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World Microfinance Forum Geneva

WMFG is a private-public partnership that promotes inclusive financial markets. Member and partners of the WMFG include the Geneva Financial Center, bringing together more than 100 mainstream financial institutions: the Swiss Microfinance Platform, uniting over 40 commercial and non-commercial organizations active in microfinance; the Swiss Agency for Development and Cooperation; The Sustainability Forum Zürich; and forward-looking family offices, microfinance investment vehicles, private enterprises and foundations promoting sustainable development and inclusive finance.

WMFG provides investors, regulators and providers of inclusive financial services with a platform for continuous networking, dialogue and learning. Key activities of the WMFG are international and regional events, and original research on investment in inclusive finance.

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Foreword

Representing more than 20% of the world's population, China is rising fast in terms of wealth, prosperity and geopolitical influence but still has a considerable proportion of its population below the poverty line. While the concerted effort to provide poor and rural populations with access to financial services dates back a long time, a more market-oriented approach to inclusive finance is still in its infancy.

Intuitively, one might think microfinance operations would flourish given the population's entrepreneurial spirit and the government's focus towards a harmonious society. However, the creation of a sustainable system of inclusive financial institutions is not just a matter of the right attitude or intentions. It takes a systematic attempt at learning from past experiences, inspiration from good practices proven elsewhere, and a lot of pilot testing to get to a system that makes sense in the specific context of China and its different regions and provinces.

The World Microfinance Forum Geneva helps leading stakeholders to take well-informed decisions that ensure the translation of good intentions into effective access for all. In line with this mission, in February 2008 it convened the first workshop on investment in inclusive finance in China. In October of the same year, it organized an international symposium in Geneva that helped to put inclusive finance in China on the international agenda. As part of the intellectual input into the 2008 events, the World Microfinance Forum Geneva commissioned and edited a series of papers from leading academics to describe the present and possible future states of microfinance within China. This document is a compendium of those papers.

The compendium starts with the overview of the state of play prepared for the international symposium. This is followed by the set of papers on different aspects of inclusive finance in China prepared for the workshop in Beijing. These papers examine the policy and regulatory framework, the demand and supply of microfinance products and services, and the role of networks and patterns of cooperation. Lastly, the compendium includes the report of the workshop.

This year the World Microfinance Forum Geneva is convening a three-year Working Group on Investment in Inclusive Finance in China, comprising some of the leading international and local investors in the sector. This Working Group is continuing WMFG's work on the promotion of responsible investment in inclusive finance in China, through high quality research and regular meetings with key decision makers in China's regulatory system.

We hope you enjoy reading the compendium and learning more about the state of the debate. The views and opinions expressed are those of the individual authors and may not reflect the opinions of the World Microfinance Forum Geneva. Any errors contained within these papers remain the responsibility of the World Microfinance Forum Geneva.

March 2010

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The Current Situation and Future Prospects for Microfinance in China

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Even though microcredit in China has gone through over 10 years of growth and has achieved remarkable progress, it must not be forgotten that it is still at a nascent stage of development. This paper provides a general picture of the current situation of microcredit in China, and discusses its prospects over the coming 5–10 years.

1 The “What Is Meant by Microcredit?” Controversy

It is very important to define what “microcredit” means when considering its situation in China; and in particular—what size is a “microloan?” Two opinions currently prevail in the many debates:

- Some argue that a microloan should be defined as not exceeding a predefined **ceiling**, such as a multiple or percentage of a country or region’s Gross Domestic Product (GDP) per capita.
- Others think it is best expressed as not exceeding a given **relative value**. For example, a microloan would be any loan smaller than that granted by traditional financial institutions.

Two points must be emphasized:

- The popular opinion that a microloan should generally be equal to or less than GDP per capita of a country or region is often not adhered to in practice. In China, some so-called “micro” loans amount to several times the country’s economy (e.g., 100,000 Yuan, which is four times greater than China’s GDP per capita of 24,000 Yuan/US\$ 3,000)! Even individual loans amounting to hundreds of thousands—or millions—of Yuan are labeled “microloans.” For example, the China Banking Regulatory Commission (CBRC) has raised the maximum value of a microloan in coastal areas to 300,000 Yuan, while some people even categorize small enterprise loans of 5 million Yuan as microloans.
- International good practice guidelines suggest that loans should be considered “micro” if they serve disadvantaged groups to whom traditional banks are unwilling or

unable to provide financial services. This low segment of the credit market includes microenterprises, sole proprietors, and middle to low income people. According to the Consultative Group to Assist the Poor (CGAP), all types of low income households hovering around the poverty line (except the most destitute), should be considered potential microcredit clients.

Here, the author defines microcredit by flexibly using absolute value. So, in general, a loan below 100,000 Yuan is considered a microloan, although different standards can be applied to developed and underdeveloped areas.

2 Types Of Microfinance Providers

2.1 Comparison of Microcredit Suppliers

Microcredit suppliers in China can be categorized into eleven different types. **Tables 1a and 1b** summarize the features and performance of these types of suppliers.

Types of microcredit suppliers:

1. Microfinance Institutions (MFIs) established as non-governmental organizations (NGOs) for the public interest
2. Subsidized microcredit projects for poverty alleviation developed by state-owned banks such as the Agricultural Bank of China (ABC) and the Agricultural Development Bank of China (ADB)
3. Farmers’ microcredit projects implemented by Rural Credit Cooperatives (RCCs)

Table 1a. Comparison of Microcredit Suppliers — Clients and Products

| | Type of Institution | Since | Regions | Target Clients | Traditional Collateral | Average Loan Size | Annual Interest Rate* | Savings | Remittances |
|-----|---------------------------|-----------|----------------------|------------------------------------|-----------------------------|-----------------------------------------------|---------------------------|---------|-------------|
| 1. | NGO MFIs | 1993 | Country-wide | Mid/low income & poor | No | Several thousands | 3–18% | No | No |
| 2. | ABC | 1996 | Country-wide | Mid/low income & poor | No | Several thousands | 2–3% or zero | No | No |
| 3. | RCCs | 1999–2000 | Country-wide | All kinds of farming households | No, but yes for large loans | Several thousands – tens of thousands | 0.9–2.3 times basic rate | Yes | Yes |
| 4. | Urban Commercial Banks | 2002 | Urban Areas | Laid-off workers | Guarantee companies | Several thousands – several tens of thousands | Zero or low interest rate | Yes | Yes |
| 5. | MCCs | 2005 | Country-wide | Citizens & micro/small enterprises | Yes | Several thousands – hundred thousands | 14–28% but 21% on average | No | No |
| 6. | Village/Township Banks | 2006 | Country-wide | Citizens & micro/small enterprises | Yes | Several thousands – hundred thousands | 0.9–2.3 times basic rate | Yes | No |
| 7. | RMCCs | 2006 | Country-wide | Member farmers & enterprises | No | Several thousands | 0.9–2.3 times basis rate | Yes | No |
| 8. | Lending companies | 2006 | Country-wide | Citizens & micro/small enterprises | Yes | Several thousands – hundred thousands | 0.9–2.3 times basis rate | No | No |
| 9. | Poverty Alleviation Loans | 2004 | Country-wide | Mid/low income & poor | No | Several thousands | Less than basic rate | Yes | Yes |
| 10. | CPSB | 2006 | Country-wide | All kinds of farming households | Pledge or no collateral | Several thousands – hundred thousands | 0.9–2.3 times basis rate | Yes | Yes |
| 11. | Commercial Banks | 2005 | More than 10 regions | Citizens | No | Several tens of thousands | Around 20% | Yes | Yes |

* Calculated on a declining balance.

Table 1b. Comparison of Microcredit Suppliers — Performance

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

Note: The information in tables 1a and 1b was extracted from relevant documents and sources, and summarized by the author.

4. Microcredit projects implemented by Urban Commercial Banks and Guarantee Companies
5. Credit-only Microcredit Companies (MCCs) – Pilot Project of the People's Bank of China (PBC)
6. Village/Township Banks – Pilot Project of the China Banking Regulatory Commission (CBRC)
7. Rural Mutual Credit Cooperatives (RMCCs) (CBRC Pilot Project)
8. Lending Companies established by commercial banks (CBRC Pilot Project)
9. Subsidized microcredit projects for poverty alleviation implemented by rural financial institutions
10. Microcredit project implemented by the China Postal Savings Bank (CPSB)
11. Microcredit projects implemented by Commercial Banks

2.2 Microcredit Suppliers with Potential for Sustainability

China requires sustainable financial service providers in order to offer financial services demanded by disadvantaged groups in the long run. The following institutions and projects engaged in microcredit operations are potentially sustainable¹:

- Rural Credit Cooperatives, Rural Commercial Banks and Rural Cooperative Banks
- Agricultural Bank of China branches
- China Postal Savings Bank branches
- Shareholding Commercial Banks
- Micro Credit Companies
- Village/Township Banks
- Unregistered private Rural Mutual Credit Cooperatives
- Social Organizations or NGO MFIs

Foreign-funded institutions are beginning to enter the field by setting up Village/Township Banks and MCCs, as well as some microcredit projects, but progress is slow.

3 Microcredit's Future Prospects

Here are some views on the future of the business operations of different kinds of microcredit institutions:

3.1 Rural Credit Cooperatives

Rural Credit Cooperatives (RCCs) are the primary financial institutions giving microcredit in rural areas, along with Rural Commercial Banks and Rural Cooperative Banks. RCCs have issued 90% of the ca. 1.4 trillion Yuan total outstanding farming household loans across the country, and have approximately 370 billion Yuan of outstanding microcredit and group loans. It is estimated they serve over 70 million—possibly 90 million—farming households, accounting for about 30% of overall farming households in the country. However, the data on these loans collected by the author from different sources varies greatly. In particular, the discrepancy in statistics is significant in terms of the loan size that farming households obtain.

Due to RCCs' high operational costs, high credit risk, overloaded credit officers, and caps on interest rates they are allowed to charge (0.9–2.3 times the basic rate), their microcredit operations are generally loss-making. For instance, an RCC in Jiangxi Province is famous for its microcredit business, but were this accounted for separately, it would show an annual deficit of several million Yuan. A virtuous spiral of expansion has been further marred by poor asset quality and the limited management capacity of many RCCs across the country.

There is little scope for growth of RCCs' microcredit business in the near future without an adjustment of the relevant policies and regulations (as a matter of fact, RCCs' microcredit business has shrunk in some places). New measures would be needed to make RCCs' microcredit business sustainable.

3.2 Agricultural Bank of China Branches

In the late 1990s, the Agricultural Bank of China (ABC) launched subsidized microcredit for poverty alleviation. For various reasons, including poor asset quality, after 2000, these projects were almost suspended nationally. Very few projects continued in some regions of Yunnan Province with the support and collaboration of local governments.

Nevertheless, over the past two years ABC changed its operational focus from targeting urban areas to simultaneously covering and developing urban and rural financial markets. Moreover, it has started to consider the development of rural microfinance as an important business area for further exploration. Its efforts here are guided by two projects: "Serving Agriculture and Farmers Countrywide" and "Commercializing Operations." As a result, it is quite likely that ABC will become a significant force in rural microfinance. It is believed that in 3 years time the business of ABC's Department for Rural, Agricultural and Farmer Finance will cover 97% of state-designated and 90% of province-designated poor counties, and eventually 30% of all rural areas (*First Finance Daily*, August 15, 2008).

ABC issued a "Jinhui Farming Benefit Card," with farmer microcredit as its core product, to alleviate farmers' difficulties in getting loans. This card offers services including subsidy payments, deposits, microloans and remittances. By thoroughly exploiting the potential of current outlets and personnel, as well as widely using electronic channels such as online banking, telephone and mobile banks, mobile POS-devices and ATMs, ABC strives to better serve millions of farmers against relatively low transaction costs (Li Zhenjiang, *China Urban and Rural Finance*, August 14, 2008).

ABC aims to issue 5 million Farming Benefit Cards by the end of 2008, and to make this an exclusive product that eventually serves 250 million farmers across the country. And in 3 years, 30% of farming households nationwide should benefit from these loans.

However, at the majority of branches, the Farming Benefit Card and microfinance services have been developing slowly—leaving a wide gap between their objectives and actual performance. Reasons include inaccurate understanding of the cards' meaning, market positioning, and core function, as well as insufficient attention given to this work.

¹ More information on these institutions is provided in a paper entitled "The Current Supply of Microfinance in China," prepared by the author for the WMFG workshop in China in February 2008, see www.microfinanceforum.org

From the author's perspective, this powerful reform demonstrates ABC's desire to change its mindset, and make full use of modern technology, such as mobile banking, to solve farmers' difficulties borrowing. It is likely that the greatest challenge will be how to avoid borrowers' moral hazard and guarantee normal loan collection, so that historical mistakes can be effectively prevented.

3.3 China Postal Savings Bank Branches

In terms of its deposits, CPSB ranks as the 5th largest bank in China, and its 37,000 branches make it the country's largest urban and rural network. It therefore has great potential to cover unbanked rural areas and become a distinctive retail bank.

Since its 2006 pledge, CPSB has piloted its microcredit business in vast rural areas, achieving preliminary results. Based on its assumption that it will be able to capture 2% of the market, CPSB believes that by the end of 2010 it will have disbursed 30 billion Yuan in microloans to farmers and 100 billion Yuan in rural microloans. In addition, it plans to gradually develop other financial services like microinsurance. It predicts that within three years, the balance of its loans below 100,000 Yuan will amount to 80 billion Yuan, and within five years the balance of its loans below 1 million Yuan will reach 600 billion. By that time, these loans will account for 30% of all outstanding loans. CPSB may also decide to provide wholesale funds for retail MFIs with good operational performance.

The challenges to CPSB's future development include a lack of talent, relevant experience, and risk control capability in operating financial business. Other problems include unsound accounting methods, an incomplete risk management framework, and flaws in internal control mechanisms (*Wealth.863171.com*, 24 November 2007).

3.4 Shareholding Commercial Banks

Most shareholding commercial banks have not paid microcredit much attention. However, some have progressed remarkably in exploiting urban and rural microcredit businesses. Twelve urban and rural commercial banks have joined pilot projects initiated by the China Development Bank (CDB) and the World Bank in 2005, including Taizhou and Baotou commercial banks. Harbin Bank is also engaging in microfinance, under internal pressure to reform.

The twelve pilot banks in collaboration with CDB have spent about 40,000 loans worth 2.7 billion with an average loan size of 70,000 Yuan. They enjoy high profitability, high growth, and their portfolio has less than 1% overdue by more than 30 days.

In 2005, Baotou Commercial Bank explicitly defined medium, small and microenterprises as core clientele. It defined micro- and small enterprise loans as those ranging from 3,000 to 3 million Yuan per client. By July 2008, it had issued 13,429 loans to micro- and small enterprises for a total value of 2,623 billion Yuan, and the total loan portfolio outstanding was 1.48 billion Yuan. Of these, 8,062 loans were outstanding with 7,311 micro-entrepreneurs for a total value of 0.574

Table 2. Projections of Microcredit Disbursed by Harbin Bank (Unit: Yuan)

| Year | Products | Accumulative Loans Disbursed | | Loans Outstanding | |
|-------|--------------------------|------------------------------|-------------------|-------------------|-------------------|
| | | Number | Amount (billions) | Number | Amount (billions) |
| 2013 | Farming Loan | 1,356,500 | 33.9 | 301,400 | 7.5 |
| | Microcredit | 31,400 | 3.1 | 22,400 | 1.6 |
| | Individual Business Loan | 11,300 | 10.2 | 2,200 | 2.0 |
| | Micro Guarantee Loan | 19,600 | 0.4 | 7,900 | 0.2 |
| | Small Enterprise Loan | 8,500 | 22.0 | 1,700 | 4.4 |
| Total | | 1,427,300 | 69.6 | 335,600 | 15.7 |
| 2018 | Farming Loan | 2,910,600 | 72.8 | 529,200 | 13.2 |
| | Microcredit | 58,800 | 5.9 | 42,000 | 2.9 |
| | Individual Business Loan | 45,700 | 41.2 | 4,600 | 4.1 |
| | Micro Guarantee Loan | 73,500 | 1.5 | 14,700 | 0.3 |
| | Small Enterprise Loan | 33,900 | 88.2 | 3,400 | 8.8 |
| Total | | 3,122,500 | 209.5 | 593,900 | 29.4 |

Notes: ≤100,000 Yuan: consists of 90% of total farming loans, microcredit, micro guarantee loans.
100,000-500,000 Yuan: consists of 10% microcredit.
0.5-5 million Yuan: consists of overall individual business and small enterprise loans.

Source of data: Harbin Bank

billion Yuan. The overdue rate among these microloans was below 2%.

Baotou Commercial Bank's five-year development goal is to make its portfolio of micro and small loans reach at least 30 billion Yuan, resulting in earnings that comprise over 1/3 of the bank's total profit. Of this portfolio, 12 billion Yuan should be for loans with an average value of 100,000 and a maximum value of 500,000 Yuan.

Projecting itself as a microfinance bank, Harbin Bank promotes the concept of inclusive finance and harmonious wealth. By June 2008, it has granted loans worth approximately 30.4 billion Yuan. Urban-rural microcredit (including small enterprise loans) account for 33% of total credit assets and 50% of overall earnings. This includes farmer loans with a maximum loan size of 100,000 and average loan size of 20,000 Yuan, and 213,000 outstanding farmer loans at 5,374 billion Yuan. Its portfolio yields 6.74%, with a non-performing loan rate of 0.51%.

Harbin Bank aims to become a first-class microfinance bank within 3–5 years in China, and world-class in 5–10. It estimates its microcredit portfolio will reach 15.7 billion in 5 years and 29.4 billion Yuan in 10, accounting for respectively 50% and 70% of total loans outstanding. This microcredit can be divided into three types: over 50% of loans are less than 100,000; about 2% are 100,000–500,000; and about 45% are 500,000–5 million Yuan.

To summarize, the microcredit operations of shareholding commercial banks can be categorized into two kinds:

- The first reflects the situation in which the majority find themselves in: so far they have not paid enough attention to their microcredit operations and need to reconfirm their willingness to engage in microcredit, and develop relevant skills—before they can expand their operations on a large scale.

- The second is represented by leading pioneers such as Baotou Commercial Bank, Taizhou Commercial Bank and Harbin Bank. With their continuous exploration and expansion, they must keep their minds alert and learn from experience. They have to improve their operational and management capacities to prevent the risk of running too fast. Issues pertaining to the quality of personnel, mechanisms of internal control and the establishment of outlets should be settled before they grow their microcredit operations.

3.5 Credit-only Microcredit Companies

In 2008, after the PBC and CBRC issued *Guidelines on the Establishment of a Microcredit Company* (CBRC 2008, File 23), many provinces had great enthusiasm for setting up MCCs. Available information indicates that over a dozen provinces, including 5 pilot provinces designated by PBC in 2005, have facilitated the establishment of private commercial MCCs with a good momentum for growth. For example, so far over 10 MCCs have been established in Ningxia Province with a total capital of more than 2 billion Yuan. And Jiangsu Province has a plan to launch dozens of MCCs with a total projected capital of 80 billion Yuan next year.

MCCs show they could be one of the microcredit providers with the fastest growth in the coming 2–3 years in China. They should pay attention to vigorous promotion and risk prevention; key causes for concern appear to be operational risk and moral hazard.

3.6 Village/Township Banks

Since 2007, no less than 70 Village/Township Banks (VTB) have been set up. Performance varies. The target clients, operational philosophy and methodology of VTBs resemble those of RCCs, but very few VTBs are keen to deliver loans as small as several thousand or tens of thousand Yuan. At county level, VTB assets are lower than RCCs'. Because they have been operating for a short time, it is difficult for VTBs to mobilize savings. At present, VTBs enjoy the advantage of greater flexibility than RCCs in the interest rates they are allowed to charge (4 times the basic interest rate). However, they are disadvantaged by an unclear tax policy, whose implementation varies across counties. Besides, VTBs cannot obtain on-lending funds from the central bank. Like RCCs, VTBs need creativity to improve *inter alia* their philosophy, operational methods, product design, and incentives.

HSBC has so far established 3 VTBs, and is preparing to launch more. It would like CBRC to allow it to set up a parent organization where the administration and management of VTBs operating in different counties could be centralized, in order to reduce operational costs through scale economies. It is not clear yet whether such a pilot system can be implemented.

3.7 Rural Mutual Credit Cooperatives

Since CBRC announced its pilot reform programme for Rural Mutual Credit Cooperatives (RMCCs) in 2007, only 9 RMCCs have been established. This is low, especially in comparison with the nearly 30 Village/Township Banks registered in the same period. Just like the unregistered rural (community) mutual credit cooperatives established before 2007, registered RMCCs experience unbalanced development with uneven performance. There are several explanations. On the one hand, as a consequence of lessons learnt with past rural

cooperative foundations, local governments have generally shown no interest in setting up RMCCs –some even objected. On the other, CBRC's requirements with respect to prudential supervision and institutionalized operation make RMCCs operational costs unbearable.

