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Microfinance in Rural China: Government Initiatives to Encourage Participation by Foreign and Domestic Financial Institutions

J. Wyatt Kendall

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Microfinance in Rural China: Government Initiatives to Encourage Participation by Foreign and Domestic Financial Institutions

I. INTRODUCTION

An ancient Chinese proverb states: "give a man a fish and you feed him for a day. Teach a man to fish and you feed him for a lifetime." In today’s rapidly developing Chinese economy, however, some people need more than a lesson in fishing to thrive. One essential need is access to banking services.1 In most developing nations similar to China, access to banking services and wealth go hand-in-hand.2 That is, people with access to banking services live above the poverty line, whereas those without access to banking services live below the poverty line.3 Studies have shown that exposure to loans and secure banking services, such as standard savings accounts, provide low-income individuals greater opportunities for business and social development.4 Absent such services, businesses never get started and families never reap the benefits of interest-bearing accounts. Discrepancies in wealth arise in developing countries in part because access to banking services is a luxury that only a fraction of people in such countries enjoys.5

In rural China, a disparity in wealth has arisen as banks

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3. See id. at 195-96.


5. See id.
have been quick to follow the population exodus from the countryside to large cities. Because Chinese banks have slowly moved their resources from small, agricultural loans to more profitable industrial loans found in China's metropolises, rural communities have not shared the same economic growth that the rest of China has otherwise recently achieved. As a result, the majority of China's 60 million impoverished citizens reside in rural communities. The Chinese government and the international community have recently taken notice of the wealth gap between China's urban and rural populations, and have actively pursued microfinance as a method to reduce poverty. Some policymakers believe microfinance, a risk-reducing approach to provide low-income communities financial services, is the solution to mitigate poverty in rural China.

Part II of this Note will outline three common reasons why banks perceive low-income borrowers as credit risks and tend to avoid offering services to them. Next, Part III of this Note will provide a background on microfinance and will examine how microfinance can lower the risks involved in offering low-income individuals financial services. Part IV will discuss the two conflicting approaches to microfinance: one centered on poverty alleviation and the other on profitability. Part IV will argue that microfinance institutions must be profit-driven rather than policy-driven in order to meet the immense demand for financial services around the world. Part V of this Note will discuss China's failure to bridge the growing disparity in wealth and why microfinance

7. Id.
8. Id.
10. See Knowledge@wharton.com, supra note 1.
11. See id.
12. See infra Part II.
13. See infra Part III.
14. See infra Part IV.
could be used.15 Further, Part VI suggests that China’s recent concession to open its banking industry to the rest of the world provides an excellent opportunity to encourage foreign banks to initiate microfinance services in rural China.16 This Note will argue that in order to meet China’s large, unmet demand for microfinance services, the Chinese government must establish a sufficient credit information system and provide more flexibility in interest rates to lure foreign investors into China’s rural economic market.17

II. LENDING RISKS ASSOCIATED WITH LOW-INCOME BORROWERS

Researchers have demonstrated that there is a strong, positive correlation between an individual’s access to traditional banking services and an individual’s well-being.18 In many developing countries, the absence of nationwide economic development arises in part because a significant portion of the low-income population lacks access to the benefits of banking services.19 Banks traditionally have avoided offering services to low-income borrowers because they have perceived the risks involved greater than the potential returns.20 This Note will specifically discuss three common risks associated with lending to low-income borrowers in developing countries.

First, poor borrowers in developing countries are commonly perceived as credit risks because banks are bereft of reliable credit information to screen these borrowers.21 Ideally, lenders gather as much information about a potential borrower’s creditworthiness as possible.22 The more information a lender obtains about a potential borrower, the easier it is to make a more

15. See infra Part V.
16. See infra Part VI.
17. See id.
19. See Jones, supra note 4, at 189-91.
20. Id.
21. See Jaffer, supra note 2, at 188.
22. Id.
accurate decision about whether to grant a loan and how to profitably construct the terms of the loan if one is granted. In developed countries, lenders are afforded the luxury of credit histories, formal loan applications, and in-person interviews to help predict the likelihood that a potential borrower might default on a loan. By contrast, most developing countries have insufficient systems for collecting credit information, making credit screening a difficult, inaccurate, and costly process. Moreover, interviewing a borrower in a developing country is usually not a cost-effective option because many poor borrowers live in remote locations and are not readily accessible in person or through the use of technology. Thus asymmetry in information regarding a borrower's creditworthiness significantly inhibits a lender's ability to anticipate the probability of success or failure for a particular loan, making lending more uncertain for the lender.

