MIFA
Promoting Microfinance in Asia

CHINA:
MICROFINANCE AND FINANCIAL SECTOR DIAGNOSTIC STUDY

FINAL REPORT

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IFC International Finance Corporation
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MICROFINANCE AND FINANCIAL SECTOR DIAGNOSTIC STUDY

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Abbreviations

ABC	Agricultural Bank of China
ADB	Asian Development Bank
ADBC	Agricultural Development Bank of China
AIG	American International Group, Inc.
BOC	Bank of China
BOCom	Bank of Communications
CAM	China Microfinance Association
CBA	China Banking Association
CAR	capital adequacy ratio
CASS	Chinese Academy of Social Sciences
CBRC	Chinese Banking Regulatory Commission
CCB	China Construction Bank (also used for city commercial bank)
CCP	Chinese Communist Party
CCXI	China Chengxin International Ltd.
CDB	China Development Bank
CFPA	Chinese Foundation for Poverty Alleviation
CGAP	Consultative Group to Assist the Poor
CICETE	China International Centre for Economic and Technical Exchanges
CIRC	Chinese Insurance Regulatory Commission
CMB	China Merchants Bank
CNY	Chinese currency, the renminbi
FPC	Funding for the Poor Cooperative
GDP	gross domestic product
GHG	greenhouse gases
HCB	Harbin Commercial Bank
HXB	Hua Xia Bank
ICBC	Industrial and Commercial Bank of China
IFC	International Finance Corporation
IFC-CPDF	International Finance Corporation–China Project Development Facility
IPO	initial public offering (of stock)
IPC	International Project Consult GmbH
KfW	Kreditanstalt für Wiederaufbau
MCC	microcredit company
MF	microfinance
MFI	microfinance institution
MSME	micro, small, and medium enterprise
NGO	nongovernmental organization
NPL	nonperforming loan
PBC	Peoples' Bank of China
PICC	People' s Insurance Company of China
PoS	point of sale
PSBC	Postal Savings Bank of China
RCC	rural credit cooperative

RDI	Rural Development Institute
ROA	return on assets
ROE	return on equity
SMAP	Sustainable Microfinance Assistance for the Poor
SME	small and medium enterprise
SOE	state-owned enterprise
TIC	trust and investment corporation
UNCTAD	United Nations Conference on Trade and Development
UNDP	United Nations Development Programme
UNFCCC	United Nations Framework on Climate Change
WTO	World Trade Organization

All dollar amounts in U.S. dollars unless otherwise noted.

Executive Summary

Financial Sector Background

As of year-end 2007, the Chinese financial system was dominated by a large banking sector comprised of 8,877 banking institutions with 189,921 outlets and almost 2.7 million employees. Total assets of the banking sector amounted to 52.6 trillion renminbi (CNY), an increase of CNY 8.6 trillion, or 9.7 percent, over 2006. In 2007 the net profit, or return on equity (ROE), and net return on assets (ROA) of the banking sector were 16.7 percent and 0.9 percent, respectively.

The top three types of banking institutions by assets in 2007 were large state-owned commercial banks, joint-stock commercial banks, and rural credit cooperatives (RCCs), which accounted respectively for 53 percent, 14 percent, and 11 percent of total banking sector assets. RCCs accounted for 11.5 percent of all deposits (CNY 2.2 trillion), 10 percent of all loans outstanding (CNY 1.6 trillion), and 85 percent of all agricultural loans.

In general, stated-owned banks mainly serve corporate clients. Commercial banks mainly serve larger small and medium enterprises (SMEs) and state-owned enterprises (SOEs). City and rural cooperatives mainly serve SMEs, although they cover only 30 to 40 percent of the loan needs of these enterprises. As a result, the loan requirements of a significant number of enterprises are not satisfied. Only recently have city commercial banks started to discover the unmet demand of SMEs and have begun serving this market segment.

Banking institutions are required to meet a capital adequacy ratio (CAR) threshold of 8 percent. Although no deposit insurance system existed in mid-2008, government plans were underway to introduce such a system some time that year. The extent of the ATM network is weak in China: in 2005 the number of ATMs in urban areas was only 272 per 1 million people; nationwide, it was 73 per 1 million—much lower than the worldwide average. Official interbank transactions go through the National Interbank Funding Center, a subsidiary of the People's Bank of China. Real time gross settlement was not available as of mid-2008.

The financial sector is dominated by five large state-owned commercial banks. Although these banks continue to enjoy the largest market share, they are being challenged by joint-stock commercial banks. Smaller, but important, players include three relatively new policy banks (China Development Bank, Agricultural Development Bank of China, and the Export-Import Bank of China); second-tier commercial banks (e.g., CITIC Industrial Bank and the Bank of Communications); and trust and investment corporations (TICs), which capture a smaller portion of the lending market.

Historically, the "big five" state banks have had specialized roles: the Industrial and Commercial Bank of China provided working capital loans to state industrial enterprises; the Agricultural Bank of China specialized in agricultural lending (but is now exiting the agriculture sector); China Construction Bank provided funds for construction and fixed asset investment; the Bank of China specialized in trade finance and foreign exchange transactions; and the Bank of Communications provided lending for transportation and infrastructure projects. All of these banks also provided numerous commercial banking products.

Over the last few years each of these banks, with the exception of ABC, has undertaken steps to reform. (Due to its complex interdependencies with the agricultural sector, the reform of ABC has been slower.) In order to address the problem of a high rate of nonperforming loans, the government in 2001 established bank asset companies to take nonperforming loans of CNY 169 trillion ($23.4 billion) off bank balance sheets. From 2003 to 2006 the banks improved their average NPL ratio from 17.9 to 7.5 percent of all outstanding loans. The banks also received a capital injection financed by the central government that helped "dress up" their balance sheets and capital adequacy ratios, with the justification that most of the bad loans—which the capital injections helped write off—resulted from "old" government-directed lending practices (i.e., those that ignored commercial and credit principles). In return, the banks were expected to apply modern, risk-based commercial banking management practices going forward; the banks have in fact begun to professionalize their credit and risk management processes. Clearly, however, the transformation of their business and credit cultures will take time.

Equity market capitalization, excluding nontradable state-owned shares, is equivalent to just 17 percent of GDP, compared to 60 percent or more in other emerging markets. Corporate bond issues by nonfinancial companies amount to just 1 percent of GDP, compared to an average of 50 percent in other emerging markets. Although still in an early state of development, the Chinese capital market as a whole is growing rapidly and, in terms of volume, both the equity and the bond markets have reached a respectable size—at least by Asian standards.

Regulation and Supervision

Two major policy-making institutions regulate the banking sector: the People's Bank of China (PBC—the central bank) and the Chinese Banking Regulatory Commission (CBRC). The PBC and CBRC officially eliminated all interest caps in October 2004; however, the Supreme Court of China has ruled that interest rates greater than four times the PBC benchmark rate (depending on the loan term) are illegal.

The PBC concentrates on regulations that concern monetary conditions and financial system liquidity with a view toward promoting economic growth and price stability. It sets the interest rate bands for loans and deposits, as well as the level of reserve requirements and other ratios that affect bank liquidity. The PBC also monitors lending by banks and is authorized to issue regulations on the extension of credit by banks. The CBRC was created in June 2003, when it assumed responsibility for the regulation and supervision of financial institutions from the PBC. Reporting to the State Council, its key objective is to protect the interests of depositors and consumers. It focuses on the strength of financial institutions, capital adequacy issues, and restructuring of the banking sector.

SMEs: Market Demand and Supply

The potential future Chinese market for financial services is vast, especially for the lower end of the market. A 2005 survey carried out by China Agricultural University in five provinces indicated that coverage of the demand for financial services was between 30 and 60 percent. Gaps in the provision of such services vary regionally and are clearly wider in rural areas, where coverage of the demand for financial services was estimated at just 50 percent. There is also substantial disparity in the provision of financial services between coastal areas and more remote western and central areas, which lack adequate access to financial services.

The lesser-served, poorer rural residents of China number close to 900 million people and constitute the majority of the population. Only about 70 million rural clients are served by rural credit cooperatives, microcredit companies (MCCs), village banks, and nongovernmental organizations that are microfinance institutions (NGO-MFIs). Given the weight of this market segment within the total population of 1.3 billion, there is great potential for the rural financial market.

A clear definition of microenterprise does not, however, exist in China. According to a 2005 survey by the Chinese Banking Regulatory Commission, SMEs represent 99 percent of all enterprises in China, 50 percent of the turnover of all firms, 60 percent of all export income, 30 percent of all tax revenues, and 70 percent of the workforce. Around 70 percent of SMEs employ fewer than five people or are individual enterprises.

According to a number of major surveys, including those conducted by the International Finance Corporation-China Project Development Facility and the Chinese Academy of Social Sciences (CASS), lack of funding is the main obstacle to SME development. A 2005 CBRC survey found that 66 percent of SMEs have difficulty accessing financial resources. Only 16 percent access credit through banks, leading to significant reliance on internal and informal financial channels. It is important to note that just because this type of finance is informal, it is not necessarily illegal. Usury lending is indeed illegal, but borrowing from private persons in general (outside of fundraising from the general public) is permitted.

The People's Bank of China (PBC) estimates that there is an "underground portfolio" of $300 billion circulating informally in the form of loans to families and private businesses. This amount represents about 20 percent of all lending in China. The informal financial sector in the country is, moreover, still growing in areas where there is no formal alternative. According to CASS, informal lending per household in 2006 was $165 (CNY 1,148). In total, 250 million households borrowed $38 million (CNY 270 million) from informal sources that year. The scale of informal lending makes it extremely hard for central policymakers to set monetary policy and manage the financial market.

Current Microfinance Initiatives

As the key policy-making and regulatory bodies for microfinance, the CBRC and PBC have implemented a series of new policies and regulations for the sector, in addition to working with provincial governments to authorize pilot projects that will expand access to finance throughout the country. In recent years two pilot microfinance initiatives have been launched: microcredit companies (MCCs, promoted by the PBC) and village banks (promoted by the CBRC). In addition, several third-tier banks are implementing downscaling programs.

The "credit only" microcredit companies (MCC) of the PBC pilot projects are permitted to provide lending services, but cannot accept deposits. Loans are financed by their own funds, donations, or wholesale funds. No more than five shareholders in an MCC are permitted in principle, and minimum capital is set at CNY 5 million. The ceiling on a single loan is CNY 100,000 ($14,100) and the lending interest rate can be negotiated between the lender and the borrower. By the end of May 2008, the five provinces in the pilot had already launched seven microcredit companies.

In late 2006, the CBRC announced a new rural finance strategy that authorized a range of new financial institutions, including village and township banks. The new policy lowered the registered capital threshold of these banks to CNY 3 million ($430,000) in counties and CNY 1 million CNY ($140,000) in townships. One important component of the policy is that existing financial institutions are required to be the initiators of new village banks; these institutions can hold no less than 20 percent of total village bank shares, while any additional private investor can hold no more than 10 percent.

By the end of May 2008, 25 village banks, 4 wholly owned lending subsidiaries of commercial banks, 9 farmers' funding cooperatives, and 9 microcredit companies (7 domestic and 2 wholly foreign-owned) had been established. Among 113 city commercial banks—another official category of Chinese banks—only 11 offer microfinance; these banks are located in Lanzhou, Taizhou, Jiujiang, Baotou, Guiyang, Guilin, Deyang, Daqing, Chonqing, Quijang, and Jingzhou. In addition, the Baotou Commercial Bank has obtained approval from the CBRC to expand to Chifeng and Ningbo.

The Postal Savings Bank of China (PSBC) was formed at the end of 2006 and assumed the banking businesses of the State Post Bureau with a mandate to broaden access to financial services, especially in rural areas (for agricultural production). Due to the extensive nationwide branch network (around 21,000 branches) of China Post, the PSBC is well positioned in the rural banking market. In addition to existing savings and money transfer services, the bank is expanding its services to include loans, insurance, and other financial services. In March 2007, the PSBC launched a pilot program that offers collateralized microloans through 1,901 offices (including 1,264 rural community offices) in 31 provinces throughout the country. As of June 2008, the program had issued a total of 488,000 loans that were collectively valued at $228 million, with about 67 percent of the loans made in rural areas.

The most prominent NGO microfinance programs in the country include the China Foundation for Poverty Alleviation, Funding the Poor Cooperative, and Sustainable Microfinance Assistance for the Poor. In general, this type of MFI in China is constrained by limited capital and institutional capacity, as well as lack of legal recognition. Although the government's interest in microfinance has been increasing—as evidenced by the 2005 "Document #1" of the Central Committee of the Chinese Communist Party and the State Department, which calls for the formulation of regulations to support the development of microfinance institutions—NGO-MFIs currently remain unsupervised by any government body. The uncertainty caused by the ambiguous regulatory environment also constrains their development and long-term sustainability. The majority of these MFIs have been funded through grants (for loan capital and operational expenses) from international donors and the government. Often programs that are begun as experiments or projects are discontinued when donor funding runs out.

Chinese microfinance NGOs are prohibited from collecting deposits and most employ Grameen lending methodology. Despite their limitations, these microfinance programs have succeeded in demonstrating that loans to poor households will be repaid, regardless of relatively high interest rates. As of year-end 2007, microfinance NGOs had extended loans of over CNY 1 billion ($141 million), with an average loan size of CNY 3,000 ($423), through some 300 programs. Overall, these programs were managing approximately $50 million in funding and serving tens of thousands of clients.

With respect to microsavings, the Agricultural Bank of China, the Agricultural Development Bank of China, the Postal Savings Bank of China, and a number of rural credit cooperatives (RCCs) have extensive branch networks, offering their services to both rural and urban populations. The Chinese insurance market, however, remains largely underdeveloped, although its growth has been rapid in recent years. Only 6 percent of the population has a modest knowledge of the benefits of life insurance, and significant distrust of insurance policies remains.

Challenges of the Financial Sector and Microfinance

Despite considerable improvements in management, operating capability, and practices, a number of weaknesses within Chinese banks and their operating environment hinder their further reform and development. For example, bank branch executives continue to be placed in their jobs based on their connections with the Chinese Communist Party. There is also continued pressure, particularly from provincial and local government entities, to make "directed loans" to local uncreditworthy borrowers.

