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An Exploration of the Characteristic of Small Loan Companies in the Chinese Credit Market

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Abstract: The small loan company is an emergent novelty for the Chinese credit market. The basic function of it is the financial intermediary which provides important services to some private sectors of the China economy. But as a new-born business, there are no systematic research on it and lack of effective supervision as well. This study investigates the features of financial service constitution, time distribution, risk management and earning capacity of small loan company. The results indicate it will continue to play an important role in China credit-system.

Key words: Characteristic; Small loan companies; Chinese credit market

1. INTRODUCTION

The traditional China credit-system is usual in consisting of large banks. Various SMEs (Small and Medium-sized Enterprises) lack of finance have constantly happened in this kind of domestic financial environments, which attributes to the deficiency of small credit for the large commercial banks. This traditional banking structure resulted largely from the legal framework that, in the past, led to the concentration of banking power in large-amount loan they serve. Over time, with change of financial environment and legal framework, more and more smaller loan companies have come into existence engaged in many regions. They provide small-amount loan services to their customers not only rely on financial information and model, but also on the basis of non-financial information, such as understanding of business conditions and profit model.

While small loan companies have market value in the China credit-system, some scholars have questioned whether they play an efficiently important role in the market economy. Policymakers and researchers not only view small loan companies as being far different from large commercial banks but also make different risk supervision. For example, up by the end of 2009, Zhejiang province a total of 105 small loan companies, loans that year reached 55.17 billion Yuan, more than 50,000 SMEs will benefit the province with the farmers. The small loan companies, the average ratio of household loans 18.6%, far higher than the national commercial bank loans accounting for 3.4% of households, the average level; support rural credit and SMEs loans accounting for 53.0%. But in the mean time, many regulators argue against the long-term success of small loan companies: lack of efficient risk-management which include loss loan provisioning and capital adequacy; excessive concentration of credit risk in narrow and small region.

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On the other hand, there are many factors why small loan companies are flourishing in China. First, facing the market competitive pressures, the small loan companies have made tremendous efforts to reweave a social safety net with Chinese characteristics. Native linkage and blood relationship are remedy actions of limitations on risk-management technology investment. Second, small loan company managers seem to examine and approve loan quickly than managers of larger banks. The shareholders of small loan companies allow giving more decision-making authority to managers, which further allows rapid decision of commercial credit. Third, in order to guide actively the participation of folk capital, Chinese government enacts the related decrees and laws. Regulators advances allow small loan companies to receive quadruple benchmark credit interest than large banks, attracting and encouraging huge amounts of folk capital into growth financial markets. The recent availability of relatively low-cost folk capital advances as a funding source has reduced capital constraints.

This paper examines the role of small loan companies in the China credit-system. The first section of the article gives the definition and distribution of small loan companies by capital scale. The second section discusses the service constitution, personal operation loans will continue to play an important role in total credit activities and aggregates, even as market conditions change. The time distribution of various loans in small loan companies is discussed in the third section. It concludes that short-term loans (loan period less than one year account for the vast majority of credit services. The next section describes the credit risk mitigation techniques (CRMT) as an effective tool for managers to make sure the safety of the small credit. Finally, we analyses the high credit interest rate level and strong earning capacity which will impose rising fees on borrowers. The study is conducted using data collected via Shanghai Small Loan Companies Association and the database of the People's Bank of China.

2. DEFINITION OF SMALL LOAN COMPANIES

There is no single definition of small loan company. However, most researchers think of small loan companies as having three key characteristics—they can’t attract deposit, they do most of loans in the area in which they are located, and they are small in size. Because size is easy to measure, most researchers define small loan companies as those below a certain capital scale.

We also adopt this approach, defining small loan company solely in terms of capital scale. It is important to note, in China, some bonding companies also provide small-amount loan services to their customers but lack of legitimacy. Similarly, some pawnshops that focus on capital financing may not qualify as small loan company because they don’t face legal capital constraint.