Besides these external factors, RMCC sustainability would require at least the moderate development of a local market economy, community cohesion, the ability to raise funds by selling shares to members, at least one respectable person capable of handling issues fairly, mechanisms and a capacity for mass democracy, relatively sound operational and financial management systems, and suitable external supervision... Therefore, one concludes there is no prospect for RMCCs to achieve relatively fast, extensive, healthy and sustainable development in the near future. But passion and potential exists for further development, were government policies to become more favourable. Then, risks would probably mainly lie in poor, unsustainable operations, illegal deposit mobilization and fundraising, and disruption of the financial order.

3.8 Social Organizations or NGO MFIs

The most significant function of these institutions is to serve middle to low income and poor clients, which other financial institutions are unwilling or unable to serve. Some RMCCs fit into this category. Until now, the central government has not promulgated any specific policy or regulation for this type of credit-only organization, even though it has clearly indicated its support for the development of microfinance institutions of various types in its "Number-One Documents."

One could consider three possible methods for regulating these organizations, depending on their stage of development:

1. Allowing their existence
2. Requiring them to submit data
3. Registering them

For each regulation method, different requirements, policies, incentives, disincentives and exit mechanisms could be adopted.

There are several options for these organizations to develop:

- Continuing as an NGO but becoming healthier and stronger
- Transforming into an MCC
- Transforming into a Village/Township Bank
- Developing microcredit business in cooperation with commercial banks
- Becoming a shareholding microfinance company operating across counties
- Transforming into an RMCC, etc.

All options rely on the existence of supportive external policies, motivation and capability, and the willingness, collaboration and management of relevant partner organizations. Their absence risks greatly that transformation will fail and asset quality will decline.

Social organizations and NGO MFIs are unlikely to reach significant scale, unless favourable policy changes are made. If they can successfully become well-managed MCCs or even banks (after going through a long and painful process), they will ultimately enjoy rapid expansion and growth; especially those in provinces where they are allowed to develop businesses across counties and prefecture-level cities. However,

if they attach more value to commercialization than to serving mid/low income and poor clients, they risk marginalizing disadvantaged groups even further.

Since NGO MFI services mostly cover remote underdeveloped or sparsely populated areas, it is worth exploring whether they can take advantage of technologies like mobile banking, POS-devices and computerized MIS systems at low cost and large scale.

4 China's Government Policies and Regulations on Microcredit

4.1 Features of the Evolution of Government Policies and Regulations

4.1.1 Policies and regulations lag, but are gaining momentum

China's development of microcredit policies and regulations started late; it is about 20 years behind early movers. The process of slow, gradual liberalization was followed by regression, until 2006 and 2007 brought accelerated policy and regulation formulation. These must now be further improved.

The process through which the development of policies and regulations on microcredit has gone reflects a steady progression from:

- Disagreement or a “wait-and-see” attitude, to
- Acknowledgment of microcredit’s effective role in reaching poor households, to
- Support for pilot microcredit projects and a confirmation of the function of microcredit in upholding rural development, to
- Requirements by central government that MFIs with diversified ownership structures be established, to
- Central government’s confirmation that microcredit is an integral part of the rural financial system—which needs active cultivation and development—and proactive promotion of relevant regulatory departments and further improvement of regulations

4.1.2 Government Has Focused More on Commercial Microcredit and Less on Microcredit for the Public Interest

Microcredit laws and regulations that have been issued until now only relate to formal commercial banks and new types of financial institutions. There are no regulatory documents for public-interest microcredit operations or institutions, which by their nature focus on poverty alleviation. Despite such an environment, public-interest MFIs have been able to develop and sustain themselves. This is mainly due to imperfect policy linkages between central and local government, as well as the vitality of organizations themselves.

4.2 Improvements in Relevant Policies and Regulations for Further Discussion

4.2.1 Relax the Territorial Limitation on Village/Township Bank and MCC Operations

Village/Township Banks and MCCs are only allowed to operate within the counties in which they are located. This causes

a lack of incentive for growth and expansion. This needs to be adjusted. For example, when they reach certain standards after 2–3 years of normal operations, they could be allowed to expand to adjacent areas.

4.2.2 Relax the Limitation on Sources of Funding and Leverage for Credit-Only MCCs

Under existing regulations, a credit-only MCC can only mobilize wholesale loans worth up to 0.5 times its registered capital from two banking institutions. This overly-conservative policy needs to be adjusted. For instance, permitted leverage could be enlarged step-by-step from 0.5 to 4 times, or even more, depending on circumstances.

4.2.3 Relax the Requirements for Commercial Bank Shareholding in Village/Township Banks

In a Village/Township Bank, a commercial bank must be the largest shareholder. Given insufficient resources for supervision and regulation, this provision seems suitable for a while. Nevertheless, with the establishment of more Village/Township Banks, it would be reasonable to consider its relaxation. Indeed, under certain conditions commercial banks could be required to take only a minority stake or no stake at all.

4.2.4 Relax the Cap on Interest Rates for RCCs and ABC

RCCs and ABC face an interest rate cap of 0.9 to 2.3 times the basic rate. This is unfair, since other organizations engaging in microcredit can charge 4 times the basic rate. Besides, it is unreasonable, since this means they cannot generate enough revenue to cover their costs (see, for instance, Wu Yuan RCC of Jiangxi province and Beijing Rural Commercial Bank). RCCs and ABC should be allowed to charge interest more in line with competitors.

4.2.5 Relax Regulations for RMCCs, in Particular at Village Level

RMCCs that are set up under the CBRC's pilot project require significant investments in security and personnel, while being subject to prudential regulations. All this unnecessarily increases costs. Besides, prudential regulations are difficult to enforce, given regulatory authorities' limited resources and capacities. Without additional support, such requirements hinder RMCC growth, making them unable to survive or develop sustainably. In addition, the theory that RMCCs set up in accordance with CBRC regulations can finance themselves from commercial banks hasn't verified in practice so far. Therefore, the author recommends that regulatory authorities apply only non-prudential regulation and supervision to RMCCs. Their transparency and integrity should be assured through a public reporting system. Furthermore, regulatory authorities should establish policies that allow RMCCs to raise necessary funds for their operations.

4.2.6 Issue Policies and Regulations for Public-Interest MFIs that Pursue Sustainability

Public-interest MFIs, defined as those MFIs that have an average loan balance per client of less than 50,000 Yuan, are currently unregulated in China. Generally speaking, existing commercial financial institutions engaged in microcredit do not reach low income and poor farming households. Therefore, public-interest MFIs that pursue sustainability deserve

an appropriate legal status, and funds and favourable policies to strengthen their quality and capacities. At the same time, the government should facilitate domestic and international investment in these MFIs.

4.2.7 Issue the Planned Money Lenders' Ordinance

The Money Lenders' Ordinance legalises informal non-depository credit practices. It effectively strengthens the positive impact of informal financial practices, and mitigates their negative impact. The Money Lenders' Ordinance should be issued. However, before it is, management and sanctioning policies and measures should be put in place to prevent illegal fundraising.

4.2.8 Open the Market to Foreign Capital and Technology

Although there is some experience with foreign capital and technology, distinct rules and regulations are unavailable. An open market can play an important role in introducing technology, management and talent, promoting competition and increasing supply, as well as in pushing forward the development of the microfinance market. At the same time, however, an open market can lead to foreign capital and technology displacing domestic investors and microfinance operators, resulting in foreign institutions taking a large market share. In the near future, the latter risk is insignificant. A more realistic risk is that foreign institutions will be unable to adapt to their surroundings and achieve successful localization. Or, they will be unwilling to serve the truly low.

International investors can be divided into 3 categories:

- 1. Commercial and social investment funds or donors targeting the middle or high segment of the microfinance market.** They are advantaged in integrating capital, technology, management and talent and achieving economies of scale. Some played an important role developing microfinance operations in the former Soviet Union and Eastern European, with success. In collaboration with actors such as IPC and the World Bank, the CDB has introduced international technology and capital and then conducted experiments in more than 10 shareholding commercial banks, resulting in delightful achievement. This model could be further tested in more regions, and improved policies could be based on the pilot's effectiveness.
- 2. International investors focusing on the mid to low segment of the microfinance market,** such as Grameen Trust (GT), ASA and ACCION International. GT has cooperated with the RCC Union of Hainan Province by providing technical assistance, and has a plan for further cooperation with domestic institutions, to set up MCCs through the method of "build, operate and transfer" (the so-called BOT model). Local governments and international microfinance networks and providers should find more efficient ways of working together, so as to provide faster proof of what works and what doesn't.
- 3. Commercial microfinance players** such as HSBC, Standard Chartered and Microcred that have set up Village/Township Banks and MCCs. The geographical limitation on Village/Township Banks and MCCs, while conducive to risk control from the regulators' perspective, restricts domestic and international investment, because it affects investment cost and profit margins; it should be relaxed.

4.2.9 Build Supporting infrastructure at the Meso Level

Besides this strategy of creating a diversified set of retail microcredit agencies, China needs to develop the infrastructure required to support their healthy development: including wholesale funds, credit bureaus, external auditing companies, rating agencies, consulting companies, training agencies, and guilds/associations or networks.

4.2.10 Publish a Systematic and Complete Set of Documents for the Purpose of Promoting Microfinance Development

Based on the discussion above, it is recommended that policies or regulations (such as *Guidelines for the Support of Microfinance Development*) or other temporary provisions be published, in order to encourage the healthy, rapid, growth of microfinance. These should include specific rules for various types of institutions engaged in microfinance. After a period of implementation—in which different practices are tested and institutions given a chance to reach a certain level of maturity—such provisions could be reformulated and turned into law. A rush to make regulations and laws will restrict innovation and end up giving the industry a wrong direction. The publication of rules and regulations that support microfinance development in China will allow all domestic and international investors and stakeholders interested in microfinance to obtain a clear and complete picture of China's government policies on microfinance. This will improve investment efficiency in microfinance, and ultimately benefit the healthy growth of microfinance business in China.

4.2.11 Define the Role of Government in Directly Providing Credit Services

On the one hand, government's inclination to directly participate or intervene in providing financial services by itself in line with best practices, generally achieves good results. On the other, under formidable pressure from society and its own precepts, government continues to support unredeemable and inefficient subsidised loans, which makes projects difficult to sustain, while distorting the market. In the presence of such unfair competition, commercialized microfinance projects cannot survive. The government should carefully consider what role it wants to play in creating an enabling environment and directly facilitating the provision of credit services.

4.2.12 Strengthen the Communication and Coordination between Different Administrative Departments that Support Microcredit.

One of the decisive factors for microcredit growth is the support and encouragement of government policies and regulations. In China, the relevant government departments include at least the PBC, CBRC, Ministry of Finance (MOF), Poverty Alleviation Offices, the State Administration of Taxation (SAT), and local governments at all levels. These should reinforce their communication, reach consensus, and take consistent steps to promote the healthy, orderly and large-scale development of microcredit organizations. ■

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The Policy and Legal Framework for Microfinance in China

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Executive Summary

There are currently three types of microfinance in China: public-interest, mutual and commercial microfinance. Chinese microfinance started as public-interest projects, normally operated by Non-Governmental or Non-Profit Organizations (NGOs/NPOs). Mutual funds have been developing rapidly in recent years while commercial microfinance projects have started to become undertaken by commercial banks, which have legal banking licenses. Theoretically, it is illegal in China for NGOs/NPOs to provide financial services. However, public-interest Microfinance Institutions (MFIs) have become an important component of the microfinance industry in China and receive governmental support in a variety of forms. The Chinese government will have to continue to focus on improving the legal and policy environment for microfinance if the industry is to continue to grow and prosper.

1

Microfinance Players in China

1.1 Definition of Microfinance in China¹

In China, microfinance only consists of microcredit operations and does not include savings, insurance or transfer payments. In rural areas, microfinance institutions (MFIs) tend to target clients from farming households and rurally-based microenterprises whilst in urban areas the institutions focus on laid-off and unemployed workers and urban-based microenterprises.

1.2 Categories and Providers of Microfinance in China

The Chinese microfinance industry can be divided into the following categories:

1.2.1 Public-interest Microfinance

Public-interest MFIs are operated by non-government organizations (NGO) or the government and their principal objective is to reduce poverty and promote social development. The main difference between NGO and governmental MFIs is that NGO MFIs pursue self-sustainability whereas sustainability is not a goal of governmental MFIs. This paper will focus on NGO MFIs.

1.2.2 Mutual Microfinance

In recent years, an emerging mutual fund model in rural communities has received significant attention from governments and donor agencies. Chinese civil society has a long history of mutual funds, known as Hehui, or ROSCA in the west. Mutual funds were created by farmers themselves, or with support from the government or international development organizations. An example of such a fund is the rural community revolving fund which was created with the support of the State Council's poverty alleviation office. External supporters also provide technical assistance and additional funds, and act as policy coordinators. Loan capital for mutual fund operations is usually mainly provided by the fund members themselves. Mutual funds are managed by, and in the interests of, the fund members.

In 2007, the Chinese Banking Regulatory Commission (CBRC) permitted the registering of a new type of mutual fund, known as a rural mutual credit cooperative (RMCC). RMCC is the only form of mutual financial institution recognized by financial regulators.

1.2.3 Commercial Microfinance

The term "Commercial Microfinance" refers to the microfinance services provided by formal financial institutions. The objective of commercial microfinance is to achieve commercial sustainability as opposed to poverty alleviation. As a result microfinance products from these providers tend to be targeted towards the mid/low income market segment.

Commercial microfinance providers include rural credit cooperatives (RCC), rural commercial banks, rural cooperative banks, village banks (VB), lending companies (LC), urban commercial banks, postal savings banks and microcredit

¹ The definition of microfinance differs between the People's Bank of China (PBOC), CBRC and NGO microfinance promoters. NGO microfinance promoters emphasize the fact that microfinance is a tool to reduce poverty, targeting mid/low income and poor clients, and that institutional sustainability is a way of promoting social development in the long run. The PBOC also has the similar requirement that clients of microfinance should be from mid/low income microenterprises in rural areas. The CBRC does not make any requirement on its clients' economic status, i.e. whether they are poor or not, but does insist that rural microcredit should involve small loan sizes and be granted to households, individual businesses and small enterprises in rural areas.

companies (MCC). However RCCs, VBs, and MCCs are the main players in this sector and therefore the focus of analysis in this paper.

MCCs are a new type of microfinance provider and were first created in 2005 as a pilot program initiated by the People's Bank of China (PBOC). With the exception of MCCs, all commercial microfinance providers are registered financial institutions.

2 Development of the Policy and Legal Framework for Microfinance in China

In 2005, Prof. Du Xiaoshan gave the following summary of the development of the Chinese policy and legal framework for microfinance:²

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

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

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

In July 1999, the PBOC published its "Temporary Management Methods for RCC Microcredit Loans."

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

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

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

From Prof. Du's analysis, we can observe two features of the development of Chinese microfinance policy and its legal environment before 2004:

Firstly, the organizational legal basis of microfinance changed from multilateral or bilateral cooperative agreements to non-profit organizational laws. Public-interest microfinance generally started as poverty alleviation projects assisted by international donor agencies. The legal basis behind these projects lies in the agreements made between the government and donor agencies. MFIs were created in order to alleviate poverty in a sustainable manner. Due to the nature

of public-interest microfinance, MFIs are generally registered as non-profit organizations (NPO), such as societal organizations, privately-run non-profit enterprises, foundations and institutions, which are formed in accordance with the respective non-profit laws.

Secondly, the legality of microfinance operations was transferred from the policy level to the level of both policy and legislation. During the early stages of microfinance in China, the main industry players were NGOs and NPOs which could not obtain business licenses or authorization from financial regulators. Since 2004, Chinese Communist Party (CCP) policies, together with recognition and praise for microfinance operations from the party's leaders, have helped to create a positive environment for microfinance development. Once formal financial institutions also started microfinance operations, more and more regulations were issued by the industry's regulators. However these regulations were not applicable to public-interest MFIs.

The most recent changes in the policy and legal environment started to occur in 2005. The PBOC launched MCC pilot projects in five provinces in the same year, and some 7 MCCs have been established thus far. As a result, the PBOC published new guidelines for MCCs in 2006. In December 2006, the CBRC published a policy paper entitled: "Opinion Regarding Easing Market Access for Banking Financial Institutions in Rural Areas in order to better Support the Construction of a New Socialist Countryside." The paper advocated the creation of three new types of rural financial institutions: Village Banks (VBs), Lending Companies (LCs), and Rural Mutual Credit Cooperatives (RMCCs). In January 2007, the CBRC issued further microfinance policy papers entitled "Provisional Rules on the Administration of Village Banks," "Provisional Rules on the Administration of Lending Companies," and "Provisional Rules on the Administration of Rural Mutual Credit Cooperatives." In December 2006 the CBRC started pilot projects in 6 provinces and then expanded the project to a total of 31 provinces, autonomous regions and municipalities in October 2007. There are currently 11 VBs, 4 LCs and 8 RMCCs operating throughout China.

3 The Policy and Legal Environment for Public-Interest Microfinance

3.1 Legal Status

3.1.1 Non-Profit Organizations

There are currently four different organizational forms for public-interest MFIs: societal organizations, foundations, privately-run non-profit enterprises and institutions. The following legal documents detail the legal frameworks behind these four organizational forms: "Rules on the Administration of Societal Organizations," "Rules on the Administration of Foundations," "Provisional Rules on the Administration of Privately-run Non-profit Enterprises" and "Provisional Rules on the Administration of Institutions."

The following articles are of interest:

- Article 2 of "Rules on the Administration of Societal Organizations" stipulates that a societal organization is a non-profit social organization
- Article 29 of "Rules on the Administration of Societal Organizations" states that a societal organization is prohibited from performing for-profit business
- Article 2 of "Rules on the Administration of Foundations" explains that a foundation is a non-profit legal organization engaging in public-interest undertakings

² Du Xiaoshan: *The Regulatory Environment for Microfinance in China*. April, 2005. www.cgap.org/regulation.

- Article 2 of “Provisional Rules on the Administration of Privately-run Non-profit Enterprises” elaborates that a privately-run non-profit enterprise is a social organization undertaking non-profit social services
- Article 2 of “Provisional Rules on Administration of Institutions” underlines that an institution is a social service organization set up by the state with state-owned assets for social public-interest purposes, undertaking efforts relating to education, technology, culture or healthcare

3.1.2 Non-Financial Institutions

Article 21 of “General Lending Rules” states that an institution engaging in lending must be approved by the PBOC (CBRC, after the year 2003), must have received a “Financial Institution Legal Organization” or “Financial Institutional Operation” license from the PBOC (CBRC, after the year 2003), and must be registered with the Administration for Industry and Commerce (AIC). Article 19 of the “Banking Regulation and Supervision” law stipulates that without the authorization of the State Council’s banking regulatory authority, no institution or individual can create a banking institution or engage in banking operations (N.B.: all credit related activities are considered as banking operations).

Thus far public-interest MFIs are yet to have obtained any approval or license from the banking regulatory authority. In addition no public-interest MFI has registered with the AIC. As a result there is currently no legal basis for the operations of public-interest MFIs.

3.1.3 Basis of Legality

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

a. National policy on poverty alleviation, rural financial reform and innovation

Since 2004, the major annual policy documents from the CCP have all been related to rural development. All of the policy papers in this area call for rural financial reform and innovation. Microfinance has been recognized and promoted as an innovative method of rural financial reform and an effective tool for poverty reduction. The policy paper of 2006 clearly advocated the formulation of regulatory rules for the administration of MFIs, while that of 2007 identified microfinance as an indispensable part of the overall financial system, including commercial finance, cooperative finance and policy finance (finance provided by government banks). In January 2007, the third national conference on finance concluded that it was necessary to further facilitate rural financial reform and financial organizational innovation, as well as to actively support various forms of microfinance.

b. International cooperative agreements

Most public-interest MFIs originated from poverty alleviation projects, financed by international donor agencies. The projects typically involved donor agencies signing agreements with the Chinese government in order to facilitate the creation of independent NPOs. These NPOs would then guarantee the continuation of microfinance operations after the end of the project phase.

c. Government-approved poverty alleviation and financial innovation pilots

Microfinance operations are consistent with the Chinese government's strategy of promoting poverty alleviation, rural financial reform and innovation. Results demonstrate that microfinance can deliver higher efficiency and effectiveness in these areas. It is because of the positive results

generated thus far that the microfinance industry has been left free to develop and attract attention and support from national and local government, regulators and domestic and international investors.

