

China Microfinance Industry Assessment Report

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Abstract

I . The Definition of Microfinance/Microcredit¹

There are two related words in international microfinance field. Microfinance refers to financial services provided for the middle and low income population while microcredit indicates credit services serving the above group. Besides the middle and low income population, there still exist many people who have no or limited access to financial services in the society, but the services for them are concluded into the concept of inclusive finance. Regarding the concept of microfinance/microcredit, no unified understanding has been reached in China. The writer suggests that it is better to follow international definition to distinguish microfinance and microcredit. At present, microfinance companies are prospering in China, but in fact they conduct their businesses just by disbursing small amount of loans, so the concept of microfinance here is different from international one. The concept of international microloan company can be adopted for microfinance companies in China.

As for microfinance, it should be regarded as one social business aiming at double bottom lines of commercial sustainability and social development.

II .Development Phases of Microfinance

The first phase was for demonstration and experimentation, during which microfinance as one means of poverty alleviation was introduced and promoted as projects.

The second phase reflected strong initiatives from central government, during which microfinance was embedded into formal financial institutions. Given insufficient financial supply in rural areas, the government facilitated the operation of microfinance as one means of poverty alleviation in rural areas and as one way of supporting start-up business and reemployment of laid-off workers in urban areas.

The third phase begins with issuing a series of regulations by regulatory bodies in favor of microfinance development, implying that microfinance steps into a phase of commercial and sustainable development.

III. Market Supply and Demand of Microfinance

In terms of supply, diversified microfinance suppliers and supply channels have come into existence in China. However, the overall volume of supply is limited, and the majority of such supply is in their pilot periods.

From the perspective of demand, there are various types of people requiring microfinance, including urban laid-off workers, rural households and microentrepreneurs etc. At the same time, the demands for microfinance services are also diversified, covering microcredit, microsavings, microinsurance and investment etc. Among all financial services, microcredit ranks first among the above demands based on the analysis of accessibility. The credit capabilities of those people

¹ In this report, microfinance and microcredit are used interchangeably in most of cases.

present clear characteristics of different levels. Consequently, different financial institutions and various forms of financial supply are required to meet those demands.

In general, the market satisfaction rate of microcredit is relatively low in China, indicating that microcredit services are insufficient, especially in rural areas as compared to urban areas.

IV. Microfinance Institutions (MFIs)

In terms of inclusive financial services, diversification of institutions engaging in microcredit business has been formed, such as the coexistence of NGO MFIs and government MFIs, public-interest MFIs and commercial MFIs, microcredit operations of specialized microloan companies and full-licensed financial institutions, informal MFIs and formal MFIs, small MFIs and large MFIs.

Nevertheless, the development of microcredit is still in its initial stage in China due to limited variety of institutions, weak management, poor performance and ambiguous goal. The trend is towards commercialization, but social development goal and social responsibility of MFIs are inclined to be ignored.

V. Impact of Microfinance Development

Microfinance embodies its influence in a various and systematic way. The research team concluded the impact of microfinance development at macro, meso and micro levels.

At the macro level, microfinance promotes the structure adjustment of agricultural industry as well as the development of appraisal undertaking. Besides, microfinance is regarded as one effective tool for poverty alleviation.

At the meso level, the introduction of microfinance strikes informal usury transaction, and facilitates diversification of financial institutions, and to some extent strengthens the competition of financial market, and further consummates financial system and promotes the optimization of credit environment.

At the micro level, microfinance shows its impact on the improvement of female involvement in their families' decisions, the change of beneficial families' status and the enhancement of beneficiaries' quality. And microfinance also promotes the growth of farmers' income and reinforces credit consciousness of farmers.

As one innovative factor, microfinance is introduced into financial market to meet the financial demands of the partial middle and low income population and to facilitate the competition, demonstrating its huge impact.

VI. Legal and Policy Framework of Microfinance

There is no specific law for microfinance development up to now in China. However, the China Banking Regulatory Commission (CBRC) and the People's Bank of China (PBC) successively promulgated a series of policies to promote the microfinance development. These policies can be categorized into two kinds, including policies promoting institutional diversification of MFIs as well as facilitating business innovation of MFIs.

The policies encouraging institutional diversification include a series of Number One

documents of central government, one new policy regarding the *Access to Financial Market* of CBRC on Dec. 20, 2006, and the *Guidance on Pilot Microloan Companies* jointly issued by the PBC and the CBRC on May 4, 2008, and so on, which lead to the emergence of new types of MFIs like microloan companies, rural mutual credit cooperatives (RMCC) and village/township banks (VTB) etc.

The typical exemplifications of the policies promoting business innovation of MFIs are the *Management Guidance on Microcredit Loans for Farmers of Rural Credit Cooperatives (RCC)* issued by the PBC in December of 2001 and the *Guidance on Rural Microloan Business Promoted by Banking Financial Institutions* promulgated by the CBRC in August of 2007. The former guided microcredit into formal financial sector and facilitated business innovation of RCCs; the latter helped expand microcredit business to all banking financial institutions.

Meanwhile, in order to promote the reemployment of laid-off workers, the PBC, the Ministry of Finance, the State Economic and Trade Commission, and the Ministry of Labor and Social Security distributed the *Management Measures of Micro Secured Loans for Laid-off Unemployed People*, facilitating the development of microfinance in urban area.

Even though all kinds of policies related to microfinance issued by the government have enormously promoted the development of microfinance, unfavorable provisions are not conducive to the fair development of the market, such as limitations on microcredit interest rate, and on the initiator qualification, shareholding structure, fund sources, and financing proportion of MFIs etc. Moreover, there is no clear policy definition for NGO MFIs.

VII. Opportunity and Threat of Microfinance Development

The microfinance in China evolves along four directions, including from microloan to microcredit, from welfare-focus to institutionalization, the interest rate cap for microcredit being gradually relaxed, and the combination of microcredit and insurance.

Since entering into 21 century, the greatest opportunity for microfinance to develop in China has emerged with the formation of a harmonious society concept advocated by central government, the importance attached on the “Farmer, Rural and Agriculture”, the demand increase for input resulting from rural economic growth, as well as the huge market of microfinance.

However, the sustainable development of microfinance in China still encounters certain challenges in terms of fund sources, risk control, legal status, governance, and regulation and supervision etc.

VIII. Policy Suggestions

With reference to the success of microfinance over the world, it can be observed that there are multiple successful factors. But in terms of the component elements of building an inclusive financial sector, these successful factors can be sorted into three levels as macro, meso and micro.

At the micro level, it is suggested to create a system for those MFIs serving the middle and low income population and microenterprises based on competition. Theoretically, it requires the formation of an inclusive financial system consisting of policy finance, commercial finance, cooperative finance and microfinance, leading to the formation of a diversified system including

various types of MFIs meeting financial demands at different levels.

At the meso level, it is suggested to set up one institutional basis so as to guarantee the competitive operation of MFIs, including building microcredit guarantee system, fostering intermediate agencies for fundraising, and establishing microfinance investment fund etc.

At the macro level, it is suggested to construct a sound legal framework and constitute rules and regulations for microfinance. The existence and development of credit-only MFIs including NGO MFIs should be allowed and encouraged, as well as be adopted with non-prudential regulations. Different regulation and supervision mechanisms should be used for different types of MFIs. And some favorable policies encouraging microfinance development should be issued, like tax policy.

Keywords: Microcredit, Inclusive Finance, Industry Assessment, Credit Demand, Credit Supply

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I . Microfinance Supply System in China

1. Basic Structure of Microfinance Supply System in China

(1) Levels of Microfinance Supply System in China

There are five levels regarding microfinance supply system in China.

The first level refers to those spontaneous informal suppliers like free lending, underground banks, individual lenders, and Rotating Savings and Credit Associations (ROSCA) etc.

The second level refers to project-based microfinance, the operation of which is subject to the fund rather than the institutionalization as a financial institution. In general, these projects conduct their microfinance business in underdeveloped regions in the name of poverty alleviation. There are over 300 such microfinance projects in China. Some projects are put on records at local bureaus of civil affairs so that they become “record-type” MFIs. Due to small scale and lower segment regarding their target groups, they are not subject to strict supervision. They only need to submit quarterly and annual reports to relevant departments. They meet certain requirements in terms of capital fund and liquidity ratio.

The third level refers to specialized registered MFIs, which are set up by banking financial institutions or private capital. They are not allowed to mobilize deposits. Instead, they are pure lending companies. They can borrow from commercial banks and conduct business within regulatory framework set by relevant government agencies. However, they are not included into the supervision system for financial institutions.

The fourth level refers to small and micro types of banking financial institutions, which serve the population in certain regions and areas, for instance, lower-end market in urban areas and all in rural areas, like VTB and RMCC. But they are not the large types of commercial banks.

The fifth level refers to microfinance operation of traditional commercial banks, which downscale their operations to microfinance business.

(2) Structure of MFIs System in China

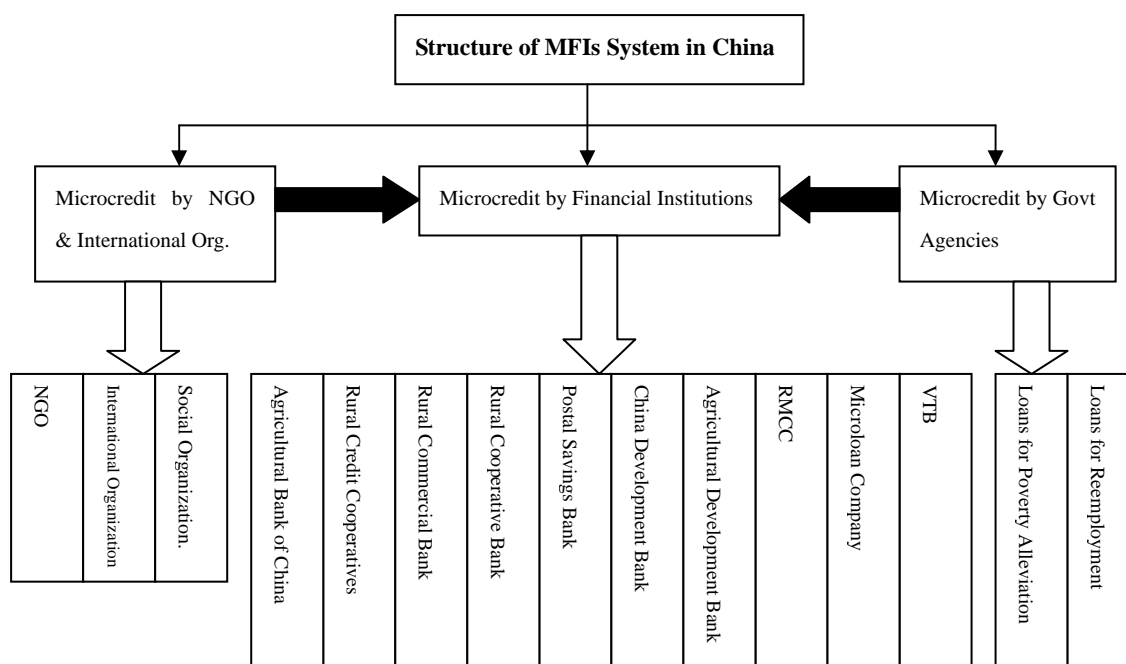
After microfinance methodology of Grameen Bank was introduced into China, microfinance has experienced the collision with economic and social reality in China, resulting in plenty of innovation and development. In terms of operational bodies, microfinance can be grouped into three types in China.

- ① Microfinance operated by NGOs, international organizations and social organizations. With the introduction of microfinance in China, NGOs become one main bodies to operate microfinance.

The representative cases include three Funding the Poor Cooperatives (FPC)

managed by China Academy of Social Sciences (CASS), poor farmers' capacity building service centers administered by China Foundation of Poverty Alleviation (CFPA), some rural development associations governed by United Nations Development Programme (UNDP) and China International Center for Economic and Technical Exchanges (CICETE), some projects of Hong Kong Oxford, Guizhou Caohai project supported by international progress organization and crane foundation, and "Happiness Project" operated by China Family Planning Association as well as "Female Farmers" project etc.

- ② Microfinance operated by government agencies. They refer to policy microfinance projects operated jointly by government agencies and financial institutions like Agricultural Bank of China (ABC) and RCCs with the mission of poverty reduction and the fund sources from state financial fund and poverty alleviation subsidized loans and micro secured loans guaranteed by the government for the purpose of solving the employment problem of urban laid-off unemployed people.
- ③ Microfinance operated by financial institutions, like ABC, RCCs, Rural Cooperative Bank, Rural Commercial Bank, Postal Savings Bank of China (PSBC) and three types of new rural financial institutions including VTB, microloan company and RMCC. Besides, China Development Bank (CDB), Agricultural Development Bank of China (ADBC) and shareholding banks like Shenzhen Development Bank (SDB) start to engage in microfinance operation, and foreign-funded financial institutions like KfW, HSBC, Standard Chartered and some international organizations like IFC also join this field by taking shares of rural commercial banks or rural cooperative banks or solely or jointly funding and setting up VTBs or microloan companies and then getting involved in direct disbursement of microcredit.



2. Branch Distribution and Service Outreach of Rural Financial Institutions in China

(1) Branch Distribution of Rural Financial Institutions in China

In China one system consisting of multilayer rural financial institutions has gradually been constructed, which offers financial services like savings and remittances covering over 90% of all rural administrative villages. The institutional coverage is higher than 30%-40% on average of other countries over the world.

Rural financial service providers or branches mostly include banking financial institutions, non-banking financial institutions and other types. Banking financial institutions comprise ADBC and its branches, and the county-level branches of those large commercial banks like Industrial and Commercial Bank of China (ICBC), ABC, Bank of China (BOC), China Construction Bank, and China Communication Bank as well as of national shareholding commercial banks, and PSBC, rural commercial banks, rural cooperative banks, RCCs, VTBs, credit companies and RMCCs etc. Non-banking financial institutions serving in rural areas consist of policy insurance companies, commercial insurance companies, security companies and future companies etc. Other types mean microloan companies, MFIs and pawn shops etc.

By the end of 2007, the county-level branches of ABC and RCCs reached 13,100 and 52,000, accounting for 10.6% and 41.5% of all county-level branches of financial institutions, respectively. While those of PSBC exceeded 23,000 according to the 2008 study of rural financial services research group of PBC.

In addition, the branches of some commercial banks, about 300 NGO MFIs and partial non-banking financial institutions like pawn shops also provide financial services in rural areas. In general, the rural population in China can access basic financial services like savings and remittances offered by rural financial institutions.

(2) Service Outreach of Rural Formal Financial Services in China

There are almost 0.7 billion farmers and about 0.23 billion rural households in China. In accordance with the statistics of CBRC, there were around 0.12 billion rural households demanding for loans by the end of 2007, among which, over 78 million rural households obtained microcredit loans and group loans from rural cooperative financial institutions, accounting for 33.2% of overall rural households and about 65% of those rural households demanding for loans.

Based on the disclosure of CBRC², by the end of March of 2008, the total agricultural loans outstanding, total loans outstanding and coverage ratio for rural households of RCCs, rural cooperative banks and rural commercial banks amounted to 1517.7 billion Yuan, 1263.4 billion Yuan and 30.5%, respectively, from which over 0.3 billion farmers benefited.

² Data Source: the speech of Mr. Zang Jingfan, director of supervision department of cooperative financial institutions of CBRC when he was interviewed by China Government Network on June 5, 2008. (www.gov.cn/zxft/ft124/content_1006300.htm)

According to the statistics of the Consultative Group to Assist the Poor (CGAP) of World Bank (WB), the number of farmers with loan accounts at rural financial institutions takes 31% of overall farmers in China, which ratio is far higher than 16% of those in India, and prominently ahead of 4% of those in Latin American countries, Caribbean regions and Middle East and North African countries.

Based on the explanation of Li Mingxian and his fellows in 2008, the outreach of rural financial services in China can be measured by breadth and depth.

- ① In terms of rural savings services, the coverage of savings branches of rural financial institutions reached only 16.3% in administrative villages, meaning only one financial institution offering savings for over five administrative villages on average. By way of such, each savings branch should serve more than 7100 rural habitants on average, much higher than the number of urban citizens that is 4200. Moreover, till the end of 2007, 9.3% of townships had no branches of any financial institutions. It is obvious that the outreach of rural savings services is not broad in China.
- ② In terms of rural loan services, first of all, the breadth of loan services outreach is very low. Every ten thousand farmers can only be served by 1.08 RCC branches, which is less than half of branch number for urban citizens. As the major loan provider, the coverage of RCCs' branches only reaches 12.6% of administrative villages, which lowers the extent of mutual understanding and relationship between RCCs and farmers. Secondly, the proportions of both farmer loans and township and village enterprises (TVE) loans are not high in the overall loan portfolio of RCCs since the coverage of loans for farmers and TVEs only amounts to 32% and 52.9%, respectively. Thirdly, the depth of loan services outreach is not high as well. Although 55.6% of farmers demanding for credit got their loans, the satisfaction ratio of loans related to their demand for capital is not desirable. The loan size per capita of farmers is only 741 Yuan in the whole rural areas, which is less than 1/4 of annual net income of farmers, while the loan size per capita of urban citizens reaches 11,679 Yuan, which is 15 times that of farmers. The loans from formal financial institutions only account for 53.5% of total borrowed fund of farmers. The residual 46.5% of fund comes from informal financial market. The satisfaction ratio of loans required by TVEs is much lower relative to their demand for fund, which is only 44.9%.
- ③ The analysis of rural remittance and settlement outreach indicates that postal institutions play a leading role in offering remittance services in rural areas, especially for migrant workers. Over half of the income of migrant workers is transferred back to rural areas through postal institutions, furthermore, the number of migrant workers who use postal green cards and remittance services account for 51% of the total. Nevertheless, the breadth of branch coverage of postal institutions is not high in rural areas, only reaching 3.2% of administrative villages. Even with such low coverage ratio, the remittance services of postal institutions can still attract lots of migrant workers due to lack of other remittance service providers in rural areas. While the remittance and settlement services of RCCs are developed

relatively late so that the breadth and depth of their remittance and settlement services are very low. The branches of RCCs which can issue bank draft only account for 2% of total branches. The average transaction amount of bank draft of RCCs only reaches over 30,000 Yuan, while every urban citizen has 2.6 bank cards on average, and the consumption amount of bank cards reaches 2,644 Yuan per capita and the transfer amount of bank cards achieves over 30,000 Yuan per capita, far higher than those in rural areas.

