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Social-enterprise-oriented Innovative Mode of Rural Micro-finance

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Abstract The rural micro-financial innovation is necessary because the traditional regular financial institutions can not satisfy peasant households' demand of small-sum (or petty) loan and the support of present small-sum loan companies is limited for rural financial development. Taking Fuping Petty Loan Company as an example, we analyzed characteristics, reasonableness and continuity of social enterprise type peasant household petty loan mode. It is believed that this mode has enormous vitality in rural areas and has great promotion value. Petty loan companies have both internal and external shortages in their current development. We put forward countermeasures and suggestions for rural micro-financial innovation from legal status confirmation, fund supply and loan product innovation.

Key words Social enterprises, Peasant household petty loan, Micro-financial innovation, Agricultural associations

1 Necessity of rural micro-financial innovation

1.1 Traditional regular financial institutions can not satisfy peasant households' demand of petty loan At present, peasant households can obtain petty loan from rural financial institutions, petty loan companies and international organizations, of which the petty loan promoted by regular financial institutions is the largest in terms of coverage and amount^[1]. However, since the credit investigation system is still not established in rural areas, it is difficult for farmers to provide credit and repayment ability proof. What's worse, farmers have no assets to mortgage and no person to provide guarantee, thus they have been excluded from regular financial service^[2]. Besides, some financial institutions, rural credit cooperatives for instance, have assessed credit households and issued loan note, but due to lack of fund and difficulty in knowing loan demand and seizing loan opportunity, peasant households still can not get loan. In 2008, among the whole 31 regions of China, rural financial institutions in only 9 regions (Shandong, Jiangsu, Zhejiang, Fujian, Henan, Inner Mongolia, Yunnan, Guizhou and Ningxia) have the loan-to-deposit ratio higher than 50%, most have the ratio about 40%^[3]. Generally, the loan-to-deposit ratio should not be lower than 50%. In other words, at least 50% of deposit should be converted into loan. This is the break even point of banks. Once the loan-to-deposit ratio is below 50%, losses may happen. Compared with rural areas, urban banks have lending impulse, and the loan-to-deposit ratio repeatedly gets close to or exceeds red line of supervision, some even exceed 130%.

1.2 The support of present petty loan companies is limited for rural financial development According to provisions

of *Guiding Opinions on the Pilot Operation of Small-sum Loan Companies*, a small-sum loan company shall be a limited liability company or a company limited by shares which is established with investments from natural persons, legal-person enterprises or other social organizations, does not absorb the public deposits and operates small-sum loan business. Small-sum loan companies can finance less than 50% of capital to two banks for granting loans. At present, small-sum loan companies are determined as general business enterprises, rather than financial institutions. The loan objects show that customers of small-sum loan companies are widely distributed in every industry, such as farmers' economic cooperatives, agricultural product deep processing enterprise, production and processing industry, service industry, logistic enterprises, civil servants, and self-employed individuals. The most outstanding feature of petty loan companies is short credit period, small sum and rapid handling speed. They mainly investigate actual operating conditions of enterprises and personal credit. Thanks to comprehensive information, petty loan companies have higher risk control ability than commercial banks. Besides, these companies adopt "Loan-Only Bank" mode, which reduces financial risk. Nevertheless, a survey indicates that large sum loan demand of rural households increases, so the present upper limit (5 000 yuan) of small sum loan gradually can not satisfy the demand. What's worse, the "Group Lending" has great difficulty and complex procedure in rural areas, and the recent several years of development indicates that it can only satisfy about 10% demand. In June of 2009, China Banking Regulatory Commission issued the *Interim Provisions on Restructuring Small-sum Loan Companies into Village Banks*, allowing qualified small-sum loan companies to be restructured into village banks. The original intention of this policy is to encourage small-sum loan companies to be turned into banks, and promote development of rural finance. However, after restructure, two unfavorable conditions may occur. One is blood drawing from rural areas^[4], and the other is improper management due

to sparing loan. Therefore, further exploring new mode of small-sum loan is of great significance.