For lenders serving poor borrowers in developing countries, risks of defaulted loans are exacerbated because lenders are not afforded the option of securing a loan with collateral in lieu of credit history information. Especially in rural communities, low-income borrowers possess “very little capital, and even the capital they have is not easily secured, because property rights are not always well-defined or formalized, and legal recourse is typically unreliable and costly.” Consequently, banks cannot readily safeguard themselves against defaulted loans. Second, banks are further discouraged from serving low-income customers in developing countries because transaction and maintenance costs substantially reduce profitability on small loans. Deficiencies in nationwide technology and infrastructure

23. Id.
25. Id.
26. See Jaffer, supra note 2, at 188.
27. See id.
28. See id.
29. Id. at 190.
30. Id.
31. See Kenneth Anderson, Microcredit: Fulfilling or Belying the Universalist
cause transaction and maintenance costs to draw a greater percentage of a bank's potential profit on a loan.\textsuperscript{32} Assuming transaction and maintenance costs could be curbed, banks are also disheartened by "the fact that it is inefficient for a commercial lender to deal in such small amounts of money."\textsuperscript{33} In developed countries, the difference between transaction costs associated with a $100 loan and a $5000 loan is insignificant.\textsuperscript{34} Everything else being equal, the $5000 loan will be more profitable for the lender than the $100 loan.\textsuperscript{35} Thus, assuming there is a market for large loans, banks will avoid issuing small loans to low-income borrowers.\textsuperscript{36}

Since these perceived risks cause banks to avoid poor communities, low-income borrowers, particularly in rural areas where operating and establishing a bank is costly, turn to loan sharks for money at financially-crippling interest rates.\textsuperscript{37} One commentator states that "low-income borrowers can gain easy access to credit but at high cost, charging poor borrowers nominal monthly effective interest rates that typically range from about 10 percent to more than 100 percent—many times the monthly effective rates of sustainable financial institutions, which are usually 2-5 percent."\textsuperscript{38} Consequently, low-income borrowers are faced with the decision of whether to take out a loan at such a high interest rate that they suffer financially from the loan's crippling cost, or to avoid ever taking out a loan altogether.\textsuperscript{39} Regardless of the choice, low-income borrowers never grasp the opportunity to escape poverty and the need for financial services in low-income communities remains unmet.\textsuperscript{40}

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32. \textit{See id.}
33. \textit{Id.} at 100.
34. \textit{See id.} at 99-100.
35. \textit{See id.}
36. \textit{See id.}
37. \textit{See Miyashita, supra note 24, at 153.}
40. \textit{See id.}
III. MICROFINANCE

A. Basics of Microfinance

Because of the immense, unfulfilled need for banking services in low-income communities, many policymakers have turned to microfinance to satisfy this high demand. Microfinance provides a way for banks and other financial institutions to extend small loans (commonly referred to as microloans) and other financially-related services to low-income entrepreneurs, while limiting the risks associated with serving low-income customers. Risk-reducing microfinance strategies include:

superior information about borrowers to reduce risks given low or nonexistent collateral; peer lending circles to serve as pre-screening devices to reduce information asymmetry; joint liability contracts among borrowers to enforce payment despite weak legal institutions; short-term loan contracts with regular repayments to substitute for information; loan ladders that permit successful borrowers to take out increasingly larger loans as incentives for repayment; social networks and shaming to increase repayment rates; and a variety of other substitutes for information, collateral, and legal enforcement to extend credit to low-income borrowers without collateral assets.

Increased profit margins captured by these strategies allow banks to offer services previously unavailable to poor borrowers, and

42. Barr, supra note 18, at 279.
43. See id.
thus, spur business opportunities for low-income borrowers and increase the overall degree of intermediation in an economy.\textsuperscript{44}