3.2 Financing

3.2.1 Current Funding Sources

Currently, public-interest MFI funding sources include international and domestic donations, and subsidies from government for such expenses as: offices, transportation, partial salaries or allowances, accumulative net earnings, small amounts of compulsory savings, and, on some occasions, fiscal funds for poverty alleviation.

3.2.2 Equity Financing

The majority of public-interest MFIs are based on one of the four forms of NPOs mentioned above. The providers of NPO funds are prohibited from receiving any economic returns on their investments and from obtaining ownership of the organization. In addition, since public-interest MFIs are state-owned, private or foreign investment is prohibited. The nature of the NPOs and state-owned institutions acts as a barrier against equity financing of public-interest MFIs.

In practice, some larger supporting organizations and foundations charge fees, based on profits, to local public-interest MFIs. The rationale for these charges is that the supporting organizations or funding foundations need to cover the cost of mobilizing funds, technical support, policy coordination and supervision of the MFIs. This practice provides a possible route towards equity financing.

3.2.3 Liability Financing

There are two main types of liability financing in general: public savings and loans from commercial banks. Unfortunately, these options are often unsuitable for public-interest MFIs.

Firstly, without licenses from financial regulators, any person or organization is strictly prohibited from working with public savings. The social and economic costs of disobeying these rules are so high that no public-interest MFIs work with public savings. Some MFIs collect a small amount of compulsory savings from clients as part of their lending methodologies, for example, as a guarantee for a loan.

Secondly, the banking regulators forbid commercial banks from supplying loans to the MFIs registered as NPOs.

3.2.4 Foreign Investment

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

As detailed above, legal barriers are currently in place prohibiting equity investment. However, it is still possible to receive foreign loans if strict conditions are followed. According to the law: “Provisional Measures on Administration of Foreign Debts,” foreign debts include: foreign government loans, international financial institution loans and international commercial loans. Article 21 of this law stipulates that without the approval of the State Council, any governmental organs, social organizations or institutions are forbidden to take on foreign debt.

Currently, there is only one case of a foreign loan being approved in China — the long-term favored loan transaction between KFW and Zhaowuda Women Sustainable Development Association in Inner Mongolia. The negotiation,

application and approval process for the loan has lasted for almost 4 years, with the involvement of the national governmental agencies of National Development and Reform Commission (NDRC), Ministry of Finance (MOF), State Administration of Foreign Exchange (SAFE), and the relevant departments at the autonomous region and municipal level. The procedure is expected to end this year.

There are currently no cases of short-term commercial micro-finance loans in China.

3.2.5 Wholesale Funds

In some countries wholesale funds, such as PKSF in Bangladesh, have been created in order to support NPO MFIs. Although such a fund is yet to be created in China, a number of microfinance promoting agencies or foundations act as wholesale funding agencies. For example, the China Development Bank (CDB) offers microcredit capital to some MFIs at local level, as well as to bigger national foundations such as the China Foundation of Poverty Alleviation (CFPA). In addition, the China International Center for Economic & Technical Exchanges (CICETE) and the Beijing Nongfa Foundation of Poverty Alleviation (known as "Funding the Poor Cooperative" and founded by the Rural Development Institute of CASS) also provide credit capital to affiliated MFIs.

3.3 Monitoring and Supervision

Public-interest MFIs may be regularly or irregularly monitored by donor agencies and relevant local official agencies. After the closure of a project, donors usually have no budget for, energy to, or interest in, monitoring the performance of the institutions. Neither do the relevant government departments and registration organs have the required levels of professional staff or knowledge to supervise the MFIs. In addition the responsibilities of financial regulators do not extend to the supervision of MFIs.

Although the above-mentioned supporting organizations, which mobilize funds and provide technical support to MFIs, play some part in supervising the institutions, they are not officially authorized supervisory bodies, and should in themselves be supervised for matters such as the receiving of donations.

The China Association of Microfinance (CAM) has tried to construct a regulatory framework for public-interest MFIs. The "Citi training center of the China Academy of Social Sciences" (CASS) has made significant efforts to provide technical training to MFIs. However, owing to their unregistered status, the CAM's requirements have no binding power over any MFI without authorization from the government. The poor performance of public-interest MFIs in China is, to a significant extent, attributable to the lack of an effective supervisory system.

3.4 Staff

The unclear legal status of public-interest MFIs means that the sector's future is uncertain, making it difficult to recruit and retain qualified professionals — one of the major obstacles to the institutions obtaining institutional sustainability.

3.5 Clients

Furthermore, again as a result of their unclear legal status, some public-interest MFIs were sued by clients in an attempt to avoid repaying their loans. The Funding the Poor Cooperative (FPC) in Hebei Province was once faced with such an embarrassing situation. Although the FPC won the lawsuit, the issue of an unclear legal status still remains a significant problem.

3.6 Taxation

As NPOs, public-interest MFIs have enjoyed exemption from corporate and income tax since their creation. However in an exception to this treatment, the FPC in Nanzhao County, Henan province, was taxed and then partially refunded at a later date. Such cases highlight the uncertainty of the tax exemption status of MFIs engaging in profit-making lending activities.

4 The Policy and Legal Environment for Commercial Microfinance

In rural areas, RCCs are typically regarded as being the largest microfinance providers. However, due to complicated problems regarding ownership, governance, and management, many RCCs are currently undergoing significant internal reform. From an investment perspective, this paper focuses on analyzing VBs and MCCs.

4.1 Ownership

The main problem concerning ownership lies in the limitations placed on VBs. Article 25 of the "Provisional Rules on Administration of VBs" states that the controlling shareholder, or sole shareholder, of a village bank must be a banking institution and that the controlling shareholder, a banking institution, shall hold at least 20 per cent of the VB's total equity.

However a number of international microfinance providers that are not financial institutions would like to start licensed microfinance operations in China. In addition, a number of owners of MCCs who are natural persons or non-financial institutions would like to convert into formal financial institutions. Although village banks are an ideal choice for both domestic and international investors, the above limitations on ownership prevent international non-financial institutions from investing in them. Moreover, domestic owners of MCCs are often unwilling to lose control of their institutions. As a result of these limitations and complications potential investors are often prevented from investing in village banks.

4.2 Registered Capital

The registered capital of county and township based village banks must be no less than 3 million and 1 million Yuan respectively whilst the registered capital of a MCC must be no less than 5 million Yuan.

Since commercial banks are the largest shareholders in village banks and are subject to stringent financial supervision and regulation, village banks are licensed to work with public savings — even though their registered capital is less than that of MCCs.

4.3 Sources of Funds

As mentioned above, all financial banking institutions are licensed to work with public savings whereas MCCs can only receive funds from their owners, as donations or as wholesale funds from one source. Furthermore, MCCs are not allowed to receive loans from banks.

The limitations on funding sources make it difficult for MCCs to rapidly expand their credit operations. As a result, potential investors tend to prefer VBs to MCCs.

4.4 Business Region

RCCs, VBs, LCs and MCCs can only do business in their registered administrative region. Moreover, VBs can only be registered in rural areas. The term "rural areas" as defined by the CBRC refers to counties (cities) and sub-county (city) areas

in the central-and-western regions, northeastern regions, Hainan Province, state and province designated poverty-stricken counties, and sub-county areas in other provinces (autonomous regions and municipalities).

Although such limitations are useful for controlling financial risk within a small region, they are not conducive to the expansion of these operations.

4.5 Interest Rate

The microcredit interest rate cap for RCCs is less than 2.3 times that of the basic interest rate set by the PBOC whilst there is no specific interest rate limitation for VBs, LCs and MCCs. Nevertheless, all financial institutions must adhere to the Civil Law which states that interest rates shall not be more than 4 times the basic interest rate set by the PBOC.

Even with such interest rate limitations, financial institutions can still make significant profits in China. The present basic lending interest rate is 7.47% and some MCCs make full use of the above provision, allowing them to charge an annual rate of approximately 24%.

4.6 Loan Size and Risk Concentration

RCCs offer two different types of microcredit products: compulsory group loans and credit loans with collateral or guarantee. According to PBOC rules, loan amounts for compulsory loans must be decided on the basis of actual needs. In principle, loan amounts should be no larger than the annual income per capita of local households. Credit loans must be within the official credit line and are set by the county (city) rural credit union after considering the local economic situation, farmers' income levels, and the level of funds available to RCCs. In addition the credit line must be approved by the county (city) PBOC sub-branch. By taking these measures, RCCs are able to set reasonable loan sizes, in accordance with the actual needs of the borrower.

The CBRC requires that VBs and LCs provide "small" loans without actually defining the term "small" and tends to only pay real attention to the issue of risk concentration. The outstanding balance of loans disbursed by a village bank, to one individual borrower or business group should not exceed 5% and 10% of the bank's net capital respectively. In the first year of the village bank pilot phase, there was no evidence to suggest that RCC and public-interest MFI clients were accessing VB loans.

MCCs are restricted to an average loan size of no more than 100,000 Yuan and no individual borrower can receive a loan worth more than 5% of the institution's registered capital. The MCC average loan size of 100,000 Yuan is extremely large in comparison with the public-interest MFI average loan size of 2,000–3,000 Yuan – indicating that public-interest MFIs are the most important financial service providers for low-income and poor households in China.

5 The Policy and Legal Environment for Mutual Funds

5.1 Rural Mutual Credit Cooperatives

RMCCs have emerged as a new type of rural credit cooperative and have been granted with a license to work with savings among its members. RMCCs are basically regarded as being banks at the village level. In order to ensure the sound development of RMCCs, stringent regulations have been put in place by regulators. However the strict requirements have led to the cost of creating and running RMCCs becoming

extremely high. Examples of such prohibitive requirements are those relating to areas such as: business premises, safety precautions and other facilities.

5.2 Government/Development Agency Supported Mutual Funds

Since the mid-1990s, a number of mutual funds have been created by international development agencies in China. Most funds are based on the share capital of its members and grants from aid agencies. It is common for a number of different names, such as "community development funds" and "revolving funds," to be used instead of "Mutual Fund." In recent years, community mutual fund microfinance operations have attracted attention from the government. The State Council's "Poverty Alleviation Office," in collaboration with the World Bank, initiated four mutual revolving fund pilot projects in rural communities and operate another mutual fund program, based on a different model, in over 270 villages.

5.3 Mutual Funds Created by Farmers

There has been a long history of mutual funds in Chinese civil society. In some villages, farmers create mutual funds themselves, sometimes with outside technical or financial support.

5.4 Problems of Mutual Funds without Financial Institution Status

RMCCs can be defined as licensed mutual funds or credit cooperatives, meaning that they are formal financial institutions. The other two types of mutual funds analyzed above do not have the legal status of financial institutions. Although these types of mutual funds can, theoretically, apply to register as RMCCs, the high costs involved, due to strict legislation, prevents them from doing so.

It should be noted that some informal mutual funds take the form of societal or specialized cooperatives instead of legal entities.

6 Expected Changes, Challenges and Impacts

6.1 Expected Changes and Challenges

6.1.1 Public-Interest Microfinance

From the perspective of financial regulators, it will be less possible for them to grant financial licenses to public-interest MFIs or to clarify their legal status. However, it is also unlikely that they will set additional limitations on public-interest MFIs.

Besides the loan agreement between KFW and the Chifeng MFI in Inner Mongolia, a number of other financing transactions, which would offer potential solutions to MFI financing difficulties, are under negotiation.

6.1.2 Commercial Microfinance

Some foreign and international, non-banking, microfinance providers have showed interest in investing in the Chinese microfinance industry. Village banks are considered as a good option to engage in microfinance operations in comparison with the other existing financial institutions types. However, the main barrier lies in the requirement that the largest shareholding party is a bank. The CBRC and PBOC have reached an agreement that a MCC can be converted into a VB by abiding by the rules set by the CBRC.

The removal of this limitation would result in a significant increase in investment in the Chinese microfinance industry.

Such an increase would require a corresponding increase in supervision and would be a considerable challenge to industry regulators.

6.1.3 Mutual Microfinance

Mutual fund pilot projects will continue to be undertaken and regulators will not be involved in the supervision of mutual funds which adopt democratic management structures. However this will only be the case if mutual funds can prove that they can help solve the financing problems of low-income and poor farmers without mobilizing savings from other people than their members. Indeed, if thousands of RMCCs are created or if unregistered mutual funds become registered institutions, financial regulators could be faced with a major challenge.

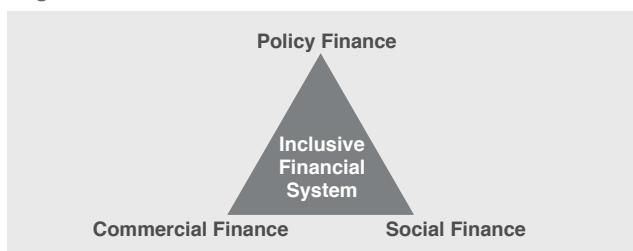
6.2 Recommendations and Likely Impact

6.2.1 Public-interest Microfinance

a. Orientation and Position

Public-interest microfinance is viewed as being an indispensable part of the inclusive financial system, which should comprise: governmental/policy finance (financial services offered by government banks), commercial finance (financial services offered by commercial banks) and social finance (financial services offered by NGO/NPO MFIs and cooperative funds). Public-interest MFIs should retain their social finance nature, taking poverty alleviation as an organizational mission. Public-interest microfinance policies and legislation should be based on the framework detailed in Figure 1:

Figure 1: Public-interest framework



b. Legal Status and Special Regulations

As a general rule, the legal status of an MFI is firstly determined by the organizational law under which the MFI is registered (such as the country's company or non-profit law), and secondly by the financial laws and regulations under which the MFI is regulated³. For example, in Brazil, microcredit NGOs are legally registered as non-profit organizations, just like any other non-profit organization. NGOs can then register with the Ministry of Justice as a microcredit provider in order to become a legally authorized lending entity. (Kate Druschel, 2005)

The Chinese government may consider the opening of a special window in order to allow NPO MFIs to undertake microfinance operations whilst maintaining their NPO identity. Such a concession could be performed by simply amending the existing non-profit law to allow, subject to certain restrictions, for the carrying out of lending-only activities.

c. Financing

It is rational to put strict requirements on mobilizing public savings so as to safeguard the public interest and the safety of the financial system. Nevertheless, there should be alternatives for MFIs to solve financing related problems.

NPO MFIs that are performing well should be authorized to refinance credit from the central bank, sub-loan from commercial banks, or be entrusted with loans from policy and commercial banks.

Establishing a wholesale fund should also be considered as an option for financing public-interest MFIs.

d. Non-Prudential Supervision

The extent of supervision or monitoring of financial institutions in a stringent regulatory framework should depend largely on the level of risk that such an institution brings to the financial system. This is why more severe regulations should only be applied to deposit-taking MFIs (CGAP 2003).

Since public-interest MFIs are not allowed to collect public savings, it is not necessary to adopt a high level of supervision.

e. Industrial Self-regulation

In order to protect the interest of the beneficiaries (the poor, low-income earners, social development, etc.), attain investor confidence and facilitate healthy development of public-interest MFIs, an appropriate supervisory system should be put in place.

The most practical form of supervision would be via industrial self-regulation. Therefore, the financial authority should support an industrial association, such as CAM, to take the responsibility of supervising the industry.

f. Taxation

The government should create a new policy which clearly states public-interest MFIs' exemption from taxation.

g. Commercial Microfinance

The financial regulators should consider allowing, subject to certain restrictions, non-financial institutions to be the largest shareholders of village banks. The lifting of current restrictions would ensure that village banks would have a bright future.

h. Mutual Microfinance

The "Farmers' Specialized Cooperative" act provides a legal framework for farmers to set up specialized economic cooperatives. Although the CBRC allows the establishment of RMCCs in rural areas, stringent regulation means that the vast majority of farmers cannot afford the cost of establishing and operating RMCCs. A solution to this problem may involve permitting the creation of a combination of specialized cooperatives and mutual funds. In this way, supervision responsibilities could be entrusted to another organization by the CBRC. ■

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An Analysis of Microfinance Demand in China

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Executive Summary

The Chinese microfinance market is currently booming. But what sectors of the population are demanding microfinance services? How large is the demand for micro credit? Is there a potential market for microfinance investors? After an empirical based analysis of financial service demand and an analysis of the potential microcredit market, it was found that there are some 249 million rural households, more than 8 million registered unemployed workers and more than 42 million SMEs and microenterprises in China. These figures confirm the existence of a potentially huge microcredit market. The current low rural coverage, limited outreach and high loan/deposit ratio of formal financial service institutions also indicate a large potential microfinance market. In addition, the Chinese government's policy of opening-up the microcredit market provides an excellent opportunity for microcredit investors.

Keywords: Microfinance, Microcredit demand, Potential market, SME, China

1

Introduction

In 2006, the World Bank published the CGAP research report "Access for All: Building Inclusive Financial Systems" by Brigit Helms which advocated the construction of an inclusive financial sector in order to allow the entire society, especially middle and low income earners, to enjoy access to financial services. The report emphasized the significance of building inclusive financial sectors at the micro, meso and macro levels. This approach quickly received popular acceptance. In the beginning of 2008, the World Bank issued a second report, "Finance for All? Policies and Pitfalls in Expanding Access" (World Bank, 2008). The report focused on the issues of financing channels, measuring indicators and the analysis of the determinant factors of access to financial services, both from the perspective of corporations and individual households. The report expounded the role that access to financial services has in economic growth, equity, and poverty alleviation. In addition the report discussed the role of government in promoting outreach of financial services and made a number of policy recommendations.

The World Bank aims to promote the construction of perfectly inclusive financial sectors. The Chinese government has been conducting continual reforms since the 1980s in order to allow all members of society, especially middle and low income earners, to enjoy equal access to financial services.

Examples of these reforms include: the reform and innovation of Rural Credit Cooperatives (RCC), the development of urban credit cooperatives and urban commercial banks, and the creation of NGO microfinance institutions (MFI). On December 20, 2006, the China Banking Regulatory Commission (CBRC) published its: "Opinion regarding easing market access for banking financial institutions in rural areas in order to better support the construction of a new socialist countryside" (CBRC, 2006, number 90). This document described the new rural financial market access policy, and outlined a pilot program in six provinces. On October 13, 2007, upon the approval of the State Council, the CBRC decided to expand the scope of the pilot project from six to a total of thirty one provinces.

Since March 1, 2007, the number of village banks has expanded rapidly from an initial number of three which operated in Yilong County of Sichuan Province, and Dongfeng County and Panshi County of Jilin Province. In addition, the village banking model has continued to evolve. By the end of 2007, more than ten village banks had already been founded by local commercial banks, commercial banks from outside regions, county RCC unions, and foreign banks. In addition, the China Development Bank (CDB) and commercial banks, such as the Agricultural Bank of China (ABC), also created village banks.

Capitalizing on the momentum caused by the publishing of the government policy document entitled: "Easing market access for banking financial institutions in rural areas," a new round of institutional reform has been formally launched in the field of rural finance in China. The new reforms focus on the diversification, marketization and standardization of financial institutions as well as on the opening up of markets. These reforms not only represent extraordinary innovation, with regard to the creation of a comprehensive rural financial system in China, but also a significant breakthrough in market access policy in the Chinese banking industry, signifying that the Chinese banking sector, and the rural banking sector in particular, is set to enter a new phase of competition, development and growth.

However the following questions remain unanswered:

- How large is microfinance demand in China?
- How much of this demand is not currently being met?
- What sections of the population are most lacking in access to financial services?
- Have financial services actually been improved?
- What aspects have been improved?
- What obstacles are restricting the improvement of financial services?

2 Analysis of the Demand for Financial Services

2.1 What Sectors of the Population Demand Microfinance?

Demand for microfinance services typically comes from: the urban unemployed, rural households, enterprises, and the government. Moreover, there are many types of financial demand, such as credit, savings, insurance, and investment. Among these types of demand, the demand for credit is the

most difficult to satisfy. Furthermore, the credit capacity of individuals at each level of demand has very distinct characteristics, and their different requirements should be met through different types of financial institutions and supply models (Table 1).

2.2 How Large Is the Demand for Microcredit?

Although the potential size of the market does not necessarily correspond to the true levels of demand for microcredit, it can be used as a starting point. The size of the market can be estimated on the basis of statistics on the number of urban unemployed workers, rural households, SMEs, and microenterprises throughout the country.

2.2.1 Massive Microcredit Demand in Rural China

At the end of 2006, there were a total of 37,000 townships, 624,000 villages, 4.5 million sub-villages, 740 million village dwellers, and 249 million rural households—a huge potential market.

Between 1978 and 2006, the size of the extremely poor rural population in China was reduced from 250 million to 21.48 million. As a result the percentage of the extremely poor rural population, as part of the total rural population, dropped from 30% to 2.3%. However, there is still a large population of poor people in rural China. At the end of 2007, there were 14.8 million people with a yearly net income lower than 785¥RMB, and 28.4 million with a yearly net income of between 786 and 1,067¥RMB (*Guang Ming Daily*, Feb. 29, 2008).