In addition, a false sense of security has been engendered by government recapitalizations and the transfer of problem loans to asset management companies. These maneuvers have created the image of "better banks," when in reality only the numbers are different, while the banks' operating and lending standards remain unchanged. Some observers fear that Chinese banks are just refilling their balance sheets with more bad loans, with their asset quality problems masked by fast loan growth. Slow capital market development and reform are also creating problems. First, banks continue to supply an inappropriate proportion of capital to Chinese state-owned companies because the vast majority of private businesses have inadequate or no access to equity markets or, effectively, bond markets. Banks are thus exposing themselves to equity risk.

Chinese bank managers, moreover, have no real experience in dealing with economic cycles. Because lending decisions for almost every loan in the portfolios of Chinese banks have been made during a period of strong economic conditions, the ability of these banks to deal with an economic downturn is a profound source of systemic risk. Unfortunately, most lending decisions are made based on the value of collateral instead of anticipated sources of cash flow repayment. Collateral valuation is, moreover, rarely realistic, as it is based on ideal market conditions for asset sale, instead of the distress or market downturn scenarios that would likely prevail in conjunction with borrower credit problems. Realizable recovery estimates also fail to incorporate liquidation costs. Finally, where credit factors are incorporated into lending decisions, credit analysis is superficial and, almost without exception, lacks forward-looking financial and business projections for borrowers.

With respect to microfinance, only a few legal windows exist in China that can be explored by investors interested in commercially sustainable providers.

- Rural credit cooperatives are regulated by the CBRC, but suffer from interest caps (2.3 times the PBC base rate) and unclear ownership. Nevertheless, they have huge outreach, as these institutions exist throughout the country.
- Village banks are able to offer deposit and credit products, but at least one investor in a village bank must be a bank.
- Microcredit companies are only allowed to offer credit products; their lending rate is restricted to 4 times the PBC base rate.

Microfinance faces a number of difficult challenges in China. First and foremost, regulatory and other governmental authorities lack an understanding of microfinance best practices. Regulatory frameworks and policies governing microfinance also remain vague, creating regulatory uncertainty. For example, there is no framework for nondeposit-taking lending institutions, such as microcredit companies (MCCs), which were initially established as nonfinancial entities, nor is there any regulation of NGO-MFIs. In addition, investment funds run by international microfinance networks are not regulated entities and no guidelines exist to support the establishment of national and regional umbrella-type microfinance entities that could invest or service multiple MFIs. Finally, no legal route exists to transform existing NGO-MFIs into MCCs or village banks; nor is there a legal route for the transformation of MCCs into commercial banks.

Introduction

Political Environment

The Chinese Communist Party (CCP) has governed the People's Republic of China (China) since 1949. At the five-year Party Congress in 2002, Hu Jintao was named President and CCP General Secretary and Wen Jiabao was named Prime Minister; they were re-elected in 2007.[1] There are no other parties that have any significant impact on the political environment in China.

In line with its economic rise, China has gained the confidence to act at the international level, for example, by showing its opposition to the Third Gulf War and by its engagement in Africa. China's need for raw materials to feed its remarkable economic growth has forced it to become a leading player in global commodities markets and to secure supplies through bilateral agreements, mostly in the developing world. However, the nature of many of these bilateral agreements has drawn much criticism, as they are seen as being far too favorable to China and exploitative of developing nations in Africa and South America (e.g., China's arm sales to Sudan and other African countries). The principle underlying China's foreign policy is termed "non-interference in domestic affairs"; the Chinese view on human rights reflects this principle. However, despite much criticism from human rights activists, China's new international presence has altered the global economic landscape.

Domestically, China's broad policy objectives are to build a well-off and harmonious society, termed "Xiaokang" (meaning the stage of development that ensures a decent material standard of living), and to meet the Millennium Development Goals. The Chinese government has emphasized specific policy goals, such as balancing development, both regionally and between urban and rural areas; creating job opportunities; improving social security and public health; and developing cultural, educational, and social programs. It is China's goal to achieve Xiaokang in the first two decades of the 21st century.[2]

For many years, China prioritized economic growth over environmental considerations, which led to a concomitant growth in greenhouse gas (GHG) emissions and other pollution. The overall increase in GHG emissions and the focus on China as the world's largest emitter creates great pressure for China to constrain emissions growth and help implement the United Nations Framework on Climate Change (UNFCC). In order to mitigate its emissions,

[1] *The Economist*, 2005, "China's New Authoritarianism," August 18, 2005, http://www.economist.com/research/backgrounders/displaystory.cfm?story_id=4300177 (accessed June 2009).
[2] UNDP, 2005, "China Development Report 2005," UNDP, New York, NY, 1–3.

numerous policies have been adopted to achieve domestic energy efficiency and renewable energy targets. China has also identified climate change as a key policy area. In June 2007, it announced the National Program on Climate Change, an important document intended to guide future national and provincial policies on climate change.

China's new labor law, which went into effect in January 2008, requires that employers and employees enter into one of three types of written contract: a fixed-term contract, an open-term contract, or a contract the term of which is linked to the completion of a specific task. Social insurance must be paid by the employer. At present, most private companies do not pay social insurance for their employees and many workers do not have labor contracts of any type.[3]

China's landmark property law, effective October 2007, provides equal protection to both state and private property. The law, approved by the national legislature in March 2007 after repeated revisions and an unprecedented eight readings, is seen as a significant step in the country's efforts to further economic reforms and boost social harmony.[4]

As of year-end 2006, the country's total population was 1.3 billion, excluding the populations of Hong Kong, Macao, and Taiwan. China has at least 56 ethnic groups, including Zhuang, Manchu, Hui, Miao, Uighur, Yi, Tujia, Mongolian, and Tibetan, which have diverse cultures, languages, and dialects. However, the majority of the population (92 percent) is Han Chinese and the official language is Mandarin Chinese.

In 2006, 43.9 percent of the Chinese population lived in urban areas and 56.1 percent in rural areas.[5]

With the spotlight of the 2008 Olympics shining on China, human rights, freedom of the press, and corruption remained major concerns in the international community. In order to win the right to host the 2008 Olympics, Chinese authorities promised in 2001 that the games would be an opportunity to foster democracy, improve

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[3] See Donald Straszheim, 2008, "China's Tangled New Labor Law," Forbes.com, January 13, 2008, http://www.forbes.com/2008/01/11/straszheim-china-labor-oped-cx_dhs_0114straszheim.html (accessed June 2009).

[4] See "China Law and Justice" section of the ChinaToday.com Web site, n.d., InfoPacific Development, Inc. Canada, http://www.chinatoday.com/law/a.htm (accessed June 2009).

[5] National Bureau of Statistics of China, 2007, *China Statistical Yearbook 2007* (Beijing: China Statistics Press), chapter 4, 4, http://www.stats.gov.cn/tjsj/ndsj/2007/indexeh.htm (accessed June 2008).

human rights, and integrate China with the rest of the world.[6] While China is becoming increasingly integrated globally, especially with respect to economic affairs, much room for improvement remains. China plans to establish a national anticorruption bureau to systematically reduce corruption at central and local levels, but results remain to be seen. In 2006, China ranked 70 among 163 countries in Transparency International's *Corruption Perception Index*.[7]

Macroeconomic Context

China started reforming its economy in the late 1970s, changing from a centrally planned system towards a more market-oriented economy. Thanks to restructuring efforts and the resulting efficiency gains, gross national product (GDP) has increased more than tenfold since 1978 and China has become a major player in the global economy.

China is currently the second largest economy in the world in terms of GDP, as measured in purchasing power parity, and is forecast to become the world leader by 2041—providing it can ensure a sound macroeconomic environment, greater social equity, and environmental sustainability. While initiatives exist on all fronts, the pace of change in the country is so rapid that tensions and instability are inevitable. For each of modern China's many achievements, there are complex trade-offs.

Nevertheless, the economy's growth—which in the past was mainly led by the manufacturing sector—is expected to continue its positive development. According to the Chinese Central Bank, four different factors should help sustain current growth levels: social and economic reforms (e.g., privatization of state-owned enterprises), foreign direct investment, development in the education and technology sectors, and, finally, urbanization (which is driving market demand and resulting in massive infrastructure investments).[8]

China's pace of growth—the country's GDP increased an average of 10.2 percent a year between 1990 and 2006[9]—is achieved on the back of massive energy demand. This growth is creating substantial inefficiencies and environmental consequences. While China's economy represents approximately 6 percent of global GDP, it is responsible for 15 percent of global energy consumption. Some 75 percent of the country's energy demand is met by coal-fired power

[6] Reporters without Borders, n.d., "Repression Continues in China, One Month before Olympic Games," Reporters without Borders, Paris, France, http://www.rsf.org/rubrique.php3?id_rubrique=174 (accessed June 2009).
[7] Transparency International, 2006, *Corruption Perceptions Index 2006* (Berlin: Transparency International).
[8] Monetary Policy Committee of the PBC, as cited by ChinaDaily.com, 2007, "Four Factors Bolster China's Economic Growth," June 18, 2007, http://www.chinadaily.com.cn/bizchina/2007-06/18/content_896806.htm (accessed June 2009).
[9] National Bureau of Statistics, 2007, *China Statistical Yearbook 2007*.

stations. China is already considered to be the world's largest GHG emitter, although its per capita emissions are one-sixth those of the United States.[10] According to the World Bank, 16 of the world's 20 most polluted cities are in China,[11] and respiratory and heart diseases related to air pollution are the leading cause of death in China.[12]

China's enormous potential market, relatively inexpensive workforce, and commitment to economic liberalization have attracted the highest levels of foreign direct investment (FDI) in the world. While FDI equaled only $1.1 billion in 1980, it grew to $20.7 billion in 1990 and $292 billion in 2006.[13] In the first five months of 2008 alone, foreign enterprises invested $42.8 billion in China. Foreign investment remains a strong element in its remarkable expansion in world trade and has been an important factor in the growth of urban jobs.

Similarly, China's outgoing foreign investment has experienced impressive changes in the last decade. From an annual average of $2.2 billion between 1990 and 2000, outward investment flows increased to $16.1 billion in 2006.[14] By the end of 2006, more than 5,000 investment entities had established almost 10,000 companies overseas in 172 countries and regions. China's total direct investments abroad amounted to $92.1 billion in 2007.[15]

China kept its currency tightly linked to the U.S. dollar for years and only moved to a new exchange rate system, which references a basket of currencies, in 2005. The Chinese renminbi (CNY) is not a freely tradable currency. Institutions need to obtain a license to be able to deal in CNY, which is not possible outside of China.

The renminbi appreciated by more than 6 percent against the U.S. dollar during 2007, during which China's current account surplus surged further, to about US$300 billion. With a surplus in both its

[10] SustainAbility, 2007, "China: New Landscapes (November)," SustainAbility, London, UK, http://www.sustainability.com/sa-services/emerging_article.asp?id=1259 (accessed June 2009).
[11] See Kiran Dev Pandey et al., 2006, *Ambient Particulate Matter Concentrations in Residential and Pollution Hotspot Areas of World Cities: New Estimates Based on the Global Model of Ambient Particulates (GMAPS),* World Bank Development Economics Research Group and Environment Department Working Paper, World Bank, Washington, DC.
[12] See WHO and UNDP, 2001, "Environment and People's Health in China," WHO, Geneva, Switzerland.
[13] UNCTAD, *U.N. World Investment Report 2007* (Geneva: UNCTAD), http://www.unctad.org/en/docs/wir2007_en.pdf (accessed June 2009).
[14] Ibid.
[15] China Council for the Promotion of International Trade, as cited in ChinaDaily.com, 2008, "China's Direct Investments Abroad Top $92b by 2007," April 17, 2008, http://www.chinadaily.com.cn/bizchina/2008-04/17/content_6624488.htm (accessed June 2009).

current and capital accounts, China had accumulated more than $1,400 billion in official foreign reserves as of year-end 2007.[16]

In February 2008 year-on-year consumer price inflation peaked at a 12-year record of 8.7 percent. Inflation has been driven by rising food prices, particularly for pork and eggs. A falling supply of agricultural land, water shortages, and rising fuel and fertilizer costs will collectively put upward pressure on food prices over the long term. High inflation expectations are becoming more entrenched among the public, and demand-driven inflationary pressures were expected to remain strong in 2008.

In 2007 China's labor force totaled 803.3 million people and the unemployment rate stood at 4 percent in urban areas. The Beijing region had the lowest unemployment rate in 2006 (only 2 percent), while the Liaoning region had the highest (5.1 percent). According to the National Bureau of Statistics, urban unemployment grew at an average rate of 6.1 percent between 2001 and 2006. Although exact figures for rural areas are not available, it is widely known that those areas continue to suffer from substantial under- and unemployment.

At the same time, the reform of state-owned enterprises (SOEs) has led to massive structural unemployment. Millions of jobless individuals, with no pensions or health care, have led a tidal migration to the cities in search of work. Nine million new jobs were created in China in 2007 for 25 million job seekers; excess unemployment may thus contribute to inexpensive labor. The protection of workers rights is often negligible and overseas multinationals that are operating or subcontracting in China have a role in encouraging and safeguarding best practices.[17]

Apart from unemployment, the income gap between rural and urban areas also remains an issue. According to government figures, the income ratio between urban and rural residents was 3.28:1 in 2006, as compared to 3.23:1 in 2003, and continues to widen.[18]

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[16] UN, 2008, *World Economic Situation and Prospects 2008* (New York: UN), 17, http://www.un.org/esa/policy/publications/papers.htm#2008 (accessed June 2009).

[17] SustainAbility, 2007, "China: New Landscapes."

[18] National Population and Family Planning Commission (NPFPC) of China, citing Xinhua, "Rural-Urban Gap Still Widening," December 27, 2007, NPFPC, Beijing, http://www.npfpc.gov.cn/en/en2007-12/news20071227.htm.

Table 1. Snapshot of Chinese Economy, 2004–2007

	2004	2005	2006	2007
GDP ($ trillions)	1.9	2.2	2.6	N/A
Annual GDP growth (%)	10.1	10.4	11.1	10.7
GDP per capita (US$)	1,490	1,706	2,020	N/A
Inflation	7	4.4	2.9	6.9
Exchange rate CNY:USD	8.28	8.07	7.97	7.61
Official unemployment rate (%)	4.2	4.2	4.1	N/A

Source: World Bank, World Development Indicators (online database), accessed June 2008.

Rating

Moody's gave China a sovereign rating of A1 in 2007. That same year, Standard and Poor's gave China a sovereign credit rating of A with a positive outlook. The China Development Bank, one of three policy banks involved in various microfinance programs, shares the sovereign ratings.

