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Challenges of Rural Microfinance in China - What Can China Learn from Bangladesh and Indonesia?

Shuyang Zhu
Trinity College, shuyang.zhu@trincoll.edu

Challenges of Rural Microfinance In China

What Can China Learn from Bangladesh and Indonesia?

By: Shuyang Zhu

Advised by: Professor James Wen

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ABSTRACT

Given that China has the largest rural population in the world, the demand of finance is very high. On one hand, Agricultural Bank of China (ABC) is moving to serve urban areas, and Rural Credit Cooperatives (RCCs), currently the most important source of formal credit in rural areas, are not doing very promisingly. On the other hand, nongovernmental programs-microfinance institutions (NGO-MFIs) have been performing well in terms of reaching the poor in the remote regions; however, due to the government's regulations they are only allowed to offer loans but not to take any deposits, thereby limiting their future development and growth. This thesis aims to explore such microfinance challenges in China in detail, particularly discussing the difficulties that NGO-MFIs with two case studies. Through the analysis of successful NGO programs in Bangladesh, *e.g.* Grameem Bank, and government-sponsored programs in Indonesia, the thesis will also suggest how China could possibly overcome the existing challenges, subject to its unique socioeconomic and political environment. Possible improvements include providing staff incentives and trainings, creating strict and clear client selection criteria, diminishing dependence on donor funds, and establishing a better regulatory environment for the development of NGO-MFIs, *etc.* Secondary sources of data and information are employed and international comparative features of microfinance are the main focus.

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ACRONYMOS

ABC	Agriculture Bank of China
ADBC	Agriculture Development Bank of China
ASA	Association for Social Advancement
ASGMCL	Aba-Songpan Grameen Microcredit Co. Ltd
BRAC	Bangladesh Rural Advancement Committee
BKD	Badan Kredit Desa
BRI-UD	Bank Rakyat Indonesia
CAM	China Association of Microfinance
CASS	Chinese Academy of Social Sciences
CBRC	China Banking Regulatory Commission
CFPA	China Foundation for Poverty Alleviation
CICETE	Chinese International Center for Economic and Technical Exchanges
FDI	Fuping Development Institute
FPC	Funding the Poor Cooperatives
GB	Grameen Bank
GT	Grameen Trust
MDGs	Millennium Development Goals
MF	Microfinance
MSMEs	Micro-, small-, and medium-sized enterprises
MSPs	Microfinance service providers
NGO-MFIs	Nongovernmental Organization – microfinance institutions
NPLs	Nonperforming loans
PBC	People's Bank of China
RCC	Rural Credit Cooperatives
RDI	Rural Development Institute
SOEs	State-owned enterprises
SSCOP	Supporting Service Centre of the Poor
UNDP	United Nations Development Progamme
VTBs	Village/Township Banks

CHAPTER I: INTRODUCTION

In 2000, 189 nations in five continents, such as China, Bangladesh, South Africa, Czech Republic, and Argentina, agreed to free people from extreme poverty and multiple deprivations by 2015 through achieving the eight Millennium Development Goals (MDGs) (United Nations Development Progamme (UNDP), 2013). The very first goal is to eradicate extreme poverty and hunger, and its one of the targets is to halve the proportion of people whose income is less than USD1 a day (United Nations, 2012). One strategy to alleviate poverty is to provide financial services to poor and low-income households. However, poor households, especially those who live in rural areas, have been exclusively excluded from the formal banking sector, simply because the conventional financial institutions incur greater transaction costs if lending a large number of small loans, and they require borrowers to have good credit history and provide collaterals in the form of financial assets, which most of the low-income people do not possess. Although poor people can have access to loans through informal lenders, interest rates of this kind of credit are normally very high.

In order to allow the poor people to gain access to credit market at affordable costs, Mohammed Yunus invented the concept of "microfinance" and established the Grameen Bank (GB) of Bangladesh in 1983. The GB has reached out to millions of poor people in Bangladesh, particularly women, to help them walk out of poverty, and amazingly its loan recovery rate has been remaining high (Grameen Bank, 2013). With the success of the GB, more and more countries started microfinance (MF) programs for the purpose of poverty reduction. Kofi A. Anan, the former UN Secretary General, once said, "…microfinance has proved its value, in many countries, as a weapon against poverty and hunger. It really can change people's lives for the better, especially the lives of those who need it most" (Latifee, 2006).

Basically, microfinance can be narrowly defined as the provision of loans, savings, insurances, and other basic financial services to the low-income clients, including the self-employed (Ledgerwood, 1999). With a broader definition, microfinance is referred as "small-scale financial services – primarily credit and savings – provided to people who farm or fish or herd; who operate small enterprises or microenterprises where goods are produced, recycled, repaired or sold; who provide services; who work for wages or commissions; who gain income from renting out small amounts of land, vehicles, draft animals, or machinery and tools; and to other individuals and groups at the local levels of developing counties, both rural and urban" (Robinson, 2003).

i) How Do Microfinance Programs Operate?

Generally, three fundamental mechanisms, *i.e.* group lending, dynamic incentives, and regular repayment schedule, allow MF programs to operate effectively and achieve high repayment rates (Ray, 1998).

First of all, group lending includes the concepts of peer selection and peer monitoring. For instance, the Grameen Bank (GB) has the lending policy that no member in the group can borrow again if defaults occur. This policy encourages individuals to form groups carefully in the very beginning and rule out bad borrowers, who do risky businesses or do not repay on time, in order to avoid any incidence of defaults. Thus, individuals with similar characteristics such as comparable credit history tend to group together, as long as they can identify one another, thereby driving the risky borrowers out of groups. In addition to peer selection, peer monitoring also increases the effectiveness of borrowing. Within one group, members tend to monitor and influence each other's activity choice so as to keep the entire group at a specific safety level to avoid defaults. Consequently, peer pressure may prevent some members from conducting risky projects or leading unhealthy, costly lifestyles. Unlike the case of individual lending, costs of defaults are not solely borne by the financial institutions; instead all members in the group are responsible for risks. In summary, due to asymmetrical information, financial institutions have great difficulty obtaining information on borrowers' characteristics, credit history, and how risky the activities are for which the loan will be used. However, borrowers in the same group normally know one another and have much easier access to each other's information, which may make peer selection and peer monitoring more effective (Morduch, 1999).

The second mechanism of MF programs is dynamic incentives. In most MF programs, small amounts of loans are provided to borrowers initially. Once loans are repaid on time within a week or a month, the loan size will increase in the next period. If they are not repaid on time, no more loans will be lent in the future. In this way, MF programs are able to screen out risky borrowers in the early stage before potential defaults take place, thereby to some extent solving the asymmetrical information problem. Such incentives may have greater influences when clients hope to receive greater amount of loans and can predict how large the loan size will be the next borrowing period (Morduch, 1999).

Regular repayment schedules are the third mechanism of MF program. Most microfinance contracts require repayments to start almost right after disbursement. For instance, the GB has the policy that "terms for a year-long loan are likely to be determined by adding up the principal and interest due in total, dividing by 50, and starting weekly collections a couple of weeks after the disbursement" (Morduch, 1999). Similar to the benefits brought by dynamic incentives, regular repayment schedules can help screen out risky borrowers and allow group members to find out potential financial problems earlier. In addition, since repayments begin before a certain project for which a borrower uses the loan receives any profit, regular repayment schedules, particularly weekly repayments as the Grameen-example, seem to force borrowers to secure an additional income source.

ii) Clients and Providers of Microfinance

Typically, MF clients are poor and low-income people who do not have access to the formal financial institutions. By poverty level, they can be categorized as vulnerable non-poor, upper poor, poor and very poor. Most of them are self-employed, household-based entrepreneurs, operating small businesses. Those living in rural areas often conduct small-income-generating activities including farming, knitting and food processing. In 2008, there were still 1,289 million of people (22.4% of the world population) worldwide living on less than USD1.25 a day, even though this figure fell down from 1,909 million in 1990 (The World Bank, 2013[b]). We can see that there is a great demand for MF programs so that the poor people can afford daily food consumption, education fees, medical expenses and even finance needed for small business operations. As mentioned in Rutherford's book, *The Poor and Their Money* (2001), there are three main categories of events that may cause the poor spending more money than what they actually have: life-cycle events (birth, marriage, holiday spending, *etc.*), emergencies (sickness, unemployment and natural disasters *etc.*), and investment opportunities (investments in businesses, land or household assets).