2.2.2 Huge Urban Unemployed Population

During the reform of State Owned Enterprises (SOEs) and collective corporations workers were laid off. In addition, the population of unemployed college graduates is growing and the numbers become even higher when also considering disabled workers and decommissioned soldiers.

Table 1. Credit Demand Levels, Main Characteristics and Methods of Supply

| Levels of Credit Demand | Main Characteristics | Ideal Methods of Meeting Credit Demand |
|-----------------------------|---------------------------------------------------|--------------------------------------------------------------------------------------------------------------------------------------------------|
| Unemployed urban population | Living expenses, initial investment credit demand | Government business start-up subsidies, informal microloans, microcredit (including commercial microcredit), policy finance, cooperative finance |
| Rural Households | Impoverished rural households | Informal microlending, microcredit (including commercial microcredit), government poverty alleviation funds, policy finance |
| | Normal rural households | Private capital, informal microloans, microcredit from cooperative financial institutions, small size commercial loans |
| | Merchant rural households | Private capital, microcredit, small size commercial loans, cooperative finance |
| Enterprises | Micro and small enterprises | Private capital, informal finance, venture capital investment, commercial credit (government guaranteed), policy finance, microcredit |
| | Medium enterprises | Private capital, commercial credit, policy finance, microcredit |
| | Market leading enterprises | Commercial credit, government funds, venture capital investment, policy finance |
| Government | Infrastructure funds demand | Fiscal funds, infrastructure bonds, BOT, etc. |

Potential microcredit demand comes from unemployed urban workers, rural households, SMEs, and microenterprises.

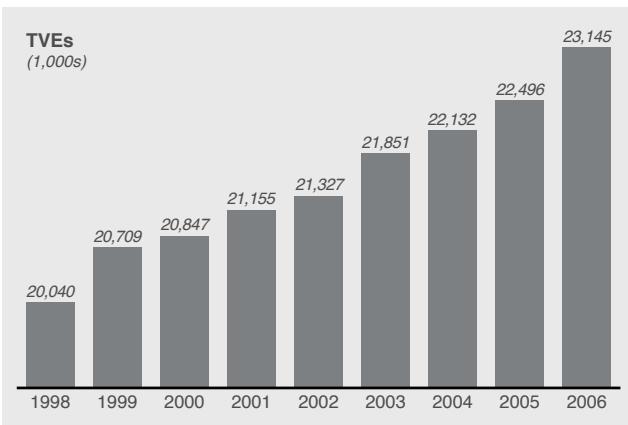
The unemployment rate increased by 1.0% between 2005 and 2006, with the total number of unemployed increasing from 8.4 million to 8.5 million. At the end of 2006, the official unemployment rate was 4.1% (State Statistics Bureau, 2006).

2.2.3 Large Number of SMEs and Microenterprises

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

The number of SMEs in China, especially small enterprises, is increasing rapidly. For example, by the end of 2006, the total number of SMEs in Shanghai had reached 363,600, accounting for 99.7% of the total number of enterprises registered in Shanghai. This number included 355,900 small enterprises, of which 26,800 were newly registered in 2006, an increase of 8.16% upon the previous year. According to the Shanghai AIC, by the end of 2006, there were a total of 264,100 registered individual proprietors. The majority of these proprietors were in the wholesale and retail industries, had a small amount of fixed assets and encountered difficulties when attempting to access loan capital (www.1128.org).

Figure 1. Trend in the Number of TVEs in China between 1998 and 2006



There are also 23.1 million township and village enterprises (TVEs) operating in China which employed 146.8 million workers at the end of 2006. Some 99% of TVEs are SMEs and microenterprises. Since the beginning of the 21st century, the number of TVEs has expanded rapidly (Table 2, Figure 1). Although the TVE category overlaps with that of private enterprises, it can be readily seen that there are an enormous number of microenterprises currently operating in China.

3

Analysis of the Potential Microcredit Market

It is difficult to directly measure the potential size of the microcredit market. However, a number of case studies have helped to clarify the situation regarding financial access to rural households and SMEs and from these results the potential size of the market can be indirectly derived.

3.1 The Great Potential of the Rural Microcredit Market

3.1.1 Significant Rural Household Demand

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

A 2005 survey of 502 rural households in four counties/cities in Guizhou Province, Tongren, Jiangkou, Shiqian, and Yuping, indicated that 89% of rural households expressed interest in obtaining credit. (He Guangwen, Li Lili, 2005b). Research also showed that 84% of 720 surveyed households, located in 6 counties in Tongren Prefecture (including Wanshan and Songtao), expressed interest in bank and RCC loans (He Guangwen, Li Lili, 2005c).

The survey also revealed that farm household loan demand did not rely on interest rates and that such households would be prepared to pay high interest rates in order to receive loans.

Table 2. Number of TVEs in China between 1998 and 2006 (National Statistics Bureau, 2006) (Unit: 1,000)

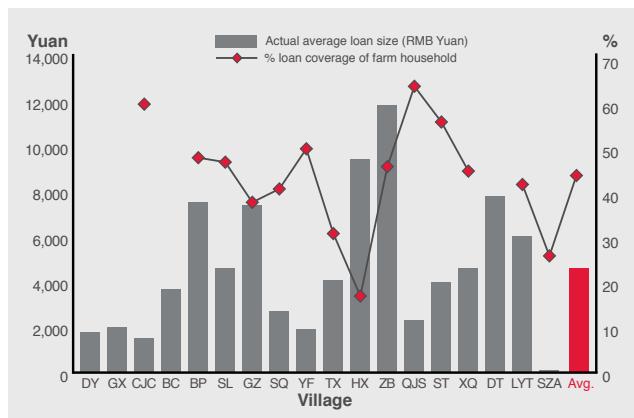
| Year | TVEs | Farming, Forestry, Animal Husbandry & Fishery | Industry | Construction | Transportation & Storage | Wholesale & Retail Trade | Hotels & Catering Services | Social Services | Other |
|------|----------|-----------------------------------------------|----------|--------------|--------------------------|--------------------------|----------------------------|-----------------|-------|
| 1998 | 20,040.0 | 189.0 | 6,620.0 | 821.0 | 4,148.0 | 5,455.0 | 2,211.0 | n/a | 595.0 |
| 1999 | 20,709.0 | 165.0 | 6,735.0 | 825.0 | 4,127.0 | 5,831.0 | 2,414.0 | n/a | 611.0 |
| 2000 | 20,846.6 | 151.2 | 6,740.1 | 795.2 | 4,125.2 | 5,913.0 | 2,491.9 | n/a | 630.1 |
| 2001 | 21,155.4 | 127.4 | 6,721.7 | 762.6 | 4,128.6 | 6,141.7 | 2,627.0 | n/a | 646.4 |
| 2002 | 21,326.9 | 321.7 | 6,276.8 | 697.5 | 3,801.3 | 6,271.2 | 2,110.2 | 1,062.9 | 785.3 |
| 2003 | 21,850.8 | 414.3 | 6,431.3 | 680.6 | 3,834.5 | 6,478.5 | 2,132.0 | 1,242.2 | 637.4 |
| 2004 | 22,132.2 | 414.4 | 6,402.8 | 654.1 | 3,775.0 | 6,773.5 | 2,085.8 | 1,366.1 | 660.5 |
| 2005 | 22,495.9 | 411.8 | 6,329.9 | 642.9 | 3,798.6 | 6,909.4 | 2,150.9 | 1,529.8 | 722.7 |
| 2006 | 23,144.7 | 410.8 | 6,565.7 | 654.3 | 3,812.3 | 7,125.6 | 2,187.0 | 1,580.5 | 808.4 |

3.1.2 Large Underserved Market.

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

In 2005 a survey was undertaken by a research team from the China Agricultural University in order to calculate the total number of loans disbursed by 11 township RCCs to rural households in 20 villages in Guizhou's Tongren, Jiangkou, Shiqian, and Yuping. The statistics from the survey show that, as of June 30, 2005, the average loan size for rural households was only 4,612 Yuan, approximately 80% of China's per capita GDP, and that only a small portion of total demand was being met. The figures also show that RCC loan supply remains limited in rural areas, with a lowest coverage rate of 17% in HX village (Figure 2), and confirm that there is still significant unmet demand (He Guangwen, Li Lili, 2005b).

Figure 2: RCC Coverage and average loan size in selected villages



3.1.3 Informal Lending Market

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

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

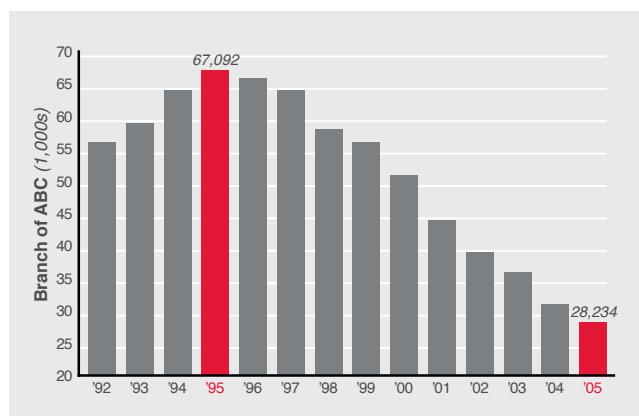
According to recent research, rural household and SME financing still faces major problems. Analysis of a 2003 survey, performed by the Ministry of Agriculture's "Agricultural Economic Research Center," of 217 rural households in 18 villages of 6 counties in Anhui Province (Zhu Shouyin, 2003)

revealed that, not one loan, from a total of 524, was from a commercial bank. Some 84 loans (16%) were from RCCs, whilst informal loans accounted for 79% of all loans. Informal lending accounted for 80% of the total value of loans made, while RCCs only accounted for 15%. Guo Xiaoming's 2005 survey of 243 rural households in 17 villages of 4 counties in Sichuan Province found that the proportion of loans provided by RCCs and informal lenders was 33.5% and 66.5% respectively, highlighting that the informal sector was still the main source of loan funding for rural households.

3.1.4 Withdrawal of State-Owned Banks

The fact that state-owned commercial banks have gradually withdrawn from rural areas has further magnified the unfulfilled demand for rural microcredit services. Since the mid-late 20th century, Chinese state-owned commercial banks have gradually closed their county and lower-level branches. Between 1995 and 2004, the number of branches of the four largest state owned commercial banks decreased by 77,000 (49.8%). ABC, which is regarded as the traditional credit bank in rural areas, has been declining in size since 1995. By the end of 2005, ABC's branch network had shrunk by some 58% from 67,092 to 28,234 (Figure 3).

Figure 3: Trend in the number of ABC branches



According to a survey performed in two underdeveloped regions, the total number of banking financial institution branches, at the end of 2005, amounted to 1,161,317 less than in 2000. Indeed, during this time, the largest state owned banks closed a total of 222 branches and reduced staff-levels by a total of 2,234 employees (Wang Jin, Zhang Mingliang, 2006).

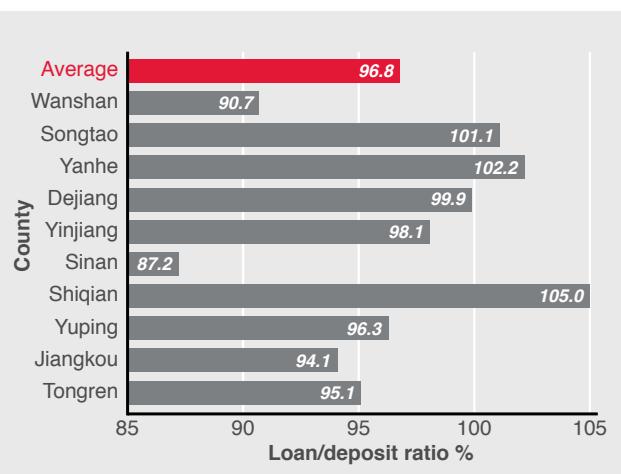
The branches which were closed by the "Big Four" state owned commercial banks previously provided direct services to rural households and SMEs, and, geographically, were often the only viable banking provider option for their clients.

At the same time as the number of branches was being reduced, state owned banks were also restricting the ability of rural branches to disburse loans. Indeed, since 2000, branches in traditional and developed regions have only been able to collect savings. According to estimates by the author, the yearly amount of outflow of savings funds from rural areas has reached approximately 400 billion Yuan.

3.1.5 High Loan/Deposit Ratio

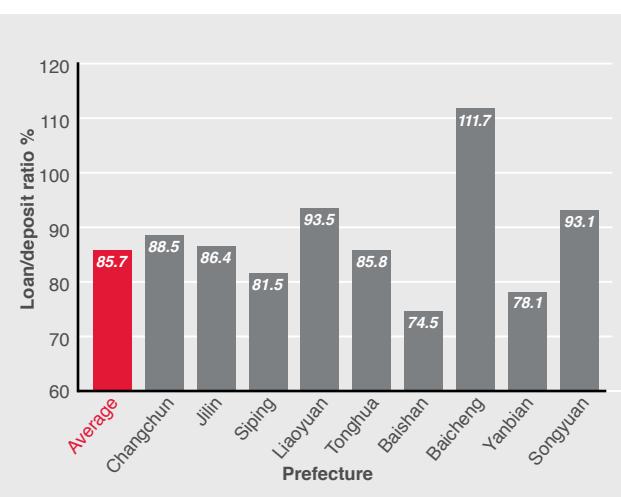
The loan/deposit ratio of RCCs in traditional rural areas is very high, illustrating the huge demand for capital from rural households and the large size of the potential market. Many RCCs, especially those in underdeveloped regions have a very high proportion of loans to deposits, demonstrating the serious shortage of funds and the overuse of capital. Figure 4 presents the findings from a 2005 China Agricultural University study of RCCs in 10 counties of the Tongren region in Guizhou Province. The average loan/deposit ratio was 95.1% and even exceeded 100% in Shi Qian County, Yan He County, and Song Tao County.

Figure 4: Loan/Deposit ratio in 10 counties of Guizhou province in May 2005



At the beginning of June 2007, another study (He Guangwen, 2007) came to the same conclusion with regard to their research in Jilin Province. In May 2007, the loan/deposit ratio of RCCs in Jilin Province stood at 85.7%. This number greatly exceeds the required liability/asset ratio, indicating serious operating problems. RCCs in Bai City had loan/deposit ratios of 111.7% (Figure 5).

Figure 5. Loan/deposit ratio of RCCs in Jilin province in May 2007



3.2 The Enormous SME Finance Market

3.2.1 Limited Business Start-up Funds

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

3.2.2 Shortage of Funding Sources to Fuel Business Growth

Due to the shortage of start-up capital and limited assets, enterprises also have difficulties in financing business growth.

3.2.3 Limited SME Transformation Opportunities

In June 2004, the Shenzhen Stock Exchange launched an SME module in order to enable SMEs (with total share value below 50 million Yuan and total trading shares below 30 million) to become listed. At the end of 2007, the number of listed SMEs reached 138 with a total IPO value of 40.4 billion Yuan and average financing funds of 293 million Yuan per enterprise (SME Department of NDRC, 2008). However it should be noted that the number of listed SMEs is limited and that the SMEs that are listed tend to become large-scale enterprises. As a result, the majority of small enterprises are unlikely to access funds through this channel.

3.3 Huge Financing Gap for the Unemployed

Unemployed people have no stable income source and it is difficult for them to offer loan guarantees. As a result, it is extremely difficult for them to start a business or to gain reemployment. Urban commercial banks in many cities, such as the Bank of Beijing and Tianjin Commercial Bank, have initiated micro guarantee loans for unemployed workers. Local government financial departments have also set up microcredit guarantee funds through which microcredit guarantees can be provided to unemployed workers. In August 2003, the financial department and labor and social security departments of Anhui Province published its: "Management methods of microcredit guarantee funds for provincial laid-off and unemployed workers" (Caijin[2003]606).

However, during the implementation of the project, some financing difficulties were experienced. Firstly, when commercial banks offer loans, guarantee fund companies require that borrowers provide guarantees and provide 50% of the working capital themselves. Secondly, the maximum loan limit is very small. Normally, an individual loan, secured by the guarantee fund, should not exceed 20,000 Yuan. Thirdly, competition in the start-up business market is fierce whilst providing finance to the unemployed can be a very risky undertaking.

4 Conclusion

4.1 Differing Requirements of the Population

Unemployed urban workers require financial resources in order to help meet living expenses and initial investment credit requirements. The ideal methods for meeting such demands are: informal microlending, microcredit (including commercial microcredit), government finance and cooperative finance.

Impoverished rural households need credit in order to finance small scale farming production and living expenses. The ideal methods for meeting such demand are: informal microlending, microcredit (including commercial microcredit), government poverty alleviation funds, and government finance.

Regular farming rural households need credit in order to finance small scale farming production and living expenses. The ideal methods for meeting such demand are: private capital, informal microlending, microcredit from cooperative financial institutions, and small commercial loans.

Merchant rural households need credit in order to finance specialized large scale production and industrial and commercial industry. The ideal methods for meeting such demand are: private capital, microcredit, small size commercial loans and cooperative finance.

Micro and small enterprises need credit in order to finance start-up and expansion capital. The ideal methods for meeting such demand are: private capital, informal finance, venture capital investment, commercial credit (government guaranteed), government finance and microcredit.

4.2 Huge Microfinance Demand

Some 249 million rural households, more than 8 million registered unemployed workers and more than 42 million SMEs and microenterprises form the base of a potentially huge Chinese microfinance market.

4.3 Unsatisfied Demand Indicating Large Potential Market

Reduced coverage of formal financial services, limited outreach of formal financial institutions and higher loan/deposit ratios also indicate the existence of a large potential microcredit market in China.

4.4 Government's Opening-Up of Microfinance Market

China's opening-up policy in the microcredit market provides an excellent opportunity for microcredit investors. ■

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The Current Supply of Microfinance Services in China

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Executive Summary

The article describes the supply of microfinance services in China. It introduces the four stages in the history of the development of microfinance in China and details the different types of microfinance providers. Each provider type is then analyzed and information is given on areas such as: history; target region and clients; lending methodology; other products (savings, insurance, remittances); and performance and challenges. The article also describes the sources of funds, and challenges faced by the microfinance providers.

1

Introduction

Before considering the microfinance industry in China, it is important to firstly define what is meant by the terms “microfinance” and “microcredit.” In particular it is important to clarify whether there are any limitations on loan size. Opinion is often split when considering such fundamental questions. Generally speaking, two opinions currently prevail. The first argues that any single microfinance loan should be capped at an absolute value. For instance, any loan below a certain amount can be called a microcredit, or a multiple or percentage of a country or region’s GDP per capita can be set as a standard. The second point of view states that the term “microcredit” should be based on relative value instead of absolute value. For example, any loan smaller than that disbursed by a traditional financial institution should be regarded as a microcredit.

In this article, the writer defines microcredit by using absolute value in a flexible way. For instance, at present, a microcredit

means one single loan less than 100,000 Yuan in China – a sum four or five times greater than China’s GDP per capita of almost 24,000 Yuan (approximately USD 3,000). According to the China Banking Regulatory Commission’s (CBRC) definition of “small enterprise loan,” any single loan should not exceed 5 million Yuan. As a result it can be seen that, if applying 100,000 Yuan as the standard threshold microcredit value, microfinance clients will not comprise small entrepreneurs and will instead only include micro-entrepreneurs, farming households, and poor families.

2

History of Microfinance Development

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

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

Abbreviations

| | |
|------|----------------------------------------|
| CBRC | China Banking Regulatory Commission |
| PBOC | People’s Bank of China |
| RCC | Rural Credit Cooperatives |
| RMCC | Rural Mutual Credit Cooperatives |
| CASS | China Academy of Social Sciences |
| ABC | Agricultural Bank of China |
| ADBC | Agricultural Development Bank of China |
| NPL | Non-performing loan |
| MCC | Microcredit Company |
| CDB | China Development Bank |
| WB | World Bank |

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

The fourth phase (2005–present) started when central regulatory departments encouraged non-government and overseas funds to engage in the experimental activities of commercial MFIs. According to the guidelines of the PBOC, seven private microcredit companies were built in five provinces located in the central and western part of China in 2005. In late 2006, upon the approval of the CBRC, Rural Mutual Credit Cooperatives (RMCC) started to be set up in six provinces. One of the phase's characteristic features was the regulatory department's efforts to issue regulations to facilitate the investment of non-government and international funds in underdeveloped regions and to seek solutions to cases of financial insufficiency and inadequate competition by increasing funds in those areas.

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

The quality and sustainability of portfolio for these MFIs varies. Among the 100 MFIs, around 20 can be considered as good performers with repayment rates of over 95%. Only 10 MFIs have managed to become operationally self-sufficient.

The three major challenges faced by the MFIs are related to their: legal status, sources of funding and capacity for expansion. In addition there are a number of other issues to deal with, such as: ownership and governance, internal control mechanisms, cohesion, fund management, and external supervision.