- ④ Regarding rural insurance outreach, the breadth and depth are extremely low based on the present situation. In terms of the breadth of outreach, every life insurance branch serves 58,000 persons in rural areas but less than 5000 persons in urban areas, resulting in the difference of ten times between two areas. In terms of the depth of outreach, the income of insurance premium at the county level accounted for less than 2% of GDP in rural areas. Insurance premium per capita is only 177 Yuan in rural areas, equivalent to 1/5 of that in urban areas which is 940 Yuan. Thus it can be concluded that life insurance, endowment insurance, agricultural insurance and medicare services are still in their initial stage in rural areas. The above figures include the data of those counties with relatively advanced economy. If only rural areas under the county level are considered, the relevant proportion will dramatically drop. In addition, even though plenty of experiments have been undertaken regarding agricultural insurance, its premium income only accounts for 0.57% of total premium income for property insurance in current year. Therefore, agricultural insurance needs further development.

II . Analysis of Microfinance Demand in China

1. Analysis of Financial Demand Body and Characteristic of Demand

(1) Microfinance Demand Body

From the perspective of the origin of demand for financial services, the demand comes from urban poor people and start-up businesses, urban laid-off workers, rural households, enterprises and governments. 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 capacities of individuals with loan demand have very distinct characteristics, so that their different demands should be met through different forms of financial supply and different financial institutions.

As such, the potential microfinance demand includes urban poor people and start-up businesses, urban laid-off workers, rural households, SMEs and microenterprises.

(2) Scale of Microfinance Demand Body

① There are many poor people. The concept of poor people includes the poor population in both rural and urban areas, which may overlap with the concept of rural households, urban laid-off workers and start-up businesses. However, it is undeniable that there are about 0.13 billion people living with less than \$1 per day in China.

② There exist massive demands for microcredit in rural China. At the end of 2006, there were a total of 37,000 townships, 624,000 villages, 4.533 million sub-villages, 740 million villagers, and 249 million rural households, which was a large market.

③ The huge urban registered unemployed population³. Firstly, laid-off workers emerged during the reform of State-owned Enterprises (SOE) and collective corporations. Secondly, the number of college graduates waiting for employment is growing. Thirdly, individuals such as disabled workers and returning soldiers are included.

The unemployed population reached 8,390,000 and 8,470,000 at the end of 2005 and 2006, respectively. The unemployment rate increased 1.0% between 2005 and 2006. At the end of 2006, the registered unemployment rate was 4.1% (State Statistics Bureau, 2006).

④ There are large number of SMEs and microenterprises. The Chinese government has a certain standard for the definition of SMEs and has altered this definition several times. However, the definition of microenterprises remains ambiguous. The current government statistics provide

³ According to the explanation of Annual Statistics of China's Labor, urban registered unemployed population refer to the people who are not rural residents and have laboring capacity within certain laboring ages (older than 16 yrs but younger than 50 yrs for men and 45 yrs for women), being unemployed but looking for jobs and having registered for job application at local employment agencies.

some basic numbers, but cannot illustrate the whole picture. For example, the 2004-2006 economic investigation revealed that there were 4,300,000 private enterprises across the country in 2005. The State Statistics Bureau defined private enterprises based on such categories as the number of employees, investors, and registered capital. This definition did not designate the categories of SMEs and microenterprises. At the same time, those enterprises included in these statistics have already reached significant scale and sole proprietors were not counted in those statistics.

As of the end of June, 2007, there were more than 42,000,000 SMEs, accounting for 99.8% of the total number of enterprises in China and the SMEs and microenterprises (sole proprietors) registered under the Administration of Industry and Commerce (AIC) amounted to 4,600,000 and over 38,000,000, respectively (SME Department of the National Development and Reform Commission [NDRC], 2008)

The number of SMEs, especially small enterprises, is increasing rapidly. For instance, at the end of 2006, the total number of SMEs in Shanghai reached 363,600 (this did not include sole proprietors), making up 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, growing 8.16% from the previous year. According to the Shanghai AIC, by the end of 2006, the total number of registered sole proprietors amounted to 264,100, the majority of which were in wholesale and retail industry with a small amount of fixed assets that encountered difficulties in accessing loan capital. (www.1128.org)

Another category is TVE, which reached 23,144,700 and employed 146,801,100 workers by the end of 2006. 99% of TVEs are SMEs and microenterprises. Since the beginning of the 21st century, the expansion rate in the number of TVEs has been quite rapid. The TVE category overlaps with that of private enterprises. Nevertheless, it is an obvious fact that there exist an enormous number of microenterprises in China.

2. Analysis of the Potential Market for Microfinance

It is difficult to directly measure the potential size of the microfinance market. Meanwhile, measuring the potential size of the microfinance market is an empirical issue. According to the statistics of CBRC, 32.8% of rural households got their loans over the country by the end of 2007, meaning that 67.2% of them didn't obtain credit services. Certainly, those who were not served by credit might not have demand for loans.

There are a few case studies that revealed the situation of financial access for rural households and SMEs, from which the potential size can be indirectly derived.

(1) The Great Potential in the Rural Microfinance Market

Firstly, rural households express a significant demand for funds. According to a 2003 survey conducted through interviews with 291 rural households in Zhejiang and Ningxia provinces by a research team at the China Agricultural University, the credit demand of rural households was substantial. Given the current interest rate and earning capacity of rural households, 64% of

surveyed households expressed a demand for credit. Regarding credit demand for the next two years, 63% of households showed their interest in obtaining credit, and if they received appropriate technical training, 78% of households said they would have a credit demand (He Guangwen, Li Lili, 2005a). A 2005 survey of 502 rural households in four counties/cities in Guizhou Province, Tongren, Jiangkou, Shiqian, Yuping, indicated that 89% of rural households expressed a demand for credit (He Guangwen, Li Lili, 2005b). In 6 counties located in Tongren Prefecture, including Wanshan and Songtao, the research showed that out of 720 surveyed households, 84% showed a demand for bank and RCC loans (He Guangwen, Li Lili, 2005c).

Secondly, the market share of microcredit provided by RCCs is still relatively small and the remaining potential market is massive. Since early 2002, the RCCs have promoted microcredit business for rural households across the country. Based on the statistics of PBC, by the end of September 2007, out of China's 230 million rural households, the number of loan clients exceeded 77 million, covering 33% of the total number of rural households (PBC, 2007). This illustrates that there still remains a large potential microfinance market. (The loans outstanding for rural households reached 1.16 trillion Yuan, and the number of rural households exceeded 78,190,000, accounting for 73% of those rural households which have credit demand and are qualified for credit.) (The fourth quarterly monetary policy report of 2007, PBC)

Statistics from a 2005 survey undertaken by a research team from the China Agricultural University calculating the loans disbursed by 11 township RCCs to rural households in 20 villages in Guizhou's Tongren, Jiangkou, Shiqian, and Yuping demonstrate (He Guangwen, Li Lili, 2005b): Firstly, the average loan size for rural households was only 4612.6 Yuan as of June 30th 2005, which was very small and only met a small portion of the total demand. Secondly, RCC loan supply still remains limited in rural areas, with the lowest coverage rate of 17% in some villages, thus there is still a great unmet demand.

Thirdly, some well-executed case studies reflect that informal lending in rural areas is extremely active, which indirectly illustrates the potential size of the rural microfinance market.

A 1998 study done 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 of all loans accessed by rural households, 38.43% were from formal lending channels (RCC, ABC, other banks, and non-banking financial institutions) and 61.57% 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 from the Agricultural Economic Research Center of the Ministry of Agriculture of 217 rural households in 18 villages of 6 counties in Anhui Province (Zhu Shouyin, 2003) reveals that among 524 loans, not one loan was offered by commercial banks, 84 loans were from RCCs, accounting for 16%, and informal lending made up 79% of all loans. In terms of the total value of loans supplied, informal lending provided 80%, while RCCs only offered 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, displaying that the informal sector was still the main source of loan funding for rural households.

Fourthly, state-owned commercial banks have withdrawn from the rural areas, further magnifying the unfulfilled demand for rural credit. Since the mid to late 20 century, China state-owned commercial banks have closed their branches at or lower than the county level. As compared to 1995, by 2004, the number of branches of Big Four state owned commercial banks decreased by 77,000 and a total of 49.8%. The ABC is regarded as the traditional credit bank in the rural areas. Its branch network reached its largest point in history in 1995. By the end of 2008, the number of ABC branches was only 24,200 and shrunk by over 60%.

According to a survey in two underdeveloped regions, at the end of 2005 the total number of branches of banking financial institutions amounted to 1,161, which were 317 less than in 2000. Among that, the big four state owned banks reduced their branches by 222 and downsized by 2,234 employees (Wang Jin, Zhang Mingliang, 2006).

Those branches which were eliminated by the Big Four state owned commercial banks previously provided direct services to rural households and SMEs, and were also the relatively closer banking branches to these clients.

At the same time that these branches were being reduced, state owned banks were also decreasing the authorization of rural branches at or lower than the county level to disburse loans. The branches in traditional and developed regions only collected savings. In recent years, the amount of outflow of savings funds from rural areas has reached around 400 billion Yuan.

Fifthly, the loan/deposit ratio of RCCs in traditional rural areas is very high, manifesting 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 over-use of capital. Based on the findings from a 2005 study of RCCs in 10 counties of the Tongren region in Guizhou Province, which was conducted by a team from the China Agricultural University, the loan/deposit ratio of RCCs reached as high as 95.1% on average and even exceeded 100% in three counties.

At the beginning of June 2007, the team of China Agricultural University came to the same conclusion in their research in Jilin Province. By the end of May 2007, the loan/deposit ratio of RCCs in Jilin Province was 85.7%. This number greatly exceeds the ratio required by liability to asset management ratio, which shows serious operating problems. The loan/deposit ratio of RCCs in Bai City even amounted to 111.7% (He Guangwen, 2007).

(2) The Enormous Market for SME and Microenterprise Finance

① Difficulties in financing for business start-up of microenterprises. Based on a 2005 survey of 592 small enterprises with annual sales volume of 5 million Yuan or below, which was undertaken by SME Bureau of Zhejiang Province (Wu Jiayi, 2006), at the business start-up phase, only 28.7% of the total surveyed small enterprises took loans from banks, 14.7% of them got a section of start-up funds from informal lenders, and 29.4% of them got some funds from friends/relatives. The survey still indicated that 65.2% of the surveyed small enterprises invested with their own funds, accounting for over 50% of the total initial capital.

② Difficulties in indirect financing for the business growth of SMEs. Firstly, banks are

unwilling to lend to SMEs because of high transaction and supervision costs; secondly, in order to solve the problem of adverse selection in credit business, financial institutions adopt the mechanism of requiring collateral and guarantee for SMEs lending, resulting in the low proportion of pure lending on credit. It is very difficult for SMEs to obtain fund support from banks due to their limited assets, lack of collateral assets and high financing costs etc. Therefore, a difficulty in credit financing is one major bottleneck to constrain the development of SMEs. According to statistics, out of total enterprises, large-scale enterprises only take 0.5% but possess over 50% of loans outstanding, while small-scale enterprises account for 88.1% but only have 20% of loans outstanding (http://www.ce.cn/cysc/cysczh/200707/30/t20070730_12354320.shtml). For SMEs, borrowing from banks is one main channel of financing. The bank loans of SMEs across the country amount to 98.7% of their gross financing volume.

③ Difficulties in direct financing in financial market for SMEs. In terms of securities financing, it stipulates in the Securities Law of China that the actual circulation amount of company debenture should not be less than RMB 50 million Yuan, which sets a high threshold for securities financing. The China Securities Regulatory Commission (CSRC) issued the *Pilot Method Regarding Issue of Company Debenture* on August 14, 2007, which further standardized the process of enterprise financing from securities. However, in actual operation, companies need to acquire guarantee from banks to get on list and issue shares or bonds, but banks are unwilling to offer guarantee for debenture issue, resulting in an unquestionable fact that enterprises encounter difficulties in direct financing.

In June 2004, Shenzhen Stock Exchange launched SME module so that the growth-type of SMEs with total share value below 50 million Yuan and total trading shares below 30 million obtained an opportunity to get on list. At the end of 2007, the number of listed SMEs reached 138 with total IPO value of 40.4 billion Yuan and the average financing funds of 293 million Yuan per enterprise (SME Department of NDRC, 2008). Firstly, the number of listed SMEs is limited. Secondly, these SMEs become actually the large-scale enterprises. Therefore, the majority of small enterprises are unlikely to access funds through this channel.

④ Insufficient support for SMEs by government. It is a common practice internationally that government supports or funds the setup of SMEs guarantee system. There are near 50% of countries across the world, which have built up such system. In 1980-1998, Small Enterprises Bureau of USA offered 280,000 guarantee loans to SMEs, and Credit Guarantee Association of Japan helped 53% of SMEs to obtain credit guarantee. And Taiwan set up SMEs Credit Guarantee Fund in 1974 with around 8000 guarantee projects every month, which has facilitated 28% of manufacturing enterprises to grow and develop. Nevertheless, in China, policy, mutual and commercial guarantee organizational systems have been established, but policy guarantee system lags far behind. The reasons are as follows: firstly, a few policy guarantee institutions exist so that their outreach is very limited; secondly, guarantee institutions have small scale and insufficient fund; thirdly, specialized guarantee institutions in line with industry groups and industrialization trend are less developed; fourthly, guarantee policies and regulations as well as other matching systems cannot match with the development of the sector, for instance, industrial regulations are not in place; there are no guarantee risk sharing mechanism and risk compensation mechanism so that guarantee companies bear excessive risk.

For example, by the end of 2008, there were about 88,000 SMEs and over 800,000 sole proprietors in Shaanxi province, which created and offered 50% of local GDP, 40% of financial income, 60% of exported goods value, 40% of overall employment, 80% of new employment in urban and rural area as well as 50% of net income per capita of farmers. SMEs and private entities have become the main body of rural economy and county economy, the major channel of labor employment and income increase of urban and rural habitants, the important source of local financial income and the important part of provincial economy. However, there are only 50 policy guarantee institutions in Shaanxi province, indicating that the depth of policy guarantee is extremely inadequate.

According to one IFC survey of private enterprises in Beijing, Chengdu, Shunde and Wenzhou of China in 1999, no matter at which growth stage Chinese private enterprises are, their fund sources heavily depend on their inner funds, and over 90% of their initial funds are provided by major owners, start-up team members as well as their family members. After their start-up phase, owners' capital and retained earnings account for 30% and 26% of fund sources of Chinese private enterprises, respectively, while company debenture and external equity financing take only less than 1%.

(3) The huge financing demand of the unemployed population

Unemployed people have no stable income source; meanwhile, it is difficult for them to offer a guarantee for credit. Thus, to start a business or to get reemployed seems to be much more difficult. Therefore, urban commercial banks in many cities, like Bank of Beijing and Tianjin Commercial Bank, have initiated micro secured loans for laid-off workers. Financial departments of local government have also set up microcredit guarantee funds for laid-off workers, by which a guarantee for microcredit can be provided to the unemployed people. In August 2003, the Financial Department and Labor and Social Security Department of Anhui Province issued "The management method of microcredit guarantee fund for provincial laid-off and unemployed population" (Caijin[2003]606). During the implementation, there still exist some difficulties in financing.

Firstly, when commercial banks offer loans, guarantee fund companies require borrowers to provide guarantee and then the borrowers are requested to possess 50% of the working capital from their inner capital sources.

Secondly, the highest loan amount is very small. Normally, the single loan size secured by guarantee fund should not exceed 20,000 Yuan.

Thirdly, the competition in the start-up business market is quite drastic.

III. Microfinance Sector Development in China

1. History of Microfinance Development in China

(1) Microfinance Development Course

① Microfinance project experiment at its early stage in China

In 1981-1993, some international foreign-aid projects in cooperation with other projects developed credit plans for a number of specific groups by using the methodology of microfinance.

The representative microfinance projects include the following:

a. Small enterprise loans supported by United Nations Women Development Fund (UNWDF) for the purpose of providing employment opportunities for women.

b. Microfinance launched by International Foundation for Agricultural Development (IFAD) at the end of 1980s for the purpose of improving food supply and increasing the nutrition level of middle and low income rural households in rural areas.

c. The “Women, Population and Development” project implemented by UNFPA since 1989 in some counties of Gansu, Qinghai and Ningxia, and most of funds were invested as revolving capital.

d. International heifer project initiated since 1984 in western poor regions to assist those rural households with the income per capita lower than local average income.

e. Rural integrated development project of Hong Kong Oxford started in 1992, one part of which is to provide credit for rural households to purchase livestock, improve breeding technique, and offer epidemic prevention and veterinary services. The project sites cover lots of poor counties in Guizhou, Guangxi and Yunnan provinces.

