Serving China’s Frontier Regions through Sustainable, Prudent Financial Inclusion

Responsible finance—the pragmatic way forward in the global microfinance community today—is helping IFC have an impact on its clients’ operations and bottom lines as well as influence the markets where they operate. Responsible finance brings the focus back to end clients and encourages financial institutions to build client-centric operating practices that support prudent and sustainable financial growth over the long term. This Smart Lesson uses recent projects in China to show how responsible finance is breaking new ground for IFC in microfinance, enhancing IFC’s relationships with its existing clients, and providing demonstration results to share with potential new clients, within microfinance and beyond.

Background

More than 600 million Chinese people have moved out of poverty over the past 30 years. From 1981 to 2008, the number of people living on the equivalent of $1.25 or less per day decreased from 835 million to 173 million. However, inequality—of income, consumption, assets, and opportunity—is increasing, with the gap between rural and urban populations wide and growing. And it is even starker at the bottom of the pyramid.

The Gini index, measuring income-distribution inequality, increased from near 0.30 in 1985 to about 0.47 in 2007—the most sustained increase in the world, placing China at the high end of income inequality among Asian countries. Although this increase has leveled off, thanks in part to more transfers of public resources to poor rural areas, other dimensions of inequality—such as asset ownership, particularly housing—continue to rise and are mirrored and exacerbated by large disparities in opportunities to access quality social services and social protection.

Chinese microfinance market has experienced explosive growth. Over 8,000 microcredit companies now provide more than $100 billion in loans to micro, small, and medium enterprises, and these numbers are constantly increasing. Yet the majority of China’s poorest, especially in rural and frontier regions, remain largely underserved, making the case for continued growth in the sector.

However, microfinance crises around the world have shown the often disastrous results of aggressive growth combined with diluted focus on end clients—demonstrating the need for consumer-centric practices. The Chinese financial market is establishing ground rules for responsible finance and consumer protection to manage this rapid growth, avoid market overheating, and avert future crises. For financial institutions to effectively serve lower-income populations and assure long-term sustainability, they must “build in” responsible lending practices.

A pioneer in responsible finance, IFC has worked with the Smart Campaign, since its inception in 2011, to pilot, test, and refine client-protection principles through IFC.
investees in India and Bosnia. IFC brought lessons learned from implementing those principles to the microfinance sector in China. To expand microfinance lending to China’s poor, IFC partnered with 13 microfinance institutions with investment and advisory services and international best practices. As of May 2014, IFC’s committed investment in China’s microfinance sector amounted to $266 million, reaching about 700,000 microfinance customers as a whole, including in frontier, rural, and remote areas, and incentivizing microfinance institutions to implement responsible-finance practices from the outset.

**Lessons Learned**

Among IFC’s partners in China, MicroCred Nanchong, CPFA (China Foundation for Poverty Alleviation) Microfinance, and Xinjiang Tianrong MCC (Micro Credit Company) are some of the fastest growing microfinance institutions operating in urban, rural, and frontier regions. Responsible finance is becoming a core part of their mission, vision, and way of doing business. The following are lessons learned through the work of these three microfinance institutions.

**MicroCred Nanchong: Leading the way toward greater client awareness**

ICF invested $2.9 million of equity in MicroCred Holding, a global microfinance holding company with subsidiaries in Madagascar, Senegal, Nigeria, and China. MicroCred Nanchong (MC Nanchong), one of two subsidiaries of MicroCred China, provides working-capital and investment-capital microloans (to purchase fixed assets) ranging from RMB 5,000 to RMB 75,000 (about $800 to $12,000) to microentrepreneurs in the frontier region of Nanchong.

Today, with IFC support on responsible finance, MC Nanchong is a pioneer in the field in implementing declining-interest-rate balance practices and offering pricing transparency and financial awareness to its clients. MC Nanchong trains staff to inform clients about all costs, fees, terms, and conditions prior to signing a loan. This responsible-finance program—reaching some 10,000 clients in Nanchong—is a first-of-its-kind client-centric financial-awareness activity on responsible pricing and transparency.

**Lesson 1a: Establish core responsible-finance standards as a management tool to inform decisions.**

MC Nanchong established core responsible-finance standards and indicators—such as percent of borrowers that never had a relationship with a financial institution before MicroCred and percent of borrowers with increased turnover in activity(ies) by 25 percent during the credit period—to track the impact of its products and services on end clients over time. Senior management uses this periodic analysis to 1) ensure that MC Nanchong is meeting its mission and vision; 2) understand the impact of microfinance loans for its end clients; and 3) make strategic decisions on modifying or offering new products and services to better serve its client base. Understanding which products and processes are most beneficial to clients increases MC Nanchong’s client base, laying the foundation for long-term institutional stability, profitability, and growth.

