Emerging Risks on China's Path towards Financial Inclusion

PlaNet Finance Microfinance Robustness Program

By Ed Wu and Xiaofang Yuan

Supported by the Credit Suisse Microfinance Capacity Building Initiative

Foreword

Towards a More Robust Chinese Micro and Small Lending Sector

by Arnaud Ventura

Microfinance is at a new stage of development around the world. The sector has achieved significant milestones, and at present has accumulated total assets of more than USD 80 billion worldwide. However, as in any sector, unrestricted growth can lead to crisis and those crises are happening more and more frequently. As an industry, it is crucial that stakeholders come together to put the proper emphasis on risk management to ensure the sector continues to develop on a sustainable path.

A recent CGAP study effectively summarizes our current situation: "Growth has exposed vulnerabilities in microfinance that market infrastructure initiatives must take into account in the future".[1] The Microfinance Banana Skins report - which has been tracking the key risks based on annual surveys – has also given us a glimpse of the multitude of risks facing the microfinance sector. Among the key risks identified in the 2012 survey, over-indebtedness, corporate governance, management quality, and credit risk were ranked the highest. The report also notes that the current period, "is one of exceptional fluidity which could have strong influence on the shape of this evolving industry as it moves into the next stage of its development".[2]

Through the "**Microfinance Robustness Program**", PlaNet Finance aims to help the microfinance sector prepare for its long-term success and integration within the financial system. It will do this by **strengthening risk management** in line with internationally accepted best frameworks and guidelines, while delivering key solutions that will become references in the sector for risk management best practices. [3]

Beginning in 2011, it was decided to focus on the specific needs of the Chinese micro and small lending sector, which remains in an early stage of development. China has a population of over 1.3 billion but an estimated 400-500 million people still live on two dollars a day. The sheer volume of unmet demand for micro and small lending points to the important role China will play in advancing financial inclusion efforts. And while further development of the sector is crucial, the speed of recent growth in China is raising concerns regarding new challenges and risks.

"Robustness" will thus be critical to China if it is to avoid the mistakes of other markets. The need for heightened industry awareness of the risks unique to China is clear. Defining benchmarks and best- in-class models are urgently needed. Additionally, stakeholders domestically and internationally require a better understanding of challenges facing the sector in China; at present the sector remains opaque to many observers (China has 67 MFIs reporting on the Mix Market, fewer than the 71 and 77 MFIs reported by Peru and Nigeria, respectively).

PlaNet Finance combines global exposure to microfinance around the world (we have operated in more than 60 countries, as a microfinance adviser, financier and operator), with an intimate knowledge of the Chinese micro and small lending sector. We were one of the first international microfinance groups to be established in China (in 2003), and we have been on the front line of developing the sector through technical assistance to some of the first microfinance institutions, as well as advising policymakers and microfinance networks. With strong local expertise and the support of Credit Suisse, we are well equipped to support efforts to build a robust microfinance sector in China.

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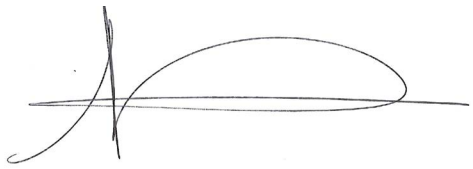
[1] *CGAP Focus Note: Growth and Vulnerabilities in Microfinance,* CGAP, February 2010

[2] *Microfinance Banana Skins 2012,* the Centre for the Study of Financial Innovation, July 2012

[3] PlaNet Finance, through the Microfinance Robustness Program, develops and disseminates practical risk management resources and tools to the Chinese microfinance sector, including a risk mapping tool for MFIs, a risk dashboard tool for better portfolio risk management, and video lectures by risk management experts (for more information, please see page 15).

By highlighting some of the risks we see emerging in China through the work and activities of the Microfinance Robustness Program, this paper aims to contribute to dialogue on building a more enduring Chinese microfinance sector, and to help in preventing the negative consequences of rapid growth in what remains one of the most promising microfinance markets in the world.



Arnaud Ventura
Co-Founder PlaNet Finance Group
Founder & CEO MicroCred Group

PlaNet Finance is currently delivering the Microfinance Robustness Program in China with the following goals to:

- Lower the risk profile of promising Chinese micro and small lending institutions through technical assistance, with the goal of developing best-in-class MFIs matching current risk requirements of regulators and capital markets.
- Find replicable risk management models for the Chinese microfinance sector and promote their implementation
- Get the right people prepared for the implementation of best practices in risk management by running training sessions on risk management that target chief financial officers and risk managers of Chinese micro and small lenders
- Complement technical assistance and capacity building with research on key challenges in the Chinese microfinance sector, in collaboration with universities and premier research institutes

For more information, please visit the Microfinance Robustness Program blog at:
http://blogs.planetfinancegroup.org/blogs/microfinance-risk-management

The program is made possible through the funding and expertise of the Credit Suisse Microfinance Capacity Building Initiative.

