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Modalities of Microfinance Delivery in Asia and Latin America: Lessons for China

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Abstract

Microfinance, the provision of small size loans and other financial services to low income households, is often seen as the key innovation of the last 25 years in terms of means of reaching out to the poor and vulnerable. There is extensive experience in microfinance provision in both Asia and Latin America, but as yet relatively little use of the approach in China. This paper assesses different approaches to microfinance delivery using a threefold distinction, the credit union approach, the non-government organization approach and the banking approach, to generalize across recent Asian and Latin American experience and discuss the role of microfinance in poverty reduction in a theoretical framework. Considering the current state of microfinance in China and international experience, we suggest the banking approach as the way to best increase outreach of micro-financial services in China.

Key words: Asia, banking, China, credit union, Latin America, microfinance
JEL codes: O19, G21, D02

I. Introduction

Microfinance, the provision of small size loans and other financial services to low income households, is often seen as the key innovation of the last 25 years in terms of means of reaching out to the poor and vulnerable. There is extensive experience in microfinance

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provision in both Asia and Latin America, but as yet relatively little use of the approach in China.

In Section, this paper assesses different approaches to microfinance delivery using a simple threefold distinction to generalize across recent Asian and Latin American experience. Section III considers the merits of these alternatives in the context of a theoretical discussion of the role of microfinance in poverty reduction. Section IV addresses the current relatively undeveloped microfinance sector in China and Section V asks what China might learn from experiences elsewhere.

II. Modalities of Microfinance Delivery

1. The Credit Union Approach

One of the oldest modalities of microfinance delivery is the credit union, or financial cooperative. In the informal sector, Rotating Savings and Credit Associations (ROSCA) have always been an important way for poor households to fill the gap left by formal financial institutions. Credit unions are probably best characterized as "semi-formal": unlike informal ROSCA, they are registered entities subject to commercial law, but are not usually regulated or supervised under banking law, although in some countries specific regulations for credit unions are being developed. These institutions are member owned and provide financial services to members: usually savings and loan services, in some cases insurance. They are non-profit institutions and there are no external shareholders. Traditionally, membership in a credit union was the result of some common bond among the members: employment or membership in the same community. Closed bond credit unions are usually organized at the workplace and membership is open only to employees. Open bond credit unions operate in a given community and membership is open to any member of the community.

Where available, financial cooperatives often choose to become affiliated with a national apex institution, which will provide training and technical assistance and channel resources from external donors to the national financial cooperative system. These national institutions might in turn affiliate with one of the international credit union apex agencies. The World Council of Credit Unions (WOCCU), the largest of these international credit union apex agency, reports that there are now 40 421 credit unions[1], enabling 123 million members in 84 countries to gain access to affordable

[1] As of 2002, WOCCU reports 2287 credit unions operating in Latin America and the Caribbean and 16 586 in Asia.

financial services.

2. The Non-Governmental Organization Approach

To many outside the microfinance sector its natural delivery mechanism might be expected to be a non-profit making non-governmental organization (NGO). This modality was the basis of what has come to be called “the microcredit revolution” in both Asia and Latin America and the pioneering institutions in both regions were NGOs. For example, the Grameen Bank in Bangladesh, which founded many of the fundamental concepts we associate with microcredit, such as small loans to groups of female micro-entrepreneurs, and Prodem, the successful Bolivian microfinance institution (MFI) that later became the first microfinance NGO to transform into a commercial bank, both started as NGOs.

The breadth of outreach of NGOs varies greatly between countries. In South Asia, NGOs have much greater outreach in Bangladesh, for example, than in India or Pakistan. In Latin America outreach is far greater in the smaller economies of Bolivia and Central America than in the larger economies of Brazil, Mexico and Argentina.

