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Microcredit in China: Recommendations for Policy Makers

中国小额贷款：对于政策制定者的推荐

Abstract

This is the first of a series of planned reports on microcredit in China. In this paper we offer our view of what is preventing microcredit from developing in China and offer a list of recommendations for Chinese policy makers that wish to promote this sector. Our preliminary analysis suggests that microcredit is not developing fast in China due to a set of regulations that need to be amended, the tight economic viability of a microcredit companies, the lack of access to both domestic and international capital markets as a source of funding, and lack of true microcredit service offered by Village Banks. Our main belief is that while the various initiatives of several NGOs operating on a non-profit basis in China are laudable and successful, even within the limited scope in which they operate, a true development of microcredit in China that can make a real impact on the vast number of mid-low income residents can only occur if a double-bottom-line approach is implemented. That is both serving the social mission of helping poor people and establishing financially viable lending entities. Therefore, we propose the creation of a new more flexible type of institution, regulated by a new body, independent from the China Banking Regulatory Commission. The new microcredit institution will be allowed to receive customer deposits, will not have strict minimum capital

requirement, can operate across a whole province, is tax-exempt and can accept investment from both domestic and international investors. In exchange for these relaxed rules, such a new microfinance concern (that we will call 'Microfinance Company Plus Deposit', or MCC+D), will have to commit to serve the low-income population, and have maximum loan size capped, so that true micro-loan products are offered. This report is aimed at Chinese policy makers, in Central and Local Governments, People's Bank of China, China Banking Regulatory Commission, as well as existing and potential practitioners and investors who wish to gain an initial assessment of the industry. The first section of the report briefly introduces some key relevant facts; in section two, we highlight current problems and, at the end, we offer some policy recommendations. Our conclusions are the results of field visits to the Association of Rural Development of Yilong county, in Sichuan province, plus several meetings and exchange of views with many organisations, including, UNDP, PlanetFinance, Chinese Academy of Social Science, HSBC, Grameen, GTZ, Graduate School of People's Bank of China, staff and students at Zhejiang University and London Metropolitan University.

1. Microcredit in China – Industry Overview

Definition of microcredit

Generally speaking, microcredit consists of the provision of small-loans (from a few hundred to a few thousand dollars) to both individuals and micro-enterprises mostly in rural but also in urban areas, without the need of collaterals. Loan size is generally defined as no more than 70% of an area's GDP per capita (Giehler 2008), although this is a topic of heated debate.

Using such a definition, due to the large variations of GDP per capita across Chinese provinces, and even more across counties, the meaning of what is truly microcredit varies. Of course, the generally used definition of 70% of GDP is not a strict limit, but it is useful as a way to assess if a certain organization's activities fall within the scope of microcredit. As a result, while in Shanghai a loan value of 50,000 RMB would fall under the heading of microcredit, in Guizhou province, a loan of more than 6,000 RMB is already close to the upper limit. Figure 1 shows GDP per capita and generally accepted maximum loan size per province, according to the 70% of GDP rule. Of course, not everyone uses the same definition of microcredit and this creates confusion in the industry, as some companies even consider 'microcredit' loans of 1m. RMB. Notwithstanding this premise, in this report, we will argue for an even stricter definition of microcredit that we will define as 1x each individual customer's annual income, as discussed in Section 3.

Figure 1 – GDP per capita breakdown by province and max theoretical microcredit loan size (RMB)

Province	GDP/Cap	Max microcredit loan value	Province	GDP/Cap	Max microcredit loan value	Province	GDP/Cap	Max microcredit loan value
Shanghai	72,536	50,775	Jilin	23,497	16,448	Hunan	17,487	12,241
Beijing	61,876	43,313	Hebei	23,164	16,215	Qinghai	17,347	12,143
Tianjin	54,034	37,824	Heilongjiang	21,723	15,206	Hainan	17,087	11,961
Zhejiang	41,967	29,377	Shanxi	20,345	14,242	Sichuan	15,368	10,758
Jiangsu	39,483	27,638	Hubei	19,840	13,888	Guangxi	14,891	10,424
Guangdong	37,402	26,181	Xinjiang	19,727	13,809	Jiangxi	14,728	10,310
Shandong	32,995	23,097	Henan	19,523	13,666	Anhui	14,465	10,126
Inner Mongolia	32,157	22,510	Shaanxi	18,212	12,748	Tibet	13,795	9,657
Liaoning	31,199	21,839	Chongqing	17,952	12,566	Yunnan	12,547	8,783
Fujian	30,031	21,022	Ningxia	17,784	12,449	Gansu	12,085	8,460
						Guizhou	8,789	6,152

Source: National Bureau of Statistics, 2009

We prefer to use actual income per capita instead of GDP per capita, because in China, the relationship between GDP per capita and income per capita has experienced a disconnection, as wages have been kept low and most of the value created by economic growth has been concentrated in the corporate sector rather than at individual level.

The market for microcredit

It has been estimated that one third of the rural population (some 250m.) have no access to credit, and a significant proportion of these may be expected to qualify as potential recipients of microcredit (PlanetFinance 2009). This is in addition to those urban residents that similarly lack access to credit. For unlike what is generally assumed, microcredit is not solely aimed at rural residents, but at all low-income people. In urban areas these will included, for example, laid-off urban workers, micro-entrepreneurs, or simply very low income residents. Indeed, due to the large number of migrant workers who are moving to cities, the number of low-income urban residents, potential beneficiaries of micro-loans, tends to grow over time. In addition, as is set out below, the official registration system over-records rural residency and under-records urban. Thus, the market for microcredit in urban areas tends to be underestimated, even completely neglected, while that for the rural areas is exaggerated.

> ‘It has been estimated that one third of the rural population (some 250m.) have no access to credit’

According to data from the National Bureau of Statistics (2009), in China there are 720m. rural residents, or 200m. households. However, the actual number of citizens living in rural areas is very much less than these official figures suggest. There are two reasons for this. Firstly, according to the official definition, the large number of Chinese rural migrant workers living in cities and towns and returning home once or twice a year are still considered as rural residents because they send back the majority of their incomes to rural-based homes. Secondly, where a person moves to a city for many years, an event that would make them a true urban resident, they do not register their new residency and so keep their ‘rural’ hu kou.