2 Analysis on social enterprise type peasant household small-sum loan mode: A case study of Fuping Petty Loan Company

2.1 Pilot project of new peasant household small-sum loan mode

In 1993, economist Mao Yushi and Dr. Tang Min launched small-sum loan experiment at 500 yuan in Longtou Village, Tuanshitou Town of Linxian County, Luliang City of Shanxi Province. In March of 2003, they set up Fuping Vocational Training School (hereafter referred to as Fuping School), which is specially engaged in training domestic servants. From 2006, Fuping School started cooperating with Puzhou Township Fruit Association of Yongji City of Shanxi Province in small-sum loan service project oriented towards farmers. This project is free of mortgage and guarantee, and the single sum amount is up to 20 000 yuan. By 2009, this project has granted 1 687 loans, total loan amount close to 7 million yuan, benefiting over 1 000 peasant households. In May of 2009, Beijing Fuping Venture Capital Investment Company (founded by Fuping School) registered Yongji City Fuping Petty Loan Limited Company (hereafter referred to as Fuping Petty Loan Company) jointly with Beijing Property and Credit Limited Company and three natural persons, with registered capital of 30 million yuan. According to data issued by Fuping Petty Loan Company, by May 31, 2010, it totally granted 2 017 loans, with total loan amount up to 31.05 million yuan, totally recovered 517 loans with amount of 5.95 million yuan. Different from any successful mode in any other country, this loan mode is developed from rural practice according to actual Chinese conditions. It features high feasibility and reasonableness.

2.2 Analysis on innovation points of loan mode of Fuping Petty Loan Company

2.2.1 New rural micro-financial mode "Social Enterprise". The contribution of "the third type" economic activities to socio-economy is more and more obvious. This type of activities neither belongs to private departments, nor belongs to public sector, it is a brand-new type. In most developed countries, "the third type" organizations mainly include three types. Firstly, cooperative type enterprises, such as various agricultural cooperatives, rural credit cooperatives, insurance cooperatives, retail cooperatives, etc. Secondly, mutual association type organization, established for mutual assistance, for example, the community insurance system established for satisfying demand of local community. In some underdeveloped countries, such organization has become major part of social security system. Thirdly, association type organization, mainly providing services for specific associations, including advocacy organizations (like Green Peace Organization) and foundations (Institute for Philanthropy, for instance).

Activities of social enterprises belong to "the third type" economic activities. Social enterprises are originated from socio-economic and non-profit making sectors. They are not the further development of socio-economic and non-profit making

sectors, but incorporate a new social entrepreneur spirit. In these organizations, elements and characteristics of enterprises are significant. In general, organizations with following characteristics can be deemed as social enterprises: having a continued and definite objective to benefit the community; set up by a group of citizens and the founders bear all or part of risks; limited profit distribution; decision-making power not based on capital ownership; and some employees with pay. Fuping Petty Loan Company is, in fact, a social enterprise, because it has significant characteristics of social enterprises.

2.2.1.1 Having a continued and definite objective to benefit the community: granting small-sum loan. Credit demand of peasant households is mainly production input and consumption credit. At different stages of agricultural production, peasant households have different demands, and their production input and the demand and time for capital are also different. Rural residents, particularly poor people, have no saving capacity, thus there are serious shortage of capital in rural areas. Similarly, line and time of consumption credit show great uncertainty. If using government credit subsidy or low interest rate to support, it may lead to risks, such as corruption, rent-seeking, and not repaying the loan. Based on theory of incomplete competition, small-sum credit theory encourages overcoming information asymmetry and vacancy of mortgage through incentive mechanism, such as joint guarantee mechanism, mutual aid and cooperation, and mutual supervision of borrower; and small-sum credit institutions usually can realize win-win of self-sustainability and poverty reduction^[5]. In China, small-sum loan has a considerable demand. Most peasant households have such demand. According to the above mentioned theories and practical experience, small-sum credit institutions will have broad development prospect in rural areas of China. Fuping Petty Loan Company, based on local actual conditions and developed from Fuping School, goes with the development trend of rural micro-finance.

2.2.1.2 Set up by a group of citizens; not for making profit. For a long time, the weak support for rural credit is mainly manifested in sparing loan of financial institutions (including commercial banks and rural credit cooperatives) for peasant households, mainly because farmers have no guaranteed mortgage, agricultural investment has high risk, and the interest rate is still under the government control. Therefore, if the prospective borrower can be selected, financial institutions will be inclined to grant loan to large enterprises at lower transaction cost. In this situation, purely commercial organizations fail to effectively support rural credit at the present time. In contrast, social enterprise type small-sum loan companies can make up for this shortage with their feature of public welfare. Fuping Petty Loan Company is a company set up by Beijing Fuping School in cooperation with some social investors. It takes root and headquarters in rural areas. Small-sum loan companies can not attract deposits, and their capitals mainly come from paid-up capital of shareholders, borrowed money of investors, funds raised by other financial institutions, and some donations. The congenital conditions of small-sum loan companies determine that