\textbf{B. The Administration of Microfinance Institutions}

The administration of microfinance services is commonly achieved through microfinance institutions (MFIs).\textsuperscript{45} MFIs, which number over 10,000 worldwide, serve approximately 150 million people, and either governmental agencies, charitable non-governmental organizations (NGOs), or commercial banks manage them.\textsuperscript{46} MFIs provide a variety of financially related services to the "unbanked population,"\textsuperscript{47} including legal assistance, business consulting, and, in some cases, health insurance.\textsuperscript{48} The crucial financial service for most MFIs, however, is the apportionment of small loans known as microloans.\textsuperscript{49} Microloans are taken out by small businesses (microenterprises), which usually consist of less than five people and are commonly organized as a sole proprietorship or a family business,\textsuperscript{50} in an amount that typically ranges from $500 to $5000.\textsuperscript{51} To offset the lending risks associated with low-income borrowers, microloans possess interest rates higher than market interest rates and shorter repayment periods.\textsuperscript{52} Upon receipt of microloans, borrowers must invest in business related investments such as office supplies rather than in items of personal consumption.\textsuperscript{53} Integral to the success of issuing microloans as a method to cultivate economic growth is the

\begin{footnotesize}
\begin{enumerate}
\item See Robinson, supra note 38, at 7-9.
\item Id.
\item Id.
\item See id.
\item See Tipton, supra note 45, at 180.
\item Id.
\item Id. at 180-81.
\item Id.
\item Id.
\item See Jaffer, supra note 2, at 198.
\end{enumerate}
\end{footnotesize}
assumption that "poor people can be both reliable borrowers and avid entrepreneurs."  

C. Benefits and Basics of Microfinance

Microfinance provides the bootstrap on which self-starting, low-income borrowers can pull themselves up from poverty. With the assistance of MFIs, some low-income communities have demonstrated that they can "make the transition from 'every-day survival' to planning for the future." MFIs around the world have helped millions of people by distributing billions of dollars worth of loans. Bank Rakyat Indonesia, for instance, provided $1.7 billion in microloans to approximately three million people, and 30 million low-income households obtained savings accounts through the bank. As a result of access to these financial services, borrowers from the Bank Rakyat Indonesia saw household incomes grow by over twenty percent. One study across MFIs worldwide found that those impoverished citizens with access to a MFI were twelve times more likely to surpass the poverty line over

54. BUSINESSWEEK, Nobel Winner Yunus: Microcredit Missionary (Dec. 26, 2005), available at http://www.businessweek.com/magazine/content/05_52/b3965024.htm; see also GAIL BUYSKE, BANKING ON SMALL BUSINESS: MICROFINANCE IN CONTEMPORARY RUSSIA 16 (2007) (explaining that one reason why poor borrowers have proven to be reliable borrowers is that they "have only one chance to prove themselves. Particularly in new markets, where only one MFI is operating, a potential borrower—who typically has never had a formal loan before—has a unique opportunity to raise his or her living standards.").

55. See Rashmi Dyal-Chand, Reflection in a Distant Mirror, Why the West Has Misperceived the Grameen Bank's Vision of Microcredit, 41 STAN. J. INT'L L. 217, 231-32 (2005); see also Muhammad Yunus, Towards Creating a Poverty-Free World, in MICROFINANCE AND POVERTY: CONTEMPORARY PERSPECTIVES 26 (Farhad Hossain and Zahidur Rahman eds., 2007) (stating that “[g]iving the poor access to credit allows them an ability to immediately put into practice the skills they already know . . . And the cash earn is then a tool, a key that unlocks a host of other abilities, a key to explore their own potential.").


57. See Barr, supra note 18, at 274.


59. See Barr, supra note 18, at 283.

60. See id.
Besides the financial benefits derived from access to banking services, freedom from relying on governmental assistance or outside charity also empowers low-income borrowers and their communities. Beneficial social consequences from microfinance, which have been particularly encouraging in women, include a “positive impact on school attendance, increase[ed] gender equality, reduc[ed] infant/child mortality, reduc[ed] maternal mortality, and increase[ed] access to reproductive health.” Proponents of microfinance do not suggest it is a cure-all for alleviating poverty, but they do point to its encouraging track record of economic and social growth.

