Reflections on Micro Finance and Risk Management from
Mr. Du Xiaoshan, Chairman of China Microfinance Association

Recently, Planet Finance interviewed Mr. Du Xiaoshan, the former Secretary of the Party Committee, Deputy Director and Researcher in the Rural Development Institute of the China Academy of Social Sciences. Mr. Du has been devoting himself to microfinance and poverty alleviation since the 90s. He took up the post of the Chairman of China Microfinance Association in 2005.

During the interview, Mr. Du shared with us his opinions on the sustainability and risks of microfinance and offered suggestions on the effectiveness of microfinance regulation.

1. You have been involved in microfinance since the 1990s. The industry has really taken off in recent years. Do you think it is developing in a sustainable way? What are the major risks you see?

Generally, microcredit can be distinguished into Welfare Microcredit and Institutionalized Microcredit.

Welfare Microcredit is in the charge of the People’s Insurance Department, the Women’s Federation and Ministry of Finance. The cooperation, the financial management ability and the personnel qualities of these three departments are critical. Furthermore, as a part of the government’s policy, Welfare Microcredit pursues effective and direct loans to poor people without considering its own sustainability.

Institutionalized Microcredit, in China, is badly in need of a clear legal status and specific laws to promote its sustainable development. Specially, for Commercial Microcredit, the unreasonable rules and improper definition is preventing progress. An example of this is a policy that commercial Microcredit companies can only raise capital from two commercial banks, and the amount of capital is restricted to be no more than half of its registered capital. Judging from the average registered capital of eight thousand Microcredit institutions around the country, which is eighty million to a hundred million, it is impossible to satisfy the loan demand. Moreover, commercial Microcredit institutions should be defined as non-banking financial institutions, instead of general industrial and commercial enterprises. The changes of the definition can not only help the institutions avoid unnecessary audit obstacles, but also qualify the commercial Microcredit institutions to enjoy preferential taxation and benefit the capital raising and business expansion. The relief of burdens will advance sustainable development of the whole sector.
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As for risks, all three types of Microcredit are facing problems of management, staff quality, and fund suppliers’ moral risk. In the practice, these problems are hard to discover and could have particularly serious consequences. Therefore, it is urgent to improve the risk management process and systems of control.

Welfare Microcredit helps with direct capital injection and can stimulate growth in the initial stage of development. However, too much reliance of financial support from the government will distort markets, give rise to corruption, rent seeking, market invasion and overwhelm the government.

The ambiguity of the legal status of Welfare type of Microcredit brings about a lot of problems, such as the obstacle of registration in the Civil Administration Department, the lack of lending qualification in a lawsuit, and the difficulty of raising capital and attracting talents. Besides the need for improvement of staff quality and management, this category of microcredit is also facing market risks, for example, natural disaster.

For Commercial type of Microcredit, there may be violations of law and regulation, such as flight of capital, disguised deposit-taking, illegal lending to stakeholders and restricted industries, usuries and collection using violence. At the same time, an extensive selection and combination of lending customers also could be a problem. Financial lenders’ general understanding of the whole sector, storage of financial data and judgment of clients’ repayment willingness and ability need to be improved. Jiangsu Province independently developed a computerized information management system to centrally manage, cross check and assess all the registered Microcredit companies, as well as provide financial support. It has achieved great success and deserves to be popularized.

2. Rural NGO microfinance has been very close to your heart. However, many have been unable to reach scale and sustainability. Under the current regulations, do you feel it’s possible to achieve sustainability for more of these organizations?