Women comprise a large proportion of MF clients. In the GB, for instance, the membership was 94% women in 1991-92 (Morduch, 1999), and from 2007 to 2011 the percent even rose to 96% or greater (Grameen Bank, 2013). The reasons for such great women involvement are due to the facts that by observation women seem more reliable than men in terms of repayments, and that women generally have lower mobility, thereby in a sense avoiding the *ex post* moral hazard problem, i.e. "take the money and run" (Morduch, 1999).

Financial service providers that serve poor and low-income clients can be categorized in four general types: informal financial service provides, member-based organizations, nongovernmental organizations (NGOs), and formal financial institutions (Helms, 2006).

First of all, informal financial service providers include individual informal providers (friends and family, moneylenders, and traders) and collective clubs or associations (rotating savings and credit associations (ROSCAs) and accumulating savings and credit associations (ASCAs)). Sometimes, it is easier and quicker to simply borrow money from friends and family and it may be interest-free. Moneylenders, with the bad reputation of charging high costs and exploiting poor people are perhaps the most well-known. In rural areas where people's livings rely on agriculture, traders, processors and input suppliers are important credit providers so that farmers can obtain advance payments to cover input costs. ROSCAs consist groups of participates who make regular contributions to a central "pot", which can be offered to each contributor by rotation or lottery, while in ASCAs some participants borrow and some do not so the pot grows over time (Helms, 2006).

Second, one typical example of member-based organizations is credit unions (also called as savings and credit cooperatives), which generally rely on the members' own saving as the primary source of funds. These financial cooperatives are owned and managed by their own members and are normally not for profit. The financial services provided include savings, checking accounts, loans, insurances and fund transfer services (Helms, 2006).

Third, NGOs are considered as the true pioneers of microfinance, and international networks play an important role in establishing and supporting these NGOs. However, they encounter numerous development constraints, as it is illegal for them to mobilize savings in general, and most of them rely on donor funds, thereby not guaranteeing financial sustainability in the long run. In order to be more sustainable, some NGOs have chosen to operate in a "commercial" way, indicating that they become independent from donors and obtain commercial sources of funds to grow and reach more clients. One concern about this commercialization is "mission drift", *i.e.* the worry that the NGOs may deviate from their original mission of serving the poor, because wealthier clients may be more preferred than poorer ones. Nevertheless, we should notice that it is possible to be able to reach the poor and be profitable at the same time. For instance, 139 out of 231 institutions were found profitable in 2003 and 41 out of those 139 that targeted the poorest clients were more profitable on average than all 139 combined (Helms, 2006).

Last but not least, formal financial institutions also provide financial services to the poor and the low-income, either on their own or through partnership with other financial service providers such as NGOs. Examples of formal financial institutions are state-owned banks (such as postal banks), rural banks, specialized microfinance banks, and full-service commercial banks (Helms, 2006).

According to the Microcredit Summit Campaign (2013), by the end of 2011 there were 3,703 reported microfinance institutions (MFIs; most of them are NGOs) that have reached more than 195 million clients (over 75% female clients) with current loans, and around 124 million of these clients were among the poorest when they first joined MF programs. With over 66% of the world's population living on less than USD 1.25 a day, Asia possesses about 89% of the poorest clients. By the end of 2011, there were 1,751 reported MFIs (47% of the total) in Asia and nearly 155 million clients (almost 80% of the total). The updated 2012 data show that 22 countries in

Asia possess microfinance sectors with 58.5 million borrowers and 34.13 million depositors. The total loans and deposits in 2012 were USD 39.16 and 32.55 billion, respectively (Samarapally, 2013). With a greatest number of microfinance clients and providers, MF programs in Asia have drawn lots of attention. However, the current Asian microfinance sector has only succeeded in fulfilling a very small proportion of the total demand for microfinance services.

iii) Why Studying Microfinance in China?

Among all the Asia countries that have established MF programs, China has much less sustainable microfinance relative to its population size, and its potential demand is unmatched with its supply (Helms, 2006). As the most populous country in the world with a large rural population, there exits a huge demand for microfinance and a great potential to develop the MF market. In China, government agencies or government-sponsored programs are the key suppliers of MF services. It may be the result of extensive historic government involvement in the financial sector (Helms, 2006). However, the subsidized loan program offered by the central government has not successfully reached the poor and achieved low repayment rates. Formal financial institutions are not performing very promisingly either. The Agriculture Bank of China (ABC), one of China's four state-owned specialized banks, used to supply poverty reduction funds in the rural areas. Nonetheless, the number of its branches has shrunk significantly since 1995, and the ABC became commercialized and shifted its services from the rural to urban areas. The Rural Credit Cooperatives (RCCs) are currently the primary microfinance providers in the rural China, but most of them are not financially or operationally sustainable and have not reached the real poor. NGO-MFIs play an indispensable role in supplying microfinance in the rural areas and reaching the real poor, because they are smaller-scale and locally based. But, as the current financial regulations forbid NGO-MFIs from taking deposits from clients, they have to highly depend on donors' funds to maintain regular operations and loan mobility. Such donor dependence restricts the expansion of NGO-MFIs and adversely affects its sustainability. The thesis will explore these problems and suggest some possible solutions in the last chapter.

iv) Why Choosing Bangladesh and Indonesia to Compare with China?

Bangladesh and Indonesia are considered as the MF giants in Asia (Helms, 2006), both of which have achieved great success in providing microfinance to the poor and low-income individuals. Mohammad Yunus established the Grameen Bank (GB) in Bangladesh in the mid-1970s, which brought the "microfinance" concept to the entire world through its remarkable success. When microfinance was first initiated in China in the early 1990s, a large number of MF programs adopted the GB model (with certain modifications in some cases), either because they admired the GB's success and wish to duplicate it, or because there were no other models that they could potentially follow. Hence, it is important to understand how the GB model works before analyzing the MF situation in China. In addition, its two NGO-MFIs, Bangladesh Rural Advancement Committee (BRAC) and Association for Social Advancement (ASA), have shown great progress, which may inspire the development NGO-MFIs in China in some ways. Indonesia, on the other hand, has valuable experience in developing its government-sponsored MF programs, from which China can extract some essence and potentially apply to its own state-run programs.

v) The Organization of The Thesis

Chapter II will discuss some successful MF programs in Bangladesh and Indonesia, in which the Grameen Bank will be essentially emphasized. In Chapter III, through the detailed discussions of MF clients and suppliers in China, the development of microfinance in China will be demonstrated. The existing challenges that the MF suppliers are facing will also be covered. At the end of Chapter III, there will be a subsection specifically illustrating the regulatory environment in China for microfinance with the emphasis that the policies and regulations are not very favorable to the development of NGO-MFIs. Chapter IV will discuss two NGO-MFIs in China, the first of which is comparably successful while the second of which is not. The final chapter, Chapter V, will summarize and analyze several significant difficulties and challenges regarding the microfinance in China. By associating what can be learned from microfinance in Bangladesh and Indonesia based on Chapter II with China's unique characteristics, possible improvements of microfinance in China will be suggested.

CHAPTER II: MICROFIANCE IN BANGLADESH AND INDONESIA

i) Bangladesh

As the pioneer adopter of microfinance in the world, Bangladesh has achieved remarkable success in developing MF models, targeting poor clients and service diversification (Rahman *et al.*, 2012). In 2009, the rural population almost comprised nearly 75% of the total population, and one out of two people still lived below the poverty line with less than USD1 a day (Bangladesh Microfinance Industry Report, 2009). In 2011, there were 20.9 million active borrowers in Bangladesh and the total micro-loans reached USD2.8 billion. There were also 18.5 million depositors with USD2.2 billion deposits (MixMarket – Bangladesh, 2013). The microfinance service providers (MSPs) in Bangladesh are mostly financially and operationally sustainable, as they receive funds from diverse sources, including local banks, international donor grants, savings of members, loan interests, and service charges (Rahman *et al.*, 2012). Even though throughout the years more and more MSPs have been less dependent on external donor grants, they still run profitably. Grameen Bank, Bangladesh Rural Advancement Committee (BRAC) and Association for Social Advancement (ASA) are great examples to illustrate the microfinance success in Bangladesh.