IV. POVERTY ALLEVIATION VERSUS SUSTAINABILITY

Providing financial services to communities that have been unable to access these services in the past remains the general purpose of microfinance today. Two conflicting views, however, have emerged as to how MFIs should concentrate their efforts and resources. One view, mainly adopted by government and NGO managed MFIs, argues that microfinance should focus principally on poverty alleviation. The other view, adopted by comer-
cialized MFIs, posits that MFIs should be profit-driven and that achieving financial sustainability is the most effective way to spread financial services to the greatest number of low-income individuals.⁶⁸

A.  The Goal of Poverty Alleviation

Arguably the most notable microfinance model focusing on poverty alleviation is the solidarity lending approach pioneered by Nobel Peace Prize winner Dr. Muhammad Yunus through his work with the Grameen Bank in Bangladesh.⁶⁹ Pivotal to the success of the solidarity lending approach is the use of social collateral.⁷⁰ In order to secure a loan, MFIs divide borrowers into groups and require each group member to be responsible for the entire debt of the group.⁷¹ In essence, a social contract is formed whereby each group member functions as a third-party beneficiary.⁷² Creditors benefit from this form of group lending because peer pressure among group members creates an incentive for each member to be accountable for the loan.⁷³ As the group successfully repays its loans and demonstrates reliability, the MFI increases its credit limit.⁷⁴

The Grameen Bank currently provides loans to 7.39 million people across Bangladesh.⁷⁵ While the Grameen Bank and MFIs like it have achieved general success in mitigating poverty, these MFIs have had difficulty generating enough capital to maintain self-sustainable institutions.⁷⁶ Professor Kenneth Anderson noted

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68. Id.
69. See Buyske, supra note 54, at 11.
70. See Dyal-Chand, supra note 55, at 223-26.
71. See id. at 225.
72. See id.
73. See Taylor, supra note 66, at 321.
74. See Dyal-Chand, supra note 55, at 225.
that MFIs focusing on poverty alleviation "very rarely succeed in covering costs; self-sustainability is much more the extraordinary exception than the rule for microcredit organizations." One reason for this lack of success for institutions focusing on poverty alleviation rather than profitability is that they offer below-market interest rates. Below-market interest rates insufficiently cover the high administrative costs of MFIs, which range from "10 to 25 percent of their portfolio[s]." Offering charitable interest rates may beneficially drive down rates in the informal financial sector, but the lack of capital generated by these loans makes MFIs dependent on outside sources of capital. As a result, governments and NGOs are saddled with the burden of non-performing loans and have to constantly inject capital into these unprofitable MFIs to save them from their financial demise. For MFIs primarily focusing on poverty alleviation, microfinance quickly becomes a subsidy program in disguise. Though these unprofitable MFIs do benefit low-income communities, their outreach can go only as far as their donor's budget permits.

B. The Goal of Profitability and Sustainability

Microfinance, however, can alleviate poverty without converting into a welfare program. For microfinance to meet the growing need for banking services in low-income communities, striving for profitability offers policymakers the most effective method to alleviate poverty, while still expanding the outreach of microfinance services. Proponents of a profit-driven approach to microfinance argue that the supply and demand for financial

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77. Id.
78. See Miyashita, supra note 24, at 159.
79. See Christian, supra note 76, at 93.
80. See Robinson, supra note 38, at 95-97; see also Tazul Islam, Microcredit and Poverty Alleviation 65 (2007) (stating that the informal financial sector "includes the multitude of transactions, which can be contracted informally on the commodities market, the labour market, and the financial market").
81. See Miyashita, supra note 24, at 160.
82. See Robinson, supra note 38, at 95.
83. See id. at 7.
services in poor communities and the need to offset non-performing loans should dictate the availability and costs of MFI services.  

Central to the belief that MFIs can achieve profitability is that low-income borrowers are capable of repaying higher than market interest rates with the appropriate assistance and terms provided by the lender. Support for this belief has been demonstrated in India, where several MFIs charged interest rates as high as fifty percent and still retained a high repayment level and positive social benefits. The corollary effect of MFIs earning a profit from microloans is that they can expand their services to a larger portion of the low-income population. BancoSol in Bolivia is just one example of how cost-efficient MFIs can broaden their services to a greater number of low-income individuals and still alleviate poverty. BancoSol now serves over 75,000 people and even issues dividends to its shareholders. Between 2002 and 2006, the amount of capital BancoSol distributed each year rose from $80,917,000 to $164,155,000. For a developing country like China, embracing profitability as the goal for microfinance may be the most effective way to alleviate poverty and increase intermediation within their nascent banking industry.

