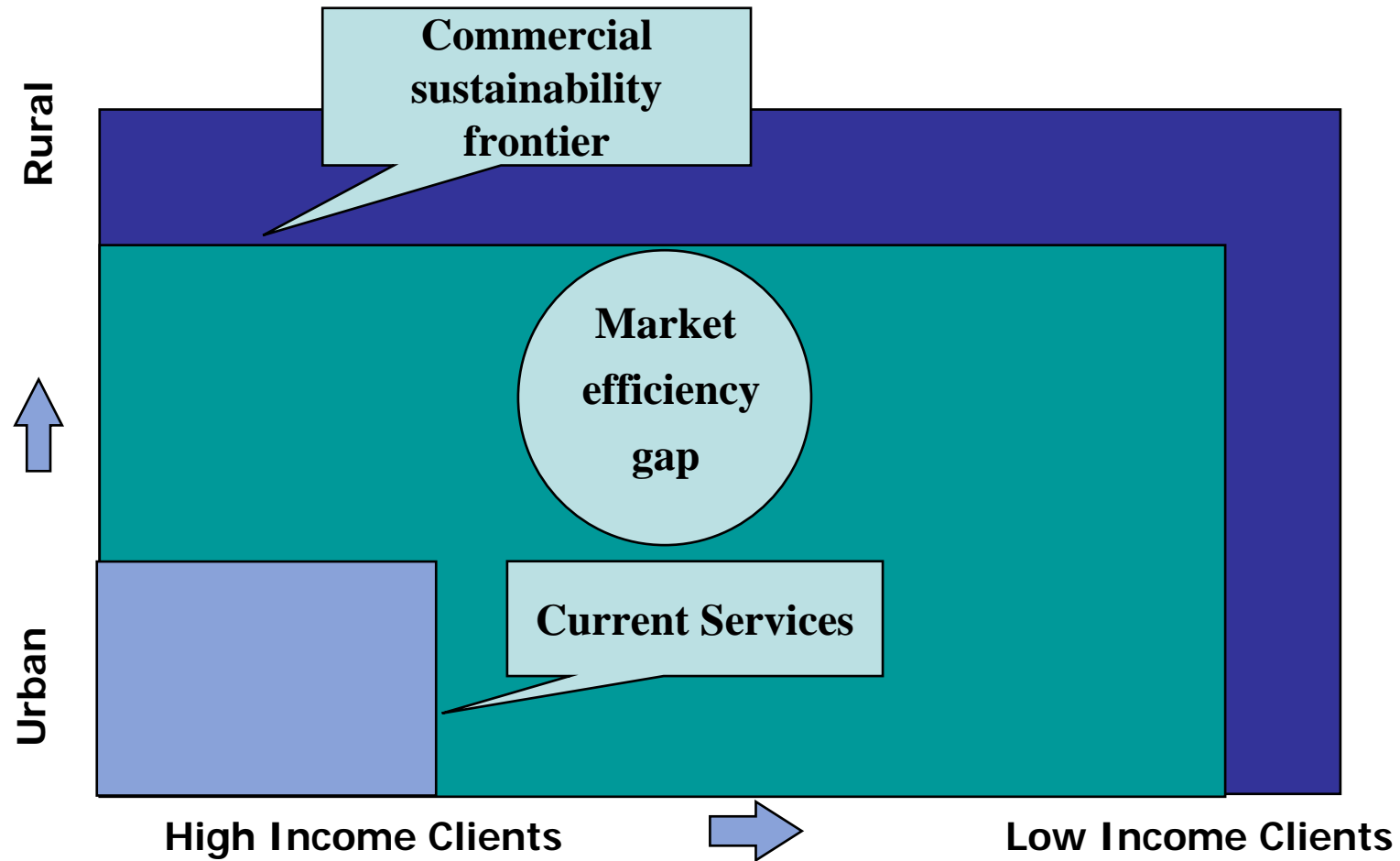


# **Promoting Commercially Sustainable MSE Finance in China**

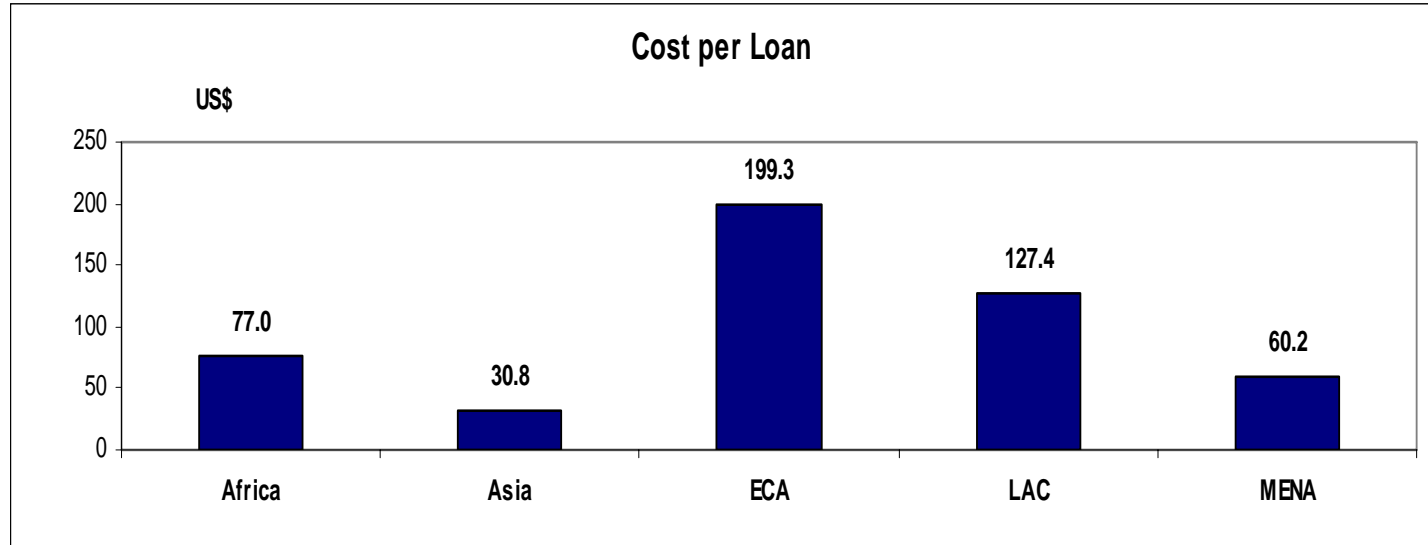
WANG Jun  
The World Bank  
At the 34<sup>th</sup> ISBC in Bangkok  
November 12, 2007