About the Credit Suisse Microfinance Capacity Building Initiative

One of several Credit Suisse engagements in microfinance, the Microfinance Capacity Building Initiative (MCBI) is the bank's grant and technical support initiative for microfinance institutions (MFIs). Launched in 2008, the MCBI aims to strengthen the microfinance industry, its institutions and their management. Credit Suisse works with carefully selected partner organizations to foster research, innovation and constructive dialogue, to spread best practices, and to develop new solutions for financial inclusion. Credit Suisse also supports microfinance institutions in their capital needs through a suite of investment vehicles and access to the capital markets.

For more information, please visit the Credit Suisse Microfinance Capacity Building Initiative at:
http://www.credit-suisse.com/microfinance

Photographer: Ed WU

Emerging Risks on China's Path towards Financial Inclusion

The Chinese micro and small lending sector began its development much later than many countries worldwide, and remains relatively untapped, despite its significant potential to contribute to global financial inclusion efforts. However, potential risks are on the horizon. These will require the nascent sector to balance between scaling up supply to a vast underserved market, and avoiding the pitfalls of overheating.

Photographer: Ed WU

Backdrop: A Nascent Sector Emerges

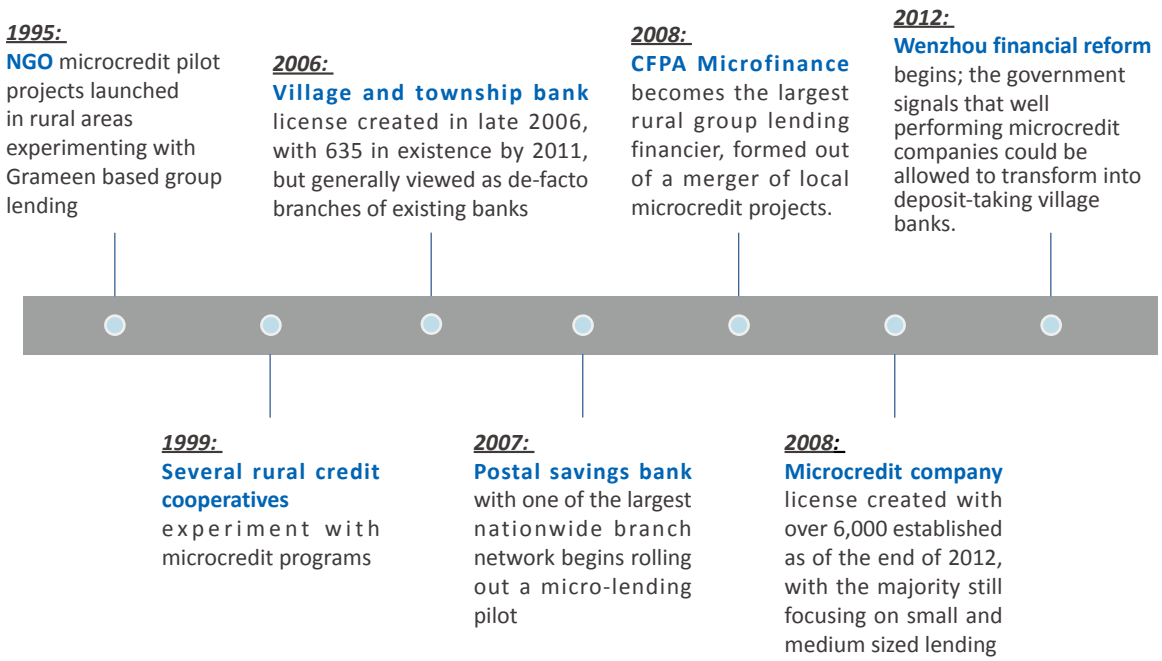
Even though micro- and small-sized businesses play a critical role in China's economy, China to this date is not known for the development of a significant micro or small lending industry. The formal financial sector has traditionally been dominated by banks that have focused mainly on loans to state owned companies and larger private enterprises, as well as retail consumer credit. This has left self-employed individuals and micro and small enterprises at the base of the pyramid, particularly in rural areas, with few options to sustainably access lending.

Yet while China remains far behind the curve compared to more developed microfinance markets worldwide, in recent years, China has rapidly forged its own path towards financial inclusion. Small-scale microfinance experimentation began in the late 1990s, with Grameen-style group lending piloted in several rural poverty counties across China spurred by donor seed funding. Those experiments provided the first glimmers of a sustainable approach to micro and small lending and signaled a gradual shift away from the state-subsidized policy lending programs. It was also a signal that there could be a larger role for the formal financial sector to create sustainable approaches to expanding credit to millions of micro and small enterprises across China.