Estimating the total number of current customers that receive microcredit services is highly problematic, as everyone’s definition of microcredit is different and there is a shortage of detailed data. It has been estimated that there are some 3.5m. micro-credit customers in China. While this is a very low number given the potential market, we believe that it is a serious overestimate. The 3.5m. estimate includes the 2.5m. customers of the Postal Savings Bank. However, these have an average loan size of 50,000 RMB;

only 10-15% of customers borrow less than 20,000 RMB. Similarly, in Zhejiang province, of the 50,000 so-called microcredit customers, over 50% borrow more than 1m. RMB. Hence, it would seem likely that of the estimated 3.5m. microcredit customers, only about half a million receive true microcredit services. However, while it seems clear that there is a very large potential market for microcredit, there is a need for some detailed research at the national level to determine the exact scale, nature and distribution of the demand. This will be the subject of our future reports.

Distribution of Microcredit Institutions across China

Currently, in China, microcredit services are offered by three main types of companies:

- NGOs
- Registered microcredit companies (MCC)
- Town/Village Banks (TVB).

A recent report by People's Bank of China (2009) shows there were, as of end of 2009, 1,334 registered microcredit companies, about 100 organisations operating as NGOs and a similar number of Village Banks (see Figure 2).

This suggests that there has been some significant increase since the end of 2008, when there were approximately 500 MCCs, 100 NGOs and 50 Village Banks. Most of the increase has been driven by newly registered MCCs, and a small increase in the number of Village Banks, while the number of NGOs has remained static. One could infer that the more than doubling in the number of MCCs indicates a healthy growth of the sector and that, indeed, MCCs represent the most dynamic player in microcredit in China. Unfortunately, as we will discuss later, this does not necessarily follow. Indeed, according to People's Bank of China report, almost all newly registered MCC reached a capital ratio of 82% within few months of starting up, suggesting that much of the funding was not only not new money flowing into the microcredit sector, but in many cases comprised funds that has already been lent.

Looking at the distribution of microcredit institutions across province, we noticed an over-representation of Inner Mongolia (which made up 11% of the country

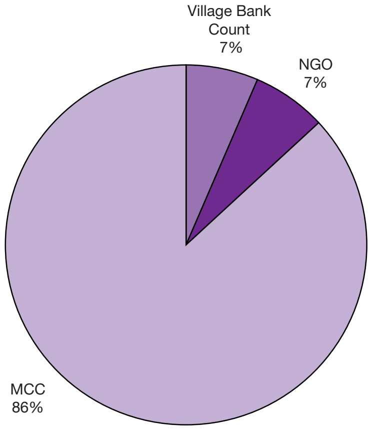


Figure 2 – Distribution of microcredit institution by type (data for end of 2009)
Source: People's Bank of China, 2009

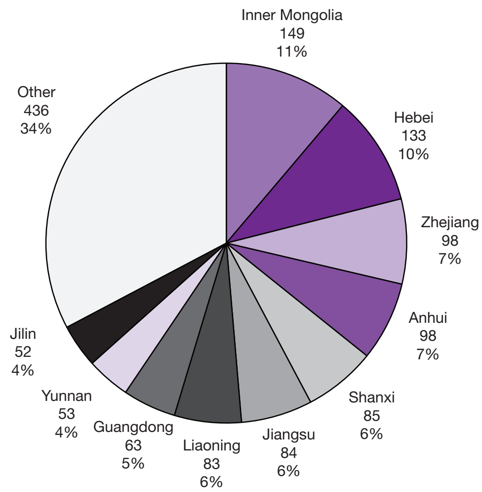
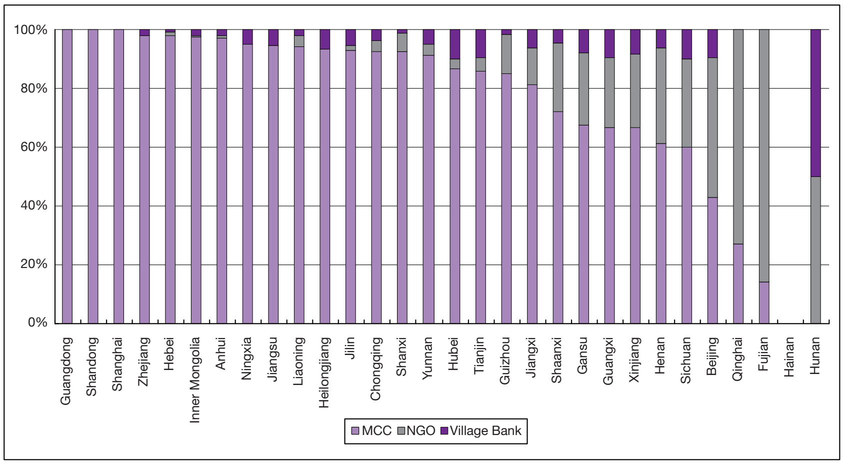


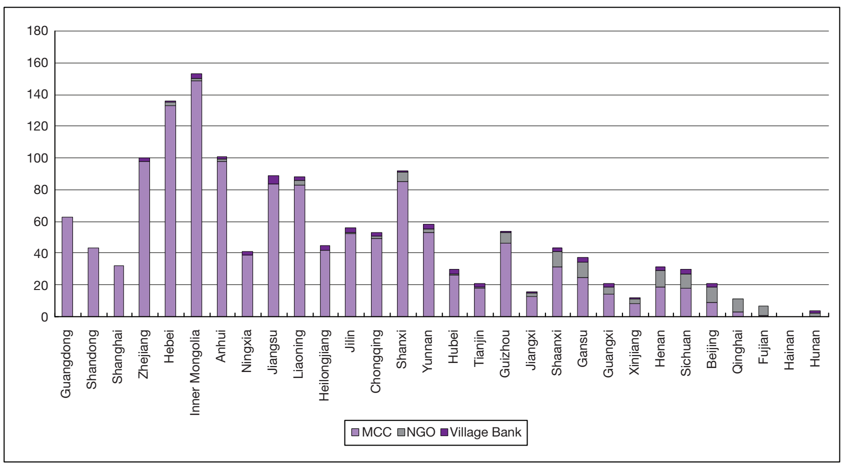
Figure 3 – Microcredit institutions break-down by province (data for end of 2009)
Source: People's Bank of China, 2009

Figure 4 – Distribution of Micro Finance Organisations by type and province (data for end of 2009)



Source: People's Bank of China, 2009

Figure 5 – Number of microcredit institution broken down by province (data for end of 2009)



Source: People's Bank of China, 2009

total), followed by Hebei with 133 institutions (10% of country total), Zhejiang with 98 institution (7% of country total) and a gently declining contribution from other province. Figure 3 shows the breakdown.