1) The Grameen Bank (GB)

Initiated by Mohammad Yunus in 1976, the GB was originally an action research in a Bangladeshi village. In 1983, it became a formal, specialized bank for the poor under government legislations (Latifee, 2006 and Rahman *et al.*, 2012). The GB is the only bank with a poverty alleviation bank license issued by the Bangladesh Bank and it remains as a member-owned, self-regulating bank. At present, borrowers own 95% of its total equity, and the remaining 5% is in the government's hand (Grameen Bank, 2013).

The fundamental features of the GB model are as following (Grameen Bank, 2013 and Morduch, 1999):

1) Strict eligibility criteria are applied to target the poorest of the poor and women have priorities to join;

2) GB staff goes to clients' homes instead of clients coming to them;

3) Loans are lent to poor households in groups, which are normally formed voluntarily; and each group typically consists of five members;

4) Collaterals are not required. Lending basically takes place in sequence within groups, so if one member defaults, there will be no subsequent loans offered to other members;

5) Small loans are repaid in weekly installments and some loan are allowed to be paid back monthly;

6) There is no joint liability, which means no members are responsible for paying back loans on behalf of anyone who defaults;

7) Group members and the bank staff together supervise credits.

Moreover, the GB provides a wide variety of financial services, including housing loans, micro-enterprise loans, savings, insurance products and pension funds, *etc.* There are also education schemes for children and a so-called Struggling Members Program for beggars (Rahman *et al.*, 2012). More impressively, GB is able to offer custom-made credit to clients, so that the staff has the freedom to create loan products that suit clients' needs (Latifee, 2006). There are four interest rates for loans offered by GB: 20%, 8%, 5% and 0% for income generating loans, housing loans, student loans and Struggling Members (*i.e.* beggars), respectively. Rates for deposits are attractive as well, the minimum and the maximum of which are 8.5% and 12% (Grameen Bank, 2013).

The number of members as well as the amounts of loans and deposits at the GB has been growing all the time since its establishment (Table 1 and Figure 1). The most recent statistics show that in 2011 GB had 2,565 branches in 81,339 villages with 22,124 staff members (Grameen Bank, 2013). In the past 20 years, GB has been gradually diminishing its dependence on funds from donors, reflected by its increasing deposit to loan ratio (Figure 2). The GB is a profitable organization and it has had net profits every year except 1983, 1991 and 1992 (Grameen Bank, 2013). Its operational self-sufficiency (OSS), which refers to the ability of an institution to generate enough revenues to cover its operating costs, was 102.6% in 2009 (Rahman *et al.*, 2012).

The GB has made a great difference in the lives of its members. One study shows that the GB borrowers move out of poverty at a rate of 5% per year. It has also empowered its female members in various ways, including enhancing their respect from spouses, self-confidence and capacity to solve social issues (Latifee, 2006).

2) Bangladesh Rural Advancement Committee (BRAC) and Association for Social Advancement (ASA)

BRAC is a development organization and the largest and fast-growing NGO in the world, with the aim for poverty alleviation, providing health, education and economic support to disadvantaged people in rural areas. Launched in 1974, its microfinance program offers a wide range of financial services to all 64 districts in Bangladesh now. Through its village organizations (VOs) that consist 30-40 people, mostly women, BRAC brings collateral-free loans (from USD100-1000) and saving services to its clients. The VOs can be regarded as a platform to implement BRAC's activities and allow women to discuss issues and share information. Microenterprise loans are also provided to small enterprise owners, supporting and expanding their businesses (Rahman *et al.*, 2012 and BRAC, 2013). BRAC disburses about USD1 billion a year and the money earned from the disbursements to the poor covers 80% of its operation costs (*The Economist*, 2010).

As one of the largest NGO-MFIs, ASA was established in 1978 and became formally registered with the government one year after. Its microfinance approach is globally renowned as "ASA Cost-effective Sustainable Microfinance Model". Many MFIs around the world that adopted this model became sustainable within a short time. Based on its model, ASA has a lean structure, faster recruitment and costless informal training, maximum utilizations of fund, and innovative management. Branch managers can make decision on all activities as long as they conform to ASA's Operation Manual, which serves as one of the facilitators for ASA's efficiency. There are no accountants or cashiers in branch offices; instead, loan officers maintain daily accounts and the branch managers maintain transactional accounts. Branches prepare their own annual work plan with fiscal targets and cash flow projection, and decide how much to spend on daily accounts based on calculations. Such policies allow branches to operate smoothly and efficiently under branch managers' administration, and district and regional managers only perform as supervisors rather than decision makers.

ASA offers two types of collateral-free loans to the poor and low-income clients. The first type is "Primary Loan" offered to the economically active poor, which has a maximum tenure of 12 months with a loan ceiling of USD650, while the other one is "Special Loan" offered to owners of small or micro-enterprises, which has a maximum tenure of 30 months and has the range between USD662 and USD6500. Both loans have flexible repayment schedules and the maximum of their interest rate is 27%. At the end of 2011, there were 3,154 ASA branches in Bangladesh serving more than 4.94 million clients. The disbursement for both loans was about USD1,080.80 million and the savings of its clients were around USD167.77 million. The data in June 2012 show that ASA had the repayment rate as high as 99.67%, and its OSS was 209.72% (ASA, 2013).

3) Microfinance Regulations in Bangladesh

Bangladesh is working towards building its microfinance regulations by a separated regulatory authority. In 1991, the NGO Affairs Bureau (NGOAB) was created to regulate NGO registration, approve project proposals, release funds and monitor projects, ensuring transparency and accountability of NGOs supported by foreign funds. Since the establishment of Microcredit Regulatory Authority (MRA) and the MRA Act 2006, MSPs in Bangladesh started being regulated. MRA is responsible for providing/cancel licenses and monitor MSPs' performance. All MSPs are required to register with MRA to be able to provide MF services legally. One exception is that the GB, the only bank in Bangladesh with a license to operate as a specialized bank for microfinance, is regulated by Bangladesh Bank, the central bank of the countryk (Rahman *et al.*, 2012 and Bangladesh Microfinance Industry Report, 2009).

ii) Indonesia

Since the 1997 Asian financial crisis, Indonesia has promoted any "pro-poor" growth strategies, one of which is microfinance (Miyashita, 2000). According to the 2011 statistics, there were more than 460,000 active borrowers in Indonesia and the total micro-loans reached

USD10.1 billion. There were also over 275,000 depositors with USD73.5 million deposits (MixMarket – Indonesia, 2013). Although its MF scale is not as large as that in Bangladesh, impressively Indonesia has achieved great success in government-sponsored MF programs, which have been delivering financial services to the poor and the low-income in both cost-effective and profitable ways (Miyashita, 2000).

1) Government-Sponsored Microfinance Programs

The unit desa[1] system of Bank Rakyat Indonesia (BRI-UD) and Badan Kredit Desa (BKD) are the examples of government-sponsored microfinance programs that perform as the national- and village-level financial institutions, respectively.