# It matters to bear in mind the frontier of commercial microfinance

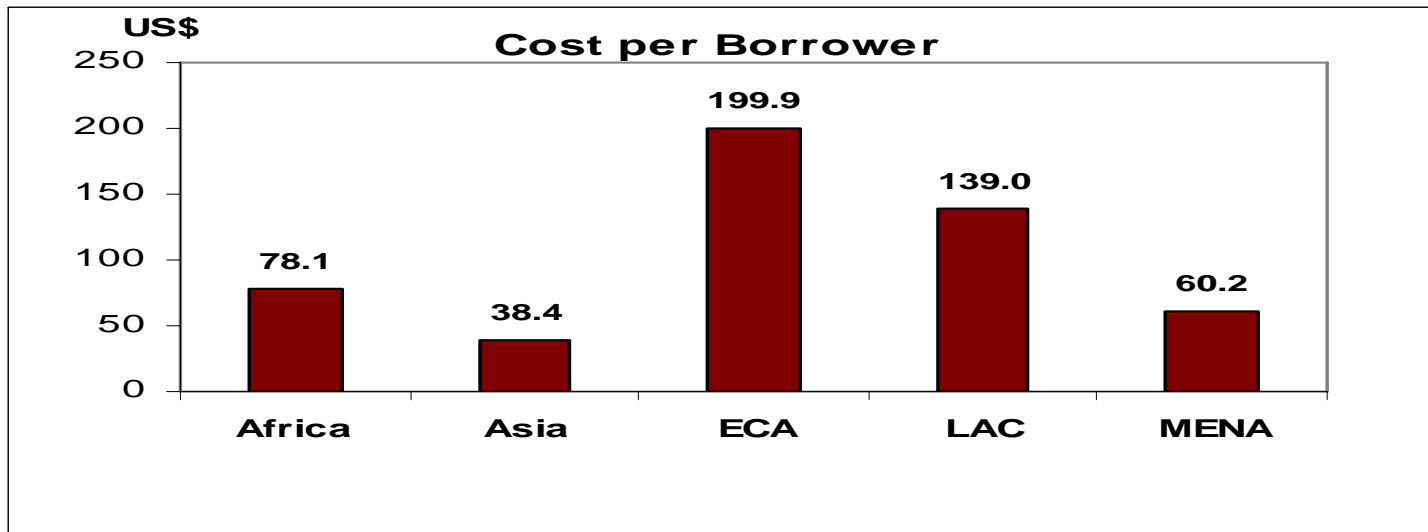


# Efficiency Indicators, 2005

单笔贷款成本

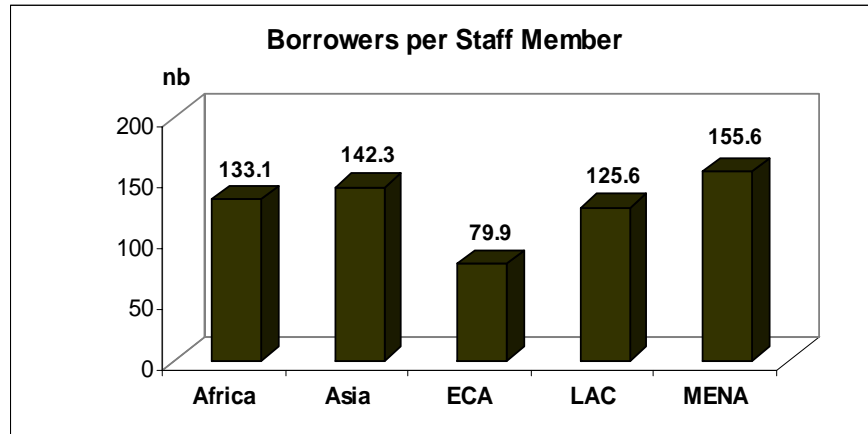


单个借款人成本

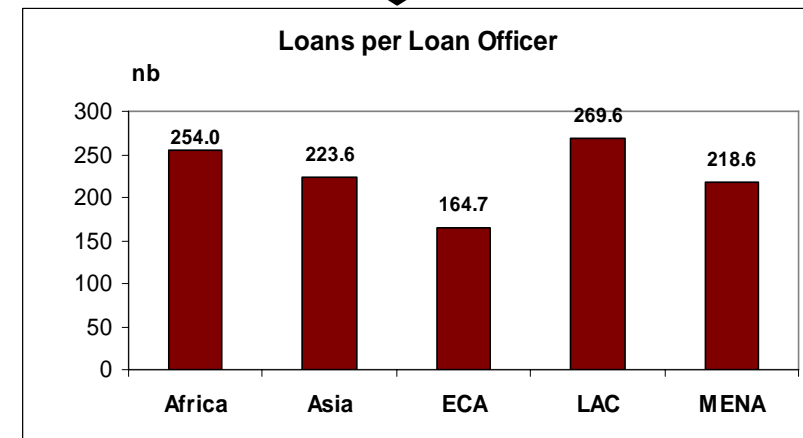
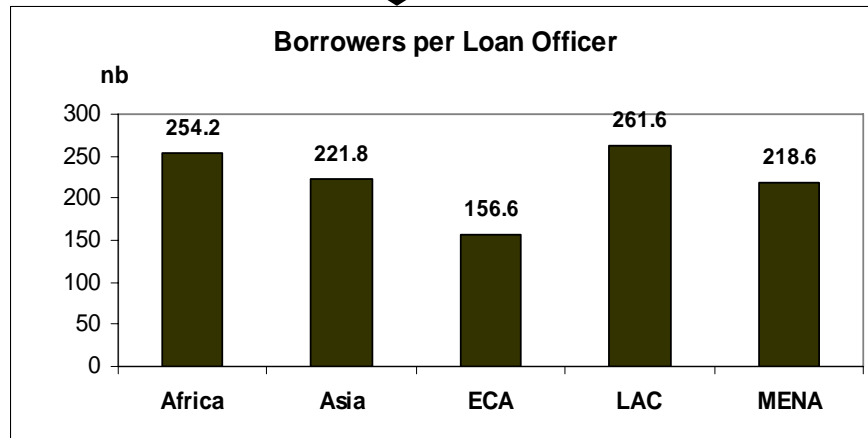
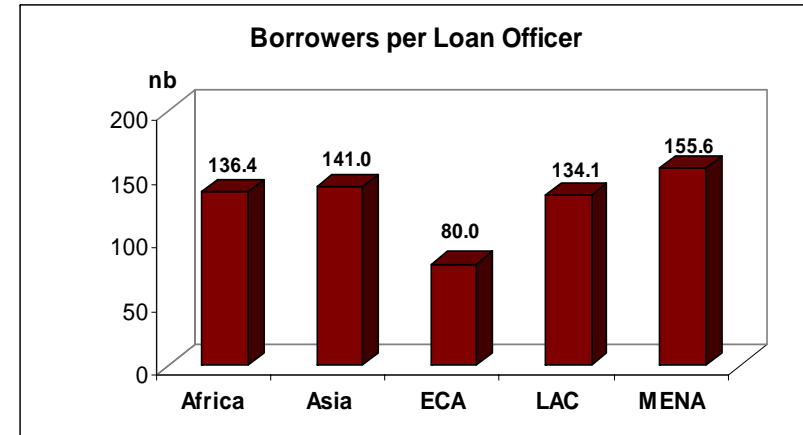