② Development outset of microfinance in China—Funding the Poor Cooperatives (FPC) project of CASS

In 1993, Rural Development Institute of CASS, with the fund and technical support of Ford Foundation and Grameen Bank (GB), introduced the microfinance methodology of GB into China, and then implemented one microfinance project named action-research plan in 1994, and set up three FPCs in Yi County of Hebei province and Yucheng County and Nanzhao County of Henan province, respectively, from the beginning of 1994 to November of 1995. The initiation of this project was regarded as the real outset of microfinance activity in China.

③ Exploration and development of microfinance in China

In 1995, UNDP undertook a microfinance experiment project at Yilong County in Sichuan Province. Unlike the early project experiment phase, microfinance projects at this stage applied

microfinance as a mechanism for poverty alleviation, the implementation of which expanded from a few counties in Sichuan and Yunnan provinces to 48 counties in 17 provinces and four big cities like Tianjin, and became one of the largest microfinance projects assisted by international organizations in China. Meanwhile, other international organizations like World Food Programme (WFP), UNICEF, and CIDA also engaged in conducting microfinance projects in poor areas in China.

At the same time, domestic poverty alleviation organizations and financial institutions also started to explore and test microfinance. Sino-German joint Jiangxi sustainable microfinance project entered into the second stage of its implementation and made full use of the status and function of RCCs in rural areas, resulting in the sustainable development of this project. While the participation of domestic government and financial institutions led to an important turning point of microfinance development in China, indicating that microfinance was developed from small-scale experiments conducted by NGOs and social organizations taking use of foreign funds to large-scale expansion operated by the government and designated state banks with support of domestic poverty alleviation funds. The provinces like Shaanxi, Sichuan, Yunnan, Hebei, Guangxi, and Guizhou experienced faster microfinance growth.

④ Innovative development of microfinance in China—microcredit loans of RCCs for rural households

In July 1999, the PBC issued the *Provisional Method of Microcredit Loans Management of RCCs for Rural Households*, and launched the experiment at RCCs in some provinces and cities to promote microcredit loans and guarantee loans for rural households.

By the end of 2001, the PBC promulgated the *Guidance on Microcredit Loans Management of RCCs for Rural Households* again, definitely requiring RCCs across the country should provide microcredit loans for rural households, simplify loan application procedures and make it convenient for farmers to borrow from RCCS.

Since 2002, the PBC has widely promoted microcredit loans for rural households across the country. Thus the microfinance development in China was expanded from poverty alleviation to rural financial sector at a larger scope. As one of formal financial institutions, RCCs became the largest microfinance practitioner in China.

⑤ Normalization of microfinance in China—pilot credit-only microloan companies

In 2005 when microfinance had been developed in China for ten years, the PBC launched pilot credit-only microloan companies in Sichuan, Guizhou, Shanxi, Shaanxi and Inner Mongolia provinces, respectively, pushing forward the normalization of microfinance in China, which was a significant event in the course of microfinance development in China as well as an important action of rural financial reform.

On December 20, 2006 the CBRC issued the *Opinions Regarding Easing Market Access for Banking Financial Institutions in Rural Areas in order to better Support the Construction of a Socialist New Countryside* (No.90 (2006) CBRC), which adjusted and eased the access threshold for banking financial institutions in rural areas. The opinions pointed out that domestic commercial banks and rural cooperative banks should be encouraged to set up fully-owned

lending companies specializing in credit business, which indeed was similar as credit-only microloan companies promoted by the PBC. The establishment of lending companies approved by the CBRC indicates another progress in the normalization course of microfinance in China.

In May 2008, the CBRC and the PBC jointly promulgated the *Guideline for Pilot Microloan Companies* (No.23 (2008) CBRC), which allowed social capital to fund and set up credit-only microloan companies.

⑥ Expansion of microfinance in formal financial sector—participation of various institutions

In March 2006, the CBRC issued the *Opinions of Pilot Management to Strengthen the Collateral-based Microloan Business of Postal Savings Bank*, which permitted postal savings bank to gradually develop its collateral-based microloan pilot operation by limiting time deposit as the only collateral.

After the issue of No. 90 document by the CBRC in 2006, two new types of small and micro banking financial institutions were promoted to set up, i.e. VTB and RMCC. The business scopes of VTB and RMCC focus on towns and counties as well as villages and towns, respectively, which are regarded as typical microfinance services.

In August 2007, the CBRC promulgated the *Guideline on How to Greatly Develop Rural Microloan Business by Banking Financial Institutions* (No.67 (2007) CBRC), which not only facilitated the further development of rural microfinance business, but also expanded rural microfinance to all banking financial institutions. Thus retail suppliers of microfinance in China included all financial institutions which were willing to offer microcredit products.

⑦ Expansion of microfinance from rural to urban areas—micro secured loans for reemployment of laid-off unemployed workers

In order to support the reemployment of laid-off unemployed people and meet the capital demand of that population, the PBC, the Ministry of Finance (MOF), the State Economic and Trade Commission, and the Ministry of Labor and Social Security (MOLSS) issued the *Management Measures of Micro Secured Loans for Laid-off Unemployed People* (No. 394 (2002) PBC) in December 2002. The departments of MOF and MOLSS at all provincial levels also jointly constituted the *Management Measures of Micro Secured Loans for Provincial Laid-off Unemployed People*, which stipulated that local government should fund the establishment of reemployment guarantee foundation which would be managed by specialized reemployment guarantee centers for laid-off unemployed people or by SME credit guarantee centers with the qualification as independent legal entities.

Guarantee is used as a pledge for microloans acquired by laid-off unemployed people. The fund sources of reemployment guarantee foundation include financial subsidies from superior departments, provincial financial budgets, provincial reemployment funds, donations from domestic and international organizations, groups and individuals, deposit interest incomes of reemployment guarantee funds as well as other sources.

Reemployment guarantee funds were deposited as a special account at the commercial banks designated by provincial financial departments, which were subject to close operation.

Guarantee centers signed guarantee agreements with commercial banks, requiring banks to deliver loans with the loan size of 1 to 5 times than reemployment guarantee funds. The guarantee loans were specialized for start-up funds and working capital so as to uphold self-employment, start-up businesses or partnership operations initiated by laid-off unemployed people.

The operation of micro secured loans for the reemployment of laid-off unemployed people not only satisfied the fund demand of those laid-off unemployed people for reemployment and facilitated the reemployment of the whole society, but also expanded microfinance from rural areas to urban areas in China.

(2) Microfinance Development Phases

The development of microfinance in China can be divided into three phases:

Firstly, from 1994 to 1999, it is regarded as the initial experiment phase, during which microfinance activities were undertaken mainly through projects. The fund sources were from international donations and soft loans without any contribution from the government at this stage. These projects were carried out for the purpose of exploring the feasibility of Grameen Model and were governed by semi-governmental agencies and informal institutions with the focus on the standardization of project operation.

Secondly, from 1999 to 2005, this phase is labelled as the entire participation of formal financial institutions and the institutionalized construction of various projects. Under the advocacy of the PBC, RCCs conducted experiments at large and expanded their microcredit businesses. In urban areas, the labor departments and commercial banks cooperated and promoted micro secured loans projects for urban laid-off reemployed people.

Thirdly, since 2005 it has evolved into the normalization and institutionalization phase of microfinance. In 2005, the PBC started to launch pilot credit-only microloan companies in Sichuan, Guizhou, Shanxi, Shaanxi and Inner Mongolia. By the end of 2006, the CBRC allowed the establishment of VTBs, lending companies and RMCCs and the No.23 document was issued by the CBRC in May 2008, which all promoted the normalization and institutionalization of microfinance in China.

2. Retail Microfinance Suppliers

(1) Legal Structure

Based on microfinance practices in China, microfinance suppliers can be categorized as follows:

① Specialized institutions or offices are set up to manage and operate foreign-aid funds in accordance with the requirements and regulations of fund providers through bilateral or multilateral projects, such as UNDP project, World Bank project, UNICEF project, Qinghai project of AusAID, and Xinjiang project of CIDA.

② Informal institutions or NGOs are created to carry out microfinance business for poverty

alleviation, such as FPC projects of CASS and projects of Hong Kong Oxford.

③ Government departments directly implement microcredit operations and/or specialized institutions are built by government departments to deliver subsidized loans for poverty alleviation, such as poverty reduction projects operated by Shaanxi, Yunnan, Sichuan and Guangxi provincial governments.

④ Financial institutions conduct microcredit businesses. For instance, microfinance project of Luanping RCC of Hebei Province, microfinance project of Qinghai ABC transferred from AusAID project after its completion, and microcredit loans and group loans for rural households developed by RCCs across the country since 2002.

The first two suppliers are usually regarded as NGO microfinance.

(2) Business Scale

The scales differ across microfinance suppliers reflecting different characteristics.

① Geographically microfinance businesses conducted by NGOs and government departments are mostly operated in economically less-developed provinces in the middle and western part of China. The former adopts project-based operations so that one single project has very small scale, but there are a number of such small projects. There have existed over 300 projects from the outset of microfinance development based on the incomplete statistics, among which the most typical representatives include the projects implemented by UN agencies, like UNDP, UNICEF, IFAD, WFP, ILO, UNFPA and World Bank, and microfinance projects of CFPA.

② As for financial institutions engaging in microfinance, RCCs promote their microcredit loans and group loans for rural households over the country, which makes RCCs be the largest microfinance supplier in China with the biggest outreach of clients and the most significant amount of loans outstanding. As of the end of 2007, the data showed that the loans outstanding for rural households of RCCs, rural cooperative banks and rural commercial banks over the country had reached 1.23 trillion Yuan, among which microcredit loans and group loans for rural households amounted to 203.8 billion Yuan and 135.1 billion Yuan, respectively. And 77.42 million rural households had obtained loans, accounting for 32.6% of overall rural households and about 60% of rural households with reasonable demands and qualification for loans. Consequently, there were over 0.3 billion farmers benefiting from those loans.

③ Other financial institutions also offer microloans to the middle and low income rural households and enterprises, but at very small scale.

By the end of March 2008, seven credit-only microloan companies in Sichuan, Guizhou, Shanxi, Shaanxi and Inner Mongolia had achieved the aggregated loans outstanding of 215 million Yuan and the aggregated loans for rural households of 98 million Yuan, accounting for 45.6% of total loans outstanding.

As for new types of rural financial institutions like lending companies, 105 such institutions that started to operate at the end of 2008 have mobilized total equity funds of 4.04 billion Yuan, with the deposits of 4.28 billion Yuan, the loans outstanding of 2.79 billion Yuan and the

accumulated loans of 3.97 billion Yuan. Moreover, 96.8% of their loans are delivered to rural households and microentrepreneurs, primarily realizing the objectives of introducing urban capital into rural areas, and retaining rural funds in rural areas and activating rural financial market.

As of December 2007, the PSBC had issued more than 900 microloans with the value of over 40 million Yuan.

(3) Products

Loans and savings are the main products offered by different types of microfinance suppliers.

① The microfinance projects of NGOs, international institutions, social organizations and government departments are mostly operated in accordance with classic microfinance methodology of Grameen Bank. Although the methodologies have been adjusted based on Chinese context, no significant changes have been made, generally following the factors like small loan size, revolving loans, group guarantee, and installment repayment. However, it is worth noticing that government departments offer subsidies to loans for rural households while NGOs, international institutions, and social organizations adopt market interest rates for microcredit loans.

As for microfinance operated by financial institutions, RCCs firstly conduct credit rating for rural households who apply for loans and then grant different credit lines based on different levels of credibility so that those rural households can circularly use loans within their credit lines. The methodologies adopted by microloan companies are more flexible, for instance, loan size ranging from several thousand to several ten thousand, loan term within one year, providing credit loans, collateral-based loans, group loans and guarantee loans, higher interest rate between 17% to 20% on average.

② In terms of savings products, NGOs and government departments require compulsory savings for their microcredit projects in the form of group funds pledging as collateral or guarantee. Meanwhile, for some projects borrowers are also requested to save a certain proportion of their loans as frequently as their loan repayment. For example, FPC projects of CASS have set some rules, stipulating that each borrower should save 5% of her/his loan as a group fund when taking loans and then save one Yuan or 0.1% of her/his loan into such fund every week. Xinjiang project of CIDA also matches savings to loans amount, requiring deposit to loan ratios of 1:10, 1:8, 1:6 or 1:4, which descends with the increase of loan size⁴. RCCs, PSBC and VTBs encourage rural households to save, but they don't require savings for microcredit. RMCCs are also able to mobilize savings. While microloan companies are not allowed to collect deposits but can only provide loan products.

It should be observed that when operating microcredit businesses formal financial institutions as ABC, RCCs, and PSBC also offer other traditional banking services like traditional savings products including term deposits and current deposits, money transfer and settlement, and remittances etc. In particular, the ABC, as one of four big state-owned commercial banks, makes use of its branches across the country to offer nationwide deposit and withdrawal business. At the

⁴ CAM, <http://www.chinamfi.net/summary.asp>.

same time, all three types of the above institutions gradually start to undertake agency businesses like insurance agency or collection and payment agency etc. VTBs belong to banking financial institutions, but they haven't developed other businesses at a large scale due to the short period of their existence.

(4) Gaps of Products and Services

① Owing to the typical methodology and geographical decentralization, microfinance projects of NGO offer products which only reach out to those target population so that limited clients benefit from their services. Furthermore, small loan size and the methodology of group guarantee and group meeting put forward a high requirement for clients to organize themselves.

② Microfinance projects of government departments mainly serve the poor population defined by central government and they also have problems regarding small loan size and requirement for clients to organize themselves. Meanwhile, it should be realized that with the issue of the *Provisional Management Measures of Microcredit Loans of the ABC* in April 1999, it definitely stipulated that for microcredit loans, poor households should directly sign loan contracts with the ABC, which should not be onlent by any intermediary organization. Such a provision objectively sets a requirement for the ABC to open affiliated institutions. However, this was opposite to the fact that the ABC withdrew its branches from rural areas. In order to fulfill the task of delivering microcredit loans to the poor people, the head office of ABC requested in its management measures that for those villages and towns without any ABC branch, in which microcredit businesses are required to operate, county branches of the ABC can assign credit teams equipped with 2 to 3 persons. Such policy changes limit the function of microfinance methodology so that the outreach ratio and the repayment rate experience the drop at different degrees. Thus the problems of poverty alleviation loans to reach poor households and repayment issues emerge again.

③ Microcredit businesses of financial institutions like RCCs and microloan companies are commercially operated and the products offered by them are commercialized products. Therefore, the beneficial clients are those excellent clients among the middle and low income population with repayment capacity so that those rural households in lower segment of the market cannot access credit services.

(5) Development Trend

① Microcredit operation is transferring from NGOs to formal financial institutions

Since 1999 RCCs have introduced microcredit loan and group loan businesses for rural households, actually indicating that Chinese microfinance industry has started to move towards normalization. And the establishment of new types of financial institutions like microloan companies, lending companies and VTBs in 2005 and 2006 as well as the involvement of postal savings bank in the microfinance sector have greatly driven the normalization process of microfinance in China.

On May 4, 2008, the CBRC promulgated the *Guideline for Pilot Microloan Companies*,

further relaxing the constraint for microfinance development, by which natural persons, corporate legal entities and other social organizations can invest in the establishment of microloan companies. Unlike banks, microloan companies are not allowed to collect public deposits. However, it was the first time to raise the issue of fund sources of microloan companies in this guideline. In addition to financing from shareholders' capital and donated funds, microloan companies can borrow from not more than two banking financial institutions. The clear source of funding channels for microloan companies will bring new vitality.

With the continuous expansion of policy space for microfinance development, it can be seen that more and more NGO MFIs can acquire more legitimate identities in the microfinance industry by registering at the regulatory authorities as well as obtain additional sources of funding.

② The contents of products and services are enriched

In August 2007, the CBRC issued the *Guideline on How to Greatly Develop Rural Microloan Business by Banking Financial Institutions*, which expanded loan providers from rural microloan institutions to all banking financial institutions and allowed rural traditional farming households, households in a variety of business, sole proprietors and rural micro and small enterprises to take loans. This new policy enriched the contents of microfinance products and services.

First, in terms of loan use, this guideline supports all key areas and crucial links that are beneficial to develop modern agriculture, increase the incomes of farmers and improve the living conditions and production environment of farmers, including all links of agricultural production, processing, transportation and circulation, all consumer areas like the purchase of simply daily consumer products and high-end consumer durables, building or buying houses, medical treatment, and children's tuitions, and entrepreneurship fields like local production, migrant workers, start-up businesses and vocational and technical training.

Second, in terms of loan size, this guideline stipulates that the microcredit loan size in developed regions and less developed regions can be increased to 100,000-300,000 Yuan and 10,000-50,000 Yuan, respectively, and for other areas the loan size can be decided on individual cases but within the above range; The group loan size can be increased to a moderate extent based on credit loan size; For some farmers and rural small enterprises with large production scale, excellent operational performance, good credit history, and huge capital demand, the loan size can be further increased.

Third, in terms of loan process, this guideline requires that microloan providers should try to simplify microloan procedures in rural areas, to increase channels to accept loan applications, to shorten the loan processing time; to promote the use of credit line cards so that those rural households and rural small businesses who have been granted with credit line cards can directly go through loan application procedures with their credit line cards and valid identification documents; to combine the functions of farmer loans and bank cards so as to gradually upgrade debit cards to credit cards in accordance with certain conditions, to implement "one-time credit line offering, several-time using, and revolving lending" within credit lines, and to improve the convenience level of borrowing.

In terms of interest rates, the *Guideline for Pilot Microloan Companies* issued by the CBRC in May 2008 clearly emphasized that the establishment of microloan companies does not mean

loan-sharking and laissez-faire. Besides, the CBRC stressed that lending rates should not exceed the ceiling set by the judiciary departments but the lower limit should be 0.9 times the benchmark rate of a loan announced by the central bank and floating ranges can be determined in accordance with market principles.