When we combine the data on type of institution with the geographic distribution, an interesting picture emerges, with some provinces having a very high proportion of MMC registered companies and some others a high proportion of NGOs (see Figures 4 and 5). For example, in Guangdong, Shandong and Zhejiang, the three pillars of China's export industry, MCC represent almost 100% of total lending institutions, while in the less developed areas of Qinghai, Gansu, Sichuan, NGOs have a higher representation. It appears strange that just where the provision of microcredit facilities is most needed, investors are not attracted to these markets and prefer the higher-income, more developed provinces. Perhaps, other forces are in play. Once again, we find that analysing China as a whole poses serious problems and there is a need for some further detailed research.

Review of current policies governing microcredit institutions

The three main types of entities offering microcredit services in China (NGOs, MCC and Village Banks) are subject to different regulations and have enormously different degrees of flexibility. The China Banking Regulatory Commission (CBRC) in conjunction with People's Bank of China (PBC) issued in May 2008 some guidelines (Rule 23) governing the establishment and operations of microcredit companies. Subsequently, in June 2009, CRBC and PBC issued a set of requirement for any microcredit entity that wish to transform its legal status into a Village Bank (Rule 48). However, Rule 23 only provides some 'minimum requirements' guidelines, but every province has the authority to impose even more stringent rules, and in practise only in a few regions of China, is Rule 23 applied in its pure form. Figure 6 summarises the characteristics of each type of entity, while

Figure 6 – Types of micro-credit companies, scopes of operation, requirement and regulations

Type of Organisation	Sources of Fund	Geographic origin of funds	Product rage	Shareholders requirements	Tax Treatment
NGO	Only donations	Worldwide	Micro loans Cannot receive deposits from the general public		Tax exempt
Microcredit companies (Rule 23)	Donations, equity and debt investment gearing (debt/equity) cannot exceed 50%	Donation (World wide) Equity Debt Overseas direct investment (debt or equity) is not forbidden, but in practice complicated	Micro loans only. Cannot receive deposits from the general public Outstanding loan from the same borrower cannot exceed 5% of total net capital Interest rate cannot exceed 4x the statutory rate (this rule is probably going to be lifted soon)	Each shareholder (or connected parties) cannot hold more than 10% of total share capital. For companies limited by shares, 51% of shareholders must be companies registered in China	5.3% business tax, plus 20-25% enterprise income tax
Village Banks (Rule 48) or scaling down operations	Donations, equity and debt investment, customer deposits	As banks or financial institution, international investment falls under the 'restricted' list of the Ministry of Commerce and the State Development and Reform Commission	All banking services, loans, deposit, card, money transfer etc Agricultural loan must represent at least 60% of total	If domestic, must be in good financial standing and been profitable for two consecutive years prior to the application. If foreign, must have total asset of no less than US$1bn.. as of the end of previous year;	5.3% business tax, plus 20-25% enterprise income tax

Source: Derived from rule 23 and Rule 48, see China Banking Regulatory Commission, May 2008 and June 2009

Figure 7 shows each local implementation, province by province (Graduate School of The People's Bank of China 2008). The important elements that we wish to bring to your attention are:

- **NGO** can only be financed through donations/aid. They cannot raise equity or debt capital and cannot receive customer deposits. In practice their only source of funds is donations. Areas of operation are limited to each county where a permit is granted and are tax-exempt (being non-profit).
- **Microcredit companies (MCC)** can accept equity and debt investments, in theory also from overseas investors, but in practise foreign capital does not often find its way into this industry. Like NGOs, they cannot mobilise customer deposits and must obtain approval from the relevant authority for each county in which they wish to operate. They must have a minimum registered capital (Base Rule) of 5m.RMB or 10m. RMB, depending on whether the entity is registered as a limited liability company or as a joint stock limited company. As we mentioned above, minimum capital requirements vary substantially from province to province, mostly as a result of varying the multiple of the Base Rule. Multiples range from 1x Base Rule (as in Inner Mongolia) to 8x and even 10x, i.e. 100m. RMB for a company limited by shares (as in Hebei, Beijing, Tianjin, Zhejiang, Shandong). MCCs are taxed like commercial companies and must have a minimum of 10 shareholders each of whom cannot hold more than a 10% of share capital. The maximum amount of debt that an MCC can

Figure 7 – Provincial variations in Rule 23 (Base Rule)

Rule 23, Nation-wide Guideline (Base Rule)	**Limited Company 5m. RMB**	**Company Limited by Shares 10m. RMB**
Province	**Minimum Registered Capital Requirements (RMB)**	
Beijing	50m. (10x)	100m. (10x)
Tianjin	More than 50m. (10x) and less than 200m. (40x)	More than 100m (10x). and less than 200m. (20x)
Hebei	50m. (10x)	80m. (8x)
Shanghai	20m. (4x)	50m. (5x)
Jiangsu	Range from 20m. (4x) to 50m. (10x), depending on the local area	Range from 20m. (2x) to 50m. (5X) depending on the local area
Zhejiang	50m. (10x), with some exceptions, such as Wenzhou	80m. (8x), with some exceptions
Fujian	Not Available	Not Available
Shandong	50m. (10x)	70m. (7x)
Guangdong	30m. (6x)	50m. (5x)
Hainan	15m. (3x)	20m. (2x)
Liaoning	From 20m. (4x) to 30m. (6x)	From 30m. (3x) to 50m. (5x)
Jilin	10m. (2x)	20m. (2x)
Heilongjiang	10m. (2x)	20m. (2x)
Shanxi	50m. (10x), with three exceptions	50m. (5x) with three exceptions
Inner Mongolia	5m. (No Difference)	10m. (No Difference)
Anhui	20m. (4x)	40m. (4x)
Jiangxi	Not Available	Not Available
Henan	20m. (4x)	40m. (4x)
Hubei	10m. (2x)	20m. (2x)
Hunan	Not Available	Not Available
Shaanxi	30m. (6x)	60m. (6x)
Guanxi	5m. (No Difference)	10m. (No Difference)
Chongqing	20m. (4x)	30m. (3x)
Sichuan	50m. (10x) or 100m. (20x) if registered as national companies	50m. (5x) or 100m. (10x) if registered as national companies
Guizhou	5m. (No Difference)	10m. (No Difference)
Yunnan	10m. (2x)	20m. (2x)
Tibet	Not Available	Not Available
Gansu	10m. (2x)	20m. (2x)
Qinghai	10m. (2x)	20m. (2x)
Ningxia	Not Available	Not Available
Xinjiang	From 5m. (no difference) to 50m. (10x), depending if operates at county or provincial level	From 10m. (no difference) to 100m. (10x), depending if operates at county or provincial level

Source: Graduate School of the People's Bank of China, 2008 raise cannot exceed 50% of registered capital and the debt can come, at most, from two banks.