V. CHINA AND MICROFINANCE

A. China's Need for Microfinance Despite Recent Economic Success

Just focusing on China’s overall economic growth over the

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85. See id. at 87.
86. See Miyashita, supra note 24, at 159.
87. See ROBINSON, supra note 38, at 87.
89. Id. In 1997, BancoSol became the first MFI to issue dividends. Id.
90. Id.
past thirty years,\footnote{See infra notes 92-93.} one would assume that it would have little need for microfinance. Over this thirty-year span, it has emerged as an economic juggernaut, becoming the world's second largest economy, behind only the United States.\footnote{See Randall Peerenboom, Symposium: Legal Implications of a Rising China: The Fire-Breathing Dragon and the Cute Cuddly Panda: The Implications of China's Rise for Developing Countries, Human Rights, and Geopolitical Stability, 7 CHI. J. INT'L L. 17, 17 (2006). This statistic is based on China's purchasing power parity of $10.21 trillion in 2006. Central Intelligence Agency, World Fact Book, https://www.cia.gov/library/publications/the-world-factbook/geos/ch.html (last visited Nov. 18, 2007).} China's gross domestic product (GDP) grew at an average of roughly nine percent over the last decade, thereby surpassing the majority of countries in the world.\footnote{See Microfinance Gateway, supra note 6.} This upward trend seems to be continuing as China's GDP grew over eleven percent in 2006.\footnote{See Central Intelligence Agency, supra note 92.} During this period of growth, China has slowly exchanged a planned economic approach, which essentially allows the government to dictate the economy,\footnote{See id.} for a more market-oriented approach, which permits market forces to control the economy.\footnote{Berry Fong-Chung Hsu et al., Banking Liberalization and Restructuring in Post-WTO China, 21 BANKING & FIN. L. REV. 23, 24 (2005).} China's transformation has included: "the gradual liberalization of prices, fiscal decentralization, increased autonomy for state enterprises, the foundation of a diversified banking system, the development of stock markets, the rapid growth of the non-state sector, and the opening to foreign trade and investment."\footnote{See Central Intelligence Agency, supra note 92; see also Lan Cao, The Cat that Catches Mice: China's Challenges to the Dominant Privatization Model, 21 BROOK. J. INT'L L. 97, 110 (1995) (characterizing China's current economic approach as "market socialism").} Many commentators believe that China's move toward a more market economy is the impetus behind its newly-minted economic success.\footnote{See Microfinance Gateway, supra note 6.}

Amid China's rapid economic growth and transformation, some Chinese citizens have failed to reap the benefits of its newly acquired wealth.\footnote{See Knowledge@wharton.com, supra note 1.} As China moves from the rice fields to
skyscrapers, approximately 60 million citizens, the majority of whom still reside in rural areas, live below the World Bank’s standard of poverty of less than $1 a day.\textsuperscript{100} The average annual income among urban citizens is $1000, whereas the average annual income among rural citizens is only $100.\textsuperscript{101} A leading cause for this disparity in wealth is that seventy-five percent of the rural population lacks access to banking services.\textsuperscript{102}

B. Current Financial Policy in Rural China

The few rural citizens fortunate enough to access banking services obtain them from one of two governmental agencies: the Agricultural Bank of China (ABC) and Rural Credit Cooperatives (RCCs).\textsuperscript{103} Out of China’s four largest banks, the ABC is the only one that significantly serves rural citizens.\textsuperscript{104} It primarily provides low-interest subsidization loans known as poverty alleviation loans.\textsuperscript{105} Poverty alleviation loans have not been profitable for the ABC and have been a major reason why it has accrued over $100 billion in debt.\textsuperscript{106} Since the Chinese government announced its plans for ABC to issue an initial public offering in the near future, the bank has been slowly transferring its resources from small-scale, rural ventures into large-scale industrial ventures to gain more profitability.\textsuperscript{107} As the ABC continues to commercialize and to shed its rural operations, an immense need for banking services

\begin{footnotesize}
\textsuperscript{100} See id.
\textsuperscript{102} See Microfinance Gateway, supra note 6.
\textsuperscript{103} See The Microfinance Gateway, Rural Credit Cooperatives in China, http://www.microfinancegateway.org/content/article/detail/28064 (last visited Nov. 18, 2007) [hereinafter, Rural Credit].
\textsuperscript{104} See id; see also McCullough, infra note 126, at 423 (describing how China’s banking industry is dominated by the “Big Four”).
\textsuperscript{105} See Rural Credit, supra note 103.
\textsuperscript{107} See id.
\end{footnotesize}
is being left behind in rural communities.\textsuperscript{108}