3.2 Subsidized Microcredit Projects for Poverty Alleviation Developed by State-owned Banks such as the Agricultural Bank of China (ABC) and the Agricultural Development Bank of China (ADBC)

In collaboration with the Chinese government's "Eight-seven Poverty Alleviation Project,"¹ ABC and ADBC carried out a subsidized microcredit project for poverty alleviation.

The project was launched in 1997 and involved the majority of poor regions and counties in the country. Originally the project targeted mid/low income workers and poor farming households. However, the scale of the project has been decreased since 2000 and now only focuses on enterprises. In 2008, ABC plans to issue its "Jinhui" card which will give rural inhabitants preferred access to loans.

The project is mainly based on a group lending methodology and loans can be paid either in installments or in a lump sum. A group guarantee system has been adopted and no collateral is required for loans. The average loan size ranges from 1,000 to 5,000 Yuan. Although the annual loan interest rate is approximately 2.21%–3%, it can be as low as zero for loans subsidized by central and local government. There are almost no instances of additional financial products such as savings and remittances being offered.

Analysis of relevant documents and sources reveals that the project has a total loan portfolio of 23 billion Yuan. The working poor, in particular males or householders², are typically the project's main clients. However in cases where projects are held in collaboration with local women federations, female clients are also given priority.

Although the portfolio quality of the subsidized microcredit project varies over time and across regions and institutions, it can be said to be poor overall. As a result these projects are unable to achieve financial sustainability.

The project faces the following challenges:

- Lack of desire of relevant organizations and staff to implement the project
- Lack of relevant business knowledge and management capability
- Lack of personnel and outlets
- Poor collaboration with cooperative governmental agencies (such as poverty alleviation offices)
- Women federations and science and technology committees
- Unsustainable projects

¹ Meaning that the eight-thousand people living under the national poverty line should climb out of poverty within seven years.

² In China, especially rural areas, the husband is viewed as the householder.

3 Types of Microfinance Providers

3.1 NGO MFIs

This type of MFI was first launched in 1993 and originally initiated by the "China Academy of Social Sciences" (CASS) and Professor Mao Yushi. Although, at one time, there were approximately 300 such projects or organizations engaged in microcredit operations, only around 100 MFIs remain in operation today. The MFIs' services cover many provinces and regions, especially poor areas. Their targeted clients are mid/low income workers and poor farmers whilst some MFIs only target female clients. Only a handful of MFIs are based in urban regions. However, Tianjin MFI, based in Tianjin City, is an example of an MFI which has generated exceptional results by focusing on laid-off female workers in Tianjin city.

Group lending is the main methodology adopted by these MFIs, while individual lending and village banking are seldom used. Loans can be paid either in installments or in a lump sum.

Generally no collateral is required in order to receive a loan. Although many MFIs disburse group guarantee loans, some institutions require up-front group funds or compulsory savings. The average loan size ranges from 1,000 to 5,000 Yuan in rural areas and from 3,000 to 20,000 Yuan in urban regions. Annual loan interest rates (including fees) range from 3% to 18%. In terms of targeted loan clients, MFIs can be categorized into three types; no gender limitation, female-focus, and male-focus. Most MFIs are yet to develop other products such as voluntary savings, insurance or remittances. It is estimated that the combined portfolio of all NGO MFIs in China is worth approximately one billion Yuan with a total of approximately 150,000 active clients.

3.3 RCC Farmer Microcredit Project

At present there are over 8,000 RCCs operating as independent legal entities and it is said that approximately 90% of RCCs have developed microcredit operations. This type of microcredit project can be categorized into three types: credit loans, group guarantee loans, and collateral-based loans. In the case of group guarantee loans and collateral-based loans the Central Bank (PBOC) issued an official document permitting a trial of RCCs in 1999–2000. The first RCC pilot project was initiated in Wuyuan County of Jiangxi Province in 2000 and has since spread throughout the country. Potential clients are classified via a credit ranking assessment and RCCs then identify targeted clients and loan amounts. In general, RCCs give priority to sole proprietor, rich and middle-income farmers, and cover only a handful of poor households.

RCCs currently work with credit-based, group guarantee, individual collateral/large loan guarantee, and “enterprise + farmer” loan methodologies.

Loan sizes are classified into three grades: 1,000–3,000 Yuan, 3,000–8,000 Yuan and 8,000–30,000 Yuan. The classification of loan size varies across regions and the size of group guarantee loans are generally larger than those of credit loans.

Loan interest rates are set in accordance with PBOC requirements, typically 0.9–2.3 times the basic interest rate, and should be lower than those for general loans. In addition RCCs typically offer other financial products such as savings and remittances.

The current outstanding portfolio of all credit and group guarantee loans is equal to 300 billion Yuan for a total of some 70 million farm clients. Males, as householders, are given priority as clients, however a few RCCs have cooperated with local women federations where the majority of loans are disbursed to females.

Repayment and operational sustainability rates vary greatly among RCCs, and include good, mediocre, and poor performers. However, generally speaking, the repayment rate of RCCs is around 80%.

3.4 Microcredit Project Implemented by Urban Commercial Banks and Guarantee Companies

Since 2002 the PBOC has called on urban commercial banks and guarantee companies to cooperate and disburse micro guarantee loans to laid-off workers in urban areas. In such

projects, guarantee companies or fiscal guarantee funds bear either 100% or 80% of the overall risk while guarantee companies charge a management fee of 1%. Urban commercial banks offer loans with basic annual interest rates of 7.29% and receive subsidies from local financial departments with the result that borrowers pay zero or very low interest.

The project has an average loan size of around 20,000 Yuan. The highest and lowest loan amounts range between 100,000–150,000 Yuan and 5,000 to 10,000 Yuan respectively. There are various repayment methods, such as lump sum and installment.

The microcredit project has expanded to reach college students, returning soldiers, farmers without land, and low-income entrepreneurs. There is no gender limitation in terms of targeted clients, and some banks have an even distribution between male and female clients. Currently, total outstanding portfolio is equal to over ten billion Yuan with several hundred thousand active clients. In addition the banks typically offer additional financial products such as savings and remittances.

In the majority of cases, the project has a fair portfolio quality with a non-performing loan (NPL) ratio of 10%. Nevertheless, operational sustainability is poor due to high-dependency on fiscal subsidies.

The project faces the following challenges:

- Passive implementation by commercial banks instead of active engagement
- Lack of proper skills and innovation
- High risk related to loan clients
- Lack of new ideas and management capacity to handle the business
- Issue of long-term subsidy reliance

3.5 Credit-Only Microcredit Companies (PBOC Pilot Project)

In 2005, the PBOC initiated a new pilot project which encourages private capital to establish credit-only microcredit companies (MCC). The pilot is being run in five counties within five provinces located in the middle and western part of China. Statistics from the PBOC show that a total of seven MCCs had been built by September 2007 (Operational performance figures for this pilot can be found in [Table 7](#)). In addition, some local governments and foreign-funded institutions also set up similar microcredit companies in accordance with the guidelines of the PBOC pilot project.

Table 1. Summary Table for Microcredit Projects in Rural Areas

| Project Type | Starting Time | Targeted Clients | Financial Sustainability as a goal | Legal Status as Financial Institution | Annual Interest Rate | Value of Loans Outstanding in RMB |
|---------------------------------------------------------------------|---------------------|-----------------------------------|---------------------------------------|--------------------------------------------------------|-------------------------------------------------|-----------------------------------|
| International Aid Project/ Non-Official Project | Early 1990s | Poor & mid/ low income households | Some projects have this goal | No, but experiment is allowed during the project phase | Varies considerably | About 0.2 billion |
| Government-led Project (the cooperation between ABC and government) | Middle & late 1990s | Poor & mid/ low income households | No such goal but enjoy fiscal subsidy | Yes | Below 3% subsidized loan | 38 billion |
| Credit Loan and Group Guarantee Loan of RCCs | Since 2000 | All qualified farming households | Yes | Yes | Basic interest rate, but can be a little higher | More than 300 billion |

Note: The information in this summary table was extracted from relevant documents and sources.

The targeted clients of MCCs are local farming households, citizens, sole proprietors and entrepreneurs. The loan products and methodologies offered by MCCs are similar to those of RCCs. Usually collateral or guarantees are required in order to take out a loan. Although the project has an average loan size of approximately 100,000 Yuan, loans for different MCCs and clients can range from several thousand to several hundred thousand Yuan. The project has an average annual loan interest rate of over 20%.

MCCs offer no other financial products and are not allowed to mobilize savings.

The registered capital of MCCs ranges from 17 million to 50 million Yuan and thus far MCCs have been restricted to only operating within the pilot counties. The value of loans disbursed by each of the existing 7 MCCs range from several million Yuan to nearly a hundred million Yuan, respectively. The total value of loans disbursed by the 7 MCCs together amounts to several hundred million Yuan. In general, the MCCs have good portfolio quality. According to financial statements, most MCCs are likely to achieve financial sustainability with only one such institution having suffered a loss at the end of 2007.

It is estimated that the total loan funds of all MCCs in China amount to several hundred million Yuan, and together they have several thousand active clients.

MCCs face the following challenges:

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

3.6 Village Banks (CBRC Pilot Project)

At the end of 2006, the CBRC announced a new pilot project to create three types of new financial institution (village banks, lending companies and RMCCs) in 36 counties throughout six provinces. By the end of 2007, 19 village banks, 4 lending companies and 8 RMCCs had been established. In 2008, this pilot project will be expanded to 31 provinces throughout the country. Each province will then choose up to two experimental sites.

From 2007 onwards, commercial banks have been permitted to create their own village bank in the form of sole proprietorship or joint stock partnership with either individual and/or institutional investors. In the case of the joint stock partnering option, the commercial bank will have a controlling equity stake in the village bank.

The village banks can only operate within the selected counties or towns whilst their targeted clients, operational methods, and business scope resemble those of RCCs. No information is available on the average size of loans. However, the writer

believes that village banks should not be regarded as microfinance institutions. In terms of loan size, only loans lower than 100,000 Yuan can be thought of as microcredits.

According to the relevant reports, the portfolio quality of most village banks would appear to be reasonably good. By the end of 2007, two village banks had returned a profit. It is estimated that the total village bank portfolio in China amounts to approximately 0.2 billion Yuan with several thousand active clients.

The village banking project faces the following challenges:

- Control by large shareholders or traditional commercial banks
- Large loan size
- Loan disbursement only in counties
- Difficulty in collecting deposits

Questions to be considered include:

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

3.7 RMCCs (CBRC Pilot Project)

RMCCs are similar to previously existing MFIs that have adopted the village banking methodology. Currently the CBRC permits qualified organizations to register as RMCCs.

The pilot project, initiated by the CBRC in 2007, involves RMCCs being regarded as cooperative or shareholding cooperative finance institutions. They are then categorized by two different activity levels, i.e., village and township level. The local farmers, citizens and enterprises that buy shares are both owners and clients of the funds. Shareholders are permitted to make voluntary savings and to apply for either group loans or individual loans.

It is estimated that the total RMCC loan portfolio in China amounts to several million Yuan, distributed among several thousand active clients.

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

- Higher operational costs after registering
- No preferred policy
- Strict requirement for prudential regulations (not necessary as non-prudential regulations can be adopted instead)
- Difficulty in financing (even though they are allowed to mobilize funds according to current policies)
- Poor management capacity and staff quality
- High possibility of being controlled by the non-poor;
- Weak internal control mechanisms
- Low internal cohesion and operational and financial management
- Ineffective external supervision

For example, one RMCC in Lishu County, Jilin Province, was registered in 2007 with capital of 100,000 Yuan. However over 70,000 Yuan of this had to be used to purchase security facilities and hire professional accountants in accordance with the requirements of its administrative department. Although the fund later applied for a loan of 200,000 Yuan from the local bank, it is still a long way from achieving financial self-sufficiency and operational sustainability.

3.8 Lending Companies (CBRC Pilot Project)

According to the provisions of the CBRC, the registered capital for lending companies set up by banks must be no less than 500,000 Yuan. Four lending companies have been established since 2007.

The writer believes that these types of lending companies should not be considered as microfinance institutions. In terms of loan size, only loans lower than 100,000 Yuan can be regarded as microcredits. In reality, there is no significant difference between the operations of lending companies and those of PBOC launched, MCCs with the exception of how they were created. However, lending companies' capital amounts are limited in accordance with the level of support they receive from their parent banks or other financing sources. As a result, lending companies have been prevented from achieving high rates of growth. It is estimated that total lending company portfolio in China amounts to several million Yuan with several thousand active clients.

3.9 Subsidized Microcredit Project for Poverty Alleviation Implemented by Rural Financial Institutions

Since 2004, the Poverty Alleviation Office of the State Council and the Ministry of Finance have jointly conducted a pilot project. The project involves the reform of the subsidized method of poverty alleviation loans whereby a portion of central fiscal subsidized funds are allocated to local governments which then disburse poverty alleviation loans to selected financial institutions. The majority of financial institutions chosen by local governments are RCCs, while only a handful of agricultural banks are selected. Financial institutions which directly offered loans to poor households profited from a subsidized interest rate of 4% in 2004 and 5% in 2005. At first, the pilot project was carried out in 33 counties in 11 provinces throughout the country and then expanded further to 200 counties in 22 provinces in 2005. The loan fund amounted to around 2 billion Yuan within two years. Although no client data is available, if an average loan size of 5,000 Yuan is assumed, it can be estimated that the project has several tens of thousands of active clients.

The project's impact can be measured by the fact that:

- Overall loan amount has increased significantly in pilot counties
- Poverty alleviation loans are almost exclusively provided to poor farming households
- The repayment rate has been improved to over 90% for most counties (with the exception of one county with a rate of 74% — the lowest of the project)
- Poor farming households use loans in order to derive benefits from income generating activities

Since 2006, all subsidized funds have been transferred to 592 counties. The county governments are free to choose financial institutions and to directly settle the issue of subsidized interest with them. The total amount of loans disbursed to households has reached 5.92 billion Yuan.

The project faces the following challenges:

- No active engagement of rural financial institutions in some counties
- Determining whether the project can be made operationally sustainable

3.10 Postal Savings Bank Microcredit Pilot Project

In 2006, the central government approved the establishment of postal savings banks in order to offer banking services in addition to postal and savings services. In the same year, the postal savings banks launched a microcredit pilot project. As postal savings banks created special departments and hired qualified staff they gradually expanded their collateral-based microcredit trial throughout the country. After taking on board the lessons learned from the experience, the postal savings banks developed non-collateral loans for both natural persons and companies in 6 provinces. Since the first half of 2006, the State Postal Savings Bureau's "Postal Savings and Remittances Bureau" has opened a pilot business that issues microcredit with a time deposit as collateral and expanded it throughout the whole country. Postal Savings Banks intend to return money deposited with them to rural areas in the form of microcredits.

In order to manage risk, the loan size for the above microcredits ranges between 1,000 and 100,000 Yuan. However, the loan size in three pilot provinces has been as high as 500,000 Yuan. In principle, the loan amount should not exceed 90% of the capital of the time deposits used as collateral, and the loan term should be no more than one year. These loans can be used for individual consumption and productive operation instead of being invested in securities and futures.

In May of 2007, the CBRC authorized postal savings banks to offer an experimental microcredit without collateral in 7 provinces and cities including Shaanxi and Henan. The highest credit line for individual borrowers should not exceed 500,000 Yuan. The postal savings banks formally launched this loan business in Henan in June of 2007. The loan products are classified as group guarantee loans for business households with a maximum loan amount of 50,000 Yuan per household. Group guarantee loans for farming households have a maximum loan amount of 30,000 Yuan per household. The microcredit pilot project has now been expanded to cover ten provinces, with 110 million Yuan having been disbursed to several thousand active clients. Overall, results and repayment performance have been good and the postal savings banks are now planning to submit an application to the CBRC for further expansion of the project.

At present, postal savings banks hold some 1.7 trillion Yuan in savings accounts — the fifth largest holding in the country. Outstanding collateral-based loans and credit loans amount to approximately 100 billion Yuan. In addition the postal savings banks also offer other financial products such as savings and remittances.

Postal savings banks face the following challenges:

- Lack of microcredit business knowledge and management capacity
- Poor staff quality and lack of talented employees at all levels

3.11 Commercial Bank Microcredit Pilot Project

Since 2005 the China Development Bank (CDB) has cooperated with the World Bank (WB) in order to introduce a microcredit pilot project. The project was developed by the European Development Bank and targets microenterprises and disadvantaged people who have difficulty in obtaining loans. The pilot project has been carried out in over ten cities including: Taizhou of Zhejiang, Baotou of Inner Mongolia, and Benxi of Liaoning. In addition some rural commercial banks, such as Maanshan of Anhui, have also participated in the project. The project's overall loan portfolio has reached more than one billion Yuan. Some commercial banks, such as Harbin Commercial Bank, have also developed similar businesses on their own.

Loan amounts range from several thousand to several tens of thousands of Yuan with an average loan of approximately 50,000 Yuan. Microcredits are not based on collateral but on a flexible guarantee. The project's portfolio quality is fairly good with an NPL ratio of less than 1%.

Harbin Commercial Bank experimented with this type of project independently and offers microcredit to farming households on commercial terms instead of relying on the usual subsidized framework. Loan amounts range from 20,000 to 100,000 Yuan with an average loan size of 30,000 Yuan and loans are based on group guarantee and warrantor guarantee methodologies. The guarantee system for urban loans, which have an average loan size of 80,000 Yuan, is very flexible. Applicants can take out group guarantees but must submit the application in the name of an individual.

The Commercial Bank Microcredit Project faces the following challenges:

- Necessity for leaders and staff to adapt their ideas in order to successfully carry out the project
- The equipping and training of qualified staff
- The learning of relevant skills and knowledge in order to guarantee the success of the project.

4

Sources of Funds for Microfinance Providers

4.1 NGO MFIs

Funding for NGO MFIs comes in the form of donations from multilateral and bilateral international aid institutions, international NGOs and the Chinese government. Other sources include private capital, wholesale loans from banks such as the CDB, soft loans from international organizations such as the Grameen Trust, Grameen Foundation USA and KFW, and client investment in village banking projects.

This category of provider faces the following funding challenges: insufficient funds and no normal financing channels.

4.2 Subsidized Microcredit Project for Poverty Alleviation Developed by State-owned Banks such as ABC and ADBC

Capital sources include on-lending loans from the PBOC and savings from their own depositors. Central and local government also offer fiscal funds to subsidize interest and operational expenses.

The project faces the following challenges: covering costs from low interest rates; ensuring that supply (on-lending loans and government subsidy) is sustainable; meeting policy targets; making sure the financial market is not inefficient or distorted.

4.3 Farmers Microcredit Project Undertaken by RCCs

(The sources of funds and challenges are the same as those of Type 2)

4.4 Microcredit Project Implemented by Urban Commercial Banks and Guarantee Companies

Capital sources include savings from depositors, funds from social guarantee organizations and government guarantee foundations, and fiscal subsidies from local governments.

The project faces the following challenges: banks are unwilling to undertake this project in spite of sufficient funds being offered by governmental agencies; and there are doubts as to whether the project can be sustainable.

4.5 Credit-only Microcredit Companies (PBOC Pilot Project)

Capital sources include funds from individual and institutional investors and entrusted funds from financial institutions which are used as registered and loan capital.

The main challenge is that there is no source of funds for further expansion begging the question as to whether MCCs can cooperate with formal banks in order to convert into village banks, where they would become minority shareholders.

4.6 Village Banks (CBRC Pilot Project)

The capital sources include funds from investors and savings from depositors which are used as registered capital and loan capital. Theoretically, they can mobilize funds from the financial market.

Village banks face the following challenges: capital funds are limited for most village banks (except for those engaging CDB as controlling shareholder); and the shortage in sources of savings.

4.7 RMCCs (CBRC Pilot Project)

Capital sources include investment and savings from members, entrusted funds (within the same villages or towns), and donations from other organizations.

RMCCs face the following challenges: small scale; limited sources of funds; banks are unwilling to offer funds; and the fact that relevant government policy support is not in place.

4.8 Lending Companies (CBRC Pilot Project)

Capital funding comes from parent banks. Theoretically, the companies can also mobilize funds from the financial markets.

Lending companies face the following challenges: limited sources of funds and the small scale of operations.

4.9 Subsidized Microcredit Project for Poverty Alleviation Implemented by Rural Financial Institutions

Capital funding comes from depositor savings which are applied to the poor and low-income farm households. Other sources include fiscal funds from central government which are used as subsidized interest for farm household loans and as rewards for financial institutions that implement the project.

The main challenge faced by the project is the issue of sustainability. The other challenges and problems are the same as those for Type (2) and (3).