In the mid 2000s, the government leadership began to vocally support the development of less prosperous regions and the private sector – particularly medium, small (and micro) enterprises, as a means to re-balance the economy towards domestic consumption and address widening income gaps. Benefiting from the policy framework, commercial approaches to micro and small lending began to emerge on a more significant scale, with regulatory reforms and new pilot initiatives coalescing around the same time.

Around the same time, the Chinese regulators established several new financial pilot models, including the Microcredit Company and the Village and Township Bank, with the aim of providing new channels of credit at the county and district level. The bank downscaling trend began around the same time, with several smaller and medium-sized commercial banks piloting small and micro lending departments, spurred on by a combination of policy pressure to go down-market, and a growing recognition of the need to find new competitive advantages over larger banks.

Chart 1: Key Milestones in the Development of the Chinese Micro and Small Lending Sector



By 2012, under the continuing policy backdrop of developing rural areas and private enterprises, along with gradual reform of financial sector infrastructure, the micro and small lending industry has been booming. At least 20-30 commercial banks out of a total of approximately 100 across China have set up micro or small lending units. More than 6,000 microcredit companies had been registered nationwide by December 2012, only seven years since the pilot initiative was launched. A number of other non-bank financial institutions have also become players in a vast and rapidly changing micro and small lending market landscape that includes pawn shops, person-to-person (P2P) players, finance and lending companies owned by banks, as well as some guarantee and trust companies.

PlaNet Finance - which has been working in China since 2003 - has been closely observing this ongoing evolution of the sector. Its rapid growth has been the main motivation behind our implementation of the Microfinance Robustness Program, with activities on the ground in China including on-site technical assistance, development of risk management tools and approaches, research, and risk management training. This has also afforded us the opportunity to reflect upon several key areas of emerging risk.

Four Areas of Emerging Risk

Few micro and small lending markets worldwide have grown so large, so fast. From the difficulties of upgrading the internal capacity of microfinance institutions themselves, to the challenges of supervising a complex, rapidly changing, and vast industry, the Chinese micro and small lending sector is entering a critical juncture of opportunities and risks.

Photographer: Yuting JI

1.

Can the internal capacity of recently established Microcredit Companies keep up with the rapid pace of growth?


Photographer: PlaNet Finance China

Concerns are emerging about potential risk in the Chinese micro and small lending sector due to the large number of relatively young lending operations, some of which pursue aggressive portfolio growth.

Under the Microfinance Robustness Program, one of the focus areas for technical support is the emerging imbalance between fast growth and lagging capacity. The microcredit company is a new type of lending license launched by the People's Bank of China in 2006. The regulator's goal was to create a new type of specialized non-bank lending company to channel credit to private enterprises and rural areas, providing an alternative to the bank-dominated Chinese financial sector. Simultaneously, the creation of the license encouraged the entry of new private capital into the market, and provided a path to formalization for informal lenders.

By the end of 2007, seven pilot licenses in five provinces had been authorized by the People's Bank of China, and the pilot scope subsequently expanded nationwide the next year. According to the People's Bank of China's own data collection, by the end of June 2012 – only five years since the first handful of microcredit companies was established – an impressive 6,000 microcredit companies had already been established countrywide.

The growth of microcredit companies represents a significant milestone in financial inclusion efforts in China, with outstanding loans of RMB 489 billion by the end of June, 2012.[4] However, of the 5,267 microcredit companies registered, only 25% had an operating history of more than three years, and only 50% had an operating history of longer than two years. These heady days of growth are raising concern about the need to upgrade sector-wide capacity.

The majority of these new microcredit companies are owned by private Chinese small- and medium- sized enterprises, many of these making their first forays into lending activities. Many are attracted by the chance to gain entry into the tightly controlled banking and finance sector, as operating costs, risks, or the investment needed

[4] Statistic source: *People's Bank of China*

to set up a lending company that can achieve long-term sustainability.

Because shareholders and management generally come from industry backgrounds (with some management also being hired away from banks), PlaNet Finance has found that credit methodologies do not depart significantly from traditional Chinese corporate banking approaches, emphasizing an "experienced-based" analysis of soft aspects, industry risk, and hard collateral. A common approach among microcredit companies is to limit the scope of their lending activities to a small group of enterprises (often concentrated along a particular industry value chain) where they can benefit from shareholder networks (for acquisition) and shareholder industry expertise (for experienced-based risk assessment). These tend to be small (or sometimes medium-sized) enterprises where a traditional bank underwriting approach can still be used. These enterprises are characterized as having reached a certain degree of scale and formalization, but still lacking sufficient access to bank financing.