To help fill this void, the Chinese government has appointed RCCs as the chief means of delivering financial services to rural citizens.\textsuperscript{109} RCCs are a network of formal banking institutions similar to credit unions that concentrate on supplying rural communities with financial services.\textsuperscript{110} They were once a subunit of the ABC, but after 1996, they became independent institutions under the supervision of the PBC.\textsuperscript{111} Since separating from the ABC, the number of RCCs has grown to over 35,000, and they now account for approximately eighty-five percent of China’s agricultural loans.\textsuperscript{112} Like the ABC, RCCs have not been profitable in rural China\textsuperscript{113} because caps on interest rates have prohibited RCCs from compensating for the high operating costs in rural communities.\textsuperscript{114} As non-performing loans have mounted, RCCs have been forced to depend on the government subsidies.\textsuperscript{115} By 2001, forty-four percent of the loans issued by RCCs were non-performing and over a quarter of the RCC system was in such a financial crisis that the government had to bail them out.\textsuperscript{116} The inadequacy of both the ABC and the RCC system has left many Chinese policymakers calling for a more profit-driven approach.\textsuperscript{117}

\begin{thebibliography}{99}
\bibitem{108} See Microfinance Gateway, supra note 6.
\bibitem{109} See Rural Credit, supra note 103.
\bibitem{110} See id.
\bibitem{111} See id.
\bibitem{113} See Knowledge@wharton.com, supra note 1.
\bibitem{114} See id.
\bibitem{115} See Gale & Collender, supra note 112.
\bibitem{116} See id.
\bibitem{117} See, e.g., Cao, supra note 97, at 177 (stating that “Chinese provinces have become progressively less willing to expend precious funds to subsidize bankrupt state firms. The growth of markets and mounting pressures posed by competition have meant that government intervention through subsidies is no longer automatic. For example, Chinese provinces must now compete with one another for access to domestic and foreign capital. Since expenditures for subsidies means that less money will be available to finance profitable and invest-friendly ventures such as airports, telecommunications, and other necessary infrastructure projects, subsidies as a solution to inefficiency have progressively less appeal. The message to the state enterprises is, of course, to look to the market and not to the government for financial salvation.”).
\end{thebibliography}
C. China’s Shift Toward Profitability

The Chinese government recently has expressed an interest in adopting new microfinance initiatives.\footnote{Knowledge@Wharton, Can Rural Finance Take Root in China? About 750 People Hope So, Aug. 29, 2007, http://www.knowledgeatwharton.com.cn/index.cfm?fa=viewfeature&articleid=1699&languageid=1.} In 2006, President Hu Jintao recognized China’s wealth disparity and claimed that as China’s economy continues to grow, it needs “to repay its debt to the countryside.”\footnote{Id.} As part of the government’s focus on improving access to financial services in rural communities, the government has initiated pilot programs to experiment with different microfinance policies.\footnote{See id.} One such program experiments with permitting foreign banks to fully serve rural Chinese communities.\footnote{Id.} The experimental program’s goal is to make rural provinces more accessible for the commercial banking industry.\footnote{REUTERS, Citibank, Grameen Join China’s Rural Banking Pilot, Oct. 27, 2007, http://www.reuters.com/article/companyNewsAndPR/idUSPEK689820071023.} Hong Kong and Shanghai Banking Corporation (HSBC) recently became the first foreign bank to launch microfinance services in rural China\footnote{Id.} and other major banks are considering similar paths.\footnote{Id.} Just last quarter, Citibank, partnering with the Grameen Bank for technical support, agreed to participate in the pilot program and launch a rural branch.\footnote{See CHINACSR, Rural Banking Opens Opportunities for HSBC, Aug. 14, 2007, http://www.chinacsr.com/2007/08/14/1597-rural-banking-opens-opportunitiesfor-hsbc.}

D. Foreign Banks in China

Foreign banks have not always been able to freely operate branches in China. In the past, China’s “Big Four”—the Agricultural Bank of China, the Bank of China, the China Construction Bank, and the Industrial and Commercial Bank of
China—have dominated its banking sector. Now, the Chinese banking system also consists of policy banks, joint stock commercial banks, and urban and rural cooperatives to compliment the Big Four. These alternative banks offer specialized banking services to target citizens in specific geographical locations. Two Chinese regulatory entities hold the Big Four and policy banks accountable: the People's Bank of China (PBC) and the China Banking and Regulatory Commission (CBRC). The PBC mainly formulates monetary policy, whereas the CBRC mainly supervises China's banking system.