# Efficiency Indicators, 2005

平均每个员工承担的借款人数



平均每个员工承担的单笔贷款数

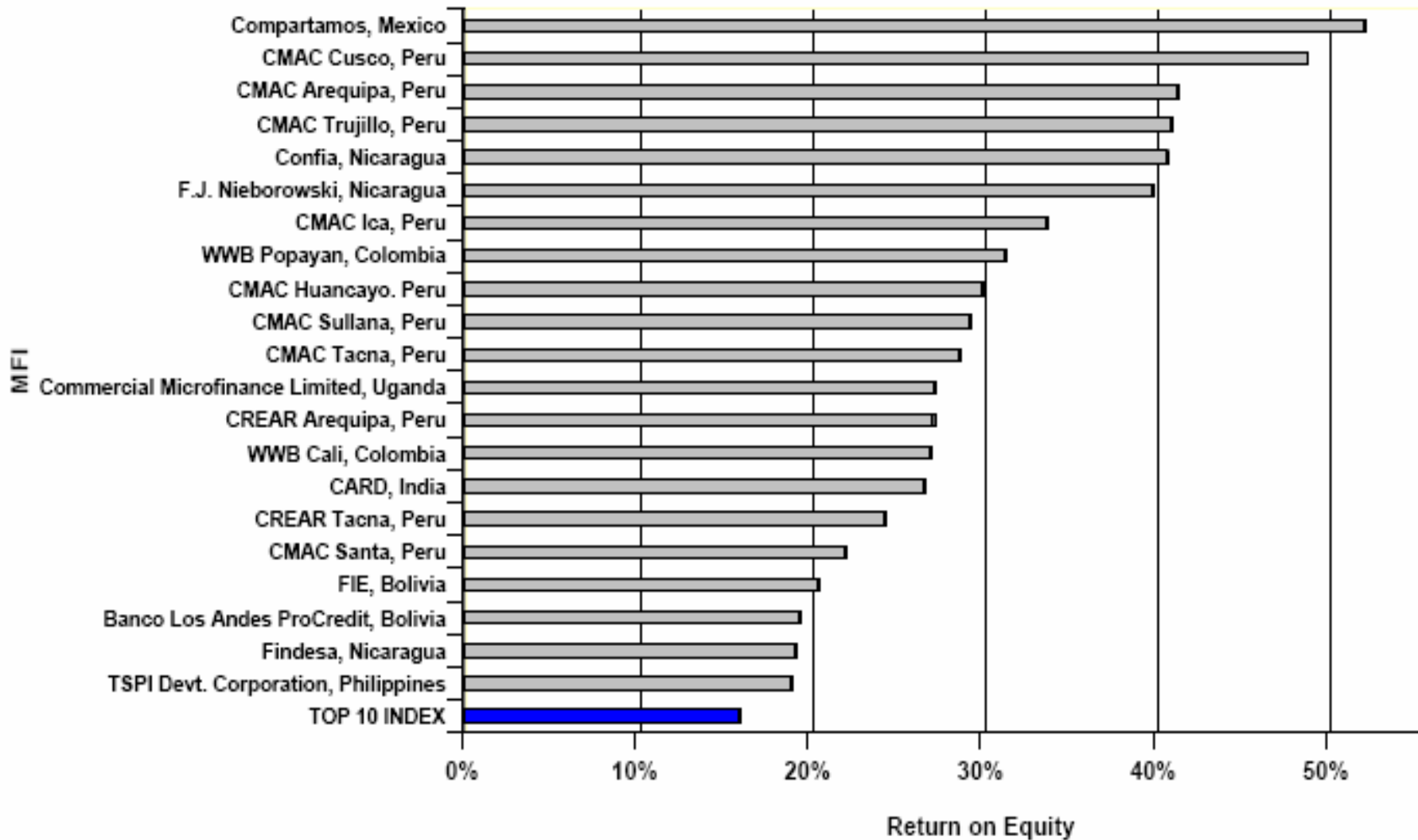


每个信贷员承担的借款人数

每个信贷员承担的贷款数

# ROE Comparison between Best MFIs and Top Ten Banks

## 效益最好的微贷机构与排名前十位银行的ROE比较, 2003



# Objectives and performance indicators

- To provide access to finance to a massive number of micro and small businesses (outreach) ...
- ...and do so on a commercially sustainable basis (subsidy independence), and ...
- ...achieving those objectives through building up institutional and human capacity in the participating financial institutions (PFIs) in the provision of commercially-oriented MSE lending

# Why commercial MSE lending

- MSEs are an important force in job creation, economic growth, science and technology innovation, and social stability
- But for various reasons MSEs over time became the forgotten segment
  - The rural microfinance has received increasing attention especially lately
  - The larger SMEs are considered bankable and have access to capital market financing

# **Most Chinese banks are not able to lend to MSEs...profitably**

- Have taken enormous savings deposits and are fairly liquid...
  - ...but are doing poorly in converting savings to investments
  - The main reason is lack of incentives and technology in processing the information of micro and small businesses
- ...But there are other reasons too...

# Lack of differentiation in strategy

- Banks, large or small, pursue large corporate clients...
- Including those newly-established rural commercial banks
- ...regardless of their core competence

# Banks not able to lend to MSEs

- Even if some banks made attempts at lending to MSEs, the efforts often lead to failure
- Because trying to apply traditional corporate lending practices to MSEs quickly gave rise to massive NPLs
- Some blame the failure on lack of public infrastructure
  - Legal and judiciary
  - Credit information framework
  - Secured transactions framework

# Characteristics of MSEs

- Informal or unreliable financial statements
- Multiple sources of cash flows and shared repayment responsibilities
- Untraditional collaterals
- Need for simple and quick loan processing
- Need for permanent funding sources and value reputation
- Access to convenient, quick and sustainable credit is more important than the pricing of loans

# **Banks are misled by erroneous concepts**

- Once frustrated, banks increasingly turn to collaterals and guarantees
- But these are no solutions to outreach and safety of MSE lending except increasing transactions costs
- Making MSEs lending either impossible or a costly proposition

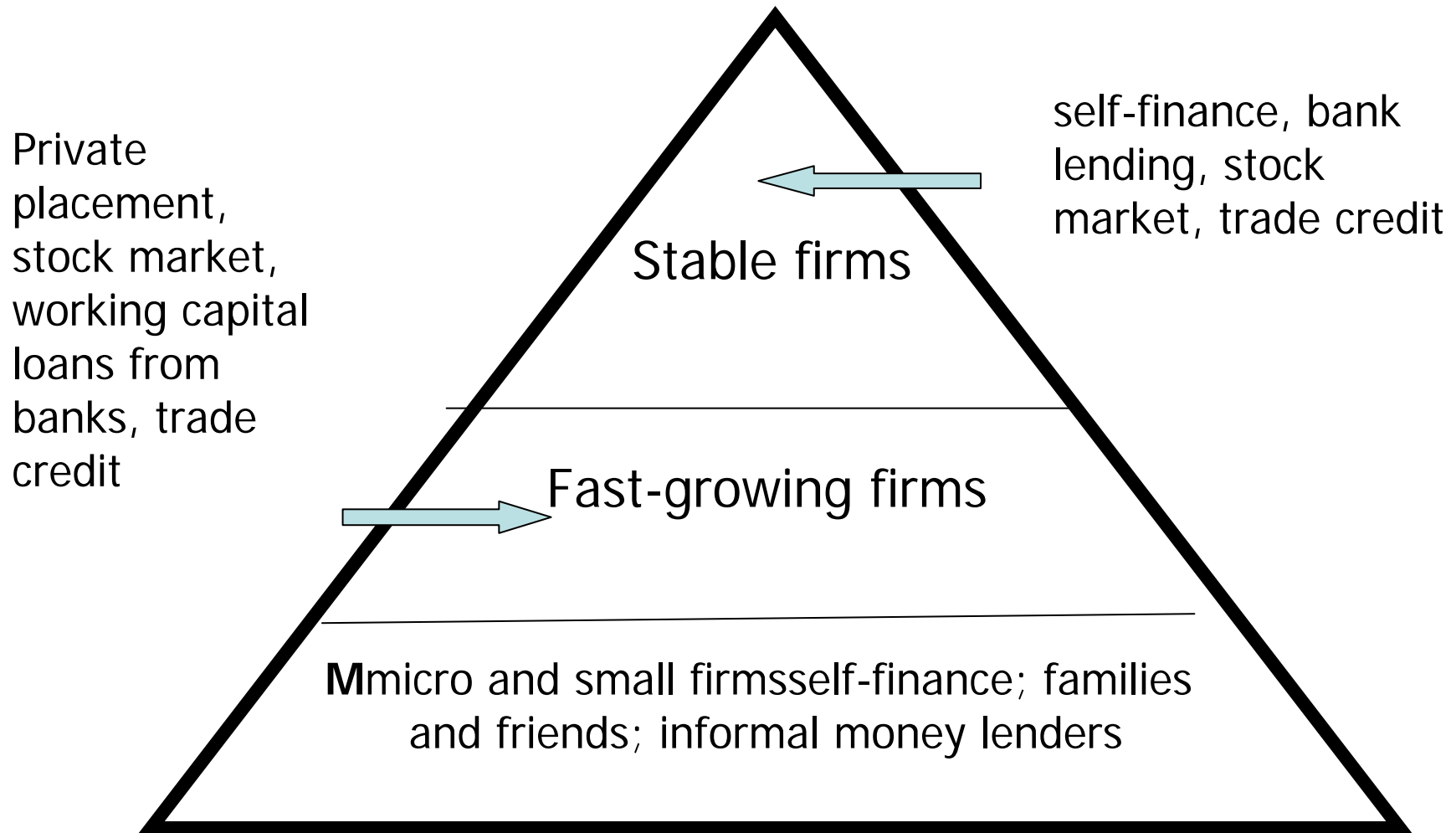
# Pricing policies also constrained

- Banks are not willing, nor able, to raise lending interest rates
- But given the fixed costs, banks cannot lend to MSEs with sustainability without charging lending rates that cover both costs and risks and enable them to make a reasonable profit