Government Priorities

The 11th Five-Year Plan (2006–2010), approved by the National People's Congress in March 2006, calls for a 20 percent reduction in energy consumption per unit of GDP by 2010 and an estimated 45 percent increase in GDP by the same year. The plan states that conserving resources and protecting the environment are basic goals, but lacks details on the policies and reforms necessary to achieve these goals.[19] The key points of the plan are:[20]

- building a new socialist countryside
- optimizing and upgrading industry
- accelerating the development of the service industry
- promoting balanced development among regions
- building a resource-conserving and environmentally friendly society
- developing China through science and education
- deepening institutional reform
- carrying out an "opening up" strategy
- building a socialist democratic political system
- promoting national defense and the army

[19] CIA, 2008 (June), *World Factbook* (online version), CIA, Langley, VA, https://www.cia.gov/library/publications/the-world-factbook/geos/ch.html (accessed June 2008).
[20] National Development and Reform Commission (NDRC), 2006, "The 11th Five-Year Plan: Targets, Paths, and Policy Orientation" (March), NDRC, Beijing, China, http://english.gov.cn/2006-03/23/content_234832.htm (accessed June 2008); Gov.cn (official Web portal of Chinese government), 2006, "The 11th Five-Year Plan," http://www.gov.cn/english/special/115y_index.htm (accessed June 2009).

- establishing and improving the implementation mechanisms of the five-year plan

The incorporation of a "scientific outlook on development" into the CCP constitution during the October 2007 Party Congress suggests that improving the quality of economic growth remains a policy focus for 2008–2009. The concept emphasizes sustainable and balanced growth. Although President Hu Jintao has stressed the need for continued rapid expansion of the economy, "scientific outlook" is likely to mean that increasing attention will be paid to the environmental impact of growth. In addition, the government will continue its drive to spread the benefits of development to all sections of society and thus narrow income disparities.[21] In this context microfinance is becoming an increasingly important instrument in the development of the rural financial sector and the delivery of financial products and services to "un-banked" groups in the population.

Private Sector/ MSME Overview

In China, a clear definition of microenterprises does not exist. For small and medium enterprises (SMEs) the categorization is defined as shown in table 2 below. Due to the fact that there is no clear definition of microenterprises, the following section focuses on SMEs, presuming that the challenges faced by these institutions are similar to those experienced by microenterprises.

[21] The Economist Intelligence Unit, 2007, *Country Report: China* (London: EUI).

Table 2. Standards for Enterprises of Different Sizes, by Industry

Industry	Index	Unit of Measure-ment	Large	Medium	Small
Industrial enterprises	# of employees sales volume total assets	person 10,000 CNY 10,000 CNY	> 2,000 > 30,000 > 40,000	< 300 – 2,000 < 3,000 – 30,000 < 4,000 – 40,000	< 300 < 3,000 < 4,000
Construction enterprises	# of employees sales volume total assets	person 10,000 CNY 10,000 CNY	> 3,000 > 30,000 > 40,000	< 600 – 3,000 < 3,000 – 30,000 < 4,000 – 40,000	< 600 < 3,000 < 4,000
Wholesale industry	# of employees sales volume	person 10,000 CNY	> 200 > 30,000	< 100 – 200 < 3,000 – 30,000	< 100 Below 3,000
Retail industry	# of employees sales volume	person 10,000 CNY	> 500 > 15,000	< 100 – 500 < 1,000 – 15,000	< 100 < 1,000
Transportation industry	# of employees sales volume	person 10,000 CNY	> 3,000 > 30,000	< 500 – 3,000 < 3,000 – 30,000	< 500 < 3,000
Delivery services	# of employees sales volume	person 10,000 CNY	> 1,000 > 30,000	< 400 – 1,000 < 3,000 – 30,000	< 400 < 3,000
Hospitality industry	# of employees sales volume	person 10,000 CNY	> 800 > 15,000	< 400 – 800 < 3,000 – 15,000	< 400 < 3,000

Source: National Bureau of Statistics, 2003, based on Document No. 143 [May 22, 2003] of the State Economic and Trade Commission, Beijing, China.

Since the first economic reforms in the 1980s, the number of private firms has grown rapidly. About 200 large state companies remain, basically in natural resources and the heavy industries, such as power and construction.

According to a survey by the Chinese Banking Regulatory Commission (CBRC), SMEs represent:

- 99 percent of all enterprises in China
- 50 percent of the turnover of all firms
- 60 percent of all export income
- 30 percent of all tax revenues
- 70 percent of the workforce.[22]

Excluding the over 20 million individually owned enterprises, the proportion of formally registered, nonstate-owned legal entities among all formally registered businesses grew from 26.1 percent to 70.1 percent between 1996 and 2005. The special nature of Chinese SMEs reflects their specific influence on the ongoing transition of the

[22] CBRC, 2005, "SME Finance in China" (November), CBRC, Beijing, China. Even though there is no clear definition of microenterprises, it can be assumed that they comprise a large number of small enterprises.

country's economic system and social structure. For example, the development of privately owned SMEs has not only changed the enterprise ownership structure, it has also laid an important foundation of China's developing market economy.[23]

Around 70 percent of SMEs employ fewer than five people or are individual enterprises.[24] According to data from the *China Labor Statistical Yearbook 2007*, about 42 million SMEs are registered, accounting for more than 99 percent of all registered enterprises. SMEs are involved in the trade of goods from the primary, secondary, and tertiary industrial markets. While SMEs are located throughout China, statistics show that one-sixth of all such enterprises are located in the eastern provinces. SMEs are expected to contribute to a number of positive developments, including helping create new jobs, advance productivity, narrow the gap between urban and rural areas, iron out regional disparities, and increase the income of urban and rural residents.

Obstacles to SME Growth and Access to Finance

The following obstacles currently hamper SME growth:[25]

- China's law on enterprises creates too many obstacles to business formation
- lack of social safety nets for workers
- poor implementation of current labor laws, especially those regarding working conditions and dismissals
- lack of access to finance

According to a number of major surveys, for example, those conducted by the International Finance Corporation-China Project Development Facility (IFC-CPDF) or the Chinese Academy of Social Sciences (CASS), lack of funding is the main obstacle to SME development.[26] According to the 2005 CBRC survey, 66 percent of SMEs have difficulty accessing financial resources. Only 16 percent access credit through banks, leading to significant reliance on internal and informal financial channels. Among the reasons for poor access to finance are:[27]

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[23] Shan-shan Meng and Hui-ying Wang, 2007, "Solutions to Small- and Medium-sized Enterprise Financial Services of China," *China-USA Business Review* [China Business Review, Flushing, NY] 6, no. 3 (March): 79–82.
[24] Chris Hall, 2007, "When the Dragon Awakes," *CESifo Forum* [Ifo Institute for Economic Research, Munich] 8, no. 2 (summer): 29–34, http://www.cesifo-group.de/portal/page/portal/ifoHome/b-publ/b2journal/30publforum/_publforum?item_link=forumindex2-07.htm (accessed June 2009).
[25] W. Mako, 2004, "Investment Climate for Small and Medium Enterprises in Western China," World Bank, Washington, DC, iv–v.
[26] CBRC, 2005, "SME Finance in China" (November).
[27] Ibid.

Macro obstacles:

- a dysfunctional legal system
- a vague and restrictive regulatory structure
- medium-sized companies lack financing options on capital markets
- lack of a legal requirement that banks serve smaller clients, given insufficient competition in the banking sector[28]
- long previous use of interest rate caps
- most banks consider serving low-end market groups a social, not commercial, objective
- an obstructive social, legal, and credit environment, especially regarding property rights[29] and the use of floating liens
- preferential access to bank credit by large state-owned enterprises and government infrastructure projects, which crowd out nonstate enterprises, especially SMEs

Micro obstacles:

- banking institutions lack core credit technologies and skills to profitably exploit SME markets, particularly the microfinance market
- the credit culture and management policies of commercial banks cannot be adapted to SME lending
- banks lack experience lending to smaller enterprises
- SMEs were unable until recently to use inventory or receivables as collateral[30]
- under-utilization of credit registries, making it more difficult for banks to obtain credit information on potential borrowers
- incomplete application of international accounting and auditing standards by SMEs, which reduces financial transparency and increases risk
- the higher transaction costs of smaller loans
- intrinsic risk of lending to SMEs as opposed to large firms, given their greater vulnerability to market changes and often inadequate management capabilities

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[28] This situation has changed moderately, as several city commercial banks are now forced to deal with micro and small enterprise clients due to intense competition in other markets.

[29] The new property law of 2007 has improved the property rights situation.

[30] "Capitalist Fillip for China's New Socialist Countryside," 2007, *China Development Brief* (online publication, Beijing, China), March 16, 2007, http://www.chinadevelopmentbrief.com/node/1029 (accessed June 2009).

Demand for Financial Services

Current Structure of Bank Coverage

The demand for financial services in China is difficult to establish, given the enormous size of the country, relatively large size of the grey economy, and lack of documentation and data. Total financial services demand, especially loans demanded for SME development, far exceeds the actual amount supplied. Although start-up capital for most small and medium enterprises originates from self-accumulation or fundraising, more than 50 percent of these enterprises still rely on loans from financial institutions.

Once SME businesses are operational, their demand for financial services is even greater during production and investment expansion (the latter is mainly demand for working capital and some fixed asset investment). If one wants to invest, there must be financing. Except for some well-performing SMEs, the vast majority do not have enough self-accumulated capital to thoroughly meet investment requirements and, hence, must find a way to fill the financing gap.[31]

In general, stated-owned banks mainly serve corporate clients. Commercial banks mainly serve larger SMEs and state-owned enterprises (SOEs). City and rural cooperatives mainly serve SMEs, although they cover only 30 to 40 percent of the loan needs of these enterprises. As a result, the loan requirements of a significant number of enterprises are not satisfied. Only recently have city commercial banks started to discover the unmet demand of SMEs and have begun to serve this market segment.

Since the lending competence of state-owned commercial banks at the county level is fairly low,[32] they often need up to three months to process a loan application—a delay that adversely affects SMEs in need of immediate capital. Since state-owned bank branches at or below the county level lack objective means to evaluate the operational conditions of SMEs, the banks face losses in this business sector and have moved to the cities (1,450 such branches have been closed since 2000). City and rural credit cooperatives (coops) could step in to meet the capital needs of micro, small, and medium enterprises (MSMEs). But due to the capital limitations and structural problems of these banks, together with their high ratio of nonperforming loans (approximately 25 percent of the total loan portfolio), compared to state-owned commercial banks, their ability

[31] Ibid.
[32] China has 1,464 counties, which cover an area smaller than a province but bigger than a township.

to increase the loan supply has been small (CNY 25 billion in 2002). Coops in particular lack the human and financial resources to meet increased demand.

As a result of the lack of credit for MSMEs, informal lending continues to play a large role in China's financial sector. The People's Bank of China (PBC) estimates that there is an "underground portfolio" of $300 billion circulating informally—that is, illegally—in the form of loans to families and private businesses. This amount represents about 20 percent of all lending in China. The informal financial sector in the country is, moreover, still growing in areas where there is no formal alternative. According to CASS, informal lending per household in 2006 was $165 (CNY 1,148). In total, 250 million households borrowed $38 million (CNY 270 million) from informal resources that year. The scale of informal lending makes it extremely hard for central policymakers to set monetary policy and manage the financial market.

A great deal of lending continues to be based on *guanxi* (relationships or connections) rather than sound commercial criteria. In general, SMEs do not have the kind of connections needed to secure a loan, forcing them to rely on informal lending sources. And despite the efforts of international development agencies to encourage microfinance experiments in China, a deficit of "microcredit technology" remains with respect to smaller borrowers.[33]

Coverage of the demand for financial services varies both regionally and by urban/rural location. In urban areas and more developed provinces, coverage is relatively high. Financial services for SMEs are provided mainly by second-tier (joint-stock) banks. Coverage is very low in rural and less-developed provinces, partly due to the abovementioned constraints on state-owned commercial banks and cooperatives. Rural households rely on the informal sector—loans from family, friends, and various informal institutions—for roughly two-thirds of their financing needs.[34] Formal rural financing is available principally through the Agricultural Bank of China, the Agricultural Development Bank of China, Rural Credit Cooperatives, and in some provinces, village banks, microcredit companies, and outlets of the Postal Savings Bank. The loan supply provided by city and rural credit coops was just CNY 25 billion in 2002.[35]

[33] "Capitalist Filip," China Development Brief, 2007.
[34] ADB, 2004, "Lessons for People's Republic of China" (December), ADB, Beijing, China, 8.
[35] Yanzhong Wang, 2004, "Financing Difficulties and Structural Characteristics of SMEs in China," *China & World Economy* (Wiley-Blackwell) 12, no. 2, 42.

Demand/Supply Gaps in Financial Services

The potential future Chinese market for financial services is vast, especially for the lower end of the market. A 2005 survey carried out by China Agricultural University in five provinces indicated that coverage of demand for financial services was between 30 and 60 percent.

As noted previously, gaps vary regionally and are clearly wider in rural areas. The lesser-served, poorer rural residents of China number close to 900 million people and constitute the majority of the population. Only about 70 million rural clients are served by rural credit cooperatives (RCCs), microcredit companies (MCCs), village banks, and nongovernmental organizations that are microfinance institutions (NGO-MFIs). Given the weight of this market segment within the total population of 1.3 billion, there is great potential for the rural financial market.

According to the China Banking Regulatory Commission and the State Bureau of Statistics, in early 2008 the supply of financial services in rural areas was $407.8 billion (CNY 2.8 trillion) and demand, $849.6 billion (CNY 5.9 trillion), meaning that only 48 percent of rural demand was covered.[36]

The demand and supply of microfinance differs considerably between East China and Central and West China. The eastern provinces of the country are much more developed than the western provinces. Provinces in Central and West China, where most of the country's poorest people live, have greater demand for rural finance. Providing this group better access to credit could mitigate the otherwise potentially adverse distributional impacts of current financial reforms.[37]

Although the RCC system has an extensive branch network all over China, RCCs are not serving the microfinance market effectively. Not only do cooperatives lack suitable MSME products, they traditionally have significant problems with internal organization; most operate without a strategy or prudent and profitable procedures.

According to the central government, 592 counties in China are designated poor. According to provincial governments, the number is greater.

