

## **Wu Xiaoling: Creating a favorable social environment for the development of micro-credit business**

Speech by Ms Wu Xiaoling, Deputy Governor of the People's Bank of China, at the Asia Pacific Micro-Credit Forum, Beijing, 22 March 2006.

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Ladies and Gentlemen,

Good morning!

Let me first express my warm congratulations on the opening of the Asia Pacific Micro-credit Forum. In the past century, human beings created tremendous wealth and improved evidently the living and welfare standards. However, we face many problems at the same time as economic aggregates grew rapidly, such as environment pollution, resources constraint and polarization between rich and poor etc. The common issues many countries face in the 21<sup>st</sup> century will be how to make the earth on which mankind relies for existence much cleaner and how to give everyone an equitable development chance in the process of economic growth.

Since the last century, China has achieved remarkable accomplishments in social and economic development. But in terms of distribution, the income gaps between urban and rural areas and between different regions have widened gradually and drawn more and more attention. Some researchers pointed out that, development chances usually belong to people with certain capitals in the period when financial intermediaries were underdeveloped or in countries where financial intermediaries were less developed, while people lack of capitals are excluded from economic growth and could not share the benefits of economic growth. However, with the innovation of financial institutions and financial instruments, in a comparatively developed financial system, people lack of capital but possess some production skills or entrepreneurships will obtain development chances thanks to the available and suitable financial instruments. In recent years, micro-credit, as an available and suitable financial innovation, has drawn many attentions from the public, international institutions and international donors and even some explicit supports from governments in developing countries because it can help people from low-income country who have willingness and development potential to grasp the opportunity to increase income and shake off poverty. When the income gaps between urban and rural areas and between different regions widen continuously, large low-income population in rural areas and mid-western regions of China as well as numerous private producers and micro-enterprises demand urgently for the suitable financial services including equity financing and micro-credit financing.

Since 2005, Chinese government has paid increased attention to micro-credit. First, reform of the rural credit cooperatives has been underway smoothly and the number of rural households that have access to micro-credits and joint guaranteed micro-credits from rural credit cooperatives (RCCs) nationwide reached 71.34 million as of the end-September, 2005, accounting for 32.31 percent of the total 220 million rural households. Given that around 120 million rural households of the 220 million rural households had real borrowing needs, the micro-credit provided by the rural credit cooperatives met 60 percent of their needs. Second, the CBRC issued the *Guideline on the Credit Business of Commercial Banks to Small Enterprises* in July 2005, with a view to promoting financial services to small enterprises through guiding banking sector to establish "six mechanisms", including interest risk pricing, effective discipline and default information disclosure mechanisms. Many banks established successively special units to manage small enterprises' loans. For example, the Industrial and Commercial Bank of China and the Agricultural Bank of China established special units for credit to small enterprises in pilot regions, Shanghai Pudong Development Bank, China Minsheng Banking Corp. and China Everbright Bank established small & medium-sized customers department or small & medium-sized enterprises servicing center, and some other city commercial banks and rural commercial banks established special units or teams as well. Furthermore, China Development Bank also joined in a special way, by signing a strategic cooperation agreement with Taizhou Commercial Bank to conduct pilot credit business to micro-enterprises. As of end 2005, the outstanding balance of micro-enterprises loans of the main banking institutions in China amounted to 2.68 trillion yuan, increasing by 205.736 billion yuan from the beginning of the year. Third, apart from about 300 micro-credit projects led by non-government organizations in China, 5 provinces are undergoing the pilot commercialized micro-credit organization program. At end-2005, two private micro-credit institutions in

Pingyao, Shanxi province were established with approval to extend loans, and more similar institutions will be established on a pilot basis in other regions.

But currently the development of micro-credit business has not fully met the social and economic development needs. To advance economic growth in mid-western regions and vast countryside and include low-income population in such regions into the general economic development track so that they can enjoy the benefits of economic growth, micro-credit should play a more important role in this regard. We have to cope with various challenges, such as the credit market in China is not fully diversified, institution setup does not fit in with risk control requirements and credit culture and legal environment need to improve etc. Therefore, we should create a better social environment with a view to promoting the healthy development of micro-credit.