4.10 Postal Saving Bank Microcredit Pilot

Postal savings banks are national first-grade legal entities, and all capital funding comes from their own depositors.

The main challenge faced by postal savings banks is how to guarantee the portfolio quality of loans.

4.11 Commercial Bank Microcredit Pilot Project

Capital funding comes from loans from international organizations such as the WB, wholesale loans from financial institutions, and client savings. Other sources include technical assistance funds which are generally used for training and capacity building.

The main challenge faced by commercial banks is in determining whether the microcredit project can be expanded and whether microcredit can become the leading product of and main income source for commercial banks. ■

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Annex

Table 2a. Comparison of Microcredit Providers — Clients and Products

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

Note: The information in this summary table was extracted from relevant documents and sources.

* Calculated on a declining balance.

Table 2b. Comparison of Microcredit Providers — Performance

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

Table 3. The Overall Financial Situation of Non-Financial Microfinance Institutions (1999–2002)

| Item | Year | 1999 | 2000 | 2001 | 2002 |
|---------------------------------------------------------|------|------------|------------|------------|-----------|
| Average Value of Annual Profit in Yuan | | -14,644.36 | -28,809.19 | -28,927.65 | -9,745.56 |
| Proportion of Projects in Loss (%) | | 50 | 55 | 57 | 50 |
| Average Rate of Annual Operational Self-Sufficiency (%) | | 0.7935 | 0.7447 | 0.8296 | 0.7524 |

Data Source: Cao Zijuan (2005), selected from Wang Shuguang etc., "Rural Finance," Peking University Press, 2008.

Table 4. The Statistics of Farmers Microcredit Loans of RCCs in Guizhou Province (Unit: 10,000 Yuan)

| Item | Year | 1999 | 2000 | 2001 | 2002 | 2003 | |
|----------------------------------------------------------------------------------------------------------|------|----------|---------|----------|---------|-----------|---------------|
| Farmers loan balance at the end of year | | 221.0 | 327.5 | 371.2 | 599.7 | 705.7 | (10,000 Yuan) |
| Annual growth rate of farmers loan balance at the end of year | — | 48.3 | 13.3 | 61.0 | 17.7 | (%) | |
| Farmers microcredit loans balance at the end of year | | 50.0 | 70.7 | 138.0 | 244.9 | 279.0 | (10,000 Yuan) |
| Annual growth rate of farmers microcredit loan balance at the end of year | — | 54.5 | 80.0 | 77.4 | 13.9 | (%) | |
| Ratio of farmers microcredit loans balance at the end of year to farmers loan balance at the end of year | | 22.5 | 23.4 | 37.2 | 40.8 | 39.5 | (%) |
| Total savings at the end of year | | 274.0 | 340.6 | 467.5 | 644.7 | 769.4 | (10,000 Yuan) |
| Annual growth rate of total savings at the end of year | — | 24.1 | 37.3 | 37.0 | 19.3 | (%) | |
| Ratio of farmers loans to savings | | 80.5 | 96.2 | 79.4 | 93.0 | 91.7 | (%) |
| The on-lending loan balance of PBOC | | 13.0 | 45.6 | 88.7 | 158.0 | 176.0 | (10,000 Yuan) |
| Annual growth rate of the on-lending loan balance of PBOC | — | -248.2 | 94.5 | 78.1 | 11.8 | (%) | |
| Ratio of non-performing loan balance | | 59.0 | 61.0 | 65.9 | 37.6 | 34.4 | (%) |
| Net assets | | -14.0 | -11.5 | -27.9 | -10.8 | 6.8 | (10,000 Yuan) |
| Annual net profit | | -96589.0 | 19708.0 | -33166.0 | 46433.0 | -120671.0 | (10,000 Yuan) |

Data Source: Cheng Enjiang (2004), selected from the same as Table 3.

Table 5. The Statistics of Institutional Type and Microfinance Methodology (2002)

| Institutional Type | Group Loan | Individual Loan | Village Banking |
|---------------------------------------------|------------|-----------------|-----------------|
| Governmental Microfinance (n=31) | 10 | 21 | 0 |
| Quasi-Governmental Microfinance (n=23) | 7 | 14 | 2 |
| International Sponsored Microfinance (n=49) | 35 | 13 | 1 |
| Informal Microfinance (n=3) | 3 | 0 | 0 |
| Total (n=106) | 55 | 48 | 3 |
| Proportion (n=100%) | 51.89% | 45.28% | 2.83% |

Data Source: Cao Zijuan (2005), selected from the same as Table 3.

Table 6 Financial Performance of Chifeng MFIs

| | 2000 | 2001 | 2002 | 2003 | 2004 | April of 2005 |
|--------------------------------------|--------|--------|---------|--------|--------|---------------|
| Active Clients | — | — | 3268 | 3764 | 3541 | 3631 |
| Ending Balance (ten thousand Yuan) | 137.28 | 192.06 | 294.96 | 366.69 | 439.94 | 549.70 |
| Number of Clients per Credit Officer | 150 | 256 | 272 | 234 | 244 | — |
| Unit Fund Cost for Lending | 0.21 | 0.049 | 0.05 | 0.05 | 0.05 | — |
| ROA | 5.9% | 8.96% | 9.72% | 9.55% | 9.78% | — |
| OSS | 49% | 91% | 102.08% | 101% | 102.7% | — |
| Delinquency Ratio | 0.00% | 0.00% | 0.00% | 0.16% | 0.52% | 0.41% |
| PAR Ratio | 0.00% | 0.00% | 0.00% | 0.74% | 0.52% | 0.41% |

Data Source: Booklet of Chifeng MFI, selected from the same as Table 3.

Table 7. Interest Rates of Non-financial Microfinance Institutions

| Item | Average Value of Nominal Interest Rate | Average Value of Effective Interest Rate |
|--------------------------------------|----------------------------------------|------------------------------------------|
| Governmental Microfinance | 2.53% | 4.52% |
| Quasi-Governmental Microfinance | 3.80% | 4.16% |
| International Sponsored Microfinance | 7.17% | 12.95% |
| Informal Microfinance | 8.00% | 16.00% |

Data Source: Cao Zijuan (2005), selected from the same as Table 3.

Table 8. Basic Situation of Seven MCCs of PBOC September 30, 2007 (Unit: 10,000 Yuan)

| Pilot Region | Pilot Company | Net Capital | Entrusted Funds | Total Loans | Classified by Targeted Clients | | | | | | Classified by Methodology | | | | | | | | | | |
|---------------------------|---------------|-------------|-----------------|-------------|--------------------------------|--------|---------|--------|-----------------|-----------------|---------------------------|--------|----------------------|--------|------------------|-------|--------------------|--------------------|--------------------|----------------|---------|
| | | | | | Individual Loans | | | | Corporate Loans | | | | Non-collateral Loans | | Collateral Loans | | Minimum Loan Rates | Maximum Loan Rates | Average Loan Rates | Bad Loan Rates | Profits |
| | | | | | Individual Loans | % | Loan | % | Farmers Loans | Corporate Loans | Loan | % | Loan | % | Loan | % | | | | | |
| Pingyao, Shanxi | 1 | 2049 | 501 | 2716.5 | 3426.6 | 1816.5 | 66.9 | 1816.5 | 900.0 | 33.1 | 315.5 | 11.6 | 2401.1 | 88.4 | 15.66 | 23.26 | 20.65 | 0.74 | 323.20 | | |
| | 2 | 2284 | 885 | 3524.2 | 4528.3 | 3074.2 | 87.2 | 3074.2 | 450.0 | 12.8 | 23.8 | 0.7 | 3500.4 | 99.3 | 16.20 | 21.60 | 18.55 | 0.00 | 330.00 | | |
| Total | 4333 | 1386 | 6240.7 | 7954.9 | 4890.7 | 78.4 | 4890.74 | 1350.0 | 21.6 | 339.3 | 5.4 | 5901.5 | 94.6 | 15.66 | 23.26 | 19.80 | 0.32 | 653.20 | | | |
| Guangyuan, Sichuan | 3 | 1000 | 0 | 990.9 | 1009.7 | 697.9 | 70.4 | 508.4 | 51.3 | 239.0 | 29.6 | 639.1 | 64.5 | 35.5 | 14.40 | 25.92 | 24.13 | 7.75 | 49.91 | | |
| Jiangkou, Guizhou | 4 | 600 | 0 | 110.3 | 108.8 | 60.3 | 54.7 | 49.3 | 44.7 | 50.0 | 45.3 | 5.6 | 5.1 | 104.7 | 94.9 | 1740 | 2763 | 18.10 | 1.72 | 3.28 | |
| Hu county, Shaanxi | 5 | 2200 | 0 | 468.0 | 754.0 | 468.0 | 100.0 | 18.0 | 3.8 | 0.0 | 0.0 | 0.0 | 0.0 | 468.0 | 100.0 | 22.32 | 24.48 | 22.32 | 0.00 | 33.50 | |
| | 6 | 2100 | 0 | 1499.7 | 373.0 | 1038.7 | 69.3 | 1038.7 | 69.3 | 461.0 | 30.7 | 84.0 | 5.6 | 1415.7 | 94.4 | 23.40 | 24.84 | 23.40 | 0.00 | 45.80 | |
| Total | 4300 | 0 | 1967.7 | 1127.0 | 1056.7 | 76.6 | 1056.7 | 53.7 | 461.0 | 23.4 | 84.0 | 4.3 | 1883.7 | 95.7 | 22.32 | 24.84 | 22.86 | 0.00 | 79.30 | | |
| E'erduosi, Inner Mongolia | 7 | 5000 | 0 | 5922.7 | 6438.9 | 5829.3 | 98.4 | 1567.3 | 26.5 | 93.4 | 1.6 | 1828.0 | 30.9 | 4094.7 | 69.1 | 14.40 | 27.36 | 23.37 | 0.00 | 348.69 | |
| Total | 15233 | 1386 | 15232.3 | 16639.3 | 12984.9 | 85.2 | 8072.4 | 53.0 | 2247.4 | 14.8 | 2895.9 | 19.0 | 12336.4 | 81.0 | 14.40 | 27.63 | 21.50 | 0.65 | 1127.82 | | |

Note: 1. Total loans are counted from the beginning of this year to the day of statistics report.

2. The loan rate is annual interest rate.

Data source: PBOC's MF research group, Microfinance Newsletter, No. 3, 2007.

Chinese Microfinance Networks and Cooperation Patterns

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Executive Summary

This paper is focused on the meso-level issues of the microfinance industry in China. It attempts to identify all kinds of networks and cooperation patterns currently in practice and suggests some new cooperation patterns for the development of an inclusive microfinance sector in China. Besides the industry-wide network, the paper discusses two kinds of microfinance networks that are not industry-wide — NGO MFI networks and networks of commercial banks and companies. The paper explores the transition of the cooperation patterns, from traditional projects to commercial undertakings. In the new cooperation patterns suggested by the paper all stakeholders participate in the effort to build a truly inclusive financial sector.

List of abbreviations

| | |
|--------|---------------------------------------------------------------------------|
| ABC | Agricultural Bank of China |
| ACFTU | All-China Federation of Trade Unions |
| ACWF | All-China Women's Federation |
| ADB | Asian Development Bank |
| BWTP | Banking with the Poor |
| CAM | China Association of Microfinance |
| CASS | China Academy of Social Sciences |
| CBRC | China Banking Regulatory Commission |
| CDB | China Development Bank |
| CFPA | China Foundation for Poverty Alleviation |
| CGAP | Consultative Group to Assist the Poor |
| CICETE | China International Center for Economic & Technical Exchanges |
| FDC | Foundation for Development Cooperation |
| FPC | Funding the Poor Cooperative |
| GTZ | Gesellschaft für Technische Zusammenarbeit (German technical cooperation) |
| IFC | International Finance Corporation |
| IPC | International Project Consult |
| KfW | Kreditanstalt für Wiederaufbau (German Development Bank) |
| MCC | Micro Credit Company |
| MFI | Microfinance Institution |
| MIS | Management Information System |
| MOCA | Ministry of Civil Affairs |
| MOF | Ministry of Finance |
| MOFCOM | Ministry of Commerce |
| MOST | Ministry of Science and Technology |
| NGO | Non-Governmental Organization |
| PBOC | People's Bank of China (Central Bank) |
| RDI | Rural Development Institute |
| SCO | Supporting and Coordinating Office |
| SEEP | Network |
| SMAP | Sustainable Microfinance for Alleviating Poverty |
| UNDP | United Nations Development Program |
| UNFPA | United Nations Population Fund |
| UNICEF | United Nations Children's Fund |

1 Networks

1.1 Definition and Categories of Networks

The networks listed in this paper are those that meet the following criteria:

- A network is a group of organizations that are legally independent, not the branches of one organization
- These organizations share a common vision, purpose and interests
- They demonstrate evidence of a unified management system, based on an agreement or memorandum of understanding (MOU)

The networks will be introduced in this paper by the following categories:

- Networks at the industry level
- Networks of NGO Microfinance Institutions (MFIs)
- Networks of commercial banks or companies

2 China Association of Microfinance (CAM) — the Network at the Industry Level

2.1 History

In 2003, representatives from more than 100 domestic MFIs (mostly NGO-MFIs) attended the China Microfinance Summit, sponsored by Ford Foundation and Citi Foundation. The participants appealed for the establishment of an association of microfinance organizations in China. After the Summit, the Rural Development Institute (RDI) of the China Academy of Social Sciences (CASS, the first institution

devoted to the introduction of microfinance in China), together with the China International Center for Economic & Technical Exchanges (CICETE, the manager of the largest Microfinance program in China), the Women Development Department of the All-China Women's Federation (ACWF) and the China Foundation for Poverty Alleviation (CFPA) decided to jointly initiate and create the China Association of Microfinance.

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

In 2004, Citi Foundation committed to a five-year project, in partnership with CASS, to support the establishment of CAM.

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

CAM currently has a total of 110 members. With the exception of two commercial banks and two microcredit companies, all of the association's members are NGOs. It should be noted that CFPA decided to withdraw from the CAM project.

2.2 Partners

- Citi Foundation is CAM's principal donor
- UNDP and other international organizations have seats in the Advisory Committee representing donors and technical assistance providers
- Grameen Trust acts as a strategic cooperator and donor
- PBOC, CBRC (China Banking Regulatory Commission), the Ministry of Commerce, and other government line agencies function as regulators and policy makers
- Ford Foundation, Grameen Foundation USA, Planet Finance and other international NGOs represent donors and technical assistance providers
- SEEP Network is a technical assistance provider
- CASS and CICETE provide administrative support and subsidies

2.3 Purpose of Network/Cooperation

- Policy coordination and lobbying
- Self-regulation
- Technical assistance and training
- Communication and support
- Fundraising services

2.4 Performance

2.4.1 Policy Coordination:

- Invited by PBOC and CBRC, CAM is directly involved in the process of rural financial system reform. CAM has also been requested to join the "National Consultative Committee on Inclusive Financial Sectors" led by PBOC
- Prof. Du Xiaoshan, the director of CAM's Administrative Committee, and Mr. Bai Chengyu, the Secretary General of CAM, have submitted several letters and documents on policy issues to the State Council and government leaders on behalf of CAM's members. In some cases, the instructions and commands given by government leaders have been conveyed to regulators for their consideration
- Successfully invited Nobel Peace Prize Laureate-Professor Muhammad Yunus to join the Grameen Trust Microfinance Workshop in China in October 2006, significantly reinforcing the awareness of the Chinese general public and the central government of microfinance operations, as well as promoting the issue of new regulations
- Co-organized the Asia Microfinance Forum in Beijing in March 2006 together with Foundation for Development Cooperation (FDC) and Banking with the Poor (BWTP)
- Since 2005, CAM has organized the Citi Micro-Entrepreneurship Award for three consecutive years, playing a significant role in creating publicity and awareness of microfinance operations
- Conducted research activities and submitted reports and policy advice to the relevant regulatory authorities for their reference with regard to policy making

2.4.2 Self-Regulation:

- Created rules for self-regulation among its members
- Developed a financial manual, created a unified financial indicator system for MFIs, and required all members to follow this manual and system. The financial management manual has been used by PBOC in its "Guidance for Microcredit Company Management" document

2.4.3 Technical Assistance and Training:

- Provided guidance regarding management skills to MFIs
- Helped some MFIs to design their transformation schemes for the purpose of commercialization
- Cooperated closely with the Citi-China Microfinance Training Center, which organizes at least twenty training courses every year

2.4.4 Communication and Advocacy:

- Compiled bimonthly microfinance newsletters which are then sent to all relevant government agencies and regulatory departments, MFIs and international organizations
- Opened its own website providing news, an online library, forum, and messaging system. The website is currently the professional microfinance website with the highest click rate in China
- Produced annual reports each year since the association's creation
- Published three research reports (only in Chinese)
- Organized several peer learning visits among members

2.4.5 Fundraising Services:

- CAM has forged links between investment institutions and MFIs. Citi, Standard Chartered, International Finance Corporation (IFC), BlueOrchard, ACCION International, Planet Finance, Hope International, Plan International, SEEP and a number of other international organizations have formed cooperative relationships with CAM. Other organizations and institutions simply stay in contact with CAM
- Offered consultancy services to investors. Such offers have been met with numerous requests from international and domestic visitors

2.5 Challenges

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

3

Networks of NGO MFIs

3.1 Funding the Poor Cooperative (FPC) of CASS

3.1.1 History

CASS's Rural Development Initiative (RDI) was the first agency to demonstrate the potential of microfinance (Grameen model) as a financial service for the poor in China. The agency's projects proved that, that as in other parts of the developing world, microcredit can be an effective tool for poverty alleviation in China.

The first Funding the Poor Cooperative (FPC) branch was set up in Yixian County of Hebei Province in 2003 as a research project. Currently there are a total of five FPC branches, two of which are located in Hebei Province, two in Henan Province and one in Sichuan Province. Each branch is registered as an independent NGO at the county level.

In 2005, FPC's headquarters were separated from the RDI and registered as a foundation in Beijing.

Since 2006, Shenzhen Zhonganxinye Credit Company has provided technical assistance to FPC branches in Henan and Hebei provinces and conducted a feasibility study for further investment.

In 2001, the China Microfinance Training Center was established with funding and technical assistance from the Consultative Group to Assist the Poor (CGAP). After receiving funds from Citi Foundation in 2004, it was renamed as the "Citi-China Microfinance Training Center."

3.1.2 Partners

- Grameen Trust provided funding and technical assistance for the establishment of branches from the very beginning of the project
- Ford Foundation offered funding for research and advocacy.
- CGAP provided funding and technical assistance for the China Microfinance Training Center
- Citi Foundation provided a wholesale loan fund through Grameen Trust, and now provides funding for the Citi-China Microfinance Training Center
- Mr. Yang Lin's Taiwan based enterprise has invested in the FPC in order to allow the repayment of the loans from Grameen Trust
- Shenzhen Zhonganxinye Credit Company provides technical assistance to FPC branches in Hebei and Henan provinces, and produced a feasibility study for investment
- CICETE provides expertise and resources to the training center
- Local government provides policy support and managerial staff
- CASS functions as project initiator and manager

3.1.3 Purpose of the Network

- Research and demonstration of Grameen Bank microcredit model in China
- Support for microfinance development in China
- Dissemination of successful results and knowledge of microfinance development

3.1.4 Performance

- The project achieved its target of demonstrating microcredit as a tool for poverty alleviation and helped to promote the development of microfinance in China
- The project has total loan assets of approximately 20 million RMB Yuan
- Whilst no branches have realized financial self-sufficiency, at least two branches have achieved operational self-sufficiency
- The FPC foundation's headquarters still rely on donations and subsidies from CASS

3.1.5 Challenges

- **Legal and regulatory:** As NGOs, FPC and its branches have no legal status as credit operators
- **Ownership:** Ownership of the loan fund is uncertain. Mr. Yanglin still has the right to withdraw his investment at any time
- **Governance:** FPC branches have a centralized governance structure under the leadership of the Rural Development Initiative
- **Sources of funds:** FPC branches have no legal status to obtain funds from financial institutions or to obtain commercial investment as long as they remain NGOs. Moreover, social investment is limited in scale and the FPC is prohibited from working with public savings
- **Management capacity:** FPC branches are not yet ready to increase the scale of their operations
- **Staff:** The project's managerial staff are neither professional nor stable

3.2 CICETE/UNDP Microfinance Program

3.2.1 History

The CICETE/UNDP microfinance program has passed through three key stages of development:

- **First Stage (Demonstration):** From 1994 to 2000, CICETE/UNDP implemented a comprehensive poverty alleviation pilot program. Microcredit operations were one of the components of the overall trial. By 2000, a total of forty-eight rural MFIs throughout seventeen provinces and one urban MFI in a large city had been successively built. All of these MFIs are NGOs registered at the local level. The program strongly promoted microcredit as a tool for poverty alleviation throughout the country. A Supporting and Coordinating Office (SCO) was set up within CICETE in 1998 to act as the headquarters for the microcredit program.
- **Second Stage (Sustainable Development):** In 2001, CICETE/UNDP implemented a second microcredit development program and named it "Sustainable Microfinance for Alleviating Poverty" (SMAP). Four pilot MFIs were selected from the forty-eight rural "demonstration" MFIs. During this period, the SCO and SMAP jointly developed, with technical assistance from international consultants, a set of management manuals and a computerized Management Information System for the four pilot MFIs. In addition, all of the other MFIs were still being managed by the SCO at this time. Cooperation with the PBOC with regard to policy research and the publishing of a research document formed the second component of the SMAP project. The research activity was also an educational process and helped PBOC to become a strong promoter of microfinance development in China.
- **Third Stage (Commercialization and Integration into Inclusive Financial Sectors):** After the completion of SMAP in 2005, CICETE/UNDP started to design the third stage of microfinance development in China. The new project has been approved by UNDP, and was recently named the "Establishment of Inclusive Financial Sectors in China" project. The project has two components: a) to continue to cooperate with PBOC at the policy level on the founding of a national Advisory Committee on Inclusive Financial Sectors; b) to cooperate with China Development Bank (CDB) to set up an investment fund for commercialized MFIs.