# Access or low interest rates: which matters to MSEs?

- It is not uncommon for MSEs to have high marginal returns to investment, sometimes up to 700%
- Low interest rates are desirable, but only if the loans are available within a reasonable time frame
- But it is often the case that loans at low interest rates are not available
- Compare with the rates charged by the informal money lenders

# MSMEs are not a homogeneous group



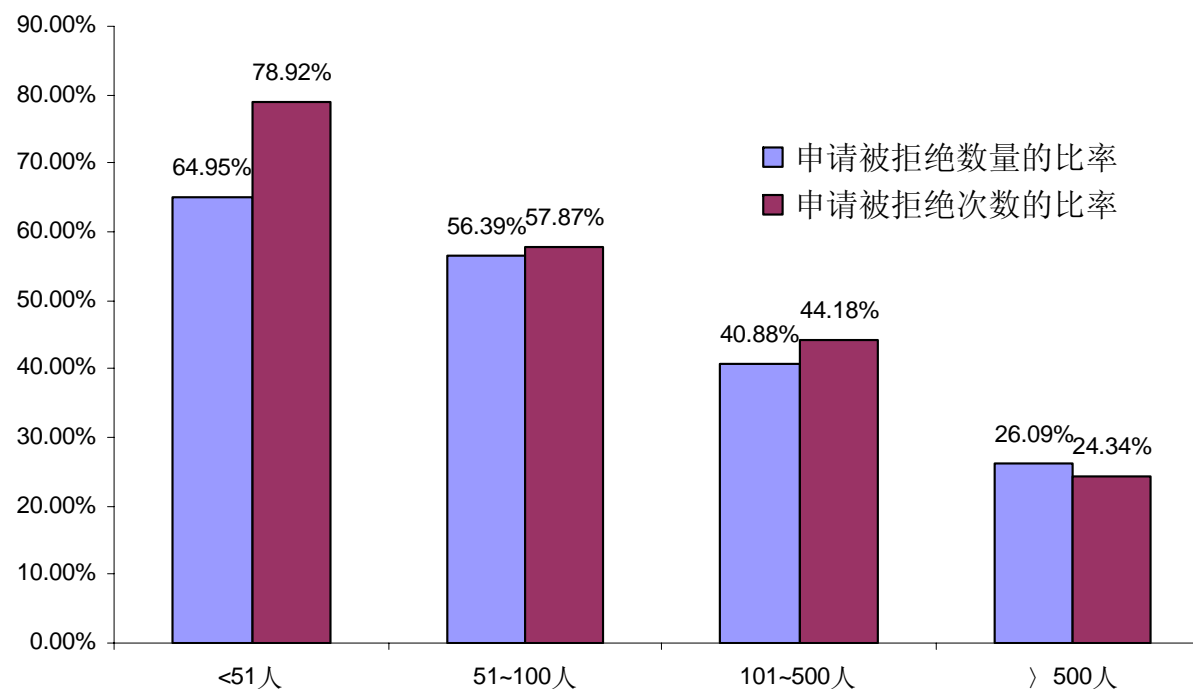
# The World Bank definition of MSMEs

企业 Enterprise	雇员数目 Employees	总资产 Total assets	年销售额 Annual sales
微型 Micro firms	1-10	<US\$1000,000	<US\$1000,000
小型 Small firms	11-50	US\$1000,000 <TA<US\$ 3 million	US\$1000,000 <AS<US\$3 million
中型 Medium firms	51-300	US\$<3 million<TA<U S\$15 million	

# The EU definition of MSMEs

企业 Enterprise	雇员 Employees	总资产 Total assets ( 欧元 euro)	年销售额 Annual sales (欧元 euro)	自主权/控制 权
微型 Micro	1-9	<2,000,000	<2,000,000	25%以上股权 或控制权
小型 Small	10-49	<10,000,000	<10,000,000	25%以上股权 或控制权
中型 Medium	50—249	<43,000, 000	<50,000,000	25%以上股权 或控制权

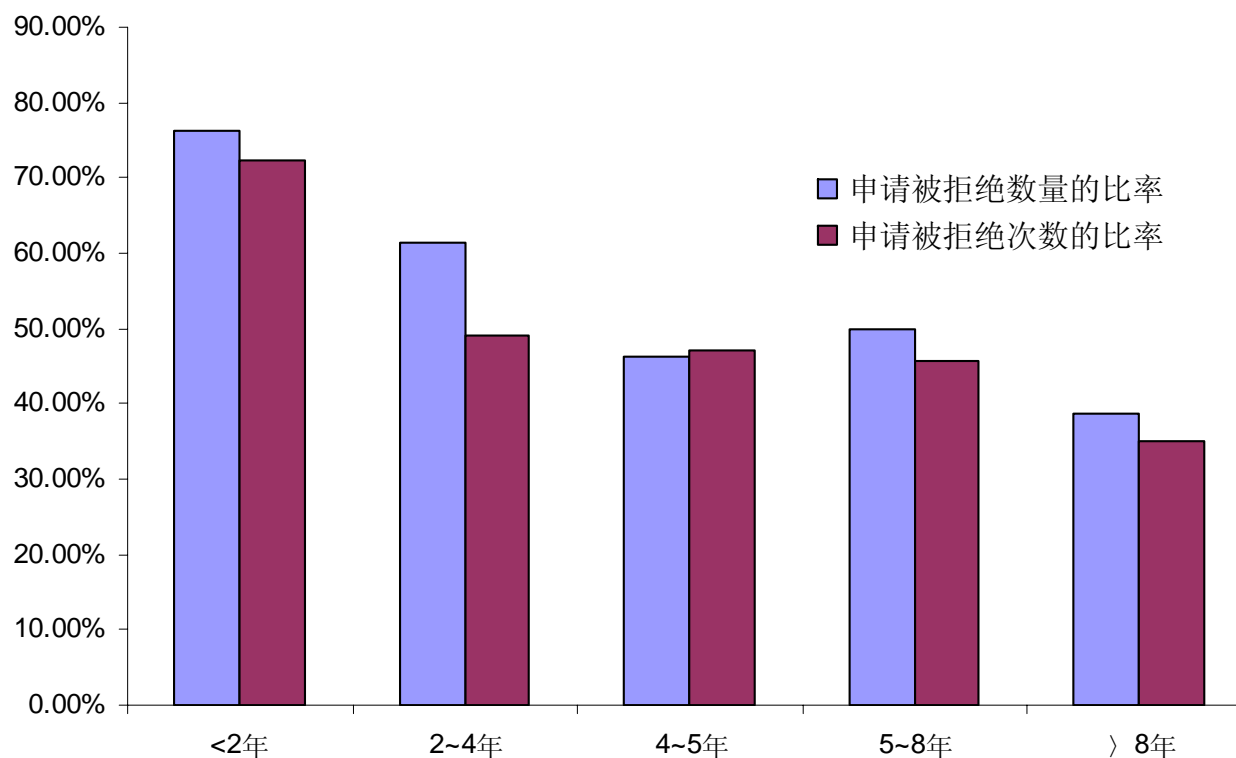
# Reasons why loan applications are rejected by banks