- **Town/Village Banks**, simply put, are just like any other bank: they can take customer deposits and offer all kinds of additional financial services; they are often referred to as microfinance companies, as their scope of business extends beyond microcredit per se, as they are allowed to offer the full range of financial services. They can be financed by debt or equity and fall under the strict supervision of CBRC. As financial institutions, they are regulated by the Ministry of Commerce and State Development and Reform Commission. They must have a three year operational history and have been profitable for the last two years. Furthermore, over 60% of their loans must be to agriculture.

2. Microcredit in China – Current Issues

In this section, we highlight what we perceive are the main issues that are preventing microcredit in China developing into a large-scale industry, contributing to development in rural areas and helping low-income strata in urban areas.

It is perhaps natural to think that China would be an ideal candidate for microcredit services: it has a large rural population (even if smaller than official 720m.); a significant portion of the population – about 100m. people – still live in poverty; and, despite being the second largest economy in the world, its GPD per capita and more especially income per capita, remain low. Micro-loans could be used by Chinese farmers to acquire seeds, fertilizers, small machinery, transport vehicles, and to make other small investments, including in the education of their children. Thus, microcredits that will help poor people increase their income, live with more dignity and, above all, hope. Overall, it will help narrow the existing income disparity between urban and rural areas, and between high-income and low-income urban citizens.

However, despite a great deal of effort, some local success stories, like ARDY (Association for Development of Yilong) and Microcred Nanchong, new regulations and Government policies aimed at encouraging the development of rural areas (see the recently published Document No.1[1]), the microcredit industry in China has not yet developed its full potential. It is estimated that only one third of the rural population has access to some sort of credit services, but not all is microcredit. This leaves a large untapped demand from potential customers who just cannot get access to basic financial services. The bottleneck is, therefore, in the supply-side.

In our view, the reason for this is three-fold: firstly, microcredit in China is too focused on a social mission; that is serving the needs of poor people, almost as a charity-based system, which prevents even moderately profit-oriented capital entering this field. Secondly, current regulations governing the setting-up and operations of microcredit companies (MCC) are too restrictive for them to be run in an economically viable manner. Lastly, large, established banks find it difficult to scale-down their operation to serve the low end of the market. In our view, however, none of these institutions is well suited to help the development of microcredit in China. Below, we summarise why:

- NGO – Have limited access to funds and cannot expand
- MCC – Strict regulation make MCC financial viability uncertain, to put it mildly
- Village Bank – Requirement for new start-up is too tight and existing large banks may see little economic return for downscaling.

NGOs cannot accept investments, neither debt nor equity, so they only rely on donations.

Non-Government Organisations (NGO) already operate in China, offering microcredit services, mostly in rural areas. Our research and analysis suggests that the main issue preventing them from growing is the limited capital available. NGOs cannot receive either equity or debt financing from investors; and rely on donations as the only source of capital. For example, ARDY received initial funds from the UNDP and from Wokai (that continue to contribute small funds). However, their total capital, after 15 years of operations remains in the region of US$1m. and customer numbers remain low (around 5,000). We believe that ARDY's business, although small in size, is successful, repayment ratio is high and improvement in the livelihood of their customers is visible. However, their expansion prospects are limited by the lack of substantial donations flowing in. Our admittedly still limited information suggests that the situation is similar for other NGOs. As a result, NGOs future funding and even their long-term survival is at risk.

China is not perceived as a county in need of aid money, hence NGOs find it difficult to raise funds

Aid/Donation funds, in the perception of most Western citizens should be directed to either immediate relief efforts caused by catastrophes, or to help those who lack basic life necessities (food, medicine). In other words, the first priority is to save lives, the second is to offer development. This is evident from people's response to calamities such as the earthquakes in Sichuan and Haiti, or food/medicine relief in Africa. Development aid normally comes from large organisations (UN, Oxfam, DFID, etc.) or private foundations. Unfortunately, China is not perceived as a main destination for international aid efforts, despite still having a large portion of its population (over 100m.) still living in poverty. This is due, paradoxically, to the successful economic development achieved in rural areas over the thirty years since opening up and reforms. Growing international trade disputes, large trade imbalance and the resulting accumulation of foreign reserves, further complicates matters and reenforce the view that China does not really need external money to help its poor. In other words, Western donors prefer to leave the rich Chinese government to solve the problem of income disparity and development of less affluent areas. Furthermore, since Chinese the domestic charity arena is still not as developed as that of the West, NGO funding is at risk.

NGOs are too focused on social impact and not on financial return
Although the initiative of NGOs are highly laudable and indeed offer financial services otherwise denied to the rural communities, they are focussed on providing poverty alleviation support, as they should be. Naturally, NGOs by definition are non-profit organisations and, therefore, cannot pursue financial objectives. However, we believe that without economic incentives, the contribution of NGOs to the development of microcredit in China will remain very limited.

Absolute poverty in China has already been reduced substantially: what is the role of microcredit?
According to data from Asian Development Banks, 9% of people in China suffer from hunger, i.e. are undernourished. Although, this is still a large number (over 100m. people), the role of microcredit in China cannot be the same as in Bangladesh or India. Rather, the *mission* of Microcredit institutions should shift from poverty alleviation *per se*, to foster economic and social development beyond primary needs (i.e. food and shelter, which is already in place) and address the needs of micro-small enterprises, which are the core of Chinese economy.