Established in 1970 as a part of the state-owned BRI, BRI-UD was initially a channeling agent for targeting and subsidizing government loans. Due to the Indonesian government's first major financial deregulation package in 1983, BRI-UD became a large state-owned commercial bank, increasing financial service availability for the poor and the low-income. Its BRI-UD has a single loan product with an effective annual interest rate of 32%, which is much lower than that charged by local moneylenders but higher than the market rates. This can enable the real poor have access to credits at lower costs, as they used to borrow from moneylenders, and meanwhile it helps exclude wealthier borrowers who can actually receive loans from the conventional financial sector. Locally mobilized savings finance all the loans at BRI-UD, which partially explains the unit desa system's profitability since 1986 and independence on subsidy since 1987. The repayment rate related to this loan product has been very high too. Even during the 1997 financial crisis, BRI-UD still enjoyed its growth, remaining stable and profitable. One of the

[1] "Desa" in Indonesia means "village".

reasons is that BRI-UD understands the local markets and provides suitable financial services to clients based on their needs. The staff is well trained about the markets and microfinance operations, and staff incentives such as performance-based cash awards also motivate them to perform as bankers and deliver the best services to clients (Miyashita, 2000 and Robinson, 2003).

In addition to BRI-UD, there are also small-scale MF programs sponsored by the provincial or village governments. Although compared with BRI-UD they have smaller loans and deposits, higher interest rates, and higher operation costs, they in fact help fill gaps in the BRI-UD network by reaching more poor clients in the remote regions. Supervised by BRI, BKD is such a village-owned example, known as the world's oldest commercial microfinance institution. Unlike BRI-UD that is located at the sub-district level, serving the surrounding villages, the BKD units operate at the village level, reaching deeper in their own villages. Each BKD unit provides short-term, weekly-repaid loans and voluntary saving services to its clients within its corresponding village. Individual loans are offered without collaterals as well (Miyashita, 2000 and Robinson, 2003).

CHAPTER III: THE DEVELOPMENT OF MICROFINANCE IN CHINA

As the most populous country in the world, China had the population of 1.34 billion and with its GDP growth rate being 9.3% in 2011 (The World Bank, 2013[a]). Although the standard of living improves all the time, until 2008 there was still 13.1% of the population in China living with merely USD1.25 per day (The World Bank, 2013[a]), and the most recent statistics from the State Statistics Bureau (2011) show that there were over 122 million rural people living below the national poverty line[2], which was set at RMB 2,300 (USD 366). Microfinance was initiated in China in the early 1990s with the goal of alleviating poverty mainly in the rural areas. Since 1996, the Chinese government has regarded microfinance as a potentially effective alternative for funding the poor (Zhang *et al*., 2010).

i) Who Demands Microfinance in China?

There are four groups of people in China with very limited access to financial services: rural households, low-wage workers, micro-, small-, and medium-sized enterprises (MSMEs), and unemployed people (Sparreboom and Duflos, 2012).

Rural households, particularly farmers, livestock raisers and fishermen, consist of the largest group in China that has difficulty obtaining financial services. According to the most recent 2010 population census, there were 674 million rural residents living in over 200 million rural households (Sparreboom and Duflos, 2012). Although some data show that approximately 31% of all the rural population was able to receive loans from financial institutions (Bedson, 2009), it is hard to say whether these 31% were the very poor or the poor or the upper poor. The

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2 Ravallion (2010) defines a poverty line as “the money an individual needs to achieve the minimum level of ‘welfare’ to not be deemed ‘poor’”.

conventional financial institutions in China are reluctant to provide credit to the rural population, because of asymmetrical information, lack of collateral, high costs of lending small loans, and high risks of defaults. Rural households may only be able to provide houses, labor, or machinery as collaterals; however, they are either non-physical, like labor, or worth too little, like machinery. Moreover, rural population highly depends on agriculture, which is influenced by natural conditions, making their incomes unpredictable and unstable (Zhou and Takeuchi, 2010). Due to the fact that personal relationships are easily developed in small rural communities, which makes the problem of asymmetrical information less severe, informal lenders such as pawn brokers and moneylenders can provide credit to rural population, but with rather high interest rates. Such high interest rates hinder poor rural households to obtain any loans. As a matter of fact, informal lenders do not have the government's approval and most of them operate illegally. Hence, we can see that there is a great demand for reliable and cheaper microfinance, which consequently leads to the great potential for the rural MF market. Conducted in 2005, a survey of 502 rural households in four counties/cities in Guizhou Province, located in the southwest of China, show that 89% of the interviewed households expressed their interests in obtaining credit (He, 2008). Another survey conducted in Zhejiang Province and Ningxia Autonomous Region in 2003 implies that with appropriate technical training provided, more households were willing to receive loans (He, 2008). As in China poverty is a rural phenomenon, caused by the limited rural-urban migration (Wang *et al.*, 2004), microfinance provided to rural households in China is the emphasis of the thesis. The following paragraph will briefly discuss the other three groups that demand microfinance.

The second largest group is low-wage workers, including rural migrant workers. Although they leave their rural homes and work in towns or urban areas, with little amount of income they may not have collaterals and are still considered risky by the formal credit sector. Rural migrant workers may also find difficult to open a bank account or obtain a loan, as they do not have residence status in the town/city where they currently live and work. The third group is MSMEs that are smaller-scale and riskier businesses, compared with the large, state-owned companies. MSEMs often need finance for start-ups, expansions, and innovations, *etc.* There are a large number of MSMEs in China and this number keeps increasing rapidly. Shown by the statistics at the end of June 2007, there were more than 42 million legally registered MSMEs, accounting for 99.8% of the total number of enterprises in China (He, 2008). As it is uncertain whether they can make a profit or loss in the near future, formal financial institutions are less willing to offer loans to MSMEs. The last group is the unemployed workers including lay-off workers from state-owned enterprises (SOEs) and rural job seekers in urban areas. Due to the reform of SOEs in China, lots of workers in poorly managed, inefficient, and wasteful SOEs were laid off. In addition to that, it takes considerable amount of time for rural people to find jobs in urban areas, because they are less educated and secured. Hence, in order to meet basic living needs, they demand credit as well.

ii) Who Supplies the Rural Credit in China?

There are four primary rural credit providers in China: informal lenders, government agencies, formal financial institutions, and NGO-MFIs. They have different impacts on the poor and the low-income.

Jointly cooperating with state-owned financial institutions such as the People's Bank of China (PBC), *i.e.* the central bank in China, and the Agriculture Bank of China (ABC), government agencies provide microfinance through the government poverty reduction program.

One example is the "8-7 Plan" introduced in 1994, *i.e.* National Plan for Poverty Reduction, whose ultimate objective was to "lift the majority of the remaining 80 million poor above the government's poverty line during the seven year period 1994-2000" (Wang *et al.*, 2004). Out of the three focused programs of the 8-7 Plan, the subsidized loans program[3] used over 50% of total poverty funds, which were RMB 113 billion in total (USD13.6 billion) from 1994 to 2000 (Wang *et al.*, 2004). The aim of this program was to directly support economic development of poor areas and households, and loans were only used for investment. The PBC allocated subsidized loans to the provincial ABCs, which in turn passed on the loans to the county-level ABCs. The government allocated some of the subsidized loan funds to MF activities, applying the GB approach with variations. The interest rate was charged at 2.88%, which was far lower than the market interest rate, 8-10% (Park, 2001). However, the subsidized loan program was found not reaching the poor and achieving low repayment rates, which were as low as 50% (Park, 2001). This was partly because the program's objectives of reaching the poor and enhancing economic development conflicted with one another. More loans were in fact offered to enterprises and richer households, because they could bring more financial benefits. Several other factors contributed to its poor performance: 1) procedures for loan application and approval were complicated; 2) physical collateral was required by the ABC that excluded some poor households; 3) due to high repayment risk, there was less incentive for the ABC or local governments[4] to lend to the poor; 4) lack of knowledge and experience in credit management and the bureaucratic model of welfare delivery were two of reasons for the low repayment rate; 5) because of political or social concerns, the government tended to forgive defaults, which led to disincentives of borrowers to repay future loans (Wang *et al.*, 2004 and Zhang *et al*., 2010).

[3] The subsidized loan program was in fact dated back to 1986. The other two programs were food-for-work program and government budgetary grants.
[4] Since 1998, the repayment risk was passed from ABC to local governments.