③ The market will be more open

The relaxation of the loan use and loan size of microcredit makes it possible to expand microfinance market, especially for microcredit operations of financial institutions. As for microcredit loans and group loans for rural households of RCCs, the loan size is too small to meet capital demand of most of rural households, which is regarded as the problem existing from the beginning of this business. While the CBRC "untied" microfinance in rural areas so that a larger amount of loans which belong to the traditional loan market content can also be disbursed through the methodology of microcredit and then the market space of microcredit can be expanded. At the same time, the setup of two new-type microloan companies and lending companies, and the participation of VTBs, RMCCs and postal savings institutions also enable the market to further develop.

④ The development is inclined to networking

The development towards networking is an important guarantee for the self-regulation and standardization of a microfinance industry. On November 9, 2005, the China Association of Microfinance (CAM) was set up, consisting of domestic MFIs, relevant administrative departments, and domestic and international organizations as well as experts and scholars which care for and support the undertaking of microfinance, which is a collaborative, service-oriented, and self-disciplinary organization. Its mission is to promote the government's support for microfinance and inclusive financial sectors, to strengthen international cooperation in microfinance, to enhance self-regulation of the guild, to upgrade the management of MFIs, to provide fundraising services for MFIs, to offer demand-driven financial services to the poor and low-income population, and to make a contribution to achieving the objective of all-round construction of a harmonious society. The main five functions of the CAM include policy coordination, self-regulation, technical assistance and training, information exchanges, and fundraising services.

⑤ Wholesale funds and guarantee institutions will gradually emerge in the microfinance sector

The emergence of microfinance wholesale funds and guarantee institutions set up by the funds from various channels of capital sources will further promote microfinance to deepen the development of the industry in China.

3. Wholesale Microfinance Business

Although there is no specialized microfinance wholesale fund in China so far, actually similar institutions have already existed based on the practices of microfinance in China. Among those, the most representative institution is the China Development Bank (CDB), which is actively involved in the microfinance industry at all its aspects. Meanwhile, with the issue of No. 90

document of the CBRC in 2006 and the *Guideline for Pilot Microloan Companies* in May 2008, more and more banking financial institutions take shares of or inject funds into microfinance retail institutions like VTBs and microloan companies. Without doubt, such participation and injection present the nature of wholesale funds.

(1) The CDB supports the microfinance industry

As a policy bank, the CDB participates in microfinance businesses through five models.

First is to inject wholesale funds into NGO microfinance projects and institutions so as to support the development of microfinance. On December 20, 2006, the CDB signed an agreement with the China Foundation for Poverty Alleviation (CFPA). The CDB would provide loans of 100 million Yuan to give a special support to microfinance projects conducted by the CFPA, which was the first time for MFIs in China to utilize wholesale funds offered by a national policy bank for the implementation of microfinance projects.

Second is to cooperate with commercial lending institutions to carry out microcredit businesses. For instance, since 2006 the Shenzhen Branch of the CDB has started the cooperation with the Zhongan Trust Investment Company in two ways, which are to provide debt capital for the Zhongan Trust Investment Company and to engage Zhongan Trust Investment Company into its microcredit business as an assistant institution so that both parties can build an effective risk control mechanism.

Third is to collaborate with different institutions to conduct microcredit businesses by offering onlending funds and technical assistance since the CDB cooperated with World Bank and KfW in 2005 and introduced the microfinance technique of IPC. Therefore, the CDB cooperated with city commercial banks in Taizhou of Zhejiang, Baotou of Inner Mongolia, Jiujiang of Jiangxi, Lanzhou, Guiyang, Chongqing, Daqing, Deyang, and Jinzhou one after another through signing agreements, by which loans were delivered to sole proprietors and farmers with credit demands.

Fourth is to directly involve in the formation of VTBs. In 2007, the CDB participated in the initiation and formation of five VTBs. On October 18, 2008, the CDB as an initiator collaborated with seven enterprises, such as Inner Mongolia Xindadi Congstruction Group Co., Ltd. and natural persons to co-fund the establishment of one local financial institution with an independent legal qualification – Erdos Dalate CDB VTB was set up at the Shulinzhao Town of Dalate Banner.

Fifth is to create a new methodology for loan disbursement named "CDB + Association + Enterprises (Farmers)". Given that it was difficult for farmers and SMEs to offer loan collaterals, in June 2004, the CDB helped Hainan Chengmai County to set up urban and rural credit associations whose mission was that "members take part in voluntarily, SME guarantee companies provide guarantees, and then the CDB grants loans to members of the Association". Their membership covered more than 10 industries like rural farming, agro-processing, storage and transportation. The associations followed the principle of "the CDB promotes with its funds, the government organizes and coordinates, and members conduct democratic management". In 2004, the CDB disbursed loans of 8.9 million Yuan to SMEs (including farmers) that were members of 11 credit associations including Chengmai Guoda Industry Company.

A shortage of funds for shipbuilding has been one bottleneck of the development of marine

industries in Sanya City. This city has explored one model of “CDB + SOEs + Associations + Fishermen”, which allows Sanya SOEs as the main borrowers. SOEs apply for loans of 125 million Yuan to the CDB in order to unify shipbuilding, but the fishermen have to pay the rental deposits. After the completion of the shipbuilding, the fishermen can use those vessels for fishing.

(2) The Agricultural Bank of China (ABC) engages in microcredit

Firstly, since the late 20th century, the ABC has involved in the issuance of subsidized loans for poverty alleviation;

Secondly, the ABC directly engaged in the formation of Hanchuan VTB of Hubei and Chifeng Keshiketeng Banner VTB of Inner Mongolia in 2008. On August 18, 2008, two VTBs of Hubei and Inner Mongolia set up by the ABC as their sponsor opened at the same time, creating a pioneer for large Chinese state-owned commercial banks to firstly launch VTBs, and indicating that the ABC made an important step on the provision of financial services for “Agriculture, Farmers and Rural Areas” by multiple channels.

(3) Equity participation and fund injection of new-type rural financial institutions

By referring to the period starting from the issue of the new policy regarding rural financial market access by the CBRC at the end of 2006 to the establishment of VTBs by the end of 2008, their sponsors were local commercial banks, RCCs, rural commercial banks, rural cooperative banks, the ABC, the CDB and foreign banks like HSBC. These organizations provided original capital as the sponsors of VTBs, accordingly, VTBs used those funds for their microcredit retail businesses, which without doubt promoted the development of microfinance industry. For example, the major wholesale fund provider - the CDB, as the main sponsor, has set up six VTBs. As of the end of December 2008, four lending companies were established whose sponsors were local commercial banks, being also equivalent to inject wholesale funds into the microfinance industry.

On May 4, 2008, the CBRC promulgated the *Guideline for Pilot Microloan Companies*, further relaxing the constraint for microfinance development. Meanwhile, the issue of funding channels for microloan companies was firstly raised. In addition to financing from shareholders' capital and donated funds, microloan companies can borrow from not more than two banking financial institutions.

(4) Supporting new trend of microfinance development

In August 2007, the CBRC promulgated the *Guideline on How to Greatly Develop Rural Microloan Business by Banking Financial Institutions* (No.67 (2007) CBRC), which expanded microfinance businesses to all banking financial institutions. And in May 2008, the CBRC and the PBC jointly promulgated the *Guideline for Pilot Microloan Companies*, which opened up the microloan market access to all kinds of capital. Thus, in China's microfinance industry, all different types of microfinance forms will continue to emerge so that a variety of innovative microfinance retail businesses will prevail and some large financial institutions will begin to

engage in microfinance businesses by providing wholesale funds, taking shares and injecting funds etc, which has a very positive significance for the further growth of microfinance industry in China. For example, after the establishment of PSBC, based on its own development situation, PSBC positions itself to focus on two aspects for its asset businesses, one is small impawn loans, microcredit loans and other retail businesses; another is large-scale wholesale fund businesses.

(5) Foreign investors enter China's microfinance market

In December 2007, Nanchong Microcred opened its business in Nanchong, which was funded by PlaNet Finance, KfW and IFC together.

The HSBC is one active investor in China's microfinance market. Hubei Suizhou Zengdu HSBC VTB, Chongqing Dazu HSBC VTB, and Fujian Yong'an HSBC VTB opened their businesses in December 2007, on September 2, 2008 and on October 15, 2008, respectively. On January 23, 2009, Guangdong Enping HSBC VTB started its test operation. All the above four HSBC VTBs are the wholly-owned subsidiaries of HSBC with the registered capital of 40 million Yuan for each VTB. On September 12, 2008, HSBC submitted the application of establishing one VTB at Miyun County in Beijing, which was approved by Beijing bureau of the CBRC. This VTB is also a wholly-owned subsidiary of HSBC with the registered capital of 50 million Yuan. According to the disclosure of Mr. Wang Dongsheng, the executive director of HSBC who is responsible for the operations of Hong Kong and mainland, HSBC will set up 30 VTBs in 2008 and after 2-3 years.

On September 26, 2008, the Overseas Investment Corporation of Citi submitted the application of setting up two lending companies in Hubei Province, which was approved by local regulatory authority. These two lending companies are located at Gong'an County and Chibi City with the registered capital of 17 million Yuan. They are not allowed to collect savings and can only conduct lending businesses locally. On December 16, 2008, Citi China announced its first lending company - Hubei Jingzhou Gong'an Citi Lending Company Ltd. to open its business, which was the first lending company set up by foreign banks in mainland China.

In addition, the CDB is preparing to set up an inclusive financial investment fund; the IFC also actively participates in domestic investment projects of microloan companies; Grameen Trust (GT), ACCION International, ASA International, and BlueOrchard and other international microfinance investment institutions also come to China one after another and seek investment opportunities, and they are ready to operate microfinance companies.

A new microfinance internet trust platform is quietly entering into Chinese markets, and KIVA of USA, WOKAI and other internet companies have developed their businesses in China; Domestic microfinance financing platforms on internet also emerge, like 51 GIVE and "patted loan".

4. Performance of Microfinance Supply System in China—Assessment by Types

Different organizations implementing microfinance projects have their own characteristics: NGOs and foreign-aid projects attach importance to the goals of both social development and

sustainable development; government projects focus on the growth speed and scale; the projects of financial institutions mostly pay attention to sustainability and risk control.

The major bodies of China's microfinance mainly include three categories: First, microfinance conducted by NGOs, international organizations and social organizations; Second, microfinance promoted by government departments; Third, microfinance operated by formal financial institutions.

(1) Microfinance operated by formal financial institutions

In China's rural financial markets, microfinance operated by formal financial institutions is regarded as an important innovation and development of traditional microfinance, which is the main body of an inclusive financial system.

China's rural financial market has begun to take shape by the RCCs, PSBC, ABC, Agricultural Development Bank of China (ADBC), VTBs, RMCCs, and microloan companies and other formal financial institutions, forming a diversified market structure, which effectively raises the level of financial services in rural areas. Due to small amount of fund needs of rural households and agriculture in general, thus farmer loans and agricultural loans disbursed by formal financial institutions in fact can be attributed to microcredit.

The statistics of China's financial system regarding farmer loans and agricultural loans can basically reflect the microcredit businesses of financial institutions. According to CBRC's statistics, as of the end of 2007, the loans outstanding of rural banking institutions including ABC, ADBC, RCCs, rural cooperative banks, rural commercial banks, PSBC and new-type rural financial institutions reached 7.7 trillion Yuan with an increase of 16.6% as compared to last year, accounting for 27.8% of total loans of banking financial institutions. Among them, the balance of agricultural loans of three financial institutions including RCCs, rural cooperative banks and rural commercial banks amounted to 1.5715 trillion Yuan with an increment of 244 billion Yuan over the beginning of that year, equivalent to an increase of 21.0%, and their farmer loans reached 1.0612 trillion Yuan with an increment of 141.3 billion Yuan over the beginning of that year, equivalent to an increase of 15.4 %; while PSBC added the funds of 133.6 billion Yuan to be used in rural areas, and the funds with the accumulated amount of 48.9 billion Yuan were returned to rural areas; new-type rural financial institutions accumulatively disbursed the loans of 398 million Yuan.

(2) Microfinance promoted by the government

Chinese government promotes microfinance for two purposes: First is to solve the problem of rural poverty; second is to facilitate re-employment of urban laid-off workers.

① Microfinance under the circumstance of rural poverty alleviation

In order to effectively mitigate fund shortage problem of poor households for development needs, and to actively explore and perfect the new mechanism and new model of use and management of fiscal funds for poverty alleviation, and to improve the capability of self-development and sustainable development of poor villages and poor households, the Poverty

Alleviation Office of State Council and the Ministry of Finance jointly issued the *Notice on Pilot Work of Developing and Establishing Village-level Mutual Funds in Poor Villages* on May 18, 2006, which covered 14 provincial pilot sites, including Hebei, Shanxi, Inner Mongolia, Heilongjiang, Anhui, Jiangxi, Henan, Hunan, Sichuan, Guizhou, Shaanxi, Gansu, Ningxia and Xinjiang provinces (autonomous regions and municipalities). Each province (autonomous region and municipality) identified a total of 10 poor villages out of 1-2 key counties designated by the state as pilot villages.

The source of mutual funds consists of two parts: first, in accordance with the average amount of 150,000 Yuan each pilot village, the central fiscal funds for poverty alleviation of the provinces (autonomous regions and municipalities) should be used as grants to help pilot villages to set up mutual funds. Specific amount of grants for each village can be determined by the provinces (autonomous regions and municipalities) based on the actual situation of pilot villages; second, villagers in poor villages should be encouraged to buy shares with their own funds or by other means so as to enlarge the scale of mutual funds, but free shares can be given to poor farmers.

In the actual operation, because the microfinance projects promoted by relevant government departments such as the All-China Women's Federation (ACWF) and the Poverty Alleviation Office, are mainly operated in a way of exerting the autonomy of rural communities, such microfinance projects can also be classified as NGO microfinance to a large extent.

② Micro secured loans in urban areas

The development process of micro secured loans in China's urban areas can be divided into three phases:

The first phase is the initial start-up phase from September 2002 to March 2004. In September 2002, the *Notice of Further Completing Re-employment Work of Laid-off Workers* promulgated by central government (Central Govt. [2002] No. 12) mentioned for the first time that China would implement micro secured loans policy for laid-off workers. In December 2002, the PBC, the MOF, the State Economic and Trade Commission, and the MOLSS issued the *Management Measures of Micro Secured Loans for Laid-off Unemployed People* (No. 394 (2002) PBC). In June 2003, the MOF, the PBC and the MOLSS distributed the *Management Measures of Fiscal Subsidized Funds for Micro Secured Loans for Laid-off Unemployed People Engaging in Projects with Meager Profit*. All the above policies aimed at facilitating urban laid-off workers to start up businesses by use of micro secured loans.

The second phase is the improvement phase from March 2004 to the end of 2007. In March 2004, the PBC, the MOF and the MOLSS jointly issued the *Notice of Further Promoting Micro Secured Loans Work of Laid-off Workers* (PBC [2004] No.51); In November 2005, the State Council promulgated the *Notice of Further Strengthening Employment and Re-employment Work* (State Council [2005] No.36); In January 2006, the PBC, the MOF and the MOLSS jointly distributed the *Notice of Further Improving and Completing Micro Secured Loans Policies* (PBC [2006] No.5). The issue of these policies further reinforced the work of micro secured loans.

The third phase is the management and promotion phase starting from 2008. On January 1, 2008, the *Employment Promotion Law* came into effect. In February 2008, the State Council

issued the *Notice of Completing the Work to Promote Employment* (State Council (2008) No.5); In May 2008, the PBC, the MOF and the MOLSS jointly promulgated the *Notice of Further Improving the Management of Micro Secured Loans and Actively Promoting Business Start-Up and Employment* (PBC (2008) No.238). These policies resulted in the increase of the proportion of loans discount and the expansion of the scope and size of such loans.

According to statistics, as of the first half of 2008, micro secured loans with the cumulative amount of nearly 20.5 billion Yuan were disbursed over the country. The central finance allocated subsidized funds with the cumulative amount of 1.9 billion Yuan for micro secured loans. Based on the quarterly reports' statistics of urban micro secured loans of 100 cities, as of the second quarter of 2008, 415,000 people started their businesses through micro secured loans in those 100 key cities across the country, which has brought 1,268,000 people in employment, with the average employed number of 3.05 persons promoted by each person with a start-up business, and with the average employed number of 1.35 persons driven by every ten thousand loan. By the end of August 2008, a total of almost 3600 college graduates realized their micro-entrepreneurial aspirations through micro secured loans, and more than 7,000 labor-intensive small businesses got access to micro loans. A total of 1500 credit community have been established over the country. There are over 430 institutions which offer micro secured loans in cities and above level across the country.

At the same time, micro secured loans have lower risk. As of the end of the second quarter of 2008, urban micro secured loans in 100 key cities entered into their loan repayment periods with the cumulative repayments of 6.08 billion Yuan, and the cumulative overdue repayments of 450 million Yuan, and the loan recovery rate of 93.1%. According to statistics, there are 60 cities with the loan recovery rate of 90% and above; 25 cities with that of 80-90%; 16 cities with that of lower than 80%.

(3) Microfinance conducted by non-financial institutions like NGOs

The most typical NGO microfinance projects in China include the following. First, the Rural Development Institute of CASS set up the FPCs in Yi County of Hebei, Yucheng County and Nanzhao County of Henan and Danfeng County of Shaanxi in accordance with Grameen Bank methodology. Second, since 1995, the UNDP and the CICETE have promoted microfinance projects with the goal of poverty alleviation in 48 counties (cities) out of 17 provinces across the country. And later the UNDP has carried out urban microfinance projects targeting laid-off workers in Tianjin and some cities in Henan Province. Third, the CFPA conducts its own microfinance projects. In 2000, the CFPA began to involve in microfinance businesses for poverty alleviation. As of the end of 2008, the CFPA established a total of nearly 20 branch offices in the country, managing the loan capital of about 100 million Yuan and the active loan clients of over 30,000 people.