For above reasons, a small loan company is defined as a financial institution owned registered capital with no less than 5 million Yuan, it make loans but can't attract deposit in the urban. This definition is also used by China Banking Regulatory Commission.

Applying the above definition to the data, there were 1,924 small loan companies on June 2010. The total quantity of small credit reached 186 billion Yuan. Almost half of all small loan companies belong to organizations under 10 million Yuan in capital scale. The most important group of small loan companies are those middle capital scale category—which owned registered capital between ￥10 million to ￥100 million in size. These companies account for over half of all small credit scales and represent 69.4% of all small loan companies (Table 1).

Table 1: Distribution of Small Loan Companies by Capital Scale

Capital scale	Number	Percent of all small loan companies	Percent of all small credit scales
< ￥10 M	568	29.5	14.6
￥10 M to ￥100M	1,010	52.5	69.1
>￥100M	346	18.0	16.3
All	1,924	100.0	100.0

Source: Yearbook of Shanghai Small Loan Companies Association (2010)

3. SERVICE CONSTITUTION

Personal operation loans account for a very large share of all small loan companies of total credit activity. As shown in Table 2, personal operation loans represented 34 percent of all credit activities and 41 percent of credit aggregates at the end of 2010. In contrast, SMEs loans accounted for 22 percent of all credit activities, 25 percent of credit aggregates. The reason SMEs loans hold a smaller proportion than of personal operation loans is that small loan companies have the apparent preference for the latter.

Some managers argue small-sized firms fail to obtain loans because business life is too short to record credit history. While the business owners have personal reputation and credit records which means relatively easy in business lending. Small loan companies have become adept at collecting massive amounts of information about lenders' financial condition and efficiently to give credit decision-making. In addition, given the high rate of business bankruptcies among SMEs, there will always be some businesses projects cannot pass a credit-scoring test because the firms have too few assets to offer as collateral. On the contrary, individuals have longer credit lifetime and more unlimited joint and several liabilities. The personal borrowers are supposed to bear unlimited liability for its obligation if there exists casual relation between the illegal conducts of the actual enterprise applying for the small loans in their own name and discharging the claimant's obligatory right, the personal borrowers should also bear unlimited joint and several liability.

The periodic financing requirement on small businesses and personal loans may increase the need for small loan companies to make capital call market. In this market, fellow-trader can exchange applicant's prospects information and to swap loans through interbank offered contact. If so, interbank offered credit' comparative important in total credit activities and aggregates may increase.

Table 2: Service Constitution (2010)

Loan Service	**Proportion in Total Credit Activities**	**Proportion in Total Credit Aggregates**
Personal operation loans	34.4%	41.2%
SMEs loans	22.0%	25.7%
Personal consumption loans	17.2%	8.4%
Interbank offered credit	14.7%	17.2%
Other category loans	11.7%	7.5%

4. TIME DISTRIBUTION OF VARIOUS LOANS

As an emerging thing in recent three years, small loan company's account for a relatively small share of the total quantity of loan in the China credit-system, they remain highly important in short-term small loan. Large community banks and small loan companies face the segmented loan-supply markets: large community banks refer to the long-term and project loans claimed by the large business, while small ones have competitive advantage in short-term credits claimed by the small business.

Short-term loans (loan period less than one year) are especially important in credit services, accounting for 95 percent of all credits (Table 3). While small loan companies account for a much smaller percent of long-term and project crediting activity, they do play an important role in stressful financing market. In stressful financing market with less than half a year loan refunding period, very few large banks offer operation loans. From the car dealer stock financing angle, small loan companies are well to innovate stressful automobile finance and services under the fiduciary condition, to meet car dealer's financing need well, thus to serve well the Chinese automobile industry.

Half month loans represented 31 percent of all credit activities and 22 percent of all credit aggregates. One-month loans are the second important pillar in credit activities than other loans. While Trimester loans account for about a third of all credit activities as a whole, they account for 34 percent in all credit aggregates.