**Lesson 1b: Conduct a widespread transparency campaign for end clients to encourage responsible decisions and avoid overconsumption of credit and potential overindebtedness.**

MC Nanchong clients learn that the “flat” rate charges interest on the original loan amount, resulting in nearly double the cost of declining-balance interest. MC Nanchong also helps its clients understand the fees charged for microfinance loans from market providers. Because microfinance loans are short-term, fees of even 1 percent upfront can add double digits to the annual percentage rate. Understanding these elements allows clients to calculate and compare the true cost of using different loans. While Chinese regulation has not yet mandated this level of transparency, MC Nanchong has been a market leader in ensuring that clients have full information to make optimal decisions, thereby promoting personal financial well-being, institutional sustainability, and the health of the sector as a whole.

**Lesson 1c: Train staff on the client-centric mission and vision, and align staff incentives with client protection.**

MC Nanchong trains staff on the importance of responsible and transparent communication with clients at each stage of the product lifecycle—originations (in marketing materials and outreach), appraisal (on pricing, rights and responsibilities), and collections (treating clients fairly and respectfully). MC Nanchong also explains to staff the negative impact of nontransparent pricing on the whole microfinance sector. When prices are unclear, microfinance institutions are vulnerable to a domino effect, where 1) consumers don’t understand the full implications of products and take out too much credit; 2) market competition is hindered; 3) the prospect of high profits is a strong temptation for staff who, if incentivized by volume and growth targets alone, strive for high client acquisition; 4) clients struggle to repay and may become overindebted; 5) the institution’s reputation suffers when clients are in default, and efforts to recover the loan are perceived as aggressive collection practices; and 6) governments step in with stringent regulations and caps that curb microfinance institutions’ growth and profitability. MC Nanchong trains staff on its mission and vision—and the link between treating clients responsibly and long-term institutional sustainability. Staff incentives are also aligned with responsible practices and portfolio quality rather than growth targets alone.

**Lesson 1d: Build client protection into audit guidelines, and train auditors to monitor compliance and be alert to red flags, including through client interviews.**

MC Nanchong auditors are trained in client-protection principles and their importance to the MC mission and vision. In addition to regular audit procedures to validate consistency of data collected by loan officers and the use of loan proceeds, auditors check with clients to ensure that ethical and respectful

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collection practices are followed, that no items intended to meet a client's basic needs (beds, clothes, dishes, and so on) have been compromised because of the loan, and that clients have an opportunity to provide feedback and have their issues heard and resolved in a systematic way. Senior management directly reviews these audit reports to ensure that even remote branches are treating clients fairly and respectfully—avoiding risks inherent in institutional growth through locally based staff serving low-income communities in rural, remote, and diverse geographies.

Lesson 1e: Partner with local institutions to introduce microfinance as a career path and begin to build a cadre of trained, qualified resources for the sector.

One of the biggest challenges in the microfinance sector in China is a lack of local trained staff to move into operational and middle-management positions at microfinance institutions. To tackle this issue, MC Nanchong launched a microfinance module with Nanchong University to offer students an overview of the microfinance sector, business model, implementation challenges, and operational realities in the field. As part of the program, students follow senior MC Nanchong loan officers as they conduct client appraisals and interact with clients, providing practical know-how on working with low-income, vulnerable communities. The pilot, which was well-received by students and university staff and piqued interest in the microfinance sector, is being formalized as a paid course at the university.

Learning about the intricacies of offering microfinance to low-income vulnerable communities in China has inspired a potential new career path.

—Student, Nanchong University

CFPA Microfinance: Influencing the microfinance sector through sustainable, responsible growth

The China Foundation for Poverty Alleviation, established as a nongovernmental organization (NGO) in 1989, started microfinance operations in 1996. With advisory and financial support from IFC, it transformed from an NGO to a competitive and commercially sustainable microfinance institution, emerging as a market leader in the provision of microfinance and nonfinancial services to some of the poorest rural households in China. CFPA has experienced strong growth and today is the microfinance institution with the largest outreach in China, working in rural parts of over 107 counties in 16 provinces—80 percent of the country’s poorest counties. It has over 200,000 clients, with a $230 million portfolio and PAR > 30 (portfolio at risk greater than 30 days) at less than 1 percent.³

Lesson 2a: Deliver investment jointly with performance-based advisory services to achieve a multiplier effect toward greater financial inclusion.

In 2005–2006, when microfinance was first formally launched by China’s central bank, stakeholders were not convinced that a microfinance institution could achieve commercial sustainability. In China, microfinance institutions were nascent and lacked technical experience and know-how on microfinance. In early 2008, IFC organized a visit by CFPA senior management to several microfinance institutions in neighboring Cambodia, including ACLEDA, CEB, Prasac, and Amret. Particularly impressed with the successful transformation of ACLEDA from an NGO into a commercial bank, CFPA management decided to transform into a commercial microfinance institution.