Rule 23 places too many restrictions on MCCs.
In May 2008, the China Banking Regulatory Commission (CBRC) issued Rule 23, setting guidelines for the establishment and operation of microcredit companies. This was a great step forward in the development of the industry as, for the first time, rules were clearly set out and microcredit companies granted legal status (up to then, the only way to offer microcredit services was through NGOs). Notwithstanding this improvement, we believe that this policy is not quite adequate to allow MCC to generate sufficient returns for investors, as we have just discussed in the previous paragraph. The policies that we wish to bring to your attention as possible candidates for amendments are:

> ‘Without economic incentives, the contribution of NGOs to the development of microcredit in China will remain very limited’

- Inability to accept any form of customer deposits
- Maximum leverage (debt/equity) not to exceed 50%
- High registered capital of 5m. RMB and 10m. RMB, for limited company and company limited by shares.

However, almost every other item within Rule 23 penalises MCC, far more than Chinese Company Law stipulates. It is as if an unnecessary burden is placed on the shoulders of microcredit companies, just because they engage in money-lending activities.

It is unclear whether microcredit companies are actually financially viable.

We believe that microcredit companies (MCC) cannot be profitable, mostly because of the regulation imposed by Rule 23 of CBRC. Just to be clear we use the term 'profitable' to mean 'adequate return on equity', not 'net income'. Too often we have seen in other industries around the world companies claiming to be profitable, only to discover that they 'buy' profitability and growth via large capital investment. This is not a sustainable modus operandi. Therefore, our concern is 'can Microcredit companies offer decent returns to investors?' Our answer is, probably not. Hence, their long-term survival is unclear.

The most controversial regulation imposed on Microcredit companies is their inability to accept any customer deposits and the maximum Debt/Equity ratio that cannot exceed 50%. In other words, for every 100 RMB of total capital, 66 must be equity and 33 Debt. Even if interest rates charged to customers can be as high as 15-20% (and even higher, if interest cap regulation were to be lifted), the economics of an un-levered financial institution simply don't work out. Figure 8 shows a simplified income statement for a typical microcredit company, using varying operating and financing assumptions, with

Figure 8 – Return on Equity Sensitivity Analysis for varying operating and financing assumptions (%)

	Scenarios						
	0	1	2	3	4	5	6
Balance sheet							
Loans	100	100	100	100	100	100	100
liabilities (deposits/debt)	33	0	33	33	33	33	33
Equity	67	100	67	67	67	67	67
Operating Assumptions							
Interest yield	20.00	20.00	15.00	20.00	20.00	15.00	15.00
Cost of debt	5.00	5.00	5.00	5.00	5.00	5.00	8.00
Cost/income ratio	0.00	0.00	0.00	20.00	30.00	30.00	35.00
LLP/loans	1.50	1.50	1.50	1.50	1.50	1.50	1.50
Enterprise Tax	25.00	25.00	25.00	25.00	25.00	25.00	25.00
Business Tax	5.50	5.50	5.50	5.50	5.50	5.50	5.50
ROE	17.00	13.00	12.00	13.00	11.00	8.00	6.00

the most relevant variables being interest yield (15%), and a cost income ratio of 35%, already a good figure even for very large banks.

Scenario 0 is the ideal case, but will not happen, as assumptions are way too optimistic, even unrealistic. Yet, that is the best we can do and the Return on Equity, 17%, is barely acceptable (we believe that any investors seeking to invest money in new Chinese microcredit companies with no track record, and mostly located in remote rural areas, will require at least 20%). Under this ideal scenario, we assume that debt/equity ratio reaches its maximum allowed by law. All capital (debt and equity) is fully utilised and lent to customers. Interest yield, on average, is 20%, almost the highest allowed by law. Cost of debt is very low 5% (in reality, investor would require close to 10%). Finally, cost/income ratio is assumed to be zero, i.e. the company has no operating costs: personnel salaries, transports, communications, accounting, IT/Software etc all come for free. Even under this more-than-ideal scenario, Return on Equity is barely acceptable.

All other scenarios use a combination of both operating and financing assumptions which would, naturally, yield an even lower Return on Equity. Scenario 6 is what we believe is the most likely one. Average interest rate is 15% and cost/income ratio 35%, already generous given the lack of economies of scale of microcredit companies (large banks Cost Income Ratio is around 30%). The Return on Equity for this scenario is a mere 6%, lower than any reasonable investor would be prepared to accept.

We, therefore, conclude that current limitation on the financial and operating conditions of microcredit companies does not allow them to offer decent returns to investors. Rule 23 is the main culprit.

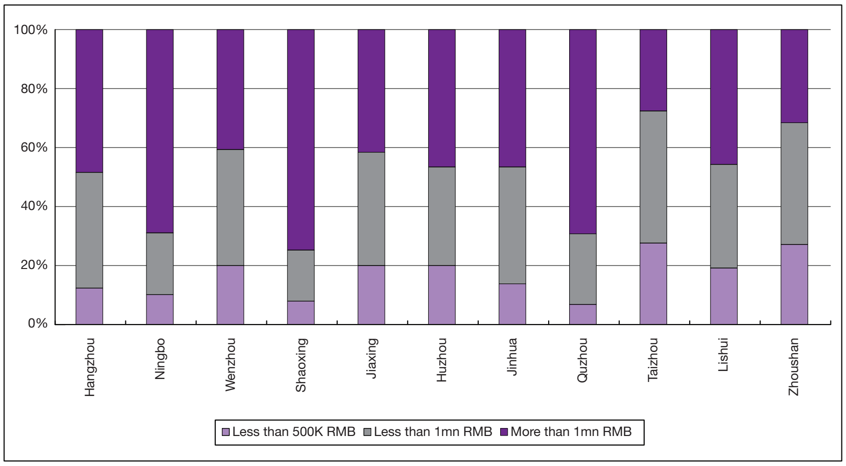
The paradox of Zhejiang and minimum capital requirement

Although Rule 23 sets the basic minimum requirement for MCC, every province in China has the freedom to impose its own, stricter conditions.