[36] China Banking Regulatory Commission and the State Bureau of Statistics, 2008, "Enterprise Solutions to Poverty," presentation, March 2008.
[37] Marco Saladini, 2005, "Access to Finance for Chinese Poor Households and Micro, Small, and Medium Enterprises," term paper, "China's Changing Role in the Global Economy" course, Nitze School of Advanced International Studies, Johns Hopkins University, Washington, DC, 6.

Savings and insurance play a key role in helping poor people manage emergencies and seasonal incomes. The situation of microsavings in China can be described as sufficient, since the Agricultural Bank of China, the Agricultural Development Bank of China, the Postal Savings Bank of China, and a number of RCCs[38] have extensive branch networks, offering their services to both rural and urban populations.

The Chinese insurance market remains largely underdeveloped. Its non-life insurance market is also still in the early stages, despite rapid growth in recent years.[39]

Remittances are also important in China. Labor migrants send home between CNY 200 billion and 300 billion annually. This money contributes up to half of the total income of receiving households and is crucial for sending children to school, improving their homes, paying for health care, or just meeting basic consumption needs. Secure remittances will become an ever more important means of channeling funds to remote and impoverished areas as the economy grows and labor migration increases.[40]

Financial Sector Overview

Overview

The Chinese financial system is dominated by a large banking sector comprised of 8,877 banking institutions with 189,921 outlets and almost 2.7 million employees. The financial sector is dominated by five large state-owned commercial banks. Smaller, but important, players include the policy banks (e.g., China Development Bank and the Export-Import Bank of China); second-tier commercial banks (e.g., CITIC Industrial Bank and Bank of Communications); and trust and investment corporations (ITICs), which capture a smaller portion of the lending market. Table 3 shows the financial institutions that made up the sector as of year-end 2007.

[38] See description of RCCs in the "Microfinance" section of this report.
[39] Benfield Group Limited, 2006, "China Insurance Market Review: Major Changes, Rapid Growth" (September), Benfield Industry Analysis and Research, Benfield Group Limited, London, UK.
[40] Renaud Meyer, Deputy Resident Representative UNDP China, 2006, "Speech at Asia Microfinance Forum," Beijing, March 22, 2006, UNDP China Web site, http://www.undp.org.cn/modules.php?op=modload &name=News&file=article&catid=13&topic=31&sid=258&mode=thread&order=0&thold=0 (accessed June 2009).

Table 3. Financial Institutions in China, Year-end 2007

Institution	Total number
Policy banks	3
State-owned commercial banks	5
Joint-stock commercial banks	12
City commercial banks	124
Urban credit cooperatives (UCCs)	42
Rural credit cooperatives (RCCs)	8,348[a]
Rural commercial banks	17
Rural cooperative banks	113
Village and township banks	19
Lending companies	4
Mutual credit cooperatives	8
Postal Saving Bank	1
Trust and investment corporations	54
Finance companies of enterprise groups	73
Financial leasing companies	10
Money brokerage firms	2
Auto financing companies	9
Foreign bank subsidiaries	29

Source: CBRC, 2007, "2007 Annual Report," CBRC, Beijing, China.
Note: [a] According to the CBRC's *2007 Annual Report*, the classification of RCCs changed from 2006 to 2007 due to the consolidation of many of these institutions, which explains the big decrease in their number from 19,348 in 2006 to 8,348 in 2007.

The pervasive state ownership of the banking sector in China and the historical role of banks as cash conduits in a controlled economy, rather than commercially managed financial institutions, has given rise to several weaknesses in the sector. These include a large proportion of nonperforming loans, poor profitability, a weak institutional framework for the banking system, weak corporate governance, and reduced competitive pressures on banks to operate as profit-making enterprises. A large share of bank funding goes to state-controlled companies, regardless of their profitability, leaving companies in the private sector credit constrained. Loans to the private sector, however, are increasing, rising from CNY 4.3 trillion in April 2007 to CNY 5.4 trillion in May 2008.[41]

The Chinese government has begun to liberalize the financial sector in recent years and international players now compete with domestic institutions in retail, corporate, and investment banking, as well as insurance. With the restructuring of China's postal system, the Postal Savings Bank of China (PSBC) was formed with the aim of

[41] PBC, "Statistics: 2008," PBC Web site, Beijing, China, http://www.pbc.gov.cn/english/diaochatongji/tongjishuju/ (accessed June 2009).

broadening access to financial services, especially for rural agricultural production.[42] At the end of 2006, the CBRC approved the establishment of the PSBC and its assumption of the banking businesses of the State Post Bureau.

In order to address the problem of a high rate of nonperforming loans (NPLs), the government in 2001 established bank asset companies to take nonperforming loans of CNY 169 trillion ($23.4 billion) off bank balance sheets. From 2003 to 2006 the banks improved their average NPL ratio from 17.9 to 7.5 percent of all outstanding loans. Through 2006, these asset companies accumulated CNY 1.4 trillion ($196.2 billion) in NPLs. At roughly the same time (2003), China implemented "Principles for Effective Banking Supervision" in order to foster improved risk management practices and better transparency, as well as to move closer to meeting Basel II standards.[43]

Rising corporate savings have been the main reason why overall savings have gone up in China.[44] As of June 2008, corporate savings roughly equaled household savings—about 23–24 percent of GDP. In December 2006, the government announced that state-owned enterprises (SOEs) were expected to disburse between 5 and 10 percent of their profits.[45] Since the enterprise reform implemented in 1999, the government has not sought dividends from SOEs, not even from those that are listed on the stock exchange and pay dividends to private shareholders. These enterprises either reinvest their profits or place them in low-earning deposit accounts.

Lending by banks is also hampered by lack of adequate information on borrowers' credit histories and financial performance, making lending to SOEs a low-risk option, given their government backing. Lack of enforcement by regulatory bodies that are politically connected has also created a very weak governance environment.[46] Furthermore, the highly decentralized structure of Chinese banks prevents them from reaping the benefits of scale. It also makes lending decisions at the branch level amenable to local government

[42] China Post News (online publication in Chinese), n.d., http://www.chinapostnews.com.cn/1061/10610103.htm (accessed June 2008) [in Chinese].
[43] CBRC, 2007, "2007 Annual Report," 60.
[44] Both state-owned enterprises (SOEs) and private SMEs accumulate large volumes of savings. Weak corporate governance by the government has allowed SOEs to accumulate savings, whereas private SMEs accumulate them because poor financial intermediation limits their access to bank credit. (IMF, 2007, "China's Rebalancing Act," *Finance and Development Quarterly Magazine* 44, no. 3 [September]).
[45] Ibid.
[46] Syetam Hansakul, 2004, "China's Financial Sector: Institutional Framework and Main Challenges," January 9, 2004, Deutsche Bank Research, Frankfurt, Germany, 4.

influence, preventing the allocation of loans according to market criteria.[47]

Table 4. Depth and Outreach of Chinese Financial Sector, 2004–2006

Item	2004	2005	2006
Total loans ($ trillion)	2.6	2.9	3.3
Loan growth (%)	11.07	0.10	13.19
Loans as % of GDP	118.00	113.00	122.00
Total deposits in ($ trillion)	3.5	4.2	4.8
Deposit growth (%)	14.9	18.57	15.94
Deposits as % of GDP	158.00	164.00	178.00
Loans as % of deposits	74.00	69.00	68.00
Cash as % of total deposits	N/A	N/A	N/A
No. of loans per 1,000 people	N/A	N/A	N/A
Number of financial institutions per 100,000 people	N/A	N/A	1.5
Number of branches per 100,000 people	N/A	N/A	14

Source: CBRC, 2006, "2006 Annual Report," CBRC, Beijing, China, http://www.cbrc.gov.cn/english/home/jsp/docView.jsp?docID=20070629AEBA179D923CBB30FFFBB638800F6300 (accessed June 2009).

Notes: N/A = not available.

State-owned Commercial Banks

The five large state-owned banks in China still enjoy the largest market share in the banking sector, but are being challenged by joint-stock commercial banks. Historically, these banks have had specialized roles: the Industrial and Commercial Bank of China (ICBC) provided working capital loans to state industrial enterprises; Agricultural Bank of China (ABC) specialized in agricultural lending; China Construction Bank (CCB) provided funds for construction and fixed asset investment; the Bank of China (BOC) specialized in trade finance and foreign exchange transactions; and the Bank of Communications provided lending for transportation and infrastructure projects. At the same time, all of these banks provided numerous commercial banking products. The ABC and the Postal Savings Bank of China (PSBC) are described in more detail below, given that both have launched microfinance initiatives.

Over the last few years each of these banks, with the exception of ABC, has undertaken steps to reform. (Due to its complex

[47] Meghana Ayyagari, Asli Demirgüç-Kunt, and Vojislav Maksimovic, 2008, "Formal versus Informal Finance: Evidence from China," World Bank Policy Research Working Paper, no. 4465, Development Research Group, Finance and Private Sector Team, World Bank, Washington, DC, 6–7.

interdependencies with the agricultural sector, the reform of ABC has been slower.) The banks received a capital injection financed by the central government that helped "dress up" their balance sheets and capital adequacy ratios, with the justification that most of the bad loans—which the capital injections helped write off—resulted from "old" government-directed lending practices (i.e., those that ignored commercial and credit principles). In return, the banks were expected to apply modern, risk-based commercial banking management practices going forward; the banks have in fact begun to professionalize their credit and risk management processes. Clearly, however, the transformation of their business and credit cultures will take time. The ownership structure of these banks has also been reformed: the state sold a portion of its holdings, retaining an ownership stake of 67.97 percent in CCB, 67.49 percent in BOC, and 70.66 percent in ICBC.[48] The effects of the reforms are already being reflected in the rising profit margins of these banks.[49]

Agricultural Bank of China

ABC was established in 1979 and took over the rural branch network of the People's Bank of China (PBC) when PBC was transformed into China's central bank. ABC is responsible for agricultural and economic development in rural areas, channeling government funds into this area. It is, however, steadily withdrawing from the agricultural sector; its principal areas of operation are now international business, personal banking, corporate banking, online banking, and bank cards.

Although the reform of ABC has been slower than that of the other four state-owned commercial banks, it was preparing for an initial public offering (IPO) of stock in 2007. The bank reported an NPL ratio of 23.6 percent in 2007, 2.5 percentage points lower than in 2005, but still well above the government-required 5 percent level for commercial banks.[50]

ABC is the only one of the "big five" state-owned banks that has ventured into small-scale microfinance services, which are offered at subsidized interest rates with low recovery and low sustainability rates. The bank has been entrusted with managing and operating the government's microcredit program.

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[48] Shanghai Stock Exchange, 2007, "China Construction Bank Annual Report 2007," Shanghai Stock Exchange, Shanghai, China, 84.

[49] Syetam Hansakul, 2007, "China's Bankensektor—Bereit für die nächste Runde" (March 6), Deutsche Bank Research, Frankfurt, Germany, 2–3.

[50] Reuters.com, 2008, "UPDATE 1-China AgBank's NPL Ratio Rises to 23.6 Pct in 2007," February 15, 2008, Thompson Reuters, New York, New York, http://www.reuters.com/article/rbssFinancialServicesAndRealEstateNews/idUSPEK34907620080215 (accessed June 2009).

Postal Savings Bank of China

China Post, a well-established provider of savings and money transfer services, received authorization in 2007 to establish the Postal Savings Bank of China (PSBC) as an independent financial institution to provide rural retail services. Due to the extensive branch network (around 21,000 branches) of China Post throughout the country, the PSBC is well positioned in the rural banking market. In addition to existing savings and money transfer services, PSBC is expanding its services to include loans, insurance, and other financial services.[51]

In March 2007, the PSBC launched a pilot program for collateralized microloans through 1,901 offices (including 1,264 rural community offices) in 31 provinces throughout the country. As of 2007, the program had issued a total of 488,000 loans collectively valued at $228 million, with about 67 percent of the loans made in rural areas.[52]

Policy Banks

In 1994 the government established three policy banks to relieve the "big five" of their state-directed lending role. They are the Agricultural Development Bank of China, which primarily took over the policy lending role of the ABC; China Development Bank, which mainly took over the policy lending role of the CCB and, to a certain degree, the ICBC; and the Export-Import Bank of China, which mostly took over the policy lending role of the BOC, particularly its trade financing function. Policy banks primarily fund themselves by issuing bonds, and secondly, by accepting deposits. The continued presence of state-directed lending in the banking sector is reflected in the rapid growth of the combined assets of these three policy banks, which now make up around 8 percent of total banking sector assets.[53]

China Development Bank

China Development Bank (CDB), founded in March 1994, is under the direct jurisdiction of the State Council. At present it has 32 branches and 4 representative offices across the country. Over the past decade CDB has conscientiously followed China's macroeconomic policies, carrying out its macro-control functions in support of national economic development and strategic structural readjustment. CDB has been a major player in the long-term financing of key development projects and has supported construction in infrastructure and other industries vital to the development of the national economy. Since 2005, through a refinancing facility funded by the World Bank and KfW, the CDB

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[51] J. Isern and L. Zou, 2007, "Highlight on China, Part 1: A View of the Landscape," October 7, 2007, CGAP/ Microfinance Gateway, Washington, DC, http://www.microfinancegateway.org/p/site/m//template.rc/ 1.26.9145 (accessed June 2009).

[52] J. Jiao, 2007, "Highlight on China, Part 4: Interview with People's Bank of China, Research Bureau," October 2007, CGAP/Microfinance Gateway, Washington, DC, http://www.microfinancegateway.org/p/ site/m//template.rc/1.9.26826 (accessed June 2009).

[53] Hansakul, 2004, "China's Financial Sector," 4.

has supported city commercial banks in their plans to expand MSME lending.

