# Lifting the Poor (and Profits)

Previously unfavourable factors are showing signs of change, as China begins to pave a way for the commercialisation of microfinance.

By Jessica Beaton

**Pigeon farming is one of many microbusinesses run by clients of Funding for the Poor, a microfinance institution working in Henan and Hebei Provinces.**

In the world of development there used to be two camps of thought – focused on either more humanistic development models or on markets and profits. Through recent decades, they continued to travel divergent paths. However, the 2006 Nobel Peace Prize awarded to Mohammad Yunus and the Grameen Bank paved a convergence, a reconciliation of sorts. Several persons or groups have won the prize for peace – but a small bank?

The honour conferred by the Nobel committee was an acknowledgement of a recent trend that lays a common ground for two disparate beliefs through for-profit microfinance institutions (MFIs). In fact, these MFIs can benefit not only their investors, but also give the approximately 500 million impoverished people worldwide the bootstrap with which to begin to pull themselves up and out.

## Vehicle for Capital and Credit

The World Bank and the UNDP, as well as other donor institutions, believe that one of the core problems of poverty in less developed countries is a lack of access to capital and, therefore, credit markets. The International Finance Corporation's (IFC) Banking on Sustainability Report, says: "The success of microcredit has been demonstrated in many markets… microcredit borrowers should more correctly be categorised as pre-bankable: they have a potential to use microcredit as an entry to other banking services. Thus, microcredit is increasingly gaining credibility in the mainstream finance industry…as a source of future growth."

Countries like China are now looking at how to take advantage of this growing trend, slowly removing the institutional and ideological barriers that have stood in the way of microfinance programmes in the past. The term "microfinance" can refer to a range of financial services from savings programs to newly developed insurance policies. More generally known, however, are lending programs, or 'microcredit'. The two terms are commonly used interchangeably.

According to the IFC, microcredit is a type of financial innovation that has come out of development practises in developing countries. These programmes have empowered extremely impoverished people, the majority of whom are women, to engage in self-employment and begin the process of exiting the cycle of poverty, by giving them access to small loans often between RMB1,000 and RMB3,000 (USD132 and USD395). Historically, China has not had a hospitable environment for rural poor to gain access to the microfinance sector.

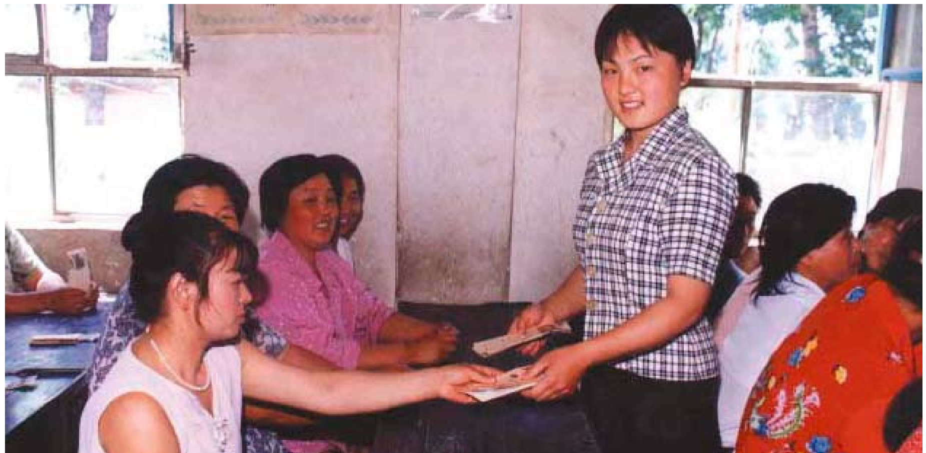
## Jumble of (Past) Problems

A 2006 UNDP report recently stated that in 2004, 16.6 per cent of China's total population – approximately 220 million people – was living on less than USD1 per day. Although the enormity of this statistic is daunting, it reflects the potential market for MFIs. Unfortunately, the same data also highlights some of the structural problems that have plagued China's microfinance-based programs in the past. For instance, China's rural poor often live in small, remote communities. Inaccessibility is one of the many challenges to programmes trying to serve the poor.

In an interview for Knowledge@Wharton for the Wharton Business School in 2006, Bai Chengyu, Secretary General of the China Association of Microfinance, described the situation as such: "Although the payment rate is very high in some microfinance institutions (MFIs), most are not running efficiently; nor is this trend unique to China." Inefficiency here refers to government regulation on international monies, the legal statuses of MFIs and partner institutions, as well as the physical implementation of microcredit programmes. Although, in the 1990s, there were smaller-scale programs, mainly directed by the Chinese government, no comprehensive regulatory framework gathered sufficient momentum to govern microfinance programmes.