All above these three kinds of loans make up to 71.7% of all credit activities and 77.7% of all credit aggregates. One reason these loans are more important in small loan companies is that most of commercial banks have long time to review petty loan application in rural areas and urban areas than small loan companies as a whole. The Industrial and Commercial Bank（ICBC）, for example, more than 90 percent of the credit review for petty loan applications need 30 days waiting stage and guaranty procedures generally need 30 days too. The given waiting period explained the competitive advantage of small loan companies in the petty loan market. For urgent credit application that require quick decisions and on the back of relatively clear and complete information, the personal decision approach should apply due to its obvious advantages of being straightforward, easy to practice and quick in decision-making. Even though quick decisions actually did good to the petty loan applications, the defects increasingly are obvious and become obstacles preventing financial institution from expanding with the changes of credit scale and capital scale. In each of the large community banks, the collective credit approval system control most of long-term and project loans.

Table 3: Time Distribution of Various Loans (2010)

Time distribution	Proportion in Total Credit Activities	Proportion in Total Credit Aggregates
half month	31.2%	22.6%
one-month	22.0%	20.3%
trimester	18.5%	34.8%
half a year	15.4%	11.3%
one year	7.1%	5.9%
more than one year	5.8%	5.1%

5. CREDIT RISK MITIGATION TECHNIQUES

Given the importance of competitive advantage in short-term credits, it comes as no surprise that small loan companies are also efficient at risk controlling process. While the credit scoring is a much less important component of credit risk control than customer recognition, small loan companies are still heavily dependent on credit risk mitigation techniques (CRMT). Indeed, customer recognition is of great importance to the credit risk controlling, and the selection of high-grade customer is the key process in risk identification. Credit manageress analysis the different aspects to different customers in the customer identification framework. Judging the clients' credit from their paying behaviors scoring.

Because it is difficult to struggle for the loan high quality customer. Shanghai Small Loan Companies Association defines such unstable operation customers as those in which enterprise life is no more than five years. Credit risk mitigation techniques (CRMT) are an effective tool for small loan companies to ensure customer to pay loan. Introducing the philosophy and methods of CRMT can be a good strategy to retain their good customers and enhance competitiveness.

Like small business loans, small personal loans require substantial credit risk mitigation by the lender, helping explain why the guarantee loans account for an even larger portion than credit loans. At present, the forms of small loans guarantee mainly include property mortgage, security, joint guaranty, and pledge in China. Mortgage, security, joint guaranty and pledge are different from their legal subjects, legal relationships, the way of its rights realizing. For the regulation of the bill hypothecation in security law and negotiable instrument law lacks practical function, and because there is confliction between the two regulations, there are still some problems lefts to be solved.

Property mortgage as an effective tool held 42 percent of all small loans at the end of 2010 — a third of all business loans and a half of all personal loans. As shown in Table 4, joint guaranty provided the majority of such small loans—38 percent of all business loans held by SMEs and 21 percent of all personal loans. The share of pledge is especially low for personal loans, no exceeding 10 percent for consumption loans and operation loans.

Table 4 : Shares of Credit Risk Mitigation in Small Loan Companies

Type of loan	Business loans	Personal loans
Credit loans	**10.7%**	**11.4%**
Guarantee loans	**89.3%**	**88.6%**
Property mortgage	31.9%	51.4%
Joint guaranty	38.0%	21.5%
Pledge	15.1%	9.7%
Security	4.3%	6.0%

6. CREDIT INTEREST RATE LEVEL AND EARNING CAPACITY

Along with the accelerating of market-orientation reform, interest rate of national debt has increasing shown the function as the benchmark rate and its strong forecast effect on the commercial credit interest rate changes because of its' own characters. Chinese government allows small loan companies to receive quadruple benchmark credit interest than large banks. It attracts huge amounts of folk capital into small lending markets as a funding source.

