizations such as World Bank, UNDP, UNFPA, UNICEF, IFAD, ILO, FAO, bilateral agencies such as CIDA, DFID, AusAid, GTZ, Dutch Cooperation, JICA, have provided or have been providing funding in this regard. It is widely believed that at least more than US$50 million have been invested both in credit capital and related capacity building for microfinance development in China. Most investments and actions took place in the rural areas. Most projects have been sprinkled in a wide geographic areas and little networking mechanism and capacity have been built; there is no umbrella-like association or organization that is able to represent the sector’s interests, assume necessary lobbying, and provide reliable managerial and operational support services where needed.

Regarding urban microcredit, UNDP is one of the few investors in the donors’ community. After the completion of “Microfinance for laid-off female workers” in Tianjin, where RMB 4.5 million have been disbursed to 2,586 female laid-off workers during five years, another UNDP-assisted project of “Capacity building for the trade union” was started in 2002, where UNDP, ACFTU and Henan provincial government have provided RMB 5 million to establish a guarantee fund for laid-off borrowers. The major challenge of the project is the process of changing local government and partners’ mentality from welfare support to sustainable development.
A relatively low profile but down-to-earth support modality is the one implemented by ILO through its ILO/Japan Inter-Country Project on Strategic Approaches Toward Employment Promotion (ILO/PEP). Since 1997, the project has established a partnership with MOLSS to carry out its pilot activities in China’s rural and urban areas. The project has a microcredit component and during its phase one from 1997 to 2000, it disbursed microcredit loans totaling US$2.4 million to 5,776 beneficiaries and directly supported jobs for 10,630 people. Skill development opportunities were also provided to 13,137 beneficiaries. The most interesting part of the project should not be the credit outreach, but the five models adopted to enhance job creation, which are: household based self-employment; group-oriented self-employment; sub-contracting (company + households); training center graduates and private enterprise. The project’s phase two has been launched in 2001 to last till end of 2004; local banks are involved in grant small loans to people who have received the Start-your-business training organized by local employment bureaus, which also provide credit guarantee with the established Credit Guarantee Funds (CGFs). This is so far the best modality in urban microcredit with balanced development targets within project life in China.

**Informal credit** sources mainly come from some self-arranged lending between households and individuals.

Informal lending exists among families, relatives and friends, usually on a basis of 1 to 3 % interest rate monthly. The most popular monthly rate is reported at 2%. Interest rate is usually calculated on a flat-rate way and interest income is mostly deducted at disbursement. This is generally considered as loan-shark practice by local authorities and borrowers, but somehow accepted by the rural population, as the real cost is lower compared to the formal credit sources, for there is little or no transaction cost in self-arranged credit.

Informal credit borrowers are typically average poor households, which have no access to the formal financial services because of lack of means of guarantee and collateral as required by formal FIs. Empirical field visits in villages of Central and West China found that more than 70% of the households have to borrow from informal credit sources regularly to maintain sufficient cash flow for production or to meet emergent consumption needs. Repayment of informal credit is reported to be timely and disciplined, as the rules of the game is clear for both lenders and borrowers and
consequence of delinquency is a general ban on credit access among the neighboring communities.

1.11 Challenges and Constraints

More than 10 years of experimentation through pilot projects lead to the conclusions that microcredit is feasible in China and it is an efficient alternative tool to provide credit access to the poor households, especially the poor woman-led ones in the rural areas. However, Two major challenges that stakeholders and practitioners are facing:

- Financial sustainability vs. social mandate of targeting the real poor,

- Atomized spread of small-scale schemes without umbrella association/organization.

Besides, a number of constraints also make microfinance difficult to be sustainable within a limited timeframe. The most topical issues in microfinance development in China can be summarized as following:

- Strict entry barriers to establish financial institutions specialized in microfinance,

- Existing FIs have regulatory and organizational constraints to downscale their services to provide credit access to low-income and poor households,

- Ambiguous legal and institutional status of non-government organizations (NGO) and illegality of their handling finance-related activities,

- NGOs trying to act as bankers

- Political targeting of the poor vs. technically targeting with product and procedures adapted to the market’s needs,

- Subsidized credit culture for poverty alleviation, both at the supply and demand sides,
2. Lack of understanding on a comprehensive support system, which should mobilize resources and efforts from legal and regulatory, governmental, financial, industrial and NGO components.

2. Development opportunities

2.1 Assessment of current and foreseeable future development

Current interest rate ceiling will be removed within the next three years but challenges related to market rate will still exist in the microfinance practices, mainly because of time needed to change the welfare credit culture.

As the first results of microcredit experimentation are positive and they meet the needs of fill the service gaps where public services and formal financial institutions failed to be effective, the Government will continue promoting microcredit, but giving preference to reforming RCCs which are expected to lead the mainstream in rural finance. In the urban areas, the Government will improve the functionality of the already established credit guarantee funds and urge small and medium-size commercial banks to downscale their services and include a part of the vulnerable groups.