The term "microcredit company" may seem misleading (at least at this point in time) given that most of these companies favor small- and medium- sized enterprise clients (with loans ranging from RMB 100,000 upwards), with less outreach to the micro lending clients (generally below RMB 100,000) who remain vastly under-served in rural and urban areas.[5] There is still a widespread perception among players that micro-clients are difficult to reach in an efficient and cost-effective way, as they possess neither collateral nor financial statements.

While this has proven to be a partially false assumption (several high-performing microcredit companies serving micro-and small enterprises have emerged)[6], the perception of the difficulties is not helped by current regulatory restrictions on microcredit companies' leverage and geography. The bias towards small or even medium-sized enterprise lending may also be due to lack of awareness (and in some cases simply an agnostic view) among shareholders and managers to the financial inclusion and poverty alleviation goals of the global microfinance movement. Finally, the current situation is also due to the fact that small- and medium-sized enterprises are also simply under-banked in the Chinese context, and clearly in need of financing support.

Some observers have stated that microcredit companies limit their risk exposure by lending to sectors and clients that are familiar to the shareholders and management. However, through risk mappings of microcredit companies performed by PlaNet Finance, we have concluded that this selective focus can cause Microcredit Companies to have very high loan and industry concentration risk. It is not uncommon for us to encounter microcredit companies with portfolios of twenty to thirty small enterprise clients, serviced by a handful of staff. According to a People's Bank of China survey conducted in June 2012, the average number of microcredit company staff was 11.6.

At the individual firm level, our work has also exposed the widespread phenomenon of microcredit companies mainly focusing on credit risk, without reference to the other risks at play in the framework, such as governance risk (particularly related-party lending), external risk, operations risk, IT systems risk, and liquidity risk, among other areas. Further contributing to potential risks, many individual firms pay little attention to principles of responsible lending commonly accepted internationally. PlaNet Finance has been enabling microcredit companies to take a more holistic approach to risk assessment through the development and implementation of a more comprehensive approach to mapping risks. This institution-building will be critical to those microcredit companies that have the perspective to go beyond serving a handful of clients to build a broader base of customers and long-term sustainability.

High loan concentration risk and lack of

[5] According to CGAP, microfinance is broadly defined as not exceeding 2.5 times of gross national income per capita. Based on the current GNI per capita in China published in 2012, micro loans would be defined as loans approximately RMB 85,000 or below, although this figure may increase or decrease between urban and rural areas and by region)

[6] Microcred - a subsidiary of the PlaNet Finance Group – operates two microcredit companies in Sichuan Province which are successfully focusing on the micro client segment http://www.microcredgroup.com/

comprehensive approaches to risk management does not bode well for the ability of microcredit companies to weather an economic contraction or a crisis brought on by stresses to other areas of the financial sector (such as the shadow banking sector, a separate space in the financial sector which is often cited as an area of growing risk in the near- to mid-term). For the time being, microcredit companies are unlikely to cause a systemic shock to the system, as loans totaled RMB 489 billion as of June 2012. This is a drop in the bucket compared to figures in a February 2013 analyst report by Credit Suisse, which estimates the size of the shadow banking sector as approaching RMB 22 trillion.[7] Nonetheless, a significant deterioration in portfolio quality as a result of a broader macro-economic contraction would be a setback to the credibility of this emerging sector.

In addition to microcredit companies, as mentioned above, a number of other new micro and small lending players have emerged. These include person-to-person (P2P) lenders, guarantee companies, pawn shops, and other non-bank entities, all of which are at the beginning stages of capacity building, with similar early-stage growing pains and which will also require strong capacity-building support.

In contrast, the small- and medium- sized banks involved in micro and small lending can leverage the existing comprehensive risk management frameworks in the bank, and benefit from the loan portfolio diversification as commercial banks in China. For these organizations, the main challenges are adopting the right credit methodologies, IT systems, and monitoring approaches, as they scale up their impact.

2. Bottleneck to long term sustainability: Microcredit Companies struggle to scale up due to restrictions in funding access

Aside from near-term risks, addressing the long-term sustainability of the micro and small lending sector has also been a key focus of research efforts under the Microfinance Robustness Program. Through joint research conducted with the People's Bank of China (PBOC), PlaNet Finance has found that the ability of the many newly set up microcredit companies across China to reach economies of scale and become sustainable faces significant limitations, both from the regulatory framework, and from the inherent lack of capacity of microcredit companies.

Microcredit companies were designed by regulators as non-deposit-taking lending institutions to protect depositors and to limit sector-wide risk; they are therefore mainly funded by shareholder capital. Microcredit companies are allowed to access wholesale funding from two commercial banks, but the maximum amount of bank debt that a single microcredit company can utilize is capped at 50% of their equity. This is a low level of leverage compared to microfinance worldwide, where it is not uncommon to have a ratio between debt financing and equity of 4 to 5.