Joint-stock Commercial Banks

Joint-stock commercial banks are incorporated as joint-stock limited companies under China's company law. The shareholding structure of most of these banks is, however, still largely dominated by the state. Currently, there are 12 shareholding banks, which include such well-known names as the Bank of Communications, China Minsheng Bank, China Everbright Bank, China Merchants Bank, Shanghai Pudong Development Bank, and Shenzen Development Bank. They are allowed to offer a wide variety of banking services, including accepting deposits, extending loans, and providing foreign exchange and international transaction services. Due to their smaller size and a corporate culture more oriented towards the private sector, they are more competitive than their state-owned counterparts and have successfully gained market share at the expense of the big five. They have also successfully entered the small and medium enterprise (SME) loan market, an area in which state-owned banks are traditionally weak. Joint-stock commercial banks also tend to be more profitable, with higher rates of return on assets (ROA). Recently, international banks have indicated their preference for joint-stock banks as joint-venture partners in their attempts to gain access to China's banking sector.[54]

Foreign Banks

As a result of its accession to the World Trade Organization (WTO), China committed itself to a much wider opening of the banking sector to foreign competition, beginning in 2007. Foreign banks will not only be allowed to enter the country to serve their foreign customers, they will also be allowed to operate renminbi-denominated accounts and deal directly with Chinese customers in selected regions. An immediate challenge to Chinese banks is disintermediation. Savings diverted to foreign banks will reduce the arrival of fresh money into Chinese banks, which typically make loans to unprofitable state-owned enterprises, or enterprises and projects with explicit or implicit government backing. Reduced deposits will force previously latent problems (of both the banks and the enterprises) into the open.[55]

Despite WTO norms, however, experience indicates that additional domestic regulations or requirements may effectively constrain the ability of foreign banks to engage in renminbi-related business. For example, a foreign bank branch may need as much as CNY 600 million (roughly $84.6 million) in operating capital to support

[54] Ibid.
[55] Jin Chen, 2006, "China's Financial System: An Evaluation and Some Recommendations" *Perspectives* 7, no. 4 (December), 211.

activities in both hard currency and CNY. In addition, the PBC requires a capital adequacy ratio of 8 percent on top of that amount. Furthermore, the PBC announced in July 2002 that interbank borrowing would be capped at 40 percent of total CNY liabilities, which limits the CNY liquidity of foreign banks. Taken together, these restrictions make the opening of domestic branches by a foreign bank less commercially attractive.[56]

Still, most international players in the banking sector are active in China, opening branches (as well as locally registered entities) or investing in domestic banks (e.g., Citigroup, HSBC, Standard Chartered, and Deutsche Bank).

Nonbank Financial Institutions

In China three main types of nonbank financial institutions exist: trust and investment companies (TICs), finance companies, and leasing companies. Their total assets account for around 1 percent of all financial sector assets. Some of the large TICs have close relationships with provincial governments and function as a real estate investment vehicle for them.[57] Securities, asset management, and insurance companies also offer nonbank financial services.

Since the 1990s securities companies have been playing a significant role in the development of the stock exchanges in China. A recent trend shows ownership of securities companies is changing, with the private sector gaining more influence. Although the state-owned People's Insurance Company of China Group continues to dominate the insurance industry, most new domestic insurance companies are now joint-stock companies rather than state owned. These companies have also shifted their focus from earning market share to earning economic returns. Since China's WTO entry, its insurance sector has received great interest from foreign investors. Asset management firms, on the other hand, are relatively new: at the end of 2002, some 23 asset management companies managed around CNY 138 billion ($16.6 billion) worth of assets.

Challenges in the Banking System

Despite considerable improvements in management, operating capability, and practices, a number of weaknesses within Chinese banks and their operating environment hinder further reform and development, as indicated by the list below.

[56] Hansakul, 2004, "China's Financial Sector," 5.
[57] Ibid, 6.

- There is continued pressure, particularly from provincial and local government entities, to make "directed loans" to local uncreditworthy borrowers.
- Given the inexperience of Chinese bank managers in dealing with economic cycles, the impact of an economic slowdown or downturn on these banks will be more profound than on their developed market counterparts. Because lending decisions for almost every loan in the portfolios of these banks have been made during a period of strong economic conditions, the ability of these banks to deal with an economic downturn is a profound source of systemic risk. This systemic risk could lead to considerable losses when the Chinese economy eventually slows.
- Lending decisions are made based on the value of collateral instead of anticipated sources of cash flow repayment. Collateral valuation is, moreover, rarely realistic, as it is based on ideal market conditions for asset sale, instead of the distress or market downturn scenarios that would likely prevail in conjunction with borrower credit problems. Realizable recovery estimates also fail to incorporate liquidation costs.
- Where credit factors are incorporated into lending decisions, credit analysis is superficial and, almost without exception, lacks forward-looking financial and business projections for borrowers.
- The reform of state-owned enterprises remains slow due to government fear of loss of control and the political turmoil resulting from enterprise closures and lost jobs. The slowing of this reform makes the efforts of banks to improve borrower credit awareness and business practices, including borrower commitments to provide full and accurate information to bankers and to repay their loans, much more difficult.
- Barriers to improved information flow and internal controls persist, resulting from continued decentralization of management and authority. This decentralization is the legacy of the "planned economy" epoch, when branches were autonomous operating entities controlled by local political bosses who directed lending and staffing.
- Bank branch executives continue to be placed in their jobs based on their connections with the Chinese Communist Party (CCP) and other ties.
- A false sense of security has been engendered by government recapitalizations and the transfer of problem loans to asset management companies. These maneuvers have created the image of "better banks," when in reality only the numbers are

different, while the banks' operating and lending standards remain unchanged. Some observers fear that Chinese banks are just refilling their balance sheets with more bad loans, with asset quality problems masked by fast loan growth.

- There has been a lack of progress in improving the legal infrastructure. The CCP is not in a hurry to cede authority to the rule of law. The enforceability of existing laws is thus a matter of political expediency in the provinces.
- Loan officers lack credit skills. Many Chinese banks have markedly improved their risk management processes and loan decision-making standards, as well as upgraded the skill level of the senior and middle managers involved in lending and risk management. However, the lack of resources needed to adequately train the armies of bank loan officers who conduct initial credit assessments and analyze potential borrowers has left the first crucial element of risk management weak. Further, most Chinese banks do not understand the investment of time and resources required to adequately train loan officers; many believe that a credit seminar of a few days or a week constitutes credit training.
- Slow capital market development and reform is leading to two problems. First, banks continue to supply an inappropriate proportion of capital to Chinese state-owned companies because the vast majority of private businesses have inadequate or no access to equity markets or, effectively, bond markets. Banks are thus exposing themselves to equity risk. Second, Chinese families have no prudent savings alternatives to banks, as equity markets are inefficient and more or less equivalent to gambling. Banks thus have access to cheap and easy funding from deposits made by families and businesses that have no other choices as to where to place their money. These deposits are artificially cheap and available, and thus undervalued in the intermediation process.

Microfinance

Microfinance Providers

The concept of microfinance was introduced in China in 1993. Subsequently, donors, government authorities, and NGOs developed a range of microcredit projects or credit components—mainly in less-developed regions—mostly for poverty reduction purposes. A commercial microfinance industry did not really emerge in China until recently, due to the lack of an enabling environment.

In recent years two pilot initiatives have been launched: microcredit companies (promoted by the PBC) and village banks (promoted by the CBRC). In addition, several city commercial banks are implementing downscaling programs. The pilot projects of the PBC and CBRC are well underway and have resulted in several preliminary achievements. By the end of May 2008, 25 village banks, 4 wholly owned lending subsidiaries of commercial banks, 9 farmers' funding cooperatives, and 9 microcredit companies (7 domestic and 2 wholly foreign-owned) had been established.

Several international financial institutions and city commercial banks are also involved in MSME lending. As a result of all these activities, international microfinance banks and networks have started to show interest in the Chinese market (e.g., ACLEDA, XAC Bank, Grameen Bank).

The main approaches to microfinance delivery are listed below.

City Commercial Banks

Some 113 city commercial banks (CCBs) have been created from former urban cooperatives.[58] The majority shareholders of these banks are typically local governments (municipal and sometimes provincial) and enterprises (including SOEs and private companies). Thus, government intervention persists and their management approach, efficiency, and internal controls require further reform.

Most CCBs have very ambitious goals for developing MSME business. However, they have to balance rapid growth against the need to gain a full understanding of the MSME market and, consequently, sustainability measures.

Through a refinancing facility funded by the World Bank and KfW, the China Development Bank is supporting the CCBs in their plans to expand MSME lending. International Project Consult GmbH (IPC) is providing technical assistance to the CCBs. From the project's inception in December 2005 through the end of March 2008, over 29,000 MSME loans representing $288 million had been disbursed.[59] About 93 percent of the outstanding portfolio of MSME loans consists of loans in amounts up to $13,315 (CNY 100,000).

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[58] CGAP, 2007, "Highlight on China, Part 2: Interview with IPC," CGAP/Microfinance Gateway, Washington, DC, http://www.microfinancegateway.org/p/site/m//template.rc/1.9.26825 (accessed June 2009).
[59] IPC, 2008, "China Development Bank Microfinance Project," project update, March 2008.

Rural Credit Cooperatives, Rural Commercial and Cooperative Banks

Rural credit cooperatives (RCCs) were established in China during the rural cooperative movement of the 1950s. As of year-end 2007, they accounted for 11.5 percent of all deposits (CNY 2.2 trillion), 10 percent of all loans outstanding (CNY 1.6 trillion), and 85 percent of agricultural loans in the financial sector as a whole. As of year-end 2007, China had about 8,348 RCCs, with some 314,000 employees.[60]

RCCs have long been influenced by various levels of government and have suffered from such problems as unclear ownership structure, poor corporate governance, inadequate business scope, weak internal controls, a poor administrative and supervisory framework, inadequate staff capacity, nonstandard accounting practices, poor asset quality, and dismal financial performance. These problems have been partially resolved, but by the end of 2001, the NPL ratio of the RCC system remained 44 percent.

In June 2003, the State Council issued a reform policy directive aimed at fundamentally restructuring the RCCs. The reform program had two objectives: (i) to clarify the ownership structure and strengthen the corporate governance of RCCs, and (ii) to transfer their administrative responsibilities to provincial governments.[61]

Rather than propose a "one-size-fits-all' model, the directive required RCCs to choose between four ownership structures: (i) a commercially oriented rural bank owned by shareholders; (ii) a shareholder cooperative bank; (iii) a real cooperative amalgamated into a credit union, or (iv) a discrete, township-level cooperative that is a legal entity in its own right. It is likely that RCCs in the richer provinces will opt to become commercial banks, whereas the cooperative and credit union models are more likely to be taken up in poorer areas by RCCs that have less capital and fewer local enterprise clients. Whichever model the provinces choose, the PBC will assume responsibility for repaying 50 percent of the existing bad debt of RCCs and the new operations will enjoy tax breaks.

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[60] *People's Daily* Web site, n.d., http://english.peopledaily.com.cn/200308/20/eng20030820_122667.shtml (accessed June 2008).

[61] PlaNet Finance, 2005 (June), "Rural Credit Cooperatives in China: Background Information," PlaNet Finance, Paris, France, 2–3. Available on the Web site of the Microfinance Gateway, Washington, DC, http://www.microfinancegateway.org/p/site/m//template.rc/1.9.26797 (accessed June 2009).

Since 2004, the RCCs have reported aggregate profits, with the large majority of individual RCCs proving profitable. During this time, their proportion of bad debts has also been significantly reduced.[62]

Village Banks

In late 2006, the China Banking Regulatory Commission (CBRC) announced a new rural finance strategy with new licensing and supervision requirements. The strategy authorized a range of new financial institutions, including "village and township banks." Building on this action, the CBRC launched a village bank pilot project to deliver lending and deposit services in 36 counties of the provinces of Sichuan, Qinghai, Gansu, Inner Mongolia, Jilin, and Hubei.[63]

The new policy lowered the registered capital threshold of these banks to CNY 3 million ($430,000) in counties and CNY 1 million CNY ($140,000) in townships. One important component of the policy is that existing financial institutions are required to be the initiators of new village banks; these institutions can hold no less than 20 percent of total village bank shares, while any additional private investor can hold no more than 10 percent.[64]

China's first village bank opened for business in February 2006 in Sichuan Province. The Sichuan Yilong Huimin County Bank in Nanchong has a registered capital of CNY 2 million. According to officials from the Sichuan branch of the CBRC, Nanchong City Commercial Bank holds a 50 percent stake in the new village bank. Five private companies based in Nanchong own the other half of the bank.[65] Additionally, HSBC has received approval from the CBRC to set up a village bank in the central province of Hubei, becoming the first foreign bank to expand its business in the country's huge rural areas.[66] Under the pilot project, 25 village banks have been established. According to CBRC Directive No. 23 of 2008, all provinces are allowed to apply for village bank licenses. The CBRC is planning to extend licenses to permit the founding of 110 village banks in total.

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[62] CBRC, 2006, "2006 Annual Report," CBRC, Beijing, China, 40.

[63] D. Xiaoshan, 2007, "Highlight on China, Part 2—Interview with China Microfinance Association," CGAP/Microfinance Gateway, Washington, DC, http://www.microfinancegateway.org/p/site/m//template.rc/1.9.26822 (accessed June 2009).

[64] Thorsten Giehler et al., 2007, "Microcredit Companies and Village Banks: Competition or Pluralism," CGAP/Microfinance Gateway, Washington, DC, http://www.microfinancegateway.org/p/site/m//template.rc/1.9.24203, p. 4 (accessed June 2009).

[65] ChinaDaily.com, 2007, "First Village Bank Opens in Sichuan," March 2, 2007, ChinaDaily.com, Beijing, China, http://www.chinadaily.com.cn/cndy/2007-03/02/content_817284.htm (accessed June 2009).

[66] Xinhua News Agency, 2007, "HSBC Approved to Set up Village Bank in China," August 10, 2007. Available on the Web site of the China Development Gateway, Beijing, China, http://en.chinagate.cn/povertyreduction/2007-08/10/content_8660628.htm (accessed June 2009).

Microcredit Companies

In order to explore the possibility of establishing a competitive rural financial market, in the first half of 2005 the PBC decided to carry out a microcredit pilot program in Sha'anxi Province, Shanxi Province, Sichuan Province, Guizhou Province, and the Inner Mongolia Autonomous Region. The pilot project is aimed at establishing microcredit companies, predominantly with private capital, to provide competition to the RCCs and thus invigorate rural financial markets.