5. Financing Difficulties Faced by MFIs

(1) A single source of funding channels of NGO microfinance

As for NGO microfinance projects for the purpose of poverty alleviation, they basically acquire their funding from domestic and foreign donations, mostly from international donors. Majority of the projects did not have follow-up financing arrangements, under the circumstances without sustainability, it would be difficult for them to get further investment.

(2) The potential threat of financing chain disruption encountered by credit-only microloan companies

Commercial microloan companies clearly define their investors and owners, which lays a sound foundation for the establishment of a good corporate governance structure and the prevention of unclear funds' ownership and possible moral hazard. However, microloan companies can only disburse loans without deposits collection. According to the definition of the *Guideline for Pilot Microloan Companies* (No.23 (2008) CBRC) on May 4, 2008, the principal source of funds of microloan companies includes the capital paid-in by shareholders, donor funds, and borrowed funds from not more than two banking financial institutions. Within the scope of the provisions in relevant laws and regulations, the amount of borrowed funds from banking financial institutions acquired by a microloan company shall not exceed 50% of its net capital. Therefore, the funding channel is very narrow so that the scale can not be bigger.

(3) The insufficient volume of mutual funds to meet loan demands

Although RMCCs are allowed to absorb deposits from their own members, the deposits made by those members with real needs for large amount of funds are negligible. Thus RMCCs are still unable to meet the huge loan demands in the regions of their coverage only with their insignificant capital and meager deposits.

(4) The special difficulties faced by foreign investors

With the opening up of China's financial market, more and more international professional investment institutions in microfinance hope to open up markets in China and to promote the international successful microfinance experience, but they encountered many policy and legal problems in the course of investment:

① International professional investment institutions in microfinance are often not commercial banks, thus they are not qualified to initiate the formation of VTBs and they can only hold not more than 10% of the shares.

② The provisions related to shareholding proportion of VTBs and microloan companies set a serious obstacle for the participation of international professional investment institutions in microfinance.

IV. The Impact of Microfinance Industry Development in China

1. The Impact of Microfinance Industry Development at the Macro Level

(1) Microfinance supported the adjustment of industrial structure of agriculture

The implementation and expansion of microfinance have imported a large number of funds in rural areas to support rural economic development and eased the contradiction of shortage in agricultural funds so that the adjustment of industrial structure of agriculture has a strong financial support.

(2) Microfinance is an effective tool for poverty alleviation

Microfinance through the provision of deposit, credit and insurance instruments makes the poor access appropriate financial services, and enhances the resistance capacity of the poor against risk, and helps the poor to make more stable consumption, conduct more effective risk management for small businesses, and increase their own profitability and their incomes as well as improve the quality of their lives.

Luonan County in Shaanxi Province as an example, microcredit loans of 15.01 million Yuan were directly delivered to poor households in 1997, which supported 15,000 households with the average increase of 910 Yuan in income and solved the food and clothing problems of 82,000 poor habitants of the whole county. Within one year, the number of the people who got free from the food and clothing problems was more than the sum of the previous 3 years. As of the end of 2002, microcredit loans of 5.235 billion Yuan were disbursed in overall Shaanxi province with loans outstanding of 2.674 billion Yuan and cumulative clients of 1,577,100 households, of which there were 1,573,100 poor households with the average loan size of over 3300 Yuan. Most of households supported by microcredit loans got out of the poverty line.

(3) The implementation of microfinance promoted the development of assessment undertaking

The implementation of microfinance in rural areas is built on the basis of farmers' credit without any collateral and guarantees, while the identification and ranking of farmers' credit are determined completely by adopting a modern assessment theory in line with market economy. Thus, farmers' credit is identified based on the assessment and rural microcredit loans have gone through some useful trials in terms of the establishment of evaluation organizations and assessment methods.

2. The Impact of Microfinance Industry Development at the Meso Level

(1) The involvement of microfinance squeezed out informal lending to some extent.

In China, informal lending activities are quite active, and most of their rates are high, while the development of microfinance provides a new source of funds for informal capital market and then pushes out some loan sharking activities.

(2) Microfinance promoted the diversification of rural financial institutions

In 1999, RCCs started to carry out microcredit loan businesses for rural households, which was regarded as the first time for formal financial institutions to introduce microcredit operations; in 2005, pilot credit-only microloan companies were set up in five provinces including Sichuan, Guizhou, Shaanxi, Shanxi and Inner Mongolia; by the end of 2006, the CBRC further allowed the establishment of three new-type rural financial institutions like lending companies, VTBs and RMCCs, which again broadened the policy space for the rapid development of microfinance in rural finance; since March 2006, the PSBC has begun to conduct pilot micro collateral-based loans business, which has also promoted the expansion of microfinance in formal financial sectors. Diversified MFIs facilitate the diversification of rural financial institutions as well as the diversification of the businesses and fields of rural financial institutions, and increase the number of rural finance suppliers, which not only meet the demands for financial services in rural areas, but also strengthen effective competition among institutions, resulting in improved efficiency and the quality of rural financial services.

(3) Microfinance further completed the development of rural financial system

Microfinance is different from formal commercial banks as well as from the features of traditional policy finance, thus it can achieve some degree of sustainable development when serving the middle and low income and poor people with financial services, which is the most basic characteristic of microfinance as an emerging financial organization. Microcredit requires market-oriented interest rates so that it explores a special path of development that integrates with commercial finance in terms of systems and with policy finance in terms of objectives.

(4) Microfinance optimized rural credit environment

Especially microcredit loans for rural households of RCCs are issued based on the credibility of farmers, while this reputation comes from the collaboration of the township government and villagers, which is an effective way to combine financial credit and social credit, leading to a favorable credit environment. At the same time, through the issuance of microcredit loans, the businesses of RCCs in rural areas will also extend from pure breeding households and sole proprietors to farmers and poor households in general, which can expand the depth and breadth of their businesses.

3. The Impact of Microfinance Industry Development at the Micro Level

(1) The impact of microfinance on women

① Participation in family decision-making. Microfinance has changed the traditional patterns of women's behaviors and offered opportunities for women to participate in family decision-making. It is estimated that by the end of 2008 there were around 50 million poor women access to microloans.

Due to the fact that women handled all the operations from loan application, loan disbursement, investment and repayment, most of women had to go outside their houses, enter the market and participate in commodity trading under the pressure of regular repayment. Through contacting with the outside world, women not only had the opportunity to learn, but also greatly increased their participation rights in family decision-making as well as their family status.

② Status changes. Microfinance improves the fairness of lending opportunities and also provides income-generating funds and opportunities for the disadvantaged groups, especially for poor women. Through the operation of microfinance projects, women have created considerable economic incomes, and some women even earned more than the men in their families so that women have played a role in family decision-making, significantly changing the "patriarchal" family status. Owing to the success of microfinance projects and the changes in family status, women's courage and confidence have been enhanced, thus women attend more and more social activities, which further increases their self-confidence and their status in the family and the community.

③ Quality improvement. Microfinance provides financial services like credit loans for women together with a lot of non-financial services such as training, technical assistance and material support. These non-financial services not only offer production skills to loan borrowers, but also help them to improve their job-related skills, update their awareness and increase their knowledge. For example, the training courses of children's rights and breast-feeding knowledge for women enabled women to know more scientific raising knowledge and then better take the responsibility of motherhood.

(2) Microfinance helped increase the income of farmers.

According to the survey on how farmers in Henan Province used microcredit loans for rural households, 100 rural clients in Jiyuan City of Henan realized the net income of 2,852 Yuan per capita in 2002, with an increase of 1,147 Yuan than that of 1999, equivalent to an increment of 67.3%; The average net income brought by microcredit was 5,802.35 Yuan per household, which was twice than that before taking loans.

(3) The promotion of microfinance enhanced the credit awareness of farmers

When implementing microcredit, RCCs cooperated with the township and village government to create credit villages (households) so that the credit concept of farmers greatly changed. On the one hand, farmers have the sense of indebtedness to develop production; On the

other hand, a sense of trustworthiness has been established. With the reinforcement of the credit concept of farmers, the social credit environment of overall rural areas has been further improved.

V. The Development Policy and

Legal Environment of Microfinance in China

1. The Development Model, Policies and Legal Definition of Microfinance in China

(1) Microfinance with the support of international donors

This type of microfinance projects has two typical characteristics: First, no deposits taking, a single source of funds, and basically operating donated funds; Second, targeting the poor groups, small loan size, and simple procedure.

At the same time, without public savings mobilization microcredit with the support of international donated funds has a weak influence on financial market but exposes to relatively lower financial risk. Thus strict and prudential regulatory measures are not suitable for this type of microfinance institutions. In order to reduce the operating costs and maintain the flexibility of the project operations, the Chinese government mainly adopts the principle of non-prudential regulations for such microfinance. Furthermore, there are no definitions by relevant policies and laws and regulations.

(2) Policy-oriented microfinance as a means of national poverty alleviation

The major fund sources of this type of microfinance are mostly from the state's fiscal capital and subsidized loans for poverty alleviation. Government agencies and financial institutions (mainly the ABC and RCCs) are the operating institutions, which is regarded as one typical model for the state to achieve poverty alleviation with the application of financial instruments. Since the mid 1980s, with the poverty reduction model transferring from relief to development, the ABC has taken the main task of reducing poverty by providing credit in poor areas. And the management of credit funds for poverty alleviation also experienced a change from raising funds by the PBC to self-funding, and the support focus of credit was also gradually transferred from farmers and entities to industrialization and leading enterprises. In addition, the policy banks like the CDB and the ADBC provided wholesale credit funds for RCCs and PSBC as well as other MFIs, with a sense of pro-poor.

As for such microfinance, the management and supervision are mainly based on the relevant operation measures set by the government.

(3) Commercial microfinance conducted by formal financial institutions

The microcredit of formal financial institutions is more like a concept of loans in a small

amount.

RCCs become the major supplier of rural microcredit businesses with its unique advantages of “wide coverages, large volumes, many branches” in rural areas. In 1999, RCCs with the support and cooperation of local governments began to use bank deposits and onlending funds of the PBC to disburse microcredit loans and group loans to those rural households who could not offer collateral in rural areas, in accordance with the policy of “once approval, lend when need, balance control, revolving use”. In January 2001, by referring to the system design of pilot microfinance projects of NGOs, RCCs created a set of policies regarding group guarantee, compulsory savings, group funds, installment payment, subsequent loans etc. Since December 2001, microcredit loans for rural households have started to be fully implemented by RCCs in various regions across the country.

On August 6, 2007, the CBRC promulgated the *Guideline on How to Greatly Develop Rural Microloan Business by Banking Financial Institutions*, which was regarded as the first regulatory document to give the unified guidance on microfinance businesses for policy banks, state-owned commercial banks, joint-stock commercial banks, PSBC, the provincial RCC Unions, rural commercial banks, rural cooperative banks, VTBs, lending companies and RMCCs. So far, microfinance has actually become one routine business approved by the regulatory authorities and the central bank.

(4) Microfinance businesses of new-type rural financial institutions

In December 2006 the CBRC issued the *Opinions Regarding Easing Market Access for Banking Financial Institutions in Rural Areas in order to better Support the Construction of a Socialist New Countryside*, and then promulgated the *Provisional Regulations on the Management of VTBs*, the *Provisional Regulations on the Management of RMCCs*, and the *Provisional Regulations on the Management of Lending Companies* in January 2007. On April 24, 2008, the PBC and the CBRC jointly issued the *Notice of Relevant Policies about VTBs, Lending Companies, RMCCs and Microloan Companies* and then together delivered the *Guideline for Pilot Microloan Companies*, and so on. Thus, a series of normative documents set an institutional basis for VTBs, lending companies, RMCCs and microloan companies invested by social capital to operate and develop their businesses. It follows the general principle of “low threshold but strict supervision” to deal with these new-type financial institutions.

2. The Assessment of Development Policy and Legal Environment of Microfinance in China

(1) Narrow scope of non-prudential regulation and unclear goal

China's microfinance operations are mostly conducted by NGOs, the banking financial institutions, non-banking financial institutions and private capital etc. As for non-governmental MFIs and microloan companies, non-prudential supervision should be adopted, but in general, the former and the latter are respectively subject to the supervision of local administration bureau of

civil affairs and local department designated by the government such as financial management office or SME management bureau etc. The supervision is lax and the scope of supervision generally involves the requirements including the prohibition of mobilizing savings, registered capital, qualifications for market access, business scope, asset quality, the accounting system, the level of interest rates and financing channels. Apart from the FPCs of CASS and the “Rural Development Associations” of UNDP /CICETE which obtained the permission from the PBC, the other microfinance projects of NGOs are mainly operated based on the agreements signed between donors and local governments as an informal business permission so that the access of these MFIs has no formal procedures and regulations, and the roles and responsibilities within these institutions are also not clearly defined and classified.

(2) Unclear qualification and instable legal status of MFIs

Microfinance in China lacks independent regulators and appropriate regulatory policies and laws and regulations. The related regulatory system for formal financial institutions to conduct microfinance is only made for RCCs. In July 1999, the PBC issued the *Provisional Method of Microcredit Loans Management of RCCs for Rural Households*, mentioning that microcredit loans for rural households should adopt the management method of “once approval, lend when need, balance control, revolving use” and clearly stipulating loan conditions, uses and sequence as well as more detailed standards of credit assessment. In January 2000, the PBC promulgated the *Guidance on Group Loans Management of RCCs for Rural Households* again. On basis of the system arrangement of pilot microfinance projects of NGOs, RCCs created a set of policies regarding group guarantee, compulsory savings, group funds, installment payment, and subsequent loans etc. And then the PBC continued to strengthen the extent of managing, regulating and supporting microcredit businesses of RCCs. However, these established norms are primarily a number of administrative regulations and departmental rules with the lack of long-term strategic objectives and sustainable designs. Moreover, a set of comprehensive and applicable methods regarding risk assessment, monitoring and management measures of credit loans have not been established in some areas. Accordingly, the supervision of microfinance relatively lags behind.

With the entry of new-type rural financial institutions, at this stage, the development of microfinance in China has been formed in the pattern of mutual competition in rural financial market with diversified institutions as main bodies. The diversity of MFIs requires financial regulatory authorities to distinguish between the nature and business scope of MFIs so as to differentiate the supervision and management. However, it is regrettable that, despite the existence of various forms of institutions, such as MFIs for poverty alleviation, microcredit operations of RCCs, microloan companies managed by local governments and new-type rural financial institutions (VTBs, RMCCs and lending companies) regulated by the CBRC, a regulatory framework for different types of MFIs has not yet been set up. Furthermore, the uncertainty of development policies and regulatory frameworks results in the instability of the legal status of MFIs and the uncertainty of its expectation, leading to the following issues: First, the instability of expectation for the future makes it difficult for MFIs to adopt effective measures in a long run, instead, they pay more attention to their short-term effects; Second, the lack of legal status affects

investors' confidence in long-term investment, resulting in the interruption of the funds chain and then the difficulty in continuous operations. Therefore, it is particularly urgent and important to build a clear regulatory framework and grant an appropriate legal status to MFIs.

(3) Interim institutional arrangements lead to the poor stability of regulation and supervision

The initial experiment of microloan companies was initiated by the PBC. In May 2008, the PBC and the CBRC jointly issued the *Guideline for Pilot Microloan Companies* (CBRC [2008] No. 23), clearly stipulating that as long as provincial governments can designate one administrative department (finance office or relevant departments) to be in charge of the supervision and management of microloan companies and be willing to take responsibility for the risk disposal of microloan companies, they are allowed to carry out the formation of pilot microloan companies within the counties of their provinces (autonomous regions and municipalities). At this point, the supervision right of microloan companies was transferred from the PBC to local governments. Such temporary system design and arrangement renders unclear regulatory bodies, and frequent translocation is not conducive to the stable operation and long-term development of microloan companies.

(4) Local government departments increase the access threshold for microloan companies

On May 4, 2008, the CBRC and the PBC jointly promulgated the *Guideline for Pilot Microloan Companies* (CBRC [2008] No. 23), stipulating that a microloan company can be registered as a limited liability company or a joint stock limited liability company. The registered capital of a limited liability company and a joint stock limited liability company shall not be less than 5 million Yuan and 10 million Yuan, respectively. The shares held by single natural persons, corporate legal entities, other social organizations and the related parties should not exceed 10% of the total amount of registered capital of microloan companies. The low access threshold provides convenience for all types of funds' owners in rural areas to enter rural financial markets, being more conducive to enlarging funding sources of rural financial markets. Nevertheless, in the implementation course of pilot microloan companies, most of provinces increase the access threshold in terms of the registered capital requirements and the quality of applicant enterprises. For example, the provisions of the Beijing government require that the registered capital of microloan companies as a limited liability company and as a joint stock limited liability company shall not be less than 50 million Yuan and 100 million Yuan, respectively, which are 10 times than the standards of the CBRC. Even in the underdeveloped areas like Sichuan, local government requires that the registered capital of microloan companies shall not be less than 100 million Yuan.

Meanwhile, the pilot mode of credit-only microloan companies presents obvious government-led features, for instance, the number of pilot microloan companies in certain areas is limited, the monopoly of access, and the market is open but held; at the same time, microloan companies have a single source of funds, and the regulatory approach is transparent.

The researchers of this report argue that: ① setting a certain access threshold is necessary, however, the current threshold is too high; ② after setting a certain threshold, the number control of market access should be relaxed so that those who are willing to enter this market can have opportunities; ③ In terms of the geographical distribution, microloan companies should be more inclined to set up in traditional rural areas, underdeveloped regions and townships so as to solve the issues of vacant financial suppliers and insufficient competition in these areas.