[7] *China: Shadow banking – Road to heightened risks*, Credit Suisse Securities Research & Analytics, February 2013

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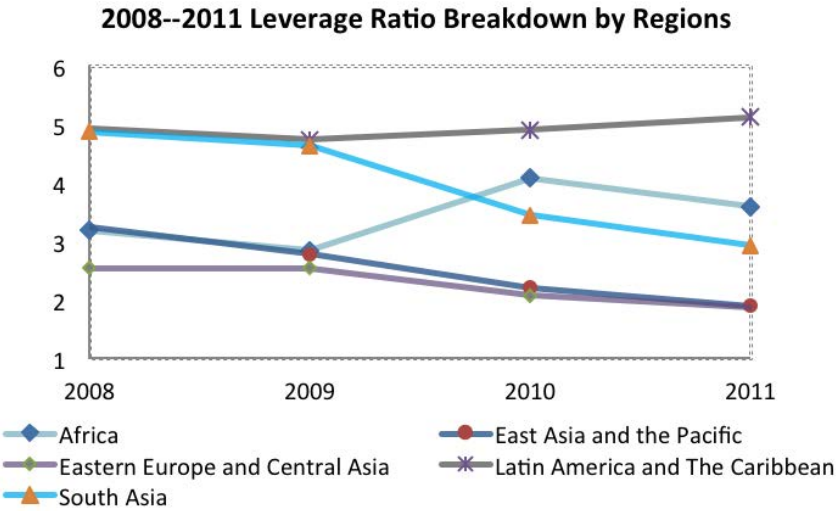

Our research with the PBOC has found that the majority of microcredit companies are funded through equity, and have not reached their leverage threshold. This is mainly due to the fact that many of them have yet to qualify for bank funding. Also working against them is the commercial banks' perception of microcredit companies as high-risk SME clients without land, real estate or other acceptable collateral, and with only their loan portfolios to offset risk. As a result, high-performing microcredit companies have been disproportionately impacted by the funding restrictions.

Low leverage - combined with limitations on geographical scope - have also inclined many microcredit companies towards cost optimization, with limited staffing and disbursement of a small number of small- and medium-sized loans. Another consequence is that some microcredit companies that might have down-scaled their operations to micro-enterprise clients and rural areas will not carry out these plans because it takes higher levels of leverage and wider geographical scope in order to make this investment.

While several high-performing microcredit companies have been able to negotiate with local regulators to win relaxation of leverage restrictions in some provinces, these exceptions are not granted in a systematic way that is based on consistent criteria. Generally, it has been insufficient relative to the demands of a number of high-performing microcredit companies, some which could do much more in expanding financial inclusion efforts to the base of the pyramid if they had access to additional funding. The absence of strong rating industry players for rating of micro and small lenders is also considered to have contributed to this situation.

Work on initiatives to open up new regulated and sustainable channels for funding is ongoing. The feasibility of commercial paper and medium term notes issuance, for example, is presently the focus of the joint research between PlaNet Finance and the People's Bank of China. However, no Microcredit Company has to date successfully issued bonds due to perceived regulatory restrictions, although a number of microcredit companies have already reached the scale and sustainability where bond issuance could be a feasible option - once the policy environment is liberalized.

While the majority of microcredit companies have simple funding structures consisting of equity and bank funding, some have turned to more sophisticated (and often higher-cost) funding structures such as bank agency models. There have also been concerns that some microcredit companies are crossing over to small scale unauthorized fundraising through securitization of loans via trust company structures, or illegal raising of funds from individuals (essentially deposit taking). Separate from microcredit companies, other new types of non-deposit

taking lenders (registered as regular companies rather than as lending entities) are also sprouting up. These lenders, unlike microcredit companies, do not face leverage restrictions, but operate in the grey area of the current regulatory framework. These trends have sparked concerns about the potential for reputation risk among industry stakeholders, especially as there are indications of potential spillover into some peripheral activities of the shadow banking sector, both on the asset and lending side. However, those links are generally not perceived to be widespread, as regulators have been cognizant, and taken certain actions to limit the risk, for example, when they recently restricted microcredit companies from working with trust companies.

The regulators have resisted pushing for a nationwide relaxation of leverage requirements to help high performers. This more gradual policy approach could in part be due to the fact that microcredit companies are currently directly supervised by the local Financial Affairs Office in the regions they operate. The Financial Affairs Office has historically not been a regulatory body charged with supervision, thus there may be concerns about increasing leverage too quickly, given the heavy supervisory burden on so many new institutions.