Until recently, the lack of formal regulation on MFIs and the legal grey area in which MFIs operate meant not having a formal operating charter, and sidelining the programmes as “experimental” or “pilot”. MFIs were subject to changing political tides and local government bureaucracy. The increased risk due to lack of formality limited the efficacy and scale of the microfinance sector and, therefore, stunting the promise of sustainable commercialisation.

When asked what was needed to have a thriving commercialised microfinance sector, Bai said, “The major bottleneck to the commercialisation of micro-lending is the lack of policies to encourage involvement by commercial financial institutions, the failure to open the financial market to the private sector, artificially low interest rates and the lack of a legal environment.”



**A loan officer from Funding for the Poor meets with clients during a weekly meeting.**

## Adjusting Policies and Regulations

Kate Druschel, Regional Coordinator for East and South East Asia for the Washington, D.C.-based Grameen Foundation, sees China as a good candidate for a sustainable commercial microfinance sector. She says, “We [the foundation] believe that a number of factors aid the commercialisation of this sector, including…commercial lenders and investors who are engaged and interested in lending and investing in MFIs; and an enabling regulatory framework which allows for efficient financial markets for the poor.”

Currently a main challenge that MFIs in China must face is the limit on the receipt of foreign currency loans. There have been strict restrictions over the transfer and conversion of these monies overseas, although these restrictions are currently being relaxed in some areas. By not liberalising the policies through which MFIs can obtain funding, both domestically and internationally, potential future donors saw these complexities as a deterrent to future investment and, thus, further limit the sources of funding available to MFIs.

In a recent interview with *CSR Magazine*, Alex Counts, Director of the Grameen Foundation, said, “The greatest challenge we face in [commercially] financing our partner MFIs… Foreign exchange restrictions and the regulatory environment for microfinance have made it very difficult in China for us to get loan financing to the MFIs…. The changing regulatory environment for microfinance means that it should become easier in the future.”

In addition to changing its regulations on conversion of overseas monies, the Chinese government has begun to alter how it regulates MFIs. Approved programmes are no longer “experimental” and are not left to interpretation by local governance.

Druschel explains that progress began in late 2005, when the People’s Bank of China (PBOC), along with the Chinese Banking Regulatory Commission (CBRC) reformed regulations dealing with provisions of financial services in rural China. These changes laid the foundation for approval by the PBOC’s for six provinces – Shanxi, Shaanxi, Guizhou, Inner Mongolia, Gansu and Sichuan – to have pilot for-profit, micro-credit programs for the poor in early 2006. Later that year, the CBRC approved regulations for new village banking licenses in Sichuan, Gansu, Qinghai, Hubei, Jilin and Inner Mongolia.

> “The potential market [for microcredit in China] can be measured in the tens of millions of households.”

The regulatory environment continues to evolve and there are various legal forms for microfinance institutions. “Since late 2005, the People’s Bank of China and the Chinese Banking Regulatory Commission have done some significant reforms that will eventually change the landscape for financial services in the rural countryside,” says Druschel.

## Ripe for For-profit Expansion

Despite these positive moves, commercial banks are now only beginning to tentatively test the waters in China’s microfinance sector. A recent World Bank report highlighted what it hoped to be a new trend, by noting: “While most microfinance programmes have been funded by governments and donors, efforts are now shifting to fostering commercial microfinance institutions.” This will be a difficult task for many due to the lack of access to collateral for the poor. Other countries around the world have been able to reduce the role of collateral in microcredit since collateral does not exist for the majority of the impoverished.

Druschel remarked that the majority of Grameen’s borrowers have incomes of less than USD1 per day, have no commonly accepted collateral to secure a loan and have no credit history. All of which make these borrowers part of a high-risk group that banks have been reluctant to lend to. Part of the microcredit schemes use group lending methods such as support groups as well as community ties, to reduce the risk to the lender.

Robert Annibale, Global Director for Citigroup Microfinance, was quoted in an interview with Knowledge@Wharton as saying that he’s been “impressed by the credit performance, profitability and depth of client outreach to under-served communities that MFIs have demonstrated. The challenge is to manage costs for relatively high volume, small notional size loans.” He continued by saying, “However, there are models and institutions that make such a proposition commercially attractive and scalable.”

“The stakes are high for microfinance in China,” says Druschel. “The potential market can be measured in the tens of millions of households.” If China is able to overcome the obstacles facing it and create a commercial banking and microcredit system for the poor, that potential could be developing an ever larger driving force in a country already forging full-steam ahead. ❑