their ultimate objective is not maximizing profit, but helping disadvantaged groups to realize ideals of life, and establishing a credible society. Since their objective is not to maximize profit, it is able to avoid the phenomenon of sparing loan. Furthermore, because the enterprise founders have to bear all or part of risks, managers should make effort to obtain proper commercial borrowing profit to realize continuous growth of the organization, and shareholders not sharing dividends of profits guarantee the continuity of organization. In sum, Yongji Fuping has set up a new small-sum loan mode, which can truly make the micro-financial service comprehensively promote growth of rural areas and form new harmonious countryside. This mode is different from successful case in Bangladesh, but more suitable for Chinese rural areas.

Besides, profit distribution of Yongji Fuping is limited. Some employees are paid, while some are volunteers. The above analyses indicate that social enterprise is a brand-new mode of rural micro-finance.

2.2.2 Organic integration of capital supply and demand thanks to close cooperation with local agricultural associations. Vitality of Fuping Petty Loan Company lies in its close cooperation with local associations and energetically supporting local economic development. In 2004, Puzhou Nongping Yijin Association of Yongji City was formally incorporated. From 2007, it changed its name to be Fruit Association. During 2006 to 2008, Fuping School provided small-sum loan service for Nongping Yijin through projects all the time. This service is free of mortgage and guarantee, and single loan amount up to 20 000 yuan. From 2006 to 2009, it granted 1 687 loans, with total loan amount close to 7 million yuan, and over 1 000 families were benefited. Puzhou Fruit Association presently contains over 3 000 members, 40 cooperatives, each of which have five councils. In the first year, each cooperative is controlled within 20 households, to avoid too rapid growth. 40 cooperatives form an association, 40 directors form the council, and the council takes charge the overall growth direction and mutual supervision. This is completely different from Bangladesh small-sum loan modes. Many people take for granted that the countryside is an acquaintance society and cross-guarantee is very easy. In fact, it is difficult to find 4 guarantors in rural areas. Besides, many Bangladesh poor people depend on handicraft industry and circulation industry, so they have cash at hand, and it is possible to repay loan weekly. In contrast, Yongji City is an agricultural region, after sowing wheat, farmers have to wait till autumn, so it is hard to repay the loan weekly. Fuping Company closely combines these two characteristics of local agricultural production, uses institutional design and financial product design principle, and provides reasonable repayment method, greatly satisfying demands of peasant households and produced remarkable effect. Heather *et al.* analyzed the earliest and largest bank, Khushhali Bank, launched small-sum finance in Pakistan. They found that although small-sum loan improved food consumption of peasant households, raised probability of rural children to participate in medical insurance, increased survival rate of children, its contribution to growth of production in-

come of peasant households is still minor^[6]. Special operating style of Fuping Petty Loan Company well covers shortage of Khushhali Bank, and is worth learning by other countries.

2.2.3 Proper institutional design raised the repayment rate of peasant households.

2.2.3.1 Local loan officers can solve the problem of information asymmetry. Backbones of present small-sum loan companies are basically activists cultivated by the Fruit Association. Local credit officers reduce lending risk, because it is easy to get credit information of fellow villagers. It obtains the borrower's information through affiliation and geographical relationship of capital supply and demand parties, and establishes performance mechanism of contract combined self-implemented reputation mechanism and collective punishment mechanism. These effectively reduce transaction cost with the aid of trust and cooperative mechanism generated from repetitive game transaction.