Limits on the NGO modality are mostly regulatory. NGOs cannot access domestic or international capital markets. In most countries, NGOs cannot legally offer savings services and, therefore, cannot mobilize deposits, using client deposits as a way to finance other parts of the organizations operations such as lending. Both of these restrictions in effect limit the scale of most NGO operations. In countries where microfinance NGOs have achieved significant scale, regulators have either come up with a regulatory framework suitable for MFIs separate from banks (Bolivia), or have allowed the sector to flourish unregulated (Bangladesh), what some in the industry have referred to as “benign neglect”.

3. The Banking Approach

The most recent entrants to the microfinance industry are commercial banks. This modality includes many variants: transformed microfinance NGOs, government owned development banks, reformed state banks and diversification into microfinance by existing commercial banks. The Khushhali Bank in Pakistan is an unusual example of a newly-established retail commercial bank specialized in micro-finance.

The transformation of NGOs into commercial banks is still a relatively new phenomenon, but so far they seem to be performing well in terms of profits and have been able to expand the scale of their operations significantly (Fernando, 2004). In comparison, state banks have generally underperformed. In the heyday of directed credit in the 1970s, subsidized loans often went to politically-favored wealthy-landowners rather than poor farmers. Despite this, repayment rates were low and many programs operated at a loss. However, many state-owned banks have extensive branch networks, enabling them to achieve significant outreach. There are an increasing number of examples of commercial banks diversifying into microfinance, either directly or through partnerships with financial NGOs. Even big multinational banks such as ABN Amro, Citibank and Deutche Bank are now involved in microfinance.

The examples above of incorporation of microfinance into the formal financial system are paradoxical given that the initial motive of microfinance was to serve poor borrowers who could not have access to formal finance. In some cases, such as in Nepal or India, sector lending requirements may be the impetus behind diversification of large commercial banks into microfinance. But ICICI Bank in India, for example, has expanded its involvement in microfinance beyond the minimum requirement and very little of their involvement in the microfinance sector now counts toward meeting the regulatory requirements. In these cases or others where such requirements do not exist, the motive seems to be profits and diversification of business lines. In Latin America in particular there is a growing market for relatively small loans and in several countries the larger MFIs have been generating considerably higher returns than have commercial banks. In contrast, smaller MFIs (principally NGOs) in the region show negative returns (Ramirez, 2004).

4. Comparison of the Three Approaches

The distinction between the three approaches, NGO, credit union and commercial banking, is becoming blurred as credit unions and NGOs themselves take a more commercial approach to microfinance (see Charitonenko, *et al.*, 2004; Drake and Rhyne, 2002). For example, in the late 1980s, WOCCU embarked on a new strategy to renovate and strengthen credit unions using a commercially oriented approach, which has been particularly well-received in Latin America (Lennon and Richardson, 2002; Westley and Branch, 2000). The more commercial approach among NGOs is exemplified by the small number of NGOs that have transformed into microfinance banks or regulated non-bank financial institutions. Transformation is still far from a dominant trend in the sector, but many microfinance NGOs borrow funds from apex institutions at market rates, requiring a more commercial approach to their overall operations. It should be noted that from an early stage in the evolution of the sector MFIs in Latin America have had a greater focus on commercial returns and financial sustainability than have their counterparts in Asia. This can be

Table 1. Modalities of Microfinance

	NGO	Credit union	Commercial bank
Target clients	The poor, especially disadvantaged groups	Members	All small clients, particularly microenterprises and traders
Primary source of funds	Donors	Members	Depositors, investors
Strengths	Deep outreach (strong poverty focus), credit combined with training and support	Participatory, access to remote rural areas	Savings mobilization, access to commercial funds and regulation to ensure prudential operations
Weaknesses	Limited sources of funds for expansion, governance issues and management standards	Governance issues, managements standards and outreach limited to members	Mission drift and exclusion of poor and constraint on expansion because of prudential requirements.

seen in the emphasis placed on loans to microenterprises rather than to individual households. However, in the aggregate, microfinance NGOs and credit unions do not cover costs.[2]

Despite this apparent convergence to a commercial approach to the provision of micro-financial services, one can still draw broad distinctions between these three approaches, as summarized in Table 1.