State-owned formal financial institutions play an important role of providing microfinance in rural areas, such as the ABC, Agriculture Development Bank of China (ADBC), Rural Credit Cooperatives (RCCs), and Village/Township Banks (VTBs) *etc.* The ABC is one of China's four state-owned specialized banks, founded in 1979 to provide poverty reduction funds in rural areas. However, since 1995 the size of ABC has been shrinking every year, from 67,092 branches in 1995 to 23,461 at present (He, 2008 and ABC, 2013). This is mainly because of its transition toward a more commercial-based lending model, which has caused the ABC gradually shifting its services from rural to urban areas and focusing more on large, state-owned, and more profitable enterprises (Guo, 2009).

Located at the township level, the RCCs have been the dominant financial institution in rural areas since the mid-1990s when they ceased affiliation with the ABC and started being regulated and supervised by the PBC. During that period of time, the RCCs had problems regarding nonperforming loans (NPLs) and financial losses, which triggered the PBC to launch several reforms in order to make RCCs more sustainable and regulated. One of such reforms was to introduce a MF program, through which rural households could have access to loans coming from agriculture lending of the PBC. The interest rate was affordable for the rural poor, but below the rate that ensured cost recovery for most RCCs. In this MF program, loans are small in amount and short in time, and there are no loan repayments in installments and gender targeting required. Basically, the credit rating staff is responsible for assessing the credit ratings of rural households with the help of village officials in some ways. This implies RCCs focus on providing rural credit more widely rather than targeting the poor. Once approved qualified, rural households will receive a credit certificate with a specific credit limit, then they can obtain loans from RCCs with the certificate up to that limit (Xie, 2003).

Although RCCs have "cooperative" in its name, in fact they are not real cooperatives. A cooperative is "a nonprofit democratic organization created voluntarily by members with a common goal", and members should be able to take part in the decision-making process, and share profits and risks (Xie, 2003). The reality is that RCCs are not very democratic, as under most situations local governments and officials make the final, important decisions, and members are not fully informed of RCCs' financial conditions. Furthermore, instead of maximizing members' benefits, RCCs seem to seek profits, which may make them reluctant to lend loans to the real poor. One 2002 study shows that among about 900 rural households in three chosen provinces, only 16% of borrowed from RCCs (Zhou and Takeuchi, 2010). Also, there are moral hazard problems involved due to soft budget constraints and implicit deposit insurance offered to RCCs. As the primarily important vehicle for the government to provide credit in rural areas, RCCs are bailed out by the PBC once they face financial difficulties, implying that RCCs would never go bankrupt. This fact diminishes RCCs' incentives to operate efficiently (Xie, 2003). In 2003, there was another reform initiated by the PBC and China Banking Regulatory Commission (CBRC) in 7 provinces, with the objective of clarifying RCCs' ownership structure, strengthening their corporate governance, and transferring administrative responsibilities to provincial governments, all of which could help solve the problems discussed above to some extent and allow RCCs to be more operationally and financially sustainable. Due to the positive impact, 21 more provinces were covered in the following year.

NGO-MFIs that sometimes cooperate with international organizations also provide a substantial amount of microfinance in rural areas. One of the most important NGO-MFI players in China is the Funding the Poor Cooperatives (FPC), the first MF organization in China, whose four branches mainly provide MF services to farmers in Hebei and Henan provinces. The Rural

Development Institute (RDI) of the Chinese Academy of Social Sciences (CASS) initiated FPC in 1993. Although it has received funds and subsidized loans from the Ford Foundation, Grameen Trust, and Citigroup *etc.*, FPC strives to achieve financial sustainability. Basically, it is a Grameen replication program that started as a pilot project so as to explore a new poverty alleviation approach. Table 2 gives a performance overview of its four branches. FPC has delivered the loans of more than RMB 100 million, which have helped over 30,000 households. Impressively, FPC's repayment rate remains over 95% (FPC, 2013). FPC is considered as a milestone in China's MF development and a successful MF program that follows the Grameen Bank (GB) model.

Another NGO-MIF example is the Microfinance Department under the China Foundation for Poverty Alleviation (CFPA), which is one of the largest NGO-MFIs in China. CFPA is committed to helping the low-income, especially women, in poor areas with access to basic social services. Established in 1996, the Microfinance Group provides small loans as well as practical training and information workshops for its clients. In 2008, the Microfinance Department was transformed into CFPA Microfinance Management Co., Ltd, *i.e.* CFPA Microfinance, and was responsible for implementing and managing microfinance pilot projects. By the end of February 2013, there were 138,602 active clients, RMB 939 millions of loans outstanding and in total RMB 4 billion of loans disbursed. With 66 branches, it covered 14 provinces, 66 counties and more than 18,000 villages. Possessing some similar features of the GB model, CFPA offers loans of up to RMB 12,000 for a single loan to a group of five with no collateral required. The loan period is from 6 to 12 months loans are repaid monthly (CFPA Microfinance, 2013). Statistics in 2011 show that 99% of CFPA's clients were farmers; 91% of clients were women; 68% of loans were used for farming and animal breeding (CFPA, 2011). In addition, free agricultural technical training and financial education were provided to farmers.

Similar to the two examples above, most of the NGO-MFIs in China adopted the GB model. Compared with the formal financial institutions, NGO-MFIs normally reach more very poor households in very poor and remote rural areas, because their projects sites are often located in "the nationally-designated or provincially-designated poverty counties in remote central-western mountainous areas, where the very poor and minorities concentrate" (Zhang *et al.*, 2010). Although some MF programs such as FPC have certain eligibility criteria, some studies have found that these programs tended to provide services to an increasing number of middle and above-middle income households (Zhang *et al.*, 2010). This may be because some loan officers choose to exclude those very poor households who have greater risks in order to achieve high repayment rates as well as operational and financial sustainability. At the same time, those very poor individuals may also exclude themselves, as they do not think they can repay loans. Furthermore, another significant challenge that NGO-MIFs encounter is their lack of national scope. For instance, the four FPC branches only cover two Chinese provinces. In China, the expansion potential of NGO-MFIs is very limited because they are not legal financial institutions and do not have corporate status, which results in their inability to mobilize deposits or obtain loans. Hence, some of these NGO programs are attempting to transform into MF companies or become project offices under a local government of development association (PlaNet Finance, 2013).

Two small-scale, NGO MF programs will be particularly studied in Chapter IV in order to demonstrate the challenges and difficulties the NGO-MFIs in China have been facing in general.

iii) The Regulatory Environment for Microfinance in China

Before we move on to Chapter IV, let us first take a look at what the regulatory environment in China for microfinance, supplied by both formal financial institutions and NGO-MFIs, is like.

The PBC and the China Banking Regulatory Commission (CBRC) are two important banking regulators in China. They are responsible for promulgating policies and providing guidelines to regulate the MF market in China. RCCs, the primary supplier of financial services to the poor and low-income households in rural areas, were under the ABC's regulations prior to 1996. With the Decision of the State Council on Rural Financial Institutional reforms announced in 1996, the PBC replaced the ABC and started supervising RCCs. Three years later, the PBC issued the *Provisional Method of Microcredit Loans Management of RCCs for Rural Households*, which states that the management methods of microcredit loans should be "once approval, lend when need, balance control, revolving use". Loan conditions and standards of credit assessment were included as well. In 2000, the *Guidance on Group Loans Management of RCCs for Rural Households* was put forward to clarify a set of RCC policies regarding group guarantee, compulsory savings and installment payment *etc.* (He *et al.*, 2009). In 2003, the CBRC took over the supervision of RCCs (Du, 2005). More guidelines were issued for other formal financial institutions. In 2007, *Guideline on How to Greatly Develop Rural Microloan Business by Banking Financial Institutions* promulgated by the CBRC was the first regulatory document that summarizes the unified guidance on MF businesses provided by formal financial institutions, including provincial RCC Unions, rural cooperative banks, and state-owned commercial banks *etc.* (He *et al.*, 2009).