Until recently, the PBC and CBRC have tightly monitored China's banking system under a planned economic approach. Beginning in 2001, however, this trend changed because in exchange for admission to the World Trade Organization (WTO), China agreed to allow foreign banks unrestricted access to its banking industry by December 2006. This included the removal of "all 'non-prudential' restrictions on the banking sector, including ownership and operation restrictions." For the first time in history, foreign banks could establish extensive branch networks within China and serve Chinese citizens directly in Chinese renminbi.

Shortly after the WTO agreement in 2001, major investors saw equity investments as the safest approach to break into


127. See id.


129. See id.

130. See Rural Credit, supra note 103.


132. Id. at 338.

China's banking system and into the rest of China's economy.\(^\text{134}\) Across all industries in 2003 and 2004, China obtained $53.5 billion and $60.6 billion in foreign direct investment (FDI), respectively.\(^\text{135}\) To demonstrate the magnitude of China's FDI, India's FDI only reached $4.3 billion and $5.3 billion respectively over the same years.\(^\text{136}\) Notable foreign banks like Citigroup, HSBC, Bank of America, and Wachovia initially acquired equity interests in the Big Four rather than opening branches and having to decipher the PBC's and CBRC's complicated regulatory schemes.\(^\text{137}\) For instance, in 2003, Citibank acquired more than a five percent interest in the Shanghai Pudong Development Bank for $72 million with an option to increase its ownership stake to over twenty-four percent.\(^\text{138}\) Similarly, in 2005, Bank of America acquired a nine-percent interest in the Construction Bank of China.\(^\text{139}\) As 2006 approached and China gradually opened its doors on account of the WTO agreement, foreign banks began complimenting their equity investments with the establishment of bank branches.\(^\text{140}\) According to the CBRC, seventy-four foreign banks had established branches in China as of the end of 2006.\(^\text{141}\) By creating branch networks and investing heavily in Chinese banks, the major foreign banks are fighting for the best position to tap China's $1.3 trillion in savings and 1.3 billion people.\(^\text{142}\)

\(^{134}\) See id.

\(^{135}\) Id. The United States Business Council website notes that China's Ministry of Commerce stopped publishing the country's FDI in 2005. Id.


\(^{137}\) See Rural Credit, supra note 103.


\(^{139}\) The US-China Business Council, supra note 133.


VI. ENCOURAGING COMMERCIALIZATION OF MICROFINANCE THROUGH POLICY INCENTIVES IN THE POST-WTO ACCESSION AGREEMENT ERA

A. Assets of Commercial Banks

Although it may seem antithetical to imagine major foreign banks as a resource for poverty mitigation, they may actually provide China the best opportunity to meet its 900 million-person demand for financial services. Commercial banks possess distinct advantages in their ability to "reach down" to low-income communities and help the Chinese economy. They have established and streamlined management systems and, unlike the Chinese government, a history of expertise in market-driven economies. Commercial banks also possess significant capital that may be utilized without regard to overarching governmental policies. Despite China's gradual economic liberalization, communist ideologies still bind domestic policy. One reason for China's $900 billion in non-performing loans is that Chinese banks are still hindered by the government's social agenda. Consequently, government capital is inevitably susceptible to redistribution on account of public concerns like natural disasters, education, and national security. In contrast, foreign banks, free from the strictures of public policy concerns, could provide such a significant level of capital so as to liberate the Chinese government from paying millions of dollars worth of subsidies each year in rural China. A derived benefit of private funding is that the Chinese government could reallocate more of its resources to improve its financial infrastructure or to other pressing matters.