At the same time, CICETE has made a strategic decision to transform the existing NGO MFIs into commercialized MFIs by:

- Clarifying the ownership of the loan fund
- Investing in an SRI company for microfinance
- Transforming NGOs into Micro Credit Companies (MCCs) through investment by other companies

CICETE is also considering the creation of a national microfinance bank in the future in cooperation with other investors, MFIs and networks.

In 2007, CICETE transformed two existing local NGOs into commercialized MFIs in Gansu and Hunan provinces. At the request of the local government, CICETE has decided to invest in a Micro Credit Company at the previous project site in Hainan Province.

3.2.2 Partners

- UNDP is the main donor and cooperation partner
- Citi Foundation has provided on-lending funds to some MFIs through the Grameen Trust
- PBOC offers assistance and cooperation with regard to policy research and advocacy
- The Ministry of Science and Technology (MOST) offers assistance and cooperation with regard to project management and cost sharing for UNDP projects
- CASS provides consultancy expertise with regard to project management
- The Agricultural Bank of China (ABC) has offered subsidized loans to two MFIs
- The Women's Federation assists with local level MFI management
- The Government Office for Poverty Alleviation assists with local level MFI management
- The Trade Union assists with a guarantee fund for microfinance in urban areas
- Grameen Trust has provided donations and technical assistance and has also invested in a Micro Credit Company in Sichuan Province
- Planet Finance acts as a technical assistance provider
- KFW has provided 10,000 RMB yuan in soft loans plus 5 million RMB yuan in grants to the Chifeng Women's Development Association, one of CICETE's best performing MFIs. The project belongs to a government cooperation project through the Ministry of Finance (MOF)
- Local government provides administrative support and managerial staff
- CICETE is a project executing agency, microfinance operation supervisor and potential future investor

3.2.3 Purpose of the Network

- Demonstration and promotion of microfinance
- Policy lobbying and advocacy
- Sustainable microfinance operations and development for people without access to financial services

3.2.4 Performance

- The program has achieved its target of promoting microfinance development in China
- The forty-eight MFIs have approximately 50,000 clients and a total loan portfolio of 50 million Yuan. The majority of clients have improved their standard of living thanks to the microcredit services
- Although approximately five MFIs have realized operational self-sufficiency, none of them are financially self-sufficient.
- CICETE has set up a professional task force (SCO) for microfinance management
- CICETE has also developed a unified management system including a computerized Management Information System

3.2.5 Challenges

- Legal and regulatory: MFIs have no legal status to offer credit services
- Ownership: Must be clarified and redefined
- Governance: The program's headquarters has no effective control over MFIs due to the decentralized governance structure
- Sources of funds: The program cannot receive commercial investment whilst retaining its NGO status. Furthermore, social investment is limited in scale and the program is prohibited from working with public savings
- Management capacity: Although the program's headquarters has professional staff, it is underresourced. In addition, the majority of the MFIs' managerial employees are neither qualified nor stable
- SCO (headquarters): Currently relies on subsidies from UNDP and CICETE

3.3 Microfinance Project of China Foundation for Poverty Alleviation (CFPA)

3.3.1 History

The project was started by the Western Human Resource Center as one component of the World Bank's poverty alleviation loan program in 1996 with the creation of two MFIs in Sichuan and Shanxi provinces.

In 2000, the microfinance project and its management team were merged into the "China Foundation for Poverty Alleviation" (CFPA). At present, the Foundation manages a total of ten MFIs, including the two original MFIs that were established by CFPA.

In 2005, CFPA adjusted its strategy for microfinance development by shifting its focus from project management to institutionalization. CFPA's target was to forge a professional and sustainable MFI in China. Since then, CFPA has reformed the governance structure by converting local MFIs into branch offices. Thus far, a total of six MFIs have been transformed.

CFPA is now considering the separation of the microfinance business from the foundation in order to form an independent institution.

3.3.2 Partners

- The Leading Group Office for Poverty Alleviation functions as a policy umbrella
- Mercy Corps is a donor and technical assistance provider
- The Hong Kong Kadoorie Foundation is a donor
- Private sector companies (Shell, Bayer, Microsoft, Corning) act as donors and technical assistance providers
- China Development Bank (CDB) has provided 100 million RMB Yuan of on-lending funds
- Standard Chartered has offered 20 million RMB Yuan of on-lending funds
- Planet Finance is a technical assistance provider
- The Grameen Trust acts as a donor and technical assistance provider

3.3.3 Purpose of the Network

- Provide financial services to the poor
- Strengthen the capacity of poor people
- Sustainable development of microfinance

3.3.4 Performance

- Seven of the ten MFIs are performing well and have achieved operational and financial self-sufficiency
- According to the July 2007 progress report, the program has a loan portfolio of 51.9 million RMB Yuan, a total of 26,079 active clients, and a PAR over 30 days of approximately 20%¹
- The program's headquarters still relies on donations and subsidies from the foundation

3.3.5 Challenges

- **Legal and regulatory:** CFPA has no legal status to offer credit services
- **Ownership:** As a foundation, all of the program's capital has come from public trust funds
- **Governance:** A centralized, headquarters based, management system has been adopted
- **Sources of funds:** It is illegal for the program to receive commercial on-lending funds if it remains within the CFPA. Moreover, social investment is limited in scale and the program is prohibited from working with public savings
- **Management capacity:** The program's headquarters has professional staff but is underresourced. The capacity of branch management staff needs to be improved

3.4 MOFCOM/UNICEF/UNFPA Microcredit Program

3.4.1 History

The United Nations Population Fund (UNFPA) was the first international organization to introduce microcredit operations in China through its projects in the late 1980s. Since the 1990s, the United Nations Children's Fund (UNICEF) has also integrated microcredit components into its Social Development Program for Poor Areas (SPPA) and Local Planning and Action for Children (LPAC) projects. Thus far, these projects have launched microfinance operations in more than fifty poor counties in China.

In 2003, the evaluation report of the UNICEF project suggested the building of a management center at the national level. The report recommended that management activities regarding the sustainable development of microcredit operations should be performed by a professional agency such as CICETE. However, UNICEF and MOFCOM did not accept this suggestion.

By the end of 2008, UNICEF will have completed all of its microfinance projects in China. The projects are now entering into the evaluation phase and UNICEF will soon make a decision regarding the future management of its existing microfinance operations.

¹ From CFPA official website: [http://www.fupin.org.cn/UserFiles/File/Micronan%20Monthly%20Progress%20Report/Project%20Progress%20Report%20\(Jul.\).xls](http://www.fupin.org.cn/UserFiles/File/Micronan%20Monthly%20Progress%20Report/Project%20Progress%20Report%20(Jul.).xls)

3.4.2 Partners

- MOFCOM provides administrative support for project management through its local offices
- Local Government offers administrative support and managerial staff
- UNFPA and UNICEF function as donors and project monitors
- CICETE and CASS are technical assistance providers
- Grameen Trust provides loan funds to one MFI
- Other donors

3.4.3 Purpose of the Network

- Capacity building for poor females
- Achieving the national development goals for women and children

3.4.4 Performance

- The program has realized its social development goals
- All of UNFPA's microfinance activities ceased after the project was completed with the exception of those in two counties
- Only 50% of the MFIs created by UNICEF are still in operation and few of them have high quality loan portfolios

3.4.5 Challenges

- Legal and regulatory: Projects have no legal status to offer credit services
- Ownership: Has been transferred to local governments
- Governance: Currently no microcredit management department within the program's headquarters. Furthermore, the program's decentralized management system has made it difficult to control operations after the closure of a project
- Funding resources: No further resources are available
- Management capacity: Capacity of branch managerial staff needs to be improved

3.5 Women's Federation

3.5.1 History

Since the 1990s, the All-China Women's Federation (ACWF) has encouraged its local organizations to provide microcredit services. The federation provides several different types of microfinance services. The services typically have one of four possible objectives:

1. To help MFIs with client mobilization and identification
2. To help MFIs to collect loans
3. To set up microcredit funds and operate MFIs directly
4. To cooperate with other organizations in order to establish an MFI and occupy a seat within the board of directors

It should be noted that ACWF submitted a proposal to the State Council regarding the creation of a Women's Bank in China, which was refused.

3.5.2 Partners

- Local government provides funds and policy support
- International organizations such as UNDP, UNICEF and UNFPA, provide donations
- Local communities make donations
- Some local women's federations act as project supervisors
- ACWF functions as a policy supporter and coordinator

3.5.3 Purpose (Function) of the Network

- Capacity building for females
- Improving the living conditions of women and their families
- Strengthening the capacity of the women's federation itself

3.5.4 Performance

Some of the projects supervised by the All-China Women's Federation, with the assistance of international organizations, have been quite successful. Examples of such projects are the MFIs in Tianjin City and Chifeng City of Inner-Mongolia. However the other projects are not performing well.

3.5.5 Challenges

The ACWF has similar problems to those experienced by all other NGOs.

3.6 Trade Unions

In the early 1990s, trade unions founded numerous credit unions in urban areas. Some of the credit unions were developed as urban credit cooperatives. However, the government closed all of these credit unions during the financial crisis in 1997.

Since 2000, in order to help laid-off workers of state owned enterprises, some local trade unions set up microcredit loan funds and provided loans to micro-entrepreneurs. The successful experiences were identified and summarized by the "All-China Federation of Trade Unions" (ACFTU) and replicated by many local trade unions.

In order to strengthen ACFTU's capacity, UNDP assisted ACFTU, CICETE and the Henan provincial government to jointly set up a microcredit guarantee fund in Henan, and to deliver microcredit in three large cities in cooperation with local commercial banks.

ACFTU also discussed the possibility of credit union rehabilitation in urban areas with the WOCCU delegation when they visited China in 2007.

3.7 Hope International

HOPE China was established in 2000 in Zhangjiakou City, Hebei Province. The program currently employs 30 local staff members who work in 8 offices throughout northern China. HOPE China has disbursed over 11,000 loans since its inception and now serves more than 750 clients.

Owing to the challenging political and legal structures in northern China, growth has been slow with focus instead being put on quality of service rather than rapid and unrestricted expansion.

Loans in China start as low as 500 Yuan (\$70) and on-time loan repayment rates currently stand at 97.6%. Some of Hope International's branches became financially self-sufficient in 2003 by charging interest rates of more than 24%.

3.8 Plan International

Plan International started microfinance activities in Shaanxi Province in 2003 and now operates in five counties, with a total loan fund of approximately 5 million Yuan. NGOs were set up at the county level in cooperation with the local women's federation.

Plan International aims to provide sustainable microfinance development in favor of the poor. They have invested significant sums on capacity building, including developing a computerized MIS. In collaboration with the "90 Foundation" from the United States, Plan International is transforming one of its MFIs into a Micro Credit Company.

4 Networks of Commercial Banks and Companies

4.1 China Development Bank (CDB) and its Microfinance Projects

4.1.1 History

As a policy bank, providing financial services to microenterprises is one of the strategic priorities of CDB. In 2000, CDB began to study and analyze the microfinance industry. CDB's previous strategy had been to provide on-lending funds to microfinance projects or MFIs. For example, in 2004, CDB approved an on-lending fund to Tianjin Women's Development Association, the first urban MFI in China set up by a UNDP assistant. However, the Tianjin Women's Development Association has not yet used this fund because the financial cost of doing so is currently too high. This strategy was eventually successfully implemented by signing an on-lending loan agreement with CFPA.

In 2004, CDB began to cooperate with the World Bank and KFW on a Microfinance Development Project. CDB set up a Microfinance Group to implement the project and the World Bank offered US \$1 million in technical assistance funds and a US\$100 million commercial loan to CDB in 2005. KFW provided a US\$50 million commercial loan plus 3 million euros in grants in 2006. German International Project Consult (IPC) is the technical service provider for the project.

In 2005, CDB launched the project in cooperation with three city commercial banks in three provinces. The experiment was very successful and CDB launched three similar projects in cooperation with local commercial banks in 2006. By the end of 2007, twelve local banks were involved in the project and CDB plans to cooperate with more banks in the future.

In order to develop these social investment loan businesses, CDB set up a new department in Shanghai named the "Social Welfare Center." The Microfinance Group and the project were subsequently merged into this center.

In January 2008, UNDP approved a new project with the aim of establishing inclusive financial sectors in China. One component of the project involves the creation of an investment fund for commercial microfinance institutions in cooperation

with CDB. CDB has committed at least 100 million Yuan to the fund and the fund management office will be set up within CDB's headquarters.

4.1.2 Partners

- World Bank and KFW are donors and loan fund providers
- UNDP is a donor and technical assistance provider
- IPC functions as a technical service provider
- Local commercial banks are cooperative partners
- CFPA and other MFIs are recipient organizations for on-lending funds
- CDB acts as a wholesale bank and coordinator

4.1.3 Purpose of the Network

To develop microfinance operations for microenterprises and people who have no access to financial services.

4.1.4 Performance

By the end of January 2008, twelve local commercial banks had joined the project and six had disbursed loans. They had a total of 25,000 accumulated loans and a portfolio of 1.7 billion Yuan. The project's average loan size is 66,600 Yuan whilst the default loan rate over 30 days stands at only 0.3%.

4.1.5 Challenges

International best practices show that commercial banks should establish separate branches in order to deliver microfinance services. The pilot commercial banks have not separated microfinance operations from their common business. It remains to be seen whether the commercial banks will be converted into professional microfinance organizations or whether special microfinance branches will be set up instead.

The success of the pilot project lies in the provision of technical assistance, a substantial part of which has been covered by donors. In order to replicate the pilot project on a larger scale, with more commercial banks being involved at a lower cost, localization approaches need to be developed.

4.2 PBOC Micro Credit Company Pilot

4.2.1 History

In 2005, PBOC launched an experimental project that created commercialized microfinance organizations and allowed the private sector to invest in Micro Credit Companies (MCCs). By the end of that year, two MCCs had been registered in Shanxi Province.

In 2006, the Asian Development Bank (ADB) and GTZ started to cooperate with PBOC in order to provide technical assistance to the MCCs.

In 2007, Microcred, IFC, KFW and American International Group jointly invested in an MCC in Sichuan Province. The MCC was approved by the provincial government with support from PBOC.

Thus far, a total of seven MCCs in five provinces have been officially registered and continue to operate with PBOC's direct support and guidance. In addition, there are at least another eight MCCs, which operate with the guidance of PBOC, that have been registered in other provinces with the support of the local government.

Table 1: Monitoring Report of Seven Pilot MCCs (Unit: Million Yuan)*

| MCC Name | Jinyuantai | Rishenglong | Quanli | Huadi | Xinchang | Dayanghuixin | Rongfeng | Total/leverage |
|----------------------------------|-------------------|-------------------|------------------|------------------|------------------|-----------------|-------------------|-------------------|
| Net assets | 20.46 | 23.41 | 10 | 6 | 22 | 21 | 30 | 132.87 |
| Trust fund | 3.01 | 4.75 | 0 | 0 | 0 | 0 | 0 | 7.76 |
| Loan Portfolio | 24.25 | 26.788 | 9.166 | 0.945 | 3.623 | 12.57 | 18.454 | 95.795 |
| Portfolio of personal loans | 17.35 (71.5%) | 24.338 (90.9%) | 8.606 (93.9%) | 0.445 (47.1%) | 3.573 (98.6%) | 9.21 (73.3%) | 17.236 (93.4%) | 80.757 (84.3%) |
| Portfolio of enterprise loans | 6.90 (28.5%) | 2.45 (9.1%) | 9.35 (18.3%) | 0.5 (52.9%) | 0.05 (1.4%) | 3.36 (26.7%) | 1.219 (6.6%) | 15.039 (15.7%) |
| Portfolio of non-collateral loan | 1.738 (7.2%) | 0.325 (1.2%) | 6.023 (65.7%) | 0.07 (7.5%) | 0 | 0.845 (6.7%) | 8.845 (47.9%) | 17.846 (18.6%) |
| Portfolio of collateral loans | 22.512 (92.8%) | 26.463 (98.8%) | 3.143 (34.3%) | 0.874 (92.5%) | 3.623 (100%) | 11.69 (93%) | 9.609 (52.1%) | 77.92 (81.3%) |
| Average annual interest rate | 21.39% | 17.84% | 18.8% | 19.28% | 22.23% | 19.32% | 22.15% | 20.09% |
| Rate of past due | 0.82% | 0.00 | 6.24% | 4.92% | 0 | 0 | 0 | 0.85% |

* Resource: Microcredit News Letter published by PBOC in Apr. 2007

4.2.2 Partners

- PBOC acts as a policy maker and guidance provider.
- The private sector provides investment.
- Local government acts as a regulator.
- ADB and GTZ are technical service providers.
- MCCs are operators.

4.2.3 Purpose of the Network

- To demonstrate a commercially sustainable microcredit business
- To demonstrate new kinds of financial institutions
- To push the reform of Rural Credit Cooperatives by creating competition in financial markets
- To provide microfinance to people without access to financial services

4.2.4 Performance

Since MCCs are regulated by local governments, the performance of individual MCCs varies considerably. Although the best performing MCCs realized a profit in the first year without any defaults, the poorest performers are struggling for survival.

4.2.5 Challenges

- Policy and regulation: MCCs do not currently have a CBRC issued financial license. Since regulatory functions are provided by local governments, as opposed to PBOC or CBRC, there are no national regulations regarding MCC management
- Most MCCs are currently operating in the same conventional way as banking institutions i.e. their products are mostly based on collateral, not targeting the poor
- MCC funding sources are very limited because they can neither work with public savings nor receive on-lending funds from other financial institutions
- MCC business operations are restricted to the local area of registration

5

Existing Cooperation Patterns

By reviewing the networks listed above, two types of cooperation patterns can be identified:

- Traditional cooperation patterns, or donor-/government-led patterns
- Commercial cooperation patterns, or investor-led patterns

5.1 Traditional Patterns

These patterns have been commonly used by microfinance projects for poverty alleviation and employment and consist of two different types: donor-led pattern and government-led pattern.

5.1.1 Donor-Led Pattern

Main Characteristics:

- Stakeholders: donors, government agencies, NGOs, research institutes, policy makers
- Short-term management arrangement for project duration
- Focus on social development goals
- Subsidized by donors
- Dependent on limited seed money and assistance
- Delivered by the government project office or NGOs

5.1.2 Government-Led Pattern

Main characteristics:

- Stakeholders: government, guarantee funds, commercial banks, NGOs
- Promoted by the government for policy purposes and social development goals
- Short-term management arrangement
- Subsidized and guaranteed by the government
- Funds received from fiscal budget
- Delivered by commercial banks or NGOs (Women's Federation and Trade Union etc.)

5.2 Commercial Patterns

5.2.1 Upgrading Pattern

This pattern is shared by NGO MFIs and networks that have a desire to be commercialized and become sustainable microfinance institutions. Under this pattern, the main cooperation partners are as follows:

- NGO MFIs: have experience in delivering financial services to the lowest segments of the market and have many mature clients. They do not have legal status and funding sources
- Policy makers and regulators: could create more favorable regulations for the upgrading process of NGOs. Such changes would result in the increased availability of financial services to the lower-end of the market
- Investors: can help NGOs to upgrade through investment of funds and changes in the governing structure of the institution. Investors should be able to quickly obtain returns on their investments considering NGOs' successful operations in the past
- Donors: can provide both funds and technical assistance in order to help projects become sustainable

5.2.2 Down-Scaling Pattern

This pattern has been used by policy banks to develop microfinance services for the lower segment markets. The following partners are involved:

- Investors: international financial institutions and national policy banks that are committed to microfinance development
- Commercial banks: have recognized the potential profitability of microfinance operations but do not have any experience in the field

5.2.3 Greenfield Pattern

This pattern is used by policy makers to promote financial market reform and the development of microfinance operations for people without access to financial services. The partners working to this pattern mainly comprise:

- Financial market policy makers
- Private investors who are keen to enter the financial market
- Local government who can mobilize investment by creating MCCs

5.3 Cooperation Patterns under the Inclusive Financial Sectors Framework

The traditional or existing cooperation patterns separate the microfinance sector from the overall financial system. They also constrain the growth of microfinance outreach and the sustainability of microfinance development in China. The new concept of inclusive financial sectors will help microfinance operations to become integrated into the overall financial system by broadening cooperation patterns and sharing the advantages among all stakeholders.