Essentially, one must trade-off the advantages of expansion through commercial banks (principally, access to finance and prudential regulation) against the poverty focus that can be obtained through NGOs and credit unions operating in poor areas. These need not of course be wholly mutually exclusive. One modality sees microfinance as part of the formal financial sector, with the key difference from other financial activities only being the size of transactions. The other two see microfinance as part of the aid delivery and poverty targeting system, which need not be financially self-sustainable. To clarify the options for China it might be useful to explore further how microfinance fits into theorizing on poverty.

[2] This can be seen in the fact that the average return on assets for MFIs and credit unions in the late 1990s was negative (at –4.5 percent); more recent figures suggest a close to breakeven position; see Ramirez (2004).

III. Microfinance and Poverty

In terms of understanding poverty, a simple distinction can be drawn within the group "the poor" between the long-term or "chronic poor" and those who temporarily fall into poverty as a result of adverse shocks, the "transitory poor". Within the chronic poor one can further distinguish between those who are either so physically or socially disadvantaged that without welfare support they will always remain in poverty (the "destitute") and the larger group who are poor because of their lack of assets and opportunities. Furthermore, within the non-destitute category one may distinguish by the depth of poverty (that is, how far households are below the poverty line) with those significantly below it representing the "core poor", sometimes categorized by the irregularity of their income. In some Latin American cases, for example, the core poor or destitute are taken to be those below 50 percent of the poverty line (although Latin American poverty lines are generally higher than in Asia).

In principle, microfinance can relate to the chronic (non-destitute) poor and to the transitory poor in different ways. The condition of poverty has been interpreted conventionally as one of lack of access by poor households to the assets necessary for a higher standard of income or welfare, whether assets are thought of as human (access to education), natural (access to land), physical (access to infrastructure), social (access to networks of obligations) or financial (access to credit) (World Bank, 2000). Lack of access to credit is readily understandable in terms of the absence of collateral that the poor can offer conventional financial institutions, in addition to the various complexities and high costs involved in dealing with large numbers of small, often illiterate, borrowers. Therefore, the poor have to rely on loans from either moneylenders at high interest rates or friends and family, whose supply of funds will be limited. NGO MFIs initially attempted to overcome these barriers through innovative measures such as group lending and regular savings schemes, as well as the establishment of close links between poor clients and staff of the institutions concerned. As we have seen in more recent years, a more strictly commercial approach has been applied in some MFIs.

The case for microfinance as a mechanism for poverty reduction is simple. If access to credit can be improved, it is argued, the poor can finance productive activities that will allow income growth, provided there are no other binding constraints. This is a route out of poverty for the non-destitute chronic poor. For the transitory poor, who are vulnerable to fluctuations in income that bring them close to or below the poverty line, microfinance provides the possibility of credit at times of need and in some schemes the opportunity of regular savings by a household itself that can be drawn on. The avoidance of sharp declines in family expenditures by drawing on such credit or savings allows "consumption smoothing".

It is one of the most interesting generalizations to emerge from the microfinance and poverty literature that the poorest of the chronic poor (the core poor) will borrow essentially for protectional purposes given both the low and irregular nature of their income. This group, it is suggested, will be too risk averse to borrow for promotional measures (that is, for investment in the future) and will, therefore, be only a very limited beneficiary of microfinance schemes (Hulme and Mosley, 1996).[3] The view that it is the less badly-off poor who benefit principally from microfinance has become highly influential and, for example, was repeated in the World Development Report on poverty (World Bank, 2000).

The poorest of the poor may be missed by microfinance for many of the reasons that the poor as a whole are excluded from the formal financial sector: higher transaction costs and default rates usually result in higher interest rates than the formal financial sector, and in the absence of collateral lenders may ration credit even at these higher rates. If the investment projects undertaken by the poorest of the poor have lower marginal returns, perhaps because this group suffers from a lack of other capital inputs, they will not be able to bear these higher rates of interest anyway. And even if relatively high return projects are available to them, the poorest of the poor may not be willing to undertake such projects if they incur greater risks (Weiss and Montgomery, 2005).