2.2.3.2 It grants loan to association members to drive the borrower to repay the loan. From the viewpoint of financing contract design, due to existence of moral risk and limited liability, to encourage borrowers to repay the loan, borrowers have to bear limited liability rent, which increases requirement for mortgage^[7]. Organization is the initial mechanism for improving financing condition and reducing limited liability rent. In addition, central problem of micro-finance is to design a proper mechanism that can drive borrowers to repay their loan. Group lending realizes rise of repayment rate through establishing a driving mechanism. Group lending refers to a type of loan, in which three or more peasant households form a group and each group member bears joint liability. Many researchers state that the difference between strategic default of group lending and individual loan indicates that unless group members form great social constraint and consequently form the peer pressure, the default of group lending will be higher than individual loan. Group lending has following features: forming a group is the precondition for peasant households to obtain loan; every member can obtain loan; each group member bears joint liability; peer pressure transaction cost is substantially reduced. These are major functions of group lending. Mutual guarantee of members greatly reduces possible losses of banks, and actually forms "mortgage" function. In the group lending, advantage of group action brings about availability of future loan, then it is necessary to repay the loan in time^[8]. Fuping mode has no clear requirement of group lending, but since the prospective borrowers belong to the same agricultural association, in other words, there is a reasonable organization, so it can be said that a group lending relationship has been actually formed between peasant households. It can reduce the limited liability rent, and borrowers have motive to repay their loan. Besides, Fuping small-sum loan is oriented towards local peasant households with family as unit. That is to say, to obtain loan, peasant households have to apply in the name of a couple or a whole family. Under appropriate internal pressure of family, farmers' loan action will become more rational and more cautious in using loans.

2.2.4 Higher interest rate resolves problem of insufficient support of rural credit. When analyzing related problems of small-sum loan, some scholars assume that the interest rate at Chinese credit market is not market-oriented yet, and farmers' loan action is basically not influenced by market interest rate^[9], so the rural credit support is usually insufficient. According to provisions of China Banking Regulatory Commission, the interest rate of small-sum loan companies should not be higher than 4 times the bench mark of loan interest rate of the corresponding period, which in fact provides a greater floating space for small-sum loan and is favorable for credit of peasant households. The annual interest rate of Fuping Petty Loan Company is 21%, close to the upper limit. Data from the New York Times indicates that the average interest rate of small-sum loan in Mexico is 70%, while the global average interest rate is 37%. Several experimental zones of small-sum loan in China show that the approximate interest rate of 20% is feasible. In Yongji City of Shanxi Province where Fuping Petty Loan Company is situated, farmers' rate of return is in the range of 100% to 150%, so the annual interest rate of 21% should be feasible compared with production. Take a peasant household who contracted 26.67 hm² land to plant corn, if he fails to obtain loan of 20 000 yuan to apply chemical fertilizer, there will be drop of yield in every hectare, equivalent to 3 600 yuan. If he obtains the 20 000 yuan, he will obtain extraneous income of 80 000 to 90 000 yuan. Using such extraneous income to repay 24 000 principal and interest is completely affordable, because there is still 50 000 to 60 000 yuan surplus.

Establishment of Fuping Petty Loan Company not only has reasonable theoretic foundation, but also has remarkable effect in practice. Thus, it can be said that such small-sum loan mode has vigorous vitality in rural areas. However, the strong and sturdy growth of small-sum loan companies is also restricted by some internal and external conditions, and requires some relevant parties to take effective measures.

3 Countermeasures and suggestions for rural micro-financial innovation based on the level of small-sum loan companies

3.1 Making clear legal status of small-sum loan institutions at macroscopic level Without independent small-sum credit laws, there will be no standard for small-sum credit business, and the supervision and management of small-sum credit business will lack corresponding criterion. On one hand, the state should base on reality of rapid development of small-sum loan company pilot work, to study the legislation of small-sum loan companies, make clear their legal status, and let them to enjoy equivalent treatment with the regular financial institutions in financial right safeguarding and tax preference, to ensure lawful rights and interests of small-sum loan companies. In *Several Opinions of the State Council on Encouraging and Guiding the Healthy Development of Private Investment*, it encourages introduction of private capital into financial service fields, and implements financial subsidy for agriculture-related businesses of small-sum loan companies, but small-sum loan companies fail to enjoy such preferential tax policy all the time. On the other hand, it is required to make clear legal obligations of small-sum loan companies and actively implement provisions

of supervision of legal authorities. Branch offices of the People's Bank of China should follow up and monitor interest rate and fund flow of small-sum loan companies, and incorporate small-sum loan companies into credit investigation system. Small-sum loan companies should submit business information of borrowers, loan amount, loan guarantee and loan repayment to credit investigation system of branch offices of the People's Bank of China and information dynamic monitoring system of government's finance office on a regular basis. In addition, considering the essential difference between small-sum loan and general commercial banking business, it is required to distinguish them through small-sum credit method, determine the purpose, form, interest rate implementation method, and provisions of loan and repayment, so as to promote healthy development of small-sum loan companies.