B. Incentives to Encourage Business in Rural China

In order for the Chinese government to capitalize on the

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143. See Jones, supra note 4, at 211.
144. See Silk & Malish, supra note 126, at 111-12.
145. See Gale & Collender, supra note 112.
146. See Silk & Malish, supra note 126, at 115-18.
potential benefits commercial banks could provide, it must ensure a greater prospect for profitability. To do so, the Chinese government must furnish incentives for commercial banks to make up for the reduction of profitability on account of the asymmetry in credit information, deficiency in collateral, and high transaction costs in rural China.\footnote{147} Two methods to lower these risks would be to establish a comprehensive credit information system and to permit commercial banks more leeway in setting interest rates.\footnote{148}

To narrow the asymmetry of information between banks and low-income borrowers, the Chinese government should establish a uniform credit information system consisting of comprehensive and updated information.\footnote{149} A collective database of pertinent borrower information would greatly benefit commercial banks because it would reduce the risk of lending to low-income borrowers without commercial banks having to expend any capital. Several countries with profitable track records in the microfinance industry have successfully implemented similar public databases.\footnote{150} For instance, the Mexican government created a network of financial institutions that allows the institutions to efficiently share credit information.\footnote{151} Crucial to the success of a credit information network is for the government to provide enough technology to readily disperse the information and to provide comprehensive reports. The more updated and transparent the information system, the more efficient commercial banks will be in using their resources in rural China.\footnote{152}

In addition to creating an information infrastructure in rural China, commercial banks must have more flexibility in

\footnote{147} See Miyashita, supra note 24, at 150; see also Knowledge@wharton.com, supra note 1 (stating that "the major bottleneck to the commercialization of microlending is the lack of policies to encourage involvement by commercial financial institutions, the failure to open the financial market to the private sector, artificially low interest rates and the lack of a legal environment").

\footnote{148} See Barr, supra note 18, at 288-90.

\footnote{149} See Alexandra O'Rourke, Article, Public-Private Partnerships: The Key to Sustainable Microfinance, 12 LAW & BUS. REV. AM. 179, 198 (2006).

\footnote{150} Id.

\footnote{151} See Jones, supra note 4, at 208.

\footnote{152} See id.
setting interest rates. As discussed above, interest rate caps have stifled profitability and led to millions of non-performing loans. Though the CBRC currently provides RCCs some leniency in setting interest rates higher, the interest rates are still not set high enough to generate a profit. The CBRC must find the equilibrium between cost-efficient interest rates and those rates that will not ostracize potential low-income borrowers. Other countries have implemented interest rate caps and have seen similar losses in profits. After the government established a cap on interest rates for MFIs in Nicaragua, the profitability of the average MFI fell from 30 percent to just over one percent. By contrast, banks in Indonesia have issued annual interest rates of over fifty percent without reducing its outreach. Even if MFIs have to charge higher interest rates, the rates are still significantly lower than alternative rates in the informal market. Flexibility in establishing interest rates forces competition among commercial banks and informal lenders, which may lead lenders to lower interest rates and create better products for low-income communities.

153. See Gale & Collender, supra note 112.
154. See Knowledge@wharton.com, supra note 1.
156. See Miyashita, supra note 24, at 159-60.
157. See O’Rourke, supra note 149, at 186 (noting that “in Bangladesh, the commercial APR is between 10 and 13 percent, the MFI APR is approximately 20 to 35 percent, and the informal sources APR is approximately 180 to 240 percent....[t]his example shows that while MFIs have to charge higher interest rates on average, they are significantly preferable to rates charged in the informal market”); see also Robinson, supra note 38, at 7 (stating that “[e]ven when real (inflation adjusted) interest rates are used and borrowers transaction costs are included, it is normally far less expensive to borrow from a commercial microfinance institution than from a local moneylender”).
158. See Robinson, supra note 38, at 7 (noting that “[c]ommercial microfinance institutions can also offer much in-demand savings services that provide savers with security, liquidity, and returns, a combination not generally available in the informal sector”).
VII. CONCLUSION

Despite China’s overall economic growth, a disparity in wealth continues to widen. China’s current policy-driven initiatives for offering low-income communities access to banking services have done little to lift rural citizens from poverty. The failing policies have also left the Chinese government with millions of non-performing loans. \(^{159}\) As foreign banks flock to China, the government needs to seize the opportunity to channel the resources that these banks possess into microfinance initiatives in rural communities. \(^{160}\) To do so, the Chinese government must reduce the costs and risks associated with doing business in rural China. \(^{161}\) The Chinese government must entice commercial banks, which are not known for their interest in serving low-income communities, with the prospect for greater profits. \(^{162}\) By building a nation-wide network of credit information and allowing flexibility in interest rates, the Chinese government will not only modernize its own banking system, but also bridge the financial gap between its rurally impoverished and its nouveau riche urban population.

J. WYATT KENDALL

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159. See supra Part V.
160. See supra Part VI.
161. See id.
162. See id.