IV. Microfinance in China

Rural households in China must rely on the informal sector (loans from family, friends and various curb market institutions)[4] for roughly two-thirds of their financing needs

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[3] The microfinance sector has responded in a several cases by establishing special programs for the core or "ultra poor". The best known of these are in Bangladesh and involve the well-established institutions of BRAC and ASA. The programs essentially aim to provide a range of services, covering training, health provision and more general social development for the disadvantaged, as well as grants of assets or credits. The ultra poor are encouraged to build up a savings fund and to graduate to conventional microfinance programs. Other variants of this approach involve greater flexibility in repayment terms for the poorest (Fernando, 2004).

[4] Tsai (2004) discusses informal channels of financing in China, such as moneylenders and pawnshops.

(Cui, 2004). Such sources are, of course, limited and problems with informal sector financing in China have been publicized in the international press (The Economist, 2004), although Tsai (2004) argues that such abuses are the exception. Formal financing for rural China is available principally through the Agricultural Bank of China (ABC), the Agricultural Development Bank of China (ADBC) and the Rural Credit Co-operatives (RCCs). Non-official organizations including Rural Credit Foundations (RCFs), Mutual Savings Associations, informal sector, and micro-credit projects have been developed as a source of informal financing aiming at poverty relief (IFAD, 2004).

The ABC used to be the biggest source of rural finance in China, but its involvement in rural areas is diminishing. The ABC was originally a state-owned bank, its role being to disburse poverty reduction funds in poor counties. In 1994 the ADBC was established and took over the role of the ABC in funneling policy loans aimed at promoting agricultural development and poverty alleviation. The main role of the ADBC is now to provide finance to state-owned food enterprises operating in China and the ABC has been transformed into a commercial bank, focusing on state-owned and private enterprises and large township-level agricultural enterprises (Zhu, *et al*. 2002). Despite its name, privatization prompted the ABC to significantly shift its focus, and now agricultural loans comprise only approximately 10 percent of its total loan portfolio (Han, 2003).

RCCs were established during the rural cooperative movement in the 1950s. RCCs have gone through several rounds of restructuring. Despite their name, with its reference to credit cooperatives, in the past they functioned as part of the state-banking sector and were under the administrative umbrella of ABC from the late 1970s. From 1996, they operated directly under the central bank until the early 2000s. After the shift of bank and RCC supervisory function from the People’s Bank of China (PBC) to the China Banking Regulatory Commission (CBRC) in April 2003, it was clear that neither PBC nor CBRC could administer RCCs while fulfilling their own mandates. In June 2003, the first phase of RCC reform was initiated in 7 provinces: Zhejiang, Jiangsu, Shandong, Jiangxi, Guizhou, Jilin, Shanxi provinces, and in one municipality, Chongquing Municipality. There were two fundamental restructuring objectives: (i) to clarify ownership structure and strengthen corporate governance; and (ii) to transfer administrative responsibilities to provincial governments and to resolve historic financial burdens. The results of the 2003 reform were judged to have been generally positive (ADB, 2004). Therefore, a full-scale implementation of the reforms was announced by PBC and CBRC on 30 August 2004 for 21 additional provinces.

As part of the reform process, over 10 000 RCCs have been closed or merged and the number of permanent staff has been reduced by 10 000 (30 000 temporary staff have also left). Under the reforms, RCCs with serious financial problems could be liquidated and RCCs were allowed to transform into agricultural commercial banks (ACBs) and agricultural cooperative banks. The objectives of the reforms were to improve corporate governance and management of the RCCs and to make them financially viable. To transfer RCCs' administrative responsibility to provincial governments and to resolve balance-sheet issues, mainly in the form of non-performing loans, the aim was to establish provincial RCC unions and to provide them with financial incentives, such as partial compensation of losses from policy driven-subsidized loans, reduction of RCC corporate tax by 50 – 100 percent, and provision of special PBC refinancing loans. Loan interest rates were made flexible.