RCCs reached by urbanization will be reformed and converted into local joint-stock and cooperative banks. As they are the latecomers in the urban market, they will strategically avoid direct competitions with the big four and other well established commercial banks, by positioning themselves in the SME, and microenterprises segments. RCCs operating in the rural areas will target the better-off and average households, but downscale their services to reach a part some bankable poor, which are economically active with sought IGA projects and good credibility of repayment.

RCCs’ market position will be less monopolistic within five years, as entry barriers will be lowered by the regulators and newcomers will enter to create a relatively more competitive environment in medium term (6-10 years). During the same period, the Government would gradually reduce its investments in subsidized lending, and its PA investments may shift to infrastructure and supporting services provision. Its main contribution in microfinance would be providing a functional policy and regulatory framework that matches the market efficiency.
Community-based and NGO-led microcredit schemes that have demonstrated sought management and operation capacities would be allowed to operate microcredit with official approval from regulators; however, savings mobilization will remain an exclusive business for formal financial institutions. As far as they are not converted into financial institutions specialized in microfinance under the supervision of CBRC, NGOs would not allowed to mobilize community savings. The regulators would encourage the conversion to facilitate the supervision, but such change may also mean a technical takeover of NGO microcredit by the existing RCC network.

Such development would make the market screening and sort out the future winners and losers of the current stakeholders and practitioners.

### 2.2 Future winners

- NGOs active in microfinance and demonstrating a strong commitment to financial independence, will either expand their microfinance-related activities, or institutionally upgrade themselves as non-banking financial institutions specialized in microfinance;

- RCCs in East and South regions converted into local commercial banks will build on their current microcredit methodology and experience to penetrate the urban small and micro-enterprise segments and develop them as core markets;

- Donors supporting microfinance development at regional levels (province and lower) with multi-period planning of implementation will make interlinking and leverage of their investments of different stages to achieve better sustainability and outreach.

### 2.3 Future losers

- ABC lending with its own funds at subsidized rate will suffer losses of loan principal contributed from its own savings;

- Central and West RCCs caught in a dilemma of ambiguous institutional identity and superficial reform process will lose their chance of strengthening their market position before the newcomers enter the market;
- NGOs operating microcredit but reluctant to cut the cord with the Government will not sustain at the moment the Government spin them off;

- Donors continuing pilot projects by using government agencies/extensions as distribution channel will realize they are supporting the Government or replacing the Government’s roles instead of supporting development in the sector;

- Donors ambitious in policy advisory services without successful showcase will not catch the Chinese policy-makers’ attention and their efforts would be considered as lips services both by the Government and the donors’ community.

2.4 Constraints related to development cooperation projects

Besides the challenges and constraints identified in microfinance development in China, a number of constraints related to development cooperation projects could be summarized as following:

- Project approach with primary focus on outreach;

- Short-term planning compromising sustainability that supports outreach;

- Ambiguity in institutional ownership of executing agency;

- Ambiguity in revolving funds’ ownership during and after project;

- Been lobbied by the Government to focus on demand side and little capacity building for supply side;

- Using rural reference to tackle urban problems;

- Been lobbied or pushed by the Government to cover a poor and remote areas where there are less chance to build a success story within a normal project life cycle.

2.5 Recommendations

The following recommendations are based on the past experience of donors’ support in microfinance in China, as well as the future development trends:
- Build field success story and undertake comparative research/analysis to support policy advisory objectives;

- Undertake institutional approach instead of simple project approach, at least at the later stage/phase of the project, which should promote institutional capacity building and local ownership strengthening;

- If supporting existing institutions (such as RCC or commercial banks), put the operational management at provincial level but keep national-level counterpart as coordinator;

- If supporting NGO, choose national organization with clear vision, strategic plan and firm commitment to gradually become MFI;

- Focus on capacity building instead of grant or generous credit line;

- Ensure counterpart’s commitments and risk sharing in terms of financial and human resources contributions, instead of in-kind matching.

### 2.6 Proposed development paths

Following are some development paths that are in conformity with the development needs and trends, realizable with short and medium donors’ supports:

- Build an urbanized RCC model performing in its new market competition and coach it in targeting the urban small enterprise and micro-enterprise segments;

- Build a RCC turnaround model that will be managerially and operationally sought in the West and Central rural areas to provide reference to the RCCs left behind the current reform plan;

- Support CASS’ training and consultancy center by building in some marketable services resources and turn it into a platform of information and resources sharing and exchange;
- Support development of microfinance umbrella association by identifying a national organization with clear vision and interests, helping introduce strategic planning to establish a comprehensive support system;

- Combine microfinance development with NGO promotion, and support the process of conversion from donor-assisted scheme to NGO, from NGO to future FI specialized in microfinance.