The degree of small loan companies' interest rate is quite high at present. The credit interest rate control lowly and adjust freely, lacking of the standard interest pricing model. One of the key factors to determine the interest rate is to find the proper pricing method on the basis of market-orientation. To meet the demand of market-orientation of interest rate, the current loan pricing method in small loan companies is flexible. The same trade average revenue rate is regarded as a basic interest rate, loan risk premium and the clients relationship also considered at the same time. So it is intrinsic for the small loan company to choose an appropriate and effective credit interest rate as attraction point by the benchmark interest rate. The basic half a year interest rates for loans in China has been keeping the level of 4.86 % for 25 months since lowering the interest rate of RMB in December of 2008. Facing the soaring of the price, the People's Bank of China is determined to raise the rates in the financial institution and bring it into effect from February 9, 2011. The half a yea benchmark interest rate for credit of financial institution raises 0.25 percent. It shows the necessity to adjust the interest rate of small loan companies as optimal attraction point in the market competition.

It is well known that ROE reflects both the ability to generate a return on invested assets (ROA) and the use of financial leverage. The latter is determined by the comparative amounts of debt and equity financing in a bank’s capital structure and is characterized by the firm’s equity multiplier (EM).Note that

ROE = ROA x EM,

where ROE is equal to net income/total (average) stockholders’ equity, ROA is equal to net income/total (average) assets, and EM is equal to total (average) assets/total (average) stockholders’ equity.

Median equity-to-asset (leverage) ratios, the inverse of EM, for our various small loan company classifications appear in Table 5. For medium-scale companies（Capital scale from ￥10 M to ￥100M）, the equity ratio generally declines consistently with asset size, indicating that the associated EM increases with size. Thus, the larger the scale is, the greater the multiplier effect of financial leverage on ROE. Smaller-scale companies operate with the highest ratio of equity capital to total assets, possibly reflecting their limited diversification and ownership structure more closely tied to family-owned institutions. The lower leverage, in turn, partially explains why aggregate ROEs are lower, for small-scale companies than for medium-scale companies. In other words, the lower ROEs observed for smaller companies (Capital scale<￥10 M) appear due in part to the desire to employ relatively less financial leverage. Smaller companies appear to prefer less risk and pay for this with slightly lower ROEs. In addition, the larger equity-capital-to-asset ratios at many small loan companies suggest that owners and managers are less willing to expose them to the risk of insolvency even in times of good asset quality.

We find that median-scale companies earn greater risk-adjusted yields than do larger companies. These results suggest that the lack of scale advantages is not a serious handicap for median companies. The latter might be better to make good lending choices because they have pricing power and customer management advantage relative to the larger-scale companies. It would appear that the larger companies（Capital scale> ￥100M） in our sample are relying on income from SMEs loans much more than medium-scale companies are. For the larger-scale companies, SMEs loans generate lower interest income relative to assets for the weak bargaining position. Median-scale and smaller-scale companies reported lower labor costs relative to assets versus the larger companies. Median-scale companies seem to benefit from strong bargaining position because their business is mainly concentrated in personal operation or consumption loans. It is in apparent consistent with scale and scope economies.

Table 5: Earning Capacity of Various Small Loan Company

Capital scale	The average ROE	The average ROA	The average EM
Smaller (< ￥10 M)	18.57%	16.29%	1.14
Medium (￥10 M to ￥100M)	23.12%	17.52%	1.32
Largest (>￥100M)	20.35%	14.96%	1.36

7. CONCLUSIONS

While the small loan companies hold only a low share of the nation’s banking assets, they provide important financial services to some private sectors of the China economy. This research argues such a view is misleading that small loan companies are homogeneous financial intermediaries. Based on the classification standard of capital scale we describe the service constitution and time distribution of small loans， analysis of credit risk mitigation technique feature and earning capacity difference. The result show that SMEs loans hold a smaller proportion than of personal operation loans, and short-term loans (loan period less than one year) are especially important in all credit services. On the other hand, small loan companies are also efficient at risk controlling process. What’s more, median-scale loan companies in China operate very differently and earn greater risk-adjusted yields than do commercial banks. All above findings may be helpful to China credit-system development and financial supervision policies making.

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