3.2 "Social enterprise" type small-sum loan companies should actively explore new effective supply mechanism for small-sum loan fund

To realize sustainable development, small-sum loan companies should have certain scale and coverage rate, but this is often restricted by subsequent fund source, and it is also one of the major factors limiting development of Chinese small-sum loan institutions. Although "loan only without deposit" is an important measure of supervision authority to control risk of small-sum loan and save supervision cost, there are also other positive motivation mechanism that can expand fund sources for small-sum loan institutions. For example, increase the financing proportion of those small-sum loan institutions that have better operation performance and high internal management level. It is possible to allow their financing proportion not to exceed 1.5 to 3 times the capital owned, and strengthen their lending capacity according to their operating conditions. Besides, it is also practical to explore organic integration mode of social public welfare fund and small-sum loan institutions, enhance public welfare feature of small-sum loan institutions, and increase the support of social public welfare fund to rural development.

3.3 Actively exploring new types of small-sum loan It is proposed to explore new types of small-sum loan suitable for both rural and urban areas according to features of different demands of urban and rural residents, such as local culture, age structure and cultural quality, etc. Application method, handling procedure and product design should be oriented towards credit demand of peasant households as much as possible. It is preferred to work out different financing methods according to particularity and periodicity of agricultural production and the difference of different production stages in size and period of fund. Besides, it is proposed to introduce different financial service products and expand channels of credit fund for supporting agriculture, countryside and farmers. For example, allow those small-sum loan companies with better operation performance and higher internal control level to carry out interbank lending according to fund liquidity, and effectively utilize idle fund through fund procurement. Also, it is required to properly design payback period, reloan condition and interest rate for peasant households. Through derivation of mathematic and physical model, Gwendolyn states that proper punishment may force borrowers to make repayment in time, but it is required to design a proper payback period to urge borrowers to make repayment. This period should not be too short. In special case,

it allows to exempt from punishment. Besides, even if there is negative fluctuation of economy, it is not proper to refuse to grant loan again to borrowers, otherwise, they may fail to make repayment^[10]. Research and development of the above types of small-sum loan can not do without participation of financial talents. Small-sum loan companies take root in rural areas, thus most of their management personnel come from local backbones, so it is proposed to carry out various trainings to improve financial quality of their employees. Finally, small-sum loan companies can select volunteers who have financial background to lift operating capability.

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2.3 Market positioning of rural credit union From the positioning of the business areas, it is appropriate to develop rural credit union in economically backward and poverty-stricken areas, relatively isolated remote areas. From the positioning of customers, the main service target of rural credit union should be focused on farmers and micro-enterprises, especially the impoverished households^[6]. From the product positioning, it mainly provides the business of deposits, loans, and settlement for members. At the same time, it should actively carry out business consulting services for members and micro-enterprises, to help members alleviate poverty, increase income and promote the development of micro-enterprises in rural areas.

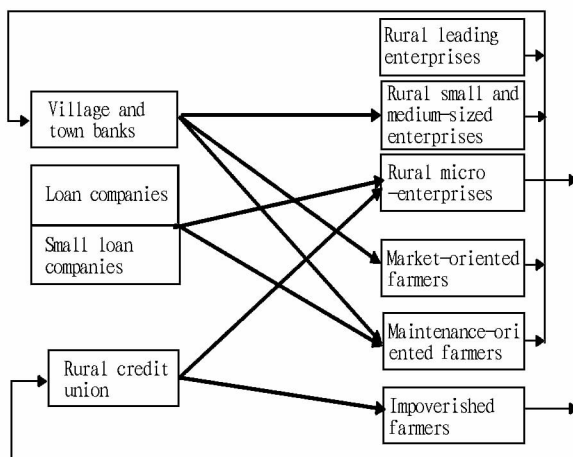


Fig.1 Customer positioning model of new rural financial organizations

3 Conclusions

The market need subjects of rural finance mainly include farmers and rural enterprises, with great differences in the

content of economic activities and production scale, therefore, different types of financial need subject have the characteristics of diversity and hierarchy in terms of financial needs, thereby needing different types of credit pattern and credit mechanism for satisfaction.

On the basis of fully understanding the characteristics of the rural financial market needs, we put forth the market positioning of advantage complementation and differentiated development between new rural financial organizations, which not only protects the "providing services for agriculture" business objective of new rural financial organizations, but also effectively avoids the vicious competition between the various organizations. The reasonable positioning of new rural financial organizations plays an active role in promoting the establishment of multi-level and multi-structure rural financial system, improving efficiency in the use of financial resources, and achieving incremental reform and competition pattern of the rural financial system.

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