> ‘Our concern is “can Microcredit companies offer decent returns to investors?” Our answer is, probably not’

This results in some provinces (like Inner Mongolia) adopting Rule 23 in its pure form, while other provinces (like Zhejiang) impose even tighter conditions. This creates two main problems: firstly, the lack of a harmonious, clear set of rules across the country that confuses investors and practitioners. Secondly, it leads to the paradox whereby richer coastal provinces impose higher capital requirement for MCCs, just in the areas, where, due to the lower proportion of low-income people, the target market for microcredit

Figure 9 – Zhejiang Province, average loan size distribution by city



Source: Zhejiang Provincial Governmen, 2009

companies is smaller and, therefore, their long-term financial viability is more challenged. We fear that the apparent successful development of Microcredit companies in Zhejiang province – where 105 MCC are registered – is aimed mostly at offering credit facilities to the several small-medium enterprises than to the low income population. Figure 9 shows how average loan size is distributed across the province: it is discouraging to see that only 15% of loans are below 50,000 RMB, while the vast majority is in excess of 100,000 RMB and more than half of all loans are even higher than 1,000,000 RMB, hardly microcredit.

Existing Village Banks do not really offer microcredit services and establishing a new entity is challenging

Recently, there have been reports that Village Banks are finally entering the microcredit industry. However, we remain very dubious that such ventures really offer micro-loans and address the needs of low income populations. Even the much publicised 2.5m. microcredit customers reported by the Postal Saving Bank have an average loan size of 50,000 RMB, and only 10-15% of those customers receive loans below 20,000 RMB. Not quite microcredit. A CCTV report, aired at the time of the release of 2010 Document No.1, discusses Anhui Moshaan bank as an example of microcredit service to rural area, but the average loan size is 50,000 RMB, again a little too high. Village banks face two issues: on one hand, scaling down operation does not make clear economic sense for large banks, on the other hand, a Greenfield start-up requires too much capital and regulations (as outlined in Rule 48) are very strict, thus discouraging new entrants to the market. We, therefore, don't expect a significant number of MCCs will voluntary convert to Village Bank status.

3. Policy Recommendations

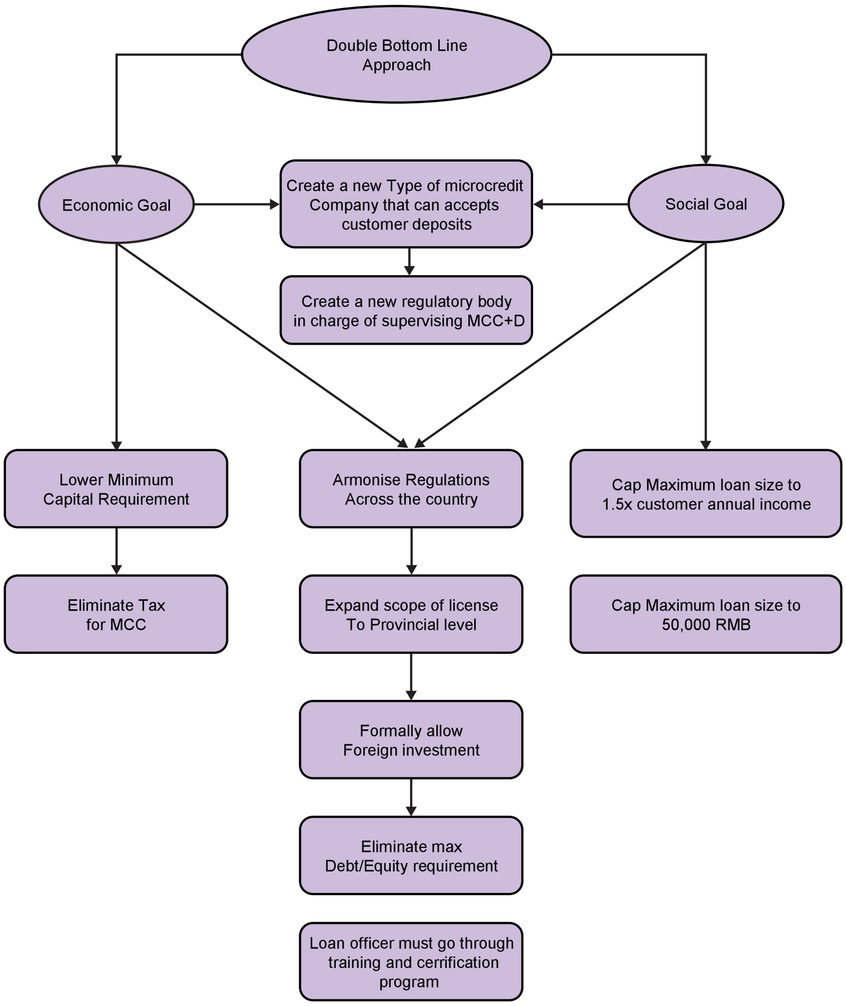
Before describing our proposed policy recommendation, the key questions for the Chinese authorities, including the National Development & Reform Commission, People's Bank of China and the China Banking Regulatory Commission are as follows 'Are we happy to hand over, at least part of, the responsibility for the development of rural and low-income population to independent, private, sometimes foreign, entities? Do we need their help in order to alleviate poverty and develop rural economy, micro-enterprise and low-income urban residents or can we do this by ourselves through direct government intervention? Can the risk of possible social development imbalances resulting from some geographic areas having access to better financial services than others be mitigated? In other words, can we afford a 'vertical' economic and social development in only parts of the country, or is it better to implement 'horizontal/blanket' policies and actions leading to a more homogeneous advancement across the country as a whole? If the answer to those question is 'yes', or at least a partial 'yes', in this section we offer our ideas and suggestions on how microcredit in China can be further developed.

Our main view is that the development of microcredit must follow a 'double-bottom line' approach

We believe that in order for a new sector to develop successfully, the financial and economic aspect cannot be ignored. NGOs have pioneered microcredit in China and some of them have been and continue to be successful, as in the case of ARDY, but their reach is limited to only a few areas and a several thousand customers. One key reason for this somewhat limited success is that they are capital-constrained and cannot further expand. Therefore, in order to foster the second stage of development, the microcredit industry must attract new sources of funds and, therefore, must be economically viable and offer investors the required financial returns. Of course, the microcredit industry must not depart from the original social mission of contributing to alleviating poverty and offering credit services to that portion of the population which is excluded from the mainstream banking sector. Hence, our view is that a double-bottom line approach offers the best combination for ensuring that microcredit in China becomes both sustainable and capable of major expansion. In order to achieve this, we believe that it is necessary for the industry to make money for its shareholders. We see no moral contradiction here, provided that the microcredit concerns also adhere firmly to their social mission.