(5) The policies among regulatory bodies are not fully compatible

Less than one year after the experiment of credit-only microloan companies led by the PBC, the CBRC issued the *Opinions Regarding Easing Market Access for Banking Financial Institutions in Rural Areas in order to better Support the Construction of a Socialist New Countryside* (CBRC (2006) No.90) on December 20, 2006. Neither the PBC or the CBRC makes a clear explanation about the legal status, nature and management of microloan companies, instead, the rules are more related to the access of institutions. These new institutions can disburse micro loans, but the system design excludes microloan companies from the regulatory framework from the very beginning, making microloan companies fall into the plight of unsustainable funds chain. Later on, the CBRC promulgated one after another the *Provisional Regulations on the Management of VTBs*, the *Provisional Regulations on the Management of Lending Companies*, and the *Provisional Regulations on the Management of RMCCs* again, attempting to further clarify the nature, access, and business scope of MFIs and so on from the perspective of institutional arrangement. However, it is inexplicable that VTBs and RMCCs are banking financial institutions, with lack of regulatory provisions in the “Provisional Regulations”, VTBs are subject to the *Law on Commercial Banks*, while RMCCs have no rules to follow, besides, lending companies are defined as limited liability companies by nature but they are also applicable to the *Law on Commercial Banks* confronting regulatory gaps in the provisions without considering whether or not the strict prudential supervision framework of the *Law on Commercial Banks* is fully suitable for the new rural financial institutions.

In order to break the incompatible policy dilemma of the pilot programs of the PBC and the CBRC, the PBC and the CBRC jointly issued the *Notice of Relevant Policies about VTBs, Lending Companies, RMCCs and Microloan Companies* and the *Guideline for Pilot Microloan Companies* in May 2008, trying to find a policy channel for microloan companies operated by private capital to allow those with good performance to be transformed into VTBs on the basis of their shareholders’ will. The question is that the provisions in the *Guideline for Pilot Microloan Companies* neither consider the development will of microloan companies nor clarify the specific transformation rules.

(6) Unfair competition environment of interest rate policy

China has relaxed to a greater extent the restriction on deposit and loan interest rates, that is, the PBC sets the benchmark interest rates on deposits and loans, different types of financial institutions are allowed to self-determine interest rates within the floating range permitted by the relevant policy. RCCs have the autonomy right to set lending rates between 0.9-2.3 times than the benchmark interest rate stipulated by the PBC, while the lending rates of microloan companies,

VTBs, RMCCs and lending companies can float between 0.9-4.0 times than the benchmark interest rate, which is clearly defined by law or policy. However, the problem is that in accordance with the existing policy, in addition to urban credit cooperatives, other financial institutions in urban financial sectors enjoy the full liberalization of lending rates, but there are no clear legal provisions and policy framework on how to price their microcredit services. This makes the current interest rate policy unfair since the different pricing regulations are adopted to institutions which provide the same financial products in the same rural financial markets. Furthermore, some NGOs disburse microcredit loans and charge effective lending rates much higher than the benchmark interest rate set by the PBC, but such practices do not have legitimacy according to China's relevant laws and regulations.

VI. The Opportunities and Challenges

of Microfinance Development in China

1. Development Trends of Microfinance Industry

With the increasing impact of finance in the economy, all circles gradually realize that it is not only a simple fund act, but also a right for the residents from all walks of life to enjoy financial services, resulting in the production of inclusive finance concept with a far-reaching impact, which promotes the rapid development of microfinance.

(1) From microloan to microfinance

Since the 1980s, microfinance has experienced a rapid growth, and the scale of microfinance has dramatically risen, and microfinance products and services have been gradually closer to the characteristics of microfinance market and regional economic development, and MFIs as well as microfinance products and services have been diversified. An increasing number of international agencies have recognized that, with the exception of micro loans, other integrated financial services, including microsavings (including the voluntary savings and compulsory savings), microinsurance, remittance, collection, credit guarantees and leasing etc., are at least equally important for the middle and low income population, implying that the development of microfinance in the international community starts to gradually convert from the traditional “micro loans” to “microfinance” that provides comprehensive financial services for the middle and low income customers.

(2) From welfarism to institutionalism

Most of the initial microfinance projects of NGOs were initiated as social experiments based on the purpose of reducing poverty and promoting rural economic growth. These organizations regard social development as their duties, and make efforts to achieve the goal of poverty reduction and economic growth through the provision of microfinance services, as well as other non-financial social services such as technical training, education, and medical care and so on, which are called as “welfarism microfinance.” In contrast, the “institutionalism microfinance” is primarily concerned with commercial sustainability and tries to expand business coverage on the basis of sustainable operation so as to serve more middle and low income population with financial services. With the rapid development of MFIs at the international level, the primary concern for sustainability has increasingly received wide international recognition, which means that the concept of institutionalism will be paid more attention. The institutionalism adheres to the social commitment of “win-win” and the requirements for sustainable development, making the government’s consideration for the feasibility of financial input, the public and the international donors’ desire for poverty alleviation of their funds, and the academia’s viewpoint of emphasizing

the principle of marketization reach a consensus view, which also represents the community's expectations.

(3) Gradual relaxation of the microcredit interest rate control

Since MFIs mainly target those customers without collateral and disburse small-size loans, they are bound to have a high transaction cost and high risk of loss. Therefore, all MFIs often require a higher interest rate from loan customers in order to cover their costs. Calculated in accordance with the effective interest rate, the interest rates required by many organizations reach more than 20%, some even 100%. However, although microcredit interest rates are much higher than those of commercial banks and international financial markets, they are still much lower than those of sharking loans. Another more important and more fundamental reason to support the high-interest rate policy is that higher interest rates help improve the accessibility of loans for the middle and low income people. Rural finance practices have shown that subsidized low-interest or preferential loans will inevitably lead to the over-demand and credit rationing in rural financial markets. As for the competition for those subsidized loans, the middle and low income people are often at a disadvantage, so the funds are usually obtained by those classes with certain advantages in rights, at the same time, rent-seeking behavior of the staff of financial institutions often occurs. In fact, if the middle and low income groups want to acquire low-interest loans in such a circumstance with a non-market competition, they will pay lots of other costs, such as lobbying and bribery costs. However, the sum of these costs may have been far greater than the higher interest rates required by MFIs. On the contrary, the higher interest rates charged by MFIs can effectively exclude non-target groups so that it can ensure the accessibility of microcredit for the middle and low income people.

(4) Combination of microcredit and insurance promotes the microfinance development

Another financial service of microfinance industry that has drawn greater attention is microinsurance. Microinsurance makes the microcredit disbursed by rural financial institutions like RCCs as a breakthrough point, and then transfers the risk that farmers cannot repay loans on time resulting from lack of economic capacities due to illness, disability or death caused by accidents. Microinsurance products have clear target and lower rates, resolving the problems of risk guarantee of both farmers and RCCs. Microinsurance for rural households belongs to the typical protection products with the characteristics of clear target and low premium, but their economic and social benefits can not be ignored. It can not only achieve the purpose of the three win-win situation of borrowers, rural financial institutions and insurance companies, but also open up a new path in terms of serving "Agriculture, Farmers and Rural Areas" and exploring an innovative cooperation model between banks and insurance companies.

The expansion and development of microinsurance based on microfinance development facilitate more diversified products and services in rural financial markets, and improve the rural financial market system, and then promote the development of microfinance industry when ensuring the demands of farmers for insurance products.

In addition, like microcredit, the deposit, collection and credit guarantees in microfinance industry have played a crucial role in enriching rural financial markets and providing a wide range

of financial services for middle and low income groups and rural areas.

2. Opportunities Faced by the Development of Microfinance Industry in China

(1) The tremendous success of the international microfinance industry brings experiences to China for reference

Microfinance has expanded from certain areas of the world to almost the entire developing countries and some developed countries. Regarding its expansion sizes, it has achieved a model at a national scale. In terms of its institutional structures, there exist examples of national formal banks implementing successful microfinance operations, models of NGOs serving the poorest population and achieving double bottom lines, pioneers of specialized MFIs continuing to expand their businesses, and successful cases of special banks meeting special needs. Nevertheless, the norms and the history of successful microfinance are not long, and the proportion of successful examples is not high. It is also a newborn thing in the international community, still facing a variety of risks and challenges. All the countries still need to actively explore how to promote microfinance from the experiment to expansion and then to institutionalized development, and many questions are yet to be answered by microfinance researchers, practitioners and policy makers.

(2) The rapid development of international microfinance industry serves as a demonstration for China's microfinance industry

The cumulative experiences in microfinance model in 1980s basically display that poverty reduction model can be extended under certain conditions, leading to tremendous development of the global microfinance industry. With the increasing impact of finance in the economy, all circles gradually realize that it is not only a simple fund act, but also a right for the residents from all walks of life to enjoy financial services, resulting in the production of inclusive finance concept with a far-reaching impact, which promotes the rapid development of microfinance.

(3) The assistance and support of international microfinance industry for China

Since the mid 1990s, the number of NGO MFIs and projects has reached around 300 in China. The coverage of relatively large institutions and projects achieves about 5,000 rural households, but less than 1,000 households for small ones. More importantly, the donation from international agencies is the overriding source of funds for Chinese NGO MFIs, supporting the microfinance development of China in different ways.

Since 2005, owing to an enormous success enjoyed by microfinance industry, China's rural financial market has attracted more and more foreign financial institutions to set foot in the microfinance industry in rural financial markets.

HSBC and Citi are the foreign financial institutions which involve in China's microfinance industry at its earlier stage.

Grameen Bank, through its sister organization-Grameen Trust, has been discussing the implementation of a number of pilot microfinance schemes with their Chinese counterparts in China.

The Bank of East Asia and the Standard Chartered Bank presented their great enthusiasm for China's rural financial markets. At the same time, ACCION International of USA, ASA of Bangladesh, and IFC under World Bank and other institutions also engaged in the bidding process of microloan companies, indicating that foreign capital shows its growing interest in China's rural finance.

(4) Domestic microfinance policies are increasingly liberal

From 2004 to 2009, the No.1 Documents of the successive 6 years issued by central government stress that the microfinance development should be supported under the premise of effective financial risk prevention, laying a policy foundation for the development of domestic microfinance industry and creating a relaxed environment.

The No.1 Document of 2004 points out that it should be encouraged to actively set up financial organizations with various forms of ownership directly serving "Agriculture, Farmers and Rural Areas" through the absorption of foreign capital under the premise of effective financial risk prevention and strict supervision in some areas with conditions.

The No.1 Document of 2005 more clearly defines that fostering a competitive rural financial market, the relevant departments should pay close attention to set up the access conditions and supervision methods for new rural financial institutions with various forms of ownership, and under the premise of effective financial risk prevention, experimental work should be started as soon as possible. In some areas with conditions, it can be explored to establish microfinance organizations initiated by a natural person or an enterprise, being closer to the needs of farmers and rural areas.

The No.1 Document of 2006 states that under the premise of sufficient capital, strict financial supervision and reasonable and effective exit mechanism, it should be encouraged to set up community financial institutions with various forms of ownership and to allow private capital and foreign capital to take shares and it should also be vigorously cultivated to initiate microfinance organizations by natural persons, corporate legal entities or associations, thus relevant departments should pay close attention to develop management measures.

The No.1 Document of 2007 indicates that it should continue to deepen the reform of RCCs, and identify the proportion of new deposits of financial institutions being used in local counties as soon as possible, and guide the return of postal savings funds back to agriculture, and greatly develop rural microfinance, and carry out and foster the pilot rural financial organizations with various forms of ownership in the poor areas.

The No.1 Document of 2008 suggests that it should be accelerated to promote the pilot work of adjusting and relaxing the access policy for banking financial institutions in rural areas; increase the efforts of the ADBC in supporting "Agriculture, Farmers and Rural Areas"; push forward the reform of the ABC; continue to deepen the reform of RCCs, intensify the degree of

support; the PSBC should actively expand its scopes of agriculture-related businesses through a variety of ways; actively cultivate microfinance organizations and encourage the development of credit loans and group loans.

The No.1 Document of 2009 emphasizes that the capacity of rural financial services should be strengthened, and under the premise of strengthening supervision and preventing risks, it should speed up to develop various new-type rural financial organizations and small and medium-sized regional banks serving rural areas. It should be done to encourage and support financial institutions to make innovation in their rural financial products and services, and to greatly develop microcredit and microfinance services. Rural micro and small financial institutions can borrow funds from financial institutions through a variety of ways.

With the encouragement of a series of No.1 Documents announced by the central government, the development of microfinance came to a new stage in China. The dominant ideology of this new phase is to transfer from focusing on poverty alleviation and social development as the center to achieving poverty reduction and supporting microenterprises' development as well as realizing sustainable operations of MFIs so as to provide financial services for middle and low income groups and microenterprises in a sustainable way.

From a specific point of view, the history of China's microfinance development is very short, but its growth is rapid. Since 2003, RCCs, PSBC, CDB, ADBC and VTB and other new-type rural financial institutions have introduced microcredit businesses one after another, opening a new chapter of China's formal financial institutions engaging in the microfinance business. Since 2003 the Chinese government has introduced a number of microfinance policy documents, and undertaken a set of broad and decisive financial reform and innovation:

① Since the beginning of 2003, the CBRC has continued to push forward the reform of property rights and management system of RCCs, and encouraged them to vigorously develop microcredit loans and group loans for rural households.

② In July 2005, the CBRC issued the *Guidance on Banks Engaging in Loan Business for Small Enterprises*, facilitating financial services for small enterprises by guiding banking financial institutions through the establishment of the six mechanisms including an interest rate risk pricing mechanism, an effective incentive and restraint mechanism, and a default disclosure mechanism.

③ At the beginning of 2005, on the basis of the original 300 microfinance projects run by NGOs, the PBC began to promote the implementation of pilot projects of commercial microfinance organizations.

④ On December 20, 2006, the CBRC promulgated the *Opinions Regarding Easing Market Access for Banking Financial Institutions in Rural Areas in order to better Support the Construction of a Socialist New Countryside* (No.90 (2006) CBRC), identifying a new access policy of rural financial markets, and it was firstly launched in six pilot provinces and cities. On October 13, 2007, upon the approval of the State Council, the CBRC decided to expand the pilot scope of the above policy, and extended from six provinces (regions) to all areas in 31 provinces and cities.

⑤ On December 31, 2006, the CBRC formally approved the establishment of the PSBC. On

March 20, 2007, the PSBC was officially launched. In accordance with the provisions of the CBRC, the PSBC will position itself in rural financial markets and focus on serving the “Agriculture, Farmers and Rural Areas” with financial services.

⑥ On April 24, 2008, the CBRC promulgated the *Notice of Relevant Policies about VTBs, Lending Companies, RMCCs and Microloan Companies*, clarifying the support policy of the four categories of new-type rural financial institutions in terms of the deposit reserve ratio, deposit and lending rates, and payment and settlement. The introduction of supportive policies will solve the rear troubles of new-type rural financial institutions to carry out their businesses, which is conducive to the cultivation and development of these institutions and the promotion of financial reforms in rural areas.

⑦ On May 4, 2008, the CBRC and the PBC jointly issued the *Guideline for Pilot Microloan Companies*, standardizing microloan companies from the aspects like nature, the establishment, funding sources and use, regulatory and termination, which enabled microloan companies promoted by the PBC to acquire the legal identity and opened up the funding channels for microfinance companies separately implemented by the PBC and the CBRC, being conducive to the long-term development of microloan companies.

The series of reforms are regarded not only as an act of innovation to build up a sound rural financial system in China, but also as a major breakthrough in the policy of market access to China's banking sectors, indicating that the development of China's banking sectors, especially of banking financial institutions in rural areas, will enter into a new era. Thus the issue of “*Easing Market Access for Banking Financial Institutions in Rural Areas*” was taken as an opportunity to officially launch a new round of institutional change in the field of rural finance in China centering on the establishment of diversified, market-oriented, standardized financial institutions and open markets. Since 2003 a number of rural financial policies and reforms have demonstrated that China's microfinance industry has more relaxed policy environment so that its future development will usher in a new situation.

At the same time, the *Ordinance of Lenders* was drafted by relevant departments before the end of 2008, which will contribute to the development of microfinance industry. The constitution of *Ordinance of Lenders* will help improve the legal environment where microfinance organizations exist, and identify the legitimacy of informal lending activities, and also regulate the operations of lenders, and then provide a legal basis for the disputes settlement of microcredit loan contracts. More importantly, the *Ordinance of Lenders* gives emphasis to protect the lending rights of fund owners, which is regarded as the respect for their rights to use their private properties. The establishment of this ordinance enables normative informal lending to block illegal fund channels like underground banks as well as to play an important role in promoting the financing of SMEs.

(5) It is possible for MFIs to transform

At the international level, a number of NGOs turn themselves into microfinance banks, and gradually develop and entirely become an integral part of the mainstream banking system, for instance, Banco Sol of Bolivia and Mi Banco of Peru are such cases. As for NGO MFIs, the Chinese government has no clear policy. However, with the gradual relaxation of the control of rural financial markets by the Chinese government, there are two kinds of possibilities as follows:

① NGO MFIs are allowed to register as the formal financial institutions and then exist as legitimate entities. Some member-based institutions with good performance and management may also be permitted to absorb deposits.

