Discussion on Developing China's Microfinance

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Abstract - It is inevitable that the creation of microfinance follows the financial deepened development and the financial innovation. Capital acceleration drives economic growth and credit is necessary for some fields especially for micro-agriculture and micro-industry to develop. But most people believe that the risk of credit to the poor is higher because they are short of assurance. Moreover trading costs to offer them financial services are higher. This leads to financial market failure in the countryside, which cannot afford sufficient funds for farmers and small industrialists to produce. Therefore it is urgent for the current economic growth to settle the issue.

Index Terms - Microfinance, Microcredit, Sustainable development

1. Introduction to Microfinance

A. The "groups" of microfinance institutions

Microfinance can be clearly divided into two "groups" in the mature models or practical institutions in the current international stage: welfare and institutionalism. The former emphasizes on the effect of microfinance to the poor and the latter focuses on the sustainable development of credit institutions. But with the development of credit technology and financial products, microfinance tends to show fusion and to search for "win-win" from the angle of China's financial institutions after entering into the 21st century.

Then how to reach the fusion and win-win draws much attention in the current theory stage of microfinance and is the most important topic of microfinance research. Especially after more than 30 years' development, China's microfinance has experienced lots of trials and lessons and the final target of fusion and win-win is becoming clearer and clearer.

B. Assumptions of microfinance institutions serve

Before microfinance appears, financial practitioners generally believe that the poor are the groups without credit grades and should be excluded from the financial credit system. The emergence of microfinance means the improvement of financial environments, revises the ideas of the poor cannot get financial services and becomes an effective way to indirectly serve the social vulnerable groups.

The reason that microfinance institutions give up traditional ideas to serve the low-income groups is that they are based on certain assumptions, that's the low-income groups don't really fail to have good credit. Under the circumstance of good operation and management, microfinance not only can ease the poverty and help the low-income groups but also can produce profits for realizing their own sustainable development. This means microfinance institutions offer financial services to the low-income groups, on the other hand, they make sure their own existence and sustainable development. In another word, this presents those microfinance institutions' double natures----commercial and social natures. These natures increase the efficiency of funding the poor.

Moreover, microfinance institutions set procedures to select customers, which can avoid funding those whose don't really want because of information asymmetry. Meanwhile, the institutions can supervise the utility of the loans they offered and increase the efficiency of the capital. The institutions also can take advantage of offering loans to draw idle money from the poor, which increases the liquidity and total amount of the capitals. The institutions fund the poor with the help of the capital from the rich. The redistribution of income is good at narrowing the gap between the rich and the poor, at the same time it increases the poor's commercial ideas and commercial consciousness and strengthens the poor's idea that they must insist on in the market finance. Recently, microfinance institutions also get capitals with the help of securitization techniques, which widens their funding channels and enhancing the capability to help the poor.

2. Issues China's Microfinance Institutions Face When Developing

To reach the above targets, China's microfinance institutions should first solve a most important issue, that's the issue of microfinance sustainable development.

International academia is focusing on the hot issue of microfinance sustainable development and how to make it realistic. At present, the dominant view on microfinance sustainable development is a microfinance institution can make use of the benefits from financial services and operations to compensate all cost items including capital costs and operating costs, compensate the adjustment of inflation and subsidies, and also can offer a sufficient reserve to offset bad debts.

A. The research on microfinance sustainable development takes financial sustainable researches as basis.

The route of practicing financial sustainable development can be found by analysing the financial conditions of microfinance projects, judging whether the projects have reached the level of sustainable operations or sustainable economy, then analysing the management factors influencing institutions to realize financial sustainable development from the angle of income and cost.

The lowest standard of realizing sustainable development is operational self-sustaining (OSS) and financial self-sustaining (FSS).

OSS=operating revenues/(operating expenses + financial costs + loan loss reserves)

FSS=operating revenues/(operating expenses + financial costs + loan loss reserves + capital costs)

capital costs=inflation rate (average property-average fixed assets) + (average debt capital*market interest rate of debt-real financial costs)

When the ratio of FSS is more than 100%, we can believe that the financial institution realizes its sustainable development.

B. Microfinance sustainable development is supposed to be backed by loan rate.

Under the circumstances of the current financial market, the sources of microfinance funds are mainly donation and government assistance. Therefore, the loan rate is determined by a new absorbed element G.

The expected revenue of one-year loan is

L(1+r)(1-a).

r is the interest rate the lender requires, a is the ratio of bad debt provision, and L is the scale of one-year loans.