These changes have left the RCCs as the most important source of formal credit in China. As of June 2003 China had 32 397 RCCs, with some 628 000 employees, and 2441 RCC unions at the county level, 65 at the prefecture level and 6 at the provincial level. They accounted for 11.5 percent of deposits, 10 percent of loans outstanding of the banking sector and 85 percent of agriculture loans (ADB, 2004).

Microfinance, however, remains relatively undeveloped in China. There are some specialized microfinance programs operating in China. The government finances programs in at least 9 provinces (Park and Ren, 2001). There are also several non-governmental organizations or collaborative programs between the government and NGOs that provide microfinance. Cui (2004) estimates that around 300 such programs are operating. Most of these programs follow the original Grameen Bank lending methodology: many of the clients are women, and although loans are given to individuals, if any clients from a given group default, all group members are barred from future borrowing (Armendariz and Morduch, 2000). These NGO programs, at least, report good results: repayment rates of most programs are reported to be over 90 percent (Chinabrief, 1999), they are successfully reaching the poor and there is evidence that these programs are having an impact where they operate (Park and Ren, 2001). Park and Ren (2001) also report that some of the most supported NGOs are achieving impressive operational self-sufficiency ratios.

At present, China's extensive network of RCCs provides the main window for central bank micro-credits, which are channeled through RCCs to farm households. As commercial banks began withdrawing from rural areas in the late 1990s, policy-makers in China began to think about ways to use the existing infrastructure of the RCCs to provide microfinance to the rural poor. The prime initiatives include: (i) commercialization of RCCs and establishment of agricultural commercial and cooperative banks in economically advanced areas; (ii) streamlined provincial administration of RCCs; (iii) expansion of capital bases; and (iv) reduction of historical burdens and future risks through non-performing loans resolution.

The microfinance program operated by the RCCs is the largest in China and the only nationwide program. However, coverage remains well below potential demand and in some parts of the country only a small proportion of households are reached.

V. Challenges for China in Developing a Microfinance Sector

Building on current institutions, there seem to be three possible paths for the development of a formal microfinance sector in China with significant breadth of outreach: (i) the establishment of a special microfinance unit within the ABC or ADBC; (ii) a significant expansion in the outreach of NGO microfinance programs; and (iii) further deregulation of the RCC system.

The establishment of a special microfinance unit within the ABC or ADBC or downscaling of commercial banking, as we have seen in other countries, seems an unlikely path for China. The mandate of the ABC and ADBC has never been to provide microcredit, nor to particularly target poor households, so neither bank has a developed expertise in microfinance. Both banks are withdrawing from rural areas, focusing on enterprises in towns and cities. The ABC also suffers from a high rate of non-performing loans: the highest of any of the four major state-owned commercial banks (Han, 2003). ABC's current non-performing loans are still at 25 percent.[5] Poor management and services supplied by the ABC in rural areas, plus a view amongst borrowers that government funds should be treated as grants are said to have created this problem. Neither bank seems a good candidate for establishing a special microfinance unit.

Although established microfinance programs run by NGOs in China are performing well by various indicators, currently, these programs reach only a small share of the rural poor in China.[6] Most NGOs operating in China were formed as part of donor-

[5] This information is drawn from statements by the banking sector specialist Wang Yi of McKinsey & Co., Beijing Office, March 2005; Source: Planet Finance, June 2005.

[6] Park and Ren (2001) point out that some of the programs are large in absolute terms in comparison to programs in other countries. The largest program in southern Shaanxi Province reached over 50 000 households in its first year.

supported projects and, despite the non-governmental label, many have an ambiguous ownership status with close involvement of local government units. As a result, their activities are limited. As officially unregulated organizations, they cannot accept deposits and so are limited in the type of financial services that they can offer clients and in their sources of funds. Officially, many of these programs are able to set their own terms on loans, but in fact interest rates rarely rise above 20 percent per annum, which may make significant expansion or even operational or financial self-sufficiency at the current scale impractical for most programs. Currently, there is not special regulatory status in China for MFIs, and the requirements for NGOs to transform into rural banks are a long way off.