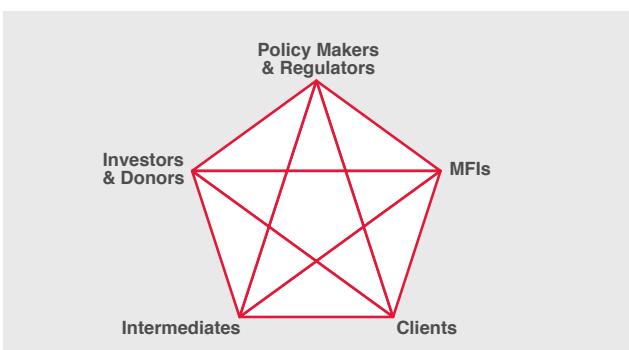
5.3.1 The stakeholders

The stakeholders in the framework of inclusive financial sectors are:

- Policy makers and regulators (PBOC, CBRC etc.)
- Investors:
 - Policy banks
 - Commercial banks
 - Commercial investors
 - APEX fund
 - Social investors
 - Donors
- MFIs:
 - Commercial Banks
 - Commercial MFIs
 - NGOs
- Intermediates:
 - Associations
 - Research institutes
 - Rating and evaluation agencies
- Clients

Table 2: Existing Cooperation Patterns

| Stakeholders | Traditional Patterns | | Commercial Patterns | | |
|------------------|----------------------|----------------|---------------------|-------------|------------|
| | Donor-Led | Government-Led | Upgrading | Downscaling | Greenfield |
| Government | ● | ● | ● | | ● |
| Donors | ● | | ● | | ● |
| NGOs | ● | ● | ● | | |
| Commercial Banks | | ● | | ● | |
| Investors | | | ● | | ● |
| Regulators | | ● | ● | ● | ● |
| Researchers | ● | | ● | | |

Figure 1: Stakeholders in Inclusive Financial Sectors

5.3.2 New cooperation patterns for inclusive financial sectors

The following cooperation patterns are part of the framework of inclusive financial sectors:

- **National Advisory Committee for Inclusive Financial Sectors:** will invite all stakeholders to participate in the dialogue and develop a common vision
- **Wholesale Fund (APEX):** will build up investments to a large scale and provide them to MFIs more effectively
- **Commercial banks + NGOs pattern:** Although, commercial banks have funds, legal status, professional risk management systems and access to credit bureaus, they do not have experience within the microfinance industry or microfinance delivery arms. NGO MFIs have such experience and delivery arms but lack legal status, funds etc. Commercial banks can downscale their services to lower market segments by entrusting NGOs to act as retailers and loan delivery and collection agents
- **A strong association at industry level** can contribute to microfinance development by:
 - Providing demand-driven services to all partners
 - Facilitating regulators to create certain kinds of non-prudential self-regulated systems
 - Developing industrial benchmarks together with rating agencies
 - Improving the transparency of the industry
 - Protecting the right of clients

5.3.3 The Role of Donors

The role of donors in the past and at present

- Introduced the microfinance concept into China
- Proved microfinance as an effective tool for poverty alleviation by demonstration and experiment
- Established a group of pilot MFIs and microfinance networks through funding and technical assistance
- Promoted the reform and improvement of the regulatory and legal framework for microfinance development
- Introduced the new concept of commercialization and inclusive financial sectors

5.3.4 The roles of donors in the future

- Facilitate the formation of an inclusive financial sector platform
- Facilitate further improvement of the regulatory and legal framework and environment
- Provide technical assistance for the upgrading of NGO MFIs
- Facilitate the establishment of APEX or wholesale funds
- Provide technical assistance for human resource development
- Provide technical assistance to improve the capacity of the industry network
- Provide technical assistance on microfinance management innovation ■

Workshop Report: A Glimpse at the Microfinance Industry in China

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

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

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

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

On the 27th of February 2008, a workshop entitled “Inclusive Access to Financial Services in China: Challenges and Opportunities” was held in the Jianguo Garden Hotel in Beijing. The workshop was jointly sponsored by the World Microfinance Forum Geneva (WMFG) and the United Nations

Development Program (UNDP), and was organized in collaboration with the China International Center for Economic and Technical Exchanges (CICETE) and the China Association of Microfinance (CAM). The event attracted approximately 100 microfinance operators, regulators, international microfinance investors, foreign and domestic financial institution representatives, and microfinance researchers and experts.

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

1

Overview of the Microfinance Environment

1.1 The General Financial System

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

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

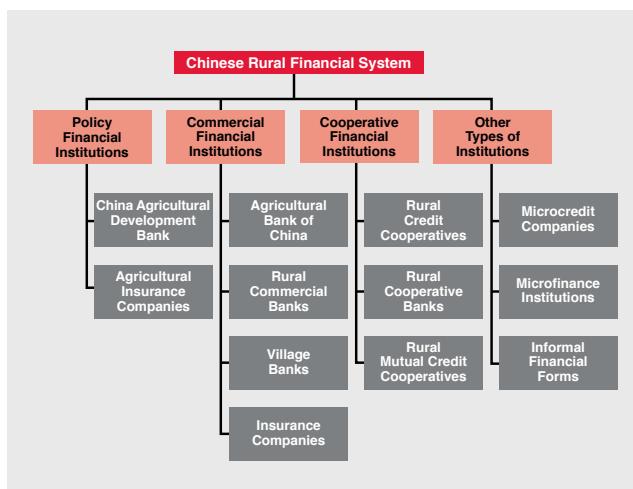
- Banking System:** China's banking system has total assets of US\$7.5 trillion (December 2007) and comprises: 3 policy banks (China Development Bank, Export-Import Bank of China, and the Agricultural Development Bank of China), 5 state-owned commercial banks (Bank of China, Industrial and Commercial Bank of China, China Construction Bank, Agricultural Bank of China, and Communication Bank of China), 12 shareholding commercial banks, 113 urban commercial banks, 13 rural commercial banks, 244 foreign-funded banks, 80 rural cooperative banks, 19,348 rural credit cooperatives (RCC), and 31 recently created rural financial institutions (CBRC pilot project, Village Banks, Lending Companies, and Rural Mutual Credit Cooperatives).
- Insurance Sector:** China's insurance sector has total assets of US\$400 billion (December 2007) and comprises: 62 insurance companies, 6 insurance groups, 2 insurance asset management companies, and 1,142 professional insurance intermediary agencies.
- Securities Industry:** China's securities industry has total assets of US\$1.1 trillion (December 2007) and comprises: 130 security companies, 42 fund management companies, 2 security exchanges, and 1 futures exchange.

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

1.2 The Current Rural Financial System

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

Figure 1.



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

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

1.3 The Policy and Legal Framework for Microfinance

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

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

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

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

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

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

In December 2001, the PBOC published its: "Management Guidelines for RCC Microcredit Loans and Requirements for Implementing Microfinance."

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

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

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

In December 2006, CBRC published its "Opinion Regarding Easing Market Access for Banking Financial Institutions in Rural Areas in order to better Support the Construction

of a Socialist New Countryside" and granted permission for the establishment of three new types of rural financial institutions: Village Banks (VB), Lending Companies (LC), and Rural Mutual Credit Cooperatives (RMCC). RMCC's are fully-licensed financial institutions and although they are regulated and prudentially supervised by the CBRC, they do not enjoy preferential policies on taxation and savings reserves, nor do they have access to the subsidies that RCCs receive.

In January 2007, the CBRC published "Provisional Rules for the Administration of Village Banks," "Provisional Rules for the Administration of Lending Companies," and "Provisional Rules for the Administration of Rural Mutual Credit Cooperatives."¹ In December 2006, the CBRC started pilot projects in 6 provinces before expanding the experiment to a total of 31 provinces, autonomous regions and municipalities in October 2007. To date, 31 such rural financial institutions have been created.

1.4 Policy and Legal Environment for Public-Interest Microfinance

1.4.1 Legal Status

Non-Profit Organizations

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

Basis of Legality

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

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

1.4.2 Financing

Equity Financing

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

Liability Financing

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

Foreign Investment

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

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

¹ Rules are available on CBRC official website (www.cbrc.gov.cn)

Wholesale Funds

There is no specialized wholesale fund for microfinance in China.

Monitoring and Supervision

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

1.5 Policy and Legal Environment for Commercial Microfinance

Ownership

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

Funding Sources

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

Business Region

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

1.6 Policy and Legal Environment for Mutual Funds

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

For the past 15 years, Chinese microfinance policy has been shaped by ad-hoc agreements and exceptions. However, the period of minimal regulation is now starting to come to an end. Dr. Sun Tongquan suggested that, if the central government wished to achieve the goal of an inclusive financial sector, it would need to build a more supportive environment for microfinance growth, including more favorable laws and regulations.² In this context, it was most encouraging to hear from Jiao Jinpu of the PBOC that new MCC legislation is being drafted jointly by the PBOC and CBRC, and is expected to be passed in the near future.

² For more information on the policy and legal environment, please refer to Sun Tongquan's workshop input paper entitled "Policy and Legal Framework for Microfinance in China."

2

The Demand for Microfinance

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

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

Prof. He Guangwen discussed the questions above.

2.1 Analysis of the Potential Size of the Market

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

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

2.1.1 Massive Rural Population

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

2.1.2 Huge Urban Registered Unemployed Population³

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

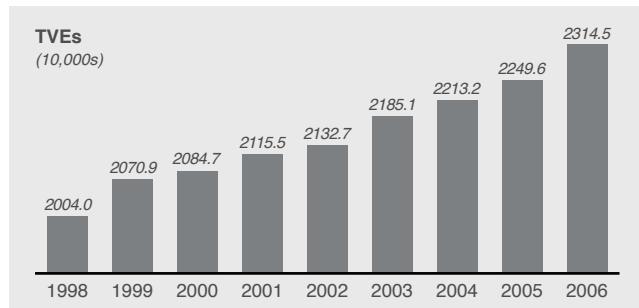
The unemployment rate in China increased by 1.0% between 2005 and 2006, with the total number of unemployed increasing from 8.4 million to 8.5 million. At the end of 2006, the official unemployment rate was 4.1% (State Statistics Bureau, 2006).

2.1.3 Large Number of SMEs and Microenterprises

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

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

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



2.2 Analysis of Current Access to Financial Services

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

2.2.1 Significant Rural Household Demand for Microcredit

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

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

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

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

³ According to Chinese labor statistics, the term "urban registered unemployed population" refers to people who are not rural residents, have laboring capacity, and who are within a certain age group (16–50 yrs for men and 16–45 yrs for women). In addition they must be unemployed, searching employment, and have registered at a local employment agency.

coverage rate of 17% in HX village, and confirm that there is still significant unmet demand (He Guangwen, Li Lili, 2005b).

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

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

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

2.2.2 Enormous Market for SME Finance

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

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

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

2.2.3 Huge Financing Gap for the Unemployed

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

However, during the implementation of the project, some difficulties have been experienced. Firstly, when commercial banks offer loans, they require that borrowers provide up-front guarantees and 50% of the working capital. Secondly, the

maximum loan limit is very low; normally, an individual loan, secured by the guarantee fund, does not exceed 20,000 Yuan.

2.3 Conclusions

- There is a huge demand for microfinance services in China
- The demand varies for different sectors of the population
- The current fulfillment of microfinance demand in China is very low. As a result a huge underserved market exists
- The Chinese government's policy of opening up the microfinance industry will provide excellent opportunities for investors⁴

3

The Supply of Microfinance

3.1 History of Microfinance Development

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

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

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

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

⁴ For more information on the demand for microfinance, please refer to Prof. He Guangwen's workshop input paper entitled "An Analysis of the Demand for Microfinance in China."

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

3.2 Types of Microfinance Providers

3.2.1 Comparison of Microfinance Providers

Since the first microfinance seed was planted in China, a vast number of different types of microfinance operators have appeared within the Chinese market including: NGO MFIs, the Agricultural Bank of China (ABC) and the Agricultural Development Bank of China (ADB), RCCs, Urban Commercial Banks and Guarantee Companies (UCB & GC), Rural

Financial Institutions (RFI), China Development Bank (CDB) and Harbin Commercial Bank (HCB), Microcredit Companies (MCC), Village Banks (VB), RMCCs, Lending Companies (LC), and Postal Savings Banks. These providers are described in **Tables 1 and 2**.

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

Table 1. Comparison of Microcredit Providers — Clients and Products

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

Note: The information in this summary table was extracted from relevant documents and sources.

* Calculated on a declining balance.

Table 2. Comparison of Microcredit Providers — Performance

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

3.2.2 Current Challenges Faced by Microfinance Suppliers

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

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

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

This section will now discuss the problems faced by other microfinance supplier types.⁵

NGO MFIs

NGO MFIs face three major challenges:

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

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

RCC Farmer Microcredit Project

RCC Farmer Microcredit projects face a number of challenges:

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

MCCs

MCCs face the following challenges:

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

- No source of funding which would allow a growth in scale

Village Banks

VBs face the following challenges:

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

Questions to be considered include:

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

RMCCs

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

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

Postal Savings Banks

Postal savings banks face the following challenges:

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

Commercial Bank Microcredit Pilot Project

Commercial banks face the following challenges:

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

⁵ For a more detailed analysis of different types of microfinance providers, please refer to Prof. Du Xiaoshan's workshop input paper entitled "The Current Supply of Microfinance in China."

3.3 Dilemma in Microfinance Supply

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

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

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

It was concluded that in order to resolve the current dilemma in microfinance supply, microfinance growth in China should be facilitated at three levels: macro, meso and micro⁶.

4 Domestic Networks and International Cooperation

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

4.1 Industry Level Network

4.1.1 History

In 2003, representatives from more than 100 domestic MFIs (mostly NGO-MFIs) attended the China Microfinance Summit, sponsored by the Ford and Citi foundations. The participants appealed for the establishment of an association of microfinance organizations in China. After the Summit, the Rural Development Institute (RDI) of the China Academy of Social Sciences (CASS, the first institution devoted to the

introduction of microfinance in China), together with the China International Center for Economic & Technical Exchanges (CICETE, the manager of the largest Microfinance program in China), the Women Development Department of the All-China Women's Federation (ACWF) and the China Foundation for Poverty Alleviation (CFPA), decided to jointly initiate and create the China Association of Microfinance. CAM's principal function would be to focus on five aspects of policy: dialogue and coordination, self-regulation, communication and advocacy, training and technical assistance, and fund-raising services.

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

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

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

4.1.2 Performance of CAM

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

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

⁶ Macro level refers to policy makers and regulators, such as the PBOC, CBRC, State Council etc.; Meso level refers to networks such as CAM and wholesale funds such as CDB; Micro level refers to microfinance practitioners such as NGO MFIs, MCCs, RCCs, VBS, RMCCs, LCs, Postal Savings Banks etc.

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

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

4.1.3 Challenges

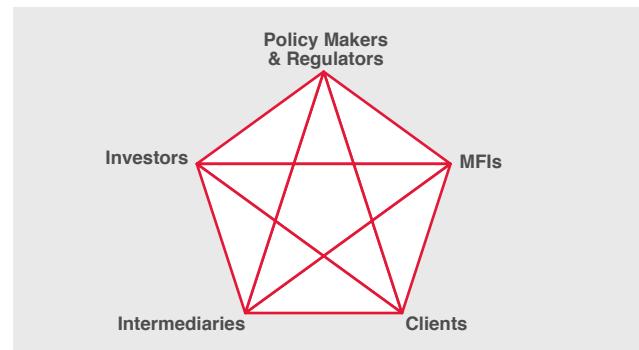
- **Legal status:** CAM has not yet been legally registered due to the fact that the majority of its members provide credit illegally.
- **Ownership:** Members are not obliged to pay membership fees due to the fact that CAM has not yet been registered.
- **Governance:** Although CAM has its own administrative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

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

4.2 New Cooperation Patterns for an Inclusive Financial Sector

At the end of his workshop presentation, Bai Chengyu, Secretary General of CAM,⁷ gave an overview of all stakeholders in an inclusive financial sector (Figure 3).

Figure 3: Stakeholders in an Inclusive Financial Sector



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

- Upgrading of NGO MFIs
- Downscaling of commercial banks
- Building of greenfield microfinance institutions

⁷ For more information on networks and cooperation patterns, please refer to "Networks and Cooperation Patterns of Microfinance in China" by Bai Chengyu.

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

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

In fact, UNDP and its Chinese partners are about to launch a new program to develop commercially viable microfinance institutions which serve lower market segments in a sustainable way, with the aim of eventually creating a more inclusive Chinese financial sector. Two components of this program are very similar to Bai Chengyu's proposal, mentioned above: the formation of a national committee with the objective of making a national strategic plan for an inclusive financial sector in China, and the establishment of a competitive fund to catalyze the growth of promising MFIs via a comprehensive package of support.

During the workshop, Bold Magvan of Xac Bank shared Mongolia's success in taking full advantage of such a national committee and of international cooperation to accelerate the healthy and rapid growth of the country's microfinance industry. In addition, representatives of ASA (Bangladesh) and GTZ said that what is most important for Chinese microfinance operators, in terms of international cooperation, is how to convert available international experience and resources into reality, so that various types of microfinance products and services can be delivered on the ground. In conclusion, Bai Chengyu pointed out how international organizations planted the first microfinance seeds in China and made a great contribution to the development of the industry. With the support of international cooperation, domestic networks can bear more responsibility and play a more important role in building an inclusive Chinese financial sector⁸.

5 Possible Impact of New Technology

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

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

⁸ For more information, please refer to Bai Chengyu's workshop input paper entitled "Networks and Cooperation Patterns in Microfinance in China."

5.1 Potential of Mobile Banking in China

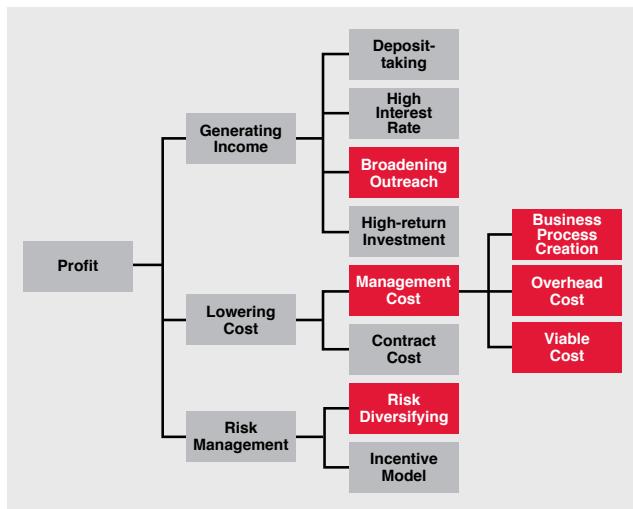
Reform and the opening up of the economy in 1978 meant that, by 2000, China had achieved rapid economic growth. However, rural development lagged behind in terms of infrastructure, education, financial services, medical care, and telecommunications. In order to improve the livelihoods of the rural population,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

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

5.2 Impact and Challenges of Mobile Banking

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

Figure 4: Profit Model Improved by New Technology



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

However, Xu Weichang of IFC pointed out that, although mobile banking has successfully been adopted by some African countries with sparsely-located populations and a wide

coverage of mobile networks, it may take some time to find solutions to a number of problems in China. Also, many MFIs in China are restricted to operating within a certain region and would therefore be unable to profit from the dramatic expansion in outreach that mobile banking would offer.

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

6 Foreign Investor Perspective

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

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

6.1 Investment in NGO MFIs

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

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

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

6.2 Investment in MCCs

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

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

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

6.3 Investment in RCCs

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

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

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

6.4 Investment in Village Banks

Financial institutions, enterprises and individuals are involved in investment in Village Banks. With regard to laws and regulations, registered foreign banks in China can set up solely-funded or joint-venture village banks and non-banking foreign organizations can take stakes in the form of equity or debt.

However, the equity stake of a foreign investor must not exceed 10%.

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

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

6.5 Establishment of Solely-funded Village Banks and MCCs

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

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

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

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

6.6 Future Development of Microfinance in China

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

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

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

7

Conclusion

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

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

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

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

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

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