If the operations are sustainable, the expected revenues should be more than the total of credit expectation, that's L+C, C is the total of interest rate costs and operation and management costs. So the condition of the micro-credit can be sustainable is

$L(1+r)(1-a) > L+C$

The rate of break even that sustainable development requires is $r=(C/L+a)/(1-a)$. If $c=C/L$, which refers to the total costs of the loan per yuan in the time, we can get

$r=(c+a)/(1-a)$

If the returns out of the other microfinance loans are I, we get

$L(1+r)(1-a)+I > L+C$

The critical rate of profits and losses should be

$r=(C/L-I/L+a)/(1-a)$

Supposing that $i=I/L$ refers to the net return from the loan per yuan, the critical rate will be

$r=(c-i+a)/(1-a)$

Supposing that G is the government assistance and the aids from other fields microfinance institutions get, we get

$L(1+r)(1-a) > L+C-G$

The critical rate of profits and losses should be

$r=(C/L-I/L-G/L+a)/(1+a)$

Supposing $g=G/L$ refers to the total assistant the loan per yuan can get, the critical rate will be

$r=(c-i-g+a)/(1-a)$

If the loan rate is more than r, the sustainable development is available.

3. Countermeasures to Develop China's Microfinance

A. The Improvement in Outer Environment of Microfinance

Three factors to confine the economic growth are system, technology and resource, among of which system is the primary factor because what systems the microfinance market and institutions build and execute determines the effectiveness in the market. To promote the standardization and sustainable development of microfinance, the flowing aspects should be emphasized at least.

1) Fix common understandings

Though China's government fixes clear speculations on microfinance, the understandings during the execution are not unified. The disunity in understandings will influence on executing the policies more or less. The area differences are obvious in large China, so it is difficult for China to create a suitable model without inspections of practices. Open and moderate attitudes are wanted for China to pilot trials. China's competent supervision and currency authorities must make sure a clear target and direction to develop microfinance. When executed, flexible and applicable supervisory policies are wanted.

Related authorities should clear and distinguish the definitions of micro-credit, microfinance and inclusive finance and also should fix a standard to understand them. According to the international execution standards, micro-credit refers to the credit line is five times of the GDP per capita in the local area. In China, GDP per capita is about RMB15-20 thousand, micro-credit line should be RMB75-100 thousand. But China needn't have followed the standards to measure its microfinance development. According to the standard of the international poverty, the loans China offers should be no more than RMB 2000 in micro-credit. China's economic growth has been beyond the level in the other developing countries, such as People's Republic of Bangladesh, Republic Indonesia, Republic of Kenya and so on. So China's standard to the microfinance should be more than that in those countries. In China, microfinance is not only utilized in small businesses or in settling the problems of planting in the countryside, but is used to meet the capital demands for producing or operating. So the standard of the credit line shall be increased to RMB2 million. Though the amount is larger, the number conforms to the sum that microfinance entities or individuals demand. Thus the understandings to the micro-credit in China should be lifted to the stage of microfinance. Compared to micro-credit, microfinance has enlarged many financial functions in definition and in the future it will upgrade to inclusive finance.

2) Effective but not stiff or prudential supervision on microfinance

The supervision to microfinance institutions captures lots of supervisory resources. It is investigated that supervisory costs to the microfinance institutions are 2% of their revenues, even 5% in their beginning period to develop. Therefore, in the beginning period, non-prudential supervision is executed by those institutions that don't accept deposits and whose external effect is not greater. The effective supervision in the period should be to authorize the microfinance institutions loan licenses in a simple way, to protect consumers, to avoid frauds and financial crimes and to build related agencies to offer credit information services, and to revise related legislations.

While prudential supervision is taken by those commercial banks that accept public deposits as long as microfinance grows into another higher stage. At this stage, the related supervisory authorities should grasp the opportunity to execute prudential supervision from non-prudential supervision. In case prudential supervision is in the stage, equity diversifications should be considered whether there is necessity for the requirements of equity to exist. The authorities should also set a minimum capital demand for the differentiation because non-governmental organizations are different from the governmental organizations or commercial banks in the capital demands. At the same time, the authorities should ease the requirements to the credit lines of loans without guarantees and the reserves of loan losses. To those remote areas, the authorities can eliminate the contents in the reports and also can decrease the frequency of submitting reports because in the remote areas, there are not enough constructions of transportation and communication for related organizations to submit financial conditions periodically. It is necessary for the authorities to simplify the procedures and decrease frequencies.

Restricted supervision is taken by the financial institutions that only can accept large deposits. These supervisions in different levels are good for supervisory competition and financial innovation. To microfinance, innovation is its kernel. If there is no innovation, there is no necessity for microfinance to exist. Up to now, it is reasonable for supervisory mechanisms to grow, but they should be adjusted with the financial development.

