The Chinese micro and small lending sector: paving the road for sustainable growth

China's microlending sector has tremendous growth potential and is developing rapidly. With the support of the Chinese government, new channels of credit are opening up to micro- and small-sized businesses, which play a critical role in China's economy. However there are several emerging risks on the horizon. Proactive intervention is required, and Credit Suisse employees have contributed to programs designed to pave the road towards sustainable growth in the sector.

With a population of 1.36 billion \(^1\) and an estimated 400-500 million people still living on $2 per day in China, the numbers speak for themselves: the market for microlending has tremendous growth potential. China has been relatively slow in meeting the demand for microfinance compared to other countries, even though micro- and small-sized businesses play a critical role in China's economy. Self-employed individuals and micro and small enterprises have traditionally had few options to access debt-financing as banks in the formal financial sector have focused mainly on loans to state-owned companies and larger private enterprises, as well as retail consumer credit.

In the mid-2000s, the government leadership began to vocally support the development of small and micro enterprises, as a means of addressing widening income gaps and re-balancing the economy towards domestic consumption. Chinese regulators established several financial pilot models to provide new channels of credit at the country and district level. Smaller and medium-sized commercial banks also began piloting microlending departments, driven by a combination of policy pressure and recognition of the need to find new competitive advantages over larger banks. Since then more than 7,500 microcredit companies have been registered nationwide,\(^2\) 20 to 30 of China's commercial banks have set up micro or small lending units, and a number of other non-bank financial institutions have also entered the micro and small lending market landscape.\(^3\) These include pawn shops, person-to-person players, finance and lending companies owned by banks, as well as some guarantee and trust companies.

The rapid development of the micro and small lending sector in China now raises the question of not "how much growth is possible" but rather "is this growth sustainable?" PlaNet Finance, one of the first international microfinance groups to be established in China (in 2003), seeks opportunities to intervene in the market to promote sustainability of the industry through on the ground activities in China that include on-site technical assistance, research, development of tools and training programs catering to management of microcredit companies. In particular, its Microfinance Robustness Program, in partnership with the Credit Suisse Microfinance Capacity Building Initiative, focuses on strengthening the risk management standards and practices of this growing sector. To help microcredit companies and other small lending institutions develop better risk assessment practices in order to keep pace with the rapid growth in volumes, PlaNet Finance has developed a risk mapping tool, a credit risk dashboard and a financial risk dashboard initially targeted at microfinance institutions. These tools are available to the sector in Chinese and in other languages and can be implemented across a wide range of institutions.

The risk mapping tool facilitates a more holistic understanding of the risks facing an institution, taking into account medium to longer term risks related to governance risk, external risk,
information and technology risk, and liquidity and market risks, in addition to credit and operational risks which are commonly monitored on a day-to-day basis in microfinance institutions. The excel-based dashboard is another tool developed by PlaNet Finance to help address the practical day-to-day operational needs of microlending institutions as they scale up. The dashboard provides real time analysis of credit portfolio risk by key variables such as project, branch, industry, loan officer, and region, to enable risk managers to spot and address risks in a timely manner. Both the risk mapping tool and the credit risk dashboard are made publicly available via the PlaNet Finance China website (news resources), which PlaNet Finance has established as a platform to facilitate interaction and exchange of ideas between industry players, to disseminate microfinance tools and resources, and to give the international community a better insight into the rapidly changing microfinance industry in China. PlaNet Finance also conducts trainings, workshops and pilot programs with selected successful microfinance institutions and their risk managers, to help encourage implementation of best practice risk management standards.

Credit Suisse provides funding for the Microfinance Robustness program, but also technical expertise and the sharing of employee expertise through the Global Citizens Program. For example, Credit Suisse employees David Soh and Vishal Singhvi worked with the PlaNet Finance team to trial and implement the risk management tools in China and Cambodia. During her assignment, Carolina Baker developed and gave lectures on microfinance risk management, focusing on asset and liability management for chief risk officers and chief finance officers of leading Chinese microfinance institutions.

Through collaboration with research institutes such as the People’s Bank of China, the IFC (World Bank) and other think-tank bodies, PlaNet Finance also publishes research papers with recommendations for policy changes that aim to facilitate a more sustainable market environment for the microcredit sector. In the publication titled “Emerging Risks on China’s Path towards Financial Inclusion”, PlaNet Finance discuss several areas of emerging risk to the sustainability of the microlending sector in China. Recently established microcredit companies struggle to keep up with the rapid pace of growth due to limitations on internal capacity. Many newly established microcredit companies have difficulty scaling up their operations due to restrictions in funding access, with regulatory limitations on leverage and limited access to bond markets. Market leaders face the challenge of fast expansion, with lack of standardization, controls and systems that have not kept pace with the increasing scale and complexity of operations. While the micro and small lending market still remains relatively under-penetrated, pockets of over-competition have appeared in certain urban markets, raising concerns about potential risks on the horizon due to over-indebtedness and inadequate consumer protection.

Another key area affecting sustainability of the industry is the limited access of microcredit companies to funding sources necessary for development and expansion. Microcredit companies in China are prohibited from accepting public deposits as a funding source, and bank lending is capped at a maximum of 50 percent equity. In a joint research publication with the People’s Bank of China Research Institute of Finance and Banking, PlaNet Finance detail the current situation in China and draw on international experience from the United States and Mexico to argue that access to the short- and medium term bond market enables non-deposit taking lenders, such as the Chinese microcredit companies, to diversify their funding channels, manage liquidity, decrease costs, and optimize leverage to expand financing support to their clients. While policy changes are required to give microcredit companies access to bond markets, PlaNet Finance also highlight the need for microcredit companies to improve their operating performance and risk management practices, and perceptions thereof, to build confidence amongst investors.

Credit Suisse employees from Private Banking Research, Fixed Income and the Investment Banking department, including Wing-Son Chen, Head of Fixed Income Research APAC, provided technical expertise for the PlaNet Finance publications on emerging risks and on the access of microcredit companies to funding sources.

PlaNet Finance’s proactive approach to identifying risks to industry sustainability is helping to lay the foundations of the road to microfinance robustness in China. More intervention is required, and Credit Suisse continues to support the work of PlaNet Finance, through grant funding, subject matter expertise and employee expertise. More Credit Suisse employees will have a chance to work with PlaNet Finance through various assignments as part of the 2014 Global Citizens Program.

Credit Suisse’s Engagement in Microfinance
Credit Suisse has had over a decade of engagement in impact investing through microfinance, uniquely combining financing through innovative investment products and services for clients with capacity building of microfinance institutions and the industry through grants and sharing of expertise. For more information: www.credit-suisse.com/microfinance

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