Below, we discuss our key recommendations, some of which serve the social mission, some of which serve the economic goal, some serve both goals, in the attempt to create

Figure 10 – Our Proposed Policy Recommendations Map



a give-and-take set of rules and a balance between policies and practitioners, in the interests of all parties involved, including, of course, end customers. Our suggestions must be read in their totality, not as isolated ideas, as we believe the inter-relation among them is key to the success of microcredit. Figure 10 shows a summary of our recommendations.

We advocate the creation of a new type of company, Microcredit Company Plus Deposit (MCC+D), which can accept customer deposits, up to 50% of total equity

ECONOMIC GOAL: This will reduce overall cost of funding, increase interest income ratio and, in turn, profitability. Partial solution: be able to accept early repayments (increase capital efficiency); be able collect customer deposits and transfer those funds to a licensed bank, thus acting as intermediary (retain customer relationship and make a small margin)

We know the idea of a microcredit company being able to accept customer deposits creates some uneasiness in policy makers around the world, due to the need to safeguard at all costs customers' deposits. Indeed, CBRC purposely issued Rule 48, to allow microcredit companies to turn into village banks and, thus, be able to receive customer deposits. However, the conditions for converting into a Village Bank are extremely tight and we would be surprised if a large number of existing MCC were to take this route. The key issue is that the 'distance' between an MCC (Rule 23) and a Village Bank (Rule 48) is too far, especially, during the industry or a company growth phase, when customer demand and profitability are uncertain. Microcredit companies do not need to offer a complete range of financial services (credit cards, money transfer) nor will they engage in other activities typical of a 'normal' bank (trading securities, investment in other entities and other risky operations). Limiting deposits to, say, 50% of total equity, would not substantially increase their operational risk and the resulting risk of default on customer deposits, provided adequate monitoring of loan portfolio risk is implemented. After all, the core equity Tier 1 Ratio would be 50%, well above any Basel requirement which sets 4% as the minimum, with 7-8% being regarded as a solid level) This can be achieved without a full-blown 'banking sector' style set of regulations. On the other hand, having access to customer deposit will significantly lower the overall cost of financing. Without the ability to accept customer deposits, the operational viability of such enterprise is tight: given an acceptable interest rate to be charged to customers (10-15%), a required return on investment by shareholders (can be as high as 15 or 20%), only mitigated by some debt (in itself also limited to a maximum of 50% of total equity), the resulting net interest spread may well be zero or negative. Combining this with the possibility that not all capital is put to use at anyone time (especially during the growth phase), there is a non-zero probability that MCCs are likely to immediately run into negative net interest income (NII). Furthermore, even a tightly positive NII can be wiped out by the actual operational costs (personnel, rent, transport, communications and tax). In addition, accepting customer deposits would reduce significantly the liquidity risk of the MCC. Customer deposits are generally 'sticky' and stable, while wholesale markets can dry out overnight when systemic risks affect the financial markets, as seen in a spectacularly manner during the sub-prime crises and the resulting worldwide credit crunch. Accepting customer deposits, on which only a nominal interest rate is paid out, would immediately reduce the cost of funding by 2/3 (assuming an all-equity financed entity), giving that much needed breathing space for an ongoing profitability and sustainability of the business.

While the above suggestion is being implemented – which could be a protracted process- we suggest two intermediate, less painful, developments that could be introduced more quickly:

1. MCC+D to be allowed to accept early repayment, so that capital efficiency can be increased and customer default risk further mitigated.
2. MCC+D to be allowed to collect customer deposits, but pass these on to fully licensed banks. MCC would then act as intermediary and retain customer relationship, while, perhaps, making a small margin. This will not enhance MCC's loan capabilities, nor reduce the cost of funding, but would be an important customer retention tool useful to avoid the situation whereby a client approaches MCC for loans, but then places his deposits with another institution, which could, at some point in the future, decide to enter the microcredit market, and therefore take that customer away, after he has been nurtured by the MCC.

Creation of a new monitoring body, independent from the CBRC, that is responsible to regulate MCC+D companies

SOCIAL GOAL: Ensure the protection of customer deposits

Our proposed new entity (microcredit company Plus Deposit), will not engage in any financial services other than lending and borrowing, therefore, regulations imposed on full-blown banks may not be appropriate. Hence, the responsibility for monitoring their operations and ensure the protection of customer deposits may not fit the role of CBRC, which is too busy in dealing with the wider banking system and, we hear, already under-staffed at county level where only three staff members are employed. Instead, we propose a new regulatory and monitoring commission whose only role is to oversee MCC+D enterprises.

Reduce minimum capital requirement for MCC+D enterprises

ECONOMIC GOAL: Lower barriers to entry, allow more efficient use of funds

We believe current minimum capital requirements (5m. RMB for Limited Liability Company and 10m. RMB for company limited by shares) are too high for microcredit companies. Furthermore, Chinese company law establishes lower requirements for limited companies: minimum capital requirement for a limited company is 30,00 RMB, while minimum capital requirement for companies limited by shares is 5m. RMB, but only 20% must be contributed at inception, with the rest being paid-in within two years of formation. So, why should microcredit companies have a higher minimum capital requirement? Developing a microcredit activity from start-up is not easy and it takes time. Having such large capital requirement increases the cost of funding during the start-up phase, when revenues are still low,

> 'Opening up the market to foreign investment will attract more money as well as expertise from other microfinance practitioners'

hence puts the financial viability of the company at risk. As an example, ARDY (Association for Development of Yilong county, in Sichuan), although operating as an NGO and somewhat capital constrained, after 15 years of operations has a loan portfolio of only about 6m. RMB. We therefore propose lowering the minimum capital requirement to 500,000 RMB and 1,000,000 RMB, respectively for the two types of companies. By doing this, new small entrepreneurial entities can be attracted to enter the market.