B. The Growth of Microfinance Institutions Themselves

1) Promote production innovation

Microfinance institutions can offer customers similar services and products as those formal financial institutions. At present, the standardization of microfinance is focused on enterprises' borrowings which are the main product that microfinance institutions offer. Under the current circumstances and developing experiments, however, microfinance institutions can strive to develop other auxiliary products out of the primary one, such as deposits, consumption loans or emergency loans, insurance, enterprises training and so on. It is necessary for them to offer the poor deposits and insurance but not only credits. Even to the credits, they should offer the poor specific credit services but not changeless products. They should take customers as a kernel, offering the poor various financial products to meet poor consumers' different demands.

2) Strengthen cooperation

Friend cooperation relationship should be formed between microfinance and formal finance. Microfinance institutions can be backed positively by state-owned commercial banks to develop businesses with mutual benefits and win-win under which those larger commercial banks don't need to microfinance businesses directly. On the contrary, microfinance should search for large commercial banks' support positively, asking them for help to offer nets, personnel training, credit asset management and so on, and ask them to offer temporary, assistant and permanent capital aids and favourable policies in deposits and loans at various workable levels. During this process, Agricultural Bank of China (ABC) and Rural Credit Cooperatives can form an effective operating channel without any inputs to accept depositary capitals more sufficiently, to enlarge the scale of credit products and to increase their own income levels through the successful operations of microfinance institutions.

3) Make sure the developing trend and clear the developing ideas

In a microfinance institution, there are three big units, one is governmental departments which aim at serving the public under democratic politic; the other is microfinance enterprises in the market economy which aim at producing profits; and the third is non-profitable organizations or public welfares which aim at reaching their special missions for human beings, shown as Figure 1.

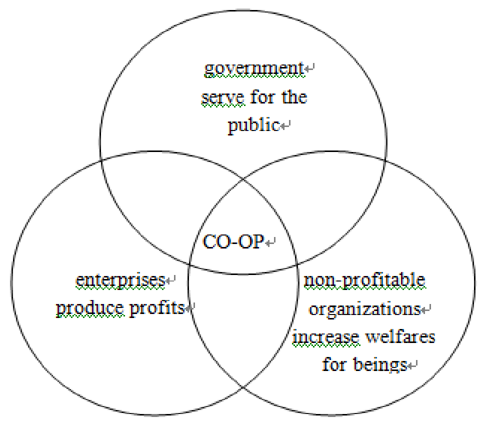

Fig. 1: cooperation between three big units

Co-op, intersection of the three units, is another social economic business. Its mission is to offer services and its common purpose is "not for profits, not for assistance, only for service". Building the units aims at meeting the members' demands and wishes for common economy and social cultures. If their special functions can be used fully, the Co-op will be the best bridge to connect the three units, which will be the highest point in the development of microfinance market.

From the above view, microfinance institutions are involved in dilemma between the social performance of decreasing poverty and the economic sustainability. Where and how should microfinance institutions tend to develop? This has been a most important topic the practitioners and theoretical researchers. It is gratifying that with the attention to the social performance of the financial institutions from the financial practitioners and researchers highlighted, also with the development of credit technologies and financial products, the two "groups" of "welfare" and "institutionalism" have managed to appear "fusion". The microfinance practice has begun to seek for win-win of economic returns and social rewards.

The future microfinance institutions will grow to the financial mode of syncretism, that's welfare and institutionalism are organically combined to seek for a balanced development of financial performance and social performance. The microfinance syncretism mode is an arrangement of inclusive financial system. It takes welfare as its aim and institutionalism as its means. Its value theory is to make sure that the social individual will get the basic equal right of enjoying financial services, to emphasize at offering services to all of the social levels and groups efficiently and fully, especially offering services to the social groups who are not included in the current financial system.

Inclusive financial system has double natures of social performances and economic performances. In the future, China needs to build a reasonable systemic arrangement to drive the healthy development of inclusive financial system. This needs to do the following aims well:

Microfinance institutions themselves should try their best to get more returns through increasing customers and designing perfect deposit and loan mechanism as much as possible; to control operating costs by establishing efficient execution mechanism. Supervisory authorities should enhance the supervision of the commercial capitals flowing into microfinance institutions and avoid the occurrence of systemic risks. Finally related microfinance legislation should be perfected. Owing to the fact that commercial banks law does not suit for most of microfinance institutions in the inclusive financial system, related microfinance legislation on the management of microfinance institutions in the inclusive system should be constantly discussed and perfected. This will make sure the healthy development of microfinance institutions in a legal environment.

Generally speaking, microfinance is a special financial instrument, whose kernel is to settle the difficulties for the lower-income people to make loans and increase incomes. But the key point for microfinance is not only financial services, also other social effects such as poverty alleviation, developing capacities of communities and so on. The special functions of microfinance with poverty alleviation and financial services drive it undoubtedly to become a part of improving and deepening the financial system and a necessary link of increasing the financial system.

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