资料来源：IFC(2000)七个城市商业银行及其分支机构的抽样调查

# Loan rejections by age of MSEs

## 按年龄划分的企业贷款拒绝情况



资料来源： IFC(2000)七个城市商业银行及其分支机构的抽样调查

# Heterogeneity covers multitude of sins

- Broad definition of SMEs conceals high-end firms that may be found bankable
- It is the micro- and small-firms with short history that encounter acute problems in accessing finance
- Thus finding solutions for this group of firms holds policy implications

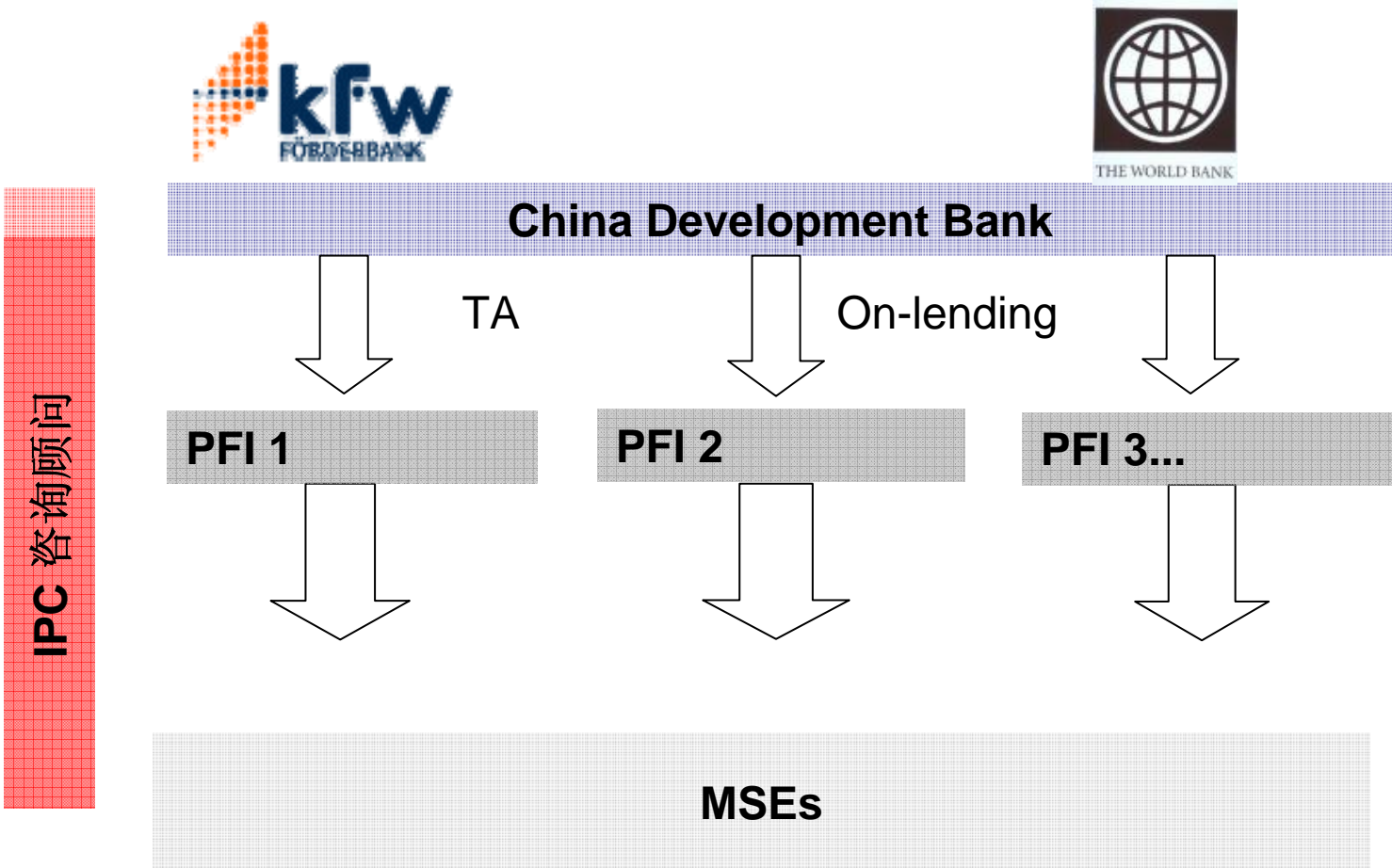
# Strategy to promote MSE finance

- Promote reforms in financial and regulatory policies
- Assist CDB in becoming a center of excellence in promoting MSE lending in China
- Build capacity of banks in lending to MSEs