For the time being, the overall regulatory approach has been to allow experimentation mainly with bank funding at the local level through relaxation of leverage on a case-by-case basis for high performers. Regulators are adopting a "wait and see" attitude towards more comprehensive reform – and studying the possibility of a tiered approach to regulation, and different conditions on leverage that could be based on the performance and quality of different microcredit companies. Initiatives are also being discussed in Wenzhou to provide funding channels through pilots related to upgrading microcredit companies to village banks, and potentially, private placement bonds.

3.

Market leaders face the challenge of fast expansion

While the majority of financial non-banking and banking institutions making forays into the micro and small lending sector are still in the early stages of expansion, PlaNet Finance has observed that a few market leaders have already reached significant business scale, or are on the path to scale. These are typically institutions which began lending to the micro or small enterprise segment comparatively early, and which benefited from existing infrastructure to ramp up lending activities faster (this was especially true of banks); some obtained and applied early access to knowledge of more mature models of micro or small lending.

Most significantly, this group includes the Postal Savings Bank, which entered the micro and small lending arena in 2007 after implementing pilots in several provinces, and subsequently began rolling out micro and small lending operations to its nationwide network. In addition to the Postal Savings Bank, several rural and city commercial banks, a handful of microcredit companies and other non-bank lenders, have also experienced very rapid growth in recent years.

These emerging market leaders are beginning to face the risks inherent in a rapid - often nationwide - expansion strategy, including the challenges of maintaining control and standardization, particularly as portfolio monitoring, risk management, and IT systems have not kept pace with the increasing scale and complexity of operations. A number of these leading lenders are still practicing basic portfolio risk management without the kind of


Photographer: Yuting JI

sophistication in IT infrastructure, reporting, and technology, that is driving improved risk management and efficiency in MFIs outside of China. PlaNet Finance has therefore been working on creating tools such as IT-linked risk dashboards to support the efforts of leading players to produce detailed and timely portfolio risk management analysis. These market leaders also face the potential limits of organic growth, exacerbated by the broader lack of experienced micro and small lending staff in China relative to demand.

4.

Pockets of over competition in the micro and small lending sector have emerged in several urban areas across China, requiring the vigilance of regulators

The micro and small lending market still remains relatively under-penetrated in China, particularly in the rural microfinance market. Yet a recent trend has been a disproportionately fast increase in lending volume in certain urban markets, raising concerns about potential risks down the line due to overcrowding of competition, over-indebtedness, and inadequate consumer protection.

Through its risk management work on the ground, PlaNet Finance has found that on the surface, loan quality among micro and small enterprise lenders in recent years has remained very good (while comprehensive data is hard to come by, a number of reports and sources show non-performing loans below 1% for micro loan portfolios of banks and non-banks). This situation is generally attributed to a combination of factors: the absence of a severe nationwide economic

Chart 3: Regulation of Players in Micro and Small Lending

Types	Regulatory body	MSME loan outstanding[1]	Nbr of entities
PSB	CBRC	390 billion	1
CCB	CBRC	N/A	147
New-type rural financial institution[2]	CBRC	62 billion	786
MCC	Local financial affairs office	39 billion	4282
NGO MFI	Mainly local poverty alleviation office	N/A	300[3]

1. The statistic indicates the outstanding loans in 2011
2. The 786 new type rural financial institutions include 726 village and township banks, 10 loan companies and 50 rural mutual fund cooperatives.
3. This number is estimated by the China Microfinance Association

contraction, the relative under-penetration of the micro and small lending market, as well as the ample liquidity in the market, for the time being.

However, a potential contraction in the economy in the next years will also impact the operating performance of micro, small, and medium sized enterprises. This will be a stress test for the portfolio quality of the nascent industry, particularly in those areas where higher levels of competition and over-indebtedness would exacerbate loan quality deterioration during a period of economic recession. While the market remains by and large, untapped, pockets of over-competition have appeared.

In Shenzhen, a special economic zone on the border of Hong Kong with a vibrant economic center, a population of over 10 million, and a more liberalized approach to the financial sector, there has been a rapid growth in the number of micro and small lenders. The proximity to Hong Kong has also led to a fast adoption of consumer lending models, which indirectly serve the micro and small enterprise segment through the provision of personal loans and credit cards.

Shenzhen is already experiencing signs of over-competition and over-indebtedness among clients, many of whom who also borrow from the informal lending sector. Over-indebtedness is further exacerbated by the lack of widespread awareness or adoption of responsible lending principles in China - crucial not only to preventing over-indebtedness, but also to protect customers from collections abuse (often spawned by over-indebtedness), and reducing sector-level reputation risk.

Over-indebtedness has also focused attention on the importance of access to the credit reporting system. In principle, non-bank lenders such as microcredit companies and consumer finance companies can access the People's Bank of China credit reporting system, which went online in 2006. In reality, many have yet to gain access, in large part because these lenders have yet to reach the minimum requirements in terms of data security, data quality, and systems investment to support entry into the credit bureau.