The "credit only" microcredit companies (MCC) in the pilot project are permitted to provide lending services, but cannot accept deposits. Loans are financed by their own funds, donations, or wholesale funds. In principle, no more than five shareholders are permitted in an MCC, and minimum capital is set at CNY 5 million. The lending interest rate is liberalized, but capped at four times the statutory benchmark interest rate of the PBC. The clients of microcredit companies must either be farmers, engaged in agricultural-related industries, or located in rural areas. Microcredit can, moreover, only be extended within the administrative jurisdiction where a microcredit company is located. The ceiling on a single loan is CNY 100,000 ($14,100) and the lending interest rate can be negotiated between the lender and the borrower. By the end of May 2008, the five provinces in the pilot had already launched seven microcredit companies (see table 5 below).[67]

In addition to the seven domestic MCCs, two wholly foreign-owned MCCs were created with the assistance of the International Finance Corporation (IFC). These MCCs have the same approach and are supervised by the PBC. The first, MicroCred Nanchong, is the first wholly foreign-owned microcredit company in China that offers microfinance services. It started trial operations in Nanchong City in southwestern Sichuan Province in November 2007. With an aggregate investment of CNY 55 million (about $7.37 million) from MicroCred SA of France, the IFC, KfW Bankengruppe, and American International Group, the microcredit company targets small firms, rural households, and self-employed businessmen.[68] The second foreign-owned MCC, Chifeng, began operations in 2008.

[67] Giehler et al., 2007, "Microcredit Companies," 2–3.
[68] Xinhua News Agency, 2007, "First Foreign-invested Microfinance Company Sets Up in China," November 5, 2007.

Table 5. PBC Microcredit Company Pilot Project

Province	Institution name	Inauguration date	Registered capital (CNY millions)
Shanxi	Shanxi Pingyao Jinyutai Microcredit Company Ltd.	Dec. 27, 2005	16
	Shanxi Pingyao Rishenglong Credit Company Ltd.	Dec. 27, 2005	15
Sichuan	Sichuan Guangyuanzhongqu Quanli Microcredit Company Ltd.	Apr. 10, 2006	20
Guizhou	Guizhou Jiangkou Huadi MicrocreditCompany Ltd.	Aug. 15, 2006	30
Inner Mongolia	Inner Mongolia Erdous Rongfeng Microcredit Company Ltd.	Oct. 10, 2006	50
Sha'anxi	Xian Dayang Huijin Microcredit Company	Sept. 18, 2006	21
	Xian Xinchang Microcredit Company	Sept. 18, 2006	22

Source: Giehler et al., 2007, "Microcredit Companies and Village Banks—Competition or Pluralism," report commissioned by the German Technical Cooperation (GTZ) and the International Fund for Agricultural Development (IFAD). Available on the CGAP/Microfinance Gateway, Washington, DC. http://www.microfinancegateway.org/p/site/m//template.rc/1.9.24203 (accessed June 2009).

The pilot program is still under development, but has shown very positive results. As of late March 2008, the loan volume of these MCCs totaled CNY 152.9 million ($20.5 million) and the total outstanding loan portfolio balance was CNY 95.8 million ($12.9 million). Overdue loans accounted for just 0.85 percent of this total. Interest rates were stable, ranging from 14.4 to 24.48 percent, yielding a weighted average of 20.08 percent—the equivalent of 3.14 times the one-year adjusted benchmark rate. However, given restrictions on deposit-taking and the lack of refinancing by commercial banks to date, the growth of MCCs is hampered by limited sources of refinancing.[69] However, CBRC Directive No. 23 and PBC Directive No. 137, both issued in 2008, confirmed that MCCs are recognized by the CBRC as a part of the financial system and that the MCC pilot would be expanded from five provinces to the whole country.

Informal Financial Sector

Informal finance in China takes a myriad of forms; here the term refers to all financing forms outside of formal regulatory frameworks. Informal financing may involve lending by individual moneylenders, enterprise mutual lending networks, pawnshops, or underground financial organizations (e.g., the *hehui, biaohui,* or *taihui*). It is important to note that just because this type of finance is informal, it is not necessarily illegal. Usury lending is indeed illegal, but borrowing

[69] Jiao, 2007, "Highlight on China, Part 4: Interview with PBC."

from private persons in general (outside of fundraising from the general public) is permitted. Moreover, there is even legal protection of informal financial contracts as long as the interest rate does not exceed four times the level of the official lending rate for the respective duration.[70]

While the importance of the informal financial sector in providing funds for private enterprises in China has long been recognized, until recently there has been little information on the size of this sector. A nationwide survey by the Central Finance University of China in late 2003 was the first attempt to estimate its size. Implemented in 20 out of 31 provinces, the survey found that the size of the informal financial sector at the end of 2003 stood between CNY 740 and CNY 830 billion, representing the equivalent of 31–35 percent of all corporate borrowing in the formal banking sector, or 5.5–6.2 percent of GDP that year. There were large variations across provinces in terms of the share of informal financing used by local residents and small enterprises, with the least-developed provinces having the highest share, although the smallest absolute size, of total informal financing.[71]

While Chinese law prohibits nonfinancial institutions *de jure* from providing financial services to the public, NGOs have been given rather tenuous informal permission to practice microfinance in the interests of alleviating poverty. Although the government's interest in microfinance has been increasing—as evidenced by the 2005 "Document #1" of the Central Committee of the CCP and the State Department, which calls for the formulation of regulations to support the development of microfinance institutions—NGOs currently remain unsupervised by any government body. The uncertainty caused by this ambiguous regulatory environment constrains the development and long-term sustainability of microfinance NGOs. Because these NGOs seem to lack permanence, they find it difficult to attract quality staff and long-term funding; their uncertain status also negatively affects repayment behavior. NGOs must register with the local civil administration bureau and receive sponsorship from a local government agency, a requirement that imposes governmental influence. NGO-MFIs are not permitted to distribute profits; hence they are not attractive equity investments for commercially oriented investors.[72]

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70 K. Tanaka and M. Molnar, 2007, "What is Different about Monitoring by Informal Financial Institutions?" paper presented at a conference sponsored by the Hong Kong Monetary Authority, "Opening and Innovation on Financial Emerging Markets," Beijing, China, March 2007, 4.

71 Ibid.

72 Business & Finance Consulting (Devex), 2005, "Feasibility Study: Microfinance Programme China" (October), study prepared for KfW Bankengruppe, Frankfurt, Germany, 289.

NGO-MFIs in China are also prohibited from collecting deposits. Consequently, these organizations have been funded through grants (for loan capital and operational expenses) from international donors and the government. Such grant funding has proven unstable and limits the sustainable development and expansion of microfinance NGOs. Nevertheless, a few exceptions to this rule exist, such as the China Foundation of Poverty Alleviation (CFPA), which has received commercial loans from city commercial banks.

Despite these limitations, microfinance NGOs had, as of year-end 2007, extended loans of over CNY 1 billion ($141 million), with an average size of CNY 3,000 ($423), through some 300 programs. These programs were managing approximately $50 million in funding and serving tens of thousands of clients. The most prominent programs included:

- China Foundation for Poverty Alleviation, funded by the World Bank, among others.
- Funding the Poor Cooperative, funded by the Ford Foundation, Grameen Trust, and Canada Fund, and administered by Rural Development Institute of the Chinese Academy of Social Sciences.
- Sustainable Microfinance Assistance for the Poor, funded by the UNDP. Managed by the China International Centre for Economic and Technical Exchanges, this project has funded several MFIs and provided them technical assistance.[73]

Most Chinese microfinance NGOs employ Grameen lending methodology. These microfinance programs have succeeded in demonstrating that despite relatively high interest rates, loans to poor households will be repaid. Unfortunately, most microfinance NGOs have been constrained by limited capital and institutional capacity, as well as lack of legal recognition. Often programs that are begun as experiments or projects are discontinued when donor funding runs out.[74]

Funding for the Poor Cooperative. As of June 2007, this NGO had 14,451 active clients and a loan portfolio of $2.2 million. With operations in China's Henan and Hebei Provinces, Funding for the Poor Cooperative (FPC) is one of the oldest and largest microfinance

[73] J. Isern, L. Zou, and X. Yang, 2007, "Highlight on China, Part 4: The Policy Perspective" November 5, 2007, CGAP/Microfinance Gateway, Washington, DC, http://www.microfinancegateway.org/p/site/m//template.rc/1.26.9148 (accessed June 2009).

[74] M.C. Alcorn, 2005, "China City Commercial Banks: Opportunity for Microfinance Delivery?" article from report prepared for CGAP, October 2005, Washington, DC, 2–3. Available online on the Microfinance Gateway Web site, http://www.microfinancegateway.org/p/site/m//template.rc/1.9.27373 (accessed June 2009).

programs in the country. The NGO organizes groups of women into solidarity groups who guarantee each other's loans. Many are engaged in farming or are raising sheep, pigs, or chickens. To qualify for loans, clients must have an annual income of less than CNY 1,000 ($123) and total household assets less than CNY 10,000 ($1,234).[75]

China Foundation for Poverty Alleviation. This organization is the largest NGO in China working in the field of poverty reduction. It operates in different sectors, such as health, education, rural community development, disaster relief, and rural finance. China Foundation for Poverty Alleviation (CFPA) began microfinance operations in 1996 and now has 10 branch offices in rural China. The NGO's branch expansion demonstrates one of the main advantages of its unregulated status, as MCCs and village banks are not allowed to operate beyond the province in which they are established.

CFPA is trying to transform the microfinance project into an independent MFI. CFPA has grown rapidly, supported by a loan from the China Development Bank, and now faces the challenge of building up capacity to keep pace with its growth and transformation plans.

According to CFPA, it had disbursed a total of CNY 47 million ($6.6 million) in loans by year-end 2006 to 20,948 households. Active clients at that time totaled 15,052, with a total outstanding loan portfolio of CNY 28 million ($3.9 million). The NGO's coverage areas, clientele, and loan scale have all reached new records; at the same time, portfolio quality has continued to improve. By the end of 2006, the portfolio at risk (PAR) ratio over 30 days was less than 0.1 percent.[76]

Other Initiatives

PlaNet Finance, an NGO active worldwide in microfinance, has signed a three-year cooperation agreement for a downscaling project with the Harbin Commercial Bank (HCB) of China. The goal of the cooperation is to bring Harbin's microfinance operation fully into line with international best practices.[77]

Citibank and Grameen Trust are following HSBC by taking part in a Chinese pilot program for expanding financial services in Jilin province.

[75] "Funding for the Poor Cooperative (FPC)," n.d., Web site of the Grameen Foundation, http://www.grameenfoundation.org/where_we_work/east_and_southeast_asia/china/fpc/ (accessed June 2009).
[76] See the Mix Market online information service, Washington, DC: www.mixmarket.org (accessed June 2009).
[77] PlaNet Finance, 2007, "Planet Finance and Harbin CCB Signed Downscaling Agreement," News Release, June 26, 2007, PlaNet Finance, Beijing, China.

Zhong An Credit in Shenzen is owned by an American investment banker and is cooperating with the IFC to broaden its microfinance activities, opening several branches in different counties.

The Postal Savings Bank of China has also started a microfinance pilot project in March 2007. Given its network of 36,000 branches throughout China, successful implementation of the pilot would give the bank the means to become a microfinance service delivery giant.

Qinghai Agricultural Bank Microfinance Program is a microfinance provider that is not an NGO. It is funded by the Agricultural Bank of China and supported by AusAID.

Microinsurance Distribution Channels

The Chinese microinsurance market is quite untouched. China's insurance regulator is endeavoring to develop a microinsurance market in rural areas to help farmers and low-income families better manage risk. In 2006, the five biggest Chinese agricultural insurance companies (Anxin Agricultural Insurance Company, Anhua Agricultural Insurance Company, Sunlight Mutual Insurance, People's Insurance Company, and China United Property Insurance Company) earned 99 percent of total agricultural insurance premium income.[78] Although several microinsurance companies serve the rural agriculture market, Chinese farmers are not well protected against all kinds of risks due to lack of proper insurance products.[79]

Microlife insurance products, which often require an annual premium of several thousand CNY, are not affordable for farmers or low-income urbanites. More suitable products have been developed, such as one offered by China Life, which gives farmers a refund of eight times the annual premium of CNY 100 ($13.80) to guard against fatal accidents.[80]

China Life. According to the China Insurance Regulatory Commission (CIRC), China Life extended life insurance to 1.2 million farmers in rural areas in 2007. In addition to life insurance, the company offers microinsurance products for planting, livestock breeding, farm machinery, farmers' houses and household property, as well as micro-medical insurance and insurance against microloans.

[78] China Insurance Regulatory Commission (CIRC), n.d., Chinese-language Web site, http://www.circ.gov.cn (accessed June 2009).
[79] Xinhua News Agency, 2008, "China Promotes Micro Insurance to Extend Coverage in Rural Areas," January 1, 2008, http://news.xinhuanet.com/english/2008-01/16/content_7432966.htm (accessed June 2009).
[80] Xinhua New Agency, 2008, "Cheaper Cover for Farmers," January 17, 2008, available on the Web site of China.Org.Cn, Beijing, China, http://china.org.cn/english/government/239712.htm (accessed June 2009).

These kinds of products are also offered by several commercial insurance companies.[81]

Postal Savings Bank of China. Roughly 25 million households bought insurance from the PSBC through year-end 2006. These policies account for 20 percent of all insurance sold by banks in China.

American International Group. The CIRC has given American International Group (AIG) permission to sell group insurance products in China. The company is allowed to offer group contracts with five or more participants for life, health, estate, and asset insurance. This permission gives AIG the opportunity to distribute its products without a national partner.

Other

Mobile Banking. With the launch of mobile banking and information services by China Mobile and China Unicom in July 2004,[82] another actor entered the financial services sector. With more than 600 million mobile phone users in China as of June 2007, text payments and other mobile banking applications are starting to grow in popularity. While policy, regulatory, and other challenges remain, mobile banking applications launched by China Mobile and China Unicom (in collaboration with the BOC, CCB, ICBC, ABC, China Merchants Bank, and Hua Xia Bank) could help reduce costs and significantly expand the range of financial services offered in remote areas.[83]

The UNDP and Ericsson signed a memorandum of understanding in March 2008 to help raise the standard of living in rural areas of China using affordable, innovative mobile solutions for development. The two organizations plan to implement mobile phone banking in a few branches of the PSBC, although a policy and regulatory framework needs to be discussed and adopted.

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[81] Xinhua News Agency, 2008, "China Promotes Micro Insurance."
[82] China Unicom, July 21, 2004, http://www.uni-wise.com/docpage/c1863/200407/0721_1863_1268.aspx (Chinese-language Web page, accessed June 2009).
[83] PlaNet Finance, 2008, "China: Country Overview," PlaNet Finance, Paris, France, 14. Also see J. Isern, X. Yang, and L. Zou, 2007, "Highlight on China, Part 2: Financial Service Providers," CGAP/ Microfinance Gatewa;y, Washington, DC, http://www.microfinancegateway.org/p/site/m//template.rc/1.26.9146 (accessed June 2009).