NGO-MFIs are not as regulated as the formal financial institutions. According to China's financial laws and regulations, it is illegal for non-financial institutions including NGOs to supply any financial services. Having received written approval from the State Council and the PBC, only FPC, the Supporting Service Centre of the Poor (SSCOP), and Chinese International Center for Economic and Technical Exchanges (CICETE) that works cooperatively with UNDP, are considered legal organizations to conduct MF activities (Zhang *et al.,* 2010), which means theoretically other NGOs are illegal. Due to these NGOs' important role in alleviating poverty, in fact the PBC and the CBRC silently permit NGOs to supply MF services (Du, 2005). Without a clear legal status, NGOs are often subject to "changing political factors and local government's interference" (Zhang *et al*., 2010). In addition, organizations that have more than RMB 8 billion (USD 965.5 million) of annual assets and RMB 3 billion (USD 362.1 million) of net assets in the previous year are qualified to apply to be MF companies, which are regulated by the PBC and can only supply financial services to member enterprises (Du, 2005). Due to such strict licensing and client requirements, MF organizations usually find unqualified or infeasible to transform into MF companies.

The government regulations cover three main areas: financing, interest rates and taxation. Regarding financing, formal financial institutions mainly receive funds from deposits, fiscal funds, international grants and the PBC's refinancing facility. Grants from international donors are the key source of funding for NGO-MFIs, and they cannot take deposits or receive financial support from the PBC, which implies that they normally have less ample, continuous and stable financing sources. In the case of interest rates, the PBC determines the ceiling of deposit interest rates and the minimum interest rates of loans for commercial banks. RCCs can have loan interest rates floating 0.9-2.2 times around the base interest rate. The interest rates charged by NGO-

MFIs vary between different institutions, but under certain situations these rates are higher than the PBC's base interest rate, which is in fact not permitted by the laws. Regarding taxation, RRCs are subject to operating taxes and added operating taxes but are exempt from income tax. The government has not set clear taxation policies for NGO-MFIs; however, some local governments may levy taxes on their microfinance operations, which to some extent deepen their financial burden (Du, 2005).

Based on the facts above, we can see that the Chinese government ought to put forwards specific regulations that can stimulate and supervise the development of NGO-MFIs.

CHAPTER IV: TWO NGO MICROFINANCE CASE STUDIES IN CHINA

i) Yushi Mao and His Microfinance Program

Economist Yushi Mao is a pioneer in microfinance and poverty alleviation programs. He initiated a MF pilot project in 1993 with RMB 500 (USD 86) in Longshuikou Village of Tuanshuikou Town, located in Lin County, Shanxi Province. Primarily targeting rural farmer households, this small-scale MF program followed some features of the GB model but there were some modifications as well so as to reflect China's specific characteristics. For instance, he did not adopt the 5-individual lending practice, as defaults would harm one's reputation in rural China where people tend to know everyone in small villages (Fuping Development Institute, 2013 and *Chinese Business Reviews*, 2006). Mao established strict policies when this MF program just started operating. According to the policies, there were two types of loans. The first type was interest-free, and could be used for the purpose of disease treatment and education with one-year loan period. The program staff would verify such uses of loans before loans were offered. The other type of loans was primarily used for production purpose, including purchasing fertilizers and operating micro-enterprises, with six-month loan period, and its annual interest rate was12.68% and 21%, respectively, before and after the year of 2009 (Bai, 2011). By the end of 2012, 190 million of loans were disbursed and more than 3,000 households have benefited from the microfinance programs (Fuping Development Institute, 2013 and *Chinese Business Reviews*, 2006).

With his personal influence, Mao was able to obtain funds from private donors as well as domestic and international organizations at the interest rate of 6%. However, donors were the individuals who had the ownership of the funds so that they could cease donations at any time if they wanted to do so. Having realized that the program could not rely on donations all the time, Mao encouraged deposits from the clients. The deposit interest rate was set at 6% initially, but in order to reduce operation costs it fell to 3% later on (*Chinese Business Reviews*, 2006). Gladly, this decrease in the deposit interest rate did not stop villagers from saving more money, as they have established a very good relationship with this MF program, which has been helping them improve their standard of living. Mao also established some good management practices. For example, for safety unused funds should be kept in banks; one week before repayment the program staff would remind borrowers of their upcoming repayments, which ensured the smooth lending operation; and the program was transparent because uses of funds were reported to borrowers quarterly (*Chinese Business Reviews*, 2006).

In 2002, Mao co-founded the Fuping Development Institute (FDI), a NGO that focuses on low-income people in China and has four core operations: microfinance, eco-agriculture, early education and domestic and community service. Its MF operation is the expansion of the MF program in Longshuikou Village and more households in three more areas have been reached, including Yongji, Shanxi province, Dayi, Sichuan province, and Beijing[5]. With the average loan size being up to RMB 30,000, FDI MF requires no collateral as well. Similar to the MF program in Longshuikou Village, other branches are set up in the villages and townships so as to be closer to clients and provide swift door-to-door services (FDI, 2013). What has been changed is that with the establishment of FDI, the MF program in Longshuikou Village started providing loans more to individuals who have the payback ability rather than only to those who are really in need. According to Mao, the reason for this dramatic shift was because the program ought to be profitable in order to maintain its normal operation and continuity of loans (Bai, 2011).

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[5] The program in Beijing is designed to support rural migrant entrepreneurs.

Mao with his MF program is a typical case in China. As mentioned earlier, under Chinese regulations and laws it is illegal for NGO-MFIs to accept deposits and receive sources of funds from the general public, which can be regarded as a way of "illegal fundraising". During the interview with *Shen Zhen Special Zone Newspaper,* Mao claimed that he did not think that illegal fundraising being a crime made any sense to him, and admitted that if it was truly a crime he had definitely broken the law (Zhou, 2012). Even though what he does is illegal, it seems to be the only way of allowing his MF program to operate smoothly and provide financial services to the poor in need consistently. Some people also criticized that Mao's intent was actually to make profits through his MF program, because compared with the Grameen model, Mao's MF program charges higher loan interest rates but lower deposit interest rates. In his own defense, he explained that the rural population urgently needs accessible credit and his job is to provide this for them; however, in order to continue its operation the MF program must be profitable (Bai, 2011). Even though his statement seems not that convincing, we cannot omit the substantial influences that Mao and his MF program have brought to the local rural areas where the program operates. Undoubtedly, there may be other numerous MF programs at various places in China that truly consider seeking profits rather than poverty reduction as the target. What China seriously lacks is to have a robust MF system that can oversee and regulate these currently unregulated NGO-MFIs.

ii) Aba-Songpan Grameen Microcredit Co. Ltd in Songpan County, Sichuan Province[6]

In 2006, after being awarded the Nobel Peace Prize, Dr. Muhammad Yunus was invited to attend the Grameen International Conference on Microcredit in China, organized by Grameen

[6] Most of the facts and data in this subsection are based on Niu and Zeng (2012).

Trust (GT) and China Association of Microfinance (CAM). During the visit, he expressed his interest in opening up a "GB" in China. To response to his interest, the PBC offered a license to him to start BOT projects in China. And the Vice President of the PBC suggested experimenting in a county in Sichuan Province. Here, a BOT project refers to a "build-operate-transfer project". In a BOT project, "the public sector grantor grants a private company the right to develop and operate a facility or system for a certain period, in what would traditionally be a public sector project", and "operator finances, owns and constructs the facility or system and operate it commercially for the concession period, after which the facility has is transferred to the authority" (Public Private Partnership, 2013). In our case, the PBC granted the GT the right to develop and operate a microfinance company for a certain period of time and eventually the PBC or the central government would take over this program, as long as it was viable.

The GT is an international wholesale fund that supports MF programs at their start-ups and scaling-up stages, and in difficult situations. It follows the GB model, brings key personnel from Grameen, recruits local staff and trains them to become professionals in microfinance. The GT has had the BOT projects operating in several countries, including Myanmar, Turkey, Zambia and Indonesia. And they are all doing well in terms of reaching the poor and operating sustainably (Latifee, 2006).