② Credit-only microloan companies are allowed to transform into banking financial institutions. Microloan companies promoted by the PBC have a driving force to be transformed into VTBs and some local governments are also intended to facilitate such a transformation test. Nevertheless, according to the provisions of the *Provisional Regulations on the Management of VTBs* issued by the CBRC, VTBs must be initiated by the existing banks as the main shareholder, and other natural and legal persons and their associated persons shall not take shares over 10 percent each, thus such provisions restrict the transformation initiatives of microloan companies led by private capital. However, it can be predicted that some provisions on market access set by the CBRC that are not conducive to the fairness of the market, will eventually be abandoned with the further improvement of market regulatory measures and the gradual maturity of investors.

3. Challenges Faced by Sustainable Development of Microfinance Industry in China

(1) Sources of funding

All kinds of new-type rural financial institutions have problems to a different extent regarding sources of funding. Unlike large-scale rural financial institutions, with the influence of factors like small-scale registered capital and lower-level deposits, VTBs and RMCCs have difficulties in mobilizing savings so that insufficient sources of funding become the congenital defects in the pilot phase. It is difficult for new policies to solve the problem of the funding sources in a short term. As for microloan companies, the new policies expand their sources of funding, allowing them as non-banking financial institutions to borrow from banking financial institutions, but the borrowed amount shall not exceed the 50% of their net capital. However, experts generally believe that this proportion is still low.⁵

In general, the development of most of domestic microfinance projects encounters the same problem that is the source of funding. If there is no continuous inflow of funds, these projects will not be able to continue their normal operations.⁶ As compared to foreign MFIs, the problem of funding sources of MFIs in China is even worse, which needs efforts to solve.

(2) Control of risk

Rural financial markets are full of risk so that MFIs expose to various risks, which requires that on the one hand, MFIs should have a sound risk management system in order to better ensure that the MFIs can operate in a highly efficient and low-cost way; on the other hand, the MFIs should also price their products based on the risk of the products (that is, to determine their own lending rates) so that the best pricing enables financial institutions to cover the costs and risks.

⁵ Data source: "Microloan companies walk out of "grey areas"", www.jsco-op.gov.cn/JSCO.

⁶ Data source: Xu Zhenchun & Ren Dapeng, "Research on Legislation of Rural Microcredit in China", *Rural Economy*, No. 1, 2007.

Overseas experiences have shown that, if there is no sound internal control mechanism, the risk of MFIs is much higher than that of commercial banks. This is because: ① the stability of the portfolio of MFIs is relatively poor as compared to that of traditional banks so that the asset quality might deteriorate in a short term. Microcredit is usually unsecured or not secured in full, so the incentive for borrowers to repay their loans is a wish to obtain subsequent loans from the institutions. If one borrower finds that other borrowers can not repay their loans, even if he/she repays his/her loans, he/she may not be able to get loans again, the repayment initiative will be reduced and then he/she will adjust his/her repayment decision. Such a sentiment will quickly affect other borrowers. ② the unit cost of MFIs loans is higher than that of traditional bank loans, thus if with the same amount of loan losses, the capital level of MFIs drops faster. ③ the history of microfinance development is relatively short so that operators and regulatory authorities lack the experience of controlling microfinance risk.

However, the risk control ability of China's MFIs is also very weak, the evidence of which is their high rates of non-performing loans. Take RCCs as an example, according to statistics, the non-performing loan ratio was about 15.53% in 1999 and increased up to 27.25% in 2000, and since then, it has been increasing year by year and accelerating later on. The loans that are overdue for 90 days account for 50% to 70% of total loans of microfinance projects with the government background, and the repayment rate and portfolio yield of other community organizations reach 90% and about 7%, respectively. The indicators present a remarkable gap as compared to those of foreign institutions. The high rates of non-performing loans are mainly attributive to the nature of microcredit and the specific management factors. Microcredit specifically targets the poor group, and this group itself has a high repayment risk, especially in the absence of relevant technology, management and policies, it is difficult for loans to successfully play its original role; meanwhile, the management teams of MFIs mostly consist of government officials, thus owing to lack of professionals, NGOs have no experiences and abilities in the identification and issuance of loans as well as debt recovery.

Furthermore, operational risks still exist in MFIs. Since microcredit loans don't require any collateral or guarantee, the institutions engaging in microfinance projects are at a great risk. Due to the huge impact of natural conditions on agriculture, the development of agriculture and the incomes of farmers are obviously affected by the influence of climate and weather. Meanwhile, such impact will prevail over the entire region so that the MFIs operating in such area will bear a greater risk. In addition, owing to the reasons from farmers' side and the factors such as information asymmetry, farmers are also at a disadvantage in the market economic activities, which without doubt will also indirectly increase the risk of MFIs. Operational risks also stem from the high operating costs of MFIs: firstly, most of MFIs have to rely on the government in terms of the funds, policies and personnel, thus the expenditures of personnel and office of MFIs can not be separated from those of government agencies, resulting in the serious waste of money; secondly, there are no sound financial accounting systems or no relevant professionals for supervision and control; thirdly, the costs of assets depreciation and personnel training are covered by the funding agencies for free so that these costs are not counted.

As for microloan companies, they also face a special kind of financial risks, resulting from

their ambiguous legal status.⁷ First of all, the biggest risk of microcredit still derives from the credibility of borrowers, while the integrity assessment system of the society has not been established, and the supporting laws are not in place. The existing *Law on Commercial Banks* is not applicable to microloan companies, and there are no specific rules for the issues such as the settings, disposal, pledge, and mortgage of items used for security and anti-security. The loan products of microloan companies are essentially based on the credibility of borrowers, thus the risk of credit loans is considerably huge given that a sound credit system has not yet been established in China. Secondly, microloan companies can only disburse credit loans, and they are not allowed to absorb social capital, leading to a dilemma: on the one hand, microloan companies have no legal basis to acquire the capital, and it is difficult for the central government to give any policy support regarding capital absorption due to many factors such as the supervision and credibility of microloan companies themselves. On the other hand, a fund intermediary institution is credit-only or non-deposit, which violates the conventional operation and makes it difficult for the institution to grow and develop so that its vitality is greatly restricted.

Many reasons are leading to microcredit risks:

① Shortage of funds and single delivery. The development of any microcredit business rely on the funds owned by lending institutions that can be used for lending so that adequate funds are the foundation for microfinance projects to carry out. The incentive for borrowers to repay their loans is the possibility of obtaining subsequent loans, while if borrowers are informed that MFIs have no guarantee or no follow-up source of funds, they probably do not repay or delay their payment, resulting in the failure of microfinance projects. The credit funds disbursed by China's MFIs are mainly from international assistance, donations and subsidized loans for poverty alleviation etc. However, the majority of microfinance projects fall in a serious shortage of funds within 1-3 years after the startup of projects. The loan size of microcredit is very small and can not meet the needs of farmers, which is one of the reasons for the high risk. The delivery of microcredit loans for rural households mostly focuses on the same product or the same project, leading to the geographic and industrial concentration of loan disbursement so that credit risk can not be effectively dispersed. Under the circumstance of limited growth potential of agricultural production and operation, the existence of the higher covariance risk results in low enthusiasm of RCCs in carrying out their unsecured microcredit businesses.

② The interest rates and terms of microcredit lack flexibility. In China most of MFIs follow a preferential interest rate policy with no floating or less floating. Such low interest rate policy can not make up for the high operating and management costs of microcredit so that microcredit exposes itself to the interest rate risk before loan disbursement. Moreover, low interest rate policy has also led to the occupation of funds to a large extent by wealthy farmers and enterprises, drifting away from their target group. The loan term has an impact on loan repayment schedule, the financial incomes of credit institutions, the financial expenses of clients and ultimately the sustainability of the use of loans. The loan term of microcredit is up to one year while the adjustment cycle of industrial structure of agriculture is generally longer so that it gives rise to the mismatch of microcredit loan term and agricultural production cycle, affecting the use and

⁷ Note: On April 24, 2008, the CBRC issued the *Notice of Relevant Policies about VTBs, Lending Companies, RMCCs and Microloan Companies*, enabling the microloan companies promoted by the PBC to acquire a legitimate identity, but such regulation cannot radically solve this type of risk.

turnover of agricultural funds and reducing the efficiency of use of funds.

③ Credit rating system is not sound. Microcredit theory suggests that the target of RCCs' loans should be the middle and low income class with a certain repayment capacity and a willingness to repay. In China the appraisal of repayment capacity and willingness regards the level of credit rating of farmers as a standard. Therefore, the accuracy and authenticity of credit rating of farmers are an important part to determine whether the repayment rate is high or low. In actual operation, due to the inaccurate and untimely credit file and information, rating displays its blindness; credit evaluation is subject to multiple sources of interference and influence, for instance, village cadres consider their relatives with obvious bias through falsifying data when conducting credit rating; credit rating lacks a review assuming its singularity. As a result, the people who are not qualified for loans can obtain loans in virtue of inaccurate credit rating and unscientific approved credit lines.

④ The guarantee mechanism of microcredit is not sound. The microcredit system implemented in China to a large extent replicates that of Grameen Bank. In the model of Grameen Bank, the two basic principles are periodic repayment system and group/center meeting system. On account of the implementation of these two basic principles, the repayment rate of borrowers maintains up to over 98%. This is because periodic repayments enable farmers to disperse their repayment pressure and then greatly minimize loan losses of lending institutions; group/center meeting system allows farmers to achieve mutual assistance, mutual supervision and mutual guarantee through their groups. However, microcredit for farmers in China basically adopts a one-time pay off system in the way of repayment; and the cost of convening group/center meetings is high since the rural population in China live in poor areas with poor traffic conditions, and most of residents' houses scatter in the areas. According to the survey, it takes two hours and over ten kms for some farmers to travel on both ways in order to take part in a meeting. At the same time, MFIs don't attach great importance to the center meetings so that group/center meetings exist only in name, mutual guarantee of group members loses its function, and the loan delinquency rate increases.

⑤ The post-lending management of microcredit for agriculture is not in place. The most important reason of low repayment rate of microcredit for agriculture is that the post-lending management is not in place. For a long time, the wrong recognition of "focus on disbursement rather than management" has been spreading at the grass-roots. Therefore, after the disbursement of microcredit for agriculture, the post-lending management can not keep up. Some credit officers failed to actively track the use of microcredit for agriculture and then to formulate appropriate measures for improvement in accordance with the issues being found. At the same time, there is no technical training for borrowers after the loan disbursement, leading to a high failure rate of farmers' projects, inefficient use of funds, and inability to repay loans.

In conclusion, to effectively control the risk of MFIs is an important factor affecting its sustainable development in China.

(3) Interest rate of loans

Since it is unnecessary to set up new financial organizations to deliver microcredit and the

methodology of loan disbursement is relatively easier than foreign method, China's formal financial institutions are likely to have lower cost when issuing similar loans as foreign ones, but they also require the spread of 5%-7%. Given the capital cost of about 3.5%, RCCs must set their lending rates at 8%-10% so as to achieve self-sufficiency of their projects. Therefore, the calculation of breakeven point should be based on local situation, and then a reasonable level of microcredit interest rate can be calculated by adding up normal profit.

On April 24, 2008, the CBRC issued the *Notice of Relevant Policies about VTBs, Lending Companies, RMCCs and Microloan Companies*, stipulating the lending rates of the four categories of new-type rural financial institutions: management based on the market principles, liberalization of loan interest rate cap, but the interest rate shall not exceed the ceiling set by the judiciary, that is, 4 times the bank lending rate over the same period; the lower limit is 0.9 times the loan benchmark interest rate announced by the central bank, floating rate shall be self-determined on the basis of market principles. The provisions like loan term and repayment arrangement in loan contracts shall be negotiated and determined by both lenders and borrowers in accordance with the law under the principle of fair and voluntary consultation. It is clear that to unleash the threshold of establishing microloan companies does not mean that usury can be allowed.

(4) Legal status

As for China's MFIs, unclear legal status is a major constraint for MFIs to further develop.

The pilot microloan companies of the PBC were always regarded as “special institutions” without legal status before the new policy was issued in 2008: as a company, it is bound to conduct an independent operation for profit, however, the business activities of microloan companies were greatly affected by the local government and they are strongly pro-poor. Although microloan companies are only allowed to deliver credit, they still face the problem of unclear legal status. If the legal status of an organization is not clear, the primary issue is that it can not be registered. On April 24, 2008, the CBRC issued the *Notice of Relevant Policies about VTBs, Lending Companies, RMCCs and Microloan Companies*, enabling pilot microloan companies of the PBC to acquire a legal identity, and stipulating that natural persons, corporate legal entities and other social organizations that meet the registration requirements can invest in the establishment of microloan companies, and allowing eligible microloan companies to be transformed into VTB or lending companies. Such provisions in the policy clarify the “awkward status” of microloan companies walking on the “edge” of the policy, enabling microloan companies to determine the issues such as nature, establishment, funding sources and use, and supervision based on the law, which is conducive to the healthy development of microloan companies.

At the same time, there are more than 100 NGO MFIs or quasi-governmental MFIs, their operating funds mostly depend on the donations of external organizations and individuals, thus their funding source is relatively single. Due to lack of funds, only a few MFIs can achieve institutional and financial sustainability.

(5) Governance structure

The governance structure of MFIs includes the main two categories:

① Non-profit NGO MFIs. They were generally set up with the donations of donors or the loans, so they have no real owners. In the absence of owners, the non-profit organizations have to assume that their board of directors has responsibility for their sources of funding as well as their mission. Without the supervision from consigners, the operation of these organizations mostly relies on the sense of responsibility of their leadership. In some successful NGO MFIs, their boards of directors comprise all the members with a strong sense of responsibility, thus they are effectively motivated to work hard. Meanwhile, the successes or failures of NGO MFIs are closely related to the reputation of directors, forming a binding mechanism for them to work hard and then generate an efficient governance. The success of these institutions enables them to choose whether to be transformed into a formal institution. In fact, most of institutions chose to convert to formal institutions.

② For-profit MFIs. There are usually two such institutions: one is commercial banks and financial companies; another is transformed NGOs or NGOs in transition. Unlike non-profit NGOs, the board of directors of for-profit NGOs contains owners and directors on behalf of the owners, and may also involve different types of investors – different investors have different capacity and willingness in governance. For-profit MFIs have more complicated ownership structure, and their owners may include private investors, NGO investors, the public sector of the government, and professional equity funds etc.

The main problems for such institutions regarding their governance are as follows:

a. The distortion between principal - agent relationship. A key issue of governance faced by such institutions is that it can not form an appropriate combination among directors generated by election, recruited managers and member owners. While this distorted combination can be encountered in any financial institutions, but the inherent characteristics of such institutions exacerbate this distortion. As member owners, customers can fall into two categories: net savers and net borrowers. In the operation and position of such institutions, each category of owners have their preferential choices according to their own interests. As a result, such institutions are facing not only the typical separation situation of ownership and decision-making power, but also the target dispersion of the owners. Directors are democratically elected, but they are often concerned only with the interests of his constituents, so that the different opposing factions often appear in the board of directors, which makes it difficult for them to coordinate and make efforts to achieve institutional goals.

b. The representation of the board of directors. The second issue of governance encountered by such institutions is that an unfair situation may arise when the board of directors represents the interests of net savers and net borrowers. In some credit unions of Latin America, the institutional control is in the hands of net borrowers, resulting in the inclination of institutions to offer cheap funds to the borrowers. In this traditional structure, savings get little attention, thus it is difficult for credit unions to absorb the savings funds from members. And then the small scale of savings funds have also led to their difficulties in obtaining commercial capital from formal financial

institutions. Moreover, these institutions may also have external funding in arrears, and the atmosphere of default can slowly be formed, resulting in lower repayment rate of their own institutions.

c. The lack of regulation and supervision. The third issue of such institutions is the lack of regulation and supervision. Since such institutions only mobilize savings from their members rather than obtain funds from the capital market, they are hardly subject to control in general. However, an effective monitoring can prevent managers from engaging in high-risk businesses and then protect depositors.

As for MFIs in China, the above issues of governance structure still exist in a wide range, thus how to improve their governance structures in the future development will be one of the key factors affecting their healthy and sustainable development.

(6) Monitoring system

Although China has a large number of MFIs, a complete framework and system has not yet been formed to regulate and supervise those MFIs. There exist the issues of over-regulation as well as lack of supervision, furthermore, lack of flexibility and differentiation is also one problem of regulation and supervision. Regulatory issues increasingly become a major challenge for the future sustainable development of MFIs in China.

In China, owing to the short history of microfinance development, the regulatory authorities lack the experience of controlling microcredit risk. Since 2000, with the increasing emergence of important roles of MFIs playing in poverty reduction, support for SME development and employment settlement, as well as the diversification of funding sources and the scale expansion of MFIs, the regulatory issues of MFIs are gradually floating out of the water.

In addition, the poor quality of practitioners has an impact on the sustainable development of MFIs in China. The successful experiences of MFIs around the globe have shown that the training for farmer borrowers is another key to the success of microfinance. Farmers are the vulnerable groups in market economy, and they are not sensitive enough to respond to quickly changing market, and they don't fully understand the appropriate technology. Therefore, the implementation of microfinance projects requires large-scale training programs to be conducted for farmers so as to enhance their capabilities in utilizing market information, new technologies and loans. At the international level, microfinance projects usually take out a lot of training funds. In China, farmers need more relevant training. They need not only to be aware of new technologies, but also to learn how to adjust their own cultivation and animal husbandry projects, as well as production methods based on market needs. The better training can greatly increase the success rate of investment projects, meanwhile, it can reduce the risk of microcredit loans. In institutional settings, China's RCCs have no capacity to conduct large-scale training for farmers, so it requires the intervention of local government, for instance, local government allocates special funds for the training programs for farmers who participate in microfinance activities.