Market Structure

Assets

As of year-end 2007, total assets of the banking sector amounted to CNY 52.6 trillion, an increase of CNY 8.6 trillion, or 9.7 percent, over 2006. Several changes occurred in 2007 with respect to the market share of banking institutions. The top three types of banking institutions by assets were large state-owned commercial banks, joint-stock commercial banks, and rural cooperative financial institutions, which accounted respectively for 53 percent, 14 percent, and 11 percent of total banking sector assets in 2007. The growth of the respective market shares of these three types of institutions in 2007 were joint-stock commercial banks, 1.4 percent; rural cooperative financial institutions, 0.6 percent; city commercial banks and urban credit cooperatives, 0.3 percent; and foreign-funded banks, 0.3 percent. In general, small and medium-sized commercial banks have been gradually expanding their market shares.

Liabilities

In 2007, the total liabilities of the banking sector reached CNY 49.6 trillion, an annual increase of CNY 7.9 trillion, or 18.8 percent, over 2006. Owners' equity in the banking sector grew to CNY 3 trillion, an increase of CNY 791.3 billion, or 35.3 percent, in 2007. Total deposits reached CNY 40.1 trillion at year-end 2007, including CNY 14.5 trillion in corporate deposits, CNY 17.6 trillion in household deposits, CNY 321 billion in trust deposits, and CNY 7.7 trillion in other deposits. Corporate deposits represented 36 percent of total deposits; household deposits, 44 percent; trust deposits, 0.8 percent; and other deposits, 19.2 percent. At the same time, the currency in circulation (M0) amounted to CNY 3 billion. And since December 31, 2007, the annual interest rate on interbank lending has been adjusted to 4.14 percent.[84]

Loans account for almost 90 percent of financial products in China. Corporate bonds and equity are of significant, but minor, relevance. As the institutional framework for other sources of finance remains underdeveloped, credit will keep the lead, although its proportion of total financing will decline. This is partly because Chinese banks earned large fee-based business profits from the rapid development of the stock market in 2007 while monetary policy remained tight. The official outreach of the banking sector (as cited by regulatory authorities) is, at first glimpse, quite impressive: 14 branches per 100,000 people. But most of these branches are RCC outlets with low financial capacity.[85] The World Bank Financial Development

[84] CBRC, 2007, "2007 Annual Report." For interest rate information, see the English-language Web site of the PBC, http://www.pbc.gov.cn/english (accessed June 2009).
[85] Hansakul, 2007, "China's Bankensektor," 3.

Indicators cited an adjusted figure of 1.33 branches per 100,000 people in 2005.[86]

Table 6. Financial Institution Indicators, 2005

Type of institution	Total Number	Staff (000s)	Equity ($ billions)	Assets ($ billions)	% of total financial sector assets	ROE (%)
Policy banks	3	56	23.9	480.5	8.0%	17.9
State-owned banks	5	1,469	187.3	3,535.1	58.8%	14.6
Joint-stock commercial banks	12	118	26.4	753.3	12.5%	22.5
City commercial banks	113	113	16.9	358.7	6.0%	14.8
Rural commercial/ cooperative banks	93	57	7.5	134.1	2.2%	17.4
Foreign banks	14	17	10.4	128.4	2.1%	7.7
Nonbank financial institutions	130	9	16.2	146.5	2.4%	11.1
Rural credit cooperatives	19,348	634	20.8	477.3	7.9%	12.4

Source: CBRC, 2007, "2007 Annual Report."

Performance

Table 7. Performance of Chinese Banking Sector, 2006

Type of institution	Growth of loan portfolio	Net interest margin	ROA (%)	ROE (%)	NPLs ($ millions)	CAR (%)
State-owned banks	15.52%	2.91%	0.88%	15.67%	1,115	13.0%
Policy banks	18.78%	N/A	1.14%	13.68%	N/A	N/A
City commercial banks	27.50%	N/A	0.74%	15.08%	51.2	N/A
Joint-stock commercial banks	31.53%	2.94%	0.78%	16.67%	86.0	10.1%
Foreign banks	33.07%	N/A	0.49%	5.19%	3.2	N/A

Source: CBRC, 2007, "2007 Annual Report."
Notes: ROA – return on assets; ROE – return on equity; NPL – nonperforming loan; CAR – capital adequacy ratio.

In 2007 commercial banks continued their reform and restructuring efforts and accelerated their write-offs of NPLs. As a result, asset quality improved. The NPLs of the major commercial banks measured by the CBRC totaled CNY 1.2 billion ($169 million) in 2007, representing 6.72 percent of all loans, a decline of 0.79 percentage points from 2006.

[86] World Bank, 2005, World Development Indicator database.

As of year-end 2007, provisions for bad loans set aside by major commercial banks totaled CNY 538 billion, an increase of CNY 75.9 billion ($11.1 billion) from 2006. The coverage ratio of loan loss provisions increased by 5.2 percentage points, to 39.2 percent. As a result, Chinese banks improved their resilience to risk.[87]

In 2007 the net profit, or return on equity (ROE), and net return on assets (ROA) of the banking sector were 16.7 percent and 0.9 percent, respectively. Net interest income, investment returns, and net fee-based income constituted the three major streams of income. With the CBRC's support, banking institutions improved their capital adequacy ratio by expanding fundraising channels in various ways, such as issuing shares, retaining earnings, restructuring, going public, introducing strategic investors, and issuing subordinated debt. Through the end of 2007, 161 commercial banks, whose assets accounted for 79 percent of total banking sector assets, met the minimum CAR requirement.[88]

At the end of 2007, the assets the Agricultural Development Bank of China, the RCCs, the Postal Savings Bank of China, and the new rural financial institutions amounted to CNY 5.3 trillion, an increase of 17 percent over 2006. Among them, small credit loans to farmers reached CNY 188.4 billion, an increase of 157 percent since late 2002.[89]

Financial Infrastructure

Capital Markets

The equity and bond markets in China are smaller than those of most other countries in terms of both market capitalization and total value traded as a percentage of GDP. Equity market capitalization, excluding nontradable state-owned shares, is equivalent to just 17 percent of GDP, compared to 60 percent or more in other emerging markets. Corporate bond issues by nonfinancial companies amount to just 1 percent of GDP, compared to an average of 50 percent in other emerging markets.[90] Although still in an early state of development, the Chinese capital market as a whole is growing rapidly and in terms of volume, both the equity market and the bond markets have reached a respectable size—at least by Asian standards.[91]

[87] CBRC, 2007, "2007 Annual Report."
[88] Ibid.
[89] Ibid.
[90] Ayyagari, Demirgüç-Kunt, and Maksimovic, 2007, "Formal vs. Informal Finance."
[91] H. Byström, 2007, "Structured Microfinance in China," Lund University, Sweden, November 2007, 15.

Payment System The use of cash is extremely widespread in China; personal checks are not used. In 2007, 83 percent of all payment transactions were made in cash, in comparison to 21 percent in the United States.[92] Although debit cards are widespread and credit cards are beginning to be introduced, cash continues to be the payment method of choice for consumers. China has a single debit and credit card network: Moneylink. Its rates are regulated by the PBC, although complaints regarding the level of fees are widespread. Many medium-sized and small merchants do not offer debit card payment because of the fees and the cost of acquiring point-of-sale terminals for debit (and credit) card payment.[93] Whereas the extent of the ATM network is still weak in the country—in 2005 the number of ATMs in urban areas was only 272 per 1 million people, 73 per 1 million nationwide—which is much lower than the worldwide average. Real time gross settlement is not available.[94]

Interbank/ Money Market Official interbank transactions go through the National Interbank Funding Center, which is a subsidiary of the People's Bank of China. Its main functions include providing systems for CNY lending and bond trading; organizing interbank foreign exchange trading, CNY lending, and bond trading; prompting the clearing of CNY lending and bond trading; and providing an online commercial paper quotation system.[95]

Deposit Insurance The Chinese government has acknowledged the importance of a deposit insurance system. China's intention to establish such a system was announced at the People's Congress in March 2008 and in a report by Prime Minister Wen Jiabao. The financial industry expected the system to be introduced in 2008; however, as of July 2008 there was still no obligatory deposit insurance for financial institutions.

Accounting Standards In February 2006, the Ministry of Finance promulgated "Accounting Standards for Business Enterprises," comprising one basic standard and 38 detailed accounting standards. Compulsory compliance with these standards by listed companies was required as of January 1, 2007. In principle, the new accounting standards are in line with

[92] Jan Bellens, Chris Ip, and Anna Yip, 2007, "Developing a New Rural Payments System in China," *McKinsey Quarterly* (May), http://www.mckinseyquarterly.com/Telecommunications/Equipment_Services/Developing_a_new_rural_payments_system_in_China_2002 (accessed June 2009).
[93] Jerry Hausman, Jeffrey YuHu, and Xinzhu Zhang, 2004, "Economic Analysis of Wireless Point of Sale Payment in China," Center for e-Business @ MIT, Massachusetts Institute of Technology, Cambridge, Massachusetts, ebusiness.mit.edu/research/papers/212_JHausman_ChinaEPayment.pdf (accessed June 2009), 1–2.
[94] As cited on Chinese-language Web site of China Unionpay, www.chinaunionpay.com (accessed June 2008).
[95] Information provided by China Foreign Exchange Trade System & National Interbank Funding Center.

International Financial Reporting Standards (IFRS). According to the requirements set by the Ministry of Finance, all of China's listed banking institutions must adopt the new accounting standards. By the end of 2007, 14 listed banks had implemented the standards (among them, the ICBC, BOC, CCB, and BOCom).[96]

Table 8. Timetable for Bank Implementation of New Accountings Standards

Category	Year of implementation
Listed banks(14)	2007
Policy banks	2008
Agricultural Bank of China	2008
Asset management companies	Year after completion of restructuring (no later than 2009)
Auto financing companies	2008
City commercial banks	2008
Foreign-funded banks	2008
Joint-stock commercial banks	2008
Finance companies of enterprise groups	2008
Financial leasing companies	2008
Money brokerage companies	2008
Postal Savings Bank of China	2008
Rural credit cooperatives	2009
Rural commercial banks	2009
Rural cooperative banks	2009
Three new types of rural financial institutions	2009
Trust and investment corporations	2008
Urban credit cooperatives	2009

Source: CBRC, "Enhance Market Discipline," Part 4, CBRC, Beijing, China, 6.

Audit Standards

International Audit Standards (IAS) are being implemented. Despite the CBRC's efforts, however, not all banks seem to be following IAS requirements.

Rating & Credit Information

There are at least 41 rating institutions in China. Among them is a joint venture, China Chengxin International Ltd. (CCXI), founded in 2006 by Moody's (49 percent ownership) and China Chengxin Credit Management Co. Ltd. (CCX, the biggest local rating agency, founded in 1992). Rating agencies generally cover corporate businesses, financial institutions, bonds and guarantee companies, among others.[97]

[96] CBRC, 2007, "Enhance Market Discipline," CBRC, Beijing, China.
[97] See Chinese-language Web site of the Beijing Credit Ratings Co. Ltd., Beijing, China, http://www.bjratings.com/introduction.asp?ctype=1 *and* http://www.bjratings.com/content.asp?tchoose=list&ctype=dynamic&id=252 (both accessed June 2008).

In recent years, China has taken steps to build a credit information system. The PBC established a consumer credit information system, to which all commercial banks are connected. However, most institutions active in microfinance, such as RCCs or village banks, are not yet linked to the system. It is expected that the system will be expanded to include information from more RCCs and the four new types of pilot MFIs.

Apex Banks

Despite capital injections from the PBC, the main apex bank for microfinance institutions is the China Development Bank. (See description of the CDB under "Policy Banks" in the earlier section entitled "Financial Sector Overview.")

Industry Associations

The **China Banking Association** (CBA) was founded in May 2000 as a social organization and is registered with the Ministry of Civil Affairs. The CBA, on behalf of its 70 full members and 37 associate members, brings together various categories of banking institutions to represent the interests of this rapidly changing industry.

The **China Microfinance Association** (CAM) was established in 2005. CAM consists of domestic MFIs, national and international institutions, and individuals interested in supporting the microfinance industry. It is a self-regulated organization that follows national laws, policies, and guidelines to promote the development of the microfinance industry.

Training, Education, Consulting

Human resource capacity is lacking in China, since the domestic education system does not meet international standards, and wealthier families educate their children overseas.

Apart from a few courses provided by the China Banking Association, there is no standard, systemized training in the banking sector. The Shanghai International Banking and Finance Institute provides nondegree training for banking staff and larger banks have their own training centers.

In the microfinance sector, the Chinese Academy of Social Sciences has been providing training for microfinance practitioners through a facility provided by Citigroup. ACCION is in the midst of establishing a training center with Credit Swiss that will specialize in rural finance, and Binhai Rural Commercial Bank plans to open a microfinance training center in Binhai in October 2009. IPC, PlaNet Finance, and GTZ all currently offer consulting services in the microfinance sector.

Technology

Table 9. State of Banking Technology in China, 2007

Item	Number
Core banking system	N/A
Accumulated online transactions	229.3 trillion
Equipped with ATM and POS	N/A
ATMs	120,000
POSs	1,180,000
Banks that issue payment cards	169
Total number of cards	1.5 billion
Internet banking	N/A

Source: Bellens, Ip, and Yip, 2007, "Developing a Rural Payments System in China."

There is no standard core banking system among banking institutions in China. The five state-owned commercial banks and joint-stock commercial banks have each developed their own systems independently.