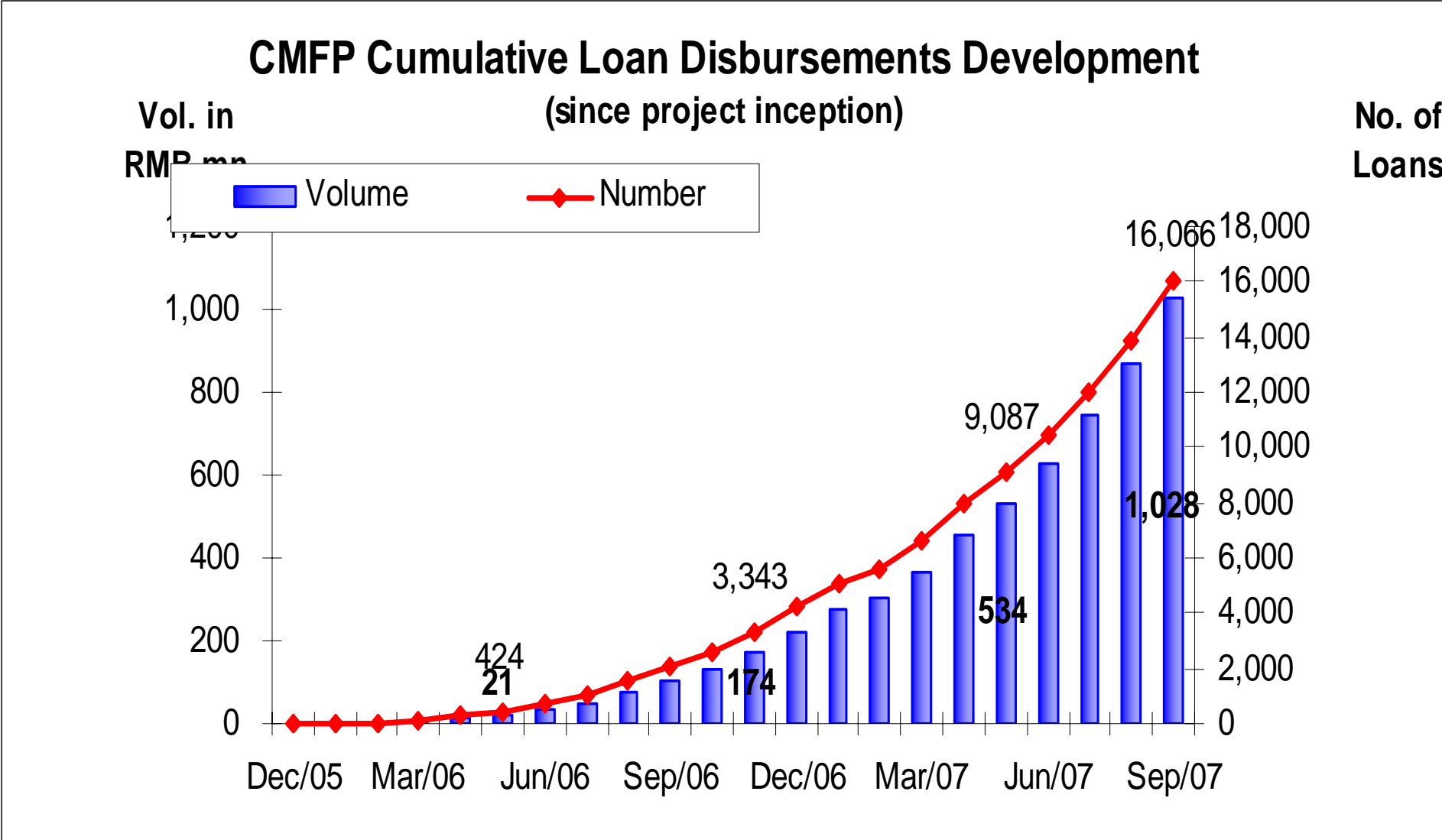
# Structure of the WB loan project

- Credit facility in the order of USD 95 million, for on-lending to PFIs through CDB, to be disbursed to MSEs
- TA facility of USD 5 million to provide technical assistance to PFIs