Although initially the experimental site was chosen to be in Wenchuan County, the project was forced to cease due to the huge earthquake in 2008. One year after, Songpan County was selected instead to be the new site where the microfinance company, which was later named as Aba-Songpan Grameen Microcredit Co. Ltd (ASGMCL), could be established. In the same year, One Foundation and Alibaba Group took part in this project as well. One Foundation was founded under a partnership with the Red Cross Society of China. In 2010, it was approved to be a public welfare foundation in Shenzhen, which has the independent legal status to engage in public fundraising activities. The other participant, Alibaba Group, is the largest Internet-based e-commerce business in China. In order to successfully import the Grameen approach to China, One Foundation invested RMB 5 million, and Alibaba Group invested RMB 0.1 million plus RMB 6.8 million donated to ASGMCL on behalf of the GT. With these investments, ASGMCL was able to successfully and formally registered with the government in November 2010. However, only after two years, the company had to cease its operations. What has happened over this period of time?

First of all, the clients of ASGMCL were not the very poor, and the ASGMCL staff selected their clients based on their reputation and credibility instead of their income levels and financial needs, which differed from the GB model. Another difference is that it usually takes 3-6 months for the GB staff to find a group of 5 borrowers, as the staff needs to visit lots of households to identify who are qualified for the MF services, while the staff at ASGMCL chose a more convenient way by selecting qualified clients from a list of households provided by the local village officers. As a result, those whose income levels reached or even above the average in a certain village were able to borrow loans. Even though some households were qualified, they decided not to obtain loans from ASGMCL, because the repayment period was only one month, which was too soon for the farming households who had to wait for the harvest season to get their investments back. This is particularly true in Songpan County, which has scattered population and relatively short farming season. In addition, ASGMCL charged the interest rate of 10%, higher than 9% offered by the local credit union when it coordinated a special program with the ABC. Even if the credit union charged higher after that program was over, rural households would probably still choose to go to the credit union, as it offers larger amount of loans during each borrowing period.

Second, there were cultural barriers between the project manager sent by the GT to China, and the local staff as well as the local environment. There have been three project managers coming from Bangladesh to help facilitate the operation of ASGMCL. However, the first two did not adjust to the local environment very well and got sick, thus returning home instead before they even fulfilled their duties in China. Because of this management inconsistency, in March 2012, ASGMCL finally distributed the first loans. Before its cessation, there were only 50 clients receiving loans from ASGMCL, which is part of reason for the ASGMCL's financial loss. The total loans disbursed in these 9 months were RMB 0.5 million with interest earnings being RMB 50,000; however, the company's operation costs were as high as RMB 1 million, implying very low operational sustainability. Moreover, at the GB it is very competitive to be qualified as a microfinance staff, who has to come from a local poor family and is required to go through half a year of training, and there is only probability of 60% to be selected. Staff selection is very crucial, which directly determines the quality of financial services they will provide in the future. However, in the ASGMCL case, Mr. Thacker, the last project manager sent by the GT to Songpan, honestly pointed out that the three staff at ASGMCL was not very qualified, as they did not receive sufficient training and they who in fact do not live in poorer families got this job through personal network. Gradually, Thacker started to realize how important a personal network is in such a small Chinese community.

Last but not least, there were conflicts and distrust between the two large donors and the management from the GT. As both One Foundation and Alibaba Group invested a big sum of money in ASGMCL, they were the two most important shareholders who got involved the decision-making process during the ASGMCL's operation. The representative from One Foundation raised his doubt on the ASGMCL's business model and claimed that the model should be modified; otherwise, it was simply waste of money. In addition, he considered there was something wrong with the financial records managed by the GT, which could be the key reason for the potential loss. However, after certain investigation, everything looked good and no personal interests were ever involved.

Some scholars went to Songpan before it ceased operation and concluded that ASGMCL did not follow the GB model at all but used a traditional Chinese way of borrowing and lending. Certainly, it is also improper to apply all the GB features in the ASGMCL case (for the summary of comparison between the classic GB model in Bangladesh and the modified GB model adopted by ASGMCL, please refer to Table 3), but it is really important to realize that: 1) different types of microfinance services should be supplied according to clients' needs, so that more clients would be attracted to take loans; 2) The selection and training processes for microfinance staff are very crucial, because to some extent it determines the quality of the services provided, repayment ability of clients, and sustainability of a specific MF program in the future. Hence, it would better follow the GB practices regarding this aspect.

CHAPTER V: POSSIBLE SOLUTIONS TO MICROFINANCE CHALLENGES IN CHINA

i) What can China learn from Bangladesh?

As the examples of the GB, BRAC and ASA in Bangladesh discussed in Chapter II, there are several good points that the NGO-MFIs in China should consider learning:

1) It is very important to reach the poorest of the poor, especially women, to alleviate poverty effectively. As mentioned earlier, women are more responsible and care more about the their families and children than men. Some NGO-MFIs in China have a large proportion of female clients, such as CFPA and ASGMCL discussed in Chapter III and IV, respectively. Although having a high percentage of female clients may not necessarily guarantee high repayment rate, but there is ample empirical evidence that has shown it had make a difference.

2) There should be strict and clear selection criteria designed during the client selection process. The GB does a good job spending a significant amount time visiting and interviewing rural households, and then decides whether they are qualified in term of personal characters, income levels and family conditions *etc*. ASGMCL in Songpan County simplified the interviewing process, which did not help form a close lender-borrower relationship initially. Also, the company did not focus on the real poor households who demanded credit the most. Although there were no relevant data and analysis available showing whether the economy of the county has improved or not after ASGMCL operated there, not serving the real poor cannot help alleviate poverty radically.

3) Microfinance staff ought to actively bring the MF services to the people in need and regularly visit the clients to find out whether they encounter any difficulties; if they do the staff can assist them to sort out, which would help improve repayment rates. It may be costly for the

formal financial institutions to provide this type of door-to-door services, because some households who live in remote or mountainous areas are hard to reach. This suggests that more local branches ought to be built up nearby those hard-to-reach rural areas or some small-scale NGO-MFIs should be encouraged to start their businesses there.

4) All the three MF programs in Bangladesh show that the poor are able to utilize loans and repay them on time as long as effective procedures and provider-client relationships are well established and maintained. Some RCCs in China still require clients to provide collaterals when borrowing loans, which may deter a large number of the poor from borrowing. RCCs could consider put forwards some policies involved dynamic incentives, as mentioned in Chapter I, such as increasing loan size after each timely repayment, which may be a better approach of avoiding defaults than requiring any collaterals.

5) Competition is necessary among MSPs so that a variety of innovative products that fulfill different clients' needs can be created. For example, the GB has designed services for beggars and students, specifically, and Mao's MF program offers two different types of loans based on their uses.

6) MSPs, especially NGO-MFIs should diminish their dependence on donor grants and find their own ways to be both operationally and financially sustainable. Accepting savings is one of the good options and the Cost-effective Sustainable Microfinance Model designed by ASA is worth studying and applying with adaptions.

7) A well-established, separated regulatory authority is indispensable for the MF sector to be regulated differently from the conventional financial sector. The Chinese government has a lot to work on in order to establish a legalized environment for NGO-MFIs.

ii) What can China learn from Indonesia?

MFIs in China can adopt some of good policies and practices from the government-sponsored BRI-UD and BKD programs and modify them based on China's own characteristics:

1) Experiences from BRI-UD and BKD further confirm that character references can be regarded as an effective collateral substitute to guarantee repayments. It is also important to realize this type of non-physical collaterals depend on how important one's character in his or her community. Since most of rural microfinance programs in China operate at the village level, tight relations and social pressure would be able to serve as a good collateral.

2) Different from the cases in Bangladesh, BRI-UD and BKD charge higher-than-market interest rates in order to cover operational costs, which allows them to be self-sufficient. In spite of such high interest rates, there are still a large number of borrowers. This indicates to some extent, the poor and the low-income think the access to credits more important than high interest rates. MFIs in China could consider charging higher interest rates, not only to be sustainable and independent from donor funds, but also to use it as a strategy to screen out wealthier borrowers.