In our view, recent developments in reforming the RCCs hold the most promise for developing a significant formal microfinance sector in China. The RCC network already has an impressive infrastructure in place in rural areas throughout the country, and these rural branches provide an effective way for poor rural households to save. However, the current system has its limitations. Most microfinance programs only offer traditional Grameen style group lending. At present, the maximum size is RMB5000 (approximately US$600) and loans are offered for a 1-year term. Expansion under this style of lending methodology is usually slow, and the inflexible loan products might not match well with demand. However, the most serious limitation on expansion is the interest rate ceilings in force. RCCs cannot set rates at more than double the base-lending rate and for direct loans to households rates can be no more than 20 percent above the base rate. These restrictions prevent most of the programs from covering operating costs, even at the subsidized rate at which funds are on-lent from the People's Bank of China.

Problems in the process of reform continue to exist. Those highlighted in ADB (2004) include: (i) wrongly placed incentive structures as a result of a top-down approach by the central government; (ii) lack of participation by farmer–owners in the reform process and their decreased participation in restructured RCCs; (iii) unclear objectives and a conflict of interest at the level of provincial RCC unions; (iv) lack of progress in interest rate liberalization; and (v) an incomplete supervisory and regulatory framework. In the current second phase of reforms, these issues need to be addressed carefully.

Despite the challenges, further reform of the RCCs, building upon their existing infrastructure in rural areas and experience in rural financing, seems the most realistic path for significant breadth of outreach in China.

VI. Conclusions

Any suggested path for the development of the microfinance industry in China must recognize that China is a highly regulated, state-dominated environment and that any microfinance initiatives will likely be subject to heavy government intervention.

With this in mind, although existing microfinance NGOs have performed well by a variety of standards, we feel this modality unlikely to flourish under "benign neglect" in China as it has in Bangladesh. Unless a special regulatory framework for MFIs is established, most microfinance NGOs are still a long way from meeting the requirements to become a rural bank and, therefore, will be handicapped in efforts to achieve significant numbers of clients and to provide a range of financial services.

Development of the credit union approach faces similar constraints. In some areas ROSCAs (or *hui*) have been banned. Although they remain unregulated and quite active in most areas, this modality of microfinance delivery also seems unlikely to achieve significant outreach unless officially sanctioned by the government.

Continued reform of China's RCCs seems the most promising modality for achieving significant breadth of outreach in China. The RCCs are not credit unions or true cooperatives and offer many of the advantages of the banking approach. The RCCs are already under prudential regulation, which has been tightened in recent years. The RCCs already have an extensive network of rural branches and have already achieved significant success in mobilizing savings in rural areas. The RCCs' ability to offer savings along with credit and other financial services and their location in areas convenient to where China's rural poor live and work, provide the potential for significant outreach.[7]

Policy-makers in China might look to the impressive performance of the Bank Ryakat Indonesia's U*nit Desa*, which, taking advantage of strengths similar to that of the RCCs, were successfully reformed from a loss-making conduit for subsidized credit into one of the largest and most efficient MFIs in the world. However, in recommending that approach, we caution that this policy prescription might still miss the poorest of the poor. NGOs in China, although lacking impressive breadth of outreach, are reported to perform better in depth of outreach; that is, they reach a poorer segment of the population than the RCCs (Jackelen and Xianfeng, 1997). Part of Bank Ryakat Indonesia's success may rest on the fact that it does not target this

[7] Hendricks (2003) explains how the aid-funded Chongqing Comprehensive Poverty Alleviation Project views working through local RCC as the most viable exit strategy when aid funding ceases.

group of the poorest of the poor. This group might be better served by the NGO modality or government supported poverty targeting programs.

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