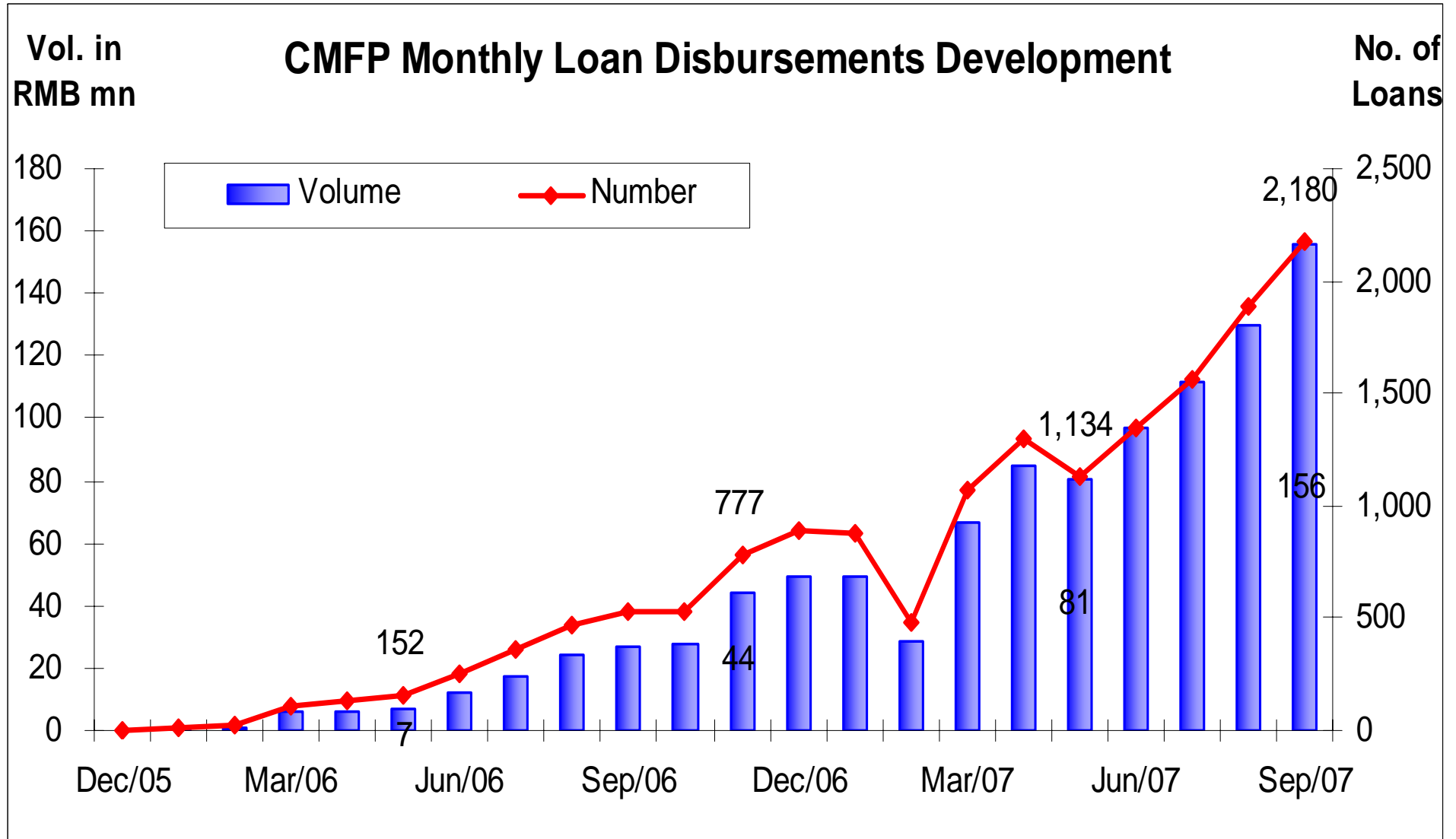
# Structure of the MSE finance project



# Number and volume of MSE loans

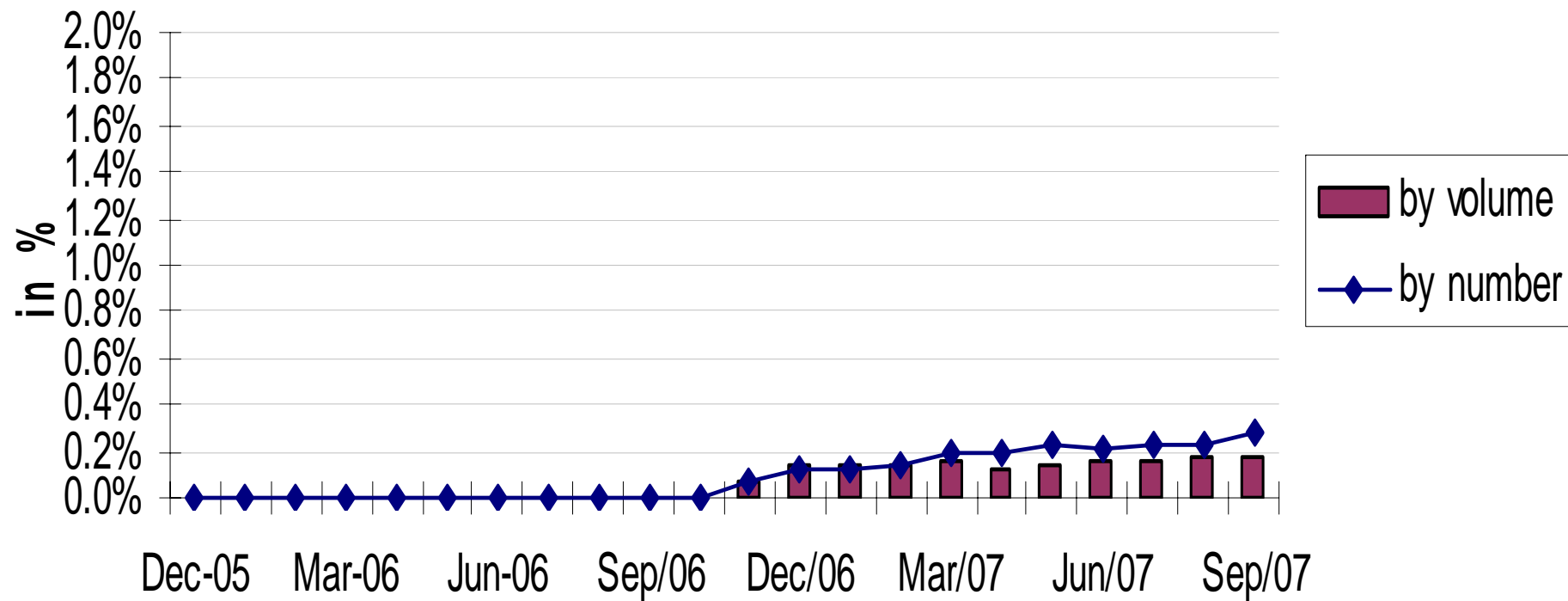


# Monthly disbursements

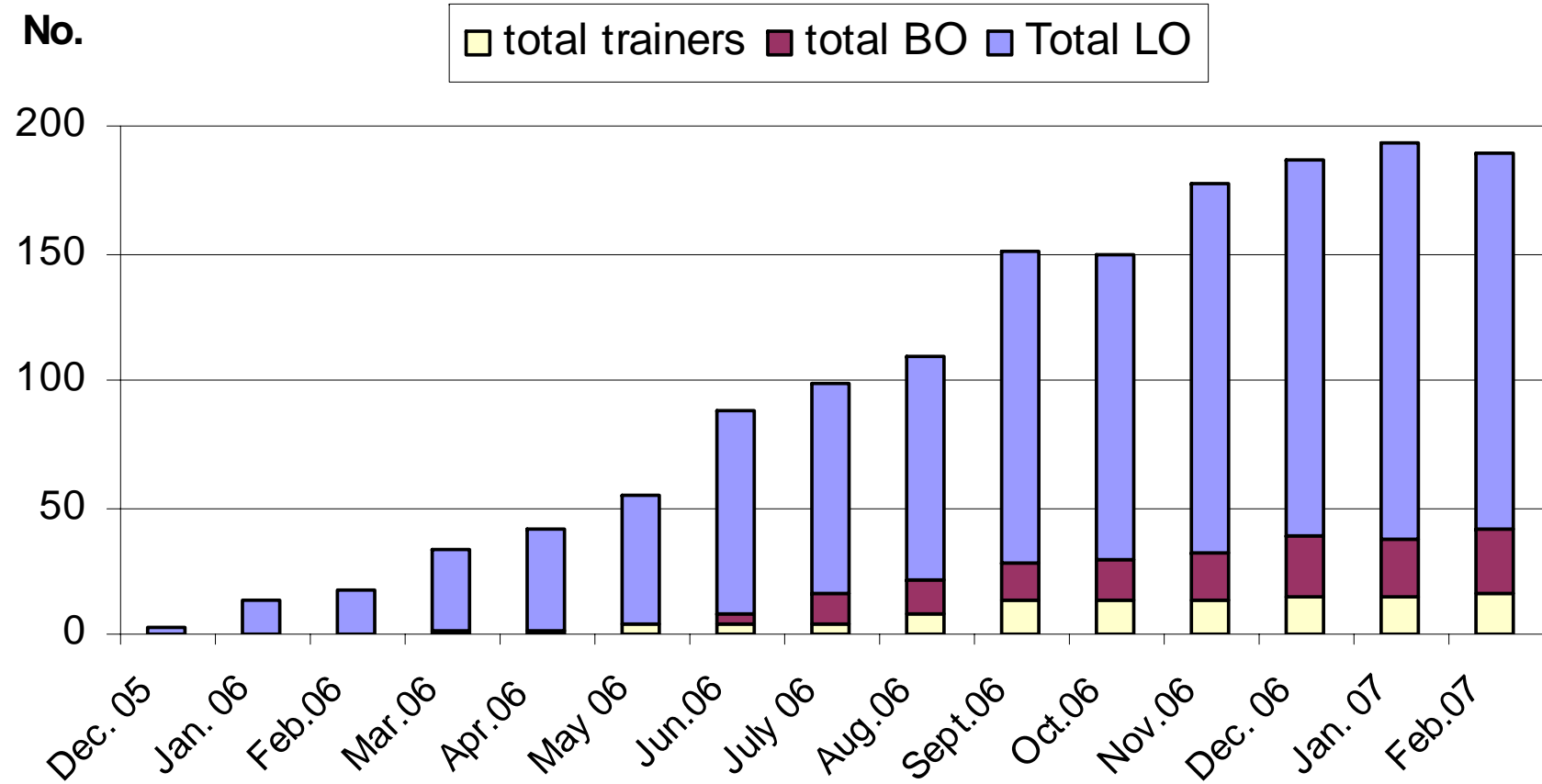


# Portfolio performance

**CMFP Arrears > 30 days  
(as percentage of Portfolio)**

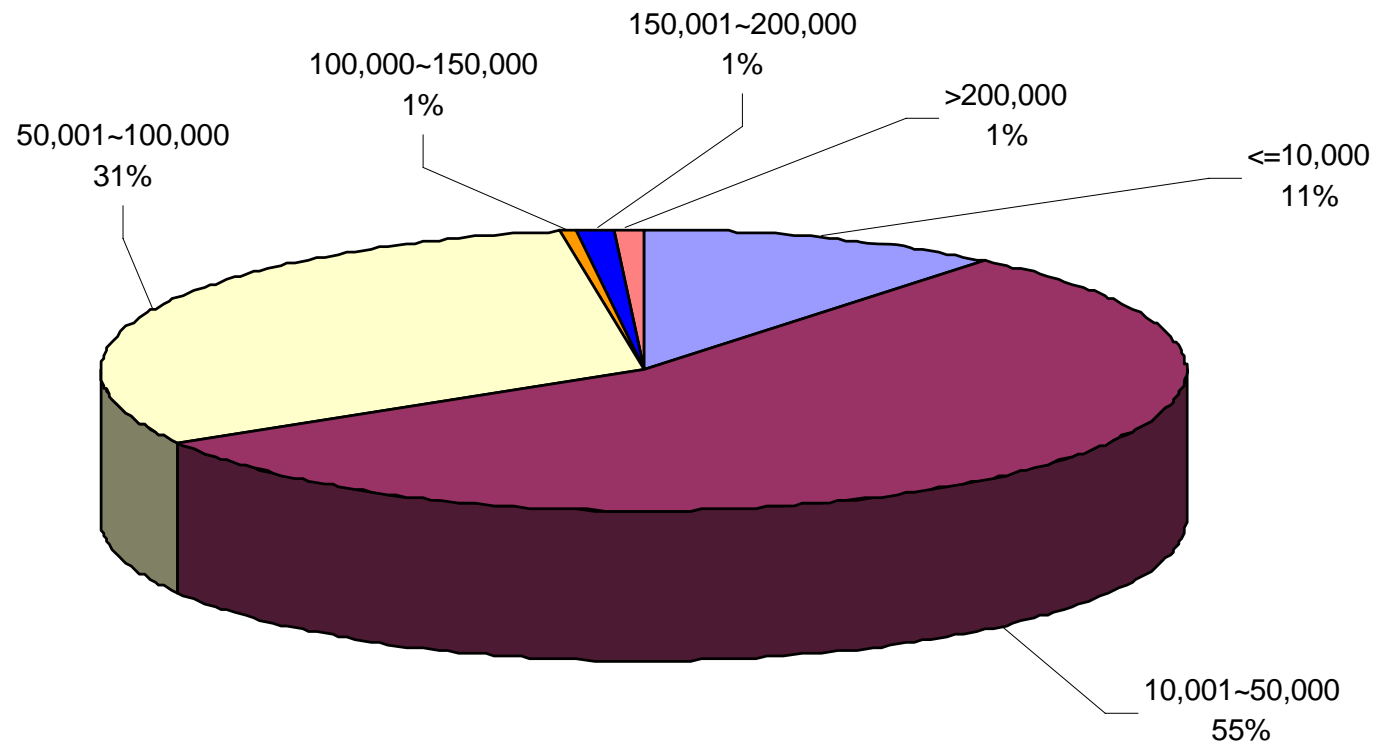


# Development of MSE credit staff



# Loan distribution by size (in RMB)

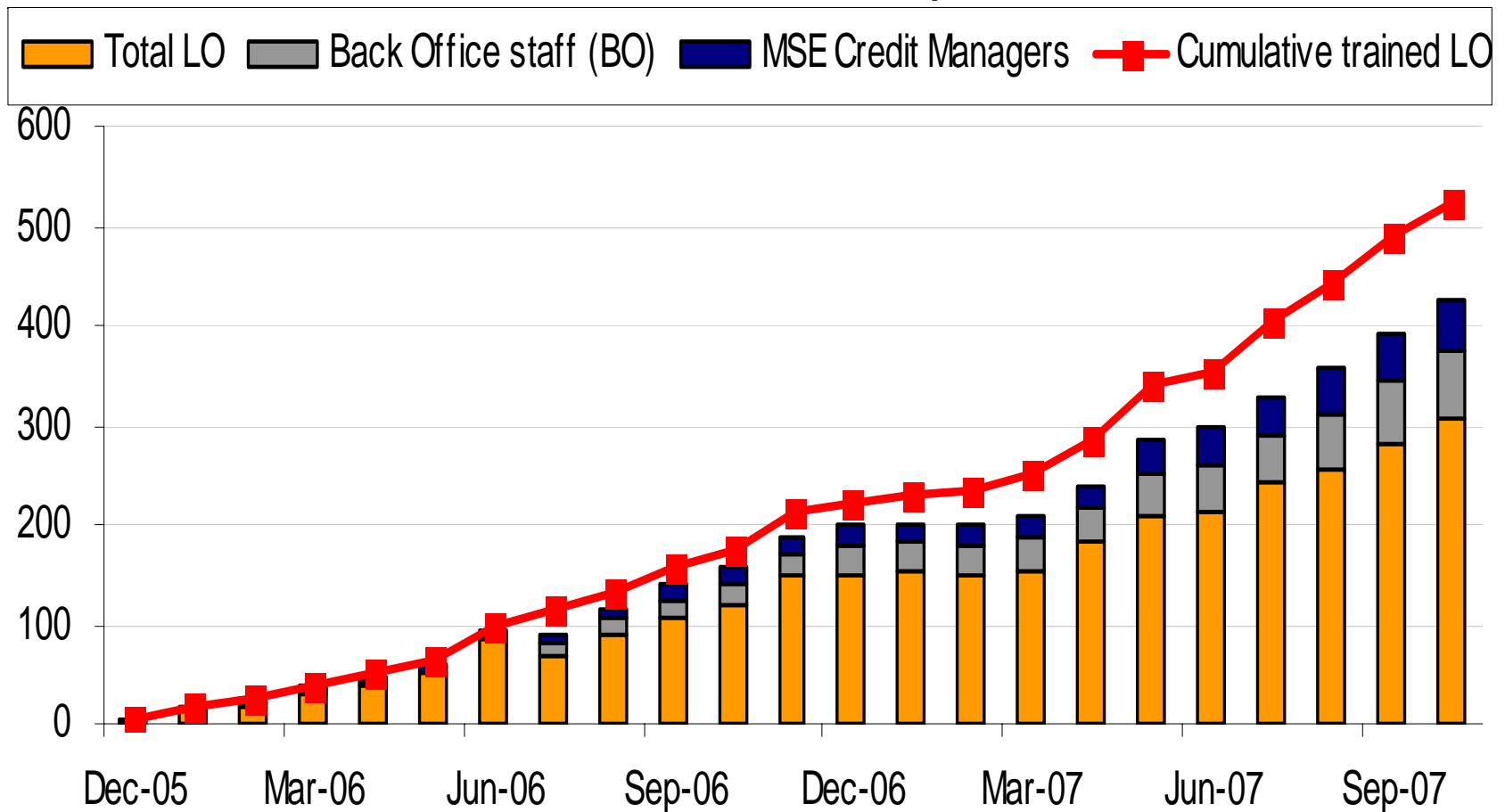
No. of Loans Outstanding in February 2007



# Number of credit staff trained

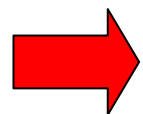
No. of Staff

## CMFP MSE Credit Staff Development



# Outlook: roll-out phase 2008 – 10

- expand sustainable MSE credit operations at PFI across China
- Focus institution building measures and training on launch-phase at each PFI and guiding roll-out
- more centralised training
- Develop PMU to roll-out mass CDB MSE lending activities



Substantial outreach to MSE

Significant strengthening of Chinese financial sector

Institutionalised Chinese lending and institution building capacity

# Comparison of the MSE lending technology

Lending practices among Chinese banks	Practices promoted by the MSE credit technology
Loan approval mainly based on collateral or guarantee	Loan approval based on cash flow analysis and debt capacity of client
Credit analysis based on official documentation (financial statements)	Financial information is retrieved by loan officers by “auditing” and interviewing the borrowers and checking the information gathered on consistency and plausibility.
Excessive documentation requirements that lead to high transaction costs and processing time	Only core documents required and MSEs have no difficulty presenting them
Low interest rates without fees but with high hidden costs	Market-based lending rates which tend to be higher than those to large borrowers but typically lower than those charged by informal money lenders
Large loans usually over RMB 1 million	Micro and small loans with average loan size of RMB 40,000
Business plans and feasibility studies required which tend to turn MSE borrowers off as they usually do not have them	Never request business plans or feasibility studies as they are not essential for the very small borrowers