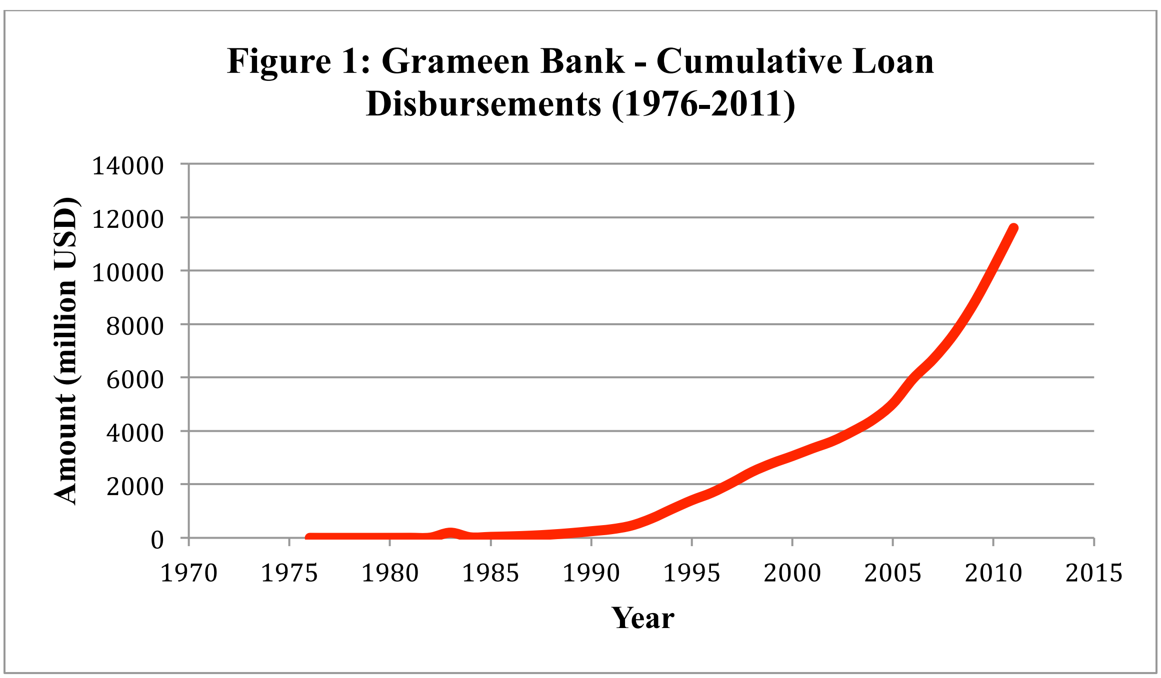
3) Staff incentives are important to maintain high-quality microfinance services. With appropriate incentives, either financial or non-financial, staff is more likely to be careful in the client selection process and establish good relationship with clients, which will largely result in higher repayment rates. It may not be a good idea to hire all employees on the part-time basis, as they would have fewer incentives to reach more clients and deliver satisfying services.

4) The experience that the state-owned BRI-UD supervises the village-based BKD can be learned by the MFIs in China. Supervision by formal, experienced financial institutions can help MFIs in various ways, including staff trainings, sources of loans, trust gained from borrowers and depositors and legal practices, etc.

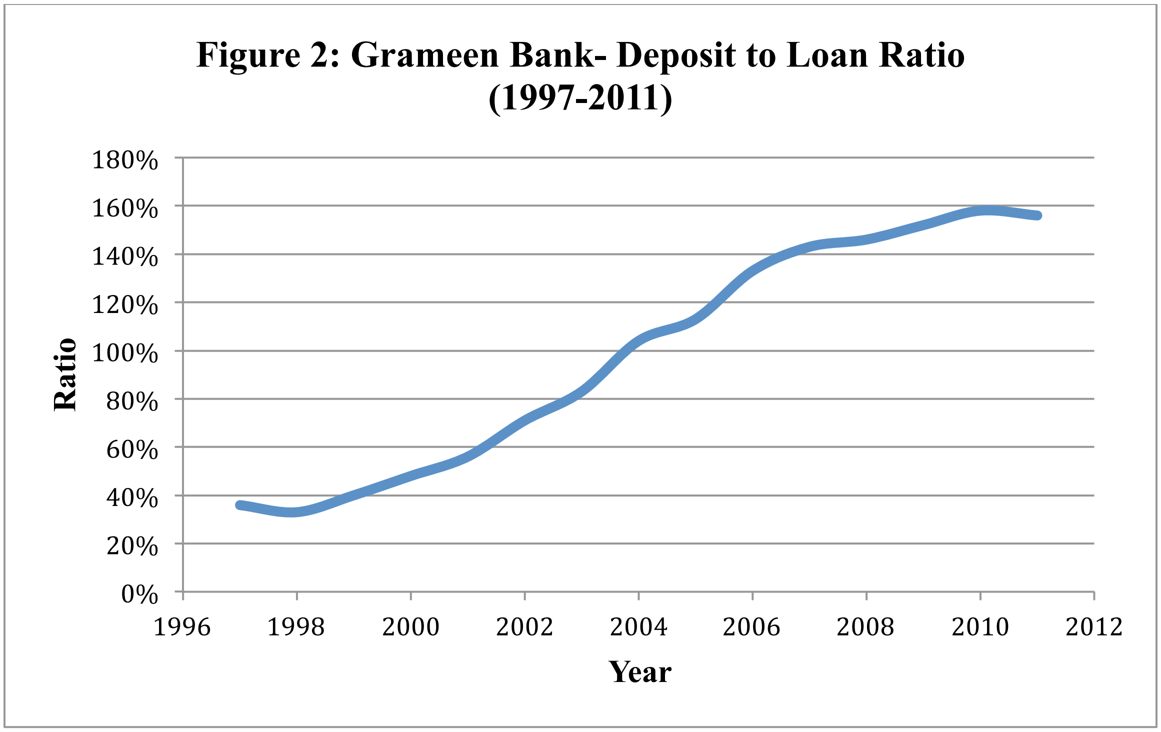
APPENDIX: TABLES AND FIGURES

Table 1: Grameen Bank Historical Financial Data (Based on the data from http://www.grameen-info.org/; amount in million USD)

Performance Indicator	1976	1983	1990	2000	2011
Cumulative Loans	0.001	194.95	248.08	3,060.44	11,350
Cumulative Deposits	NA	18.51	25.86	126.78	1,475.03
Number of Members	10	58,320	869,538	2,378,601	8,372,081
Percentage of Female Members	20%	46%	91%	95%	96%
Number of Branches	1	86	781	1160	2565
Profit/Loss	NA	-0.0059	0.0027	0.21	8.59



Source: Grameen Bank – Bank for the Poor. http://www.grameen.com/



Source: Grameen Bank – Bank for the Poor. http://www.grameen.com/

Table 2: Overview of FPC's Four Branches (2007) (Based on the information from http://www.supportmicrofinance.org/en/welcome)

Branch Name	Number of Members	Repayment Rate	Percentage of Female Clients
Laishui	1,785	-	100%
Nanzhao	6,283	99%	100%
Yixian	18,406	99%	83%
Yucheng	1,808	-	100%

Table 3: Comparison Between the Classical GB Model and ASGMCL's Modified GB Model (Adapted from Niu and Zeng (2012))

Particular	**The GB model in Bangladesh**	**The GB model in ASGMCL**
Clients	Primarily women who are required to be very poor	Mostly richer households or relatives of local village officials
Repayment Schedule	Weekly – high frequency	Monthly, starting from the third month after the initial borrowing
Selection of MF Staff	Better to come from poor families	Tended to have good family background and strong relationship with the local government
MF Staff Training	Normally last half a year with acceptance rate up to 60%	No systematic training performed and the longest training was only 4 months
Selection and Interaction with Clients	Selecting qualified clients through door-to-door visits; training is offered to clients	Picked qualified households from a list given by the local village officials
Formation of Groups	Relatives are rarely in the same groups	Most of members were relatives
Form of Communication	Discuss and tackle problems through group meetings	Tried to reduce the frequency of meetings
Financial Services (other than loans)	Accept savings	No savings accepted
Other	NA	Recommended to establish a good relationship with the local government

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