Some well run leading NGOs has achieved sustainability in a limited scale. In my opinion, a lack of explicit laws is a major constraint of development. In 2006, the No. 1 document in Central Committee clearly pointed out that the establishment of Microcredit organizations sponsored by natural persons, business entities and judicial associations are encouraged and related departments should formulate regulations as soon as possible. In 2008, The China Banking Regulatory Commission issued guidance on pilots for commercial Microcredit companies, but there’s still no regulation for public Microcredit institutions. The law in Cambodia divided the Microcredit institutions into six categories. Firstly, there are legal institutions permitted to be developed. Secondly, those institutions can be registered to
become non-deposit lending institutions once the standards are reached. Thirdly, they can also be changed into deposit-taking institutions with a higher standard. Fourthly, there are companies engaged in business activities similar with Chinese Microcredit companies. The fifth and sixth categories are specialized banks and full-service banks. Therefore, different types are regulated respectively. If a specific guidance is issued for public Microcredit institutions, a lot of problems about capital-raising, business expansion, registered capital, clients and regulators can be solved, which would benefit the supervision and operation of Microcredit institutions a lot.

On the other hand, some institutions are considering transformation for better development. Generally speaking, banks, Microcredit companies and other institutions all have broad prospects with different market positions and should be considered strategically. However, my suggestion is to be specific, outstanding and professional in the public sector. Public institutions can have a larger share of the industry and a greater impact on the society. Although there’s also a lack of commercial institutions, public institutions providing specific service for the poor people are more in need. The balance of loans now in China is about seventy trillion, which means the scope that a commercial institution can achieve is comparatively quite minute. But in the sphere of public micro-finance, a well-developed microfinance institution will have special functions, influence and reputation. Referring to Grameen Bank, Employees’ wages are almost the same as civil servants’, and the staffs have a strong sense of achievement and honor.

3. The industry is growing, and some say in a very commercial way with more a focus on SME lending and commercial gains. What is your view on the proper role of associations like CMIA and CAM in ensuring the sustainability of the microfinance sector?

Both of commercial and public Microcredit have advantages and should be supported. It is associations’ mission to promote the sector’s sustainable and healthy development. CAM mainly performs the following five tasks to accomplish the mission. First of all, we promote self-regulation. Secondly, we help with the communication in information and talents between domestic and international organizations. Thirdly, we organize trainings and workshops to help institutions clearly position themselves and improve operation and risk management ability. Moreover, we communicate with the regulators to inform them with status of industry, research result and domestic and international experience. Last but not the least, we provide various approaches, such as wholesale funds and cooperation between entrepreneurs to help with capital-raising.

4. P2P lending has been growing in recent years. Some say that P2P player is just a convenient way to get around regulation but occupies a grey area in the legal
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framework. Others say that it is on the vanguard of financial innovation and should be promoted as they are non deposit taking. What is your opinion? What do you see as the risks related to the development of P2P type players?

Generally, my attitude of P2P is positive. However, it needs to be improved in the aspects of requirements for market access, operation models and regulation,

Judging from the development direction, P2P is a part of service for the vulnerable groups in society and is an innovation which can facilitate financial inclusion. The supervising agencies have also affirmed it to a certain extent by agreeing to nail down regulatory agencies, systems and rules.

I believe that P2P has bright prospects if the policies are well-executed and the development of commercial and public institutions is balanced. What we have to emphasize is that the bad phenomenon in this sector has developed into an extent that we have to take some measures as a response. It is urgent to establish associations for self-regulation and binding treaties. Moreover, since P2P has been developed for eight years with advantages and disadvantages exposed, the government should issue regulations to provide positive incentives as soon as possible.

5. How would you rate the role of the regulators (Financial Affairs, CBRC, and PBOC) in their efforts on financial inclusion? What are areas that need more focus to ensure the sector does not undergo the problems we see in other countries?

The system of dual regulation has been commonly recognized and even mentioned in the No. 1 document in Central Committee this year. I advocate collaboration between the central and the local departments and in multiple levels of government. The departments includes PBOC, CBRC, CSRC, CIRC and ministries, such as Ministry of Industry, Trade and Industry Bureau, Poverty Alleviation Office, Development and Reform Commission, Ministry of Finance, Ministry of Agriculture, and Forestry Bureau. The multiple levels mean administration structures such as Provinces, Cities and Counties. Cooperating with each other, the central government is in charge of national and macro matters and draft regulations. The local is responsible for regional and detailed problems and execution of the regulations.