VII. The Suggestions on Sustainable Development of Microfinance Industry in China

With reference to the success of microfinance over the world, it can be observed that the successful factors are manifold. However, in terms of the component elements of building inclusive financial sectors, these successful factors can be summed up as three levels of micro, meso, and macro:⁸

Firstly, at the micro level, it is necessary to create a system for those MFIs serving the middle and low income population and microenterprises with microfinance based on competition, including NGO MFIs, PSBC, RCCs, loan companies, member-based community financial organizations (community development funds and community credit cooperatives etc.), regional, local, small private and state-owned commercial banks, as well as other non-banking financial institutions, such as financial companies, insurance companies, finance companies, and leasing companies. It should even allow non-financial institutions to provide microfinance services.

Secondly, at the meso level, it is suggested to construct one institutional basis to ensure the competitive operation of MFIs, including customers credit system, sound rating system for MFIs, audit oversight mechanism, payment system, liquidity guarantee mechanism, disclosure mechanism of MFIs' operation information, and to create mechanisms that are conducive for MFIs to enter into domestic and foreign currency and capital markets, such as distribution of microfinance venture capital fund, bond issuance, asset securitization and so on, and even to set up a sound deposit insurance system, providing institutional guarantee for the operation of microfinance system within which institutions achieve the diversified development.

Thirdly, at the macro level, it is recommended to build up a sound legal framework and constitute rules and regulations for microfinance, including the relatively liberal system arrangements for microfinance market access, and the system framework of non-prudential regulation implemented by the government for microfinance, and to improve the supervision means and monitoring mechanisms, and to ensure the independence and effectiveness of regulation and supervision. In addition, it is necessary for the government to involve in fostering a good financial ecological environment. The participation of the government and the cultivation of both a healthy credit culture and a financial eco-environment are an environmental foundation for the benign sustainability and existence of small banking financial institutions.

To sum up, the construction of a rural microfinance system needs to be based on four points: (1) it is conducive to surmount the information asymmetry; (2) it helps overcome the financing plight of farmers and microenterprises due to the lack of collateral; (3) it increases the accessibility of farmers to financial resources; (4) it promotes financial efficiency with a market-oriented model. Constructed according to the above four points, a rural financial system

⁸He Guangwen, "Basic Elements of Microcredit Success", China Finance, No.7, 2008.

should be an inclusive financial system in which all the people with financial needs including all middle and low income groups are able to enjoy financial services. Therefore, the improvement of China's rural financial system and inclusive financial sectors requires a comprehensive coordination, taking all factors into consideration. It must be achieved to adhere to the mission of serving the “Agriculture, Farmers and Rural Areas”, and to hold a target conducive to rural economic development, and to consider the obvious imbalance in actual economic development across the country as well as the objective demands of rural financial development, enabling policy finance, commercial finance and cooperative finance to realize mutual cooperation and coordinated development. In order to further improve China's inclusive financial sectors, the following policy recommendations are mentioned by the writer:

1. To Change the Cognition and Orientation of Microfinance

Microfinance is not only an important method of reducing poverty, but also an innovation of financial services. The two objectives of serving middle and low income groups at a large scale and realizing institutional self-sufficiency can be consistent. On the one hand, it should be emphasized that microfinance serves specific groups and special operation approaches are required by this special market so that relevant policies and regulatory measures can be in place without deviating from their expected objectives; On the other hand, it should be stressed that microfinance needs to achieve sustainability, and that in the light of international experiences and with the guidance of market principles, its operation strategies and business objectives should be transferred from project-based to institution-based, from subsidization to sustainability, and from government-driven to market-driven. Meanwhile, it should also be paid attention to develop small-scale commercial credit institutions, to improve the efficiency of microfinance, to coordinate the relationship between poverty alleviation activities of the government and business practices of microfinance, and to simultaneously achieve political objectives and economic goals.

2. To Establish a Sustainable Inclusive Financial System and to Construct An Institutional Foundation for Microfinance Development

The concept of an inclusive financial system is same as the guiding ideology of establishing a modern rural financial system raised at the Third Plenary Conference of the 17th Session, that is the establishment of a multi-level, wide coverage and sustainable financial system. To this end, it is necessary to nurture and develop multi-level financial organizations with various types of ownership and various forms of governance, meeting the needs of all kinds of markets.

(1) To clarify the function orientation of rural commercial finance

In China's rural financial markets, the commercial financial institutions mainly include RCCs, PSBC, new-type rural financial institutions, local commercial banks and branches of state-owned commercial banks. It is undeniable that given that state-owned commercial banks contract their agricultural credit operations, the ADBC orients its business towards the purchase of grain, cotton and oil so that its role is limited. Thus the major tasks of developing rural financial markets fall on such commercial financial institutions as RCCs and PSBC. Consequently, it is necessary to

continue to deepen the reform of financial institutions in rural areas such as RCCs and ABC, to identify their functions and positions, and to form a system of rural financial institutions with mutual coordination and cooperation and complete function.

(2) To construct financial markets with appropriate competition

For example, two pairs of competition can be formed for different types of loans: as for general business loans, the competition should be created among RCCs, local commercial banks and ABC; as for loans reaching out to households and microfinance, the competition should exist between RCCs and rural MFIs. Only with competition, a more reasonable level of capital price and interest rate can be formed and social capital can be guided into the agricultural economy through these financial institutions. The mechanism of market competition can direct informal lending and enable it to play a complementary role in the formal financial system.

(3) To create new-type professional or policy-oriented banking institutions and to provide policy financial support for the development of microfinance

① To establish rural land banks. Rural economy has experienced some new changes. Given that the double operation systems of household contract have been stabilized, a number of new operation forms have emerged, for instance, the farm land is concentrated in the hands of farming masters and rich families growing grain. Therefore, it is necessary to timely launch rural land banks, and to promote land improvement, land operation at a large scale and land circulation by using policy loans, and to ensure synthetic food production capacity, and to achieve “storing grain in farmland” and to eventually safeguard national food security.

② To set up rural policy-oriented credit institutions for real estate. Farmers have insufficient production capital, besides, they also make consumption investment in fixed assets like houses, resulting in a shortage of funds. Therefore, it is necessary to timely establish rural policy-oriented credit institutions for real estate. With the support of rural policy-oriented credit institutions, the following functions can be achieved: Firstly, to enable farmers to gradually release their investment in house building, and to ease the phenomenon of squeezing productive capital by consumption investment in fixed assets. Secondly, to transfer consumption investment to productive investment by offering mortgage loans. Thirdly, to save land resources and to reduce the occupied space of agricultural production through the concentrated and connected development of real estate. Fourthly, to speed up the construction of small towns and to promote the process of urbanization.

(4) To gradually build a system of non-banking financial institutions

① To establish agricultural insurance companies (or the existing insurance institutions issue agricultural insurance), and to expand rural microinsurance market. Firstly, it should address the fear of the agricultural insurance, and start to deliver the insurance with smaller risk, and then the experience can gradually be accumulated. Along with the development of agricultural productivity and the improvement of the ability to resist disasters, the probability of compensation payment will continue to reduce. Secondly, it should be partially funded by the state finance, and then raise

capital in the whole society so as to expand agricultural insurance companies and to reduce operational risks.

② To set up a variety of fund companies in rural areas, and build a rural micro fund market system. Firstly, to establish investment funds for agricultural industrialization. The central budget should increase the investment in agricultural industrialization projects, and the local finance should also take part of funds to set up the investment funds for agricultural industrialization, and organize all agricultural, financial and operational talented persons to establish investment fund management companies so as to maintain and increase their value as much as possible. Secondly, to utilize capital markets, and to build venture capital funds for agriculture and to conduct industrialized operations.

③ To actively create conditions for the gradual establishment of the rural capital market system. Firstly, to encourage oriented fundraising and to implement joint-stock operations. Secondly, to give priority to the leading enterprises of agricultural industrialization and to approve them to be listed. Thirdly, to form agricultural venture capital banks. It can guide social capital to invest in agricultural science and technology industrialization projects with high-tech, high-yield, high-return and high risk by use of project demonstration advantage of venture capital banks. Fourthly, to strive to create superior investment environment, and to dredge capital channels and to attract more capital flows in China's rural microfinance market.

④ To establish a rural credit guarantee system. In general, the credit capacity of rural enterprises or individuals is weaker and lacks qualified collateral, thus it is necessary to build credit support institutions and to provide credit guarantees for rural enterprises and individuals in order to increase effective demands for microfinance in rural areas.

(5) To guide the creation of wholesale MFIs

Wholesale MFIs, in particular microfinance investment funds, are the basis of funding sources for the healthy and stable development of microfinance industry.

(6) To provide financial infrastructure for microfinance

The development of MFIs also requires a number of intermediary services, such as microfinance customer credit information systems, management information systems, rating systems for MFIs, audit and supervision mechanisms of MFIs' operation, and mechanisms for MFIs to enter domestic and foreign currency markets and capital markets, and so on.

3. To Increase Government's Efforts to Support Microfinance and to Offer Institutional Environment for Microfinance Development

(1) To adopt preferential policies and measures like tax reduction or exemption and financing convenience

The central bank and financial departments should adopt favorable policies to a certain

degree in taxes, financing and interest rates, especially in tax policy, they should give MFIs special preferential arrangements. Besides, they should explore the feasibility of relending to MFIs, and reduce the high threshold limit in an interbank market so that MFIs can conduct free financing activities in the interbank market and then increase the supply of funds in microfinance market.

(2) To speed up the construction of social credit system and to cultivate a good credit environment

Firstly, to establish a social credit system and the credit information database of rural enterprises and individuals, and to network at the national level and to achieve information sharing. Secondly, to implement a credit rating system, and to build the sound evaluation indicator system and supervision mechanism of personal credit. Credit rating agencies carry out an objective and fair assessment for rural enterprises and individuals according to a standardized indicator system and scientific assessment methods. Loan guarantee agencies with certain conditions can collaborate with the local PBC to inquire individual credibility in the investigation before loan disbursement. Thirdly, to increase the education of personal credit awareness, and to set up an effective mechanism combining default and punishment, and to adopt different credit reward and punishment mechanisms for enterprises and individuals with different credit rating so as to constrain the behavior of main financial consumers. Fourthly, to effectively maintain financial creditor's rights, and to strike debt escaping activities, and to rectify the whole order of credit environment and optimize the credit environment.

(3) To respect the operation autonomy of MFIs and to reduce inappropriate administrative intervention

Firstly, the government should change the methods of leading and managing MFIs, and fully respect the autonomy of business operations of rural financial institutions without interfering in their normal operations. Secondly, law enforcement agencies should normalize their working activities and hold an objective and fair attitude to tackle various kinds of financial cases. When police, procuratorial, and juridical departments deal with disputes cases of microfinance, they should eliminate local protectionism, and handle them according to the law without any bias to any side.

(4) To achieve sustainable development of microfinance through institutional innovation

To adopt a more flexible interest rate policy for microfinance, and to allow MFIs to freely determine their interest rates based on the market mechanism and under the supervision of the law; to set up microfinance guarantee funds so as to create conditions for MFIs to obtain funds from financial markets; to properly promote the improvement of MFIs towards deposit-taking institutions; to continue to expand the experiment of market-oriented profit-seeking financial institutions like microloan companies, at the same time, to play the role of regional financial institutions; to carry out pilot projects regarding diversified and multi-ownership MFIs so as to create relaxed policy conditions for new financial institutions with an independent legal qualification in the county and to facilitate the financing of citizens, and to reduce the threshold

of engaging in legitimate financial activities and thus to effectively reduce the probability of people engaging in illegal financial activities; to properly introduce private capital and foreign financial institutions and to create financial environment with appropriate competition, and to improve the level and quality of microfinance services.

(5) To strengthen the legislation, and to further improve the policy and legal environment, and to regulate the development of microfinance market

As for microfinance business, relevant policies and regulations in China are still limited to related issues of microloan companies, thus it is necessary to improve the regulatory systems regarding further market-oriented interest rates as well as allowing commercial banks to involve in rural microfinance industry. Besides, it should be guaranteed that commercial banks involving in rural microfinance industry are less vulnerable to administrative intervention in the region so as to ensure the commercialized operation of their businesses.

4. To Build an Environment for the Sustainable Development of Microfinance

The trend of international microfinance industry is to develop commercial and sustainable MFIs guided by market-oriented principles. Sustainable microfinance should be the development direction of microfinance industry in China, at the same time, the success of microfinance must be equipped with some basic elements:

- (1) To establish an incentive mechanism for clients to take initiative to repay loans.
- (2) To design a mechanism in favor of the mitigation of repayment pressure.
- (3) To identify the high time cost related to small size, short term and multiple installments.
- (4) To create a business development mechanism in favor of approaching clients and realizing information symmetry.
- (5) To build a participatory expansion model of microfinance business.
- (6) To adopt general operation principles of market economy.
- (7) To absorb the characteristics of informal self-help groups and cooperative organizations and externalize the operational costs.
- (8) To promote the construction of microfinance credit culture.

5. To Normalize and Effectively Implement the Regulation and Supervision of Microfinance

From the perspective of promoting microfinance development, regulatory agencies should clarify the access and exit mechanisms of MFIs, and ensure their legitimacy and normalization, and facilitate the integration of microfinance and formal financial system, and maintain its consistency with the development of financial system and the prudence of its supervision through relevant legal and institutional arrangements. Meanwhile, they should provide technical assistance

for the establishment and operation of MFIs. On the one hand, they should strengthen exchanges, cooperation and personnel training, on the other hand, they should help MFIs to carry out the construction of infrastructure so as to enhance the management level of MFIs.

(1) To strengthen the financial regulation and supervision of rural financial institutions in general and RCCs in particular by the regulatory bodies, and to urge rural financial organizations to reinforce internal control system, improve the governance structure, and enhance the capacity of self-restraint and the management level.

(2) To intensify the supervision and inspection of the asset quality, profit and loss situation, internal control mechanism of rural financial institutions, to strict the management of senior managers and key operational personnel, and to prevent and dissolve financial risks.

(3) To enlarge the application of financial warning system, to adopt early intervention counseling and intensified management model, and to strengthen professional consultation for both RCCs and grass-roots organizations of state-owned commercial banks with high operational risks so as to correct deficiencies in their operations and reduce operational risks as early as possible.

(4) To break monopoly and eliminate disorderly competition, and to maintain good order in rural finance, and to resolutely crack down on illegal rural financial organizations and their illegal activities.

6. To Combine Microfinance Development and Cultivation of Rural Cooperative Social Service Organizations

When farming businesses with a small scale integrate with market economy, the first problem is the weakness of rural social service organizations. Informal cooperative service organizations are created through the voluntary unity of farmers who have already begun the professional production of some agricultural products and these organizations conduct self-operation, self-service and self-monitoring, which is the most vital form among rural social service organizations. The development of microfinance and the cultivation of such voluntary associations of farmers are highly complementary, and their combination is bound to play a positive role in rural economic development. It is necessary to respect the demands of poor farmers who suffer extreme financial distress but have urgent needs for funds to develop their production, to protect their rights to receive financial services apart from the corresponding microfinance system guarantee, and to believe the initiative and creativity of self-management of those borrowers, because it is closely related to the change of their own destiny and they have a strong internal drive to find new ways to make themselves and other members out of poverty.

7. To Build and Improve Entrepreneurial Training and Microfinance Linkage Mechanism

Microfinance is often linked with microentrepreneurship, therefore, the first is to increase entrepreneurship training and strengthen the training related to integrity education and business management, and to improve the quality of entrepreneurship training, and to promote the full

implementation of supportive policies such as micro guarantee loans, tax relief or exemption and workplace arrangements etc. The second is to enhance the coordination and cooperation of entrepreneurial training organizations and MFIs, to further carry out the tracking management and guidance services for entrepreneurship training personnel, and to improve the stable operation rate of entrepreneurship. The third is to reinforce the building of expert teams for entrepreneurship guidance and increase the quality of services, and to help entrepreneurs undertake the demonstration and evaluation of start-up businesses before loan appraisal and then provide effective follow-up guidance services after loan disbursement.

8. To Conduct Financial Education and to Establish Credit Culture

Finance has been playing an important role in the allocation of resources in present economy, while financial risks will also bring tremendous trauma for the development of material economy. As a result, it is necessary to enhance the financial quality of the population and the prevalence rate of financial knowledge, and to improve the quality of financial professionals. Both the quality of financial professionals and the education of the majority of investors and consumers as the recipients of financial services are extremely important for the sound growth of finance and the harmonious and stable development of the whole society.

In terms of the number of people on demand, the demand bodies for microfinance in China include farmers, microentrepreneurs in urban and rural areas, entrepreneurs and unemployed persons in urban and rural areas, but the improvement of their financial awareness, credit awareness and indebtedness consciousness is a key element of the development of microfinance industry. Therefore, it is necessary to conduct comprehensive financial education and training activities for urban and rural grass-roots cadres, farmers, urban and rural microentrepreneurs, and undertake microfinance businesses and technical training activities for credit backbone staff of financial institutions under the county level and microloan companies, and to carry out the training activities related to relevant laws and regulations, microfinance and agricultural insurance and the management of microloan companies as well as microfinance methodology etc., which is also advocated by Madame Wu Xiaoling, the former vice governor of the PBC, and she has also suggested to “promote economic development by conducting financial education”.

Financial education toward microfinance demanders and investors should be regarded as an important aspect to promote the development of microfinance industry. The first is to change the credit awareness of its demanders and investors and forge an environment with integrity through the popularization of microfinance knowledge. The second is to enhance the quality of microfinance practitioners and to promote the development of microfinance industry as well as the standardization process. The third is to comprehensively facilitate the application of microfinance technology, and to provide financial support for microfinance demanders so as to solve their difficulties in raising start-up funds.

Microfinance education can be divided into three tiers: the education of the professional conducts and professional skills of microfinance practitioners, the education of recipients, consumers or investors of microfinance services, the education of potential recipients of microfinance services and of the overall population.

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