Also in 2008, CFPA co-sponsored a workshop with IFC on “microfinance NGO transformation” for field staff and local government, to gain buy-in for the transformation. IFC staff also worked with the board to introduce international best practices and influence a responsible, sustainable approach for the microfinance institution. IFC’s microfinance specialists helped the company build core processes, such as credit and risk management, for long-term institutional sustainability.

After the successful transformation, IFC made an equity investment in CFPA of about $5.80 million in 2010 and subsequently participated with the first and second capital increases of the company, for a total equity investment of about $15.65 million (19.2 percent of shares). In 2013, IFC also approved a $20 million loan to CFPA, which is successfully serving some of the poorest, most vulnerable rural populations as a market-based institution.

Lesson 2b: Introduce responsible finance at a nascent stage to build client protection into the DNA of an institution.

As part of the performance-based advisory services, IFC introduced responsible finance to CFPA and encouraged it to formalize responsible lending principles in its people, policies, procedures, and practices. Today, in addition to financial viability and performance, CFPA remains committed to responsible finance and poverty outreach with its rural, poor clients. The average loan outstanding is RMB 7000 ($1,200), one of lowest of microfinance institutions in China. Of its clients, 93 percent are women, 89 percent previously had no access to formal banking services, and 21 percent are ethnic minorities.

CFPA, which positions itself as a socially responsible enterprise dedicated to providing microcredit in poverty-stricken rural areas of China, developed a three-year (2012–2014) strategic plan on social performance and set up a social performance committee to supervise and monitor it. CFPA reports its social indicators to MIX Market and was one of the earliest microfinance institutions in China to endorse the Smart Campaign. It also communicates responsible-finance practices with staff and clients through training and broad-based financial awareness and has developed a standard procedure to effectively handle customer complaints. CFPA continues to improve its client-protection practices and is one of the few microfinance institutions in China that conducts an annual customer-satisfaction survey of its clients.
CFPA’s solid financial and social performance has positioned it to 1) become one of the microfinance institutions in China with highest leverage (its total borrowing from commercial banks is about three-times its equity value); 2) access privileged interest rates from commercial banks; 3) achieve strong client and staff loyalty; 4) increase productivity through loan officers (from 205 in 2009 to 255 in 2013); 5) attain success and recognition locally and globally through numerous awards, including the Best Performer in Responsible Finance in 2013; and 6) act as a key influencing stakeholder across the broader microfinance sector in China.

**Lesson 2c: Introduce good practices and share results—for a vibrant demonstration effect.**

CFPA Microfinance has been active in policy advocacy with government authorities and shared its experiences with other microfinance institutions, resulting in a strong demonstration effect. With IFC support, it launched a series of knowledge products for the sector on such topics as 1) the need for a sound regulatory environment on microfinance; 2) the difference between microfinance and SME lending; 3) international best practices on microfinance; and 4) CFPA’s own responsible-finance practices.

**Xinjiang Tianrong MCC: Banking at the frontier**

**Lesson 3: Leverage existing microfinance good practices—through knowledge sharing and successful South-South investments—to contribute toward developing the whole sector.**

Xinjiang is one of the most sparsely populated frontier regions in China and home to 47 ethnic minority groups. Although the region plays an important economic role in connecting China with Europe, its GDP per person is 20 percent lower than the country’s average. In 2012, to enhance financial inclusion in Xinjiang, IFC partnered with XacBank, a successful microfinance bank in Mongolia, and invested $1.6 million to set up the greenfield microfinance institution, Xinjiang Tianrong MCC.

Along with the investment, IFC provided performance-based advisory support to develop the institution and embed responsible-finance principles into its mission and operations from inception. In May 2013, Xinjiang MCC management visited CFPA to learn from the earlier advisory support provided to CFPA and its current microfinance practices. As part of the project, Xinjiang MCC also developed and submitted its long-term responsible-finance strategy to IFC in December 2013. At that time, its loan portfolio included 562 loans totaling $6.5 million, double the projections for its first full year of microfinance operations. It completed its first two years of operations in September 2014.

Today, Xinjiang Tianrong MCC has successfully integrated responsible-finance and client-protection principles into its operations, expanded its branch network from three to four offices, and served some of the most remote, vulnerable, low-income communities in China. It is creating new opportunities for those previously without access to finance—in a responsible, transparent way.

**Conclusion**

The experiences and lessons learned from MC Nanchong in China are being documented for implementation across MicroCred’s entire operations in other subsidiaries in Africa and Asia. **CFPA Microfinance** has a stable senior management team, the majority of whom joined before its commercial transformation. Its NGO background and commitment to responsible finance and client impact has allowed CFPA to mature into a large, commercial, self-sustainable institution with a strong reputation. To demonstrate its commitment to responsible finance, **Xinjiang Tianrong MCC** has appointed a social and environmental manager/coordinator. It also has plans to establish a responsible-finance working group, under which a monitoring team and an implementation team will be set up to integrate responsible finance throughout the organization, building a quality institution to serve one of China’s poorest rural areas.