#### **I. Developing micro-credit that provides services for private producers and micro-enterprises should center on developing regional financial institutions.**

Private producers and micro-enterprises are characterized by weak production stability, unsound financial situations and hard to standardize relevant credit registration, therefore the direct contact between lenders and clients becomes crucial, and accordingly micro-credit is a labor-intensive work. The successful micro-credit activities in China rooted in the diligence of credit issuers and the good customer relationships they have established. One credit issuer of Agricultural bank in Siyang county, Su Qian of Jiangsu province has issued more than 60 million yuan of rural household's loans in 16 years, involving thousands of loans without any bad ones, thanks to his visit to every household. Taizhou Commercial bank has high quality loans because the client managers paid tremendous visits to farmers to obtain many "soft information". They said, "Once an old client comes to us, we could basically tell why he comes to the bank today; if one client asks for credit, we can reply promptly whether we will extend loans and how much we can. Sometimes our clients joked that the client managers in Taizhou Commercial Bank are able to read faces."

If a national big bank directly conducts retail business in micro-credit field, it will face high costs of risk control and transaction. On one hand, big banks will find out that they don't understand the risk profiles of those micro and seemingly irregular clients, at the same time, such clients may not be able to provide enough qualified mortgages or pledges so as to put big banks in such a plight when they encounter problems as pre-loan "adverse selection" and "moral hazards" after loan issuance. On the other hand, negotiating individually with numerous micro-clients is likely to incur high transaction costs while the financial services requirements of those clients are not complicate enough to bring benefits of economic scale for big banks. Accordingly, there are no technical advantages for big banks to directly conduct micro-credits.

Economic development in China is not balanced judged from many aspects. Multi-layered economic development level and complicated economic structure require multi-level financial institutions to provide relevant services. Accordingly, various financial institutions should divide the credit market according to "cost-efficiency" principle and comparative advantages to precisely choose their target markets and development strategy. Contrast to national big banks, regional financial institutions have comparative advantages in regards of micro-credit fields that target private producers and micro-enterprises. Apart from having more natural advantages, regional financial institutions could also resort to some flexible measures that regular financial institutions lack of to deal with information exchange and transaction costs. Regional financial institutions are located in communities, so their client managers understand more about the risk characters of potential micro-credit clients in the community as well as control credit risks through some "social assets" of their clients except their economic assets or in virtue of some informal guarantee and mortgage that is hard for big banks to take. As a result, developing micro-credit business that provides services for private producers and micro-enterprises should focus on the development of regional financial institutions and community financial institutions.

#### **II. Create a moderately competitive financial environment to improve financial services and reduce service fees.**

In order to enhance the quality of county-level economy and rural financial services, we should strive to create a moderately competitive financial environment. While big commercial banks including the ICBC, BOC and CCB gradually cut down their branches in county-level economies due to cost and risk control factors, Agricultural Bank of China and Agricultural Development Bank of China should persist in the direction of serving for agricultural development and establish organizational structures

and function mechanism suitable to the development of agriculture through reform. We should encourage big commercial banks to restructure their outlets in counties and encourage private capital to participate in such restructuring of financial institutions in order to reduce shocks from restructuring and strengthen their services for county-level economies. We should also create much eased policy environment for the newly established financial institutions with independent legal status in a county.

Credit cooperatives have become an important financial service provider in counties and wide rural areas of China. We must deepen the reform of rural credit cooperatives by persisting in the direction of serving for agriculture and farmers. We should pay proper attention to the external constraint of rural credit cooperatives' operation, such as market competition and possible M &A activities apart from focusing on reestablishing effective internal control system, namely, reasonable corporate governance structure. We propose to reform the traditional "one RCC in one township" arrangement by liberalizing cross-region operation and competition of the RCCs and removing the restriction that only one RCC is allowed to establish in one township to encourage establishing new institutions and stimulate RCCs to provide service for the rural economy.