All state-owned commercial banks, joint-stock commercial banks, city commercial banks, and certain other banking institutions at the county level have been equipped with ATMs and POSs. The first three types of institutions have also launched Internet banking services.[98]

Consumer Financial Education

Consumer financial education in China is weak in comparison to international standards. Recently, international institutions have begun to invest in this area. At the beginning of 2008, Citigroup announced that it would support financial education for low-income households in China. The initiative, called the "Global Financial Education Program," is led by a strategic partnership of two organizations: Microfinance Opportunities and Freedom from Hunger. In the first step, financial organizations across China, including microfinance institutions, commercial banks, and the central bank, will be trained. In the second step, trained personnel will disseminate their new-found knowledge and skills among poor communities by organizing either training-of-trainers workshops or offering direct training sessions.[99]

In China, consumers are generally protected by consumer protection laws, contract laws, and other laws, such as those that govern bonds. Even so, consumer protection is inadequate due to consumers' limited access to independent information and an impenetrable legal

[98] CBRC, 2007, "2007 Annual Report."
[99] "Citi Supports Financial Education for Low-income Households in China," press release, 2008, Citi Bank, http://www.citi.com/citigroup/press/2008/080116a.htm (accessed June 2008).

system. Moreover, consumers are often either unaware of their legal rights or have no opportunity to obtain help. The academic community has acknowledged this weakness and has called for strengthening consumer rights.[100]

Legal, Regulatory, and Policy Framework

Major Prudential Regulations for Financial Sector

- Banking institutions are required to meet a capital adequacy ratio (CAR) threshold of 8 percent.
- The PBC and CBRC officially eliminated all interest caps in October 2004; however, the Supreme Court of China has ruled that interest rates greater than four times the PBC benchmark rate (depending on the loan term) are illegal.
- As the time of this writing, China was raising interest rates for the sixth time in 2008 to cool down a red-hot economy, which was expected to expand 11.5 percent that year. Inflation had also climbed to a 12-year high.
- At the time of this writing, China was planning to raise the one-year deposit interest rate by 27 basis points to 4.14 percent and the lending rate by 18 basis points to 7.47 percent.
- On January 25, 2008, the PBC raised the reserve requirement ratio by 0.5 percentage points to 15 percent, the highest ratio since 1984. It raised the ratio 10 times and the benchmark interest rate six times in 2007.
- Registered capital requirements: Joint-stock commercial bank, $123.3 million; rural commercial banks, $6 million; city commercial banks, $100 million.
- The CBRC allows a maximum NPL ratio of 5 percent.

Regulatory Framework

China's government imposes a ceiling on deposit rates, a floor on lending rates, and manages the exchange rate, despite changes made to the exchange rate regime in 2005.

The PBC, China's central bank, concentrates on regulations that concern monetary conditions and financial system liquidity with a view toward promoting economic growth and price stability. The

[100] Chinalawinfo (Chinese-language online information resource), 2008, Beijing University Center for Legal Information, Beijing, http://article.chinalawinfo.com/article/user/article_display_spid.asp?ArticleID=20494 (accessed June 2008).

CBRC focuses on the strength of financial institutions, capital adequacy issues, and restructuring of the banking sector.[101]

The CBRC was created in June 2003, when it assumed responsibility for the regulation and supervision of financial institutions from the PBC. Reporting to the State Council, its key objective is to protect the interests of depositors and consumers. It also aims to build and maintain market confidence in the banking system, preserve financial stability, educate the public on the role of modern finance, and eradicate financial crime. As of mid-2008, the CBRC was headed by Mr. Liu Mingkang, the well-respected former president of the Bank of China.

While the supervision of financial institutions has been transferred to the CBRC, the PBC remains very influential with respect to Chinese banks and continues to exercise regulatory power through its mandate to manage monetary policy. The PBC sets the interest rate bands for loans and deposits, as well as the level of reserve requirements and other ratios that affect bank liquidity. The PBC also monitors lending by banks and is authorized to issue regulations on the extension of credit by banks. In an effort to constrain lending and reign in growth and inflation, the PBC increased the reserve rate on liabilities from 16 to 16.5 percent on May 20, 2008. The PBC also imposed a series of reserve rate increases beginning in early 2007, with the rate increasing to 16 percent on April 16, 2008.

The CBRC, on the other hand, sets capital requirements for individual institutions. It can raise this requirement to above 8 percent if and when necessary, given the actual risk profile and management of a specific institution. In 2006, the CBRC actively guided banking institutions to expand their capital funding sources through measures such as capital injections, fundraising, and the issuance of subordinated debt. By the end of 2006, China's major commercial banks had raised over CNY 1.5 trillion ($211 billion) in new capital. Certain Chinese commercial banks have begun to integrate compliance risk management into their daily operations, requiring senior executives to assess their risk exposure and control mechanisms within their jurisdictions at least once a year.[102] While many leading commercial banks with substantial resources have pushed risk management reform internally, the CBRC has been a major influence in pushing smaller banks to improve overall risk management.

While the banking system overall has made great efforts to reform and catch up to international standards, a number of challenges lie

[101] Hansakul, 2004, "China's Financial Sector," 8–11.
[102] CBRC, 2006, "2006 Annual Report," 68–78.

ahead. To state some examples: the reform of the exchange rate system is not complete, interest rate regulations should be eliminated in order to allow real competition, and the capital market needs to develop further while government intervention is reduced. However, the pace of financial reforms will be subject to other issues, such as political stability and reforms, environmental issues, and existing income inequalities.[103]

Regulatory Environment for Microfinance

Since 2004, the Chinese central government has placed a high priority on agriculture and rural development. Expanding financial services in rural areas is part of the national response to President Hu Jintao's call for new approaches to rural development. In a clear sign of reform, the State Council issued a range of pioneering policy statements in 2005, including those that stipulated that:

- relevant government agencies should formulate regulations on market access and the supervision of newly emerging rural financial institutions to cultivate competitive rural financial markets
- provincial and local governments should begin piloting reforms
- in some provinces, new microfinance organizations could be established to serve rural clients

As the key policy-making and regulatory bodies for microfinance, the CBRC and PBC have implemented a series of new policies and regulations for the sector, in addition to working with provincial governments to authorize pilot projects that will expand access to finance throughout the country.[104] The CBRC in 2007 approved the establishment of a new set of rural financial institutions. By the end of 2007, a total of 31 new such institutions, including 19 village and township banks, 4 lending companies, and 8 rural mutual credit cooperatives, had started operations. These institutions have further expanded the channels for funneling different types of funds into rural areas, constituting a major breakthrough in rural financial services. In 2007, the ownership reform of rural credit cooperatives advanced, with a new supervisory framework established and major interim progress achieved. In addition, reform of provincial rural credit cooperatives unions deepened, and a pilot program for the cross-regional development of rural credit cooperatives started.[105]

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[103] Chun Chan, 2008, "China's Financial Development: Reforms and Challenges" (January), presentation, China Europe International Business School, Shanghai, China, available on the Web site of the Kellogg School of Management, Northwestern University, Illinois, www.kellogg.northwestern.edu/research/fimrc/papers/chang010708earlierversionppt.ppt (accessed June 2009).
[104] Jiao, 2007, "Highlight on China, Part 4: Interview with People's Bank of China."
[105] CBRC, 2007, "2007 Annual Report."

By the end of 2007 the rural credit cooperatives had been consolidated into 130 banking institutions, with 1,825 county- and city-level legal entities. Significant progress was also made in reforming rural commercial banks and preparing them for public listing. As a result, the capacity of rural credit cooperatives to serve agriculture, rural areas, and farmers was enhanced.[106]

The CBRC recognizes that in addition to developing rural areas by meeting the needs of simple production and traditional seasonal farming, rural microcredit can meet the demands of larger and more sophisticated production. Based on this recognition, the CBRC issued the document "Guidance on Developing Rural Micro-credit Business by Banking Institutions" in August 2007, which broadens their scope to provide micro rural credit and expands target microcredit recipients to include traditional grain growers, farmers, self-employed people, and small enterprises.

Microcredit has also been included in key policy initiatives that support the development of modern agriculture, increase the income of farmers, and improve farmers' living standards. The limit for microcredit loans was raised by CNY 100,000 to reach CNY 300,000 for developed areas, and by CNY 10,000 to reach CNY 50,000 for underdeveloped areas. The limit on jointly guaranteed loans (i.e., group loans) can be moderately increased on the basis of the credit loan limit. In addition, loan terms can be extended up to three years depending on the characteristics of seasonal agriculture, the cycle of a production project, the use of a loan, and the repayment capacity of borrowers. Meanwhile, within the allowed scope of laws and regulations, banking institutions are permitted to independently determine the interest rates on loans and simplify the procedures for microcredit, shorten the review time for loan applications, improve their services, foster rural credit culture, and improve incentive mechanisms.

In general, NGO-MFIs must register with the civil administration bureau of the relevant province, but remain unsupervised by any government body. As noted earlier, the uncertainty caused by this ambiguous regulatory environment constrains the development and long-term sustainability of microfinance NGOs. There are just **a few legal windows** for microfinance that can be explored by investors interested in commercial sustainability:

- Rural credit cooperatives are regulated by the CBRC, but suffer from interest caps (2.3 times the PBC base rate) and unclear

[106] Ibid.

ownership. Nevertheless, they have huge outreach, as these institutions exist throughout the country.

- Village banks are able to offer deposit and credit products, but at least one investor in a village bank must be a bank.
- Microcredit companies are only allowed to offer credit products; their lending rate is restricted to 4 times the PBC base rate.

Two new policy directives were issued in April and May 2008 (PBC Directive No. 137 and CBRC Directive No. 23, respectively) that announce new rules and regulations for MCCs and village banks (see annex 1).

Gap Analysis

Regional Disparities

- There is substantial disparity in the provision of financial services between coastal areas of China and more remote western and central areas, which lack adequate access to financial services.
- In rural areas of the country, coverage of financial services demand is estimated at just 50 percent.
- Out of 113 city commercial banks, only 11 offer microfinance; these banks are located in Lanzhou, Taizhou, Jiujiang, Baotou, Guiyang, Guilin, Deyang, Daqing, Chonqing, Quijang, and Jingzhou. Recently, the Baotou Commercial Bank obtained approval from the CBRC to expand to Chifeng and Ningbo.
- In sum, 7 domestic and 2 wholly foreign owned MCCs, 25 village banks, 4 wholly owned lending subsidiaries of commercial banks, and 9 funding cooperatives have been established with a focus on microfinance. The operations of these institutions are limited to the county level, which constrains their opportunity to expand outreach.
- The PBC estimates that an “underground portfolio” of $300 billion is circulating informally and illegally in loans to families and private businesses.

Sector Funding

- Liquidity is generally adequate in China. Individual institutions (e.g., MCCs), however, need refinancing, combined with technical assistance, in order to commercialize, expand, and improve operations.
- Due to the regulatory framework, MCCs have limited access to bank refinancing.
- Microfinance NGOs have limited capital and institutional capacity. They also lack legal recognition.

Regulatory and Institutional Issues

- Regulatory frameworks and policies governing microfinance in China remain vague, creating regulatory uncertainty.
- China does not have a framework for nondeposit-taking lending institutions such as MCCs, which were initially established as nonfinancial entities.
- Investment funds run by international microfinance networks are not regulated entities.
- There are still no guidelines that support the establishment of national and regional umbrella-type microfinance entities that could invest or service multiple MFIs, including national and/or regional MCCs, service companies, microfinance investment companies, etc.
- No legal route exists to transform existing NGO-MFIs into MCCs or village banks, nor is there a legal route for the transformation of MCCs into commercial banks.
- Regulatory and other governmental authorities lack an understanding of microfinance best practices.

Training and Technology

- MFI staff at all levels lack training in all areas of banking.
- Information technology and management information systems are inadequate among microfinance providers, as is training in this technology.

Financial Infrastructure

- Credit bureaus, rating agencies, and the national payment system are still rather undeveloped in China; microfinance institutions in particular lack access to this infrastructure.

Financial Services

- Legal and regulatory hurdles remain regarding **mobile banking.** For example, there is no common law on the usage of related technologies, and licenses are granted on a case-by-case basis, creating uncertainty in business strategies. Moreover, as many phones are not registered to a specific user, identification issues remain.
- The huge number of migrant Chinese workers, who live both outside of the country and in big Chinese cities, indicates considerable demand for **remittance** services. Not all financial institutions, however, are able to provide appropriate services. The need for these services is not, however, as urgent as the demand to expand sustainable institutional approaches.
- **Microinsurance** products are offered by several pilot projects and by PSBC and ADBC. Distribution channels remain limited and product offerings are inadequate.

Annex 1. Overview of Ownership Requirements for Establishing MCCs and Village Banks

Criteria	MCCs	Village banks
Shareholder structure	Limited company: under 50 shareholders Limited stock company: stock limited to 2 to 200 people, half of whom must reside in China Natural person, legal person, other social organization, or connected parties are not allowed to hold more than 10 percent of total registered capital	Nonbanking institutions: maximum 10 percent ownership Banking institutions: at least 20 percent ownership
Registered capital	Limited company: not < CNY 5 million Stock company: not < CNY 10 million	County based: ≥ CNY 3 million Township based: ≥ CNY 1 million
Registration process	1. Submit application to provincial authority department 2. When approved, register at bureau for industry and obtain business license 3. Submit relevant materials to local police, CBRC branches, and PBC branches within 5 days	1. Submit application for incorporation 2. When approved, apply for business commencement license
Source of funds	Equity of shareholders, contributions, funds from no more than 2 banking financial institutions (which can represent no more than 50 percent of net capital). Unclear if latter provision is relevant to foreign and local investors	Domestic or foreign financial institutions, domestic nonfinancial enterprises, domestic natural persons. However, the controlling shareholder must be a banking institution* that holds at least 20 percent of the bank's equity. Individual natural persons, nonbank financial institutions, and nonfinancial enterprises may each hold no more than 10 percent of the bank's total equity
Regulatory body	PBC and CBRC	PBC and CBRC
Transformation	Depending on its legal business record and history of bad credit, an MCC can transform into a village bank	Alterations are permitted, such as changing corporate form or the scope of business, but are subject to the approval of local CBRC offices. Shares must not be transferred or pledged within 3 years of establishment of the bank.

Source: CBRC, 2008, "Provisional Rules Governing Township or Village Banks," Directive No. 23, English-language Web site, Beijing, China, www.cbrc.gov.cn/english/home/jsp/docView.jsp?docID=20070518B45B01B69A22D905FFB6CBF6956DAF00 (accessed June 2009).

* Philip Lagerkranser, 2008, "China to Relax Rules on Foreign-owned Rural Banks (Update 1)," Bloomberg News Service, May 27, 2008, available on the Web site of LONDoneYE, http://blog.udn.com/clsc/1907601 (accessed June 2009). The CBRC will also allow financial companies other than banks to become the biggest or only shareholder in rural banks. The largest investors must own at least 20 percent of such a bank.

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