Loan procedures are complex, involve many departments and hierarchy levels, leading to processing times of 3 months and more.	“Time to cash” is crucial to successfully compete with informal finance providers and to reach sufficient lending efficiency. Typically, loans are disbursed in 1-3 days after application.
Short loan maturities with frequent rollover of loans	Loan maturity matched with cash flow and debt capacity and finance needs; no rollover of debt
Loan officers have incentives to go after large corporate borrowers to disburse large loans	Loan officers are motivated to lend to MSEs with small loans, and incentives are built in their compensation schemes accordingly to disburse loans and ensure repayment
Immovable assets are required as collateral and their evaluation by third parties increases transaction costs for clients	Flexibility in collateral requirements allows items of emotional value to qualify as collateral whose evaluation is conducted by loan officers
Bullet repayment of loans making it difficult for the lender to incentivise and monitor the borrowers	Equal monthly installment loans serve as a monitoring as well as an incentive device

# Techniques are not enough

- Safe and sound FIs are needed to:
  - Develop MSE loan products with correct pricing
  - Make necessary institutional changes and appoint competent managers to lead the MSE departments
  - Recruit and train new credit officers and provide them with the right incentives

# PFI selection criteria

- Corporate governance
- Finance conditions
  - Capital adequacy ratio
  - Asset quality
  - Risk management and internal controls

# What if things are not perfect

- Formulate corrective action plans with CDB
- The CAP must be time-bound
- CDB will monitor PFI's performance

# Lessons learned so far

- PFI selection is a critical condition
  - Strategy and planning
  - Institutional setup
  - HR policies, incentive schemes, and training

# Monitoring and evaluation through a randomized study

- Outreach
- Sustainability
- Impact on the MSE borrowers
- If gone well, the study is expected to push out the frontier of our understanding on the true impact of the commercial MSE lending approach