This leaves a gap in the ability of institutions to properly assess the debt capacity of borrowers.

At the same time, reliable data regarding loan portfolio quality and customer debt is still by and large unavailable (exacerbated by the prevalence of lending from informal lending and shadow banking channels in China), posing a challenge for regulators at the local, provincial, and national levels. Going forward, the importance of building a more robust regulatory framework will become ever greater in markets where "crowding" of competitors has already taken place in a few fast growing (often urban) markets located in areas on the eastern coast and the Pearl River Delta, among others.

Complicating the effort to properly regulate the sector is the large number of different regulatory agencies including the China Banking and Regulatory Commission, the Financial Affairs Office in each province, and the People's Bank of China, which are involved in the different areas of regulation of financial entities, and are particularly numerous around the non-banking sector.

On top of this, regulation of the many new types of non-banking players in China has been quite de-centralized, reflecting the challenge of supervising the many new players spanning the 22 provinces, five autonomous regions, and four municipalities of mainland China. Given the size and geographical dispersal of China, the importance of the quality of supervision at the local level has particular relevance for efforts to control risk at both the firm and industry level.

As part of the Microfinance Robustness Program, PlaNet Finance is providing technical assistance to leading Chinese micro and small lenders with the objective of lowering their risk profile and building "best in class" lenders matching current risk requirements of regulators and capital markets, so as to become replicable models for the microfinance sector in China. In 2012, PlaNet Finance partnered with Huimin Microcredit Company in Ningxia Autonomous Region (a leader in rural micro lending) providing the institution with on-the-ground assessment of their risks through risk mapping, and providing technical assistance and risk management tools to prepare Huimin for future growth.

Risk Management Tools for the Chinese Microfinance Sector

Mapping Risks of a Chinese MFI

With over 6,000 new microcredit companies established in China within a relatively short time span, PlaNet Finance, together with Credit Suisse experts, saw the need to develop a replicable risk mapping tool to help Chinese micro and small lenders holistically understand the risks facing their institutions, and to complement the day-to-day operational monitoring of risks. As mentioned above, Chinese micro and small lenders tend to focus on credit and operational risks, and do not take an approach to risk management that considers the gamut of risks that can face a lending institution, including governance risk, financial risk, external risk, HR risk, and IT risk. The risk-mapping tool draws upon the best practices and guidelines from risk management in the mainstream banking sector, with adaptation to the specificities of the Chinese context, aiming to become a key reference for best practice in risk management amongst the many young micro and small lenders in China.

A Dashboard for Risk Managers

Through the work of the Microfinance Robustness Program, PlaNet Finance has found that many leading Chinese micro and small lenders still utilize basic IT and reporting systems that cannot keep pace with the loan portfolio monitoring needs of a MFI as it scales its operations and client base. To address the practical day-to-day operational needs of these leading lenders as they scale up, PlaNet Finance partnered with experts from the banking sector to develop a user-friendly excel-based dashboard tool. This provides Chinese micro and small lenders the ability to analyze in real time their own credit portfolio risk by key variables such as product, branch, industry, loan officer, and region. The detail and real-time data helps risk managers to spot risks across a diversified and growing portfolio, so that risks can be addressed in a timely manner. With support through the Robustness Program, PlaNet Finance's aim is to provide a concrete and operation-ready tool for risk managers.

Risk Management resources including practical tools for risk managers and video lectures on risk management can be downloaded free of charge at the Microfinance Robustness Program blog at:
http://blogs.planetfinancegroup.org/blogs-classification/risk-management-resources

As part of the Microfinance Robustness Program, in 2012, PlaNet Finance organized the first annual China risk management workshop, bringing together for the first time executives from leading Chinese micro and small lenders from across the industry spectrum - ranging from NGOs, commercial banks, microcredit companies, to village and township banks, and providing a platform for exchange of views while disseminating risk management best practices and practical tools to participants.

A Regulator's Perspective on Risks Facing the Chinese Micro and Small Lending Sector

Liu Ping, Office of Senior Advisors, People's Bank of China

In the interview below, PlaNet Finance invited the Director General of the Office of Senior Advisors of the People's Bank of China, Mrs. Liu Ping, to share her perspective on the state of the Chinese micro and small lending sector, and on key risks facing the industry going forward.


Photographer: People's Bank of China

PlaNet Finance: What is your view of the development of microcredit companies and the current challenges they face?

Liu Ping: The original intent of the regulators in establishing the microcredit company – a new type of lending license – was to solve the funding issue for micro-, small-, and medium-sized businesses. This is very much in line with the goals and desire of the government. However, due to misunderstandings of some stakeholders about the status of Microcredit Companies (ie. they are formally licensed and regulated lenders, rather than organizations doing informal lending), the problems of microcredit company funding leverage, and other well-known problems, the microcredit company segment still faces relatively large challenges as it makes its next big step.