We should, through tax policy, guide the financial institutions to provide financial services for rural areas and transfer funds to countryside so as to promote the modernization of the agricultural industry and urbanization of countryside.

### **III. Create a good social environment for the development of formal financial institutions through guiding rational development of the informal financial services**

Informal financing exists since long time ago. If private funds participate in lending activities in accordance with relevant rules on interest rate, informal financing is unlikely to damage social economic order rather it could be a beneficial supplement to formal financing and even a barometer of social financial demands. Judged from past experiences, problems in informal financing stemmed from illegal public financing activities without permission. I believe, a good policy to prevent social and financial disorder should focus on establishing a governing mechanism that guide its healthy development while imposing harsh punishment on irregularities.

Regular informal financing is usually based on kin relationship or community relationship, so it features in high efficiency but low financing amount due to the low credit registration cost and hash punishment on credit slippage. Informal financing should be a normal phenomenon in terms of laws and regulations given that we should respect the rights of a citizen to treat his or her own wealth and the freedom of signing agreement with other citizens. But sometimes informal financing may be taken advantage by some bad men, so it is necessary for the government to guide and regulate informal financing activities to protect public interests. For example, although the *Usury Act* in South Africa has clauses to punish usury activities, registered micro-credit activities are not subject to the restrictions in the *Usury Act*.

A practical choice to guide the development of informal financing will be to allow individuals or special companies to provide micro-credit under regulations stipulated by local governments and restrictions of the Contract Law and the individual credit registration system when credit environment in China is not much healthy. Facilitating citizens' financing activities and cutting down the threshold of conducting legal financing activities will reduce the probability of illegal financing actions in essence, and effectively crack down criminal activities as well.

The No.1 document of the central government in 2004 called to "continue the effort to expand micro-credits and the joint-guaranteed loans to the farmers. Efforts should be made, through attracting social and foreign funds, in setting up financial institutions with diversified ownerships to directly provide services for the rural economy. The No.1 document of the central government in 2005 already clarified that regions in good conditions could explore to establish micro-credit organizations close to the needs of farmers and villages and launched by natural persons and enterprises. Furthermore, the No.1 document of the central government in 2006 pointed out that, establishing community financial organizations in counties with diversified ownerships were encouraged, and private as well as foreign capitals are allowed to invest in such entities. Efforts should be made in fostering micro-credit organizations launched by natural person, enterprises and associations with legal person status. Farmers will be guided to develop credit unions. Informal financing should be regulated." In fact, the No.1 documents of the central government in following 3 consecutive years all put emphases on encouraging institutional innovation in rural financial system, while in recent two years it clarified that micro-credit should be developed greatly as an appropriate financial innovation. Obviously, a micro-

credit organization is unlikely to become an important component of the rural financing system, but it is indeed a catalyst to activate rural financing. One of the responsibilities of the government is to maintain the social and economic order and make citizens responsible for the consequence of their own behaviors while respecting citizens' economic freedom. Once a citizen hands his money to a third person for collective usage, the government should point out the potential risks and conduct prudential supervision over the fund receivers, which is the function of financial supervision authorities. We will not allow the proposed micro-credit company to absorb public deposits but only use its equity from several limited shareholders and wholesale financing from other institutions to conduct relevant business. The shareholders of the micro-credit company and the institutions that provide funds should bear relevant risks from funds operation. Once the micro-credit company failed, it would not bring external damages to our society. On the contrary, a well-functioned micro-credit company will win trusts of the society and therefore has more diversified financing channels or create conditions to establish a new form of financial institution. To regulate the lending activities of the micro-credit companies, the central government or local government should stipulate the *Rules on Management of Creditors*, in which the industrial and commercial administrative authorities should be responsible for registration management; the individual credit registration system should require lending information to be registered and provide basic financial knowledge training program for both the borrowers and lenders, and the court should be able to adjudicate borrowing contract disputes.

Regulated informal borrowing and lending activities could change the society into a financial university. In this university, public risk awareness and credit profile will be improved and people who are interested in financial business will have a chance to practise. We are expecting our society to reach consensus in this issue.