MCC+D maximum loan size should be capped at 1.5 times 18 individual customer annual income, and not higher than 50,000 RMB

SOCIAL GOAL: Offer services to low-income population as the primary objective

We propose to impose such a constraint onto MCC+D companies, in order to prevent them from falling into the trap of increasing loan size, for the sake of profits per-se. A number of our suggestions are aimed at facilitating long-term financial viability of MCC+D, but they should also be forced to respect the mission of contributing to the development of low income strata of the population. We suggest capping the maximum loan size at to 1.5 times each customer's annual income and, in any case, not to exceed 50,000 RMB. By doing this, we can be sure that the loan size is appropriate to the economic situation of the customer.

Harmonise regulations across China, eliminate provincial difference

ECONOMIC GOAL: Enhance clarity on rules and regulation across the country

SOCIAL GOAL: Eliminate preferential treatment of some provinces and the 'Zhejiang Paradox'

As we discussed before, although Rule 23 sets minimum capital requirement for microcredit companies (which we propose to lower, anyway), every province sets its own rule. In practise minimum capital requirement are often much higher than Rule 23 suggests. In general, richer provinces impose higher requirements (Zhejiang, Beijing) than poorer provinces (Inner Mongolia).

Licence to operate should be granted at provincial level, not at county level

ECONOMIC GOAL: Allow companies to reach economies of scale

SOCIAL GOAL: Ensure that all counties, or at least adjacent ones, have access to the same level of financial services

Currently, MCC companies need to apply at county level to be able to operate. If they wish to extend their operations to another county, a separate up independent entity must be set-up. Eliminating this restriction and allowing company registration at provincial level, will allow Microcredit companies to expand their reach beyond county borders, serve more customers and have a better chance to succeed financially. This will avoid the scenario whereby customers is one county have access to microcredit services, while people living in a neighbouring area are denied the provision of such services; on the other hand, expanding customer reach will help MCC+D entities to reach economies of scales, which is very difficult under current conditions.

Eliminate all taxes for Microfinance institutions

ECONOMIC GOAL: Allow MCC to be more profitable

Currently, microcredit companies are taxed like all commercial entities and have to pay 5.5% sales tax plus 25% enterprise tax on income. In our view, there is no real reason for the government to impose this tax, while it discourages new entities from being set up. Tax revenues from the microcredit sector are absolutely negligible for the government budget – we don't know the actual number, but given the small number of companies – 1300 – and the low, if any profitability, it is natural to think that eliminating this tax will not cripple the Chinese economy.

MCC+D should be allowed to take investment (debt/equity) from abroad

ECONOMIC AND SOCIAL GOAL: Attract more capital and foreign know-how, increase customer reach

Although it is not explicitly forbidden, little foreign capital finds its way into the China microcredit sector. Especially during the current financial crisis and recovery, when bond yields are low, new money from abroad is looking at new investment opportunities, opening up the market to foreign investment will attract more money as well as expertise from other microfinance practitioners. We understand that, out of the total 1300 MCCs, only Microcred Nanchong is fully funded from foreign capital. Discussion with Private Equity companies, including Blue Orchard, shows that foreign investors have an interest in the Chinese microcredit industry, but the conditions are not yet sufficiently attractive. The worry that a flurry of hot money could come into China, upsetting the already fragile exchange rate regime, should be played down, as the microcredit industry is still small in size and even if millions of dollars were to pour in, this would still be small compared to, say, the current level of FDI of US$90bn.

Eliminate debt/equity ratio limit of 50%

ECONOMIC AND SOCIAL GOAL: Increasing Return on Equity, makes MCC

more profitable, attracts more investment and be able to serve more customers
Debt is the key factor for a financial institution's profitability, as it increases the operational leverage and allows for higher Return on Equity. At the moment, the level of debt an MCC can accept cannot exceed 50% of registered equity capital. While we discourage over-leveraging the business, which might create liquidity problems (as we have seen during the recent financial crisis), debt/equity, or gearing ratio, can be relaxed to, say 100%, without significantly altering the risk profile of the business. Debt is investors' money, not customer deposits, hence there would be no additional risk for customers. A debt level equal to 100% of equity, in addition to being able to mobilise deposits up to 50% of equity, as we propose, would take the Core equity Tier 1 Ratio to 40%, again well within Basel requirements. On the other hand, higher level of debt tends to increase return on equity, thus making microcredit companies financially more attractive and, in turn, attract more capital, expand their customer reach and achieve both economic and social goal

MCC+D personnel should be trained

We also propose a formal mandatory certification required by all practitioners in the microcredit sector. Certification from those institutions should be mandatory before loan officers can operate. This will ensure that only properly trained people have the authority to offer loans and will be aware of loan risk management techniques, so as to reduce the risk of defaults.

Update the Hu Kou

Finally, we believe it is time to update the Hu Kou system (residential system), so that a real picture of China rural population can be assessed. This will help companies and investor to asses market demand in a more reliable manner and make better informed investment decisions.

4. Conclusions

In this first paper on the microcredit industry in China, we have argued that while there is a large potential market, current regulations do allow microcredit companies (MCC) to be run as financially viable entities. Despite the large number of MCCs created over the last 12 months, most appear to have a large average loan size, about 50,000 RMB, which we do not regard as true microloans. We also argued, that these companies' return on equity is too low to attract external investors and, therefore, we fear that, after the initial enthusiasm, many could run into financial difficulties, and put the development of microcredit sector at risk. In our view, the main culprit is Rule 23, which imposes too tight conditions on MCCs. Instead of changing almost everything which is contained in Rule 23, we propose the creation of a new more flexible type of institution that will be allowed to accept customer deposits, will not have strict minimum capital requirement, can operate across a whole province, is tax-exempt and can accept investment from both domestic and international investors. In exchange for these relaxed rules, such a new microfinance concern (that we will call 'Microfinance Company Plus Deposit', or MCC+D), will have to commit to serve the low-income population, and have maximum loan size capped at 1.5 times customers' actual annual income and, in any case, not higher than 50,000 RMB, so that true micro-loan products are offered. However, further research is necessary on how this might be implemented, its likely impact and the extent of the market that needs to be served. These topics will be dealt with in our future reports.

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Endnotes

1 The so-called 'Document No.1' is a yearly document issued by the Central Committee of the Communist Party of China and the State Council, that sets goals and priorities for the country's economic development during the following 12 months. The December 2009 issue is available at:
Full Text (Chinese): http://www.gov.cn/jrzg/2010-01/31/content_1524372.htm
Summary (Chinese): http://www.gov.cn/jrzg/2010-02/02/content_1526510.htm

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