Currently, regulation and supervision of Microcredit Companies is mainly de-centralized at the level of the local Financial Affairs Office. The details of specific regulations vary from location to location, and there is no common regulatory standard or regulatory platform. How can we more effectively regulate

microcredit companies and other types of non-deposit taking lenders, and further promote the standardization of their operations? Building a sounder regulatory framework is still in the phase of exploration.

Even though microcredit companies are facing challenges and problems related to this particular phase in its development, I am of the view that as long as we uphold the original design intent, specifically, "small loan amounts, large numbers of loans, and service to micro and small entrepreneurs", and continue to improve the regulatory framework, the prospects for microcredit companies' further development will be bright.

PlaNet Finance: In your opinion, what are some of the key risks currently facing Microcredit Companies?

Liu Ping: The macroeconomic environment this year is not very good. Businesses are facing rapid rises in salaries, and difficulties in hiring workers. The overall profitability margin in the real economy is getting thinner. If you broadly compare this year with last year, the problem of funding difficulties has evolved into an issue of funding costs. The increase in funding costs for small- and medium-sized enterprises has become a worrisome problem. Currently, the outlook for the real economy is not so optimistic. Businesses in the coastal regions are experiencing a decrease in orders, and profit margins are going down.

The real economy and the financial system are interdependent. Microcredit companies have already faced challenges in their development, and now they face the simultaneous challenge of both access to funding and cost of funding. Thus, this year, external risk is more noteworthy. Our new generation of government leaders attach particular importance to the development of the real economy, and have elevated the development of the real economy to an important place. This is the foundation for the prosperity of all industries.

PlaNet Finance: It is commonly known that Chinese microcredit companies cannot take deposits, and have relied primarily on their own shareholder capital for their lending activities. Their ability to leverage commercial bank funding is quite limited compared to the situation internationally, where it is common for non-deposit-taking institutions to have leverage of up to 4 to 5 times their equity. Currently our organizations are jointly tackling the funding challenges facing microcredit companies, and researching the possibility of Microcredit Companies accessing the commercial paper and medium term notes market. Can you tell us more about the goals of this joint research?

Liu Ping: This research topic has great significance. Microcredit companies are one of the important actors involved in solving the financing problem for micro-, small- and medium-sized enterprises. Thus, if we can solve the problem of microcredit company funding, this has important implications for the funding challenges of these enterprises. Our current research collaboration with PlaNet Finance focuses on experiences of non-deposit-taking lenders accessing commercial paper and medium term notes. We have been looking at whether domestic microcredit companies could use the debt markets as an effective funding mechanism. According to our research findings, in many countries internationally, non-deposit-taking lenders – particularly those with high quality management and mature models – rely on commercial paper and medium term notes as part of the funding mix. In particular, commercial paper has lower costs and a relatively faster transaction speed, and is thus widely used by non-deposit-taking lenders. If the funding issue for non-deposit-taking lending institutions can be resolved , then we are one step closer to the goal of sustainable development.

PlaNet Finance: Can you share your perspectives on the regulation of Microcredit Companies?

Liu Ping: The Wenzhou financial reform pilot has been the prelude to bringing the informal lending sector "into the sunshine". At the current time, several different experimentations are still in the process of exploration. If high-performing microcredit companies were able to issue private bonds, this would be a breakthrough in the recent Wenzhou financial reforms.

Regarding the issue of designing a tiered approach to microcredit company regulation, this requires additional research. As the number of microcredit companies across the country increases, differences in operations have become more evident. Therefore, a trend of industry consolidation for microcredit companies would be hard to avoid. Designing a standard rating for microcredit companies should be part of the current discussion. We also strongly encourage those microcredit companies with competitive advantages in terms of management capacity and strong risk management to promote the sustainable and healthy development of the sector through scaling up their operations through consolidation, merging, entrusted models of management, and other avenues. We also encourage microcredit companies to enter the People's Bank of China credit bureau system in order to better grasp the credit history of borrowers, decrease the costs of financial analysis, and reduce the credit risks that come with information asymmetry.

About PlaNet Finance

PlaNet Finance is one of the positive and responsible economic global leaders. For nearly fifteen years, it has worked to help poor populations gain access to financial services, and so improve their living conditions in a sustainable way by integrating them into the economic system. The PlaNet Finance group contributes to the development of the microfinance sector by implementing specific products and services that address the needs of people who suffer due to their exclusion from the system. PlaNet Finance operates not only in the developing countries, but also in the French suburbs. With an international presence in more than 80 countries, the PlaNet Finance group is now recognized as a major contender in the fight against poverty. It was founded in 1998 by Jacques Attali and Arnaud Ventura.
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